Decision 11-05-045 May 26, 2011

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ARCO Products Company, Mobil Oil Corporation, and Texaco Refining and Marketing Inc., Complainants, vs. Santa Fe Pacific Pipeline, L.P., Defendant.	Case 97-04-025 (Filed April 7, 1997)
And Related Matters.	Case 00-04-013 Case 06-12-031 Application 00-03-044 Application 03-02-027 Application 04-11-017 Application 06-01-015 Application 06-08-028

(See Appendix B for a List of Appearances)

DECISION RESOLVING CASE 97-04-025, DISMISSING APPLICATION 00-03-044, AND RESOLVING IN PART OTHER CONSOLIDATED PROCEEDINGS

TABLE OF CONTENTS

Title **Page**

TABLE OF CONTENTS
(Cont'd)

Title **Page**

DECISION RESOLVING CASE 97-04-025, DISMISSING APPLICATION 00-03-044, AND RESOLVING IN PART OTHER CONSOLIDATED PROCEEDINGS

1. Summary

SFPP, L.P. (SFPP) is a regulated oil pipeline whose intra-state services are regulated by the Commission. This decision resolves and closes Case (C.) 97-04-025 and C.00-04-013, dismisses Application (A.) 00-03-044, a request for market based rates, and partly resolves A.03-02-027, a general rate case. In doing these things, the decision addresses these specific outcomes: SFPP has dedicated its Sepulveda Line to public utility service; SFPP is not entitled to a ratemaking allowance for income taxes; SFPP has not correctly allocated environmental costs between its California pipeline operations, terminal operations, and non-jurisdictional operations; Watson Station and Sepulveda facilities must be recovered in cost-based and not market-based rates; SFPP's application for market-based rates is stale and must be dismissed without prejudice; adopts a 2003 capital structure and cost of capital for ratemaking purposes; requires a Tier 1 advice letter to implement rate refunds; and directs parties to pursue alternative dispute resolution of the remaining ratemaking issues in the consolidated proceedings.

The exact costs and refunds to ratepayers are not known at this time. These consolidated proceedings remain open.

2. Introduction

SFPP, L.P. (SFPP)[1] is a regulated oil pipeline whose intrastate services are regulated by the Commission. Over the past 13 years (1997 – 2010), SFPP has been the defendant in three pending complaint cases and the applicant in five pending applications. The later proceedings have become dependent on the resolution of unresolved issues in the earlier proceedings. This decision will be the first step to resolving the earliest proceedings. The oldest, Case (C.) 97-04-025 which was remanded for rehearing, is closed herein. We then address major portions of the 2003 test year revenue requirements for Application (A.) 03-02-027.

Before we can address A.03-02-027, we must complete the rehearing of C.97-04-025, and resolve C.00-04-013, in this decision. We find in rehearing C.97-04-025 that: the Sepulveda Line is subject to the Commission's jurisdiction; defendant has not established entitlement to a ratemaking allowance for income tax expense; defendant's environmental costs should be allocated between inter- and intrastate operations; and, as adjusted herein, defendant's rates for the Watson Station facilities are reasonable.

We find, based on the criteria set forth in our earlier decision, D.99-06-093, that after adjusting SFPP's rates for the rehearing issues resolved herein, the rates then in effect were just and reasonable. We dismiss without prejudice A.00-03-044, SFPP's request for market-based rates and we therefore dismiss C.00-04-013.

[1] The applicant's legal name is now SFPP, L.P., although it was previously named Santa Fe Pacific Pipeline, L.P.

This decision resolves the cost of capital for A.03-02-027 and then directs parties to attempt to settle, with the aid of a mediator, the remaining issues in A.03-02-027, which will resolve the proceeding. Finally, the remaining issues in the consolidated proceedings, A.04-11-017, A.06-01-015, A.06-08-028, and C.06-12-031 remain pending disposition in a subsequent decision. We also direct the parties to attempt to settle these open proceedings and we will provide a mediator to assist them. If there is an impasse or incomplete resolution after a good-faith settlement effort, the assigned Commissioner and assigned Administrative Law Judge (ALJ) will set a prehearing conference (PHC) and resume litigation of all outstanding issues.

3. Scope of this Decision

Before the Commission are three complaint cases and five applications, which are inter-related and therefore require sequential resolution. They span SFPP's operations from April 1997 through December 2006.

To bring these consolidated proceedings to a reasonable conclusion, we must first resolve the complaint case, C.97-04-025. We then decide the cost of capital issue in A.03-02-027, which is a general rate case application by SFPP. Additionally, we find that A.00-03-044, a request for market-based rates, can be dismissed. This decision's scope and procedural approach is the result of a settlement effort which tried to develop options for SFPP's eight open proceedings (discussed below).

4. Background

SFPP operates a network of pipelines for the transportation of refined petroleum products, such as gasoline, diesel, and jet fuel. Most of this network provides public utility service and both this Commission (CPUC) and the

Federal Energy Regulatory Commission (FERC) have regulatory authority over portions of SFPP's operations.

A ruling dated August 25, 2006, consolidated these proceedings pursuant to Rule 55[2] of the Commission's Rules of Practice and Procedure except for A.06-08-028 and C.06-12-031, which were subsequently consolidated at a February 26, 2007 PHC.

4.1. Procedural History

4.1.1. Introduction

See Appendix A for an abbreviated procedural history of each of the consolidated proceedings. Various parties timely protested all applications and SFPP timely replied to all complaints. Although the composition of the group of complainants and protestants has changed over the years, this decision refers to them collectively as Indicated Shippers (the term they use themselves in filings here and at FERC), except where necessary to distinguish a specific party's position or interests. The record for this opinion is composed of all filed documents and pleadings and the exhibits received into evidence for the consolidated proceedings.

Subsequent to C.97-04-025, SFPP filed five separate applications for rate increases: A.00-03-044, filed March 16, 2000; A.03-02-027, filed February 21, 2003; A.04-11-017, filed November 16, 2004; A.06-01-015, filed January 26, 2006; and A.06-08-028 filed August 25, 2006. These applications each seek a separate and unique increase in retail rates and were implemented subject to refund pursuant

[2] "Proceedings involving related questions of law or fact may be consolidated." That is, consolidation is a discretionary act.

to Public Utilities (Pub. Util.) Code Section 455.3 upon 30-day notice.[3] Additionally, two more complaints were filed: C.00-04-013 filed on April 14, 2000, and C.06-12-031 on December 29, 2006.

[3] Pub. Util. Code § 455.3: "(a) Notwithstanding any other provision of law, including, but not limited to Section 454, no later than January 1, 1998, the commission shall adopt rules and regulations that substantially revise the manner in which oil pipeline corporations may change and use rates.

"(b) The revised rules and regulations shall adhere to the following criteria:

(1) Pipeline corporations shall be required to give the commission and all shippers no less than 30 days' notice of rate changes.

(2) After the 30-day notice of rate change, pipeline corporations shall be permitted to change rates and use those rates prior to commission approval.

(3) The commission shall have the authority to suspend a rate change and use of the changed rate for a period of time not to exceed 30 days from expiration of the 30-day notice period specified in paragraph (1).

(4) Pipeline corporations shall refund, with interest, any portion of the rate change that is subsequently disallowed by the commission to all shippers within 30 days of the commission's decision becoming final. Interest shall accrue from the date the new rate is first charged.

(5) Any increase in the shipping rate charged by an oil pipeline corporation prior to commission approval shall not exceed 10 percent per 12-month period. The commission shall determine the appropriateness of allowing retroactive charge and collection of subsequently approved rate increases above 10 percent.

"(c) It is the intent of the Legislature that oil pipeline corporations be permitted to use new rates after the period of the suspension of a rate change, if any, by the commission pursuant to paragraph (3) of subdivision (b) prior to commission approval, provided any disallowed portion of the new rate is fully refunded with interest."

Unless otherwise indicated, all statutory references are to the Public Utilities Code.

4.1.2. Summary of Consolidated Proceedings

In short, these proceedings include the following issues.

C.97-04-025 – Whether:

- the Sepulveda Line is subject to the Commission's jurisdiction;
- SFPP is entitled to a ratemaking allowance for income tax expense;
- SFPP's environmental costs should be allocated between inter- and intrastate operations; and
- SFPP's rates for the Watson Station facilities are reasonable.

A.00-03-044 – Whether:

- SFPP's tariff rates should be market-based due to competitive alternatives.

C.00-04-013 – Whether:

- SFPP's rates as charged at that time were just and reasonable.

A.03-02-027 – Whether:

- It is reasonable to grant SFPP's rate request proposal for test year 2003. Issues include:
  i. A fair and reasonable cost of capital;
  ii. Fair and reasonable other costs, some of which are dependent on rehearing C.97-04-025; and
  iii. all other test year costs.

A.04-11-017 – Whether:

- It is reasonable to grant SFPP an increase in its rates for pipeline transportation services within California.

A.06-01-015 – Whether:

- It is reasonable to grant SFPP an increase in its rates for pipeline transportation services within California.

