127 FERC ¶ 63,023
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Chevron Products Co.,		
BP West Coast Products LLC	Docket Nos.	OR03-5-000
ExxonMobil Oil Corporation, and		OR05-4-000
ConocoPhillips Co.		OR05-5-000
v.		
SFPP, L.P.		
America West Airlines, Inc., Southwest Airlines Co., Northwest Airlines, Inc. And Continental Airlines Inc.	Docket No.	OR04-3-000
v.		
SFPP, L.P.		

INITIAL DECISION

(Issued June 9, 2009)

Appearances

Elisabeth R. Myers, *Gordon Gooch*, *Shannon P. Coleman*, and *Shannon Maher Bañaga* on behalf of BP West Coast Products LLC and ExxonMobil Oil Corporation

Kevin J. Vaughan, *Thomas J. Eastment* and *Joshua B. Frank* on behalf of ExxonMobil Oil Corporation

Todd L. Normane on behalf of BP West Coast Products LLC

George L. Weber on behalf of Chevron Products Company

Marcus W. Sisk, Jr., *Frederick G. Jauss IV*, and *Timothy J. Koeppl* on behalf of ConocoPhillips Company

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

Richard E. Powers, Jr. and *Christopher K. Diamond* on behalf of Continental Airlines, Inc., Northwest Airlines, Inc., Southwest Airlines Co., and US Airways, Inc.

Charles F. Caldwell, Randy P. Parker, Albert S. Tabor, Jr., Dean H. Lefler, , Daniel W. Sanborn, Michelle T. Boudreaux, Andrea M. Halverson, and *Amy L. Hoff* on behalf of SFPP, L.P.

Joel M. Cockrell and *Mary C. Hain* on behalf of the Federal Energy Regulatory Commission

Bobbie J. McCartney, Presiding Administrative Law Judge

JOINT STATEMENT OF THE CASE[1]

The current complaint proceeding effectively makes up the third generation of complaints in a series of complaint proceedings challenging SFPP's system-wide rates filed with the Federal Energy Regulatory Commission ("Commission" or "FERC"). The first generation of complaints challenging SFPP's rates involves Docket Nos. OR92-8, *et al.* The second generation of complaints challenging SFPP's rates involves Docket Nos. OR96-2, *et al.* This Joint Statement of the Case will discuss each of those proceedings as they pertain to the East Line and West Line, the two lines at issue in this proceeding.

Final and non-appealable orders have not been issued in any of the complaint proceedings discussed below, except for the approval of settlements of the East Line rates in Docket Nos. IS06-283 and IS08-28 that resolved the East Line rates from June 1, 2006 forward.

I. First Generation of Complaints – Docket Nos. OR92-8, *et al.*

The first generation of complaints was consolidated under Docket Nos. OR92-8-000, *et al.*, and included complaints filed by El Paso Refining Company, Chevron, Navajo Refining Company, L.P. ("Navajo"), ARCO Products Company (ARCO"),

[1] The Joint Statement of the Case was prepared and submitted by Continental Airlines, Inc., Northwest Airlines, Inc., Southwest Airlines Co., and US Airways, Inc. ("Airlines"), BP West Coast Products LLC("BP"), Chevron Products Company ("Chevron"), ConocoPhillips Company ("ConocoPhillips"), ExxonMobil Oil Corporation ("ExxonMobil"), Valero Marketing and Supply Company ("Valero"), the Commission Staff and SFPP, L.P. ("SFPP") at my direction for incorporation into this Initial Decision. Tr. 2117. It is incorporated without substantive changes.

Texaco Refining and Marketing Inc. (“TRMI”), Mobil Oil Corporation (“Mobil”) and Tosco Corporation (“Tosco”). Docket Nos. OR92-8-000 *et al.* addressed complaints filed between August 1992 and August 1995. Proceedings under Docket Nos. OR92-8-000, *et al.*, were the subject of the Court orders in *BP West Coast Products LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) (“*BP West Coast*”) and *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945 (D.C. Cir. 2007) (“*ExxonMobil*”).

The proceedings under Docket Nos. OR92-8-000, *et al.*, addressed, among other matters, cost-of-service issues for the East Line and West Line rates.

A. Initial Filings

On July 31, 1992, SFPP filed FERC Tariff Nos. 15, 16, and 17, to be effective September 1, 1992. Complaints and protests were filed by several shippers.

On September 29, 1992, the Commission’s Oil Pipeline Board (“Board”) initiated an investigation into Tariffs 15, 16 and 17, and ordered the rates therein to be suspended and collected subject to refund.

On January 29, 1993, the Board initiated an investigation and allowed the rate to be collected subject to refund.

On April 2, 1993, the Commission vacated the original suspension order and ruled that the case would proceed as an ICA Section 13(1) complaint proceeding. *SFPP, L.P.*, 63 FERC ¶ 61,014, *aff’d on reh’g*, 63 FERC ¶ 61,275 (1993).

B. Enactment of EPAct

On October 24, 1992, the Energy Policy Act of 1992 (“EPAct”) was enacted into law. Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776 (1992).

C. Order Applying EPAct

On October 5, 1993, FERC held that the West Line rates were “grandfathered” under Section 1803(b) of EPAct and that the Shippers were required to establish “substantially changed circumstances.” FERC also held that SFPP’s East Line rates were not “grandfathered” under EPAct because those rates had been subject to challenge during the one-year period ending on the day EPAct was enacted. *SFPP, L.P.*, 65 FERC ¶ 61,028, at 61,378 (1993).

D. Initial Decision

On September 25, 1997, the Presiding Administrative Law Judge ("ALJ") issued an Initial Decision. *SFPP, L.P.*, 80 FERC ¶ 63,014 (1997). The ALJ ruled that the West Line Shippers had not met the standards established in Section 1803(b) of EPAct.

The ALJ also found that SFPP's East Line rates were not just and reasonable. He ordered SFPP to file revised rates and pay reparations to East Line complainants.

E. Opinion No. 435, *et al.*

On January 13, 1999, on review of the Initial Decision, FERC issued Opinion No. 435. *SFPP*, *L.P.*, 86 FERC ¶ 61,022 (1999) ("Opinion No. 435"). Therein, FERC concluded that SFPP's West Line rates remained grandfathered under EPAct. Opinion No. 435 at 61,061-62. FERC reviewed SFPP's East Line rates on a cost-of-service basis, and concluded that they were not just and reasonable. *Id.* at 61,084-111.

FERC directed SFPP to file revised East Line tariffs for the years 1994-1998, and to estimate reparations.

On March 15, 1999, SFPP filed its compliance filing along with revised East Line rates. On April 14, 1999, FERC suspended these rates subject to refund and the outcome of the further proceedings in Docket No. OR92-8, *et al*.

On May 17, 2000, FERC issued an order on rehearing of Opinion No. 435. *SFPP, L.P.*, 91 FERC ¶ 61,135 (2000) ("Opinion No. 435-A"). Therein, FERC denied rehearing of the issues involving the "changed circumstances" standard with respect to the West Line rates.

The Commission required SFPP to submit a revised compliance filing and revised rates within 60 days.

On July 17, 2000, SFPP submitted its compliance filing along with revised East Line rates. The Commission accepted the revised rates and suspended them to become effective August 1, 2000, subject to refund.

On September 13, 2001, FERC issued an order on rehearing of Opinion No. 435-A. *SFPP, L.P.*, 96 FERC ¶ 61,281 (2001) ("Opinion No. 435-B"). The Commission held that the complainants were entitled to reparations beginning two years prior to the filing of their complaints. *Id*. at 62,071-74.

The Commission required SFPP to submit a compliance filing and revised tariff, including revised estimates of reparations and refunds, within 60 days, with an August 1, 2000, effective date.

F. *BP West Coast Products, L.L.C. v. FERC*

On July 20, 2004, the U.S. Court of Appeals for the D.C. Circuit ("D.C. Circuit") remanded FERC's Opinion No. 435, *et al*. In *BP West Coast Products*, the D.C. Circuit generally upheld FERC's determination that the Complainants had not established substantially changed circumstances with regard to the West Line rates. The D.C. Circuit also upheld most of FERC's rulings regarding the 1994 cost of service used to determine the reasonableness of the East Line rates. However, the D.C. Circuit remanded the issues concerning an income tax allowance, the method for allocating regulatory litigation expenses between the East and West Lines, and the denial of the recovery of SFPP's line rehabilitation costs.

II. Second Generation of Complaints – Docket Nos. OR96-2, *et al.*

The second generation of complaints was consolidated under Docket Nos. OR96-2-000, *et al.*, and included complaints filed by ARCO, TRMI, Mobil, Ultramar Diamond Shamrock Corporation ("Ultramar"), Tosco, Navajo, and Refinery Holding Company. Docket Nos. OR96-2-000 *et al.* addressed complaints filed between December 1995 and August 2000.

The proceedings under Docket Nos. OR96-2-000 *et al.* addressed, among other matters, cost-of-service issues for the East Line and West Line.

A. Initial Filings

On October 22, 1997, ARCO, TRMI, and Mobil filed a complaint challenging all of SFPP's rates. Subsequently, other shippers also filed complaints. The Commission consolidated the complaints, determined that they raised the same or similar issues to those pending in Docket Nos. OR92-8, *et al.*, and thus held the consolidated complaints in abeyance pending a final decision in OR92-8, *et al*. *Tosco Corp. v. SFPP, L.P.*, 84 FERC ¶ 61,139 (1998).

The ALJ separated the proceedings into two phases. The first phase addressed the issue of whether SFPP's rates on the West Line, among other lines, remained protected by the grandfather provision of EPAct. The second phase addressed whether SFPP's non-grandfathered rates were just and reasonable on a cost-of-service basis.

B. Phase I

On March 26, 2004, FERC issued a decision in Phase I of Docket No. OR96-2-000, *et al.*, addressing whether there was a substantial change in the economic circumstances underlying SFPP's rates on the West, North, and Oregon Lines. *SFPP*, 106 FERC ¶61,300 ("March 2004 Order"). FERC determined the complainants had not established that there were substantially changed circumstances with regard to the North Line or Oregon Line rates and thus those rates continued to be grandfathered. However, FERC held that the grandfather protection should be removed from the West Line rates as a whole beginning in 1995, and for certain specific points on the West Line in 1995 and 1997.

Finally, FERC established a Phase II hearing to explore the rate issues.

C. Phase II

On September 9, 2004, the ALJ issued an Initial Decision in Phase II addressing the reasonableness of the East Line and West Line rates, holding that those rates were unjust and unreasonable. *Texaco Refining and Marketing v. SFPP, L.P.*, 108 FERC ¶ 63,036 (2004**)** (Phase II Initial Decision). Several of the findings of the Phase II Initial Decision were addressed in the December 2005 Order, *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005), ("December 2005 Order"), *appeal pending*, D.C. Circuit Case No. 06-1008, *et al.*

D. Income Tax Policy Statement

In response to the *BP West Coast* remand, on May 5, 2005, FERC issued its Policy Statement on Income Tax Allowances. The Income Tax Policy Statement concluded that a pass-through regulated entity should be permitted an income tax allowance if its partners had an "actual or potential" income tax liability. *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139, at P 1 (2005) ("Income Tax Policy Statement").

On June 1, 2005, FERC issued an order on the jurisdictional issues remanded by the D.C. Circuit in *BP West Coast* and the Phase II rate issues, including the income tax allowance issue. *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) ("June 2005 Order").

On December 16, 2005, FERC addressed in the December 2005 Order the Initial Decision in Phase II involving the reasonableness of the rates and it addressed the income tax allowance issues. In addition, FERC addressed SFPP's depreciation rates, and directed SFPP to submit a compliance filing.

On March 7, 2006, SFPP submitted a compliance filing together with the required related tariff filing in Docket No. IS06-215-000.

On March 22, 2006, the shippers filed initial comments, and protests were subsequently filed.

E. *ExxonMobil Oil Corporation, et al. v. FERC,* 487 F.3d 945 (D.C. Cir. 2007)

On May 29, 2007, the D.C. Circuit issued a decision on the appeal of Phase I of Docket Nos. OR96-2, *et al*. In *ExxonMobil,* the Court denied the petitions challenging the Income Tax Policy Statement, finding it was not inconsistent with *BP West Coast*.

On December 26, 2007, FERC issued an order in Docket Nos. OR92-8, *et al.*, and OR96-2, *et al.*, *SFPP, L.P.*, 121 FERC ¶ 61,240 (2007) ("December 2007 Order"). There, FERC addressed the issues of income tax allowance, substantially changed circumstances, and reparations as well as other cost of service issues raised by the compliance filing submitted on March 7, 2006.

FERC directed SFPP to modify its March 2006 compliance and tariff filings.

On February 26, 2008, SFPP submitted its compliance filing ("2008 Compliance Filing"). In conjunction with this 2008 Compliance Filing, SFPP also submitted a tariff filing in Docket No. IS08-137-000, therein establishing interim rates for the East Line and West Line.

F. Return on Equity Policy Statement

On April 17, 2008, FERC issued a policy statement with respect to the calculation of the rate of return for master limited partnerships such as SFPP. *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 (2008), *order on reh'g*, 123 FERC ¶61,259 (2008).

III. Third Generation of Complaints – Docket Nos. OR03-5, *et al.*

The third generation of complaints was initially consolidated into Docket Nos. OR03-5-000, *et al.* The complaints were filed by Chevron, BP, ExxonMobil, ConocoPhillips, and the Airlines between July 2003 and December 2004.

The Commission accepted Chevron's complaint and held it in abeyance. *Chevron Products Company*, Order on Complaint, 105 FERC ¶ 61,142 (2003).

On February 25, 2005, FERC accepted the other complaints for filing, consolidated them and held the consolidated proceedings in abeyance. *BP West Coast Products LLC, et al., v. SFPP, L.P.*, 110 FERC ¶ 61,183 (2005).

On February 13, 2006, the Commission issued an order which severed the portions of the complaints challenging SFPP's North Line and Oregon Line rates and consolidated them in Docket No. OR03-5-001. FERC also held the parts of the complaints challenging SFPP's East Line and West Line rates in abeyance. *See Chevron Products Co. v. SFPP, L.P.*, 114 FERC ¶ 61,133 (2006).

A. North/Oregon Lines

On November 18, 2008, ALJ Silverstein issued an Initial Decision focused on SFPP's rates on the North and Oregon Lines. *Chevron Products Company, et al.,* 125 FERC ¶ 63,018 (2008).

B. East/West Lines

On January 23, 2008, FERC set the portions of the complaints dealing with SFPP's East and West Lines for hearing in this proceeding. *Chevron Products Co. v. SFPP, L.P.*, 122 FERC ¶ 61,052 (2008).

On January 24, 2008, the Chief Judge issued an order designating Bobbie J. McCartney the Presiding Judge in this proceeding.

On February 20, 2008, the Presiding Judge adopted the Protective Order for this proceeding.

On April 16, 2008, the Presiding Judge issued an order directing SFPP to prepare and submit East Line and West Line cost-of-service studies for calendar years 2003 and 2004, as well as a West Line cost-of-service study for calendar year 2007.

On May 7, 2008, the Presiding Judge issued a revised procedural schedule to permit prepared direct and reply rounds of testimony to be filed with respect to the 2007 cost of service.

On June 20, 2008, SFPP filed direct testimony with respect to the 2007 cost of service. On July 21, 2008, the Presiding Judge issued an order granting SFPP leave to withdraw the 2007 cost-of-service data and the related direct testimony it had filed.

On August 6, 2008, the Presiding Judge issued an order adopting a joint motion of the participants regarding the use of evidence.

On October 22, 2008, the Presiding Judge issued an order denying the Airlines' motion to compel SFPP to produce a 2006 cost-of-service study.

The hearing began on November 19, 2008, and lasted until December 12, 2008. At the hearing 19 witnesses testified and 354 exhibits were admitted into evidence.

IV. East Line and West Line Rate Cases Initiated after the Third Generation of Complaints

Subsequent to the initiation of the proceedings in Docket Nos. OR03-5-000, *et al.*, SFPP filed requests for rate increases with respect to its East Line and West Line rates.

A. East Line

On May 1, 2006, SFPP filed to increase the East Line rates in Docket No. IS06-283 to reflect the costs of placing in service its Phase I expansion. The filing was protested and the East Line rate issues were resolved by settlement. *SFPP, L.P.*, 122 FERC ¶ 61,107 (2008).

On December 1, 2007, SFPP placed in effect in Docket No. IS08-28, new East Line rates reflecting completion of Phase II of the East Line expansion.

On January 29, 2009, FERC issued an order approving a settlement of all issues in Docket No. IS08-28 and the establishment of prospective rates on the East Line. *SFPP, L.P.*, 126 FERC ¶ 61,076 (2009).

B. West Line

On June 30, 2008, SFPP's filed to increase the West Line rates in Docket No. IS08-390.

On July 29, 2008, FERC issued an order accepting SFPP's rate increase, suspending it and authorizing the rates to become effective on August 1, 2008, subject to refund and further order of FERC. *SFPP, L.P.*, 124 FERC ¶61,103 (2008). A hearing in this matter is scheduled to commence on June 2, 2009.

JOINT STATEMENT OF ISSUES

At the direction of the undersigned a "Revised Joint Statement of Issues" was prepared and submitted by Participants in this proceeding on December 12, 2008. The issues are addressed in the Analysis section of the Initial Decision in substantially the same order as set forth herein below. [2]

I. Burden of Proof

A. Which participants bear the burden of proof in this proceeding?

B. Which participants bear the burden of proof on the issue of the Income Tax Allowance, if any, for SFPP?

C. Whether SFPP can lawfully increase the rates found to be just and reasonable by the percentages of the subsequent annual index rate increases.

II. Allowed Return - for each complaint year and for the test year used to determine rates:

A. What is the appropriate rate base?

B. What is the appropriate inflation-adjusted deferred return?

C. What is the appropriate methodology for calculating each year's deferred return?

D. What is the appropriate amortization rate and amortization period?

E. What is the appropriate treatment of ADIT?

F. What is the appropriate capital structure?

G. What, if any, are the appropriate adjustments for purchase accounting and goodwill?

H. What is the appropriate cost of debt?

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[2] A Revised Final Joint Statement of Issues was prepared and submitted by the Airlines, BP, Chevron, ConocoPhillips, ExxonMobil, Valero, Staff and SFPP on December 12, 2008.

I. What is the appropriate methodology for deriving a rate of return on equity (including any concerns about the Policy Statement on Composition of Proxy Groups)?

J. Where should SFPP be placed in the range of the appropriate proxy group?

K. What is the appropriate rate of return on equity?

L. Whether some adjustment should be made to the equity return to credit ratepayers for the benefits that flow from some aspects of the partnership structure and, if so, how to make that adjustment.

III. Income Tax Allowance - for each complaint year and for any test year used to determine rates:

A. Whether SFPP is entitled to any income tax allowance as a matter of law or fact.

B. To the extent that SFPP is entitled to an income tax allowance, what is the appropriate income tax allowance?

C. What is the appropriate treatment of ADIT?

D. How do you determine the "taxable income" of SFPP and of the relevant partners?

E. How do you determine the "tax rate" for the relevant partners?

F. Should SFPP's rates include compensation for all or any part of any taxes that may be assessed in the future on the profits, if any, on the cash received from a new purchaser? If they do, should ratepayers have to pay all or any part of such taxes, and if so, how should that allowance be calculated?

G. Are there unintended consequences of applying the income tax policy statement of which the Commission should be aware?

IV. Operation And Maintenance Expenses — for each complaint year and for the test year used to determine rates:

A. What is the appropriate allocation of general and administrative expenses?

1. Mass Formula

2. KN Formula

B. What is the appropriate depreciation expense?

C. What are the appropriate allocation factors for investment and operating expenses?

D. What is the appropriate development and allocation of environmental remediation expenses?

V. Throughput volume - for each complaint year and for the test year used to determine prospective rates, what is the appropriate throughput volume level?

VI. What are the just and reasonable rates that SFPP should be allowed to charge for the periods covered by the complaints in this proceeding?

VII. What Are The Proper Remedies?

A. Are complainants entitled to reparations in this proceeding?

B. What is the appropriate level of reparations?

ISSUE ANALYSIS

I. Burden of Proof

A. Which participants bear the burden of proof in this proceeding?

<u>Positions of the Parties</u>

ACC Shippers

1. The ACC Shippers argue that, under Section 13(1) and 15(1) of the Interstate Commerce Act ("ICA")[3], a party that files a complaint challenging an oil pipeline's existing rate bears the burden of proving that the rates on file with the Commission are unjust and unreasonable.[4]

Indicated Shippers

2. The Indicated Shippers agree that Complainants bear the burden of proof under Section 13(1) of the ICA.[5] Further, the Indicated Shippers allege that Complainants have met their burden by showing that SFPP's rates produced revenues in excess of its costs.[6]

Commission Trial Staff

3. Staff explains that, because this is a complaint proceeding under Section 13 of the ICA, Complainants bear the burden of proof.[7]

SFPP, L.P.

4. According to SFPP, Complainants bear the burden of proof in this proceeding and cannot prevail where they have not presented evidence to support an allegation or where their evidence does not meet the required burden of proof.[8]

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[3] An Index of Abbreviated Terms is attached as an Appendix to this Initial Decision.

[4] ACC Shippers Initial Brief at 5 (citing 49 U.S.C. app. §§13, 15(1988)) (hereinafter ACC IB).

[5] Indicated Shippers Initial Brief at 2 (hereinafter IS IB).

[6] Indicated Shippers Reply Brief at 2 (hereinafter IS RB).

[7] Commission Trial Staff Initial Brief at 1-2 (hereinafter Staff IB).

[8] SFPP Initial Brief at 1 (hereinafter SFPP IB).

5. Further, SFPP explains, the challenged rates were established pursuant to indexing and so this complaint proceeding is subject to Section 343.2(c)(1) of the Commission's regulations.[9] According to SFPP, Complainants and Staff have the burden of proving: (1) SFPP's 2003 and 2004 East and West Line filed rates were unjust and unreasonable; and (2) the rates proposed by Complainants and Staff are just and reasonable. Here, SFPP asserts that neither the Complainants nor Staff have met their burdens.[10]

<u>Discussion and Findings</u>

6. All parties agree that Complainants bear the burden of proof in this proceeding based on Section 13(1) of the Interstate Commerce Act.[11] When a carrier proposes changing its rates, the burden of proof is on the carrier to show that the proposed new rate is just and reasonable.[12] However, when a party files a complaint against a pipeline's rates pursuant to Section 13(1), that party has the burden of showing that the rates currently on file are unjust and unreasonable.[13]

B. Which participants bear the burden of proof on the issue of the Income Tax Allowance, if any, for SFPP?

<u>Positions of the Parties</u>

ACC Shippers

7. The ACC Shippers cite the Commission's *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139, at P 32 (2005) ("Income Tax Policy Statement") for the proposition that SFPP has the burden of proof to demonstrate that its unitholders have "actual or potential" income tax liability.[14] While SFPP argues that it has the initial burden and then the burden shifts back to Complainants to prove that SFPP is not entitled

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[9] SFPP Reply Brief at 1 (citing 18 C.F.R. § 385.706 (2008)) (hereinafter SFPP RB).

[10] *Id*. at 1-2.

[11] ACC IB at 5; IS IB at 2; Staff IB at 1-2; SFPP IB at 1.

[12] 49 U.S.C. app. §15(7).

[13] See *SFPP, L.P.*, 66 FERC ¶ 61,210, at 61,479, n. 10 (1994); Order No. 561, Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992, FERC Stats. & Regs. ¶ 30,985 at 30,955).

[14] ACC IB at 5.

to an income tax allowance, the ACC Shippers reiterate that the ultimate burden lies with SFPP.[15]

Indicated Shippers

8. Like the ACC Shippers, the Indicated Shippers note that, under the Income Tax Policy Statement, "any pass-through entity desiring an income tax allowance on utility operating income must be prepared to establish the tax status of its owners, or if there is more than one level of pass-through entities, where the ultimate tax liability lies and the character of the tax incurred."[16] Moreover, the Indicated Shippers state that the U.S. Court of Appeals affirmed the application of the Income Tax Policy Statement to SFPP, explaining that SFPP is eligible for a tax allowance only if it can prove that its partners have "actual or potential" income tax liability.[17]

9. The Indicated Shippers allege that SFPP has not met its burden of proof on the issue of income tax allowance because the facts show that Kinder Morgan Energy Partners' ("KMEP") limited partners suffered only losses in 2003 and 2004, and all income was taken off the top by KMEP's general partner.

10. In contrast, SFPP claims to have met its burden by producing copies of its tax returns and acknowledging that KMEP's partners receive an IRS Form 1065, Schedule K-1 ("K-1").[18] The Indicated Shippers argue that this does not demonstrate that there is an actual or potential income tax liability.[19] Moreover, they note that KMEP's IRS Forms 1065 show millions of dollars in losses in income allocated to KMEP's limited partners in 2003 and 2004.[20]

Commission Trial Staff

11. Staff does not take a position on this issue.[21]

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[15] ACC Shippers Reply Brief at 5 (hereinafter ACC RB).

[16] IS IB at 2 (citing Income Tax Policy Statement at P 42).

[17] *Id*. at 2-3 (citing *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945, 954 (D.C. Cir. 2007) ("*ExxonMobil*").

[18] IS RB at 3.

[19] *Id*. (citing *ExxonMobil*, 487 F.3d at 954).

[20] *Id*. (citing Ex. BPX-5 at 15).

[21] Staff IB at 2.

SFPP, L.P.

12. According to SFPP, the ultimate burden of proving that SFPP is not entitled to an income tax allowance rests with the Complainants.[22] SFPP explains: (1) that it has the initial burden of providing evidence required by *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005) ("December 2005 Order") and *SFPP, L.P.*, 121 FERC ¶ 61,240 (2007) ("December 2007 Order"); (2) that it has met this burden; and (3) that the Complainants must now prove either that SFPP failed to follow the Commission's procedures or that the Commission's presumptions regarding marginal income tax rates should not apply to SFPP.[23] SFPP argues that Complainants have not made either showing.[24]

<u>Discussion and Findings</u>

13. SFPP bears the burden of proof with regard to income tax allowance. Under the Income Tax Policy Statement, "any pass-through entity seeking an income tax allowance in a specific rate proceeding must establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income."[25] Further, an entity "must be prepared to establish the tax status of its owners, or if there is more than one level of pass-through entities, where the ultimate tax liability lies and the character of the tax incurred."[26]

14. With respect to SFPP specifically, the D.C. Court of Appeals affirmed the Income Tax Policy Statement, placing the burden on SFPP to "demonstrate – in a rate proceeding – that its partners incur 'actual or potential' income tax liability on their respective shares of the partnership income" in order to prove its eligibility for an income tax allowance.[27] Whether SFPP has met its burden is discussed in Issue III.A.

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[22] SFPP IB at 2.

[23] *Id*.

[24] SFPP RB at 2.

[25] Income Tax Policy Statement at P 32.

[26] Income Tax Policy Statement at P 42.

[27] *ExxonMobil*, 487 F.3d at 954.

C. Whether SFPP can lawfully increase the rates found to be just and reasonable by the percentages of the subsequent annual index rate increases

<u>Positions of the Parties</u>

ACC Shippers

15. The ACC Shippers state that they address this issue in Section VII.B.[28]

Indicated Shippers

16. The Indicated Shippers emphasize two points with respect to this issue: (1) in a complaint case, a public utility may not obtain a rate increase; and (2) if a public utility can seek to increase rates in a complaint case, the burden of proof is on the public utility to show that index-based rate increases to just and reasonable rates are just and reasonable.[29] According to them, SFPP did not provide evidence to support rate increases after the test years at issue in this proceeding.[30]

17. Elaborating, the Indicated Shippers explain that, under the Interstate Commerce Act, the Commission cannot increase rates above a just and reasonable level in a Section 13 complaint case, and, even assuming that the Commission could increase just and reasonable rates, it could not avoid the requirement in Section 15(1) of the ICA that a pipeline cannot raise rates without making a filing with the Commission.[31] As mentioned, if SFPP were able to increase its rates in the complaint case, the burden would be on SFPP to justify that the index-based increases to rates were just and reasonable.[32] SFPP has not met this burden, and forward looking indexing for subsequent years, according to the Indicated Shippers, must be denied in this proceeding.[33]

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[28] ACC IB at 6.

[29] IS IB at 3.

[30] *Id*. at 4.

[31] *Id*. at 3-4.

[32] *Id*. at 4.

[33] *Id*. at 6.

Commission Trial Staff

18. Staff takes the position that any just and reasonable rates resulting from this proceeding must be indexed forward to establish prospective rates and determine refunds.[34]

SFPP, L.P.

19. SFPP explains that the just and reasonable rates established in this proceeding will be indexed forward unless Complainants can prove that indexing should not apply.[35] According to SFPP, Complainants did not carry their burden; they did not prove that indexing should not apply to the 2003 and 2004 rates.[36]

20. SFPP claims that indexing the rates established in this proceeding is consistent with Commission and Court precedent.[37] Complainants' arguments against indexing should be denied, SFPP argues, because they agreed to use test years in this case instead of litigating each year at issue.[38] Their arguments confuse indexing with an attempt by SFPP to seek a rate increase, SFPP explains.[39] SFPP asserts that it does not seek a rate increase, but instead seeks to avoid litigating cost of service studies for the years at issue other than 2003 and 2004.[40]

21. Further, responding to the ACC Shippers' argument that SFPP is not entitled to an index adjustment for 2005, SFPP points out that the Commission and the D.C. Circuit have already approved indexing for use in determining just and reasonable rates for calculating reparations beyond the test years used in a proceeding.[41] SFPP also maintains that there is no risk of double recovery, as the 2004 rates will recover only actual 2004

[34] Staff IB at 2 (citing December 2005 Order at P 49).

[35] SFPP IB at 2.

[36] *Id*. at 2-3.

[37] SFPP RB at 2 (citing December 2007 Order at PP 72-75; *SFPP, L.P.*, 121 FERC ¶ 61,163, at P 5 (2007); *SFPP, L.P.*, 117 FERC ¶ 61,285, at P 89 ("2006 Sepulveda Order"); *BP West Coast Products, LLC v. FERC*, 374 F. 3d 1263, 1302, 1306-07 (D.C. Cir 2004) ("*BP West Coast*")).

[38] *Id*. at 3.

[39] *Id*.

[40] *Id*.

[41] *Id*. (citing December 2007 Order at PP 72-75; *SFPP, L.P.*, 121 FERC ¶ 61,163 at P 5; 2006 Sepulveda Order at P 89; *BP West Coast*, 374 F. 3d at 1302, 1306-07).

costs and will not reflect forward-looking cost adjustments.[42] SFPP notes that the ACC Shippers inappropriately attempt to rely on *SFPP, L.P.*, 117 FERC ¶ 61,271 (2006), but that that case involved different facts and does not suggest that the 2005 index in this case would be inappropriate.[43]

22. The ACC Shippers also assert, SFPP states, that it is not possible to tell at this time whether the 2006 and 2007 index adjustments are appropriate and claim they should have the opportunity to challenge them at the compliance filing stage, an argument which, SFPP contends, has already been rejected by the Commission.[44] A party that has already had an opportunity to offer evidence on an indexing adjustment cannot do so again at the compliance filing stage, SFPP maintains.[45]

23. Lastly, SFPP argues that, under Section 343.2(c)(1) of the Commission's regulations, the burden of proof is on an entity challenging an index adjustment.[46] Here, Complainants have not proven that it is inappropriate to index the rates.[47]

Discussion and Findings

24. The Indicated Shippers argue that a public utility cannot raise its rates in a complaint proceeding.[48] Both Staff and SFPP, however, argue that the just and reasonable rates established in this proceeding should be indexed forward to establish prospective rates and determine refunds.[49] The ACC Shippers address this issue with respect to reparations in Issue VII.B, and their arguments will be addressed in that context.

25. The Indicated Shippers' arguments on this issue are misguided. According to them, SFPP seeks to increase its rates in the context of a complaint proceeding, in contradiction to Section 15(7) of the ICA, which requires that a pipeline make a filing with the Commission if it wishes to raise its existing rates.[50] However, SFPP does not

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[42] *Id*.

[43] *Id*. at 4.

[44] *Id*. (citing ACC IB at 87; December 2007 Order at P 102).

[45] *Id*. at 4-5 (citing December 2007 Order at P 102).

[46] *Id*. at 5 (citing 18 C.F.R. § 343.2(c)(1)(2008)).

[47] *Id*.

[48] IS IB at 3.

[49] Staff IB at 2; SFPP IB at 2.

[50] IS IB at 3; IS RB at 4.

seek to increase its rates *sua sponte*, but instead seeks to index the 2003 and 2004 rates developed and newly established to be just and reasonable in this proceeding forward for use in calculating reparations to avoid litigating cost of service studies for multiple years.[51] The Commission took this approach in past proceedings, allowing newly developed just and reasonable rates to be indexed forward for reparation purposes.

26. In the 2006 Sepulveda Order at P 89, the Commission required that SFPP develop a 1996 rate and then index that rate forward to an effective date of February 1, 2007, which would apply to shipments made over SFPP's Sepulveda Line after that date.[52] The rates in that proceeding were indexed forward for determining prospective rates.[53] Further, in *SFPP, L.P.*, 121 FERC ¶ 61,163 at P 5, the Commission explained that an approved index factor should be applied to the just and reasonable rates determined in a complaint proceeding and then "carried forward to the date on which the revised rates become effective." The Commission's Opinion No. 435-A also states that, for reparations purposes, "[a]ll rates may be indexed under the Commission's indexing methodology."[54]

27. Consistent with Commission precedent, SFPP can lawfully increase the rates found to be just and reasonable in this proceeding by the percentages of the subsequent annual index rate increases.

II. Allowed Return for Each Complaint Year and for the Test Year Used to Determine Rates

A. What is the appropriate rate base?

<u>Positions of the Parties</u>

ACC Shippers

28. Using their witness's capital structure for the years 2000 through 2004, the ACC Shippers claim that the 2003 Average Net Trended Original Cost Rate Base was $33,616,999 for the East Line and $140,867,000 for the West Line, while the 2004 East

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[51] SFPP RB at 3.

[52] 2006 Sepulveda Order at 89.

[53] *Id*.

[54] *SFPP, L.P.*, Opinion No. 35-A, 91 FERC ¶ 61,135, at 61,516 (2000).

Line Average Net Trended Original Cost Rate base was $42,716,000 and, for the West Line, $135,198,000.[55]

29. While SFPP, according to the ACC Shippers, claims that no party challenges its cost of service calculations, the ACC Shippers argue that the rate base used by SFPP was not appropriate for use in the calculation of just and reasonable rates.[56] The problem with SFPP's rate base, they continue, is that it uses an inaccurate capital structure for the years 2000 through 2004 and includes SFPP's problematic Accumulated Deferred Income Tax ("ADIT") Account balance.[57] The proper rate base depends upon the resolution of the capital structure and ADIT balance.[58]

Indicated Shippers

30. The Indicated Shippers state that they do not take a position on this issue, or, they defer to the other shipper Complainants.[59]

Commission Trial Staff

31. Staff explains that while it uses basically the same historical rate base as SFPP for the period 1983-2002, Staff adjusts SFPP's 2003 and 2004 associated accumulated depreciation rates, resulting in the use of a different rate base for those years.[60]

SFPP, L.P.

32. SFPP explains that the appropriate rate base can be found in SFPP's cost of service calculations, has not been contested by Complainants or Staff, and is calculated based on oil pipeline ratemaking precedent.[61] Because SFPP claims that its return on equity and capital structure are correct, SFPP alleges that any proposed changes to its rate base calculated using other proposed capital structures must be rejected.[62]

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[55] ACC IB at 6 (citing Exs. ACC-69 at 1, ACC-71 at 1, ACC-70 at 1, ACC-72 at 1).

[56] ACC RB at 6.

[57] *Id*.

[58] *Id*. at 6-7.

[59] IS IB at 4.

[60] Staff IB at 2.

[61] SFPP IB at 3.

[62] *Id*.

33. SFPP states that the challenges to its rate base should be rejected.[63] Staff claims that SFPP should use Staff's depreciation adjustments, which SFPP claims are erroneous.[64] Further, SFPP argues that the ACC Shippers' capital structure calculations are likewise erroneous, and thus would not utilize them in its rate base.[65]

Discussion and Findings

34. The ACC Shippers claim that the 2003 Average Net Trended Original Cost Rate Base was $33,616,999 for the East Line and $140,867,000 for the West Line, while the 2004 East Line Average Net Trended Original Cost Rate base was $42,716,000 and, for the West Line, $135,198,000.[66] Staff agrees with SFPP's rate bases for the period from 1983-2002, but does not adopt SFPP's 2003 and 2004 rate bases completely because it believes that SFPP's depreciation rates must be changed.[67]

35. The appropriate starting test year rate base for use in this proceeding depends upon the appropriate capital structure and whether SFPP's current depreciation rates need to be adjusted. These determinations are addressed under Issue II.F and Issue IV.B.

B. What is the appropriate inflation-adjusted deferred return?

Positions of the Parties

ACC Shippers

36. The ACC Shippers state that they do not address this issue.[68]

Indicated Shippers

37. The Indicated Shippers state that they do not take a position on this issue, or, they defer to the other shipper Complainants.[69]

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[63] SFPP RB at 6.

[64] *Id*.

[65] *Id*.

[66] ACC IB at 6 (citing Exs. ACC-69 at 1, ACC-71 at 1, ACC-70 at 1, ACC-72 at 1).

[67] Staff IB at 2.

[68] ACC IB at 6.

[69] IS IB at 4.

Commission Trial Staff

38. For the period from 1983-1999, Staff did not adjust SFPP's inflation adjusted net deferred earnings.[70] Staff's net deferred earnings, however, differ from SFPP's due to Staff and SFPP's use of varying capital structures.[71]

SFPP, L.P.

39. SFPP explains that its appropriate inflation-adjusted deferred return is found in its cost of service calculations which were calculated based on oil pipeline ratemaking precedent.[72] SFPP alleges that any proposed changes to its net deferred earnings calculations calculated using capital structures proposed by Complainants and Staff, must be rejected because SFPP's capital structure is correct.[73]

Discussion and Findings

40. Staff and SFPP are the only parties that addressed this issue and agree that the net deferred earnings depend upon the appropriate capital structure. Therefore, SFPP should adjust the net deferred earnings consistent with the ruling on capital structure made under Section II.F.

C. What is the appropriate methodology for calculating each year's deferred return?

Positions of the Parties

ACC Shippers

41. The appropriate methodology for calculating each year's deferred return, according to the ACC Shippers, is dependent upon using a correct capital structure for each year.[74] The ACC Shippers maintain that, to the extent that they disagree with SFPP's capital structures, the calculation of deferred return will be correspondingly different and in dispute.[75]

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[70] Staff IB at 3.

