



# REGULATORY DUE DILIGENCE

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# Overview

- Topics to address
  - Analysis of Regulatory Economic Risks
  - Review of Accounting Requirements
  - Review of Tariff Requirements
  - Discussion of Recordkeeping Issues

# Disclaimer

- This presentation covers due diligence issues related to the economic regulation of oil pipelines. It is not intended to be a comprehensive discussion of all due diligence issues (e.g., environmental, safety, etc.) that a potential buyer may wish to undertake prior to acquiring an asset.
- The following presentation should not be relied upon independent of the statements and explanations presented herewith. Not all issues addressed in this presentation are applicable to every transaction. In particular, the nature of the transaction (i.e., asset purchase vs. company acquisition) may impact the relevance of certain issues.

# Limitations

- Certain analyses discussed in this presentation may not be feasible due to lack of time, the stage of the acquisition progress, the seller's willingness to share information or the nature of the seller's operation.

# Sources of Economic Risk

- Typically an internal acquisition price target is based on a series of assumptions regarding future revenues, operating costs and capital requirements.
- Revenue assumptions in turn are based on projected volumes and rates
- Section 1(5) of the Interstate Commerce Act requires that oil pipeline rates be “just and reasonable.

# Sources of Economic Risk (con't)

- Rate Relationships May Not Be Unreasonably Discriminatory, Preferential or Prejudicial (ICA §§ 2, 3(1))
- If existing rates are determined not just and reasonable, the Commission may prescribe new rates.
- For purposes of this presentation we are assuming that other parties within the organization will assess any risks associated with capital and operating costs.

# Revenue Exposure

- Identify the various components of the revenue stream and determine support for each
  - Transportation Revenue
  - Other Traffic-related Revenues
  - Non-Carrier/Non-jurisdictional Revenues
  - Volume Commitments
  - Seller Affiliated Throughput

# Revenue Exposure (con't)

- Break down the ancillary transportation and non-transportation revenues
  - Are these included in the tariff?
  - Are these reflected as carrier activity?
  - Are these FERC jurisdictional?
  - How are the costs captured?
  - Where are the cost records?
  - How is the revenue tracked?
  - Will these services be impacted by the transaction?
  - What is a reasonable projection of the costs and revenues post transaction?



# Revenue Exposure (con't)

- How were the existing transportation rates established?
  - Cost-based
  - Indexing
  - Market-based
  - Settlement
- Each method will need to be assessed to determine if the existing rates are supportable.

# Cost-Based Rates

- Obtain copy of current Page 700 COS model.
- Obtain a copy of all cost information used to develop COS model.
- Review cost information for internal consistency and consistency with prior period Form 6 data.
- Review how costs and revenues are allocated to non-FERC jurisdictional activities.
- Examine any affiliated transactions and determine if they are well documented and supported.

# Cost-Based Rates (con't)

- Review methodology used to compute COS and ensure it reflects the current opinions.
- Review model logic looking for hard coded figures or questionable formulas.
- Consider recreating the COS by inserting inputs in a working COS model.
- Perform a rate design analysis to determine support for individual rates.
- Estimate any potential revenue reduction association with resetting rates to a cost-basis.

# Indexed Rates

- Obtain a copy of the most recent index ceiling worksheet.
- Obtain a copy of the tariff in effect on January 1, 1995.
- Obtain copies of any non-index rate increases since 1/1/1995.

# Indexed Rates (con't)

- Compute ceiling rates based on indices published on FERC web site and compare to information provided by the seller.
- Examine the change in Page 700 COS and the change in rates for at least the past two years.
- Based on this information the buyer could estimate any revenue exposure associated with index rate challenges.

# Market-Based Rates

- Identify each origin and destination where carrier has market-based ratemaking authority.
- Obtain copies of prior applications and Commission orders relating to market power studies.
- Determine the products and services that were covered by the Commissions order(s).

