20111216-4007 FERC PDF (Unofficial) 12/16/2011

137 FERC ¶ 61,220
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

SFPP, L.P. Docket Nos. IS08-390-004
IS08-390-006

OPINION NO. 511-A

ORDER ON REHEARING AND COMPLIANCE FILING

(Issued December 16, 2011)

20111216-4007 FERC PDF (Unofficial) 12/16/2011

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

SFPP, L.P. Docket Nos. IS08-390-004
IS08-390-006

OPINION NO. 511-A

APPEARANCES

Charles F. Caldwell, Esq., Andrea Halverson Harper, Esq., Michelle T. Boudreaux, Esq., Amy Hoff, Esq., Albert S. Tabor, Jr., Esq., Randy P. Parker, Esq., Daniel Sanborn, Esq., and Dean Leafler, Esq., on behalf of SFPP, LP.

Frederick G. Jauss IV, Esq., Beth Forsythe, Esq., and Timothy J. Koeppl, Esq., on behalf of ConocoPhillips.

George L. Weber, Esq., on behalf of Chevron Products Company.

Thomas J. Eastment, Esq., Gregory S. Wagner, Esq., Joshua B. Frank, Esq., Christina M. Vitale, Esq., Eunice B. Sutter, Esq., and Kevin J. Vaughan, Esq., for ExxonMobil Oil Corporation and BP West Coast Products, LLC.

Melvin Goldstein, Esq., Matthew Corcoran, Esq., and Barron W. Dowling, Esq., on behalf of Tesoro Marketing and Refining.

Steven A. Adducci, Esq., on behalf of Valero Marketing and Supply Company.

Richard E. Powers, Jr., Esq., and Christopher K. Diamond, Esq., for Continental Airlines, Inc., Northwest Airlines, Inc., Southwest Airlines, Inc., and US Airways, Inc.

Derek L. Anderson, Esq., and Debora E. Lyon, Esq., on behalf of the FERC Trial Staff.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

OPINION NO. 511-A

TABLE OF CONTENTS

Paragraph Numbers

OPINION NO. 511-A

137 FERC ¶ 61,220
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Jon Wellinghoff, Chairman;
Philip D. Moeller, John R. Norris,
and Cheryl A. LaFleur.

SFPP, L.P. Docket Nos. IS08-390-004
IS08-390-006

OPINION NO. 511-A

ORDER ON REHEARING AND COMPLIANCE FILING

(Issued December 16, 2011)

1. This order addresses requests for rehearing of Opinion No. 511 issued February 17, 2011 in Docket No. IS08-390-002.[1] Opinion No. 511 addressed briefs on and opposing exceptions to an Initial Decision issued on December 2, 2009 concerning a cost of service rate case filed by SFPP, L.P. (SFPP) for its West Line rates.[2] This order also addresses SFPP's April 25, 2011 compliance filing submitted in compliance with Opinion No. 511.[3]

---

[1] *SFPP, L.P.*, 134 FERC ¶ 61,121 (2011) (Opinion No. 511).

[2] *See SFPP, L.P.*, 129 FERC ¶ 63,020 (2009) (2009 ID).

[3] SFPP, L.P. April 25, 2011 Compliance Filing in Docket No. IS08-390-006 (Compliance Filing). On April 25, 2011, as replaced on May 16, 2011, SFPP filed tariffs for its West Line that reflect the revisions required by Opinion No. 511 and other corrections SFPP identified in its Compliance Filing. *See* SFPP, May 16, 2011, Tariff Filing, Docket No. IS11-338-000. On June 15, 2011, the Commission issued an order accepting the tariffs to be effective June 1, 2011, subject to refund and to the outcome of SFPP's cost of service Compliance Filing in Docket No. IS08-390-006. *See SFPP, L.P.* 135 FERC ¶ 61,235 (2011). The Commission noted that its conditional acceptance of the tariffs in Docket No. IS11-338-000 is subject to further order, and any additional process that may subsequently be required upon review of the Compliance Filing in Docket No. IS08-390-006. *Id.* P 8.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

2. The Commission affirms its prior findings regarding throughput, litigation costs, capital structure and the cost of capital (both debt and equity), and all income tax allowance issues except those related to the calculation of allowance for deferred income taxes (ADIT). As discussed below, the Commission generally denies the requests for rehearing regarding overhead cost allocation except regarding the assignment of certain costs to SFPP and the exclusion of the KM Canada Entities. The Commission also grants rehearing to require SFPP to recalculate its starting rate base write-up. The Commission grants rehearing on the issue of substantial divergence and requires SFPP to modify its indexing calculations. The Commission therefore directs SFPP to make a revised compliance filing consistent with these rulings and to recalculate the refunds due its shippers.

I. Background

3. On June 30, 2008, SFPP submitted, pursuant to 18 C.F.R. § 342.4(a), revised FERC Tariff Nos. 171 and 172 to reflect proposed cost of service rates which would result in a rate increase for all shipments on SFPP's West Line between Watson Station, Los Angeles County, California and Phoenix, Arizona. The proposed rates were protested by BP West Coast Products LLC and ExxonMobil Oil Corporation (together "ExxonMobil/BP"), Tesoro Refining and Marketing Company (Tesoro), ConocoPhillips Company, Continental Airlines, Inc., Northwest Airlines Inc., Southwest Airlines Co., US Airways, Inc., Chevron Products Company (Chevron), and Valero Marketing and Supply Company (together, the ACV Shippers). The protesting shippers alleged that SFPP failed to demonstrate a substantial divergence between SFPP's actual costs and its current ceiling rates such that the ceiling rates would preclude SFPP from being able to charge just and reasonable rates. The protesting parties raised numerous issues of material fact regarding SFPP's claimed actual costs and proposed rate levels.

4. SFPP supported its proposed rate increase arguing that the rate increase responds to a decline in volumes on SFPP's West Line that are a result of a corresponding increase in throughput to Phoenix from SFPP's East Line. SFPP calculated its West Line cost of service for the test period at $47,162,000. SFPP's test period revenue under its then-existing rates would have been $41,988,000, resulting in an under-recovery of approximately $5,174,000 or 12.3 percent. SFPP projected that the test period revenue under the proposed rates would be approximately $47,157,000. SFPP used calendar year 2007 as the base period for actual costs, revenue, and throughput data. SFPP used the first nine months of 2008 (January through September) for the test period to adjust the base period for known and measurable changes.

5. By order issued July 29, 2008, the Commission accepted and suspended SFPP's proposed rates for the West Line to become effective August 1, 2008 subject to refund.[4] The issues surrounding the proposed West Line rates were set for hearing and settlement judge procedures. After settlement discussions reached a stalemate, a hearing was held in June 2009. The Presiding Administrative Law Judge (ALJ) issued the Initial Decision on December 2, 2009 (2009 ID). The principal sections of the 2009 ID address (1) the base and test periods, (2) allowed return, (3) income tax allowance, (4) the level and allocation of operating and maintenance expenses, (5) the throughput volume level for determining rates, and (6) classification of costs for Account No. 590. The 2009 ID concluded that the just and reasonable going-forward rates for the West Line are those rates calculated after all of the adjustments ordered by the ALJ are implemented. Subsequently, the parties filed briefs on exceptions and briefs opposing exceptions.

6. In Opinion No. 511, the Commission generally affirmed the ALJ's determinations. However, the Commission determined that several issues required revisions. Specifically, the Commission modified the ALJ's findings regarding throughput, purchase accounting adjustments, the allocation of litigation costs, and some rate base and secondary cost of service issues. The Commission ordered SFPP to file an enhanced overhead cost recovery analysis, revised tariffs, and an estimated refund report consistent with the conclusions in Opinion No. 511. The Commission affirmed most of the other rulings by the ALJ, including his holdings regarding goodwill, the allocation of costs among SFPP's affiliates, and between SFPP's jurisdictional and non-jurisdictional services, and most capital structure and income tax allowance issues.

7. On April 25, 2011, SFPP submitted its Compliance Filing in response to Opinion No. 511 in Docket No. IS08-390-006. The Compliance Filing contains the cost of service information SFPP filed to support the revised West Line rates, including the further justification of SFPP's overhead cost allocations required by the Opinion No. 511.

8. SFPP, Tesoro, ExxonMobil/BP, and the ACV Shippers request rehearing of Opinion No. 511.[5] These rehearing requests are summarized below and then addressed by topic. Each section of this order also contains a discussion of issues that were properly raised in the parties' comments and reply comments on the SFPP Compliance Filing. The Commission does not address any comments raising matters that should have been addressed in the parties' rehearing requests or which only repeat the arguments in those rehearing requests. It is well established that the only matter to be addressed in a

[4] *SFPP, L.P.*, 124 FERC ¶ 61,103 (2008).

[5] This order uses "Shipper Parties" to reference more than one of the shipper litigants in this proceeding.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

compliance filing is whether that filing conforms to the rulings of the relevant order, in this case Opinion No. 511.[6] The Shipper Parties' requests for rehearing also contain numerous quotations and citations to the findings of an Initial Decision in Docket No. IS09-437-000,[7] SFPP's pending East Line rate case (East Line ID). No part of the record in that docket is before the Commission in the instant docket and the East Line ID has no precedential value in this proceeding. Therefore, they are accorded no weight here.[8]

II. Test Year Definition and Throughput

A. Opinion No. 511

9. In Opinion No. 511, the Commission determined that throughput and related cost of service items should be derived based upon a test period using annualized actual data for January 1, 2008 through September 30, 2008.[9] Opinion No. 511 concluded that this data was the most representative of likely future volumes on the West Line. The Commission explained that the expansion on SFPP's East Line into Phoenix created an alternative for West Line shippers into the Phoenix market. As a result, SFPP's shippers began to transfer some of their volumes from the West Line to the East Line beginning in January 2008.[10] Opinion No. 511 also rejected as speculative arguments advanced by

[6] *Kern River Gas Transmission Co.*, Opinion No. 486-D, 133 FERC ¶ 61,162, at P 84, 89 (2009). (Opinion No. 486-D).

[7] *SFPP, L.P.*, 134 FERC ¶ 63,013 (2011) (East Line ID).

[8] *Texas New Mexico Power Company v. El Paso Electric Company*, 110 FERC ¶ 61,258, at P 10 (2005); *KeySpan Energy Development Corporation v. New York Independent Sys. Operator, Inc.*, 108 FERC ¶ 61,201, at P 4 (2004); *see also Illinois Power Co.*, 62 FERC ¶ 61,147, at 62,062 n.17 (1993); *Southern Company Services, Inc.*, 61 FERC ¶ 61,339, at 62,336 n.63 (1992).

[9] SFPP, L.P., Opinion No. 511, 134 FERC ¶ 61,121, at P 27-30 (2011). Commission regulations require a 12-month base period followed by a 9-month adjustment period. 18 C.F.R. § 346.2 (2011). In this proceeding the base period is January 1, 2007 through December 31, 2007. The nine-month adjustment period for test period changes is from January 1, 2008 through September 30, 2008.

[10] Opinion No. 511, 134 FERC ¶ 61,121 at P 27.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Tesoro and ACC Shippers that the January 1, 2008 to September 30, 2008 throughput was not representative due to an economic downturn.[11]

B. Rehearing

1. Rehearing Arguments

10. ACV Shippers and Tesoro seek rehearing of the throughput levels adopted by Opinion No. 511. The ACV Shippers contend that Opinion No. 511 disregarded Commission regulations that set forth a 12-month base period followed by a 9-month adjustment period.[12] ACV Shippers assert that if the Commission always relies on actual data from the adjustment period, the base period would become meaningless. Instead, both ACV Shippers and Tesoro contend that the prevailing policy has been to consider whether changes in the adjustment period are lasting changes and to make changes to the base period data accordingly.[13]

11. The ACV Shippers seek to distinguish the cases cited by Opinion No. 511 for using actual data from the adjustment period because those cases involved natural gas pipelines as opposed to oil pipelines. The ACV Shippers state that the Commission subjects a rate filing pursuant to section 4 of the Natural Gas Act (NGA)[14] to a nearly automatic five-month suspension before the new rate takes effect. Thus, in these natural gas pipeline proceedings, the ACV Shippers assert the end of the adjustment period coincides with the time when the revised rate becomes effective subject to refund. In contrast, the ACV Shippers state that oil pipeline rates often take effect subject to refund on one day's notice. Thus, ACV Shippers assert that in oil pipeline rate cases, the most recent actual data prior to the effectiveness of the new rate is the base period data – not the adjustment period data.

---

[11] *Id.* P 29.

[12] 18 C.F.R. § 346.2 (2011).

[13] ACV Rehearing at 79 (citing *Texaco Ref. & Mrktg. Inc., et al. v. SFPP, L.P.*, 117 FERC ¶ 61,285, at P 69 (2006) (December 2006 Sepulveda Order); *Texaco Ref. & Mrktg. Inc., v. SFPP, L.P.*, 112 FERC ¶ 63,020, at P 129 (2005); *Colorado Interstate Gas Co.*, 43 FERC ¶ 61,089 (1988)).

[14] 15 U.S.C. § 717c (2006).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

12. ACV Shippers and Tesoro also assert that the January 1, 2008, through September 30, 2008, adjustment period throughput is not representative of the conditions likely to prevail while the West Line rates remain in effect. Both parties argue that adjustment period throughput levels were temporarily decreased due to the effects of an economic recession. The ACV Shippers argue that the effects of the recession on throughput are not speculative. Rather, they contend that the Commission should not assume a lasting recession, noting that historically recessions have not resulted in lasting changes in Arizona gasoline use[15] and that recessions have not lasted longer than one year and four months. Similarly, Tesoro argues that the January 1, 2008 through September 30, 2008 period represents a temporary downturn in throughput on the West Line. In support, Tesoro states that prior to 2008 petroleum product demand to Phoenix had been growing rapidly. Tesoro asserts that projections prepared by SFPP and other analysts prior to and after the onset of the recession forecasted annual increases in demand. Tesoro further cites population growth in the Western region between 2008 and 2010.

13. Tesoro disputes Opinion No. 511's discussion of the U.S. Energy Information Agency's (EIA) "Annual Energy Outlook 2010" that was published on May 11, 2010. Tesoro notes that the EIA published new estimates in December 2010 and revised its projections upward, showing motor gasoline consumption in the Mountain Region surpassing 2008 levels in 2010. Tesoro states that the more recent December 2010 projection showed motor gasoline consumption levels surpassing 2007 levels in 2014. Similarly, Tesoro argues that the December 2010 Report showed a more rapid recovery in liquid fuel consumption, projecting 2008 levels to be surpassed in 2011 and 2007 levels to be surpassed in 2015.[16] Tesoro further references a report from the California Energy Commission published in May 2010 after the record in this proceeding closed. Tesoro states the report shows Arizona fuel demand rebounding back to 2008 (and in some cases 2007) levels.[17]

---

[15] ACV Rehearing at 80 (citing Ex. ACV-297; Ex. ACV-304).

[16] Tesoro Rehearing at 15 (citing "Energy Consumption by Sector and Source, Mountain Region, AEO 2011 Reference Case," http://www.eia.gov/oiaf/aeo/tablebrowser/#release=AEO2011&subject=0-AEO2011&table=2-AEO2011&region=1-8&cases=ref2011-d120810c (accessed March 2, 2011)).

[17] Tesoro Rehearing at 16-17 (citing *Transportation Energy Forecasts and Analyses for the 2009 Integrated Energy Policy Report*, California Energy Commission, May 2010)).

14. ACV Shippers also object that Opinion No. 511 improperly relied upon complaint procedures as a remedy for shippers should West Line volumes increase in the future. ACV Shippers contend that only shippers that filed complaints are able to obtain compensation other than a prospective reduction in rates. ACV Shippers also argue that it can take years for complaint proceedings to be processed.

15. Finally, ACV Shippers allege that West Line volumes established in Opinion No. 511 combine with the Administrative Law Judge's Initial Decision in Docket No. IS09-437-000, *et al*., regarding the East Line to establish a total throughput to Phoenix that is far lower than recent actual levels of Phoenix demand as reflected in combined East and West Line volumes.

16. Tesoro further contends that the Commission acknowledged that the January 2008 to September 2008 throughput volumes are not the most accurate depiction of actual throughput changes on the West Line because the Commission ordered SFPP to reflect changes in 2008 volumes to the Yuma Marine Corp Air Station and the Calnev interconnect at Colton, California.

17. ACV Shippers and Tesoro propose alternative throughput levels. ACV Shippers contend that West Line rates should be based on throughput levels as proposed by witness Matthew O'Loughlin. Mr. O'Loughlin adjusted Phoenix 2007 base period volumes on the West Line downward by the adjustment period increase in East Line volumes. ACV Shippers state that this approach avoids incorporating any effects related to the recession. Similarly, Tesoro advocates using the throughput levels proposed by its witness, Phillip Ashton, consisting of the first 11-months of data from 2008 adjusted for volumes that Tesoro claims resulted from the temporary affects of the recession.

2. <u>Commission Determination</u>

18. The Commission denies rehearing and upholds the adoption in Opinion No. 511 of test period volumes consisting of annualized, actual January 1, 2008 through September 30, 2008 throughput.

19. Opinion No. 511 correctly relied upon precedent involving natural gas pipelines for the principle that the Commission sometimes uses actual adjustment period data.[18]

---

[18] Opinion No. 511, 134 FERC ¶ 61,121 at n.34 (citing *Kern River Gas Co.* Opinion No. 486, 117 FERC ¶ 61,077, at P 263 (2006); *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, at P 49 (2005); *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260, at P 315 (2002); *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,048-49 (2000);

(continued…)

20111216-4007 FERC PDF (Unofficial) 12/16/2011

The Commission's oil pipeline and natural gas pipeline cost of service regulations relating to the base and test period are nearly identical.[19] As such, the text of the regulations supports the application of a similar regulatory scheme. The distinction that ACV Shippers seek to create based upon the Commission's suspension policies is not persuasive. As ACV Shippers note, the Commission typically suspends for five months a contested rate increase proposed by a natural gas pipeline. In contrast, the Commission typically allows oil pipeline rate increases to be effective with a minimal suspension.[20] However, even without the imposition of a longer suspension in this proceeding, the actual throughput levels during the adjustment period (between January 1, 2008 and September 30, 2008) coincide with the throughput levels in effect when the rate increase in this proceeding was filed (June 30, 2008) and its effective date (August 1, 2008). Thus, Opinion No. 511's reliance upon the natural gas pipeline cases was appropriate, and to the extent that actual data during the adjustment period provides more accurate throughput projections, the Commission is justified in using the more recent information.

20. Similarly, the ACV Shippers' and Tesoro's reliance upon the 2006 Sepulveda Order is also misplaced. In the 2006 Sepulveda Order, the Commission stated that test period adjustments to data must reflect "a significant lasting change, not a cyclical change."[21] In that decision, the Commission declined to make certain modifications to base period throughput based upon the 9-month adjustment period because it was unclear whether the proposed modifications constituted a significant lasting change.[22] In making

---

Northwest Pipeline Corp., 87 FERC ¶ 61,266, at 62,027, 62,030 (1999); *Williston Basin Interstate Pipeline Co.*, 72 FERC ¶ 61,074, at 61,360 (1995)).

[19] Both sets of regulations specify a 12-month base period followed by a 9-month adjustment period. *Compare* 18 C.F.R. § 154.303 (2011) *with* 18 C.F.R. § 362.2(a) (2011).

[20] The different practices result from the Commission's light-handed regulation of oil pipeline rates under the Interstate Commerce Act and a different regulatory scheme under the Natural Gas Act.

[21] December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 69. The December 2006 Sepulveda Order involved a calendar year 2006 base period followed by a nine-month adjustment period in 2007. The Commission accepted adjustments to the base period data due to the drop in volumes experienced by one shipper (Ultramar). However, it did not accept an adjustment based upon a drop in volumes by another shipper (GATX), finding that the drop in volumes was not a significant lasting change.

[22] December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 69-70.

this factual determination, the 2006 Sepulveda Order did not preclude the Commission from using actual adjustment period data to the extent this data reflected future conditions.[23] In Opinion No. 511, the Commission assessed a different set of facts and concluded that the actual adjustment period volumes provided an appropriate projection of likely future throughput levels. The ACV Shippers' contention that Opinion No. 511 departed from Commission oil pipeline base and test period regulations lacks foundation.[24]

21. Within this regulatory framework, the Commission also re-affirms its position that the annualized actual data from the nine-month adjustment period of January 1, 2008 through September 30, 2008 are the most representative of future throughput. The volume data after January 1, 2008, reflects the effects of the East Line expansion on West Line throughput and other throughput level changes.[25] Opinion No. 511 correctly rejected ACC Shippers' and Tesoro's proposed throughput levels because these projections did not provide a realistic estimate of future volumes. As stated in Opinion No. 511 and uncontested on rehearing, on a per barrel per day basis, the West Line to Phoenix volume levels proposed by ACV Shippers and Tesoro exceed the actual volume

---

[23] Rather, the December 2006 Sepulveda Order gave consideration to using 12-month actual data that overlapped with much of the adjustment period. December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 69-70.

[24] Furthermore, Opinion No. 511's decision to use the last 12-months of the 21-month test period is not inconsistent with the requirement that pipelines provide initial base period data. As the Commission has explained:

> The Commission also does not agree that using the updated data for the last twelve months of the test period means that the pipeline's evidence supporting the initial filing is a waste of time. The evidence ensures that the pipeline may not file for a rate change without justification, aids the discovery process, and establishes a base period for the parties to work with.

Northwest Pipeline, Corp., 87 FERC, at 62,029.

[25] Opinion No. 511 recognized that the decline in the West Line volumes in 2008 was not entirely due to the additional capacity on the East Line. Opinion No. 511, 134 FERC ¶ 61,121 at n.33 (citing Ex. ACV-1 at 8).

level for every single month in the adjustment period from January 1, 2008 through September 30, 2008.[26]

22. ACV Shippers and Tesoro rely upon various economic projections to justify their departure from the actual adjustment period data, but as Opinion No. 511 determined, such projections and estimates are inherently speculative. Tesoro notes that between May 2010 and December 2010, the EIA increased its projections for consumption of motor gasoline and liquid fuels in future years. However, this change simply reflects the uncertainty and contingent nature of such future projections.[27] Given these uncertainties, Opinion No. 511 appropriately used actual annualized data from January 1, 2008 through September 30, 2008. These are the conditions characterizing the actual conditions when the rates were filed and entered into effect on July 1, 2008. Consistent with the Commission's regulations, to the extent that events in the post-test period alter cost of service components for future years, Commission regulations permit shippers to file complaints.[28]

23. The Commission also rejects Tesoro's suggestion that the Commission should utilize post-test period data. Whereas the Commission has often used post-base period

---

[26] Opinion No. 511, 134 FERC ¶ 61,121 at P 29 n.35 (citing Ex. SFP-187).

[27] To the extent that future projections were to be entertained, Opinion No. 511 had taken administrative notice that the 2010 EIA Energy Outlook issued May 11, 2010, projected that (a) 2008 Mountain Region levels would not be equaled until 2013 for motor gasoline and liquid fuel and (b) 2007 would not be exceeded until 2018 for liquid fuels and 2017 for motor gasoline. *See* U.S. Energy Information Agency, Energy Outlook 2010, Supplemental Table 8, Mountain Region, *available at* http://www.eia.doe.gov/oiaf/archive/aeo10/aeoref_tab.html (Released May 11, 2010). The December 2010 projections estimate that (a) 2008 motor gasoline levels will be equaled in 2010 and 2008 liquid levels will be surpassed 2012 and (b) 2007 motor gasoline levels will be surpassed in 2014 and liquid fuels in 2015. *See* U.S. Energy Information Agency, Energy Outlook 2011, Mountain Region, December 16, 2010 Early Release Reference Case, *available at* http://www.eia.gov/oiaf/aeo/tablebrowser/#release=AEO2011&subject=0-AEO2011&table=2-AEO2011&region=1-8&cases=ref2011-d120810c.

[28] ACV Shippers' objection to the Commission's complaint proceedings as a remedy is without merit. Under section 13(1) of the ICA and Commission regulations, a complaint has been the longstanding remedy for shippers raising objections to rates they no longer believe are just and reasonable.

data, the Commission only uses data outside the combined 21-months consisting of the 12-month base period and the 9-month adjustment period for good cause shown.[29] Opinion No. 511 specifically considered actual post-adjustment period data from October 2008-September 2009 and found no good cause for departure from the general regulatory practice of limiting consideration to the base and adjustment period.[30] Tesoro's rehearing request fails to explain why it believes the Opinion No. 511's analysis of this actual post-adjustment period data was incorrect. The perpetual consideration and incorporation into cost of service data from outside the 21-month period would create a forever moving target. Tesoro has not presented good cause for departing from the general regulatory practice of limiting consideration to the base period and adjustment period data.

24. Likewise, the Commission will not reconsider, as requested by ACV Shippers, the West Line volumes adopted by Opinion No. 511 based upon an Administrative Law Judge's decision in Docket No. IS09-437-000 involving the East Line volumes. As an initial matter, the Administrative Law Judge's decision is not Commission precedent. More fundamentally, Docket Nos. IS08-390 and IS09-437 are two separate proceedings, filed one year apart and with effective dates one year apart.[31] The base and adjustment periods in the two proceedings are also different and have been developed in separate records.[32] Consequently, it is not necessary for the cost of service calculations in one case to correspond to the cost of service calculations in the other proceeding.

---

[29] 18 C.F.R. § 346.2(a)(ii) (2011). Tesoro's discussion of this issue relies heavily upon *Williston Basin Interstate Pipeline Company*, 52 FERC ¶ 61,170 (1990) and *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266. However, the referenced discussions in both *Williston* and *Northwest* used data from within the 21-month period consisting of the base period and the subsequent nine-month adjustment period. *Williston*, 52 FERC at 61,646-49; *Northwest Pipeline Corp.*, 87 FERC at 62,028. Neither case used actual data from outside the 21-month test period.

[30] Opinion No. 511, 134 FERC ¶ 61,121 at P 29 & n.38.

[31] Docket No. IS08-390-000 involves a proposed a rate increase for the West Line to be effective August 1, 2008. Docket No. IS09-437-000 involves a proposed rate increase for the East Line to be effective September 1, 2009.

[32] Under Rule 716 of the Commission's Rules of Practice and Procedure, the Commission has discretion to reopen the record when good cause is shown. 18 C.F.R. § 385.716 (2011). As discussed below, on its own motion the Commission provided for additional materials to be provided on the issue of SFPP's overhead cost allocations. The Shipper Parties assert on rehearing that the Commission failed to meet the standard of its own regulation and therefore should not have provided SFPP an opportunity to provide

(continued…)

25. Contrary to Tesoro's suggestions, the Commission's requirement that SFPP use the actual annualized January 1, 2008, to September 30, 2008 volumes, for the Yuma Marine Corp. Air Station and the Calnev Interconnect at Colton are consistent with the Phoenix throughput levels adopted by Opinion No. 511. Rather than undermining the test and base period adopted by the Commission, this directive merely assured that all volumes being used to determine West Line throughput were from the same January 1, 2008 to September 30, 2008 period.

C. Compliance Filing

1. SFPP's Compliance Filing

26. In Schedule 21 of its Compliance Filing, SFPP calculated its annualized January 1, 2008 through September 30, 2008 West Line throughput to be 72,389,800 barrels. As directed by Opinion No. 511, SFPP states that it adjusted throughput to all West Line destinations in order to synchronize volumetric data across the entire cost of service. SFPP also states that it adjusted throughput-related costs as directed by Opinion No. 511.

2. Shipper Protests

27. Trial Staff states that the annualized throughput levels contained within SFPP's Compliance Filing conflict with the throughput levels over the same period in Trial Staff witness Bonnie Pride's testimony of 72,453,200 barrels[33] as well as SFPP witness James Kehlet's testimony. In protesting SFPP's Compliance Filing, Tesoro and ACV Shippers challenge the findings of Opinion No. 511, reiterating many of the arguments they raised on rehearing.

28. In SFPP's answer, it responds to Trial Staff that the annualized volumes reflected on Schedule 21 used the same monthly volume data as utilized by Mr. Kehlet in his Exhibit No. SFP-64. SFPP urges the rejection of Trial Staff's methodology because,

---

additional evidence regarding the allocation of its overhead costs. Despite that objection to the Commission's action involving overhead cost allocation, the ACV Shippers fail to request on rehearing that Rule 716 be applied here nor do they discuss the applicable standard as it would relate to the additional record evidence from Docket No. IS09-437-000. They fail to do so even though the additional material they seek to submit would fall outside the base and adjustment period of this proceeding.

[33] Trial Staff June 15, 2011 Protest of SFPP Compliance Filing at 4 (citing Ex. S-22) (Trial Staff Protest).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

according to SFPP, Staff annualized the January to September 2008 volumes using an approach that assumed each month had the same number of days. In contrast, SFPP states that it used a more accurate approach which converted the January to September 2008 volumes to annual volumes on a daily basis. SFPP further notes that the difference between Staff's and SFPP's calculation is a mere 0.09 percent of the total barrels.

29. SFPP argues that the protests filed by ACV Shippers and Tesoro argue that Opinion No. 511 reached the wrong result, not that SFPP failed to comply with Opinion No. 511. SFPP also alleges that ACV Shippers and Tesoro improperly rely on documents not in the record.

3. Commission Determination

30. In the next compliance filing, the Commission will require SFPP to file additional explanation to support the throughput level of 72,389,800 barrels contained in its Compliance Filing. Specifically, SFPP has not provided work papers in its Compliance Filing or its answer demonstrating how the proposed throughput level of 72,389,800 barrels was derived from Exhibit No. SFP-64 as claimed in its answer. This information is necessary to address the objections and concerns raised by Trial Staff regarding the accuracy of SFPP's calculations.

31. The Commission rejects the concerns raised by Tesoro and ACV in their protests to SFPP's Compliance Filing. Tesoro and ACV Shippers challenge the findings of Opinion No. 511 itself. To the extent ACV Shippers and Tesoro raised these arguments on rehearing, the Commission has addressed them. However, as posed in a protest to a compliance filing, such objections to Opinion No. 511 are untimely.

III. Volumetric Allocation of Costs

32. Opinion No. 511 held that consistent with the Commission's discussion of West Line throughput, the volumes used in the route directory to allocate expenses between interstate and intrastate costs and at the Phoenix Terminal should use the annualized actual data for January 1, 2008 to September 30, 2008, for all destinations.[34]

33. SFPP states that its Compliance Filing reflects these volume adjustments.[35] SFPP explains that because the adjustments to the separation factors of the route directory

---

[34] Opinion No. 511, 134 FERC ¶ 61,121 at P 57.

[35] SFPP Compliance Filing, Tab A, Schedule 13.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

affect both the direct investment and expense attributable to West Line interstate service, these changes ripple through virtually every aspect of the cost of service calculations.[36]

34. No party protests this aspect of SFPP's filing, and the Commission finds that SFPP has complied with the directives of Opinion No. 511 in this regard.

IV. Operating Expenses and Rate Design

A. Litigation Costs

1. Opinion No. 511

35. Opinion No. 511 determined that SFPP may recover its regulatory litigation expenses attributable to this proceeding through a three-year surcharge developed to reflect the costs incurred in this proceeding during the hearing, rehearing, and compliance phases. Opinion No. 511 noted that a similar litigation recovery surcharge has been previously adopted in complaint proceedings involving SFPP and stated that a surcharge based upon actual litigation costs recoverable over a limited period provides an appropriate means to avoid both over-recovery and under-recovery. Opinion No. 511 further noted the protracted litigation historically involving SFPP and stated that under these circumstances, there is little assurance that base period data, test period data, or any other normalization would provide sufficiently representative estimates of future expense levels.

2. Rehearing

a. Rehearing Arguments

36. ACV Shippers contend that the Commission erred by not limiting SFPP's recovery for litigation costs to those incurred during the base period. ACV Shippers argue that under Commission regulations,[37] cost of service must be defined based upon a historical base period and non-recurring costs are to be eliminated or normalized from the cost of service included in rates. The ACV shippers state that the Commission provided no justification for treating litigation costs differently from SFPP's other operations and maintenance expenses. ACV Shippers also state that Opinion No. 511's treatment of litigation costs is inconsistent with Commission policy prohibiting recovery of costs incurred outside of the test period.

---

[36] *Id.* at Affidavit of Thomas A. Turner at P 4.

[37] ACV Rehearing at 65-66 (citing 18 C.F.R. § 346.2(a) (2011)).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

37. ACV Shippers acknowledge that the Commission has allowed similar treatment of SFPP's litigation costs in the past,[38] but the ACV Shippers dispute that a similar approach is appropriate here. ACV Shippers seek to distinguish these prior cases, stating that the Commission only allowed recovery of such non-recurring, post-test period litigation costs because it was a complaint proceeding and SFPP did not control the timing of the underlying complaint that caused the costs. ACV Shippers dispute that the treatment of litigation costs in Opinion No. 511 will avoid a risk of substantial over-recovery in the future. ACV Shippers also argue that the Commission's holding will create perverse litigation incentives if SFPP knows in advance that it will recover all of its litigation costs.

38. Tesoro argues that the Commission inappropriately dismissed its argument in favor of a five-year surcharge because Tesoro failed to raise this objection on exceptions and waited until its brief opposing exceptions. Tesoro avers that the Commission is overlooking a substantive argument on the basis of a technicality.

b. Commission Determination

39. The Commission denies rehearing. Pipelines are entitled to recover their reasonably incurred rate litigation costs.[39] The Commission has permitted SFPP in prior complaint proceedings to recover its litigation costs based upon a surcharge.[40] Although this proceeding relates to a filing initiated by the pipeline, Opinion No. 511 explained that such a surcharge was also appropriate in this instance:

> Where significant litigation costs have been incurred and it is uncertain whether those litigation costs will continue into future years, a surcharge based upon actual litigation costs provides an appropriate means to avoid both over-recovery and under-recovery. The protracted litigation that has historically involved SFPP creates unique circumstances rendering it very difficult to determine a

---

[38] ACV Rehearing at 71 (citing *SFPP, L.P.*, 111 FERC ¶ 61,334, at P 47 (2005) (June 2005 Order).

[39] *SFPP, L.P.*, Opinion No. 435-A, 91 FERC ¶ 61,135, at 61,512 (2000) (stating "Litigation related to the pipeline's cost of service and the structure of its tariff are part of its normal, ongoing operations, and such costs are recoverable as part of the pipeline's cost of service").

[40] *See supra* note 39.

> representative level for SFPP's future regulatory litigation costs. Under these circumstances, there is little assurance that base period data, test period data, or any other normalization would provide sufficiently representative estimates of future expense levels. The surcharge allows recovery of actual costs without creating a risk of substantial over-recovery in the future.[41]

40. The Commission rejects ACV Shippers' argument that such a surcharge is limited to complaints. The principle that pipelines may recover their prudently incurred FERC litigation costs applies whether a pipeline is filing a rate increase or responding to a complaint. Given this principle, practical considerations undermine the rigid application of the Commission's test period regulations to litigation costs as urged by ACV Shippers. As Opinion No. 511 emphasized, it is difficult to develop a reasonable level of litigation costs based upon historical costs given the complicated and protracted litigation between SFPP and its shippers over the past two decades.[42] Furthermore, most of SFPP's litigation costs related to this proceeding are not reflected in the base or adjustment periods.[43] Thus, if the Commission rigidly applied its test period principles to SFPP's litigation costs, the pipeline would be deprived of its ability to recover litigation costs that are representative of the costs incurred to support this rate filing unless it filed a second rate case. Such an approach is neither administratively efficient nor consistent with SFPP's right to recover its reasonably incurred litigation costs.

41. The ACV Shippers' other objections are without merit. Although SFPP made the decision to file the rate increase, it does not control the degree to which shippers have litigated the issues raised in this proceeding. Regarding ACV Shippers' concern that the litigation surcharge will create perverse incentives, pipelines are limited to their prudently incurred litigation costs.

42. The Commission also affirms its adoption of a three year period to collect the surcharge as opposed to a five-year period. As Opinion No. 511 concluded, Tesoro did

---

[41] Opinion No. 511, 134 FERC ¶ 61,121 at P 35 (citations omitted).

[42] *Id.*

[43] Opinion No. 511, 134 FERC ¶ 61,121 at P 36; *see also* Ex. SFP-188 at 26-27. For example, ACV Shippers' reliance on the 2007 base period produced an annual West Line litigation charge of $429,492, which is not representative of the $6.7 million that SFPP reports in its Compliance Filing as the total cost to litigate this case over roughly the past three years. *See* SFPP Compliance Filing, Tab A, Statement B.

not raise this issue in a timely manner on exceptions and waited until its brief opposing exceptions.[44] Moreover, as Opinion No. 511 explained, although prior SFPP decisions have applied a five-year surcharge, the Commission determined that a three-year surcharge is an appropriate time period for recovery of litigation costs in this proceeding because the costs have been incurred over approximately three years of litigation.

3. Compliance Filing

43. In its Compliance Filing, SFPP has filed to recover accumulated litigation costs of \$6.7 million.[45] These litigation costs are for expenses associated with this proceeding as billed to SFPP through the date of the Compliance Filing, generally representing litigation services through March 2011.[46] SFPP explains that this results in a litigation expense surcharge per barrel of \$0.0310, and that Page 2 of Schedule 24 provides the total litigation expenses implicitly recovered by SFPP through the surcharge during the refund period (August 1, 2008 through May 31, 2011) of \$6.2 million.

44. Trial Staff and ExxonMobil/BP argue that SFPP's tariff should separately state the litigation surcharge and explicitly state that the surcharge will be removed after a three-year period. ExxonMobil/BP explains that separately stating the surcharge will ensure compliance with Opinion No. 511.

45. In a related argument, Trial Staff notes that SFPP's Compliance Filing cost of service includes an annual litigation surcharge amount of \$2,242,831 in Account 520 of Schedule 15, which is described in a related footnote as "[a]ctual IS08-390 litigation expense amortized over three years" for regulatory litigation expense. They note that Schedule 15 does not mention the elimination of the surcharge in three years. Trial Staff contends that this expense must be removed from the cost of service because it will be

---

[44] Opinion No. 511, 134 FERC ¶ 61,121 at P 34 n.41. Tesoro's reliance upon the *Mid-America* case is misplaced. Tesoro Rehearing at 51 (citing *Mid-America Pipeline Company, LLC*, 130 FERC ¶ 61,123, at P 84 (2010)). In that proceeding, the Commission considered a brief opposing exceptions by a party *supporting* an administrative law judge's initial decision. *Mid-America Pipeline Company, LLC*, 130 FERC ¶ 61,123 at P 77-84. In this case, Tesoro advocated a modification to the 2009 ID in its brief opposing exceptions.

[45] SFPP Compliance Filing, Affidavit of Thomas A. Turner at P 5; s*ee also* SFPP Compliance Filing, Tab A, Schedule 24.

[46] SFPP Compliance Filing, Affidavit of Thomas A. Turner at P 5.

collected from a surcharge rather than as part of the tariff rate and to prevent this expense from being included in the cost of service upon which a future index filing will be based.

46. Trial Staff and ACV Shippers also argue that if SFPP is permitted to recover this expense through a separate surcharge, such costs should be treated separately on SFPP's Form No. 6 (including on page 700) and should not be included in determining the level of the Commission's oil pipeline index.[47] Tesoro argues that the legal costs in SFPP's Compliance Filing appear to be inflated and may not be justified. Tesoro asserts that SFPP should be required to explain in further detail what exactly is contained in this cost category before the rates that it is requesting are approved. Finally, Tesoro asserts that SFPP's rates should be appropriately reduced by August 2011 to reflect the end of the amortization period. ACV Shippers also challenge the holdings of Opinion No. 511 itself, reiterating many of the arguments previously raised on rehearing.

47. In its answer, SFPP responds that the Shipper Parties' challenges to the holding of Opinion No. 511 are procedurally flawed. SFPP also argues that there is no merit to Trial Staff's and ACV Shippers' request that SFPP state its litigation surcharge separately in its FERC Form No. 6 or its tariff sheets. SFPP states that page 700 of the FERC Form No. 6 does not contain a specific line item requiring that the litigation surcharge be separately stated. SFPP states that there is no basis for showing its litigation charge as a separate item on the Form No. 6.

48. SFPP also states that it did not list a separate rate to recover its litigation costs in its tariff sheets and does not believe that establishing a separate charge is necessary. SFPP states that the litigation surcharge is clearly set forth in its Compliance Filing and that it will track its costs and revenues to ensure that it recovers no more than its actual costs.

49. The Commission accepts the litigation costs of $6.7 million contained within SFPP's Compliance Filing. Tesoro states that it requires more information to assess the litigation costs in SFPP's Compliance Filing, but Tesoro does not provide a sufficient basis for believing that the monthly figures provided by SFPP in schedule 24 are not credible. Although some protests raised concerns that SFPP had not identified the surcharge separately on its tariff sheets, this issue is moot because collection of the three year surcharge began August 1, 2008 and stopped August, 1, 2011. With respect to the rates calculated based upon Opinion No. 511, SFPP did not apply an index increase to the

[47] ACV Shippers June 15, 2011 Protest of SFPP Compliance Filing at 46 (ACV Protest) (citing *Magellan Pipeline Co. L.P.*, 115 FERC ¶ 61,276, at P 13 (2006); *SFPP, L.P.*, 118 FERC ¶ 61,267, at P 8 (2007)).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

litigation component of its costs.[48] This is appropriate because SFPP is recovering its litigation costs via a surcharge for accumulated litigation costs that already incorporate inflationary changes over the August 1, 2008 through August 1, 2011, period in which they have been collected.

50. The Commission will not address in this proceeding the treatment of the litigation surcharge in the calculation of the Commission's oil pipeline index. This question is more appropriately addressed at the time of the next five-year index review.[49] However, in its Compliance Filing and as a note in its next annual Form No. 6 filing, SFPP must provide information (a) identifying its litigation costs for each year related to this case, (b) explaining how much it recovered in the surcharge, and (c) explaining how these litigation costs have been reported on the Form No. 6, including page 700. This information will help the Commission and interested parties monitor SFPP's compliance with Opinion No. 511 and will facilitate further evaluation during the next five-year review.

51. The Commission rejects the arguments raised by ACV Shippers in their protest against SFPP's Compliance Filing that challenge the determination of Opinion No. 511. ACV Shippers should have raised these arguments on rehearing, and to the extent these arguments were properly raised on rehearing, the Commission addressed them above. However, when raised in a protest to a compliance filing, such objections are untimely.

B. Environmental Costs

52. Opinion No. 511 upheld the 2009 ID and adopted an environmental remediation cost of $1,877,610. The Commission denied arguments made by Trial Staff on exceptions that the 2009 ID improperly included non-jurisdictional costs.[50] No party sought rehearing on this issue.

53. In its Compliance Filing, SFPP states that it included $1,877,610 of environmental remediation expenses in its West Line cost of service reflected in adjustments from SFPP's Exhibit SFP-57C to costs at the Colton Terminal, Liberty and Watson Station sites. SFPP states that it applied volumetric separation factors attributable to the

[48] SFPP Compliance Filing, Tab A, Schedules 20 and 22.

[49] The Commission reviews the index level every five years and completed its most recent review in 2010-2011.

[50] Opinion No. 511, 134 FERC ¶ 61,121 at P 70.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

remaining costs, reducing the total amount included in SFPP's Compliance Filing to $1,836,482.

54. Tesoro asserts that SFPP improperly calculated its environmental remediation expenses in its Compliance Filing. Tesoro explains that Opinion No. 511 adopted the 2009 ID's adjustments regarding environmental expenses.[51] Tesoro explains that although SFPP removed costs associated with the Liberty and Watson sites as required by the 2009 ID, SFPP did not make further adjustments required by the 2009 ID based upon 2008 costs rather than the 2007 costs used by SFPP.[52] Tesoro states that the testimony of SFPP witness Michael A. Hanak[53] provides 2008 environmental costs as required by the 2009 ID and upheld in Opinion No. 511. Based upon this data, Tesoro claims that the 2008 actual environmental costs should be $1.6 million rather than $1.8 million.

55. In its reply comments, SFPP states that Tesoro's argument rests upon a mistaken description of the 2009 ID. SFPP states that the 2009 ID adopted $1,877,610 as the appropriate amount for environmental remediation costs and did not order SFPP to make any additional reductions to that figure.[54] SFPP notes that if Tesoro disagreed with the 2009 ID's findings, it should have raised the issue on exceptions. SFPP adds that Opinion No. 511 also expressly determined that $1,877,610 to be the appropriate amount for environmental remediation costs,[55] and SFPP notes that Tesoro never raised the issue on rehearing. Finally, SFPP concludes that Tesoro provided no support for its position other than a misreading of the 2009 ID. SFPP states that Tesoro does not cite any evidence supporting the claim that 2008 environmental remediation costs should be used or supporting the amount of environmental remediation costs that Tesoro now advances.

[51] Tesoro June 15, 2011 Comments on SFPP Compliance Filing at 30 (Tesoro Protest) (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 70).

[52] *Id.*

[53] *Id.* at 30-31 (citing Ex. SFP-120 at 4; Ex. SFP-123 at 4).

[54] SFPP July 11, 2011 Reply Comments Regarding Comments on SFPP Compliance Filing at 69 (SFPP Reply Comments) (citing 2009 ID, 129 FERC ¶ 63,020 at P 824 & n.276).

[55] *Id.* at 70 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 67-70).

56. Also in reply comments, Trial Staff supports Tesoro's position, asserting that the 2009 ID, as upheld by Opinion No. 511, directed SFPP to use 2008 data in calculating remediation expenses.

57. The Commission accepts SFPP's inclusion of $1,836,482[56] of environmental remediation expenses in its cost of service. Opinion No. 511 authorized SFPP to include this sum in its cost of service.[57] No party challenged Opinion No. 511's findings regarding environmental costs on rehearing or sought clarification of the relationship between Opinion No. 511 and the 2009 ID. Thus, the objections raised in comments on SFPP's Compliance Filing are untimely. It is not appropriate to revisit different interpretations of the 2009 ID at this stage in the proceeding.

C. Fuel and Power Costs

58. In Opinion No. 511, the Commission determined that throughput and related cost of service items should be derived from a test period using annualized actual data for January 1, 2008 through September 30, 2008.[58] In its Compliance Filing, SFPP included fuel and power costs of $6,608,495.[59]

59. In its protest to SFPP's Compliance Filing, Tesoro argues that fuel and power levels in SFPP's Compliance Filing are incorrect because SFPP determined the fuel and power costs based upon too low a throughput level, as opposed to the throughput level favored by Tesoro. Tesoro also objects to SFPP's adjustment for a power increase at Yuma. Trial Staff states that SFPP failed to comply with the directives of Opinion No. 511 which required that throughput-related cost of service items should be derived from a test period using annualized actual data for January 1, 2008 through September 30, 2008.

60. In reply comments, SFPP states that its Compliance Filing used fuel and power costs for 2007 whereas Opinion No. 511 provides that fuel and power costs were to be based on data for the first nine months of 2008 annualized. SFPP states that it will

[56] Opinion No. 511 authorized SFPP to include environmental costs of $1,877,610. In its Compliance Filing, SFPP adjusted this number solely to account for Opinion No. 511's decision altering the volumetric separation factors.

[57] Opinion No. 511, 134 FERC ¶ 61,121 at P 70.

[58] Opinion No. 511, 134 FERC ¶ 61,121 at P 27.

[59] SFPP Compliance Filing, Tab A, Schedule 15, Page 1.

correct this item in the revised compliance filing following the Commission's order on rehearing of Opinion No. 511. SFPP states that this change will render moot Tesoro's objection to the power increase at Yuma Station because using the first nine months of data from 2008 will reflect the actual costs at Yuma Station.

61. SFPP also states that Tesoro's objection to throughput levels improperly challenges the merits of Opinion No. 511. In its reply comments, Trial Staff also states that Tesoro's adjustment to fuel and power costs is improper.

62. The Commission directs SFPP to modify its fuel and power costs as proposed in its reply comments. Fuel and power costs vary depending upon throughput levels. To the extent that SFPP is using the throughput for the January 1, 2008 through September 30, 2008 period, it must also use the annualized fuel and power costs incurred for the same period. However, Opinion No. 511 rejected the volume levels advocated by Tesoro, and thus the Commission must also reject the fuel and power costs that are based upon Tesoro's proposed volume levels.

V. Overhead Cost Allocation

A. General

1. Summary of 2009 ID Determinations

63. Allocation of overhead costs is a significant issue in this rate proceeding as approximately 11 percent of SFPP's West Line cost of service is attributable to the allocation of corporate overhead expenses. Neither SFPP nor KMEP, the master limited partnership that wholly owns SFPP, have any employees. Rather, all operating and administrative services and related overhead functions are provided by either Kinder Morgan, Inc. (KMI) or KinderMorgan General Partner Services (GP Services). Both KMI and GP Services provided overhead services to both SFPP and multiple other companies operated by KMEP.

64. The 2009 ID made seven main findings regarding the KMI/KMEP cost allocation methodology and accounting structure. First, that the accounting structure is consistent with the purpose of the Massachusetts formula because it directly assigns overhead costs to specific subsidiaries where possible, and then allocates the residual costs through KMEP's Massachusetts formula.[60] Second, that the KMI-Operated Entities, certain Joint Ventures, and the KM Canada Entities were properly excluded from the KMEP's

[60] 2009 ID, 129 FERC ¶ 63,020 at P 750-758.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Massachusetts formula.[61] Third, that KMI's accounting system assigned or allocated costs with reasonable accuracy.[62] Fourth, that year-end plant balances should be used to determine the rate base element used in SFPP's Massachusetts formula, and thereby rejected SFPP's proposal to use a two-year (semi-annual) average.[63] Fifth, that any purchase accounting adjustments should be removed from both jurisdictional and non-jurisdictional entities.[64] Sixth, that it is acceptable to use Tejas Consolidated's net revenues in applying the Massachusetts formula if Tejas Consolidated were included in KMEP's Massachusetts formula.[65] Seventh, that KMI's capitalized overhead costs must be excluded from the Massachusetts formula.[66] The 2009 ID therefore rejected the ACC Shippers'[67] proposal that all entities included in the KMI business structure be consolidated in a single corporate-wide "all in" Massachusetts formula that would include all of the overhead costs of all the KMI-Owned, KMI-Operated, KMEP-Operated, Joint Venture and KM Canada entities.[68] The 2009 ID also rejected ACC Shippers' alternative proposal, which is similar to Tesoro's, that all KMEP-Owned Entities be included in KMEP's Massachusetts formula. The 2009 ID also rejected Trial Staff's proposal to use a KMEP-wide formula on an interim basis.[69]

2. Opinion No. 511

65. In Opinion No. 511, the Commission generally affirmed the ALJ's findings regarding the allocation of overhead costs among SFPP's affiliates and between SFPP's

[61] *Id.* P 759-768.

[62] *Id.* P 775-778.

[63] *Id.* P 779-780.

[64] *Id.* P 781-785.

[65] *Id.* P 786-790.

[66] *Id.* P 791-796.

[67] The ACC Shippers includes the Airlines, Chevron, and ConocoPhillips. At the hearing phase, Valero had not yet joined with the ACC Shippers.

[68] *Id.* P 769.

[69] *Id.*

jurisdictional and non-jurisdictional services.[70] In Opinion No. 511, the Commission, concurring with the ALJ, determined that the KMI/KMEP cost allocation methodology is generally appropriate in that it assigns costs at the lowest possible level of KMEP's business structure, and then allocates the residual costs through the Massachusetts formula to each business entity that benefits, by more than a de minimis amount, from the KMI-shared or GP Services costs.[71] Thus, KMI's accounting methodology complies with the requirements of the Massachusetts formula. However, the Commission concluded that further documentation of some of the accounting details was required to ensure accurate assignment of costs.[72] However, the Commission required SFPP to provide a fuller analysis and explanation of the relevant responsibility centers (RCs) including the audit material and supporting analysis to allow the Commission to determine whether the costs flowing to KMEP and SFPP from GP Services and KMI are assigned and allocated with reasonable accuracy to KMEP, and ultimately to the KMEP-Operated Entities, which includes SFPP.[73]

66. The Commission further concluded that nothing in the record supports a finding that all GP Services' overhead costs must be allocated through KMEP-wide Massachusetts formula to all of KMEP-Operated Entities without regard to what costs can be directly assigned to those entities.[74] The Commission found acceptable that KMEP accounts for overhead costs differently in its SEC annual 10-K filing versus the regulatory accounting used in this rate case.[75] Further, the Commission found that inevitable human error involved in using any accounting structure did not itself render the accounting arbitrary and subjective.[76]

67. Regarding the ALJ's exclusion of certain KMEP-Owned Entities from KMEP's Massachusetts formula (certain Joint Ventures, Marine Terminal and the KM Canada Entities, and eight KMI-Operated natural gas entities), the Commission found that all but

[70] Opinion No. 511, 134 FERC ¶ 61,121 at P 73-150.

[71] *Id.* P 94.

[72] *Id.* P 130.

[73] *Id.* P 130-138.

[74] *Id.* P 97.

[75] *Id.* P 101.

[76] *Id.* P 103, 128-138.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

the KM Canada Entities were correctly excluded.[77] With respect to KM Canada, the Commission held that SFPP must provide additional information and documentation to support their exclusion.[78]

68. Finally, the Commission ruled on challenges to SFPP's application of four cost categories and one revenue factor in its calculation of KMEP's Massachusetts formula.[79] Specifically, the Commission ruled that SFPP's method of assigning certain employee related costs (i.e., allocating ongoing pension and related employee benefits through its Massachusetts formula rather than directly assigning those costs) was in error, and ordered SFPP to adjust these employee-related costs in its Compliance Filing.[80] Next, on the issue of the proper method for removing purchase accounting adjustments (PAA) from the rate base of KMEP-Operated and KMI-Operated Entities, the Commission held that SFPP correctly removed all PAAs from both jurisdictional and non-jurisdictional entities in applying KMEP's Massachusetts formula.[81] With regard to KMI's so-called "going-private" costs, the Commission upheld SFPP's treatment of $5.572 million of the going-private costs as a recurring costs, but noted that SFPP may not include any of the remaining $262.2 million buy-out cost in KMEP's cost allocation pool because they were non-recurring costs.[82] Next, with respect to the capitalization of overhead costs related to capital investments, where SFPP disputed the determination in the 2009 ID that SFPP should allocate indirect overhead costs involving capital investments through KMEP's Massachusetts formula, the Commission directed SFPP to address this issue in its Compliance Filing.[83] Last, on the issue of whether to use Tejas Consolidated's gross or net revenues in calculating KMEP's Massachusetts formula, the Commission concluded that it was correct to use net rather than gross revenues.[84]

[77] *Id.* P 110-127.

[78] *Id.* P 120.

[79] *Id.* P 139-147.

[80] *Id.* P 140-141.

[81] *Id.* P 142.

[82] *Id.* P 143.

[83] *Id.* P 145.

[84] *Id.* P 146-147.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

69. Regarding SFPP's KN Method, which is used to allocate overhead costs between SFPP's jurisdictional and non-jurisdictional facilities, and among SFPP's different jurisdictional activities, the Commission reversed the ALJ and directed SFPP to apply the KN Method set forth in Opinion No. 731.[85]

B. <u>Rehearing Requests</u>

70. SFPP, Tesoro, and the ACV Shippers sought rehearing of most overhead cost allocation issues. SFPP seeks rehearing of the Commission's determination regarding the KN Method. Tesoro and ACV Shippers sought rehearing of virtually every determination regarding SFPP's application of the Massachusetts formula. As noted above, both the ACV Shippers and Tesoro rely on the East Line Rate Proceeding record to date, i.e., the presiding ALJ's initial decision in Docket No. IS09-437-000 (East Line ID) to support their rehearing requests. An initial decision pending before the Commission on exceptions is not a final Commission decision, and as such does not create binding precedent.[86] The Commission again reiterates that the East Line ID, now pending on exceptions, is of no precedential value for purposes of this case. Accordingly, the Commission will not acknowledge or address any arguments that rely on the East Line ID to support their position.

71. In addition, both Tesoro and ACV Shippers repeat a significant portion of their rehearing requests in their June 15, 2011 comments on SFPP's Compliance Filing. These arguments do not pertain to the specific matters that are the subject of SFPP's Compliance Filing. Rather, ACV Shippers and Tesoro use their comments to challenge Commission findings, conclusions and directives in Opinion No. 511. SFPP also falls victim to this by responding in its July 11, 2011 Reply Comments to Shipper Parties' recitation of their rehearing arguments in their comments on the Compliance Filing. The Commission will not consider arguments raised in pleadings in the compliance phase of this proceeding that are not focused on whether the specific Commission directives are being correctly implemented in the Compliance Filing.[87]

---

[85] *Id.* P 150.

[86] *Texas New Mexico Power Co. v. El Paso Electric Co.*, 110 FERC ¶ 61,258 at P 10; *KeySpan Energy Development Corp. v. New York Indep. Sys. Operator, Inc.*, 108 FERC ¶ 61,201 at P 4 (2004); *see also Illinois Power Co.*, 62 FERC at 62,062 n.17; *Southern Company Services, Inc.*, 61 FERC, at 62,336 n.63.

[87] *Delmarva Power & Light Co.*, 63 FERC ¶ 61,321, at 63,160 (1993) (Commission will not consider arguments raised in a compliance proceeding that are not

(continued…)

1. Appropriateness of SFPP's Cost Allocation Methodology

a. Rehearing Requests

72. Tesoro challenges the Commission's general determination that the KMI accounting methodology for allocating overhead costs employed by KMEP is a valid, accurate method in contrast to the approaches presented by shipper witnesses Daniel Arthur and Peter Ashton.[88] Tesoro argues on rehearing that SFPP's multi-tiered approach to the allocation of general and administrative costs is inherently unreliable and likely leads to cross-subsidization and unjustifiably inflates SFPP's rates. Tesoro further argues that SFPP has the burden of proof to validate the reliability of the accounting system as well as the methods employed to allocate corporate overhead expenses. Tesoro argues that the Commission erroneously concluded that KMI's accounting methodology is consistent with the purpose of the Massachusetts formula. Tesoro states that evidence shows KMI's accounting structure and allocation methodology are not transparent and notes that neither the Commission nor any of the shippers can audit the individual direct assignments to ensure consistency with the objective of the Massachusetts formula. Tesoro concludes that the KMI accounting system is inconsistent with cost causation because it cannot be audited and cannot be matched with cost causation. Tesoro states that the issue is whether the application of KMI's accounting structure and methodology produces accurate, reliable results, which can be verified by the Commission and shippers.