[71] *Id*.

[72] SFPP IB at 3.

[73] *Id*.

[74] ACC IB at 7.

[75] ACC RB at 7.

Indicated Shippers

42. The Indicated Shippers state that they do not take a position on this issue, or, they defer to the other shipper Complainants.[76]

Commission Trial Staff

43. Staff states that it did not adjust SFPP's methodology for calculating deferred return.[77]

SFPP, L.P.

44. SFPP states that the appropriate methodology for calculating deferred return is provided with its cost of service calculations.[78] According to SFPP, its cost of service elements are calculated in accordance with the Commission's oil pipeline ratemaking precedent and are not contested by Complainants and Staff.[79] SFPP argues that it has shown that its capital structure calculations are appropriate and that those presented by the other participants are incorrect.[80]

Discussion and Findings

45. The appropriate methodology for calculating deferred return is dependent upon the appropriate capital structure for 2003 and 2004. Therefore, the deferred return appropriate for use in this proceeding must be calculated using a capital structure based on the capital structure rulings made by the undersigned in this proceeding under Issue II.F.

D. What is the appropriate amortization rate and amortization period?

Positions of the Parties

ACC Shippers

46. The ACC Shippers do not address this issue.[81]

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[76] IS IB at 4.

[77] Staff IB at 3.

[78] SFPP IB at 3.

[79] *Id*.

[80] SFPP RB at 6 (citing SFPP IB at 6-14).

[81] ACC IB at 7.

Indicated Shippers

47. The Indicated Shippers state that they do not take a position on this issue, or, they defer to the other shipper Complainants.[82]

Commission Trial Staff

48. Staff claims that SFPP's proposed amortization period need not be adjusted.[83]

SFPP, L.P.

49. According to SFPP, the appropriate amortization rate and amortization period can be found in its cost of service calculations as set forth in Exhibits SFW-67 and SFW-68.[84] SFPP notes that these calculations are uncontested.[85]

<u>Discussion and Findings</u>

50. All participants in this proceeding either agree with or do not contest SFPP's proposed amortization rate and amortization period as set forth in its cost of service calculations in Exhibits SFW-67 and SFW-68. Thus, SFPP's recommended amortization rate and period are both adopted in this proceeding.

E. What is the appropriate treatment of ADIT?

<u>Positions of the Parties</u>

ACC Shippers

51. The ACC Shippers explain that they discuss this issue as it pertains to income tax allowance in Issue III.C.[86]

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[82] IS IB at 4.

[83] Staff IB at 3.

[84] SFPP IB at 3.

[85] SFPP RB at 6-7.

[86] ACC IB at 7.

Indicated Shippers

52. According to the Indicated Shippers, the appropriate treatment of ADIT for a pass-through entity is to terminate the ADIT process and make refunds to the shippers through amortization of the full ADIT dollars collected in order to reduce the cost of service.[87] ADIT allows a taxpaying corporate public utility to “defer” the benefits of accelerated depreciation and call upon ratepayers to pay an income tax allowance as if there were no accelerated depreciation.[88] Such reasoning, the Indicated Shippers argue, does not work for partnerships like SFPP where all deductions, including accelerated depreciation, are flowed through to the partners each year and nothing is held back for future tax liability.[89] The accelerated depreciation flowed through can (a) lower current income taxes, if any, or (b) be carried forward in time to lower future taxes, they argue further.[90] There is no justification, according to the Indicated Shippers, for making ratepayers pay additional dollars to cover the same potential cost twice.[91]

53. The Indicated Shippers allege that SFPP’s ADIT account is 100% overfunded and should be amortized back to ratepayers as a credit to the cost of service.[92] According to them, depreciation is a non-cash expense deducted from revenues to determine taxable income.[93] In the ratemaking process, the Indicated Shippers explain, straight-line book depreciation is used when calculating the depreciation component of cost of service, while accelerated depreciation reduces taxable income above straight-line depreciation and is accounted for separately.[94] They continue, stating that a corporation deducts the full amount of accelerated depreciation from its income tax return, which reduces potential income taxes in early years of operation, under the assumption that the corporation defers that payment of those taxes until book depreciation catches up with accelerated depreciation.[95] In that situation, the Indicated Shippers note, the ratepayers will pay an income tax allowance up front, thus paying more in rates than the utility pays that year.[96] The difference between the two amounts goes into the ADIT account.[97] If

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[87] IS IB at 5.

[88] *Id*.

[89] *Id*.

[90] *Id*.

[91] *Id*.

[92] *Id*. at 7 (citing Ex. BPX-17 at Revised p. 24).

[93] *Id*. (citing Ex. BPX-17 at 21).

[94] *Id*.

[95] *Id*.

[96] *Id*.

this account is overfunded, then the corporation must flow that amount back in the form of reduced rates.[98]

54. A problem arises, according to the Indicated Shippers, because SFPP is not a corporation, but a partnership which flows through all income and deductions to the partners in the reporting year.[99] Further, they add, SFPP does not pay income taxes and does not have any income taxes to defer.[100] Therefore, SFPP's ratepayers should not pay income taxes on more than that taxable income which is flowed through the partnership.[101] The account is 100% overfunded, the Indicated Shippers allege, and should be amortized back to the ratepayers as a credit to cost of service.[102]

55. SFPP, the Indicated Shippers remark, dismisses the argument that it should return its ADIT balance to the ratepayers, despite the fact that a partnership flows depreciation to the partners each year, and are thus already covered for higher future taxes, according to the Indicated Shippers.[103] By collecting additional cash from ratepayers, SFPP is double dipping, the Indicated Shippers assert.[104] SFPP, the Indicated Shippers state, relies on an interim Commission decision, the December 2007 Order, as support for its arguments.[105] There, the Commission does not address the Indicated Shippers' argument in this proceeding, which is that in a partnership situation, there is no deferral of taxes, and nothing is held back to pay future taxes.[106]

56. Further, they continue, because the Commission forbids raising ADIT issues in future cases, there is no opportunity for judicial review, which, the Indicated Shippers argue, violates due process rights and the right to petition the government for redress of grievances.[107] The Commission, according to the Indicated Shippers, threatens that if a proscribed issue is even raised, the entire complaint will be dismissed.[108] Further issues

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[97] *Id*. at 7-8.

[98] *Id*. at 8.

[99] *Id*. (citing Ex. BPX-5 at 28).

[100] *Id*. (citing Ex. BPX-11).

[101] *Id*. (citing Ex. BPX-17 at 23).

[102] *Id*. at 9.

[103] IS RB at 7.

[104] *Id*.

[105] *Id*. (citing SFPP IB at 5).

[106] *Id*. at 8.

[107] *Id*.

[108] *Id*. at 9.

arise, they add, with respect to *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 (2008) ("Proxy Group Policy Statement"), such that a policy statement cannot be challenged because it is subject to litigation, and yet it cannot be challenged in litigation because the Commission states that the Proxy Group Policy Statement must be implemented in all pending cases.[109] Essentially, the Indicated Shippers contend that their constitutional, statutory, and regulatory rights have been violated.[110]

Commission Trial Staff

57. Staff states that it treats ADIT in the same manner as SFPP.[111]

SFPP, L.P.

58. SFPP explains that the Commission requires pipelines to determine ADIT, which reflects the tax effects of timing differences between the accelerated depreciation a pipeline uses for income tax purposes versus the straight-line depreciation the Commission prescribes for ratemaking purposes.[112] Further, SFPP continues, ADIT is deducted from rate base to reflect the return that may be earned on any cash which is generated by the deferred income tax liability, and is consistent with SFPP's income tax allowance calculation as performed by its witness, George R. Ganz ("Ganz").[113]

59. The Commission, SFPP claims, has considered and rejected all criticisms of ADIT.[114] In response to claims that its ADIT account is overfunded due to the use of incorrect weighted tax rates, SFPP alleges that its income tax rates are calculated in accordance with Commission directives, and, because the same weighted federal and state income tax rates were used to calculate ADIT, it too is correct and in accordance with Commission precedent.[115] Moreover, SFPP argues that using the top marginal income tax rates for the years 1992 through 2003 has been rejected by the Commission, and instead income tax allowances that were determined for each year should be used when calculating ADIT.[116]

[109] *Id*. (citing Proxy Group Policy Statement).

[110] *Id*. at 10.

[111] Staff IB at 3.

[112] SFPP IB at 3-4.

[113] *Id*. at 4.

[114] *Id*. at 6.

[115] *Id*. at 4.

[116] *Id*. at 4-5.

60. Further, according to SFPP, arguments that SFPP should not calculate ADIT because it flows through all income and deductions to its partners each year, as well as arguments that SFPP's ADIT is overfunded and must be credited back to shippers, are premised on the assumption that a partnership does not pay taxes and therefore should not track ADIT.[117] SFPP cited *ExxonMobil*, 487 F.3d at 955, as having rejected this premise, and adds that the Commission considers the issue of a partnership's use of ADIT "closed for the purpose of any further complaints against an oil or gas master limited partnership."[118] Moreover, SFPP continues, the Commission requires entities to calculate ADIT if they include an income tax allowance in their costs of service and do not use straight-line depreciation for income tax purposes.[119]

Discussion and Findings

61. The issue with respect to ADIT is whether SFPP, as a pass-through entity, can accumulate deferred income taxes and at what rate it should do so. The Indicated Shippers argue that the appropriate treatment of ADIT for a pass-through entity is to terminate the ADIT process and make refunds to the shippers through amortization of the full ADIT dollars collected in order to reduce the cost of service.[120] SFPP argues to the contrary, explaining that the Commission requires pipelines to determine ADIT to reflect the tax effects of timing differences between the accelerated depreciation a pipeline uses for income tax purposes versus the straight-line depreciation the Commission prescribes for ratemaking purposes.[121] Staff adopts SFPP's position on this issue, while the ACC Shippers discuss their position in conjunction with income tax allowance issues.[122]

62. The Indicated Shippers explain that SFPP should not be allowed to calculate ADIT because "the theoretical underpinning of ADIT – that taxpaying corporate public utilities 'defer' the benefits of accelerated depreciation and call upon ratepayers to pay an income tax allowance as if there were no accelerated depreciation – does not exist with partnerships like SFPP."[123] Because SFPP flows everything through to its partners,

[117] *Id*. at 5.

[118] *Id*. (quoting *America West Airlines, Inc. v. Calnev Pipe Line, L.L.C.*, 121 FERC ¶ 61,241, at P 10 (2007) ("*America West*")).

[119] *Id*. at 5-6.

[120] IS IB at 5.

[121] SFPP IB at 3-4.

[122] ACC IB at 7; Staff IB at 3.

[123] IS IB at 5.

including accelerated depreciation, there is nothing left for future tax liability, and thus SFPP's ADIT account is 100% overfunded, they argue.[124]

63. The Indicated Shippers' arguments have already been addressed by the Commission. The Commission determined that pipelines, including pass-through entities like SFPP, are entitled to accumulate deferred income taxes.[125] In *ExxonMobil*, 487 F.3d at 954, the D.C. Circuit Court decided that SFPP, or any regulated pipeline, will be eligible for an income tax allowance if it can show that its partners incurred "actual or potential" income tax liability. The D.C. Circuit affirmed the Commission's statement that "the income taxes for which SFPP will receive an income tax allowance are real, albeit indirect."[126] Further, the income "taxes are 'attributable' to the regulated entity, given that partners must pay tax on their share of the income regardless of whether they actually receive a cash distribution."[127]

64. In the December 2007 Order, the Commission uses *ExxonMobil* to resolve the issue of whether a pipeline may calculate ADIT.[128] There, the Commission explained that the argument that "there should be no ADIT because the partnership does not pay taxes . . . was resolved by *ExxonMobil* in that the partners' marginal tax rate is imputed to the partnership."[129] Additionally, any argument "that a partnership does not pay taxes and therefore a partnership should not have ADIT" has likewise been resolved by *ExxonMobil*.[130]

65. In the instant proceeding, so long as its partners have "actual or potential" income tax liability, SFPP is entitled to calculate ADIT. The "actual or potential" income tax taxes, according to the Commission, will be attributable to SFPP. Therefore, so long as there are taxes which are attributable to SFPP, SFPP must calculate ADIT. The Indicated Shippers' argument that SFPP should not be allowed to calculate ADIT because it is a pass-through entity has already been addressed and rejected by the Commission.

66. With respect to the rate used for calculating ADIT, the ACC Shippers argue that SFPP should have calculated ADIT using the top marginal income tax rates for corporations for the years from 1992 to 2003 and 2004 because that was the rate it

[124] *Id*.

[125] December 2007 Order at P 141.

[126] *ExxonMobil*, 487 F.3d at 954.

[127] *Id*. at 955.

[128] December 2007 Order at P 141.

[129] *Id*.

[130] *Id*.

collected from its shippers.[131] However, the Commission's December 2007 Order explained that the ADIT calculation should apply the partners' weighted marginal tax rate.[132] Further, the Commission addressed the issue of using the same income tax allowance component each year, and determined that SFPP was instead correct when it adjusted its income tax allowance component of the ADIT account on an annual basis.[133]

67. In the instant proceeding, SFPP witness Ganz explained that, because the weighted income tax rate changes from year to year, "layers of over-funded and under-funded ADIT developed, depending upon whether the weighted income tax rate decreased or increased."[134] Ganz states that SFPP amortizes the over- and under-funded amounts annually, "and the annual amortization . . . is used as an adjustment to the income tax allowance in the cost-of-service calculations."[135] SFPP's method is consistent with the Commission's method as set forth in the December 2007 Order, while the ACC Shippers' arguments for use of the top marginal income tax rates for corporations when calculating ADIT do not coincide with the Commission's determination that the weighted marginal tax rates are appropriate.[136]

F. What is the appropriate capital structure?

<u>Positions of the Parties</u>

ACC Shippers

68. The ACC Shippers argue that the appropriate capital structure must be adjusted for purchase accounting adjustments.[137] They do not believe, however, that adjustments need be made prior to the year 2000.[138] The ACC Shippers state that the appropriate capital structure for evaluating the 2003 and 2004 East and West Line rates are KMEP's December 31, 2003 and 2004 capital structures, respectively.[139] KMEP's capital

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[131] ACC IB at 31.

[132] December 2007 Order at P 23.

[133] *Id*. at PP 143-144.

[134] Ex. SFW-65 at 19.

[135] *Id*.

[136] December 2007 Order at P 23.

[137] ACC IB at 7.

[138] *Id*. at 8.

[139] *Id*. at 7.

structure should be used, they state, because it provides SFPP's financing.[140] After the removal of purchase accounting adjustments, the ACC Shippers recommend a December 31, 2003 capital structure of 42.37% equity and 57.63% debt, and a 2004 capital structure of 44.62% equity and 55.38% debt.[141] As support, the ACC Shippers cite *SFPP, L.P.*, Opinion No. 435, 86 FERC ¶ 61,022 at 61,097 (1999) and the December 2005 Order at PP 65-67.[142]

Indicated Shippers

69. The Indicated Shippers explain that SFPP is not a stand-alone entity and KMEP is responsible for SFPP's debts and securing borrowed capital.[143] Therefore, as the parent company, KMEP's capital structure should be used.[144] This capital structure, according to the Indicated Shippers, is calculated after excluding all consequences of purchasing the assets of other companies and writing up the depreciated original costs, including purchase accounting adjustments and goodwill, which skew capital structure in favor of equity.[145] Specifically, the Indicated Shippers explain that purchase accounting adjustments and goodwill artificially inflate the equity component of rate base and produce an unwarranted increase in the cost of service to ratepayers.[146] The Indicated Shippers thus recommend a 2004 capital structure of 61% debt and 39% equity after the exclusion of the write-ups for purchase accounting adjustments and goodwill.[147]

Commission Trial Staff

70. Staff recommends using a debt to equity ratio of 62.08%/37.92% for 2003 and 59.06%/40.94% for 2004.[148] Further, Staff recommends using KMEP's capital structure for SFPP because KMEP controls SFPP's debt.[149] This capital structure, Staff states, is composed of the balance between long-term debt and common equity for 2000-2004 and

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[140] *Id*. at 8 (citing Ex. ACC-68 at 8).

[141] *Id*. at 7 (citing Exs. ACC-1 at 8-9, ACC-9 at 1, 3; Tr. 219).

[142] *Id*.

[143] IS IB at 9 (citing Ex. BPX-17 at 3).

[144] *Id*.

[145] *Id*.

[146] *Id*. at 10 (citing Ex. BPX-36 at 30).

[147] *Id*. at 10-11 (citing Ex. BPX-19).

[148] Staff IB at 3 (citing Ex. S-31 at 2).

[149] Staff IB at 4 (citing *Transcontinental Gas Pipeline Corporation*, Opinion No. 414-A, 84 FERC ¶ 61,084, at 61,413 (1998); Ex. S-13 at 15).

is derived from KMEP's Securities and Exchange Commission ("SEC") Forms 10-K.[150] Like the Complainants, Staff advocates removing purchase accounting adjustments from the equity ratios for 2000 through 2004.[151]

71. Staff states that, when a regulated entity does not provide its own financing, the Commission will use the capital structure of the parent that does the financing unless that capital structure is anomalous to those of the proxy companies used in the DCF formula, in which case it will use a hypothetical capital structure.[152] Staff insists that KMEP's capital structure is not anomalous and is within the range of oil pipeline equity-debt ratios approved by the Commission.[153]

72. According to Staff, SFPP misuses the "anomalous" test to determine whether the parent's capital structure or a hypothetical capital structure should be used.[154] SFPP asserts that Staff and the ACC Shippers' equity ratios are anomalous to the capital structures of its proxy companies because the equity ratios they recommend are lower than those of the proxy companies.[155] The anomalous test, however, Staff claims, does not apply here because no party advocates the use of a hypothetical capital structure and all parties agree that KMEP's capital structure should be used.[156] Further, Staff explains that, even if the test were to apply in this situation, the equity-debt ratios advanced by itself and the ACC Shippers are not outside the range of ratios approved by the Commission so as to consider them as "anomalous" to those of the proxy companies.[157]

73. Staff also responds to SFPP's argument that Staff's recommended capital structure is not market-tested.[158] However, both Staff and the ACC Shippers, Staff explains, based

[150] *Id*. at 3-4 (citing Ex. SFW-1 at 30).

[151] *Id*. at 5.

[152] *Id*. at 6 (citing *BP Pipelines (Alaska) Inc., et al.*, Opinion No. 502, 123 FERC ¶ 61,287, at PP 174-175 (2008); *Entegra Gas Pipeline Co.*, 113 FERC ¶ 61,327, at P 32 (2005); *Transcontinental Gas Pipeline Corp.*, 90 FERC ¶ 61,279, at 61,928 (2000)).

[153] *Id*. at 7.

[154] Commission Trial Staff Reply Brief at 4 (hereinafter Staff RB).

[155] *Id*.

[156] *Id*. (citing *BP Pipelines (Alaska) Inc.*,123 FERC ¶ 61,287 at P 175; *Transcontinental Gas Pipeline Corp*., 90 FERC ¶ at 61,928).

[157] *Id*. at 5.

[158] *Id*. (citing SFPP IB at 13).

their capital structures on KMEP's actual 2003 and 2004 capital structures and removed the PAAs.[159]

74. Next, simply because Staff's proposed equity ratio is below the lowest equity ratio for proxy companies for one year and only slightly above the lowest for another does not indicate that adopting Staff's capital structure "would imperil the financial integrity of SFPP," Staff point outs.[160] On this note, Staff makes three assertions: (1) capital structure is only one part of the determination of just and reasonable rates; (2) there is no evidence that the ultimate rates proposed by Staff will threaten SFPP's financial integrity; (3) SFPP has not provided evidence that the rates will make it difficult for SFPP to attract capital; and (4) SFPP has not provided evidence that these rates will not provide SFPP with a return that is similar to returns on investments in enterprises having corresponding risks.[161]

SFPP, L.P.

75. SFPP believes that using capital structures for prior periods that have been previously approved by the Commission is appropriate in this proceeding, and claims that both Staff and the Complainants agree.[162] SFPP's witness, J. Peter Williamson ("Williamson"), set forth what SFPP states are the appropriate capital structures for 2000-2004 in his Exhibit No. SFW-20. SFPP explains that criticisms of its capital structure are erroneous because they are based on misguided notions regarding PAAs and goodwill.[163]

<u>Discussion and Findings</u>

76. The main point of disagreement on SFPP's capital structure relates to the appropriate adjustments for purchase accounting and goodwill, which are discussed in Issue II.G.

77. For the period from 1984-1994, SFPP uses the capital structures from its Opinion No. 435-A Compliance Filing, which have already been approved by the Commission.[164] Similarly, for 1995-1999, SFPP uses the capital structures from its filing in compliance with the December 2005 Order.[165] With respect to the 1984-1994 and 1995-1999 capital

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[159] *Id*.

[160] *Id*. at 6.

[161] *Id*. at 6-7.

[162] SFPP IB at 6 (citing Exs. SFW-3 at 3, SFW-17 at 1, SFW-1 at 28-29).

[163] SFPP RB at 7.

[164] Ex. SFW-3 at 3; SFPP IB at 6.

[165] Ex. SFW-17 at 1; SFPP IB at 6.

structures, ACC Shippers' witness Matthew P. O'Loughlin ("O'Loughlin") stated that he does "not propose to adjust the capital structures used by SFPP prior to 2000."[166] Likewise, Staff's Exhibit No. S-20A references SFPP's compliance filing for capital structures prior to 2000.[167] The Indicated Shippers do not address capital structure for the years prior to 2000. Because no party objects, the appropriate capital structure for the periods from 1984-1994 and from 1995-1999 for purposes of this proceeding are those that are set forth in SFPP's Exhibit Nos. SFW-3 at 3 and SFW-17 at 1.

78. The parties disagree with respect to the appropriate capital structure for the period from 2000 through 2004. The ACC Shippers argue that KMEP's capital structure should be used for SFPP, and purchase accounting adjustments should be removed, resulting in a December 31, 2003 capital structure of 42.37% equity and 57.63% debt, and a 2004 capital structure of 44.62% equity and 55.38% debt.[168] The Indicated Shippers also recommend using KMEP's capital structure, but they remove goodwill along with purchase accounting adjustments.[169] They recommend a 2004 capital structure of 61% debt and 39% equity.[170] Staff suggests using KMEP's capital structure and a debt to equity ratio of 62.08%/37.92% for 2003 and 59.06%/40.94% for 2004, which it has adjusted for purchase accounting adjustments.[171] SFPP is the only participant that does not adjust the capital structure for purchase accounting adjustments. SFPP does, however, also use KMEP's capital structure for determining its 2003 debt to equity ratio of 54.07% to 45.93% and a 2004 debt to equity ratio of 52.03% to 47.97%.[172]

79. The Commission explains that it "use[s] the capital structure of the regulated entity unless it does not provide its own financing," in which case "the Commission will generally use the capital structure of the parent company that does the financing."[173] The parent company's capital structure may be used if it is "reasonable when compared to the equity ratios of the proxy companies and equity ratios accepted by the Commission in other proceedings."[174] "However, if the parents' capital structure is anomalous relative to the capital structures of the publicly-traded proxy companies used in the discounted cash

[166] Ex. ACC-68 at 7.

[167] Ex. S-20A at 20.

[168] ACC IB at 7 (citing Exs. ACC-1 at 8-9, ACC-9 at 1, 3; Tr. 219).

[169] IS IB at 9-11 (citing Exs. BPX-17 at 3).

[170] *Id*. at 10-11 (citing Ex. BPX-19).

[171] Staff IB at 3-5 (citing Ex. S-31 at 2).

[172] Exs. SFW-1 at 30, SFW-20 at 1.

[173] *BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287 at P 174.

[174] *Michigan Gas Storage Company*, 87 FERC ¶ 61,038, at 61,157 (1999).

flow (DCF) analysis and capital structures approved for other regulated pipelines," or if the capital structure of the parent does not accurately represent the pipeline's risk, then an average capital structure of comparable firms will be used to determine an appropriate capital structure for the pipeline.[175]

80. As explained by Indicated Shippers' witness Elizabeth H. Crowe ("Crowe"), SFPP is not a stand-alone entity and thus must look to its parent company for appropriate capital structure.[176] SFPP witness Williamson explains that he used KMEP's capital structure for the years 2000 through 2004 because KMEP is "the entity that was responsible for providing the financing for SFPP during those years."[177] Here, SFPP does not issue its own debt and does not have its own bond rating, and its debt is controlled by KMEP.[178] All parties concur that KMEP's capital structure should be used for SFPP, and Commission precedent also indicates that use of SFPP's parent's capital structure is appropriate in this situation.

81. As all parties agree that KMEP's capital structure should be used for SFPP in this proceeding, it follows that no party believes that KMEP's capital structure is "anomalous relative to the capital structures of the publicly-traded proxy companies used in the discounted cash flow (DCF) analysis and capital structures approved for other regulated pipelines."[179] SFPP does, however, attempt to use this test in its argument against adjusting KMEP's capital structure for purchase accounting adjustments ("PAA").[180] SFPP's use of the anomalous test in this context is incorrect. The Commission considers whether capital structure is anomalous to the capital structures of the proxy companies when deciding whether to use the parent company's capital structure or whether to use a hypothetical capital structure.[181] The Commission does not, as SFPP attempts, use the anomalous test to determine whether to use actual capital structure or capital structure adjusted for PAAs.[182] Therefore, the test does not apply in this context, and the undersigned need not address either the arguments made by SFPP or Staff's responses on this point. As noted by Staff in its reply brief, "[t]hat test simply does not apply here."[183]

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[175] *BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287 at P 174.

[176] Ex. BPX-17 at 3.

[177] Ex. SFW-1 at 30.

[178] Ex. S-13 at 15.

[179] *BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287 at P 174.

[180] SFPP IB at 12.

[181] *BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287 at P 174; Staff RB at 4.

[182] *See BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287 at P 174.

[183] Staff RB at 4.

82. Further arguments for and against the removal of PAAs and goodwill from KMEP's capital structure are addressed below in Issue II.G. A determination on the appropriate capital structure will be made in conjunction with that issue.

G. What, if any, are the appropriate adjustments for purchase accounting and goodwill?

<u>Positions of the Parties</u>

ACC Shippers

83. While, according to the ACC Shippers, the Commission has recognized that the use of purchase accounting adjustments is compatible with Generally Accepted Accounting Principles ("GAAP") and Commission principles of accounting for bookkeeping purposes, the Commission has established that the use of PAAs is not compatible with established ratemaking practices.[184] The ACC Shippers' argument is that the purchase accounting adjustments increase the equity component of capital structure, thus increasing the cost of capital.[185] This is problematic, they assert, because the higher the equity component, the higher the cost of service, and the greater the adverse impact it has on ratepayers.[186] In order to avoid this impact, the ACC Shippers suggest that PAAs be removed from capital structure absent a showing that a new service or substantial benefit has been provided to ratepayers.[187] Here, they argue that SFPP has not made such a showing.[188] Additionally, the ACC Shippers note that it is appropriate to adjust only the equity side of capital structure because debt has the first claim on the value of the assets, and if a purchase accounting adjustment is made to the assets that increase their value above the original cost, then the entirety of that increase will impact the equity balance.[189] The ACC Shippers claim that the arguments against removing PAAs are without basis because they confuse accounting structure and ratemaking

[184] ACC IB at 8 (citing December 2005 Order at P 65; *SFPP, L.P.*, 114 FERC ¶ 61,136, at PP 14-15 (2006) ("February 2006 Order"); *Chevron Products Co.*, 125 FERC ¶ 63,018 at PP 535-36; *SFPP, L.P.*, 116 FERC ¶ 63,059, at P 82 (2006)).

[185] *Id*. (citing February 2006 Order at P 15).

[186] *Id*. (citing December 2005 Order at P 64 n. 92).

[187] *Id*. at 8-9 (citing December 2005 Order at P 65; *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) ("June 2005 Order")).

[188] *Id*. at 9 (citing *Chevron Products Co.*, 125 FERC ¶ 63,018 at P 536).

[189] *Id*. at 10.

structure, ignoring the Commission's statements that there is a need for separate accounting and ratemaking books.[190]

84. The ACC Shippers state that SFPP's arguments regarding the treatment of PAAs are without merit, misdirected, and should be rejected by the Commission.[191] SFPP's argument that removing PAAs would distort KMEP's capital structure is based upon an unrealistic hypothetical, the ACC Shippers assert.[192] The actual differences between the ACC Shippers' suggested capital structure, which does not include PAAs, and SFPP's suggested capital structure, is minimal compared to that which is shown in the hypothetical.[193] This proves, according to the ACC Shippers, that SFPP incorrectly based its argument on an inept hypothetical.[194]

85. Further, SFPP's claim that removing PAAs would alter the level of risk perceived by investors has been rejected by the Commission in the February 2006 Order at P 15.[195] According to the Commission, the ACC Shippers note, PAAs in KMEP's capital structure should be removed unless there is a demonstrated benefit to ratepayers.[196] SFPP incorrectly relies on the 2006 Sepulveda Order at P 32 for the proposition that the PAAs should not be removed from KMEP's capital structure.[197] The ACC Shippers point out, however, that the facts in that case are different than those in the instant proceeding, and SFPP did not present any evidence showing how the Commission should rule similarly in the current case.[198]

86. SFPP also cites the 2006 Sepulveda Order, the ACC Shippers note, where the Commission did not exclude the PAA associated with KMEP's acquisition of SFPP because the acquisition had not distorted its capital structure.[199] The ACC Shippers allege that SFPP's interpretation of the Order is inaccurate, and that the PAA was not actually associated with KMEP's acquisition of SFPP.[200] SFPP's reliance on *FPC v.*

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[190] *Id*. at 9.

[191] ACC RB at 8.

[192] *Id*. (citing SFPP IB at 11-12; Ex. SFW-1 at 32).

[193] *Id*. at 9 (citing Exs. SFW-67 at 3, ACC-1 at 8-9, ACC-9 at 1, 3, SFW-68 at 3).

[194] *Id*.

[195] *Id*.

[196] *Id*. (citing December 2005 Order at P 65; February 2006 Order at P 14).

[197] *Id*. at 10.

[198] *Id*. (citing 2006 Sepulveda Order at P 32).

[199] *Id*. (citing SFPP IB at 8).

[200] *Id*. at 10-11 (citing December 2005 Order at P 6).

Hope Natural Gas Co., 320 U.S. 591 (1944) ("*Hope*") and *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Virginia*, 262 U.S. 679 (1923) ("*Bluefield*") is similarly misguided, the ACC Shippers contend.[201]

87. Furthermore, the ACC Shippers cite the February 2006 Order in which the Commission found that inclusion of the PAA would increase the overall cost of capital by increasing the equity component in violation of Commission policy.[202] In accordance with this finding, the ACC Shippers recommend that PAAs be removed from KMEP's capital structure.[203]

Indicated Shippers

88. Like the ACC Shippers, the Indicated Shippers condone the removal of purchase accounting adjustments from the equity portion of SFPP's capital structure.[204] Similarly, the Indicated Shippers think that goodwill should also be removed because both goodwill and the PAA are write-ups of the asset side of the balance sheet and must be removed in order for the books to balance.[205] It is their view that neither purchase accounting adjustments nor goodwill has any usefulness for ratepayers.[206] Goodwill and PAAs, according to the Indicated Shippers, inflate the equity component of rate base, which increases the cost of service to ratepayers.[207] Also, they add, goodwill does not provide any economic benefit to ratepayers and is an accounting device that should not be employed for ratemaking purposes.[208]

89. The Indicated Shippers state that they do not argue that goodwill and PAAs do not belong on the balance sheet; instead, they argue that their presence on the balance sheet does not require that they be included for ratemaking purposes.[209] The assets, the Indicated Shippers continue, are not "used and useful" at the present time, and so cannot be used for ratemaking purposes.[210]

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[201] *Id*. at 11.

[202] *Id*.

[203] *Id*. at 11-12 (citing Exs. ACC-1 at 8, ACC-9, ACC-68 at 7-8).

[204] IS IB at 11.

[205] *Id*. at 11.

[206] *Id*. at 12.

[207] IS RB at 11 (citing Ex. BPX-36 at 30).

[208] *Id*. at 11-12 (citing Ex. BPX-41).

[209] *Id*. at 12.

[210] *Id*.

90. The write-ups do not affect the liability component of capital structure, the Indicated Shippers explain, and debt remains the same regardless of the PAAs and goodwill.[211] According to them, the offset is in the equity component.[212]

Commission Trial Staff

91. Staff states that, when determining a capital structure for SFPP, it started with KMEP's capital structure and removed the PAAs from equity, as supported by Commission precedent, which requires that the PAAs be removed unless there is a demonstration of new services or substantial benefits to existing customers.[213] SFPP, the only party that did not remove PAAs, conceded to all relevant facts that would make such removal mandatory, Staff argues.[214]

92. While the Commission took a different position in the 2006 Sepulveda Order, the facts in that case are not analogous to those at hand, according to Staff.[215] There, the Commission stated that the normal standard of excluding PAAs from the equity portion of capital structure did not apply because the PAA in question could not impact the rate base of SFPP's Sepulveda Line at issue because it was fully amortized before the case was filed.[216] Further, there were not grounds in that proceeding to conclude "that [the] entire PAA was added to the equity component of SFPP's capital structure or that the revised capital structure would cause any harm to the ratepayers."[217] Such circumstances, Staff maintains, do not exist in this proceeding, and thus PAAs should be removed from the equity component of capital structure, consistent with Commission precedent.[218] Staff returns to its discussion of the 2006 Sepulveda Order on reply, stating that, in that case, the normal standard for determining whether PAAs should be removed, the substantial benefits test, was not applicable because (1) the line was fully amortized so there would be no rate effect from the PAA in any event; and (2) because there was no reason to

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[211] IS IB at 12.

[212] *Id*. at 12.

[213] Staff IB at 8, 10 (citing Ex. S-13 at 8; *SFPP, L.P.*, Opinion No. 435, 86 FERC at 61,097; *ARCO Products Co. et al. v. SFPP L.P.*, 106 FERC ¶ 61,300, at PP 79-80 (2004); June 2005 Order at P 67).

[214] *Id*. at 10.

[215] *Id*. (citing 2006 Sepulveda Order at P 32).

[216] *Id*. at 10-11 (citing 2006 Sepulveda Order at P 32).

[217] *Id*. at 11 (citing 2006 Sepulveda Order at P 32).

[218] *Id*.

conclude that the entire PAA was added to the equity component of SFPP's capital structure or that the revised capital structure would harm ratepayers.[219]

93. Here, SFPP asserts that the substantial benefits test does not apply since SFPP has not sought to include PAAs in rate base.[220] This argument, Staff alleges, ignores the language from the 2006 Sepulveda Order which states that, in the OR96-2 proceedings, the PAA was removed from the equity portion of capital structure because there were no demonstrated benefits to ratepayers.[221] Staff explains that, through it arguments, SFPP attempts to make the 2006 Sepulveda Order the rule, rather than the exception.[222] Meanwhile, SFPP's witness, Staff states, conceded that the Commission requires that PAAs be removed from the equity component of capital structure and that SFPP has not shown that a new service was developed or that ratepayers receive any special benefit that would warrant that they not be removed.[223]

SFPP, L.P.

94. SFPP takes the approach that KMEP's capital structure should not be adjusted for purchase accounting adjustments or goodwill and such adjustments made by Staff and the Complainants should be rejected.[224]

95. According to SFPP, Commission precedent does not support Staff and the Complainants' assertion that PAAs must be removed from equity because SFPP has not shown a benefit to ratepayers associated with the PAAs.[225] SFPP cites the 2006 Sepulveda Order for the two-part test to determine how a purchase accounting adjustment should be treated for ratemaking.[226] The test, as stated by SFPP, is "(1) if the PAA increases the carrier's rate base, the carrier must demonstrate that the increase benefited the rate payers in order to retain the PAA in rate base ("Substantial Benefits Standard"), and (2) the PAA must be removed from the carrier's capital structure to the extent that it has a distorting impact on capital structure."[227] SFPP states that its rate base has not been

[219] Staff RB at 10 (citing 2006 Sepulveda Order at 32).

[220] *Id*. at 11.

[221] *Id*.

[222] *Id*.

[223] *Id*. at 12 (citing Tr. 560-61, 565).

[224] SFPP IB at 6-7.

[225] *Id*. at 7 (citing December 2005 Order at 68; February 2006 Order at P 15; 2006 Sepulveda Order at P 32).

[226] *Id*. at 8.

[227] *Id*. at 8 (citing 2006 Sepulveda Order at P 32).

increased by the purchase accounting adjustments, and thus the assertion made by Staff and Complainants that the Substantial Benefits Standard applies and that SFPP is required to satisfy it is erroneous.[228] The Substantial Benefits standard applies when a carrier seeks to include PAAs in rate base, which SFPP claims it does not attempt to do in this proceeding, it claims.[229]

96. SFPP also contends that the purchase accounting adjustments do not distort the capital structure for the purposes of determining the debt to equity ratio, and, in fact, would distort capital structure if they were removed.[230] Further, SFPP argues that capital structure must be market-tested and include a market-determined cost of equity.[231] Specifically, the capital structure used to determine overall return must be that which is relied on by investors in making their determination of their expected return; capital structures which are published in the financial statements of the company and not adjusted for PAAs.[232]

97. Lastly, SFPP also disagrees with the removal of goodwill from capital structure.[233] According to SFPP, the Indicated Shippers were not able to support the removal of goodwill through the record in this proceeding and such adjustments are theoretically erroneous.[234]

98. According to SFPP, the impact to capital structure that could occur as a result of an acquisition of a regulated company at more than book value comes from the type of financing used, and not from goodwill or the PAA.[235] Moreover, the acquisitions that generated the KMEP PAA, SFPP argues, did not distort KMEP's capital structure.[236] In fact, SFPP continues, the financing would cause an increase in the debt balance, rather than the equity balance from which capital structure is calculated.[237]

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[228] *Id*. at 9.

[229] SFPP RB at 12.

[230] SFPP IB at 9, 11 (citing Ex. SFW-1 at 31-32).

[231] *Id*. at 12.

[232] *Id*. (citing Proxy Group Policy Statement at PP 47-48).

[233] *Id*. at 14.

[234] *Id*.

[235] SFPP RB at 9.

[236] *Id*. at 10.

[237] *Id*.

