Decision 07-05-061 May 24, 2007

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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. and CALNEV PIPE LINE, L.L.C.).	Application 06-09-016 (Filed September 18, 2006)
Joint Application of The Goldman Sachs Group, Inc., American International Group, Inc., Carlyle Partners IV, L.P., Carlyle/Riverstone Global Energy and Power Fund III, L.P., for Exemption Under Section 852 of the Public Utilities Code for Certain Future Transactions Involving Non-Controlling Interests in California Public Utilities.	Application 06-09-021 (Filed September 22, 2006) [Formally Consolidated]

INTERIM OPINION APPROVING, WITH CONDITIONS, TRANSFER OF INDIRECT CONTROL AND AUTHORIZING, WITH CONDITIONS, EXEMPTION FROM PUBLIC UTILITIES CODE SECTION 852 FOR SOME INVESTORS IN KNIGHT HOLDCO

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INTERIM OPINION APPROVING, WITH CONDITIONS, TRANSFER OF INDIRECT CONTROL AND AUTHORIZING, WITH CONDITIONS, EXEMPTION FROM PUBLIC UTILITIES CODE SECTION 852 FOR SOME INVESTORS IN KNIGHT HOLDCO

1. Summary

This interim decision resolves all but one issue in these formally consolidated applications. The issue we defer is whether Carlyle/Riverstone Global Energy and Power Fund III (Carlyle/Riverstone III) and Carlyle Partners IV, two of the investors in Knight Holdco LLC (Knight Holdco), should be granted the same exemptions from Public Utilities Code Section 852 that we grant to Goldman Sachs Group, Inc. (Goldman Sachs) and American International Group, Inc. (AIG), also investors in Knight Holdco.[1] To resolve the issue for Carlyle Partners IV and Carlyle/Riverstone III, we must decide whether to modify two other decisions affecting another utility. Defective notice prevents us from deciding the issue in this decision.

We approve, pursuant to Section 854 and subject to specified conditions, the transfer of indirect ownership and control over jurisdictional portions of two common carrier pipeline utilities, SFPP, L.P. (SFPP) and its affiliate, Calnev Pipe Line, L.L.C. (Calnev). Kinder Morgan Inc. (KMI), a publicly-traded corporation, indirectly owns and controls the pipelines at present. Our approval will permit finalization of the acquisition of KMI by a group of private investors through Knight Holdco, a private limited liability company. The investors include several individuals involved in KMI's current management, including

[1] Unless otherwise stated hereafter, all references to a section or sections refer to the Public Utilities Code.

Richard Kinder, the present Chairman and CEO of KMI, and four large financial institutions: Goldman Sachs, AIG, Carlyle Partners IV, and Carlyle/Riverstone III.

The conditions we order are designed to ensure the Commission's ongoing ability to discharge its jurisdictional obligations to monitor the continued ability of the two common carrier pipeline utilities to meet their obligation to serve through reasonable rates, terms and conditions of service and to operate in an environmentally safe manner in this state. Among these conditions are the following: Commission access to books, records and witnesses that we deem cognate and germane to our ongoing regulation of the public utilities; recognition by Knight Holdco and other intermediaries in the organizational structure, as a first priority, of the capital requirements of SFPP and Calnev; assurance that adequate measures exist to structurally separate ("ring-fence") SFPP and Calnev to prevent them from being pulled into a bankruptcy of Knight Holdco or any organizational intermediary; provision of a letter of credit from a national bank to ensure payment of up to $100 million in potential intrastate rate refunds. All conditions are set out in the Ordering Paragraphs.

We also approve, subject to limitations that they now propose, an exemption from Section 852 for Goldman Sachs and AIG. The exemption covers only non-controlling, passive investments in the stock of California utilities. Both entities recognize that acquisitions of controlling interests will continue to require advance Commission approval under Section 854.

2. Identity of SFPP, Calnev and Other Parties

For ease of discussion, we generally refer to Application (A.) 06-09-016, which seeks approval of a change of control under

Section 854, as the Section 854 Application, and to A.06-09-021, which seeks an exemption from Section 852, as the Section 852 Application. Where there is no need to distinguish between Section 854 and Section 852 Applicants, we collectively refer to them as Joint Applicants. Section 854 and Section 852 Applicants filed joint briefs and we refer to those documents as Joint Applicants' initial or reply briefs.

2.1. Organization & Operation of SFPP & Calnev

The Commission-regulated, intrastate-portions of SFPP and Calnev subject to the Section 854 Application are public utility pipelines which serve as common carriers of refined petroleum products, such as gasoline, diesel fuel, and jet fuel.

SFPP, a Delaware limited partnership qualified to do business in California, also operates in several other western states. SFPP's Commission-jurisdictional intrastate operations consist of several independent pipeline segments. The Section 854 Application summarizes the four major lines:

- The San Diego Line, which is a 135-mile pipeline serving major population areas in Orange County, immediately south of Los Angeles, and San Diego from refineries and port complexes in Los Angeles and Long Beach;
- The North Line, which consists of approximately 864 miles of trunk pipeline in five segments and transport [sic] products from Richmond and Concord, California to Brisbane, Sacramento, Chico, Fresno and San Jose, California, and Reno, Nevada from refineries in the San Francisco Bay Area and various pipeline marine terminals;
- The West Line, which consists of approximately 705 miles of primary pipeline and currently transports products for 38 shippers from six refineries and three pipeline terminals in the Los Angeles Basin to Phoenix and Tucson,

> Arizona and various intermediate commercial and military delivery points located within California. Products for the West Line also come through the Los Angels and Long Beach port complexes; and
>
> - The Bakersfield Line, which is a 100-mile, 8-inch diameter pipeline serving Fresno, California.

(Section 854 Application at 3-4.)

Calnev, a Delaware limited liability company qualified to do business in California, consists of a 550-mile pipeline system that extends from Colton, California (where it connects with SFPP) to Las Vegas, Nevada. The intrastate portion includes a 55-mile pipeline that serves Edwards Air Force Base in the Mojave Desert. According to the Section 854 Application, the extension into Las Vegas provides non-stop transportation of "more than 1 million gallons of gasoline a day." (*Id.* at 4.)

2.2. Current Ownership & Control of SFPP & Calnev

2.2.1. De Jure & De Facto Relationships

Attachment 1 to today's decision illustrates the complex arrangement by which KMI, through Kinder Morgan Energy Partners, L.P. (KMEP) and other KMI subsidiaries, indirectly owns and controls SFPP and Calnev.[2] KMI is a Kansas corporation, which the Section 854 Application describes 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

[2] The diagram is Exhibit (Ex.) J (Pre-Transaction) to the Section 854 Application.

> gas distribution service to over 1.1 million customers. (*Id*. at 5.)

The Section 854 Application describes KMI's ownership and control over SFPP and Calnev thus:

> 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.)

The full name of KMGPI is Kinder Morgan G.P., Inc.

As Attachment 1 shows, KMEP holds SFPP and its affiliate, Calnev, via a 98.9899% limited partner interest in the KMEP subsidiary, Kinder Morgan Operating Limited Partnership-D (OLP-D); KMGPI holds the 1.0101% general partner interest in OLP-D. OLP-D owns 100% of Calnev through a subsidiary, Kinder Morgan Pipe Line, LLC (Kinder Morgan Pipeline), and holds a 99.5% general partner interest in SFPP (Santa Fe Pacific Pipelines, Inc. retains a 0.5% limited partner interest). KMEP, a master limited partnership organized under Delaware law, has ownership interests in four other operating limited partnerships besides OLP-D. These arrangements effectively provide 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).

Neither Kinder Morgan Management, LLC (KMR[3]), KMGPI, KMEP, OLP-D, Kinder Morgan Pipeline, SFPP or Calnev has any employees. Attachment 2 to today's decision illustrates, schematically, the vehicles KMI uses to provide employees to its subsidiaries and allocate costs for shared services. Employees work for KMGP Services Company, Inc. (KMGP Services Co.), which is 100%-owned by KMGPI. KMGP Services Co. then dedicates all of its employees to KMEP (to be managed by KMR). Allocations for shared services occur through Kinder Morgan Services LLC (KM Services), which is 100%-owned by KMR.[4]

Commission approval for the existing ownership, as to SFPP, can be traced through D.98-01-047, authorizing SFPP's acquisition by KMEP, and D.99-10-015, authorizing SFPP's subsequent acquisition by KN Energy, Inc. (KN Energy) via KN Energy's acquisition of KMI. KN Energy later

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[3] Since most of references in the record use the term KMR, which is the New York Stock Exchange (NYSE) listing for Kinder Morgan Management, LLC, today's decision follows that convention. On the other hand, while record references to KMEP sometimes use its NYSE listing, KMP, most do not and today's decision therefore uses the acronym KMEP, unless quoting testimony or a document that uses KMP.

[4] Attachment 2 is Ex. PKA-3 to Ex. 102, the prepared testimony of Indicated Shippers' witness Peter K. Ashton, President of Innovation & Information Consultants, Inc., an economic and management consulting firm. The layout of Attachment 1, while somewhat cleaner and easier to grasp visually, lacks detail shown in Attachment 2 and does not show KMGP Services Co. or KM Services.

changed its name to KMI, leaving KMI with effective ownership and control of SFPP.

However D.01-03-074, the last change of control decision concerning Calnev, authorizes only KMEP to acquire Calnev. While D.01-03-074 notes that "KMEP is a subsidiary of Kinder Morgan, Inc.," KMI is not an applicant in the underlying proceeding (A.00-12-004), and the ordering paragraphs of D.01-03-074 do not transfer ownership and control to KMI. (D.01-03-074, 2001 Cal. PUC LEXIS 173, *2.) The Section 854 Application, however, asks us to approve transfer of control over Calnev from KMI to Knight Holdco and KMI, not KMEP, is the applicant.

2.2.2. Calnev Problem & Remedy

Joint Applicants, in their reply brief, argue that:

> Approval by the Commission of the transfer of control of Calnev to KMEP effected, by operation of law, KMI's ownership of KMEP's general partner, KMGPI. As such, while the relationship between KMEP and KMI was described in A.00-12-004 (and reflected in D.01-03-074), it was not believed necessary to include KMI as a named applicant in A.00-12-004. (Joint Applicants' Reply Brief at 32.)

Joint Applicants' argument does not square with Section 854(a), however.[5] The statute unambiguously requires advance Commission

[5] Section 854(a) provides:

> No person or corporation, whether or not organized under the laws of this state, shall merge, acquire, or **control either directly or indirectly** any public utility organized and doing business in this state **without first securing authorization to do so from the commission**. The commission may establish by order or rule the definitions of what constitute merger, acquisition, or control activities which are subject to this section. Any merger, acquisition, or **control without that prior authorization shall be void and of no effect**. No public utility organized and doing business

Footnote continued on next page

approval of a change of control over any California public utility and renders void any change of control that lacks such preapproval. We recognize, however, that while the A.00-12-004 proponents failed to properly formulate their request, they did disclose the KMI/KMEP relationship in their filing.

Joint Applicants propose a solution which we think provides an acceptable resolution of this matter, given the particular circumstances involved and most importantly, because it does not appear that the A.00-12-004 proponents intended to mislead the Commission or that any harm has befallen the public interest as a result of their error. Joint Applicants propose that they file a petition to modify D.01-03-074, requesting clarification and correction of D.01-03-074 to extend the transfer of control of Calnev to KMI, in addition to KMEP. We make the filing of such a petition one of the conditions of our approval here.

2.3. Identity of Other Applicants

As the caption indicates, in addition to the three parties already identified -- SFPP, Calnev and KMI -- Section 854 Applicants include a fourth party, Knight Holdco. Knight Holdco is a private limited liability company formed under Delaware law; upon approval of the proposed transaction, Knight Holdco will become KMI's parent and KMI will no longer be publicly-traded.

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under the laws of this state, and no subsidiary or affiliate of, or corporation holding a controlling interest in a public utility, shall aid or abet any violation of this section. (Emphasis added.)

Attachment 3 to today's decision illustrates the post-transaction organizational structure, including Knight Holdco's ownership by five groups of investors.[6] The preliminary proxy statement filed with the United States Securities and Exchange Commission (SEC) provides information 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%.[7] The KMI Management Group, identified in Attachment 3 as the "KMI Rollover Investors," consists of Richard Kinder, the current Chairman and CEO of KMI , William Morgan (though KMI's Portcullis Partners, LP), and two current KMI board members, Fayez Sarofim and Michael Morgan.

Goldman Sachs, AIG, Carlyle Partners IV and Carlyle/Riverstone III are also the Applicants in A.06-09-021, the Section 852 Application. There they are identified generically as "investment banks, diversified financial services providers, or private equity funds engaged in a broad range of financial activities that may involve acquiring securities in the ordinary course of their business." (Section 852 Application at 2.)

Goldman Sachs is a publicly traded Delaware corporation. It is "a leading global investment banking, securities and investment management

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[6] The diagram is Ex. J (Post-Transaction) to the Section 854 Application.

[7] We grant the unopposed *Motion of the Goldman Sachs Group, Inc., American International Group, Inc., Carlyle Partners IV, L.P., Carlyle/Riverstone Global Energy and Power Fund III, L.P. to Place Knight HoldCo Ownership Information into the Record and for the Commission to take Judicial Notice of the SEC Filing Containing this Information*, filed February 20, 2007, which contains a link to the SEC filing: http://www.sec.gov/Archives/edgar/data/54502/000104746906013030/a2173932zprer14a.htm.

firm that provides a wide range of financial services to a substantial and diversified client base that includes corporations, financial institutions, governments and high-net-worth individuals." (*Id*. at 4.) Goldman Sachs' "three core businesses" are "(1) Investment Banking; (2) Trading and Principal Investments; and (3) Asset Management and Security Services." (*Id.* at 4-5.)

AIG, also a publicly traded Delaware corporation, "is a holding company which, through its subsidiaries, is engaged in a broad range of insurance and insurance-related activities worldwide." (*Id.* at 5.) The 852 Application states:

> AIG's primary activities include both general insurance and life insurance and retirement services operations. Other significant activities include financial services and asset management. Through these operations, AIG subsidiaries provide insurance and investment products and services to both businesses and individuals in more than 130 countries and jurisdictions. AIG's asset management operations comprise a wide variety of investment-related services and investment products, including institutional and retail asset management offered to individuals and institutions both domestically and overseas. (*Ibid*.)