73. Similarly, ACV Shippers argue that the Commission's approval of SFPP's general and administrative (G&A) overhead cost allocation methodology is arbitrary and not well founded. ACV Shippers take issue with the Commission's acceptance of the "arbitrary and subjective predilection of individual pipeline's or their parent's unique accounting method," notwithstanding that the accounting methodology is nowhere publicly identified or recognized such as in the audited financial reports filed with the U.S. Securities and Exchange Commission (SEC). In sum, ACV Shippers argue that SFPP failed at hearing

---

responsive to the complying party's response to the explicit directives of the Commission's earlier order).

[88] ACV Shippers' witness Dr. Arthur advocates the "all in" approach. Specifically, Dr. Arthur proposes a combined KMEP/KMI Massachusetts formula which allocates $340.1 million of overhead expenses to all KMI and KMEP subsidiaries without any direct assignments of overhead expenses. *See* 2009 ID, 129 FERC ¶ 63,020 at P 263. Likewise, shipper witness Mr. Ashton rejects SFPP's proposed multi-tired Massachusetts formula. *See id.* P 298-299.

to provide adequate data to demonstrate transparency, consistency, reliability, and credibility regarding its G&A overhead cost allocation scheme.

74. ACV Shippers argue that the Commission erred in allowing SFPP to file additional data to support its G&A overhead cost allocation methodology rather than rejecting it for failure to carry its burden of proof. ACV Shippers argue that this unfairly gave SFPP a second bite at the apple. They further argue that although shippers will be able to comment on SFPP's Compliance Filing, it is not a meaningful opportunity to test the credibility and probative value of SFPP's claims through discovery, testimony, and cross-examination. ACV Shippers assert that the Commission's rules provide that evidence may not be added to the evidentiary record after the record is closed, unless reopened under Rule 716 which rule allows the Commission to reopen a record if it has reason to believe that reopening is warranted by changes in conditions of fact or of law or by the public interest. Finally, ACV Shippers note that requiring a compliance filing is unnecessary because the Commission already has before it updated analyses, clarifications, and evidence regarding SFPP's alleged accounting methodology and related overhead scheme, including its direct assignments all of which have been tested through discovery and cross-examination in SFPP's East Line rate case. The ACV Shippers advocate, on the issue of the appropriateness of SFPP's cost allocation methodology, relying on the record G&A overhead data in the East Line proceeding instead of the supplemental overhead data provided in SFPP's Compliance Filing.

75. The ACV Shippers further argue that the Commission, in reviewing SFPP's overhead cost allocation methodology, failed to apply the level of scrutiny required in past proceedings based on concerns for cross-subsidies between affiliates and jurisdictional and non-jurisdictional facilities. The ACV Shippers point out that Kinder Morgan has a strong incentive to allocate and/or assign as high a level of overhead expenses to SFPP as possible in order to increase SFPP's rates and revenues. To support this argument, ACV Shippers cite two cases for the proposition that Commission will scrutinize transactions between affiliates.[89]

76. ACV Shippers further seek rehearing of the Commission's rejection of their proposed "all in" KMI/KMEP combined Massachusetts formula for allocating G&A overhead costs. ACV Shippers state that the sole reason the Commission gave for rejecting ACV Shippers' proposal is the Commission's belief that SFPP's proposed G&A overhead accounting methodology provides a credible, reliable, and accurate assignment

[89] *See* ACV Rehearing at 99 (citing *Northeast Utility Service Co.*, 66 FERC ¶ 61,332, at 62,089-90 (1994); *Missouri River Energy Servs., et al.*, 130 FERC ¶ 63,014, at P 433-437 (2010)).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

or allocation of overhead costs. ACV Shippers state that the Commission also erred in accepting the Trial Staff's assertion that the ACV Shipper's "all in" method was the antithesis of matching cost allocation with causation.[90] ACV Shippers assert that its proposed "all in" method is consistent with the single-tier, three-factor Massachusetts formula, and reasonably matches G&A overhead costs with causation where direct assignment of such costs cannot be reliability or accurately made or lack justification.[91] ACV Shippers assert that the Commission's rejection of the "all in" method is based on the erroneous conclusion that Kinder Morgan's accounting methodology can reasonably and credibly isolate costs within entities or groups of entities.

77. ACV Shippers claim that the Commission, in rejecting the "all-in" method, ignores the fact that SFPP witness Bradley (i) testified that the use of the Commission's single-tier Massachusetts formula methodology for all subsidiaries of a parent company is reasonable,[92] (ii) agreed that there is a causal connection between the three Massachusetts formula factors and the incurrence of KMEP's G&A overhead costs,[93] and (iii) agreed that the Commission's single-tier Massachusetts formula model reasonably matches residual corporate overhead costs with causation. ACV Shippers reiterate that the Commission fails to make any attempt to reconcile its own precedent established in *Williston Basin*,[94] where the direct assignment of G&A overhead costs cannot be made on a reliable and accurate basis or justified, such G&A overhead costs are to be allocated pursuant to the Commission's established three-factor, single-tier Massachusetts formula.

78. ACV Shippers assert that their witness, Dr. Arthur, proposed "all in" or combined KMI/KMEP Massachusetts formula allocation of unallocated G&A overhead costs is clearly required in order to develop a just and reasonable level of G&A overhead costs for designing rates.[95] ACV Shippers note that Dr. Arthur explained that given (i) the fact

---

[90] ACV Rehearing at 203 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 96).

[91] *Id.* (citing *Williston Basin Interstate Pipeline Co.*, 95 FERC ¶ 63,008, at 65,116-119 (2001) (*Williston Basin), aff'd in relevant part*, 104 FERC ¶ 61,036, at 61,108-109 (2003), *order on reh'g*, 107 FERC ¶ 61,164 (2004)).

[92] *Id.* at 205 (citing ACV-287 at 49-50).

[93] *Id.* (citing ACV-287 at 57-58).

[94] *Williston Basin*, 95 FERC at 65,119, *aff'd in relevant part*, 104 FERC at 61,108-109.

[95] ACV Rehearing at 210 (citing Ex. ACV-40 at 46-47).

that neither KMEP nor SFPP have any employees and all overhead expenses that are allocated or assigned to KMEP originate at KMI, (ii) the complexity associated with the KMI and KMEP organizational structure, (iii) the lack of any transparency, objectivity, and accuracy associated with Kinder Morgan's allocation of G&A overhead costs between KMI and KMEP, (iv) the fact that Kinder Morgan policy allows, at any moment, for KMI or GP Services employees to perform work for any Kinder Morgan entity, (v) the blatant inaccuracies, potential for unfettered and subjective manipulation, and (vi) the improper cross-subsidies created between the subsidiaries of KMI and KMEP, there is no credible, reliable, or reasonable foundation for believing or even ascertaining that a KMEP-only Massachusetts formula allocation reasonable represents the amount of overhead expense incurred for the benefit of KMEP's subsidiaries.

b. <u>Commission Determination</u>

79. The Commission denies the shippers' overarching challenge on rehearing of the Commission's approval of SFPP's cost allocation methodology. This case presents the Commission with two cost allocation approaches from which to choose. The first option is SFPP's "multi-tiered" costing methodology. The second alternative, supported by the Tesoro and the ACV Shippers, is the single, corporate-wide (or single-tiered) Massachusetts formula, the "all in" approach. The Commission must determine which of these two cost allocation approaches to use. In addressing this issue, the central holding that controls is that "[c]ost allocation is not an exact science and no one method may be said to fit all situations."[96] In deciding which cost allocation methodology to apply, the Commission must choose from the cost allocation alternatives available on the record.[97] Thus, the Commission "must sometimes conclude which is the more reasonable of the several [cost allocation] alternatives."[98] To make the decision, the Commission considers which methodology most closely conforms to the Commission's long standing practice of trying to align cost allocation with cost causation.[99]

---

[96] *Michigan Gas Storage Co.*, 89 FERC ¶ 61,131, at 61,376 (1999).

[97] *See id.* (stating that where the record presents the Commission with three flawed approaches from which to choose, it must choose from the alternatives available on the record).

[98] *Transcontinental Gas Pipe Line Corp.*, 106 FERC ¶ 61,299, at P 190 (2004); *see also Colorado Interstate Gas Co.* v. *FPC,* 324 U.S. 581, 589 (1945) (noting "[a]llocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science.").

[99] *Transcontinental Gas Pipe Line Corp.*, 106 FERC ¶ 61,299 at P 190.

80. Both SFPP's and the shippers' cost allocation methodologies apply the Commission-approved Massachusetts formula for allocating indirect costs. Thus, the major difference between the two methodologies is the use of direct assignments for certain costs. Under SFPP's multi-tiered cost allocation methodology, costs are assigned to different operating levels (tiers) within the KMEP structure and then are allocated via the Massachusetts formula. Under this method, there are four tiers. Tier 1 encompasses all KMEP-Operated Entities. The overhead costs included in Tier 1 are those applicable to all of the KMEP-Operated Entities that cannot be assigned to any other tier. These Tier 1 costs are allocated via the Massachusetts formula to all the entities within Tiers 2, 3, and 4. Tier 2 is comprised of KMEP's products pipeline subsidiaries, which includes SFPP. The overhead costs included in Tier 2 are those that are incurred on behalf of any of KMEP's products pipelines and related facilities and can be directly assigned to this tier. Tier 2 is further subdivided into four regional groups, and all costs that can be directly assigned to a specific regional group are assigned to that group and then allocated via the Massachusetts formula among the subsidiaries in that specific regional group. The Tier 2 overhead costs that cannot be attributed to any one of the regional groups are allocated, via the Massachusetts formula, to all of the entities within Tier 2. Tier 3 assigns and allocates costs to KMEP's CO_2 pipeline entities. Tier 4 assigns and allocates costs to bulk terminals and the terminals that are not associated with the products pipelines contained in Tier 2.

81. The cost allocation approach presented by Shipper Parties is the "all-in" approach. Under the "all-in" approach, all of the overhead costs for the entire corporate family (including all KMI and KMEP subsidiaries) would be allocated via the Massachusetts formula to all KMI and KMEP subsidiaries, without any direct assignment of overhead expenses. Shipper Parties advocate for the "all-in" method because they believe that it is impossible under KMI's accounting structure to make reasonably accurate direct assignments of overhead costs among the entities in the KMI-KMEP corporate structure.

82. The Commission affirms on rehearing that of the two cost allocation methodologies presented in this proceeding, SFPP's multi-tiered allocation approach more closely gives effect to the Commission policy that costs be directly assigned when it is possible to do so. As the Commission explained in *Williams Natural Gas Co.*,[100] "the [Massachusetts] formula is intended to allocate corporate costs to the subsidiaries to the extent that each subsidiary uses or benefits from the services provided by the corporate cost centers. A direct charge is the most accurate way to match the benefit with the cost, and it should be used as the first step where a direct charge can be assessed."[101] The

[100] 85 FERC ¶ 61,285, at 62,138 (1998) (*Williams*).

[101] *Williams*, 85 FERC at 62,138.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Commission further explained in *Williams*, "only after costs are directly charged where appropriate is the general allocator used."[102]

83. The Commission policy requiring direct charges arises from the principle of cost causation. Under the principle of cost causation, the Commission must ensure that the costs allocated to a beneficiary are at least roughly commensurate with the benefits that are expected to accrue to that entity.[103] The Commission, in reviewing SFPP's proposed multi-tiered cost allocation methodology, considered whether SFPP's methodology is consistent with this cost causation principle. However, both the Commission and the U.S. Court of Appeals have made clear that cost allocation is not an exact science.[104] The D.C. Circuit has long recognized that agency ratemaking is "far from an exact science" and involves policy decisions.[105] Moreover, the D.C. Circuit has explained that cost causation "does not require exacting precision in a ratemaking agency's allocation decisions."[106]

84. SFPP's multi-tiered approach seeks to maximize the direct assignment of costs to the lowest levels in the operating and accounting structure. The record includes substantial testimony supporting the multi-tiered approach as adhering to the Commission's principles of cost causation.[107] KMEP directly allocated costs to the

---

[102] *Id.* (explaining that direct charges are those charges that have a clearly identifiable beneficial or casual relationship to the product or service provided, but that does not mean the pipeline must engage in an administratively burdensome and expensive process of attempting to allocate directly costs that are not susceptible to direct allocation. Rather practicality may be considered in determining which costs to allocate directly).

[103] *Midwest Indep. Transmission Sys. Operator*, 133 FERC ¶ 61,221, at P 27 (2010).

[104] *Id.*

[105] *Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424, 1431 (D.C. Cir. 1996).

[106] *Midwest ISO Transmission Owners, et al. v. FERC,* 373 F.3d 1361, 1369 (D.C. Cir. 2004) ("we have never required a ratemaking agency to allocate costs with exacting precision"); *see also Sithe/Independence Power Partners, L.P. v. FERC*, 285 F.3d 1, 5 (D.C. Cir. 2002).

[107] *See e.g.*, 2009 ID, 129 FERC ¶ 63,020 at P 46-59 (describing Bradley direct testimony), P 68-74 (describing Dr. Webb direct testimony), P 451-460 (describing Bradley rebuttal testimony), and P 497 (describing Dr. Webb rebuttal testimony).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

incurring entity wherever possible. Further, the multiple tiers of cost allocation imposed by KMEP further helps to directly assign costs to the specific entity or groups of entities that incurred the cost, avoiding a general assignment of KMEP overhead costs to all subsidiaries. Specifically, through the use of a system of separate employees (i.e., GP Services, KMI-dedicated and KMI-shared), RCs, salary splits, time sheets and shared services accounts, the overhead costs associated with the KMI-operated and KMI-owned entities are reasonably separated from the overhead costs associated with the KMEP-operated entities. Thus, the pool of costs allocated through KMEP's Massachusetts formula includes only those costs associated with the subsidiaries that benefit from the activities that generated the costs, the KMEP-operated entities. SFPP states that KMEP's allocation of residual overhead costs that cannot be directly assigned to an individual subsidiary or group of subsidiaries is allocated through a traditional, "one-tier" Massachusetts formula.[108] It would be contrary to the principle of cost causation for an entity outside the KMEP-operated entities to be allocated any KMEP costs through a Massachusetts formula because there is no credible evidence here that those entities benefit from any GP Services costs or from the portion of the KMI costs included in the KMI cross-charge to KMEP.

85. Conversely, under the shippers' "all in" approach there is no attempt to directly assign any of KMI's overhead costs. Rather, under the "all in" approach all of KMI's and KMEP's overhead costs would be allocated using the Massachusetts formula to all of the Kinder Morgan entities without any regard to which entities benefited from the costs. Under the "all in" approach, all of GP Services' costs would be allocated via the Massachusetts formula to KMEP-Operated Entities (including SFPP) without regard to whether a portion of GP Services' overhead costs were occurred on behalf of and therefore, directly assigned to specific entities or regional groups other than SFPP. This would result in SFPP being assigned a portion of costs from which SFPP did not benefit. Thus, the "all-in" approach is fundamentally flawed for failing to directly assign costs to the extent practicable. The Commission therefore finds that the "all-in" method would result in unjust and unreasonable rates because KMEP's and KMI's overhead costs would be inappropriately allocated among a wide range of jurisdictional and non-jurisdictional entities, including several natural gas pipelines that are subject to the Commission's authority under the Natural Gas Act.[109] The Commission therefore affirms that of the two

[108] *See* SFPP Initial Brief at 83 (Sept. 30, 2009) (citing Staff witness Mr. Sosnick, Ex. S-12 at 14-20).

[109] *See* 15 U.S.C. § 717 *et seq*. Several of the eight KMI-Operated natural gas pipelines are subject to the Commission's jurisdiction including: Trailblazer Pipeline Company, TransColorado Gas Transmission Company, and Rockies Express Pipeline.

cost allocation approaches presented in this case, SFPP's multi-tiered cost allocation method is the most consistent with the Commission's principle of cost causation and the purpose of the Massachusetts formula.

86. Further, the Commission remains unconvinced by Tesoro's and the ACV Shippers' objections to the multi-tiered approach. Shippers' challenges to SFPP's multi-tier cost allocation methodology generally fall into one of two categories: (1) concern with the complexity associated with the KMI and KMEP organizational structure, and (2) concern regarding the accuracy of the assignments. With respect with the arguments regarding the complexity of the Kinder Morgan accounting structure, SFPP should not be penalized because it is a subsidiary within a complex corporate structure. The concerns regarding the accuracy of the assignments are addressed in the section on the quality of the direct assignments below as are arguments related to the cost allocations among various KMEP subsidiaries.

87. The Commission next addresses the ACV Shippers' arguments that SFPP witness Bradley acknowledged that a single-tier or "traditional" Massachusetts formula cost allocation is a reasonable form of cost allocation for indirect costs. The Commission agrees that a single-tier Massachusetts formula can be a reasonable and appropriate overhead cost allocation methodology. This acknowledgement is not a concession that the KMEP multi-tiered overhead cost allocation methodology is unreasonable or that the Shipper Parties' "all-in" method is appropriate here. Thus, the past acceptance of a single-tier Massachusetts formula cost allocation methodology does not prevent a regulated pipeline from seeking approval of a multi-tier cost allocation methodology as SFPP does in this case.[110] Commission approval of the use of a single-tier Massachusetts formula does not make it the only appropriate cost allocation methodology. Rather, if a regulated pipeline seeks to modify the application of the Massachusetts formula, the Commission will review the proposed methodology, in this case the multi-tiered methodology, to ensure it does not result in unjust and unreasonable rates.

88. Finally, with respect to ACV Shippers' due process arguments, the Commission denies rehearing. The ACV Shippers' concern is that the Commission, by requiring SFPP to submit additional record evidence in its Compliance Filing, did not allow other parties an adequate opportunity to respond. First, under Rule 716, it is fully within the Commission's discretion to reopen the record in a proceeding if the Commission has "reason to believe that reopening of a proceeding is warranted by . . . the public interest."[111] In Opinion No. 511, the Commission required SFPP, as part of its

[110] Further, the shippers did not cite any precedent to the contrary.

[111] 18 C.F.R. § 385.716 (2011).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Compliance Filing, to provide additional justification and verification regarding the overhead cost assignments and allocations from certain RCs.[112] The Commission found this approach was consistent with the approach taken in *Williams*,[113] and is necessary; i.e., is in the public interest, to assure that the costs flowing to KMEP and SFPP from GP Services and the KMI cross-charge are assigned and allocated with reasonable accuracy to the KMEP-Operated Entities, including SFPP.[114]

89. In directing SFPP to provide the additional record evidence in its compliance filing, the Commission further noted that protesting parties, Trial Staff, and the Commission would be able to evaluate the compliance filing and its impact on the rate design. The Commission further stated that it would then determine whether to require a further hearing on this matter after reviewing SFPP's compliance filing. Thus, the ACV Shippers and the other shipper litigants have had an opportunity to rebut SFPP's evidence presented in SFPP's Compliance Filing as demonstrated by the hundreds of pages of comments on the Compliance Filing and supporting affidavits and documents filed by the shipper litigants. The ACV Shippers alone filed a 52-page protest and comments on SFPP's Compliance Filing supported by a 57-page affidavit of its witness Dr. Daniel Arthur, which was accompanied by multiple exhibits. The Commission finds that shipper litigants have had the same opportunity to rebut and respond to the supplemental evidence submitted in the SFPP Compliance Filing as if the Commission had remanded the issue for further briefing on the issue.[115] Notably, none of the shipper litigants that protested SFPP's Compliance Filing requested that the Commission set the issue of the quality of the direct assignments for further hearing or discovery.

90. While the ACV Shippers argue that the Commission erred in providing SFPP with a so-called second bite at the apple, the paper hearing that was afforded in the context of this Compliance Filing was an opportunity for the Shipper Parties to address the statement in Opinion No. 511 that their critique of SFPP's testimony and cost allocation

---

[112] Opinion No. 511, 134 FERC ¶ 61,121 at P 137.

[113] In *Williams*, the Commission directed additional information to be obtained through a formal hearing. *Williams*, 85 FERC at 62,137. However, a full hearing is not obligatory in these matters if an opportunity for comment is provided.

[114] Opinion No. 511, 134 FERC ¶ 61,121 at P 137.

[115] *See e.g., Kern River Gas Transmission Company*, 123 FERC ¶ 61,056, at P 188-190 (2008) (order on rehearing in which the Commission reopened the record to give all parties an opportunity to submit additional evidence).

methodology lacked sufficient analytical rigor.[116] As part of its Compliance Filing, SFPP provided all the accounting information that lay behind its cost allocation methodology for the 2007 test year. However, the Commission finds that the Shipper Parties' protests of SFPP's Compliance Filing contain several fundamental limitations. First, much of their evidence consists of testimony from the East Line rate proceeding, Docket No. IS09-437-000. This is inappropriate because it has no legal relevance here and reflects the Shipper Parties' failure to effectively address the additional material submitted by SFPP in this proceeding. Second, the Shipper Parties have not modified the litigation strategy they used at hearing, which was (1) to make arguments based on a literal interpretation of parts of *Williams*, and (2) to challenge SFPP's multi-tier cost allocation methodology based on errors found in a relatively narrow portion of that methodology. By relying on their prior arguments and material inappropriately excised from the Docket No. IS09-437-000 record Shipper Parties did not avail themselves of the opportunity to make a more refined statistical and analytical critique of SFPP's direct assignments and accounting structure.

91. Next, the Commission addresses more specific issues raised on rehearing regarding Opinion No. 511's determinations on SFPP's overhead cost allocation. In two specific instances, we grant rehearing where we conclude that SFPP's evidentiary presentation is inadequate.

2. Relevance of Using Different Accounting Methods for Different Regulatory Bodies

a. Rehearing Requests

92. Tesoro challenges on rehearing the Commission's acceptance of the fact that SFPP uses different accounting systems for different purposes, i.e., uses a different accounting or reporting system for purposes of filings made with the SEC versus the allocation methodology used in rate proceedings before the Commission. Tesoro states that in KMEP's SEC Form 10-K filing, Kinder Morgan officers submitted sworn statements representing that certain overhead expenses are not attributable to any particular SFPP entity business segment. Tesoro, therefore, asserts that KMEP has represented that a completely different overhead allocation methodology correctly represents its overhead costs. The ACV Shippers echo this argument on rehearing and in its Compliance Filing protest, stating that SFPP's allocation methodology has no purpose other than for ratemaking, thus there can be no presumption of reasonableness or accuracy associated

---

[116] *See* Opinion No. 511, 134 FERC ¶ 61,121 at P 136.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

with Kinder Morgan's purported methodology used for assigning and allocating G&A overhead costs.

93. The ACV Shippers also argue that the fact that Kinder Morgan presents differing overhead cost allocation methodologies to the SEC and the Commission is conclusive evidence that SFPP's G&A overhead cost accounting and allocation methodology was developed solely for ratemaking purposes and was not used for internal business purposes by Kinder Morgan's management. ACV Shippers thus conclude that SFPP's overhead cost accounting and allocation methodology is not an objective business practice. As an example, the ACV Shippers note that KMEP's SEC 10-K states that $278.7 million of G&A overhead costs were items not attributable to any segment. Yet in this proceeding, SFPP claims that KMEP can directly assign $111.9 million of these same G&A overhead costs to individual KMEP subsidiaries and groups of subsidiaries. Moreover, the ACV Shippers note that KMEP's SEC Form 10-K is prepared in accordance with the SEC regulations and Financial Accounting Standards Board (FASB) accounting standards, which require reporting by business segments in the manner used internally to evaluate subsidiary performance. Thus, the ACV Shippers conclude that because Kinder Morgan does not and has not incorporated SFPP's proposed G&A overhead accounting and allocation methodology in its SEC Form 10-K reporting, SFPP's proposed G&A overhead methodology is not relied upon internally by senior management within Kinder Morgan to evaluate subsidiary performance or for making operating decisions. Thus, ACV Shippers conclude SFPP's proposed G&A overhead ratemaking methodology cannot be considered an objective Kinder Morgan business practice. In short, the ACV Shippers complain that Kinder Morgan pays no meaningful recognition to SFPP's purported G&A overhead methodology outside SFPP's rate proceeding. Accordingly, the ACV Shippers argue that the Commission erred in stating in Opinion No. 511 that "[i]t cannot be reasonabl[y] contested here that KMI's accounting system is designed to assign and allocate[] for purposes of internal administration as well as for rate design."[117]

b. Commission Determination

94. The Commission again rejects this argument that both Tesoro and the ACV Shippers have pursued through this proceeding. The argument, at its core, is that the accounting methodologies that SFPP used to allocate overhead costs must be rejected because they are not identical to the accounting used for its corporate SEC filings. This argument is without merit. The SEC and the Commission serve different regulatory purposes and as such, have different accounting and financial reporting requirements for

[117] ACV Rehearing at 109-110 (quoting Opinion No. 511, 134 FERC ¶ 61,121 at P 101).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

jurisdictional entities. While the Commission does not normally comment on the regulatory practices of other agencies, the record here indicates that the SEC reporting method precludes the assignment of costs to business segments that are not directly incurred by those segments and precludes the allocation of the costs that may be incurred by several different functions or subsidiaries.[118] In contrast, the Commission's Uniform System of Accounts, 18 C.F.R. Part 352, is to be used by oil carriers to comply with the Commission's accounting and financial reporting regulations and is specifically designed to distinguish situations where the direct or indirect allocation of costs is appropriate.[119] This reflects the fact that, in a ratemaking context, the Commission requires direct assignment of costs where possible and the formulaic allocation of the remaining indirect costs to relevant subsidiaries.

95. This difference in purpose is consistent with the Commission's prior recognition that "[j]urisdictional entities are routinely required to report financial information to the Commission in a manner that is not entirely consistent with the methodology used for external reporting purposes."[120] The Commission also requires reported financial information to be based on Generally Accepted Accounting Principles (GAAP) standards, which are promulgated by FASB.[121] The Shipper Parties provide no evidence that Kinder Morgan's direct cost assignment methodology at issue here is inconsistent with GAAP. For example, the Shipper Parties have provided no evidence that KMI/KMEP maintains a parallel set of ledger entries, time sheets, or other documents that are designed to capture operating and financial costs in a manner that is inconsistent with the direct cost assignment methodology SFPP has advanced here. More is required

---

[118] SFPP Brief Opposing Exceptions at 60-61 (citing SFP-139 at 14-15 (Webb testimony)). In other words, unless the costs can be directly assigned, then they are deemed not to be capable of allocation under the SEC reporting standards. An example is that pension costs or financing costs incurred at the level of a corporate parent are not to be assigned to a subsidiary or function that does not directly incur those costs.

[119] A specific example in this case is whether certain capital expenditures should be directly assigned or included in a broader cost category and allocated by formula. *See* Opinion No. 511, 134 FERC ¶ 61,121 at P 145.

[120] *Cal. Indep. Sys. Operator Corp.*, 126 FERC ¶ 61,263, at P 13, 15-16 (2009).

[121] *Id.*

20111216-4007 FERC PDF (Unofficial) 12/16/2011

here than the facial inconsistency of different regulatory regimes and an inference that the difference is intended to deceive.[122]

96. As it pertains to this case, the Commission has regulatory oversight over SFPP's rates and rate design. The issue here is cost allocation. Cost allocation is a ratemaking issue, not an accounting issue. The Commission has long recognized that accounting rules do not dictate ratemaking, noting: "Despite the obvious relevance of accounting precepts for some regulatory policies, they cannot supply an independent basis for action when they may conflict with established ratemaking principles."[123] The standard of review here is whether the direct assignment methodology SFPP advances here is reasonably designed to meet the ratemaking principle of maximizing the direct assignment of costs in a specific regulatory proceeding. What the SEC requires for financial reporting purposes is not controlling any more than the Commission's past recognition that some accounting treatments are not necessarily related to operational realities or other components of ratemaking. For these reasons, the Commission denies rehearing on this issue.

3. Quality of Direct Assignments

a. Rehearing Requests

97. Next, the Commission addresses the Shipper Parties' arguments that errors in a small sample of RCs invalidate KMI/KMEP's direct assignment and multi-tiered cost allocation methodology in their entirety. Tesoro states on rehearing that the Commission erred in dismissing evidence of rampant and significant errors inherent in the timekeeping

---

[122] The Shipper Parties' argument that there is no connection between the allocation method at issue here and KMI/KMEP's business accounting concerns is inconsistent with the assertion that it is readily used to manipulate regulatory costs. To use this type of manipulation in a skilled manner assumes the effort has some grounding in the realities of the company's operations. Otherwise, it would collapse under any type of rigorous scrutiny. In fact, where the costs at issue here do not seem to be adequately tied back to specific operations and geographic locations, the Commission is rejecting the assignment.

[123] *See Alabama-Tennessee Natural Gas Co. v. FPC*, 359 F.2d 318, 336 (5th Cir 1966) (stating "[Accounting] for tax purposes and even the Commission's present Uniform System of Accounts may be valuable tools, but they cannot dictate ratemaking policies.").

20111216-4007 FERC PDF (Unofficial) 12/16/2011

process that serves as the foundation for KMEP's assignments.[124] Tesoro states that evidence in the record of that proceeding indicates that 64 percent of the employee time and cost assignments of overhead expenses purportedly reflected on KMEP's general ledger were incorrect. Tesoro argues that a methodology that produces erroneous results 64 percent of the time is not reasonable. Tesoro states that this error rate undercuts any claim that SFPP's accounting structure has strong internal protocols for ensuring accuracy, and instead shows that the errors are pervasive and reflect a fundamentally flawed system.[125]

98. The ACV Shippers also contest the Commission's findings regarding the quality of SFPP's direct assignments.[126] ACV Shippers argue that Kinder Morgan's purported G&A overhead accounting methodology fails to reliably or credibly isolate KMI overhead costs and does not rigidly separate KMI and GP Services employees and related costs. ACV Shippers argue that Opinion No. 511 ignores the fact that SFPP presented no data or evidence regarding KMI-dedicated employee costs in order to verify, test, or audit how those costs have been assigned or allocated, i.e., that there is no record evidence to demonstrate that KMI-dedicated employees' G&A overhead costs are directly assigned on a consistent and accurate basis. ACV Shippers support this allegation with citations to the East Line rate proceeding (Docket No. IS09-437-000). Thus, ACV Shippers state that because SFPP's G&A cost allocation has not been shown to be a credible mechanism for isolating overhead costs or to be a reasonable or accurate methodology for assigning or allocating costs between KMI and KMEP, the only reasonable methodology is the proposed "all-in" cost allocation methodology presented by ACV Shippers' witness Dr. Arthur.[127]

99. ACV Shippers also challenge the Commission's acceptance that KMI and GP Services employees are "rigidly" separated for cost accounting purposes. ACV Shippers argue that the record clearly demonstrates that there is no rigid separation of these employees. To support their claim, ACV Shippers state that employees of GP Services directly oversee employees of KMI, and therefore, these GP Services employees are indirectly performing overhead services for the KMI-Owned and KMI-Operated

[124] Tesoro Rehearing at 30-32.

[125] *Id.* at 32.

[126] ACV Rehearing at 110-121.

[127] *Id.* at 111.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

subsidiaries.[128] Next, the ACV Shippers assert that certain KMI employees are overseen by the management group overseeing KMEP's products pipelines, which includes GP Services employee Tom Bannigan, President of KMEP's Products Pipeline divisions. ACV Shippers thus conclude that if employees of GP Services are overseen by employees of KMI and GP Services are overseeing KMI employees, there is no rigid separation. Specifically, ACV Shippers argue that the employees of KMI and GP Services are functionally operating as one integrated unit as there are no bright lines or firm boundaries that separate the two entities or the overhead services they perform.

100. ACV Shippers again argue that the Commission erred in affirming the ALJ's determination that SFPP's G&A overhead assignment and allocation methodology is "based on sound accounting principles." They assert that this claim is undermined by the fact that Kinder Morgan's accounting structure and cost allocation methodology may have been developed, in part, for business rather than for regulatory purposes. ACV Shippers argue that SFPP's G&A accounting methodology has no recognized business purpose, as SFPP's G&A accounting methodology is the antithesis of Kinder Morgan's representations in its SEC Form 10-Ks and related audited financial statements. They state that the fact that Kinder Morgan does not recognize or use SFPP's proposed methodology in its SEC Form 10-K reports establishes that Kinder Morgan does not rely on or recognize SFPP's proposed G&A overhead methodology to evaluate the performance of its subsidiaries; i.e., has no meaningful business purpose. The ACV Shippers assert that this undermines the Commission's conclusion in Opinion No. 511 that "the reliance on an accounting system that also has business functions has long been acceptable to the Commission if the methodology is adequately supported."[129]

101. The ACV Shippers further argue that the Commission arbitrarily trivialized the deficiencies and inaccuracies in SFPP's G&A overhead assignment as "technical errors."[130] The ACV Shippers then give a detailed discussion of the record evidence on this issue. For example, the ACV Shippers note that SFPP's direct assignment of overhead costs for RC 1002 (Commercial Management Team Orange) demonstrated that SFPP's primary company witness in this proceeding, James Kehlet, assigned 100 percent of his time to SFPP.[131] However, Mr. Kehlet testifies that as Vice President, Marketing

[128] *Id.* at 119 (citing Ex. ACV-50C at 4; Ex. ACV-51C at 25, 29, 30).

[129] *Id.* at 122 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 103).

[130] *Id.* at 124.

[131] *Id.* at 125 (citing Ex. ACV-279HC at 1). RC 1002 is one of the five RCs that directly assign costs to SFPP.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

West for KMEP, he was directly responsible for marketing for the Pacific Region of Kinder Morgan, including West Coast, Terminals, SFPP, and Calnev Pipe Line LLC (Calnev). Next, ACV Shippers point to its witness Dr. Arthur's analysis of the time and labor cost assignments reflected on KMEP's books and records for RC 1006 (Logistics KMP Pipelines) showed the vast majority of the employees in this RC as having 100 percent of their time and expenses assigned to SFPP notwithstanding the numerous other KMEP pipeline and terminal subsidiaries which would necessarily require logistical services from RC 1006.[132] ACV Shippers state that Dr. Arthur's analysis demonstrated the inconsistency of having supervisors assigning 100 percent of their time to SFPP while at the same time the employees they supervise were assigning their time to KMEP subsidiaries other than SFPP. ACV Shippers note that at hearing SFPP's witness Mr. Bradley included a revised G&A overhead model during the hearing that corrected the cost allocation to correct inaccuracies. They assert that SFPP's revised overhead allocation model did nothing to mitigate the basic flaws in SFPP's proposed methodology and there is no basis to believe that SFPP's self-survey captured all of the time/cost assignment errors. Thus, the purported "correction" lacked credibility and was incomplete.[133]

102. In sum, the ACV Shippers make the overarching assertion that Kinder Morgan proposes a G&A overhead accounting structure for assigning overhead expenses to SFPP that allocates as much G&A overhead expenses to SFPP as possible. They assert this is done to support an excessive rate level and benefit non-regulated affiliates. ACV Shippers assert that Kinder Morgan uses a completely different accounting methodology or no accounting methodology at all, for internal evaluation of the performance of its subsidiaries and making decisions on how to allocate capital among the subsidiaries. They further argue that if different accounting methods are used by Kinder Morgan for ratemaking versus internal business decision-making, then there are serious concerns and questions regarding the ratemaking accounting methodology.[134] ACV Shippers' argument implies that the direct assignment methodology at issue here is designed specifically to manipulate cost allocations for purposes of regulatory ratemaking.

103. ACV Shippers argue that the Commission must investigate the accuracy and reasonableness of the G&A overhead cost assignments and allocations associated with all

[132] *Id.* (citing Ex. ACV-279HC at 2-4). RC 1006 is one of the five RCs that directly assign costs to SFPP.

[133] *Id.* at 127-129.

[134] *Id.* at 207.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

of GP Services' and KMI's RCs. ACV Shippers further argue there is no basis or foundation to claim that Kinder Morgan's G&A overhead accounting methodology effectively captures and/or isolates overhead costs with individual or groups of Kinder Morgan subsidiaries or that it is based on "sound accounting principles." ACV Shippers next argue that the Commission erred in claiming that G&A overhead RCs that do not directly or indirectly assign costs to SFPP are irrelevant.[135] The ACV Shippers argue that even though an RC may not assign costs to SFPP, the entity or entities that these RCs assign costs to is critical to the verification of whether SFPP's proposed methodology is accurate and reliable and whether SFPP has included in the Massachusetts formula all of the applicable and relevant entities that are causing and benefitting from Kinder Morgan's G&A overhead services. Thus, the ACV Shippers conclude that where SFPP has only provided data on five RCs and this same data conclusively demonstrated that assignments of G&A overhead time and costs were inaccurate 64 percent of the time, there is no rational basis to simply assume that all of the other RCs do not reflect errors of similar magnitude or would identify other anomalies, such as the improper exclusion of entities which would further demonstrate the lack of credibility and reliability to be attributed to SFPP's proposed G&A overhead accounting methodology.

104. The ACV Shippers state that the Commission erred in asserting that SFPP has established that Kinder Morgan has developed effective policies and protocols to capture and isolate G&A overhead costs for the Kinder Morgan subsidiaries without any evidentiary foundation for this assertion. The ACV Shippers note that SFPP's only support in the record for SFPP's claims about Kinder Morgan's ability to track and isolate G&A overhead costs with individual or groups of subsidiaries were sample salary splits and time sheets for a small set of employees.[136] ACV Shippers state SFPP presented no evidence of any internal protocols for monitoring the reasonableness or accuracy of G&A overhead time and costs assignments existed or had been performed. To support its argument that Kinder Morgan has not developed uniform or specific protocols or policies for assigning G&A overhead costs, the ACV Shipper cite to SFPP witness Knudsen, a Kinder Morgan employee in RC 1006, who testified that he was unaware as to who was responsible for establishing the allocation of his time and that he had not received any written or verbal guidelines on how he should allocate his time, although Mr. Knudsen stated that "years back" he was provided instructions on coding his time to Kinder Morgan capital projects.[137]

[135] *Id.* at 145 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 131-132).

[136] *Id.* at 153 (citing Ex. SFP-41; Ex. SFP-43).

[137] *Id.* at 154 (citing Tr. 974).

b. Commission Determination

105. The Commission denies rehearing with respect to Tesoro and the ACV Shippers' general challenge to the quality of the direct assignment of costs to KMEP-Operated Entities either via the KMI cross-charge or GP Services charges. The core of their argument is that errors in the RCs examined at hearing are evidence that all of KMI/KMEP's direct cost allocations are unreliable and unacceptable for use in this proceeding. Their central point is that the RCs assigning costs directly to SFPP had a 64 percent error rate. From this observation ACV Shippers and Tesoro extrapolate that a similar error rate is likely to apply to all aspects of KMEP's overhead cost allocation and therefore it should be rejected.[138] As discussed in detail below, the Commission rejects the argument that the 64 percent error rate reflects a systemic problem with the overhead cost allocation because (i) the error rate reflects the Location Code 0002 error which is limited to five RCs, and (ii) Shipper Parties fail to justify attributing a 64 percent error in five RCs to the hundreds of unexamined RCs.

106. First, the record, including SFPP's Compliance Filing, demonstrates that the 64 percent error rate in the RCs that directly assign costs to SFPP is not representative of a possible error rate in other RCs. As discussed in detail below in section V.C.1 of this order,[139] the five RCs that directly assign costs to SFPP were subject to an error, the Location Code 0002 error, that was limited to those five RCs.[140] The Location Code

[138] Costs are assigned or allocated to SFPP from five sources. The first source is costs directly assigned from five RCs to SFPP. The second source is costs directly assigned to the Pacific Pipeline Group, a subgroup within Tier 2, which costs are allocated among the members of the Pacific Pipeline Group (i.e., SFPP, Calnev and West Coast Terminals) using the Massachusetts formula. The third source of costs are those directly assigned to the Tier 2 Products Pipeline Group, which group includes the Pacific Pipeline Group, Mid-Continent Pipeline Group, Eastern Pipeline Group and Southeast Pipeline Group, and are then allocated to all members of the Products Pipeline Group using the Massachusetts formula. The fourth source is costs generated by GP Services on behalf of KMEP-Operated Entities, which costs could not be directly assigned, to all of the KMEP-Operated Entities using the Massachusetts formula. The fifth source is costs generated by the KMI-shared employees or RCs for the benefit of KMEP-Operated Entities, which costs are assigned to KMEP through the KMI cross-charge and then allocated to all of the KMEP-Operated Entities using the Massachusetts formula.

[139] *See infra* at P 181-200.

[140] The five RCs that directly assign costs to SFPP are: RC 1002, RC 1006, RC 1009, RC 1011, and RC 1040.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

0002 error is the result of the accounting department misapplying the Location Code 0002 tag used by the G&A employees in those five RCs. SFPP states that the G&A employees intended for their labor costs coded to Location Code 0002 to be assigned to the Pacific Pipeline Group sub-tier. Instead, the accounting department directly assigned costs in the five RCs at issue coded to Location Code 0002 to SFPP. The Location Code 0002 error affects a large percentage of the $9.3 million in costs directly assigned to SFPP and appears to account for the Shipper Parties' claimed 64 percent error rate. The Commission finds that the Location Code 0002 error is isolated and contained in nature and is not evidence of "rampant" errors inherent in the timekeeping process such that KMEP's entire cost allocation methodology is irretrievably undermined.

107. Second, Shipper Parties fail to substantiate their claim that a large number of errors within the five RCs that directly assign costs to SFPP reflect a systemic problem in the KMI/KMEP cost allocation methodology. The Shipper Parties' argument assumes that the impact on SFPP of errors at the KMI level, i.e., the KMI-shared employees or KMI-shared RCs, reflects the same probability of error and impact as those of a much smaller sample. The Commission agrees that human error, or in the case of costs directly assigned to SFPP, the incentive for error is greatest at the lowest level at which the costs are captured. In contrast, at the KMI level, shared costs are aggregated with all of the shared costs assigned to KMEP through the KMI cross-charge. The KMI cross-charge is then allocated to all KMEP-Operated Entities, including SFPP, using the Massachusetts formula. Thus, the impact of any errors in the KMI-shared costs is diluted as the costs flow down through KMEP Massachusetts formula. Thus any implication that a 64 percent error rate in the five RCs directly assigning costs to SFPP is relevant here has two incorrect assumptions: (1) that the same error rate occurs elsewhere and (2) that it is material. In that regard, as Opinion No. 511 points out, it makes a considerable difference whether the erroneous timesheets in the sample have an error rate of 30 out of 40 hours or 2 out of 40 hours.[141]

108. Shipper Parties also incorrectly assume that the incentives for distortion are the same at the KMI level as at the operating level of the Pacific Pipeline Group. In short, the incentive for distortion as well as the ability to implement it declines as a cost center becomes more removed from SFPP's operations, its costs, and its return on the KMEP's income statement. Absent some evidence of systemic manipulation, which there is none in the record, this broad brush argument fails.

109. There is also a practical limitation to the Shipper Parties' general argument concerning KMI/KMEP's accounting structure. First, despite the hearing record and the

---

[141] *See* Opinion No. 511, 134 FERC ¶ 61,121 at P 131-135.

opportunity for further analysis, the Shipper Parties present no factual evidence that any costs have been shifted to SFPP from separate groups such as the CO_2 pipeline group (Tier 3), within the KMEP structure or between the KMI-Owned Entities that are served only by KMI employees. Given this, they make no practical showing beyond their broad brush attack that any limitations within those other groups have any impact on SFPP's costs whatsoever. Moreover, Opinion No. 511 recognized that there was a possibility that KMI-shared costs could be over assigned (not allocated) to KMEP for distribution through its Massachusetts formula. Opinion No. 511 directed SFPP to review those assignments with the recognition that some of KMI-shared RCs were more relevant to SFPP's operations and more likely to have an impact than others.[142] SFPP performed the analysis and adjusted the figures using sources from the 2007 test year.[143]

110. Shipper Parties did not appear to review the more important KMI-shared RCs, perform a sensitivity analysis of their possible impact, or draw a basic statistical sample from the underlying work papers to challenge SFPP's analysis. Instead, Shipper Parties rely primarily on an argument that extrapolates a 64 percent error rate for all of KMI-shared and GP Services RCs from the 64 percent error rate in five RCs studied by the Shipper Parties. This argument is insufficient to substantiate their proposed "all in" Massachusetts formula approach given the Commission's strong preference for direct assignment and the lack of any meaningful correlation between cost incurrence and cost allocation that would occur if a KMI/KMEP wide Massachusetts formula were used in this proceeding. The Commission therefore finds that the record reflects that Tesoro's and ACV Shippers' blanket objection that SFPP's direct assignment of corporate overhead costs is fundamentally flawed and failed to satisfy the burden of persuasion the shippers bear in this case of providing sufficient record evidence on the matter they sought to establish.[144]

111. The Commission is not blindly accepting all of SFPP's conclusions regarding overhead cost allocation. The Commission recognizes that direct cost assignments to SFPP, to the Tier 2 Pipeline Products group and to the Pacific Pipeline Group are the

[142] Opinion No. 511 provides a specific example of this point and provides guidance on how one might approach the issue of the assignment of jointly-shared costs from KMI to KMEP. *See* Opinion No. 511, 134 FERC ¶ 61,121 at P 134-35.

[143] *See* SFPP Compliance Filing, Bradley Affidavit at P 39-48.

[144] *See e.g., Complex Consolidated Edison Co. of New York, Inc. v. FERC*, 165 F.3d 992, 1008 (D.C. Cir. 1999) (citing *City of Winnfield, La. v. FERC*, 744 F.2d 871 (D.C. Cir. 1984)).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

areas where accounting errors can have the most direct impact on SFPP. They are also the areas where managers may have the greatest incentives to shift costs among closely related affiliates. As such, in this case the Commission required SFPP to present in its Compliance Filing a detailed presentation supporting the direct assignment of costs. The Commission applies this standard when examining the exclusion of certain affiliates and reviewing relevant RCs in the next sections of this order. As a result, the Commission rejects certain direct cost allocations to SFPP and rejects the exclusion of the KM Canada Entities from the Massachusetts formula allocation with respect to costs in certain RCs.

112. The Commission also rejects ACV Shippers' contention that SFPP presented no evidence of any internal protocols for monitoring the reasonableness or accuracy of G&A overhead time and costs assignments. They assert that SFPP has not established that its system for capturing costs is reliable because there are no accounting or quality-control procedures in place. The Commission finds that SFPP established that there is uniform time keeping system in place, that it is periodically reviewed to see if there are discrepancies between budgeting and performance, and that the system has protocols for changing an employee's base allocation of time within cost centers if the employee's assignment or function changes. A statement by one employee that he was unaware of the system is simply another example of attempting to discredit an entire system based on one observation. The Commission affirms that the KMI/KMEP overhead cost allocation system is conceptually sound and is an acceptable regulatory construct. The Commission also rejects ACV Shippers' argument that the KMI/KMEP overhead cost allocation methodology may be invalid because it has some business purpose. An efficient regulatory accounting system must be grounded in the business aspects of the regulated entity's operations if the regulatory system is to have any effective purpose. If the regulatory system and actual business practice are too divergent, then the accounting system will fail its most fundamental purpose, which is to support a close relationship between cost incurrence and cost allocation. But the fact that there are divergences or different systems for different business purposes does not render the various systems invalid in their own right.

113. Based on the foregoing, the Commission rejects the Shipper Parties' general challenge on rehearing to the quality of all direct assignments and, again, rejects argument that the most reasonable method for allocating overhead costs in this proceeding is their "all in" method. This order now turns to arguments regarding specific cost assignments and allocations, including some of the detailed assertions that the Shipper Parties made in support of their generic argument that their "all in" method was the most appropriate one for this proceeding.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

4. Exclusion of Certain KMEP Subsidiaries

a. General Issues

i. Rehearing Requests

114. Tesoro seeks rehearing of the Commission decision to permit SFPP to exclude from any allocation of G&A overhead costs (i) eight corporate entities that KMEP owns and KMI operates; (ii) four joint ventures in which KMEP has an ownership interest; and (iii) KM Canada Entities. Tesoro states that the record evidence dictates allocating G&A overhead costs to these entities. However, Tesoro basis its argument exclusively on the subsequent East Line Initial Decision in which the ALJ rejected the exclusion of the above-identified entities.

115. The ACV Shippers also argue that the Commission erred in permitting the exclusion of KMEP subsidiaries from the allocation of KMEP G&A overhead costs. In general, ACV Shippers allege that Commission precedent requires all KMEP subsidiaries and joint ventures to be included and accorded a proportional level of G&A overhead costs in a proper Massachusetts formula allocation of such costs, rather than being completely excluded. ACV Shippers state that the exclusion of any KMEP subsidiary causes the remaining KMEP subsidiaries (which includes SFPP) to subsidize the excluded entities. ACV Shippers criticize the Commission's interpretation that *Williams* left open the possibility that a subsidiary may reasonably be excluded from a Massachusetts formula allocation if it receives only a small amount of overhead services and inclusion would result in an irrational or excess allocation of costs. In short, ACV Shippers argue that the Commission should not have departed from the objective standard set forth in *Williams* that if a subsidiary benefited "at all" it would be included in the Massachusetts formula allocation.

ii. Commission Determination

116. The Commission first rejects Tesoro's request for rehearing regarding the exclusion of KMEP subsidiaries because Tesoro inappropriately relies exclusively on the East Line Initial Decision to support its request. Next, the Commission turns to the ACV Shippers' request for rehearing regarding the Commission's interpretation and application of *Williams* in Opinion No. 511 regarding the inclusion or exclusion of affiliated subsidiaries in the parent's Massachusetts formula. The ACV Shippers construe *Williams* as requiring the inclusion of any subsidiary in the Massachusetts formula allocation when directors and officers of the parent company have any responsibility, however, nominal, for the operations of the subsidiary. In Opinion No.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

511, the Commission explained that *Williams* is not as categorical as Valero[145] asserted.[146] The Commission interpreted *Williams* as leaving open whether it may be reasonable to exclude a subsidiary receiving less than a five percent overlap of costs if inclusion of the affiliate would result in an unreasonable or excessive allocation to or from the regulated entity.[147] The Commission further found that the statement in *Williams* that, "all subsidiaries, including those that WNG considers to be marginal activity subsidiaries, must be included in the allocation formula if they benefitted from the corporate cost center,"[148] is unduly rigid in an era of increasing corporate complexity where a company often owns numerous jurisdictional entities.

117. On the issue of which entities must be included in a Massachusetts formula allocation, the Commission has previously cited *Williams* for the proposition that "even if the parent company's employees only expended 5 percent of their time on a subsidiary, such an insignificant amount of time should not be ignored for cost allocation purposes."[149] In Opinion No. 511, the Commission clarified that if the expended effort is less than 5 percent, there is no rigid requirement that the subsidiary be included for purpose of allocating overhead costs. Thus, there is no support for ACV Shippers' interpretation that *Williams* mandates a strict bright-line approach under which *any*

---

[145] Valero did not join with the ACC Shippers to form the ACV Shippers group until rehearing. Accordingly, Valero presented its own witnesses at hearing and independently filed a Brief on Exceptions and Brief Opposing Exceptions.

[146] Opinion No. 511, 134 FERC ¶ 61,121 at P 107.

[147] *Id.* P 109.

[148] *Williams*, 85 FERC at 62,137.

[149] *SFPP, L.P., et al.*, 121 FERC ¶ 61,240, at P 134 n.186 (2007) December 2007 Order. *See also*, *Chevron Prods. Co., et al*., *v. SFPP, L.P.*, 127 FERC ¶ 63,024, at P 354 (2009) (noting "all parties agree that the applicable standard is the one adopted by the Commission in the *Williams* case; that even if the employees of the parent company expend only 5% of their time on a subsidiary, that time is sufficient for the inclusion of that subsidiary within the parent company's application of the formula."); *see also Mid-America Pipeline Co., et al.*, LLC, 124 FERC ¶ 63,016, at P 785-786 (2008) (citing *Williams*, the ALJ found that certain subsidiaries must be included in the overhead cost allocation because the record reflects that "significant" and "substantial" overhead costs and oversight actions related to those entities).

benefit, no matter how minute, from the corporate parent requires an entity's inclusion in the overhead cost allocation.

118. The Commission has properly applied *Williams* in this rate proceeding to determine whether to include certain Kinder Morgan entities. This entails performing a careful analysis of particular costs and cost centers to determine whether to require a portion of each cost center to be allocated to a subsidiary. Consistent with Commission precedent, if the record evidence demonstrates that a particular entity received more than a de minimis benefit from the parent company or a specific RC, i.e., at least 5 percent, then the costs from that cost center must be included in the Massachusetts formula allocation of the costs associated with the entities relevant to that particular RC. Thus, if costs directly assigned to SFPP from a particular RC are inadequately justified in the Commission's judgment, then the costs from that RC must be rolled into the Massachusetts formula for the lowest-level tier to which those costs apply. This could be the Pacific Pipeline Group sub-tier, the Tier 2 KMEP pipeline group, or the general KMEP Tier 1 as appropriate. The specific application of this principle is discussed in the following subsections of this order.

b. Exclusion of the KMI-Operated Natural Gas Pipelines

i. Rehearing Requests

119. ACV Shippers argue that the Commission erroneously determined that SFPP may exclude KMEP's natural gas pipeline subsidiaries that are operated by KMI from any allocation of KMEP's G&A overhead costs. In support of their argument, ACV Shippers state that the Commission arbitrarily ignored substantial record evidence with respect to the level of service performed for the benefit of the KMI-Operated entities. They note that Opinion No. 511 arbitrarily dismisses the undisputed record fact that various GP Services employees are principal officers of the KMEP natural gas pipeline subsidiaries or its direct controlling parent. ACV Shippers point to the record regarding Ms. Armstrong, a "GP Services employee and owner of RC 1007,"[150] who is a principal officer (i.e., VP-Accounting) of the excluded KMEP natural gas pipeline related subsidiaries TransColorado, KMIGT, Trailblazer, and Kinder Morgan NatGas Operator LLC and the KMI subsidiary Kinder Morgan Illinois Pipeline LLC. In addition, ACV notes that Ms. Armstrong is a principal officer of the excluded KMEP Tejas Consolidated natural gas pipelines.[151] ACV Shippers state that the Commission erred in concluding

[150] ACV Rehearing at 172.

[151] *Id.* (citing Ex. ACV-57 at 4, 6, 9, 10, 14; Ex. ACV-239 at 14; ACV-240 at 14).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

that it appears reasonable that Ms. Armstrong does not have responsibility for the accounting functions of the KMI-Operated Entities, despite the fact that Ms. Armstrong's official job description, posted on Kinder Morgan's website, as the "P-Accounting" for these KMEP natural gas pipeline subsidiaries. Specifically, the website states that such an officer has primary responsibility for management of the organization's accounting function and responsibility for maintaining all accounting records, designing and implementing budgetary and other systems for internal control, and preparing financial reports for management and shareholders.[152]

120. ACV Shippers further state that Opinion No. 511 glosses over the fact that other GP Services employees hold officer positions associated with the KMI-Operated Entities. Specifically, Mr. Bannigan, President of Products Pipelines, Mr. Jeff Armstrong, President of KMEP's Bulk Terminals, and, Mr. R.T. Bradley, President of KMEP's CO_2 division are all principal officers of Kinder Morgan OLP-A, which is the direct parent of the multiple KMI-Operated Entities as well as Kinder Morgan Management and which has ultimate control and management authority over KMEP and all KMEP subsidiaries.[153] ACV Shippers further state that Opinion No. 511 summarily ignores the fact KMEP, as the owner of the KMI-Operated Entities, retains both managerial and oversight authority and performs other G&A overhead responsibilities that generate G&A overhead expenses. For example, ACV Shippers state operating and reimbursement agreements specifically indicate that KMEP, as the owner of the KMI-Operated Entities, is to play a material role in the management of the natural gas pipeline subsidiaries.

ii. <u>Commission Determination</u>

121. The Commission denies rehearing on the exclusion of the natural gas pipelines from the KMEP overhead cost allocation. Opinion No. 511 fully analyzed shipper arguments, principally Valero's, that KMEP's officers and directors have operating and legal responsibility for the KMI-Operated natural gas pipelines and therefore, those entities should be included in KMEP's Massachusetts formula. In particular the Commission scrutinized the testimony regarding Ms. Armstrong's role.[154] ACV Shippers raise no arguments on rehearing that alter the Commission's conclusion on this issue.

---

[152] *Id.* at 173 (citing Ex. ACV-300).

[153] *Id.* at 174 (citing Ex. ACV-72 at 5-8; Ex. ACV-170 at 14-15).

[154] Opinion No. 511, 134 FERC ¶ 61,121 at P 123.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

122. ACV Shippers' argument on rehearing that KMEP, as the owner of the KMI-Operated Entities, retains both managerial and oversight authority and performs other G&A overhead responsibilities that generate G&A overhead expenses is similar to the arguments ACV Shippers raised regarding the joint ventures, as discussed above. Likewise, the Commission's conclusion is the same, as discussed below. ACV Shippers present no evidence that KMEP's ownership oversight authority over the KMI-Operated natural gas pipelines would result in benefits or costs that were more than miniscule, or that any benefits or costs were even incurred. ACV Shippers have not attempted to quantify these possible costs. Accordingly, there is no evidence in the record that these possible benefits and costs arising from KMEP's ownership oversight were more than de minimis, i.e., more than five percent of the total costs within each RC that are subject to allocation via KMEP's Massachusetts formula. Based on the foregoing, the Commission denies rehearing regarding the exclusion of the KMI-Operated natural gas pipelines.

c. Exclusion of KM Canada

i. Rehearing Requests

123. ACV Shippers argue that SFPP failed to carry its burden of proof with regard to whether the KM Canada Entities[155] should be excluded from KMEP's G&A overhead cost allocation. They further assert that the Commission erred in giving SFPP an opportunity to submit additional evidence to support KM Canada's exclusion in its Compliance Filing. ACV Shippers argue that giving SFPP this opportunity to supplement the record violated fundamental due process principles, and is highly prejudicial to shippers who have participated fully and actively throughout the proceeding. ACV Shippers state that the Commission's decision effectively allows SFPP to relitigate its failed attempt at justifying its proposed G&A overhead accounting methodology.