# Market-Based Rates (con't)

- Evaluate if the market concentration (HHI) or applicant's market share has changed significantly since the Commission issued its order.
- Determine if there is any overlap between the buyer and seller which would significantly impact the market concentration or market shares included in the Commission's order granting market-based rates.

# Market-Based Rates (con't)

- If there is a significant change, or if market statistics exceed any relevant thresholds then consider alternate rate support.
- Compare sellers' market-based rates to comparable rates for the competition.
- Based on this information the buyer could estimate any potential revenue exposure associated with market-based rates.



# Settlement Rates

- Obtaining copies of any settlement agreements currently in effect.
- Determine if the settlement agreements transfer in the acquisition.
- Examine the terms and limitations the settlement imposes upon rates and revenues.
- Determine potential revenue impact compared to other rate justification methods.

# Grandfathered Rates

- Were any of the rates in effect on October 24, 1991?
- If so, a Grandfathered floor may apply
  - Determine if existing cost support exceeds grandfathered rate level
  - Determine if the nature of the services has changed since 1992
  - If the grandfather floor exceeds current or future expected cost-based rate and nature of service has not changed, obtain information needed to perform a Substantial Change in Economic Circumstances (“SCEC”) analysis.

# Grandfathered Rates (con't)

- Identify economic basis (e.g., Return on Equity) for rate which ultimately became grandfathered in 1992 (Period A)
- Determine the economic basis at the time EPA Act was enacted (Period B).
- Calculate current economic basis and projected basis after the transaction (Period C+)

# Grandfathered Rates (con't)

- Using the Commission's SCEC methodology (currently ROE) determine if  $C-B/A$  exceeds relevant threshold (currently 25% sustained).
- Note:
  - $C-B/A$  formula may be subject to corollaries based on economic performance in Period A and B

# Grandfathered Rates (con't)

- If the analysis demonstrates that a potential SCEC has occurred, then if challenged the rates could be reduced below the grandfathered floor on a perspective basis.
- Based on this information the buyer could estimate the potential revenue exposure associated with losing its grandfathered status.

# Accounting Requirements

- Part 352 1-6(e)... a change in the accounting entity must be approved by the Commission.
- Instruction 3- 11 addresses accounting for property acquired by merger consolidation or purchase. Carriers should review the specific instruction on Part 352 to determine proper journal entries, and necessary approvals from the Commission.
- In general, purchased assets from non-affiliates are recorded on the new Carrier's books at the acquired cost or the fair value of the consideration given.

# Accounting Requirements (con't)

- Acquisition of a share in a pipeline system owned in undivided joint interest has specific accounting requirements (Part 352 3-1(d))
- Property acquired from an affiliate is typically reflected at the same amounts that were recorded on the affiliate's books, provided contributions by non-carrier affiliates shall not exceed the fair value of the property.
- Tentative journal entries recording acquisition of the pipeline property shall be submitted to the commission for approval. Inst. 3-11(c).
- These values may be different than those used for ratemaking purposes.
- Property Records vs Depreciated Original Cost, 154-B and Trended Original Cost (e.g., 1983 Valuation Data)

# Tariff Requirements

- Carriers must notify the Commission when:<sup>1</sup>
  - There is a change in the pipeline's legal name,
  - Transfer of all the carrier's property, or
  - Change in ownership only a portion of the carrier's property.
- Carrier(s) must file notice by publication of adoption notice no later than 30 days following occurrence
  - Adoption notices require no notice period before being effective
  - Adoption notices may contain no other matters
- Tariffs canceling or bringing forth the relevant rules and rates must be filed by both carriers within 30 days of the adoption notices with the appropriate references. See Part 341.6.

<sup>1</sup>Part 341.6 (a)



# Tariff Requirements (con't)

- Determine if carrier participates in any joint tariffs, if so, obtain copies of:
  - The joint tariff agreement,
  - Any division sheets, and
  - Concurrences.
- The new Carrier should obtain a copy of the relevant tariff subscribers list from the seller.