Carlyle Partners IV, "a $7.85 billion private equity fund that was launched in 2005 … conducts leveraged buyout transactions primarily in North America in targeted industries." (*Ibid*.) Its controlling general partner is affiliated with The Carlyle Group, "a global private equity firm … with over $44.3 billion under management." (*Ibid*.) The Carlyle Group "invests in buyouts, venture and growth capital, real estate and leveraged finance in Asia, Australia, Europe and North America, focusing on aerospace and defense, automotive and transportation, consumer and retail, energy and power, healthcare, industrial, technology and business

services, and telecommunications and media." (*Id.* at 5-6.) The Section 852 Application also states that TC Group, L.L.C., which is affiliated with The Carlyle Group, indirectly owns and controls the general partner of Carlyle Partners IV and also indirectly holds a joint venture interest in the general partner of Carlyle/Riverstone III.

The final entity, Carlyle/Riverstone III, "is a $3.8 billion private equity fund that was launched in 2005 to invest in the energy and power industry." (*Id.* at 6.) The Commission's recent decision approving a change of control for the independent natural gas storage facility, Wild Goose Storage, Inc. (Wild Goose), notes that Carlyle/Riverstone III, a limited partnership registered in Delaware in 2005, is one of four investment funds established by the joint venture between The Carlyle Group and Riverstone Holdings LLC (Riverstone Holdings), another Delaware limited liability company.[8] The Section 852 Application states that the general partner that controls Carlyle/Riverstone III is affiliated with The Carlyle Group and with Riverstone Holdings LLC, "an energy and power-focused private equity firm founded in 2000, with $7 billion currently under management." (*Ibid*.) Riverstone Holdings "conducts buyouts and growth capital investments in the midstream, upstream, power, oilfield service and renewable sectors of the energy industry." (*Ibid*.)

[8] See generally, Decision (D.) 06-11-019, 2006 Cal PUC LEXIS 499. The decision authorizes the transfer of control of Wild Goose from the Canadian company, EnCana Corporation, to Niska Gas Storage US, LLC, whose parent is a limited liability company 80%-owned by the joint venture of Carlyle/Riverstone III and its affiliated fund, Carlyle/Riverstone II, and 20%-owned by SemGroup, an Oklahoma-limited partnership.

2.4. Identity of Opposing Parties

The core group that opposes the Section 854 Application (unless approval is specifically conditioned as discussed below) consists of major California customers on SFPP and Calnev. Five of these customers -- Valero Marketing and Supply Company, Ultramar Inc., BP West Coast Products LLC, ExxonMobil Oil Corporation, and Chevron Products Company—in some instances joined by a sixth, Tesoro Refining and Marketing Company, refer to themselves as the Indicated Shippers. A seventh customer, ConocoPhillips Company, has appeared separately from the Indicated Shippers, though it generally shares interests and positions common to them. Today's decision refers to all of these customers as Shippers, unless separate identification is necessary for procedural or substantive reasons. These parties participated in hearings on the Section 854 Application and filed post-hearing briefs, but have taken no position on the Section 852 Application, either separately or collectively.

Consumer Federation of California (CFC), a non-profit federation of individuals and organizations whose own memberships consist of California consumer groups, senior citizens groups, and labor organizations, opposes both the Section 854 and Section 852 Applications. CFC participated in the Section 854 Application hearing and filed post-hearing briefs. CFC has participated because it views the Commission's decision in this consolidated docket to be precedential for future equity fund/insurance company investment in and ownership of California public utilities.

The Division of Ratepayer Advocates (DRA) did not actively participate at hearing but filed post hearing briefs, which argue against

any absolute exemption from Section 852 and propose certain conditions, including an agreement negotiated with the Joint Applicants. DRA avers that its views should not be interpreted as support or opposition for either Application, however.

3. Request for Public Utilities Code Section 854 Authority

3.1. Nature of the Proposed Change of Control

Section 854 Applicants ask the Commission to authorize a proposed change of control over the intrastate portions of SFPP and Calnev. Under the proposal, KMI, the publicly-traded corporation which effectively controls the pipelines now, would be acquired by a group of private investors through Knight Holdco, a private limited liability company. As the Applicants succinctly state, "[t]he proposed acquisition of KMI would result in the transfer of KMI from public to private ownership and the transfer of direct and indirect control of all of KMI's subsidiaries and business interests, including SFPP and Calnev." (Section 854 Application at 7.)

The Section 854 Application relates that on August 28, 2006, KMI's Board of Directors announced that it had accepted a buyout offer from a group of investors led by Richard Kinder, and comprised of other members of KMI management as well as affiliates of Goldman Sachs, AIG, The Carlyle Group, and Riverstone Holdings. Collectively referred to as the KMI Investor Group, these individuals and entities offered to buy all outstanding shares of KMI at $107.50 share, or about US $15 billion -- a 27% premium over the closing price of KMI shares as of May 26, 2006, the last trading day before the KMI Investor Group's initial proposal was

made. The KMI Investor Group also agreed to assume about $7 billion in existing KMI debt.

Ex. 210, which consists of selected pages of the Schedule 13D/A proxy statement filed with the SEC, breaks the $22 billion cost of the deal down into four components: up to $5 billion in new equity from Goldman Sachs and the three other financial institutions; up to $2.9 billion in rollover equity from the KMI Investor Group; approximately $7.3 billion of new debt; and acquisition of outstanding debt, estimated to be approximately $7.2 billion.

The public version of Ex. 11, the December 11, 2006 commitment letter by which Goldman Sachs and other lenders (Citigroup Global Markets Inc., Deutsche Bank Securities Inc., Wachovia Capital Markets, LLC and Merrill Lynch Capital Corporation) agree to provide $17.2 billion of the necessary financing, includes a statement of the rationale for the transaction:

> The purpose of the merger is to enable KMI's public stockholders to immediately realize the value of their investment in Kinder Morgan, Inc. through their receipt of the per share merger price of $107.50 in cash, without interest …
>
> The management group participants ("Rollover Investors") believe that the merger will provide Kinder Morgan with the flexibility to pursue alternatives that it would not have as a public company, including the ability to execute transactions and focus on long-term value creation outside of public market constraints. Additionally, following consummation of the merger, the Investor Group plans to offer to sell the Trans Mountain Pipeline system to KMP as well as consider whether Kinder Morgan, Inc. ought to undertake a variety of additional possible transactions, including the spin-off, sale, joint venture or public offering of all or a portion of NGPL, Terasen Gas, its power operations, the Express/Platte pipeline system, the general partner of KMP, the sale of units in KMP

> owned by KMI, the sale of listed shares of KMR owned by KMI, or any combination of the foregoing transactions taken individually or in concert. (Ex. 11 at 6.)

Upon consummation of the deal, all outstanding shares of KMI, whether contributed by Kinder and other members of KMI management participating in the deal or repurchased from nonparticipating shareholders, will be held by Knight Holdco or one of its subsidiaries. This transfer of all KMI shares will vest ownership and control of KMI in Knight Holdco, which will have an eleven-member Board of Managers. Kinder will be entitled to designate four members and the four financial institutions will be entitled to six, with Knight Holdco's Chief Executive Officer (Kinder) serving as the eleventh member. Thus, Kinder will control five of the eleven members of the Board of Managers, at least initially. The Section 854 Application represents that the "expected allocation" of the other six seats is: Goldman Sachs - 2, AIG - 2, Carlyle Partners IV – 1, and Carlyle/Riverstone III – 1. (Section 854 Application at 8.)

Kinder will not only be Knight Holdco's CEO, but also Chief Manager of the Board of Managers. He can be removed as Chief Manager for cause or for failure to meet the business plan's financial performance targets by at least 90%. Ex. 9 reports the targets for each of the five years from 2006 (approximately $1.1 billion) to 2010 (approximately $2.0 billion); the targets increase by roughly $200 million from year-to-year, nearly doubling from 2006 to 2010.

The day-to-day operations of SFPP and Calnev will not be affected, according to the Section 854 Application. "[C]ontrol will continue to remain in the hands of KMEP's management and Board of Directors" or in

other words, the Board of Directors of KMR, since this board, "as delegate of KMEP's general partner, serves as the board of directors of KMEP." (*Ibid*.) Under cross-examination, Thomas A. Bannigan, President of Products Pipelines for KMEP, whose oversight includes SFPP and Calnev, testified that the boards of directors of KMEP, KMGPI and KMR are identical. Each board consists of the same five individuals -- Kinder, another KMI associate, and three others who are not employees or officers of KMI.

Ex. 1, Bannigan's prepared testimony, expands upon Section 854 Applicants' claim that the proposed transfer will have no effect upon SFPP and Calnev:

> There will be no change in the employees of SFPP and Calnev, the Board of Directors of Kinder Morgan Management, or any other officers or managers responsible for the pipelines' financial and operating conditions. There will be no change in the operations, as well as no change in the regulatory, accounting, engineering, planning or any other function of the SFPP, Calnev or the people performing those functions as a result of the proposed transaction. (Ex. 1 at 2.)

However, Bannigan also confirmed projections that SFPP and Calnev pipeline revenues will increase over the next four to five years by 4% to 4½% per year and admitted that such revenues could not be obtained through an increase in volumes alone, since "intrastate volumes have grown about an average of 2% per year." (Tr. 122.) Asked about Ex. 109, a January 12, 2006 letter from KMEP to BP West Coast Products LLC (and other pipeline shippers) which solicits advance agreement to a KMEP-specified rate increase on the proposed expansion between Colton and Las Vegas as a condition of construction, Bannigan conceded that

KMEP might decide not to build "if we cannot get the appropriate rate certainty around this investment." (Tr. 109.)

Ex. 3, the prepared testimony of Joesph Listengart, Vice President, General Counsel and Secretary of KMI, KMEP and KMR, describes the distribution of revenues from SFPP, Calnev and other KMEP subsidiaries to KMEP's limited partners, KMGPI, and KMR, the latter through i-units. The i-units in KMR are additional ownership units distributed in lieu of cash – the actual cash is not paid to unit holders, but held elsewhere according to Ex. 102, the prepared testimony of Indicated Shippers' witness Ashton. This entire arrangement is expected to continue post-transfer.

> KMEP's partnership agreement requires that it distribute 100% of "Available Cash," as defined in the partnership agreement, to its partners within 45 days following the end of each calendar quarter in accordance with their respective percentage interests. "Available Cash" consists generally of all of KMEP's cash receipts, including cash received by its operating partnerships and net reduction in reserves, less cash disbursements and net additions to reserves. Available Cash is calculated after taking into account all cash disbursements from SFPP and Calnev in the operation of their respective businesses, including amounts payable to the former general partner of SFPP in respect of its remaining 0.5% interest in SFPP and satisfaction of liabilities, which would include the payment of rate refunds, if any are awarded. (Ex. 3 at 4-5.)

Our search of the record has located the definition of "Available Cash" in four documents: Ex. 14, the Limited Liability Agreement for KMR; Ex. 15, the Limited Liability Agreement for KMEP; Ex. 16, the

Limited Partnership Agreement of OLP-D; and Ex. 19, the Limited Partnership Agreement for SFPP.[9]

Listengart testified that KMEP pays out more cash than it earns in income, partially funding distributions by "regularly" borrowing money. (Tr. 314.) Listengart explained that money to fund pipeline maintenance or expansions "is not sitting in a bank account in a reserve. It is raised by cash from operations, or it is raised by capital-market transactions." (Tr. 317.) Likewise, no actual reserves have been established for potential pipeline rate refunds. Ex. 101, the prepared testimony of Indicated Shippers' witness Kellye Jennings, CPA, together with Ashton's Ex. 102, essentially posit that the enterprise's cash distribution policy has rendered both pipelines insolvent as stand-alone entities. These witnesses rely upon various data including Federal Energy Regulatory Commission (FERC) Form 6 filings which show the pipelines' liabilities exceeding assets.

Ex. 2 and Ex. 4, respectively the prepared and rebuttal testimony of Section 854 Applicants' witness James Volkman, a principal of Corporate Valuation Advisors, Inc., state that SFPP's asset base would provide significant borrowing capacity. Ex. 2 includes Volkman's solvency opinion, together with a January 22, 2007 letter to Volkman from Wachovia

[9] In response to the Administrative Law Judge's (ALJ) request at hearing that Joint Applicants produce all other material governing documents not yet provided, on March 1, 2007 Joint Applicants produced these documents, together with Ex. 13, Delegation of Control Agreement Among KMGPI, KMR, KMEP, OLP-D (and KMEP's other operating limited partnerships) and Ex. 18, the Calnev Limited Liability Company Agreement. CFC's objection, filed March 8, 2007 argues that we should require a verification that no other responsive documents exist, but we think that Rule 1.1 of the Commission's Rules of Practice and Procedure is adequate in this circumstance.

Securities which states, "Wachovia is confident that a financing total of $1 billion is financeable." (Ex. 2, Attachment.) Indicated Shippers' Ashton calculates SFPP's maximum borrowing capacity at a lower sum of about $820 million. He argues that Volkman has underestimated SFPP's outstanding and potential liabilities (including potential rate refunds in California and at FERC) and has overestimated its future rate revenues. Ashton concludes that SFPP's borrowing capacity is insufficient to fund all of its potential liabilities.

Ex. 110, selected pages from KMEP's Prospectus Supplement dated January 2007, advises that "Credit rating agencies have announced that the ratings assigned to KMI will be reduced to below investment grade upon completion of its going private transaction" and report bond downgrades by Standard & Poor's – to below investment grade for KMI and to BBB for KMEP. (Ex. 110, S-3.) Both Moody's and Fitch have announced that they also are likely to issue downgrades, the Supplement reports.[10] It also states:

> As previously disclosed, the credit rating agencies have discussed with our management and KMI that if certain steps were taken, our credit rating would remain investment grade. Discussions with the rating agencies centered around an

[10] Fitch did so on April 11, 2007, lowering KMI's rating to B+ and KMEP's rating to BBB, reflecting "weak near-term, post-transaction credit fundamentals and the uncertainty and execution risk of [Kinder Morgan's] future structure." (Reuters, April 11, 2007.) We grant the April 17, 2007 *Motion of Indicated Shippers to Reopen the Record* to receive this information and reject Joint Applicants opposition, filed the same day. We find that the information is material and therefore meets the requirements of Rule 13.14 of the Commission's Rules of Practice and Procedure. We identify the one-page document as Ex. 126 and receive it in evidence as of the effective date of today's decision.

> additional $1 billion of equity being committed to KMI upon the occurrence of certain specified events, KMI's existing regular quarterly dividends being discontinued, an independent minority investment in our general partner being obtained from an unaffiliated third party, and various steps, such as changing KMI's name following the transaction to emphasize KMI's separate nature from us. Though no assurance can be given, we expect our senior unsecured indebtedness, including the notes, to continue to be rated investment grade. (*Ibid*.)