124. Further, ACV Shippers argue that Opinion No. 511 arbitrarily failed to address any of the evidence which conclusively demonstrated that Mr. Bradley's purported survey lacked any evidentiary credibility. ACV Shippers argue that at hearing they demonstrated that the purported KM Canada survey prepared by Mr. Bradley contained multiple erroneous entries and was far from comprehensive in attempting to capture related overhead costs. For example, ACV Shippers state that contrary to Mr. Bradley's claim that he removed all costs associated with KM Canada from his G&A overhead allocation model, the record established that various RCs and associated employees were

[155] The terms "KM Canada Entities" and "KM Canada" are used interchangeably in this order.

not involved in or investigated as part of the historical survey and that substantial G&A overhead expense were not captured as part of the survey. For example, Mr. Bradley conceded that RC 1002 (Commercial Management Team Orange) was not part of the KM Canada survey. Yet the record unambiguously established that various GP Services employees in RC 1002 were actively involved in providing G&A overhead support and services to KM Canada.[156] ACV Shippers conclude that, in light of the deficiencies in SFPP's analysis of KMI-shared and GP Services G&A overhead services provided to KM Canada, there is no evidentiary foundation to claim that KM Canada has "few services" provided by KMEP or KMI or that Kinder Morgan's accounting methodology is designed to accurately isolate and accurately record such costs for specific entries.
125.

ii. SFPP Compliance Filing

126. In its April 25, 2011 Compliance Filing, SFPP submitted additional information regarding KM Canada. The Compliance Filing includes the affidavit of Mr. Bradley, SFPP's Director of Property Accounting for KMI (Bradley Affidavit). In his affidavit, Mr. Bradley summarizes record evidence regarding KM Canada including the following: (i) KM Canada is operated and managed almost exclusively by Canadian employees with limited G&A support from employees in certain KMI or GP Services RCs;[157] (ii) the vast majority of the G&A costs associated with the operation and management of the KM Canada Entities are incurred by KM Canada and are kept in separate accounts and in a separate general ledger from the costs associated with all other KMI and KMEP subsidiaries;[158] (iii) the limited amount of G&A cost incurred in 2007 by KMI-shared and GP Services employees on behalf of KM Canada Entities has been removed from the costs allocated through KMEP's Cost Allocation Methodology in this proceeding to ensure that none are allocated to SFPP. In the Compliance Filing, SFPP removed all of the labor, payroll taxes, and benefits as well as non-labor support provided to KM Canada in 2007 by KMI-shared employees and GP Services, removing an amount equal to $213,507.[159]

---

[156] ACV Rehearing at 166 (citing Tr. 1328; Valero Brief on Exceptions at 33 n. 34; Tr. 1329-30).

[157] Bradley Affidavit at P 7 (citing Ex. SFP-133).

[158] *Id.*

[159] *Id.* P 37 and Tab D, Exhibit 9.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

127. SFPP included in its Compliance Filing a detailed discussion of the KM Canada survey. SFPP notes that the KM Canada Entities were acquired over the course of 2007; thus in 2007, Kinder Morgan was in the process of determining a permanent method of G&A cost recovery. SFPP explains that to account for the costs associated with the support of the KM Canada Entities during the interim period before a permanent method of G&A cost recovery was implemented Kinder Morgan surveyed both KMI-shared and GP Services RCs in November and December 2007.[160] The 2007 survey resulted in a finding that KMI and GP Services employees incurred approximately $477,000 in labor and non-labor costs related to the KM Canada Entities. A permanent survey method was implemented in 2009.

128. SFPP witness Bradley states that in the course of re-surveying and recalculating costs related to support the KM Canada Entities he identified several errors and omissions related to the original 2007 survey data. Thus, in the SFPP Compliance Filing, Bradley advocated using the 2009 survey method to better capture estimates of the labor and non-labor G&A costs associated with the services GP Services and KMI-shared RCs provided to the KM Canada Entities in 2007. Bradley conducted a re-survey using the 2009 survey method to correct for the issues identified with the original 2007 interim survey method. Based on the re-survey of the relevant RCs, the total amount associated with services provided to the KM Canada Entities in 2007 that was removed from the pool of costs allocated through KMEP's methodology is $1,438,011 (in SFPP's original filing the amount attributed to KM Canada was $477,000). Specifically, Bradley proposes to deduct $1,156,215 from the KMEP Tier, $65,893 from the PPL Tier, $43,224 from the Pacific Pipeline Group sub-tier, and $172,679 from the Terminal and MidCon Tiers. Bradley states the total reduction to SFPP's costs is $213,507.

129. Regarding the KM Canada Entities' Acquisition Costs, Bradley states that no acquisition costs associated with the KM Canada Entities are included in the KMEP G&A costs allocated to SFPP.[161] Bradley explained that in surveying the RCs regarding their estimated labor expenses committed to each of the KM Canada Entities in 2007 and annualized those amounts. The KM Canada survey results reflect a normalized, prospective labor commitment from the RCs that dedicate time to the KM Canada Entities. According to Bradley, because these percentages were normalized, any time committed to the acquisition of the KM Canada Entities by employees in these RCs was already excluded from KMEP's cost allocation methodology.

---

[160] *Id.* P 50.

[161] *Id.* P 58.

130. In its Compliance Filing, SFPP further notes that the $1,471,698 in non-labor costs associated with the Trans Mountain Acquisition has been removed from the KMI cross charge.[162] SFPP witness Bradley further states that the remaining $5.5 million in G&A costs identified in KMEP's Form 10-K represents the G&A costs incurred by KM Canada employees on behalf of Trans Mountain prior to the acquisition. These costs were captured by KM Canada and were not allocated through KMEP's cost allocation methodology.

iii. <u>Response to Compliance Filing</u>

131. In response to SFPP's Compliance Filing, Trial Staff argues that KM Canada should be included in the KMEP Massachusetts formula. Trial Staff notes that SFPP's argument at hearing for removing KM Canada from the KMEP Massachusetts formula was that "only a few of KM Canada's costs were incurred within GP Services or KMEP."[163] Trial Staff argues that now that SFPP has significantly increased the total amount of costs incurred within GP Services or KMI to support KM Canada from $477,000 to $1,438,011, this increase contradicts SFPP's initial argument that KM Canada received only de minimis benefits. Trial Staff concludes that the re-survey highlights the errors in SFPP's original case and its failure to establish that KM Canada should be excluded from the KMEP Massachusetts formula.

132. In their protest of the Compliance Filing, ACV Shippers argue that SFPP's newly proposed adjustments to the assignments of G&A overhead costs to KM Canada lack credibility, reliability and reasonableness. The ACV Shippers note that SFPP's Compliance Filing does not provide the additional evidence necessary to justify and support the KM Canada costs originally presented in the rate proceeding; rather, SFPP provides an entirely new amount, of approximately $1.4 million based on a survey conducted in 2011. ACV Shippers note that the SFPP witness on the issue, Mr. Bradley, has changed positions three times regarding the basis and accuracy of the cost entries associated with the original 2007 KM Canada survey. ACV Shippers conclude that SFPP's new KM Canada survey conducted in conjunction with the Compliance Filing, like the original 2007 survey, lacks any indicia of reliability or credibility and fails to

[162] *Id.* P 59 (noting that this $1.5 million is the cost identified in KMEP's Form 10-K as highlighted by Valero).

[163] Trial Staff July 11, 2011 Reply Comments on SFPP Compliance Filing at 8 (Trial Staff Reply Comments) (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 118; Ex. SFP-38 at 35-37).

reflect an accurate, verifiable or reasonable level of G&A overhead costs associated with KM Canada.

133. In support of the ACV Shippers' protest, Dr. Daniel Arthur, the ACV Shippers' economic consultant, states that it is inappropriate to exclude the KM Canada entities from receiving an allocation of Kinder Morgan overhead expenses. Dr. Arthur notes that SFPP's basis for excluding KM Canada was that the costs associated with KM Canada are kept separate from the costs associated with all other Kinder Morgan entities and are assigned solely to the KM Canada Entities. Dr. Arthur states it is clear that multiple KMI-shared and GP Services overhead employees are providing overhead services for the benefit of the KM Canada Entities, and SFPP is unable to credibly identify and directly assign a justified and reasonable amount of overhead expenses to KM Canada.[164] First, Dr. Arthur notes that SFPP's Compliance Filing fails to comply with the Commission's directive in Opinion No. 511 that SFPP provide greater clarity regarding its assignment of G&A costs to KM Canada as well as a fuller explanation and documentation of its proposed assignment of $477,000 of G&A overhead costs to KM Canada. Instead, SFPP admitted in its Compliance Filing that it cannot support the claimed $477,000 of G&A overhead cost assignment for KM Canada based on the 2007 survey and instead would rely on a 2011 survey of the activities performed during 2007 to exclude KM Canada. Dr. Arthur characterizes SFPP's Compliance Filing as an abandonment of Kinder Morgan's prior record evidence in support of its claimed $477,000 of G&A costs associated with KM Canada. Based on SFPP's inability to rely on its own 2007 survey and its attempt to recreate a survey in 2011, Dr. Arthur argues it is more reasonable to include KM Canada, and all overhead expenses purported to be associated with the KM Canada Entities, in a single Massachusetts formula allocation.

134. Dr. Arthur also reasserts the ACV Shippers' argument attacking the credibility of SFPP's position that RC 0020 (Treasury), RC 0050 (Human Resources), RC 0065 (KMI Controller), RC 0077 (KMI Financial Process), RC 0031 (Legal), and RC 0999 (KMI G&A Corporate Costs) do not provide any overhead support or services to the KM Canada Entities in 2007.[165] ACV Shippers argue that this is inconsistent with the fact that $7 million in unallocated G&A overhead expenses, which they assert would have involved all of these RCs, were reported to be generated in 2007 in connection with the pre-acquisition and acquisition of TransMountain by KMEP.[166]

---

[164] ACV Protest, Affidavit of Dr. Daniel Arthur at P 89 (Arthur Affidavit).

[165] Arthur Affidavit at n.195.

[166] *Id.* (citing Ex. ACV-231 at 77-78).

iv. SFPP Reply Comments

135. In its July 11, 2011 reply comments, SFPP responds to Shipper Parties' arguments that the updated KM Canada survey should be rejected and that KMEP's entire cost allocation methodology should be replaced with the Shipper Parties' proposed "all-in" methodology. SFPP states that *Williams* does not support ACV Shippers' arguments for including the KM Canada Entities in the KMEP Massachusetts Formula. Specifically, SFPP states:

> *Williams* focused on whether particular subsidiaries benefitted from particular G&A costs and caused those G&A costs to be incurred. Only after analyzing specific cost centers and finding that at least five to ten percent of a cost center's G&A costs benefited a particular subsidiary did *Williams* require a portion of that cost center to be allocated to the subsidiary. *Williams* does not require, or even suggest, that it would be appropriate to allocate a portion of all of the parent company's cost centers to a subsidiary merely because the subsidiary was found to have benefited from a single cost center, as ACV and Dr. Arthur suggest. Instead, *Williams* suggests that when certain costs are associated with only a subset of subsidiaries, the appropriate course of action is to allocate those costs only to that subset.[167]

136. In defense of the updated survey, SFPP states that the process for removing from KMEP's Cost Allocation Methodology the cost of services provided by GP Services and KMI-shared RCs to the KM Canada Entities has evolved with the benefit of time and experience. SFPP argues that this evolution has led to a more accurate capturing of costs related to the KM Canada Entities. SFPP asserts that using the updated KM Canada survey results in a more accurate distribution of G&A costs to the KM Canada Entities than use of a Massachusetts Formula allocation and a better matching of costs with the entities that caused them to be incurred.[168]

137. SFPP further argues that, in contrast, the inclusion of the KM Canada Entities in a Massachusetts formula allocation, as proposed by ACV, Dr. Arthur, and Staff, would cause SFPP to subsidize services provided to KM Canada Entities and would completely disregard the Commission's preference for matching costs with the entities that generated

---

[167] SFPP Reply Comments at 52-53.

[168] *Id.* at 54.

them.[169] SFPP describes the ACV Shippers' position as requiring all of the KM Canada Entities' G&A costs to be lumped together with the KMEP-Operated Entities G&A costs and then allocated through a single Massachusetts formula allocation. SFPP urges the Commission to reject ACV Shippers' and Trial Staff's "all-in" proposal, noting that, in *Williams*, the Commission expressed concern about going "further than necessary to correct the misallocation problem."[170]

v. Commission Determination

138. The Commission grants rehearing on this issue. While SFPP attempts in its Compliance Filing to correct the substantial newly identified errors with the 2007 survey, SFPP offers little evidence that would attest to the probable accuracy of SFPP's 2011 survey of the relevant GP Services and KMI-shared RCs performed services for KM Canada entities. Despite the fact that SFPP, based on its 2011 survey, has almost tripled the amount of costs associated with KM Canada to be removed from overhead costs that are allocated to SFPP, the fact that the amount tripled calls into question whether SFPP's original justification for excluding KM Canada for the Massachusetts formula still stands. SFPP's witness, Mr. Bradley, in his October 16, 2008 direct testimony, stated that "in order to ensure that no portion of SFPP's rates could possibly be subsidizing KM Canada, I removed the entire amount of $477,000 from the cross charge account before performing the Massachusetts formula allocations for purposes of this proceeding. . . . The removal of the entire $477,000 from the cross-charge ensures that no overhead costs associated with KM Canada are charged to SFPP."[171] SFPP's Compliance Filing provides little support for SFPP's avowal that even under SFPP's 2011 re-survey, which identified $1.4 million of costs associated with KM Canada, "no portion of SFPP's rates could possibly be subsidizing KM Canada."

139. In Opinion No. 511, the Commission instructed:

> Consistent with *Williams II*, SFPP should structure any further analysis on a cost center by cost center basis, and assuming adequate documentation, remove the costs from KMEP's total costs accordingly. For example, if all of KM Canada's human resource activities were handled through its own administrative structure and

[169] *Id.* at 55.

[170] *Id.* at 57-58 (citing *Williams*, 85 FERC at 62,137).

[171] Ex. SFP-38 at 36-37.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

> none by GP Services or KMI, then that particular KM Canadian RC may be excluded from KMEP's Massachusetts formula. Finally, if portions of KM Canada cost are included in KMEP's Massachusetts Formula this does not mean all of KM Canada's costs must be included. This is because, as *Williams II* requires, the review centers on individual KM Canada RCs, not the overhead costs of that entity in their entirety.[172]

The Commission finds, upon review of SFPP's Compliance Filing regarding the KMI-shared employees and GP Services employee's costs associated with providing services to KM Canada, SFPP fails to provide adequate documentation with respect to any of the relevant RCs. This means the Commission is unable to determine, with respect to each of RCs that provided services to the KM Canada Entities, whether the amount of such services is de minimis or if it is at or greater than the five percent rebuttable threshold consistent with *Williams*.[173]

140. To correct this lack of documentation, the Commission makes the following determinations. First, the Commission again rejects the Shipper Parties' proposed "all-in" solution to correct for SFPP's inability to identify in the relevant time period the costs associated with services provided to the KM Canada Entities. As SFPP notes in its reply comments, the "all-in" proposal is inconsistent with *Williams* and would "be choosing to use an ax rather than a scalpel to perform what should be a careful removal of costs."[174] Second, consistent with *Williams* and Opinion No. 511, with respect to the KM Canada Entities, no amount, neither the $477,000 nor the $1.4 million, should be removed from KMEP's total overhead costs. Further, the KM Canada Entities must be included in KMEP's Massachusetts formula allocation with respect to any GP Services or KMI-shared RC that SFPP has identified in this proceeding as providing any amount of services to the KM Canada entities in 2007.[175] To implement this directive, the KM

[172] Opinion No. 511, 134 FERC ¶ 61,121 at P 121.

[173] Notably, the vast majority of the updated surveys reflect that for each RC ten percent of the individual RC's total labor costs were provided for the benefit of the KM Canada Entities, which is twice the *Williams* five percent threshold. The specific percentage break-down is: Vancouver Wharves, three percent; Trans Mountain, five percent; and Cochin Canada, two percent.

[174] *See* SFPP Reply Comments at 58.

[175] To be clear, we are *not* directing or suggesting that any of the cost of the G&A services provided by KM Canada to KM Canada Entities be included in the pool of

(continued…)

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Canada Entities must be included in the Massachusetts formula for allocating the costs from each RC listed in Tab D, Exhibit 9 of SFPP's Compliance Filing.

d. Exclusion of Joint Ventures Heartland, Red Cedar, and Thunder Creek

i. Rehearing Requests

141. The ACV Shippers argue that, with respect to the Joint Ventures, Heartland, Red Cedar, and Thunder Creek, the Commission failed to analyze the specific benefits received or their materiality, let alone examine whether inclusion of these Joint Ventures would result in an excess or irrational allocation of overhead costs. ACV Shippers argue that each of the three Joint Ventures have two sets of relevant overhead costs. First, there are the G&A overhead costs associated with managing the actual operations and day-to-day activities of these Joint Ventures. Second, there are the G&A overhead costs that are specifically incurred by Kinder Morgan's management overseeing KMEP's ownership interest and related employees. The ACV Shippers assert that SFPP is wrong to claim that the second category of G&A overhead services are not provided by Kinder Morgan employees. ACV Shippers argue that it is inconceivable to believe that some other entity independent of Kinder Morgan employees would oversee KMEP's ownership interest in a Joint Venture. With respect to each of these three Joint Ventures, ACV Shippers argue that although Kinder Morgan's Office of the Chairman oversees and supervises all subsidiaries, including KMEP's ownership interests in these Joint Ventures, SFPP has made no attempt to quantify or exclude any of the executive-related supervisory costs (or any related G&A support costs such as HR, IT, or Benefits costs) as it relates to the Joint Ventures. In short, ACV Shippers claim that the Office of the Chairman costs, including those associated with supervising the ownership interest in each of Heartland, Red Cedar and Thunder Creek, are included, in part, in the KMI cross-charge and, thus allocated to all of the KMEP-Operated subsidiaries, including SFPP.

142. Further, ACV Shippers complain that SFPP's G&A overhead proposal allocates a significant quantity of KMEP residual overhead costs, costs that cannot be identified with any individual subsidiary or group of KMEP subsidiaries, even though these residual

---

KMEP costs to be allocated to the KMEP-Operated Entities. The only costs at issue here are the costs incurred by GP Services and KMI-shared employees on behalf of the KM Canada Entities. Nor is the Commission directing or suggesting that the KM Canada Entities generally be included in KMEP Massachusetts formula cost allocation used for allocating costs to the KMEP-Operated Entities.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

costs necessarily benefit all KMEP subsidiaries including Heartland, Thunder Creek, and Red Cedar Joint Ventures.

143. With respect to Heartland, the ACV Shippers claim that SFPP witness Mr. Bradley stated that KMI employees provide certain physical operational support services to Heartland based on Heartland's proximity to other KMI assets, and that Heartland reimbursed KMI for these operational employees' services. ACV Shippers argue it is implausible that the KMI operational employees that generate $1 million a year in billings to Heartland do not also require the incurrence of G&A overhead costs associated with such items as HR, IT, Payroll, Benefits, and Accounting at the KMI-shared RC level.

144. With respect to Red Cedar, the ACV Shippers note that there are G&A overhead costs that are incurred as a result of Kinder Morgan overseeing, managing, and supervising its 49 percent ownership interest in Red Cedar. ACV Shippers assert that KMEP provides direct oversight activities associated with Red Cedar through its three KMEP managers who sit on Red Cedar's management committee. These KMEP managers' costs are included in KMI-shared RC 0375. SFPP witness Mr. Bradley states that the costs of RC 0375 are removed from the KMI cross-charge. But, ACV Shippers nonetheless argue that the removal of the RC 0375 costs does not capture all of the overhead costs associated with Red Cedar because it does not remove any HR, IT or Benefit costs (reflected, respectively in RC 0050, RCs 0080-0092, and RC 0999) that are associated with the managers booking their time to RC 0375.

145. With respect to Thunder Creek, ACV Shippers state that whether or not Kinder Morgan performs G&A support for Thunder Creek regarding its day-to-day operations is irrelevant to the issue of whether Kinder Morgan incurs G&A overhead costs with respect to supervising and managing its ownership interest in Thunder Creek. ACV Shippers note that KMEP holds a 25 percent ownership interest in Thunder Creek and that Kinder Morgan has at least one representative on the operating committee which is responsible for evaluating the success of the Joint Venture and managing the affairs of the operation.[176] ACV Shippers make the same argument as made for Red Cedar. Specifically, that SFPP's exclusion of Thunder Creek was justified because SFPP had removed the costs associated with the KMI-shared RC 0375. ACV Shippers state that this is not enough because it does not quantify or capture other costs such as the supervisory, benefits, HR and IT G&A overhead costs associated with the managers that supervise the ownership interest in Thunder Creek.

[176] ACV Rehearing at 161 (citing Ex. ACV-40 at 24-25).

ii. Commission Determination

146. The Commission denies rehearing and affirms its determination in Opinion No. 511 that SFPP properly excluded Heartland, Red Cedar, and Thunder Creek Joint Ventures from the overhead cost allocation. The question at issue is whether any of these three Joint Ventures benefit from services provided under RCs that are charged to KMEP for allocation via the Massachusetts formula. And, if so, whether the benefits are more than a de minimis amount with five percent being a rebuttable threshold of what constitutes a significant or more than de minimis amount. Heartland, Red Cedar and Thunder Creek are joint ventures in which KMEP owned in 2007 an equity interest in of 50 percent or less. Each Joint Venture is managed by and receives all overhead services and support from an unaffiliated third party.[177]

147. First, the Commission will address Heartland. SFPP acknowledges that KMEP had a representative on Heartland's board of directors, a KMI employee in RC 1001 who charged all his time and expenses to OLP-A, the KMEP subsidiary that held the equity interest in Heartland. SFPP testified that neither RC 1001 nor any other OLP-A expenses are included in the KMI cross-charge to KMEP, thus the expenses associated with this KMI employee sitting on Heartland's board of directors are not allocated to SFPP or another other KMEP-Operated Entity.[178]

148. Second, regarding Red Cedar, SFPP states that as with Heartland, a KMI employee sat on the board of Red Cedar in 2007. All of the expenses associated with that KMI employee were charged to RC 0375, which is a KMI-shared RC. Because RC 0375 is charged to KMEP through the KMI cross-charge, SFPP removed the entire costs associated with RC 0375 from the KMI cross-charge for 2007.[179] With respect to Thunder Creek, SFPP stated that like Red Cedar, a KMI employee sat on the board of directors of Thunder Creek in 2007, but all time and expenses associated with this activity were charged to RC 0375, the same RC discussed above, which SFPP removed from the KMI cross-charge for 2007. Accordingly, SFPP's record evidence shows that there are no residual expenses associated with these Joint Ventures that could be subject to allocation through KMEP's Massachusetts formula.[180]

---

[177] Ex. SFP-38 at 37.

[178] *Id.* at 37-39.

[179] *Id.* at 39.

[180] *Id.* at 41.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

149. The thrust of ACV Shippers' argument is that with respect to each of these three Joint Ventures the KMI/KMEP Office of the Chairman necessarily must oversee and supervise all subsidiaries, including KMEP's ownership interests in these Joint Ventures and thus, there must be some executive-related supervisory costs. ACV Shippers' second argument is that SFPP has not identified certain residual costs associated with the Joint Ventures. Specifically, ACV Shippers state that there necessarily are human resources, IT or benefits overhead costs (respectively, RC 0050, RCs 0080-0092, and RC 0999) associated with either the Chairman's office or the KMI managerial employees that sit on the Joint Ventures' boards of directors.

150. The Commission finds that based on the record evidence regarding the management and oversight of these Joint Ventures that if there is any time or costs associated with either the Chairman's office or related to HR, IT and benefits associated with the KMI employee board member that such time and costs would be miniscule. ACV Shippers have not quantified these possible costs. Accordingly, there is no evidence in the record that these possible benefits and costs would be more than de minimis, i.e., five percent or more of the total costs within each RC that are subject to allocation via KMEP's Massachusetts formula. Based on the foregoing, the Commission denies rehearing regarding the exclusion of Heartland, Red Cedar, and Thunder Creek Joint Ventures.

e. Exclusion of Joint Venture International Marine Terminal

151. ACV Shippers note that SFPP excluded Marine Terminal from the overhead cost allocation because only one KMEP representative sits on Marine Terminal's board of directors and the costs associated with this single representative are captured in GP Services RC 001, which was assigned to KMEP's MidCon Tier, and away from SFPP. ACV Shippers argue that Marine Terminal should be included because SFPP witness Mr. Bradley subsequently testified in the East Line Rate Case that "while Marine Terminal has historically been excluded from KMEP's cost allocation methodology because it was not operated by KMEP, it is now included in the allocation methodology because GP Services employees, on behalf of KMEP, took over its operations and management."[181] ACV Shippers acknowledge that there is no similar testimony in the record in this proceeding.

152. The Commission denies rehearing on the issue of the exclusion of Marine Terminal because the ACV Shippers' entire argument regarding Marine Terminal is

---

[181] ACV Rehearing at 163 (quoting Docket No. IS09-437, Ex. SPE-139HC at 44).

based on record evidence from a subsequent East Line proceeding. As stated previously, the Commission will only consider the record in this case.

f. Exclusion of Rockies Express Pipeline

i. Rehearing Requests

153. ACV Shippers argue that the Commission improperly excluded Rockies Express Pipeline (REX), a limited liability company joint venture pipeline of which KMEP is a 51 percent owner, from the allocation of KMEP's G&A overhead costs.[182] ACV Shippers argue that the Commission failed to address REX in Opinion No. 511, stating that the only reference to REX in Opinion No. 511 was in a single footnote. ACV Shippers argue that despite SFPP's claim that KMI operates REX, certain corporate documents show otherwise. ACV Shippers point to an operating agreement and REX's 2007 FERC Form 2 which designate KMEP or its subsidiary Kinder Morgan NatGas Operator, LLC (NatGas Operator) as the operator of REX.[183] ACV Shippers note that NatGas Operator is a wholly-owned subsidiary of OLP-A and claim that before and after January 1, 2008, employees of KMI or GP Services were performing services for REX on behalf of KMEP or its indirect wholly-owned subsidiary, NatGas Operator.[184]

154. ACV Shippers argue that any KMI or GP Services employee performing overhead services for REX, for the time period at issue, was performing such services as an agent (or on behalf) of KMEP or its indirect wholly-owned subsidiary, NatGas Operator, for the benefit of REX. Thus, these employees should have been assigning or allocating their time and overhead expense to KMEP or NatGas Operator which, as owner and/or operator would assign or allocate these same overhead expenses to REX as the beneficiary thereof. ACV Shippers claim there is no evidence that KMEP has allocated or assigned any overhead costs to REX. Further, ACV Shippers argue that there is no evidence regarding to what extent KMI, as the entity which employed the KMI or GP Services personnel who were performing the overhead services on behalf of KMEP and/or Nat Gas Operator, has assigned any G&A overhead costs to REX. ACV Shippers further state that while SFPP witness Mr. Bradley contends that REX pays a management fee intended to reflect overhead costs and that certain overhead costs were assigned to REX, Mr. Bradley failed to provide any evidence or specifics regarding the management

[182] *Id.* at 181 (citing Ex. ACV-40 at 17).

[183] *Id.* at 182 (citing Ex. ACV-40 at 18; Ex. ACV-58 at 12).

[184] *Id.* (citing Ex. ACV-40 at 18).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

fee or even the amount thereof. Moreover, SFPP failed to present any evidence that the receipt of this management fee serves to reduce, in any way, KMI's cost center levels which specifically make up the KMI cross-charge. Finally, ACV Shippers conclude that the record clearly reflects that the costs KMI assigned to REX reflect costs associated with operational personnel rather than any costs associated with KMI G&A overhead costs centers. Accordingly, ACV Shippers reassert that REX should be included in the allocation of KMEP's G&A overhead costs.

ii. Commission Determination

155. The Commission denies rehearing regarding the exclusion of REX from KMEP's G&A overhead cost allocation. Contrary to ACV Shippers' assertions, the Commission fully discussed the basis for the exclusion of REX in Opinion No. 511.[185] As noted in Opinion No. 511, REX is one of the eight KMI-Operated entities.[186] SFPP stated on the record that KMI was reimbursed for its overhead costs associated with REX through the payment of a fee that varied monthly based on REX's actual direct payroll expenses.[187]

156. In reaching its conclusion in Opinion No. 511 that the KMI-Operated Entities, including REX, should be excluded from KMEP's G&A cost allocation, the Commission noted that in response to shipper exceptions on this issue, SFPP established that even after a survey and audit, Valero (the sole exception shipper on this issue) did not uncover a single situation where the employees of the audited RCs that directly assigned costs to SFPP included the costs of any of the KMI-Operated Entities. The Commission found that the costs of the employees responsible for the KMI-Operated Entities are captured in Account 184600 and that four of the KMI-Operated Entities are billed fixed fees for these costs. The Commission further found any of the Account 184600 costs that are not recovered through fixed fees are allocated only to KMI-Owned and KMI-Operated Entities through KMI's Massachusetts formula. Thus, it is clear the costs associated with REX and the other KMI-Operated Entities do not and cannot reach SFPP. Specifically, with respect to REX, which is one of the four KMI-Operated Entities that pays a fixed fee to KMI, there is no possibility of a cross-subsidy by SFPP for any shortfall amount to the extent the fee REX pays does not fully cover the costs incurred. SFPP stated that any residual costs that are not covered by the fixed fees are allocated by KMI's Massachusetts formula which allocates costs only to KMI-Owned Entities and KMI-Operated Entities.

---

[185] *See* Opinion No. 511, 134 FERC ¶ 61,121 at P 122-127.

[186] *Id.* P 138, n.226.

[187] *See* Ex. SFP-38 at 29.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

157. The Commission also addressed in Opinion No. 511 Valero's argument in its brief on exception, which argument is reasserted in ACV Shippers' Rehearing, that because KMEP's officers and directors have operating and legal responsibility for the KMI-Operated Entities, these entities should be included in KMEP's Massachusetts formula. The Commission found SFPP's testimony on the issue to be credible and Valero's evidence, which the Commission described as corporate documents, to be inadequate to contradict explicit witness testimony from SFPP. The Commission has weighed the record evidence on this issue and affirms that SFPP properly excluded REX from KMEP's G&A overhead cost allocation.

5. Appropriateness of Certain Cost and Revenue Components

158. Both ACV Shippers and Tesoro challenge the Commission determinations regarding (i) removing PAAs when calculating the gross plant factor for the Massachusetts formula and (ii) whether to capitalize or expense certain overhead costs related to KMI's "going-private" transaction. In Opinion No. 511, the Commission affirmed the 2009 ID conclusion that SFPP properly removed all PAAs from both jurisdictional and non-jurisdictional entities in applying KMEP's Massachusetts formula. The Commission also concluded that SFPP adequately proved that $5.572 million of the $26.2 million of "going-private" costs incurred when KMI went private were recurring costs and may be included in SFPP's cost of service. ACV Shippers also seek rehearing of the decision to allow the use of net revenues in place of gross revenues in the Massachusetts formula Allocation of G&A Overhead costs to KMEP's subsidiary Tejas Consolidated.

a. PAAs

i. Rehearing Requests

159. With regard to SFPP's PAAs, both the ACV Shippers and Tesoro challenge SFPP's removal of PAAs from the gross property, plant and equipment allocation factor of KMEP's unregulated subsidiaries. Tesoro asserts that this contravenes Commission precedent. Tesoro and the ACV Shippers cite to the 1992 *Arkla Energy* order which supports that PAAs are to be removed from the gross property, plant and equipment factors only for regulated subsidiaries,[188] arguing that the purpose of removing the PAAs is to ensure that the gross property balances of regulated facilities reflect the original cost

[188] *Arkla Energy Resources*, a Division of Arkla Inc., et al., 61 FERC ¶ 61,004, at 61,037-38 (1992) (*Arkla Energy*) (if a party purchases jurisdictional facilities for a price in excess of their net book value, it is not entitled to recover the excess through its jurisdictional rates).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

of the asset.[189] ACV Shippers state the removal of PAAs from only rate-regulated entities has a long established basis and underlying rationale founded in original cost ratemaking.[190]

160. ACV Shippers explain that the fundamental premise for removing PAAs from the gross property of rate-regulated entities is to have the gross property balance reflect original cost and not to have the allocation of overhead expense to the rate regulated subsidiaries be influenced by the purchase price of the regulated subsidiaries. ACV Shippers state that the Commission, in concluding that the PAAs should be removed from both the jurisdictional and non-jurisdictional entities, failed to recognize that, unlike regulated entities which have a distinct rate base, there is no relationship between the prices, revenues, and profitability of unregulated subsidiaries and the original cost of an unregulated subsidiary's gross property and no rate base.[191] ACV Shippers claim that the Commission erred in concluding that failure to remove the PAAs from the non-jurisdictional entities will overstate their relative weight in the asset (rate base) component of KMEP's and KMI's Massachusetts formulas.[192] They further note that the Commission failed to cite to any precedent or support for this proposition.

161. Finally, ACV Shippers acknowledge that in a February 13, 2006 order on rehearing, the Commission did require SFPP to remove PAAs from gross property, plant, and equipment balances for both KMEP's regulated and unregulated subsidiaries.[193] However, ACV Shipper state that this February 2006 Order was an anomaly and is of questionable precedential value.

ii. <u>Commission Determination</u>

162. The Commission denies rehearing and affirms that SFPP properly removed all PAAs from both jurisdictional and non-jurisdictional entities in applying KMEP's

[189] ACV Shippers also cite *SFPP, L.P.*, *et al*., 113 FERC ¶ 61,277, at P 85-86 (2005) (December 2005 Order).

[190] ACV Rehearing at 200-201 (citing Ex. ACV-40 at 37-38; *Arkla Energy*, 61 FERC at 61,037-38).

[191] *Id.* at 198-199.

[192] *Id.* at 199 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 142).

[193] *SFPP, L.P.*, *et al*., 114 FERC ¶ 61,136, at P 17 (2006) (February 2006 Order).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Massachusetts formula. Re-reviewing the record, the Commission finds that SFPP submitted sufficient evidence demonstrating that failure to remove the PAAs from the non-jurisdictional entities will overstate their relative weight in the asset (rate base) component of KMEP's and KMI's Massachusetts formulas. Specifically, a SFPP witness testified that removing the PAAs from FERC-regulated entities while including the PAAs of other entities could distort the Massachusetts formula, since it allocates corporate overhead expenses to both classes of entities.[194]

163. Further, contrary to Tesoro's and ACV Shippers' claims, SFPP's removal of the PAAs from both jurisdictional and non-jurisdictional entities is consistent with Commission precedent. In a December 16, 2005 order, the Commission stated:

> [F]or gross plant, SFPP fails to include all of KMEP's subsidiaries (e.g., Red Lightning, Plantation Pipeline Co., Kinder Morgan Interstate Gas Transmission, and Trailblazer Pipeline Co.) and includes the PAA for other KMEP subsidiaries, including SFPP. Gross plant is the net book value of plant – the original plant cost less accumulated depreciation of the facilities. SFPP's use of the purchase premiums in its calculations of gross plant for KMEP and itself results in an inflated ratio of overhead costs
> . . .
> Accordingly, the Commission requires SFPP to recalculate its Massachusetts Formula allocation factors based on Staff's calculation of gross plant. This adds the costs attributable to the additional KMEP subsidiaries acquired during the test period (calendar year 1999), and removes the PAA from KMEP's subsidiary plant costs.[195]

In 2006, the Commission again affirmed that SFPP is to remove the PAAs from the calculation of the gross plant factor with respect to the allocation of corporate overhead expenses under the Massachusetts formula among the various KMEP entities, including non-jurisdictional entities.[196] Moreover, the case that Tesoro and the ACV Shippers cite as precedent, *Arkla Energy*, addresses the treatment of PAAs in a different context than what is at issue here. In *Arkla Energy*, the Commission affirmed the longstanding

---

[194] Ex. SFP-38 at 21-22.

[195] December 2005 Order, 113 FERC ¶ 61,277 at P 85-86.

[196] February 2006 Order, 114 FERC ¶ 61,136 at P 16-17.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

principle that a jurisdictional utility can include in its rate base only that portion of an asset's purchase price that represents the net book value of the property to the original owners, regardless of the acquisition cost.[197] However, *Arkla Energy* does not address whether the PAAs should be removed from both jurisdictional and non-jurisdictional entities when calculating the gross plant factor to be used in the allocation of corporate overhead costs under the Massachusetts formula. Accordingly, Tesoro's and ACV Shippers' requests for rehearing on the issue of the removal of PAAs are denied.

b. <u>Going-Private Costs</u>

i. <u>Rehearing Requests</u>

164. In this proceeding, $5.572 million of the $26.2 million in costs associated with KMI's "going private" transaction were included in the pool to be allocated through KMEP's 2007 Massachusetts formula. Tesoro refutes SFPP's claim that the $5.572 million of the $26.2 million in "going-private" costs were a recurring costs that represented normal employee bonuses.[198] Tesoro points to the fact that in a California Public Utility Commission (CPUC) proceeding, SFPP witnesses claimed that the "going private" transaction would have no effect on SFPP, claiming that it is improper for SFPP to attempt to recover any costs associated with the going private transaction after previously swearing in testimony that it would never attempt to do so. Tesoro further states that in the 2007 SEC 10-K KMEP stated that it had no obligation to pay any of the expenses and did not expect to do so.

165. The ACV Shippers also challenge the inclusion of the $5.572 in going-private costs stating that the Commission erroneously found Valero's argument based on KMEP's 2007 SEC Form 10-K to be insufficient to rebut SFPP's specific evidence that the $5.572 million is a recurring cost. ACV Shippers argue that for a cost to be a recurring cost, it must be a cash expense. ACV Shippers argue that the $26.2 million in going-private costs are non-cash costs for KMEP. In support of this conclusion, ACV Shippers point to KMEP's 2008 SEC Form 10-K. In it, they state that KMEP described its unallocated 2007 G&A overhead costs as including the $26.2 million expense allocated to KMEP from KMI associated with the going-private transaction and stated that "[KMEP] do[es] not have any obligation, nor do we expect to pay any amounts

[197] *Arkla Energy*, 61 FERC at 61,038.

[198] No party challenges that KMI incurred $26.2 million in costs when the company went private and became Knight, Inc.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

related to this expense."[199] ACV Shippers further state that SFPP's witness Mr. Bradley makes no claim that any of the $26.2 million reflects cash expenses.[200] Next, ACV Shippers state that for a cost to be a recurring cost, the cost must be related to an event that recurs and not a one-time event. They assert that a going-private transaction is clearly a one-time event. Last, ACV Shippers reassert their argument that the $26.2 million in overhead costs related to KMI going-private did not benefit KMEP or SFPP, as SFPP represented to the CPUC.[201]

ii. <u>Commission Determination</u>

166. The Commission denies rehearing on this issue. In Opinion No. 511, the Commission noted that SFPP presented witness testimony that the $5.572 in going-private costs at issue related to stock options that would have previously been granted to employees, which were replaced by cash bonuses of approximately the same level.[202] Based on this record evidence, the Commission concluded that Valero's argument based on KMEP's 2007 Form 10-K was insufficient to rebut SFPP's specific evidence that the $5.572 million at issue should be considered a recurring cost.[203] The Commission rejects Tesoro's and ACV Shippers' arguments that SFPP witness testimony before the CPUC should have any bearing on the treatment of the going-private costs in a proceeding before the Commission. First, the SFPP witness testimony relates to the effect the going-private transaction would have on SFPP's transportation services in California, i.e., SFPP's intrastate rates, not its interstate rates. This is made clear from other portions of the testimony.[204] A regulated entity's recovery or treatment of a cost in its intrastate rates is irrelevant to the treatment of that cost in Commission jurisdictional rates.[205]

---

[199] ACV Rehearing at 197 (citing Ex. ACV-231 at 62-63, 77-78).

[200] *Id.* (citing Ex. SFP-129 at 48-52).

[201] *Id.* at 197 (citing Ex. ACV-40 at 41-42; CPUC D.07-95-061 at 30 (2007) (quoting SFPP stating they "unreservedly commit that they will not seek recovery in utility rates of any cost associated with the proposed [going private] transaction.")).

[202] Opinion No. 511, 134 FERC ¶ 61,121 at P 143.

[203] *Id.*

[204] *See* Prepared Testimony of Thomas A. Bannigan, CPUC Application No.: 06-09-016, January 24, 2007, included in the record as Ex. ACV-83. Specifically Mr. Bannigan testifies "Given that the proposed transaction has no effect upon the status quo as it pertains to either SFPP's or Calnev's intrastate pipeline facilities and related

(continued…)

20111216-4007 FERC PDF (Unofficial) 12/16/2011

167. The only record evidence that Tesoro and ACV Shippers presented to counter SFPP's position regarding the $5.572 portion of the going-private costs is the following statement from KMEP's 2007 SEC Form 10-K: "[KMEP] do[es] not have any obligation, nor do we expect to pay any amounts related to this expense."[206] SFPP witness Dale Bradley testified that approximately $26.2 million of costs associated with the going-private transaction were costs incurred to buy out employees' restricted stock grants and stock options and to pay the associated payroll taxes.[207] Mr. Bradley further testified: "in a typical year (i.e., one in which there is no going-private transaction), these types of costs – restricted stock grants and stock options, as well as associated payroll taxes – would be allocated between KMI and KMEP, and among the KMEP-Operated Entities, exactly as they were here."[208] Mr. Bradley further explained that: (i) the costs at issue were typical costs associated with employee compensation which are pushed down to the subsidiaries within the Kinder Morgan organization; (ii) employee compensation costs typically amortize over time; (iii) because of the going-private transaction, the amortization scheduled for all of the restricted stock grants and stock options at issue accelerated causing the costs to be charged to KMEP in a single year; (iv) he performed an analysis to account for the fact that the costs were accelerated to determine what amount of the costs would have been allocated through the KMEP Massachusetts formula in 2007 had the going-private transaction not occurred; (v) his analysis determined that $5.572 of the $26.2 million of employee compensation costs is the portion of the employee compensation costs that SFPP would have received in a typical year.[209] In other words, Mr. Bradley testified that $5.572 million represents the amount that would

---

operations, there will be no adverse impact on competition for refined petroleum product transportation services in California." *Id.* at 5:24-27. Another example, Mr. Bannigan's following statement: "Given that the proposed transaction has no effect upon the status quo as it pertains to either SFPP's or Calnev's intrastate pipeline facilities and related operations, there will be no adverse impact on employees." *Id.* at 6:9-11.

[205] *See, e.g., Virginia Electric and Power Co.*, 128 FERC ¶ 61,026, at P 22 (2009) (holding "The treatment of a cost at the wholesale level . . . is unrelated to whether a state regulator will or will not permit recovery of a rate that includes such costs in a wholesale customer's retail rates.").

[206] ACV Rehearing at 197 (citing Ex. ACV-231 at 62-63, 77-78).

[207] *See* Ex. SFP-129 at 48:13-23.

[208] *See id.* at 49:11-14.

[209] *See id.* at 51-52.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

have been allocated through KMEP's 2007 Massachusetts formula in 2007 had the going-private transaction not occurred. Neither ACV Shippers nor Tesoro presented any evidence that directly counters the analysis that Mr. Bradley performed. Accordingly, the requests for rehearing regarding the going-private transaction costs are denied.

c. Use of Net Revenues in Place of Gross Revenues

168. ACV Shippers challenge the Commission decision to allow the use of net revenues instead of gross revenues for the KMEP subsidiary referred to as Tejas Consolidated.[210] The Commission denies rehearing because this issue is moot. Tejas Consolidated is one of the eight KMI-Operated Entities.[211] The Commission in Opinion No. 511, as affirmed in this order, has excluded Tejas Consolidated, along with all of the other KMI-Operated Entities from KMEP's Massachusetts formula. Thus, the issue of whether, with respect to Tejas Consolidated, to allow the *Distrigas* methodology to be used to perform the revenue allocation factor of the Massachusetts formula is moot.

6. KN Method

a. Rehearing Request

169. SFPP seeks rehearing of the Commission's determination that SFPP's proposed approach to the KN Method was incorrect and that SFPP instead must follow the KN Method set forth in Opinion No. 731.[212] SFPP argues the Opinion No. 731 KN Method allocates G&A expenses in a manner that is inconsistent with the principle of cost-causation and, thus, is inconsistent with the Commission's principles. SFPP uses the KN Method to allocate G&A costs at the SFPP company level, i.e., among the individual functions or services provided by SFPP.

170. SFPP's proposed approach to the KN Method is a "simple average approach" that is similar to its Massachusetts formula in that it utilizes a simple average of the three

---

[210] ACV Rehearing at 186 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 147).

[211] Opinion No. 511, 134 FERC ¶ 61,121 at P 78, n.89, P 146 (citing Ex. SFP-38 at 26, 27-30; Ex. SFP-129 at 31-32).

[212] *Kansas-Nebraska Natural Gas Co. Inc.*, 53 FPC 1691 (1975) (Opinion No. 731), *order on reh'g*, 54 FPC 923, *aff'd*, *Kansas-Nebraska Natural Gas Co. Inc. v. FPC*, 534 F.2d 227 (10th Cir. 1976).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

factor ratios (gross plant, direct labor and gross revenue) to allocate all residual G&A expenses. SFPP states that Trial Staff, which endorses using the traditional KN Method as articulated in Opinion No. 731, asks only whether the G&A costs are labor-related or plant-related. SFPP argues that under the Opinion No. 731 approach, if the G&A costs are labor related (such as salary for an accountant who performs work at the G&A level) the costs are allocated 100 percent to labor at the SFPP level. If the G&A costs are associated with plant costs, the costs would be allocated 100 percent to plant at the SFPP level. Thus, SFPP argues under this traditional KN Method, virtually all G&A expenses ultimately would be allocated based, not on the purpose for which the G&A expenses were incurred, but simply because the G&A costs are themselves labor or plant.

171. SFPP provides specific examples of how Trial Staff's traditional Opinion No. 731 KN Method would disregard the purpose for which the G&A costs were incurred. According to SFPP, this approach runs contrary to the principle of cost causation. One example is the cost of lighting and office equipment at Kinder Morgan's corporate offices. SFPP argues that these costs would be allocated as plant at the SFPP level even though the power at these offices supports all aspects of SFPP's business and not just SFPP's plant.

b. Commission Determination

172. The KN Method is used to allocate general and administrative expenses among a pipeline company's divisions or functions after the overhead costs are allocated from the pipeline's parent company to the pipeline company through the Massachusetts formula. Under Opinion No. 731, such G&A costs are allocated based on the ratio of direct labor and capital investment of each of the pipeline's functions and services at issue to the total direct labor and capital investment of all divisions involved.[213] Opinion No. 731, which originally set forth the formula for the KN Method, requires that G&A expenses first be divided in labor-related, plant-related, and "other" categories. After the initial division, the "other" category is allocated between the labor- and plant-related categories in proportion to each category's total so that all expenses are classified as either plant or labor related. The categories are then allocated among the jurisdictional entity's (in this case SFPP) functions by multiplying the total labor-related G&A by each function's direct labor ratio, and multiplying the total plant-related G&A by each function's direct plant ratio. Then, within each function, the expenses are added together and the ratio of each total to the total amount allocated is that function's KN ratio. The final step is to multiply each A&G expense by the applicable KN ratios in order to allocate it across the

[213] *See SFPP, L.P. et al.*, 86 FERC ¶ 61,022 at 61,082 (1999) (citing *Mojave Pipeline Co.*, 83 FERC ¶ 61,267 (1998)).

functions. Opinion No. 731's KN formula has been affirmed by the Commission in numerous decisions.[214]

173. SFPP does not appear to dispute that the KN Method, as articulated in Opinion No. 731, is as set out in the above two paragraphs. Rather, SFPP continues to argue on rehearing that its "simple average approach" for applying the KN Method is an appropriate substitution in lieu of the KN Method articulated in Opinion No. 731. SFPP justifies using its "simple average approach," arguing that it is fully consistent with KMEP's Massachusetts formula and that "Trial Staff's approach" to the KN Method runs directly contrary to the principle of cost causation. First, SFPP fails to present how the Trial Staff's approach differs from the KN Method set forth in Opinion No. 731. Second, the Commission did not, as SFPP states in its rehearing request, "order[] SFPP to follow Staff's approach." Rather, the Commission clearly ordered in Opinion No. 511 SFPP to follow the KN Method as articulated in Opinion No. 731. Accordingly, the Commission denies rehearing regarding the KN Method and affirms its determination in Opinion No. 511 that SFPP's "simple average approach" does not conform to Opinion No. 731 and that SFPP must apply the KN Method set forth in Opinion No. 731.[215]

174. The Commission also rejects SFPP's arguments that its "simple average approach" should be accepted because it is fully consistent with its Massachusetts formula, which SFPP states uses a simple average of three factors to allocate residual costs. If the Commission had intended for the same formulaic approach to be used for allocating residual G&A costs among both affiliate subsidiaries as well as among functions within the regulated company, then the Commission would not have adopted and continued to use separate methods, the KN Method and the Massachusetts formula, for each type of allocation.

175. For the foregoing reasons, SFPP's request for rehearing regarding the KN Method is denied.

---

[214] *Idaho Power Company*, 3 FERC ¶ 61,108 (1978); *Missouri Power and Light Co.*, 5 FERC ¶ 63,003 (1977); *Panhandle Eastern Pipeline Co*., 46 FERC ¶ 61,183 (1989); *Questar Pipeline Company*, 74 FERC ¶ 61,126 (1996); *Transcontinental Gas Pipeline Corp*., 101 FERC ¶ 63,022 (2002); *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077, at P 288-294 (2006).

[215] Opinion No. 511, 134 FERC ¶ 61,121 at P 150.

C. Compliance Filing On Cost Allocation Issues

176. On April 25, 2011, SFPP submitted its Compliance Filing implementing Opinion No. 511. The Compliance Filing includes supporting explanatory statements and documentation regarding overhead cost allocation issues as required in Opinion No. 511. The supporting documentation includes an affidavit of Mr. Bradley and supporting documentation for the overhead cost allocation as required in Ordering Paragraph (B) of Opinion No. 511. At issue is whether to accept the supporting documentation on overhead cost allocation provided in the Compliance Filing.

177. In Opinion No. 511, the Commission directed SFPP, as part of its Compliance Filing to, on the issue of whether the KMI-shared costs allocated or assigned to KMEP or directly to SFPP from a particular RC are reasonable and are reasonably well documented, identify the RCs that require the most critical examination and document the details of the costs allocated within those critical RCs.[216] The Commission also directed SFPP to provide a fuller analysis and explanation of its previous clarifications and adjustments in its Compliance Filing, along with the source materials for such an audit and the supporting analysis.[217] The Commission also ordered SFPP to respond to Valero's criticisms, particularly for assignments and allocations to and within the Products Pipeline Group.[218] The Commission further stated:

> [I]n its compliance filing SFPP must clearly explain the basis for any deduction from KMEP's cost of service for ambiguous situations based on its review of the time sheets or time split involves. If SFPP's pending assignment and allocation of costs to SFPP involves ambiguous situations, SFPP must explain how these will be resolved. For example, SFPP might determine that the best resolution is to roll some of the costs now directly assigned to SFPP (about $9.3 million) up to a higher level in its accounting structure, such as the Pacific or the Products Pipeline Group. This would result in some reallocation of costs below the KMEP level, but would not affect the allocation of costs to KMEP-Operated Entities that have nothing to do with product pipeline operations. Similarly, if some elements included in the cross-charge to KMEP are unclear,

---

[216] *Id.* P 135.

[217] *Id.* P 137.

[218] *Id.*

> SFPP could provide documentation that supports eliminating some dollar amount of a specific cross-charge from KMEP's total cost of service, or alternatively, assign or allocate those costs to those entities that are operated by KMI.[219]

178. With regard to the overhead cost issues, the Commission generally accepts the Compliance Filing, with some exceptions, as discussed in detail below.

1. G&A Costs Directly Assigned to SFPP, Pacific Pipeline Group Sub-tier, or PPL Tier

a. Compliance Filing

179. SFPP's Compliance Filing includes the following background information regarding its organizational structure and how it intersects with its cost allocation methodology. SFPP is one of the KMEP-Operated Entities. KMEP has no employees. GP Services and KMI-shared employees provide all the support for the KMEP-Operated Entities. GP Services employees operate and manage the KMEP-Operated Entities. With only a few exceptions, GP Services employees do not perform work for the KMI-Owned Entities or the KMI-Operated Entities. GP Services employees do perform work for KM Canada. KMI-shared employees perform certain managerial and other G&A functions for the KMEP-Operated Entities as well as the KMI-Operated Entities.

180. SFPP also explains in its Compliance Filing its RC accounting concept. SFPP states that all costs, including G&A costs, originate in RCs and flow to the subsidiaries each RC serves. KMI-shared employees and GP Services employees (and their associated costs) are divided into RCs based on their functional duties and, in some instances, the geographic locations of the subsidiaries they support. Each RC has its own budget and tracks its labor and non-labor costs. The relevant focus in the Compliance Filing is the GP Services costs assigned to the PPL Tier, the Pacific Pipeline Group sub-tier and to SFPP individually. According to SFPP, GP Services G&A costs are distributed among KMEP-Operated Entities (which includes SFPP) using a combination of direct assignments to individual entities and to groups of entities (e.g., PPL Tier or Pacific Pipeline Group sub-tier), with residual costs allocated via a Massachusetts formula.

181. SFPP states in 2007 only five RCs directly assigned labor costs to SFPP individually. The five RCs are RC 1002, 1006, 1009, 1011, and 1040. These five RCs

---

[219] *Id.*

20111216-4007 FERC PDF (Unofficial) 12/16/2011

also assigned labor costs to the Pacific Pipeline Group sub-tier or the PPL Tier. SFPP resides within both these tiers.

182. These five RCs were subject to an error called the “Location Code 0002” accounting error. SFPP explains that in 2007, the G&A labor costs associated with GP Services employees were generally directed in the accounting system to the applicable subsidiaries or tiers using account codes called “location codes.” Generally, in 2007, Location Code 0002 was to be used by employees to tag costs to be assigned to the Pacific Pipeline Group sub-tier, which includes SFPP, Calnev, and West Coast Terminals. However, for RCs 1002, 1006, 1009, 1011, and 1040 (the RCs that directly assign costs to SFPP), the accounting department read Location Code 0002 as tagging costs to be assigned directly to SFPP, even though the employees who assigned the location code thought Location Code 0002 was to be used to tag costs assignable to the Pacific Pipeline Group sub-tier. The result of the Location Code 0002 error was that too many G&A labor costs originating in the five affected RCs were directly assigned to SFPP.

183. Mr. Bradley states he identified this error when reviewing Exhibit No. ACV-279HC in this proceeding. Mr. Bradley states that he has corrected this error for ratemaking purposes in this proceeding. To correct the error, Mr. Bradley and Ms. Armstrong interviewed the individuals within the five RCs, and created the surveys in Exhibit SFP-334HC. If the surveyed employee stated that the salary split in the general ledger accurately reflected how he or she spent their time in 2007, SFPP left the salary split as recorded in the general ledger for that employee. If an employee indicated that the salary split was wrong, the interviewer asked the employee to indicate the subsidiaries or groups of subsidiaries for which they had provided G&A support and asked them indicate the percentage of time they had spent on each. For any individual who was no longer employed by KMEP, that employee’s labor costs were corrected by placing all the costs in the PPL Tier. Mr. Bradley states that the surveys and corrective actions reflect that approximately $1.7 million was erroneously directly assigned to SFPP. Thus, in its Compliance Filing, SFPP reduced the direct assignments amount attributed to SFPP by $1.7 million.

184. Outside of the Location Code 0002 error, SFPP states that the surveys conducted in 2009 set forth in Exhibit SFP-334HC provide the “detail regarding the salary splits and the associated labor costs.”[220] Mr. Bradley asserts that the surveys accurately capture employees’ salary splits for 2007 and should be used in this proceeding.

[220] Bradley Affidavit at P 29.

185. Mr. Bradley also notes that the labor costs for employees in RCs 1009 and 1011 who did not code to Location Code 0002 were not interviewed as part of the survey. Therefore, the labor costs associated with those RC 1009 and 1011 employees remain unchanged. The applicable labor costs from RC 1009 were coded to the PPL Tier and the labor costs from RC 1011 were coded to either the West Coast Terminals or Calnev. Mr. Bradley further states that the remaining non-labor costs in RCs 1002, 1006, 1009, 1011, and 1040 (the five RCs that directly assign costs to SFPP) bear no relation to labor. Mr. Bradley states these non-labor costs were coded by the accounting department and did not involve interpretation of employees' labor coding. Thus, to the extent any of these costs were directly assigned to SFPP, Mr. Bradley states those direct assignments were correct.

186. Next, SFPP addressed the RCs that directly assign costs to either the Pacific Pipeline Group sub-tier or the PPL Tier. SFPP states that, in addition to the five RCs noted above, six other RCs assigned costs to the Pacific Pipeline Group sub-tier or the PPL Tier. These six RCs are 1003, 1010, 1012, 1030, 1064, and 1007. SFPP states that none of these six RCs directly assign costs to SFPP individually. SFPP stated that there are no other GP Services RCs that assigned costs to SFPP (either individually or through a shared cost distribution) in 2007. Mr. Bradley further describes that while some RC 1012 G&A costs were assigned to the Pacific Pipeline Group sub-tier, the costs for RCs 1030 and 1012 generally were assigned to the PPL Tier and allocated among the subsidiaries in the products pipeline group (PPL Tier), including SFPP. RCs 1003, 1010, 1064, and a portion of the accounting group in RC 1007 generally assign their non-residual costs to the Pacific Pipeline Group sub-tier.