# Certificates

- To the extent applicable, the buyer may need to seek modification of any Certificates of Public Necessity and Convenience issued by any public utility commission.

# Record Keeping

- Part 356 establishes requirements for the preservation of records
- Every carrier must designate a representative to supervise the company's record preservation and authorized destruction program. Part 356.2 (b)
- Carriers must provide reasonable protection of records from fires, floods and other hazards that could damage the records.
- All records stored on magnetic media must have a life expectancy at least equal to the applicable minimum retention period required in Part 356.3.

# Record Keeping (con't)

- Carriers are required to have internal control procedures to ensure the reliability and ready access to data stored electronically.
- If records are lost or prematurely destroyed, the carrier must notify the Commission within 90 days of the discovery.
- Carriers must arrange and index records so they are readily identifiable and available to the Commission's representatives

# Record Retention

- Record retention periods in Part 356.3 are considered minimums.
- If a company merges with another company under jurisdiction of the Commission, the successor company must preserve records of the merged company in accordance with the regulations.

# Record Retention (con't)

Item No. and description	Retention period
<b>Corporate and General</b>	
<b>1. Incorporation and reorganization:</b>	
(a) Charter of certificate of incorporation and amendments	Permanently or at termination of the corporation's existence
(b) Legal documents related to mergers, consolidations, reorganizations, receiverships, and similar actions which affect the identity or organization of the company	Permanently or at termination of the corporation's existence
<b>2. Minutes to Directors', Executive Committees', Stockholders', and other corporate meetings</b>	5 years

# Record Retention (con't)

Item No. and description	Retention period
<b>3. Titles, franchises, and authorities:</b>	
(a) Certificates of public convenience and necessity issued by regulating bodies	Until expiration or cancellation
(b) Operating authorizations and exemptions to operate issued by regulating bodies	Until expiration or cancellation
(c) Copies of formal orders of regulatory bodies served upon the company	1 year after expiration or cancellation
(d) Deeds, charters, and other title papers	3 years after disposition of property

# Record Retention (con't)

Item No. and description	Retention period
<b>4. Contracts and agreements:</b>	
(a) Contracts and related papers for transactions which are subject to the provisions of the Clayton Antitrust Act (15 U.S.C. 20)	4 years after expiration, provided there is no pending litigation or governmental inquiry or proceeding involved
(b) Service contracts, such as for operational management, accounting, financial or legal service, and agreements with agents	3 years after expiration or termination
(c) Contracts and other agreements relating to the construction, acquisition or sale of real property and equipment except as otherwise provided in paragraph (a) of this item	3 years after expiration or termination



# Record Retention (con't)

Item No. and description	Retention period
<b>5. Accountant's, auditor's, and inspector's reports:</b>	
(a) Certifications and reports of examinations and audits conducted by public and certified public accountants	3 years
(b) Reports of examinations and audits conducted by internal auditors, time inspectors, weight inspectors, and others	3 years
<b>Treasury</b>	
<b>6. Long-term debt records:</b>	
(a) Bond indentures, underwriting, mortgage, and other long-term credit agreements	6 years after redemption

# Record Retention (con't)

Item No. and description	Retention period
<b>Financial Accounting</b>	
<b>7. Ledgers:</b>	
(a) General and subsidiary ledgers with indexes thereto	3 years.
(b) Balance sheets and trial balance sheets of general and subsidiary ledgers	3 years.
<b>8. Journals:</b>	
(a) General journals	3 years.
(b) Subsidiary journals and any supporting data, except as otherwise provided for, necessary to explain journal entries	3 years.
(c) Schedules of recurring or standard journal entries with entry identifications	Until superseded.