A.06-08-028 – Whether:

- It is reasonable to grant SFPP an increase in rates for pipeline transportation services within California by authorizing an Ultra Low Sulfur Diesel Surcharge.

C.06-12-031 – Whether:

- SFPP's rates as charged at that time were just and reasonable for shipments of refined petroleum products on the North, West and South Lines.

4.1.3. Evidentiary Hearings

Evidentiary hearings, on an unconsolidated basis, were held as follows:

1) C.97-04-025 on October 23 – 27, 2000 (Rehearing of D.98-08-033 ordered by D.99-06-093);[4]
2) A.00-03-044 on February 1, 2, 5, 6, 13, 2001, and May 13, 2003;
3) C.00-04-013 on February 1, 2, 5, 6, 2001; (concurrent with 2, above, but not consolidated); and
4) A.03-02-027 on December 9 - 12, 2003.

4.2. Preliminary Settlement Discussion

By ruling dated August 25, 2006, ALJ Long ordered a PHC to discuss the possibility of settling the as yet unconsolidated proceedings. At the PHC, the ALJ consolidated the six oldest proceedings, through A.06-01-015. ALJ Long directed the parties to meet and develop a settlement plan. Following the October 17, 2006 PHC, the parties met with ALJ Weissman, assigned as a mediator, to develop a potential framework for settlement discussions.

SFPP and Indicated Shippers failed to resolve any issue and subsequently determined that their preferred course was to resume litigation. As a result, ALJ Long scheduled a further PHC on February 26, 2007, during which he added the two newest proceedings, A.06-08-028 and C.06-12-031, to the consolidated proceedings. (Transcript at 156 and 162.) The parties stated their preferred

[4] D.99-09-038 denied SFPP's request for a rehearing of D.99-06-093, which granted the rehearing of D.98-08-033 in C.97-04-025. (2 CPUC3d 344.)

option was for Administrative Law Judge Long to render a proposed decision primarily on the ratesetting issues included in A.03-02-027, relying upon the filed documents and evidentiary record developed earlier, in hearings before ALJ Brown, from December 9 to 12, 2003. Consequently, ALJ Long set aside submission so that parties could provide one further exhibit as well as concurrent opening briefs on April 16, 2007, and concurrent replies on May 7, 2007. (Transcript at 167.) These dates were subsequently extended at the request of all parties to April 26, 2007 and May 17, 2007, respectively.

4.3. Control of SFPP

This section describes the ownership and control of SFPP in effect when the consolidated proceedings were filed. It then describes recent changes. We take official notice of the record in A.06-09-016[5] for the most current information regarding SFPP's organization immediately prior to and after the transfer of control, which the Commission approved in D.07-05-061. The ownership in place for the record periods of these consolidated proceedings is relevant to deciding certain issues, including whether to adopt an allowance for income tax expenses in revenue requirements.

4.3.1. Kinder Morgan Inc.'s (KMI) Prior Ownership & Control of SFPP

In these consolidated ratesetting proceedings, the relevant owner of SFPP was KMI as it existed prior to the transfer of control to Knight Holdco, LLC (Knight Holdco) authorized in D.07-05-061. Attachment 1 to D.07-05-061 (and

[5] Joint Application of SFPP, L.P. (PLC-9 Oil), Calnev Pipe Line, L.L.C., Kinder Morgan, Inc., and Knight Holdco LLC, for Review and Approval under Public Utilities Code Section 854 of the transfer of Control of SFPP, L.P., Calnev Pipe Line, L.L.C.

also attached here as Appendix C, Attachment 1) illustrates the complex arrangement by which KMI, through Kinder Morgan Energy Partners, L.P. (KMEP) and other KMI subsidiaries, indirectly owned and controlled SFPP and its affiliate Calnev Pipe Line, LLC (Calnev).[6] D.07-05-061 describes KMI, a Kansas corporation, as:

> [O]ne of the largest energy transportation, storage and distribution companies in North America. It owns an interest in or operates approximately 43,000 miles of pipelines that transport primarily natural gas, crude oil, petroleum products and CO2; more than 150 terminals that store, transfer and handle products like gasoline and coal; and provides natural gas distribution service to over 1.1 million customers. (D.07-05-061, at 7, citing the application, (A.06-09-016) at 5.)

---

[6] As Attachment 1 shows, KMEP held SFPP and its affiliate, Calnev, via a 98.9800% limited partner interest in the KMEP subsidiary, Kinder Morgan Operating Limited Partnership-D (OLP-D); KMGPI held the 1.0101% general partner interest in OLP-D. OLP-D owned 100% of Calnev through a subsidiary, Kinder Morgan Pipe Line, LLC, and held a 95.5% general partner interest in SFPP (Santa Fe Pacific Pipelines, Inc. retained a 0.5% limited partner interest). KMEP, a master limited partnership organized under Delaware law, had ownership interests in four other operating limited partnerships besides OLP-D. These arrangements effectively provided KMI with indirect control over not only SFPP and Calnev, but also numerous other business enterprises (*e.g.,* transportation of oil, natural gas and refined petroleum; storage of refined petroleum products, chemicals, and other liquids; production of crude oil and carbon dioxide).

There are no employees in Kinder Morgan Management, LLC (KMR), KMPGI, KMEP, SFPP or Calnev. Attachment 2 to D.07-05-061 (and also Appendix C, Attachment 2 here) illustrates, schematically, the means by which KMI provides employees to its subsidiaries and allocates costs for shared services. Employees work for KMGP Services Company, Inc. (KMGP Services Co.), which is 100% owned by KMPGI. KMGP Services Co. then dedicates all of its employees to KMEP (managed by KMR). Allocations for shared services occur through Kinder Morgan Services LLC (KM Services), which is 100% owned by KMR.

D.07-05-061 also describes KMI's ownership and control over SFPP and Calnev during the period under review here:

> KMI owns a minority equity interest in KMEP and, in addition, the general partner interest of KMEP. The majority ownership in KMEP is publicly held through publicly traded units in the KMEP limited partnership. KMI's direct and indirect ownership in KMEP as of December 31, 2005 was approximately 15.2 percent. KMI exercises control over KMEP, however, through its ownership of the general partner interest and through its ownership of all of the voting shares of Kinder Morgan Management, LLC, to which KMEP's general partner, KMGPI, has delegated the authority to manage the business and affairs of KMEP (subject to certain approval rights of KMGPI). Because the general partner of KMEP and its delegate are controlled by KMI, KMI effectively maintains indirect control of SFPP and Calnev through its indirect control of KMEP. [footnote omitted]. (*Id*. at 5, emphasis added.)

4.3.2. Recent Change in Control of SFPP

The Commission authorized a change of control over the intrastate portions of SFPP and Calnev, both common carrier pipeline utilities, to Knight Holdco. Knight Holdco is a private, limited liability company formed under Delaware law, and it became KMI's parent. It is this structure that now operates and controls SFPP and the other companies.[7]

---

[7] Attachment 3 to D.07-05-061 (and also attached here as Appendix C, Attachment 3) illustrates the post-transaction organizational structure, including Knight Holdco's ownership by five groups of investors. The preliminary proxy statement filed with the Securities and Exchange Commission provided information to the Commission on the anticipated, respective ownership interests upon closing: KMI Management Group – 36.63%; Goldman Sachs -25.14%; AIG – 16.02%; Carlyle Partners IV – 11.11%; and Carlyle/Riverstone III – 11.11%.

Pursuant to D.07-05-061, Knight Holdco or one of its subsidiaries now owns all outstanding shares of KMI, whether contributed by Kinder and the other KMI management participating in the deal, or repurchased from nonparticipating

Footnote continued on next page

5. Standard of Review

In an application seeking new rates, the applicant must demonstrate by a preponderance of the evidence that its request is just and reasonable, and that the related ratemaking mechanisms are fair. In a complaint challenging the reasonableness of rates already in effect (including oil pipeline rates which are put into effect 30 days after filing, under certain conditions), the burden of proof is on the complainant. Thus, D.98-08-033 (the first decision in C.97-04-025) properly placed the burden of proof on complainants. We also observed: "While it is true that evidence that covers all of the elements of a complainant's case shifts the burden of production to defendant, merely shifting the burden of production does not meet the burden of persuasion." (*Id*. at 27.)

D.99-06-093, the decision granting rehearing of D.98-08-033, confirmed and further explained the standard applicable to complaints:

> In complaint cases challenging the reasonableness of rates, the Commission "has long held that the burden of proof rests upon the complainant to show by clear and satisfactory evidence that the rates complained of are unreasonable . . . " (BBD Transportation Co., Inc. v. Pacific Southcoast Freight Bureau, et al. [D.82645] (1974) 76 Cal.P.U.C. 485, 508.) Recent cases describe the amount of evidence required to meet this burden as a "preponderance." (City of Long Beach v. Unocal California Pipeline Company [D.93-12-015] (1993), abstracted at 52 Cal.P.U.C.2d. 317.)
> (D.99-06-093, 1 CPUC3d. 418, 423.)