187. Mr. Bradley also describes the adjustments to the GP Services costs made in testimony and at hearing and further adjustments made in the Compliance Filing.[221] These new adjustments include: (1) reallocating and reassigning health and welfare costs, pension costs, and the cost of other benefits to follow labor costs resulting in a reduction in the amount of $146,128 in costs that flow to SFPP; (2) adjusting certain non-labor costs that follow labor costs based on the 2009 survey to correct the Location Code 0002 error, resulting in a $178,808 reduction in costs flowing to SFPP; (3) adjustments made to reflect corrected amount of costs associated with the support of the KM Canada Entities, which reflects a $213,507 reduction in these costs flowing to SFPP; and (4) adjusting the property, plant and equipment (PP&E) balances to reflect only year-end 2007 balances, which changes slightly the percentages used in the allocations.

---

[221] *Id.* at P 34-38.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

b. **Protest**

188. The ACV Shippers were the only party to protest SFPP's Compliance Filing materials supporting the direct assignments. With respect to the Location Code 0002 error, ACV Shippers generally assert that SFPP's explanation and proposed correction of the Location Code 0002 error exemplifies the fact that SFPP repeatedly abandons any reliance on Kinder Morgan's accounting structure, underscoring that it is inaccurate and unreliable. ACV Shippers argue that SFPP attempts to introduce new corrections and proposals based on retroactive surveys of employees. ACV Shippers' consultant, Dr. Arthur, explains that SFPP's survey of the individuals in the five RCs that directly assign G&A overhead costs to SFPP was substantially incomplete and highly questionable. ACV Shippers state that SFPP's attempt at correct the $9.8 million of direct assignments to SFPP through Mr. Bradley's survey process shows that this information is highly questionable and unreliable given (i) the significant time period that elapsed between when the work was performed and when Mr. Bradley conducted the survey, (ii) the presence of contradictory survey data collected by a third-party accounting firm during the test period in this proceeding, and (iii) the incomplete, arbitrary, and deficient nature of Mr. Bradley's survey process itself.[222]

189. Dr. Arthur recaps his prior testimony and evidence that he asserts shows that SFPP's proposed direct assignment of $9.8 million to SFPP was clearly erroneous.[223] Dr. Arthur states that Exhibit ACV-279HC is a summary of the salary assignments by individual employees in three RCs who were directly assigning overhead costs to SFPP. One example of potential errors identified in Exhibit ACV-279HC is with RC 1002. RC 1002 showed 100 percent of James Kehlet's 2007 salary was assigned to SFPP, yet Mr. Kehlet testified that he was responsible for (i) the regulatory affairs for SFPP, Calnev, and West Coast Terminals and (ii) supervising individuals who allocated a portion of their time to entities other than SFPP. Dr. Arthur also states that Exhibit ACV-279HC showed that the vast majority of the employees in RC 1040 (Environmental Compliance) assigned their time and costs only to SFPP, which in Dr. Arthur's opinion was implausible given the extent of KMEP's operations and assets.

190. With respect to the Location Code 0002 error, Dr. Arthur states that Mr. Bradley's description of the error is inconsistent with the proposed correction.[224] Dr. Arthur quotes Mr. Bradley's affidavit on this issue as stating that the "G&A employees in all of the RCs

[222] ACV Protest at 22-23 (citing Arthur Affidavit at P 62-70, 74-78).

[223] Arthur Affidavit at P 50-54.

[224] *Id.* P 55.

– including the five RCs that were the subject of the error – intended that their labor costs coded to Location Code 0002 be assigned to the Pacific Pipeline Group sub-tier and allocated among SFPP, Calnev and West Coast Terminals."[225] Dr. Arthur argues that based on Mr. Bradley's description of the Location Code 0002 error, i.e., that the Location Code 0002 expenses were intended to be assigned to the Pacific Pipeline Group sub-tier, the correction for the Location Code 0002 error should have been to switch the dollar amounts from being directly assigned to SFPP to being directly assigned to the Pacific Pipeline Group sub-tier. Dr. Arthur notes that SFPP did not do this in its Compliance Filing, and instead SFPP choose to: (1) reject its accounting records completely, (2) attempt to survey individual employees in mid-2009 regarding their activities during 2007, and (3) reallocate the labor-costs based on the incomplete results of that survey.[226] Finally, Dr. Arthur stated that Mr. Bradley fails to provide any information or data to verify that the direct assignments to groups of subsidiaries by the RCs that also relied on the Location Codes to assign costs are accurate or reasonable. Dr. Arthur supports this attack on SFPP's general reliance on location codes based on data provided in the East Line proceeding.

191. With respect to the non-labor costs in the five RCs affected by the Location Code 0002 error, Dr. Arthur asserts that the assignment of these costs are not credible because the costs were assigned by the accounting department and it does not appear that any RC manager or anyone else associated with the actual RCs reviewed the data to determine whether the costs should be directly assigned to SFPP.[227] Dr. Arthur also states that the data provided by Mr. Bradley does not verify the accuracy of Mr. Bradley's claims as the data is simply a printout of general ledger data with brief descriptions of the cost item that provides no detail and no assurance that the costs are uniquely related to SFPP.

192. ACV Shippers also challenge one of SFPP's adjustments proposed in the Compliance Filing. First, ACV Shippers argue that SFPP's new treatment of the benefit costs lacks any verifiable basis.[228] ACV Shippers complain that SFPP fails in its Compliance Filing to provide any backup material regarding the proposed reallocation and reassignment of benefits costs to individual subsidiaries or groups of subsidiaries. Dr. Arthur explains that in the Compliance Filing, SFPP removes tens of millions of dollars of benefits costs from the KMP Tier, and directly assigns it to specific groups

[225] *Id.* P 56 (quoting Bradley Affidavit at P 22).

[226] *Id.* P 59.

[227] *Id.* P 72.

[228] *Id.* P 80-81.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

(lower tiers) and to individual subsidiaries. As a result of this adjustment, SFPP is now assigned $7.4 million of these benefits costs. Dr. Arthur notes that the backup material for the adjustment to the benefits costs is a one page schematic that shows the results of its reallocation and reassignment, without any of the underlying calculations or a justification for the underlying calculations. Consequently, ACV Shippers were unable to verify the accuracy or reasonableness of SFPP's calculations.

c. <u>SFPP Reply Comments</u>

193. SFPP asserts in its reply comments that ACV Shippers and Dr. Arthur have put forth no evidence that the GP Services G&A costs assigned and allocated to SFPP are inaccurate. SFPP asserts that ACV Shippers offer scant actual analysis of the documents provided in the Compliance Filing and instead reply on evidence imported from the East Line rate proceeding, Docket No. IS09-437-000. SFPP claims that in their comments ACV Shippers' witness Dr. Arthur simply recapitulates previously identified and corrected errors.[229] Regarding the Location Code 0002 error, SFPP notes that the error had been identified, corrected and explained at the time of the hearing. Thus, Dr. Arthur's critique that Mr. Bradley's explanation is not plausible is "tardy as well as off-base."[230] Further, SFPP states:

> [E]rrors in RCs 1002, 1006, 1009, 1011, and 1040 do not reflect upon the individual RC owners' ability to track their own or their employees' costs. In 2007, each RC owner received a report each month that detailed the RC's labor distribution that reported to which location code – not to which entity or entities – their employees' time (and costs) was being billed. When managers in these RCs saw that labor was being coded to Location Code 0002, it would have appeared to them that people were assigning their time to the Pacific Tier because that is how the employees, including managers, were intending Location Code 0002 to be used.[231]

Regarding the Location Code 0002 correction, SFPP states that the "simple" correction of throwing all of the Location Code 0002 labor costs back into the Pacific Pipeline Group sub-tier would not have been as precise as the survey approach undertaken by

---

[229] SFPP Reply Comments at 40 (citing Arthur Affidavit at P 50-52).

[230] *Id.* at 40.

[231] *Id.* at 41-42.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Mr. Bradley.[232] In support of its position that the Location Code 0002 survey correction was more precise, SFPP details:

> By mid-2009, KMEP was implementing what it had learned from the KPMG Study in the normal course of business. KMEP was confident that the employees in the affected RCs could identify their labor costs to an individual entity rather than to a tier, as had been the practice in 2007. Based on this knowledge, KMEP felt confident that, in correcting the error, costs could be assigned more precisely to the entities that incurred them.[233]

Further, SFPP states that contrary to Dr. Arthur's assertion, the Location Code 0002 error does not reflect on the employee's ability to code their time.

194. Regarding Dr. Arthur's argument that the 2008 KPMG Study undermines the 2007 G&A cost assignments, SFPP states this argument is without merit as the 2008 Study has no relevance to this proceeding and reflects an attempt by Dr. Arthur to import select evidence from the East Line rate proceeding.

195. SFPP states that Dr. Arthur's claim that SFPP failed to provide data from RCs whose costs are allocated or assigned to SFPP is patently false and shows that Dr. Arthur did not analyze or ignored the data given to him.[234] SFPP asserts that discarding an entire methodology because of a limited number of errors pertaining to a limited number of costs in a limited number of RCs, which errors were corrected, would make no sense.[235]

196. Regarding the employee benefits costs, SFPP states that the schematic provided in its Compliance Filing at Tab D, Exhibit No. 2, page 5, shows the reassignment of benefits SFPP made in compliance with the Commission directive in Opinion No. 511.[236] SFPP further states that, after reviewing ACV Shippers' comments regarding the lack of supporting documentation, it realized that it failed to include with the Compliance Filing a work paper showing the calculations that underlie the benefits reassignment

---

[232] *Id.* at 42.

[233] *Id.* (internal footnote omitted).

[234] *Id.* at 46.

[235] *Id.* at 47.

[236] *Id.* at 50-51.

schematic.[237] SFPP's attached work paper details the reassignment of employee related costs and shows that the reassignment resulted in a $146,128 reduction in the amount being allocated to SFPP.

d. Commission Determination

197. With respect to the Location Code 0002 error, in Opinion No. 511, the Commission directed SFPP to explain any ambiguous situations based on its review of the time sheets or time splits involved.[238] The Commission further stated that, if SFPP's pending assignment of costs to SFPP involves ambiguous situations, SFPP must explain how these will be resolved and noted that SFPP might determine that the best resolution is to roll some of the costs now directly assigned to SFPP (about $9.3 million) up to a higher level in its accounting structure, such as the Pacific Pipeline Group sub-tier or the Products Pipeline Group.

198. SFPP described the Location Code 0002 error as follows: "G&A employees in all of the RCs – including the five RCs that were the subject of the error – intended that their labor costs coded to Location Code 0002 be assigned to the Pacific Pipeline Group sub-tier and allocated among SFPP, Calnev and West Coast Terminals."[239] The Commission reads this statement to mean that every employee that billed their time to one of these five RCs used Location Code 0002 to designate a cost that should be assigned to the Pacific Pipeline Group sub-tier, not directly assigned to SFPP. However, for the five RCs at issue, the accounting department directly assigned costs coded to Location Code 0002 to SFPP. SFPP proposes to correct the Location Code 0002 error by surveying in 2009 the applicable employees or, where the particular employee was unavailable, interviewing the employee's supervisor or manager or even a co-worker "who was thoroughly familiar with that individual's duties," and asking them to indicate the percentage of time they spent in 2007 on SFPP.[240]

199. The Commission rejects SFPP's proposed resolution of the Location Code 0002 error. The obvious correction for this error is, as the ACV Shippers advocate, to treat any labor cost in RCs 1002, 1006, 1009, 1011 and 1040 coded with Location Code 0002 as a cost assigned to the Pacific Pipeline Group sub-tier to be allocated via a Massachusetts

---

[237] *Id.* at 51 & Attachment.

[238] Opinion No. 511, 134 FERC ¶ 61,121 at P 138.

[239] Bradley Affidavit at P 22.

[240] *Id.* P 25.

formula among the three entities within the Pacific Pipeline Group – SFPP, Calnev, and West Coast Terminals. To be consistent, the non-labor costs in RCs 1002, 1006, 1009, 1011, and 1040 that follow labor costs that were coded with Location Code 0002 must also be assigned to the Pacific Pipeline Group. SFPP is directed to make this change and reflect the change in the rates to be filed in a further compliance filing.

200. To the extent there are any other labor or non-labor costs from RCs 1002, 1006, 1009, 1011 and 1040 that were not coded to Location Code 0002 or do not follow costs coded to Location Code 0002, no party raised specific challenges to these cost assignments. The only specific argument ACV Shippers raise is a challenge to the credibility of the Location Code 0002 non-labor costs, which concern has been addressed by the above directive that SFPP assign all such non-labor costs to the Pacific Pipeline Group sub-tier. ACV Shippers' general arguments in their protest regarding the reliability and credibility of the process for assigning and allocating G&A overhead costs are insufficient to move the Commission to direct any further changes to the GP Services G&A costs directly assigned to SFPP, Pacific Pipeline Group sub-tier, or PPL Tier from RCs 1002, 1006, 1009, 1011 and 1040 and RCs 1003, 1010, 1012, 1030, 1064, and 1007.

201. With respect to the four adjustments described in Mr. Bradley's affidavit, ACV Shippers challenge the adjustment to the employee benefits costs. Specifically, ACV Shippers assert SFPP failed to provide the supporting analysis that would allow for the accuracy of this adjustment to be verified.[241] In Opinion No. 511, the Commission directed:

> Since the calculation is relatively mechanical, SFPP should be able to adjust these employee-related costs based on the information now available to it and which underpins the record. SFPP must prepare its compliance filing accordingly and provide a *supporting analysis* therewith.[242]

In response to ACV Shippers' protest on this issue, SFPP submitted in its reply comments the supporting work paper that shows how it calculated the amount of benefits costs to be redistributed to SFPP. Thus, the Commission finds SFPP complied with the directive in Opinion No. 511 requiring it to provide a supporting analysis. Further, the Commission has reviewed the work paper and finds that SFPP complied with the

---

[241] ACV Shippers' challenge to the KM Canada adjustment is discussed *supra* at P 123-139.

[242] Opinion No. 511, 134 FERC ¶ 61,121 at P 141 (emphasis added).

Commission's directive that any employee benefits costs that relate to G&A labor be allocated and assigned to follow labor. Accordingly, the Commission accepts SFPP's reallocation and assignment of health and welfare costs, pension costs and the cost of other benefits as set forth in its Compliance Filing and Reply Comments.

2. G&A Costs in KMI Cross-Charge

a. Compliance Filing

202. SFPP witness Mr. Bradley states that KMI uses three shared-services accounts to capture corporate G&A costs that cannot be directly assigned to a particular KMEP-Operated, KMI-Owned or KMI-Operated Entity. The three accounts are as follows: Account 184601, Account 184600, and Account 107001.[243] Account 184601 is the KMI cross-charge account. This account is used to capture the G&A costs incurred by KMI-shared employees and RCs for the benefit of the KMEP-Operated Entities, which includes SFPP. Thus, the only KMI costs that are charged to the KMEP-Operated Entities are those in Account 184601. KMI-dedicated employees and KMI-dedicated RCs are not allowed to budget expenses or charge time to Account 184601.

203. SFPP states that 39 RCs assign costs to Account 184601.[244] SFPP provides the 2009 salary splits for the KMI-shared employees as an example of how the costs of KMI-shared employees are accounted for in the Kinder Morgan accounting system. SFPP notes that the 2007 salary splits are no longer available, thus it cannot produce the actual individual salary splits for 2007. Last, SFPP provides the detail for the 39 RCs that code to the KMI cross-charge. The supporting documents include the journal entries from 2007 pulled from the general ledger and the raw data from Kinder Morgan's general ledger before any adjustments.

204. Next, SFPP explains the adjustments made to the KMI-shared costs.[245] These adjustments are as follows: (1) correction of the misapplication of the fixed fee payments KM North Texas Pipeline and KM Mexico made to KMI that should have been applied to Account 184600, (2) removal of all costs in RC 0375 as well as applicable benefits and

---

[243] Costs recorded in Accounts 184600 and 107001 are charged only to KMI-Owned Entities and KMI-Operated Entities. They are not included the KMI cross-charge.

[244] The 39 RCs are listed in SFPP's Compliance Filing. *See* SFPP Compliance Filing at Tab D, Exhibit 4.

[245] Bradley Affidavit at P 44-48.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

payroll taxes from RC 0999 from the KMI cross-charge in order to ensure that none of the costs of the time spent on Red Cedar's management committee are allocated to SFPP, and (3) reduction by $7.974 million of the amount of restricted stock and stock options recorded in May 2007 related to the going-private transaction to reflect only the $5.572 million in recurring costs. Further, SFPP details the source of the $7.68 million that was removed from the KMI cross-charge in Exhibit SFP-134.

205. In addition, SFPP describes two new adjustments that SFPP proposes in the Compliance Filing (1) removal of certain costs associated with the Trans Mountain acquisition, and (2) certain legal costs. SFPP states that these adjustments resulted from the review SFPP undertook as a result of Opinion No. 511. Regarding the Trans Mountain acquisition costs, SFPP states that its review of KMI-shared costs showed that six invoices related to KMEP's acquisition of Trans Mountain were erroneously included in the KMI cross-charge in RC 0999. Those six invoices totaled $1,471,698, and have been removed from the KMI cross-charge.[246] Regarding the legal invoices, SFPP identified two legal invoices, totaling $99,574 related to the natural gas entities that were misapplied to the KMI cross-charge and thus, $99,574 has been removed from the KMI cross-charge.[247]

b. Protests

206. In their protest, ACV Shippers reassert that SFPP has failed to justify or support the costs included in the KMI cross-charge.[248] The ACV Shippers' consultant Dr. Arthur states the data provided by SFPP does not reflect the basis or justification for the KMI-shared employee allocations. Specifically, Dr. Arthur states the additional data provided by SFPP is simply a summary of the amounts allocated to three separate accounts (Account 107001 – Capital Burden Pool; Account 184600 – KMI G&A Overhead Pool; and Account 184601 – Cross-Charge) as well as the underlying general ledger data that is after the allocations are made to the various accounts; i.e., SFPP is simply providing a presentation of the results of the allocation, not the basis or justification for the initial allocation among the three accounts, nor any evidence that the allocation is accurate.[249] Dr. Arthur notes that it is "the initial splitting of the KMI-shared costs that is relevant, which should include an examination of the reasonableness and accuracy of the initial

[246] *Id.* P 46.

[247] *Id.* P 47.

[248] ACV Protest at 17-20.

[249] Arthur Affidavit at P 26.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

allocation of overhead costs by Kinder Morgan to the various groups of subsidiaries, not simply looking at the amount allocated to one group as a result of the initial allocation."[250]

207. Dr. Arthur next asserts that evidence shows that the initial split of KMI shared costs among the three accounts is not accurate because overhead services were clearly performed for entities that are excluded from the KMEP Massachusetts formula. Dr. Arthur asserts that this record, including the Compliance Filing, is devoid of any information or evidence which can be used to verify, test, audit, or substantiate: (i) the reasonableness, accuracy, or even the basis for the actual splitting of the KMI-shared costs, (ii) that no KMI-dedicated employee assigned costs to Account 184601, or (iii) even the process used in which KMI-shared employees were actually splitting costs between the two accounts.[251] Dr. Arthur rejects SFPP's proffer of the 2009 salary splits, stating that the data is not from the relevant time period and the costs were allocated to more than the three accounts used in 2007. Dr. Arthur supports his challenge regarding the veracity and accuracy of KMI-shared employee cost allocations with a discussion of the record evidence in the SFPP East Line rate proceeding, Docket No. IS09-437-000.

208. Last, Dr. Arthur argues that the arbitrariness exercised by Kinder Morgan regarding capitalized overhead costs between KMI and KMEP further contradicts any claims of effectively isolating costs with relevant Kinder Morgan entities, or any related accuracy, credibility, or reasonableness associated with the assignment and/or allocation of KMI-shared G&A overhead labor costs.[252] Dr. Arthur notes that in 2007, SFPP identified $6.1 million of overhead expenses that were initially allocated to the KMEP-Operated Entities included in Mr. Bradley's model (through the Account 184601, KMI cross-charge) and that this $6.1 million was subsequently assigned to the KMI-Operated subsidiaries. Dr. Arthur asserts that this shift in cost assignment was made by transferring $6.1 million from Account 184601 to Account 107001, which re-assignment Dr. Arthur believes shows that the allocation of KMI-shared employee costs between the three accounts cannot possibly be an effective method for isolating costs or be accurate or reasonable.

209. With respect to SFPP's proposed removal of approximately $1.5 million of legal costs related to the Trans Mountain acquisition and $99,574 of legal invoices related to the natural gas entities, Dr. Arthur complains that SFPP provides no supporting data on

[250] *Id.* P 28.

[251] *Id.* P 29.

[252] *Id.* P 38.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

how these invoices were assigned to Account 184601 in error, how SFPP determined that these invoices were assigned in error, and no documentation supporting the remainder of the amount of legal costs assigned to Account 184601.

c. SFPP Reply Comments

210. SFPP assert that ACV Shippers' protest of the Compliance Filing focuses on the two KMI-Shared accounts that are irrelevant to this proceeding, Accounts 184600 and 107001.[253] SFPP reiterates that costs allocated or assigned to Accounts 184600 and 107001 are not distributed to SFPP and therefore, are irrelevant. SFPP notes that it has provided transaction-level detail for every cost in Account 184601, and that ACV Shippers witness Dr. Arthur failed to identify a single cost that was misapplied to Account 184601, other than the errant costs that SFPP itself had identified and removed from the KMI cross-charge.

211. With respect to the additional Trans Mountain invoices and legal invoices that SFPP identified and removed from Account 184601 in its Compliance Filing, SFPP notes the fact that these few invoices out of tens of thousands of invoices processed by KMI in 2007 were erroneously included in Account 184601 does not indicate that the overall cost allocation system is unreliable.[254] Rather, SFPP states that all it represents is a mistake occurred in inputting a few invoices, which mistakes have been corrected for in this proceeding. Last, SFPP states that Dr. Arthur did not identify any other costs that were misapplied, despite his suggestion that some errors may exist.[255] SFPP argues that there is no need to reject the entire accounting system simply because someone erred in inputting eight invoices.[256]

212. Regarding Dr. Arthur's criticism of the 2009 salary splits, SFPP explains why the 2009 salary split exhibit contains additional accounts.[257] SFPP states that the exhibit contains all of the salary splits for all of the employees for KMI-shared RCs that charged to Account 184601 and that some of these KMI-shared employees perform shared services for the KMEP-Operated Entities as well as directly for individual KMI-Operated

---

[253] SFPP Reply Comments at 33-39.

[254] *Id.* at 36.

[255] *Id.* (citing Arthur Affidavit at P 40).

[256] *Id.*

[257] *Id.* at 37.

and KMI-Owned Entities, which costs are reflected in these additional direct assignment accounts. SFPP further explains that it did not address these "additional accounts" because they are not charged to KMEP-Operated Entities. SFPP also responds to Dr. Arthur's claim that the 2009 salary splits are "unverifiable after-the-fact cost split data," stating that these are the salary splits provided to accounting by employees to ensure that labor G&A costs and non-labor G&A costs that follow labor were distributed correctly. SFPP further states the only additional detail that could be provided to "verify" the salary splits would be to interview each of the nearly 600 employees to confirm that the splits were accurately reported.[258]

d. <u>Commission Determination</u>

213. In Opinion No. 511, the Commission directed SFPP to identify the KMI-shared RCs that contribute to the KMI cross-charge that require the most critical examination and to document the details of the costs allocated within those critical RCs.[259] The Commission also noted that it was not clear how SFPP reached the $7,681,768 in corrections to the 2007 KMI cross-charge reflected in Exhibit SFP-134.[260] Finally, the Commission stated that "if some elements included in the [KMI] cross-charge to KMEP are unclear, SFPP could provide documentation that supports eliminating some dollar amount of a specific cross-charge from KMEP's total cost of service, or alternatively, assign or allocate those costs to those entities that are operated by KMI."[261] The Commission also noted in Opinion No. 511, that Valero's "blanket criticisms" are not particularly helpful, particularly because Valero does not state what percentage of the hours on each timesheet may be in error, and the potential impact of the errors.[262] Thus, the Commission indicated that it would expect to see "an integrated presentation that addresses the relevance and materiality of its criticism."[263]

214. The Commission accepts SFPP's Compliance Filing with respect to the adjusted amount of the KMI cross-charge. The Commission finds that supporting documentation

---

[258] *Id.*

[259] Opinion No. 511, 134 FERC ¶ 61,121 at P 135.

[260] *Id.* P 136.

[261] *Id.* P 137.

[262] *Id.* P 136.

[263] *Id.*

provided in the Compliance Filing with respect to the 39 RCs SFPP identified as contributing to the KMI cross-charge account (Account 184601) to be adequate. ACV Shippers (which group includes Valero) are the sole party to protest the KMI cross-charge with any specificity. However, the ACV Shippers' criticisms continue to be blanket criticisms, mostly criticisms of the scope and quality of the supporting documentation provided by SFPP in the Compliance Filing. In short, ACV Shippers continue to attack the validity of Kinder Morgan's overall accounting methods, an argument the Commission, in this order, rejects on rehearing. To the extent ACV Shippers specifically challenge specific RCs, or specific costs, it inappropriately does so based on the record in the East Line rate proceeding (Docket No. IS09-437-000). The Commission will not consider any challenges solely or substantially supported by the East Line ID or record.

215. ACV Shippers also argue that the 2009 salary splits are irrelevant and immaterial. While the Commission agrees that the 2009 salary splits are not illuminating in this proceeding for the reasons detailed by Dr. Arthur, the Commission will not condemn SFPP for its inability to produce the 2007 salary splits. SFPP has explained that the 2007 salary splits are unavailable due to Kinder Morgan's regular business practice of eliminating the prior year's salary splits when the new salary splits are decided upon; i.e., each year the updated salary splits automatically replace the prior year's salary splits in Kinder Morgan's system. However, SFPP's inability to produce the 2007 salary splits alone is not enough to undercut the veracity of Kinder Morgan's overall accounting methodology as it relates to the KMI-shared employees and the KMI cross-charge.

216. With respect to the ACV Shipper's argument regarding the $6.1 million adjustment related to capitalized overhead costs, the Commission finds the argument meritless. Dr. Arthur argues that KMI's unilateral shift of $6.1 million in costs from the cross-charge account to another shows that Kinder Morgan's overall accounting methods are flawed. The Commission finds that SFPP has previously provided a detailed explanation for how the adjustment is made and why.[264] Specifically, SFPP explained that if the amount in Account 107001 is insufficient to cover the rate applied to each capital project in a given month, KMI credits the cross-charge account (Account 184601) and the shared-services account for the KMI-Operated and KMI-Owned Entities (Account 184600) for the amount of the insufficiency, and debits Account 107001 for that amount.[265] Further, SFPP explained that the amount of the credit is split between

[264] *See* Ex. ACV-77 at 2-3 (SFPP's Third Supplemental Response to the Second Set of Discovery Requests of ConocoPhillips).

[265] *Id.*

Account 184600 and Account 184601 based on the percentage of the total labor costs in Account 184600 as compared to the total labor costs in Account 184601.[266] The Commission finds this explanation to be sufficient to conclude that KMI does not "unilaterally" or arbitrarily shift costs between the three accounts at issue, Account 184600, 184601, and 107001, such that this $6.1 million adjustment signals a fundamental flaw with Kinder Morgan's ability to effectively isolate costs.

217. Last, ACV Shippers also complain that SFPP failed to include in the Compliance Filing supporting data regarding the approximately $1.5 million Trans Mountain acquisition invoice adjustment and the $99,574 legal invoice adjustment. SFPP stated that these two adjustments relate to errors identified when preparing the Compliance Filing. Other than pointing out the lack of supporting detail or documentation, the ACV Shippers question the adjustments only to support its over-arching claim that, as a whole, SFPP has not provided sufficient data to verify the amount of the cross-charge. The Commission is uncertain what additional detail ACV Shippers would like to see on this issue. SFPP witness Mr. Bradley stated in his sworn affidavit that when reviewing the KMI-shared costs in conjunction with the Compliance Filing he determined these invoices had been erroneously included in the KMI cross-charge. Upon finding this error, Mr. Bradley removed the total amount of the invoices from the KMI cross-charge. The Commission finds the fact that SFPP did identify these additional errors helps show that it did undertake a closer review of the RCs that charge costs to the KMI cross-charge. The Commission rejects ACV Shippers' blanket criticism regarding these two adjustments.

3. Indirect G&A Capital Project Costs

218. With respect to the capitalization of overhead costs related to capital investments, in Opinion No. 511 the Commission instructed SFPP to support its position that it only included incidental expenses or indirect costs in its Massachusetts formula.[267]

a. Compliance Filing

219. Mr. Bradley states that "under Commission regulations, we cannot and do not capitalize any [] indirect G&A costs for ratemaking or FERC Form 6 purposes."[268]

---

[266] *Id.*

[267] Opinion No. 511, 134 FERC ¶ 61,121 at P 145.

[268] Bradley Affidavit at P 62. SFPP also notes that indirect G&A expenses associated with capital projects are treated differently under the Commission's natural

(continued…)

Mr. Bradley explains that indirect expenses associated with KMEP's capital projects are just that -- expenses not capital costs. Mr. Bradley states Commission regulations prohibit oil pipelines from capitalizing the indirect G&A costs associated with capital projects into its rate base and recovering them through depreciation over time. SFPP also states that the capitalization of the costs is done through a separate methodology outside of the cost allocation methodology and is done only for GAAP purposes, e.g., for reporting to the SEC and not for ratemaking purposes. Mr. Bradley represented that KMEP expenses all indirect G&A costs associated with capital projects in the period in which they are incurred. SFPP notes that because under the Uniform System of Accounts for oil pipelines there is no separate account to capture indirect G&A expenses associated with capital projects, KMEP treats these G&A expenses like any other indirect G&A cost. Accordingly, the indirect costs associated with capital projects are allocated through KMEP's cost allocation methodology.[269]

220. According to SFPP, GP Services employees who indirectly support capital projects for the KMEP-Operated Entities charge their indirect costs either to groups of subsidiaries or to the KMP Tier, which is the pool of costs that is allocated through KMEP's Massachusetts formula.[270] KMI-shared employees who indirectly support capital projects for the KMEP-Operated Entities charge the KMI cross-charge account, Account 184601. SFPP further notes that these costs are not earmarked or specifically identified in the system as costs associated with KMEP capital projects.

221. SFPP next explains that for GAAP reporting purposes (e.g., SEC reporting) a separate process is undertaken to capitalize a portion of the indirect G&A expenses that have already been distributed to the individual subsidiaries. Specifically, after each KMEP-Operated Entity receives its distribution of G&A costs through KMEP's methodology, each KMEP-Operated Entity determines the portion of its G&A expenses that qualifies for capital treatment for GAAP reporting purposes based on its level of

---

gas pipeline regulations. *See id.* P 72. Mr. Bradley states that the Commission's natural gas pipeline regulations provide for the capitalization of these indirect costs and also provides a means for capturing these costs in order to segregate them from the indirect G&A costs associated with the other day-to-day activities of the pipeline. *See id.* P 74. Mr. Bradley further notes that because KMI follows the natural gas pipeline accounting regulations KMI uses Account 107001 (the capital burden pool) for the purpose of capturing the indirect G&A costs associated with capital projects. *See id.*

[269] *Id.* P 67.

[270] *Id.*

20111216-4007 FERC PDF (Unofficial) 12/16/2011

capital spending. Each KMEP-Operated Entity then capitalizes that amount on its GAAP books.[271] SFPP asserts that capitalizing these costs in its GAAP books is unrelated to KMEP's allocation of these costs.

222. SFPP lists in its Compliance Filing the RCs that incur indirect G&A expenses in support of KMEP capital projects and the types of activities that generate these costs.[272] SFPP further notes that because indirect costs associated with capital projects are not differentiated from other indirect costs generated by day-to-day activities, it is not possible to provide the magnitude of these indirect costs on an RC-by-RC basis. The types of activities identified by SFPP include: (i) customer conversations, economic modeling, work with engineers; (ii) engineering and design work; (iii) environmental permitting; (iv) landowner relations; (v) prep line for digs, control center ACTs, coordinating engineering and field operations; (vi) engineering and technical support for drilling wells; and, (vii) contractor safety support, corporate fire safety, and corporate hygiene.

b. <u>Protests</u>

223. Both Tesoro and Trial Staff protest this issue. Tesoro's protest restates its general attack with respect to capitalized overhead expenses. Tesoro states that recent Commission proceedings have indicated that capitalized overhead should not be included in the Massachusetts formula. Tesoro further states:

> [I]n his initial testimony [Tesoro witness], Mr. Ashton advocated a single-tier KMEP [Massachusetts] method with total overhead of approximately $307.3 million. Removing capitalized overhead expenses of $53.47 million would therefore reduce the total SFPP overhead to approximately $253.6 million.[273]

224. Trial Staff states that Kinder Morgan's RC-based accounting methodology fails in that it does not allow a manner for employees to record time spent providing general support for capital projects related to KMEP-Operated entities.[274] Trial Staff argues that SFPP's claims in its Compliance Filing do not address this deficiency. Trial Staff also

---

[271] *Id.* P 68.

[272] *Id.* P 75.

[273] Tesoro Protest at 24.

[274] Trial Staff Protest at 6.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

reject SFPP's claim that Commission regulations prohibit oil pipelines from capitalizing indirect G&A costs associated with capital projects. Trial Staff argues that section 3-3 (Cost of Property Constructed) of Part 352 of the Commission's regulations includes direct and other costs, but excludes "incidental" costs. Trial Staff believes SFPP confuses the term "indirect" with "incidental." Trial Staff believes "indirect" costs are the "other costs" referred to in section 3-3, and should be capitalized. Trial Staff argues that SFPP must identify which costs are incidental and which are indirect or "other" pursuant to Part 352, section 3-3. Trial Staff asserts that any costs that fall under the "other costs" referred to in section 3-3 should be capitalized.[275]

c. SFPP Reply Comments

225. SFPP reiterates in its reply comments that the capitalization of these costs occurs only after all of the expenses have been distributed through KMEP's cost allocation methodology to SFPP and other entities, and the capitalization occurs outside of, and has no impact on, KMEP's cost allocation methodology.[276] SFPP argues that Trial Staff's implication that KMEP is doing something wrong by expensing indirect G&A costs associated with KMEP capital projects for ratemaking purposes and capitalizing them for GAAP purposes is similar to ACV Shippers' argument that KMEP is doing something wrong by reporting G&A costs differently for SEC reporting and FERC reporting.[277] SFPP cites to *Sea Robin* to support its claim that the Commission requires indirect G&A costs related to capital projects to be reported as expenses, while GAAP requires they be reported as capital expenditures.[278] SFPP further states that if the Commission does not allow it to expense these costs, SFPP would be deprived of the opportunity to recover these prudently incurred costs because these indirect G&A costs for 2007 and for prior years have not actually been included in SFPP's rate base. If such costs had been included in SFPP's rate base, it could then recover the costs through depreciation and its allowed return.[279]

---

[275] *Id.* at 7.

[276] SFPP Reply Comments at 60 (citing Bradley Affidavit at P 63).

[277] *Id.* at 60-61.

[278] *Id.* at 61 (citing *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 186-87 (D.C. Cir. 1986)).

[279] *Id.*

20111216-4007 FERC PDF (Unofficial) 12/16/2011

d. Commission Determination

226. The Commission agrees with Trial Staff's description of the Commission's regulations governing treatment of oil pipelines' indirect overhead expenses associated with capital projects. Part 352, section 3-3 lists the "direct and other costs" that is considered a cost of constructing property.[280] Specifically, section 3-3 provides:

> Cost of property constructed. The cost of constructing property chargeable to the carrier property accounts shall *include direct and other costs as described hereunder*:
>
> (1) Cost of labor includes the amount paid for labor performed by the carrier's own employees and officers. This includes payroll taxes, vacation pay, pensions, holiday pay and traveling and other incidental expenses of employees. No charge shall be made to these accounts for pay and expenses of officers and employees who merely render services incidentally in connection with extensions, additions or replacements.
>
> . . .
>
> (7) Cost of injuries and damages includes expenditures for injuries to persons or damage to property when incident to construction projects, and shall be included in the cost of the related construction work.
>
> . . .
>
> (12) Cost of disposing of excavated material shall be included in the cost of construction . . . .

The Commission reads section 3-3 to mean that the "cost of property constructed" includes the direct costs of constructing property as well as "other costs" as identified in the enumerated list provided in section 3-3; specifically, items (1) through (13). "Other costs" would include those costs listed in section 3-3, such as the cost of an injury to a person or the cost of disposing of excavated material. For purposes of SFPP's Compliance Filing, it is necessary to determine whether SFPP correctly interpreted section 3-3(1) which addresses which labor costs should be considered a cost of property constructed.

227. Section 3-3(1) broadly includes cost of labor performed by the carrier's own employees *and officers* and is limited only by the statement: "No charge shall be made to

---

[280] 18 C.F.R. Part 352, § 3-3 (2011).

these accounts for pay and expenses of officers and employees *who merely render services incidentally in connection with extensions, additions or replacements*." Incidental means: "depending upon or appertaining to something else as primary; something necessary, appertaining to, or depending upon another which is termed the principal."[281] Here the principal item is the particular construction project whether it is an extension, addition or replacement. A plain reading of section 3-3(1) is that any labor performed by the carrier's employees in furtherance of constructing the property at issue is chargeable to the carrier property accounts. The Commission reads this section as including labor associated with any of the categories of costs enumerated under section 3-3, such as labor related to permits (section 3-3(8)).

228. Applying this reading of section 3-3, the Commission reviewed the RC activities listed in SFPP's Compliance Filing as "indirect G&A expenses" associated with capital projects. The Commission finds many of the activities listed by SFPP as indirect labor, such as engineering and design work (RC 1010), environmental permitting (RC 1040), engineering and technical support for drilling wells (RCs 1046, 1047, 1048, 1049), supervision of engineers and project managers (RC 6213), contractor safety support, corporate fire safety, and corporate hygiene (RC 0275), appear to be labor related to the types of "other costs" enumerated in section 3-3.[282] Thus, the Commission disagrees with SFPP's statement that section 3-3(1) excludes indirect labor costs, and further disagrees with SFPP's implication that all of the indirect labor costs it identifies in its Compliance Filing are services rendered "incidentally in connection with extensions, additions or replacements."

229. Accordingly, the Commission finds SFPP's Compliance Filing to be unpersuasive on this issue. Further, the Commission generally affirms the 2009 ID on this issue,[283] finding that the approach advocated by Trial Staff is the proper approach. Trial Staff asserts that capitalized overhead costs should not be allocated through the KMEP Massachusetts formula. The Commission agrees. Accordingly, SFPP is instructed in its next compliance filing to remove from KMEP's cost allocation pool, any indirect overhead cost associate with capital projects that Kinder Morgan ultimately capitalized.

---

[281] *Black's Law Dictionary* 762 (6th ed. 1990).

[282] Given the limited descriptions of the "RC activities" provided in the Compliance Filing, the Commission cannot undertake an exhaustive review of each "indirect expense" to determine which expenses may relate to an "other cost" category enumerated in section 3-3.

[283] 2009 ID, 129 FERC ¶ 63,020 at P 791-795.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

VI. Capital Structure and the Cost of Capital

A. PAA

1. Opinion No. 511

230. As Opinion No. 511 notes, all parties agreed that the capital structure of KMEP, SFPP's parent company, should be used to determine SFPP's cost of service. However, the Commission reversed the 2009 ID to hold that capital structure need not be adjusted to account for purchase accounting adjustments (PAA).[284] The Commission concluded that the PAAs did not have a distorting effect upon KMEP's capital structure, and that the most accurate reflection of KMEP's capital structure was the debt to equity ratio reflected in its financial statements.[285] Using similar reasoning, Opinion No. 511 affirmed the 2009 ID that no adjustment was necessary for goodwill related to acquisitions made by KMEP.[286]

231. The 2009 ID also held that commercial paper and long-term debt due within one year must be incorporated into the debt component when determining KMEP's capital structure.[287]

2. Rehearing Requests

232. Tesoro was the only party to challenge the Commission's capital structure decisions on rehearing, and it asserts that the Commission erred in holding that PAAs do not distort KMEP's capital structure. Tesoro asserts that the Commission in the December 2005 Order[288] and the February 2006 Order[289] addressed the very same PAA

---

[284] A PAA is an accounting adjustment that occurs when a purchaser pays more than book value (original cost minus accumulated depreciation) for an asset with a resulting increase in the asset base of the regulated entity.

[285] Opinion No. 511, 134 FERC ¶ 61,121 at P 166-175.

[286] *Id.* P 179.

[287] *Id.* P 183-184.

[288] December 2005 Order, 113 FERC ¶ 61,277.

[289] February 2006 Order, 114 FERC ¶ 61,136.

that resulted from KMEP's acquisition of SFPP at issue in this proceeding. Tesoro states that in these orders, the Commission concluded that this PAA distorted KMEP's capital structure. Tesoro argues that the Commission's attempts to distinguish the December 2005 and February 2006 Orders are unconvincing. Tesoro adds that the December 2006 Sepulveda Order cited by the Commission dealt with a different PAA from 1988 and involved a unique fact pattern in which after the purchase involving the PAA SFPP subsequently made an initial public offering of roughly 60 percent debt and 40 percent equity. As a result, Tesoro argues that the 1988 PAA was an adjustment to equity that was made before the creation of SFPP's capital structure and could have no impact on the amount of debt and equity that were sold at the initial public offering.[290]

233. Tesoro argues that the Commission ignored its prior rulings by accepting arguments based on accounting, not ratemaking. Tesoro also asserts that convincing evidence was presented that the PAAs actually distort KMEP's capital structure. As support, Tesoro states that testimony by ExxonMobil witness Dr. Horst shows that a write down of the value of a pipeline's asset must by its very nature alter the equity side of the balance sheet, not the debt side.

234. Tesoro also states that the Commission provided no evidence to support its finding that the impact of the PAAs in KMEP's capital structure is consistent with the capital structures of other pipelines. Rather, Tesoro asserts that removal of the PAAs would affect rates by lowering the equity component by as much as six percentage points (from 62.8 percent equity to 56.8 percent equity in 2000) and by an average of 3.5 percentage points for the period 2000-2008.[291]

3. <u>Commission Determination</u>

235. The Commission denies rehearing on this issue. Tesoro has not raised any arguments that warrant reconsideration of the findings in Opinion No. 511.

236. Tesoro claims that Opinion No. 511 improperly relied upon the December 2006 Sepulveda Order but Tesoro's attempt to distinguish the December 2006 Sepulveda Order is not persuasive. In the December 2006 Sepulveda Order the Commission explained that it will only adjust the capital structure for the effect of a PAA if the PAA is

[290] Tesoro Rehearing at 46 (citing December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 32).

[291] *Id.* at 48 (citing Ex. TES-3).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

in fact distorting the capital structure.[292] Although Sepulveda involved a PAA for a different transaction with a different fact pattern,[293] these general principles apply whenever the Commission considers potential adjustments to a company's actual capital structure for PAAs. As Opinion No. 511 stated, a PAA merely increases the size of the asset base of a utility, not necessarily the ratio of debt and equity used to finance the asset base.[294] Thus, as Opinion No. 511 concluded, the mere presence of a PAA does not necessarily demonstrate that the PAA has in fact distorted capital structure by rendering the debt to equity ratio different than it would have been absent the PAA.[295] Opinion No. 511 proceeded to explain why alteration to the capital structure due to the PAAs was not appropriate in this case:

> In assessing the existence of distortions to capital structure, the primary question to consider is not the financing of any particular transaction, but whether the increased asset base resulting from the presence of the PAAs is distorting capital structure. This is because

---

[292] December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 32.

[293] In the December 2006 Sepulveda Order, the Commission considered a PAA resulting from the 1988 sale of assets from the predecessor pipeline to SFPP. The 1988 sale thus increased the size of the asset base when the assets were transferred to the new owner, SFPP. The new owner proceeded to raise financing, resulting in a capital structure of approximately 60 percent debt and 40 percent equity. Under these circumstances, the Commission determined that there was no basis to conclude the PAA had been added entirely to the equity component or that any distortion of capital structure had occurred as a result of the PAA. The Commission explained there is no reason "to believe that this market established debt-equity ratio would have changed if the 1988 asset base resulting from the 1988 sale was the same, smaller, or larger." December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 32. Thus, the Commission rejected arguments that the capital structure should be adjusted for PAAs.

[294] Opinion No. 511, 134 FERC ¶ 61,121 at P 169. Opinion No. 511 distinguished between the effect of a PAA on capital structure and the effect of a PAA on rate base. *Id.* P 167-168. Regarding rate base, the distortions of a PAA are readily apparent. When a PAA is added to rate base, the PAA increases the rate base above book value. If the PAA is not excluded from rate base for ratemaking purposes, the presence of the PAA in rate base would allow the utility to recover depreciation and a return on more than the original investment in the asset. As explained in Opinion No. 511 and in this decision, the effect of a PAA on capital structure is not as straightforward.

[295] *Id.*

20111216-4007 FERC PDF (Unofficial) 12/16/2011

> capital is fungible. For this reason the financing related to a particular purchase must be considered as a part of the overall pool of funds used to finance the assets of the company. Moreover, over time, financial strategies shift, debt retires, and new issuances of debt and equity are made even as the asset base continues to include the residual effects of PAAs. Thus, for KMEP, an MLP with multiple subsidiaries that regularly makes new issuances of debt and equity, it is not possible to isolate and distinguish the ongoing impact of a PAA on the capital structure's debt to equity ratio. Moreover, without making any adjustment for PAA, KMEP's capital structure remains within industry norms. As a result, the evidence does not support a finding that the increase to KMEP's asset base resulting from the PAAs has distorted capital structure. [296]

237. Similarly, the Commission is not persuaded by Tesoro's attempt to rely upon the December 2005 and February 2006 Orders to refute the findings of Opinion No. 511. Opinion No. 511 acknowledged the concerns expressed in the December 2005 and February 2006 Orders that the PAAs were causing distortions to KMEP's capital structure.[297] The December 2005 and February 2006 Orders used this as one justification for adopting SFPP's capital structure (as opposed to KMEP's capital structure) in those proceedings.[298] However, in this proceeding, all parties agree that KMEP's capital structure should be used, necessitating a more comprehensive consideration of the effect of PAAs upon KMEP's capital structure. Given the opportunity for a more comprehensive review, Opinion No. 511 provided an extensive explanation for why no adjustment is appropriate to KMEP's capital structure in this proceeding. Primarily, it is not clear that the overall ratio of debt to equity in KMEP's financing would be any different had its acquisition not included the added cost associated with the PAAs. Tesoro's continued reliance on the December 2005 and February 2006 Orders does not undermine Opinion No. 511's more extensive analysis.

238. Furthermore, contrary to Tesoro's assertions, neither the December 2005 Order nor the February 2006 Order determined that an adjustment to KMEP's capital structure for PAAs would require that the PAAs should be removed entirely from the equity

---

[296] *Id.* (citations and footnote omitted).

[297] *Id.* P 172 (citing December 2005 Order, 113 FERC ¶ 61,277 at P 66; February 2006 Order, 114 FERC ¶ 61,136 at P 15).

[298] *Id.*

20111216-4007 FERC PDF (Unofficial) 12/16/2011

component.[299] Rather, the December 2005 and February 2006 Orders adopted SFPP's capital structure instead of KMEP's. Thus, any adjustments in those earlier proceedings to the capital structure involved conditions specific to SFPP, not KMEP.[300] In this proceeding, all parties agree that KMEP's capital structure should be used, not SFPP's capital structure. As Opinion No. 511 explained, the record in this proceeding does not support the contention that removing the alleged PAAs entirely from the equity component of KMEP's capital structure would result in a more accurate estimation of KMEP's capital costs.[301]

239. Tesoro provides no basis for its further claim that Opinion No. 511 was based upon adherence to accounting rules in disregard of ratemaking principles.[302] Opinion No. 511 considered how the additional asset base created by the PAAs would have altered the ratio of debt to equity in KMEP's capital structure. Rather, it is Tesoro's rehearing that seeks to use analogies with accounting principles. Tesoro reiterates arguments raised on exceptions by ExxonMobil/BP and its witness Dr. Horst contending that because a "write down" of the value of an asset alters the equity side of the balance sheet, any adjustment for a PAA must be made to equity. Opinion No. 511 specifically addressed ExxonMobil/BP's argument, stating "As a matter of accounting, it is true that if an asset is revalued, this revaluation does not reduce a utility's debt level. However, the Commission's adjustments to exclude the effect of a PAA from capital structure are not analogous to an actual write down of an asset's value."[303] Rather, the Commission's

[299] *Id.*

[300] Opinion No. 511, 134 FERC ¶ 61,121 at P 171.

[301] *Id.* P 170-174.

[302] Despite alleging the Commission was led by SFPP witnesses into using accounting rather than ratemaking principles (Tesoro Rehearing at 47), Tesoro does not show how Opinion No. 511 improperly relied upon SFPP witnesses. As support, Tesoro only cites, without further explanation, to the Commission's rejection of an attempt by ExxonMobil/BP to analogize adjustments for PAAs to write-downs under accounting rules. *See* Tesoro Rehearing at 47 n.118 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 173). Opinion No. 511 did not cite to any exhibits produced by SFPP in this part of the decision, and, as discussed above, the Commission rejected ExxonMobil/BP's analogy precisely because it depended upon accounting principles that were not applicable to evaluating the impact of a PAA on capital structure for ratemaking purposes. Opinion No. 511, 134 FERC ¶ 61,121 at P 173.

[303] Opinion No. 511, 134 FERC ¶ 61,121 at P 173.

inquiry is whether and how an increased asset base changed KMEP's debt to equity ratio relative to the debt to equity ratio that would have existed absent the PAA. The PAA represent the additional cost to KMEP of the acquisition above the asset's book value, and there is no evidence that capital markets required KMEP to raise the additional cost represented by the PAA solely from equity.[304]

240. Tesoro has also not refuted Opinion No. 511's determination that KMEP's capital structure absent adjustments for PAAs is consistent with industry norms. The Commission typically approves oil pipeline capital structures between 45 and 55 percent equity.[305] The companies used in the proxy group for determining the return on equity in this proceeding had capital structures consisting of a range between 58 percent and 46 percent equity.[306] In its Compliance Filing based upon the adjustments required in Opinion No. 511, SFPP represents that KMEP's capital structure is 42.97 percent equity and 57.03 percent debt as of September 30, 2008.[307] With an equity level below 45 percent, KMEP's September 30, 2008, capital structure is slightly more favorable to shippers than the "typical" capital structure because equity typically has a higher rate of return than the interest cost on the pipeline's debt.

241. Also, Tesoro's argument that removing the PAA would affect KMEP's capital structure by an average of 3.5 percent is premised upon removing the PAA entirely from equity. As Opinion No. 511 explained, such a position is not supported in this case.[308] Furthermore, Tesoro's suggestion that the effect of the PAAs on KMEP's capital structure can be measured is dubious, even if Tesoro had applied more neutral criteria such as the financing used for each transaction containing the PAAs. Capital at the parent company level is essentially fungible and the debt to equity ratio in a particular transaction may be offset by other financial issuances.[309] Moreover, any possible effect

[304] *Id.* P 170 n.281.

[305] *BP Pipelines (Alaska) Inc., et al., v. BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287, at P 175 (2008).

[306] Ex. SFP-93. The list includes eight pipelines, but Enterprise Products was required to be removed from the proxy group list by Opinion No. 511.

[307] SFPP Compliance Filing at Tab A, Schedule 9.

[308] Opinion No. 511, 134 FERC ¶ 61,121 at P 170-174.

[309] *Id.* P 169, 174.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

becomes more difficult to ascertain as the acquisition involving the PAA becomes more distant and the company's financing evolves over time.[310]

4. Compliance Filing

242. On compliance, SFPP's cost of service incorporates a capital structure of 42.97 percent equity and 57.03 percent debt as of September 30, 2008.[311] SFPP states that this capital structure reflects Opinion No. 511's determination that expiring long-term debt and commercial paper should be added to the debt component of KMEP's capital structure. SFPP states that Opinion No. 511 did not address whether revolving credit facility balances should be included in the debt component of capital structure. However, SFPP states that it had an outstanding revolving credit facility balance as of December 31, 2000, December 31, 2001, and September 30, 2008. To minimize the issues on compliance, KMEP's states that it has incorporated the revolving credit facility balance into the debt component of its capital structure.

243. In protesting SFPP's Compliance Filing, Tesoro once again attacks the findings of Opinion No. 511, arguing that PAA costs should have been removed from KMEP's capital structure. In its Answer, SFPP states that it complied with Opinion No. 511, and SFPP also argues that the PAAs do not distort KMEP's capital structure.

244. The Commission finds that SFPP has complied with Opinion No. 511's requirements regarding the calculation of capital structure. In its protest, Tesoro has not alleged that SFPP's has failed to comply with the directives of Opinion No. 511. Rather, Tesoro challenges the findings of Opinion No. 511 itself. When raised in a protest to a compliance filing as opposed to rehearing, such objections are untimely and procedurally defective.

---

[310] *Id.* P 179.

[311] SFPP Compliance Filing at Tab A, Schedule 9.

B. Debt Cost

1. Opinion No. 511

245. Opinion No. 511 noted that all parties agree that the cost of debt for SFPP's parent, KMEP, should be used. Opinion No. 511 reversed the 2009 ID and ruled that tax exempt and special purpose debt must be factored into the cost of debt.[312] Opinion No. 511 also concluded that because it calculated KMEP's cost of capital as of September 30, 2008 and KMEP had no outstanding commercial paper on that date, exceptions to the 2009 ID's treatment of commercial paper were moot.[313]

2. Rehearing Requests

246. No party on rehearing challenged the findings of Opinion No. 511 related to commercial paper or industrial revenue bonds. However, ExxonMobil/BP states that the Commission erred by not clearly addressing whether KMEP's long-term debt expiring within one year should be included in its overall weighted average cost of debt. ExxonMobil/BP notes that the Commission held that such debt should be reflected in capital structure,[314] but failed to make any ruling with respect to its treatment regarding the cost of debt. ExxonMobil/BP claims that the Initial Decision also failed to address this issue, but that ExxonMobil/BP had raised this issue in its brief on exceptions.[315] ExxonMobil further adds that where the Commission has required SFPP to include expiring long-term debt in its capital structure, the Commission made no express finding regarding the cost of debt but nonetheless adopted a cost of debt that was calculated using the expiring debt.[316]

247. As discussed below, SFPP states in its Compliance Filing that it will include expiring long-term debt in determining its cost of debt. Thus, the issue raised by ExxonMobil/BP is moot for the purposes of this proceeding.

---

[312] Opinion No. 511, 134 FERC ¶ 61,121 at P 191-192.

[313] *Id.* P 186.

[314] ExxonMobil/BP Rehearing at 86 (citing February 17 Order, 134 FERC ¶ 61,121 at P 184).

[315] *Id.* (citing ExxonMobil/BP January 25, 2010 Brief on Exceptions at 53-54).

[316] *Id.* P 87 (citing December 2005 Order, 113 FERC ¶ 61,277 at P 69).

3. Compliance Filing

248. In its Compliance Filing, SFPP calculated its cost of debt to be 6.32 percent,[317] determined as of September 2008 as required by Opinion No. 511. SFPP also states that it incorporated into the cost of debt the tax exempt and special purpose debt as required by Opinion No. 511. SFPP adds that although Opinion No. 511 did not address whether the cost of long term debt should include expiring long-term debt and the cost of revolving credit facility balances, it included these types of debt in determining the cost-of-debt to minimize the issues on compliance.

249. No party objects to SFPP's cost of debt calculations, and the Commission finds that SFPP has complied with Opinion No. 511.

C. Return on Equity

250. The Commission determines return on equity based on the Discounted Cash Flow (DCF) analysis. The DCF methodology is based on the premise that the price of a stock is determined by the present value of its future cash flows as discounted at a market rate commensurate with the stock's risk. Under the constant growth DCF formula used by the Commission, the cost of capital is equated with the dividend yield (dividends divided by share price) plus the estimated constant growth in dividends.[318] The Commission uses a two-step procedure to determine the projected growth in dividends of the proxy group companies, averaging short-term and long-term growth estimates. The Commission uses five-year Institutional Broker's Estimate System (IBES) growth projections for the short-term growth projection. The Commission uses the growth rate of the Gross Domestic Product as its long-term growth rate. The Commission gives two-thirds weight to the short-term growth projection and one-third weight to the long-term growth projection.[319]

251. In this case, the parties have not disputed this basic methodology. The issue litigated by SFPP is whether it is appropriate to update the DCF analysis to reflect the most recent financial data in the record, even if it is post test-period data.

---

[317] SFPP Compliance Filing at Tab A, Schedule 11.

[318] *Northwest Pipeline Corp.*, 79 FERC ¶ 61,309, at 62,378 (1997).

[319] *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260, at P 215 (2002) (footnotes omitted).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

1. Opinion No. 511

252. In Opinion No. 511, the Commission upheld the ALJ's decision to reject SFPP's proposed use of post-test period data, specifically data for the six month period ending either April 30, 2009 or for the period ending January 31, 2009, for purposes of the DCF analysis. The Commission, like the ALJ, found both the January 2009 and April 2009 post-test period data proposed by SFPP to be anomalous. Thus, even though the Commission typically uses the most recent financial data in the record for calculating a pipeline's ROE, the Commission declined to do so in this case because the more recent January 2009 or April 2009 cost of equity data is not representative of the pipeline's long term equity cost of capital. The Commission noted that, depending on the time period from which the data was pulled, the equity cost of capital varies as follows:

Data Period[320]	ROE
September 2008	7.64[321]
January 2009	14.30
April 2009	14.83
February 2010	9.09
March 2010	8.72

Accordingly, the Commission held that because the West Line rate at issue in this proceeding will be in effect indefinitely, the ROEs resulting from a DCF analysis based on data for the six months ending January 2009 or April 2009 are not representative of SFPP's cost of capital during the future periods the rates proposed in this case may be in effect.[322]

2. Rehearing Requests

253. SFPP asserts that the Commission erred in not using the most recent rate of return on equity data available, the April 2009 data, with an adjusted inflation factor. SFPP argues that the Commission should follow its policy of using the most up-to-date rate of return on equity data in the record, the data from the six-month period ending April 30, 2009. SFPP notes that the Commission declined to follow its policy because the most recent data in this case reflected an anomalous inflation factor, specifically negative

[320] Reflects the end date for the data for the six-month period.

[321] This is the ROE accepted in the 2009 ID.