# Record Retention (con't)

Item No. and description	Retention period
<b>9. Vouchers:</b>	
(a) Voucher registers or equivalent	5 years
(b) Paid and canceled vouchers, expenditure authorizations, detailed distribution sheets, and other supporting data including original bills and invoices, except as otherwise provided herein	5 years
<b>10. Accounts receivable, record, or register of accounts receivable</b>	3 years after settlement
<b>11. Records of accounting codes and instructions</b>	3 years after discontinuance

Item No. and description	Retention period
<b>12. Property records:</b>	
(a) Records which maintain complete information on cost or other value of all real property or equipment	3 years after disposition of property
(b) Records and additions and betterments made to property and equipment	3 years after disposition of property
(c) Records pertaining to retirements and replacements of property and equipment	3 years after disposition of property
(d) Records pertaining to depreciation:	
(1) When group method and depreciation rates are prescribed by the Commission	3 years after disposition of property
(2) Other	3 years after disposition of property
(e) Records of equipment number changes	3 years after disposition of property
(f) Records of motor and engine changes	Destroy at option
(g) Files of detailed authorizations for expenditures, work or job orders showing estimated costs of additions and betterments, extensions, replacements, major repairs and dismantlements, approved by proper officials, together with supporting data	3 years after disposition of property
(h) Periodical inventories of property and equipment	3 years after prior inventory

Item No. and description	Retention period
<b>13. Engineering records:</b>	
(a) Plans and specifications	3 years after the disposition of the property
(b) Estimates of work, engineering studies, construction bids, and similar data pertaining to property changes actually made	15 years
<b>Personnel and Payroll</b>	
<b>14. Payroll records:</b>	
(a) Registers, abstracts, or summaries showing earnings, deductions, and amounts paid to each employee by pay periods	3 years
(b) Records showing the detailed distribution of salaries and wages to various accounts	3 years

Item No. and description	Retention period
<b>Taxes</b>	
15. Copies of tax returns and supporting schedules filed with taxing authorities, supporting working papers, records of appeals of tax bills, and receipts for payment. See Subsection 9(b) for vouchers evidencing disbursements:	
(a) Income tax returns	3 years after final tax liability is determined
(b) Property tax returns	3 years after final tax liability is determined
(c) Sales and other use taxes	3 years final tax liability is determined
(d) Other taxes	3 years after final tax liability is determined
(e) Agreements between associate companies as to allocation of consolidated income taxes	3 years after final tax liability is determined
(f) Schedule of allocation of consolidated Federal income taxes among associate companies	3 years after final tax liability is determined

# Record Retention (con't)

Item No. and description	Retention period
16. Information returns and reports to taxing authorities	3 years, or for the period of any extensions granted for audits
<b>Purchase and Stores</b>	
17. Material ledger, records of material and supplies on hand at all locations	2 years
18. Inventories: General Inventories of material and supplies on hand, with record of adjustments between accounts required to bring stores records into agreement with physical inventories	2 years

Item No. and description	Retention period
<b>Transportation</b>	
<b>19. Oil and other products stocks and movement pipelines only:</b>	
(a) Records and receipts, deliveries, pumpings, stocks, and over and short	3 years
(b) Run tickets showing quantities by tank measurement of meter reading of oil and other products received into the delivered from company's lines	3 years
(c) Statements of oil and oil products consumed as fuel including quantity value, and where consumed	3 years
(d) Statement of oil and other products lost by line breaks and leaks including quantity, value, and location of breaks and leaks	3 years
(e) Reports of power furnished by producers: monthly reports of the quantity of oil run in connection with which power was furnished by producers, and records of payment for such power	3 years



Item No. and description	Retention period
<b>Tariffs and Rates</b>	
20. Official file copies of tariffs, classifications, division sheets, and circulars relative to the transportation of property	3 years after expiration or cancelation
21. Authorities and supporting papers for transportation of property for free or at reduced rates	3 years
22. Copies of concurrences and powers of attorney	2 years after expiration or cancelation
23. Correspondence and working papers in connection with the making of rates and compliance of tariffs, classifications, division sheets, and circulars affecting the transportation of property	2 years after cancelation of tariff
<b>Reports and Statistics</b>	
24. Reports to Federal Energy Regulatory Commission and other regulatory bodies, annual financial, operating and statistical reports, file copies, and supporting data	5 years