Listengart testified that in response to the credit agencies' concern about increased bankruptcy risk, KMEP plans to create an independent investor in KMGPI (that is, an investor with no interest in Knight Holdco). The sole power of this new interest in KMGPI will be to hold veto power over any determination to place KMEP and its subsidiaries, including SFPP and Calnev, into bankruptcy. The position has not been established yet, nor has it been determined what percentage of the general partner interest will be sold, nor what the price will be. Listengart testified that the "expectation" is that the interest will sell for "$100 million." (Tr. 309.) After the transaction has been approved, according to post-hearing information from Joint Applicants, both the KMGPI Articles of Incorporation and the Bylaws will be amended to create this new interest in the general partner and its bankruptcy veto power.[11]

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[11] By email sent to all parties on April 9, 2007, the ALJ asked Joint Applicants to identify and provide copies of those documents proposed to be amended to effectuate the new general partner interest. Joint Applicants responded the same day by forwarding copies of KMGPI's Articles of Incorporation and Bylaws. We identify these documents, respectively, as Ex. 20 and Ex. 21, and receive them in evidence as of the effective date of today's decision. CFC's objection, filed April 18, 2007, argues that we should require a verification, but we think that

Footnote continued on next page

Indicated Shippers contend that the purported safeguard created by this new interest in the general partner is of limited value for three reasons. First, since the new general partner interest will receive a share of KMEP's cash distributions and income, "this stockholder has every incentive to put SFPP and Calnev into bankruptcy so that cash flow can be increased by wiping out" pipeline liabilities such as future potential rate refunds or environmental damages. (Indicated Shippers' Reply Brief at 26.) They point out that KMGPI receives about half of the cash flow from KMEP's subsidiaries. Second, they argue that under the Delegation of Control Agreement (Ex. 13), KMGPI has delegated to KMR full authority over KMEP's subsidiaries and "so the "watchdog" in KMGPI is toothless." (*Ibid*.) Three, they underscore that absent anything in writing, the proposal remains conceptual.

Section 854 Applicants respond that the notion that KMI would wish to force the pipeline utilities into bankruptcy to escape rate refund liability and therefore forgo $250 million or more in annual revenues makes no sense. As for the authority of the new general partner interest, Section 854 Applicants merely state, without citation, that "[t]he record reflects that post-transaction a passive minority investor in KMEP's general partner, KMGPI, will have veto authority over any contemplated bankruptcy of SFPP or Calnev." (Joint Applicants' Reply Brief at 18.)

Indicated Shippers point out repeatedly that the current KMEP, KMGPI and KMR governing structure (identical, five-member boards)

Rule 1.1 of the Commission's Rules of Practice and Procedure is adequate in this circumstance.

means that the two "inside" directors need only obtain the vote of one "outside" director to form a majority; and that the two outside directors can be removed without cause at any time. Listengart agreed that a majority of directors can revise the partnership agreements and other documents which govern each of these entities. Indicated Shippers also argue that through the Knight Holdco Limited Liability Company Agreement, Ex. 8, the financial institutions who collectively will own over 60% of KMI will have will have the ability to compel the restructuring of existing arrangements below.

In response Listengart testified:

> This agreement [Ex. 8] cannot unilaterally amend the KMR agreement and the KMEP partnership agreement. Those remain unaffected by this. There is nothing that this contract can do without the participation … of KMR or KMGP[I] or Kinder Morgan Energy Partners governed by their governing documents. (Tr. 370.)

The Knight Holdco Limited Liability Company Agreement is an unexecuted document that will not be executed until the transaction has been fully approved.

3.2. Standard of Review

The applicable law is Section 854 and the body of decisions interpreting it. As we have already noted (see footnote 5 and accompanying text, above) Section 854(a) requires Commission authorization before the finalization of any transaction that results in a change of control, whether direct or indirect, over a public utility in this state. The purpose of Section 854 and related statutes is to enable the Commission, before any transfer of public utility authority is consummated, to review the situation and to take such action, as a

condition of the transfer, as the public interest may require.[12] Absent prior Commission approval, Section 854(a) provides that the transaction is "void and of no effect."

The standard traditionally applied by the Commission to determine if a transaction should be approved under Section 854(a) is whether the transaction will be "adverse to the public interest."[13] On occasion the Commission has inquired whether a transfer will provide positive benefits and such an examination is expressly required under Section 854(b) when one or more parties to the proposed transaction has gross annual California revenues exceeding U.S. $500 million. Likewise, Section 854(c) requires the Commission to review such transactions for other, enumerated impacts (on financial condition of the utility, quality of service, etc.). The Section 854 Application represents that no Applicant meets this financial threshold but recognizes that even when Section 854(b) and (c) do not expressly apply to a transaction, the Commission has used the criteria set forth in those statutes to provide context for a public interest assessment.[14]

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[12] See *San Jose Water Co.* (1916) 10 CRC 56.

[13] See, for example, *Quest Communications Corp.*, D.00-06-079, 2000 Cal. PUC LEXIS 645, *18. This is also the standard applied by D.03-06-069, 2002 CalPUC LEXIS 975, authorizing a transfer in control over Wild Goose to EnCana; by D.05-12-007, 2005 CalPUC LEXIS 527, authorizing the transfer of a 50% interest in the parent of Lodi Gas Storage, L.L.C.; and more recently by D.06-11-019, 2006 CalPUC LEXIS 499), authorizing the transfer in control over Wild Goose to Niska Gas Storage, as described more particularly in footnote 8, above.

[14] See for example, D.02-12-068, 2002 Cal. PUC LEXIS 909, concerning the change of control of California-American Water Company.

3.3. Discussion

We focus our public interest review of the Section 854 Application on three central issues, which the *Scoping Memo and Ruling of Assigned Commissioner*, January 23, 2007 (Scoping Memo) articulates, in a slightly different order, as follows:

- Will the proposed change of control have any impact on future rates, terms, and conditions of service, including service quality?

- Will the proposed change of control have any impact on Commission or Shipper access to the books and records of SFPP and Calnev? What access will the Commission or Shippers have to the books and records of Knight Holdco and how does this differ from the access presently available?

- Shippers' refunds. The Commission need not determine in this consolidated docket whether Shippers are entitled to a refund in C.97-04-024 et al. and if so, in what sum. However, should approval of A.06-09-016 be conditioned on measures to ensure collection of a refund order or to provide some alternative remedy?

Review of these issues, together with the necessary assessment of any impact under the California Environmental Quality Act (CEQA), will provide a thorough public interest review given the circumstances the Section 854 Application presents. As the evidentiary record and briefs clearly demonstrate, each of these issues is of great concern to Shippers.[15]

[15] The evidentiary record consists of the following: prepared testimony by witnesses for Section 854 Applicants, Indicated Shippers and CFC; limited examination of Indicated Shippers' witnesses by the ALJ; and cross-examination and redirect of witnesses for Section 854 Applicants. Section 854 Applicants waived all cross of opposing parties' witnesses.

Their underlying contention is that the status quo has given rise to problems which the change of control will only exacerbate. Shippers argue that Section 854 Applicants have failed to meet their burden of proof that the proposed transaction will not further endanger the public interest and that accordingly, the Commission cannot approve the transfer without imposing conditions to protect that interest. CFC shares Shippers' concerns but argues for a wider array of conditions, including structural changes within the enterprise's general partner/master limited partnership/limited liability company organization. CFC also argues that we should impose on SFPP, Calnev and their owners and affiliates the Affiliate Transaction Rules for Large California Energy Utilities adopted in D.06-12-029. Finally, CFC urges the Commission to defer approving the transfer until all structural changes and other conditions have been implemented.

Joint Applicants' initial brief argues that the evidentiary record emphatically supports findings that the proposed transfer of control is not adverse to the public interest and that it should be approved free of any conditions. As we discuss below, however, their reply brief appears to make certain concessions on both future rates and future access to books and records.

3.3.1. Impact on Future Rates, Terms, and Conditions of Service

While oil pipelines tend to be less in the public eye than energy, communications, or water utilities, they are subject to this Commission's regulation, including rate regulation, under Section 216. It is undisputed that SFPP and Calnev transport significant quantities of refined petroleum products (gasoline, diesel fuel and jet fuel) on an intrastate basis. Ex. 202, a

California Energy Commission map entitled "West Coast Petroleum Flows," identifies 22 separate flows into, across and out of California, one half of them controlled by "Kinder Morgan." Several private pipelines also exist, and transportation by ship/barge along the coast and by truck elsewhere provides some limited competition for SFPP and Calnev.

Though Section 854 Applicants resist Shippers' characterization of SFPP and Calnev as natural monopolies and while no market power studies have been introduced in this record, neither can obscure the reality that SFPP and Calnev are the primary common carriers of refined petroleum products in this state. Indicated Shippers, referencing the pipelines' FERC Form 6 report for 2005, state that SFPP transported 263,729,529 barrels in California that year and Calnev, 6,478,705 barrels. A barrel is 42 gallons. The prepared testimony of their witness Ashton represents that the pipelines move "over one-third of the total volume of refined products consumed in California." (Ex. 102 at 3.)

While it is always germane to inquire how a proposed change of control may affect a Commission-regulated public utility's rates, terms and conditions of service, the inquiry becomes increasingly more critical to the degree that utility customers have few effective alternatives. Even large, sophisticated entities like the oil companies who ship refined petroleum products over SFPP and Calnev are entitled to the assurance of fair and reasonable rates, terms and conditions of service.[16]

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[16] In contrast, the Commission's "light-handed" rate regulation of independent gas storage providers expressly relies upon a "let the market decide" policy based on the fact that those entities have no captive customers and must assume

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The greatest problem the evidentiary record poses for Section 854 Applicants is the complexity, coupled with lack of transparency, of their chosen form of business organization. Post-transaction, with a private Knight Holdco at the head, complexity and obscurity will increase. Indicated Shippers' witness Daniel Wm. Fessler, described the master limited partnership and limited liability company arrangement as highly "plastic." (Tr. 42.) As operated by Section 854 Applicants, this business organization permits the funneling of large amounts of cash upstream from SFPP, Calnev and other KMEP subsidiaries through regular, quarterly distributions. The cash flow from SFPP and Calnev (about $250 million annually) constitutes a substantial portion of the cash distributed to KMEP. Ashton reports that "KMI received approximately 42% of all quarterly cash distributions in 2005 in its role as general partner and 9% in its role as a limited partner for a total of 51%." (Ex. 102 at 26.) Section 854 Applicants state they do not plan to change this practice post-transfer.

Witnesses Bannigan and Listengart, both affiliated with KMI, testified repeatedly that the transaction is not intended to have any effect on SFPP or Calnev. But the record contains sufficient evidence, some direct and some circumstantial, to raise questions about whether the transaction, in fact, will be neutral over either the short-term or long-term. The conflicting record fails to establish that Knight Holdco and its investors cannot influence the management and operations of KMEP's

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all market risks associated with any unused capacity. See for example, D.93-02-013, 1993 Cal. PUC LEXIS 66 at *87, Finding of Fact 37.

subsidiaries, including the bankrupting of them. Neither is the record clear about the respective, legally binding powers of KMGPI and KMR, among others. This situation is partly due to the late production of many of the operative agreements, partly due to the wholly executory nature of the Knight Holdco Limited Liability Company Agreement, partly due to the complex interrelationship of that draft with the operative agreements, and partly due to the absence of any written agreement governing the new general partner interest. What the record does establish is that SFPP and Calnev provide a regular and substantial revenue stream and that the impetus exists at every level within the organization to maximize its distribution upward. Furthermore, though Joint Applicants insist it would be contrary to their best interests to do so – and presuming no ill intent whatsoever – one can conceive of scenarios (however unanticipated at present, they are far from fanciful) where future pipeline liabilities, such as those attributable to environmental disasters, could make recourse to bankruptcy a preferred economic option.

Indicated Shippers' initial brief (with extensive citations) provides a useful summary of their view of the evidentiary record and the several ways that the proposed transaction could affect the rates, terms and conditions of service on SFPP and Calnev. We further summarize their points as follows:

- Pipeline rates will go up as a result of increased interest rates attributable to debt downgrades in response to the Knight Holdco transaction;
- Kinder's obligation, as Chief Manager of Knight Holdco's board, to double revenues within five years will force rate increases;

- SFPP and Calnev will be placed in bankruptcy to shed rate refunds owed to pipeline shippers as well as other public utility obligations;
- Goldman Sachs and the other financial institutions have the ability to force the sale of assets, including KMGPI, the general partner of KMEP, or its delegate, KMR, even against the wishes of Kinder and the other KMI Rollover Investors;
- KMGPI is a guarantor (through a pledge of KMI stock) of the $7 billion in existing debt taken on by the KMI Rollover Investors;
- Goldman Sachs and the other financial institutions can require a greater distribution of cash from KMEP and its subsidiaries than occurs at present;
- KMEP is expected to buy at least one large asset from KMI and this acquisition may affect rates for SFPP and Calnev.

Section 854 Applicants continue to contest most of these assessments in their reply brief; however they conclude with the following promise:

> [T]he Section 854 Applicants unreservedly commit that they will not seek recovery in utility rates of any cost associated with the proposed transaction, including that relatively small portion of the increase in KMEP's debt (caused by the transaction-related, ratings downgrade) that might otherwise be allocated to SFPP and Calnev for ratemaking purposes. (Section 854 Applicants' Reply Brief at 14.)

To ensure that no pass through of any transaction-related costs occurs, we require as a condition of our approval, that both SFPP and Calnev file general rate applications with this Commission for a test year 2009. Each filing shall be made within 12 months of the effective date of today's decision. We note that the Commission has three complaints and five rate applications involving SFPP pending before it in another

consolidated docket, Case (C). 97-04-024 et al. (see Section 3.3.3 of today's decision).[17] Resolution of C.97-04-024 et al. will eliminate or at least minimize the major rate disputes that have plagued SFPP and Calnev over the last decade. That, together with the ALJ Division's current familiarity with the issues presented in A.06-09-016 et al., should enable the Commission to process a new rate case in an efficient and timely manner.

However, given the complexity of the business organization now and the increased complexity and lack of transparency under private limited liability company ownership, the substantial debt now and increased debt post-transfer, and the ongoing reliance upon regular cash infusions from the pipeline utilities, we place several other conditions on our approval. We draw some of the conditions from the recommendations of Shippers or CFC (though we do not accept everything they propose). In particular, on this record we decline to impose the detailed Affiliate Transaction Rules adopted in D.06-12-029, given the many differences between the oil pipeline and energy utility regulatory frameworks.