[322] Opinion No. 511, 134 FERC ¶ 61,121 at P 209.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

inflation. SFPP states that the data from the six months ending September 2008 also reflects an anomalous inflation factor, specifically a 4.94 percent inflation factor which SFPP states is well outside the range of recent economic experience. Accordingly, SFPP argues that whether the data ending April 2009 period is used or the data from the period ending September 2008 is used, the Commission must correct the inflation factor in those rate of return on equity calculations to ensure that the resulting ROE is representative of the actual inflation "that has occurred during the time the rates at issue in this proceeding have been in effect."[323]

254. SFPP states that the Commission's two concerns regarding the April 2009 data are (1) the data from this period "reflects the collapse of the stock market" and (ii) the inflation rate is anomalous. SFPP refutes the first, the collapse of the stock market, as not well founded. SFPP counters the anomalous inflation rate issue by stating that the inflation rate that relates to the September 2008 ROE is equally anomalous. SFPP urges the Commission to follow its policy and to use the April 2009 data and to use an average inflation factor based on the two and a half year period during which the rates in this proceeding have been in effect (August 2008 through February 2011) which is 1.11 percent.

255. SFPP also argues that the September 2008 ROE is unrepresentative. SFPP argues that although the rate of return on equity as of September 30, 2008 is consistent with historical periods (12.63), the real rate of return on equity is not. The real rate of return on equity reflected in the September 2008 ROE is unusually low (7.69 percent), which is the result of an unusually high inflation factor of 4.94 percent as of September 30, 2008. SFPP cites that in the 17 year period between January 1992 and April 2009, the inflation factor equal to or higher than 4.94 percent in only four months. Each of those four months occurred during the six month period reflected in the September 2008 ROE.[324]

3. Commission Determination

256. The Commission denies SFPP's rehearing requests to use the post-test period financial data for the six months ending April 30, 2009 and to modify the inflation factor to use an average inflation factor culled from the two and a half year period during which the rates in this proceeding have been in effect (August 2008 through February 2011) rather than the inflation factor from the end of the test period. All parties have

[323] SFPP Rehearing at 8.

[324] SFPP Rehearing at 12 (citing Ex. SFP-84 and SFP-323).

recognized in this proceeding that the period of time in question was a volatile economic period.

257. As the Commission stated, generally, the Commission's policy is to use the latest six months dividend yields, growth rates and GDP data in the record for its DCF analysis in pipeline rate cases.[325] The Commission applied this policy in a natural gas pipeline rate proceeding, *Portland Natural Gas Transmission System* (*PNGTS*),[326] which order issued concurrent with Opinion No. 511. In *PNGTS*, a case involving a 12 month base period ending December 31, 2007, as adjusted through the test period which ended September 30, 2008, the Commission determined that the appropriate time period for the DCF analysis was the six month period ending April 2009. However, the Commission acknowledged that the ROE arrived at based on using the most recent record data "may not be entirely representative of a long term ROE that one would expect for natural gas pipelines," and that using the most recent financial data in the record for the DCF analysis was particularly warranted because the case involved rates for a limited locked-in period ending November 30, 2010.[327]

258. Conversely, in this proceeding, the Commission justified its decision to depart from the general policy of using the most recent financial data on the record in light of its overarching principal that the cost of service adopted in a rate proceeding should be representative of the costs that the pipeline is likely to incur over the period that the rates at issue are in effect, which in this case could be indefinitely.[328] Specifically, "the goal is to set a future, lawful rate by predicating it upon reliable information that will be

[325] Opinion No. 511, 134 FERC ¶ 61,121 at P 208; *see also Portland Natural Gas Transmission System*, 134 FERC ¶ 61,129, at P 242 (2011) (*PNGTS*).

[326] *PNGTS*, 134 FERC ¶ 61,129 (2011).

[327] *Id.* P 246-247 (holding "the ROE approved in this order reflects the effects of the financial crisis that occurred in late 2008 and early 2009 during the locked-in period and yet is limited in its prospective application to a time period representative of the actual effects of that crisis").

[328] Opinion No. 511, 134 FERC ¶ 61,121 at P 208-209; *see also Enbridge Pipelines (KPC)*, 102 FERC ¶ 61,310, at P 123-128 (2003) (*Enbridge KPC*) (holding "[c]ost-of-service ratemaking seeks to establish a representative level of future costs based on historical cost and known and measurable changes").

20111216-4007 FERC PDF (Unofficial) 12/16/2011

representative of the conditions likely to happen while the rate is in effect, but without being so open-ended as to time that the test year is obscured."[329]

> Whether a pipeline initiates a rate proposal or a complainant successfully has proved that an existing rate is unlawful, the next step in either situation is to have the Commission authorize a just and reasonable, forward-looking rate. Exercising discretion is an essential part of the undertaking. Far from being a mechanical chore, *especially these days where a rate may continue indefinitely due to indexing*, the objective is to make a reasoned, judicious effort to decide the matter through some type of test-year approach.[330]

In this case, the Commission declines to use the most recent financial data in the record, the post-test period financial data for the six months ending April 30, 2009, because we do not find that using such updated data will produce a just and reasonable, forward-looking rate, especially given that SFPP's West Line rates set in this proceeding may continue indefinitely.

259. The Commission also declines to modify the inflation factor to use an average inflation factor. It would be incorrect to adjust one input into the ratemaking, the inflation factor, to account for an anomalous economic time period, without making corresponding modification to other inputs, for example applying the same modified period SFPP seeks to use for the inflation factor, for the divided yield average for the DCF analysis to reflect the change in stock prices. If SFPP were permitted to use an averaged inflation factor that reflected a larger and later period (August 2008 through February 2011), the resulting ROE would be artificially higher because there would not be any offsetting downward adjustments to other inputs to the DCF analysis that would arise out of using a later period.

---

[329] *See, e.g.*, *Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54, 56-57 (D.C. Cir. 1999); *Indiana & Michigan Mun. Distrib. Ass'n v. FERC*, 659 F.2d 1193, 1197-98 (D.C. Cir. 1981).

[330] *Texaco Refining and Marketing Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036, at P 313 (2004) (emphasis added).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

D. Rate Base and Deferred Return

260. In Opinion No. 511, the Commission concluded that SFPP has correctly calculated its deferred return using only the equity portion of the SRB write-up and not the entire SRB write-up as ExxonMobil/BP argued.[331]

1. Rehearing Requests

261. ExxonMobil/BP seek rehearing stating that the Commission erred in concluding that SFPP correctly calculated the deferred return on its SRB write-up.[332] ExxonMobil/BP request that the Commission grant rehearing and direct SFPP to recompute its deferred return for each year since 1983, and the resulting net deferred return used in calculating current rates. ExxonMobil/BP state that the issue is not with how the SRB write-up should be calculated. Rather, the only issue is whether SFPP calculated the deferred return from only the equity portion of the SRB write-up rather than from the full net SRB write-up. ExxonMobil/BP state that the full net SRB write-up as of 1983 is $12,173,000 rather than $31,004,000, and the equity portion of the SRB write-up is $4,779,120 ($12,173,000 times 39.26 percent). It is this figure that should be the starting point in 1983 for the computation of deferred return each year. ExxonMobil/BP assert that the use of revised figure, $4,779,120 rather than the $12,173,000 approved in Opinion No. 511, reduces SFPP's deferred return in each year since 1983 and in the test year in this case even though the SRB write-up is fully amortized.

2. Commission Determination

262. The Commission grants rehearing on this issue. The Commission incorrectly found in Opinion No. 511 that SFPP calculated its deferred return using only the equity portion of its SRB write-up rather than the entire SRB write-up. As the presiding ALJ noted in the 2009 ID, SFPP's calculation of deferred return deviates from the standard

[331] Opinion No. 511, 134 FERC ¶ 61,121 at P 214.

[332] ExxonMobil/BP reiterate this challenge in their June 15, 2011 protest of on SFPP's Compliance Filing. *See* ExxonMobil/BP Protest at 9-11. In turn, SFPP submitted reply comments defending its calculation of the SRB write-up. *See* SFPP Reply Comments at 21-23. The Commission will not address either ExxonMobil/BP's Protest or SFPP's Reply Comments on this issue because the SRB write-up issue is outside the scope of the Compliance Filing.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

deferred return calculation methodology as established in Opinion No. 154-B.[333] Notwithstanding this deviation the 2009 ID stated:

> [T]he Commission seems to have approved SFPP's deferred return methodology when it accepted SFPP's compliance filings in the proceeding underlying Opinion No. 435. The Commission is free to permit deviations from its own established methodology as long as the resulting rate is just and reasonable, and that appears to be the case here, as determined previously by the Commission. Therefore, since the Commission previously approved the deferred return methodology employed by SFPP in this case, and since Staff takes no position adverse to SFPP on this issue, and because the Shippers have not produced a study demonstrating the rate-impact of SFPP's deferred return methodology, the undersigned finds that SFPP's deferred return methodology was appropriately calculated in this proceeding. If the Commission believes it inadvertently allowed the aforementioned deviations to take place, it may adopt Exxon's position and should require SFPP to recalculate in accordance with its directives.[334]

In Opinion No. 511, the Commission did not intend to approve a deviation from the Opinion No. 154-B methodology for calculating the SRB write-up. In Opinion No. 154-B, the Commission explained that the real rate of return times the equity share of the rate base yields the yearly allowed equity return in dollars.[335] The inflation factor is to be multiplied by the equity rate base to yield the equity rate base write-up or deferred return. In Opinion No. 154-B, the Commission made clear that the deferred return (or the write-up of the starting rate base) is only a write-up of the equity portion of the rate base.[336] Thus, the Commission affirms that the appropriate method for calculating the SRB write-up is as set forth in Opinion No. 154-B. To the extent the Commission accepted an SRB write-up calculation in past SFPP proceedings that was inconsistent with the Opinion No. 154-B method, such acceptance is applicable in those proceedings only and does not change the Commission's stated policy on this issue as articulated in Opinion No. 154-B.

---

[333] 2009 ID, 129 FERC ¶ 63,020 at P 619-621.

[334] *Id.* P 621.

[335] *Williams Pipe Line Co.*, Opinion No. 154-B, 31 FERC ¶ 61,377, at 61,833-35 (1985).

[336] *Id.* at 61,835.

263. On rehearing, the Commission finds that the record in this proceeding, as developed by ExxonMobil/BP demonstrates that SFPP's methodology for calculating its SRB write-up does not comply with Commission policy for calculating the SRB write-up as set forth in Opinion No. 154-B.[337] On review of ExxonMobil witness, Dr. Horst's testimony as well as ExxonMobil/BP's Brief of Exceptions, the Commission finds ExxonMobil/BP accurately identified SFPP's deviation from the Opinion No. 154-B SRB methodology. SFPP should have multiplied the depreciated original cost (DOC) rate base (SFPP's Statement E4, Line 12) by the debt ratio, and the ICC valuation rate base (Statement E4, Line 11) by the equity ratio, then add the two results together.[338] Next, SFPP should have subtracted the DOC rate base from the result of the first equation, which would have yielded the SRB write-up.[339] The SRB write-up should then be multiplied by the equity ratio before calculating SFPP's deferred return. As Dr. Horst found, instead of following the above-calculation, SFPP subtracted the DOC rate base (Line 12) from the ICC rate base (Line 11) and multiplied the result (Line 13) by the equity ratio (Line 14), yielding a number that SFPP labeled as the "equity portion" of the SRB write-up (Line 15), when it was actually the full SRB write-up.[340]

264. The Commission finds ExxonMobil/BP's illustration of the SRB calculation using actual figures to be helpful. First, ExxonMobil/BP notes that the SRB equals the net replacement new rate base multiplied by the equity percentage plus the net DOC of plant (other than land and ROW) multiplied by the debt percentage. For SFPP, the SRB results from the equation ($51,139,000 x 39.26 percent) + ($20,135,000 x 60.74 percent) or $20,077,000 + $12,230,000. This yields an SRB equal to $32,307,000 for SFPP. The SRB write-up is equal to the SRB less the DOC, or $32,307,000 - $20,135,000 = $12,172,000. These numbers show that the $12,172,000 amount on Line 13 of SFPP's Statement E4 is the entire SRB write-up, which must be divided between debt and equity so that only the equity portion of the SRB write-up is used to calculate the deferred return.[341]

---

[337] Opinion No. 154-B, 31 FERC ¶ 61,377.

[338] ExxonMobil/BP January 25, 2010 Brief on Exceptions at 44 (citing Opinion No. 154-B, 31 FERC at 61,833).

[339] *Id.* (citing *Arco Pipe Line Co.*, Opinion No. 351, 52 FERC ¶ 61,055, at 61,236 (1990)).

[340] ExxonMobil/BP January 25, 2010 Brief on Exceptions at 44.

[341] *See id.* at 45 n.17.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

265. The Commission finds that SFPP's full net SRB Write-Up as of 1983 is $12,172,000, and the equity portion of the SRB Write-Up is $4,779,000 ($12,173,000 multiplied by 39.26 percent). Accordingly, SFPP is directed to use $4,779,000 as the starting point in 1983 for the computation of deferred return each year in its Statement E2.

VII. Income Tax Allowance Issues

266. This part of the order addresses income tax allowance issues raised on rehearing. The discussion includes the following: (1) a summary of Opinion No. 511, (2) a summary of the issues on rehearing, (3) whether the Commission's current income tax policy should be revisited, (4) whether granting a master limited partnership (MLP) an income tax allowance results in a double recovery of the partner's income taxes, (5) whether an MLP income tax allowance is inconsistent with Congressional purpose and the Commission's rate authority, (6) whether certain aspects of the Commission's MLP income tax allowance methodology violate the stand-alone doctrine, (7) whether an MLP's regulatory return should be adjusted to reflect the benefit of tax deferrals from owning a partnership interest, and (8) computational issues, including allowance for deferred income taxes (ADIT) and the proper source for state income taxes.

267. The Commission denies all requests for rehearing asserting that a jurisdictional MLP should not have an income tax allowance or that there should be adjustments to an MLP's return or cost of service to reflect the benefits of an income tax allowance. The Commission grants one rehearing request regarding the method for calculating SFPP's ADIT. As with most other matters addressed by this order, the Commission finds that the comments of the Shipper Parties on SFPP's April 25, 2011 Compliance Filing do not assert that the SFPP failed to comply with the directions of Opinion No. 511 in calculating the income tax component of its regulatory cost of service. Rather, they repeat the numerous arguments opposing SFPP's income allowance contained in their requests for hearing. Therefore the Commission will accord no weight to those comments.

A. Opinion No. 511

268. Opinion No. 511's analysis of income tax allowance issues included the following: (1) whether the Commission's income tax allowance policy should be revisited, (2) the appropriateness of that policy's implementing methodology, (3) the relevance of the Commission's stand-alone methodology, (4) proposed adjustments to SFPP's rate-of-return on equity (ROE) to reflect any benefits that may flow from income taxes deferrals,

20111216-4007 FERC PDF (Unofficial) 12/16/2011

(5) issues involving accumulated deferred income taxes, and (6) the method for determining the marginal tax rate for the state income tax component of any allowance.[342]

269. In response to arguments that the Commission should revisit its income tax allowance policies, Opinion No. 511 concluded that *ExxonMobil Oil Corporation v. FERC*[343] correctly held that income taxes are a real, if imputed, business and regulatory cost for partnerships.[344] Opinion No. 511 thus rejected arguments that *BP West Coast Products, LLC v. FERC*[345] is still good law and that a partnership income tax allowance compensates for "phantom taxes," that is for an income tax cost that a partnership does not incur.[346] Opinion No. 511 further concluded that the fact that cash distributions may be made to a partner and thereby reflected in the after-tax ROE percentages generated by the Commission's discounted cash flow (DCF) model does not mean that there is a double recovery of a partner's income tax liability.[347] Opinion No. 511 also acknowledged that because there is no double taxation of a partner's income, a partner can expect to receive more after-tax cash than a corporate shareholder.[348] Opinion No. 511 recognized that this results in more cash flows flowing through the DCF model that is used to determine a jurisdictional pipeline's ROE.[349] Therefore, the equity units of a partnership will have a higher market value than the shares of a corporation due to the double taxation on any dividends paid to the corporation's shareholders.[350] Opinion No. 511 also concluded that this higher market value occurs because financial markets will equalize the percentage return on the equity securities of partnerships and

[342] Opinion No. 511, 134 FERC ¶ 61,121 at P 219-321.

[343] *ExxonMobil Oil Corporation v. FERC*, 487 F.3d 945 (D.C. Cir. 2007) (*ExxonMobil*).

[344] Opinion No. 511, 134 FERC ¶ 61,121 at P 230-231.

[345] *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) (*BP West Coast*).

[346] Opinion No. 511, 134 FERC ¶ 61,121 at P 232-240.

[347] *Id.* P 241-250, 261-262.

[348] *Id.* P 245.

[349] *Id.*

[350] *Id.* P 239, 257-258.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

corporations of the same risk.[351] Thus, although the dollar return to the partnership's partner may be higher than that of a corporate shareholder, the percentage ROE will be the same for jurisdictional pipeline securities of the same risk.[352] Opinion No. 511 held this is consistent with the *Hope* capital attraction standard.[353]

270. Opinion No. 511 also recognized that the MLP's higher equity price per unit gives it an advantage in raising equity capital as the higher unit price means that an MLP can issue fewer equity units than a corporation to obtain the same dollar amount of capital, which lowers the MLP's equity cost of capital.[354] It further concluded that this financial advantage reflects Congress' intention to encourage investment in energy-related facilities. Opinion No. 511 concluded that this financial incentive is not inconsistent with the Commission's ratemaking responsibilities under the Interstate Commerce Act, or with the capital attraction standard underpinning a jurisdictional entity's rates of return.[355] Opinion No. 511 also held that the presumptions the Commission uses to determine the marginal tax rates that are used to impute taxes to a jurisdictional partnership do not incorporate a double recovery of a partner's income taxes via the DCF model.[356] Opinion No. 511 again concluded that granting an income tax allowance to a jurisdictional MLP is not unfair to its rate payers since an MLP's revenue requirement is no higher than that of a jurisdictional corporate pipeline.[357] It also held that the Shipper Parties had not proven that MLPs had a higher cost of service and revenue requirement based on a statistical analysis of the fact that MLP natural gas pipelines had higher ROEs than corporate natural gas pipelines in 2007 and 2008.[358] Opinion No. 511 therefore concluded that granting a jurisdictional MLP an income tax

---

[351] *Id.* P 249.

[352] *Id.* P 245-246, 249.

[353] *Id.* P 259 (citing *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944) (*Hope*)).

[354] *Id.* P 249-250.

[355] *Id.* P 251-259, 261-262.

[356] *Id.* P 296.

[357] *Id.* P 261.

[358] *Id.* P 298-304.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

allowance does not result in a phantom income tax cost, the double recovery of the partner's income tax liability, or unjust or unreasonable rates.[359]

271. With regard to the methodology used to implement the Commission's income tax allowance policy, Opinion No. 511 stated that a partner's income tax Form K-1 showing positive or negative partnership income was sufficient to prove that an MLP met the actual or potential income tax standard affirmed by *ExxonMobil*.[360] Opinion No. 511 also held that positive (taxable) partnership income need not be recognized in the base or test year to obtain an MLP income tax allowance[361] and that the actual date of recognition did not need to be known or projected with certainty.[362] Opinion No. 511 also rejected arguments that the capital gains taxes from future sales of equity interest are reflected in the Commission's income tax allowance methodology.[363] It also held that use of incentive distributions is not inequitable nor do income allocations to the general partner violate the Commission's stand-alone doctrine.[364] It further concluded that any distributions paid to a mutual fund should reflect that marginal rate paid on those dividends by the shareholder, i.e., whether they are qualified or ordinary dividends for taxation purposes.[365] Opinion No. 511 also held that the state income tax component of an income tax calculation should be based on the source state of the partner's income.[366]

272. Opinion No. 511 did recognize that there are tax deferrals that benefit the partners investing in the MLP format, but that these deferrals and any related tax savings serve to encourage infrastructure investment. Thus the Commission need not pass such tax savings back to the rate payers as any such savings are already reflected in a higher price for the partnership equity units.[367] Opinion No. 511 therefore rejected all proposed

[359] *Id.* P 249-50, 258, 259, 261, 296.

[360] *Id.* P 273 (citing December 2007 Order, 121 FERC ¶ 61,240 at P 27).

[361] *Id.* P 271-274.

[362] *Id.* P 280-282.

[363] *Id.* P 275-277.

[364] *Id.* P 283-291.

[365] *Id.* P 292-295.

[366] *Id.* P 314.

[367] *Id.* P 302-308.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

adjustments to SFPP's ROE to reflect the present value of benefits that might flow to a partner from income tax deferrals resulting from the ownership of an MLP's equity interests. As with the analysis of the double counting issue, it concluded that if there are tax savings from such deferrals, any such deferrals or tax savings reflect Congress' intention to encourage investment in energy MLPs.[368] Opinion No. 511 likewise held that any tax savings that might result from the mandatory election of section 743(b) depreciation do not violate the Commission's stand-alone doctrine and thus any time value of tax savings from such depreciation need not be normalized for the rate payer's benefit.[369] Opinion No. 511 also held that in calculating its cost of service, SFPP must use the highest marginal tax rate in effect in any tax year in calculating the ADIT component of its rates under the Opinion No. 154-B oil pipeline rate methodology.[370]

B. Summary of the Requests for Rehearing

273. ExxonMobil/BP and ACV Shippers filed extensive requests for rehearing of Opinion No. 511's findings regarding MLP income tax allowances. Their central argument is that SFPP may not be provided an income tax allowance as this will result in double recovery of its partners' income tax liability. Shipper Parties claim this will occur because the cash flow to pay those taxes is already embedded in the after-tax returns calculated by the Commission's DCF model.[371] They assert that unlike previous SFPP proceedings that addressed income tax allowance issues, this double recovery of an MLP's partner's income taxes is clearly established by the record in this proceeding. They assert that given this new evidence the Commission may not stand on its current income tax allowance policy and its regulatory methodology implementing that policy. Rather, as a matter of law, the Commission must revisit its income tax allowance policy given this new evidence that the double recovery of an MLP's partner's income tax liability will result in rates that are excessively high and therefore are unjust and unreasonable.[372]

---

[368] *Id.*

[369] *Id.* P 309-311.

[370] *Id.* P 320; Opinion No. 154-B, 31 FERC ¶ 61,377.

[371] ExxonMobil/BP Rehearing at 3, 7-9, 13-15; ACV Rehearing at 9-10, 14-15, 20-21.

[372] ExxonMobil/BP Rehearing at 9-13; ACV Rehearing at 10-14.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

274. The Shipper Parties also assert that the Commission's current income tax allowance policy is grounded on an arbitrary and inaccurate concept of parity that equates the after-tax returns of MLP partners on their equity in a jurisdictional partnership's rate base and the after-tax ROE on the equity component of the rate base of a jurisdictional corporation having the same risk.[373] They assert that the record establishes that both *ExxonMobil* and the Commission incorrectly compare an MLP partner's return to a corporation's return. Shipper Parties maintain that the proper comparison of the after-tax dollar and percentage ROEs is between those obtained by an MLP's partners and a corporation's shareholders.[374] They claim that the capital attraction standard under *Hope*[375] requires investors in pipeline enterprises of similar risks to receive comparable after-tax ROEs. The investors are the equity holders of the MLP or the corporation.[376] Shipper Parties further argue that granting an MLP an income tax allowance results in higher after-tax cash flow for the partners and a higher revenue requirement for the MLP even though the income tax burden to its partners is less than a corporation's and its shareholders' tax burden.[377] Shipper Parties assert that because the partners double recover their income taxes they will obtain an ROE greater than that required to attract capital, which violates the capital attraction standard.[378] They assert that this double recovery gives an MLP a financial and regulatory advantage over a corporation that comes at the cost of excessively high rates for an MLP's shippers.[379] They conclude that the remedy; i.e., to obtain parity between investors in MLPs and corporations, is to deny MLPs an income tax allowance.[380]

275. The Shipper Parties also assert that Congress did not grant the Commission authority to permit jurisdictional MLP pipelines to double recover an MLP's investor tax

[373] ExxonMobil/BP Rehearing at 28-37; ACV Rehearing at 15-16.

[374] ExxonMobil/BP Rehearing at 27-30, 32-36; ACV Rehearing at 26-30.

[375] 320 U.S. 591, 605.

[376] ExxonMobil/BP Rehearing at 27-28, 33-34, 36; ACV Rehearing at 10, 21-22, 28-29.

[377] ExxonMobil/BP Rehearing at 24, 40, 57; ACV Rehearing at 24-26.

[378] ExxonMobil/BP Rehearing at 16, 27-28; ACV Rehearing at 10, 21-22.

[379] ExxonMobil/BP Rehearing at 22-24; ACV Rehearing at 18-19.

[380] ExxonMobil/BP Rehearing at 31-32, 37-38; ACV Rehearing at 25-26, 30.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

liability when Congress exempted certain partnerships from corporate tax liability.[381] They further assert that Opinion No. 511 improperly relied on Congressional silence in reaching the opposite conclusion.[382] In that regard, the Shipper Parties assert the legislative history cited in Opinion No. 511 does not support the Commission's conclusions that (i) an MLP income tax allowance is lawful and (ii) section 7704 of the Internal Revenue Code (IRC) authorized an MLP income tax allowance.[383] They also argue that Congress did not authorize the Commission to permit a monopoly pipeline to retain the savings from any income tax allowance exemptions.[384] Shipper Parties urge the Commission to pass all savings through to rate payers,[385] particularly since Congress has stated when it would permit a pipeline to retain those savings.[386] They assert that the just and reasonable ratemaking standard and judicial precedent requires that same result.[387]

276. The Shipper Parties further claim that if an income tax allowance is afforded an MLP, then the Commission must assure that any tax savings from the avoidance of double taxation or from tax deferrals that benefit the MLP or its partners are passed on to the rate payers.[388] In that regard they argue that Opinion No. 511 contains two conclusions that are inconsistent with the Commission's stand-alone doctrine. They claim that including incentive distributions in the calculation of an MLP's income tax allowance improperly shifts distributive income from the limited partners to the general partner.[389] They also assert that the limited partners' use of an IRC section 743(c) deduction provides the limited partners benefits requiring an adjustment to SFPP's

[381] ExxonMobil/BP Rehearing at 38-40; ACV Rehearing at 30-31, 37-39.

[382] ExxonMobil/BP Rehearing at 42-44; ACV Rehearing at 31-33, 39-41.

[383] ExxonMobil/BP Rehearing at 53-57; ACV Rehearing at 33-35, 50-57.

[384] ExxonMobil/BP Rehearing at 48-49, 68-70; ACV Rehearing at 35-37, 41-42.

[385] ExxonMobil/BP Rehearing at 49-50; ACV Rehearing at 41-42, 47-49.

[386] ExxonMobil/BP Rehearing at 51-52; ACV Rehearing at 49-50.

[387] ExxonMobil/BP Rehearing at 41-42, 49-51; ACV Rehearing at 17-18, 30, 32-33.

[388] ExxonMobil/BP Rehearing at 58-61, 64-65, 67-70; ACV Rehearing at 47-50.

[389] ACV Rehearing at 58-64.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

ROE.[390] They state that this should be done by adjusting the MLP's ROE to reflect the present value of any benefits that occur. [391] The Shipper Parties also contend that the Commission incorrectly stated that an income tax allowance is required to assure that jurisdictional MLPs will be able to compete for equity capital with non-jurisdictional MLPs in competitive markets as the jurisdictional MLPs are monopolies that do not require such an allowance.[392] They also argue that the state income tax rate used to determine SFPP's income tax allowance incorrectly uses the marginal tax rate of the source state rather than that of the taxpayer's residence.[393]

277. The Shipper Parties therefore urge the Commission to reverse Opinion No. 511 and to adopt the financial analysis advanced at hearing by their witness Dr. Horst. Based on his conclusion that MLP partners double recover their income taxes if the MLP receives an income tax allowance, the Shipper Parties request that the Commission (1) deny SFPP an income tax allowance,[394] or (2) reduce SFPP's income tax allowance to 78.4 percent of the standard calculation to reflect the tax benefits that limited partners receive from owning equity interests in SFPP's parent MLP partnership, KMEP.[395] Such an adjustment, together with an adjustment to reflect the proper calculation of the state income tax allowance, would reduce the marginal tax rate on SFPP's income by approximately two percent.[396]

278. SFPP has two requests for rehearing on income tax issues related to its ADIT calculation. It first asserts that Opinion No. 511 incorrectly required the use of the statutory maximum rate to calculate the allowance for deferred income taxes (ADIT) to be used in years prior to the 2007 base period in this proceeding.[397] Second, it asserts that the Commission did not select the right date for the application of its Income Tax

[390] ExxonMobil/BP Rehearing at 49-51, 65-67.

[391] *Id.* at 58-60, 63-65.

[392] *Id.* at 41-42, 48-49; ACV Rehearing at 42-48.

[393] ExxonMobil/BP Rehearing at 70-72.

[394] *Id.* at 7, 11, 16-17, 19, 44.

[395] *Id.* at 62-63.

[396] *Id.* at 72.

[397] SFPP Rehearing at 22-27.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Allowance Policy Statement[398] to SFPP's ADIT calculation.[399] SFPP's reply comments on its April 25, 2011 Compliance Filing support the income tax allowance holdings in Opinion No. 511 and reject the arguments contained in the Shipper Parties' rehearing requests and their comments on SFPP's Compliance Filing.

C. Whether to Revisit the Commission's Income Tax Allowance Policy

279. This part of the order addresses the Shipper Parties' assertions that the Commission should reverse Opinion No. 511 and thereby hold that *BP West Coast* remains good law in light of the new record evidence in this proceeding. This section first reviews the regulatory framework governing MLP income tax allowances, which was discussed in detail throughout the income tax allowance part of Opinion No. 511.[400] The order then addresses in detail several technical issues that underpin the Shipper Parties' core argument that providing an MLP an income tax allowance causes the MLP partners to double recover the income taxes on the distributive income they are allocated by an MLP. Those issues include regulatory, accounting, and financial arguments that the Shipper Parties advance in support of their central conclusion that *ExxonMobil* incorrectly held that granting an MLP an income tax allowance was reasonable and could be appropriately included in an MLP's regulatory cost of service.[401] These arguments are centered on the Shipper Parties' assertion that an income tax allowance double recovers the MLP partners' income tax liability because that liability is already priced into the ROE generated by the Commission's DCF model. At bottom this is not a legal determination but a financial, accounting, and mathematical issue. Therefore, this order addresses the technical issues in detail within the context of the regulatory framework discussed in Opinion No. 511. Those analyses include a review of the Commission's DCF model, an analysis of Dr. Horst's testimony and analysis on behalf of the Shipper Parties, the Commission's analysis of the relative after-tax ROEs of partnerships and corporations, an analysis of certain portions of Opinion No. 511, including Ex. SFP-98 and Ex. SFP-99, and a discussion of the capital attraction standard.

280. The Commission's analysis here also includes a series of Commission-drafted

---

[398] *Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (Income Tax Policy Statement).

[399] SFPP Rehearing at 27-30.

[400] Opinion No. 511, 134 FERC ¶ 61,121 at P 219-321.

[401] *ExxonMobil*, 487 F.3d at 952-554.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

tables (Tables 1 through 7) that illustrate that granting an income tax allowance does not result in the double recovery of a MLP partner's income tax liability. In doing so, the Commission explains and corrects a methodological error in Ex. SFP-98 and Ex. SFP-99 that could lead one to the opposite conclusion. The following analysis also establishes that the revenues required to cover a partner's income tax liability can be obtained either by grossing up a non-jurisdictional entity's operating revenues, as such a revenue gross up would be reflected in the DCF analysis,[402] or by obtaining an income tax allowance, but not both. In contrast to the way in which income taxes are grossed up outside the context of Commission regulation, the Commission does not gross up a jurisdictional entity's operating revenues or return to cover the income taxes that must be paid to obtain its after-tax return. Rather the income taxes on the jurisdictional entity's allowed equity return are covered through the income tax allowance. Thus there is no double recovery of a partner's income tax liability by providing an income tax allowance to an MLP. *ExxonMobil* correctly affirmed granting MLPs an income tax allowance.[403]

1. <u>The Regulatory Context of an Income Tax Allowance</u>

281. The central issue Shipper Parties assert is that the Commission must revisit its income tax policy because the record here purportedly establishes that granting an income tax allowance to an MLP results in a double recovery of the MLP's partners' income taxes. Shipper Parties also argue that an administrative agency is required to reexamine its existing policies if there are reasonable grounds to conclude that those policies are no longer sound and that failure to do so would be arbitrary and unreasonable.[404] For example, ExxonMobil/BP contend that the record here establishes that an MLP pipeline that is allowed an income tax allowance has a higher revenue

---

[402] The revenue gross up is the additional revenue the firm must earn to pay the income taxes on its net operating revenue and thereby obtain an adequate after-tax return. For example, if the firm desires an after-tax return of $100 and its marginal tax rate is 35 percent, it must gross up its operating revenue sufficiently to generate approximately $154 in pre-tax income. After payment of the income taxes, the result is after-tax income of $100, the desired dollar return provided in this example. *Id.*

[403] The focus on this proceeding is on MLPs given the increased ownership of jurisdictional assets by such entities. However the income tax allowance issues discussed here are applicable to any other type of jurisdictional partnership. Therefore, this order uses the term "partnership" to reflect all types of FERC jurisdictional partnerships and uses the term "MLP" when specifically addressing master limited partnership issues.

[404] ExxonMobil/BP Rehearing at 9-13; ACV Rehearing at 10-14.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

requirement and higher rates than a corporate pipeline.[405] Shipper Parties, therefore, argue that Opinion No. 511 erred by following *ExxonMobil*.[406] They conclude that on rehearing the Commission should hold that providing an MLP an income tax allowance results in the double recovery of an MLP partner's income taxes and compensates the MLP partners for an unjustified cost in violation *BP West Coast*.[407]

282. In Opinion No. 511, the Commission provided a detailed review of its income tax allowance policies. Except as necessary to respond to an argument on rehearing, the Commission will not repeat Opinion No. 511's discussion of the mechanics of the Commission's income tax allowance policy, but reiterates here the more important statements in *ExxonMobil*.[408] In upholding the Commission's Income Tax Policy Statement[409] and the June 2005 Order[410] implementing that Policy Statement, the court in *ExxonMobil* agreed that tax liability for partnership income occurs at the partner level, and that the partner is responsible for any taxes on distributive income from the partnership.[411] The court stated:

> In the Policy Statement and the Remand Order, the Commission resolved the principal defect of the *Lakehead* policy, which was the unexplained differential treatment of individual and corporate partners. FERC then determined that it would be 'just and reasonable' to grant regulated pipelines an income tax allowance to the extent that all of the pipeline's partners – whether individual or corporate – incur actual or potential tax liability. The Commission

[405] ExxonMobil/BP Rehearing at 24, 38-39, 40.

[406] ExxonMobil/BP Rehearing at 9, 12-14; ACV Rehearing at 14-15.

[407] ExxonMobil/BP Rehearing at 13, 17, 19, 26, 38, 40 (citing *BP West Coast*, 374 F.3d at 1291, 1293); ACV Rehearing at 9-10, 14, 31, 37-38.

[408] Opinion No. 511, 134 FERC ¶ 61,121 at P 221-321.

[409] Income Tax Policy Statement, 111 FERC ¶ 61,139.

[410] June 2005 Order III FERC ¶ 61,334 at P10-46.

[411] *ExxonMobil*, 487 F.3d at 951-52, 954 (holding that under the principles of partnership law "investors in a limited partnership are required to pay tax on their distributive shares of the partnership income, even if they do not receive a cash distribution").

> reasonably determined that such taxes are 'attributable' to the regulated entity, given that partners must pay tax on their share of the partnership income regardless of whether they actually receive a cash distribution. Additionally, the Commission reasonably relied upon evidence that a full income tax allowance is necessary to ensure that <u>corporations and partnerships</u> of like risk will earn comparable after-tax returns.[412]

The court then reviewed a comparison of the pre- and after-tax returns of a corporation and the partners of an MLP absent an income tax allowance:

> In the Policy Statement, FERC concluded that it would be inequitable to grant a full income tax allowance to corporations while denying a similar allowance to limited partnerships. For example, if the corporate tax rate is 35 percent, then a pipeline that operates as a corporation is permitted to charge a rate of $154 in order to earn after-tax income of $100. As several commenters pointed out, 'if an income tax allowance is not allowed the partnership, then the partners must pay a $35 income tax on $100 of utility income, leaving them with only an after-tax return of $65.'[413]

The court continued:

> Based on these comments, the Commission has determined that pipelines operating as limited partnerships should receive a full income tax allowance in order to maintain parity with pipelines that operate as corporations. This conclusion was not unreasonable and we defer to FERC's expert judgment about the best way to equalize after-tax returns for <u>partnerships and corporations</u>.[414]

Having again concluded that partnerships have the equivalent of an entity level tax, albeit indirect, on a regulated entity's income, the court stated:

> And there is at least one aspect of partnership law that supports

---

[412] *Id.* at 955 (emphasis added).

[413] *Id.* at 953 (interior citations omitted). *See also Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, at P 10-15 (2008) (Proxy Group Policy Statement).

[414] *ExxonMobil*, 487 F.3d at 953 (emphasis added).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

> FERC's conclusion but was not advanced by the Commission in *BP West Coast* – investors in a limited partnership are required to pay tax on their distributive shares of the partnership income, even if they do not receive a cash distribution. As explained above, this supports FERC's determination that taxes on the income received from a limited partnership should be allocated to the pipeline and included in the regulated entity's cost of service. In this sense, petitioners' likening of partnership tax to shareholder dividend tax is inapposite because a shareholder of a corporation is generally taxed on the amount of the cash dividend actually received.[415]

Through these holdings the court recognized that an MLP's partner and a corporation must pay taxes on a jurisdictional entity's income, but that a corporation's shareholders only pay taxes on cash dividends and as such only on income that is actually received. Therefore, dividends are not jurisdictional income that is used to measure the return on the equity component of a jurisdictional entity's rate base.[416] The court also recognized that to obtain a regulatory after-tax return of $100, taxable income must be $154 assuming a 35 percent marginal tax rate.[417] This requires pre-tax net income of $154, or a gross up of $54.[418] The Commission's rate design methodology provides this through the income tax allowance, not by grossing up the firm's operating revenues to cover the income tax liability.[419] In contrast, a non-jurisdictional entity would gross up its operating revenue to reach the $154 in pre-tax net income, which after payment of the income taxes results in the required after-tax return of $100.

---

[415] *Id.* at 954-55 (citations omitted) (emphasis added).

[416] In fact, at bottom *BP West Coast* concurs in this basic fact and the distinction is central to its conclusions. *See BP West Coast*, 374 F.3d at 1290-91.

[417] *ExxonMobil*, 487 F.3d at 953.

[418] The standard formula for calculating the amount of the gross up necessary to cover the income taxes on any given dollar of pre-tax income is 1/(1- the marginal tax). Thus, if the desired after-tax income and return is $100 and the marginal tax rate is 35 percent, the formula is $100/(1-.35), or approximately $154. The exact amount is $153.85. This order uses the rounded $154 as was done in *ExxonMobil*. *See ExxonMobil*, 487 F.3d at 953.

[419] *See* Appendix for how this is done under the Commission's rate design methodology.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

283. On rehearing, Shipper Parties assert that *ExxonMobil* incorrectly held that it is necessary to provide an income tax allowance to an MLP in order to obtain an after-tax dollar return of $100. They state that the new evidence provided in this case establishes that it is not necessary to provide the income tax allowance of $54 discussed in *ExxonMobil*. Their argument is that the $54 "gross up" discussed in that opinion is provided through the tax gross up embedded in the after-tax returns generated by the Commission's DCF model. In essence, their conclusion is that the after-tax return included in the return component of the MLP's regulatory cost of service generates the cash flow needed to provide the required after-tax regulatory rate of return. They claim that this in turn will equalize the after-tax dollar cash flows of partners and shareholders if there is no MLP income tax allowance. Their position thereby rejects the conclusion in *ExxonMobil* that comparison of returns should be at the entity level. At bottom, Shipper Parties' analytical position is that the after-tax cash flows reflected in the ROEs generated by the DCF model have the same purpose and structure as the cash flows the Commission develops in the context of rate design.

284. The Shipper Parties' position is fundamentally incorrect because it rejects the distinction between how revenue is grossed up to cover taxes outside the context of Commission ratemaking and how income taxes are covered in the context of Commission ratemaking. As previously stated, outside the context of Commission ratemaking a firm grosses up its operating revenues and return by the amount necessary to pay its income taxes and to obtain the $100 after-tax return discussed in *ExxonMobil*. However, under the Commission's rate design methodology, the pipeline's cost of service contains a series of discreet cost of service components that form a part of its regulatory cost of service before income taxes. This is shown by Appendices A and B, both of which demonstrate that rate base return, operating expenses exclusive of depreciation, depreciation, and two other items are stated as specific dollar amounts that would be based on test year numbers developed in a general rate case proceeding.[420] Appendices A and B make clear that these cost of service components are <u>not</u> "grossed up" to provide additional operating revenue that would cover income taxes <u>outside</u> the context of ratemaking. In other words, the pipelines rate design will only reflect the specific dollar amounts derived from each of the pipeline's cost of service components. Because those cost of service components are not grossed up in the pipeline's rates, the cash flow

[420] *See* SFPP 2010 FERC Form No. 6, Page 700, Appendix A hereto. Appendix B reproduces Statement A of SFPP's Compliance Filing and similarly shows separate cost of service components for overall return on rate base, income tax allowance, operating expenses excluding depreciation, deprecation and certain specialized amortizations. *See also* April 25 Compliance Filing at Statement A; *see also* Attachment B hereto. *See also Williston Basin Pipeline Co. v. FERC*, 165 F.3d 54, 57 (D.C. Cir. 1999) (*Williston*).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

necessary to pay the taxes on the equity dollar return must be derived from another source. Under the Commission's rate design methodology this is achieved through the income tax allowance which becomes the equivalent of a revenue and return gross up outside the context of Commission rate design.[421] Thus, in the context of rate design the Commission limits a pipeline's pre-tax income to the dollar amount of its equity dollar return component. Absent an income tax allowance a jurisdictional entity will not have the cash flow necessary to pay the income taxes on its income and obtain its regulatory ROE as stated by the analysis in *ExxonMobil*.

285. To illustrate this critical difference between how the required tax "gross up" functions within and outside the context of Commission rate design, the Commission developed two tables that do not involve the complications of the corporate business model.[422] Moreover, because of the continuing controversy regarding the pass-through characteristics of partnerships, these two tables display the results for a partnership and an individual owning a sole proprietorship as there is no dispute here that the income taxes are a cost of doing business to such an individual. Table 1 therefore compares a sole proprietor and a partnership that are not subject to the Commission's rate jurisdiction. Examples 1 and 3 of Table 1 assume that both business formats have only enough revenue to cover operating costs and earn pre-tax income of $100. With a marginal tax rate of 35 percent, in Examples 1 and 3 after-tax income drops to $65 dollars, or an after-tax return on the firm's equity of 6.5 percent. This is less than the posited required 10 percent after-tax ROE required by its investors and the capitalized value of both firms is only $650. In contrast, Examples 2 and 4 show that if both firms are able to gross up revenues by an additional $54, then pre-tax income is $154. After payment of the income taxes, after-tax income is $100, and their capitalized market value is $1000. By grossing up their revenue both firms earn their required after-tax equity cost of capital.

[421] For the calculation of the gross up for tax purposes see SFPP Compliance Filing at Statement D, appended to this order as Appendix C.

[422] As with the parties' analyses, the Commission's examples exclude the growth factor from the equity cost of capital. This simplifies that analysis, but does not change the results. *See* Opinion No. 511, 134 FERC ¶ 61,121 at P 244 n.415; Ex. SFP-94 at 42-43. The analysis also assumes that cash from deprecation is reinvested to maintain the same level of utility. Therefore that cash neither causes growth nor is it distributed.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

286. Table 1 also addresses Shipper Parties' assertion that a MLP should not receive an income tax allowance because an MLP does not actually pay the income taxes.[423] *ExxonMobil* rejected this point stating that the Commission reasonably concluded that the taxes a partner must pay on partnership income should be imputed to the partnership.[424] As such, this federal precedent preempts any state decisions to the contrary. In contrast to any arguments that income taxes are not part of a partnership's cost of business, Table 1 shows that the sole proprietor pays the income taxes directly and the MLP partners pay the taxes on the partnership income distributed to them. Table 1 also shows the after-tax dollar return, the after-tax ROE and the capitalized ownership values of both formats are the same regardless of whether the sole proprietor or the partners pay the income tax.[425] However, a rationale based on who actually pays the taxes would grant the sole proprietor an income tax allowance while denying one to the MLP even though the after-tax dollar results are the same for both business formats.

[423] Motion of Chevron Products Company, Conoco Phillips Company, Continental Airlines, Inc., Northwest Airlines, Inc., Southwest Airlines Co., US Airways, Inc., and Valero Marketing and Supply Company to Lodge the decisions of the Public Utilities Commission of the State of California and the Arizona Corporation Commission dated July 5, 2011. The motion to lodge is denied because the actions of state regulatory agencies at issue here are inconsistent with *ExxonMobil* and the Commission's subsequent rulings. Moreover, the cited state decisions add nothing to the arguments that the Shipper Parties are assert here.

[424] *ExxonMobil*, 487 F.3d at 951-52, 954-55.

[425] *See* Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 40 (noting how public utility income controlled directly by an individual may be taxed and that an MLP is simply an intermediate ownership device that leads to the same result).

Table 1. Comparison of Income Tax Impacts for an Individual Proprietor and an MLP with no FERC Regulation
The assumed required after-tax return is 10 percent

Example 1 - Individual without revenue gross up		Example 2 - Individual with revenue gross up		Example 3 - Partnership without revenue gross up		Example 4 - Partnership with revenue gross up	
Equity	$1,000	Equity	$1,000	Equity	$1,000	Equity	$1,000
Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900
Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100
Revenue	$1,000	Revenue	$1,000	Revenue	$1,000	Revenue	$1,000
Oper. Rev. Gross up to cover taxes	$ -	Oper. Rev. Gross up to cover taxes	$ 54	Oper. Rev. Gross up To cover taxes	$ -	Oper. Rev. Gross up to cover taxes	$ 54
Gross Revenue	$1,000	Gross Revenue	$1,054	Gross Revenue	$1,000	Gross Revenue	$1,054
Individual Pretax Return (Sum of after-tax return plus revenue gross up for taxes)	$100	Individual Pretax Return (Sum of after-tax return plus revenue gross up for taxes)	$154	Partnership Pretax (Sum of after-tax return plus revenue gross up for taxes)	$100	Partnership Pretax (Sum of after-tax return plus revenue gross up for taxes)	$154
No Pass Through Same as above	$ 100	No Pass Through Same as above	$ 154	Partner Pretax Income/Return	$ 100	Partner Pretax Same as above	$ 154
Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54	Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54
Individual After tax Income/Return	$ 65	Individual After tax Income/Return	$ 100	Partner After tax Income/Return	$ 65	Partner After tax Income/Return	$ 100
Return on Equity	6.5%	Return on Equity	10.0%	Return on Equity	6.5%	Return on Equity	10.0%
After Tax Dividend	$ 65	After Tax Dividend	$ 100	After Tax Distribution	$ 65	After Tax Distribution	$ 100
Value at 10 times after tax return	$ 650	Value at 10 times after tax return	$1,000	Value at 10 times after tax return	$ 650	Value at 10 times after tax return	$1,000
Does Equity Earn the Required Return ?	No	Does Equity Earn the Required Return ?	Yes	Does Equity Earn the Required Return	No	Does Equity Earn the Required Return ?	Yes

Assumptions: The analysis assumes no growth and there is no FERC regulation. To pay the income taxes the businesses must gross up" revenues to cover those income taxes, as reflected in the line captioned "Oper. Rev. Gross up to cover taxes." The gross revenue is that required to cover all costs including the "Oper. Rev. Gross up to cover taxes."

287. Table 2 presents the same analysis as Table 1, but for a jurisdictional sole proprietor and jurisdictional partnership. Absent an income tax allowance, taxable income is only $65 for both business formats, and the after-tax ROE is 6.5 percent. This is less than the required 10 percent after-tax ROE and the capitalized value of both firms is only $650. Thus, neither firm recovers the required after-tax ROE or its regulatory cost of service. In contrast, if either firm is granted an income tax allowance, this increases taxable income to $154 and the after-tax ROE (income) is $100. This equals 10 percent of the equity rate base of $1000, results in a capitalized market value of $1000, and both firms recover their after-tax regulatory equity cost of capital and cost-of-service. Table 2 illustrates that no jurisdictional firm will recover its required after-tax ROE if denied an income tax allowance because the Commission does not structure a jurisdictional entity's cash flows to gross up its operating revenues to obtain the after-tax return generated by the DCF model. Only after the income tax allowance is added to the pipeline's cost of service through the income tax component of a jurisdictional entity's rate design will there be sufficient pre-tax return (income) to cover the income taxes on the return component of a jurisdictional cost-of-service.

288. The Commission developed Tables 1 and 2 to illustrate the context in which the findings of *ExxonMobil* occur. That decision only discussed the narrow mechanics of how an income tax gross up results in the required equity dollar return, that is $100 as stated in that decision.[426] Tables 1 and 2 illustrate how the result in *ExxonMobil* flows logically from the cost of service structure and the related cash flows that are embedded in the Commission's ratemaking methodology.[427] *ExxonMobil* thus held that income taxes are an appropriate part of a partnership's jurisdictional cost of service, albeit an indirect one, and that an income allowance does not result in a phantom income tax.[428] This order next addresses the relevance of the DCF model to this conclusion.

[426] *ExxonMobil*, 487 F.3d at 953.

[427] In fact, Tables 1 and 2, and the subsequent Tables 3 through 6, are a simplified version of the obligatory cost of service formats reproduced in Appendices B and C.

[428] *Id. at* 952-54.

Table 2. Comparison of Income Tax Impacts for an Individual Proprietor and an MLP with FERC Regulation
The assumed required after-tax return is 10 percent

Example 1 - Individual without tax allowance		Example 2 - Individual with tax allowance		Example 3 - Partnership without tax allowance		Example 4 - Partnership with tax allowance	
Equity	$1,000	Equity	$1,000	Equity	$1,000	Equity	$1,000
Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900
Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100
Income Tax All.	$ -	Income Tax All.	$ 54	Income Tax All.	$ -	Income Tax All.	$ 54
Total Cost of Service	$1,000	Total Cost of Service	$1,054	Total Cost of Service	$1,000	Total Cost of Service	$1,054
Individual Pretax Return (Sum of after-tax return plus income tax allowance)	$100	Individual Pretax Return (Sum of after-tax return plus income tax allowance)	$154	Partnership Pretax (Sum of after-tax return plus income tax allowance)	$100	Partnership Pretax (Sum of after-tax return plus income tax allowance)	$154
No Pass Through Same as above	$ 100	No Pass Through Same as above	$ 154	Partner Pretax Income/Return	$ 100	Partner Pretax Same as above	$ 154
Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54	Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54
Individual After tax Income/Return	$ 65	Individual After tax Income/Return	$ 100	Partner After tax Income/Return	$ 65	Partner After tax Income/Return	$ 100
Return on Equity	6.5%	Return on Equity	10.0%	Return on Equity	6.5%	Return on Equity	10.0%
After Tax Dividend	$ 65	After Tax Dividend	$ 100	After Tax Distribution	$ 65	After Tax Distribution	$ 100
Value at 10 times after tax return	$ 650	Value at 10 times after tax return	$1,000	Value at 10 times after tax return	$ 650	Value at 10 times after tax return	$1,000
Does Equity Earn the Required Return ?	No	Does Equity Earn the Required Return ?	Yes	Does Equity Earn the Required Return	No	Does Equity Earn the Required Return ?	Yes

Assumptions: The analysis assumes the owners will value the firm at 10 times after tax cash because they desire an after-tax return of 10 percent on their investment. Because there is no growth factor, after tax cash and income are equivalent values.
Unlike Table 1, the firms do not "gross up" revenues, but are provided an income tax allowance by Commission policy.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

2. Analysis of the DCF Methodology

289. The second core element to Shipper Parties' double recovery argument is that the Commission's DCF model reflects after-tax ROEs that include a gross up component for the payment of income taxes on the income distributed to the partners of an MLP, and that this provides the cash flow necessary to pay the MLP partner's income tax. They provide an example from Opinion No. 511 stating that if the required after-tax ROE is six percent and the marginal tax rate is 25 percent, the investor will require a DCF ROE of eight percent and that the 25 percent marginal tax rate will be reflected in the ROEs calculated by the Commission's DCF model.[429] Shipper Parties assert that because a tax gross up is built into an after-tax DCF ROE, this means that an MLP income tax allowance is not required to obtain the after-tax ROE required by the capital attraction standard contained in *Hope Natural Gas*.[430] Shipper Parties repeatedly refer to the gross up reflected in the ROE's as a "built in" income tax allowance.[431]

290. As previously discussed, this argument fails because the tax gross up is not built into the ROE component of the jurisdictional rates of either a corporate pipeline or an MLP pipeline since the Commission does not gross up a jurisdictional pipeline's revenues to cover the income tax liability on the pipeline's allowed equity dollar return. This is in contrast to the operation of the Commission's DCF model which develops the after-tax return that is to be applied to the equity component of the pipeline's rate base. Such DCF results do reflect the actual after-tax returns, and therefore the pre-tax gross up, of the jurisdictional firms included in the DCF sample, but do not provide after-tax cash flow or income in the context of Commission rate design.[432] To explain this distinction fully requires a further review of the DCF model.

291. The Commission stated in its Proxy Group Policy Statement,[433] that the Supreme Court has held that "the return to the equity owner should be commensurate with the

[429] ExxonMobil/BP Rehearing at 13.

[430] *Hope*, 320 U.S. 591; *Bluefield Water Works & Improvement Co. v. Public Service Comm'n*, 262 U.S. 679 (1923).

[431] ExxonMobil/BP Rehearing at 13, 22, 29, 30.

[432] These actual returns reflect the firm's operations and do not necessarily equate to the amount of the allowed return embedded in the firm's jurisdictional rates.

[433] Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 3.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[434] Therefore, since the 1980s, the Commission has used a DCF model to develop a range of ROEs earned on investments in companies with corresponding risks for purposes of determining the ROE to be awarded natural gas and oil pipelines. The DCF model was originally developed as a method for investors to estimate the value of securities, including common stocks. It is based on the premise that "a stock's price is equal to the present value of the infinite stream of expected dividends discounted at a market rate commensurate with the stock's risk."[435] With simplifying assumptions, the investor uses the following DCF formula to determine the share price:

$$P = D/(r-g)$$

where P is the price of the stock at the relevant time, D is the current dividend, r is the discount rate or rate of return, and g is the expected constant growth in dividend income to be reflected in the capital appreciation of the stock over the time of the analysis.[436]

292. The Commission uses the DCF model to determine the ROE (the "r" component) to be included in the pipeline's rates, rather than to estimate a stock's value. Therefore, the Commission solves the DCF formula for the discount rate, which represents the rate of return that an investor requires in order to invest in a firm. Under this DCF formula, ROE equals current dividend yield (dividends divided by share price) plus the projected future growth rate of dividends:

$$r = D/P + g$$

This approach means that the Commission observes what is occurring in the market by examining the price of the security and the dividend paid in order to determine the yield, including the compounding return caused by DCF model's short and long term growth factors. Because no two firms have exactly the same risk, the Commission develops a proxy group of firms with comparable risks in order to arrive at a representative yield for the jurisdictional firms included in the sample. It is clear from the parties' exhibits that

---

[434] *Hope*, 320 U.S. 591, 605.

[435] *CAPP v. FERC*, 254 F.3d 289, 293 (2001) (*CAPP*).

[436] *See id*.; *see also National Fuel Gas Supply Corp*., 51 FERC ¶ 61,122, at 61,337 n.68 (1990); *Ozark Gas Transmission System*, 68 FERC ¶ 61,032, at 61,104 n.16 (1994).

the resulting median DCF return is the required after-tax ROE.[437] This median after-tax ROE is applied to the equity portion of the pipeline's rate base to obtain the after-tax dollar ROE that becomes the equity return rate component of the pipeline's rate design.[438]

293. The analysis in the prior section explained a fundamental consequence of the different approaches used by an investor and the Commission. That difference is demonstrated in Tables 1 and 2. In those Tables, the first point for comparison is the firm's return on book equity or the equity component of its rate base. In both those Tables the firm has equity of $1000 and earns $100 after all expenses and income taxes by <u>either</u> grossing up revenues to cover the income taxes <u>or</u> by obtaining an income tax allowance for the same purpose. However, either case results in an after-tax ROE of 10 percent. Regardless of the ROE (in dollars or a percent) earned by the firm, the investor obtains the required after-tax return of 10 percent. If the firm has an after-tax return of $100, the investor values the firm at $1000, or its book equity, because $100 is 10 percent of $1000. If the firm only has an after-tax return of $65 as it lacks the revenues to cover the income taxes, the investor values the firm at $650 because $65 is 10 percent of $650.

294. In contrast to the investor, the Commission would conclude from prior examples here that the investor is requiring an after-tax ROE of 10 percent because if the dollar return to the investor is $100, the investor values the firm at $1000. The Commission would also conclude that the after-tax cost of capital is 10 percent if the dollar return to the investor is $65 and the investor pays $650 to obtain that return. But in one case the firm is earning 10 percent after-tax on its equity and in the other the firm is only earning an after-tax on equity of 6.5 percent.[439] In the latter case the firm would not recover its cost of equity capital even though the market values its equity interest at 10 times its after-tax return because the investor's required after-tax equity ROE is 10 percent.

295. As explained in the prior section, the Shipper Parties' argument breaks down upon application of the median DCF ROE to a jurisdictional entity's rate base. The ROEs generated by the DCF model do reflect how the firms included in the DCF sample have grossed up their revenues above non-tax costs to generate the discounted cash flows to meet the required after-tax ROE. Thus, Examples 2 and 4 of Table 1 reflect the fact that

---

[437] *See* Ex. XOM-1 at 41, Table 2 prepared by Dr. Horst; *see also* Ex. SFP-97. intended to correct Dr. Horst's Table 2.