Item No. and description	Retention period
<b>Transportation</b>	
19 (f) Records of producers' property identifying ownership and location for producers' tanks or wells to which carrier's lines are connected	3 years after disconnection
(g) Division or other periodical inventory reports of oil and other products on hand	3 years
(h) Division orders: Directions received by carrier as to the division of interest and to whose account transported oil should be credited	3 years after discontinuance
(i) Directions received by the carrier for the transfer of division order interests from one interest owner to another	3 years after discontinuance
(j) Transfer orders for the transfer of ownership of oil or other products in carrier's custody	3 years

# Record Retention (con't)

- Records may be destroyed after the business is discontinued, the company is completely liquidated and all dissolution transactions are final.
- Notwithstanding the minimum retention periods, if a pipeline is involved in pending litigation it must retain all relevant records.
- Records must be maintained beyond the required retention period if the pipeline intends to reflect costs or adjustments in a current or future rate case.

# Rate Case Records

- The following is a list of records which most likely be required if a carrier files for a cost-based rate adjustment.
- This list is intended to be representative, however it may not be exhaustive.

# Rate Base Elements

- Carrier Property
  - Asset ledgers at the lowest level of detail available which contain the original costs of construction the assets (by asset number, location code and FERC USoA property account, etc.) for as far back as possible.
  - Property activity (i.e., additions, retirements, transfers, etc.) at the lowest level of detail available for as far back as possible.
  - Monthly balances of construction work in progress for as far back as possible.
  - Any idle or non-carrier pipeline assets (by assets number) which are part of the transaction.

# Rate Base Elements (con't)

- Accrued Depreciation
  - Depreciation activity (i.e. depreciation expense, retirements, adjustments, etc.) at the same level of detail as provided for carrier property.
  - Depreciation rates used to calculate depreciation expense from beginning of operation.
  - Copies of all FERC depreciation orders.
  - Copy of most recent Depreciation study

# Rate Base Elements (con't)

- Working Capital
  - Monthly balances for the following (back to 1983 if possible):
    - Oil inventories
    - Materials and supplies
    - Prepayments
    - Operating Oil Supply
- Determine how prior owned recorded Interest During Construction related to capital additions.

# Operating Expenses

- Actual carrier operating expenses by FERC account, AFE, and other available categories on a monthly basis for the period at the lowest level of detail available for:
  - the last three to five years,
  - 1991 and 1992 calendar years, and
  - the 12 months preceding and subsequent to the date any grandfathered rates became effective.



# Operating Expenses (con't)

- Any overhead expense allocated to the pipeline from its parent company for the periods described above.
- Copies of the work papers or other data supporting these allocations and descriptions of the methodology employed.

# Volumes

- Throughput (book movements) for:
  - the last five years,
  - 1991 and 1992, and
  - the year before and after the effective date of any Grandfathered Rates.

# Volumes (con't)

- Volume data should be broken down to the lowest level of detail possible, such as, by:
  - Month ,
  - Origin and destination with Corresponding mileages,
  - Product type,
  - Shipper,
  - Jurisdiction, and
  - Tariff and tariff item number associated with each transaction (if available).

# Other Ratemaking Items

- Federal and state tax rates for all historic years available
- If acquisition is an MLP, obtain historic split of unit holder classifications and income allocated to each category
- Parent Capital Structure and Cost of Debt for Parent and Pipeline (if applicable) back to 1983, if available.
- 1983 valuation reports (ACV) submitted to FERC, if available.
- Detailed 1983 Valuation Report issued by FERC

A faded, grayscale background image of a typewriter, showing the keyboard on the left and the carriage on the right. The text "Questions?" is overlaid in the center.

Questions?