---

shareholders. This transfer of all KMI shares vested ownership and control of KMI in Knight Holdco.

6. Resolving the Outstanding Rehearing Issues

6.1. Background on Rehearing D.98-08-033

On April 4, 1997, Indicated Shippers filed C.97-04-025.[8] The Commission reached a decision (D.98-08-033, 81 CPUC2d 418)) generally favoring SFPP. In D.99-06-093, (3 CPUC3d 418) the Commission granted rehearing of D.98-08-033 upon the request of Indicated Shippers.

The Commission ordered rehearing to reconsider four disputed issues: (1) the public utility status of the Sepulveda Line, (2) the proper ratemaking treatment of partnership tax expenses, (3) calculation of environmental costs, and (4) the proper ratemaking treatment for the Watson Station facilities.

The Commission dismissed a second application for rehearing filed by SFPP in D.99-09-038 (2 CPUC3d 344). The rehearing request alleged the Commission erred when D.99-06-093 granted rehearing of the first decision (D.98-08-033). We concluded that the second application for rehearing did not show error and was not the proper vehicle for raising SFPP's claims. Therefore, the remaining issues in C.97-04-025 are those identified by D.99-06-093 and are addressed in the following discussion.

6.2. Sepulveda Line Dedication

In D.98-08-033 the Commission found that SFPP had not dedicated the Sepulveda Line to public use and, therefore, the Sepulveda Line was not part of SFPP's public utility pipeline system. After reviewing the law of dedication,

---

[8] ARCO Products Company, Mobil Oil Corporation, and Texaco Refining and Marketing Inc., v. SFPP L.P. (alleging violations of the Pub. Util. Code § 451 for charging rates that are not just and reasonable for the intrastate transportation of refined petroleum product).

D.98-08-033 concluded dedication could only be found by a demonstration that SFPP had an "unequivocal intent to serve the public" that "evidence of that intent is missing in this case." (*ARCO Products Company et al. v. SFPP, L.P.*[D.98-08-033], *mimeo* at 14; *see also* D.99-06-093, *supra*.) In its rehearing decision, the Commission questioned the formulation of the "dedication test" used in D.98-08-033. The Commission stated in D.99-06-093 that:

> The Decision's findings on dedication rely on the principle that dedication is determined by looking for an unequivocal intent to serve the public. However, the Decision does not explain that this intent can be inferred from a company's actions and need not be explicit. [Citation omitted.] Also, while it acknowledges that the public served must be indefinite, it does not clarify that the dedication requirement is met "not necessarily by service to all of the public, but to any limited portion of it, such portion, for example as could be served by [the utility's] own system, as counterdistinguished from [the utility's] holding [its]self out as serving or ready to serve only particular individuals, either as a matter of accommodation or for other reasons peculiar and particular to them." (Van Hoosear v. Railroad Com. (1920) 184 Cal. 553, 554). (D.99-06-093, 1 CPUC3d 418, 419, emphasis as added in D.99-06-093.)

Therefore, in today's decision we determine the public utility status of the Sepulveda Line in light of the proper standard for dedication. We find that D.98-08-033 too narrowly construed the requirement that SFPP must state its intention in writing to allow use of the Sepulveda Line as a public utility facility. We determine that by its actions, *e.g.*, deliberately, and repeatedly allowing customers to ship product over the facility, SFPP has effectively dedicated the Sepulveda Line to public utility service.

6.3. Ratemaking Treatment of Partnership Tax Expenses

In this section we find that SFPP has not demonstrated that it will incur a corporate income tax paid by the utility before distributing its earnings to investors. The Commission allows a regulated utility to recover in base rates a forecast of its operating costs to provide customers safe and reliable service. Because there is no corporate tax expense incurred by SFPP, there is no need for a tax allowance in rates.

6.3.1. Background

D.98-08-033 found a "tax allowance" expense of $5.4 million should be included among SFPP's expenses for the purpose of determining if SFPP's rates were reasonable. The Commission determined SFPP itself does not directly pay tax on the income it generates because SFPP is organized as a limited partnership. However, this does not mean that income generated by SFPP is necessarily tax-free. SFPP's income could be eventually taxable in the hands of SFPP's upstream owners, regardless of the amount of cash SFPP actually distributes to them. The amount of tax paid on income SFPP generates depends on the tax situation of each of its owners--including the possibility that the tax obligation may be passed on to a further, indirect owner of SFPP.

6.3.2. Taxable Entities

There is a legal distinction between corporations and partnerships. Corporations are separate legal entities that receive income in their own right, and, subject to applicable law and regulations, pay tax on it. Section 11(a) of the Internal Revenue Code (IRC) provides: "A tax is hereby imposed for each taxable year on the taxable income of every corporation." (26 USC § 11.)

For federal income tax purposes, the predominant forms of business are "C" Corporations and "S" Corporations. "C" Corporation earnings are taxed first as net earnings at the corporate entity level, and secondly, after the earnings are distributed to shareholders as dividends. Each shareholder is liable for taxes on the dividends.

"S" Corporations are taxed as partnerships. There is no federal income tax on partnerships because partnerships do not pay an income tax on their earnings at the entity-level. IRC § 701 provides: "A Partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." (26 USC § 701.) In other words, the government taxes the individual partners on their share of the partnership's earnings.

The tax law does not explicitly define a partnership. The definition or characteristics of this operating structure draw from principles of business law where a partnership is a union of two or more individuals or entities, as co-owners for the purpose of carrying on a business, venture, or other activity for profit. However, a definition by exclusion is provided in IRC § 761(a) which states: "For purposes of this subtitle, the term 'partnership' includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title (subtitle), a corporation or a trust or estate." (26 USC § 761.)

At the practical level the Internal Revenue Service states:

> Generally, a partnership does not pay tax on its income but "passes through" any profits or losses to its partners. Partners must include

> partnership items on their tax returns. (Internal Revenue Service, Publication 541 Contents (Rev. February 2006).)[9]
>
> And:
>
> Although the partnership generally is not subject to income tax, you are liable for tax on your share of the partnership income, whether or not distributed. (2006 Internal Revenue Service, Partner's Instructions for Schedule K-1 (Form 1065).)[10]

6.3.3. Commission's Ratemaking Practice for Taxes

An often-cited Commission decision, D.84-05-036, holds that for a regulated utility, other corporate relationships including subsidiaries, holding companies, or affiliates, should not affect the ratemaking treatment for income tax expenses. The regulated corporate entity receives a rate allowance calculated on a stand-alone basis. The objective is to provide an allowance in rates caused by the expected eventual payment of corporate income taxes on the utility's taxable income:

> It is the practice of the Commission, in calculating the test-year income tax expense, to assume a separate return basis considering solely utility operations. **By making this assumption the Commission presumes that the utility will pay the income taxes generated by the adopted rates**. However, because of a utility's affiliated or nonutility operations, **its actual income tax liability will be determined as one member of a consolidated tax return**. Thus, income taxes collected through authorized rates may not actually be paid, but may be used to offset tax losses of other nonutility and affiliated members of the consolidated return. (*Income Tax Expenses for Rulemaking Purposes* (1984) 15 CPUC2d 42, at 49.) (Emphasis added.)

---

[9] http://www.irs.gov/pub/irs-pdf/p541.pdf.

[10] http://www.irs.gov/pub/irs-pdf/i1065sk1.pdf.

This policy grew of necessity due to the complexity of individual regulated utilities, such as Pacific Gas and Electric Company (PG&E) and others,[11] expanding over time to conduct non-utility activities through subsidiaries, not just inside the utility company. This led several California utilities to seek a reorganization of their corporate structure so that a new parent company emerged owning the common stock of the regulated company and the stock of various other non-utility companies within the whole group. On a consolidated basis, only the parent pays income taxes on the total of all the affiliated companies' activities. Losers offset winners: i.e., a loss by one affiliate offset the parent's tax liability on the otherwise profitable and taxable results of another more successful venture.

Without the stand-alone treatment of the regulated entity, the non-utility activities could result in a tax expense or savings unrelated to the costs of providing utility service. By excluding the effects of affiliates, the only expense included in rates is the expense for liability attributable to the utility's income, based on an assumption that the utility's income will be taxable. An obvious result is that the income of these utilities is subject to federal income taxes while still within the overall control of the parent that is actively managing the company and making decisions on reinvestment or distribution of earnings. On a before-tax basis, the integrated management may make operational and

[11] In addition to PG&E Corp., which is the parent holding company that now owns the utility PG&E, SEMPRA is now the holding company parent of utilities Southern California Gas Company (SoCalGas) and SDG&E, and SCE Corp. is now the parent of electric utility Southern California Edison Company (Edison). All of these regulated utilities gave birth to new parent companies. The parent, or holding company, was spun off the original company, a regulated utility.

strategic decisions that might legally avoid, or defer income tax obligations prior to disbursing earnings to investors in the form of dividends. The first time the corporate income is taxable to the individual investors is when after-tax dividends are declared and a portion of the earnings leave the control of the company.