[438] *See* SFPP Compliance Filing, Schedule D.

[439] This calculation is illustrated in Tables 2 through 6.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

the firm has "grossed up" its operating revenue to produce a ROE (and the related distributions or dividends) that will provide the required after-tax return of $100. But as Table 2 demonstrates, the Commission's rate design methodology does not "gross up" a jurisdictional pipeline's operating revenues to achieve the required pre-tax ROE as is displayed in Table 1. As Table 2 displays, the Commission first determines the jurisdictional entity's operating revenue and return requirements without grossing up its revenue or its return to reflect the income tax cost element that is embedded in the investor's required after-tax ROE. The Commission then uses the income tax allowance to add back the required income tax rate design component (Examples 2 and 4 of both Tables) to achieve the necessary after-tax ROE.[440] This provides the jurisdictional entity the cash flow that is necessary to pay the income taxes on its allowed equity return. The difference between the cash flows and returns in Table 1 and Table 2 is subtle, but essential to the difference of how a jurisdictional entity's cost of-service is defined and how its revenue requirements would be reflected in the returns generated by the Commission's DCF model. At bottom, the ROEs generated by the DCF model inform the Commission of the equity rate of return (a percent) to be used to design a jurisdictional pipeline's rates. However the dollar equity return that results from the application of that percent that is included in the pipeline's cost of service does not in itself generate the funds to cover the income taxes that must be paid on that return because that return is not grossed up to do so.[441]

296. Thus the central error of the Shipper Parties' argument is again that it equates the way that cash flows, and thereby returns, are reflected in the after-tax ROEs generated by the DCF model with the way that a jurisdictional entity's revenues and cash flows are structured under the Commission's rate design methodology. To reiterate, Table 1 reflects the cash flows in a non-jurisdictional context. If the firm is able to "gross up" its revenues to recover the tax impacts on its net revenue income, it will recover all of its costs, including its after-tax cost of capital. If the firm cannot gross up revenue, it will not recover its equity cost of capital. As Table 2 displays, if a jurisdictional partnership does not obtain an income tax allowance, it lacks the equivalent of the "gross up" of the non-jurisdictional firm and thus will not recover its regulatory cost of service.[442] Thus,

[440] *See* SFPP 2010 FERC Form No. 6, Page 700, Attachment A hereto.

[441] See Lines 3 and 8 of Appendix C for the derivation of the total dollar taxable allowed return prior to the application of the income tax allowance.

[442] This does not mean that an MLP denied an income tax allowance will have negative income or cash flow. In the examples here, a jurisdictional MLP only has an after-tax return 6.5 percent on its equity rate base if denied an income tax allowance rather than the after-tax return of 10 percent generated by the DCF model. However,

(continued…)

contrary to the Shipper Parties' arguments, denying an income tax allowance to a jurisdictional MLP reduces both its after-tax dollar and percent equity return below that required by the capital attraction standard of *Hope*.[443]

3. Comparative Analysis of MLP and Corporate Returns

297. This section of the order extends the previous analyses to address arguments regarding (1) the relative after-tax dollar and percentage returns on equity of an MLP and a Schedule C corporation and (2) their respective revenue requirements. The Shipper Parties' premise is that an income tax allowance provides more after-tax cash and percentage returns on equity to the MLP partner than to a corporation shareholder holder.[444] ExxonMobil/BP asserts that Opinion No. 511 demonstrates that MLPs make greater cash distributions to an MLP's partners that a corporation does to its shareholders and that this results in an over-recovery of the MLP partners' income tax costs.[445] ExxonMobil/BP further argues that this alleged extra cash of an MLP causes the MLP to have a higher revenue requirement than a corporation even though an MLP and its partners have an overall lower tax burden than a corporation and its shareholders.[446] They conclude that the resulting higher security prices for an MLP thus stem from total revenues that are higher than is necessary to meet the capital attraction standard of *Hope*.[447] The Shipper Parties assert that the resulting benefits to the MLP and the MLP's partners means an MLP's rates will be higher than would be the case without an income tax allowance and therefore the rates are unjust and unreasonable.[448]

---

even though it has a positive return, the MLP will not obtain the after-tax return of 10 percent that a corporate pipeline earns if the latter is provided an income tax allowance. *See* Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 33.

[443] *Hope*, 320 U.S. 591, 605; *see also ExxonMobil*, 487 F.3d at 954 (noting the practical results of denying an MLP an income tax allowance).

[444] ExxonMobil/BP Rehearing at 15-16, 18, 24, 38; ACV Rehearing at 18-19, 22-23, 28-30.

[445] ExxonMobil/BP Rehearing at 38.

[446] *Id.* at 24, 38-40.

[447] *Id.* at 31, 36, 38 (citing *Hope*, 320 U.S. 591, 605); ACV Rehearing at 18, 24-26, 28-30.

[448] ExxonMobil/BP Rehearing at 38-39, 43-44; ACV Rehearing at 12-13, 21-22, 28-29.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

298. This portion of the Shipper Parties' requests for rehearing is grounded in two analyses. The Shipper Parties rely in part on the statistical analysis Dr. Horst submitted at hearing to establish (1) that an MLP's partners will double recover their income taxes if an MLP is provided an income tax allowance and (2) that an MLP income tax allowance will result in a higher revenue requirement for an MLP than a corporation.[449] They also rely heavily on the two exhibits attached to Opinion No. 511 as appendices, Ex. SFP-98 and SFP-99 to support their position.[450] Ex. SFP-98 concluded that granting an income tax allowance to both an MLP and a corporation results in a greater after-tax value for the MLP securities, but that the partner and the shareholder will receive the same percentage ROE. Ex. SFP-99 concluded that the after-tax value of an MLP and a corporation will be equal if an MLP is denied an income tax allowance and if the MLP investor and the shareholder have the same marginal tax rate.[451] The Commission turns first to a review of Dr. Horst's testimony on behalf of the Shipper Parties, second to its own technical analysis of the relative after-tax returns of partnerships and corporations, and third, reprise the analysis of Opinion No. 511 and of the two SFFP exhibits attached to that Opinion.

a. <u>Analysis of Dr. Horst's Statistical Methodology</u>

299. Opinion No. 511 affirmed the ruling by the 2009 ID that Dr. Horst's statistical methodology did not establish that there was a double recovery of an MLP partner' s income tax liability.[452] On rehearing, the Shipper Parties reprise Dr. Horst's analysis in several important regards and urge the Commission either to deny SFPP an allowance or adjust SFPP's ROE. Shipper Parties rely in part on Dr. Horst's testimony that (1) an MLP income tax allowance results in the double recovery of an MLP partner's income tax liability from an MLP, and (2) this is reflected in the higher ROEs of MLP natural gas pipelines compared to corporate natural gas pipelines.[453] Opinion No. 511 did not

---

[449] ExxonMobil/BP Rehearing at 13-14, 16.

[450] *Id.* at 16, 20, 22-23, 30; ACV Rehearing at 14, 24-25.

[451] *See* Ex. SFP-98 and Ex. SFP-98 respectively. The Commission explains below why this conclusion is incorrect in the context of the Commission's rate design methodology.

[452] Opinion No. 511, 134 FERC ¶ 61,121 at P 298-301.

[453] Prepared Answering Testimony of Thomas Horst on Behalf of ExxonMobil Oil Corporation, Ex. XOM-1 at 5-23.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

analyze Dr. Horst's recommendation in detail. Rather Opinion No. 511 stated that if two firms have equivalent risks, but different after-tax cash flows, their stock prices will adjust to reflect a higher after-tax security price.[454] Opinion No. 511 then reasoned that because there is no double recovery of the MLP partner's income tax liability, the higher security price of an MLP's equity interests is not caused by the MLP's income tax allowance, but because there is no double taxation of the MLP partner's income.[455] The Commission therefore concluded that no further analysis was required based on the ruling that an MLP income tax allowance was appropriate under *ExxonMobil*.

300. Dr. Horst served as a witness for ExxonMobil at hearing. There he testified that an MLP income tax allowance does not result in the parity of after-tax returns of MLP and corporate pipelines, and that in fact granting an MLP income tax allowance results in a higher ROE for the MLP pipelines even though the MLP and its partners have a lower combined income tax burden than a corporate pipeline and its shareholders. Dr. Horst concluded that there was a difference in the median after-tax ROE between MLPs and corporations of 3.67 percent in 2008[456] and 4.01 percent in 2007.[457] Dr. Horst explained that he analyzed the relative risk of the members of his proxy group sample to assure that differences in risks were not the cause of the difference in MLP and corporate ROEs. Dr. Horst concluded that a 3.67 percentage point difference in an MLP ROE and a corporate ROE creates a 4.68 percent after-tax difference in the ROE of a MLP partner versus a corporate shareholder..[458] He further testified that the source of this difference in after-tax percentage return is driven by the additional cash provided the MLP by the income tax allowance and is reflected in the difference between the ROEs of MLP and

---

[454] Opinion No. 511, 134 FERC ¶ 61,121 at P 245-249. Dr. Horst (ExxonMobil) and Dr. Schink (SFPP) appear to agree on this point. *See* Ex. XOM-1 at 17-18 and Ex. SFP-94 at 16. Where they disagree is the source of the difference in the after-tax cash flows, i.e., whether it is from the double recovery of the MLP partner's income tax liability or due to the impact of double taxation.

[455] Opinion No. 511, 134 FERC ¶ 61,121 at P 301. The Income Tax Policy Statement noted this adjustment at the outset of the debate about partnership income tax allowances. *See* Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 4 n.6. *See also*, Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 65 n.82.

[456] *See* Ex. XOM-4.

[457] *See* Ex. XOM-5.

[458] *See* Ex. XOM-1 at 41, Table 2.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

corporate gas pipelines in 2008. Given this supposed discrepancy, Dr. Horst sought to equalize the DCF ROEs of the MLP and the corporate pipelines by denying an MLP income tax allowance. By doing so, he reduced the after-tax 3.67 percent differential between a partner's and a shareholder's after-tax ROE in 2008 to 1.01 percent.[459] Alternatively, Dr. Horst recommended adjusting the ROE of MLP pipelines to the median ROE of the corporate natural gas pipelines to 10.13 percent based on his 2008 sample.[460] He also recommended adjusting SFPP's ROE to reflect the present value of any income tax deferrals benefits from the ownership of the limited partnership interests.[461]

301. The Commission did not address SFPP's criticisms of Dr. Horst's methodology in Opinion No. 511 because it reasoned there was no double recovery. However, the core issue in reviewing Dr. Horst's analysis is whether the seven MLPs and seven corporate gas pipelines used in his proxy group analysis have similar risks.[462] If they do not, this could account for the 3.7 percent difference in ROE between MLPs and corporations. In its rebuttal testimony, SFPP provided a table that summarized the business activities of the seven MLPs and seven corporations for the three years 2006 through 2008. These activities were divided into three groups: gas pipelines, local distribution companies (LDC), and other activities.[463] With one exception, Dr. Horst's MLPs had natural gas pipeline activities of 84 to 100 percent.[464] The exception was Atlas Pipeline Partners, L.P. (Atlas), which had natural gas pipeline activities of 7 to 14 percent. Moreover, one of the MLPs lacked an investment grade credit rating and two MLPs had no credit rating.[465] Of the seven natural gas pipelines only two, El Paso and Southern Union, had

---

[459] *See id.* at 42, Table 3.

[460] *See id.* 13-17.

[461] *See* Ex. XOM-1 at 35-36 and Ex. XOM-10, as amended by Ex. XOM-21 and Ex. XOM-25. *See also* ExxonMobil/BP Rehearing at 63, n.27.

[462] *See Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 697, 699-700 (D.C. Cir. 2007) (*Petal*); *see also*, *ExxonMobil*, 487 F.3d at 953. Both opinions cite *Hope*, 320 U.S. 603.

[463] Other activities include exploration and production, marketing, treating natural gas, retail propane, petrochemical services, and timber. These are market driven activities that Commission has found to be riskier than gas pipeline activities.

[464] *See* Ex. SFP-103.

[465] *See* Ex. SFP-94 at 22.

pipeline related activities of more than 50 percent. Two natural gas corporations had strong LDC activities and four had a range of other activities. Similarly, Questar and three other corporate pipelines had significant other activities that had exceeded the natural gas pipeline and LDC functions combined.[466] Two corporate pipelines, El Paso and Williams lacked an investment grade debt rating and had notably unstable dividend payouts.[467]

302. Against this background, the Commission concludes that Dr. Horst included firms in his sample that had significantly different characteristics from each other, and thus this could account for the 3.7 percentage point difference in the after-tax ROE for the MLPs and corporations in his analysis. Furthermore, the Commission would not have included six of the fourteen entities in a proxy group because of these deficiencies. The Commission notes that within the MLP group one pipeline (Atlas) is particularly dependent on non-pipeline revenue and three have credit ratings that are either below investment grade or none at all. At least three of the corporate pipelines, Williams, Questar, and Oneok had significant exposure to other activities in 2008 and Williams lacked an investment credit rating as well.[468] For these reasons all six of those companies would not be included in a Commission proxy group as they would be viewed as having too much risk to be a representative firm.[469] One of the firms, National Fuel, had an LDC component of about 50 percent and second one, Equitable, close to 40 percent.[470] These two firms have a risk profile below what the Commission generally considers representative.[471] In fact, only one of the corporate natural gas pipelines meets the

---

[466] *See* Ex. SFP-103.

[467] *See* Ex. SFP-94 at 22-23.

[468] *See* Ex. SFP-94 at 21-22 and Ex. SFP-104.

[469] *Kern River Gas Transmission Company*, 129 FERC ¶ 61,240, Opinion No. 486-C, at P 21 n.37 & 69 (2009) (regarding the exclusion of Williams Gas Marketing, Inc. and El Paso Natural Gas Company from a proxy group due to their undue financial risk. Opinion No. 486-C excluded one diversified natural gas company, Questar Corporation, on the grounds that its risk was too high due to its heavy exploration and production function).

[470] Ex. SFP-103, lines 10 and 9 respectively.

[471] Opinion No. 486-C, 129 FERC ¶ 61,240 at P 62, 65-69 (explaining why diversified natural gas companies with a large LDC component generally have less risk that an interstate gas pipeline with a transmission function that equals at least 50 percent

(continued…)

Commission's standards for inclusion in proxy group as a firm of comparable risk to SFPP. Therefore Dr. Horst did not successfully modify his sample for risk, as SFPP's testimony at hearing convincingly demonstrates.[472] Consequently, Dr. Horst's analysis sought to establish that the difference in after-tax ROEs between MLP and corporate gas pipelines is attributable to Commission's income tax allowance assuming all other things are equal.[473] In short, the Commission finds that Dr. Horst failed to establish that a 3.7 percent difference in 2008 between the ROEs of MLPs and corporations in Dr. Horst's proxy group stem from the Commission's income tax allowance policy and not differences in business focus and risks.

303. Dr. Horst's analysis is also deficient because it does not isolate sources of the cash flow for the dividends or distributions.[474] Indeed, Dr. Horst's proxy group analysis does not distinguish between the revenues generated by jurisdictional activities and those from

---

of its activities). In the *Kern River* rate proceeding, the Commission ultimately excluded two LDC dominated firms, Equitable Gas Resources, Inc. and NiSource, from Kern River's proxy group. *See* Opinion No. 486-C, 129 FERC ¶ 61,240 at P 72-80, 86-93. NiSource was also excluded because it had cut its dividend and this could result in an unrepresentative DCF calculation. *See also* Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 51.

[472] *See* Ex. SFP-94 at 18-20; Ex. SFP-102 *passim*.

[473] *See* Ex. XOM-1 at 6.

[474] The DCF model's first component is the dollar distribution in the last six months of the test year. This determines the current yield when measured against the price of the equity interest. Because the distribution is compounded in the subsequent years and then discounted back to the test year, a large distribution has a material impact on the calculation. In some cases the five year IBES forecast for an MLP can be close to that of a corporation. If the MLP distribution is significantly higher than that of a corporation, the MLP ROE could be higher. This means that any analysis must carefully compare the source of cash for the distribution. This can include net cash from operations, cash flow from the depreciation component of the cost of service, the return component of the cost of service, distributions of external sources, distributions from non-jurisdictional sources, and the jurisdictional income tax allowance. Dr Horst's statistical analysis is inadequate to address these different factors and he has provided no analytical basis to support a conclusion that the difference in ROEs between an MLP and a corporation is driven by the MLP's income tax allowance. *Cf.* Opinion No. 511, 134 FERC ¶ 61,121 at 244-245.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

non-jurisdictional activities. If the income and cash flow of a diversified firm is driven by non-jurisdictional activities, the Commission's income tax allowance is not relevant to that portion of the firm's operations. However the distributions or dividends from such non-jurisdictional income would still be reflected in yields and in the growth factors contained in the Commission's DCF formula.[475] Compared to complexities and relative subjectivity of Dr. Horst's analysis, the Commission's practice of developing an ROE cost-of-capital from a sample of firms with comparable risks is well established.[476] The Commission's DCF approach is therefore grounded in the basic assumption that firms of the same risk will generate similar returns.[477] As such, the Commission's DCF method provides a well defined and reliable measure of relative risk and return under different market conditions while Dr. Horst's analysis does not.

304. Finally, Dr. Horst's analysis is grounded in his Table 2 comparing the relative gross ups of an MLP and corporate pipeline and from that comparison the relative after-tax returns of the MLP partner and shareholder. However Dr. Horst's Table 2 starts from a basic error in its efforts to display the relative after-tax return of the MLP partner and the corporate shareholder. First, it assumes based on Dr. Horst's statistical analysis that there is a different revenue requirement and after-tax ROE required for an MLP pipeline and a corporate pipeline as adjusted for risk, that is, the 3.67 percent displayed in that Table. The Commission has concluded this statistical analysis is unsound. Second, Dr. Horst's Table 2 states that the pre-tax return to the MLP and the after-tax return to the partner are both 13.80 percent.[478] This is mathematically impossible because the pre-tax and after-tax figures cannot be identical unless the marginal tax rate is zero. It is also inconsistent with the Shipper Parties' argument that the ROEs generated by the DCF model include a gross up adequate to cover the investor's income tax liability and to meet the investor's after-tax return. Under the Shipper Parties' central theory here the

---

[475] Thus, in the case of National Fuel the Commission's income tax allowance policy would apply to some ten percent of income compared to 100 percent for Oneok Partners, L.P., assuming that in 2008 either had a full income tax allowance actually embedded in their rates in that year. *See* Ex. SFP-103, line 10 and line 6 respectively.

[476] Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 3, 7, 47-49; *see also*, *Petal*, 463 F.3d at 699-700 and *ExxonMobil*, 476 F.3d at 953.

[477] *Cf. Petal*, 496 F.3d at 698-700. If the firm's risk, yield, and growth prospects were identical, then their ROE's also would be. As the text states, adjusting all the factors of a range of firms to reach that identity is difficult, if not impossible.

[478] *See* Ex. XOM-1 at 41.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

calculations of the MLP's pretax DCF return and the MLP's partner's after-tax return cannot be the same because the marginal tax rate of the partner is embedded in the ROE generated by the DCF model. SFPP correctly points out, if the partner's marginal tax rate is 32 percent, the after-tax return to the partner in Table 2 should be 9.34 percent, not 13.8 percent.[479]

305. To that end, SFPP's Ex. 96 partially corrected Dr. Horst's Table 2 to correctly state that the MLP pipeline and its partners have the same required after-tax ROE of 13.80 percent as does the corporate pipeline. This is because the two business forms have the same costs either in a competitive environment or under Commission regulation, and hence the same revenue requirement. The gross up is somewhat different because the partners and the corporation have different marginal tax rates leaving the MLP pipeline with a before-tax ROE of 20.29 percent and the corporation with a before-tax ROE of 21.23 percent. After allowing for double taxation of the corporate return the after-tax return to the partner is 13.80 percent and 12.42 percent to the shareholder using Dr. Horst's marginal tax rate on dividends of 10 percent. After the adjustment in the equity price of the MLP and the corporation the return is 13.80 percent with the MLP equity price at $100 and the corporate equity price at $90 based on the 10 percent marginal tax rate Dr. Horst applies to dividends.[480] SFPP's Ex. 97 extends the analysis in Ex. SFP-96 to assume a marginal tax rate on dividends of 32 percent. At that marginal tax rate the adjustment results in a corporate share price of $68 compared to a MLP equity price of $100, and thus is again a direct function of the marginal tax rate on the dividends.[481] These tables and the Commission's analysis below start from the basic financial assumption that an MLP and a corporate pipeline have the same economic

[479] *See* Ex. SFP-94 at 15, 40-41.

[480] Ex. SFP-96. SFPP's corrections are described at Ex. SFP-94 at 28-33. The after-tax value for the corporation equity of $90 is similar to the $85 after-tax value of corporate equity in the Commission's Table 4 *infra*, which uses a marginal tax of 15 percent rather than the 10 percent assume in Dr. Horst's analysis. *See* Ex. XOM-1 at 10. As discussed below in Tables 3 though 7, the difference in the value of the equity interests is a function of the marginal tax rate on the dividends paid to the shareholders.

[481] Ex. SFP-97. SFPP's additional adjustments are discussed at Ex. SFP-94 at 39-40. The result is comparable to the Commission's Table 6 *infra* which uses a marginal tax rate on dividends of 35 percent and therefore results in a corporate share price of $65 compared to the MLP equity price of $100. The Commission takes no position on the appropriateness of the 32 percent marginal rate as this does not affect the outcome here. Either way the stock price will adjust to reflect the shareholder's marginal rate.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

functions. As such, they correctly conclude that the difference in the after-tax cash return and the price adjustment is a function of double taxation, not a statistical difference driven by the income tax allowance.

306. Therefore, for the reasons stated, the Commission rejects Dr. Host's analysis and his conclusions that (1) the difference in ROEs between MLP and corporate pipelines is driven by "double recovery" of the MLP partner's income tax liability due to excess cash resulting from an MLP income tax allowance, and (2), that granting an income tax allowance thereby destroys the parity of regulatory returns of MLP and corporate pipelines. In this regard ExxonMobil cites paragraph 261 of Opinion No. 511 for the proposition "granting an income tax allowance to MLPs results in an adjustment in the relative investment price of an MLP's and a corporation's securities to the former's advantage."[482] The implication is the income tax allowance provides unnecessary cash to cover the income tax liabilities of the partners and that this results in an undeserved price advantage for the MLP. The actual context is:

> Under both the Income Tax Policy Statement and *ExxonMobil,* the comparison of relative returns was between the MLP as a regulated entity, including the imputed income tax liability, and the corporation as a regulated entity, with its explicit income tax liability. The comparison was not between the individual unit holder and the corporate shareholder as the ACV Shippers urge here. The Income Tax Policy Statement recognizes that unlike corporate income, MLP income is not subject to double taxation. Thus granting an income tax allowance to MLPs results in an adjustment in the relative investment price of an MLP's and a corporation's securities to the former's advantage. *ExxonMobil* accepted the Commission's determination that elimination of the allowance would create a disincentive for using partnerships because it would lower the relative returns for partnerships as compared to corporations. Thus the difference in dollar returns resulting from an income tax allowance was addressed in the examples provided in the Income Tax Allowance Statement and was affirmed by *ExxonMobil*. Further, the price advantage MLPs hold over corporations was recognized in the Income Tax Policy Statement and was upheld by

[482] ExxonMobil/BP Rehearing at 18, 24 (citing in part Opinion No. 511, 134 FERC ¶ 61,121 at P 261).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

the court.[483]

In contrast to ExxonMobil/BP's inference, Opinion No. 511 established that an MLP income tax allowance is necessary for parity at the entity level and that it is the impact of double taxation that causes an advantage at the investor level. As discussed further in the next section, the taxation of dividend income unquestionably means a shareholder will have less after-tax income and cash return than an MLP partner due to the impact of double taxation of the corporation and of the shareholder. But this does not mean that an MLP necessarily distributes more cash to its partners than a corporation could in dividends. This is because an MLP has the same cost of service as a corporation and therefore the same pre-tax revenue and pre-tax cash flows. Rather, as Opinion No. 511 states, the difference between the MLP and corporate equity holder is properly reflected in the adjusted price of their equity interests, which results in their having the same percent ROE.[484]

b. Commission's Technical Analysis of the Relative After-tax Returns of an MLP Pipeline and a Corporate Pipeline

307. In a prior section the Commission presented a basic example of the impact on the relative after-tax cash flows and the values of equity interests of an income tax allowance (both the presence and absence of one), but without the corporate format. Here the Commission extends its analysis to compare the relative after-tax cash flows, ROEs, and value of the ownership interests of an MLP partner and a Schedule C corporation shareholder, again with or without an income tax allowance. Tables 3 through Table 7 and the related analysis demonstrate that granting an MLP an income tax allowance does not result in (1) a higher after-tax percentage ROE for MLP partner compared to a shareholder, and (2) an MLP having a higher revenue requirement than a corporation even though an MLP partners have an overall lower income tax burden than the combined income tax burden of a corporation and its shareholders. The five additional tables compare the after-tax dollar and percent ROEs of a partner and the corporation, and the relative after-tax cash flow and dollar value of a partner's and the shareholder's equity interests. These tables also show whether an MLP or corporate pipeline recovers its after-tax equity cost of capital and thus its regulatory cost of service. The analysis here also serves as a foundation for the analysis in the next section of the order of the portions of Opinion No. 511 that relied in part on Ex. SFP-98 and Ex. SFP-99 in addressing these same topics.

---

[483] Opinion No. 511, 134 FERC ¶ 61,121 at P 261 (citations omitted).

[484] *Id.* P 301; Income Tax Policy Statement, 111 FERC ¶ 61,139 at n.6. *See also* December 2007 Order, 121 FERC ¶ 61,240 at P 53.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

308. As before, the Commission's analysis does not include a growth component and posits an all equity firm with a required after-tax rate of ROE of 10 percent. Moreover, as all cash flow from depreciation is reinvested to maintain the same level of service and all other net cash is distributed, taxable income and pre-tax cash flow of the partnership and corporation are the same, as are their respective distributions and dividends. Imputing the partner's income tax liability to the partnership as per *ExxonMobil*, the income tax allowance is stated on the same line for both the partnership and the corporation. To distinguish the results of the MLP, the partner, and a corporation, the analyses display separately the partnership's, the partner's, and the corporation's after-tax income and percent ROE as well as the pre-tax and after-tax dollar return to the shareholder. In Tables 3 through 7 a 35 percent tax rate always applies to the partner's and the corporation's taxable income and a marginal tax range of 0 to 35 percent apply to the shareholder's dividend income.

309. Having calculated both the partner's and the shareholder's after-tax dollar ROE, the tables then determine the capitalized value of the partner's and the shareholder's equity interests at ten times the dollar value of the distribution or dividend. That value reflects the principal amount required to provide an after-tax 10 percent ROE on the investor's equity interest. For example, if the after-tax dollar return to a partner is $100 and the after-tax dollar return for the shareholder is $85, given the required after-tax ROE of 10 percent the partner's equity is valued at $1000 and the shareholder's equity is valued at $850. The Commission adopts this format because a dollar figure displays most clearly the impact of double taxation on after-tax dollar returns and equity values.

310. Table 3 compares the partnership and shareholder ROEs and values when the marginal tax rate on dividends is zero percent. Example 4 of Table 3 discloses that when there is no tax on dividends the corporation has 10 percent after-tax ROE. Example 3 of Table 3 further shows that in the absence of double taxation the after-tax percentage ROE to the partnership (and its partners) is the same as that corporation, 10 percent, <u>and</u> the after-tax dollar return of the partner and the shareholder is the same, $100, as is the value of their equity, $1000. Example 1 and Example 2 of Table 3 demonstrate the partnership (and thus its partners) and the corporation both earn an after-tax rate ROE of only 6.5 percent if either is denied an income tax-allowance. Thus neither the partnership nor the corporation earns the required after-tax ROE. However, whether the after-tax return is 6.5 percent or 10 percent given the presence or absence of the income tax allowance, the partner and the shareholder have the same after-tax dollar and after-tax percent ROEs if there is no double taxation.

311. In contrast to Table 3, Tables 4 through 6 include a tax on corporate dividends at different marginal tax rates. The marginal tax rate for Table 4 is 15 percent, Table 5 is 25 percent, and Table 6 is 35 percent. The results at the entity level are always the same for the MLP (and thus for its partners) and the corporation for both the after-tax dollar

20111216-4007 FERC PDF (Unofficial) 12/16/2011

and percentage returns. Thus in Table 4 if both the partnership and the corporation are provided an income tax allowance, both the partners and the corporation will have an after-tax ROE of 10 percent and their after-tax income is the same. If neither is provided an income tax allowance, the after-tax ROE drops to 8.5 percent for both entities and neither obtains the required after-tax rate of return. Regardless of whether the after-tax ROE is 10 percent or 8.5 percent, the after-tax dollar and percent ROEs at the entity level are the same.[485] Moreover, if an income tax allowance is provided to the partnership, the dollar return to the partner remains $100 and the capitalized value of the partner's equity is $1000 as there is no double taxation of that income. But the shareholder's dollar return and equity value drop in proportion to the marginal tax rate on dividends. Table 4 thus shows a shareholder return of $85 and a capitalized value of $850, Table 5 shows a shareholder value of $75 and a capitalized value of $750, and Table 6 shows a shareholder value of $65 and a capitalized value of $650.

312. Tables 3 through 6 thereby show that if an MLP has no income tax allowance, it will not recover its cost of capital. Of equal importance, Tables 3 through Table 5 show that if the MLP is denied an income tax allowance, the after-tax dollar return to its partners will be <u>less</u> than the after-tax return to the shareholder and the MLP equity interests will have a lower capitalized value than the shareholders until the partner and the shareholder have the same marginal tax rate of 35 percent, the essential holding of *ExxonMobil*.[486] Table 6 shows that the MLP will not recover its cost of service when the partner and the shareholder have the same after-tax dollar return because this occurs only if the MLP does not have an income tax allowance.[487] Tables 3 through 6 also show that an MLP and a corporate pipeline have the same revenue requirement regardless of the marginal tax rate if both are provided an income tax allowance.

---

[485] This assumes that an MLP and a corporation are both either granted or denied an income tax allowance so that there is no difference in their comparative cash flows.

[486] Compare Example 1 to Example 4 on each of the Tables.

[487] *See* Opinion No. 511, 134 FERC ¶ 61,121 at P 248. As discussed below, Opinion No. 511 did not make this point and that Opinion has therefore been construed by the Shipper Parties as an admission that the returns of the partner and the shareholder are equal if the MLP is denied an income tax allowance. However, in the context of Commission rate design policy, got the MLP Ex. SFP-99 incorrectly grosses up the return in the example as well as denying an income tax allowance. As previously noted, Ex. SFP-99 will reach the same result as the Commission's Table 6 if the gross up to the return line is eliminated, namely that the MLP does not recover its cost of service.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

313. It is important to note that just because the capitalized value of the after-tax return to the shareholders is less than the dollar value of the corporation's equity rate base does not mean that the corporation fails to earn its required after-tax ROE under the Commission's ratemaking methodology if it is provided an income tax allowance. The corporation's after-tax return is $100, which is the required after-tax ten percent ROE on the corporation's equity rate base of $1000. However given a 15 percent marginal tax rate, at a required ten percent after-tax ROE the shareholder's after-tax dollar return is $85 or the capitalized value of the shares is $850, the principal amount required for a 10 percent after-tax rate of return ROE. But a comparison of the partner's and the shareholder's after-tax percent ROE shows that the after-tax percent ROE is the same both, that is a 10 percent after-tax return on the capitalized value of their interests.

314. Tables 3 through 6 confirm that an MLP benefits from the absence of double taxation through the higher equity dollar value that results from the absence of double taxation. However, as Opinion No 511 states, the MLP partners will not benefit from the absence of double taxation if the prices adjust to accurately reflect the difference in the capitalized value of the after-tax cash flows because the MLP partners pay a higher price for the security than the corporate shareholders in order to obtain the same after-tax dollar return.[488] Thus, while Opinion No. 511 did state that Congress intended that any tax benefits from use of the MLP format were for the account of the investors and not the rate payers,[489] it is more accurate to say that the benefits are to flow to the MLP through the lower cost of equity capital it derives from the higher priced shares. Even so, the single taxation and tax deferrals can make for an attractive investment vehicle for the MLP partner, if the investor captures some of the higher equity price that theoretically flows to the MLP. But in either case there is no doubt that Section 7704 of the IRC was to provide that incentive for certain types of business formats to encourage investment.[490] Where the Shipper Parties and the Commission disagree is that the Commission again concludes that Congress intended that either the investor or the MLP retain the benefits of single taxation and tax deferrals depending on the price the investor actually pays for the MLP equity interests. Opinion No. 511 was correct in concluding any tax advantage to an MLP from single rather than double taxation is not for the benefit of the rate payers.

---

[488] As noted, this is a point that Dr. Horst conceded in his testimony. *See* Ex. XOM-1 at 17-18; *see also* Ex. SFP-94 at 16, 32-33, 36-37, 40.

[489] Opinion No. 511, 134 FERC ¶ 61,121 at P 251-256.

[490] *Id.* P 253, 256, 259, 308.

Table 3. Comparison of after-tax returns of MLP and Corporation at the entity level and the relative value of a partner and the shareholder interest assuming a required after-tax return of 10 percent and a 0 percent tax on dividends

Example 1 – Partnership without tax allowance		Example 2 - Corporation without tax allowance		Example 3 - Partnership with tax allowance		Example 4 - Corporation with tax allowance	
Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000
Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900
Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100
Income Tax All.	$ -	Income Tax All.	$ -	Income Tax All.	$ 54	Income Tax All.	$ 54
Cost of Service	$1,000	Cost of Service	$1,000	Cost of Service	$1,054	Cost of Service	$1,054
Pretax Return	$ 100	Pretax Return	$ 100	Pretax Return	$ 154	Pretax Return	$ 154
(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)	
Partner Pretax Income/Return	$ 100	No Pass Through Same as above	N.A.	Partner Pretax Income/Return	$ 154	No Pass Through Same as above	N.A.
Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54	Tax at 35 Percent	$ 54
After Tax Income	$ 65	After Tax Income	$ 65	After Tax Income	$ 100	After Tax Income	$ 100
Return on Equity	6.5%	Return on Equity	6.5%	Return on Equity	10.0%	Return on Equity	10.0%
Partner After tax Income/Return	$ 65	Corporate Dividend	$ 65	Partner After tax Income/Return	$ 100	Corporate Dividend	$ 100
		Shareholder Rate	0%			Shareholder Rate	0%
		Dollar Tax Paid	$ -			Dollar Tax Paid	$ -
		After Tax Return	$ 65			After Tax Return	$ 100
Partner Value	$ 650	Shareholder Value	$ 650	Partner Value	$1,000	Shareholder Value	$1,000
Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	Yes	Does Equity Earn the Required Return?	Yes

Conclusion – When there is no tax on the dividend and the MLP and the corporation both receive an income tax allowance, both entities earn the required return and after-tax value of the partnership's and the corporate equity's interest are identical.

Table 4. Comparison of after-tax returns of MLP and Corporation at the entity level and the relative value of a partner and the shareholder interest assuming a required after-tax return of 10 percent and a 15 percent tax on dividends

Example 1 – Partnership without tax allowance		Example 2 - Corporation without tax allowance		Example 3 - Partnership with tax allowance		Example 4 - Corporation with tax allowance	
Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000
Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900
Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100
Income Tax All.	$ -	Income Tax All.	$ -	Income Tax All.	$ 54	Income Tax All.	$ 54
Cost of Service	$1,000	Cost of Service	$1,000	Cost of Service	$1,054	Cost of Service	$1,054
Pretax Return (Sum of the after-tax return plus income tax allowance)	$ 100	Pretax Return (Sum of the after-tax return plus income tax allowance)	$ 100	Pretax Return (Sum of the after-tax return plus income tax allowance)	$ 154	Pretax Return (Sum of the after-tax return plus income tax allowance)	$ 154
Partner Pretax Income/Return	$ 100	No Pass Through Same as above	N.A.	Partner Pretax Income/Return	$ 154	No Pass Through Same as above	N.A.
Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54	Tax at 35 Percent	$ 54
After Tax Income	$ 65	After Tax Income	$ 65	After Tax Income	$ 100	After Tax Income	$ 100
Return on Equity	6.5%	Return on Equity	6.5%	Return on Equity	10.0%	Return on Equity	10.0%
Partner After tax Income/Return	$ 65	Corporate Dividend	$ 65	Partner After tax Income/Return	$ 100	Corporate Dividend	$ 100
		Shareholder Rate	15%			Shareholder Rate	15%
		Dollar Tax Paid	$ 10			Dollar Tax Paid	$ 15
		After Tax Return	$ 55			After Tax Return	$ 85
Partner Value	$ 650	Shareholder Value	$ 553	Partner Value	$1,000	Shareholder Value	$ 850
Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	Yes	Does Equity Earn the Required Return?	Yes

Conclusion - Under the stated assumptions the partnership will not earn the required return on equity if denied an income tax allowance but the corporation earns the required return on equity if granted an income tax allowance. The difference in value between the partner's and the shareholder's interest is a direct function of the marginal tax rate on dividends, or $15.

Table 5. Comparison of after-tax returns of MLP and Corporation at the entity level and the relative value of a partner and the shareholder interest assuming a required after-tax return of 10 percent and a 25 percent tax on dividends

Example 1 – Partnership without tax allowance		Example 2 - Corporation without tax allowance		Example 3 - Partnership with tax allowance		Example 4 - Corporation with tax allowance	
Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000
Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900
Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100
Income Tax All.	$ -	Income Tax All.	$ -	Income Tax All.	$ 54	Income Tax All.	$ 54
Cost of Service	$1,000	Cost of Service	$1,000	Cost of Service	$1,054	Cost of Service	$1,054
Pretax Return	$ 100	Pretax Return	$ 100	Pretax Return	$ 154	Pretax Return	$ 154
(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)	
Partner Pretax Income/Return	$ 100	No Pass Through Same as above	N.A.	Partner Pretax Income/Return	$ 154	No Pass Through Same as above	N.A.
Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54	Tax at 35 Percent	$ 54
After Tax Income	$ 65	After Tax Income	$ 65	After Tax Income	$ 100	After Tax Income	$ 100
Return on Equity	6.5%	Return on Equity	6.5%	Return on Equity	10.0%	Return on Equity	10.0%
Partner After tax Income/Return	$ 65	Corporate Dividend	$ 65	Partner After tax Income/Return	$ 100	Corporate Dividend	$ 100
		Shareholder Rate	25%			Shareholder Rate	25%
		Dollar Tax Paid	$ 16			Dollar Tax Paid	$ 25
		After Tax Return	$ 49			After Tax Return	$ 75
Partner Value	$ 650	Shareholder Value	$ 488	Partner Value	$1,000	Shareholder Value	$ 750
Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	Yes	Does Equity Earn the Required Return?	Yes

Conclusion - Under the stated assumptions the partnership will not earn the required return on equity if denied an income tax allowance but the corporation earns the required return on equity if granted an income tax allowance. The difference in value between the partner's and the shareholder's interest is a direct function of the marginal tax rate on dividends, or $25.

Table 6. Comparison of after-tax returns of MLP and Corporation at the entity level and the relative value of a partner and the shareholder interest assuming a required after-tax return of 10 percent and a 35 percent tax on dividends

Example 1 – Partnership without tax allowance		Example 2 - Corporation without tax allowance		Example 3 - Partnership with tax allowance		Example 4 - Corporation with tax allowance	
Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000
Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900
Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100
Income Tax All.	$ -	Income Tax All.	$ -	Income Tax All.	$ 54	Income Tax All.	$ 54
Cost of Service	$1,000	Cost of Service	$1,000	Cost of Service	$1,054	Cost of Service	$1,054
Pretax Return (Sum of the after-tax return plus income tax allowance)	$ 100	Pretax Return (Sum of the after-tax return plus income tax allowance)	$ 100	Pretax Return (Sum of the after-tax return plus income tax allowance)	$ 154	Pretax Return (Sum of the after-tax return plus income tax allowance)	$ 154
Partner Pretax Income/Return	$ 100	No Pass Through Same as above	N.A.	Partner Pretax Income/Return	$ 154	No Pass Through Same as above	N.A.
Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54	Tax at 35 Percent	$ 54
After Tax Income	$ 65	After Tax Income	$ 65	After Tax Income	$ 100	After Tax Income	$ 100
Return on Equity	6.5%	Return on Equity	6.5%	Return on Equity	10.0%	Return on Equity	10.0%
Partner After tax Income/Return	$ 65	Corporate Dividend	$ 65	Partner After tax Income/Return	$ 100	Corporate Dividend	$ 100
		Shareholder Rate	35%			Shareholder Rate	35%
		Dollar Tax Paid	$ 23			Dollar Tax Paid	$ 35
		After Tax Return	$ 42			After Tax Return	$ 65
Partner Value	$ 650	Shareholder Value	$ 423	Partner Value	$1,000	Shareholder Value	$ 650
Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	Yes	Does Equity Earn the Required Return?	Yes

Conclusion - Under the stated assumptions the partnership will not earn the required return on equity if denied an income tax allowance but the corporation earns the required return on equity if granted an income tax allowance. If the partnership is denied an income tax allowance, then partner and shareholder after tax values are the same, but the partnership does not recover its regulatory cost of service.

315. It is in this context that the Shipper Parties assert that Opinion No. 511 concedes that the MLP format is a tax advantaged business format that distributes extra after-tax cash flow to their partners compared to that available to a corporation.[491] In that regard, the Commission has always recognized the MLPs have financial advantages over corporations because the income of an MLP is not subject to double taxation when it is distributed, unlike corporate dividends.[492] Moreover, the Commission has recognized that MLPs usually make greater cash distributions to the partners than a corporation does with its dividends because MLPs normally distribute all available cash to their partners.[493] This in turn results in a reduction of the partner's basis and the deferral of income taxes to the extent the distributed cash exceeds the partner's distributed income.[494] But this does not mean that MLPs distribute cash that results in the double recovery of partner's income tax liability. The pre-tax cash distributions to the partner and the pre-tax dividends to the shareholder are the same assuming that all available cash is distributed, but the MLP partner obtains more after-tax cash than the corporate shareholder. This result is precisely because the partners (and under *ExxonMobil* the MLP) have a lower over-all tax burden than a corporation and its shareholders.[495] It does not follow that the over-all lower tax burden results in excessive after-tax cash flow to the MLP's partners or the double recovery of the MLP partner's income tax liability.

---

[491] ExxonMobil/BP Rehearing at 38, 40; ACV Rehearing at 19, 30-31, 53.

[492] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 4, 9, 30, 33, n.6.

[493] The Commission has ruled that corporations usually retain more cash for use as internal financing. MLPs rely more on external financing and may distribute the cash generated by depreciation and external financing in addition to that from earnings and the income tax allowance. *See* Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 11-13, 15, 92-93. But as the tables display, this does not mean that an MLP generates more cash from operations than a corporation or that the greater amount of cash distributed comes from the income tax allowance assuming both firms have the same costs, revenues, and risk. The Shipper Parties' inference to the contrary is inaccurate.

[494] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 36, n.35. *See also* December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 45 (recognizing this point but then reaching the incorrect conclusion that there must be an adjustment to the pipeline's equity return to reflect the value of any income tax deferrals).

[495] As argued by ExxonMobil/BP in their rehearing request at 24, 38-39, 40.

316. Rather the difference in the price of their equity securities is due to single taxation that makes the MLP a tax-advantaged entity, not that there are any income tax dollar savings on net operating income (return) generated by the <u>entity's jurisdictional operations</u>. In other words, the MLP's tax advantage occurs at the investor level when the MLP limited partners pay a higher price for the MLP's equity interests. ExxonMobil/BP distorts this basic conclusion by citing paragraph 247 of Opinion No. 511 for the proposition that extra cash generated by the income tax allowance causes an unwarranted rise in this price.[496] The actual statement is that "as the risk is the same for both business models, the higher MLP unit price reflects its higher after-tax dollar income and cash returns compared to the corporation."[497] Opinion No. 511 at paragraph 245 makes clear, however, that this sentence occurs in the context of "comparing the after-tax returns of an MLP and a corporation as presented in the Income Tax Policy Statement and repeated in *ExxonMobil*."[498] Aside from the fact that both the cited sources <u>approved</u> the income tax allowance as necessary to maintain parity in the returns of partnerships and corporations, any inference that Opinion No. 511 stated that the excess cash is generated by an MLP income tax allowance is incorrect. The double taxation of corporate income or an MLP partners' tax deferrals occur at the investor level and not at the level of the operating entities regardless of whether they are a partnership or a corporation. Thus, as a matter of cost of service analysis, it is incorrect to imply that the "tax savings" to the MLP partners from the elimination of double taxation or tax deferrals are reflected in the MLP's regulatory cost of service or rate design.[499]

317. In contrast to the Shipper Parties' arguments, an MLP's financial advantage stems from the avoidance on the tax on dividends that must be paid by a corporation's shareholders. This means that the corporation's equity interests are priced lower than those of the MLP because neither the corporation nor the MLP can charge higher rates nor obtain lower costs than the other. Because the corporation cannot obtain higher gross revenues or lower costs than the MLP, the corporation's gross revenues will never be sufficient to cover the income tax on the dividends it distributes to its shareholders.

---

[496] ExxonMobil/BP Rehearing at 30, 38 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 247).

[497] Opinion No. 511, 134 FERC ¶ 61,121 at P 247.

[498] *Id.* P 245 (citations omitted).

[499] *Id.* P 41. Similarly, the conclusion at P 45 of the December 2006 Sepulveda Order that the pipeline benefits at the expenses of the rate payers contradicts the earlier statement at P 41 that income tax deferrals are not part of the pipeline's cost of service.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Thus, as long as there is tax rate on dividends, the after-tax cash flow to the shareholder and the value of the shareholder's interest is always less than that of MLP partner even though both the dollar and the percentage returns on rate base are the same at the entity level.

318. However ExxonMobil further argues that the Commission arbitrarily excluded shareholders as investors by focusing parity on the first tier of ownership, i.e., at the MLP partner and the shareholder level.[500] But this argument assumes that the shareholder and the partner have identical ownership interests, which they do not. Because the MLP is a pass through entity, the MLP partner has a direct interest in assets which are reflected in the partner's partnership account. The partner's returns directly reflect the revenue, expenses, and income of the partnership and the partner must pay the taxes thereon whether or not provided the cash to pay the taxes. In this regard, the MLP partner's ownership interest is accounted for on a balance sheet and income statement that is very similar to those of a corporation. The MLP partner's tax return reflects net changes to the entity's capital account from net income, plant, and investments from external sources and from losses and distributions (similar to dividends). In contrast, the shareholder's interest in the assets is indirect and the shareholder has no direct accounting interest in the corporation's assets and the corporation's balance sheet is not reflected in shareholder's net worth. A shareholder has no asset account that replicates the entity's rate base and has no liability for taxes on the income generated by the entity's rate base. *ExxonMobil* clearly recognized this fundamental distinction.[501]

319. The foregoing shows that the Shipper Parties are simply incorrect that the Commission should equalize the returns of partners and shareholders. Indeed, the court in *ExxonMobil* affirmed the Commission's decision to equalize the after-tax returns at the level of the jurisdictional entity.[502] It is at the entity level the Commission establishes the allowed ROE on the rate base of a jurisdictional entity and it is at that level that the Commission determines if a jurisdictional entity has a realized ROE that is less than, equals, or exceeds its allowed jurisdictional after-tax return. Tables 3 through 6 in this order apply the *ExxonMobil* analysis to the equity rate base of partnership and corporate business structures and calculate the resulting ROEs. Those tables show that when both business formats obtain an income tax allowance the returns on the equity portion of the

---

[500] ExxonMobil/BP Rehearing at 30, 34, 36; *cf.* ACV Rehearing at 27-28.

[501] *ExxonMobil*, 487 F.3d at 951-53.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

jurisdictional rate base are the same for both business formats. This is true even though the after-tax dollar return to the shareholder is less than that of the MLP partner due to the impact of double taxation. In turn the percentage return to the partner and the shareholder is the same due to difference in the capitalized value of their positions.

320. However, in theory the Commission could equalize both the after-tax percentage and the after-tax dollar returns of partners and shareholders as urged by the Shipper Parties and assure that both earn their required regulatory ROE. This could be done by providing the corporation an additional income tax allowance to cover the marginal tax rate on the shareholder's dividends. This would replicate how a corporation must gross up operating revenue not only for the 35 percent tax on its earnings, but also to cover the estimated tax cost on the dividends distributed to its shareholders. This is shown by Examples 2 and 4 in Table 7. In Example 4, the corporate after-tax dollar return increases to $118 and to a percentage after-tax ROE of 11.77 percent instead of 10 percent. After applying the marginal tax rate to the dividend, the partner's and the shareholder's after-tax value of their equity interests is the same.[503] However the corporation over-recovers its cost of service.

321. Therefore, consistent with Opinion No. 511, the Commission again concludes that it is mathematically incorrect to argue that an MLP's partners will double recover their income taxes if the MLP is provided an income tax allowance.[504] Contrary to the assertions on rehearing, as discussed above, the difference in dollar value between a partner's and the shareholder's equity interest results from double taxation and not from granting the MLP an income tax allowance. Because an MLP will not recover its cost of service if denied an income tax allowance, that difference cannot be remedied under the Commission's ratemaking methodology by means that will allow a partnership and corporation to both earn an appropriate after-tax return on the equity portion of their jurisdictional rate base.[505]

---

[503] Table 7 assumes a 15 percent marginal tax rate on dividends.

[504] Opinion No. 151, 134 FERC ¶ 61,121 at P 250.

[505] *See ExxonMobil*, 487 F.3d at 953-55 (holding that a comparison of equity returns must be at the entity level).

Table 7. Comparison of after-tax returns of MLP and Corporation at the entity level and the relative value of a partner and the shareholder interest assuming a required after-tax return of 10 percent and a 15 percent tax on dividends
In this case the Commission provides an income tax allowance to cover the 15 percent tax on the dividends

Example 1 – Partnership without tax allowance		Example 2 - Corporation without tax allowance		Example 3 - Partnership with tax allowance		Example 4 - Corporation with tax allowance	
Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000	Equity Rate Base	$1,000
Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900	Operating Exp.	$ 900
Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100	Equity Return	$ 100
Income Tax All.	$ -	Income Tax All.	$ -	Income Tax All.	$ 54	Income Tax All.	$ 81
Cost of Service	$1,000	Cost of Service	$1,000	Cost of Service	$1,054	Cost of Service	$1,081
Pretax Return	$ 100	Pretax Return	$ 100	Pretax Return	$ 154	Pretax Return	$ 181
(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)		(Sum of the after-tax return plus income tax allowance)	
Partner Pretax Income/Return	$ 100	No Pass Through Same as above	N.A.	Partner Pretax Income/Return	$ 154	No Pass Through Same as above	N.A.
Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 35	Tax at 35 Percent	$ 54	Tax at 35 Percent	$ 63
After Tax Income	$ 65	After Tax Income	$ 65	After Tax Income	$ 100	After Tax Income	$ 118
Return on Equity	6.5%	Return on Equity	6.5%	Return on Equity	10.0%	Return on Equity	11.8%
Partner After tax Income/Return	$ 65	Corporate Dividend	$ 65	Partner After tax Income/Return	$ 100	Corporate Dividend	$ 118
		Shareholder Rate	15%			Shareholder Rate	15%
		Dollar Tax Paid	$ 10			Dollar Tax Paid	$ 18
		After Tax Return	$ 55			After Tax Return	$ 100
Partner Value	$ 650	Shareholder Value	$ 553	Partner Value	$1,000	Shareholder Value	$1,000
Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	No	Does Equity Earn the Required Return?	Yes	Does Equity Earn the Required Return?	Exceeds

Conclusion – When the dividend marginal tax rate is 15 percent both the partnership and the corporation earn their required return and thus their regulatory cost of service when the comparison of returns is at the entity level but the corporation over-recovers its cost of service.

c. Reprise of Opinion No. 511

322. The previous sections in this part of the order have explained why an MLP will not recover its regulatory cost of service if denied an income tax allowance because the Commission's rate design methodology does not permit a jurisdictional entity to gross up operating revenue or the pipeline's return component to recover the income taxes on the after-tax return derived from the Commission's DCF model.[506] The analysis in Opinion No. 511 was more narrowly focused and held that denying an MLP an income tax allowance would have two results. First, the MLP would have lower after-tax cash flow than a corporation, as was affirmed in *ExxonMobil*.[507] Second, the MLP after-tax dollar return and the price of the MLP equity interests would drop relative to those of a corporation, but the MLP equity owner and the shareholder would continue to have the same percentage ROE because the price of the securities would adjust to reflect the difference in the after-tax cash flow.[508] Opinion No. 511 also held that while the distributions or dividends to pay income taxes on distributive income is reflected in the ROEs generated by the DCF model, the argument of a double-recovery of an MLP's partners income tax allowance was incorrect because corporations and MLPs have the same revenue requirements.[509] In doing so, Opinion No. 511 relied in part on Ex. SFP-98 and Ex. SFP-99 to conclude that granting an MLP an income tax allowance will not provide a higher ROE to the MLP investor or cause a higher revenue requirement for the MLP than for a shareholder or the corporation. Thus, Opinion No. 511 held there is no double recovery of an MLP partner's income tax liability from an MLP income tax allowance.[510]

323. In their rehearing requests, the Shipper Parties placed increased reliance on the Ex. SFP-98 and Ex. SFP-99 to assert[511] that (1) Opinion No. 511 concedes that the after-tax

---

[506] Opinion No. 511, 134 FERC ¶ 61,121 at P 263.

[507] *Id.* P 264, 301.

[508] *Id.* P 245-46, 249, 261.

[509] *Id.* P 250.

[510] *Id.* P 249-250, 265.

[511] ExxonMobil/BP at 16, 17-18, 20-21, 22-23; ACV Rehearing at 18, 24. The arguments regarding Ex. SFP-98 and Ex. SFP-99 are within the bounds of a rehearing request of despite the fact that they were embedded in a section of ExxonMobil/BP's request for rehearing captioned by a reference to the East Line initial decision in Docket

(continued…)

dollar returns of a MLP partner and a corporate shareholder will be the same only if the MLP is denied an income tax allowance, and (2) that Ex. SFP-98 and Ex. SFP-99 support this conclusion because they demonstrate that an MLP income tax allowance double counts cash flow required to pay a partner's income tax liability.[512] ExxonMobil/BP further contends that SFPP's own witness Dr. Schink agreed that a jurisdictional MLP can obtain an adequate return without an income tax allowance.[513] They therefore again conclude that an income tax allowance is unnecessary to recover an MLP partner's income taxes as the necessary cash flow is reflected in the ROEs calculated by the Commission's DCF model.[514]

324. The Commission denies the double recovery rehearing requests consistent with its rulings in Opinion No. 511. Opinion No. 511 explained that the after-tax cash flow of an MLP partner and a corporate shareholder will differ depending on (1) whether the MLP is provided an income tax allowance, and (2) the level of the marginal tax rate on corporate dividends. The analysis in Opinion No. 511 relied on the fundamental fact that a greater distribution or dividend will result in a higher stock price and a lower distribution or dividend will result in lower stock price because prices adjust to reflect the same after-tax return.[515] In doing so Opinion No. 511 did not concede that the income tax allowance was a double recovery of the investor's income tax cost, that an income tax allowance resulted in an artificial cost, or that the fact that the ROE reflects an after-tax cost support this conclusion. The statement that an ROE analysis must reflect a pre-tax yield 8 percent to reflect an ROE yield of 6 percent did not mean that Opinion No. 511 conceded that the gross up to 8 percent is reflected in the regulatory return component of a jurisdictional entity's regulatory cost-of-service.

No. IS09-437-000. *Id.* at 19-20. Therefore the arguments are addressed here but without regard to the East Line ID.

[512] ExxonMobil/BP Rehearing at 18, 21, 22-23; ACV Rehearing at 24.

[513] ExxonMobil/BP Rehearing at 16.

[514] ExxonMobil/BP Rehearing at 16, 20-21, 25; ACV Rehearing at 18-19, 24-26, 29-30.

[515] *Cf.* Opinion No. 511, 134 FERC ¶ 61,121 at P 246-249. This conclusion is implicit in Opinion No. 511's discussion of the relative cash flows of an MLP pipeline and a corporate pipeline with and without an income tax allowance, but is not explicitly stated.

325. In fact, in examining a jurisdictional entity's cost of service and cash flows Opinion No. 511 reached the same conclusion as the court's example in *ExxonMobil*,[516] namely that absent an income tax allowance a jurisdictional MLP (and its partners) will not have as much after-tax return (or cash) as that of a jurisdictional corporation. Opinion No. 511 thus concluded that a jurisdictional MLP will have lower after-tax cash flow if denied an income tax allowance. It thus followed the MLP would have a lower security price than a corporation if denied an income tax allowance. This necessarily supports the conclusion in *ExxonMobil* that "termination of the allowance would clearly act as a disincentive for the use of the partnership format, because it would lower the returns of partnerships vis-à-vis corporations, and because it would prevent certain investors from realizing the benefits of a consolidated income tax return."[517] As noted, Opinion No. 511 assumed that a jurisdictional MLP would not recover its regulatory cost of service if denied an income tax allowance.[518] The earlier analysis in this order shows that this would be the case and thus that the ultimate conclusions in Opinion No. 511 are correct.

326. Turning now to Ex. SFP-98 and Ex. SFP-99, these exhibits were developed for two purposes. The first was to display the proper format for comparing the after-tax percentage ROEs of partners and shareholders and thereby display how the relative price MLP and how the equity interests adjust to reflect the difference in the after-tax cash flows of a partner and a shareholder. Both exhibits start with a required after-tax percent equity return (line 1), gross up the percentage ROE (not dollars) to the required pre-tax percent ROE (line 3), state several cost of service assumptions (lines 6-12) determine the after-tax cash flow available to the MLP unit holder and the shareholder (line 21), and then calculate an imputed share price (line 25), the investor's after-tax percent ROE (line 26), and the resulting DCF ROE (line 27).[519] These two SFPP exhibits do support two conclusions in Opinion No. 511 as they stand. First, that with or without an income tax allowance the after-tax percentage ROE is the same for the partner and the shareholder as the price of the equity interests always adjusts to obtain that result. This is also the conclusion of the Ex. SFP-96 and Ex. SFP-97, which corrected Dr. Horst's Table 2 testimony that the difference in the ROE's of an MLP and corporate gas pipeline in 2007

---

[516] *ExxonMobil*, 487 F.3d at 953.