99. According to SFPP, when PAAs are removed from equity, the capital structures are distorted and become anomalous to other oil pipeline equity ratios that have been approved by the Commission.[238] Specifically, SFPP continues, the 2003 equity ratio promoted by Staff is lower than the equity ratios for all of the proxy companies.[239] SFPP alleges that the KMEP capital structures calculated by the participants in this proceeding, which remove PAAs from the equity ratio, are "significantly lower than the capital structures for the proxy companies, are anomalous, and are neither actual, market-tested capital structure nor hypothetical market-tested capital structures," while SFPP uses KMEP's actual, market-tested capital structure.[240]

100. SFPP argues that the Indicated Shippers' implication that GAAP requires the removal of PAAs and goodwill from equity should be rejected.[241] While PAAs are not included in the rate base for ratemaking purposes, they are embedded in the fixed asset balance on the GAAP balance sheet, which is used for deriving capital structure, SFPP explains.[242] Removing these PAAs would violate GAAP.[243] Also, SFPP points out that the Indicated Shippers' witness testified that "any adjustment to the balance sheet to account for the removal of PAAs from rate base would be made to fixed assets and/or goodwill – both asset accounts – rather than to the liabilities and owners' equity side . . . from which capital structure is derived," and also agreed that any adjustment to an asset account can be offset by adjusting another asset account without affecting liabilities or owners' equity.[244]

101. SFPP disagrees with the Indicated Shippers' characterization of goodwill and also argues that they have no basis for claiming that goodwill inflates equity.[245] Based on testimony from Indicated Shippers' witness Kellye Jennings ("Jennings"), SFPP concludes that goodwill is no different from any other asset on a balance sheet and also admits that debt and equity balances are affected not by the presence of goodwill, but by the financing of an acquisition.[246]

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[238] *Id*. at 12-13.

[239] *Id*. at 13 (citing Exs. SFW-120, S-31 at 4).

[240] *Id*. at 13-14.

[241] *Id*. at 14.

[242] *Id*. at 14-15.

[243] *Id*. at 15.

[244] *Id*. at 15-16 (citing Tr. 177-82, 183-84).

[245] *Id*. at 16, 17 .

[246] *Id*. at 17 (citing Tr. 186, 173-76; Ex. SFW-78 at 3-4).

Discussion and Findings

102. The issue of the appropriate adjustments for purchase accounting and goodwill is essential when determining the appropriate capital structure in this proceeding. Staff and Complainants advocate removing PAAs from the equity side of capital structure. The Indicated Shippers support not only the removal of PAAs, but also the removal of goodwill. SFPP disagrees with the other participants in this proceeding, arguing that neither PAAs nor goodwill should be removed from capital structure.

103. In its December 2005 Order, the Commission explains that while a PAA is consistent with GAAP and required in a FERC Form 6 annual report, a PAA write-up cannot be used for ratemaking purposes.[247] A PAA must be removed in order to "prevent an unwarranted increase in the cost-of-service to the ratepayers."[248] In 2006, the Commission concluded that the December 2005 Order discussed this matter to the extent that no further discussion is required on the issue.[249] A PAA, however, can be included for ratemaking purposes if the pipeline can show that it provided a new service or a substantial benefit to the ratepayers.[250] Here, SFPP has not attempted to show that the PAAs provide such new service or substantial benefit to its ratepayers. Therefore, the PAAs should be removed from the equity component of KMEP's capital structure.

104. The Indicated Shippers also argue that goodwill should be removed from the equity component of KMEP's capital structure under the theory that, "like a PAA, [goodwill] artificially inflates the equity component of rate base and thereby produces an unwarranted increase in the cost of service to ratepayers."[251] Moreover, the Indicated Shippers classify goodwill, like the PAA, as a "write-up," and argue that it does not result in an economic benefit to SFPP ratepayers.[252] Their argument, however, is contrary to the Financial Accounting Standards Board's definition of goodwill, which explains that goodwill is an "asset representing the *future economic benefits* arising from other assets acquired in a business combination that are not individually identified and separately recognized."[253] Because it is an asset representing a future benefit to the ratepayers, goodwill cannot be treated in the same manner as a PAA, which is a write-up that does *not* provide such benefit. It is the determination of the undersigned that while PAAs

[247] December 2005 Order at 65.

[248] *Id*.

[249] February 2006 Order at P 15.

[250] December 2005 Order at 65; June 2005 Order at 67.

[251] IS IB at 10 (citing Ex. BPX-36 at 30).

[252] *Id*. (citing Ex. BPX-41).

[253] Ex. SFW-82 at 4 (emphasis added).

should be removed from the equity component of KMEP's capital structure, goodwill should remain.

105. Given the above determinations, KMEP's 2003 and 2004 capital structures, adjusted for purchase accounting adjustments, should be used to determine the appropriate East and West Line rates in this proceeding. SFPP is hereby directed to resubmit its proposed capital structure with purchase accounting adjustments removed from the equity component.

H. What is the appropriate cost of debt?

<u>Positions of the Parties</u>

ACC Shippers

106. The ACC Shippers recommend using KMEP's December 31, 2003 cost of debt of 6.15% for 2003, and the December 31, 2004 cost of debt for KMEP of 6.09% for 2004.[254] According to them, SFPP's suggested costs of debt are inappropriate because they exclude KMEP's commercial paper debt, Economic Development Revenue Refunding Bonds, Industrial Revenue Bonds, and Operating Limited Partnership "B" ("OLP-B") specific bonds, which the ACC Shippers claim are debt instruments that KMEP treats as long-term debt for determining its capital structure.[255]

107. In response to SFPP's arguments that its commercial paper and special purpose debt are short-term in nature and thus cannot be treated as long-term debt, the ACC Shippers cite the Commission's December 2005 Order, in which the Commission held that if SFPP treated short-term debt as long-term debt on its balance sheet, then that debt should be considered long-term.[256] With regard to the special purpose debt, the ACC Shippers continue, the Commission has stated that debt instruments cannot and should not be traced to specific assets.[257] SFPP, however, claimed that the special purpose debt instruments were unavailable to finance SFPP, but did not present any evidence proving this assertion.[258] Additionally, the ACC Shippers note the inconsistency in SFPP's arguments that these debt instruments should be included in capital structure but excluded

[254] ACC IB at 10.

[255] *Id*. at 10-11.

[256] ACC RB at 12-13 (citing December 2005 Order at P 69; *SFPP, L.P.*, 116 FERC ¶ 63,059 at P 87).

[257] *Id*. at 13 (citing *Kern River Gas Transmission Co.*, Opinion No. 486, 117 FERC ¶ 61,077, at P 195 (2006) ("*Kern River*")).

[258] *Id*. (citing SFPP IB at 19).

in cost of debt.[259] Both are used for ratemaking purposes, they assert, and special purpose bonds should thus be included in the cost of debt.[260]

Indicated Shippers

108. The Indicated Shippers also contend that SFPP erroneously excluded the cost of commercial paper from its long-term cost of debt calculations. [261] According to them, the debt should be classified as long-term because that is how it was classified by KMEP.[262] The Indicated Shippers calculated a total weighted cost of long-term debt of 6.10%.[263]

Commission Trial Staff

109. Staff proposes using KMEP's cost of long-term debt of 6.15% for the calendar year ending December 31, 2003 and 6.09% for the calendar year ending December 31, 2004.[264] Staff takes issue with SFPP's cost of long-term debt because SFPP excluded commercial paper debt and KMEP's special purpose debt from its long-term debt calculations, claiming that it is short-term debt.[265]

110. While the cost of debt used in a rate proceeding is usually limited to long-term debt (debt having a maturity date beyond one year from the date of issuance), Staff explains that exceptions have been made.[266] Specifically, in its 2003 and 2004 SEC Forms 10-K, KMEP specified that it intended to and had to the ability to refinance some short-term debt on a long-term basis, and thus, according to Staff, classified those amounts of long-term debt on its balance sheets.[267] Therefore, Staff classified this commercial paper debt as long-term debt.[268] SFPP, on the other hand, claims that this debt should still be considered short-term no matter what.[269] Staff refutes SFPP's claim,

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[259] *Id*. at 14 (citing SFPP IB at 19-20).

[260] *Id*.

[261] IS IB at 12 (citing Ex. BPX-17 at Revised p. 6).

[262] *Id*. (citing Ex. BPX-19A).

[263] *Id*. at 12

[264] Staff IB at 11 (citing Ex. S-13 at 23, S-31 at 9).

[265] *Id*. at 12.

[266] *Id*. (citing *Transok, Inc.*, 70 FERC ¶ 61,177, at 61,555 (1995); *Pacific Gas Transmission Co.*, 43 FPC 837 (1970)).

[267] *Id*. at 12-13 (citing Ex. S-31 at 11).

[268] *Id*. at 13 (citing Ex. S-31 at 11).

[269] *Id*. at 13 (citing Ex. SFW-1 at 40).

stating that, historically, in this situation the commercial paper debt has been treated as long-term debt, and should be again in this case.[270]

111. With respect to special purpose debt, Staff asserts that SFPP erroneously removed the cost of KMEP's Economic Development Revenue Refunding Bonds, its Industrial Bonds, and its OLP-B bonds from KMEP's cost of long-term debt calculation for 2003 and 2004, while including the outstanding level of this debt in the balance of long term debt in the capital structure.[271] According to Staff, because the special purpose bonds were used to meet the long-term financial needs of KMEP and contributed to the consolidated, total debt amount and cost of capital for KMEP, it is inappropriate to exclude them from the cost of long-term debt calculation.[272] SFPP disagreed with Staff's view, stating that only debt specifically available for financing the rate base should be relevant when determining the cost supporting the rate base.[273] However, Staff points out that SFPP did include this issuance in the debt ratio of capital structure, which is inconsistent with excluding them from the calculation of long-term debt.[274]

112. Further, Staff argues that the special purpose debt issuances were used to meet KMEP's long-term financial needs, thus contributing to total debt.[275] Staff also states that if SFPP's position is adopted, then every future debt issuance would be controversial as to what exactly the debt was used to finance; such dollar tracing, according to Staff, would be inappropriate and impossible.[276]

113. SFPP, according to Staff, cites Old Dominion Electric Cooperative, 70 FERC ¶ 62,065 (1995) ("Old Dominion") for support that its commercial paper should not be treated as long-term debt.[277] While in that decision, the Commission stated that short-term debt is that which has a maturity of less than one year, Staff asserts that "there is nothing . . . to suggest that short-term debt which the company intends to refinance and treat as long-term debt must still be classified as short-term debt."[278] Further, Staff notes

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270 *Id*. at 14 (citing December 2005 Order at P 69).

271 *Id*. (citing Ex. S-31 at 9)

272 *Id*.

273 *Id*. at 14-15 (citing Ex. SFW-1 at 40)

274 *Id*. at 15 (citing Ex. SFW-1 at 41).

275 *Id*. (citing Ex. S-31 at 9).

276 *Id*. at 15-16 (citing Ex. S-31 at 10; *Kern River*, 117 FERC ¶ 61,077 at P 195).

277 Staff RB at 14 (citing SFPP IB at 16).

278 *Id*.

that SFPP also inappropriately relies upon Trailblazer Pipeline Co., 106 FERC ¶ 63,005 (2004), which is not binding precedent because it was vacated as a result of settlement.[279]

114. Where special purpose debt is concerned, SFPP, according to Staff, makes the following concessions, which comport with the arguments set forth by Staff and the ACC Shippers: (1) KMEP funds its operations in a consolidated fashion; (2) KMEP classified the special purpose debt as long-term on its balance sheet; and (3) SFPP admits that the special purpose bonds are included in capital structure.[280]

SFPP, L.P.

115. According to SFPP, the appropriate costs of long-term debt for use in this proceeding are those that were reviewed and approved by the Commission in prior proceedings. [281]

116. Contrary to the positions of the Complainants and Staff, SFPP argues that Commission precedent shows that commercial paper is short-term in nature and should not be included in calculating the cost of long-term debt.[282] According to SFPP, the commercial paper at issue has a maturity date of one year or less, the interest rate for the commercial paper is not representative of long-term debt, and the commercial paper is not useful for setting future rates because its level fluctuates frequently.[283] SFPP notes that the Commission has used these factors in the past when determining whether commercial paper was includable as long-term debt.[284] Because the commercial paper meets this three-factor test, SFPP argues that it is short-term debt and should be treated as such, despite KMEP's statements in its SEC Form 10-K.[285]

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[279] *Id*. at 15 (citing *Shoshone-Bannock Tribes v. Reno*, 56 F.3d 1476, 1483 n. 5 (D.C. Cir. 1995)).

[280] *Id*. at 16 (citing SFPP IB at 18, 19).

[281] SFPP IB at 15 (citing Exs. SFW-19 at 1-2, SFW-3 (Opinion No. 435-A compliance filing showing costs of debt for 1984-1994); Exs. SFW-17 at 5-9 (December 2005 Order compliance filing showing costs of debt for 1995-1999), SFW-19 at 1-2 (2000-2004), SFW-1 at 39-42, SFW-18).

[282] *Id*. at 16 (citing *Old Dominion*, 70 FERC ¶ 62,065).

[283] *Id*. at 17.

[284] *Id*. at 16 (citing *Trailblazer Pipeline Co.*, 106 FERC ¶ 63,005).

[285] *Id*. at 18 (citing *Old Dominion*, 70 FERC at 64,187).

117. SFPP also argues that excluding tax exempt and special purpose debt from the long-term debt calculation is consistent with Commission precedent.[286] SFPP explains that the cost of debt should reflect the cost of obtaining debt financing to fund SFPP's operations, and, therefore, if a part of KMEP's long-term debt is not used to finance these operations, the cost of debt should exclude that debt from the cost of long-term debt.[287] SFPP contends that both Staff and the ACC Shippers included bonds that were not used to finance the West or East Line rate bases in their cost of debt calculations.[288] SFPP also disagrees with the argument that the bonds should be included in the cost of debt because they are included in capital structure.[289] SFPP notes that, by including the bonds in capital structure, it is disadvantaged because excluding them would result in a higher return.[290] Further, SFPP argues that KMEP's balance sheet is used by KMEP investors when determining financial risk, and this capital structure is what is relevant to cost of equity and underlies the company's assets.[291] The debt cost applicable to SFPP's rate base, however, is not of interest to the investors.[292] According to SFPP, this is good reason to treat these bonds differently in capital structure and in the cost of debt analysis.[293]

118. SFPP discusses the ACC Shippers' and Staff's erroneous statement that their argument is supported by the fact that KMEP funds its operations in a consolidated fashion.[294] Staff cites *Kern River*, 117 FERC ¶ 61,077 at P 95 for support, but SFPP notes that in that case the bonds were available to finance the pipeline's rate base, which is not true in the instant case.[295] SFPP also addresses the ACC Shippers' argument that there was a small amount of Central Florida Pipeline Debt in SFPP's cost of debt calculations, which then requires that all Bonds must be included.[296] SFPP responds, stating that it included this debt because while it was not necessarily used to finance

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[286] *Id*.

[287] *Id*. (citing Tr. 1991-92).

[288] *Id*. (citing Exs. ACC-1 at 12-13, ACC-68 at 12-13, S-13 at 25-26, S-31 at 9-10).

[289] *Id*. at 19-20.

[290] *Id*. at 19.

[291] *Id*. (citing SFW-1 at 41).

[292] *Id*.

[293] *Id*. at 20.

[294] SFPP RB at 20 (citing ACC IB at 11; Staff IB at 15).

[295] *Id*.

[296] *Id*. (citing ACC IB at 11-12).

SFPP, it was available for pipeline financing.[297] Also, if this debt was included accidentally, the remedy would not be to include all bonds, but instead to exclude this specific bond, SFPP points out.[298] SFPP also notes that Staff's statement that SFPP's position is "not workable because it would require determining exactly what assets each debt issuance was used to finance" lacks support.[299]

Discussion and Findings

119. The issue of cost of debt depends upon whether certain special purpose bonds and commercial paper should be included in SFPP's cost of long term debt.

120. Both Staff and the ACC Shippers calculate a 2003 cost of debt of 6.15%, and a December 31, 2004 cost of debt of 6.09%.[300] Each notes, for the reasons that KMEP's capital structure must be used for SFPP, so must KMEP's cost of debt.[301] The Indicated Shippers only offered one recommended cost of debt of 6.10% without specifying whether it is a 2003 or 2004 calculation.[302] While Staff and Complainants advocate including special purpose bonds and commercial paper debt in SFPP's cost of debt, SFPP claims that this debt is short-term and should not be included.[303] SFPP's recommended costs of debt therefore differ from the other participants, at 6.77% for 2003, and 6.5% for 2004.[304]

121. All parties agree that KMEP's cost of debt should be used for SFPP in this proceeding. In *Michigan Gas Storage Co.*, 87 FERC at 61,166, the Commission explained that "when [it] imputes the capital structure of a corporate parent to a subsidiary, it also will impute the parent's costs of debt." It is thus appropriate here to use KMEP's cost of debt, consistent with the use of its capital structure.

122. Staff and Complainants argue that KMEP's commercial paper debt should be included in its cost of long-term debt, while SFPP states that commercial paper is short-term in nature and thus should not be included in the cost of long-term debt. The

[297] *Id*. (citing Tr. 535).

[298] *Id*. at 20-21.

[299] *Id*. at 21.

[300] ACC IB at 10 (citing Exs. ACC-1 at 1, 11, ACC-12 at 1, 4, ACC-68 at 11-13); Staff IB at 11 (citing Exs. S-13 at 23, S-31 at 9).

[301] ACC IB at 10; Staff IB at 11.

[302] IS IB at 12.

[303] ACC IB at 10; IS IB at 12; Staff IB at 11; SFPP IB at 15.

[304] Ex. SFW-19 at 2.

Commission, in *Old Dominion*, 70 FERC at 64,187, explained that debt with a maturity date of not more than one year from the date of issuance is classified as short-term debt, and debt with a maturity date of more than one year is classified as long-term debt. While generally only debt with a maturity date of more than one year, or long-term debt, is included in the cost of debt for rate purposes, exceptions have been made.[305]

123. Here, while commercial paper debt has a maturity date of less than one year, KMEP stated, in its December 31, 2003 SEC Form 10-K, that it "intend[s] and ha[s] the ability to refinance $428.1 million of [its] short-term debt on a long-term basis under [its] unsecured long-term credit facility."[306] Therefore, that amount was classified as long-term debt on its consolidated balance sheet.[307] In 2005, the Commission found that when KMEP treated short-term debt as long-term debt, this debt, although due in one year, should be treated as long-term debt.[308] Likewise, in this proceeding, KMEP treats short-term debt as long-term debt, so it must be included in KMEP's cost of long-term debt.

124. The ACC Shippers and Staff also argue that Economic Development Revenue Refunding Bonds, Industrial Revenue Bonds, and OLP-B specific bonds should be included in KMEP's cost of debt calculation.[309] SFPP argues that "the cost of debt should reflect the cost of obtaining debt financing to fund SFPP's operations," and that this tax-exempt and special purpose debt was not available to finance the East and West Line rate bases at issue in this proceeding.[310] On cross-examination at the hearing, SFPP witness Williamson explains that special purpose bonds cannot be used for financing pipelines.[311] Further, he notes that, although KMEP does not restrict the flow of cash from one company to another, it would be illegal for KMEP to take money from a tax-exempt project and use it to finance another project.[312] The tax-exempt bonds and special purpose bonds are used to finance specific projects and are not available to finance the East and West Line rate bases. Therefore, it is the determination of the undersigned that they should not be included in the KMEP's cost of debt calculation. The appropriate cost of debt in this proceeding is KMEP's actual 2003 and 2004 costs of debt, including commercial paper that KMEP classified as long-term debt, but not including special purpose and tax-exempt bonds.

[305] *See Pacific Gas Transmission Co.*, 43 FPC 837.

[306] Ex. ACC-13 at 10.

[307] *Id*.

[308] December 2005 Order at P 69.

[309] ACC IB at 11; Staff IB at 14.

[310] SFPP IB at 18-19 (citing Tr. 531, 1991-92; Ex. SFW-1 at 40-41).

[311] Tr. 535.

[312] *Id*. at 536.

I. What is the appropriate methodology for deriving a rate of return on equity (including any concerns about the Policy Statement on Composition of Proxy Groups)?

<u>Positions of the Parties</u>

ACC Shippers

125. The ACC Shippers advocate the use of SFPP's updated return on equity figures for 2003 and Staff's 2004 return on equity figures, claiming that they are consistent with the Commission's Proxy Group Policy Statement.[313] The Policy Statement concludes that master limited partnerships ("MLP") should be included in a proxy group, that there should be no cap on the level of distributions, and also sets forth what should be the basis for short- and long-term growth factors for use in the discounted cash flow ("DCF") calculation and how they should be weighted.[314]

126. According to the ACC Shippers, the Institutional Brokers Estimated System ("IBES") forecasts should be the basis for the short-term growth forecast, while the long-term growth rate used to calculate an MLP's equity cost of capital should be adjusted.[315] They explain that the long-term growth rate should be equivalent to half of the Gross Domestic Product, and the Commission draws it from three sources: (1) Global Insight: *Long-Term Macro Forecast – Baseline (U.S. Economy 30-Year Focus)*; Energy Information Agency ("EIA"), *Annual Energy* Outlook; and the Social Security Administration ("SSA").[316] The short- and long-term growth factors should be weighted two-thirds and one-third, respectively, they add.[317]

127. The ACC Shippers argue that SFPP inappropriately included Enterprise Products Partners, L.P. ("Enterprise") in its proxy group, ignoring Enterprise's significant merger and acquisition activity which caused price volatility.[318] The Commission has excluded Enterprise from proxy groups for this reason, and it should likewise be excluded here.[319]

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[313] ACC IB at 12-13.

[314] *Id*. at 13.

[315] *Id*.

[316] *Id*.

[317] *Id*.

[318] ACC RB at 14-15.

[319] *Id*. at 15 (citing *Kern River Gas Transmission Co.*, Opinion No. 486-B, 126 FERC ¶ 61,034, at PP 79, 81 (2009) ("*Kern River II*")).

Indicated Shippers

128. The Indicated Shippers state that the appropriate method for determining rate of return on equity is to divide income by the current stock market price and then adjust for projected growth in earnings.[320] They note that it does not matter whether MLPs or corporations are used in the proxy group for determining return on equity, so long as the income that reaches the investors whose investments are traded on the New York Stock Exchange ("NYSE") is used.[321]

129. A problem arises, according to the Indicated Shippers, when cash distributions are used in place of income when determining rate of return on equity.[322] Cash distributions are a return of capital; a return on the investor's investment dollars.[323] They are not an equivalent to income, which, the Indicated Shippers claim, was recognized by the Commission before it adopted the Proxy Group Policy Statement.[324] The MLPs included in SFPP's proxy groups, the Indicated Shippers point out, had to borrow money in order to make cash distributions, and, they add, money that is borrowed is not earned income.[325] Using cash distributions in the DCF formula results in an unjust and unreasonable higher rate of return and a larger income tax allowance.[326] This problem arises in the case of the use of MLPs in a proxy group, where cash distributions are substituted for dividends in the dividend yield formula.[327] The Indicated Shippers argue that there is no way to tell whether the cash distributions come from income, from capital originally contributed, or from borrowing at the partnership level.[328]

130. Furthermore, the Indicated Shippers continue, KMEP's limited partners were allocated millions of dollars in losses for income tax purposes in both 2003 and 2004.[329] If this is the case, that all limited partners who buy and sell on the NYSE were allocated losses, then, the Indicated Shippers maintain, the dividend yield would be zero and return

[320] IS IB at 13.

[321] *Id*.

[322] *Id*.

[323] *Id*.

[324] *Id*. at 13-14 (citing Proxy Group Policy Statement).

[325] *Id*. at 14 (citing Exs. BPX-20, BPX-38; Tr. 1619).

[326] *Id*. at 16.

[327] *Id*. at 17.

[328] *Id*. at 18 (citing Exs. BPX-5 at 8, BPX-1 at 6).

[329] *Id*. (citing Exs. BPX-9, BPX-12).

on equity would be in the negative, even if cash distributions were received.[330] Cash distributions, they specify, cannot be substituted for the dividends, and because there is no income, it is not possible to determine a dividend yield in order to determine return on equity.[331] Therefore, the Indicated Shippers contend that only corporations should be used for calculating the rate of return on equity.[332]

131. The Indicated Shippers are concerned that the Proxy Group Policy Statement is contradictory to the Income Tax Policy Statement, which presumes that an investor pays ordinary income taxes on income received from the public utility each year, while the Proxy Group Policy Statement makes the opposite presumption.[333] Further, they are concerned with the fact that the Proxy Group Policy Statement requires shippers to pay capital gains taxes on the sale of the investment in the future, when, in reality, an income tax allowance is used to shelter ordinary income, not to guarantee investors that their investment can be sold at a profit in the future.[334]

132. Using only corporations in its DCF formula, the Indicated Shippers calculated a range of dividend yields from 0.33% to 5.00% for 2004, with an average of 2.78%, and a range of returns from 7.11% to 13.42%.[335]

133. SFPP argues, contrary to the Indicated Shippers' position, that it is appropriate to determine the dividend yield by using the cash flowed through to the investor divided by the stock market price.[336] Cash distributions are made up from many sources of cash which are not income, and thus should not be treated as income in the dividend yield formula.[337] The cash distributions could not be made, the Indicated Shippers continue, had the MLPs in the proxy group not borrowed money.[338] Further, KMEP's partners received only losses in income, which would result in a negative real return on equity.[339]

[330] *Id*. at 19 (citing Ex. BPX-5 at 17-18).

[331] *Id*.

[332] *Id*. (citing Ex. BPX-17 at 18).

[333] *Id*. at 14.

[334] *Id*. at 15.

[335] *Id*. at 20 (citing Ex. BPX-17 at Revised p. 17).

[336] IS RB at 13.

[337] *Id*. at 14.

[338] *Id*. (citing Ex. BPX-38; Tr. 514-16).

[339] *Id*. at 15.

Commission Trial Staff

134. Staff states that it agrees with SFPP as to the composition of the proxy group used for 2003.[340] Staff agrees with SFPP's 2004 proxy group, with the exception of SFPP's inclusion of Enterprise.[341] Due to its merger with GulfTerra Energy Partners L.P. ("GulfTerra"), Staff explains, Enterprise may experience stock price volatility, which can distort inputs to the DCF model.[342] Both Staff and SFPP removed Kaneb from the 2004 proxy group for this same reason.[343] Staff also contends that Standard & Poor's gave Enterprise an issuer credit rating that was below investment grade, and thus it should not be included in the proxy group.[344] The Commission, according to Staff, uses such ratings when determining membership in proxy groups, and not the Value Line Safety Rating, as suggested by SFPP.[345]

135. Staff furthers its argument by explaining that it relied on the actual merger press to demonstrate that Enterprise's 2004 merger was a major event that resulted in price uncertainty, while SFPP, it claims, relied only on "unsupported comments and conjecture."[346] Staff also alleges that it relied on a variety of precedent for its arguments that bond ratings are used as a measure of risk, while SFPP fails to cite even one Commission case in support of its proposition that the Commission should focus on Value Line Safety Ratings.[347] Lastly, Staff points out that the Commission, in *Kern River II*, excluded Enterprise from a proxy group for the same reasons that Staff excludes it in this proceeding.[348]

SFPP, L.P.

136. To determine rate of return on equity, for 2000-2004, SFPP used the Commission's DCF methodology in accordance with the Commission's Proxy Group

[340] Staff IB at 17 (citing Exs. S-13 at 21, S-31 at 5, SFW-1 at 24).

[341] *Id*. at 17-18.

[342] *Id*. at 18 (citing Ex. S-33 at 38-41).

[343] *Id*. (citing Ex. S-31 at 6).

[344] *Id*. (citing Ex. S-31 at 6).

[345] *Id*. at 21.

[346] Staff RB at 17-18.

[347] *Id*. at 18.

[348] *Id*. at 18-19 (citing 126 FERC ¶ 61,034 at PP 76-81).

Policy Statement, while for 1984-1999, SFPP states that it used the returns on equity required by the Commission in prior SFPP proceedings.[349]

137. According to SFPP, as per the Proxy Group Policy Statement, full, uncapped MLP cash distributions should be used in the DCF formula.[350] Cash distributions are not a return of capital, as claimed by the Indicated Shippers, SFPP contends.[351]

138. SFPP explains next that the differences between Staff and SFPP's DCF analyses are minor.[352] After SFPP's cost of capital witness discovered that other cost of capital witnesses were averaging high and low stock prices during each month in the DCF analysis, SFPP's witness, like Staff, began to do so for 2004 onward.[353] For the years prior to 2004, SFPP used only monthly closing prices, and claims that this should not be rejected since it has been accepted in the past, adopted by the ACC Shippers, and is not biased relative to Staff's method.[354]

139. SFPP also argues that its use of Social Security Administration growth forecasts is correct because they match the time horizons of the Energy Information Administration and Global Insight forecasts which are used in the overall Gross Domestic Product growth forecast calculation.[355] Moreover, SFPP defends its use of a forward-looking model - using the most recent cash distribution for each proxy company at the end of the year - for its calculation of the cash distribution yield because it reflects investor expectations.[356]

140. According to SFPP, the MLPs that it chose for its proxy group have significant oil pipeline business and are appropriate for this proceeding.[357] The proxy group proposed by the Indicated Shippers is inappropriate, SFPP claims, because it is made up of only

[349] SFPP IB at 20.

[350] *Id*. at 20.

[351] *Id*. at 20.

[352] *Id*. at 21.

[353] *Id*. (citing Exs. S-31 at 7, SFW-1 at 17).

[354] *Id*. at 21-22; Staff RB at 24 (citing Exs. ACC-68 at 13, SFW-1 at 17, S-13 at 21).

[355] *Id*. at 22.

[356] *Id*.

[357] *Id*. at 23 (citing Ex. SFW-1 at 13-14).

corporations with no MLPs included, and thus is non-representative and should be rejected.[358]

141. SFPP also responds to Staff's claim that one proxy company, Enterprise, should not be included in the proxy group because of a merger causing unusual stock price volatility and a non-investment grade credit rating.[359] With respect to Enterprise's bond rating, SFPP notes that Enterprise received an average safety rating from Value Line, which publishes safety ratings for all of the proxy companies.[360] Its safety rating was even identical to that of another proxy company that was included by Staff, according to SFPP.[361] These safety ratings, SFPP argues, are more important than safety related to bond ratings when determining the comparable risk of proxy companies, and thus Enterprise should not be excluded based on the bond rating.[362] By focusing on bond ratings and creditworthiness, SFPP asserts, Staff confused cost of debt with cost of equity.[363] Staff also erroneously asserts that the Commission "consistently used bond ratings in determining the membership of proxy groups," but cites no oil pipeline orders in support.[364] Instead, Staff only cited *Kern River II*, a gas pipeline order, which SFPP differentiates from the situation presented here.[365]

142. Nor was the merger a proper reason for Enterprise's exclusion, SFPP continues.[366] A significant amount of time passed prior to the merger and prior to the period reflected in the 2004 DCF analysis, which would allow for unit prices in the DCF analysis to reflect stable investor perceptions, refuting Staff's claims that the merger would cause price volatility.[367]

143. With respect to its methodology for calculating the cash distribution yield, SFPP claims that it followed that which was used by the Commission in the Opinion No. 435

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[358] *Id*.; SFPP RB at 26 (citing Ex. BPX-21; Proxy Group Policy Statement at P 79).

[359] SFPP IB at 24 (citing Ex. S-31 at 6; Tr. 571).

[360] *Id*. (citing Ex. SFW-7 at 23).

[361] *Id*. (citing Tr. 573, Ex. S-31 at 5-6).

[362] *Id*. (citing Tr. 572-73).

[363] SFPP RB at 26 (citing Staff IB at 21).

[364] *Id*. at 26-27 (citing Staff IB at 21).

[365] *Id*. at 27.

[366] SFPP IB at 25.

[367] *Id*. (citing Tr. 574).

series of opinion in Docket No. OR92-8.[368] Specifically, SFPP calculated the yield for each proxy company using the most current distribution, "the annualized cash distributions for each proxy company paid during the fourth quarters of 2003 and 2004."[369] The most recent cash distribution should be used because the DCF model, according to SFPP, is forward looking and intended to reflect investor expectations.[370]

144. SFPP responds to the three alleged inconsistencies between the Income Tax Policy Statement and the Proxy Group Policy Statement discussed by the Indicated Shippers, claiming that none are valid and each has been previously rejected by the Commission.[371] First, the Indicated Shippers claim that the Income Tax Policy Statement presumes that investors pay ordinary income taxes on income received from a public utility, while the Proxy Group Policy Statement presumes that the investor does not receive taxable ordinary income.[372] Both statements, according to SFPP, are incorrect; the Income Tax Policy Statement recognized that some partners may not receive an allocation of taxable income each year, while, in the Proxy Group Policy Statement, the Commission did not need to make any presumptions about allocation of taxable income because there the focus was on MLP distributions.[373]

145. Second, SFPP states that the Proxy Group Policy Statement does not presume that cash distributions are income, as the Indicated Shippers assert, and did not need to make such a presumption because the Policy Statement concludes that the DCF model requires the use of full distributions to unitholders, which are not required to constitute taxable income.[374] Furthermore, SFPP points out that there is no relationship between the income tax allowance in its cost of service and the distributions it pays to its unitholders, nor is there a relationship between the income tax allowance and taxable income.[375] SFPP states that income tax allowance is based on the allowed return in the cost of service.[376]

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[368] SFPP RB at 24.

[369] *Id*. at 24-25 (citing Exs. SFW-16, SFW-5 at 4-5).

[370] *Id*. at 25.

[371] *Id*. at 28 (citing IS IB at 64).

[372] *Id*. (citing IS IB at 14-15).

[373] *Id*. at 28-29 (citing Income Tax Policy Statement at P 39).

[374] *Id*. at 29.

[375] *Id*. at 29-30.

[376] *Id*. at 30 (citing December 2007 Order at PP 52-53; Tr. 1482-83).

146. Third, the Indicated Shippers claim that the Income Tax Policy Statement has shippers pay current income tax allowance as if there were taxable income, while the Proxy Group Policy Statement "calls for shippers to subsidize any future capital gains taxes . . . with a yet-to-be-articulated deduction for the time value of money."[377] SFPP's response indicated that the income tax allowance compensated SFPP for a cost of doing business in 2003 and 2004 and was properly calculated based on after-tax equity return in SFPP's cost of service.[378] Furthermore, SFPP continues, allowed return does not subsidize anything, but instead provides compensation for the cost of capital that a pipeline uses when providing services.[379]

Discussion and Findings

147. The appropriate methodology for deriving a rate of return on equity for use in this proceeding depends upon a variety of factors including: (1) composition of the proxy group, specifically the inclusion of particular companies and the issue of whether MLPs should be included in the proxy group used for determining SFPP's rate of return on equity; (2) the proper growth factors and weightings to be included in the discounted cash flow model; and (3) the use of cash distributions in the dividend yield formula.

148. In the Proxy Group Policy Statement, the Commission continued to use the discounted cash flow methodology for determining a rate of return on equity, and also determined that MLPs should be included in the proxy group used for determining rate of return on equity.[380] The rate of return on equity, according to the Commission, is equal to "current dividend yield (dividends divided by share price) plus the projected future growth rate of dividends."[381] If MLPs are used in the proxy group, cash distributions, rather than dividends, are used in the dividend yield formula, but, the Commission determined, "there should be no cap on the level of distributions included in the Commission's current DCF methodology."[382]

149. The proxy groups recommended by the ACC Shippers, Staff, and SFPP are all composed of master limited partnerships, while the Indicated Shippers offer a corporate proxy group for use in the DCF formula because, they claim, there is an issue with respect to what to use for dividends in the dividend yield formula if MLPs are included in

[377] *Id*. (citing IS IB at 42).

[378] *Id*. at 30-31.

[379] *Id*. at 31.

[380] Proxy Group Policy Statement at P 2.

[381] *Id*. at P 5.

[382] *Id*. at PP 2, 60.

the proxy group.[383] They argue that a cash distribution, which would be used as "income" when MLPs are used in the DCF formula, is a return *of* capital, rather than a return *on* capital; the investor is simply getting back the money that he or she invested.[384] The Commission, however, rejected this argument in its Proxy Group Policy Statement.[385] Specifically, the Commission held that "concern with the distinction between return *on* capital and return *of* capital improperly conflates cost-of-service rate-making techniques with the market-driven DCF method for determining the pipeline's cost of obtaining capital in the equity markets."[386] The Indicated Shippers further base their arguments against using MLPs on the fact that the cash distributed in a cash distribution comes from multiple sources, including borrowing at banks, sales of new securities, depreciation, and income.[387] The Commission also addressed this argument, explaining that "all cash flows, whatever their source, contribute to the value of stock."[388] The Indicated Shippers' arguments regarding the use of MLPs and cash distributions in the dividend yield and DCF formulas fail to convince the undersigned and have been previously rejected by the Commission. MLPs should be included in the proxy group used for determining SFPP's rate of return on equity.

150. While Staff, SFPP, and the ACC Shippers agreed that MLPs should be used in the proxy group, and agreed upon the composition of the proxy group for 2003, they do not agree with respect to the proxy group used for determining SFPP's 2004 rate of return on equity. Both Staff and SFPP agree that Buckeye Partners LP, Enbridge Energy Partners, L.P., Kinder Morgan Energy Partners LP, Plains All American, and TEPPCO Partners should be included in the proxy group used for determining SFPP's 2004 rate of return on equity.[389] However, while SFPP includes Enterprise in its 2004 proxy group, neither Staff nor the ACC Shipper believes that the inclusion of Enterprise is appropriate.[390] According to them, Enterprise should not be included in the proxy group because it was involved in a 2004 merger with GulfTerra.[391] Staff explains that a merger "*can* lead to unusual stock price volatility, which can distort inputs to the Discounted Cash Flow []

[383] IS IB at 17.

[384] IS IB at 13.

[385] Proxy Group Policy Statement at P 57.

[386] *Id*.

[387] IS IB at 13.

[388] Proxy Group Policy Statement at P 58.

[389] SFW-5 at 5; Staff IB at 17.

[390] SFW-5 at 5; Staff IB at 18; ACC IB at 14.