6.3.4. SFPP's Position

SFPP has argued consistently that the Commission should regulate its operations no differently than those of any other utility subject to the Commission's jurisdiction for cost of service rate regulation. That is, in SFPP's view, it is not relevant that it happens to be a partnership with a complex multi-layered ownership structure: it should receive an allowance in cost of service rates for income tax expense computed as a stand alone corporate entity. SFPP further argues that an income tax allowance is a standard forecast allowance and no actual proof of payment of corporate income taxes is necessary.

SFPP also argues (2007 briefs) that only taxes in the 2004 and later rate applications are at issue because neither the rehearing decision nor the scoping memo for A.03-02-027 specifically identified income tax as an issue for the our consideration.

6.3.5. Complainants' Position

Indicated Shippers argue that when viewed as a stand-alone entity, the SFPP partnership does not incur a corporate tax liability. Its earnings are not directly taxed by the federal or state government before the earning are distributed (for financial reporting and/or income tax reporting purposes) to the individual partners under the specific terms of the partnership agreement. Thus, since SFPP, the regulated entity, is not itself a taxpayer, there should be no

"phony" tax expense in rates. The Complainants look only to the operating utility level of structure, SFPP, and argue that because it does not pay taxes itself, there should be no tax expense allowed in rates.[12]

6.3.6. Analysis

The federal tax allowance is an issue for A.03-02-027 and in the earlier proceedings, because no scoping memo need identify every single issue.[13] Any expense as a component of revenue requirement in a ratesetting proceeding is at issue. Further, we believe the tax treatment issue is an open issue in the pending rehearing and we therefore address it here for all pending SFPP complaints and applications.

SFPP should receive an appropriate allowance for income tax expense, if it is liable for income tax. However, D.98-08-033 erred in adopting a specific dollar allowance for income taxes in revenue requirement without a showing that income taxes are incurred by SFPP. SFPP has failed to demonstrate that there is a corporate tax liability that should be recovered in rates. Rather, SFPP suggests

---

[12] We should be clear that here, when Indicated Shippers speak of a "phony" tax, they mean there is never a corporate income tax imposed on a taxpayer corporate owner of SFPP. This is different from another long-resolved California ratemaking tax issue, that of "phantom" taxes, which are the result of the timing differences between accounting for financial reporting and accounting for federal income taxes. "Phantom taxes" are not at issue here. In a later section of this decision on FERC policy, the appeals court uses the term "phantom" whereas here we use Indicated Shippers' term, "phony."

[13] A scoping memo may specifically exclude issues, but it is not reasonable to otherwise require a scoping memo to include every disputed issue. Many detailed specific issues are known only after parties perform discovery. Others are simply subsumed within the broader issue of deriving the just and reasonable revenue requirements for a test year. An appropriate income tax allowance would be just one of many items within the revenue requirement.

that taxes are simply one of several automatic forecast allowances included in rates.

We only provide an allowance where the utility expects to incur an expense. If, for example, SFPP were suddenly able to conduct business entirely without paper, solely using electronic communications, there would no longer be a need to purchase paper, ink, pens, postage, storage boxes, file cabinets, etc. No one would reasonably argue that SFPP should still have a theoretical allowance for paper and pens, and related items included in its expense forecast. If there is no likely expense, there should be no expense forecast in rates.

Applicant has not demonstrated that it pays any corporate tax under its ownership structure, nor do we know the rates of taxation applicable when the partnership distributions are first subject to taxation.[14] But this too may not matter: if there is no taxation on earnings while the earnings are still within the operating control of SFPP, there is no income tax obligation to recognize as a utility operating expense in rates.

Partnership units are beneficial to investors because a publicly traded partnership allows the business's cash distributions to circumvent the "double taxation" that would normally be imposed, which generally means greater distributions for partnership unit holders. In a structure like SFPP's, the cash distributions of the company are taxed only at the unit holder level and not at an operating business level. Another benefit of this type of investment to the investor is that because the partnership units are publicly traded, there is a high

[14] See the discussion on income tax issues in D.98-08-033 (81 CPUC2d 573, 587 – 590) and D.99-06-093. (1 CPUC3d 418, 420 – 422.)

degree of liquidity for investors. These units can usually be sold in a manner similar to shares in a corporation.

In granting rehearing, the Commission acknowledged that "although we believe the use of a tax allowance is likely to be permissible," D.98-08-033 improperly concluded that to avoid reducing the return to some owners a tax expense must be adopted in order to comply with an established "tax allowance policy."[15] That decision mishandled the issue of tax allowances: an allowance for tax expense is only a just and reasonable charge when there is likely to be an actual tax expense by the utility. The Commission determined that in rehearing it would be necessary to consider other alternative solutions. One suggested alternative is the "FERC approach" (Lakehead Pipeline Co. (1996) 75 FERC 61 & 181, as cited in D.99-06-093). The order granting rehearing also found: "the Decision improperly concludes that *Southern California Gas co. v Public Utilities Com. (1979) 23 Cal.3d 470, 477*, need not be considered when determining whether or not to allow a partnership to claim a 'tax allowance' for ratemaking purposes. The Decision contends that case only applies to tax benefits resulting from the 'investment tax credit' provisions of federal tax law and does not have general application, especially in cases involving partnerships." (D.99-06-093, 1999 Cal. PUC LEXIS 442.)

Therefore, in this decision we will determine whether SFPP is entitled to an allowance for income taxes consistent with the SoCalGas decision as argued by SFPP. We will also consider the most current FERC approach, as well as any other persuasive evidence and argument in the record. We also note that we are

[15] D.99-06-093.

not required to set intra-state rates in exactly the same manner that FERC employs.

The parties have made numerous filings, including motions for the Commission to consider various FERC actions over the past few years. One of the more recent was Indicated Shipper's September 7, 2005 motion, opposed by SFPP, asking us to consider an "Initial Decision" by a FERC ALJ dated August 24, 2005, in FERC Docket Nos. OR 96—2 and IS98-1, et al.[16] These filings ask the Commission to consider, admit, or abide by FERC rulings or initial decisions, that are not the final opinion by FERC. We deny these motions because the matters at FERC are not final and we will not consider the interim or proposed solutions of another agency.

SFPP filed a petition on May 5, 2005 asking the Commission to set-aside submission and take official notice of a final FERC action, the May 4, 2005 issuance of FERC's Policy Statement on Income Tax Allowances (111 FERC 61,139.).[17] We will take official notice of a final FERC order or an applicable decision of the federal courts and therefore grant all motions in which either party asked to lodge, or have the Commission take official notice of, a final FERC decision or a published court opinion.

Below, we consider the most recent and relevant final decisions and policies and discuss whether FERC's current practice is relevant to California-jurisdictional rates. We note, however, that we are not bound to follow any final

[16] Similar motions were filed by Indicated Shippers in the other pending SFPP case and applications.

[17] Similar motions were filed by SFPP in the other pending SFPP case and applications.

FERC order or rule. We will take notice of relevant decisions and will factor into our decision-making the guidance that may apply to this specific proceeding.

6.3.6.1. Federal Policy

On May 4, 2005, FERC issued a new Policy Statement on Income Tax Allowances (Policy Statement) which holds:

> The Commission concludes that such an allowance should be permitted on all partnership interests, or similar legal interests, if the owner of that interest **has an actual or potential income tax liability** on the public utility income earned through the interest. This order serves the public because it allows rate recovery of the income tax liability attributable to regulated utility income, facilitates investment in public utility assets, and assures just and reasonable rates. (70 FR 25818, emphasis added.)

This most recent policy statement followed the rejection of prior FERC holdings by the U.S. Court of Appeals for the District of Columbia remand in *BP West Coast Products, LLC, v. FERC*.[18] In reversing itself, FERC concluded that it should:

> . . . return to its pre-Lakehead[19] policy and permit an income tax allowance for all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets. Thus a tax-paying corporation, a partnership, a limited liability corporation, or other pass-through entity would be permitted an income tax allowance on the income imputed to the corporation, or to the partners or the members of pass-through entities, provided that the corporation or the partners or the members, have an actual or potential income tax liability on that public utility income. Given

[18] *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) (BP West Coast), reh'g denied, 2004 U.S. App. LEXIS 20976-98 (2004), as cited in FERC's policy statement.

[19] Lakehead Pipe Line Company, L.P., 71 FERC 61,388 (1995), reh'g denied, 75 FERC 61,181 (1996) (Lakehead) (footnote citation not in original.)

> this important qualification, any pass-through entity seeking an income tax allowance in a specific rate proceeding must establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income. To the extent that any of the partners or members do not have such an actual or potential income tax obligation, the amount of any income tax allowance will be reduced accordingly to reflect the weighted income tax liability of the entity's partners or members. (Para. 32.) (Emphasis added.)

FERC found that the actual tax allowance would have to be determined in individual rate proceedings – the same situation we face here.

SFPP has only presented testimony that supports a pro forma application of treating SFPP as a stand-alone taxable corporation. SFPP would fail the current FERC test on the record in this proceeding. SFPP has not presented us with credible evidence of the "actual or potential" tax.