[517] *Id.* at 952-53 (affirming the Commission's rationale).

[518] Opinion No. 511, 134 FERC ¶ 61,121 at P 261, 263-264.

[519] *See* Ex. SFP-98 and Ex. SFP-99 (both of which were included, respectively, as Appendix B and Appendix C to Opinion No. 511).

and 2008 was caused by an MLP income tax allowance.[520] Second, Ex. SFP-98 shows that if an MLP is afforded an income tax allowance, the revenue requirement of an MLP pipeline is no greater than that of a corporate pipeline, but affords the MLP partner a higher after-tax cash distribution. However, this does not result in a higher percent ROE to the MLP investor. Rather an MLP partner pays a higher price for an equity interest due to the greater after-tax cash distributions as the equity prices adjust to reflect the higher after-tax cash flow that is available to the MLP partners. Ex. SFP-99 shows that the revenue requirement is necessarily lower if an MLP is not afforded an income tax allowance, and the dollar and the percentage ROE is the same to the partner and the shareholder but incorrectly assumes that the MLP is recovering its regulatory cost of service.[521]

327. However it became apparent on review that both the cited SFPP exhibits contain a methodological error in structuring a jurisdictional entity's cash flow and income statement and do not reflect how these statements should function in the context of Commission ratemaking. This is because the required dollar return stated in both exhibits is grossed up to reflect the required pre-tax equity ROE for both the MLP and the corporation in contradiction to the Commission's rate design methodology. That methodology provides that that the after-tax return is not grossed up to cover the income taxes on the pipeline's net income. Rather an income tax allowance is provided instead of the gross up of the return. Therefore, if an income tax allowance is added to the analysis in Ex. SFP-98 and SFP-99 in addition to the exhibit's grossing up of the after-tax return, this will overstate the revenue requirement of both the MLP and the corporate pipeline because the necessary income tax gross up is already reflected in the dollar return component of both entities. Because the cited exhibits incorrectly include both a gross up of the equity return and an income tax allowance, they give an impression that an income tax allowance over-recovers the MLPs cost-of service.[522] However if

---

[520] *See* Ex. SFP-97 and Ex. SFP-98.

[521] Ex. SFP-99, lines 25 and 27. As discussed below, this exhibit assumes that both the MLP and the corporation are grossing up the return component of their cost of service. The corporation receives an income tax allowance in addition to the gross up but the MLP does not. Under the Commission's rate design methodology neither the corporation nor the MLP would be permitted to gross up the revenue component of their cost of service. If Ex. SFPP-99 reflected this practice the MLP would not recover its regulatory cost of service.

[522] In this regard Ex. SFP-98 and Ex. SFP-99 apply a pre-tax rate of return of 13.8 percent to the equity base to get the after-tax dollar return on rate base, or the $6,900,000 on line 13, which when included in the revenue requirement reflects the grossed-up

(continued…)

Ex. SFP-99 is revised to reflect Commission rate design methodology by eliminating the return gross up, it would show that the MLP will not recover its after-tax return or its regulatory cost of service because the MLP will have neither grossed up its return nor obtained an income tax allowance. By removing the gross up of the dollar return from both the MLP and corporate formats in Ex. SFP-98 and Ex. SFP-99, both exhibits will then establish the Commission's points that (1) there is no double recovery of the income tax liability, (2) the revenue requirement of a partnership and a corporation is the same, and (3) a jurisdictional MLP will not recover its revenue requirement without an income tax allowance. Appendix D contains a partial modification of Ex. SFP-99 to reflect the proper method for stating the required dollar equity return under the Commission's rate design methodology.

328. To clarify this matter further it should be noted that the Commission's Table 6 reaches many of the same conclusions as Ex. SFP-98 and Ex. SFP-99, but without the error of the gross up of the dollar return. Examples 3 and Example 4 of Table 6 show that if the MLP is provided an income tax allowance, then the after-tax dollar return of the MLP partner is $100 and the after-tax dollar return to the corporate shareholder is $65. The capitalized values are $1000 and $650, respectively. However, the ROE at the MLP and corporate entity level is the same for both the after-tax dollar return and the percent ROE. In contrast, Examples 1 and 4 of Table 6 show that if the MLP is denied an income tax allowance at a marginal tax rate of 35 percent, then the partner and the shareholder will also have the same after-tax dollar return of $65 and the capitalized value of their equity interests is $650. Thus Examples 1 and 2 in Table 6 demonstrate that neither the partnership nor the corporation earns its required after-tax equity cost of capital or its regulatory cost of service if either is denied an income tax allowance. Only when the Commission adds back in the income tax allowance as a separate rate element to the rate design will a jurisdictional entity recover its regulatory cost of service. Although Opinion No. 511 did not expressly discuss this limitation of Ex. SFP-98 and Ex. SFP-99, Tables 3 through 6 demonstrate that Opinion No. 511 correctly concluded that an MLP has a higher market value than a corporation results from the tax implications of the corporate structure not the Commission's income tax allowance policy.[523]

---

revenue necessary to obtain the required equity return. As such, both these SFPP exhibits reflect an investor's approach to a DCF model and assume the investor's view reflects the cash flow and income statements resulting from the Commission's rate design methodology.

[523] Opinion No. 511, 134 FERC ¶ 61,121 at 249, 257, 301.

329. Finally, it should be noted that contrary to the Shipper Parties' assertions, Dr. Schink denied that there was a double recovery on the income tax allowance.[524] What he stated was that if there is no income tax allowance, the value represented by the absence of that allowance accrues to the shippers through lower rates. Likewise, if there is an income tax allowance, the dollar value of the income tax allowance will accrue to the MLP through higher rates.[525] It does not follow from this conclusion, however, that there is a double recovery of the MLP's income tax allowance or that an income tax allowance is an improper component of an MLP's cost of service. Rather, the transcript's related discussion of "tax savings" is directed to the Shipper Parties' argument that the absence of double taxation of an MLP partner's income produces tax savings at the entity level. The Shipper Parties first assert that a MLP and its partners have only one level of taxes compared to the two levels of taxes paid by a corporation and its shareholders. They then assert that this difference is reflected in the fact that while an MLP only has to gross up to $154 to cover the taxes of the partners, a corporation has to gross up to $237 to cover the taxes of the corporation and the shareholder. They assert that the difference of $83 is a savings that should be reflected in a lower cost of service for the MLP[526] and conclude that the MLP should have lower rates than the corporation because the "tax savings" from the absence of double taxation will be passed through to the rate payers.[527]

330. But their assumption is incorrect. Under conditions of competition the only difference in the two firms is their business form and both are price takers.[528] As such they will only be able to gross up their revenues to cover the taxes required on the revenue earned at the business entity level that is on their net operating revenue. This is true because competition precludes the corporation from obtaining the higher gross up

[524] *See* Tr. 595-95.

[525] *See* Tr. 533-542.

[526] ExxonMobil/BP Rehearing at 24, 30-31; ACV Rehearing at 24-26.

[527] ExxonMobil/BP Rehearing at 38, 41, 44, 48, 53-54; ACV Rehearing at 41-42, 44-47.

[528] Because competition determines both firms' costs (their inputs) and the prices they can charge, they are price takers. On rehearing the Shipper Parties expand the concept of competition between the MLP and the corporation beyond that stated in Opinion No. 511, but fail to recognize that competition requires both firms to have the same revenue requirements and that their revenue will be limited to that of the firm with the lowest operating and cost of capital cost.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

needed to cover the additional income taxes on shareholder's distributions. Similarly, under Commission regulation, an MLP and a corporation are both limited to their actual operating costs (including depreciation) and their cost of capital, which includes an ROE. Under Commission regulation, both entities are also limited to an income tax allowance which takes the place of the return gross up that occurs under conditions of competition. Thus, as Tables 2 through 6 demonstrate, their cost of service will be the same and their after-tax dollar return and ROE will be the same at the entity level. Contrary to the Shipper Parties' assertions, the income tax "savings" occur at the investor level because the MLP partner does not have to pay a second tax on the income received. If there is a marginal tax rate on corporate dividends, then the shareholder must pay it. But, as Table 3 demonstrates, if there is no marginal tax rate on corporate dividends, then the ROE to the partnership, the partner, the corporation, and the shareholder are the same. However, any equivalence of the MLP partner's and the corporate shareholder's after-tax cash returns disappears once there is a marginal tax rate on corporate dividends. In sum, any "tax savings" are strictly at the investor level and are not reflected in an entity's regulatory cost of service. Consequently, there is no merit to the argument that there will be tax savings at the entity level from the lack of double taxation on MLP income these should be reflected in the MLP's cost of service and its rates.

4. **<u>Capital Attraction Standard</u>**

331. On rehearing the Shipper Parties again assert that the granting an MLP an income tax allowance violates the capital attraction standard of *Hope*.[529] As noted the Supreme Court has held that "the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks. That return, must be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital."[530] Regarding this standard, the Shipper Parties again argue that (1) an MLP partner's income tax allowance is recovered through the after-tax ROEs generated by the DCF model, and (2) granting an MLP income tax allowance is a double recovery of the MLP partners' income taxes and thereby violates that capital attraction standard.[531] They contend that Opinion No. 511 erred by holding that an MLP income tax allowance does not violate the capital attraction standard.

332. In Opinion No. 511, the Commission explained the Shipper Parties' capital

[529] ExxonMobil/BP Rehearing at 4-5, 26-28; ACV Rehearing at 17-18, 22.

[530] *Hope*, 320 U.S. at 605.

[531] ExxonMobil/BP Rehearing at 26, 29, 31-32; ACV Rehearing at 22.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

attraction argument was contrary to *ExxonMobil*, where the court had ruled that the Commission had adequately explained that income taxes were a cost to a partnership and therefore the Commission was correct to rule that an income tax allowance was necessary. The Commission also noted that the *ExxonMobil* court had specifically described the capital attraction standard and it concluded that the Commission's adoption of an income tax allowance for partnerships was reasonable under that standard. Therefore, the Commission affirmed the 2009 ID on this point.

333. On rehearing, the Shipper Parties have not given the Commission any reason to reverse that ruling. Rather, the Commission will further expound upon the inadequacies of the Shipper Parties arguments in light of Tables 2 through 6. Table 2 through Table 6 show that if an MLP is denied an income tax allowance, an MLP will not earn enough after-tax revenue (after attribution of the partner's income taxes) to earn the required after-tax ROE on the equity portion of its rate base. Moving beyond the more generic argument presented by those tables, the Shipper Parties assert that the Commission's income tax analysis overlooks the fact that a corporation must gross up its pre-tax income twice in order for a shareholder to obtain the same after-tax dollar and percentage return as an MPL partner. They argue if the corporation has a marginal tax rate of 35 percent and the shareholder a marginal tax rate of 35 percent, then the corporation grosses up revenues first to cover the 35 percent tax and then grosses up the resulting revenue another 35 percent to obtain the total revenue, or percentage, gross up required to cover both the corporation's and the shareholder's income taxes.[532] In contrast, they assert that the unregulated MLP has to gross up only once to cover the 35 percent marginal tax rate on the partner's income. To state the same point in dollar terms, the Shipper Parties assert that an MLP grosses up to $154, pays no taxes, and passes this $154 through to its partners. After paying a 35 percent marginal tax rate, the partner's return is $100. They state the corporate investors also gross up their return to $154 cover the tax on the dividends and the corporation will gross up to $237 in order to pay its taxes. After payment of $83 in corporate taxes, the corporation passes through $154 and the shareholder pays $54 dollars in taxes and earns $100.[533] The Shipper Parties assert this will result in equal dollar returns to partners and shareholders.

334. Shipper Parties' central conclusion from this analysis of the difference between the gross up required by a corporation and a partnership is that an MLP income tax allowance results in unnecessary cash to cover an MLP partner's income tax allowance. They claim it is this extra cash purportedly generated by the income tax allowance that

[532] ExxonMobil/BP Rehearing at 28-29, 32; ACV Rehearing at 24-25.

[533] ExxonMobil/BP Rehearing at 30-32; ACV Rehearing at 24-26, 28-30.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

causes the higher MLP stock price that the Commission concluded resulted from the impact of the double taxation of corporate dividends. The Shipper Parties contend that the difference in the after-tax cash flow between an MLP partner and a shareholder and the resulting adjustment of the shareholder's equity price is only the mirror image consequence of an unnecessary MLP income tax allowance.[534] They then conclude that the only possible way to achieve equality of returns between investors in corporations and MLPs is to remove what they view as the additional cash flows that an MLP partner receives from the inclusion of an income tax allowance in the pipelines regulatory cost of service.[535] Shipper Parties also contend that their analysis invalidates the difference between the second and first tier taxation that underpins the income tax allowance policy as it was affirmed in *ExxonMobil*.[536] Consequently, they advocate equating shareholder dividend income and partnership distributive income contrary to *ExxonMobil's* holding of the difference between first and second tier income.[537]

335. The Commission disagrees. There are two major flaws in the Shipper Parties' argument. The first flaw is the Shipper Parties' continuing assumption that under Commission rate design methodology the gross up reflected in the after-tax returns of FERC jurisdictional MLPs and FERC jurisdictional corporations is reflected in Commission rate design. As discussed earlier in this order at Sections VII.C.1 and 3.b, this is simply incorrect. The second flaw in the Shipper Parties' argument is that they incorrectly assume that a non-jurisdictional corporation can actually obtain the total revenue of $237 to cover the gross up required for both levels of taxation. As noted, an MLP only requires total revenue of $154. But under conditions of competition the gross revenues and operating expenses of the MLP and the corporation will be the same, and therefore so will their pre-tax net operating income. If gross revenues and all other expenses are the same for the corporation and the MLP, the corporation's pre-tax net revenue and return will never exceed $154. As the corporation cannot gross up above $154, the shareholder can only achieve the same after-tax percentage ROE as the partner by paying a lower price for the corporation's stock, in this case to $65. Therefore the equality in after-tax dollar return urged by the Shipper Parties cannot be obtained by

---

[534] ExxonMobil/BP Rehearing at 18, 26, 30, 34, 38; ACV Rehearing at 19.

[535] ExxonMobil/BP Rehearing at 25-288; ACV Rehearing at13, 25.

[536] ExxonMobil/BP Rehearing at 26, 28, 30, 32, 35-36; ACV Rehearing at 19-21, 26-288.

[537] *ExxonMobil*, 487 F.3d at 952, 954-55.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

grossing up the corporation's operating revenues to $237 under conditions of competitive.[538]

336. Similarly, under Commission regulation the corporation is not permitted to gross up to $237 as this would cause the corporation to over-recover its cost of service, as is shown by Table 7.[539] As Table 2 through Table 6 display, given the limitations on gross revenue imposed under the Commission's rate design methodology, both a corporation and an MLP will earn an after-tax return of $100 on their equity after the income tax is added back to the return component. The income tax allowance provides the equivalent of a non-jurisdictional revenue gross up to $154 for both the MLP and the corporation, but the income tax allowance does not duplicate the DCF gross up due to the limitations of the Commission's rate design methodology. As either competition or regulation will

---

[538] *Id.* at 952, 954. The ACV Shippers raise a similar argument. They assert that a corporation must gross up its prices to cover its cash income tax costs and that a MLP need not gross up prices to the same level because the MLP does not have cash income tax costs. They assert that in the short run the MLP will charge prices at the same level as the corporation and have a higher return because it has excess cash flow above its cash operating costs, including its ROE. They assert that over time new firms will enter the market and drive the higher cost corporations out of business and price levels will drop. ACV Rehearing at 46-47. But as has been discussed, this assumes that the corporation under competition can and will price its services above those of the MLP. This is incorrect because the costs of both firms transportation functions and their transportation prices are the same. If the income tax for both (including at the partner level) is 35 percent, then both the MLP and the corporation will price at a level that provides the gross up necessary to cover the taxes on their net operating income. However, competition will prevent the corporation from pricing at a higher level needed to cover the taxes on the shareholder's dividends and therefore the after-tax dollar return to the shareholder is less. Moreover, the ACV Shippers' present no empirical evidence that MLPs, or any other partnership, will put competing corporations out of business due the absence of double taxation. The MLPs will not because a corporation will have the same after-tax return on assets as the partnership. The difference in the after-tax cash flow is reflected at the shareholder level since the after-tax cash flow from operations is the same for both formats. The corporation's higher cost of capital is from the double taxation of its return, which reflected in its share price, not a difference in the corporation's pre-tax operating cash flow.

[539] The exercise of market power would occur because under conditions of competition the corporation cannot obtain higher gross revenues or lower expenses than an MLP, and as such may not have a higher cost of service or revenue requirement.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

constrain the corporation's pre-tax revenue and return, the shareholder adjusts the stock price as revenue is not available to pay the taxes on the dividends.

337. Therefore, contrary to the Shipper Parties' assertions,[540] the Commission's income tax allowance methodology correctly replicates an equity capital market. Under *ExxonMobil*, the first tier of taxable income is that of the partnership as distributed to its partners as well the taxable income of the corporation.[541] The second tier of taxable income stems from the dividends paid to the corporation's shareholders, whose return is not measured against the equity component of the corporation's rate base, but as reflected in the corporation's stock price. As the share price varies based on a combination of the dividend, relative risk, and the marginal tax rate on dividends (all of which the Commission cannot control), it is the entity level regulation that establishes the dollar and percentage return on the equity component of the rate base necessary to assure confidence in the financial integrity of the enterprise. It is also at the entity level (first tier) that the regulation applies the income tax allowance to cover the taxes on the required equity dollar return.[542]

338. Therefore, the Shipper Parties are incorrect that by comparing returns at the entity level the Commission has arbitrarily excluded shareholders from participating in getting the same return on assets as the partners.[543] But this occurs because of double taxation and, as Table 3 shows, if the marginal tax rates on dividends is zero, there will be no difference as the after-tax cash return is the same for the partnership, the partners, the corporation, and the shareholder. The Commission does not control marginal tax rate on dividends; Congress does, and it was Congress that provided MLPs relief from the burden of double taxation on partnership net income. However, given that there is a tax on dividends, the after-tax dollar return and the equity values of the partner and the shareholder will diverge, but the after-tax percentage return of the partner and the shareholder remain the same. For that reason the December 2006 Sepulveda Order incorrectly held that the MLP's financial advantage is at the expense of the MLP's rate

[540] ExxonMobil/BP Rehearing at 48-51, 63-64; ACV Rehearing at 44-47.

[541] *ExxonMobil*, 487 F.3d at 952, 954-55.

[542] *Williston*, 165 F.3d at 56-57.

[543] ExxonMobil/BP Rehearing at 34-36; ACV Rehearing at 28.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

payers.[544] As an MLP income tax allowance does not cause an excessive return for the partners, it is consistent with the *Hope* capital attraction standard.

5. Summary and Conclusion

339. This part of the order has demonstrated that Opinion No. 511 correctly declined to revise the Commission's Income Tax Allowance Policy Statement's conclusion that the proper comparison of regulatory returns should be at the entity level. This part also expands on Opinion No. 511's analysis of *ExxonMobil*'s determination as to whether an MLP would recover its required after-tax return absent an income tax allowance. To this end, the Commission has included Tables 2 through Table 6, which display this point by taking the after-tax dollar amounts used in the court's example and applying them to a hypothetical equity rate base of $1000.[545] Under that analysis, if the required after-tax return is 10 percent, with an income tax allowance the corporation earns $100 of after-tax income on $1000 of equity or a ROE of 10 percent at the entity level. In contrast, if an MLP is denied an income tax allowance, an MLP has only $65 after-tax income on $1000 of equity, or an ROE of 6.5 percent at the entity level. Denying a jurisdictional MLP an income tax allowance creates a rate design that precludes it from having a reasonable opportunity to recover its cost of service contrary to *Hope*.[546]

340. The foregoing also shows that the Income Tax Allowance Policy Statement correctly concluded that the returns of MLP and corporate pipelines should be compared at the entity level, not the investor level. The Commission therefore again concludes here "that a full income tax allowance is necessary to ensure that corporations and partnerships of like risk will earn comparable after-tax returns" and to recover the income tax costs that are properly included in their regulatory costs-of-service.[547] As Opinion No. 511 states, the Shipper Parties' double recovery argument fails because it erroneously considers the taxes an MLP partner pays on the MLP distributed income to be the financial and cost of service equivalent of the taxes a shareholder pays on dividends. *ExxonMobil* recognized that that they are not equivalent because an MLP is a pass-through entity and therefore the partner's income taxes are properly imputed to an MLP's

---

[544] December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 45-46.

[545] *ExxonMobil*, 487 F.3d at 953.

[546] *Cf. Hope*, 320 U.S. at 603 (precluding this result).

[547] *ExxonMobil*, 487 F.3d at 952, 954-55.

regulatory cost of service.[548] Rehearing is denied for all of the preceding income tax allowance issues.

D. Other Legal and Policy Issues

341. This part of the order examines additional legal and policy arguments that have been made on rehearing. They include: (1) Congress's intent in permitting energy MLPs; (2) the interpretation of section 7704 on the IRC; (3) the Commission's stand-alone methodology; (4) whether to adjust SFPP's income tax allowance or return to reflect any tax benefits or savings from the MLP business format; (5) the treatment of accumulated deferred income taxes; and (6) how to calculate the state marginal income tax rates. These issues are discussed in light of the earlier findings that an MLP income tax allowance does not: (1) cause an MLP partner to double recover the income tax liability on distributive income; (2) cause an MLP pipeline to over-recover its cost of service or have a revenue requirement greater than that of a corporate pipeline; or (3) violate the *Hope* capital attraction standard or the just and reasonable rate standard of the ICA.

1. Congressional Purpose in Permitting Energy MLPs

342. Opinion No. 511 concluded that granting a jurisdictional MLP an income allowance was consistent with Congress's purpose of encouraging investment in energy infrastructure by allowing energy partnerships to use the MLP business format.[549] Opinion No. 511 recognized the MLP business form gives an MLP pipeline a financial advantage over a corporate pipeline, but held that a review of the limited legislative materials available established that Congress (1) authorized the use of energy MLPs as a vehicle to encourage investment in energy infrastructure and (2) did not intend to prohibit a jurisdictional MLP from having a regulatory income tax allowance.[550] Opinion No. 511 also held that this interpretation did not create a tax cost where none had existed before, and thus it was consistent with *ExxonMobil's* approval of the use of a MLP income tax allowances in Commission rate design.[551]

---

[548] Opinion No. 511, 134 FERC ¶ 61,121 at P 250.

[549] *Id.* at P 253-258.

[550] *Id.* at P 253, 256-57; *see also* December 2007 Order, 121 FERC ¶ 61,240 at P 29-30.

[551] Opinion No. 511, 134 FERC ¶ 61,121 at. P 265.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

343. The Shipper Parties assert on rehearing that there are no grounds to conclude that Congress intended to provide a jurisdictional MLP pipeline with a regulatory advantage as well as a financial advantage since any regulatory advantage would be at the expense of the rate payers in violation of the rate reasonableness provisions of the ICA.[552] They argue that the Commission erred by concluding that a jurisdictional MLP may have an income tax allowance because Congress was silent on whether such an income tax allowance is lawful. The Shipper Parties assert that an MLP income tax allowance results in an over-recovery of an MLP's regulatory cost of service, therefore, they argue that the Commission has effectively amended through silence the maximum rate provisions of the ICA without specific statutory authorization from Congress to do so.[553]

344. The Commission, however, explained in Sections VII.C.3 and 4 why a jurisdictional MLP will not over-recover its cost of service if granted an income tax allowance and why an MLP partner will not double recover its tax liability on distributed income. The Commission further explained that, to the contrary, a FERC-jurisdictional MLP will not be able to recover its regulatory cost of service if denied an income tax allowance. For this reason, the Commission affirmed that granting an MLP an income tax allowance did not violate the *Hope* capital attraction standard or the rate reasonableness standards of the ICA. In short, if an MLP income tax allowance does not result in a rate that is unjust and unreasonable, as the Commission has held here, then all arguments that the Commission improperly amended the ICA by silence are irrelevant.

345. Moreover, while the legislative history is quite limited, there is no evidence on this record that Congress expressly intended to deny FERC-jurisdictional MLPs a regulatory income tax allowance. Shipper Parties acknowledge that Section 7704 was intended to provide a single level of taxation for entities such as MLP energy pipelines. Their argument, however, is that in the absence of specific authority this exemption does not extend to permitting a jurisdictional MLP income tax allowance as that results in an unlawful over-recovery or because explicit authority is necessary to extent the single taxation format to jurisdictional pipelines. As the prior analysis demonstrates, an MLP pipeline obtains no regulatory advantage over a corporate pipeline if the MLP pipeline is provided an income tax allowance because its jurisdictional cost of service is the same as the corporate pipeline. Therefore the Commission concludes that adopting this argument would create a regulatory structure that would make it impossible for a FERC-jurisdictional MLP to recover its cost of service. Such action would be contrary to *Hope* and its ruling that the Commission may not deny a jurisdictional pipeline a reasonable

[552] ExxonMobil/BP Rehearing at 43, 45; ACV Rehearing at 30-32.

[553] ExxonMobil/BP Rehearing at 45-47; ACV Rehearing at 33-34.

chance to recover its full cost of service at the entity level compared to that of a corporate pipeline.[554] Therefore, consistent with the Commission's rulings in Opinion No. 511, the Commission rules that an MLP pipeline does not have a regulatory advantage over a corporate pipeline.

346. Finally, the Shipper Parties assert that in certain circumstances Congress has specifically precluded jurisdictional entities from capturing the benefits of investment tax credit provisions of section 203(e) of the Revenue Act of 1964 through their rates.[555] The Commission concludes that this limitation was designed to assure that investment tax credit provisions of the Revenue Act of 1964 did not override the Commission's tax normalization practices. Those limitations applied to investment incentives involving investments in the pipeline's rate base. In that regard, the Commission's accounting regulations state that "a pipeline must compute income tax component of its cost of service using tax normalization for all <u>transactions</u>."[556] A transaction means an <u>activity</u> of the pipeline that gives rise to an accounting transaction.[557] The tax effect of a transaction that must be normalized is "the tax reduction or addition associated with a specific expense or revenue transaction."[558] The decision to remove the burden of double taxation by allowing the use of the MLP business format has nothing to do with the pipeline's <u>accounting</u> transactions or the depreciation or amortization of its rate base. This is because the absence of double taxation at the investor level causes no activity giving rise to a <u>specific expense or revenue transaction at the pipeline level</u>.[559] Rather it

---

[554] *Hope*, 320 U.S. at 603.

[555] ACV Rehearing at 49 (citing Revenue Act of 1964, Pub. L. No. 88-272, § 203(e), 78 Stat. 35 and *Kupark Trans. Co.*, 45 FERC ¶ 63,006, at 65,058 (1988), *aff'd* 55 FERC ¶ 61,122, at 61,383 (1991)); *see also* ExxonMobil/BP Rehearing at 49-53.

[556] Tax normalization means computing the income tax component as if the <u>transactions</u> recognized in each period for <u>ratemaking purposes</u> are also recognized in the same amount and in the same period for income tax purposes. 18 C.F.R. § 154.305(b)(1) (2011) (emphasis added).

[557] 18 C.F.R. § 154.305(b)(7) (2011).

[558] 18 C.F.R. §154.305(b)(6) (2011).

[559] Section 154.305(c)(2) of the Commission's regulations states that "rate base reductions or additions must be limited to deferred taxes related to rate base, construction, or other costs and revenues affecting <u>jurisdictional</u> cost-of-service." 18 C.F.R. § 154.305(c)(2) (2011) (emphasis added).

reduces the total tax burden on the net income that results from all accounting transactions of the pipeline's jurisdictional operations. Since the double counting argued by the Shipper Parties does not exist, it is hard to see why Congress would deprive an MLP pipeline the benefits of the MLP format through silence when Congress did so explicitly regarding the investment tax credit provisions of the Revenue Act of 1964. This would certainly seem to be the case when denying an MLP an income tax allowance means that an MLP would under-recover its cost of service and obtaining an after-tax return on its rate base less favorable than those of a corporate pipeline. As stated in *ExxonMobil*, this would be a clear disincentive to investment in the MLP business model.[560] The use of normalization at the pipeline operating level has no such penalty. Rehearing is denied.

2. <u>Interpretation of Section 7704 of the IRC</u>

347. Opinion No. 511 held that any benefits from the absence of double taxation or tax deferrals were for the benefits of the investors and the MLP in order to encourage investment in the interstate pipeline system.[561] The Shipper Parties advance several arguments asserting that the Commission incorrectly interpreted the purpose and legislative history of section 7704 of the IRC, which authorized the creation of energy MLPs. These include that: (1) section 7704 did not authorize income tax allowances for FERC-jurisdictional MLPs;[562] (2) the Commission's interpretation of section 7704 improperly amended the ICA;[563] (3) the Commission did not properly interpret the context in which the section was enacted;[564] (4) the legislative history cited by the Commission does not support its interpretation;[565] (5) the committees responsible for the oversight of the ICA did not address section 7704;[566] (6) Congress did not intend an MLP to retain any tax savings and has specifically stated when it wished a jurisdictional entity

---

[560] *ExxonMobil*, 486 F.3d at 952-53.

[561] Opinion No. 511, 134 FERC ¶ 61,121 at P 258, 306, 308.

[562] ExxonMobil/BP Rehearing at 42-43; 51-52; ACV Rehearing at 30-31, 37-38, 38-39.

[563] ExxonMobil/BP Rehearing at 53-57; ACV Rehearing at 35-36, 38-39.

[564] ExxonMobil/BP Rehearing at 44-45; ACV Rehearing at 33-35.

[565] ExxonMobil/BP Rehearing at 42-44; ACV Rehearing at 50-55.

[566] ACV Rehearing at 55-57.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

to do so;[567] (7) an income tax allowance is not necessary to enable FERC-jurisdictional MLPs to duplicate the results of non-jurisdictional MLPs;[568] (8) the Commission had previously determined in *Lakehead* that an MLP income tax allowance is not necessary to encourage investment in pipeline infrastructure;[569] and (9) that *Lakehead* correctly concluded that section 7704 did not require an income tax allowance because partnerships do not have income tax cost.[570] They also assert that *BP West Coast* held that the enactment of section 7704 did not authorize the Commission to provide investment incentives if this meant creating a regulatory cost where one does not exist and that is what the Commission did through its income tax allowance policies.[571]

348. As discussed in Section VII.D.1 above, the Commission rejected the arguments that (1) Congress did not authorize jurisdictional MLPs to have an income tax allowance because there are no express provisions denying such MLPs an income tax allowance, and (2) that the Commission amended the ICA by silence. The Commission agrees with ExxonMobil that Congress did not include language explicitly restricting the tax benefits of investment from section 7704 in the same manner as Congress restricted those that would flow from the investment tax credits under the Revenue Act of 1962. However, the Commission does not agree with ExxonMobil that in the absence of any explicit restrictive statutory language, *BP West Coast* nonetheless requires the Commission to deny jurisdictional MLPs the benefits of any income tax allowance since *BP West Coast* requires ratepayers to obtain all tax savings.[572] To this end, ExxonMobil relies on statutory silence to reach this conclusion by assuming that *BP West Coast* purportedly requires that all tax savings of any kind must be passed through to the ratepayers and, (3) that the avoidance of double taxation is a tax savings that is reflected in the MLP's regulatory cost of service. Both assumptions are demonstrably incorrect.

349. Neither *City of Charlottesville* nor *BP West Coast* held that the Commission must pass through all tax savings to the ratepayer.[573] Rather *BP West Coast* held that income

---

[567] ExxonMobil/BP Rehearing at 51-55; ACV Rehearing at 41-43, 49-50.

[568] ACV Rehearing at 44-47.

[569] ExxonMobil/BP Rehearing at 49-50; ACV Rehearing at 47-48.

[570] ExxonMobil/BP Rehearing at 51-52; ACV Rehearing at 30-31.

[571] ExxonMobil/BP Rehearing at 43-44; ACV Rehearing at 31.

[572] ExxonMobil Request for Rehearing at 52-53.

[573] *City of Charlottesville*, 774 F.2d 1205, 1211, 1215-16.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

tax costs are the same as any other costs and that the costs of a parent company may not be included in the cost of service of a jurisdictional subsidiary. *BP West Coast* therefore concluded that because an income tax cost is not actually incurred by the jurisdictional pipeline whose rates are at issue, a partnership pipeline may not be afforded an income tax allowance. The court ruled that this is true whether or not the partners involved were corporations or individuals.[574] After *BP West Coast*, the Commission issued its Income Tax Allowance Policy Statement explaining why income taxes are not the same as all other costs.[575] *ExxonMobil* affirmed the Commission's analysis by holding that income taxes were a legitimate component of a FERC-jurisdictional partnership's cost of service.[576] As such, there is no logical connection between Congress's decision not to deny MLPs an income tax allowance and the reference to a legal point on which *BP West Coast* is itself silent.

350. Second, it is also incorrect that the elimination of double taxation creates an income tax savings at the entity level. While income taxes are a legitimate part of an MLP's regulatory cost of service, the marginal tax rate to be applied to the equity return component of the MLP's cost of service is based on the weighted average of the MLP's partners. While the marginal tax rate is applied at the entity level, as with a corporation, in the case of the MLP the taxes are paid at the investor level due to the pass through nature of the MLP. Taxes are also paid at the shareholder level, but this is the second tier income tax in addition to the income taxes that are paid at the corporate entity level. It is the absence of the second level of taxation that results in the tax savings for the MLP partner.

351. Moreover, the MLP income tax allowance does not create an improper investment incentive by creating an income tax cost where one would not have otherwise existed. This is because there is no double recovery of the MLP partner's income tax liability, and therefore the Commission is not creating regulatory cost where one would otherwise not exist in violation of the holding in *BP West Coast*.[577] Given the findings in this order that part of *BP West Coast* is not controlling since *ExxonMobil's* held that an income tax allowance properly imputes the MLP partner's income tax cost to MLP.[578] Thus Opinion

[574] *BP West Coast*, 374 F.3d 1263, 1291-92.

[575] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 9, 21-22.

[576] *ExxonMobil*, 487 F.3d at 945-55.

[577] *BP West Coast*, 374 F.3d at 1292-94.

[578] *ExxonMobil*, 487 F.3d at 945-55.

No. 511 correctly held that an MLP income tax allowance is necessary to achieve the investment goals of section 7704 but this ruling does not create an improper incentive for investment at the expense of the rate payers.[579] Conversely, denying an MLP income tax allowance would be a disincentive to investment.

352. Shipper Parties also argue that Congress intended to restrict the scope of section 7704 based on the Treasury Department's complete opposition to that section.[580] However, Congress passed the bill over the Treasury Department's opposition and did not restrict MLPs from benefiting from its provisions. This is in contrast to the explicit limitations that were placed on the investment incentive provisions of the Revenue Act of 1964 that were discussed earlier in this order. The Shipper Parties also assert that the Congressional committees responsible for the oversight of the ICA did not review or take action on section 7704.[581] Because the Commission has not amended the ICA through its Income Tax Allowance Policy Statement, any argument based on the Commission's purported oversight responsibility of Congress is irrelevant as the Commission does not have jurisdiction over Congress. In fact, Shipper Parties' own analysis belies their argument. Indeed, there is no express statutory language or legislative history stating that MLP pipelines may not have an income tax allowance. As such, the Shipper Parties' arguments rely on inferences based on portions of the legislative history that are inconsistent with what Congress actually did in enacting section 7704.

353. Turning to the Commission's prior interpretations of section 7704, it is true that the Commission's 1994 decision in *Lakehead* stated that partnerships did not need an income tax allowance because the partnership format alone provided enough incentives for investment without a tax allowance, and that in any event section 7704 did not authorize the recovery of a non-existent tax cost.[582] However both conclusions were over-ruled by the Commission's Income Tax Allowance Policy Statement[583] and that Policy Statement was affirmed by *ExxonMobil's* holding that the an MLP income tax

[579] Opinion No. 511, 134 FERC ¶ 61,121 at P 265.

[580] ACV Rehearing at 54-55.

[581] *Id.* at 55-57.

[582] *Lakehead Pipe Line Company, L.P.*, Opinion No. 397, 71 FERC ¶ 61,338 (1995), *reh'g denied*, Opinion No. 397-A, 75 FERC ¶ 61,181 (1996) (*Lakehead*).

[583] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 1, 32-33, 38-40.

allowance does not create a non-existent tax cost.[584] That conclusion has been reaffirmed here based on the detailed financial and cost analysis in this order. As such, the Commission views *ExxonMobil* as having explicitly overruled *BP West Coast's* holding that the Commission could not use a need for investment incentives to create a cost where one does not otherwise exist. *ExxonMobil* could not have been clearer that this argument is no longer relevant if one concludes that an income tax allowance is properly included in an MLP pipeline's regulatory cost of service. Given that income taxes do not over-recover an MLP's income tax allowance and are a cost properly included in an MLP's regulatory cost of service, albeit indirectly, it is rational to conclude that denying a jurisdictional MLP its ability to recover its regulatory cost of service will reduce the incentive to use in MLP's regardless of whatever other benefits might flow from that business format.[585] Rehearing is denied for the reasons stated.

3. <u>Commission's Stand-Alone Policy</u>

354. Opinion No. 511 held that an MLP income tax allowance did not violate the Commission's stand-alone policy.[586] On rehearing, Shipper Parties assert that there are two aspects of MLP tax accounting practices that violate the Commission's stand-alone policy. The first is that allocating income to a general partner in proportion to the cash distributed to the general partner under the incentive distribution provisions of many MLP partnership agreements violate of the Commission's stand alone policy.[587] The second is the practice of providing additional depreciation to KMEP's limited partners under section 743(b) of the IRC.[588] Shipper Parties assert that Opinion No. 511 should have held that these MLP accounting practices violate the stand-alone policy. They also make several secondary arguments to the same affect.

355. Opinion No. 511 explained that the Commission's stand-alone policy separates the cost of service calculations and the accounting records of a jurisdictional subsidiary from

[584] *ExxonMobil*, 487 F.3d at 953-55.

[585] *Id.* at 952-53.

[586] Opinion No. 511, 134 FERC ¶ 61,121 at P 287-289.

[587] ACV Rehearing at 57-58, 62-64.

[588] ExxonMobil/BP Rehearing at 65-67.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

that of its jurisdictional parent.[589] What is most relevant here is that under the traditional stand-alone analysis, the dollar amount of an income tax allowance would be determined by applying the relevant marginal tax rate to the net income of a corporate subsidiary and not combining that subsidiary's net income with that of a parent company to determine the marginal tax rate. Similarly, the depreciation accounts of the subsidiary and the parent company are separated. As such, under *City of Charlottesville* there is no obligation to adjust the income tax allowance for deferrals in the year they occur when these flow from the parent company's non-jurisdictional activities.[590] The Commission further notes that before the adoption of the Income Tax Allowance Policy Statement, partnerships were treated like corporate subsidiaries for purposes of the stand-alone methodology because the *Lakehead* doctrine permitted an income tax allowance on the income that was attributed to the parent corporation, i.e. the parent's numerical partnership interests.[591] Thus, the limited use of jurisdictional pipeline partnerships prior to the early 1990's did not normally raise stand-alone issues before the increased use of the MLP business form.

a. Incentive Distributions

356. The ACV Shipper's argue that the Opinion No. 511 leaves to the general partners' undue discretion how to define how the income tax allowance is determined by the amount of income that may be shifted.[592] Opinion No. 511 explained, however, that income shifts from incentive distributions are a function of a lawful partnership structure and as such properly reflects the partnership's tax cost because that cost is the actual or potential tax burden the partners do or will incur on their distributed income.[593] It is true that the Commission does not control the amount of the income that may be shifted to the general partner through the use of incentive distributions, but there is nothing illegal about provisions that are used throughout partnerships, not just in the context of MLPs.

---

[589] Opinion No. 511, 134 FERC ¶ 61,121 at P 287, 289. *See also* December 2007 Order, 121 FERC ¶ 61,240 at P 41.

[590] *City of Charlottesville v. FERC*, 774 F.2d 1205 (1985) (*City of Charlottesville*).

[591] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 32-33. *See also* December 2007 Order, 121 FERC ¶ 61,240 at P 27.

[592] ACV Rehearing at 63-65.

[593] Opinion No. 511, 134 FERC ¶ 61,121 at P 291.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

357. The ACV Shipper's also argue that the shift in distributed income inequitably shifts SFPP's marginal tax rate toward the higher corporate marginal tax rate compared to that of other income categories used to determine the weighted marginal tax rate. This is true with regard to the income that is shifted, but this is a function of a lawful partnership business form, not the Commission's income tax allowance policy. Moreover, the weighted tax calculation is based on the income distributed to the six partnership categories used to develop the jurisdictional entity's weighted marginal tax rate, not the taxable income of a partner that results after all costs and credits that may offset distributed income when a partner prepares an IRS return. As long as the use of the MLP format results in a lower marginal tax rate on jurisdictional income, the rate payers are no worse off than they would be from using the corporate 35 percent marginal tax rate.

358. As discussed in Opinion No. 511, under an incentive distribution provision cash distributions provide a general partner an increasing percentage of distributed cash as the amount of cash available for distribution increases, to as much as forty-nine percent, hence the term incentive distributions. Opinion No. 511 further explained that dollar income is allocated to the general partner in proportion to the dollar amount of the distribution. This usually allocates income away from the limited partners while leaving their allocation of the partnership's expenses unchanged.[594] There are two consequences of such an allocation. The Commission's income tax allowance is based on the weighted income tax cost of distributed partnership income.[595] Thus, if the general partner has a book partnership interest of one percent, the limited partners have a ninety-nine percent interest in the partnership assets. Absent the incentive distribution provision, the limited partners would be allocated ninety-nine percent of distributive income and their collective marginal tax rate would apply thereto. However, if forty-nine percent of distributive income is allocated to the general partner, (usually a corporation), then the marginal tax rate of the corporation will apply to the fifty percent of income so allocated. The limited partners' marginal tax rate, which is usually collectively lower than that of a corporation, would then apply to only fifty percent rather than ninety-nine percent of the partnership income. Therefore this shift in distributed income increases the weighted marginal tax rate of the partnership as a whole. Moreover, allocation of distributed income away from the limited partners may result in a tax loss as their income is reduced,

---

[594] Opinion No. 511, 134 FERC ¶ 61,121 at P 285, 291.

[595] *Id.* P 266, 276, 285, 291; *see also ExxonMobil*, 487 F.3d at 952, 954; December 2007 Order, 121 FERC ¶ 61,240 at P 46-47, 51.

but their share of distributed expenses is not. Thus incentive distributions allocated to the general partner can be a major source of tax deferrals for the limited partners.[596]

359. At bottom, failure to reflect the income allocated to the general partner under the incentive distribution provisions would understate the actual or potential income tax cost of the partnership and thereby understate the partnership's regulatory cost of service. This would be inconsistent with *Hope* and its requirement that the partnership have a reasonable opportunity to recover its cost of service and return on the equity invested in the firm. It would also deter the use of consolidated returns in some cases where that would be economically efficient for some public utility investments.[597] Opinion No. 511 therefore correctly recognized that a practical adjustment must be made to the stand-alone doctrine to accommodate MLP tax accounting practices in a manner consistent with the recovery of the MLP's regulatory cost of service.[598]

b. Section 743(b) Depreciation

360. The additional depreciation a partner receives under an IRC section 743(b) adjustment is unique to each partner. As stated in Opinion No. 511, such depreciation reflects the amortization of the difference between the book equity value of a partnership interest and the price paid for the partnership interest at the time it was acquired.[599] The depreciation rate to recover the difference is based on the composite depreciation rate of the partnership. On rehearing the ExxonMobil/BP assert that because the dollar amount of the section 743(b) depreciation deduction reflects the depreciation rate of the partnership's assets, that amount is therefore part of the jurisdictional entity's cost of service.[600] They state that the dollar amount of this depreciation, which is a deduction on a partner's K-1 federal income information form and on the partner's tax return, often results in negative partnership taxable income for the partner and therefore often causes an income tax deferral. Thus, as with other deferrals that are caused by the pipeline's

[596] Opinion No. 511, 134 FERC ¶ 61,121 at P 305; December 2007 Order, 121 FERC ¶ 61,240 at P 56-57.

[597] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 29; *ExxonMobil*, 487 F.3d at 952-53.

[598] *See* December 2007 Order, 121 FERC ¶ 61,240 at P 57-58.

[599] Opinion No. 511, 134 FERC ¶ 61,121 at P 310-311.

[600] ExxonMobil/BP Rehearing at 62-63, 66-67.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

cost of service, ExxonMobil/BP would address this concern by adjusting the pipeline's return for any benefits that flow to the limited partners from such deferrals.[601]

361. The Commission finds that ExxonMobil/BP is incorrect that there is a cost of service linkage between the depreciation account of a specific jurisdictional entity and a limited partner's section 743(b) deduction. One of ExxonMobil/BP's own witnesses recognizes that the amount of the section 743(b) depreciation is unique to each partner and that it reflects the difference between the unit market price of each such interest and the book value of the partnership interest at the time of purchase.[602] Of importance here is that the depreciation rate of the KMEP partnership, and not that of SFPP's jurisdictional rate base, that defines the section 743(b) deduction that is applied when the KMEP partnership interest is purchased. This means that for the some 50,000 KMEP limited partners there is a different 743(b) dollar depreciation rate for each of the partnership interests that those limited partners purchased at different times. The depreciation rate for the KMEP partnership depreciation is in turn derived from a large number of jurisdictional and non-jurisdiction operations, each with its own depreciation rate.

362. In fact, as Dr. Horst stated in his Prepared Answering Testimony and the Shipper Parties recognize on rehearing, it is impossible to normalize the depreciation rate of the individual partners based on the difference in depreciation rates of the limited partners developed at the time those partners purchased their KMEP partnership interests.[603] This would seem to undercut Shipper Parties' position that the section 743(b) deduction violates the stand-alone doctrine. But more fundamentally, while the composite KMEP depreciation rate at issue is derived in part from SFPP's own composite depreciation rate, the section 743(b) depreciation rate is not part of SFPP's regulatory cost of service. As was previously discussed, under the Commission's accounting regulations normalization applies only to tax affects of a transaction and activity that involves the jurisdictional entity's cost of service. In fact, the section 743(b) depreciation does not even effect the calculation of the income tax allowance because the latter is calculated on the allocations of distributed partnership income. The section 743(b) deduction offsets distributed income at the level of the individual partner and thus may lead to negative taxable income and income tax deferrals at that level. Therefore, any adjustment to reflect

[601] *Id.* at 63-65.

[602] *See* Prepared Answering Testimony of Christopher P. Sintetos on behalf of BP West Coast Products LLC, Ex. BPW-6 at 39.

[603] *Id.*

20111216-4007 FERC PDF (Unofficial) 12/16/2011

benefits that may flow from the section 743(b) deduction is not properly grounded in the stand-alone doctrine because the so-called tax savings are not reflected in the jurisdictional entity's cost of service.

c. Other Stand-alone arguments

363. The ACV Shippers raise two further arguments that relate to partnership accounting in the context of the Commission's stand-alone policy. They first assert that because the stand-alone method separates the jurisdictional entity's revenues and expenses from those of parent, the Commission incorrectly allows the aggregation of income at the KMEP and the partner's level, but does not require the aggregation of all expenses or credits at the partner level. They also appear to conclude that the Commission inconsistently treats the distributed income that occurs at the partner level, but does not offset that income by the credits and tax savings that occur at the partnership level. They thus conclude that the marginal tax rate is improperly determined at the KMEP level, not that of SFPP.[604]

There is no merit to this position. KMEP consists of a series of interlocking partnerships, one of which is SFPP. Under basic partnership law at each level the expense of each such affiliate offsets the operating income of the same affiliate and both the income and expenses flow up through the partnership chain. Thus the net income of all KMEP's

---

[604] ACV Rehearing at 61-62. ACV Shippers incorrectly state that the December 2007 Order held that the marginal tax rate should be derived from SFPP's income, not KMEP's. The December 2007 Order explicitly states that the marginal tax rate is applied at the SFPP level once the marginal rate is determined at the KMEP level. *See* December 2007 Order, 121 FERC ¶ 61,240 at P 48. Likewise, the December 2007 Order is clear that the marginal tax rate is developed based on the categories of the publicly traded securities owned by the partners, which are indisputably owned at the KMEP level. *Id.* P 35 (stating "In light of this basic financial principal the Commission affirms it prior conclusion in the *Policy Statement*, the December Order, and the December 2006 Sepulveda Order that the income tax allowance of a pass-through entity will be determined by the weighted marginal tax rate of the owning partners."). Moreover, in the December 2007 Order, the Commission developed the marginal tax rates for those partners based on IRS statistics for various categories of those partners. To conclude that this means that KMEP's income was not relevant to determining the marginal tax rate of those partners is a distortion of the relevant paragraphs. *Id.* P 37-39. The December 2007 Order states that incentive distributions are not improper and that "SFPP properly used KMEP partnership income to determine the distributive income of KMEP's partners." *Id.* P 47. No fair reading of the December 2007 Order could conclude otherwise.

subsidiaries is distributed to the partners and all offsets in the entire enterprise are considered in the calculation of KMEP's distributable income. The Commission's presumptions of the marginal tax rate for each partnership category also recognize that any positive or negative benefits from the partnership will be reduced or enhanced by the other income and deductions used to determine the partner's marginal tax rate.[605] Thus, if tax deferrals occur at the partner level as a result of incentive distributions or the section 743(b) election, these are not different than deductions or credits that may flow to a limited partner from that partner's other economic activities to the extent that the partner is actually permitted to recognize the benefits from those activities.[606] *ExxonMobil*'s recognition that partnerships are pass-through entities for income tax purposes also implicitly recognized that stand-alone method would have to be modified to accommodate the reality of partnership taxation.[607] But even with the effect of the incentive distributions, the rate payers are better off under the MLP format than paying a 35 percent corporate marginal tax rate on the $5.328 million dollar equity return contained in SFPP's regulatory cost of service. Removing the incentive to invest in MLPs may cause pipelines to revert to the corporate mode would likely result in the application of the 35 percent marginal corporate rate to all income rather than some 32 percent weighted marginal tax rate that often applies to a jurisdictional MLP.

364. Second, the ACV Shippers assert that the Commission's Income Tax Policy Statement provide that the income tax allowance should be calculated only on the actual or potential income tax on the jurisdictional entity's utility income.[608] This essentially asserts that the marginal tax rate should be determined only on the $5.238 million in equity return included in SFPP's 2007 cost of service because that return is separated stated from KMEP's consolidated income. Thus, if the general partner was allocated

---

[605] Opinion No. 511, 134 FERC ¶ 61,121 at P 281-82; December 2007 Order, 121 FERC ¶ 61,240 at P 29, 47; Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 38.

[606] Even *BP West Coast*, while rejecting a partnership income tax allowance, recognized that neither the flow-through nor the stand-alone method can be literally applied to SFPP's rates. *See BP West Coast*, 374 F.3d at 1286 (noting that both methodologies arose in the context of the corporate ownership of a jurisdictional pipeline by a tax-paying corporation which is part of an affiliated group). This historical fact is equally true for any opinion that approved a partnership income tax allowance prior to the adoption of the *Lakehead* methodology, which *BP West Coast* overruled.

[607] *ExxonMobil*, 487 F.3d at 952-54.

[608] ACV Rehearing at 63-64.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

50 percent of distributed income, ACV Shippers' theory would appear to be that the marginal tax rate for the general partner should reflect $2.669 million. Likewise, if the general partner is only allocated one percent of utility income, then the tax rate would be that on $52,380. But this suggests that if a limited partner has an actual or potential tax liability on $4000 distributed KMEP income, that the marginal tax rate for this income should be zero even if the partner actually has a $100,000 in investment income alone and the partner's marginal tax rate is well in excess of 28 percent.

365. Unlike the case of a corporate subsidiary, basic partnership law makes it impossible to derive a meaningful marginal tax rate based solely on the MLP subsidiary's utility income. This is because all income is comingled at the partner level for tax purposes and this determines the marginal rate that will be paid on all of the utility income distributed to the partner, as *ExxonMobil* recognized.[609] Moreover, as *City of Charlottesville* recognizes, corporations and individuals make investment decisions based on the marginal rate applicable to a particular category of taxable income.[610] In the instant case that is the partner's total ordinary taxable income, of which the partnership income allocated to the partner is one component. The ACV Shippers provide no realistic answer to this problem, which arises regardless of whether incentive distributions are used to determine the proportion of partnership income that is allocated to a corporate general partner or there are deferrals and credits that may affect a partner's marginal tax rate.

4. <u>Proposed Changes to SFPP's Income Tax Allowance and Return</u>

366. This section addresses the Shipper Parties' arguments that for various reasons the Commission should pass any tax savings or benefits that flow from the use of the MLP business format through to SFPP's rate payers. These include: (1) proposed adjustments to the income tax allowance to reflect the double recovery of the partner's income tax allowance or the absence of an income tax liability, (2) proposed reductions to SFPP's equity return to reflect the time value of income tax deferrals that may flow to the limited partners from investing in MLPs, (3) arguments that Congress and the courts require that any tax savings be passed through to the rate payers, and (4) assertions that competitive markets would required any tax savings to be reflected in the consumer's prices.

---

[609] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 32, 33, *ExxonMobil*, 487 F.3d at 952, 954.

[610] *City of Charlottesville*, 774 F.2d at 1207.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

a. Adjustments to the Income Tax Allowance

367. Turning first to the requests to adjust the weighted average of SFPP's income tax allowance, ACV Shippers assert that mutual funds, pensions, and other pass-through entities receiving distributions from KMEP should be attributed a zero marginal income tax rate weight in developing the weighted average cost of any income tax allowance. The ACV Shippers assert that their economic witness Matthew P. O'Loughlin establishes that any income tax allowance is already reflected in the ROEs calculated by the Commission's DCF model.[611] The Commission examined and rejected this argument earlier in this order and therefore denies rehearing. Mr. O'Loughlin's testimony also attributed a marginal tax rate of zero to such pass-through entities because they pay no taxes. The Commission has consistently rejected this argument by holding that pass-through entities such as mutual funds or pension trustees make distributions to institutions and individuals that pay income taxes on the distributions. The marginal tax rates of the beneficiaries are reflected in the price they pay for the mutual funds and in the benefits from their pensions or trusts. Thus the marginal tax rates of the beneficiaries are properly reflected in the income tax cost of an MLP's regulatory cost of service.[612]

b. Adjustments to return based on equity and fairness

368. Shipper Parties request the Commission to reduce SFPP's rate of return to reflect the time value of any tax benefits to a limited partner from owning an MLP's limited partnership interests. In addition to their arguments based on the double recovery of an MLP partner's income tax allowance, they assert Opinion No. 511 erred by not adjusting SFPP's return as a matter of equity and fairness, citing the December 2006 Sepulveda Order.[613] They urge the Commission to reduce the amount of SFPP's equity return to reflect the present value calculations of Dr. Horst, who would reduce the income tax marginal tax rate by a factor of 78.4 percent to reflect the present value of the lower tax burden a partner incurs if the income tax burden on the income from KMEP's units is deferred for eight years.[614] Dr. Horsts' adjustment would reduce SFPP's marginal tax

[611] ACV Rehearing at 64-65.

[612] December 2007 Order, 121 FERC ¶ 61,240 at P 35, 38; Opinion No. 511, 134 FERC ¶ 61,121 at P 294-295.

[613] ExxonMobil/BP Rehearing at 58-70.

[614] *Id.* at 63-64. The analysis for Dr. Horst's 65.1 percent factor is at Ex. XOM-1 at 37-39. The calculations are at Ex. XOM-10 at 2 and Ex. XOM-1 as corrected by Ex. XOM-21 and XOM-25.

rate from 34.94 percent to 32.92 percent.[615] The lower marginal tax rate would mean a lower dollar amount for income tax allowance since the marginal tax rate is applied to the dollar equity return component of the pipeline's regulatory cost of service. This in turn would reduce the pipeline's revenue requirement and thereby its rates.

369. Like the December 2007 Order[616] before it, Opinion No. 511 over-ruled the December 2006 Sepulveda Order's holding that fairness requires adjusting a MLP's equity return to reflect the present value of any tax deferrals.[617] On rehearing, the Commission again concludes that there is a basic problem with any such adjustment. As previously discussed, basic finance theory states that tax savings from any deferrals will be reflected in the price an MLP partner pays for an MLP equity interest. As the Shipper Parties' witness Dr. Horst states, investors will always pay more for an instrument that has a lower tax impact.[618] But whatever the resulting ROE, that is market-based and reflects investor's after-tax expectations. Lowering the equity rate of return to reflect the present value of tax deferrals obtained by an MLP limited partner reduces the yield on MLP equity interests twice, once when the limited partnership interests are purchased and a second time in a Commission proceeding. A second reduction understates the cost-of-equity by reducing the yield on the MLP's equity interest below that resulting from the application of the Commission's market-based DCF methodology.[619] The December 2006 Sepulveda Order failed to raise and address this fundamental contradiction between the Commission's reliance on a DCF model for determining a pipeline's equity cost of capital and the reduction in the capitalized value of the firm that would result.[620] The

[615] ExxonMobil/BP Rehearing at 72.

[616] December 2007 Order, 121 FERC ¶ 61,240 at P 29, 32.

[617] Opinion No. 511, 134 FERC ¶ 61,121 at 307-308.

[618] Ex. XOM-1 at 17-18; *accord* Ex. SFP-75 at 20-21.

[619] *See* Ex. SFP-75 at 20-24.