Several of the conditions we have developed, ourselves, to establish safeguards we deem necessary or to obtain information required for ongoing monitoring. The conditions manifest our concern, based upon the entirety of the record, for the future of SFPP and Calnev if we take no action. They also manifest our determination to exercise our jurisdictional

[17] While, for various reasons, these proceedings have been pending for some time, the Commission expects to resolve them in the near future. Parties to C.97-04-025 et al. filed initial briefs on April 26, 2007 and reply briefs on May 17, 2007.

authority to ensure provision of safe, reliable, environmentally sound products pipeline services at just and reasonable rates.

Section 854 Applicants make two, general arguments against imposition of most of the conditions. They contend that some conditions simply are unnecessary because SFPP, Calnev and their current owners already comply. Where we impose such conditions anyhow, we do so to make clear that we expect compliance to continue post-transfer. (We make no findings about the degree or adequacy of compliance at present.) Section 854 Applicants also argue, broadly, that some conditions are beyond the scope of this proceeding. This argument not only interprets the Scoping Memo exceedingly narrowly but fails to recognize the Commission's broad general and remedial regulatory authority under Sections 701 and 761.[18] The prepared testimony of Indicated Shippers' witness Fessler and their initial brief, as well as the initial brief of DRA, and the initial and reply briefs of ConocoPhillips provide a comprehensive

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[18] Section 701 provides:

> The commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction.

Section 761 provides, in relevant part:

> Whenever the commission, after a hearing, finds that the rules, practices … or service of any public utility, or the methods of … transmission … employed by it, are unjust, unreasonable, unsafe, improper, inadequate, or insufficient, the commission shall determine and, by order or rule, fix the rules, practices … service, or methods to be observed, furnished, constructed, enforced, or employed.
>
> ….

review of the Commission's jurisdictional authority in areas "cognate and germane" to its regulation of public utilities, including the imposition of appropriate controls on utility parent holding companies.[19]

Accordingly, we further condition our approval of the change of control upon the following:

- SFPP and Calnev each shall maintain books and records in accordance with the Uniform System of Accounts and Generally Accepted Accounting Principles.
- Knight Holdco, KMI, Kinder Morgan (Delaware), Inc. (Kinder Morgan (Delaware)), KMGPI, KMR, OLP-D, and Kinder Morgan Pipeline LLC (Kinder Morgan Pipeline), including the successor of any of them, and any other intermediate entity, and any other corporate or non-corporate affiliate of Knight Holdco, each shall maintain separate books and records.
- Neither SFPP nor Calnev shall incur any indebtedness for utility purposes except as authorized by and in full compliance with Sections 816 et seq. (Article 5 "Stocks and Security Transactions) and Section 851.
- Neither SFPP nor Calnev shall guarantee the notes, debentures or other obligations of any other entity (whether in the Knight Holdco business enterprise or otherwise) by pledge of assets or any other means, without Commission approval.
- If at some time post acquisition, Knight Holdco, KMI (or any successor) no longer holds any publicly traded debt and

[19] See for example, *PG&E et al. v. CPUC*, 118 Cal. App. 4th 1174, 2004 Cal. App. LEXIS 785. The court's decision holds that the "first priority" condition, imposed at the time of formation of a utility's holding company, is cognate and germane to aspects of the Commission's regulation and enforceable by the Commission under Section 701. The first priority condition requires a holding company's board to give first priority to the capital requirements of the utility, as determined to be necessary and prudent to meet the obligation to serve or to operate the utility in a prudent and efficient manner.

therefore ceases to file 10-Q and 10-K reports with the SEC, Knight HoldCo (or any successor) shall submit annually to the Director of the Commission's Energy Division a report which provides a comprehensive overview of KMI for the past year and constitutes the substantive equivalent of Item 7 (Management's Discussion and Analysis of Financial Conditions and Results of Operations) and Item 8 (Financial Statements and Supplementary Data) of the 10-K report filed by KMI (or any successor) for the fiscal year ending December 31, 2006. The report shall be submitted within 90 days of the close of each calendar year in which no 10-K is filed. The report may be submitted under of Section 583.

- Knight Holdco (or any successor) shall submit a report to the Director of the Commission's Energy Division if the proportion of ownership in Knight Holdco (or its successor) held by Goldman Sachs, AIG, Carlyle/Riverstone III, or Carlyle Partners IV (or the successor of any of them) changes from the proportion reported to the Commission in this proceeding. If any additional persons or entities obtain ownership interests in Knight Holdco (or any successor), the report also shall include the name of each, the proportional interest acquired, and identifying information (e.g., business form, address of principal place of business, other contact information, description of business purpose and other holdings.) The report shall be submitted within 10 calendar days of the effective date of the change in ownership. (Nothing in this reporting requirement authorizes any transfer of control of SFPP or Calnev without express Commission authorization.)
- Knight Holdco (or any successor) shall submit to the Director of the Commission's Energy Division true and correct copies of the following documents within 10 calendar days of their execution or other authorization: (1) the final, post-transfer version of the Knight Holdco Limited Liability Company Agreement (Ex. 8); and (2) the final, post-transfer version of KMGPI's Articles of Incorporation and Bylaws and the final, post-transfer version of any partnership agreement, limited liability agreement, or other document that constitutes a governing agreement, which provides for a new general

partner interest in KMGPI with power to veto placing KMEP and its subsidiaries, including SFPP and Calnev, into bankruptcy.

- Knight Holdco shall submit to the Director of the Commission's Energy Division a report identifying and describing the auditable procedures put in place which effectively establish a firewall between SFPP and Calnev and any of the financial institution investors in Knight Holdco, including affiliates of the financial institutions, for the purpose of preventing affiliate abuses involving crude and refined product commodity trading operations. The report shall be submitted within 90 days of the effective date of today's decision and shall be supplemented upon revision of the auditable procedures.[20]
- The capital requirements of SFPP and Calnev, as determined by the Commission to be necessary and prudent to meet the obligation to serve or to operate each utility in a prudent and efficient manner, shall be given first priority by Kinder Morgan Pipeline, OLP-D, KMEP, KMGPI, KMR, Kinder Morgan (Delaware), KMI, Knight Holdco (and any successors of any of them), and any other intermediate entity, and by any Boards of Directors or other persons or entities now existing or established in future to own or exercise effective control over any of them.[21]

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[20] This condition is based upon the recommendation developed in Ex. 200, the prepared testimony of CFC's witness, Tyson Slocum, the Director of the Energy Program at Public Citizen, a consumer advocacy organization. Tyson discusses examples of market abuses by large energy traders that obtained non-public information from newly acquired energy infrastructure affiliates. Section 854 Applicants agree that the recommendation is reasonable (though they argue no condition is necessary). Listengart's prepared testimony states: "I believe it would be appropriate for KMEP to establish auditable procedures to ensure that no such information is made available to any Knight Holdco sponsor investor or their representatives." (Ex. 6 at 18.)

[21] The first priority condition is fundamental to the Commission's authorization of the formation of all major utility holding companies. See for example,

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- Within 90 days of the effective date of today's decision, SFPP and Calnev shall obtain and submit to the Director of the Commission's Energy Division a non-consolidation opinion that demonstrates that the ring fencing around SFPP and Calnev utility is sufficient to prevent either utility at the time the non-consolidation opinion issues from being pulled into the bankruptcy of Knight Holdco, KMI, Kinder Morgan (Delaware), KMGPI, KMR, OLP-D, or Kinder Morgan Pipeline, or the successor of any of them, or any other intermediate entity.[22] Concurrently with the effective date of any structural change in business form and organization above the utility tier, SFPP and Calnev shall obtain and submit to the Director of the Commission's Energy Division a further non-consolidation opinion that demonstrates that the ring fencing around SFPP and Calnev is sufficient to prevent either utility from being pulled into the bankruptcy of any entity above them in the business organization.

D.88-01-063, 1988 Cal. PUC LEXIS 2 *78 (Southern California Edison Company D.95-12-018, 1995 Cal. PUC LEXIS 931 *72 San Diego Gas & Electric Company), D.96-11-017, 1996 Cal. PUC LEXIS 1141 *74; as modified by D.99-04-068, 1999 Cal. PUC LEXIS 242 *151 (PG&E); D.98-03-073, 1998 Cal. PUC LEXIS 1 *260, *290 (Enova [Southern California Gas Company, SDG&E merger]).

[22] Ring-fencing is the legal walling off of certain assets or liabilities within a corporation. Conceptually, in the context of a public utility within a holding company structure, ring-fencing includes a number of measures that may be implemented to protect the economic viability of the utility by insulating it from the potentially riskier activities of unregulated affiliates and thereby, ensuring the utility's financial stability and the reliability of its service. (See Beach Andrew N., Gunter J. Elert, Brook C. Hutton, and Miles H. Mitchell. Maryland Commission Staff Analysis of Ring-Fencing Measures For Investor-Owner Electric and Gas Utilities. The National Regulatory Research Institute-Volume 3, December 2005 at page 7). A non-consolidation opinion is not a ring-fencing measure per se, but focuses on the effect of ring-fencing. A non-consolidation opinion demonstrates that a utility has enough ring-fencing provisions to protect it from being pulled into a holding company bankruptcy.

Section 854 Applicants particularly oppose imposition of a first priority condition or a ring-fencing requirement. With respect to the latter, they argue that the existing structural separation between KMI/Knight Holdco and the pipeline utilities effectively constitutes a ring fencing arrangement. If this is the case, then it should not prove difficult for them to obtain a non-consolidation opinion. If a non-consolidation opinion cannot be obtained, then Knight Holdco, KMI, Kinder Morgan (Delaware), KMGPI, KMR, KMEP, OLP-D, Kinder Morgan Pipeline, and any other intermediate entities will need to make changes in their business organization and operational arrangements in order to remedy the defects that prevent issuance of the opinion.

A primary problem with a first priority condition, Section 854 Applicants argue, is that it will undermine the existing ring fencing "equivalent" protections they have in place. But Section 854 Applicants do not provide any analysis or authority to substantiate how a parent company guarantee of pipeline utility debts (whether rate refunds or other obligations, including environmental liabilities) risks involving the utility in the parent's bankruptcy. ConocoPhillips, citing authority to the contrary, argues:

> In fact, the types of indebtedness more likely to cause consolidation in bankruptcy are upstream guarantees, where a subsidiary guarantees the debts of a parent. *See In re Bonham*, 229 F.3d 750, 764 (9th Cir. 2000). In contrast, downstream guarantees, as proposed here, are rarely questioned by bankruptcy courts. Robert J. Rosenberg, *Intercorporate Guarantees and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. Pa. L. Rev., 235, 238 (1976). In the final analysis, SFPP could be forced into bankruptcy only if the pipeline were not generally paying its debts as they come due, which

> would be no more likely to occur with the proposed parent company guarantees. (ConocoPhillips' Reply Brief at 8.)

Given that as much as $250 million in annual pipeline revenues is designated as "Available Cash" and sent up through OLP-D and KMEP to KMI and its investors – and post-transfer will be available to Knight Holdco's private investors – we think a first priority condition is absolutely critical to responsible regulation of the pipeline utilities. In Sections 3.3.2 and 3.3.3 we discuss other conditions more directly related to the two remaining Section 854 Scoping Memo issues.

3.3.2. Impact on Access to Books and Records

The record contains somewhat inconsistent representations by Section 854 Applicants regarding their view of the Commission's legal right to inspect the books and records of any entities above SFPP and Calnev.

However, Section 854 Applicants' reply brief states: "There is no real controversy …" and continues:

> No action is necessary to enhance the existing level of complete Commission or shipper access to the books and records of SFPP and Calnev.
>
> ….
>
> No specific action is required to preserve the Commission's existing statutory authority governing access to the books and records of Knight Holdco and subjecting Knight Holdco's officers and employees to Commission process. (Section 854 Applicants' Reply Brief at 25-26.)

Thus, Section 854 Applicants concede the Commission's jurisdiction to demand the production of such documents that we consider cognate and germane to our regulation of the pipelines, whether these documents

are held at the pipeline or holding company level. They also recognize our jurisdiction to order production to Shippers and other customers. However, Section 854 Applicants fail to mention our right to witnesses or to the books and records of Kinder Morgan Pipeline, OLP-D, KMEP, KMGPI, KMR, Kinder Morgan (Delaware), or KMI – entities which now hold – and will continue to hold – various degrees of authority over either the management and operation of the pipelines or the dispersal upward in the organization of the substantial revenues they generate.

To avoid any confusion in the future, we deem it prudent to condition our approval upon such access as the Commission, itself, may determine to be necessary, consistent with established precedent.[23] The situation before the Commission here, further complicated by Section 854 Applicants' complex choice of business forms and that fact that these entities are organized out-of-state, warrants such clarity.

3.3.3. Impact on Any Refunds Owed by SFPP

The central issue in the consolidated complaint/rate application docket, C.97-04-024 et al., is what constitutes just and reasonable rates for SFPP. Like Calnev, SFPP traditionally has provided pipeline common carriage under cost-based ratemaking principles, and numerous contested issues in these proceedings may affect whether rate increases SFPP has levied over the past 10 years are allowed to stand or are determined to be

[23] See for example, D.96-11-017, 1996 Cal. PUC. LEXIS 1141 at *70-*72, in which, as a condition of approving formation of a holding company and reorganization of PG&E, the Commission required access to books and records, and officers and employees, of the holding company and its affiliates.

excessive.[24] If the Commission finds against SFPP, the utility may be liable for substantial refunds. Shippers argue that they expect a favorable resolution, including a refund order of about $100 million. If the Commission should order rate refunds, Shippers want to be sure to collect them and they ask us to condition any approval of the change of control upon the establishment by SFPP of liquid collateral, such as a letter of credit, for that purpose.

Section 854 Applicants state that though they do not expect any refund liability for SFPP, the utility has adequate borrowing capacity to pay refunds, if ordered to do so. They clearly view any Commission order as unnecessary micromanagement of their business preferences; in response to ConocoPhillip's request for a reserve of cash or cash equivalents, they argue:

> ConocoPhillips asks the Commission to reform the existing KMEP partnership agreement and dilute the rights of existing unit holders by restricting the amount of cash available for distribution to them … (Section 854 Applicants' Reply Brief at 34-35.)