6.3.6.2. Appellate Review of FERC Policy

The most recent FERC policy was reviewed by the District of Columbia Court of Appeals, which found the FERC policy "was not arbitrary or contrary to law." (ExxonMobil Oil Corp. v. FERC, No. 04-1102, slip op. at 4 (D.C. Cir. May 29, 2007) 2007 U.S. App. LEXIS 12339). The court indicated: "While we agree that the orders under review and the policy statement upon which they are based incorporate some of the troubling elements of the phantom[20] tax we disallowed in BP West Coast, FERC has justified its new policy with reasoning

[20] The Court here uses "phantom" tax to describe a different situation than the California "phantom" issue of flow-through of tax benefits in rates. The Court's reference to "phantom" tax is the same as "phony" or non-existent tax argued by Indicated Shippers. (*See* footnote 12.)

sufficient to survive our review. We therefore deny the petitions for review with respect to this issue." (*Id.* at 5.) The court held:

> [W]e deny the petitions for review with respect to the income tax allowance issue. Under the arbitrary and capricious test, our standard of review is "only reasonableness, not perfection." *Kennecott Greens Creek Min. Co. v. MSHA*, 476 F.3d. 946, 954 (D.C. Cir. 2007). We need not decide whether the Commission has adopted the best possible policy as long as the agency has acted within the scope of its discretion and reasonably. (*Id. at* 17 – 18, emphasis added.)

Indicated Shippers on June 6, 2007, replied to SFPP's motion and stated it had "no objection to the Presiding Judge giving official notice to the Court of Appeals decision, although . . . we do not believe that the decision is relevant to the issues before the . . . Commission."

In this instance, we do not need our ratemaking determinations to match with FERC's ratemaking, because this Commission must also act within the scope of its discretion, and act reasonably on its record. As discussed in this decision, we find that SFPP has not shown its partnership owners have a corporate tax liability in addition to the tax liability which only accrues after partners recognize their distributed partnership income. There is no demonstrated federal tax liability on SFPP's income before it distributes earnings to its partner-owners. There is only one tax: the tax on the partner's income after distribution. (And we have no evidence related to that tax.) We find that SFPP does not have "an actual or potential income tax obligation on the entity's public utility income" in addition to the personal tax obligation of the partners after the partnership distribution. Thus, a reportable and taxable distribution of $100 in partnership income is the equivalent of $100 in reportable and taxable dividend income from a corporation. In both examples, the owner has $100 in income

derived from its investment. SFPP has not demonstrated that as a partnership it incurs a federal corporate tax liability, therefore, there is no "tax expense" to include in retail rates as a part of determining just and reasonable rates.

6.4. Environmental Costs

In D.98-08-033 (the original decision) the Commission concluded that environmental costs in the amount of $2.8 million should be included in SFPP's expenses. Complainants' calculation of SFPP's expenses made no provision for environmental costs. SFPP asserted that its California operations incurred $3.8 million in environmental expense in the test year 1996, and that 75% of that expense should be allocated to CPUC-jurisdictional intrastate pipeline services. SFPP proposed a 75% allocation because it had used a 75% allocation for property tax expenses. Although Complainants challenged the allocation method, Complainants did not propose a different allocation.

The decision only found it was more likely that SFPP spent $2.8 million (75% of $3.8 million) on environmental expense than that SFPP spent nothing. In ordering a rehearing, D.99-06-093 found that there was evidence already in the record that indicated the 75% allocation might be too high because SFPP allocated 90% of its environmental costs to California, and only 10% to its extensive operations in Oregon, Nevada, New Mexico and Texas. Further, evidence indicated that a large portion (Complainants allege 39%) of the environmental expense claimed by SFPP was not properly attributable to pipeline operations because it was related to terminals.[21]

[21] *See* D.99-06-093 (1 CPUC3d 418, at 422.)

In this decision we determine the appropriate ratemaking allocation of environmental costs to California and the further allocation between pipeline and terminal operations.

SFPP has not persuaded us that it is likely to spend 90% of all environmental costs in California jurisdictional operations. When faced with the absence of a clear, equitable and accurate allocation factor this Commission has traditionally used allocations based upon the proportional size or cost of other related factors. In this case, operating expenses, exclusive of environmental costs, is a reasonable default factor to allocate an expense proportionally among three segments of SFPP's operations. Therefore, in the absence of more accurate data, we direct SFPP to allocate the environmental costs based on the proportional share of all other operating expenses for California pipeline, terminal, and non-California operations.

6.5. Watson Station & Sepulveda Market Rates

The proposed rates for both Watson Station and Sepulveda are market-based rather than cost-based rates (separate from the proposal in A.00-03-044 for market-based rates generally) and applicant argues (1) SFPP's principal customers are sophisticated oil producers; (2) SFPP faces potential competition from new pipelines; (3) SFPP's shippers have reasonable alternatives to the use of SFPP's Watson Station and Sepulveda facilities, such as shipment by truck, vessel or proprietary pipeline; and (4) SFPP's pipeline's proposed rates compare favorably to other pipeline rates. (SFPP May 17, 2007 Reply Brief, at 43.) SFPP cites to 66 CPUC2d 28, a decision where the Commission held it could use non-cost of service methods to regulate the rates of UNOCAP, also a regulated oil pipeline.

In the January 30, 2004 Opening Brief filed by BP West Coast Products, LLC and Exxonmobil Oil Corporation, the parties argue there are no new pipelines which threaten SFPP with market competition; any near-by proprietary pipelines (used solely by the owners, not openly offered as common carriers) cannot be compelled to carry products and thus are not competition to SFPP; and barges, trains and trucks are not viable competitors. (Opening Brief at 4 - 20.)

We find these theoretical arguments of competition unpersuasive: there is no evidence of actual competition. Otherwise the shippers would rationally use the alternatives, certainly if they were cheaper, and pragmatically in order to preserve the diversity and option of the other means, if the competing services' price were near the pipeline price.

7. Dismissal of A.00-03-044

In A.00-03-044, SFPP seeks authority for market-based pricing based on the existence of viable competitive options which limit the rates that SFPP may charge customers before customers shift to alternative transportation options. This application has been unresolved for ten years and the record is hopelessly stale. We therefore deny the application, without prejudice, so that SFPP may choose to file a new application if it can demonstrate there are economically viable competitive options to justify market-based rates instead of cost-of-service rate regulation.

8. Resolving Ratemaking Issues in A.03-02-027

In this section the Commission addresses major components of revenue requirements for the 2003 test year rate case. Under general ratemaking principles, the Commission allows a utility such as SFPP to file a general rate

case application to recover in base rates a forecast of its operating costs to provide customers safe and reliable service.[22] The Commission adopts a test year forecast based on the best information about expected future events and historical trends. By using a prospective forecast methodology SFPP has an opportunity to recover its costs and earn a return (profit) on its investment in plant in service. SFPP is expected to exercise discretion to expertly manage its operations during the test year and adapt as necessary to differences between the forecast and actual events. Included in the test year forecast are allowances for damages to plant, accidents, and general maintenance and repairs. Every subsequent general rate case allows SFPP to reflect its prior actual investment in plant as a part of the forecast for the next test year. Thus when SFPP spends more money than forecast for capital projects during the prior test-period, it adjusts the new test year forecast to include the actual investment in utility plant.

8.1. Cost of Capital and Rate of Return

In this section, we adopt a test year 2003 capital structure of 60% equity and 40% debt, accept the company forecast of embedded debt cost at 7.08% and adopt a return on equity of 12.61%. We reject SFPP's argument that the risk of the oil pipeline operations subject to our regulation warrants a return on equity of 15.86%.

8.1.1. Position of Parties

SFPP requests a 2003 capital structure of 60% "equity" and 40% debt, based on the capital structure of KMEP the affiliated entity that manages SFPP's finances. (*See* § 3.3 Control of SFPP.) SFPP is a partnership, and thus this

[22] "[T]he cost principle is taken to mean that rates as a whole should cover costs as a whole." Bonbright *et al., Principles of Public Utility Rates* at 116 (2d ed., Public Utilities

Footnote continued on next page

"equity" capital represents the partners' investment or ownership interest retained in SFPP to finance its long-term assets included in rate base. For ease of reference we will identify this ownership interest as equity. Additionally, SFPP's expert witness proposed a weighted cost of debt of 7.08% and a return on equity of 15.86%. (*See* SFPP April 27, 2007 Opening Brief at 34 - 43.) SFPP argues that because of infrequent rate reviews this structure and these costs are reasonable.

SFPP admits that the debt instruments and costs of debt available to KMEP may not be available to SFPP directly, but it based the proposal on the costs available to KMEP. SFPP argues that capital investments in long-term plant are large and not uniform over time – but "lumpy" – and that over time depreciation leads to a reduced actual return (because the rate base declines as depreciation accumulates). Thus, combining the operating risks of an oil pipeline with the lumpy nature of additions, leads to the need for a high return in order to attract capital.