[391] Staff IB at 18; ACC IB at 14.

model."[392] Further, Staff argues that Enterprise also received a non-investment or "junk" credit rating from Standard & Poor's, which indicates that the company is "Below Investment Grade."[393]

151. In response to Staff's arguments, SFPP argues that Enterprise should be included and that Value Line safety ratings, rather than bond ratings, should be relied upon by the Commission when determining whether a company should be included in a proxy group.[394] Enterprise's Value Line safety rating, according to SFPP, is average and is the same as that of TEPPCO Partners L.P., another company in the proxy group.[395] Moreover, SFPP maintains that Enterprise's merger with GulfTerra would not warrant excluding Enterprise from the proxy group because it was announced enough in advance of the actual merger that investors had adequate time to assess the merger and its impacts and for the unit prices in the DCF analysis to reflect stable investor perceptions.[396]

152. In *Southern California Edison Company*, 92 FERC ¶ 61,070, at 61,264 (2000), when adopting a proxy group, the Commission noted that both Staff and the Sacramento Municipal Utility District excluded companies that were involved in merger activity from their proxy groups, and the Commission subsequently adopted the proxy group suggested by Staff in that proceeding. Also, the Commission considered Enterprise specifically in *Kern River II*, 126 FERC ¶ 61,034 at P 81, where it excluded Enterprise from a proxy group because "its financial profile was affected by [the GulfTerra] merger." In both decisions, the Commission considered merger activity when determining whether a company should be included in a proxy group. Moreover, both decisions considered bond ratings when assessing proxy companies, but neither considered the Value Line safety ratings that SFPP deems relevant.[397]

153. SFPP's argument that the facts in *Kern River II* are distinguishable from the facts in the instant proceeding is without merit. Enterprise was excluded in that case partially due to its lack of investment rating and major merger activity.[398] Enterprise should not be included in the proxy group used to determine SFPP's appropriate rate of return on equity because it does not have an investment grade bond rating and because it was involved in

[392] Staff IB at 18.

[393] *Id*. (citing Ex. S-33 at 42-46).

[394] SFPP IB at 24.

[395] *Id*.; Ex. SFW-7 at 23.

[396] SFPP IB at 25 (citing Tr. 574).

[397] *Southern California Edison Company*, 92 FERC ¶ at 61,264; *Kern River II*, 126 FERC ¶ 61,034 at PP 77, 80.

[398] *Kern River II*, 126 FERC ¶ 61,034 at PP 79-81.

a merger with GulfTerra.[399] "[S]uch large scale activity can distort share prices by creating uncertainty (positive and negative) about the impact of change," and "can also influence the stability of the dividend pattern."[400]

154. Staff and SFPP also disagree with respect to the Social Security Administration Growth Rates used when calculating long-term GDP for determining the long-term growth rates needed for the DCF model. When determining the growth rate of dividends, the Commission takes an average of short- and long-term growth estimates.[401] The Institutional Brokers Estimated System forecasts are the basis for the short-term growth factors, which are weighted two-thirds, while long-term growth, weighted one-third, is "is based on forecasts of long-term growth of the economy as a whole," determined by one half the Gross Domestic Product drawn from three sources, including the Social Security Administration growth rates.[402] Staff argues that a 50-year period should be used for the SSA growth rates when performing the GDP calculation, while SFPP uses an 18-year growth rate for 2003 and a 21-year growth rate for 2004.[403]

155. The Commission has stressed a preference for long-term growth projection. In *Williston Basin Interstate Pipeline Co.*, 88 FERC ¶ 61,301, at 61,928 (1999), the Commission explains that the long-term growth forecast should be based on economy-wide growth projections of 25 years or more, or, the longest period available. In *Williston Basin Interstate Pipeline Company*, 104 FERC ¶ 61,036 (2003), the Commission quotes an ALJ's statement regarding the Commission's preference for "truly long-term growth projection," and then agrees with the ALJ's decision that a 50-year growth horizon is appropriate for the SSA forecast.[404] The Commission also used a 50-year time period for the SSA growth rates in *High Island Offshore System, LLC*, 110 FERC ¶ 61,043, at P 153 (2005). Consistent with the Commission's preference toward a true long-term forecast, a 50-year time period for the SSA growth rates for 2003 and 2004 is hereby adopted.

156. Also at issue is how to calculate the cash distribution yield. Staff calculates a distribution yield for each month by dividing the annualized quarterly cash distribution

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[399] *See Kern River II*, 126 FERC ¶ 61,034 at PP 79-81.

[400] *Id*. at P 79.

[401] Proxy Group Policy Statement at P 6.

[402] *Id*. The three sources used to determine Gross Domestic Product are: *Long-Term Macro Forecast – Baseline (U.S. Economy 30-Year Focus)*; Energy Information Agency, *Annual Energy Outlook*; and the Social Security Administration. Proxy Group Policy Statement at P 6, n. 7.

[403] Staff IB at 23.

[404] *Williston Basin Interstate Pipeline Company*, 104 FERC ¶ 61,036 at PP 21, 32.

for each month by the average of the high and low stock prices during each month of each time period used.[405] Staff then averages the cash distribution yields for each month to derive one cash distribution yield.[406] SFPP calculates the cash distribution yield using the annualized cash distributions for each proxy company paid during the fourth quarters of 2003 and 2004.[407] Further, rather than using the average of the high and low stock prices for each month in the DCF analysis for both 2003 and 2004, SFPP used monthly closing prices in its 2003 DCF analysis.[408]

157. Staff's approach, using an average of high and low stock prices in conjunction with finding the distribution yields for each month, is a more accurate representation of the most recent past, which is the best projection of the future. Using the end point of each month with the end points of the years at issue, as SFPP suggests, is a less accurate representation of future growth. Using only the monthly closing prices and the end of year annualized quarterly cash distribution works in favor of SFPP because the distributions tend to increase with time; it is more favorable to SFPP to use the higher distributions because they push up return on equity, thereby increasing the cost of capital. This begs the question of whether SFPP would adopt Staff's method in the event that distributions were decreasing with time, as that approach would be more favorable to SFPP in that situation. As explained by Staff witness Edward Alvarez III ("Alvarez"), "using the average of the high and low stock prices during each month levelizes any swings that may occur, in turn producing a more accurate DCF calculation."[409] Using the average of the high and low stock prices captures the existing trend without permitting any volatility to skew the result. Staff's method for determining the distribution yield is adopted in this proceeding.

J. Where should SFPP be placed in the range of the appropriate proxy group?

<u>Positions of the Parties</u>

ACC Shippers

158. The ACC Shippers state that they do not address this issue.[410]

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[405] Staff IB at 23.

[406] *Id*.

[407] SFPP IB at 25.

[408] *Id*. at 24.

[409] Ex. S-13 at 22-23.

[410] ACC IB at 13.

Indicated Shippers

159. Because SFPP is less risky than the five companies used by SFPP in its proxy group for determining rate of return on equity, it should be placed at or near the bottom of the range of reasonable returns, the Indicated Shippers allege.[411] Because SFPP is the only refined petroleum products pipeline serving California and Arizona and is the only way to reach Nevada, it has a virtual monopoly over the transportation of refined petroleum products in those areas, which reduces its risk.[412] Unlike SFPP, the Indicated Shippers explain, the pipelines in the proxy group face significant competition.[413]

Commission Trial Staff

160. Staff's position is that SFPP should be placed in the median range of the proxy group.[414]

SFPP, L.P.

161. Like Staff, SFPP believes that it should be placed in the median range of the proxy group, and cited Commission precedent as support, stating that the Commission assumes that pipelines fall within a broad range of average risk, and has always placed SFPP at the median of the proxy group returns.[415] The presumption, SFPP continues, can be overcome only when "highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines" exist; however, SFPP alleged that such highly unusual circumstances do not exist in this proceeding.[416] SFPP notes that Staff and the ACC Shippers have also placed SFPP at the median.[417] According to SFPP, when the Indicated Shippers placed SFPP at the bottom of the range of reasonableness they failed to address numerous factors that impact risk, inappropriately characterized the competition SFPP faces, and introduced data that was irrelevant to risk in 2003 and 2004.[418]

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[411] IS IB at 20.

[412] *Id*. (citing Ex. BPX-17 at 19).

[413] *Id*. (citing Exs. BPX-17 at 32, BPX-42, BPX-43).

[414] Staff IB at 22.

[415] SFPP IB at 26; SFPP RB at 31 (citing December 2005 Order at P 78; December 2007 Order at P 125).

[416] SFPP IB at 26-27 (citing Proxy Group Policy Statement at P 7).

[417] *Id*. at 27 (citing Exs. ACC-1 at 15, ACC-68 at 14-15, S-32 at 11, 17).

[418] *Id*. (citing Exs. BPX-36 at 31-32, BPX-42, BPX-43; Tr. 200, 209).

Discussion and Findings

162. SFPP's rate of return on equity depends upon its risk relative to the risks faced by the pipelines included in the proxy group. While both Staff and SFPP argue that SFPP is of average risk and should be placed in the median range of the proxy group, the Indicated Shippers disagree, claiming that SFPP does not face risks of similar magnitude to those faced by the proxy companies and should be placed at or near the bottom of the range of reasonable returns.[419]

163. To set the appropriate range of reasonable returns for an oil pipeline, the Commission uses a proxy group of publicly traded companies which have risks that are comparable to those of the pipeline.[420] The Commission explains that it presumes that a pipeline falls within a broad range of average risk.[421] In order to prove that a pipeline is not of average risk and overcome the Commission's presumption, one must show "highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines."[422] In the December 2005 Order, where it was found that KMEP had average business risk, the Commission held that a pipeline's return will be set at the median of the range of reasonable returns "unless a party makes a very persuasive case in support of the need for an adjustment and the level of the adjustment proposed."[423]

164. The Indicated Shippers have not overcome the presumption that SFPP is of average risk and should be placed at the median level of the range of reasonable returns. Their arguments rest on their witness's testimony that SFPP does not face the same level of competition as the pipelines in the proxy group; according to Indicated Shippers' witness Crowe, while the proxy companies operate in competitive markets, "SFPP serves areas in California and Nevada where no other common carrier product pipeline alternatives are available to its customers."[424] They conclude that SFPP therefore faces less business risk.[425] However, this limited analysis of business risk hardly amounts to what can be called "highly unusual circumstances" which would overcome the Commission's presumption of average risk. The Indicated Shippers failed to consider a variety of factors beyond business risk that could also affect SFPP's risk in comparison to

[419] Staff IB at 22; SFPP IB at 26; IS IB at 20.

[420] Proxy Group Policy Statement at P 7.

[421] *Id*.

[422] *Id*.

[423] December 2005 Order at P 78.

[424] Ex. BPX-36 at 32.

[425] *Id*.; IS IB at 20.

the pipelines in the proxy group.[426] No party has proven that SFPP's level of risk would warrant placing it at or near the bottom of the range of reasonable returns. It is the determination of the undersigned that, when determining the appropriate rate of return on equity for SFPP, SFPP should be placed at the median level of the range of reasonable returns.

K. What is the appropriate rate of return on equity?

<u>Positions of the Parties</u>

ACC Shippers

165. The ACC Shippers explain that they do not oppose SFPP's 2003 rate of return on equity calculation of 10.03%, and agree with Staff's suggested 2004 ROE of 9.22%.[427] The ACC Shippers agree with Staff's 2004 ROE, rather than SFPP's, because SFPP includes members[428] in its proxy group that were involved in a merger or acquisition.[429] Including such members is inappropriate because of the volatility in stock or unit price which distorts the DCF results.[430]

Indicated Shippers

166. If SFPP is placed at either the median or mean of the proxy group, then the Indicated Shippers claim that ROE should be 9.56%.[431] However, according to them, SFPP should be placed at the lower end of the range of reasonableness because it does not face the same risk as other proxy companies.[432] SFPP, the Indicated Shippers continue, did not refute the evidence that SFPP does not face the same competition as members of the proxy group or that it "enjoys a virtual monopoly over the transportation of refined petroleum products by common carrier pipeline in these areas with the

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[426] Tr. 200-08.

[427] ACC IB at 14 (citing Exs. SFW-5 at 4, ACC-68 at 13-14, 15, S-31 at 5).

[428] Kaneb Pipeline Partners, L.P. and Enterprise were involved in merger and acquisition activity during 2004, according to the ACC Shippers. ACC IB at 14 (citing Exs. S-31 at 5, ACC-68 at 15).

[429] *Id*. (citing Ex. ACC-68)

[430] *Id*. (citing *Kern River II*, 126 FERC ¶ 61,034 at PP 79-81; *Southern California Edison Co.*, 92 FERC ¶ 61,070).

[431] IS IB at 20.

[432] *Id*.

attendant reduced risks.[433] Proxy groups, they add, must be risk-appropriate and, in this proceeding, SFPP does not share the risks faced by the proxy group's members.[434]

Commission Trial Staff

167. According to Staff, SFPP's rate of return on equity calculations are reasonable for 2003 and 2004, except that a correction needs to be made for the long-term GDP calculation.[435] Staff states that SFPP used an 18-year 2003 SSA Growth Rate and 21-year 2004 SSA Growth Rate, when it would be more appropriate to use the Commission-preferred 50 year time period for SSA growth rates.[436]

168. Staff also argues that the average of the high and low stock prices during each month should be used in the DCF calculation because it is more accurate than using the closing monthly stock prices, as used by SFPP, which distorts the DCF calculation.[437] SFPP did, however, use the average of the high and low prices rather than monthly closing prices for its 2004 calculation.[438]

169. Further, Staff explains that SFPP used end-of-year annualized quarterly cash distributions or indicated annualized quarterly dividends to stockholders for the proxy companies in its 2003 and 2004 calculations, which is inaccurate because cash quarterly distributions and dividends can change in the six-month period used for a DCF calculation.[439] Staff instead suggests calculating a cash distribution yield for each month of the time periods used.[440] According to Staff, using end-of-year annualized quarterly cash distribution/dividends can push up the distribution/dividend yield, increasing the ROE and increasing the cost to ratepayers.[441]

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[433] IS RB at 15-16.

[434] *Id*. at 16 (citing *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 699 (D.C. Cir. 2007)).

[435] Staff IB at 23.

[436] *Id*. at 23 (citing *High Island Offshore System, LLC*, 110 FERC ¶ 61,043 at P 153).

[437] *Id*. (citing Ex. S-31 at 7, 22-23).

[438] *Id*. (citing Ex. SFW-1 at 17).

[439] *Id*. at 24.

[440] *Id*. (citing Ex. S-31 at 7).

[441] *Id*.

170. Staff recommends a 2003 nominal ROE of 11.89% and a real ROE of 10.01%, while suggesting a 2004 nominal ROE of 12.48% and real ROE of 9.22%.[442]

171. SFPP's response on the GDP growth rate was "nonsensical and . . . defies rational analysis," according to Staff.[443] SFPP claimed that its "SSA forecasts are correct because they match as closely as possible the time horizons of the Energy Information Administration . . . and Global Insight forecasts used in the overall gross domestic product growth forecast calculation."[444] Staff argues that the "time horizons" that SFPP mentions are not at issue, and that SFPP failed to explain why a 2002 Global Insight growth rate is proper for a 2004 calculation.[445] SFPP's position should be rejected, Staff asserts, because SFPP did not rationally rebut Staff's position.[446]

172. Further, Staff contends that SFPP should have used the average of the high and low stock prices during each month to calculate the 2003 cash distribution yield, rather than the closing monthly stock prices for 2003 and the end of the period annual distribution to shareholders for 2003 and 2004.[447] SFPP employs Staff's approach for 2004, Staff states, but uses its own approach for 2003 for consistency with its approach in *Chevron Products Co.*, 125 FERC 63,018 at P 616 because it believes both approaches to be equally reliable.[448] However, Staff disagrees, stating that using the monthly closing price would distort the DCF calculation and consistency with the testimony in *Chevron* is meaningless.[449]

SFPP, L.P.

173. SFPP explains that the appropriate rates of return on equity are set forth in its testimony and in prior Commission orders.[450] For the starting rate base calculations, in the years1984 through 1994, SFPP states that it used the rates approved by the Commission and reflected in the Opinion No. 435-A compliance filing, while it used the rates as reflected in SFPP's February 2008 compliance filing in Docket No. OR96-2 for

[442] *Id*. at 25.

[443] Staff RB at 20.

[444] *Id*. (citing SFPP IB at 22).

[445] *Id*.

[446] *Id*. at 20-21.

[447] *Id*. at 21.

[448] *Id*.

[449] *Id*. at 22.

[450] SFPP IB at 27-28.

1995-1999.[451] For 2000-2004, SFPP explains that it derived the appropriate ROEs by using the Commission's methodology from Opinion No. 435, as it was modified in the Proxy Group Policy Statement.[452]

Discussion and Findings

174. The ACC Shippers explain that they do not oppose SFPP's 2003 rate of return on equity calculation of 10.03%, and agree with Staff's suggested 2004 ROE of 9.22%.[453] The Indicated Shippers recommend an ROE of 9.56% if SFPP is placed at either the median or mean of the proxy group.[454] However, the Indicated Shippers believe that SFPP should be placed at the bottom of the range of reasonableness because it does not face the same risk as other proxy companies.[455] As discussed in Issue II.J, the undersigned has rejected that argument and has determined that SFPP should be placed at the median level of the range of reasonableness. Staff recommends a 2003 nominal ROE of 11.89% and a real ROE of 10.01%, while suggesting a 2004 nominal ROE of 12.48% and real ROE of 9.22%.[456] SFPP's suggested rates of return on equity are 10.03% for 2003 and 9.56% for 2004.[457]

175. Consistent with the determinations made in Issues II.I and II.J, Staff's proposed 2003 and 2004 rates of return on equity are appropriate for use in this proceeding. Staff applies the Commission's DCF formula in accordance with the Proxy Group Policy Statement. In addition, Staff correctly uses a 50-year time period for the Social Security Administration Growth Rates included in GDP and correctly uses the average of the high and low stock prices during each month when calculating the 2003 cash distribution yield.[458] The rate of return on equity proposed by Staff is also based on its placement of SFPP at the median of the range of reasonable returns based on a finding that SFPP is of average risk.[459] The appropriate rates of return on equity for use in this proceeding, as

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[451] *Id*. at 27-28 (citing Exs. SFW-3 at 2, SFW-1 at 5, SFW-4).

[452] *Id*. at 27 (citing Exs. SFW-1 at 6, 12-14, SFW-5).

[453] ACC IB at 14 (citing Exs. SFW-5 at 4, ACC-68 at 13-14, 15, S-31 at 5).

[454] IS IB at 20.

[455] *Id*.

[456] Staff IB at 25.

[457] Ex. SFW-5 at 4, 5.

[458] Staff IB at 23 (citing *High Island Offshore System, LLC*, 110 FERC ¶ 61,043 at P 153); Staff RB at 21.

[459] Staff IB at 22.

calculated by Staff, are a 2003 nominal ROE of 11.89% and a real ROE of 10.01% and a 2004 nominal ROE of 12.48% and real ROE of 9.22%, and are hereby adopted.[460]

L. Whether some adjustment should be made to the equity return to credit ratepayers for the benefits that flow from some aspects of the partnership structure and, if so, how to make that adjustment?

<u>Positions of the Parties</u>

ACC Shippers

176. The ACC Shippers state that they do not address this issue.[461]

Indicated Shippers

177. The Indicated Shippers state that an adjustment should be made to the equity return to credit ratepayers for the benefits that flow from some aspects of the partnership structure.[462] They allege that this is shown by comparing that benefits to KMEP limited partnership unit investors with shareholders in a corporation.[463]

178. According to the Indicated Shippers, applying the Commission's traditional DCF methodology to an MLP results in an excessively high rate of return and income tax allowance, and, therefore, it does not credit ratepayers with the benefits that flow from some aspects of the partnership structure.[464] The public limited partners, they continue, receive cash distributions, as well as losses in income, both of which reduce the tax basis of their partnership units.[465] The cash distribution is a return of investment income, they point out, which is never taxed as income from a trade or a business.[466] It may be taxed as if it were a sale, however, in which case a portion of the dollars received from a purchaser may be taxable, and, if a profit is made on that sale, then the gain may be

[460] Staff IB at 25. Staff real return on equity is its nominal return on equity adjusted for inflation, as shown in Staff's rate of return on equity calculations in Exhibit No. S-32 at page 11.

[461] ACC IB at 14.

[462] IS IB at 21.

[463] *Id*.

[464] *Id*. at 23 (citing 2006 Sepulveda Order at P 46).

[465] *Id*.

[466] *Id*.

taxed.[467] This gain is calculated from the tax basis, while cash distributions are subtracted from the tax basis, and thus there is a possibility, the Indicated Shippers argue, that some or all of the dollars from the new investor, which equal the amount of the cash distribution, will be subject to a capital gains tax.[468] This is not, however, a tax on the cash distribution, they contend.[469] For a cash distribution to be taxed upon the sale of the investment, the future sales price must be a profit, and KMEP's limited partners must not have received any positive income so that there is no offset to the reduction in tax basis of the cash distribution because, if there were positive income, that income would increase the tax basis and decrease future capital gains.[470] The Indicated Shippers cite the Proxy Group Policy Statement for support, which, they claim, acknowledges that the sale of a partnership unit is not likely to occur for many years and the real cost of future taxes will decline during that time.[471]

179. In order to compensate ratepayers for the issues that arise when MLPs are included in the DCF formula, the Indicated Shippers suggest: (1) no capital gains be included in cost of service; and (2) "return on equity be reduced to reflect the future cost of capital gains associated with cash distributions, since there is no income tax associated with cash distributions."[472]

180. The Indicated Shippers continue, arguing that using cash distributions will inflate the rate of return on equity beyond what the rate of return would be if income were used in calculations, since cash distributions exceed income.[473] Further, the MLPs in the proxy group could not make cash distributions without borrowing money or selling units, which proves that SFPP's income is not sufficient to cover the cash distributions, the Indicated Shippers add.[474] They explain that a high rate of return caused by the inclusion of cash distributions will result in a higher price on the stock exchange, which lowers the future cost of the equity.[475] The Indicated Shippers argue that the Commission acknowledged that an adjustment must be made to equity if the DCF model does not effectively credit ratepayers, which, they claim, would be the case if cash distributions

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[467] *Id*. at 23-24.

[468] *Id*. at 24.

[469] *Id*.

[470] *Id*. at 24-25.

[471] *Id*. at 25, 26 (citing Proxy Group Policy Statement at PP 14, 15).

[472] *Id*. at 25-26 (citing Ex. BPX-36 at 19).

[473] IS RB at 16.

[474] *Id*.

[475] *Id*. at 17.

are used in the formula.[476] Moreover, the cash distributions are not taxed as long as the limited partner has a tax basis, they explain, and the tax basis is instead reduced and taxes are deferred until the unit is sold, which may not occur for many years, over which time the real cost of future taxes declines.[477] Therefore, the Indicated Shippers conclude, "the return on equity should be reduced to reflect the future cost of capital gains associated with cash distributions, since there is no income tax associated with cash distributions."[478]

Commission Trial Staff

181. Staff states that it does not take a position on this issue.[479]

SFPP, L.P.

182. SFPP states that the Indicated Shippers' conclusion, that "the Commission intends a fair reduction in the return component of a cost of service in order to 'credit ratepayers with the tax benefits that flow from some aspects of the partnership structure'" is incorrect because that very argument was rejected by the Commission.[480] Investors, according to SFPP, are aware that cash distributions are tax-deferred and, because they prefer smaller allocations of taxable income, will pay more for units that confer tax advantages than for those that offer no tax advantages, which benefits the ratepayers.[481] This "directly and conclusively contradicts [the Indicated Shippers'] claims of 'inherent [in]equities resulting from the use of MLPs in the DCF formula,'" SFPP asserts.[482] SFPP argues that the ratepayers need not be given an extra bonus beyond that, and the Commission, SFPP notes, also has stated that the benefits of the tax deferrals are for the enterprise and should not be credited to the ratepayers.[483] SFPP contends that no adjustment need be made to return on equity related to tax benefits that flow from the partnership structure.[484]

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[476] *Id*. at 18 (citing 2006 Sepulveda Order at P 46).

[477] *Id*. at 18-19 (citing Proxy Group Policy Statement at P 15).

[478] *Id*. at 18-19.

[479] Staff IB at 25.

[480] SFPP IB at 28 (citing Ex. BPX-36 at 10-11; *Kern River II*, 126 FERC ¶ 61,034 at P 116).

[481] *Id*. at 29 (citing Ex. SFW-1 at 26-27; Tr. 581-82).

[482] SFPP RB at 33 (citing IS IB at 25).

[483] SFPP IB at 29 (citing Tr. 582-83; *Kern River II*, 126 FERC ¶ 61,034 at P 116).

[484] SFPP RB at 32.

Discussion and Findings

183. Because MLPs are now permitted to be included in the Commission's traditional DCF formula, there is an issue of whether an adjustment should be made to the equity return to credit ratepayers for the benefits that flow from the MLP structure. The Indicated Shippers argue that such an adjustment should be made.[485] According to them, applying the Commission's traditional DCF methodology to an MLP results in an excessively high rate of return and income tax allowance, and therefore it does not credit ratepayers with the benefits that flow from some aspects of the partnership structure.[486] SFPP disagrees, contending that the Indicated Shippers' assumption that "the Commission intends a fair reduction in the return component of a cost of service in order to 'credit ratepayers with the tax benefits that flow from some aspects of the partnership structure'" is wrong, and the Commission has already rejected their claims.[487]

184. The Indicated Shippers claim that using cash distributions in the dividend yield formula will cause the rate of return on equity to be higher than it would be if income were used in the calculation because cash distributions exceed income.[488] They explain that cash distributions are not taxed so long as the limited partner has a tax basis and the tax basis is instead reduced and taxes are deferred until the unit is sold, which may not occur for many years, over which time the real cost of future taxes declines.[489] Therefore, the Indicated Shippers conclude, "the return on equity should be reduced to reflect the future cost of capital gains associated with cash distributions, since there is no income tax associated with cash distributions."[490]

185. In support of their argument, the Indicated Shippers cite the Commission's Proxy Group Policy Statement. There, the Commission explains that "distributions in excess of earnings are not taxed as long as a limited partner has a tax basis," but instead the taxes are deferred until a unit is sold.[491] Further, the Commission noted that although taxes will be due when the unit is sold, that unit may not be sold until far into the future, and, "[o]ver time the real cost of the future taxes declines while the future return of any tax

[485] IS IB at 21.

[486] *Id*. at 23 (citing 2006 Sepulveda Order at P 46).

[487] SFPP IB at 28 (citing Ex. BPX-36 at 10-11).

[488] IS RB at 16.

[489] *Id*. at 18-19 (citing Proxy Group Policy Statement at P 15).

[490] *Id*. at 18-19.

[491] Proxy Group Policy Statement at P 15.

savings that is reinvested increases," which "can significantly increase the return to the investor over the holding period of the limited partnership unit."[492]

186. The Indicated Shippers' reliance on the Commission's statement from the Proxy Group Policy Statement is not persuasive. As argued on brief by SFPP, the Indicated Shippers base their argument on the Commission's explanation of the MLP business model.[493] In this section of the Policy Statement, the Commission does not express concerns or come to any determination on any issue.[494] Instead, the Commission explains background information useful to understanding how an MLP operates. While such information is important, it should not be used as precedent in support of the Indicated Shippers' argument.

187. The Commission has, however, made on-point statements rejecting the Indicated Shippers' arguments.[495] In *Kern River II*, 126 FERC ¶ 61,034 at P 116, the Commission determined that, for purposes of the Commission's DCF model, "there is no requirement to adjust the results to reflect the tax difference between a Subchapter C corporation and a MLP" because "tax factors are assumed to be reflected in the unit prices and resulting dividend yields of the MLP." Further, the Commission held that "the benefits of any tax deferrals are for the enterprise and should not be credited back to the ratepayers."[496] Given these determinations, no adjustments need be made to the equity return to credit ratepayers for benefits that flow from certain aspects of the MLP structure.

III. Income Tax Allowance – for each complaint year and for any test year used to determine rates:

A. Whether SFPP is entitled to any income tax allowance as a matter of law or fact.

<u>Positions of the Parties</u>

ACC Shippers

188. The ACC Shippers state that SFPP is not entitled to an income tax allowance as a matter of law because it has not shown actual or potential income tax liability on the

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[492] *Id*. at P 14

[493] SFPP IB at 28; Proxy Group Policy Statement at PP 10, 14, 15.

[494] *See* Proxy Group Policy Statement at PP 10-15.

[495] *See Kern River II*, 126 FERC ¶ 61,034 at P 116.

[496] *Id*. at P 116 n. 180 (citing December 2007 Order at P 29).

income from its utility operations.[497] They argue that SFPP did not attempt to show it was entitled to an income tax allowance, but instead assumed its entitlement.[498] The ACC Shippers claim that SFPP focused on potential income tax liability because it could not prove actual income tax liability for the limited partners.[499] In addition, they contend that SFPP's argument, that sometime in the indefinite future all of the negative income reported to the limited partners would become taxable income, lacks credibility.[500]

189. Further, the ACC Shippers point out what they believe to be a discrepancy between the Income Tax Policy Statement and the Commission's ratemaking principles.[501] While the traditional focus is on the utility, according to the ACC Shippers, the Income Tax Policy Statement inconsistently focuses on the income tax liability of the regulated utility's owners.[502] They note that the Commission limits the tax allowance to utilities that pay taxes, and SFPP is a pass-through entity which does not pay taxes and has not attempted to resolve the inconsistency.[503]

190. The ACC Shippers argue that SFPP had an affirmative obligation, as the proponent of applying the Income Tax Policy Statement, to present evidence demonstrating that it is entitled to an income tax allowance.[504] SFPP did not, they claim, provide such evidence and instead erroneously relied on presumptions regarding the calculation of an income tax allowance as contained in the December 2005 Order, the 2006 Sepulveda Order, and the December 2007 Order.[505] These Orders, according to the ACC Shippers, do not change the finding in *ExxonMobil* that SFPP must demonstrate in a rate proceeding that its partners incurred actual or potential income tax liability on their shares of partnership income.[506]

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[497] ACC IB at 15 (citing *BP West Coast*, 374 F.3d at 1288-93; *ExxonMobil*, 487 F.3d at 954; Income Tax Policy Statement).

[498] *Id*. at 16.

[499] *Id*. (citing Tr. 1568-69, 1776-77).

[500] *Id*. (citing Tr. 1652-53).

[501] *Id*. at 17.

[502] *Id*. (citing Income Tax Policy Statement at PP 32, 33; *BP West* Coast, 374 F. 3d at 1289-91).

[503] *Id*.

[504] *Id*. at 18 (citing *Pacific Gas & Elec. Co. v. FPC*, 506 F 2d. 33, 38-39 (D.C. Cir. 1974)).

[505] ACC RB at 16 (citing SFPP IB at 30-35).

[506] *Id*. at 16-17 (citing *ExxonMobil*, 487 F.3d at 954).

Indicated Shippers

191. Like the ACC Shippers, the Indicated Shippers contend that SFPP is not entitled to any income tax allowance as either a matter of law or a matter of fact.[507] They cite *BP West Coast* as support for this assertion, and claim it is not overruled by the Income Tax Policy Statement.[508] Further, they argue that, even if the Income Tax Policy Statement were to become law, SFPP is still not entitled to more than a minimal income tax allowance.[509] In order to prove that it is entitled to an income tax allowance, the burden is on SFPP to show that its partnerships incur "actual or potential" income tax liability, the Indicated Shippers explain.[510] Here, they note, KMEP's partners suffered large losses in income in 2003 and 2004, and thus could not have actual or potential income tax liability.[511]

192. The Indicated Shippers address SFPP's claim that, if a partner receives a K-1 from a partnership, there is proof of actual or potential income tax liability.[512] They state that this proposition is unsupported and that witnesses for both sides stated that there is no tax liability if there is no income shown on the K-1.[513]

193. Next, the Indicated Shippers argue that SFPP calculated income tax allowance as if SFPP's taxable income were the only income flowed through to the partners based on SFPP's assertion that income tax liability is measured on a stand alone basis.[514] In doing so, they demonstrate, SFPP starts with its taxable income, 95% of which goes to its general partner, Operating Limited Partnership "D" ("OLP-D").[515] Of OLP-D's income, the Indicated Shippers explain, 99% (32% after deductions) went to KMEP, as its limited partner, while 1% went to the general partner.[516] While SFPP's income was only 24% of OLP-D's total income, SFPP claims that 100% of its taxable income is included in the

[507] IS IB at 27.

[508] *Id*.

[509] *Id*. at 28.

[510] *Id*. (citing Income Tax Policy Statement at P 42; *ExxonMobil*, 487 F.3d 945).

[511] *Id*. at 28-29 (citing Tr. 1402; Ex. BPX-5 at 15, 17, BPX-28).

[512] *Id*. at 29.

[513] *Id*. (citing Ex. BPX-5 at 17-18; Tr. 1402).

[514] *Id*. (citing *City of Charlottesville v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985)("*City of Charlottesville*")).

[515] *Id*. at 29-30 (citing Ex. SFW-69).

[516] *Id*. at 30 (citing Exs. SFW-29U at 1, SFW-30U at 23).

32% that went from OLP-D to KMEP.[517] In reality, the Indicated Shippers contend, only 24% of that 32% could have reached KMEP, and thus SFPP cannot reasonably seek an income tax allowance for the full amount of taxable income.[518]

194. Further, the Indicated Shippers continue, once at the KMEP level, the stand-alone doctrine is abandoned, a management fee is paid to the general partner off the top, and the general partner receives the same incentive payment regardless of whether there is sufficient partnership income to pay this fee or whether the partnership has losses in income.[519] If, as SFPP claims, *City of Charlottesville* is the basis for its income tax allowance calculation, then, the Indicated Shippers argue, whatever amount of SFPP's taxable income reached KMEP would have to be allocated on a per unit basis, with an amount taken off the top to account for SFPP's excess profits, the Indicated Shippers contend.[520]

195. In contrast with SFPP's methods, the Indicated Shippers assert that the correct way to calculate the taxable income that is flowed through to the partners is to deduct the costs of doing business and both accelerated and straight-line depreciation.[521] Whatever remains is the taxable income to the partners which should be used as the basis for SFPP's claimed income tax allowance.[522] Further, any revenues in excess of cost of service included in SFPP's claimed taxable income must not be taken into account when determining an income tax allowance; SFPP's claimed taxable income should be reduced by the amount of excess profits.[523]

Commission Trial Staff

196. Staff argues that SFPP should be entitled to an income tax allowance, but notes that its suggested income tax allowance reflects a lower rate base, different rate of return, and different capital structure than SFPP's due to differences in adjusted rate base.[524]

[517] *Id*.

[518] *Id*.

[519] *Id*. at 30-31 (citing Ex. BPX-5 at 36-37).

[520] *Id*. at 31 (citing Ex. BPX-17 at 20).

[521] *Id* at 31-32 (citing Ex. BPX-5 at 29).

[522] *Id*. at 32 (citing Ex. BPX-5 at 29).

[523] *Id*. (citing Ex. BPX-26 at 6).

[524] Staff IB at 25-26.

SFPP, L.P.

197. SFPP, like Staff, contends that it is entitled to an income tax allowance.[525] The D.C. Circuit, in *ExxonMobil*, affirmed the Commission's June 2005 Order and the Income Tax Policy Statement, explaining that SFPP is entitled to an income tax allowance under the Income Tax Policy Statement.[526] *ExxonMobil* also made clear, according to SFPP, that *BP West Coast* did not prohibit an income tax allowance.[527] The Policy Statement entitles a partnership which owns an interest in a regulated pipeline to an income tax allowance if those who own the partnership interests "have an actual or potential income tax liability."[528] SFPP alleges that it demonstrated that KMEP's partners incurred actual or potential tax liability on the SFPP income allocated to them.[529] Thus, SFPP argues that it is entitled to an income tax allowance as a matter of law.[530]

198. SFPP explains that, in order to calculate its income tax allowance, it was first instructed to separate KMEP unitholders that are pass-through entities into six categories: (1) Subchapter C corporation; (2) individuals; (3) mutual funds; (4) pension funds, IRAs, and Keogh plans; (5) Unrelated Business Taxable Income ("UBTI") entities; and (6) tax-exempt entities.[531] After dividing the unitholders among these categories, SFPP explains that it must determine the percentage of unitholders within each category and calculate the percentage of taxable income imputed to each group.[532] From there, SFPP can calculate its weighted federal income tax rate by using the marginal income tax rate established for each type of partner category.[533] The marginal income tax rate for Subchapter C corporations and limited liability companies that file an IRS Form 1120 income tax return, according to SFPP, is 34%,[534] while the marginal income tax rate is zero for tax exempt entities.[535] For the other categories of unitholders, the rebuttable

[525] SFPP IB at 29.

[526] SFPP IB at 30 (citing June 2005 Order at P 27).

[527] SFPP RB at 34 (citing *ExxonMobil*, 487 F.3d at 953).

[528] SFPP IB at 30 (citing Income Tax Policy Statement at P 40).

[529] *Id*.

[530] SFPP RB at 34.

[531] SFPP IB at 30-31 (citing December 2005 Order at P 45).

[532] *Id*. at 31 (citing December 2005 Order at PP 45-46).

[533] *Id*.

[534] SFPP notes that the marginal income tax rate could be 35% if SFPP proves that a corporate partner meets a certain taxable income threshold. SFPP IB at 31.

[535] SFPP IB at 31.

presumption is that the marginal income tax rate is 28%.[536] Further, SFPP states that state income taxes are a traditional cost of service element that should be included when determining federal income tax allowance.[537] The weighted state tax rates are calculated using the weighted marginal tax rate of all KMEP partners that are required to report KMEP's income for the state in which KMEP operates.[538]

199. SFPP explains that it presented the evidence required to entitle it to an income tax allowance, including: IRS Forms 1065 for SFPP, OLP-D, and KMEP; IRS Form 1120 for Kinder Morgan, Inc. ("KMI"); limited partnership agreements for SFPP, OLP-D, and KMEP; and state income tax returns.[539] According to SFPP, the Forms 1065 show the taxable income for the partnerships, and the Form 1120 shows KMI and its subsidiaries' taxable income and KMI's income tax liability on that income.[540] The partnership agreements that SFPP entered into evidence govern the allocation of income among the partnerships' partners, while the state income tax returns show the state income apportionment factors which are used to calculate the weighted state income tax rates.[541] SFPP then explains the manner in which its witness, Ganz, calculated SFPP's weighted federal and state income tax rates, which it claims is in compliance with the Commission's December 2005 Order at PP 10-46, the 2006 Sepulveda Order at PP 49-66, and the December 2007 Order at PP 20-61.[542] Further, SFPP traced its income in the manner prescribed by the Commission, while the Indicated Shippers suggest that SFPP's tracing violates the stand-alone policy.[543]

200. Moreover, SFPP argues that the taxable income allocated to KMEP's general partner, Kinder Morgan G.P., Inc. ("KMGP"), should be taken into account when developing the weighted marginal income tax rate, despite arguments by the ACC Shippers and the Indicated Shippers.[544] SFPP cites the Commission's December 2005 Order, which states, as quoted by SFPP, "it is SFPP's prerogative to allocate income and losses among its partners as it determines as long as the maximum tax rate imputed to

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[536] *Id*. at 31-32.

[537] *Id*. at 32 (citing December 2007 Order at P 59).

[538] *Id*. (citing December 2007 Order at P 61).