There is no need to discuss the somewhat "apples and oranges" presentations put forward by the parties on SFPP's ability to meet its

[24] Section 455.3 governs the manner in which oil pipelines may change rates, authorizing them to charge new rates after 30-days notice but subject to the obligation to pay refunds if the rate increases subsequently are found to be excessive. The statute, enacted by Stats. 1995, Ch. 802, Sec. 1, changes the general rule, codified in Section 454, that requires Commission approval before rate changes go into effect. This increase-upon-notice authority is somewhat limited by Section 455.3(b)(5), which provides that shipping rate increases "shall not exceed 10 percent per 12-month period."

current obligations or its borrowing ability (the record on Calnev's status is very slim). After reviewing all of the evidence on this subject, we conclude that Section 854 Applicants have not fully rebutted Shipper's claims that SFPP's borrowing capacity will be insufficient to enable it to discharge all near-term liability, including intrastate and interstate rate refunds. We are obliged to ensure that SFPP is able to honor and timely discharge any refund liability that may be determined in C.97-04-024 et al.

Under the circumstances presented here, we agree with Shippers that sound policy militates against using one potential mechanism we asked the parties to examine - a credit on future rates as the method of funding any past overcharges. Not only might such method fail to reach those Shippers due refunds if any are ordered, but potentially it could reduce the monies available for necessary, ongoing maintenance and safety. No other party supports a rate credit and we do not pursue it here.

Instead, exercising our broad general and remedial regulatory authority under Sections 701 and 761, we require as a condition of our approval of the transfer that within 60 days of the effective date of today's decision SFPP demonstrate that it holds a letter of credit for $100 million from a national bank. The letter of credit should be designed, in form and in substance, to convey the direct obligation of the bank to any Shippers entitled to refunds, notwithstanding the insolvency or credit risk of the entity or entities legally responsible for repayment of the letter of credit. Shippers ask that we have the letter of credit served on them and permit comments. We decline to hold this proceeding open to do so, though we recognize Shippers' interest in the terms of a legal document created for their potential benefit. Therefore, we will require SFPP to submit the letter

of credit in C.97-04-024 et al., by means of a motion to reopen the record of that proceeding to receive the letter of credit as a late-filed exhibit. The assigned ALJ and Assigned Commissioner, or either of them, may determine whether to allow any further proceedings in that docket in connection with the letter of credit. We think that SFPP should be able to obtain a letter of credit for less than $500,000 in the current economic climate. No costs associated with the financing shall be recovered in future rates charged to pipeline customers.

While the guarantee of a $100 million potential liability would seem to be a rather small matter for KMI and Knight Holdco considering the $22 billion value of the change of control, the matter is not inconsequential from a regulatory perspective. The Commission may not adopt a cavalier attitude toward any utilities or any utility customers, even large oil companies. KMI should have entered into its acquisition of SFPP with full realization that while a public utility may provide a regular revenue stream, it also carries public service obligations. Knight Holdco must recognize the same. If SFPP lacks resources or flexibility, we are certain that KMI and Knight Holdco have both. The Commission's 2006 decision authorizing a change of indirect control over Wild Goose includes a 10-page summary of KMI's business operations, of which SFPP and Calnev are a small part.[25] Moreover, Section 854 Applicants underscore the financial strength of the financial institution investors.

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[25] See D.06-11-019, Attachment 3, entitled *Summary of Additional Investments in the Energy and Power Industries that Carlyle/Riverstone III and Carlyle Partners IV Will Acquire as a Result of Proposed Investment in Kinder Morgan, Inc.* (referring to the Section 854 Application at issue here).

Though we acknowledge Indicated Shippers' claim that the potential refund liability is closer to $500 million if refunds due at FERC are included, our concern is with those amounts, if any, that represent a component of jurisdictional intrastate rates. Shippers must pursue their interstate claims at FERC.

3.3.4. Acknowledgment of Conditions

Consistent with past practice, we require the Knight Holdco Board of Managers to acknowledge the conditions upon our authorization of the transfer of control.[26] Similarly, we also require the Boards of Directors or the equivalent authority of KMI, Kinder Morgan (Delaware), KMGPI, KMR, KMEP, OLP-D, Kinder Morgan Pipeline, and any other currently existing intermediate entity to submit written acknowledgment of these conditions. Though different in form from the holding company organizations that led to the major restructuring of energy utilities beginning in the 1980s, the transaction by which KMI will be taken private is significant and warrants this formality.

3.4. CEQA

Under CEQA, we must consider the environmental consequences of projects that are subject to our discretionary approval and may have an impact upon the environment. (Pub. Resources Code §§ 21065, 21080.) It is possible that a change of ownership and/or control may alter an approved project, result in new projects, or change facility operations, etc. in ways that have an environmental impact.

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[26] See for example D.96-11-017, 1996 Cal. PUC LEXIS 1141 *77.

Section 854 Applicants affirmatively state in the Section 854 Application and Amendment to it that the proposed change in control of KMI will not result in any change in the "public utility operations or related activities or in any additional construction" for either SFPP or Calnev. (Section 854 Application at 14; Amendment at 2.) Indicated Shipper's claim that this proves that Calnev does not intend to pursue what they represent to be a needed pipeline extension from Barstow to Las Vegas, but their claim has nothing to do with CEQA.

We base our analysis on the following. One, the Barstow extension is not a reasonably foreseeable impact of approval of the Section 854 Application, but at this time remains a speculative future undertaking. Two, all review required under CEQA will occur in conjunction with future applications for all permits necessary to undertake the intrastate portion of such construction.

After review, we agree that the proposed transfer of control does not raise issues which will give rise to physical, operational changes that could affect the environment. Because the pipeline utilities will be operated as previously authorized by this Commission, the Section 854 Application is not a project pursuant to Pub. Resources Code § 21065, and furthermore, assuming arguendo that the proposed project is a project under CEQA, the proposed project qualifies for an exemption from CEQA pursuant to § 15061(b)(3) of the CEQA guidelines and the Commission need perform no further environmental review. (See CEQA Guidelines § 15061(b)(3).)

4. Request for Section 852 Exemption

4.1. Description of Proposed Exemption

Section 852 Applicants, Goldman Sachs, AIG, Carlyle Partners IV, and Carlyle/Riverstone III, seek an exemption from Section 852 for themselves and all of their affiliates, concurrent with approval of the Section 854 Application.[27] These entities concede that "[r]ead literally, Section 852 requires entities affiliated with California public utilities to seek approval from the Commission before purchasing any stock of another California public utility. (Section 852 Application at 3.) However, they state that imposing this pre-approval requirement on them for subsequent acquisitions that do not result in a controlling interest of a California public utility would be burdensome and contrary to statutory intent, and would "compromise the ability of California public utilities to access the capital markets by limiting the ability of significant "market makers" to acquire their shares." (*Id.* at 2-3.) Section 852 Applicant's opening brief expands upon their concern:

> As part of their normal course of business, these companies regularly acquire capital stock in a multitude of companies,

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[27] Section 852 provides in relevant part:

> No public utility, and **no subsidiary or affiliate of, or corporation holding a controlling interest in, a public utility, shall purchase or acquire, take or hold, any part of the capital stock of any other public utility**, organized or existing under or by virtue of the laws of this state, without having been first authorized to do so by the commission; provided, however, that the commission may establish by order or rule categories of stock acquisitions which it determines will not be harmful to the public interest, and purchases within those categories are exempt from this section …
> (Section 852, Emphasis added.)

> including some California public utilities. If they are required to obtain prior Commission approval for such routine, non-controlling stock acquisition, their operations and the marketplace for buying and selling shares of California public utilities will both be disrupted to no public benefit. (Joint Applicants' Opening Brief at 24.)

For the purposes of the exemption they seek, Section 852 Applicants define "affiliates" to mean "entities controlled by or under common control" with Goldman Sachs, AIG, TC Group (which indirectly owns and controls the general partner of Carlyle Partners IV and indirectly holds a joint venture interest in the general partner of Carlyle/Riverstone III), and Riverstone Holdings (which is affiliated with the general partner that controls Carlyle/Riverstone III). (*Id.* at 7.) Joint Applicants do not seek an exemption from Section 854, acknowledging "that any future acquisition of shares of a California utility that constitutes a change of control in such utility would require the prior approval of the Commission …" (*Ibid.*)

4.2. Discussion

The Scoping Memo identifies the following issues as central to determination of the Section 852 Application:

- If the Commission were to grant the Section 852 exemption, how might it define "control" for purposes of future transactions, given the lack of a bright line definition in prior Commission decisions? Should an exemption be conditioned upon some kind of notice or report to the Commission if exempted transactions occur?
- Should a Section 852 exemption be granted to a financial institution which already holds a controlling interest in another California utility or which is an affiliate of an entity with a controlling interest?

As Section 852 Applicants concede, the Commission has not adopted a definition of control for the purposes of Section 852 (or for Section 854, which uses identical language – "holding a controlling interest in"), but has relied upon a fact specific, case-by-case analysis. While many Commission decisions focus upon whether an entity, directly or indirectly, possesses the power to direct or cause the direction of the management and policies of a corporation, or has the ability to exercise control, other cases focus on evidence of working or actual control.[28]

Joint Application of San Jose Water and SJW Corp. (see footnote 28) evidences the Commission's awareness and concern that repeated purchases of non-controlling acquisitions of stock, made under authority of Section 852, over time may give rise to a controlling interest. The

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[28] See respectively, *Gale v. Teel*, D.87478**,** 81 CPUC 817, 1977 Cal. PUC LEXIS 152 [definition of control in Corp. Code 160(a) instructive for purposes of Section 854 and given facts, warranted voiding acquisition of 50% of stock in a public utility organized as a closely-held corporation by purchaser who failed to obtain Commission approval prior to purchase – power to cause direction of management and policies evidenced by purchaser's actions in ceasing utility operations, placing utility in receivership, and seeking dissolution]; *Application of Wild Goose Storage,* D.03-06-069, 1994 Cal. PUC LEXIS 43 [Commission fined EnCana for acquiring Wild Goose at the holding company level without first seeking Commission authority, finding that EnCana had the ability to control Wild Goose and intermediaries in the corporate structure and rejecting Wild Goose's contention that absent a change of intermediary management, no change of control had occurred]; *Joint Application of San Jose Water and SJW Corp*., D.94-01-025, 1994 Cal. PUC LEXIS 43, [actual or working control determinative and thus San Jose Water's holding company parent, SJW, which already owned a 9.75% interest in California Water Service (CWS), authorized to purchase additional shares to avoid dilution of that non-controlling ownership interest, but authorization limited to five years to ensure no change of control under Section 854.]

Commission conditioned its Section 852 approval in that decision as follows:

> While we accept SJW Corp.'s statement that should its ownership interest in CWS ever approach control, it will abide by PU Code § 854 before acquiring additional shares, we believe it prudent to limit our present authorization to SJW Corp. to participate in the CWS Dividend Reinvestment Plan to a period of five years, after which we would consider, after opportunity to review the CWS shareholder makeup and the "control" issue at that time, an extension. (1994 Cal PUC LEXIS 43 *8.)

Prior to the 1989 amendment that gave rise to existing law, Section 852 applied only to stock acquisitions by a public utility -- not its holding company, subsidiaries or affiliates. Though no party discusses the legislative history, our own research reveals that existing law arose out of events underlying the then-pending merger of SDG&E and Southern California Edison Company (SCE). SCE's holding company parent, known at that time as SCE Corp., and certain officers of the holding company had acquired stock in SDG&E in order to launch a proxy fight over the previously announced merger of SDG&E and Tucson Electric Company. SCE Corp. and its officers claimed that no Commission approval was needed, since none of them were public utilities. The Commission's Enrolled Bill Report urges the governor to sign Senate Bill (SB) 53, which the Legislature passed in 1989 in order to amend Section 852. The Enrolled Bill Reports states:

> It is obviously important, given recent experiences for the PUC to have the statutory ability to deal with non-utility purchases of a public utility's stock which seek to endanger that utility's financial health or quality of service. SB 53 expands the reach of Sec. 852 of the Pubic Utilities Code to cover <u>any</u> capital stock acquisition by a public utility's

> subsidiary, affiliate or holding company. Not only is this a desirable revision for protecting against predatory behavior by these affiliate entities, but it also imposes a prohibition against stock purchases which may be entirely benign – such as long-term purchase of public utility stock for the pension fund of the holding company of a different public utility.
>
> ….
>
> In response to the concern, the author amended the bill to allow the PUC to establish categories of minor stock acquisitions which would be exempted from the PUC approval requirement. (Enrolled Bill Report, August 29, 1989, Wes Franklin to Governor's Office, emphasis in original.)

Working with DRA, Section 852 Applicants have moved away from their initial request for an absolute, unconditioned exemption from Section 852. These parties have attempted to fashion a workable means of permitting at least some of the financial institutions and their affiliates to continue to make benign, passive stock acquisitions and still provide the Commission with a means to monitor potentially significant changes in market ownership. Their proposal is not complete, since it only covers Goldman Sachs and AIG; they were unable to reach agreement as to Carlyle/Riverstone III and Carlyle Partners IV. As summarized above at footnote 8, Carlyle/Riverstone III and its affiliated fund, Carlyle/Riverstone II, own 80% of Wild Goose by authority of D.06-11-019. Their affiliate Carlyle Partners IV has no ownership in Wild Goose.

Before addressing whether an exemption should extend to the Carlyle entities, we first examine the components of the agreement, entitled "Section 852 Exemption Terms," presented to us by Section 852 Applicants and DRA and made Attachment 4 to today's decision. The agreement provides for an exemption for all "Covered Entities." The parties agree that this term should be defined to mean Goldman Sachs and

AIG (Section 852 Applicants argue the definition also should include Carlyle/Riverstone III and Carlyle Partners IV) and to all entities: (1) these financial institutions control; (2) which control them; (3) which together they control; and (4) those with which they are under joint control. The agreement requires a list of all Covered Entities to be produced to the Commission, requires the list to be updated semi-annually, requires an officer to verify accuracy, and recognizes the authority of the Commission (including DRA) to conduct discovery to verify the list. The agreement also provides for a semi-annual report to the Commission's Energy Division and to DRA of "Reportable Holdings," defined to mean those which "include a 5% or greater voting stake in any California public utility or its holding company in the Energy Sector, and, if reportable, must specify the percentage and name of the California utility or its holding company." Finally, the agreement recognizes the right of the Commission to modify the exemption after notice and an opportunity for hearing.

This final provision and some of the discovery provisions essentially restate existing law or established Commission practice. Given the sophistication of the parties involved, we interpret these statements as acknowledgment of the same and do not interpret them to suggest that new territory has been charted. The other provisions, however, indicate a thoughtful effort to resolve a difficult subject in a way that reasonably balances private and public interests by means of carefully-fashioned regulatory safeguards.