A group of the intervenors, CCUV,[23] propose a 44.8% equity and 55.2% debt ratio and they rely on a proxy of four other pipeline companies' data which shows a range of 44% - 61.4% debt ratio, with a median ratio of 53.5%. (*See* CCUV April 26, 2007 Opening Brief at 38 – 51.) For ease of discussion we will round this to 45%/55% capital structure. Thus the CCUV recommended equity component is a quarter smaller, 45% compared to 60%. Before

---

Reports, Inc., 1988).

[23] The Indicated Shippers group mutated by the time of the April 26, 2007 briefs: ConocoPhillips joined with Chevron, Ultramar, and Valero, three original Indicated Shippers, to file briefs jointly as "CCUV." Meanwhile, BP West, another original Indicated Shipper, filed jointly with ExxonMobil. Additionally, Chevron, Ultramar and Valero filed separately but join with BP West and ExxonMobil on "market based" issues.

considering any return on equity differential due solely to capital structure, this difference alone would have a significant impact on cost of capital. CCUV also proposes a return on equity of 12.28% and a debt cost of 6.41%. CCUV further argues that SFPP's cost is too high because it includes certain short-term debt, that was in fact an affiliate loan, and which is more correctly identified as long-term debt. (*Id.* at 48 - 50.) Finally, CCUV proposes that the appropriate return on equity should be 12.28%.

These differences in capital structure and cost components lead to a huge 330 basis point difference in the cost of capital: SFPP requests approximately 12.35% and CCUV recommends 9.05%, as shown in the table below:

Comparison of Proposed Cost of Capital				
	SFPP		**CCUV**	
	Percentage	**Cost**	**Percentage**	**Cost**
Equity	60%	15.86%	45%	12.28%
Debt	40%	7.08%	55%	6.41%
Weighted Cost		12.35%		9.05%

8.1.2. Discussion

In D.89-11-068, the Commission reasoned that the utilities should be given some discretion to manage their capitalization with a view towards a balance among investors' interests, regulatory requirements, and ratepayers' interests.[24] The Commission also concluded that the energy utilities' capital structures should continue to be evaluated on a case-by-case basis. In 2003, the Commission adopted returns on equity ranging from 10.90% for SDG&E and

[24] 33 CPUC2d 495 at 541- 545 (1989).

Sierra Pacific Power Company (Sierra), to 11.605% for Edison.[25] PG&E was authorized a return on equity of 11.22%, but it and Edison were involved in bankruptcy or severe financial crises caused by the collapse of the state's restructuring of the electric wholesale markets pursuant to Assembly Bill 1890. Moreover, these four large utilities are corporations, whereas SFPP is a limited partnership. These differences and others only underscore the need to evaluate rate of return on a case-by-case basis.

SFPP seeks an equity return of 15.86% while the intervenors propose 12.28%. We reject SFPP's evaluation of its risk and we further reject the declining rate base argument. SFPP's rates could be in place for a significant period of time so despite the accrual of depreciation and reduction to plant in service (a proxy for rate base) there would be no reduction in rates. We are adopting rates much in arrears – a timely decision would have been in late 2003 or early 2004 and no one would have known then when SFPP would file its next proceeding or when it would be resolved. We knew, however, in 2003 that the last full rate case for SFPP was decided in May 1992 (D.92-05-018) and so 2003 base rates could also have been expected to be in effect for a long time: unchanged for the effects of depreciation or capital additions.

We will adopt SFPP's proposed capital structure, 60% equity, 40% debt because it best reflects the structure of the actual financing source, KMEP, and the forecast for KMEP's cost of debt at 7.08%. Adopting the very high equity component of 60% is a significant mitigation of risk. With the lower debt service that results from more equity and less debt, it is less likely the company will

[25] *See* 2002 Cal. PUC LEXIS 718 where the Commission adopted 2003 capital structures and cost of capital for PG&E, SDG&E, Edison, and Sierra.

have a liquidity issue, and indeed, more likely its actual cost of borrowing will be low, due to a high equity factor in the given marketplace and time-frame.

Thus, it is within our discretion, and within the recommended range, to adopt a return of 12.61% on equity, which yields a weighted cost of capital for test year 2003 of 10.40%. The equity return is significantly higher than the rate adopted for the major energy distribution utilities, and is slightly higher than the recommendation of intervenors. When viewed with the 60% equity ratio, this return should be a sufficient to compensate investors for the operating and financial risks associated with SFPP's operations. The adopted costs of capital are set forth in the following table:

Adopted Cost of Capital		
	Percentage	**Cost**
Equity	60%	12.61%
Debt	40%	7.08%
Weighted Cost		10.40%

8.2. Rate Base for 2003 and Beyond

Some portion of the $88 million in costs associated with SFPP's North Line Expansion was not expected to be incurred in calendar year 2003, but the company anticipated that all of such costs would be incurred by the end of 2004. The question is whether to include the project in test year 2003 rate base. As discussed below, we find that the project cannot be included in test year 2003 given the ratemaking mechanisms that apply to SFPP. We adopt a ratemaking adjustment for rates beginning on January 1, 2004 that includes the plant in rate base.

8.2.1. Position of Parties

SFPP argues that the test year 2003 "reflect[s] costs and conditions expected to occur during the 12 months of the test year (2003) as well as

reasonably anticipated changes in gross revenues, expenses or other conditions, which do not necessarily obtain throughout the twelve months of the test period but which are reasonably expected to prevail during the future period." (Concurrent Reply Brief at 11, emphasis deleted.) Indicated Shippers argue the plant would not be in service in 2003 and thus should be excluded from the test year rate base and therefore excluded from test year 2003 revenue requirements.

8.2.2. Discussion

SFPP cites to *Pacific Telephone and Telegraph Company v. Public Utilities Commission* (1965) 62 Cal.2d 634, without specific reference. That venerable decision describes the test year ratemaking process where the Commission uses historical data, known or forecast events, etc., with adjustment, "to present as nearly as possible the operating conditions of the utility which are known or expected to obtain during the future months or years for which the commission proposes to fix rates." (62 Cal.2d 634 at 644.) In this case, the Commission is determining rate base for 2003 and it is uncontested that the North Line Expansion was not expected to be fully complete and in service for 2003. Therefore we will not include this investment in rate base for 2003 and thus we also exclude it from 2003 revenue requirements.[26]

[26] "The test period is chosen with the objective that it present as nearly as possible the operating conditions of the utility which are known or expected to obtain during the future months or years for which the commission proposes to fix rates [*i.e*, the test year]. The test-period results are "adjusted" to allow for the effect of various known or reasonably anticipated changes in gross revenues, expenses or other conditions, which were not obtained throughout the test period but which are reasonably expected to prevail during the future period for which rates are to be fixed, so that the test-period results of operations as determined by the commission will be as nearly representative of future conditions as possible." (62 Cal.2d 634 at 644.)

SFPP errs in including post-2003 events in the test period as it proposes in its brief. The ratesetting test year is a fixed forecast period regardless of when the rate decision is actually resolved.

As noted elsewhere, SFPP's last general rate case decision was adopted in May 1993. We also could have expected test year 2003 to be in effect for some period before SFPP might have filed another general rate case. The North Line Expansion is a major facility forecast to add some $88 million to plant in service. This decision is not timely and yet it must be decided based on the record before us as expected for 2003. Unlike the major gas and electric utilities, or the Class-A water utilities, the Commission has no cyclical rate case plan with an attrition rate adjustment mechanism in place applicable to jurisdictional oil pipeline companies. Thus, we must consider these cases in such a way that we derive just and reasonable rates, avoid unnecessary additional proceedings, or otherwise burden either applicant or ratepayers. Absent a ratemaking allowance in 2003 for the North Line Expansion, SFPP could have filed a new proceeding for 2004, and possibly an entire rate case, to reflect this plant addition in 2004 and perhaps included other changes too.

A reasonable outcome, foreseeable in 2003, was the North Line Expansion would enter service in 2004, but after the test year, which would then entitle SFPP to file again for an opportunity to recover its reasonable costs in rates. The Commission is within its discretion to exclude the North Line Expansion from rates for test year 2003, but it is also reasonable to order an attrition rate adjustment for the North Line Expansion effective in 2004. This avoids improperly including the North Line Expansion in rate base for 2003 and avoids an unnecessary filing for 2004 or later to reflect a material change.

9. Corrected Rates and Refunds

SFPP implemented 2003 rates subject to refund pursuant to § 455.3(b)(4). Consequently, SFPP must file a Tier 1 advice letter pursuant to General Order 96-B, to refund to customers the effects of including an income tax allowance, misallocating environmental costs, and the other adjustments adopted herein. SFPP must file an interim refund advice letter within 30 days.

10. Closing Proceedings

We believe that this decision resolves the issues on rehearing for C.97-04-025 and therefore it should be closed. Additionally, as already discussed, we dismiss A.00-03-044 and it will also be closed. We also believe that there is no reason to continue with C.00-04-013, filed on the heels of A.00-03-044, and therefore we close that proceeding as well.