[539] *Id*. at 32-33 (citing Exs. SFW-28U, SFW-37U, SFW-23U, SFW-24U, SFW-25U, SFW-38U, SFW-39U).

[540] *Id*. at 32.

[541] *Id*. at 31-32 (citing Exs. SFW-22G at 1, 3, SFW-40U, SFW-41U).

[542] *Id*. at 33-34.

[543] SFPP RB at 34-35 (citing IS IB at 28-32, 38).

[544] SFPP IB at 34.

individuals does not exceed the maximum corporate rate."[545] In the December 2007 Order, SFPP adds, the Commission rejected arguments that incentive distributions are guaranteed payments and should be deducted from KMEP's income and stated that it considers this matter closed in this regard.[546]

201. SFPP asserts that it is entitled to an income tax allowance as a matter of fact because it has met its burden of proving that its partners have an actual or potential income tax liability.[547] Responding to Complainants' argument that SFPP has not shown actual or potential income tax liability, SFPP points out that it satisfied the evidentiary standard required by the Commission, which only requires that SFPP show that its partners are required to file an IRS Form 1040 or an IRS Form 1120 return that includes a partnership income or loss, or that the partners receive a K-1 and must report their ordinary income or loss.[548] Complainants, however, refuse to accept the Commission's decision on this subject, and thus continue to focus on the losses by various classes of KMEP limited partners and 743(b) deductions, according to SFPP.[549] SFPP's income was positive, and the Commission, SFPP states, has rejected offsetting SFPP's income with KMEP partner-level losses under the stand-alone method.[550]

202. With respect to incentive distributions, SFPP explains that they do not benefit KMGP, but are instead "an allocation of income tax liability that increases the amount of income taxes for which KMGP is liable."[551] Further, SFPP states that it would be unreasonable to assume, as the Indicated Shippers do, that such a payment would be made if KMEP has zero or negative income.[552] Addressing the ACC Shippers' argument "that the allocation by SFPP and KMEP of income tax liability related to incentive distributions should be ignored in determining SFPP's income tax allowance," SFPP contends that this method would result in "responsibility for only a small fraction of the income tax liability associated with KMEP's incentive distributions ever being attributed to its subsidiaries and would leave the remainder floating somewhere out in the ether."[553]

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[545] *Id*. at 34-35 (citing December 2005 Order at P 43).

[546] *Id*. at 35 (citing December 2007 Order at P 58; *America West*, 121 FERC ¶ 61,241 at P 10).

[547] SFPP RB at 34.

[548] *Id*. at 35 (citing December 2005 Order at P 28; December 2007 Order at P 34).

[549] *Id*. (citing IS IB at 18-19, 21, 22, 28-29, 32-33, 38-40, 41; ACC IB at 16-17).

[550] *Id*. (citing December 2007 Order at P 41).

[551] *Id*. at 37 (citing Tr. 1814-15).

[552] *Id*. (citing Tr. 1818-19).

[553] *Id*. (citing Tr. 254-62).

Discussion and Findings

203. For the reasons discussed more fully herein below, the undersigned finds that SFPP is entitled to an income tax allowance based on the evidence of record in this proceeding as applied to applicable legal precedent.

204. Arguments that the Income Tax Policy Statement does not have the force of law and therefore should not be followed by the undersigned in this proceeding are without merit.[554] The D.C. Circuit, in *ExxonMobil*, approved both the Income Tax Policy Statement and the Commission's June 2005 Order. The Commission has followed both Orders in the December 2005 Order, the 2006 Sepulveda Order, and the December 2007 Order, all of which implemented the Income Tax Policy Statement as applied to SFPP. In *ExxonMobil*,[555] the D.C. Circuit affirmed the Commission's June 2005 Order in which the Commission applied the Income Tax Policy Statement to SFPP and found that ". . . SFPP, L.P. should be afforded an income tax allowance on all of its partnership interests to the extent that the owners of those interests had an actual or potential income tax liability during the periods at issue here."[556] The December 2005 Order, the 2006 Sepulveda Order, and the December 2007 Order established evidence SFPP must present to demonstrate that its owners have an actual or potential income tax liability and how the partnership is to calculate its income tax allowance.

205. The ACC Shippers and the Indicated Shippers argue that SFPP is not entitled to an income tax allowance as a matter of law because SFPP has failed to show that its partnerships incur "actual or potential" income tax liability.[557] They also argue that KMEP's partners suffered large losses in income in 2003 and 2004, and thus could not have actual or potential income tax liability.[558]

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[554] ACC IB at 17-18; IS IB at 28. Despite the ACC Shippers' assertions to the contrary, SFPP had no burden to address the alleged inconsistency between the Income Tax Policy Statement and the Proxy Group Policy Statement. Indeed, Ganz testified that there is no such inconsistency. ACC IB at 17; Tr. at 1526-27.

[555] *ExxonMobil*, 487 F.3d at 955. *ExxonMobil* made clear that *BP West Coast* did not hold that an income tax allowance is prohibited. *Id.* at 953.

[556] The Income Tax Policy Statement at P 40 held that a partnership that owns an interest in a regulated pipeline is entitled to an income tax allowance if the owners of partnership interests "have an actual or potential income tax liability." *See also* June 2005 Order at P 27.

[557] IS IB at 28 (citing Income Tax Policy Statement at P 42; *ExxonMobil*, 487 F.3d 945).

[558] *Id*. at 28-29 (citing Tr. 1402; Ex. BPX-5 at 15, 17, BPX-28).

206. Complainants' position that SFPP has not shown it has an actual or potential income tax liability is not supportable.[559] The Commission found in the December 2005 Order that "if a partner is required to file a Form 1040 or Form 1120 return that includes a partnership income or loss, the Commission concludes that such partner has an actual or potential income tax liability for the partnership income."[560] The December 2007 Order held that "if the partner receives a K-1 and must report distributive ordinary income or loss on the partners' annual income tax return, that partner will have an actual or potential income tax liability."[561] SFPP satisfied these evidentiary standards. SFPP witness Jeffrey A. Utay ("Utay") placed into the record documentary evidence used for the income tax allowance showing. He presented the Forms 1065 (including Schedules K-1) for three partnerships (SFPP, OLP-D, and KMEP) as well as the Form 1120 for KMI, a corporation.[562] The Forms 1065 report the taxable income for the partnerships for each year, while the Form 1120 shows both the taxable income of KMI and its subsidiaries and KMI's income tax liability on that taxable income. Utay also described the unitholder study, the results of which SFPP witness Ganz used in his calculations described below.[563] In addition, Utay attached the limited partnership agreements for SFPP, OLP-D, and KMEP, which govern the allocation of income among each partnership's partners,[564] as Ganz described.[565] Finally, Utay presented to Ganz the state income tax

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[559] ACC IB at 16-17; IS IB at 28-32. The ACC Shippers are misguided in emphasizing actual income tax liability, as that reads "potential" out of the Commission's "actual or potential" tax liability standard. Tr. 1530-31. Nevertheless, their assertion that SFPP witness Ganz could not show actual income tax liability is incorrect. ACC IB at 16. Exhibit Nos. SFW-31U and SFW-36U show the *actual* tax liability for KMI and its subsidiaries, which includes KMGP and all of the entities in the chain of ownership of SFPP. Further, there is actual income tax liability on all of the income allocated to KMGP. Tr. 1815-18.

[560] December 2005 Order at P 28.

[561] December 2007 Order at P 34; Tr. 1530-31. The Indicated Shippers' assertion that SFPP witness Utay testified as to actual or potential income tax liability is false and stems from their mischaracterization of the record. IS IB at 28-29. They suggest that Utay was commenting on the actual or potential income tax liability associated with the income tax allowance. In fact, Utay explicitly stated that he "[doesn't] know anything about income tax allowance." Tr. 1401. Instead, Utay was answering a question about whether there would be income tax in a single year if an entity had losses in that year. Tr. 1402.

[562] Exs. SFW-28U to SFW-37U.

[563] Ex. SFW-22U at 8-15.

[564] Exs. SFW-23U to SFW-25U.

[565] Ex. SFW-22G at 1, 3.

returns[566] and prepared exhibits showing the state income apportionment factors used to calculate the weighted state income tax rates.[567]

207. Together, the evidence provided by SFPP witness Utay and the calculations of SFPP witness Ganz demonstrate that KMEP's partners incurred an "actual or potential" income tax liability on the SFPP income allocated to them, and, further, that SFPP has complied with the requirements of the Commission's Orders[568] in calculating its income tax allowance for 2003 and 2004. Staff is in agreement with this finding;[569] however, Staff notes that its suggested income tax allowance reflects a lower rate base, different rate of return, and different capital structure than SFPP's due to differences in positions regarding the adjusted rate base.[570]

B. To the extent that SFPP is entitled to an income tax allowance, what is the appropriate income tax allowance?

<u>Positions of the Parties</u>

ACC Shippers

208. The ACC Shippers state that a pass-through entity must establish that its partners have an actual or potential income tax liability on the entity's public utility income.[571] Further, to ensure that ratepayers will not be charged more than the actual tax cost the investors incur, the Commission requires developing a weighted marginal tax rate for the pass-through entity that reflects the income tax status of the owning interests.[572]

209. The weighted federal and state income tax rates developed by the ACC Shippers were 8.21% for 2003 and 8.58% for 2004 and are derived from an analysis of the blended rate reflecting the income tax status of the owners, based on the allocation of SFPP's income tax to KMEP's unitholders and analysis of the Commission's rebuttable tax rate

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[566] Exs. SFW-38U, SFW-39U.

[567] Exs. SFW-40U, SFW-41U.

[568] December 2005 Order at PP 10-46; 2006 Sepulveda Order at PP 49-66; December 2007 Order at PP 20-61.

[569] Trial Staff used SFPP's weighted federal and state income tax rates and net-to-tax multipliers in its costs of service. Exs. S-2A at 19, S-2B at 19, S-3A at 19, S-3B at 19.

[570] Staff IB at 25-26.

[571] ACC IB at 19 (citing Income Tax Policy Statement at P 32).

[572] *Id*.

presumptions.[573] The ACC Shippers argue that these rates should be used when determining SFPP's income tax allowance.[574]

210. Like SFPP, the ACC Shippers assume that Subchapter C corporations should be assigned a 34% federal income tax rate, with the exception of KMI and its affiliates; ACC Shippers' witness O'Loughlin accepts SFPP's claim that KMI and its affiliates are subject to a 35% federal income tax rate.[575] The ACC Shippers also agree that non-taxpaying entities should receive a 0% tax rate, but disagrees with the Commission's presumed 28% federal income tax rate for individuals, mutual funds, pensions/IRAs/Keoghs and UBTI entities.[576] According to them, the 28% rate assumes that individuals will be the ultimate beneficiaries and the point at which tax liability will fall, while, in reality, SFPP's return on equity already includes a component for such individual income taxes.[577]

211. Elaborating on that point, the ACC Shippers state that return on equity is measured before individual income taxes are paid by public unitholders and captures what public investors require in terms of pre-tax return, which includes an individual income tax component and an after-tax return element.[578] They continue, explaining that an investor in a limited partnership has to pay income taxes on income allocated to the unitholder, making it clear that purported distribution yield contains an element for payment of individual income taxes and an after-tax return on investment that is "commensurate with the entity's level of risk."[579] The DCF Model, the ACC Shippers state, bases its return on equity estimate on limited partnership distributions.[580] Therefore, they conclude, the return on equity is a return level prior to the public investor paying taxes on income received by the public investor.[581] If an income tax allowance is allowed, the public investor in a limited partnership is then compensated for income tax liability through both the return on equity and through the income tax allowance, and this double recovery

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[573] *Id*. (citing Exs. ACC-1 at 15-27 and Table 6, ACC-18, ACC-19).

[574] *Id*. at 19-20.

[575] *Id*. at 20, n. 10 (citing 2006 Sepulveda Order at P 60).

[576] *Id*.

[577] *Id*. at 20-21 (citing Ex. ACC-1 at 22; December 2005 Order at PP 31-32; 2006 Sepulveda Order at PP 61-63; December 2007 Order at PP 36-38).

[578] *Id*. at 21.

[579] *Id*. (citing Ex. ACC-1 at 22-24).

[580] *Id*.

[581] *Id*. at 21-22 (citing Ex. ACC-1 at 22-23).

causes inflated and unreasonable rates for the shippers.[582] A 0% tax allowance, the ACC Shippers contend, would avoid this unreasonable double recovery.[583]

212. In response to SFPP's claims that the ACC Shippers did not present evidence on this point, the ACC Shippers note that they adduced evidence at hearing which demonstrates that the Commission's DCF methodology for setting rate of return provides investors with a return that is before-individual-income taxes.[584] They also note that SFPP's witness agreed with this fact.[585] Therefore, they continue, if the return already includes a component for individual income taxes, then the Commission's rebuttable presumptions have been rebutted, leaving SFPP with the burden of proving why it should be entitled to a double recovery of income taxes, a burden the ACC Shippers' claim it did not meet.[586]

213. The ACC Shippers consider the UBTI ownership category, maintaining that it should be assigned a 0% tax rate.[587] An exempt entity subject to UBTI must file an IRS Form 990-T, the ACC Shippers explain, but only if that tax-exempt entity's gross income from unrelated business income is $1,000 or more.[588] There is no evidence included in SFPP's cost of service data which shows that the UBTI entities have met this threshold, the ACC Shippers note, and they argue that, based on KMEP's unitholder K-1 data, more than 99% of the UBTI Entities received less than $1,000 in unrelated business income from KMEP in a prior rate proceeding.[589]

214. The ACC Shippers explain that mutual funds are required to derive at least 90% of their income from qualified sources, must pass through at least 90% of their income to investors as dividends, and will not be taxed so long as they meet this requirement.[590] It is reasonable to presume, they continue, that a mutual fund manager would manage the fund in such a way as to avoid income taxes.[591] Further, the ACC Shippers explain that MLP income received by a mutual fund is converted into a fund dividend which qualifies

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[582] *Id*. at 22. (citing Ex. ACC-1 at 24).

[583] *Id*.

[584] ACC RB at 20 (citing Tr. 546).

[585] *Id*.

[586] *Id*. at 20-21.

[587] ACC IB at 23.

[588] *Id*.

[589] *Id*. (citing Exs. ACC-1 at 24-25, ACC-26).

[590] *Id*. at 24 (citing Exs. ACC-1 at 25, ACC-27).

[591] *Id*. (citing Ex. ACC-1 at 25).

as a qualified dividend, subject to lower income tax rates.[592] Therefore, the ACC Shippers claim that mutual funds should not be assigned a 28% federal income tax rate.[593] Additionally, they state that the evidence is sufficient to overcome the rebuttable presumption that the non-corporate unitholders should be assigned a 28% tax rate.[594]

215. Contrary to SFPP's assertions, the December 2005 and December 2007 Orders do not reject the evidence presented by the ACC Shippers showing that UBTI entities and mutual funds do not fall within the 28% tax bracket.[595] The Orders, the ACC Shippers assert, consider taxpayers in the aggregate and do not reject a showing that a particular category of unitholder does not fall within the 28% tax bracket.[596] These orders do not state that the rebuttable presumption can no longer be rebutted by evidence, the ACC Shippers add.[597] They continue, stating that SFPP's own recommendations of a 34% tax rate for UBTI entities proves that the 28% rate is not a rule and can be rebutted.[598] The ACC Shippers contend, however, that 34% is, like 28%, an inappropriate tax rate.[599]

216. The ACC Shippers explain that SFPP attempted to trace its income through its parent, OLP-D, to KMEP, the ultimate parent company, and then allocate the income according to the six unitholder classes.[600] When doing so, however, SFPP erroneously incorporated the effects of incentive distributions which caused an over-allocation of taxable income to the group with the highest marginal tax rates, Subchapter S corporations.[601] The ACC Shippers explain that a greater percentage of distributions are allocated as incentive distributions as distributions increase.[602] Income is allocated to the general partner in an amount equal to the cash distributions prior to allocation to any other unitholder.[603] The amount of the incentive distribution is based on cash flow from

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[592] *Id*.

[593] *Id*. at 24-25.

[594] *Id*. at 25.

[595] ACC RB at 21

[596] *Id*. (citing December 2007 Order at PP 37-38; December 2005 Order at PP 31-32).

[597] *Id*. at 22.

[598] *Id*. (citing SFPP IB at 32, 37).

[599] *Id*.

[600] ACC IB at 25 (citing Ex. ACC-1 at 17).

[601] *Id*. at 26.

[602] *Id*.

[603] *Id*.

all KMEP subsidiaries, not just SFPP, according to the ACC Shippers.[604] The incentive distributions determine the percentage share of taxable income assigned to the general partner, which is assumed to be the same for SFPP's taxable income, even though this taxable income is not based on SFPP's cash flow on a stand-alone basis.[605] This causes the level of SFPP taxable income imputed to the general partner to be higher than the level that would be used if SFPP were considered on a stand alone basis.[606]

217. Moreover, the ACC Shippers add, the incentive distribution scheme violates the Commission's stand-alone tax principle.[607] While SFPP relies on all KMEP-subsidiary-generated income flowed into KMEP's incentive distribution scheme to determine its level of taxable income allocated to KMGP, it should instead rely solely on SFPP's.[608]

Indicated Shippers

218. The Indicated Shippers contend that SFPP's appropriate income tax allowance is zero because there is no taxable income.[609] They continue, adding that SFPP is a pass-through entity which flows through depreciation to its partners that must be deducted from taxable income.[610] Pre-payments accounted for in SFPP's ADIT account must be amortized in the cost of service, which would also reduce taxable income to zero.[611]

219. Assuming that there was taxable income and that the Income Tax Policy Statement, the Indicated Shippers argue that only SFPP's limited partner and OLP-D's general partner can claim actual or potential taxable income because KMEP's limited partners only received losses and KMEP's general partner receives a management fee, which does not entitle it to a tax subsidy.[612]

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[604] *Id*. at 27 (citing Ex. ACC-1 at 19).

[605] *Id*. at 27.

[606] *Id*.

[607] *Id*. at 28 (citing December 2007 Order at PP 40-41).

[608] *Id*.

[609] IS IB at 32.

[610] *Id*. at 33.

[611] *Id*.

[612] *Id*.

Commission Trial Staff

220. Staff recommends, for the East Line, income tax allowances of $1,015,000 and $1,200,000 for 2003 and 2004, respectively.[613] For the West Line, Staff proposes a 2003 income tax allowance of $4,097,000 and a 2004 income tax allowance of $3,822,000.[614]

SFPP, L.P.

221. SFPP calculated its income tax allowance using a weighted federal and state income tax rate of 35% for 2003 and 34.48% for 2004.[615] A net-to-tax multiplier was also determined for each year which was used to determine SFPP's income tax allowance as part of its cost of service.[616] Additionally, according to SFPP, the ACC Shippers' arguments that the income tax allowance should be eliminated from SFPP's cost of service because there is a double recovery is contrary to the Commission's December 2007 Order.[617] SFPP contends that this argument should be rejected.[618]

Discussion and Findings

222. As previously discussed herein above, it is the determination of the undersigned that the evidence provided by SFPP witness Utay and the calculations of SFPP witness Ganz demonstrate that KMEP's partners incurred an "actual or potential" income tax liability on the SFPP income allocated to them, and, further, that SFPP has complied with the requirements of the Commission's Orders[619] in calculating its income tax allowance for 2003 and 2004. SFPP calculated its income tax allowance using weighted federal and state income tax rates of 35% for 2003 and 34.48% for 2004.[620] A net-to-tax multiplier was also determined for each year which was used to determine SFPP's income tax allowance as part of its cost of service.[621] While Staff used SFPP's weighted federal and

[613] Staff IB at 26.

[614] *Id*.

[615] SFPP IB at 35 (citing Exs. SFW-67 at 118, SFW-68 at 123).

[616] *Id*. at 35-36 (citing Exs. SFW-67 at 118, SFW-68 at 123).

[617] SFPP RB at 38 (citing ACC IB at 19-29).

[618] *Id*. at 38.

[619] December 2005 Order at PP 10-46; 2006 Sepulveda Order at PP 49-66; December 2007 Order at PP 20-61.

[620] SFPP IB at 35 (citing Exs. SFW-67 at 118, SFW-68 at 123).

[621] *Id*. at 35-36 (citing Exs. SFW-67 at 118, SFW-68 at 123).

state income tax rates and net-to-tax multipliers in its costs of service analysis,[622] Staff notes that its suggested income tax allowance reflects a lower rate base, different rate of return, and different capital structure due to differences in positions regarding the adjusted rate base.[623]

223. The December 2005 Order, the 2006 Sepulveda Order, and the December 2007 Order contain specific instructions for calculating an income tax allowance. First, SFPP was required to separate the KMEP unitholders into six categories: (i) Subchapter C corporations, (ii) individuals, (iii) mutual funds, (iv) entities that are not normally tax paying entities but would be expected to have taxpaying beneficiaries or owners (such as pension funds, IRAs, Keogh Plans), (v) UBTI entitles, and (vi) tax-exempt entities, such as municipalities.[624] To the extent that the unitholders were pass-through entities, SFPP must identify the "nature of the entity or individual ultimately subject to an actual or potential income tax liability" and categorize the unitholders as described above.[625] The Commission then required SFPP to calculate the percentage of the unitholders in each of the six categories.[626] Moreover, SFPP must calculate the percentage of its taxable income imputed to each group, "which the Commission recognize[d] may not be the same as the percentage of the actual units held by each group depending on how expenses, deductions and income are allocated among the partners."[627]

224. The Commission required that SFPP use that information to calculate a weighted federal income tax rate using the marginal income tax rate established for each type of partner. For Subchapter C corporations and limited liability companies filing a Form 1120 income tax return, the marginal income tax rate is 34% unless SFPP proves that a corporate partner meets the taxable income threshold for the higher 35% marginal income tax rate; for the municipalities and other tax exempt entities, the marginal income tax rate is zero; and, for all other entities, the rebuttable marginal income tax rate is 28%.[628]

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[622] Exs. S-2A at 19, S-2B at 19, S-3A at 19, S-3B at 19.

[623] Staff IB at 25-26.

[624] December 2005 Order at P 45.

[625] *Id.*

[626] *Id.* at P 46.

[627] *Id.*

[628] December 2005 Order at PP 29-32; 2006 Sepulveda Order at P 60; December 2007 Order at P 37. The marginal income tax rate adopted by the Commission for UBTI entities is 28%. SFPP witness Ganz explained that the Internal Revenue Code specifies the corporate rate for UBTI. Ex. SFW-22G at 5. Thus, SFPP applied the corporate rate. Because SFPP was unable to determine whether or not the UBTI entities met the

225. The December 2007 Order found that state income taxes are a “traditional cost-of-service element” and that SFPP is entitled to include them in its calculations if it is entitled to a federal income tax allowance.[629] To calculate the weighted state tax rates, the Commission required use of the weighted marginal tax rate of all KMEP partners required to report KMEP’s income for the states in which KMEP operates.[630]

226. SFPP witness Ganz calculated SFPP’s weighted federal and state income tax rates and used them to calculate the income tax allowances for 2003 and 2004.[631] First, he determined the number of limited partner units by category and the percentage of total units in each category, as required by the Commission.[632] To calculate the total SFPP taxable income allocated to each category, and the corresponding percentages, Ganz started with the taxable income reported on SFPP’s Form 1065 each year.[633] He traced that taxable income through each level of ownership to determine the share of the SFPP taxable income allocated to each partner or category of partners.[634] For example, for 2003, Ganz started with SFPP’s taxable income of $69,769,749, determined the share of income allocated to the partners in SFPP (OLP-D and Santa Fe Pacific Pipelines, Inc.), then to the partners in OLP-D (KMEP and Kinder Morgan G.P. Inc.), then to the general partner and limited partners in KMEP.[635] He then calculated the total SFPP taxable income allocated to each category of KMEP partner (corporations, individuals, etc.) and the percentage each category received.[636] To the resulting income allocation percentages, Ganz applied the appropriate marginal income tax rates identified by the Commission to compute the weighted federal income tax rate for each year.[637]

227. Ganz also calculated weighted state income tax rates for 2003 and 2004, as instructed by the December 2007 Order. The process he used is described in his

threshold for the 35% rate, SFPP used the 34% corporate tax rate. Exs. SFW-71 at 1, SFW-72 at 1.

[629] December 2007 Order at P 59.

[630] *Id.* at P 61.

[631] Ex. SFW-65 at 4-19.

[632] Exs. SFW-69 at 2, SFW-70 at 2.

[633] Exs. SFW-69 at 3, SFW-70 at 3, SFW-111; Tr. 1805-09.

[634] *Id*.

[635] Exs. SFW-69 at 3, SFW-111; Tr. 1805-09.

[636] Exs. SFW-69 at 1, SFW-70 at 1.

[637] *Id*.

testimony,[638] and his calculations are attached thereto.[639] He calculated the weighted federal and state income tax rates for both years[640] and developed the net-to-tax multipliers used to calculate the income tax allowance used in SFPP's costs of service.[641]

228. The Indicated Shippers assert that the correct way to calculate the taxable income flowed through to the partners is to deduct the costs of doing business, accelerated depreciation, and straight-line depreciation.[642] Whatever remains is the taxable income to the partners which should be used as the basis for SFPP's claimed income tax allowance.[643] Further, they assert that any revenues in excess of cost of service included in SFPP's claimed taxable income must not be taken into account when determining an income tax allowance; SFPP's claimed taxable income should be reduced by the amount of excess profits.[644] The ACC Shippers argue that the income tax allowance should be eliminated from SFPP's cost of service because there is a double recovery of income tax liability by the public unitholders.[645]

229. Neither argument is supported by the record, both are contrary to the Commission's Orders, and both the ACC Shippers' and the Indicated Shippers' arguments are hereby rejected. The Commission addressed and rejected the ACC Shippers' claim in the December 2007 Order[646] and again rejected their argument in *Kern River II*, 126 FERC ¶ 61,034 at P 116, issued one year after the ACC Shippers sought rehearing of this point in the December 2007 Order.[647] Moreover, the Commission has clearly stated that this matter is "closed for the purpose of any further complaints against an oil or gas master limited partnership."[648] Likewise, the Indicated Shippers' claims of double recovery of depreciation are rejected.[649] SFPP has addressed and refuted this

[638] Ex. SFW-65 at 15-18.

[639] Exs. SFW-71 at 2-60, SFW-72 at 2-60.

[640] Exs. SFW-71 at 1, SFW-72 at 1.

[641] Exs. SFW-67 at 118, SFW-68 at 123.

[642] IS IB at 31-32 (citing Ex. BPX-5 at 29).

[643] *Id*. at 32 (citing Ex. BPX-5 at 29).

[644] *Id*. (citing Ex. BPX-26 at 6).

[645] SFPP RB at 38.

[646] December 2007 Order at PP 52-53.

[647] On January 25, 2008, the ACC Shippers, among others, requested rehearing of this holding in the December 2007 Order.

[648] *America West*, 121 FERC ¶ 61,241 at P 10.

[649] IS IB at 34-37.

argument in its initial brief,[650] demonstrating the impropriety of using full tax depreciation as an offset to an income tax allowance. This issue was also clearly addressed and refuted on cross-examination.[651]

C. What is the appropriate treatment of ADIT?

<u>Positions of the Parties</u>

ACC Shippers

230. The ACC Shippers argue that SFPP's ADIT balances are overfunded because it used the top marginal corporate income tax rate of 35% in its rates, while the ACC Shippers recommend a 2003 tax rate of 8.21% and a 2004 tax rate of 8.58%.[652] The amount of overfunding should be amortized back to shippers, they contend, by reducing the income tax allowances and returning the overfunding to ratepayers over time.[653] Including the amortization of this balance in their rate recommendations would cause the just and reasonable rates to be even lower.[654]

231. Moreover, the ACC Shippers allege that SFPP incorrectly calculated its 2003 and 2004 ADIT balances, arguing that SFPP's calculation of its ADIT balance is inconsistent with the years and related income tax rates collected in the final East and West Line rates.[655] They state further that using a retroactive application of the Income Tax Policy Statement to determine the ADIT balance when rates collected are based on different income tax rates, as SFPP did, is not justified.[656] The ACC Shippers recommend that SFPP be directed to submit a compliance filing which amortizes the overfunded portion of ADIT by reducing the income tax allowance for future rates and should also accumulate ADIT balances from 1992 to 2003 at the top marginal rate for corporations which was the tax rate used within the rates that were collected from shippers at that time.[657]

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[650] SFPP IB at 5-6.

[651] Tr. 1494-95.

[652] ACC IB at 30.

[653] *Id*. (citing Exs. ACC-1 at 29-30, ACC-82).

[654] *Id*. at 31. (citing Ex. ACC-1 at 29-30).

[655] *Id*. (citing Ex. ACC-1 at 29-30; Tr. 285).

[656] *Id*. at 32 (citing *Enbridge Pipelines (KPC)*, 102 FERC ¶ 61,310, at P 67 (2003); *Mid-America Pipeline Co.*, 124 FERC ¶ 61,016, at PP 599-603 (2008)).

[657] *Id*.

232. Despite SFPP's assertions, the ACC Shippers state that their witness did not agree that SFPP correctly implemented the Income Tax Policy Statement.[658] Instead, the ACC Shippers point out that their witness correctly developed his own tax rate under the Income Tax Policy Statement which recognizes that SFPP's rate of return on equity already includes a component for individual income taxes and that the Commission's rebuttable presumptions inappropriately provide for double recovery of income tax liability.[659]

233. SFPP, however, incorrectly applied the Income Tax Policy Statement to both lines at issue in this proceeding.[660] SFPP accumulates ADIT balances for certain years using weighted income tax rates based on the Income Tax Policy Statement, when the rates actually charged prior to 2003 already had embedded income tax rates based on the top marginal corporate income tax rate.[661] The Income Tax Policy Statement, the ACC Shippers argue, cannot be retroactively applied when accumulating the ADIT balances for the period prior to 2003 when the top marginal income tax rate was reflected in the then-effective rates.[662] There should be a consistency, they add, "between the calculation of ADIT balances and the income tax rate reflected in the rates collected during the period in which the ADIT balance was accumulated."[663]

234. In support of their argument, the ACC Shippers cite Opinion No. 435, where the Commission rejected a similar SFPP argument, stating that its "practice is to base its decision on the policy in effect in the year a regulatory decision is made, and then apply that decision to the time frame to which the case applies."[664] SFPP has been directed to calculate the East Line ADIT balance using the lower weighted marginal income tax rate in the year of the first complaint, and, the ACC Shippers allege, such a rationale should also be followed in this proceeding.[665]

235. Moreover, the ACC Shippers note that the Income Tax Policy Statement was applied to East and West Lines in proceedings which pre-dated the 2003 and 2004 complaint years.[666] While rates were developed in those proceedings based upon a

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[658] ACC RB at 24 (citing Ex. ACC-1 at 16-17).

[659] *Id*.

[660] *Id*. at 24-25.

[661] *Id*. at 25.

[662] *Id*.

[663] *Id*. at 26.

[664] *Id*. (citing *SFPP, L.P.*, 86 FERC ¶ at 61,093-94).

[665] *Id*. at 26-27 (citing December 2007 Order at PP 141-44).

[666] *Id*. at 27.

retroactive application of the Income Tax Policy Statement, the ACC Shippers differentiate these proceedings, stating that these rates were only developed for reparation purposes with respect to specific complaints in those proceedings.[667] Here, SFPP should be directed in its compliance filing to accumulate ADIT balances from 1992 to 2003 based on the income tax rate embedded in the then-effective rates charged to the shippers during that period.[668]

Indicated Shippers

236. According to the Indicated Shippers, any prepaid income taxes in excess of possible deferred taxes should be refunded to shippers by lowering the cost of service.[669] The Indicated Shippers argue that ratepayers should not be forced to pay an "inflated income tax allowance that includes a component for the taxes not paid, as if a tax were paid."[670] The ratepayers, according to the Indicated Shippers, are charged as if a partner did not get accelerated depreciation, even though the partner did in fact get it.[671]

Commission Trial Staff

237. Staff explains that it treats ADIT in the same manner as SFPP.[672]

SFPP, L.P.

238. SFPP states that it calculated ADIT using the weighted federal and state income tax rates determined using the Commission's methodology.[673] SFPP notes that Staff's witness used SFPP's calculations when determining cost of service.[674]

<u>Discussion and Findings</u>

239. For the reasons previously discussed herein above, it is the determination of the undersigned that SFPP witness Ganz properly calculated the ADIT by using the weighted

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[667] *Id*.

[668] *Id*. at 28.

[669] IS IB at 33-34 (citing *South Georgia Natural Gas Co.*, Docket No. RP77-32 (letter order issued May 5, 1978)).

[670] IS RB at 20.

[671] *Id*.

[672] Staff IB at 26.

[673] SFPP IB at 36.

[674] *Id*. (citing Ex. S-2A at 17-18).

federal and state income tax rates that were determined annually using the methodology prescribed by the Commission.[675]

D. How do you determine the "taxable income" of SFPP and of the relevant partners?

<u>Positions of the Parties</u>

ACC Shippers

240. The ACC Shippers state their arguments on this issue in conjunction with Section III.B.[676]

Indicated Shippers

241. The Indicated Shippers calculate taxable income for an income tax allowance by multiplying an amount for taxable income by the correct weighted income tax rate, which will yield the amount of dollars to be included as income tax allowance in the cost of service.[677]

242. The Indicated Shippers explain that SFPP took greater depreciation for tax purposes than was claimed for book purposes and that SFPP, for purposes of calculating a weighted income tax rate, used a taxable income amount that was after all IRS deductions had been taken, including IRS depreciation, for a total amount of $69,769,749.[678] SFPP, when calculating an income tax allowance to be recovered through rates, however, used book income, which does not include the IRS depreciation and deductions.[679] The amount of taxes saved by the IRS accelerated depreciation was placed into the ADIT account which is then credited to rate base.[680]

243. The Indicated Shippers allege that SFPP seeks to recover through its rates a larger amount for the income tax allowance than it actually pays in income taxes through its use of this higher taxable income.[681] According to them, only 43.28% of SFPP's book

[675] Staff witness Carlton Steen ("Steen") also used Ganz's calculations in his costs of service. *See, e.g.*, Ex. S-2A at 17-18.

[676] ACC IB at 32.

[677] IS IB at 34 (citing Ex. BPX-36 at 33).

[678] *Id*. at 34-35 (citing Exs. SFW-28U at 6, BPX-26 at 5).

[679] *Id*. at 35 (citing Ex. BPX-36 at 34).

[680] *Id*. at 35-36.

[681] *Id*. at 36.

income is taxable, and thus the amount used in determining an income tax allowance should be reduced by 43.28%.[682] To remedy this problem, they suggest refunding ratepayers by amortizing the ADIT account over a five-year period and crediting it to taxable income, which would result in a 2003 taxable income of zero.[683]

244. Moreover, the Indicated Shippers contend that SFPP's method is also improper because it ignores the fact that SFPP would flow through all income and deductions, including IRS depreciation, to its partners each year.[684] Requiring the shippers to pay an income tax allowance for the partners as if there were no tax depreciation or other deductions provides the partners with more return than is shown in the cost of service.[685]

Commission Trial Staff

245. Staff states that it does not take a position on this issue.[686]

SFPP, L.P.

246. According to SFPP, SFPP's taxable income for 2003 is $69,769,749 and $130,278,246 for 2004.[687] SFPP explains that the taxable income need not be determined because it is set forth on SFPP's Form 1065 and also states that SFPP's partners' taxable income is irrelevant.[688]

247. SFPP further explains that it traced its taxable income through each level of ownership to determine what share of SFPP's taxable income is allocated to each category of unitholders.[689] SFPP did not include any passive loss carry forwards or Section 743 (b) depreciation deductions, as is consistent, according to SFPP, with Commission policy.[690]

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[682] *Id*. (citing Ex. BPX-26 at 4).

[683] *Id*. (citing Ex. BPX-46).

[684] *Id*. at 37.

[685] *Id*.

[686] Staff IB at 26.

[687] SFPP IB at 36 (citing Exs. SFW-28U at 6, SFW-33U at 6).

[688] *Id*.

[689] *Id*.

[690] *Id*. at 36-37 (citing Ex. SFW-22G at 5; Tr. 1586-1587, 1808-09; December 2007 Order at PP 40-41).

248. While the Indicated Shippers argue that SFPP should use flow-through tax accounting, SFPP states that this argument was rejected by both the Commission and the D.C. Circuit in favor of tax normalization.[691]

Discussion and Findings

249. As explained in Section III.B above, SFPP witness Ganz traced SFPP's taxable income through each level of ownership to determine the share of the SFPP taxable income allocated to each category of partners. Because they did not pertain to SFPP on a stand-alone basis, Ganz did not include any passive loss carry forwards or Section 743(b) depreciation deductions.[692] The Commission confirmed that, in tracing SFPP's taxable income to the various recipients of that income, SFPP should exclude tax deductions and losses that do not originate with SFPP.[693] While the Indicated Shippers assert that Section 743(b) deductions and passive losses should be considered in calculating SFPP's income tax allowance,[694] they were unable to identify Section 743(b) deductions or passive losses associated with SFPP.[695]

E. How do you determine the "tax rate" for the relevant partners?

Positions of the Parties

ACC Shippers

250. The ACC Shippers state their arguments on this issue in conjunction with Section III.B.[696]

Indicated Shippers

251. The Indicated Shippers explain that the Commission's presumed 28% tax rate for individuals is arbitrary and capricious because, for an individual to have a 28% tax rate, the individual's income must be at least $295,000 per year.[697] According to them, this is

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[691] SFPP RB at 40 (citing *Columbia Gulf Transmission Co.*, 23 FERC ¶ 61,396, at 61,852 (1983); *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, at 61,837 (1985)).

[692] Ex. SFW-22G at 5; Tr. 1586-87, 1808-09.

[693] December 2007 Order at PP 40-41.

[694] *See e.g.*, Ex. BPX-36 at 43-44

[695] Ex. SFW-22G at 5; Tr. 1586-87, 1808-09.

[696] ACC IB at 32.

[697] IS IB at 37 (citing Ex. BPX-5 at 27).

highly unlikely, and SFPP has not shown that "it is possible to make such a presumption regarding the possible allocation of positive taxable income received by each and every limited partner."[698] In fact, the Indicated Shippers claim that they have shown that limited partners received no positive taxable income, only losses, and that KMEP's general partner received all the taxable income plus an additional amount beyond reported taxable income, making it even clearer that there was no positive taxable income left to give out.[699] However, the Indicated Shippers note, the tax rate used to multiply against the taxable income in order to calculate an income tax allowance is a non-issue because there is no taxable income.[700]

252. Further, the Indicated Shippers argue that SFPP's weighted average federal income tax rate was calculated using rate percentages that were not possible, and the calculation failed to take 743(b) depreciation into consideration.[701]

253. Regarding income tax rates for individuals, the Indicated Shippers state: (1) basic income taxes on individuals are on a progressive scale; (2) there is no basis to assume that all individuals are in the 28% income tax bracket; and (3) individuals whose taxable income does reach that bracket will never pay 28% of their taxable income in taxes.[702] SFPP, the Indicated Shippers argue, ignores these facts and argues that the income received from SFPP falls within the 28% bracket.[703]

Commission Trial Staff

254. Staff states that it does not take a position on this issue.[704]

SFPP, L.P.