In particular, we note that "Reportable Interests" for each financial institution and its applicable affiliates must be disclosed both as an

aggregate amount and as the separate contributions of each Covered Entity toward the aggregate. Likewise, the 5% voting stake threshold appears to be set low enough to capture potentially meaningful participation levels.[29] We are mindful that creative use of business organization forms (such as master limited partnerships and limited liability companies) can maximize voting power to place effective control in the hands of those with comparatively small stock holdings. As we have seen already, KMI has effective control over SFPP and Calnev though its equity ownership is only 15%.

This issue obliges us to comment on the reliance Joint Applicants' reply brief places upon language in D.06-11-019, the recent Wild Goose decision, that discusses the Section 852 exemption requested and authorized in that proceeding. Aware that Carlyle/Riverstone III and Carlyle Partners IV intended to participate in the Section 854 Application at issue here, the Wild Goose Joint Applicants recognized that if the Commission authorized Carlyle/Riverstone II and Carlyle/Riverstone III to acquire Wild Goose, then Carlyle/Riverstone III and Carlyle Partners IV immediately would become subject to Section 852. Therefore, the Wild Goose Joint Applicants asked for a narrow, transaction-specific exemption under Section 852 so that these entities would not have to seek approval to

[29] Five percent is the threshold for the definition of "affiliate" in the most recent Affiliate Transaction Rules, referenced in section 3 of today's decision, and in the earlier version (still applicable to smaller California electric and natural gas utilities) adopted by D.97-12-088, 1997 Cal. PUC LEXIS 1139, as modified by D.98-08-035, 1998 Cal. PUC LEXIS 594. Though the transactional and reporting Rules do not apply to SFPP or Calnev, the definition there merits mention since the objective of both frameworks is a common one – meaningful compliance.

participate in the Knight Holdco deal. In referring to Carlyle/Riverstone III and Carlyle Partners IV, D.06-11-019 states:

> … their respective minority acquisitions constitute no more than a 12.5% interest in KMI by each (or 25%, combined), which translates into a much smaller indirect interest in SFPP and CALNEV.[20]
>
> [20] Carlyle/Riverstone III will have an interest of approximately 1.9% in each of SFPP and CALNEV. This investment appears to be far too small to provide indirect control over either pipeline utility. (D.06-11-019 at 24-25 and footnote 20.)[30]

The related Finding 17, in relevant part states: "The KMI investment by Carlyle/Riverstone III and Carlyle Partners IV is too small to give them or their affiliates indirect control over SFPP or Calnev. (*Id*. at 31.)

We now question this finding. While it may be technically accurate, it appears to rely upon a simplistic and perhaps inaccurate assessment of the means by which control actually is exercised over the pipeline utilities. As the record in this consolidated docket clearly shows, KMI's effective control at present is attributable to its general partner interest (KMGPI), not its equity ownership. Thus, D.06-11-019's focus on further apportioning the proportional equity interests of Carlyle/Riverstone III and Carlyle Partners IV in Knight Holdco/KMI into the resulting equity interests in SFPP and Calnev appears to be misplaced. We will have an opportunity to examine whether we should correct this finding when we decide the pending Petition to Modify D.06-11-019 filed March 2, 2007 by

[30] According to the evidence before us in A.06-09-016 et al., the interests of Carlyle/Riverstone III and Carlyle Partners IV in Knight Holdco has been reduced from 12.5% each to 11.11% each.

the Wild Goose Joint Applicants, which asks us to revise reporting conditions ordered in that decision. In a companion filing on the same date, Petition to Modify D.02-07-036, the Wild Goose Joint Applicants seek revision of reporting conditions ordered in the decision authorizing Wild Goose to expand its storage facilities.

Because some of the reporting requirements ordered by D.02-07-036 and D.06-11-019 affect Carlyle/Riverstone III and Carlyle Partners IV and their affiliates, the petitions to modify these decisions also overlap substantively with the Section 852 Application's exemption request. Specifically, to the extent that the reporting requirements ordered by D.02-07-036 and D.06-11-019 encompass non-controlling stock acquisitions by Carlyle/Riverstone III and Carlyle Partners IV (and their affiliates) in California utilities, granting them a Section 852 exemption in whole or in part would effectively modify D.02-07-036 and D.06-11-019. For example, as one of the reasons they seek modification of D.02-07-036, Wild Goose Joint Applicants argue that the decision's Ordering Paragraph 3 "could be interpreted to mean that its reporting requirements extend to non-controlling, passive investments …" (March 2, 2007 Petition at 8.) D.06-11-019 requires the continued application of the reporting requirements ordered by D.02-07-036, and orders some additional ones.

Since the petitions were not served on the service list for A.06-09-016 et al. and since the Section 852 Application was not served on the service lists for the petitions, notice is defective. Section 1708 requires notice and

opportunity to be heard before the Commission may modify a prior decision.[31] DRA makes this point in its reply brief.

The procedural deficiency leaves us with two courses of action now. We could delay the issuance of today's decision, take action to accomplish effective notice, and then resolve the Section 852 and related reporting issues for the Carlyle entities in this docket, ideally with concurrent resolution of the two petitions in a separate decision or decisions. However, we are mindful that Joint Applicants repeatedly have asked us to resolve this consolidated docket (A.06-09-016 et al.) as quickly as practicable so as to end market uncertainty about the transfer of control. Therefore, we think the preferable course, which we follow today, is to issue an interim decision in A.06-09-016 et al. on all issues except the request for a Section 852 exemption for Carlyle/Riverstone III, Carlyle Partners IV and associated Carlyle entities. We defer this issue to a subsequent decision, which we expect to issue concurrently with a decision or decisions on the petitions. Since the same ALJ is assigned to all, coordination is assured.

With respect to Goldman Sachs and AIG, however, we find that the agreement between Section 852 Applicants and DRA provides reasonable terms for an exemption from Section 852, and thus, is not adverse to the public interest. We grant the exemption as set forth in the Ordering Paragraphs. Section 852 Applicants state that they are aware that no exemption can alter their statutory obligation to gain the Commission's

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[31] Section 1708 provides in relevant part: "The commission may at any time, upon notice to the parties, and with opportunity to be heard as provided in the

Footnote continued on next page

approval under Section 854 before acquiring direct or indirect control of a California utility. We expect Goldman Sachs and AIG to comply. We emphasize that concerted action between Goldman Sachs and AIG, between either of them and Carlye/Riverstone III, or between either of them and Carlyle Partners IV, that effectively results in a change of control over SFPP, Calnev or any other California public utility not only risks this Section 852 exemption but is void under Section 854.

5. Procedural History and Miscellaneous Procedural Matters

Applicants filed A.06-09-016 on September 18, 2006 and A.06-09-021, on September 22, 2006. On October 23, 2006, Indicated Shippers filed a Protest to A.06-09-016, which among other things sought consolidation of the Section 854 Application with C.97-04-024 et al., in which Indicated Shippers and other pipeline customers seek rate refunds from the pipeline utilities. Section 854 Applicants filed a Reply on November 2, 2006. At the prehearing conference held on January 10, 2007, the ALJ determined that consolidation with C.97-04-024 et al. was neither necessary to fair resolution of either docket, nor administratively efficient, and she denied the request. However, the ALJ determined, and the parties concurred, that A.06-09-016 and A.06-09-021 should be consolidated in a single docket for hearings, as necessary, and for decision. Section 854 Applicants filed an Amendment to Application on January 23, 2007 (to remedy certain inadvertent omissions discussed at the PHC) and the Assigned Commissioner's Scoping Memo issued on January 23, 2007.

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case of complaints, rescind, alter, or amend any order or decision made by it."

By separate motions filed respectively on January 19 and January 25, 2007, CFC and ConocoPhillips requested party status; their motions were granted by ALJ ruling on February 1, 2007.[32] Evidentiary hearing followed on February 21-13, 2007. The parties filed briefs on March 19 and reply briefs on April 2, 2007, whereupon this consolidated docket was submitted for decision. On April 10, 2007 the Commission held oral argument pursuant to Section 1701.3(d). By ruling on March 9, 2007 the ALJ set aside submission to receive "late-filed" Ex. 13-19 in evidence and then resubmitted this consolidated docket. As noted in footnotes 7 and 11, above, we reopened the record to accept "late-filed" Ex. 20-21 and Ex. 126 in evidence and then resubmitted this docket. See Section 6 of today's decision for resolution of all motions outstanding at the time we mailed the ALJ's proposed decision for comment.

Regarding categorization and other preliminary determinations we note the following: by Resolution ALJ 176-3180 the Commission preliminarily categorized both Applications as ratesetting, and preliminarily determined that hearings were not necessary. The scoping memo confirmed the categorization but changed the "no hearing" designation and the Commission confirmed the change in Resolution ALJ-199.

[32] Though tendered for filing before the Scoping Memo issued (and ultimately filed on the date received by the Docket Office), minor technical problems with CFC's motion delayed its processing.

6. Resolution of Outstanding Motions

We deny each of the motions listed below. Having reached the merits in today's decision, each motion is now moot.

- January 30, 2007 *Motion to the Commission for Immediate Issuance of Interim Order Authorizing Transfer of Control and Related Section 852 Exemption* (filed by Joint Applicants);
- February 2, 2007 *Conditional Motion to Grant Transfer by KMI on or Before March 1, 2007 with Appropriate Conditions Accepted by Applicants, Owners and All Affiliates* (filed by Indicated Shippers); and
- February 22, 2007 *Motion of the Consumer Federation of California to Dismiss the Application of the Goldman Sachs Group, Inc., American International Group, Inc., Carlyle Partners IV, L.P., and Carlyle/Riverstone Global Energy and Power Fund III, LP*.

7. 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 Rule 14.2(a) of the Commission's Rules of Practice and Procedure.

We received comments and reply comments as follows: comments, filed May 9, 2007, by ConocoPhillips, May 11 by CFC, and May 14 by Indicated Shippers and Joint Applicants; reply comments filed May 21, 2007 by each of these parties and DRA. In addition, on May 18, 2007 Indicated Shippers filed a *Motion to Reopen the Record* and Joint and Joint Applicants filed their opposition the same day. After review of all of these pleadings, we make only minor changes to the proposed decision. We also correct typographical and other clerical errors and omissions.

May 18 Motion: We deny Indicated Shippers' motion, which proposes that we reopen the record to receive in evidence the prepared testimony of bankruptcy counsel on the need for a letter of credit, the

terms such a document should include, and a recommended procedure for conducting payment to Shippers of any rate refunds ordered in C.97-04-024 et al. We conclude that the prepared testimony, which essentially expands upon Shippers' already expressed views, is not necessary to the record at this late stage of the proceeding nor is it particularly helpful. We see no reason to reopen the record to take further evidence on these matters since the comments and reply comments, relying on the current record, are sufficient to cause us to further weigh our order and fashion some minor revisions.

Payment of Potential Rate Refunds: We revise the proposed decision, in including text in Section 3.3.3, to require Joint Applicants to obtain a letter of credit sufficient to guarantee rate refunds of $100 million, which all parties agree is the maximum, if any, which may be found owing in C.97-04-024 et al. Indicated Shippers have persuaded us that cash reserves are insufficiently reliable and Joint Applicants, moreover, clearly indicate that they prefer to have more flexible use of SFPP's revenues. We decline to accept Joint Applicants' preference that we recognize a debt guarantee letter from a national bank in lieu of more liquid collateral. Section 854 Applicants proposed that in their case in chief, and the proposed decision rejected it, finding that the record contained unrebutted, underlying questions about the balance between SFPP's assets and outstanding liabilities, and whether its borrowing capacity actually can close the acknowledged deficit.

Filing of California Complement to FERC Form 6, Page 700: We agree with Shippers that the proposed decision should be revised to require that SFPP and Calnev file with the Commission, annually, cost of

service, volume, and revenue data for the California intrastate market. That data is used to calculate the aggregate data filed as Page 700 of FERC Form 6 but is not reported publicly there nor anywhere else. The information is necessary to ongoing regulatory oversight and is an important input to the test year 2009 rate case application today's decision orders. We require the utilities to begin making the California filings concurrently with the first FERC Form 6 filed following the effective date of today's decision.

Non-Consolidation Opinion: We clarify that concurrently with the effective date of any future structural change in business form and organization above the utility tier, SFPP and Calnev shall submit an additional non-consolidation opinion.

Compliance with Section 816 et seq.: To ensure that no confusion exists, we reiterate that SFPP and Calnev shall continue to be bound by the statutory mandates of Section 816 et seq., which govern a utility's indebtedness for utility purposes, as well as Section 851, where required.

8. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Jean Vieth is the presiding officer and assigned ALJ in this proceeding.

Findings of Fact

1. The jurisdictional portions of SFPP and Calnev are public utility pipelines which serve as common carriers of refined petroleum products, such as gasoline, diesel fuel, and jet fuel.

2. The Section 854 Application requests Commission approval of a transfer of control over Calnev from KMI to Knight Holdco; KMI, not KMEP, is the applicant.

3. There is no evidence that the A.00-12-004 proponents intended to mislead the Commission about the relationship between KMI and KMEP nor that any harm has befallen the public interest as a result of the failure to expressly seek authorization in A.00-12-004 for the transfer of Calnev to KMI, as well as to KMEP.

4. KMI owns a minority equity interest, approximately 15.2%, in KMEP and in addition, the general partner interest of KMEP. 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 KMR, 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.

5. Knight Holdco is a private limited liability company formed under Delaware law. Upon the closing of the proposed management buy-out of KMI, Knight Holdco will be owned by the investors: KMI Management Group – 36.63%; Goldman Sachs -25.14%; AIG – 16.02%; Carlyle Partners IV – 11.11%; and Carlyle/Riverstone III – 11.11%.

6. Goldman Sachs, AIG, Carlyle Partners IV and Carlyle/Riverstone III are investment banks, diversified financial services providers, or private equity funds engaged in a broad range of financial activities that may involve acquiring securities in the ordinary course of their business.

7. Carlyle/Riverstone III, together with an affiliate, Carlyle/Riverstone II, and SemGroup (in which they have an interest), have an 80% ownership

interest and control over Wild Goose Storage. Carlyle Partners IV has no ownership interest in Wild Goose Storage.

8. The proposed acquisition of KMI would result in the transfer of KMI from public to private ownership and the transfer of direct and indirect control to Knight Holdco, of all of KMI's subsidiaries and business interests, including SFPP and Calnev.

9. Ex. 11, the December 11, 2006 commitment letter by which Goldman Sachs and other lenders (Citigroup Global Markets Inc., Deutsche Bank Securities Inc., Wachovia Capital Markets, LLC and Merrill Lynch Capital Corporation) agree to provide $17.2 billion of the necessary financing for the management buy out, includes a statement of the rationale for the transaction.