[620] If the required after-tax return generated by the DCF model is 10 percent and the equity rate base is $1000, the required after-tax dollar return to be included in the cost of service is $100. If the marginal tax rate is 35 percent, the required tax gross up is $54, or a total pre-tax return of $154 ($153.85) before payment of the income taxes. Application of the marginal tax rate then results in an after-tax return of $100, or 10 percent on the equity component of the rate base. Dr. Horst's adjustment would reduce the tax gross up to $49.08 (100/ (1 - 32.92), or a pre-tax return of $149.08. This reduces the pipeline's revenue requirement by $5.77. However the market would continue to

(continued…)

20111216-4007 FERC PDF (Unofficial) 12/16/2011

December 2006 Sepulveda Order likewise did not consider that adjusting an MLP pipeline's return would cause it to have a return on jurisdictional assets that is less than that of corporate pipeline.[621] This oversight resulted in a holding that was inconsistent with the purpose of the Income Tax Policy Statement[622] and *ExxonMobil's* recognition of the need to maintain the parity of MLP and corporate returns so that both have the same opportunity to raise equity capital.[623]

370. Moreover, as noted, reducing the yield artificially would cause the market price of the MLP equity interest to fall in response the artificially lower yield established by the Commission. This means that an MLP would have to issue more equity units to raise the same amount of capital, thus undercutting the investment incentives and advantage the Congress intended the MLP business format to posses in the first place.[624] Thus, if the incentives are to be effective, the tax deferrals must ultimately be for the benefit of the MLP, not for the rate payers. In that regard Opinion No. 511 states Congress intended that that any tax benefits from deferrals accrue to the MLP unit holders in order to encourage investment.[625] This statement was not wholly accurate as it overlooked the

---

apply a marginal tax rate of 35 percent to the pipeline's return and this would depress the equity price accordingly. Equity markets would view the difference in the marginal tax rate at approximate $94.44 ($100 - $5.77), or an after-tax return of 9.44 percent on $1000. But the posited cost of equity capital is 10 percent. Therefore the price of the equity security will adjust to $944.44 (10 x $94.44). The jurisdictional entity under-recovers its equity cost of capital of 10 percent and does not obtain a capitalized value equal to the equity component of its equity rate base ($944.44 versus $1000), a 6.6 percent reduction. Thus the MLP pipeline has an after-tax ROE and value that is less than that of a corporate pipeline.

[621] December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 39-42.

[622] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 1, 9-10, 27, 33, 35.

[623] *ExxonMobil*, 487 F.3d at 952-54.

[624] The lower yield would be reflected in the equity cost-of-capital included in the pipeline's cost of service, but the lower equity price makes it harder to raise equity capital. This apparent paradox occurs because the yield is artificially depressed. Therefore the price of the equity interests must decline to provide the market-based yield. See Ex. SFP-75 at 30 for a historical example of how prices dropped when the return was adjusted involving the Lakehead Pipeline Co., L.P.

[625] Opinion No. 511, 134 FERC ¶ 61,121 at P 253-254, 265, 305-308.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

fact that the limited partners will pay a higher price for their equity interests and therefore may not capture the entire benefit of the income tax deferrals for themselves.

371. However, regardless of whether one views the tax deferrals as a benefit to the MLP partner during the early years of the deferrals, or concludes that the MLP benefits from the resulting higher equity prices reflecting those deferrals (or some combination of both), reducing the present value of the tax deferrals reduces the incentives to invest in the MLP and misstates an MLP's equity cost-of-capital. As discussed earlier, there is no credible evidence here that Congress intended to deprive jurisdictional MLPs or their limited partners of any benefits derived from income tax deferrals resulting of an MLP. Opinion No. 511 therefore correctly affirmed the Commission's prior finding that the December 2006 Sepulveda Order incorrectly held that an MLP's rate of return should be adjusted to reflect the value of the income tax deferrals obtained by an MLP's limited partners.

c. Adjustments Based on Congressional intent

372. The Shipper Parties again argue that Congress has required that the savings of any tax benefits from income tax provisions designed to encourage investment in public utilities must be passed through to the rate payers by the normalization of those benefits. Alternatively, they assert that there is no basis for the Commission to conclude that Congress intended the jurisdictional entity to keep the financial benefits that flow from the use of the MLP format.[626] This is a variation on their argument that Congress intended that the tax normalization policies of the Commission's regulations apply to any income tax deferrals that flow from the use of the MLP format. Earlier in this order the Commission rejected arguments that Congress intended to limit the tax benefits that flow from the use of the MLP format by analogy to the limitations on investment tax credit incentives contained in section 203(e) of the Revenue Act of 1964. There is no express statement on the record here that Congress intended the rate payers to obtain any tax benefits that may flow from the MLP business format. This is true whether one views those benefits as the deferrals for the limited partners or the higher equity prices an MLP may obtain from its investors based on those deferrals. As discussed, this would reduce the incentives to use the MLP business format an investment vehicle, and in any event, an MLP pipeline's marginal tax rate is usually lower than that of corporate pipeline.

[626] ExxonMobil/BP Rehearing at 51-53; ACV Rehearing at 49-50.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

d. Arguments Based on Judicial Precedent

373. In asserting that section 7704 of the IRC provides for a tax savings to be passed on to the rate payers, the Shipper Parties' argue that judicial precedent requires that any savings in tax costs must be passed onto the rate payers.[627] They first cite *El Paso Natural Gas Co. v. FPC*,[628] which they assert holds (1) that full effect must be given to the Congressional intent to make the several tax savings available to this taxpayer because it is in the natural gas business or it is acquiring new equipment subject to the depreciation options of the 1954 Internal Revenue Act, and (2), that these tax benefits should not be translated into additional profits for the jurisdictional entity over and above a reasonable return on its investment. Their quotation from the *El Paso* decision also noted that the tax savings at issue included a substantial incentive for the exploration and development and payment for the gas consumed in reaching its conclusion. The Shipper Parties also cite *Cities of Lexington v. FPC*, which more explicitly held that the benefits for a statutory depletion allowance should be passed through to the rate payers. *Cities of Lexington* did so on the grounds that principles of cost accounting should not be used to set up a fictitious and unreal tax expense that gives the utility the entire benefit of tax saving statutes and passes none to the consuming public.[629] At bottom, Shipper Parties argue that these cases hold that any tax savings must be passed onto the rate payers, including any that may flow from the elimination of double taxation by section 7704.

374. This order previously explained that there are no "tax savings" to the jurisdictional entity from the elimination of double taxation or the from the tax deferrals that occur at the level of the MLP partner. However there are also at least three legal limitations to the Shipper Parties' argument that the two cited cases support a required pass through of "tax savings." First, both cases where decided at a time when the Commission used the flow through method for determining a jurisdictional entity's tax allowance. As explained in *City of Charlottesville*, the flow through method required that all that income and losses, including all deductions for amortization and depreciation, whether jurisdictional or non-jurisdictional, be combined, if necessary at the parent company level. If done at the parent level, the taxable income and thus the taxes of the parent would be allocated among its subsidiaries. In contrast, use of the stand-alone method, as approved by *City of Charlottesville*, usually results in higher tax allowance because the tax base, and hence

---

[627] ExxonMobil/BP Rehearing at 40-41, 49-51; ACV Rehearing at 47-49.

[628] *El Paso Natural Gas Co. v. FPC*, 281 F.2d 567, 573 (5th Cir. 1960) (*El Paso*).

[629] *Cities of Lexington v. FPC*, 295 F.2d 109 (4th Cir. 1961) (*Cities of Lexington*).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

the effective tax rate, is not reduced by the losses of the jurisdictional entity's affiliates.[630]

375. Second, while these two cited cases were decided in 1960 and 1961 long before the Commission adopted the stand-alone method in 1983 in *Columbia Gas Transmission Co.*,[631] even these cases permitted the use of tax deferrals rather than requiring immediate recognition of tax savings.[632] Moreover the cited cases, which deal with tax savings from incentives for exploration and production, were also decided over 25 years before *City of Charlottesville*, which unequivocally held in 1985 that the tax savings obtained by a parent company from such activities do not have to be used to adjust the income tax cost, and therefore the income tax allowance, of a subsidiary. *City of Charlottesville* so held even though the tax deferrals and savings were derived from the parent's gas exploration and production functions might defer recognition of taxable income for a very long period of time, as much as 15 years, or perhaps forever.[633]

376. Third, the cited language from *El Paso* might be construed as applying to depreciation and amortization that occurs from incentive based investments in pipeline facilities used for the transportation of natural gas in interstate commerce. But to the extent there are tax deferrals at the pipeline level, the Commission still requires normalization of any tax impacts that flow from activities and accounting transaction at the pipeline level that reflect pipeline operations. In contrast, any benefits that occur to the limited partners from use of the MLP format are equivalent to non-jurisdictional accounting transactions at that the level of a corporate parent company, and as such are not subject to normalization. As discussed, an MLP pipeline has the same revenue requirement as corporate pipeline but the MLP is tax advantaged because the absence of double taxation leads the MLP partner to pay a higher price for the MLP equity interest than would otherwise be the case. The so-called "tax savings" to the MLP do not come

---

[630] *City of Charlottesville,* 774 F.2d 1205, 1207-08.

[631] *Columbia Gas Transmission Co.*, Opinion No. 173, 23 FERC ¶ 61,850 (1983). The Shipper Parties cite this case for the proposition that only income taxes that are part of jurisdictional cost of service should be included in the pipeline's cost of service, and imply that this case states that MLPs should not have an income tax allowance because this permits MLPs to recover an element of its cost of service twice. The Shipper Parties' use of this citation is wholly inapposite in that it ignores the holding in *ExxonMobil* that income taxes are properly included in a MLP pipeline's regulatory cost of service.

[632] *See City of Charlottesville*, 774 F.2d at 1213.

[633] *Id.* at 1214-16.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

from a reduction in the income tax cost of an MLP or in the equity rate of return generated by the DCF model. In fact, *City of Charlottesville* recognized that for any tax benefits to accrue to the ratepayers those benefits must be generated at the level of the jurisdictional entity's jurisdictional service as that term is defined by the Commission's cost-of-service and rate design methodologies.[634]

377. The Commission previously discussed how it was necessary to adjust the stand-alone method to deal with the realities of partnership law because the relevant marginal tax rates can only be derived by the partner's taxable income. For all other matters involving jurisdictional income and expenses the Commission has retained the stand-alone method approved by *City of Charlottesville*. The issue here is whether the Commission has properly applied the underlying principles of that case to the complexities of partnership accounting, which the Commission believes that it has.

e. <u>The Relevance of Competition to Tax Savings</u>

378. Finally, the Commission addresses here a secondary point discussed in Opinion No. 511. Opinion No. 511 stated that the Commission seeks to replicate the competitive market in its regulation of jurisdictional entities. Opinion No. 511 held that if jurisdictional MLPs are denied an income tax allowance, their returns will be less attractive than those of non-jurisdictional MLPs and thus less likely to attract investment than non-jurisdictional MLPs.[635] On rehearing the Shipper Parties argue that jurisdictional MLPs are monopolies and will not reduce their prices in response to competition while a non-jurisdictional entity are subject to competitive pressure and will pass on any income tax savings to its customers. The ACV Shippers argue at length that the Commission ignores basic economic theory, which holds that competition means that a firm's marginal prices will equal its marginal costs. They assert that if a competitive firm has savings in its income tax costs, this will be reflected in its marginal costs. ACV Shippers state that in order to meet competition from another MLP or corporation competing in the same market, competition will force a non-jurisdictional MLP to pass the benefits of single taxation or tax deferrals on to its customer as its prices will decline to reflect the reduced level of its income tax costs.[636] The Shipper Parties are thus arguing that because the Commission has not required a jurisdictional MLP to pass on any tax savings from the use of the MLP business format, the Commission incorrectly

---

[634] *City of Charlottesville*, 774 F.2d 1205.

[635] Opinion No. 511, 134 FERC ¶ 61,121 at P 261-262.

[636] ExxonMobil/BP Rehearing at 48-49; ACV Rehearing at 44-47.

concluded that it is replicating a competitive market if it grants a jurisdictional MLP an income tax allowance.

379. The Commission disagrees with the Shipper Parties' argument that competition will require the tax-advantages of the MLP business format to be passed on in the rates or prices of an MLP pipeline. Their argument has several errors. One is that there are no tax savings to the MLP from the fact that an MLP partner pays only one level of taxations. As the Commission has previously shown, an MLP income tax allowance does not permit the double recovery on the partner's income tax liability; thus, this first argument lacks any analytical foundation and as such is irrelevant. Second, the Shipper Parties' marginal price equals marginal cost arguments likewise assumes that any "tax savings" from tax deferrals that may be available to the MLP's limited partners or the "tax-advantage" from the elimination of double taxation are reflected in an MLP's marginal costs. As has been previously discussed, this is incorrect. Any benefits to the MLP or its limited partners from the use of the MLP business format are reflected in the pricing investors pay when the purchase an MLP equity interest. Such investors pay a higher price for the MLP equity interest due to the absence of double taxation of corporate dividends or due to the lower tax burden resulting from any tax deferrals.

380. In contrast to costs that are part of the firm's transportation function, such as operating expenses and the cost of capital, income taxes are imposed on the net income that results from the firm's operations. For this reason such taxes are often referred to as the income tax burden on earnings.[637] As an example of this burden the Commission's tables earlier in this order discussed a required after-tax return of $100 and the marginal tax rate was 35 percent. These show that a non-jurisdictional firm must either gross up revenues to $154 in excess of its operating expenses <u>or</u> the jurisdictional firm must have an income tax allowance of $54. Now assume that the required after-tax dollar return drops to $90 because the equity cost-of-capital has declined but the marginal tax rate remains at 35 percent. The dollar amount of the revenue gross up needed by the non-jurisdictional firm to earn an after-tax return of $90 will decline because the required after-tax return has declined. This change would be the same whether the firm involved is a MLP or a corporation. This is also true regardless of whether they are jurisdictional or non-jurisdictional firms since they are assumed to have the same business risk, the

[637] This point is also discussed in the Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 21-22, stating arguments that income taxes are not a component of a pipeline's operating expenses, but are a function of net income and return. *See also* December 2006 Sepulveda Order also recognized this fundamental fact although it reached the incorrect conclusion that the benefits of any deferrals should be for the rate payers. December 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 41.

same output, and the same dollar amount of costs before income taxes and sales. Since a drop in the equity cost of capital lowers the firm's cost of service, the firm's prices or the rates will drop to reflect those lower operating costs.

381. It is of course true that a higher marginal tax rate may make it more difficult for a firm to compete because this requires a higher tax gross up or a higher income tax allowance as part of its cost of service. It is also clear that a lower tax gross up or income tax allowance results in lower prices since income tax costs are a gross up of the revenue needed to cover the firm's operating expenses and its cost of capital. But the firm is not passing on income tax "savings" through lower prices to its customers that stem from elimination of double taxation or from any tax deferrals that flow to the limited partners. Rather the amount of the income tax gross up (or income tax allowance) drops because the income tax burden is lower due to lower taxable income.[638] Moreover, if the imputed tax rate derived from the partners is less than the 35 percent marginal tax rate for the corporation, then the tax cost to the entity is lower as a result and the Commission will provide a lower tax allowance. Similarly a lower marginal tax rate would also be reflected in the lower prices a non-jurisdictional entity needs to meet its tax gross up. Thus the Commission is replicating the price difference that should result from a difference in their marginal tax rates. But that difference in the marginal tax rate occurs at the first tier (MLP and its partners or the corporation), not because there are tax deferrals to the limited partners or because an MLP is "tax advantaged" due to the absence of double taxation at the second tier. Rather it is a function of the limited partner's lower weighted average tax marginal tax rate.

382. Opinion No. 511 simply made the point that if a jurisdictional MLP is to be competitive with non-jurisdiction MLP in raising equity capital, it must have both the same after-tax dollar and percent ROE as the non-jurisdictional MLP with the same risk.[639] As Table 2 shows, if the jurisdictional MLP does not obtain an income tax allowance, the latter will not even recover its equity cost of capital. If a non-jurisdictional MLP is able to earn its after-tax equity cost-of-capital and the jurisdictional MLP cannot, it should be obvious which of the two MLPs would be more attractive to investors. In this regard the relative position of the corporate pipeline is irrelevant to that concern because the corporation is always disadvantaged by the fact of double taxation.

[638] Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 21-22.

[639] Opinion No. 511, 134 FERC ¶ 61,121 at P 263-264.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

5. Other Issues Involving the Income Tax Allowance Calculations

383. This section of the order addresses three technical issues involving the income tax allowance calculations. The first is the income tax marginal tax rate to be used in calculating the allowance for deferred income taxes (ADIT) in SFPP's regulatory cost of service. As is the case with other jurisdictional entities, the Commission's Opinion No. 154-B[640] oil pipeline methodology requires the calculation of the increases and decreases in ADIT balances over a large number of years. The ADIT account is intended to reflect the difference in any given year between the taxes actually paid by the carrier and the dollar amount of taxes generated by the income tax allowance component of the pipeline's cost of service. Since the income tax allowance is determined in part by the marginal tax rate used to develop the pipeline's cost of service, the amount of the marginal tax rate thereby affects the amount of the ADIT adjustment between the taxes actually paid and the cash generated by the income tax allowance.[641]

384. SFPP asserts on rehearing that Opinion No. 511 incorrectly held that the ADIT calculation should be based on the highest marginal income tax allowance rate in effect in for each year of that calculation.[642] SFPP first asserts that that the issue of the use of the highest marginal tax rate applies only to the period 1992 through 1996 as no party has raised the issue for period after 1996. SFPP argues that the maximum tax rate for a partnership can vary from year to year, but in any event it is simply incorrect to assume that the applicable 35 percent maximum tax rate actually applied to SFPP for the entire period 1992-1996. SFPP also argues that it should not be required to use the maximum corporate marginal tax rate after 1968 when SFPP became a partnership, but rather the lower marginal rate that would have applied to its partnership between 1988 and 1991.

385. The Commission grants rehearing on the point of whether the maximum corporate tax rate must always be used to determine SFPP's marginal tax rate, including the period 1992 to 1996. As SFPP states, the marginal tax rate for a partnership or a corporation can vary based on the year in which a rate calculation is performed. As such, it would be incorrect to assume that the maximum corporate marginal tax rate will always apply in determining the amount of ADIT incurred or amortized in any given year. Rather, the proper rate is the marginal tax rate that is embedded in SFPP's rate design in a given

---

[640] Opinion No. 154-B, 31 FERC ¶ 61,377.

[641] Opinion No. 511, 134 FERC ¶ 61,121 at P 316-317.

[642] SFPP Request for Rehearing at 21-27 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 319-320).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

year. Thus Opinion No. 511 should have held that the marginal tax rate actually used in a given year for SFPP's rate design should be the marginal rate used for the ADIT calculation. This assures that the ADIT adjustment for each year is properly calculated and does not change retrospectively absent a Commission order authorizing a change in the pipeline's rate design, as was done in a series of complaints filed between 1992 and 1996.[643]

386. More specifically, in reviewing SFPP's East Line rates in Docket No. OR-92-8-000, *et al.*, the Commission concluded that SFPP should recalculate its ADIT as of 1992 because that was the first year the Commission directed SFPP to change its rate design for those rates.[644] Thereafter, after the Commission adopted its Income Tax Policy Statement, it continued to hold that SFPP should modify its ADIT as of 1992. In doing so, the Commission notes that before 1992 SFPP would have used a full income tax allowance because the *Lakehead* methodology was not applied to its cost of service.[645] From 1988 through 1991, SFPP's regulatory marginal tax rate was that of a corporation, not a partnership and therefore its income tax allowance was based on the corporate marginal tax rate that was embedded in its jurisdictional rates at that time. Therefore the Commission correctly rejected SFPP's efforts to be afforded the income tax allowance of a partnership on a retrospective basis to 1988 and it continues to do so here.

387. For the period 1992 through 1996 the Commission permitted SFPP to change the marginal tax rate in each of those years. In that regard SFPP argues here that the ADIT calculation is a cost calculation that varies in any given year by changes in the dollar amounts on the company's books of the rate base, book and tax depreciation rates, the cost-of-capital, including the marginal tax rate. This is consistent with SFPP's earlier argument that an adjustment to the marginal tax rate was similar to the annual cost-of-

---

[643] *E.g. SFPP, L.P.*, Opinion No. 435-B, 96 FERC ¶ 61,281, at 62,077 (2001).

[644] *Id.*

[645] December 2007 Order, 121 FERC ¶ 61,240 at P 144. Given that rationale, the East Line ADIT would be properly calculated as of 1992 using the Income Tax Allowance Policy methodology. The West Line rates were not revised until May 1, 1996, and therefore the revised ADIT should have begun at that point for those rates. It is too late at this point to make that adjustment given the reparations and refunds for the West Line rates at issue in Docket No. OR96-2-000 have been paid based on a revised ADIT calculation beginning in 1992. *Id.* P 144 and Ordering Par. E.

capital adjustment included the ADIT calculation.[646] This was approved by the December 2007 Order[647] and at this point is a closed issue for the period 1992 through 1996 as Opinion No. 511 states.[648] However, the Opinion No. 511 should not have analogized an annual change in the marginal tax rate to the annual change in the cost of capital that occurs in the annual ADIT calculation on the company's books. Opinion No. 511 attempted to explain that the marginal tax rate should not vary from year to year as a matter of rate design.[649] This is because the marginal tax rate is a rate design component derived from the pipeline's cost of service test period unlike such book entries as the rate base, the actual tax payments, or the pipeline's cost of capital.[650]

388. By way of contrast to the marginal tax rate, the cost of capital is the weighted cost of debt and equity on the company's books. This book ratio will change if there is a change in ratio of debt and equity on the company's books in any given year. But the actual cost of the debt and the equity components embedded in the pipeline's rates is determined only in the context of a rate case. Such rate components may not be varied by the pipeline outside a rate proceeding nor should the marginal tax rate component of the pipeline's cost of service be varied from year to year outside the context of a general rate case proceeding. Given that the December 2007 Order should not have permitted SFPP to vary the marginal tax rate from that established by the relevant test periods, the question then becomes how to determine the ADIT calculation that should apply to the instant West Line rates given the cases that have gone before.

389. SFPP is understandably concerned that Opinion No. 511 might be construed as requiring an adjustment to the marginal tax rates that were previously used to design certain of the SFPP's rates in 1992 and 1996 through the effective date of the rates at

---

[646] December 2007 Order, 121 FERC ¶ 61,240 at P 143 (summarizing SFPP's argument regarding its ADIT calculation).

[647] *Id.* P 144.

[648] Opinion No. 511, 134 FERC ¶ 61,121 at P 320.

[649] *Id.* P 319-320.

[650] Of course if the maximum tax rate changes, it is appropriate to change the weighted marginal tax rate to reflect this. But this is driven by statute, not by a hearing process that determines the relative weight of the partner's marginal tax rate based on their proportionate ownership interests. This should not be changed outside a rate case.

issue here.[651] As discussed, in the context the Docket No. OR92-8-000 and Docket No. OR96-2-000 complaint cases the Commission applied the Income Tax Policy Statement to the East Line rates in 1992 and the West Line rates in 1996.[652] This was consistent with its prior determination that SFPP should be treated as a partnership as of 1992, the earliest year for which its rates were modified pursuant to a complaint. SFPP applied the weighted average marginal tax methodology to its East Line rates as of 1992 and the West Line rates as of 1996. In doing so it developed a separate marginal tax rate for each year between 1992 and 1996 and developed its ADIT calculations according.[653]

390. That calculation helped determine the net rate base for both the East and West Line rates during that period and thereby influenced the net rate base that would apply to the design of the West Line rates in the instant docket. The December 2007 Order also established effective dates for the rates in Docket No. OR92-8-000 as of August 1, 2000 and May 1, 2006 for the rates in Docket No. OR96-2-000. The December 2007 Order thereby established the dates for calculating reparations and refunds until both the East and the West Line rates were supplanted by later filings. Given the settlement of those cases the Commission will not disturb the calculations underpinning the design of the rates established by the December 2007 Order. Revising the ADIT balances for 1992 and 1996 would change the calculation of the West Line rates now before the Commission in a manner favorable to the shippers because the change to the ADIT balances for the period 1992 through 1996. This would be an inequitable and in effect a retroactive rate that would be unjust and unreasonable.

391. Given the previous analysis, Opinion No. 511 erred to the extent it implied that the ADIT calculation for the West Line rates in the instant docket should not reflect the ADIT calculations actually embedded in the East and West Line rates based on the ADIT

---

[651] SFPP Rehearing at 27-28.

[652] *See* June 2005 Order, 111 FERC ¶ 61,334 at P 73-74 noting it would be necessary to determine whether an income tax allowance was appropriate for the 1994 test year for the first East Line rate proceeding (Docket OR92-8-000) and the 1996 test year proceeding involving both the East and West Line rates in Docket No. OR96-2-000. The Commission thereafter accorded SFPP an income tax allowance for both lines in the December 2005 Order, but required SFPP to make a compliance filing detailing how the income tax allowance would be implemented and a revised cost of service for both the East and West Lines. December 2005 Order, *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 44-47.

[653] December 2007 Order, 121 FERC ¶ 61,240 at ordering par. (E).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

calculations that SFPP made for the period 1992 through 1996.[654] Therefore the proper marginal tax rate for the calculation of the ADIT component of the West Line rates is as follows. For 1992 through May 1, 1996 the proper ADIT rate was the adjusted annual rate as authorized by the December 2007 Order. Thereafter, as with other cost of service factors in SFPP's rate design, the marginal tax rate must be fixed until that component was changed on effective date of the current West Line rates in this proceeding.[655] This will result is a different ADIT calculation for the rates at issue here. However the ruling here will not require SFPP to modify the West Line rates effective May 1, 1996, and which underpin the reparations and refunds applicable to the period before the instant West Line rates became effective on August 1, 2008. In summary, Opinion No. 511 only intended to hold that it is incorrect to vary SFPP's weighted marginal tax rate for the period after the effective dates of the West Line rates established by the December 2007 Order. As with other rate design factors, the marginal tax rate should be fixed by the test period calculations. Rehearing on the marginal tax rate issues is granted and denied as stated.

392. The third technical issue involving the income tax allowance calculation is whether to use the marginal rate of the state in which a partner resides or the source state in which the income was generated. This decision affects the weighted marginal tax rate to be used in developing the income tax allowance. Opinion No. 511 held that the calculation should be based first on the marginal tax rate of the source state, and then on marginal tax rate of the partner's resident state. Opinion No. 511 noted that the taxes paid on the source state are normally a partial credit against the income taxes of the partner's resident state.[656] On rehearing, the Shipper Parties assert that this should be reversed because there is no evidence that taxes that are paid on the gains incurred when a partnership interest is sold are taxed at the source state.[657] This argument overlooks the fact that the Commission's income tax allowance is relevant only to ordinary income. All deferred ordinary income must be recognized when a limited partnership interest is sold and there is no evidence here that such ordinary income would not be apportioned at the source state just as is the ordinary income a partner recognizes in the year it is

[654] Opinion No. 511, 134 FERC ¶ 61,121 at P 3.

[655] This should be done using the marginal tax rate adopted in the 1996 calculation, the year that established the West Line rate design in effect between May 1, 1996 and the filing of the rate case effective August 1, 2008 in the instant docket.

[656] Opinion No. 511, 134 FERC ¶ 61,121 at P 320.

[657] ExxonMobil/BP Rehearing at 72.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

actually earned. Otherwise, the deferral component of the MLP works to the disadvantage of the source state that would tax that as ordinary income. Moreover, many states do not recognize the distinction between capital gains and ordinary income currently recognized at the federal level. This means that on the sale of a partnership interest the total tax liability to the source state may actually be greater than the amount reflected in the Commission's income tax allowance. As Opinion No. 511 states, any such capital gains are outside the scope of the income tax allowance.[658] Therefore rehearing is denied.

VIII. <u>Substantial Divergence Standard</u>

393. In Opinion No. 511, the Commission held that it could not make final determination whether SFPP's June 2010 rate filing in the instant proceeding met the substantial divergence standard of 18 C.F.R. § 342.4(a)[659] until SFPP made its compliance filing.[660] SFPP asserts that the Commission erred for two reasons. SFPP first asserts that Order No. 561-A clearly intended that the substantial divergence standard is a threshold standard designed to determine whether the pipeline should be allowed to pursue a cost of service alternative as a means of establishing just and reasonable rates.[661] SFPP argues that the order did not intend to establish a second test at hearing that would in essence determine whether the rates as filed should be accepted as just and reasonable. Second, SFPP asserts that there is no correlation between the details contained in a cost of service filing to support an oil pipeline rate case and the cost of service that underpins the compliance rates ultimately required by the Commission. Third, SFPP asserts that the holding in Opinion No. 511 is inconsistent with the purpose of a hearing under section 15(7) of the ICA, which is to establish a just and reasonable rate, not whether the carrier has a right to file a rate proceeding in the first place.

394. The Commission grants rehearing. As SFPP points out, nothing in Order No. 561-A suggests that a pipeline must establish later on in a proceeding that it has complied with a threshold test designed to determine whether there is reasonable grounds

---

[658] Opinion No. 511, 134 FERC ¶ 61,121 at P 320.

[659] 18 C.F.R § 342.4(a) (2011).

[660] Opinion No. 511, 134 FERC ¶ 61,121 at P 323.

[661] SFPP Rehearing Request at 31-32 (citing *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Order No. 561-A, 59 FR 40243 (Aug. 8, 1994) FERC Stats. & Regs. ¶ 31,000, at 40,253 (1994).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

for a making a filing. Order No. 561-A provides that "a pipeline may file a rate increase that exceeds that applicable ceiling, if it can show that its prudently incurred costs are substantially in excess of the cost changes reflected in the index."[662] While somewhat ambiguous, this concept is most reasonably construed as a threshold test. As SFPP points out, there is nothing in Order No. 561-A requiring that the test apply at the actual hearing on the reasonableness of the rates as filed or that it would function as a secondary test for establishing rate reasonableness. Moreover, in Order No. 571, a companion proceeding addressing the Commission's accounting requirements for oil pipelines, the Commission clearly stated that the substantial divergence test in Order No. 561 is "the means that the Commission has decided are necessary for a pipeline to make a prima facie demonstration that it should be allowed to pursue the cost of service alternative as a means of establishing just and reasonable rates."[663] The cited language removes any ambiguity present in Order No. 561-A or the Commission's regulations and demonstrates that the holding in Opinion No. 511 contradicts the regulatory concept of a threshold test clearly stated in Order No. 571.

395. Moreover, there is no necessary correlation between the cost of service in the initial rate filing and that required at the compliance phase. In the instant case, the Commission required SFPP to use a different throughput than contained in its case in chief that is the first nine months of 2008 annualized instead of the 2007 test period SFPP used in its rate filing. The Commission also used a lower equity cost of capital rather than SFPP's updated equity cost of capital. As SFPP points out, the Commission accepted the rate filing in question and did not hold that it was inadequate or that SFPP had done anything improper.[664] SFPP is correct that revisiting a threshold issue later in a proceeding by requiring the Compliance Filing meet the substantial divergence test is inconsistent with the Commission's prior ruling that the materials contained in the May 2008 rate filing sufficiently complied with the Commission's filing requirements to support its acceptance. Moreover, while the cited suspension order left open the question of the reasonableness of the proposed West Line rates as filed, it did not state that the issue of substantial divergence remained open until the compliance phase. The more plausible interpretation is that SFPP had made a sufficient showing that the indexing methodology would not recover SFPP's costs and that the filing was appropriate and should proceed to hearing. If the filing were not appropriate because it failed to meet the

---

[662] Order No. 561-A, FERC Stats. & Regs. ¶ 31,000 at 31,107 (footnote omitted).

[663] *Cost-of-Service Reporting and Filing Requirements for Oil Pipelines*, Order No. 571, FERC Stats. & Regs. ¶ 31,006, at 31,164-65 (1994).

[664] *SFPP, L.P.*, 124 FERC ¶ 61,103, at P 4 (2008).

20111216-4007 FERC PDF (Unofficial) 12/16/2011

substantial divergence standard, then it should have been rejected at the time it was made.

396. Finally, the Commission agrees that Opinion No. 511's ruling is inconsistent with the purpose of section 15(7) of the ICA. The purpose of that section is to establish a just and reasonable rate based on the cost of service developed on the record at a hearing. Section 15(7) does not require a determination of substantial divergence in addition to the basic finding that the proposed rates are just and reasonable as the filed rates may be modified by the Commission. Rather, the substantial divergence test is imposed by regulation under the EPAct of 1992 as part of the regulatory structure designed to facilitate a simplified ratemaking methodology. To require the substantial divergence standard be met in the compliance phase would complicate, not simplify, the determination of whether the proposed rates as filed are just and reasonable under the ICA. Applying the substantial divergence test would require the Commission to develop an additional standard to determine whether any divergence between the rates as filed and those established by the Commission is a reasonable divergence. Limiting the determination under section 15(7) to the reasonableness of the rates removes any such complexity. In short, there is not a dual standard for determining rate reasonableness under section 15(7) of the ICA. Therefore rehearing is granted.

IX. <u>Refund Related Issues</u>

397. In its Compliance Filing, SFPP calculated refunds for movements beginning August 1, 2008, when the rates filed in this proceeding became effective.[665] On May 16, 2011, SFPP filed a supplemental compliance filing to correct its Compliance Filing. In the Supplemental Compliance Filing, SFPP states that it will calculate the refunds based upon (a) the difference between the rates actually paid or projected to be paid and (b) the rates resulting from implementing the Commission's rulings in Opinion No. 511.[666]

[665] SFPP Compliance Filing, Tab F; SFPP May 16, 2011 Supplemental Compliance Filing.

[666] In SFPP's initial Compliance Filing, SFPP stated that for all movements other than Colton to Phoenix, the rates generated by implementing Opinion No. 511 are lower than the West Line rates. Thus, SFPP, in calculating refunds for these other movements, applied the difference between the rates actually paid or projected to be paid and the rates in effect prior to Opinion No. 511. However, in its May 16, 2011 supplemental compliance filing, SFPP stated that due to the provisions of a recent settlements with Shipper Parties, the last clean rate doctrine does not apply to the pre-Opinion No. 511 West Line rates. Thus, for all destinations, SFPP now proposes to calculate refunds based upon the difference between (a) the rates actually paid or projected to be paid by

(continued…)

398. In calculating the refunds owed to shippers, SFPP applied indexing to the rates to be effective August 1, 2008, pursuant to Opinion No. 511. Oil pipelines may file for an annual rate change every July 1 pursuant to the Commission's indexing regulations.[667] The indexing methodology is to account for industry-wide cost changes during the prior year. Effective July 1, 2009, oil and petroleum product pipelines were allowed an index increase up to 7.6025 percent.[668] Effective July 1, 2010, the indexing regulation required pipelines to decrease their indexed rates by 1.2974 percent.[669] On compliance, SFPP incorporated these index rate changes into its going forward rates and refund calculations.

399. ExxonMobil/BP, ACV Shippers, and Trial Staff all raise concerns about the application of the index increase by 7.6025 percent to be effective July 1, 2009.[670] ExxonMobil/BP and ACV Shippers explain that the 2009 index increase reflects the industry-wide average cost increases during the calendar year 2008. They state that Opinion No. 511 relied upon actual cost and revenue data through September 2008 with respect to throughput, throughput related operations and maintenance costs, and the allocation of costs based on throughput. They add that SFPP included an uncontested test period adjustment to all of its base period salary and wage expenses to reflect a late 2007 merit increase that would be effective during 2008.[671] ACV Shippers and ExxonMobil/BP note that the Commission previously denied an index increase where a pipeline has filed a cost of service rate increase based on periods encompassed by the index increase.[672]

---

shippers and (b) rates resulting from implementation of the Commission's rulings in Opinion No. 511.

[667] 18 C.F.R. § 342.3 (2011).

[668] *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, 127 FERC ¶ 61,184 (2009).

[669] *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, 131 FERC ¶ 61,161 (2010). Although oil pipelines are not required to apply an index increase, absent a waiver of Commission regulations, pipelines are required to apply an index decrease. *See* 18. C.F.R. § 343.3(e) (2011).

[670] No party objects to SFPP's proposed implementation of the July 1, 2010 index rate decrease.

[671] ACV Protest at 49 (citing Ex. SFP 34C at 108-111).

[672] ExxonMobil/BP Protest at 12 (citing *SFPP, L.P.*, 117 FERC ¶ 61,271 (2006) (2006 SFPP Index Filing), *reh'g denied*, 120 FERC ¶ 61,245 (2007)(2006 SFPP Index

(continued…)

20111216-4007 FERC PDF (Unofficial) 12/16/2011

400. Trial Staff also expresses concern regarding SFPP's application of the indexing methodology to its rates beginning in July 2009. However Trial Staff also states that SFPP complied with the language of the Commission's regulations providing that if the rate is changed during the year through a method other than indexing, then the pipeline must defer any rate changed to the next subsequent adjustment. Trial Staff urges the Commission to evaluate whether an indexing of a rate on the subsequent adjustment date (in this case July 2009) is appropriate when that rate is substantially based upon actual 2008 costs and could potentially lead to double-recovery of inflation expenses.

401. In its answer, SFPP responds that the protests ignore the fundamental principle behind the Commission's indexing methodology. SFPP states that in Opinion Nos. 435-A and 435-B, the Commission established just and reasonable rates for 1994 and ordered SFPP to determine the rates for the years 1995 forward using indexing adjustments applicable to those years.[673] SFPP states that the D.C. Circuit in reviewing these orders approved the Commission's use of indexing to establish just and reasonable rates for the periods after year for which the just and reasonable rates were established.[674]

402. SFPP states that in Opinion No. 511 the Commission decided that the appropriate basis for setting just and reasonable West Line rates for 2008, but did not determine the just and reasonable rate for 2009 or subsequent years. Moreover, SFPP adds that there is no record evidence available for setting a just and reasonable rate for those later years. SFPP argues that it has complied with the Commission's approach in the past, as asserted by Trial Staff.

403. SFPP contends that the December 2006 Order[675] does not support the protests' objections to SFPP's proposed indexing adjustment. SFPP states that in that proceeding, SFPP filed a cost of service rate increase on May 1, 2006, to become effective June 1, 2006, which was based on actual 2005 base period as adjusted through the first 9 months

---

filing Rehearing)). ExxonMobil argues that the limited holding in *SFPP, L.P.*, 127 FERC ¶ 61,312 (2009), which accepted SFPP's 2009 index adjustment to the West Line was a limited holding that does not foreclose an inquiry into the propriety of including the 2009 index increase in the computation of refunds and prospective rates in this case.

[673] SFPP Answer at 80 (citing Opinion No. 435-A, 91 FERC ¶ 61,135, at 61,516, *order on reh'g,* Opinion No. 435-B, 96 FERC, at 62,072).

[674] SFPP Answer at 80 (citing *BP West Coast*, 374 F.3d at 1312).

[675] 2006 SFPP Index Filing, 117 FERC ¶ 61,271.

of 2006. Later, on May 31, 2006, SFPP states that it filed for an index-based rate increase to be effective July 1, 2006. SFPP states that the Commission concluded that, in the narrow circumstances in which the base period for a cost of service filing is the same as the period on which the indexing adjustment is based, SFPP's indexing adjustment was inappropriate. SFPP argues that the circumstances here are different, i.e. that the West Line cost-based rate increase was calculated using 2007 as the base period and that the 2009 indexing adjustment is based upon 2008 data.

404. SFPP further argues that its Compliance Filing does not capture cost changes from 2007 and 2008 as claimed by Tesoro and ACV Shippers. SFPP asserts that virtually all of the operating costs reflected in SFPP's Compliance Filing reflect 2007 costs. SFPP claims that the only costs the Commission required to be used from 2008 are those costs related to throughput such as fuel and power and oil losses and shortages.[676] SFPP states that the test period changes in SFPP's Compliance Filing were fuel and power costs (which actually caused fuel and power costs to drop), oil losses and shortages expenses, litigation expenses, and a merit increase of 3.5 percent to the base period salaries and wages expense. SFPP adds that wages were about 17 percent of SFPP's total cost of service.

405. The Commission denies SFPP's proposal to apply an index increase of 7.6025 percent to its Opinion No. 511 West Line rates effective July 1, 2009. However, the Commission will allow SFPP to increase its West Line rates by 1.9006 percent, which represents one-quarter of the July 1, 2009 index increase permitted under the Commission's indexing methodology. The one quarter of the index increase for cost changes in 2008 corresponds to the three months of 2008 cost changes that are outside the January 1, 2008 – September 30, 2008 adjustment period. Therefore the cost increases in the last quarter of 2008 are not reflected in the cost of service adopted by Opinion No. 511 or the rates SFPP must establish here.

406. SFPP filed for new rates in this docket for its West Line to be effective August 30, 2008. Under Commission regulations, these rates remained the ceiling rates for the remainder of that index year, which started on July 1, 2008, and concluded June 30, 2009. As SFPP notes, Commission regulations permitted SFPP to request an index rate increase for the subsequent index year to take effect on July 1, 2009.[677]

---

[676] SFPP Answer at 82 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 9, n.4, 27).

[677] While this proceeding was advancing through the hearing process, SFPP submitted a request to increase its West Line for the index year starting July 1, 2009. *SFPP, L.P.*, 127 FERC ¶ 61,312, *as modified,* 128 FERC ¶ 61,067, *order on reh'g*, 130 FERC ¶ 61,081 (2010). Because the underlying base rates were subject to the ongoing

(continued…)

407. However, merely because the Commission regulations permit SFPP to request the index increase does not mean that the Commission is bound to accept the indexed rate increase. Commission regulations consider challenges to a proposed index increase if the increase "is so substantially in excess of the actual cost increases incurred by the carrier that the rate is unjust and unreasonable…."[678] Applying this standard, the Commission has rejected an indexed rate increase following a new cost of service rate filing where the costs incorporated into the new cost of service rates already accounted for the changes in costs associated with the index increase. In the 2006 SFPP Index Filing, the Commission rejected an indexed rate increase to SFPP's East Line to be effective July 1, 2006, which was filed to recover industry-wide cost changes during 2005.[679] The Commission noted that the East Line rate SFPP sought to increase pursuant to the indexing methodology was a recently filed cost of service rate that was based on SFPP's actual costs during its 2005 base period with an adjustment period from January 1, 2006 until September 30, 2006.[680] Thus, the cost of service rate based on 2005 data already accounted for the industry-wide cost changes during 2005 that formed the basis for the proposed index increase to the East Line rates. Accordingly, in the 2006 SFPP Index Filing, the Commission found that applying the index to the cost of service rate would be unjust and unreasonable.[681]

408. As SFPP correctly asserts, the scenario presented by this case is considerably more complicated than the fact pattern presented by the 2006 SFPP Index Filing. In the 2006 SFPP Index Filing, the base period used to determine the cost of service rates (2005) overlapped precisely with the year (2005) that served as the basis for the July 1, 2006 index rate increase. By contrast, in this proceeding, SFPP's 2007 base period data do not

---

proceedings in this docket, the Commission accepted the resulting rates subject to refund. *SFPP, L.P.*, 127 FERC ¶ 61,312 at P 22. Given that the rates were subject to refund, the Commission may now consider whether it is appropriate to grant the index increase based upon the outcome of this proceeding. *BP West Coast Prod. v. SFPP, L.P.*, 121 FERC ¶ 61,243, at P 5 (2007), *reh'g denied, BP West Coast Prod. v. SFPP, L.P.*, 123 FERC ¶ 61,121 (2008), *aff'd sub nom., ExxonMobil Oil Corp. and BP West Coast Prod. LLC v. FERC*, Nos. 07-1163, 363 Fed. Appx. 752, et al. (consolidated) (D.C. Cir.).

[678] 18 C.F.R. § 343.2(c) (2011).

[679] 2006 SFPP Index Filing, 117 FERC ¶ 61,271, *reh'g denied*, 2006 SF Index Filing Rehearing, 120 FERC ¶ 61,245.

[680] 2006 SFPP Index Filing, 117 FERC ¶ 61,271 at P 5.

[681] *Id.*; *see also* 2006 SFPP Index Filing Rehearing, 120 FERC ¶ 61,245 at P 4.

incorporate the 2008 industry-wide cost changes meant to be reflected in its proposed July 1, 2009 indexing increase.

409. However, the distinction drawn by SFPP is too simple. The rates approved by Opinion No. 511 did not rely solely on SFPP's 2007 base period data. Rather, the rates adopted by Opinion No. 511 incorporated substantial cost of service adjustments reflecting data from the adjustment period of January 1, 2008, through September 30, 2008. Specifically, Opinion No. 511 adopted fuel costs and fuel losses and shortages based upon 2008 data.[682] SFPP also proposed an annualized 3.5 percent merit increase to its base period salaries and wages expenses.[683] Taken together, these costs represent a significant proportion of SFPP total operating costs.[684] Capital costs were also heavily influenced by test period modifications to the 2007 base period rate base, the adoption of a September 20, 2008 date for determining cost of debt, and a September 30, 2008 date for determining cost of equity.[685]

410. Finally, the throughput adopted by Opinion No. 511 also reflected January 1 through September 30, 2008 volume levels.[686] In its initial filing, SFPP proposed

---

[682] Although SFPP states that the use of 2008 fuel costs actually caused rates to go down, this occurred because the fuel costs reflected decreased throughput. In total, the decreased throughput contained within the cost of service outweighed any related reductions in cost and allowed SFPP to increase its rates.

[683] The merit increase became effective in October 1, 2007. However, because the increase became effective in late 2007, it is more fully reflected in SFPP's costs for the January 1, 2008 through the September 30, 2008 period than for SFPP's unadjusted 2007 costs.

[684] Excluding depreciation and litigation, SFPP's Compliance Filing indicates that roughly half of its operating costs (labor costs in account 300, fuel and power in account 330, and the portion of costs in account 520 attributable to labor costs) have been adjusted so that they are more reflective of costs during the first nine months of 2008 rather than for the base period. Additionally, although recorded as a gain by SFPP, account 340 for oil shortages and losses also reflects data for the first 9 months of 2008.

[685] Opinion No. 511, 134 FERC ¶ 61,121 at P 151.

[686] Although not technically a cost, throughput levels were an important factor in the cost of service resulting from Opinion No. 511. Because the index increase will apply to the entirety of SFPP's rates, it seems equitable under these circumstances to consider the extent to which the entirety of January 1- September 30, 2008 data

(continued…)

20111216-4007 FERC PDF (Unofficial) 12/16/2011

significant throughput adjustments based upon a significant downturn in volumes transported during the 2008 adjustment period. Although modifying SFPP's initial proposal, Opinion No. 511 recognized the reduction to West Line volumes occurring during the adjustment period, and thus adopted the annualized January 1, 2008 through September 30, 2008 volume data. This resulted in a significant reduction in SFPP's throughput levels as compared to 2007 throughput, and thus a corresponding increase in SFPP's rates.

411. Given the substantial presence of January 1 – September 30, 2008 data reflected in the holdings of Opinion No. 511, the Commission will deny SFPP the full application of the July 1, 2009 Index increase for industry-wide cost changes during 2008. However, Opinion No. 511 did not include cost of service data after September 30, 2008. Thus, in calculating refunds and going-forward rates, SFPP may apply an index increase effective July 1, 2009, to the rates established in Opinion No. 511 and this order corresponding to the last three months of 2008 and equivalent to one quarter of the increase otherwise permitted under the indexing methodology.[687]

The Commission orders:

(A) The requests for rehearing are granted and denied for the reasons stated in the body of this order. All requests or issues that are not explicitly addressed have been considered, but do not merit further discussion and are hereby denied.

---

influenced the cost of service adopted by Opinion No. 511. Furthermore, some cost levels vary according to throughput, and it was Opinion No. 511's determination with respect to throughput that led to the adoption of certain 2008 adjustment period costs.

[687] This decision to permit only one-fourth of the July 1, 2009 index increase is based upon a fact-specific examination of the conclusions in Opinion No. 511 and a fully developed record following a hearing. Without the conclusion of the rate case, it would not have been possible to know how much cost of service data from the adjustment period would ultimately be incorporated into the going forward rates. In order to preserve the simplicity of the index, when the Commission considers an index increase to a base rate that is subject to challenge, the Commission will continue to apply the "percentage comparison test." *SFPP, L.P.*, 135 FERC ¶ 61,274, at P 12 (2011). At the conclusion of the rate proceeding once aware of its final determinations and with the benefit of a full record, the Commission will re-assess whether application of the indexed increase remains appropriate.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

(B) SFPP's Compliance Filing dated April 25, 2011 is accepted subject to the modifications required in the body of this order.

(C) SFPP shall file revised rates, a revised estimate of refunds, and a revised compliance filing consistent with the holdings of this order within 45 days after this order issues. Comments on the revised compliance filing are due within 30 days after this order issues and reply comments 15 days thereafter.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

Appendix A

Name of Respondent SFPP, L.P.	This Report Is: (1) X An Original (2) A Resubmission	Date of Report (Mo, Da, Yr) / /	Year/Period of Report End of 2008/Q4

Annual Cost of Service Based Analysis Schedule

1.) Use footnotes when particulars are required or for any explanations.
2.) Enter on lines 1-9, columns (b) and (c), the value of the respondent's Operating & Maintenance Expenses, Depreciation Expense, AFUDC Depreciation, Amortization of Deferred Earnings, Rate Base, Rate of Return, Return, Income Tax Allowance, and Total Cost of Service, respectively, for the end of the current and previous calendar years. The values shall be computed consistent with the Commission's Opinion No. 154-B et al. methodology. Any item(s) not applicable to the filing, the pipeline company shall report nothing in columns (b) and (c).
3.) Enter on line 10, columns (b) and (c), total interstate operating revenue, as reported on page 301, for the current and previous calendar years.
4.) Enter on line 11, columns (b) and (c), the throughput in barrels from the Statistics of Operations schedule, page 601, line 33b, total of items (1) and (2), from the current and previous year's FERC Form No. 6.
5.) Enter on line 12, columns (b) and (c), the throughput in barrel-miles from the Statistics of Operations schedule, page 600, line 33a, total of items (1) and (2), from the current and previous year's FERC Form No. 6.
6.) If the company makes major changes to its application of the Opinion No. 154-B et al. methodology, it must describe such changes in a footnote, and calculate the amounts in columns (b) and (c) of lines No. 1-12 using the changed application. 7.) A respondent may be requested by the Commission or its staff to provide its workpapers which support the data reported on page 700.

Line No.	Item (a)	Current Year Amount (in dollars) (b)	Previous Year Amount (in dollars) (c)
1	Operating and Maintenance Expenses	81,157,015	75,835,988
2	Depreciation Expense	19,477,899	17,161,048
3	AFUDC Depreciation	122,292	125,874
4	Amortization of Deferred Earnings	2,046,578	1,936,296
5	Rate Base	573,013,361	507,241,021
6	Rate of Return % (10.25% -10.25)	10.20	7.13
7	Return on Rate Base	58,447,362	36,166,284
8	Income Tax Allowance	22,155,578	11,973,316
9	Total Cost of Service	183,406,724	143,198,806
10	Total Interstate Operating Revenues	153,871,946	148,856,082
11	Throughput in Barrels	161,335,001	167,404,150
12	Throughput in Barrel-Miles	43,363,733,208	45,465,836,007

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Appendix B

OPINION NO. 511 – SFPP, L.P. COMPLIANCE FILING

SFPP, L.P. Statement A

West Line Interstate Cost of Service
($000's)

Line No.	Description	Source	Test Period
1	Overall Return on Rate Base	Statement C, Line 16	$8,643
2	Income Tax Allowance	Statement D, Line 13	$3,275
3	Operating Expenses Excl. Depreciation	Statement B, Line 22	$22,459
4	Depreciation Expense	Statement B, Line 14	$5,252
5	Amortization of AFUDC	Statement F2, Lines (3 + 8)	$83
6	Amortization of Deferred Return	Statement E2, Line 14	$1,108
7	Total Cost of Service	Sum Lines (1 through 6)	$41,818

Appendix C

OPINION NO. 511 – SFPP, L.P. COMPLIANCE FILING

SFPP, L.P. Statement D

West Line Interstate Income Tax Allowance
($000's)

Line No.	Description	Source	Test Period
1	Overall Return on Rate Base	Statement C, Line 16	$8,643
2	Interest Expense	Statement C, Line 19	$3,315
3	Return on Equity	Lines (1 – 2)	$5,328
4	Amortization of Deferred Return	Statement E2, Line 14	$1,108
5	Depreciation of ITC Basis Reduction	Schedule 7	$38
6	Amortization of Equity AFUDC	Statement F2, Line 3	$105
7	Amortization of Tax Rate Adjustments	Schedule 7	$168
8	Taxable Allowed Return	Lines (3 + 4 + 5 + 6 – 7)	$6,412
9	Composite Income Tax Rate	Schedule 8	34.93%
10	Net-to-Tax Multiplier	Line 9 / (1 – Line 9)	53.69%
11	Income Tax Allowance - Unadjusted	Lines (8 * 10)	$3,442
12	Amortization of Tax Rate Adjustments	Line 7	$168
13	Income Tax Allowance	Lines (11-12)	$3,275

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Appendix D

Partial Modification of Ex. SFP-99 to Conform to FERC Ratemaking Protocols for Return

Display A

Ex. SFP-99 Lines 13 through Line 17 As Currently Stated

		MLP	Corporation
Line 13	Equity Return on Rate Base	$ 6,900,000.00	$ 6,900,000.00
Line 14	Income Tax Allowance	$ -	$ 3,715,385.00
Line 15	Interest Expense	$ 3,000,000.00	$ 3,000,000.00
Line16	Operating Costs	$ 4,000,000.00	$ 4,000,000.00
Line 17	Revenue Required	$ 13,900,000.00	$17,615,385.00
	Less		
Line 18	Operating Costs	$ 4,000,000.00	$ 4,000,000.00
Line 19	Interest Expense	$ 3,000,000.00	$ 3,000,000.00
Line 20	Income Taxes By the Pipeline	$ -	$ 3,715,385.00
Line 21	Income for Shareholder or the MLP Partner	$ 6,900,000.00	$ 6,900,000.00

Analysis: This portion of Ex. SFP-99 includes both a revenue gross up and an income tax allowance for the corporation, but only a revenue gross up for the MLP. In Ex. SFP-99 the revenue gross up is calculated as Line 3 (13.800 percent pre-tax return) times line 8 (50 percent capital structure) times Line 7 (total rate base of $100,000,000).

Ex. SFP-99 assumes that the MLP (and its partners) have a different cost of service than the corporation, which is fundamentally incorrect. Moreover, the inclusion of the income tax allowance means the Corporation will have significantly higher rates because of its cost of service even though the income on Line 21 is the same for partner and the shareholder. That occurs because the income tax allowance dollars wash out when the taxes are paid. But they would still be in the rates. Finally, the exhibit implies that that the partner will have the same after-tax dollar return if the MLP is denied on income tax allowance. As shown below, this is not mathematically possible in a Commission rate design context.

Display B

Ex. SFP-99 Partially Modified to Reflect FERC Rate Design Methodology

		MLP	Corporation
Line 13	Equity Return on Rate Base	$ 4,692,000.00	$ 4,692,000.00
Line 14	Income Tax Allowance	$ 2,208,000.00	$ 2,208,000.00
Line 15	Interest Expense	$ 3,000,000.00	$ 3,000,000.00
Line16	Operating Costs	$ 4,000,000.00	$ 4,000,000.00
Line 17	Revenue Required	$ 13,900,000.00	$13,900,000.00
	Less		
Line 18	Operating Costs	$ 4,000,000.00	$ 4,000,000.00
Line 19	Interest Expense	$ 3,000,000.00	$ 3,000,000.00
Line 20	Income Taxes By the Pipeline	$ -	$ 2,208,000.00
Line 21	Income for Shareholder or the MLP Partner	$ 6,900,000.00	$ 4,692,000.00
FERC 22	Taxes Paid by Partner or the Shareholder at 32% rate	$ 2,208,000.00	$ 1,501,440.00
FERC 23	After-Tax Return to Partner or the Shareholder	$ 4,692,000.00	$ 3,190,560.00

Analysis: Under this analysis the equity return on rate base does not include the revenue gross because the FERC ratemaking methodology does not provide for either an MLP or the Corporation to do so. The return component is derived as follows from Ex. SFP-99: Line 1 (9.384%) times Line 8 (50 percent capital structure) times Line 7 (total rate base of $100,000,000). The income tax allowance is calculated using a .32 percent marginal tax rate by applying the standard tax computation formula to equity return on Line 13. Line 13 of the analysis shows that the equity return on rate base is the same for the MLP and the corporation per FERC regulatory protocols. It also shows that if an income tax allowance is provided both the MLP and the Corporation, both will have an after-tax return that is equal to the required equity return on Line 13. Please compare Line 21 to Line 23. However the after-tax dollar income to the shareholder on Line 23 is less than the after-tax income to the partner on Line 23 due to the impact of double taxation.

20111216-4007 FERC PDF (Unofficial) 12/16/2011

Display C

Display B Modified to Reflect the Absence of an MLP Income Tax Allowance.

		MLP	Corporation
Line 13	Equity Return on Rate Base	$ 4,692,000.00	$ 4,692,000.00
Line 14	Income Tax Allowance	$ -	$ 2,208,000.00
Line 15	Interest Expense	$ 3,000,000.00	$ 3,000,000.00
Line16	Operating Costs	$ 4,000,000.00	$ 4,000,000.00
Line 17	Revenue Required	$ 11,692,000.00	$13,900,000.00
	Less		
Line 18	Operating Costs	$ 4,000,000.00	$ 4,000,000.00
Line 19	Interest Expense	$ 3,000,000.00	$ 3,000,000.00
Line 20	Income Taxes Paid by Pipeline	$ -	$ 2,208,000.00
Line 21	Income for Shareholder or the MLP Partner	$ 4,692,000.00	$ 4,692,000.00
FERC 22	Taxes Paid by Partner or the Shareholder at 32% rate	$ 1,501,440.00	$ 1,501,440.00
FERC 23	After-Tax Return to Partner or the Shareholder	$ 2,484,000.00	$ 3,190,560.00

Analysis: This analysis repeats Display B, but without an MLP income tax allowance. As with Display B, the after-tax equity return on rate base is the same for MLP and the Corporation ($4,692,000) as are the operating and interest expenses as shown on Line 13. Line 21 shows that the pretax return to the partner, and therefore the partnership, is the same as the corporate shareholder. The MLP has a lower cost of service than the corporation because the income tax allowance is omitted from its cost of service. However, the after-tax return to the partner, and therefore the partnership, stated on Line 23 is less than the required equity return on Line 13 and is also less than the after-tax return to the shareholder. As such, the partnership and the partners do not recover an adequate return on the equity invested in the partnership and the related rate structure fails the capital attraction standard.

Document Content(s)