11. Next Steps

Several of the consolidated proceedings remain open and we direct the parties to meet in a further effort to settle using this decision as a baseline for some issues (notably, taxes, rate of return, cost of service rates for the North Line Expansion.) This decision does not completely resolve A.03-02-027 and the parties must therefore diligently seek settlement of the remaining portions of the revenue requirements sought in the application.

The Commission has not taken significant steps on the pending applications, A.04-11-017, A.06-01-015, A.06-08-028, or the complaint, C.06-12-031. Therefore we will direct the assigned ALJ to expeditiously schedule a PHC and take appropriate administrative steps to pursue resolution of these proceedings, with a strong emphasis on settlement. The assigned Commissioner will issue a scoping memo and schedule following the PHC. We will also provide an independent ALJ who is experienced in facilitating complex large-

scale mediations and settlements to assist the parties. We remain convinced the parties are the most knowledgeable and able to equitably resolve the pending issues and we will expect the assigned ALJ to only pursue evidentiary hearings and a litigation-based outcome if settlement efforts are unsuccessful.

12. Final Oral Argument

On April 8, 2010 SFPP filed a request for a Final Oral Argument as allowed by Rule 13.13. By ruling dated April 14, 2010 a Final Oral Argument was scheduled and subsequently held on May 5, 2010, before a quorum of the Commission. SFPP and the combined intervenors were both allowed a total of 30 minutes for opening and reply argument. The arguments made by the parties are now incorporated into the record for this proceeding.

13. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure.

On May 3, 2010, timely comments[27] were filed: jointly, by Chevron Products Company, ConocoPhillips Company, Ultramar Inc., Valero Marketing and Supply Company, and Southwest Airlines Co.; jointly by BP West Coast Products LLC and ExxonMobil Oil Corporation; by Tesoro Refining and Marketing Company; and by SFPP, L.P.[28] On May 10, 2010, timely replies were

[27] By ruling dated April 14, 2010, and as corrected on April 21, 2010, allowed opening comments were increased in length from 25 to 30 pages and the filing date was extended by one week. The time to reply was extended from five to seven days.

[28] As previously noted, over time the parties to this proceeding have changed through mergers, have changed in composition of joint filers, and Santa Fe Pacific Pipeline Company L.P became SFPP L.P.

filed: jointly by Chevron Products Company, ConocoPhillips Company, Ultramar Inc., Valero Marketing and Supply Company, and Southwest Airlines Co.; jointly by BP West Coast Products LLC and ExxonMobil Oil Corporation; by Comments of Tesoro Refining and Marketing Company; and by SFPP L.P. We accord no weight to comments to the extent that parties merely reargued their litigation positions. We have otherwise considered and incorporated changes or corrections to the body of this decision to reflect errors of fact or law, or to improve the clarity of the decision.

14. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Douglas Long is the assigned ALJ and presiding officer in these consolidated proceedings.

Findings of Fact

1. SFPP operates a network of pipelines for the transportation of refined petroleum products, such as gasoline, diesel, and jet fuel. This network provides public utility service and is regulated by this Commission.

2. By allowing customers the use of the facility, SFPP has dedicated to public service the Sepulveda Line as part of its public utility pipeline system.

3. The ownership of SFPP in place prior to the transfer of control authorized in D.07-05-061 is the ownership structure relevant to determining any reasonable income tax allowance in rates.

4. SFPP has not demonstrated that the utility has an actual or potential income tax obligation on the entity's public utility income. There is no evidentiary record to credibly support a ratemaking allowance.

5. SFPP has not shown that its environmental costs are equitably or accurately allocated between California, terminal, and non-California operations.

Absent any other allocation the Commission uses a proportional allocation method.

6. SFPP's rates are over-stated by including an income tax allowance and misallocating environmental costs.

7. The record in A.00-03-044 for market-based rates is over seven years old and is therefore hopelessly stale.

8. A capital structure of 60% equity and 40% debt is consistent with the capital sources provided by SFPP's affiliate, KMEP.

9. KMEP's weighted cost of debt is 7.08% and reflects the cost at which SFPP could attract lenders.

10. A return of 12.61% on equity will yield a reasonable overall cost of capital of 10.40% for test year 2003 base rates.

11. The North Line Expansion entered service in 2004 after the test year 2003.

12. Adjusting 2004 rates for the North Line Expansion will avoid an additional rate filing and allow SFPP a reasonable opportunity to recover its costs.

13. SFPP has not shown that there is effective competition for Watson Station and Sepulveda.

14. Without competition, rates for Watson Station and Sepulveda should be on a cost-of-service basis.

Conclusions of Law

1. SFPP bears the burden of proof to show by a preponderance of the evidence that its costs were reasonable and recoverable at the last adopted rates. In a Complaint, the burden of proof is on the moving party.

2. Complainants have shown by a preponderance of the evidence that SFPP's actions had dedicated the Sepulveda Line to public utility service.

3. SFPP has not justified by a preponderance of the evidence that an income tax allowance should be included in rates as an expense the utility is likely to pay.

4. It is reasonable to dismiss A.00-03-044 without prejudice due to a hopelessly stale record.

5. The Commission has broad discretion in adopting a capital structure and cost of capital.

6. The Commission has the discretion to adopt an attrition ratesetting adjustment effective in 2004 for the North Line Expansion, a major capital addition expected after test year 2003. This adjustment will allow SFPP to recover its reasonable costs.

7. SFPP has not met its burden of proof to justify its allocation of environmental costs.

8. The rates for Watson Station and Sepulveda should be on a cost-of-service basis.

9. Errors in SFPP's rates are refundable to customers pursuant to Pub. Util. Code § 455.3(b)(4).

10. It is reasonable to close C.97-04-025, C.00-04-013, and A.00-03-044.

11. Settlement is a reasonable means to resolve the remaining issues and it is within the Commission's discretion to direct the parties to diligently pursue settlement in lieu of litigation.

O R D E R

IT IS ORDERED that:

1. SFPP, L.P.'s Sepulveda Line is a public utility dedicated to utility service.

2. SFPP, L.P. must refund to all customers, within 90 days, the excess component in rates. SFPP, L.P. shall file a Tier 1 advice letter insert following within 30 days of the effective date of this decision.

3. SFPP, L.P. and all active parties must meet in a good faith effort to settle the remaining consolidated issues.

4. Application 00-03-044 is dismissed without prejudice.

5. The consolidated Case (C.) 97-04-025, C.00-04-013, and Application 00-03-044 are closed.

6. The consolidated proceedings remain open to resolve the pending issues in Application (A.) 03-02-027, A.04-11-017, A.06-01-015, A.06-08-028, and Case 06-12-031, and remain consolidated.

This order is effective today.

Dated May 26, 2011, at San Francisco, California.

MICHAEL R. PEEVEY
President
TIMOTHY ALAN SIMON
MICHEL PETER FLORIO
CATHERINE J.K. SANDOVAL
MARK J. FERRON
Commissioners

APPENDIX A

APPENDIX A

SFPP Consolidated Proceedings Procedural History			
Number & Date Filed	**Caption**	**ALJ Resolution**	**Calendar**
C.97-04-025 April 10, 2000	ARCO Products Company, Mobil Oil Corporation, Texaco Refining and Marketing, Inc., and Equilon Enterprises, LLC, Complainants, vs. Santa Fe Pacific Pipeline, L.P. (SFPP, L.P.), Defendant.	N.A.	April 14, 1997
C.00-04-013 April 10, 2000	ARCO Products Company, A Division of Atlantic Richfield Company (ARCO) and Mobil Oil Corporation (MOBIL), Complainants, vs. SFPP, L.P., Defendant.	Instruction to Answer April 24, 2000	April 14, 2000
A.00-03-044 March 16, 2000	In the Matter of the Application of SFPP, L.P. for Authority to Justify its Rates for Intrastate Transportation of Refined Petroleum Products on the Basis of Market Factors.	ALJ 176-3036 April 6, 2000	March 31, 2000
A.03-02-027 February 21, 2003	Application of SFPP, LP pursuant to Commission Resolution No. 0-0043 issued October 24, 2002.	ALJ 176-3108 February 27, 2003	February 27, 2003
A.04-11-017 November 16, 2004	Application of SFPP, L.P. for authority, pursuant to Pub. Util. Code § 455.3, to increase its rates for pipeline transportation services within California.	ALJ 176-3143 December 2, 2004	November 22, 2004

SFPP Consolidated Proceedings Procedural History			
Number & Date Filed	**Caption**	**ALJ Resolution**	**Calendar**
A.06-01-015 January 26, 2006	Application of SFPP, L.P. for authority, pursuant to Pub. Util. Code § 455.3, to increase its rates for pipeline transportation services within California.	ALJ 176-3167 February 16, 2006	January 30, 2006
A.06-08-028 August 25, 2006	Application of SFPP for authority, pursuant to Pub. Util. Code § 455.4 to increase rates for pipeline transportation services within California through implementation of an Ultra Low Sulfur Diesel Surcharge.	ALJ 176-3178 September 7, 2006	September 6, 2006
C.06-12-031 December 27, 2006	Tesoro Refining and Marketing Co., v. SFPP L.P. – For a refund due to unjust rates and overcharges.	Instruction to Answer January 5, 2007	December 29, 2006