255. The tax rate for the relevant partners, SFPP explains, should be determined in accordance with the Commission's prior Orders which dictate which income tax rates should be used for which type of entity.[705] Further, SFPP continues, as set forth in the

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[698] *Id*. at 37-38.

[699] *Id*. at 38 (citing Ex. BPX-36 at 27).

[700] *Id*. at 39.

[701] *Id*. at 38.

[702] *Id*. at 39-40 (citing Ex. BPX-14 at 4).

[703] *Id*. at 40.

[704] Staff IB at 26.

[705] SFPP IB at 37 (citing December 2005 Order at PP 29-32; 2006 Sepulveda Order at P 60; December 2007 Order at P 37).

Income Tax Policy Statement and other orders, the weighted federal and state income tax rates for 2003 and 2004 are appropriate for calculating cost of service.[706]

256. According to SFPP, while the Indicated Shippers challenged the marginal income tax rates used by SFPP in calculating its income tax allowance, they did not prove that any other marginal income tax rates should be used and instead only tried to prove that marginal income tax rates should not be used at all.[707] Also, SFPP notes, the Indicated Shippers confused the issue by mixing "effective" and "marginal" income tax rates, while the Commission has been clear that marginal rates are appropriate.[708]

257. Moreover, SFPP explains that the ACC Shippers were not able to rebut the Commission's rebuttable presumptions with regard to the marginal income tax rates because they presented only argument and not evidence.[709] Instead, the ACC Shippers utilized evidence that is not in the record, made assumptions and conclusions, and based arguments upon law that was not in effect in 2003 and 2004.[710] They attempt to return to the approach from *Lakehead Pipe Line Co., L.P.*, 71 FERC ¶ 61,338 (1995), *reh'g denied*, 75 FERC ¶ 61,181 (1996) ("*Lakehead*"), SFPP explains, where "a pipeline was permitted an income tax allowance in proportion to the taxable income allocated to corporations."[711] *Lakehead*, however, was overturned by the D.C. Circuit and abandoned by the Commission.[712]

<u>Discussion and Findings</u>

258. This issue was discussed and determined in conjunction with Issue III.B. As discussed in Section III.B above, SFPP has used the appropriate rates. The weighted state income tax rates should be calculated in compliance with the December 2007 Order at P 61, as SFPP has done.[713] Moreover, under the Income Tax Policy Statement and subsequent orders, the appropriate income tax rates to utilize in calculating cost of service rates in this proceeding are the weighted federal and state income tax rates for 2003 and

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[706] *Id*. at 37-38.

[707] *Id*. at 38.

[708] SFPP RB at 40 (citing IS IB at 37-40).

[709] SFPP IB at 38 (citing Ex. ACC-1 at 21-28).

[710] SFPP RB at 41 (citing ACC IB at 23-25).

[711] *Id*. (citing *Lakehead*, 71 FERC at 62,328-29).

[712] *Id*. (citing *BP West Coast* 374 F. 3d at 1288; Income Tax Policy Statement at P 33; June 2005 Order at P 16).

[713] Exs. SFW-71, SFW-72.

2004 calculated by SFPP witness Ganz. For 2003, that rate is 35.00%.[714] For 2004, that rate is 34.48%.[715] Ganz described how SFPP arrived at those rates by following the Commission's instructions in the December 2005 and December 2007 Orders.[716]

259. The Indicated Shippers challenged the marginal income tax rates that SFPP used to calculate its income tax allowance.[717] The Indicated Shippers, however, did not attempt to prove that other marginal income tax rates should apply. Instead, they attempted to prove that the use of marginal income tax rates is improper. The ACC Shippers likewise challenged SFPP's use of the Commission-required rebuttable presumptions, claiming that the marginal income tax rate for all partners other than corporate unitholders should be zero.[718] However, the ACC Shippers presented only argument; they did not present evidence sufficient to rebut the Commission-imposed presumptions. Complainants' arguments have already been rejected by the Commission.[719]

F. Should SFPP's rates include compensation for all or any part of any taxes that may be assessed in the future of the profits, if any, on the cash received from a new purchase? If they do, should ratepayers have to pay all or any part of such taxes, and if so, how should that allowance be calculated?

Positions of the Parties

ACC Shippers

260. The ACC Shippers state that they do not address this issue.[720]

Indicated Shippers

261. The Indicated Shippers respond that there is "no justification for calling on ratepayers to subsidize any taxes that may be due upon the sale of an asset to a third party."[721]

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[714] Ex. SFW-67 at 118.

[715] Ex. SFW-68 at 123.

[716] *See* Section III.B.

[717] Ex. BPX-17 at 26.

[718] Ex. ACC-1 at 21-28.

[719] *America West*, 121 FERC ¶ 61,241 at P 10; December 2005 Order at PP 31-32; December 2007 Order at PP 35-39.

[720] ACC IB at 33.

Commission Trial Staff

262. Staff states that it does not take a position on this issue.[722]

SFPP, L.P.

263. SFPP states that it addressed this issue in Section II.L.[723]

Discussion and Findings

264. This issue was addressed in Section II.L above.

G. Are there unintended consequences of applying the income tax policy statement of which the Commission should be aware?

Positions of the Parties

ACC Shippers

265. The ACC Shippers assert two unintended consequences of applying the Income Tax Policy Statement: (1) applying the Policy Statement will result in double recovery of an income tax allowance and return in excess of allowed return; and (2) applying the Policy Statement thwarts the Commission's goal, set forth in the Policy Statement, of promoting energy infrastructure investment.[724]

266. With regard to the second consequence, the ACC Shippers explain that SFPP will not use any money it collects through its income tax allowance for construction of energy infrastructure because it instead pays all its available cash to OLP-D, its parent.[725] This danger was recognized by the Public Utilities Commission of the State of California ("CPUC"), the ACC Shippers note, which indicated that this problem arises when a utility is obligated to pay out all of its available cash.[726]

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[721] IS IB at 41.

[722] Staff IB at 26.

[723] SFPP IB at 38.

[724] ACC IB at 33 (citing Income Tax Policy Statement at P 1; *SFPP, L.P.*, 116 FERC ¶ 63,059)).

[725] *Id*. at 34 (citing Ex. SFW-25U at 39-40).

[726] *Id*. (citing CPUC Decision 07-05-061, "Interim Opinion Approving, with Conditions, Transfer of Indirect Control and Authorizing, with Conditions, Exemption

Indicated Shippers

267. One unintended consequence, according to the Indicated Shippers, is that there is conflict between the Proxy Group Policy Statement and the Income Tax Policy Statement.[727] While the Income Tax Policy Statement presumes that limited partners receive taxable income because they receive a K-1, even if that K-1 shows a loss, the Proxy Group Policy Statement, the Indicated Shippers claim, presumes that the limited partners *do not* receive taxable income from the partnership, but receive income from third persons sometime in the future.[728] Essentially, the argument is that the Income Tax Policy Statement has shippers pay current income tax allowance as if there were taxable income, while the Proxy Group Policy Statement has shippers "subsidize any future capital gains taxes as well, with a yet-to-be-articulated deduction for the time value of money."[729]

268. The inconsistent presumptions lead to a high rate of return on equity, according to the Indicated Shippers, that is measured by cash distributions which are actually a return of investment.[730] This results in a claim for a higher income tax allowance despite the fact that cash distributions are not taxed as ordinary income when received.[731] Likewise, the Indicated Shippers add, cash distributions are not taxed when received from a partnership upon sale.[732] They are investment dollars which are recovered, thus reducing the tax basis of the investment.[733] While cash distributions are never taxed, some of the dollars paid by a new purchaser may be taxed, but, in order for that to be true, a partner could never have received income, or else the tax basis would have gone up, offsetting the cash distribution.[734] Cash distributions, according to the Indicated Shippers, are not deferred earnings that are taxed upon the sale of investment.[735] They cannot be used as a measure of return on equity, they are a return of capital, and they are not deferred

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from Public Utilities Code Section 852 for Some Investors in Knight Holdco," Case Nos. A.06-09-016 and A.06-09-021 (Issued May 24, 2007)).

[727] IS IB at 41.

[728] *Id*. (citing December 2007 Order; Proxy Group Policy Statement at P 15).

[729] *Id*. at 42.

[730] *Id*.

[731] *Id*.

[732] *Id*. at 43.

[733] *Id*.

[734] *Id*.

[735] *Id*. at 44.

earnings because the cash does not come from income generated by the partnership.[736] If MLPs are used in the Proxy Group, cash distributions should not be used in the dividend yield formula, the Indicated Shippers argue, but rather, taxable income allocated to the public limited partners should be used.[737]

269. According to the Indicated Shippers, there is no basis for SFPP's income tax allowance when KMEP's limited partners received only losses in the test periods.[738] The Indicated Shippers claim that SFPP agreed that the partners that have no income allocated to them on their K-1 have no actual or potential income taxes.[739]

270. First, the Indicated Shippers explain, SFPP's income (minus the amounts to its limited partner and OLP-D's general partner) did not all flow through to KMEP.[740] Deductions from taxable income, they state, were flowed through by KMEP to the limited partners, including deductions from the partnership, 743(b) deductions, and the losses in income that were necessary to offset the general partner's management fee.[741] SFPP, however, claims that, based on the stand-alone requirement, the Commission should ignore the deductions from KMEP so that all SFPP taxable income is flowed through to partners at each level.[742] Further, according to the Indicated Shippers, by allowing the partners a 28% tax bracket, SFPP ignores the fact that the partners receive losses in income and also assumes that the partners have outside income, which, the Indicated Shippers point out, is contrary to their reliance on the stand-alone requirement of *City of Charlottesville*.[743]

271. Furthermore, the Indicated Shippers argue, SFPP assumes that KMEP's limited partners' income, if there was any income, is taxed at the 28% level in order to get more money out of the ratepayers.[744] The Indicated Shippers claim that this argument lacks evidentiary support and that taxes should be based on the effective rate imposed on the aggregate of taxable income.[745]

[736] *Id*.

[737] *Id*. at 44-45.

[738] IS RB at 22 (citing Tr. 1402).

[739] *Id*. at 23 (citing Tr. 1402).

[740] *Id*. at 24.

[741] *Id*. at 25.

[742] *Id*. (citing *City of Charlottesville*, 774 F.2d 1205).

[743] *Id*. at 25-26 (citing 774 F.2d 1205).

[744] *Id*. at 26.

[745] *Id*.

272. They also argue that the partners cannot be liable for income taxes when the K-1 reports a loss in income.[746] If the partners had received income, the Indicated Shippers explain, then they would pay income taxes on that income which would be subsidized by ratepayers.[747] The partners, however, did not pay taxes because they did not receive any income, and yet, the Indicated Shippers point out, SFPP asks that ratepayers "cover the income taxes that the partners would have to pay if they had to pay income taxes."[748]

273. The Indicated Shippers next consider "whether the cash distribution, which is not taxable as income when received by the partner, becomes taxable as income when the partner makes a profitable sale in the future."[749] When a sale is made, they note, the money received by the investor is taxed, but should not be paid by ratepayers.[750] SFPP will argue to the contrary, stating that the cash distributions will then convert to income and are thus really "deferred income."[751] The Indicated Shippers state that SFPP's argument rests on the assumption that a partner never received any income at all, positive or negative.[752] They claim that this assumption is untrue, as evidenced by the losses in income received by the limited partners in the test years, which will offset income taxes in the future, up to and including upon the sale of the asset.[753] The Indicated Shippers thus allege that cash distributions are not income of any type and cannot be used in place of income when determining a rate of return on equity.[754]

274. According to the Indicated Shippers, the Commission is in the process of deciding whether an adjustment to return is needed when cash distributions are used in the dividend yield formula, or, they add, whether the formula should be amended to be a "cash distribution yield" formula.[755] This would measure how fast an investor gets investment dollars back, they note.[756] An investor may lose money, the Indicated Shippers explain, but will receive some investment dollars back at a high rate which will

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[746] *Id*. at 26-27 (citing Tr. 1402).

[747] *Id*. at 27.

[748] *Id*.

[749] *Id*. at 29.

[750] *Id*. at 30.

[751] *Id*.

[752] *Id*. at 32.

[753] *Id*. (citing Ex. BPX-28).

[754] *Id*.

[755] *Id*. at 32-33.

[756] *Id*. at 33.

result in a greater profit upon sale.[757] Likewise, losses will reduce the tax basis and make the sale appear even more profitable, the Indicated Shippers quip.[758]

275. Furthermore, the Indicated Shippers argue, under the two policy statements, a partner can have income and not have income at the same time.[759] First, it is presumed that KMEP's partners do not receive income, and so cash distributions must be used instead, and are considered deferred income.[760] However, the Indicated Shippers continue, cash distributions are also considered "not income," but instead are cash which investors expect to receive, which is never taxed as ordinary income, and thus no income tax allowance should be allowed.[761] They point out that one set of presumptions satisfies the argument for an income tax allowance, while the other justifies using cash distributions in place of income, each helping a different cost of service component.[762]

276. The Indicated Shippers sum up their argument, stating: (1) "SFPP cannot justify an income tax allowance under the Policy Statement on Income Tax Allowance;" and (2) "SFPP cannot justify treating borrowed money, sales of new units, and depreciation as if they were income."[763] SFPP, according to the Indicated Shippers, could not justify an income tax and did not justify its proxy group made up of MLPs.[764]

Commission Trial Staff

277. Staff states that it does not take a position on this issue.[765]

SFPP, L.P.

278. SFPP states that there are no unintended consequences of applying the Income Tax Policy Statement.[766] It also responds to the ACC Shippers' claim that the record demonstrates that the Income Tax Policy Statement inhibits the promotion of energy

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[757] *Id*.

[758] *Id*.

[759] *Id*. at 34.

[760] *Id*. at 35.

[761] *Id*.

[762] *Id*.

[763] *Id*. at 38.

[764] *Id*. at 41.

[765] Staff IB at 26.

[766] SFPP IB at 38 (citing Tr. 1532-34, 1522-27).

infrastructure.[767] SFPP claims there is no evidence to support this statement, and, it adds, since the Policy Statement has been in place, SFPP has been investing in its infrastructure.[768] It is clear, according to SFPP, that this logic, "that reducing cash flow will increase investment," is flawed.[769]

Discussion and Findings

279. It is the determination of the undersigned that, while Complainants were provided every opportunity to explain and support their position on this issue, they have failed to do so. Rather, the undersigned concurs with the testimony provided by SFPP witness Ganz that there are no such unintended consequences in applying the Income Tax Policy Statement to SFPP.[770]

IV. Operation and Maintenance Expenses – for each complaint year and for the test year used to determine rates:

A. What is the appropriate allocation of general and administrative expenses?

1. Massachusetts Formula

Positions of the Parties

ACC Shippers

280. The ACC Shippers explain that the Massachusetts formula, or "Mass formula," allocates corporate overhead costs based on the average percentage of three ratios: (1) the regulated utility subsidiary's operating revenue as compared to total corporate operating revenues; (2) gross plant to total corporate gross plant; and (3) the regulated utility's gross payroll, or labor, to total corporate gross payroll.[771] It is inappropriate, they add, to exclude a subsidiary from the Massachusetts formula allocation if that subsidiary benefits from the parent's overhead services in any way.[772] When a party seeks to stray from the

[767] SFPP RB at 42 (citing ACC IB at 35).

[768] *Id*. (citing Ex. SFW-65 at 23)

[769] *Id*.

[770] Tr. 1532-34; 1522-27.

[771] ACC IB at 36 (citing *KN Interstate Gas Transmission Co.*, 88 FERC ¶ 61,270, at 61,848 (1999)).

[772] *Id*. at 37.

Commission's traditional Massachusetts formula, the party seeking that change bears the burden of proving that such change is reasonable.[773]

281. For 2003, the ACC Shippers recommend allocating a total of $178.7 million through a single tier Massachusetts formula to all KMEP subsidiaries.[774] They (1) include $28.2 million of capitalized overhead in their allocation; (2) adjust the gross property, plant, and equipment of KMEP's subsidiaries to year-end 2003 balances; and (3) remove the PAAs associated with only KMEP's regulated subsidiaries.[775] Through the ACC Shippers' implementation of the formula, SFPP is allocated $15.9 million in KMEP overhead costs, $12 million of which is allocated to carrier operations.[776] The ACC Shippers state that $1.3 million of that carrier amount is allocated to the East Line operations, while $3.1 million is allocated to West Line operations.[777] For 2004, KMEP's total corporate unallocated expenses were $207.6 million (including capitalized overhead), $16.7 million of which is allocated to SFPP.[778] The ACC Shippers allocate $12.9 million to SFPP's carrier operations - $1.5 million to East Line interstate operations and $2.9 million to West Line operations.[779] These figures for both 2003 and 2004 differ from SFPP's figures, according to the ACC Shippers, because they reject: (1) retroactive direct assignment of previously unallocable overhead costs; (2) the exclusion of some KMEP subsidiaries from the Massachusetts formula allocation; (3) use of subsidiary tiers in the calculation; (4) use of net revenue as an allocation factor for Tejas Gas LLC and its subsidiaries ("Tejas Consolidated" or "Tejas"); and (5) removal of PAAs for unregulated KMEP subsidiaries.[780]

282. According to the ACC Shippers, SFPP makes a variety of "direct assignments" that lack accuracy and credibility.[781] These include assignments of KMEP overhead prior to the application of a multiple tier Massachusetts formula allocation, direct assignments as part of the Massachusetts formula allocation, and fixed-fee arrangements with

[773] *Id*. (citing *SFPP, L.P.*, 116 FERC ¶ 63,059 at P 184; *Chevron Products Co.*, 125 FERC ¶ 63,018 at P 778).

[774] *Id*. at 38 (citing Ex. ACC-34 at 21).

[775] *Id*. (citing Ex. ACC-34 at 29-30).

[776] *Id*.

[777] *Id*. (citing Ex. ACC-34 at 30-32).

[778] *Id*. at 38-39 (citing Ex. ACC-34 at 22).

[779] *Id*. at 39 (citing Ex. ACC-34 at 34-35).

[780] *Id*. at 39-40.

[781] *Id*. at 40.

excluded subsidiaries.[782] Such assignments, the ACC Shippers continue, ignore the fact that overhead costs cannot be directly assigned because they are not attributable to any segment.[783] Further, they add, while KMEP's 2003 and 2004 books and records did not include direct assignments of overhead costs, SFPP was nevertheless able to identify overhead expenses and find them directly attributable to single subsidiaries or groups of subsidiaries, which the ACC Shippers find questionable.[784] The ACC Shippers state that SFPP did not present justification or supporting material for this reallocation of expenses.[785] Moreover, SFPP utilizes a 2006 methodology for the allocation of costs which were recorded in 2003 and 2004, which the ACC Shippers claim is a form of retroactive ratemaking used to inflate cost of service.[786]

283. The ACC Shippers also note that the use of direct assignments does not reflect a matching of costs with cost causation, and point out that KMEP's Massachusetts formula allocation has undergone changes that happen to coincide with SFPP's rate proceedings and appear to be driven by income tax implications.[787] Accuracy, the ACC Shippers conclude, was not likely behind the modifications made to SFPP's Massachusetts formula.[788]

284. The ACC Shippers address the fixed-fee arrangements associated with KMEP-owned and KMI-operated natural gas subsidiaries, stating that they further prove that SFPP's direct assignments of overhead costs are inaccurate and unreliable.[789] They state that SFPP admits that there are residual overhead costs in excess of the fixed fees, but that these costs are not assumed by KMEP subsidiaries.[790] Instead, the ACC Shippers note, KMI subsidiaries assume these overhead expenses, which indicates that the overhead expenses on KMEP's books via the fixed-fee arrangements do not accurately represent the overhead costs associated with KMEP's subsidiaries.[791] Thus, the ACC

[782] *Id*. (citing Exs. SFW-45 at 11-12, SFW-46 at 11-12).

[783] *Id*. (citing Exs. ACC-34 at 28, ACC-65 at 2, 4; Tr. 875-76).

[784] *Id*. at 41 (citing Exs. ACC-34 at 26-28, SFW-43 at 54, SFW-45 at 12).

[785] *Id*. at 43.

[786] *Id*. at 41-42

[787] *Id*. at 42 (citing Exs. ACC-34 at 25-28, ACC-63 at 14-22; Tr. 614-35).

[788] *Id*. at 43.

[789] *Id*. at 45.

[790] *Id*. (citing Ex. ACC-73 at 5).

[791] *Id*.

Shippers maintain that the fixed-fee arrangements result in flawed allocations and cross-subsidization of subsidiary functions.[792]

285. SFPP, according to the ACC Shippers, improperly excluded 12 subsidiaries from its Massachusetts formula allocation that are either KMEP-owned/KMI-operated subsidiaries over which KMEP exercises managerial oversight and responsibility, or joint ventures that, while operated by third parties, still require oversight from KMEP.[793] With respect to the KMEP-owned/KMI-operated subsidiaries, the ACC Shippers argue that operating agreements between the affiliated subsidiaries specify that while KMI will operate the subsidiaries, KMEP, as their owner, will retain managerial responsibility regarding oversight of the subsidiaries.[794] The ACC Shippers also reiterate that the fixed-fee arrangements are problematic and allege that the level of fixed fees is very low relative to the size of the excluded KMEP-owned natural gas subsidiaries.[795] It seems implausible, they continue, that there are no KMEP overhead services or costs associated with these subsidiaries when they represent 35% of KMEP's total assets and an almost equal amount of operating income.[796] The ACC Shippers further contend that "either KMI is performing these overhead functions for an unreasonably, preferentially, and discriminatorily low amount and charging the balance to the KMEP subsidiaries that it does not operate, or KMEP is actually performing the overhead functions," which would result in cross-subsidization and costs that would be borne by KMEP subsidiaries included in the allocation.[797]

286. The ACC Shippers point to record evidence as support for their assertion that there are overhead services or costs that must be associated with the KMEP-owned natural gas subsidiaries.[798] Specifically, they point to a cash management agreement between a 100% owned direct subsidiary of KMEP, Kinder Morgan Operating L.P. "A" ("OLP-A"), and Trailblazer Pipeline Company ("Trailblazer"), one of the excluded subsidiaries, which makes it clear that OLP-A manages Trailblazer's cash on a daily basis.[799] OLP-A also has a similar agreement with another excluded subsidiary, Kinder Morgan Interstate Gas Transmission, LLC ("KMIGT"), making it implausible to contend that there are no

[792] *Id*. at 46.

[793] *Id*.

[794] *Id*. at 48 (citing Exs. ACC-34 at 6, ACC-39 at 7-10, ACC-40 at 8-10, ACC-41 at 7-9).

[795] *Id*. at 49-50 (citing Ex. ACC-34 at 19, Table 2).

[796] *Id*. at 50 (citing *Kern River II*, 126 FERC ¶ 61,034 at P 67).

[797] *Id*. at 51.

[798] *Id*.

[799] *Id*. at 52 (citing Exs. ACC-74, ACC-75).

KMEP overhead services associated with either excluded subsidiary.[800] OLP-A also has direct and indirect control of KMEP subsidiary Tejas Consolidated's two largest subsidiaries.[801]

287. Further, the ACC Shippers continue, at least one KMGP Services Company, Inc. ("GP Services") employee is an officer of most of the excluded KMEP-owned/KMI-operated subsidiaries, despite the fact that these employees purportedly are not involved with these excluded subsidiaries.[802] If directors and officers are responsible for the activities of an entity, that entity should be included in the allocation of overhead costs, the ACC Shippers contend, regardless of whether the director or officer made specific decisions for the entity; the inquiry is whether the director or officer had the authority to make decisions and is able to impute benefits to the subsidiary from his or her position.[803] The ACC Shippers note specifically that GP Services employee Meli Armstrong was a primary officer of the Tejas Consolidated entities in 2003 and 2004 and Vice-President of accounting for KM TransColorado, Inc. ("TransColorado"), KMIGT, and Trailblazer.[804] As an officer, the ACC Shippers explain that Ms. Armstrong has fiduciary duties and obligations on behalf of these entities and must be attentive to corporate affairs.[805]

288. The ACC Shippers list the following as the joint ventures improperly excluded from KMEP's Massachusetts formula allocation: Heartland Pipeline Company ("Heartland"), Coyote Gulch Gas Treating LLC ("Coyote Gulch"), Red Cedar Gas Treating LLC ("Red Cedar"), Thunder Creek Gas Services LLC ("Thunder Creek"), International Marine Terminal ("Marine Terminal"), and Cochin Pipeline Company ("Cochin").[806] As support for including these entities, the ACC Shippers cite specific operating and partnership agreements as well as instances of KMEP managers sitting on management committees and operating teams.[807] By erroneously excluding these and the

[800] *Id*. (citing Ex. ACC-76 at 5).

[801] *Id*. at 52-53 (citing Exs. ACC-93, ACC-94, ACC-95, ACC-96, SFW-109).

[802] *Id*. at 53 (citing Ex. ACC-34 at 5).

[803] *Id*. (citing *Williams Natural Gas Co.*, 85 FERC ¶ 61,285, at 62,140-41 (1998)("*Williams*")).

[804] *Id*. at 54 (citing Exs. ACC-91 at 34-37, ACC-92 at 4, 6, 9, ACC-93 at 13, ACC-94 at 13, ACC-95 at 13, ACC-96 at 13).

[805] *Id*. at 55 (citing *In re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 968 (Del. Ch. 1996)).

[806] *Id*. at 56.

[807] *Id*. at 56-62.

KMEP-owned/KMI-operated subsidiaries, the ACC Shippers argue, the remaining subsidiaries, like SFPP, bear added costs and cross-subsidize the excluded entities.[808]

289. The ACC Shippers contend that SFPP's use of multiple tiers in its Massachusetts formula methodology is inconsistent with the Commission's traditional model and does not objectively or accurately allocate general and administrative costs.[809] The changing methodology used by SFPP was not driven by accuracy, they allege, but instead was related to litigation and attempts to justify SFPP's cost of service and rates, as well as to lower taxable income levels.[810] The tier method is also incompatible with the fact that KMEP does not keep books and records that accurately reflect the overhead costs associated with particular business units.[811]

290. The purpose of removing PAAs from gross property when developing a Massachusetts formula allocation factor, the ACC Shippers explain, is to preserve original cost ratemaking and reflect the original cost of the assets.[812] It is not necessary to exclude PAAs from unregulated subsidiaries in order to achieve this goal because there is no relationship between the PAA and the original cost of the assets where unregulated subsidiaries are concerned.[813]

291. The ACC Shippers argue that it is appropriate to use end-of-period balances in the development of the Massachusetts formula allocation of KMEP's overhead costs because it reflects changes in gross property, plant, and equipment that occur during the year.[814] SFPP did not use end-of-period balances, they note, which is inconsistent with Commission precedent and with SFPP's use of the end-of-period balances for other allocation factors used in its cost of service calculations.[815]

292. While the standard Massachusetts formula uses gross revenue, gross property, and direct labor, SFPP recommends using net revenues if Tejas Consolidated is included in

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[808] *Id*. at 62.

[809] *Id*. at 63 (citing *Chevron Products Co.*, 125 FERC ¶ 63,018 at P 173; *Mojave Pipeline Co*., 81 FERC 61,150, at 61,677 (1997)).

[810] *Id*. (citing Tr. 614-35, 874, 1092-95).

[811] *Id*. at 63-64 (citing Ex. ACC-61).

[812] ACC IB at 65 (citing December 2005 Order at PP 85-86).

[813] *Id*. (citing Exs. ACC-34 at 29-30, ACC-73 at 23-24).

[814] *Id*. at 66 (citing Exs. ACC-34 at 30, ACC-73 at 24).

[815] *Id*. (citing December 2005 Order at PP 81-86; Ex. ACC-3, Schedules 14B, 14C, and 14F).

the allocation of KMEP's overhead costs, the ACC Shippers state.[816] They continue their explanation, asserting that, by weighing gross revenue, property, and direct labor equally, overhead expenses are allocated objectively and reasonably on a basis that is commensurate with the expected level of overhead activities that any particular subsidiary requires.[817] This rationale is undermined when net income replaces gross income because then there is no basis to believe that overhead activities associated with billions of dollars of revenue activity will be reasonably correlated with net revenue, gross property, or direct labor.[818] The ACC Shippers conclude that overhead expenses will likely be under-allocated to Tejas if net revenue is substituted for gross revenue, causing other subsidiaries to have to cross-subsidize these costs.[819] Moreover, they continue, while the Commission has allowed net revenues to replace gross revenues in the past, those entities had regulated pass-through mechanisms in place, while Tejas does not.[820] Because Tejas does not have such a mechanism, its "greater opportunity for profit and increased risk of losses reasonably requires and correlates with increased or extraordinary levels of oversight and overhead activity, as compared to those subsidiaries not engaged in high-risk commodity trading."[821] Thus, the ACC Shippers recommend that gross revenues, and not net revenues should be used so as to not "artificially suppress" overhead costs to be allocated to Tejas.[822]

293. With regard to the proper Massachusetts formula methodology, the ACC Shippers state that the use of the "two-tier methodology that was purportedly utilized in 2003 or the four-tier methodology that was purportedly utilized in 2004" is not an option in this proceeding.[823] The methodologies, the ACC Shippers point out, were not presented in this proceeding, nor did SFPP produce contemporaneous documents that would be associated with these methodologies.[824] The ACC Shippers believe that the only available methodologies in this proceeding with respect to overhead allocation are the method set forth by SFPP and the method set forth by Complainants and Staff.[825]

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[816] *Id*. at 66-67 (citing Exs. SFW-43 at 44, SFW-75 at 13, ACC-73 at 17-18).

[817] *Id*. at 67 (citing ACC-73 at 17-18).

[818] *Id*. at 68

[819] *Id*. (citing Ex. ACC-73 at 18; Tr. 759-60).

[820] *Id*. (citing *Williston Basin Interstate Pipeline, Co.*, 104 FERC ¶ 61,036 at P 74).

[821] *Id*. at 69.

[822] *Id*.

[823] *Id*. at 69 (citing Tr. 744-45).

[824] *Id*. at 70 (citing Tr. 744).

[825] *Id*.

294. In response to SFPP's claim that it is able to isolate costs to individual entities or groups of entities, the ACC Shippers argue that SFPP ignores the fact that KMEP was, at the same time, reporting to the SEC that its overhead expenses were not attributable to any segment and claiming that it does not maintain its accounts in a way to reflect costs associated with certain business units.[826] Moreover, the ACC Shippers note, SFPP stated that KMEP has no manuals or guidelines by which employees are instructed as to how to directly assign or allocate coasts among entities, and that KMEP's books and records did not include detailed allocations or assignments of overhead costs.[827] SFPP was also unable to explain how the cost accounting assignments associated with the KMI-shared employees allow for cross-charge amounts that do not relate to any KMEP subsidiary or group of subsidiaries.[828]

295. SFPP has no basis in the record for the claims that its Massachusetts formula model results in accurate and reasonable cost allocation, the ACC Shippers contend, or that it matches costs with the subsidiaries that benefitted from such costs.[829] In fact, they continue, the record indicates, through SFPP's own witness, that direct assignments (through fixed-fee arrangement) to the excluded KMEP-owned natural gas subsidiaries do not correlate to the actual overhead costs associated with these entities.[830] By stating that there are overhead expenses in excess of these direct assignments, SFPP's witness established that the amount of overhead expense recorded on KMEP's books does not accurately represent the overhead costs associated with its subsidiaries.[831]

296. Inaccuracy is further established, according to the ACC Shippers, with regard to joint ventures.[832] KMEP expressly stated that it operates Heartland Pipeline, and yet it excluded the entity from the Massachusetts formula allocation and allocated its costs elsewhere, proving, according to the ACC Shippers, that costs are not being matched with the entities that incurred those costs.[833] The ACC Shippers also claim that SFPP's direct assignments are artificial and arbitrary, citing a variety of examples as to why this is so.[834] Further, they take issue with SFPP characterizing the assignment of costs to a

[826] ACC RB at 31 (citing Exs. ACC-65 at 2, 4, ACC-61 at 2).

[827] *Id*. (citing Ex. ACC-84 at 2).

[828] *Id*.

[829] *Id*. at 32.

[830] *Id*. (citing Tr. 706-07).

[831] *Id*. at 33 (citing Ex. ACC-73 at7).

[832] *Id*.

[833] *Id*. at 33-34 (citing Exs. ACC-34 at 11-12; Tr. 737-38).

[834] *Id*. at 34-39.

group of entities as a "direct assignment."[835] When a group of entities is involved, the ACC Shippers state, there must be some sort of allocation, and calling this "allocation" an "assignment" is inaccurate.[836]

297. The ACC Shippers next criticize SFPP's reliance on the decision in *Northwest Pipeline Corp.*, 82 FERC ¶ 63,012 (1998) ("*Northwest*"), Order on Initial Decision, 87 FERC ¶ 61,266 (1999), where the Commission addressed the assignment of costs to subsidiaries outside of the Massachusetts formula methodology.[837] The decisions, according to the ACC Shippers, do not support SFPP's attempt to retroactively assign costs within the Massachusetts formula as a substitute for proper accounting or for how the costs were actually recorded.[838] Moreover, here, unlike in *Northwest*, the excluded entities benefit from the costs allocated through the Massachusetts formula, and thus should be allocated a portion of those costs.[839] The ACC Shippers maintain that SFPP was unable to support its claims that it can isolate KMEP overhead costs for assignment in a manner superior to the Commission's traditional Massachusetts formula.[840]

298. SFPP attempts to attack the ACC Shippers' use of the traditional Massachusetts formula, the ACC Shippers state, but ignores the fact that its own method is a retroactive re-allocation of costs that is artificial, inconsistent, and without credibility.[841] At the time the costs were incurred, KMEP was unable to attribute them to particular business segments, and yet, the ACC Shippers point out, SFPP is now suspiciously able to directly assign these costs.[842] Further, the Commission is required to address rates and their components, and, the ACC Shippers claim, "here it is undisputed that KMEP's overhead costs for 2003 and 2004 clearly did not include Mr. Bradley's direct assignments or SFPP's retroactive attempt to subjectively and artificially reallocate its parent's overhead costs for ratemaking purposes."[843]

299. In response to SFPP's argument that the ACC Shippers' methodology results in a reduction from the estimated overhead costs that SFPP would incur as a stand-alone

[835] *Id*. at 40.

[836] *Id*. (citing SFPP IB at 48-49).

[837] *Id*. at 40-41.

[838] *Id*. at 41.

[839] *Id*.

[840] *Id*.

[841] *Id*. at 42.

[842] *Id*. at 43.

[843] *Id*. at 44 (citing *BP West Coast*, 374 F.3d at 1274).

entity, the ACC Shippers state that it is instead SFPP's method that results in such a reduction due to the exclusion of various KMEP subsidiaries.[844]

300. The ACC Shippers next argue that, while they utilized an objective and straight forward application of the Commission's traditional Massachusetts formula, SFPP used a subjective, retroactive application of a 2006 methodology which lacks credibility.[845] The ACC Shippers have repeatedly noted that KMEP's 2003 and 2004 books and records do not reflect the direct assignments made by SFPP.[846] Further, the ACC Shippers claim that they were able to point to numerous specific examples of inaccuracies in SFPP's method that directly affected the allocation of overhead costs to SFPP.[847]

301. The ACC Shippers reiterate that all KMEP subsidiaries must be included in the Massachusetts formula unless they do not benefit from KMEP in any way.[848] SFPP argues that it is appropriate to focus on how the overhead costs associated with the excluded entities are tracked and charged through the Kinder Morgan accounting system, rather than on how the overhead activities were actually performed.[849] The ACC Shippers argue that this is SFPP's attempt to redirect focus from the fact that that KMEP had managerial authority and responsibility over these entities.[850] The ACC Shippers believe that it is inconceivable that KMEP could not have any oversight over these entities, especially given how few costs were allocated to them by KMI.[851]

302. Joint ventures, like KMI-operated subsidiaries, should be included in the Massachusetts formula because, as SFPP concedes, KMEP has oversight, managerial authority, and responsibilities associated with them.[852] Excluding the joint ventures, according to the ACC Shippers, inflates SFPP's allocation of overhead costs and conflicts with Commission cost allocation principles.[853] When the joint ventures are excluded,

[844] *Id*. at 45-46 (citing *SFPP, L.P.*, 116 FERC ¶ 63,059 at P 183; SFPP IB at 53-54).

[845] *Id*. at 46-47.

[846] *Id*.

[847] *Id*. at 47-48 (citing Tr. 722, 723-24, 731, 735, 737-38).

[848] *Id*. at 48 (citing *Williams*, 85 FERC at 62,137).

[849] *Id*. at 49 (citing SFPP IB at 57).

[850] *Id*. (citing ACC IB at 48-49).

[851] *Id*. at 50.

[852] *Id*. at 53 (citing SFPP IB at 62).

[853] *Id*.

they continue, costs identified with these entities are allocated to other entities that did not cause incurrence of these costs, including SFPP.[854]

303. Capitalized overheads are addressed next by the ACC Shippers, who state that, while SFPP claims these costs are indirect, its witness conceded that they are tied to specific entities.[855] This was one direct assignment that could legitimately be made, the ACC Shippers assert, and yet SFPP failed to assign the capitalized overheads directly.[856] Instead, these costs, which should have been directly assigned to the specific entity which incurred them, were inappropriately allocated to all subsidiaries via the Massachusetts formula.[857]

Indicated Shippers

304. The Indicated Shippers take issue with SFPP's use of GAAP books instead of regulatory books to allocate overhead for regulatory ratemaking purposes, when, they note, SFPP has stated that GAAP books are not necessarily the same as regulatory books.[858] There is no guarantee that SFPP's costs and revenues are accurately captured, the Indicated Shippers point out, when SFPP switches between various sets of books.[859]

Commission Trial Staff

305. Staff explains that the Massachusetts formula allocates corporate overhead costs based on the average percentage of three ratios to total company figures.[860] The ratios are all given equal weight, and the costs allocated through the Massachusetts formula cannot be allocated directly to a specific subsidiary.[861]

306. Staff takes issue with SFPP's exclusion of 12 KMEP subsidiaries from its Massachusetts formula allocation because all KMEP-owned subsidiaries should be

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[854] *Id*. at 54, 56 (citing Exs. SFW-43 at 52, SFW-99; *SFPP, L.P.*, 116 FERC ¶ 63,059 at P 183).