10. Knight Holdco will have an 11-member Board of Managers. Richard Kinder will be entitled to designate four members and the four financial institutions will be entitled to six, with Knight Holdco's Chief Executive Officer (Kinder) serving as the eleventh member. Thus, Kinder will control five of the eleven members of the Board of Managers, at least initially. The "expected allocation" of the other six seats is: Goldman Sachs - 2, AIG - 2, Carlyle Partners IV – 1, and Carlyle/Riverstone III – 1.

11. Richard Kinder will not only be Knight Holdco's CEO, but also Chief Manager of the Board of Managers. He can be removed as Chief Manager for cause or for failure to meet the business plan's financial performance targets by at least 90%. The targets for each of the five years from 2006 (approximately $1.1 billion) to 2010 (approximately $2.0 billion), increase by roughly $200 million from year-to-year, nearly doubling from 2006 to 2010.

12. The boards of directors of KMEP, KMGPI and KMR are identical -- each board consists of the same five individuals; Kinder needs the vote of only one of the "outside" directors for a majority.

13. KMI projections of pipeline revenue increases of 4% to 4½% per year cannot be obtained through an increase in volumes alone.

14. If shippers do not agree in advance to a KMEP-specified rate increase on the proposed expansion between Colton and Las Vegas as a condition of construction, KMEP may oppose building it.

15. KMEP's partnership agreement requires that it distribute 100% of "Available Cash," as defined in the partnership agreement, to its partners within 45 days following the end of each calendar quarter in accordance with their respective percentage interests.

16. KMEP pays out more cash than it earns in income, partially funding distributions by "regularly" borrowing money; no actual reserves have been established for potential pipeline rate refunds. The cash flow from SFPP and Calnev (about $250 million annually) constitutes a substantial portion of the cash distributed to KMEP. KMI received approximately 42% of all quarterly cash distributions in 2005 in its role as general partner and 9% in its role as a limited partner, for a total of 51%.

17. Both Standard & Poor's and Fitch have downgraded KMI's ratings to B+ and KMEP's ratings to BBB. Moody's has announced it also is likely to issue downgrades.

18. In response to the credit agencies' concern about increased bankruptcy risk, KMEP plans to create an independent investor in KMGPI (that is, an investor with no interest in Knight Holdco). The sole power of this new general partner interest will be to hold veto power over any

determination to place KMEP and its subsidiaries, including SFPP and Calnev, into bankruptcy. The position has not been established yet, nor has it been determined what percentage of the general partner interest will be sold, nor what the price will be, though the "expectation" is that the interest will sell for "$100 million." Joint Applicants represent that both the KMGPI Articles of Incorporation and the Bylaws will be amended to create this new general partner interest.

19. The record does not establish that Knight Holdco and its investors cannot influence the management and operations of KMEP's subsidiaries, including the bankrupting of them. The notion that KMI would wish to force the pipeline utilities into bankruptcy to escape rate refund liability and therefore forgo $250 million or more in annual revenues does not appear logical, but unanticipated future liabilities, such as those attributable to environmental disasters, could make recourse to bankruptcy a preferred economic option.

20. Joint Applicants have not explained persuasively how a new minority interest in KMGPI will effectively prevent the bankruptcy of SFPP or Calnev.

21. The Knight Holdco Limited Liability Company Agreement is an unexecuted document that will not be executed until the transaction has been fully approved.

22. SFPP and Calnev are the primary common carriers of refined petroleum products in California. Several private pipelines also exist, and transportation by ship/barge along the coast and by truck elsewhere provides some limited competition for SFPP and Calnev.

23. The KMI business organization is complex and not wholly transparent; these problems will increase post-transaction, with a private Knight Holdco at the head.

24. The KMI business organization is heavily debt laden at present and will carry increased debt post-transaction.

25. The record is unclear about the respective, legally binding powers of KMGPI and KMR, among others.

26. Because of the high reliance upon regular cash infusions from the pipeline utilities, impetus exists at every level within the KMI organization to maximize the distributions from SFPP and Calnev and send them upward. Post-transaction no change is contemplated.

27. SFPP and Calnev should each file a general rate application for test year 2009 to ensure realization of Section 854 Applicants' commitment not to pass any costs associated with the proposed transaction into future rates on SFPP or Calnev. Beginning with the filing by SFPP and Calnev of every FERC Form 6 filed after the effective date of today's decision, the utilities should submit to this Commission and make part of every rate change application filed here, a public document that discloses, in a format substantively equivalent to Page 700 of FERC Form 6, cost of service, volume, and revenue data for the California intrastate market.

28. Section 854 Applicants concede the Commission's jurisdiction to demand the production of such documents that we consider cognate and germane to our regulation of the pipelines, whether these documents are held at the pipeline or holding company level and our jurisdiction to order production to shippers.

29. The Commission also requires access to the books and records of Kinder Morgan Pipeline, OLP-D, KMEP, KMGPI, KMR, Kinder Morgan (Delaware), and KMI – entities which now hold – and will continue to hold – various degrees of authority over either the management and operation of the pipelines or the dispersal upward in the organization of the substantial revenues they generate. The Commission also requires access to officers and employees of Kinder Morgan Pipeline, OLP-D, KMEP, KMGPI, KMR, Kinder Morgan (Delaware), KMI, and Knight Holdco to testify concerning SFPP or Calnev, whether in Commission proceedings or otherwise.

30. Section 854 Applicants have not fully rebutted Shipper's claims that SFPP's borrowing capacity will be insufficient to enable it to discharge all near-term liability, including intrastate and interstate rate refunds.

31. Funding past overcharges by a credit on future rates is not a sound method for paying rate refunds, if any are ordered. Not only might such refunds fail to reach those Shippers due them, but use of this method potentially could reduce the monies available for ongoing maintenance and safety.

32. In order to ensure compliance with a future Commission order in C.97-04-024 et al. for intrastate rate refunds, if any, SFPP and its owners should obtain a letter of credit for $100 million from a national bank. The letter of credit should be designed, in form and in substance, to convey the direct obligation of the bank to any Shippers entitled to refunds, notwithstanding the insolvency or credit risk of the entity or entities legally responsible for repayment of the letter of credit. No costs

associated with the letter of credit should be recovered in future rates charged to pipeline customers.

33. It is reasonable to require the Knight Holdco Board of Managers and the Boards of Directors or the equivalent authority of KMI, Kinder Morgan (Delaware), KMGPI, KMR, KMEP, OLP-D, and Kinder Morgan Pipeline to acknowledge the conditions upon our authorization of the transfer of control. The transaction by which KMI will be taken private is significant and warrants this formality.

34. The conditions we impose on the transfer of control are designed to ensure the Commission's ongoing ability to discharge its jurisdictional obligations to monitor the continued ability of SFPP and Calnev to meet their obligation to serve through reasonable rates, terms and conditions of service and to operate in an environmentally safe manner in this state. Absent these conditions, we cannot find that the proposed transfer of control is not adverse to the public interest.

35. The Barstow extension is not a reasonably foreseeable impact of approval of the Section 854 Application, but at this time remains a speculative future undertaking. All review required under CEQA will occur in conjunction with future applications for all permits necessary to undertake the intrastate portion of such construction.

36. It can be seen with reasonable certainty that the change of indirect control over SFPP and Calnev will not have a significant effect on the environment. This is the independent judgment of the Commission.

37. In developing Attachment 4 to today's decision, DRA and Section 852 Applicants have worked to fashion a workable means of permitting financial institutions and their affiliates to continue to make

benign, passive stock acquisitions and still provide the Commission with a means to monitor potentially significant changes in market ownership.

38. We should reexamine the need to correct or clarify Finding 17 and associated text in D.06-11-019 when we address the pending petition to modify that decision.

39. To the extent that the reporting requirements ordered by D.02-07-036 and D.06-11-019 encompass non-controlling stock acquisitions by Carlyle/Riverstone III and Carlyle Partners IV (and their affiliates) in California utilities, granting them a Section 852 exemption in whole or in part would effectively modify D.02-07-036 and D.06-11-019.

40. As the petitions to modify D.02-07-036 and D.06-11-019 were not served on the service list for A.06-09-016 et al. and the Section 852 Application was not served on the service lists for the petitions, notice is defective.

Conclusions of Law

1. D.01-03-074, the last change of control decision concerning Calnev, authorizes only KMEP to acquire Calnev.

2. Under the circumstances here, Joint Applicants should file a petition to modify D.01-03-074, to request clarification and correction of D.01-03-074 to extend the transfer of control of Calnev to KMI, in addition to KMEP.

3. The Commission has broad general and remedial regulatory authority under Sections 701 and 761 to do all things cognate and germane to its regulation of the public utilities subject to its jurisdiction. The conditions ordered in today's decision fall within that mandate.

4. Sections 816 et seq. (Article 5 "Stocks and Security Transactions) and in some instances, Section 851, prohibit a utility from incurring any indebtedness for utility purposes except as authorized therein.

5. If conditioned as described herein, the change of control over SFPP and Calnev may be approved under Section 854(a).

6. An exemption from the requirements of Section 852, limited by the terms of Attachment 4 to today's decision, should be granted to Goldman Sachs and AIG.

7. Section 1708 requires notice and opportunity to be heard before the Commission may modify a prior decision.

8. Determination of whether to grant any Section 852 exemption to Carlyle/Riverstone III and Carlyle Partners IV should be deferred.

9. The Section 854 Application is not a project pursuant to Pub. Resources Code § 21065, and furthermore, assuming arguendo that the proposed project is a project under CEQA, the proposed project qualifies for an exemption from CEQA pursuant to § 15061(b)(3) of the CEQA guidelines.

10. Before any further, future transfer of control of SFPP or Calnev may occur, the Commission must review and approve the transfer proposal under Section 854.

11. The following motions are moot and should be denied: January 30, 2007 *Motion to the Commission for Immediate Issuance of Interim Order Authorizing Transfer of Control and Related Section 852 Exemption* (filed by Joint Applicants); February 2, 2007 *Conditional Motion to Grant Transfer by KMI on or Before March 1, 2007 with Appropriate Conditions Accepted by Applicants, Owners and All Affiliates* (filed by Indicated Shippers); February 22, 2007 *Motion of the Consumer Federation of California to Dismiss*

the Application of the Goldman Sachs Group, Inc., American International Group, Inc., Carlyle Partners IV, L.P., and Carlyle/Riverstone Global Energy and Power Fund III; and May 18, 2007 *Motion of Indicated Shippers to Reopen the Record*.

12. The following motions should be granted: *Motion of the Goldman Sachs Group, Inc., American International Group, Inc., Carlyle Partners IV, L.P., Carlyle/Riverstone Global Energy and Power Fund III, L.P. to Place Knight HoldCo Ownership Information into the Record and for the Commission to take Judicial Notice of the SEC Filing Containing this Information*, filed February 20, 2007; and *Motion of Indicated Shippers to Reopen the Record*, filed April 17, 2007.

13. This order should be effective immediately so that Joint Applicants may determine whether to proceed with the transaction.

INTERIM ORDER

IT IS ORDERED that:

1. The transfer of control over SFPP, L.P (SFPP) and Calnev Pipe Line LLC (Calnev) under Public Utilities Code Section 854 from Kinder Morgan Inc. (KMI) to Knight Holdco, LLC (Knight Holdco) is approved, subject to full compliance with the conditions contained in Ordering Paragraphs 2-15, inclusive. Conditions contained in Ordering Paragraphs 2, 10, 12, 14, and 15 must be satisfied prior to consummating the transfer of control.

2. KMI and Kinder Morgan Energy Partners, L.P. (KMEP) shall file, within 45 days of the effective date of this decision, a petition to modify Decision (D.) 01-03-074 that requests clarification and correction of

D.01-03-074 to extend the transfer of control over Calnev to not only KMEP, as ordered therein, but also to KMI.

3. Within 12 months of the effective date of today's decision, SFPP and Calnev shall each file a test year 2009 general rate application with this Commission. The rate case applications shall request no recovery in utility rates for any cost (including any increase in the cost of KMEP's debt) associated with the transfer of control from KMI to Knight Holdco and shall document that no pass through has occurred or will occur in the future. Concurrently with the filing by SFPP and Calnev of every Federal Energy Regulatory Commission (FERC) Form 6 filed after the effective date of today's decision, SFPP and Calnev shall submit to the Director of the Commission's Energy Division a public document that discloses, in a format equivalent to Page 700 of FERC Form 6, cost of service, volume, and revenue data for the California intrastate market. The most current version of this document shall be included as a part of any rate change application filed with this Commission thereafter.

4. SFPP and Calnev each shall maintain books and records in accordance with the Uniform System of Accounts and Generally Accepted Accounting Principles.

5. Knight Holdco, KMI, Kinder Morgan (Delaware), Inc. (Kinder Morgan (Delaware)), Kinder Morgan G.P., Inc. (KMGPI), Kinder Morgan Management, LLC (KMR), KMEP, Operating L.P. "D" (OLP-D), and Kinder Morgan Pipeline LLC (Kinder Morgan Pipeline), including the successor of any of them, and any other intermediate entity, each shall maintain separate books and records.

6. Neither SFPP nor Calnev shall incur any indebtedness for utility purposes except as authorized by and in full compliance with Sections 816 et seq. (Article 5 "Stocks and Security Transactions) and as required, Section 851. Neither SFPP nor Calnev shall guarantee the notes, debentures or other obligations of any other entity (whether in the Knight Holdco business enterprise or otherwise) by pledge of assets or any other means, without first having obtained Commission authorization to do so.

7. If at some time post-acquisition by Knight Holdco, KMI (or any successor) no longer holds any publicly traded debt and therefore ceases to file 10-Q and 10-K reports with the United States Securities and Exchange Commission, Knight HoldCo (or any successor) shall submit annually to the Director of the Commission's Energy Division a report which provides a comprehensive overview of KMI (or any successor) for the past year and constitutes the substantive equivalent of Item 7 (Management's Discussion and Analysis of Financial Conditions and Results of Operations) and Item 8 (Financial Statements and Supplementary Data) of the 10-K report filed by KMI for the fiscal year ending December 31, 2006. The report shall be submitted within 90 days of the close of each calendar year in which no 10-K is filed. The report may be submitted under Public Utilities Code Section 583.