(END OF APPENDIX A)

APPENDIX B

********** SERVICE LIST **********
Last Updated on 06-APR-2010 by: RC4
C9704025 LIST
C0004013/A0003044/A0302027/A0411017/A0601015/A0608028/C0612031

********** **PARTIES** **********

Thomas J. Eastment
BAKER BOTTS L.L.P.
1299 PENNSYLVANIA AVENUE, NW
WASHINGTON DC 20004-2400
(202) 639-7717
tom.eastment@bakerbotts.com
For: Counsel for ExxonMobil Oil Corporation/BP Wes Coast Products LLC

D. T. Sherman
Associate General Counsel
CHEVRON PRODUCTS COMPANY
PO BOX 5044
SAN RAMON CA 94583
(510) 242-7300

Marcus W. Sisk, Jr
FREDERICK G. JAUSS. IV
DORSEY & WHITNEY LLP
1801 K STREET, N.W., SUITE 750
WASHINGTON DC 20006
(202) 442-3502
sisk.marcus@dorsey.com
For: ConocoPhillips Company

Martha C. Luemers
PATRICIA A. WELCH
Attorney At Law
DORSEY & WHITNEY, LLP
1717 EMBARCADERO ROAD
PALO ALTO CA 94303
(650) 857-1717
luemers.martha@dorsey.com
For: ConocoPhillips

Matthew A. Corcoran
GOLDSTEIN & ASSOCIATES, P. C.
1757 P STREET, N.W.
WASHINGTON DC 20036
(202) 872-8740
mcorcoran@goldstein-law.com
For: Tesoro Refining and Marketing Company

James D. Squeri
Attorney At Law
GOODIN, MACBRIDE, SQUERI, DAY & LAMPREY
505 SANSOME STREET, SUITE 900
SAN FRANCISCO CA 94111
(415) 392-7900
jsqueri@gmssr.com
For: SANTA FE PACIFIC PIPELINE, L.P.

Robert W. Kneisley
Associate General Counsel
SOUTHWEST AIRLINES CO.
1901 L STREET, N.W., SUITE 640
WASHINGTON DC 20036

Barron Dowling
Associate General Counsel
TESORO REFINING AND MARKETING COMPANY
300 CONCORD PLAZA DRIVE
SAN ANTONIO TX 78216
(210) 283-2415
bdowling@tsocorp.com
For: Tesoro Refining and Marketing Company

John B Merritt
TRAVIS & GOOCH
34820 N DESERT RIDGE DR.
SCOTTSDALE AZ 05282-1104
For: Exxon Oil Corp.

Andrew J. Dalton
VALERO ENERGY COMPANY
ONE VALERO PLACE, ROOM 264
SAN ANTONIO TX 78212-3186

Richard E. Powers, Jr.
Attorney At Law
VENABLE, LLP
575 7TH STREET N.W.
WASHINGTON DC 20004
(202) 344-4630
repowers@venable.com

********** SERVICE LIST **********
Last Updated on 05-APR-2010 by: RC4
C9704025 LIST
C0004013/A0003044/A0302027/A0411017/A0601015/A0608028/C0612031

Melvin Goldstein
Attorney At Law
GOLDSTEIN & ASSOCIATES, P.C.
1757 P STREET, N.W.
WASHINGTON DC 20036
(202) 872-8740
mgoldstein@goldstein-law.com
For: Tesoro Refining & Marketing Co.

Geroge L. Weber
WEBER & ASSOCIATES, P.C.
SUITE 600
1000 CONNECTICUT AVEUNE., N.W.
WASHINGTON DC 20036
(202) 628-0200
For: Chevron Texaco Products Company

********** STATE EMPLOYEE **********

Douglas M. Long
Administrative Law Judge Division
RM. 5023
505 VAN NESS AVE
San Francisco CA 94102 3298
(415) 703-3200
dug@cpuc.ca.gov

Maurice Monson
Energy Division
AREA 4-A
505 VAN NESS AVE
San Francisco CA 94102 3298
(415) 703-3072
mdm@cpuc.ca.gov

Katherine S. Morehouse
Communications Division
AREA 3-D
505 VAN NESS AVE
San Francisco CA 94102 3298
(415) 703-5331
ksm@cpuc.ca.gov

Steven A. Adducci
MATTHEW D. FIELD
Attorney At Law
VENABLE, LLP
575 7TH STREET N.W.
WASHINGTON DC 20004-1601
(202) 344-4000
saadducci@venable.com
For: Valero Marketing and Supply Company

********* INFORMATION ONLY **********

Christina M. Vitale
BAKER BOTTS L.L.P.
1299 PENNSYLVANIA AVENUE, NW
WASHINGTON DC 20004-2400
(202) 639-7717
christina.vitale@bakerbotts.com

Gregory S. Wagner
BAKER BOTTS L.L.P.
1299 PENSYLVANIA AVENUE, NW
WASHINGTON DC 20004-2400
(202) 639-7717
gregory.wagner@bakerbotts.com

Joshua B. Frank
BAKER BOTTS L.L.P.
1299 PENNSYLVANIA AVENUE, NW
WASHINGTON DC 20004-2400
(202) 639-7717
joshua.frank@bakerbotts.com

John Burkholder
BETA CONSULTING
2023 TUDOR LANE
FALLBROOK CA 92028
(760) 723-1831
burkee@cts.com

Todd Normane
BP AMERICA, INC.
6 CENTERPOINTE DRIVE; LPR 6-552
LA PALMA CA 90623
(714) 228-6739
todd.normane@bp.com

************** SERVICE LIST *************
Last Updated on 05-APR-2010 by: RC4
C9704025 LIST
C0004013/A0003044/A0302027/A0411017/A0601015/A0608028/C0612031

Vahak Petrossian
Consumer Protection & Safety Division
RM. 500
320 WEST 4TH STREET SUITE 500
Los Angeles CA 90013
(213) 576-7077
vap@cpuc.ca.gov

Paul Wuerstle 3
Consumer Protection & Safety Division
RM. 2107
505 VAN NESS AVE
San Francisco CA 94102 3298
(415) 703-2183
pwu@cpuc.ca.gov

Doug Garrett
COX CALIFORNIA TELCOM, LLC
2200 POWELL STREET, SUITE 1035
EMERYVILLE CA 94608-2618
(510) 923-6220
Douglas.Garrett@cox.com

Judy Pau
DAVIS WRIGHT TREMAINE LLP
505 MONTGOMERY STREET, SUITE 800
SAN FRANCISCO CA 94111-6533
(415) 276-6587
judypau@dwt.com

Edward W. O'Neill
Attorney At Law
DAVIS WRIGHT TREMAINE, LLP
505 MONTGOMERY STREET, SUITE 800
SAN FRANCISCO CA 94111-6533
(415) 276-6582
edwardoneill@dwt.com

Frederick G. Jauss Iv
DORSEY & WHITNEY LLP
1801 K STREET, N.W., SUITE 750
WASHINGTON DC 20006
(202) 442-3521
jauss.fred@dorsey.com

Scott Blaising
Attorney At Law
BRAUN BLAISING MCLAUGHLIN P.C.
915 L STREET, STE. 1270
SACRAMENTO CA 95814
(916) 682-9702
blaising@braunlegal.com

Larry E. Farrens
CALIFORNIA TRUCKING ASSOCIATION
3251 BEACON BOULEVARD
WEST SACRAMENTO CA 95691
(916) 447-1175

Barbara Hickel
EQUILON ENTERPRISES
910 LOUISIANA
HOUSTON TX 77210
For: Equilon Enterprises

Noreen M. Tama
EXXONMOBIL OIL CORPORATION
3225 GALLOWS ROAD
FAIRFAX VA 22037
(703) 846-1712
noreen.m.tama@exxonmobil.com
For: EXXONMOBIL OIL CORPORATION

Bruce Foster
Senior Vice President
SOUTHERN CALIFORNIA EDISON COMPANY
601 VAN NESS AVENUE, STE. 2040
SAN FRANCISCO CA 94102
(415) 775-1856
bruce.foster@sce.com

************** SERVICE LIST *************
Last Updated on 05-APR-2010 by: RC4
C9704025 LIST
C0004013/A0003044/A0302027/A0411017/A0601015/A0608028/C0612031

Margaret J. Stork
DORSEY & WHITNEY, LLP
1717 EMBARCADERO ROAD
PALO ALTO CA 94303
(650) 857-1717
stork.margaret@dorsey.com

Andrew Brown
ELLISON, SCHNEIDER & HARRIS L.L.P.
2600 CAPITOL AVE, SUITE 400
SACRAMENTO CA 95816-5905
(916) 447-2166
abb@eslawfirm.com

Paul M. Premo
ENERGY ECONOMICS CONSULTING
310 HAZEL AVENUE
MILL VALLEY CA 94941-5054
(415) 383-6330
paulpremo@msn.com
For: Energy Economics Consulting

(END OF APPENDIX B)

APPENDIX C