[855] *Id*. at 57.

[856] *Id*. (citing Tr. 740-41).

[857] *Id*. (citing Exs. SFW-43 at 54; *SFPP, L.P.*, 116 FERC ¶ 63,059 at P 186).

[858] IS IB at 45 (citing Tr. 780, 781).

[859] *Id*. at 46.

[860] Staff IB at 27 (citing *KN Interstate Gas Transmission Co.*, 88 FERC at 61,848 n. 10; *Williams Natural Gas Co.*, 77 FERC ¶ 61,277, at 62,188 (1996)).

[861] *Id*. at 28 (citing December 2007 Order at P 134).

allocated a portion of KMEP's residual overhead costs.[862] Staff notes that SFPP's witness testified that, by excluding these subsidiaries, other subsidiaries, such as SFPP, will be allocated a greater portion of overhead costs, which will then be passed on to customers.[863]

307. Staff advocates a bright-line approach which would require that all subsidiaries owned by a parent must be included in the Massachusetts formula used for allocating overhead costs.[864] While KMEP may have been established as a partnership for legal and tax purposes and may be lacking in employees, Staff argues that there must be someone within upper management that oversees the operations and investments of all KMEP subsidiaries, as it is illogical to presume that the subsidiaries are not managed.[865]

308. SFPP, on the other hand, never addresses the notion of a bright-line approach, Staff states.[866] SFPP even makes the statement that Staff erred by focusing "on the activities performed on behalf of the excluded KMI-operated entities rather than on how the costs associated with those activities are tracked and charged within the Kinder Morgan accounting system."[867] This statement identifies the difference between its position and Staff's position; according to Staff, SFPP wants the Commission to accept a complex accounting mechanism while ignoring the actual activities performed for the excluded entities.[868]

309. While Staff suggests taking the bright line approach, it states that, if the subsidiaries were to be examined on a case-by-case basis, then 11 of the 12 excluded subsidiaries should be included in KMEP's Massachusetts formula.[869] The applicable standard for determining whether the subsidiaries should be included, according to Staff, is that set forth in *Williams*, 85 FERC at 62,136-37, where the Commission states that a subsidiary should be included in its parent's Massachusetts formula allocation even when the parent company's employees have expended only 5% of their time on that subsidiary.[870]

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[862] *Id*.

[863] *Id*. at 29 (citing Tr. 788-89).

[864] *Id*. at 30 (citing Tr. 2090).

[865] *Id*. (citing Tr. 2090).

[866] Staff RB at 26.

[867] *Id*. at 27 (citing SFPP IB at 57).

[868] *Id*.

[869] Staff IB at 30, 31.

[870] *Id*. at 31.

310. Staff contends that entities owned by KMEP, but operated by KMI under fixed-fee contracts,[871] should not be excluded from the Massachusetts formula allocation.[872] The fixed-fee contracts, Staff explains, require the subsidiaries to pay KMI to cover all operating costs, but do not likely cover all of the actual expenses.[873] Staff determines that this arrangement is arbitrary because the majority of the costs for these entities are not directly assignable to the entities, leaving KMEP or KMI with the ability to allocate these general and administrative costs to the KMEP-owned and KMI-operated entities in whichever manner they choose.[874] The fixed-fee arrangement has not been shown to reasonably allocate residual costs, according to Staff, which is why these subsidiaries should instead be included in the Massachusetts formula, which is designed to allocate the costs appropriately.[875] Further, Staff claims that the fixed-fee contracts may result in cross-subsidization of costs because, if the recovery of fixed fees is lower than the total costs that should be allocated to the KMEP-owned entities, then the KMI entities included in its Massachusetts formula would pay the difference between the costs incurred and the amount of the fixed-fee.[876] Staff also points out that such cross-subsidization did occur in 2003 and 2004.[877] At that time, according to Staff, the fixed-fee collected from the KMEP-owned entities was lower than the costs actually incurred, and the costs were then allocated to the KMI entities through KMI's Massachusetts formula.[878] In order to avoid this problem, Staff recommends foregoing the fixed-fee arrangement and including these entities in KMEP's Massachusetts formula.[879]

311. Staff notes SFPP's statement that the risk of the fixed-fee arrangement is on KMI and the KMI-owned entities, since expenses that are not covered by the fees are allocated through the KMI Massachusetts formula, rather than through KMEP's allocation

[871] Staff states that the following entities fall into this category: Casper-Douglas Natural Gas Gathering and Processing Systems ("Casper-Douglas"), Tejas Consolidated, KM Natural Gas de Mexico ("KM Mexico"), KMIGT, Trailblazer, and KM Canada. Staff IB at 33 (citing Ex. S-25 at 3).

[872] Staff IB at 33-34 (citing Ex. S-25 at 3).

[873] *Id*. at 33 (citing Ex. S-25 at 3).

[874] *Id*. at 34 (citing Ex. S-25 at 3-4).

[875] *Id*.

[876] *Id*. at 35 (citing Ex. S-25 at 4-5).

[877] *Id*.

[878] *Id*. (citing Ex. S-25 at 6).

[879] *Id*. at 35-36

mechanism.[880] According to Staff, SFPP is plainly stating that there was in fact cross-subsidization which occurred in 2003 and 2004 when the fixed-fee was lower than the costs actually incurred.[881] This problem can be resolved, and the risk is removed, Staff contends, by including the fixed-fee entities in KMEP's Massachusetts formula allocation.[882] Further, Staff points out that SFPP never seriously addresses Staff's claims of cross-subsidization, ignoring evidence that supports Staff's view and failing to mention the fixed-fee arrangements in its initial brief.[883] Likewise, Staff notes, SFPP fails to address arguments made by the ACC Shippers on the same issue.[884] Instead, SFPP brushes off the arguments with the statement that Staff and the ACC Shippers "did not identify any costs associated with the excluded KMI-operated entities that are actually included among the costs that were allocated through KMEP's shared cost distributions or Mass Formula."[885] Meanwhile, Staff asserts that the burden is on SFPP, not Staff or Complainants, to demonstrate that the fixed fees covered the full costs of the services.[886]

312. Staff also addresses the joint ventures[887] between KMEP and outside companies, arguing that they should be included in the Massachusetts formula allocation because it can be presumed that KMEP would pay attention to entities in which it has an equity interest.[888] To further their argument, Staff pointed out that in 2003, KMI and GP Services executives served on management committees or operating teams of these joint ventures.[889] Staff also notes that KMEP was involved with respect to treasury, accounting, tax issues, and overall management.[890] While insisting that this oversight is enough to require inclusion in the Massachusetts formula, Staff also considered the joint

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[880] Staff RB at 29.

[881] *Id*. (citing Exs. S-25 at 6, S-30 at 5).

[882] *Id*.

[883] *Id*. at 30 (citing SFPP IB at 57-61).

[884] *Id*. at 31 (citing ACC IB at 48-56).

[885] *Id*. (citing SFPP IB at 60).

[886] *Id*.

[887] Staff argues that Heartland, Red Cedar, Coyote Gulch, Thunder Creek, and Cochin are the joint ventures that should be included in KMEP's Massachusetts formula allocation. Staff IB at 37-39.

[888] *Id*. at 36 (citing Ex. S-7 at 11).

[889] *Id*. (citing Ex. S-7 at 12).

[890] *Id*. (citing Exs. ACC-50 at 1-20, S-7 at 13).

ventures on a case-by-case basis, stating reasons why all but one[891] should be included in the Massachusetts formula.[892]

313. SFPP concedes first, that even if a parent company's employees spend only 5% of their time on a subsidiary, that time is sufficient to require inclusion of the subsidiary in the parent company's overhead cost allocation.[893] Second, SFPP, according to Staff, agrees that KMEP is represented on management committees and has limited managerial oversight responsibilities.[894] Seeing as SFPP agrees with Staff's arguments, Staff asserts that SFPP "essentially conceded that the joint ventures should be included within KMEP's Massachusetts Formula application."[895]

314. Staff asserts that SFPP's alternative process for allocating costs among excluded entities is suspect.[896] Staff bases this conclusion on the discrepancies and questionable record keeping found in data showing how employees coded their time and within the salary split mechanism used in 2003 and 2004.[897] Staff concludes that KMEP's allocation process was "arbitrary, lacked guidelines and periodic oversight, and did not accurately depict the actual work of the employees in question during 2003 and 2004."[898] In its Brief, SFPP fails to comment on its faulty accounting processes and instead relies on an overbroad conclusion that its accounting processes are accurate, Staff contends.[899]

315. Staff argues that the methodology from *Distrigas of Massachusetts Corp.*, Opinion No. 291, 41 FERC ¶ 61,205, at 61,557 (1987) ("*Distrigas*") should be used with respect to the application of the net income/revenues of KMEP's Massachusetts formula for KMEP-owned entities which have an element of cost of goods sold.[900] The *Distrigas*

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[891] Staff agrees that Marine Terminal should be excluded from the Massachusetts formula because its responsibility center is not included in the KMI cross-charge. Staff IB at 37.

[892] Staff IB at 37.

[893] Staff RB at 33 (citing *Williams*, 85 FERC at 62,136-37; Tr. 796-97).

[894] *Id*. at 33-34 (citing SFPP IB at 61-62).

[895] *Id*. at 34.

[896] Staff IB at 39.

[897] *Id*. at 39-41 (citing Tr. 861; Ex. SFW-101 at 6).

[898] *Id*. at 41.

[899] Staff RB at 35.

[900] Staff IB at 28. Staff names the following entities: North System, OLPC, KMBT, River Engineering Systems, Pinney Dock, CO2, SACROC, Trailblazer, KMIGT,

method uses net income/revenues instead of gross revenues as the third factor in the overhead allocation formula when huge gross revenues of an entity would make a substantial difference in allocations to other entities.[901] Here, Staff contends that certain KMEP entities, such as Tejas Consolidated, have very large differences between gross revenue and net income that would cause an unreasonable allocation of residual corporate overhead costs to these entities.[902]

316. While SFPP uses two and four-tier methodologies for allocating residual overhead costs in 2003 and 2004, respectively, Staff recommends using a single-tier methodology, which it claims is consistent with Commission practice.[903] Staff asserts that SFPP's tiered methodologies are in conflict with the definition of residual costs (costs which cannot be attributable to a specific subsidiary or group of subsidiaries) in that they include costs that are directly attributable to certain groups of subsidiaries.[904] Only those costs which cannot be assigned to particular groups of subsidiaries are residual overhead, according to Staff, and if costs can be identified to a group of subsidiaries, they should be allocated among those subsidiaries, not automatically allocated through the Massachusetts formula.[905] Only Tier 1 of the four-tier methodology is actually in accord with the unidentified residual cost allocations that are meant to be allocated through the Massachusetts formula.[906] While Staff states that it doesn't disagree with SFPP's direct assignment of costs to subgroups, it also maintains that this step is not part of the Massachusetts formula and takes no position as to how these direct costs should be allocated among the subgroups.[907] Staff does take the position, however, that KMEP must make an attempt to directly assign these costs so that only true residual costs are included in the Massachusetts formula allocation.[908]

317. While Staff states that it agreed that if KMEP wants to directly assign overhead costs to a group of subsidiaries using the Massachusetts formula it could do so, so long as that is the most appropriate way to assign costs, Staff points out that SFPP has not

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KM Natural Gas de Mexico, Casper-Douglas, and Tejas Consolidated. Staff IB at 29 (citing Ex. S-25 at 10-11).

[901] Staff IB at 27, 42 (citing Ex. S-7 at 17; *Distrigas*, 41 FERC at 61,557).

[902] *Id*. at 42.

[903] *Id*. at 43 (citing Tr. 813; Ex. S-25 at 16-19).

[904] *Id*. at 44 (citing Ex. S-25 at 16).

[905] *Id*. at 44-45 (citing Ex. S-25 at 16-17).

[906] *Id*. at 46 (citing Tr. 1257-58).

[907] *Id*. at 46-47.

[908] *Id*. at 47.

actually introduced evidence that it is the most appropriate way to do so.[909] It is unclear whether the Massachusetts formula is the best way to allocate these costs, Staff maintains.[910]

318. Staff finds SFPP's retroactive direct assignment of costs to individual subsidiaries or groups of subsidiaries in 2006 to be inappropriate.[911] For example, no costs were directly assigned to SFPP contemporaneously in 2003-2004, but SFPP assigned substantial 2003 and 2004 costs to SFPP in 2006.[912] Staff believes that the ACC Shippers accurately determined SFPP's motivation; the ACC Shippers asserted that SFPP's multi-tier allocation methodology was formulated in response to litigation and was an attempt to justify challenged costs of service and rates and to lower taxable income levels for some subsidiaries.[913] While SFPP attempts to justify the retroactive application of a 2006 methodology, Staff contends that SFPP is unable to explain discrepancies between SFPP's direct assignments in 2003-2004 and those that were later made in 2006.[914]

319. Next, Staff addresses SFPP's argument that Staff did not allocate enough corporate overhead costs to SFPP.[915] SFPP asserts, according to Staff, that "a reasonable cost allocation methodology should not allocate more overhead costs to a subsidiary than the subsidiary would incur on a stand-alone basis."[916] However, SFPP argues that Staff allocates too few costs to SFPP, not too many, which indicates, according to Staff, that SFPP is arguing against its own premise.[917]

320. Staff contends that the purchase accounting adjustment amount should be excluded for both regulated and unregulated entities so that the property, plant, and equipment balances can be properly determined for all entities which will be allocated overhead costs through the Massachusetts formula.[918] Both Staff and SFPP agree that removing the PAAs from only Commission-regulated entities "could distort the Massachusetts formula, since it allocates corporate overhead expenses to both classes of

[909] Staff RB at 39-40.

[910] *Id*. at 40.

[911] *Id*.

[912] *Id*. at 41.

[913] *Id*. (citing ACC IB at 64).

[914] *Id*. at 42.

[915] *Id*. at 43 (citing SFPP IB at 53-54).

[916] *Id*. (citing Tr. 1155).

[917] *Id*.

[918] Staff IB at 48 (citing Ex. S-7 at 5-6).

entities."[919] Because the Massachusetts formula includes gross plant from unregulated subsidiaries, according to Staff, "the PAA treatment of unregulated entities in developing SFPP's gross plant allocator has a direct effect on SFPP's regulated cost of service," and results may be skewed if regulated and unregulated entities are treated differently.[920] The Commission, according to Staff, has already determined this issue and decided that "PAAs in the property of both jurisdictional and non-jurisdictional subsidiaries should be removed."[921]

321. It is Staff's argument that SFPP should remove capitalized overhead costs from the residual corporate overhead costs to be allocated under the Massachusetts formula.[922] "Capitalizing direct overheads related to construction projects allows a company to recover its investment, including associated overhead costs over a period of time through a depreciation expense that is booked and recovered over the project's remaining life, once the project goes into service," Staff states.[923] Staff asserts that this treatment should also apply to indirect corporate overhead costs related to capital projects.[924] Allocating corporate overhead costs that either directly or indirectly relate to capital projects through the Massachusetts formula is inconsistent with the goal of cost allocation methodology, which is to match costs with the cost-generating activity.[925] Shippers do not benefit from capital-related overhead costs prior to a facility going into service, Staff explains, which is when capitalized overhead costs arise.[926] Therefore, Staff argues, allowing KMEP to expense capital-related corporate overhead costs in the year incurred would not match the cost recovery with the type of cost.[927]

322. Moreover, Staff disputes SFPP's claim that the Commission's regulations do not include a provision permitting oil pipelines to capitalize indirect overhead costs.[928] In fact, SFPP points out, 18 C.F.R. Part 352, Section 3-3 states "[t]he cost of construction property chargeable to the carrier property accounts shall include *direct* and *other costs*

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[919] *Id*. (citing Ex. SFW-43 at 21-22).

[920] *Id*. at 49.

[921] Staff RB at 46 (citing December 2005 Order at P 86).

[922] Staff IB at 50 (citing Ex. S-7 at 18-19).

[923] *Id*. (citing Ex. S-25 at 11).

[924] *Id*. (citing Ex. S-25 at 12).

[925] *Id*. at 51 (citing Exs. S-25 at 12, SFW-75 at 3, 6).

[926] *Id*. (citing Ex. S-25 at 13).

[927] *Id*. (citing Ex. S-25 at 13).

[928] *Id*.

as described hereunder."[929] It is reasonable, according to Staff, to conclude that "other costs" includes indirect corporate overhead costs.[930] To allocate the indirect costs related to capital projects, Staff explains that a simple allocation methodology would have to be derived to spread the costs over the average of the capital projects' remaining lives.[931]

323. SFPP, according to Staff, does not dispute that capitalizing direct overhead allows a company to recover its investment, including overhead costs, through a depreciation expense that is recovered over the project's remaining life once it goes into service.[932] Staff asserts that indirect corporate overhead costs should be treated the same way.[933] SFPP proposes that the costs be allocated through the Massachusetts formula, but Staff finds that the allocation method is not at issue, but rather the disagreement involves the time period over which to spread the allocation.[934] Specifically, Staff contends that SFPP should "not be allowed to use the Massachusetts Formula as a vehicle by which to expense all of its indirect capitalized overhead costs in the current year, rather than over the life of the projects to which it relates."[935]

SFPP, L.P.

324. SFPP claims that it followed Commission policy when determining 2003 and 2004 corporate overhead allocation among KMEP's subsidiaries by first directly assigning overhead costs where possible.[936] SFPP then determined which costs could be shared over multiple subsidiaries, such as within a particular business segment, and assigned them to those groups to be distributed among their members.[937] These groups are the CO_2 Tier, the Term Tier, and the PPL Tier, and when costs are directly allocated to such groups, they are then distributed among all subsidiaries within that segment.[938]

325. Once costs are directly assigned when possible among the tiers, any remaining costs are allocated to all KMEP-operated entities through the KMP Tier, which includes

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[929] *Id*. (citing Ex. S-25 at 14).

[930] *Id*. at 51-52 (citing Ex. S-25 at 14).

[931] Staff RB at 48.

[932] *Id*. at 47 (citing SFPP IB at 65).

[933] *Id*.

[934] *Id*. at 47-48.

[935] *Id*. at 48.

[936] SFPP IB at 47 (citing Ex. SFW-43 at 11-12).

[937] *Id*. at 47-48 (citing Ex. SFW-43 at 11-12; Tr. 649, 687).

[938] *Id*. at 48 (citing Exs. SFW—48 at 24-25, SFW-45, SFW-46).

all KMEP subsidiaries.[939] These costs are allocated using the Massachusetts formula, SFPP explains, and are true residual costs that cannot be identified with any individual subsidiary or business segment because they benefit all KMEP subsidiaries.[940]

326. According to SFPP, KMEP mischaracterized its entire cost allocation process as a multi-tiered Massachusetts formula.[941] The true residual costs are actually allocated through a traditional one-tier Massachusetts formula by use of the KMP tier, SFPP explains, while the shared cost distributions are not part of the formula, but are rather a direct assignment of shared expenses.[942] KMEP's method of allocating costs, regardless of how it is described, SFPP notes, avoids subsidization by matching costs to the entities that incurred those costs, in line with the Commission's goals.[943] SFPP points out that using a tiered approach has been accepted by the Commission in the past as a proper way of handling overhead costs.[944]

327. SFPP notes that Staff has no problem with directly assigning the costs to certain groups of subsidiaries, so long as the distributions are not part of the Massachusetts formula allocation because the Mass formula is only for true residual costs.[945] SFPP clarifies that the KMP tier of its tiered methodology is KMEP's true Massachusetts formula allocation, as defined by Staff.[946] Staff also agrees that if costs are identifiable to a certain group of subsidiaries, they should be distributed directly to those subsidiaries.[947] However, SFPP notes, Staff allocated all overhead costs through a one-tier Massachusetts formula, including those that could have been indentified with specific groups of subsidiaries.[948]

328. The ACC Shippers disagree with all of SFPP's direct assignments to individual subsidiaries and groups of subsidiaries.[949] They argue that KMEP is unable to directly

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[939] *Id*. (citing Exs. SFW-45 at 11-12, SFW-46 at 11-12; Tr. 817-20).

[940] *Id*. (citing Tr. 819-820).

[941] *Id*. (citing Tr. 1169-74, 1188-91).

[942] *Id*. at 49-50 (citing Tr. 817-20, 1188-91, 1182-83).

[943] *Id*. at 50-51 (citing Ex. SFW-75 at 10-12).

[944] *Id*. at 51-52 (citing *Northwest Pipeline Corp.*, 82 FERC ¶ 63,012, *aff'd* 87 FERC ¶ 61,266 at 62,047).

[945] SFPP RB at 43 (citing Staff IB at 43-46, 47-48).

[946] *Id*. at 44 (citing Ex. SFW-105; Tr. 817, 819, 1075-77).

[947] *Id*. (citing Staff IB at 44-47; Ex. SFW-127; Tr. 2068-69)

[948] *Id*. at 45 (citing Ex. S-26).

[949] *Id*. (citing Exs. SFW-105, SFW-43).

assign any corporate overhead costs and that KMEP's 2003 and 2004 books do not contain any direct assignments.[950] In contrast, SFPP points out that KMEP's 2003 and 2004 general ledgers show $20.7 million in overhead directly assigned to specific KMEP-operated entities, proving that the direct assignments were made and were not made retroactively, as claimed by the ACC Shippers.[951]

329. In challenging the direct assignments made in 2005 and 2006, the ACC Shippers confuse the fixed fees paid to KMI-operated entities with the direct assignment of costs to KMEP-operated entities, SFPP notes, which bear no relation to one another.[952] Further, SFPP continues, the ACC Shippers make another mischaracterization when stating that KMEP was unable to perform direct assignments for purposes of its public financial reporting and that SFPP conceded that KMEP's books do not reflect costs associated with individual business units.[953] SFPP argues that these statements, which it claims were taken out of context and misinterpreted, are not sufficient to rebut the presumption that KMEP's assignments are valid and accurate.[954]

330. Because a company's books cannot be changed once they have been closed, SFPP explains that it retroactively applied the 2006 cost allocation methodology to the 2003 and 2004 costs for use in the cost of service without altering KMEP's books or financial reports.[955] SFPP made the adjustments for the 2006 methodology, it explains, because "it is more accurate than the cost allocation models used in 2003 and 2004, and thus should be used for purposes of determining SFPP's rates."[956]

331. SFPP argues that treating all costs as residual and allocating them among all KMEP subsidiaries would result in cost subsidization and is contrary to the Commission's principle of matching cost causation and allocation.[957] As an example, Staff explains that only KMEP subsidiaries in the Term Tier had unions, but, under the methodology advanced by Staff and the Complainants, all KMEP subsidiaries would be responsible for these costs from which they did not benefit.[958] SFPP asserts that using the

[950] *Id*. at 46 (citing ACC IB at 41).

[951] *Id*. (citing Ex. SFW-43 at 54-55; Tr. 787; ACC IB at 43).

[952] *Id*. at 47 (citing ACC IB at 40).

[953] *Id*. at 47-48 (citing ACC IB at 41).

[954] *Id*. at 48 (citing Exs. ACC-61, SFW-43 at 28-29; Tr. 868-72; *SFPP, L.P.*, 122 FERC ¶ 61,133, at P 15 (2008)).

[955] *Id*. at 49 (citing Tr. 675-76, 724, 875-76, 916).

[956] *Id*. (citing Tr. 675-76, 875-76).

[957] SFPP IB at 52 (citing Ex. ACC-66; S-26).

[958] *Id*. (citing Exs. ACC-66, ACC-67, S-26; Tr. 1185-87).

2006 KMEP model avoids cross-subsidization through its use of direct assignments and shared cost distributions.[959] When the ACC Shippers made specific criticisms regarding SFPP's placement of subsidiaries in particular tiers and claimed that they would cause subsidies, SFPP points out that it took this into consideration and moved the subsidiaries accordingly in order to more properly allocate costs.[960]

332. The ACC Shippers also allege that the "all-in" approach is objective, while SFPP's approach is subjective.[961] However, SFPP argues that the ACC Shippers' own witness conceded that "objectivity is neither a sufficient nor a necessary condition for a reasonable methodology," and that an allocation methodology may be objective and still be unreasonable."[962]

333. Further, SFPP contends that the cost allocation methodologies advocated by Staff/Complainants do not allocate a reasonable amount of costs to SFPP.[963] According to SFPP, "if a cost allocation methodology assigns more costs to a subsidiary than that subsidiary would incur were it a stand-alone entity, that cost allocation methodology likely is unreasonable."[964] It argues that, while the "all-in" methodology allocates less to SFPP than would be incurred by SFPP if it were treated on a stand-alone basis, the amount is low to the point that it is unreasonable, indicating that this method is flawed.[965]

334. Using a 2006 methodology to allocate overhead costs, rather than the methodology used during 2003 and 2004, results in a more accurate cost allocation, SFPP contends.[966] According to SFPP, KMEP didn't "apply a new methodology to a database of unidentifiable historical costs for the purpose of shifting additional overhead costs to its regulated pipeline subsidiaries," but instead directly assigned costs that could be identified to certain groups of subsidiaries.[967] KMEP is able to review its historical costs due to its use of Responsibility Centers ("RC"), which is currently the same as it was in 2003 and 2004, to capture and track costs associated with particular activities and

[959] SFPP RB at 50.

[960] *Id*. (citing Ex. SFW-94 at 3-5, SFW-46 at 11; Tr. 337-40, 341-43).

[961] *Id*. (citing ACC IB at 38, 41, 62-64).

[962] *Id*. at 52 (citing Tr. 343).

[963] SFPP IB at 53 (citing Ex. SFW-75 at 12-19).

[964] *Id*. (citing Ex. SFW-75 at 3-4).

[965] *Id*. at 54 (citing Ex. SFW-75 at 12-19; Tr. 1162-63).

[966] *Id*. (citing Ex. SFW-43 at 27-28; Tr. 875-876).

[967] *Id*. at 55 (citing Ex. ACC-34 at 25; Tr. 656-661).

entities, SFPP explains.[968] Additionally, SFPP notes that no party used the methodology actually used during 2003 and 2004, making the question not about whether the methodology was retroactively applied, but which methodology is more accurate.[969] SFPP points out that neither Complainants nor Staff identified any costs that were incorrectly assigned or allocated through SFPP's use of its 2006 methodology, and thus they have no basis to presume that the use of this methodology was inappropriate.[970]

335. The ACC Shippers and Staff also conclude that the methodology is unreliable because it has undergone changes over the years.[971] In contrast, SFPP argues that the changes throughout the years have instead provided greater reliability and accuracy.[972] Meanwhile, SFPP points out that the methodology used to allocate true residual costs, the traditional Massachusetts formula allocation, has not been changed.[973]

336. Additionally, SFPP points out a flaw in another ACC Shippers argument, that KMEP's consideration of tax implications in adjusting its methodology was contrived in order to push more costs to SFPP.[974] SFPP states that the ACC Shippers believe that this was done because it would be beneficial for the taxable entities to have increased overhead costs.[975] However, SFPP is a tax pass-through entity, SFPP contends, and such change would actually drive costs away from SFPP.[976] Costs are further driven away from SFPP by some of the tiers that were added, which SFPP asserts indicates that they were not created simply to justify litigation positions.[977]

337. SFPP asserts that Complainants and Staff, when criticizing SFPP exclusion of KMI-operated entities from the Massachusetts formula, incorrectly focused on activities performed on behalf of these entities, rather than on how the costs of these activities are tracked and charged.[978] While KMI-shared employees provide services to both KMEP-operated and KMI-operated entities, the costs of these employees are tracked and charged

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[968] *Id*. (citing Exs. SFW-43 at 10-14, S-44; Tr. 658-61, 870-72).

[969] *Id*. at 56-57.

[970] *Id*. at 57 (citing Tr. 657).

[971] SFPP RB at 53 (citing ACC IB at 63-64, Staff IB at 43).

[972] *Id*. (citing Ex. SFW-43 at 28)

[973] *Id*. (citing Tr. 635).

[974] *Id*.

[975] *Id*. at 53-54 (citing Tr. 622-23, 683).

[976] *Id*. at 54.

[977] *Id*. (citing ACC IB at 63; Tr. 620, 634).

[978] SFPP IB at 57.

using salary splits and time sheets, and the KMI overhead costs associated with KMI-operated entities are not included in the costs distributed through KMEP's Massachusetts formula.[979] All costs associated with the excluded KMI-operated entities are directly assigned to individual entities or charged to particular accounts, SFPP states.[980] The exclusion of such entities, according to SFPP, is "appropriate and necessary in order to adhere to the Commission's directive that costs should be assigned or allocated only to the subsidiaries that benefitted from the costs' incurrence."[981]

338. Moreover, SFPP asserts that neither the Complainants nor Staff identified any costs associated with the excluded KMI-operated entities included in KMEP's Massachusetts formula allocation.[982] They ignore the fact that, for example, the costs allocated by KMEP have no relation to three of the excluded entities (regulated natural gas entities) which would not be allowed to recover these amounts in their rates.[983]

339. SFPP claims that Staff's bright-line approach is not supported by Commission precedent, which indicates that the Commission has performed careful and detailed analyses of particular costs and cost centers when determining whether to require a portion of each cost center to be allocated to a subsidiary.[984] Further, SFPP argues that the bright-line approach would not produce a just and reasonable allocation of overhead costs to SFPP because it would allocate millions of dollars to the excluded entities that are more properly attributable to the KMEP-operated Entities, like SFPP.[985]

340. Both Staff and the ACC Shippers also argue that KMEP management must oversee operations of all of KMEP's subsidiaries.[986] SFPP alleges that it has never argued to the contrary, but instead points out that because KMEP has no employees, KMI employees perform the managerial functions on behalf of the KMI-operated entities, and then the costs associated with those functions are tracked and charged separately through responsibility centers, salary splits, and time sheets.[987] According to SFPP, "the relevant

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[979] *Id*. at 58 (citing Exs. SFW-48 at 9-14, SFW-51, SFW-101).

[980] *Id*. at 59 (citing Tr. 853-59).

[981] *Id*. at 60.

[982] *Id*.

[983] *Id*. (citing Exs. SFW-50A, SFW-101; Tr. 853-59).

[984] SFPP RB at 55 (citing *Williams*, 85 FERC ¶ 61,285).

[985] *Id*.

[986] *Id*. at 56 (citing Staff IB at 30-31, ACC IB at 48-51).

[987] *Id*. (citing Tr. 753, 863-65; Exs. SFW-43 at 7-13, SFW-50A, SFW-51, SFW-101).

inquiry is not the nature of the corporate overhead services performed for the KMI-operated entities but which employees perform those functions and how the costs associated with those functions are tracked and charged within the Kinder Morgan accounting system."[988] According to SFPP, it has shown that the overhead costs incurred on behalf of the KMI-operated entities are not included in those costs allocated through KMEP's shared cost distributions and Massachusetts formula.[989]

341. The ACC Shippers, SFPP notes, argue that the KMEP overhead expenses should be allocated to the KMI-operated entities because one GP Services employee is listed as an officer of some of these excluded entities.[990] This argument lacks merit because this employee was listed as an officer by default and performed no functions for these entities, according to SFPP.[991] While the ACC Shippers cite *Williams* in support of their argument, SFPP notes that there the Commission made an analysis of various cost centers before making a determination of whether a cost center benefited the subsidiaries; it did not assume, according to SFPP, that it would be appropriate to allocate a portion of all of a parent's cost centers to subsidiaries because they were found to have benefited from a single person.[992] Also, SFPP adds, in that case, unlike here, the officers were actively involved in managing the excluded subsidiaries.[993]

342. Further, both Staff and the ACC Shippers argue that the KMI-operated entities should be included because the fixed fees do not, and will not, equal the cost of the overhead allocated to those entities.[994] SFPP responds, stating that any amount of overhead costs that are not covered by the fixed fees are allocated among the KMI-owned entities through KMI's Massachusetts formula, and not to KMEP's subsidiaries.[995] No costs in KMEP's shared cost distribution or Massachusetts formula pool are related to the KMI-operated entities, SFPP states, and thus including these entities in KMEP's distributions would "ensure that the costs allocated . . . were unrelated to the level of

[988] *Id*. at 57.

[989] *Id*.

[990] *Id*.

[991] *Id*.

[992] *Id*. at 58 (citing *Williams*, 85 FERC at 62,139-62,150).

[993] *Id*. (citing *Williams*, 85 FERC at 62,141).

[994] *Id*. at 59-60 (citing Staff IB at 34; ACC IB at 49).

[995] *Id*. at 60 (citing SFPP IB at 45-46).

overhead costs actually incurred on behalf of either group."[996] This would also cause cross-subsidies, SFPP adds, which do not exist under the current system.[997]

343. SFPP explains that KMEP excluded from its Massachusetts formula and cost distributions joint ventures in which it owned equity interests and which were operated by third parties.[998] KMEP, according to SFPP, was represented on management committees of the joint ventures and has limited managerial oversight, but any costs associated with its representation were removed from the pool of costs to be allocated to KMEP subsidiaries, including SFPP.[999] The third-party operators' responsibility to provide overhead services to the joint ventures is much greater than KMEP's limited oversight responsibilities, SFPP explains.[1000] The operators performed corporate general and administrative functions including IT, accounts payable, and accounting functions, SFPP continues.[1001] Because neither GP Services nor KMI employees performed these functions for the joint ventures, KMEP cannot allocate a portion of its accounting, IT, or accounts payable to these entities.[1002] No portion of these costs, according to SFPP, is allocated to SFPP, and instead they remain in the pool of costs allocated through KMEP's shared cost distributions.[1003]

344. Further, SFPP explains that the costs associated with managerial oversight of the joint ventures total only $14,000, and to require the joint ventures to receive an allocation of the total pool of KMEP overhead costs for this amount is, SFPP states, "absurd."[1004] It is more appropriate, SFPP maintains, to remove these costs than to allocate costs to the joint ventures.[1005]

345. The ACC Shippers allege that the joint ventures must be included in KMEP's Massachusetts formula because they were not charged for costs incurred on their behalf.[1006] KMEP does not have access to the joint ventures' books, and thus is only able

[996] *Id*. at 61.

[997] *Id*. at 61-62.

[998] SFPP IB at 61 (citing Ex. SFW-43 at 46-53).

[999] *Id*. at 61-62 (citing Ex. SFW-43 at 51-52; Tr. 908-911).

[1000] *Id*. at 62.

[1001] *Id*. (citing Ex. SFW-43 at 46-52).

[1002] *Id*. at 62 (citing Tr. 908-11).

[1003] *Id*. at 63 (citing Tr. 908-11).

[1004] *Id*. at 64 (citing Tr. 730-32, 1141)

[1005] *Id*. (citing Ex. SFW-75 at 18-19; Tr. 1263-65).

[1006] SFPP RB at 64 (citing ACC IB at 57-58).

to recover costs by invoicing them, SFPP explains.[1007] SFPP continues, stating that KMEP has adopted a cost allocation methodology that ensures that no costs related to the joint ventures are recovered through SFPP's rates.[1008]

346. Staff argues that SFPP should include various joint ventures whose costs are included in RC 0375 in KMEP's cost allocations.[1009] However, according to SFPP, if those joint ventures were included, they would receive not only an allocation of overhead from the RCs, but also a portion of all other KMEP overhead costs from which they did not benefit.[1010] By removing RC 0375 from the pool of costs to be allocated, SFPP adds, SFPP's ratepayers are also not subsidizing the costs of joint ventures.[1011]

347. Moreover, Staff attempts to undermine Kinder Morgan's entire time and record-keeping system based solely on the hours worked by one employee.[1012] However, SFPP contends that the extra hours worked by one employee are irrelevant if, as is the case, the hours did not translate into extra salary or benefits costs.[1013] Staff also argues that the salary splits used by Kinder Morgan employees do not bear a relationship to the actual work performed because the splits were the same for each employee in the Office of the Chairman.[1014] SFPP responds, arguing that the salary split is what would be expected in the Office of the Chairman, given the responsibility over all of KMI and KMEP, and is not seen at lower levels of the corporation, where salary splits vary from responsibility center to responsibility center.[1015]

348. SFPP disagrees with Staff's exclusion of overhead costs associated with capital projects from KMEP's shared cost distributions and Massachusetts formula.[1016] Staff's exclusion, SFPP contends, ignores the fact that the capitalized overheads that are included are indirect overhead costs that have to be allocated among KMEP subsidiaries.[1017] Indirect overhead expenses are not identifiable to particular capital

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[1007] *Id*.

[1008] *Id*.

[1009] *Id*. (citing Staff IB at 38-39).

[1010] *Id*. at 65.

[1011] *Id*.

[1012] *Id*. at 66 (citing Staff IB at 40).

[1013] *Id*.

[1014] *Id*. at 67 (citing Staff IB at 41).

[1015] *Id*. (citing Tr. 1135-36; Exs. SFW-43 at 10-14, SFW-52, SFW-53).

[1016] SFPP IB at 64 (citing Exs. S-7 at 18-19, S-25 at 11-14).

[1017] *Id*. at 65.

projects, and thus, SFPP states that they should be allocated using the three factors of the Massachusetts formula, as KMEP has consistently done in the past.[1018] Changing this methodology at this point in time, SFPP alleges, would require Staff to demonstrate that this existing approach is unjust and unreasonable.[1019] Staff has made no such demonstration, SFPP states.[1020]

349. Additionally, SFPP notes that Commission regulations do not permit an oil pipeline to capitalize indirect overhead costs which are distributed among capital projects using an allocation methodology.[1021] Capitalizing these indirect overhead costs associated with capital projects is prohibited by the Code of Federal Regulations, and thus Staff is incorrect in doing so, according to SFPP.[1022]

350. SFPP argues that, if PAAs were to be removed from jurisdictional entities, but not from non-jurisdictional entities, the non-jurisdictional entities will receive disproportionally large cost allocations and would be subsidized by the regulated entities.[1023] Instead, PAAs must be treated the same for both types of entities.[1024] While the December 2005 Order required SFPP to remove the PAAs from KMEP's subsidiary plant costs, it did not specify that it was to remove them only for FERC-regulated entities, SFPP notes, and later the Commission required that they be removed from non-jurisdictional entities.[1025] Therefore, SFPP maintains that the PAAs should be removed from both types of entities.[1026]

351. According to SFPP, when applying KMEP's shared cost distributions and Massachusetts formula to KMEP's 2003 overhead costs, it is appropriate to average the end-of-year balances because it results in a more accurate reflection of the gross plant, property, and equipment balance throughout the year.[1027] The result is a more accurate allocation of costs to SFPP, SFPP states.[1028]

[1018] *Id*.

[1019] *Id*. at 65-66 (citing *Sea Robin*, 794 F.2d 182).