8. Knight Holdco (or any successor) shall submit a report to the Director of the Commission's Energy Division if the proportion of ownership in Knight Holdco (or its successor) held by the following investors (or their successors) changes from the proportion reported to the Commission in this proceeding: Goldman Sachs – 25.14%; AIG – 16.02%; Carlyle/Riverstone III – 11.11%; and Carlyle Partners IV – 11.11%. If any

additional persons or entities obtain ownership interests in Knight Holdco (or any successor), the report also shall include the name of each, the proportional interest acquired, and identifying information (e.g., business form, address of principal place of business; other contact information, description of business purpose and other holdings.) The report shall be submitted within 10 calendar days of the effective date of the change in ownership.

9. Knight Holdco (or any successor) shall submit to the Director of the Commission's Energy Division true and correct copies of the following documents within 10 calendar days of their execution or other authorization: (a) the final, post-transfer version of the Knight Holdco Limited Liability Company Agreement; and (b) the final, post-transfer version of KMGPI's Articles of Incorporation and Bylaws and the final, post-transfer version of any partnership agreement, limited liability agreement, or other document that constitutes a governing agreement, which provides for creation of a new interest in KMGPI, the general partner of KMEP, with power to veto placing KMEP and its subsidiaries, including SFPP and Calnev, into bankruptcy.

10. Knight Holdco shall submit to the Director of the Commission's Energy Division a report identifying and describing the auditable procedures put in place which effectively establish a firewall between SFPP and Calnev and any of the financial institution investors in Knight Holdco, including affiliates of the financial institutions, for the purpose of preventing affiliate abuses involving crude and refined product commodity trading operations. The report shall be submitted within 90

days of the effective date of today's decision and shall be supplemented upon revision of the auditable procedures.

11. The capital requirements of SFPP and Calnev, as determined by the Commission to be necessary and prudent to meet the obligation to serve or to operate each utility in a prudent and efficient manner, shall be given first priority by Kinder Morgan Pipeline, OLP-D, KMEP, KMGPI, KMR, Kinder Morgan (Delaware), KMI, Knight Holdco, and any successors of any of them, as well as any other intermediate entity, and by any Boards of Directors or other persons or entities now empowered or empowered after the effective date of this decision to own or exercise effective control over any of them.

12. Within 90 days of the effective date of today's decision, SFPP and Calnev shall obtain and submit to the Director of the Commission's Energy Division a non-consolidation opinion that demonstrates that the ring-fencing around SFPP and Calnev is sufficient to prevent either utility, at the time the non-consolidation opinion issues, from being pulled into the bankruptcy of Knight Holdco, KMI, Kinder Morgan (Delaware), KMGPI, KMR, KMEP, OLP-D, or Kinder Morgan Pipeline, or the successor of any of them, or any other intermediate entity. Concurrently with the effective date of any structural change in business form and organization above the utility tier, SFPP and Calnev shall obtain and submit to the Director of the Commission's Energy Division a further non-consolidation opinion that demonstrates that the ring fencing around SFPP and Calnev is sufficient to prevent either utility from being pulled into the bankruptcy of any entity above them in the business organization.

13. The books and records of Knight Holdco, KMI, Kinder Morgan (Delaware), KMGPI, KMR, KMEP, OLP-D, and Kinder Morgan Pipeline (including the successor of any of them), and any other intermediate entity, shall be made available to the Commission within the State of California upon request by the Commission, its employees or its agents. Requests for production made by the Commission's employees or agents shall be deemed presumptively valid, material and relevant. Any objections to such requests shall be timely raised before the administrative law judge or assigned commissioner to the proceeding in which such objections arise or before another administrative law judge or commissioner if the request is made outside of any pending proceeding. The party making such an objection shall demonstrate that the request is neither reasonably related to any issue within the Commission's jurisdiction nor reasonably calculated to result in the discovery of such material. The officers and employees of Knight Holdco, KMI, Kinder Morgan (Delaware), KMGPI, KMR, KMEP, OLP-D, and Kinder Morgan Pipeline (including the successor of any of them), and any other intermediate entity, shall be available to appear and testify in Commission proceedings concerning SFPP or Calnev as necessary or required.

14. Within 60 days of the effective date of today's decision, SFPP shall submit to the Director of the Commission's Energy Division and shall file as a "late-filed exhibit" in C.97-04-024 et al. a letter of credit from a national bank sufficient to pay potential California jurisdictional rate refunds of $100 million. The letter of credit shall be designed, in form and in substance, to convey the direct obligation of the bank to any Shippers entitled to refunds, notwithstanding the insolvency or credit risk of the

entity or entities legally responsible for repayment of the letter of credit. No costs associated with the letter of credit shall be recovered in future rates charged to pipeline customers.

15. Knight Holdco, KMI, Kinder Morgan (Delaware), KMGPI, KMR, KMEP, OLP-D, Kinder Morgan Pipeline, and any other currently existing intermediate entity whereby KMI exercises effective control over SFPP and/or Calnev, shall each submit a written notice to the Director of the Commission's Energy Division of their agreement, evidenced by a duly authenticated resolution of their respective Boards of Directors, Board of Managers, or the equivalent authority, to the conditions in Ordering Paragraphs 2 through 14, inclusive.

16. The Commission need perform no further environmental review under the California Environmental Act (CEQA) and CEQA Guidelines § 1506(b)(3).

17. The following motions are moot and should be denied: January 30, 2007 *Motion to the Commission for Immediate Issuance of Interim Order Authorizing Transfer of Control and Related Section 852 Exemption* (filed by Joint Applicants); February 2, 2007 *Conditional Motion to Grant Transfer by KMI on or Before March 1, 2007 with Appropriate Conditions Accepted by Applicants, Owners and All Affiliate* (filed by Indicated Shippers); February 22, 2007 *Motion of the Consumer Federation of California to Dismiss the Application of the Goldman Sachs Group, Inc., American International Group, Inc., Carlyle Partners IV, L.P., and Carlyle/Riverstone Global Energy and Power Fund III;* and May 18, 2007 *Motion of Indicated Shippers to Reopen the Record*.

18. The following motions are granted: *Motion of the Goldman Sachs Group, Inc., American International Group, Inc., Carlyle Partners IV, L.P.,*

Carlyle/Riverstone Global Energy and Power Fund III, L.P. to Place Knight HoldCo Ownership Information into the Record and for the Commission to take Judicial Notice of the SEC Filing Containing this Information, filed February 20, 2007; and *Motion of Indicated Shippers to Reopen the Record*, filed April 17, 2007.

19. Application 06-09-021 is granted, in part, to authorize an exemption from Public Utilities Code Section 852 for Goldman Sachs and American International Group, Inc., subject to all the conditions specified in the agreement entitled "Section 852 Exemptions" appended to this decision as Attachment 4.

20. No transfer of control of SFPP or Calnev or any other California public utility subject to the regulatory jurisdiction of the California Public Utilities Commission shall occur without approval of the Commission under Public Utilities Code Section 854.

21. Determination of whether to extend any exemption from Public Utilities Code Section 852 to Carlyle Partners IV and Carlyle/Riverstone Global Energy and Power Fund III is deferred to a subsequent decision.

22. The authority granted by Ordering Paragraph 1 shall continue for one year from the effective date and if not exercised by that time, shall expire.

This order is effective today.

Dated May 24, 2007, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG

TIMOTHY ALAN SIMON
Commissioners

I will file a concurrence.

/s/ JOHN A. BOHN
Commissioner

Concurrence of Commissioner Bohn on
SFPP & Calnev Change of Control

The standard traditionally applied under Section 854(a), requires that the Commission find that the transaction proposed is not "adverse to the public interest." Applicants, therefore, have the burden of proof to show that the proposed transaction does not adversely affect the public interest. The Commission in its deliberations then weighs the evidence and comes to a determination. I am not convinced that applicants in this case met their required burden of proof. The lack of transparency on the part of applicants in this proceeding is troubling and I expect this to be rectified in future proceedings. However, I concur in this decision because of the conditions imposed on the applicants.

The assigned administrative law judge, Jean Vieth, has written the most responsible decision that she could, given the scope of this proceeding, the record evidence presented, and prior Commission decisions approving transfers of ownership of the two public utilities at issue here. I feel obliged, however, to add some cautionary comments relative to this Commission's responsibility to assure that utilities under our jurisdiction are managed in the public interest. Both the direct customers of these utilities and the broader public have an interest in the sound operation of the subject utilities.

I am concerned that this Commission has not met its obligation to ensure that SFPP and Calnev remain viable utilities and is not adequately monitoring the operating and financial upkeep of these pipelines. Our

monitoring of these utilities has been minimal. We cannot tell from the record of this proceeding the state of the infrastructure, whether services have been reduced below acceptable standards, or whether these utilities have charged too much for the level of service provided. The existence of extensive refund claims in another proceeding is some evidence that there are, at least, service issues.

The Commission's seeming indifference to its regulation of SFPP and Calnev dates back to at least 1998. In D.98-01-0047, issued in January of 1998, the Commission approved Kinder Morgan Energy Partners' (KMEP) application pursuant to Public Utilities Code section 854 to acquire control of SFPP. In that decision the Commission performed what I perceive to be a cursory review of the application and approved it without conditions. The following year, in D.99-10-015, the Commission approved an application by KN Energy to acquire control of SFPP, again with little or no analysis as to how the transfer of ownership or the management thereof might affect the operations of the utility.

KMEP's acquisition of Calnev Pipeline Company was treated in the same cursory manner. In D.01-03-074 issued in March of 2001, the Commission approved Calnev's and KMEP's applications pursuant to sections 851 and 854 of the Public Utilities Code to change the ultimate corporate ownership of Calnev without examining whether the Commission should impose conditions to the transfer and how the transfer of ownership would affect the operations of Calnev.

This Commission is charged with the responsibility of fixing rates and terms of service for the intrastate portion of SFPP and Calnev. Therefore, we must be both cognizant of and sensitive to the way in which the operations of these utilities are conducted. Change of ownership, including taking the parent companies of the utilities private does not alter the duty of the owners and operators to serve the public, nor does it change this Commission's duty to regulate in the public interest. If there are insufficient earnings to provide for adequate safety, maintenance, or service at a reasonable price, or to remediate past inadequate performance, it is to this Commission that the utilities must come for permission to raise rates. Even though under the current structure, these utilities can raise rates within limits on their own motion, it should be clear to all parties that any such action remains subject to post facto reasonableness review.

For reasons shrouded in history, direct oversight of safety and maintenance of the intrastate aspects of oil pipelines has been assigned to the State Fire Marshall. Nevertheless, if there is a need for additional funding to meet maintenance or other operating requirements above that which is available from revenues, it is to this Commission that application must be made for relief. The Commission's concerns clearly extend to the financial integrity of SFPP and Calnev. If too much cash is upstreamed pursuant to contractual arrangements, then provision of adequate service at reasonable rates can negatively impacted. In the present case, we know that under current operations typically more cash is upstreamed from the utilities to the parent company than is earned from utility revenues, and

that the difference between upstream obligations and revenues is made up from borrowing. It is reasonable to inquire if continuation of such a practice is in the public interest. We also know that the credit ratings of the parent companies of SFPP and Calnev have been downgraded as a result of this proposed transaction.

This decision leaves uncomfortable loopholes which may put SFPP and Calnev at risk. There is $7.3 billion in new debt to be incurred as a result of this transaction, in part, one might suspect, in reliance of the regularity of utility returns. There is almost $400 million in inter company debt on the books of SFPP, the nature of which is not clear from the record of this proceeding. Nor do we yet have final documents setting forth the agreements contemplated to effect this transaction, and we must rely on the assurances of the parties as to what they will contain. Again and again, the bland representation was made by applicants that no changes in operations will occur as a result of this change of ownership. Yet there are admittedly new and aggressive articulated requirements for growth on earnings that must come from somewhere, and even a question whether an additional investment alluded to in the record will be made.

In order to assure ourselves that we have exercised our responsibility to make certain that these utilities are operated in the public interest, we need to verify that this Commission can reach the parties responsible for the operations of these utilities. Though there may be tax, management, financing or other reasons for the complex management structure set forth here, we must not shy away from ensuring that the

responsibility for operations of these utilities is fixed clearly on the appropriate parties who benefit from their operation and can responsibly respond to our regulation. Whether that obligation be direct or indirect, it must be clearly established that parties in charge of the operation and who benefit from its operations stand behind the utilities' duty to the public that they serve. Corporate convenience should not obscure regulatory responsibility.

After today's decision, we have, as Attachment 3 demonstrates, two regulated utilities with no employees. For Calnev, one has to travel up six layers of corporate structure to find an entity with any employees. For SFPP, there are a mere five layers of corporate structure between the utility and a holding company with any employees. And there are two additional layers of corporate structure before one reaches the parent company, Knight Holdco, LLC. Knight Holdco, in turn, is subject to the control of five groups of investors, Carlyle, AIG, Goldman Sachs, Carlyle/Riverstone and KMI Rollover Investors, some of whom buy and sell utility stock in the ordinary course of business. At the end of the day, however, it is clear that the complex ownership structure fixes control and direction of these utilities in the ownership group, Knight Holdco.

As a practical matter, I am concerned about how one regulates an entity with no employees and with the complex corporate structure that exists in this case. Who are we, the Commission, supposed to talk to in order to discuss issues regarding the operations and soundness of SFPP and Calnev? If "all available" cash generated by SFPP and Calnev flows

upstream as directed by the parent entity, how do we ensure that the public interest in the integrity and sound operation, as well as safety and other public concerns, are met? How do we prevent the parent company from using the cash capabilities of the utility to finance its debt needs or the utilities overborrowing to meet contractual needs? It is this Commission's responsibility to monitor and examine closely these issues. We need to ensure that the pipelines are not corroding, that appropriate safety standards are being met, and that the assets of the utilities are not hollowed-out, and the utilities, perhaps, ultimately driven into bankruptcy.

We have addressed some of these issues in today's decision. Others will be addressed in the ongoing consolidated rate refund cases pending before this Commission. The 2009 test year general rate case application that SFPP and Calnev are ordered to file within one year of the issuance of today's decision should permit us to effectively examine the operations of these utilities and make additional regulatory adjustments, as necessary.

Pursuant to Public Utilities Code section 761, we have the authority to order remedial action. We have a duty to ensure that SFPP and Calnev remain viable public utilities, provide adequate services, and are not at risk of being driven into bankruptcy, either as a result of future actions or as a result of past neglect. The fact that direct oversight of safety and maintenance may rest, for whatever reason, with the State Fire Marshall should not obscure the fact that remedial action, if required, comes at a cost to the ratepayers and only as a result of this Commission's authority.

For that reason we have an obligation to assure ourselves that we can ensure reasonable rates, terms, and environmentally sensitive conditions of service by these utilities.

Dated May 24, 2007, in San Francisco, California.

/s/ JOHN A. BOHN
Commissioner