[1020] *Id*. at 66.

[1021] *Id*. (citing 18 C.F.R. Pt. 352, Instr. No. 3-3 (2008)).

[1022] *Id*. (citing Ex. SFW-43 at 15; Tr. 918-19).

[1023] *Id*. at 67.

[1024] *Id*.

[1025] *Id*. (citing December 2005 Order at P 86; February 2006 Order at P 17).

[1026] *Id*.

[1027] *Id*. at 68.

[1028] *Id*.

Discussion and Findings

1. The Massachusetts Formula

352. In addressing the issue of the appropriate allocation of general and administrative expenses, the Commission provided clear and controlling precedent that must be applied. The Commission uses the Massachusetts formula or "Mass formula" to "… allocate residual overhead costs among subsidiary companies when the parent company cannot directly assign those costs to a specific subsidiary."[1029] Additionally, the Commission explains that "[d]irect costs are costs that the parent company can specifically identify and directly assign to the subsidiary that incurred the costs," and "[s]uch direct-billed corporate services are not considered in the allocation process." [1030]

353. In reviewing the record and the briefs of the parties and Staff, it is apparent that the application of the Massachusetts formula to the allocation of residual overhead costs among subsidiary companies when the parent company cannot directly assign those costs to a specific subsidiary is not really in dispute; rather, it is the question of which subsidiaries must be included in the "pool" for purposes of allocation of such residual costs and other related issues that the parties continue to dispute. Consideration of the record and the briefs in this proceeding reflect that SFPP is essentially arguing that the 12 subsidiaries in question for purposes of this inquiry should not be included in the KMEP Massachusetts formula "pool" for purposes of allocation of residual overhead costs because no costs were associated with those subsidiaries which were not specifically identified and directly assigned to the subsidiary. Interveners and Staff take issue with that contention for a number of reasons as discussed more fully below.

354. Staff suggests that there are two ways to approach the review of a decision by a parent company to exclude certain subsidiaries from application of its Massachusetts formula allocation. Staff's first suggestion, that the Commission can adopt a bright-line approach by holding that all subsidiaries owned by a parent must be included in the Massachusetts formula, is certainly more expedient but does not comport with the current state of Commission precedent. Staff's second approach, which is consistent with current Commission precedent, requires a case-by-case determination as to each subsidiary. This, of course, is the approach that the undersigned is constrained to follow. Moreover, 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

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[1029] December 2007 Order at P 134.

[1030] *Id*.

parent company's application of the formula.[1031] Most of the testimony, exhibits and briefing arguments of the parties and Staff on the issue of which subsidiaries should be included or excluded from KMEP's Massachusetts formula allocation purport to address an analysis of the *Williams* standard as applied to the record in this proceeding.

A. Overview of the KMEP organization and of KMEP's cost assignment and allocation methodology.

355. An understanding of the parent's organizational structure and cost assignment and allocation methodology is necessary to a considered analysis of this issue as it pertains to a particular subsidiary. During the years at issue, 2003 and 2004, SFPP witness Dale D. Bradley ("Bradley") affirmed that KMEP, the indirect parent of SFPP, had in excess of 50 subsidiaries. There is no question that KMEP's organizational structure is multi-tiered, complex, and has proven somewhat challenging to follow; however, both during the hearing and in the briefs the parties have attempted to summarize this information for purposes of the required case-by-case analysis under the *Williams* standard. SFPP provides a useful overview of the KMEP organization and of KMEP's cost assignment and allocation methodology in its initial brief.[1032]

356. As previously explained, KMEP, a master limited partnership, is the indirect parent of SFPP.[1033] KMEP is a complex organization that operates three distinct business segments: (1) the products pipeline division (of which SFPP is a member); (2) the CO_2 pipelines division; and (3) the terminals division.[1034] The KMEP subsidiaries in these three business segments are referred to as the "KMEP-operated entities" because they are owned and operated by, and receive all overhead services through, KMEP.[1035]

357. In addition, KMEP owns several natural gas pipeline systems (collectively, the "KMI-operated entities"), which are managed and operated entirely by KMI.[1036] As the operator, KMI directly charges the KMI-operated entities for all operations and maintenance costs and is compensated for the general and administrative overhead expenses it incurs on their behalf through fees each KMI-operated entity pays to KMI.[1037]

[1031] *See Williams Natural Gas Co.,* 85 FERC ¶ at 62,136-37.

[1032] SFPP IB at 40 et al.

[1033] Ex. SFW-43 at 1.

[1034] *See* Exs. SFW-43 at 4, 22-25, SFW-45, SFW-46.

[1035] Ex. SFW-43 at 5-6.

[1036] Ex. SFW-43 at 6-8. The KMI-operated entities are Casper-Douglas, Tejas Consolidated, KM Mexico, KMIGT, Trailblazer, and TransColorado. Ex. SFW-43 at 31.

[1037] Ex. SFW-43 at 32-35.

358. KMEP also owns equity interests in several joint ventures (collectively, the "joint ventures" or "third-party operated entities").[1038] KMEP is represented on the management committee of each joint venture, but third parties operate, manage and provide all overhead services and support to the joint ventures.[1039]

359. KMI is the indirect parent of KMEP.[1040] In addition to managing and operating KMEP's natural gas pipelines (the KMI-operated entities), KMI owns and operates its own natural gas pipeline systems and various other entities (collectively, the "KMI-owned entities").[1041] Most of the KMI-operated entities originally were owned by KMI but were transferred to KMEP over time for tax purposes.[1042] As Bradley explained, the fact that these natural gas companies were once owned by KMI is the primary reason that KMI operated and managed these companies in 2003 and 2004, and continues to operate and manage them today.[1043]

360. Only two entities within the entire Kinder Morgan organization have employees, KMI and GP Services.[1044] GP Services employees operate and manage the KMEP-operated entities for KMEP, which has no employees.[1045] GP Services employees

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[1038] Ex. SFW-43 at 46-53. The joint ventures are Heartland, Coyote Gulch, Red Cedar, Thunder Creek, Marine Terminal, and Cochin. Ex. SFW-43 at 46.

[1039] Ex. SFW-43 at 46-53

[1040] Exs. SFW-43 at 1, SFW-44.

[1041] Ex. SFW-43 at 6. The KMI-owned entities are relevant to this proceeding because the overhead expenses KMI incurs on their behalf are tracked concurrently with the overhead costs incurred on behalf of the KMI-operated entities. Ex. SFW-43 at 6.

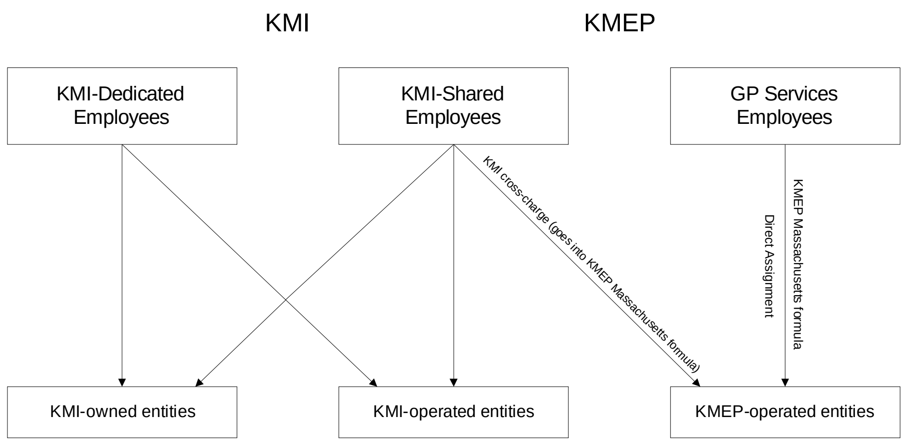
[1042] Ex. SFW-43 at 32; Tr. 788, 791.

[1043] Tr. 636-37, 645-46. As Bradley explained, most of the natural gas pipelines now owned by KMEP previously were owned by KN Energy and operated by KN Energy employees. When KN Energy and KMI merged in 1999, all KN Energy employees became employees of KMI. Thus, the employees that operated and managed the natural gas pipelines are employees of KMI. When these natural gas pipelines were transferred to KMEP for tax purposes, it was considered more cost-effective not to transfer all of the KMI employees who operated the natural gas pipelines to KMEP. In fact, KMEP has no employees in any event. Therefore, all the natural gas employees remained at KMI, and KMI continued to operate and manage these natural gas entities for a fee. Tr. 636-37.

[1044] Exs. SFW-43 at 5-6, SFW-49.

[1045] Exs. SFW-43 at 5-6, SFW-49.

perform no work for any KMI-owned entity or any KMI-operated entity.[1046] KMI employees, on the other hand, operate and manage all KMI-owned entities and all KMI-operated entities.[1047] Each KMI employee is either a "KMI-dedicated" employee, serving only the KMI-owned entities and the KMI-operated entities, or a "KMI-shared" employee serving the KMI-owned, KMI-operated, *and* KMEP-operated entities.[1048] Bradley's Exhibit SFW-49, reproduced below, reflects these relationships.



361. Kinder Morgan's accounting system is based on the concept of responsibility centers. Costs are captured in RCs and flow only to the subsidiaries each RC serves.[1049] Employees within KMI and GP Services (and their associated costs) are divided into RCs based on their functional duties and the geographic locations of the subsidiaries they support.[1050] Each RC has its own budget and tracks and assigns costs to the subsidiaries it supports.[1051] As Bradley explained, the use of RCs allows KMEP to isolate, identify and control costs by business segment and by region.[1052] Within each RC, employees use either time sheets (hourly time recording) or salary splits (percentage-based time recording) to track the time they spend performing work for various entities or groups of entities.[1053] Employees who perform operations and maintenance services use time sheets and charge their time by the hour directly to the entity or project on which they

[1046] Ex. SFW-43 at 5-9; *see also* Tr. 636-37.

[1047] *Id*.

[1048] Exs. SFW-43 at 7-9, SFW-49; *see also* Tr. 636-37.

[1049] Ex. SFW-43 at 10-13.

[1050] Ex. SFW-43 at 10-15.

[1051] Ex. SFW-43 at 11-14; Tr. 826-27, 863-65.

[1052] Ex. SFW-43 at 10; Tr. 869-72.

[1053] Exs. SFW-43 at 11-14, SFW-51, SFW-101; Tr. 753, 863-65.

work.[1054] Other employees, such as most corporate-level employees, primarily use salary splits to indicate the amount of time they spend in each pay period supporting various groups of entities or projects.[1055]

362. As noted above, GP Services RCs and employees perform *no* work for any KMI-operated entity or KMI-owned entity. As a result, GP Services costs that cannot be directly assigned to an individual KMEP-operated entity are distributed through KMEP's shared cost distributions and KMEP's Mass formula.[1056] All GP Services costs that are incurred for the benefit of a limited group of subsidiaries, such as those in a particular business segment (*e.g.* products pipelines), are directly assigned to that group of subsidiaries and then allocated among the members of that group as a shared cost distribution, using the three allocators of KMEP's Mass formula (labor, revenue and property, plant and equipment ("PP&E")).[1057] Remaining "residual" GP Services costs incurred for the benefit of all KMEP-operated entities are then allocated among all KMEP-operated entities using KMEP Mass formula.[1058] The overhead expenses generated by GP Services can be found in Exhibit Nos. SFW-45 at 11-12, lines 1-18 and 20-50 and SFW-46, pages 11-12, lines 1-19 and 21-52.[1059]

363. KMI RCs and employees directly assign their expenses to individual KMI-operated and KMI-owned entities to the extent possible.[1060] However, a portion of KMI's corporate overhead costs (such as those associated with the Office of the Chairman, which provides executive guidance and oversight to the Kinder Morgan organization) cannot be directly assigned to an individual subsidiary because the activities that generate the costs benefit multiple entities.[1061] KMI uses three shared-services accounts to capture these corporate overhead costs that cannot be directly assigned.[1062] These shared services accounts are reflected in Bradley's Exhibit SFW-50A. As discussed below, SFPP and the

[1054] *See, e.g.*, Ex. SFW-43 at 12.

[1055] *See, e.g.*, Exs. SFW-51, SFW-52, SFW-101; Tr. 753, 861.

[1056] Exs. SFW-43 at 7, 11-15, SFW-49; Tr. 867-68.

[1057] Ex. SFW-49; Tr. 817-20.

[1058] Tr. 817-20.

[1059] The GP Services costs comprised $106.1 million of the total $139.8 million allocated through the KMEP Mass Formula and shared cost distribution methodologies in 2003, and $138.9 million of the total $177.8 million allocated in 2004. Exs. SFW-45, SFW-46.

[1060] Exs. SFW-50A, SFW-43 at 7-8, 11-15; Tr. 787, 866-67.

[1061] *See* Ex. SFW-101; Tr. 854-55.

[1062] Exs. SFW-43 at 11, SFW-50, SFW-50A; Tr. 853-67.

other KMEP-operated entities receive costs only from the third shared services account, Account 184601.

364. The first two shared services accounts, 107001 and 184600, are distributed only among the KMI-owned and KMI-operated entities; they have no impact whatsoever on KMEP's Mass formula. The first shared services account, Account 107001 (also referred to as the "capital burden pool"), is used to capture all of the overhead costs associated with the support of capital projects for the KMI-operated and KMI-owned entities.[1063] Both KMI-shared employees and KMI-dedicated employees may charge time to Account 107001.[1064] The expenses in Account 107001 are not charged to KMEP or included in the pool of costs allocated through KMEP's shared cost distributions or KMEP's Mass formula.[1065] Instead, these costs are distributed among the KMI-operated and KMI-owned entities through a separate allocation methodology based on each entity's level of capital spending.[1066] The costs captured in Account 107001 have no impact on KMEP's shared cost distributions or KMEP's Mass formula.

365. The second shared services account, Account 184600, is used to capture KMI's corporate overhead costs incurred for the benefit of the KMI-Owned and KMI-operated entities.[1067] Both KMI-shared employees and KMI-dedicated employees may charge time to Account 184600.[1068] The expenses in Account 184600 are *not* charged to KMEP or allocated through KMEP's shared cost distributions or Mass formula.[1069] Account 184600 first is offset by the fees the KMI-operated entities pay to KMI.[1070] Any remaining difference between the amount in the account and the fees paid by the KMI-operated entities is then allocated among the KMI-owned entities through KMI's own Mass formula allocation, and does not flow to SFPP under any allocation scheme.[1071]

366. The third shared services account, Account 184601, is used to capture the corporate overhead costs incurred by KMI-shared employees and RCs for the benefit of

[1063] Exs. SFW-43 at 14-15, SFW-50; Tr. 856, 861-62.

[1064] Exs. SFW-49, SFW-50; Tr. 855.

[1065] Exs. SFW-43 at 14, SFW-50A; Tr. 861-65.

[1066] Exs. SFW-43 at 14-15, SFW-50, SFW-50A.

[1067] Ex. SFW-43 at 32-35; Tr. 855-59, 861-65.

[1068] Ex. SFW-43 at 7-11, 32-35; Tr. 855.

[1069] Exs. SFW-50A, SFW-43 at 11.

[1070] Ex. SFW-43 at 14-15; Tr. 797-803.

[1071] Exs. SFW-43 at 32-33, SFW-47, SFW-48.

the KMEP-operated entities, such as SFPP.[1072] KMI-dedicated employees and RCs are not allowed to budget expenses or charge time to Account 184601.[1073] Unlike the other two shared services accounts, the expenses contained in Account 184601 are charged to KMEP through the KMI cross-charge and then allocated among the KMEP-operated entities through KMEP's Mass formula allocation (the "KMP Tier").[1074] The KMI cross-charge is reflected on line 19 of Ex. SFW-45 and line 20 of Ex. SFW-46.[1075]

B. The KMI-Operated Entities[1076] are properly excluded from KMEP's shared cost distributions and Massachusetts Formula allocations.

367. SFPP contends that through the use of its 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 separated from the overhead costs associated with the KMEP-operated entities.[1077] Thus, SFPP asserts, the pool of costs allocated through KMEP's shared costs distributions and Mass formula includes only those costs associated with the subsidiaries that benefit from the activities that generated the costs, the KMEP-operated entities.[1078] It is SFPP's position that KMEP does not, and should not, include the KMI-operated entities in the KMEP shared cost distributions or Mass formula because those entities do not benefit from any GP Services costs or from the portion of the KMI costs included in the KMI cross-charge to KMEP.[1079]

368. Complainants and Staff assert that the KMI-operated entities should have been included in KMEP's residual cost allocation pool for purposes of the application of the Mass formula despite the fact that they are managed and operated entirely by KMI. These subsidiaries are owned by KMEP but operated by KMI under fixed-fee contracts where each subsidiary pays KMI monies which purportedly cover all its operating costs.[1080] These entities are Casper-Douglas, Tejas Consolidated, KM Mexico, KMIGT,

[1072] Ex. SFW-43 at 9-11; Tr. 855-59, 861-65.

[1073] Ex. SFW-43 at 9-11; Tr. 826-27.

[1074] Exs. SFW-43 at 6-8, 19; SFW-50A; Tr. 861-65, 856.

[1075] In 2003, the amount of the KMI cross-charge to KMEP was $33.7 million, and in 2004, was $38.8 million. Exs. SFW-45 at 11, line 19; SFW-46 at 11, line 20.

[1076] Again, the KMI-operated entities are Casper-Douglas, Tejas Consolidated, KM Mexico, KMIGT, Trailblazer, and TransColorado. Ex. SFW-43 at 31.

[1077] Exs. SFW-50A, SFW-43 at 10-11, 32-35, SFW-75 at 10-12.

[1078] Exs. SFW-43 at 8, 19, SFW-75 at 10-12.

[1079] Exs. SFW-50A, SFW-43 at 36-37, SFW-75 at 10-12; Tr. 889-90.

[1080] Ex. S-25 at 3.

Trailblazer and KM Canada.[1081] Staff witness Kenneth A. Sosnick ("Sosnick") found that the fixed-fee arrangements were not a justifiable basis for excluding these entities from KMEP's Massachusetts formula. Sosnick concluded that the "fixed fee arrangement is arbitrary in the sense that if the majority of the costs are not directly assigned to the entities, then KMEP or KMI retain the ability to 'allocate' the vast majority of general and administrative costs to each of the KMEP-owned and KMI-operated entities (via the fixed fee) on whatever basis they want."[1082]

369. In response, SFPP witness Bradley testified that with regard to those entities owned by KMEP, but operated by KMI under fixed-fee contracts where each subsidiary pays KMI monies to cover all its operating costs, while it might be appropriate to include costs that could not be directly assigned to those entities in a KMI residual cost allocation pool, it would still be improper to include them in the KMEP residual cost allocation pool because "[t]he risk in the fixed fee arrangement is wholly on KMI and the KMI-owned entities, since any expenses not covered by the fixed fees are allocated among the KMI-owned entities through the KMI Massachusetts formula allocations and would never be attributed to KMEP."[1083] Staff takes note of this testimony,[1084] but goes on to argue that SFPP is plainly stating here that there was in fact cross-subsidization which occurred in 2003 and 2004 when the fixed-fee was lower than the costs actually incurred.[1085] The undersigned finds Staff's argument on cross-subsidization unpersuasive given that the record clearly reflects that any expenses not covered by the fixed fees would never be attributed to KMEP.

370. It is the determination of the undersigned that the evidence of record supports a finding in favor of SFPP with regard to the KMI-operated entities. Complainants and Staff challenge exclusion of these entities, arguing that KMEP provides services and support to these entities and, therefore, inclusion is necessary to prevent the KMEP-operated entities from subsidizing the KMI-operated entities.[1086] However, Complainants and Staff were unable to indentify any costs associated with the excluded KMI-operated entities that were actually included among the costs that were allocated through KMEP's shared cost distributions or Mass formula. Although KMI-shared employees provide overhead services for both the KMEP-operated entities and the KMI-operated entities, the record supports SFPP's contention that these employees use salary splits and time sheets

[1081] *Id*. at 6. The undersigned notes that Staff and SFPP each presented a different list of KMI-operated entities. *See* Exs. S-25 at 3, SFW-43 at 31.

[1082] Ex. S-25 at 4.

[1083] *Id*. at 5-6 (citing SFW-43 at 35).

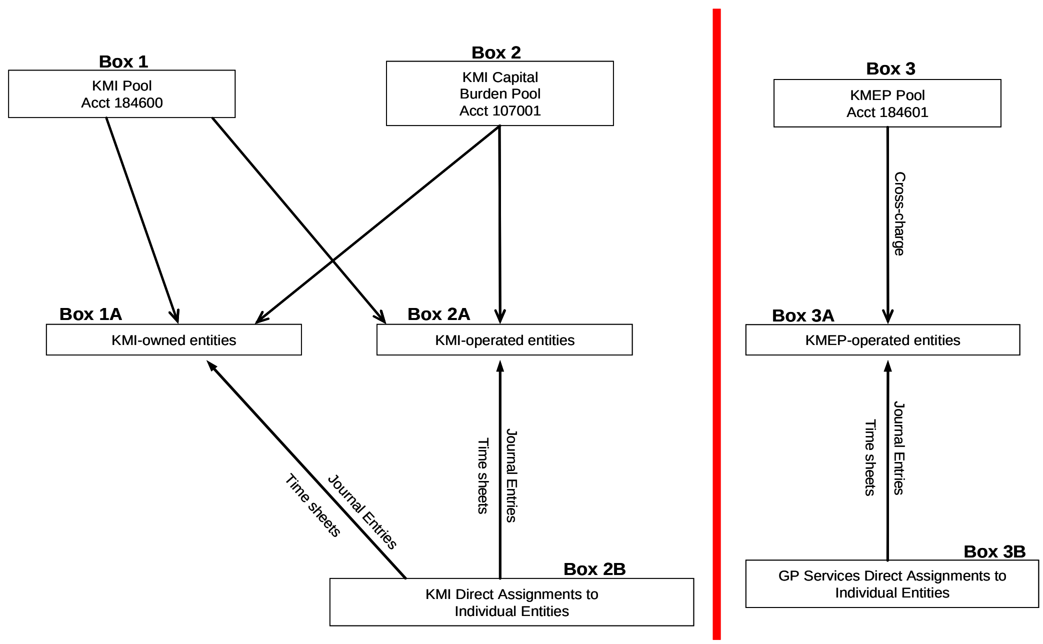
[1084] Staff RB at 29.

[1085] *Id*. (citing Exs. S-25 at 6, S-30 at 5).

[1086] Exs. ACC-34 at 9, S-25 at 4-6.

to separately track and charge costs associated with the excluded KMI-operated entities.[1087] The KMI overhead costs associated with the KMI-operated entities are *not* included in the pool of costs distributed through KMEP's Mass formula or shared cost distributions.[1088] Therefore, KMEP's exclusion of these entities is appropriate.

371. Bradley's Exhibit SFW-50A, reproduced below, is a graphic representation of how the overhead costs incurred by KMI employees flow through the Kinder Morgan accounting system, and demonstrates that none of those costs reach KMEP.



As Bradley explained, all expenses associated with the excluded KMI-operated entities are directly assigned to individual entities (Box 2B), or are charged to Account 184600 (Box 1) or Account 107001 (Box 2).[1089] The fixed fees paid by the KMI-operated entities are credited to Account 184600 (Box 1), and the amount remaining in Account 184600 is then allocated among the KMI-owned entities through KMI's own Mass formula.[1090] The costs contained in Account 107001, the KMI capital burden pool, are allocated among the KMI-operated entities and the KMI-owned entities through a separate allocation methodology based on each entity's level of capital spending.[1091]

[1087] *See, e.g.*, Exs. SFW-43 at 9-14, SFW-51, SFW-101.

[1088] *See, e.g.*, Exs. SFW-50A, SFW-75 at 3; Tr. 855-57.

[1089] Tr. 853-59.

[1090] Exs. SFW-43 at 32-44, SFW-47, SFW-48; Tr. 853-59.

[1091] Ex. SFW-43 at 14-15. Note, however, that the payment of the fixed fees by the KMI-operated entities is unrelated to the amount of overhead each is charged from

372. No charges from Account 184600 (Box 1) or Account 107001 (Box 2) cross the line to reach the KMEP-operated entities (Box 3A).[1092] The only overhead costs incurred by KMI that are charged to KMEP are those in Box 3, Account 184601, which becomes the KMI cross-charge to KMEP.[1093] The only expenses charged to Account 184601 are those incurred for the support of the KMEP-operated entities. No costs associated with the excluded KMI-operated entities are included in Account 184601 (Box 3).[1094] The costs in Account 184601 (Box 3), labeled the "KMI cross-charge," are reflected on page 11, line 19 of Ex. SFW-45 and on page 11, line 20 of Ex. SFW-46.

373. Ex. SFW-50A and SFPP witness Bradley's testimony make clear that no costs associated with the excluded KMI-operated entities are included in the pool of costs allocated through KMEP's shared cost distributions or Mass formula.[1095] Therefore, the undersigned concurs with SFPP's position that exclusion of the KMI-operated entities is appropriate and necessary since any expenses not covered by the fixed fees are allocated among the KMI-owned entities through the KMI Massachusetts formula allocations and would never be attributed to KMEP.[1096] This determination is also in accord with the Commission's directive that costs should be assigned or allocated only to the subsidiaries that benefitted from the costs' incurrence.[1097]

Account 107001, which is based entirely on each entity's level of capital spending. Tr. 803-04.

[1092] Tr. 853-59, 1160.

[1093] Ex. SFW-43 at 19; Tr. 853-59.

[1094] Tr. 853-59.

[1095] *Id*.

[1096] Staff correctly points out that Judge Silverstein's recent Initial Decision concludes that the "fixed fee had no relationship to the costs which it was supposed to cover" and that this fact undermined "SFFP's argument that the subsidiaries should be excluded." Staff IB at 6 (citing *Chevron Products Co.*, 125 FERC ¶ 63,018 at P 790). However, the fact that any expenses not covered by the fixed fees are allocated among the KMI-owned entities through the KMI Massachusetts formula allocations and would never be attributed to KMEP and therefore would never impact SFPP does not appear to have been addressed.

[1097] Indeed, the Commission has previously ruled that several of the subsidiaries at issue should be included within KMEP's formula. Staff asserts that the Commission ruled in the December 2007 Order at P 134 that Plantation Pipeline Company ("Plantation"), KMIGT and Trailblazer must be included within the application of the Massachusetts Formula; however, this issue was revisited by the Commission on rehearing. *SFPP, L.P.*, 122 FERC ¶ 61,133, at PP 13-16.

C. The Joint Ventures[1098] *are properly excluded from KMEP's shared cost distributions and Masachusetts Formula.*

374. As previously explained, KMEP also excluded from its shared cost distributions and Mass formula the joint ventures in which it owned equity interests.[1099] Staff witness Sosnick agreed with Bradley that if a case-by-case analysis is used, Marine Terminal should not be included within KMEP's Massachusetts formula,[1100] but testified that Heartland, Red Cedar, Coyote Gulch and Thunder Creek should be included within KMEP's Massachusetts formula because he believes that their RC's are included within the KMI cross-charge.[1101] With respect to Cochin, Sosnick initially agreed with Bradley that the direct assignment of $90,000 of costs from KMEP to Cochin should not be included in the residual overhead allocation.[1102] However, after further review of Bradley's testimony,[1103] he stated "I should have included Cochin because KMI-shared employees provided Cochin with corporate overhead support."[1104]

375. Sosnick analyzed the information provided by SFPP as to each of the joint ventures and concluded, among other things, that since KMEP has an equity interest in each entity, it "can reasonably be expected to maintain oversight of its investment and thus the subsidiaries should be included."[1105] He testified that it was unrealistic to presume, as Bradley testified,[1106] that KMEP simply recorded its equity interest in its joint ventures while performing no further services as to those entities.[1107] Sosnick speculated that based on the indirect costs typically associated with the oversight occasioned by one's participation in a joint venture, these subsidiaries (and, as with

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[1098] Again, the joint ventures are Heartland, Coyote Gulch, Red Cedar, Thunder Creek, Marine Terminal, and Cochin. Ex. SFW-43 at 46.

[1099] Ex. SFW-43 at 46-53.

[1100] Ex. S-25 at 7.

[1101] *Id.*

[1102] Ex. S-7 at 19.

[1103] Ex. SFW-43 at 52-53.

[1104] Ex. S-25 at 9; *See* Staff IB P. 38

[1105] Ex. S-7 at 11.

[1106] Ex. SFW-43 at 46.

[1107] Ex. S-7 at 12.

Cochin, the overhead costs which had been directly assigned to those subsidiaries)[1108] should be included in the residual costs allocation pool.[1109] ACC Shippers' witness Daniel S. Arthur ("Arthur") reached similar conclusions.[1110]

376. Bradley testified that KMEP excluded the joint ventures because they were operated by third parties, and thus, KMEP did not perform overhead activities such as accounting or IT functions for the joint ventures.[1111] Bradley testified that all corporate general and administrative functions, such as accounting, IT, and accounts payable, were performed for each joint venture by the third-party operators, *not* by KMEP.[1112] Bradley asserts that because neither GP Services employees nor KMI employees performed accounting, IT, or accounts payable functions for the joint ventures, there is no basis on which KMEP could allocate a portion of its accounting, IT or accounts payable costs to these entities.[1113] While Bradley acknowledged that KMEP *does* have limited managerial oversight of the joint ventures, he testified that no portion of those costs were allocated to SFPP.[1114] Rather, the costs associated with this limited managerial oversight were either removed from the pool of costs allocated through KMEP's shared cost distributions and Mass formula, or were de minimus.[1115]

377. Application of the *Williams* standard to the joint ventures based on the evidence of record in this proceeding supports a finding that these six subsidiaries should not be included.[1116] Requiring each joint venture to bear a share of *all* general and

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[1108] Sosnick proposes to add these monies "back into the amount of corporate overhead to be allocated through the KMEP Massachusetts Formula." Ex S-7 at 12; *See also* Staff IB at 39.

[1109] Ex. S-7 at 12.

[1110] *See* Exs. S-26; ACC-34 at 10-17; ACC-66; Tr. 2070-72.

[1111] Ex. SFW-43 at 46-53.

[1112] Ex. SFW-43 at 46-52; Tr. 908-11.

[1113] *See* Tr. 908-11.

[1114] Tr. 908-11.

[1115] Ex. SFW-43 at 51-52; Tr. 908-11. Bradley testified that costs contained in RC 1001 and RC 1025 associated with the managerial oversight of the joint ventures totaled approximately $14,000 in each year. Tr. 733, 908-11. KMEP allocated $139.8 million through its shared cost distributions and Mass Formula in 2003, and $177.8 million in 2004. Exs. SFW-45, SFW-46.

[1116] Based on a case-by-case analysis, Staff witness Sosnick agreed with SFPP witness Bradley that Marine Terminal should not be included within KMEP's Massachusetts formula allocation. Ex. S-25 at 7.

administrative services, even though neither Arthur nor Sosnick identified any general and administrative services performed on behalf of the joint ventures other than the limited managerial oversight discussed above, would be inequitable and inconsistent with the Commission's cost causation principles. Moreover, the costs associated with KMEP's limited oversight of the joint ventures which remain in the pool of costs allocated through KMEP's shared cost distributions and Mass formula were de minimus *and were not allocated to SFPP*.[1117] Bradley removed the entire amount of RC 0375, which contained costs associated with KMEP's managerial oversight of Red Cedar, Thunder Creek and Coyote Gulch (as well as other costs properly allocated to KMEP-operated entities), from the pool of costs allocated through KMEP's shared cost distributions and Mass formula. Thus, no costs associated with the oversight of these joint ventures were allocated to any KMEP-operated entity, including SFPP.[1118] Costs associated with KMEP's limited oversight of the remaining joint ventures, Marine Terminal, Cochin and Heartland, were captured in RC 1001 and RC 1025.[1119] The costs in RC 1001 and RC 1025 were allocated through KMEP's shared cost distributions, but were not allocated to SFPP.[1120] The costs in RC 1001 were allocated entirely to the products pipeline subsidiaries in the Mid-Continent Region (the "PPL Allocated-MidCon Tier"), and the costs in RC 1025 were allocated solely to KMEP's terminals subsidiaries (the "Term Tier").[1121] Therefore, the inclusion of these costs in the pool of costs allocated through KMEP's shared cost distributions had *absolutely no effect on the level of costs allocated to SFPP*. Given these facts, the ACC Shippers' argument, that exclusion of these subsidiaries requires the remaining subsidiaries, like SFPP, to bear added costs and to cross-subsidize the excluded entities,[1122] is simply not supported by the record.

D. Shared cost distributions to specific subgroups are not properly considered part of KMEP's Massachusetts Formula.

378. SFPP witnesses Bradley and Michael J. Webb ("Webb") testified that KMEP has faithfully followed Commission policy in distributing its 2003 and 2004 corporate overhead costs among its subsidiaries in this proceeding. To the extent possible, KMEP directly assigned corporate overhead costs to individual subsidiaries.[1123] However, as

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[1117] Tr. 908-11.

[1118] Ex. SFW-43 at 51-52; Tr. 649, 724-25.

[1119] Ex. SFW-43 at 51-52.

[1120] Exs. SFW-45, SFW-46.

[1121] Exs. SFW-45 at 11, SFW-46 at 11; Tr. 730-32, 733-34.

[1122] *Id*. at 62.

[1123] Ex. SFW-43 at 11-12.

Bradley explained, a large portion of KMEP's overhead costs could not be directly assigned to an individual subsidiary because they were "shared" costs that benefited multiple subsidiaries, such as those within a single business segment (*e.g.*, Mr. Bannigan's group's costs,[1124] which benefitted only the products pipeline division), or were true "residual" costs that benefitted all subsidiaries operated by KMEP (*e.g.* the costs of the Office of the Chairman, which provides oversight and guidance to all KMEP-operated entities).[1125]

379. As a result, KMEP used shared cost distributions to assign shared costs to a particular group of subsidiaries and then distribute those costs among only the members of that group (*i.e.*, "CO_2 Tier," "Term Tier," or "PPL Tier"), and then used the Mass formula to allocate the remaining residual costs among all KMEP-operated entities (the "KMP Tier").[1126] Each shared cost distribution was comprised of all KMEP subsidiaries within one of KMEP's business segments. Thus, the CO_2 Tier distributed costs among all subsidiaries in the CO_2 business segment, the Term Tier distributed costs among all subsidiaries in the terminals division, and the PPL Tier distributed costs among all subsidiaries in the products pipeline segment.[1127] The subsidiaries within the PPL Tier were then further grouped by particular geographic region (*e.g.*, the PPL Midcon Tier distributed costs among all the products pipeline subsidiaries in the mid-continent region).[1128]

380. These shared cost distributions allowed KMEP to allocate its shared costs exclusively among the particular groups of subsidiaries that benefitted from the costs.[1129] For example, the costs associated with Mr. Bannigan's group did not benefit the CO_2 or terminals business units, as each of these units had its own president; these costs benefitted only KMEP's products pipeline subsidiaries.[1130] Therefore, KMEP directly assigned the costs associated with the president of the products pipelines division to the PPL Tier and then allocated those costs only among the subsidiaries in that tier.[1131]

[1124] Mr. Bannigan is president of KMEP's products pipeline division.

[1125] Ex. SFW-43 at 11-12; Tr. 649, 687.

[1126] Exs. SFW-45 at 11-12, SFW-46 at 11-12; Tr. 817-20.

[1127] Exs. SFW-43 at 24-25, SFW-45, SFW-46. The products pipeline segment includes those terminals associated with products pipelines. Ex. SFW-43 at 25.

[1128] Exs. SFW-43 at 25, SFW-45 at 11-12, SFW-46 at 11-12; *see, e.g.*, Tr. 1267-68.

[1129] Ex. SFW-75 at 10-12.

[1130] Tr. 869-70.

Similarly, because only subsidiaries in KMEP's terminals division had unions, KMEP directly assigned all union expenses to the Term Tier and allocated those expenses among only KMEP's terminal subsidiaries.[1132]

381. After KMEP assigns all costs that can be identified with a particular business segment through the tiers, KMEP is left with residual costs that must be allocated to all KMEP subsidiaries that are operated by KMEP. KMEP performs this allocation through the KMP Tier, which is comprised of *all* KMEP subsidiaries operated by KMEP.[1133] The costs allocated through the KMP Tier using the Mass formula are true residual costs that cannot be identified with any individual subsidiary or a business segment because they are incurred for the benefit of *all* KMEP-operated subsidiaries.[1134]

382. As previously explained, in addressing the issue of the appropriate allocation of general and administrative expenses, the Commission has provided clear and controlling precedent that must be applied. The Commission "…uses the Massachusetts formula or 'Mass Formula' to allocate residual overhead costs among subsidiary companies when the parent company cannot directly assign those costs to a specific subsidiary. Direct costs are costs that the parent company can specifically identify and directly assign to the subsidiary that incurred the costs. Such direct-billed corporate services are not considered in the allocation process." [1135] It is clear then that only the costs allocated through the KMP Tier are true residual costs within the meaning of the Commission's Mass formula precedent because only these costs are costs that cannot be identified with any individual subsidiary or business segment because they are incurred for the benefit of *all* KMEP-operated subsidiaries.[1136] All other costs are direct-billed costs which KMEP has specifically identified and directly assigned to the subsidiary or sub-group of subsidiaries that incurred the costs. Thus, it is KMEP's overall cost allocation methodology, which includes the identification of specific subsidiaries and /or sub-groups of subsidiaries for purposes of direct assignments, which is multi-tiered, not the Mass formula methodology utilized for the allocation of true residual costs which have been incurred for the benefit of *all* KMEP-operated subsidiaries at the KMP Tier. This confusion in terminology became apparent during the hearing in this proceeding.[1137]

[1131] Ex. SFW-45, SFW-46; Tr. 817-20, 1099-1100. Each shared cost distribution uses the three allocators of the Mass Formula (revenue, labor and PP&E) to distribute the shared costs among the subsidiaries in the group. Tr. 817-20.

[1132] Ex. SFW-43 at 22-30.

[1133] Exs. SFW-45 at 11-12, SFW-46 at 11-12; Tr. 817-20.

[1134] Tr. 819-20.

[1135] December 2007 Order at P 134.

[1136] Tr. 819-20.

[1137] *See, e.g.*, Tr. 1169-74, 1188-91.

383. The Massachusetts formula allocates corporate overhead costs "based on an average of three ratios."[1138] These ratios are: (1) the affiliate's operating revenue to total corporate operating revenues; (2) the affiliate's gross plant to total corporate gross plant; and (3) the affiliate's gross payroll (or labor costs) to total corporate gross payroll.[1139] "Overhead costs are allocated to the affiliate based upon the average percentage of each of these three items to total company figures for these three items."[1140] Equal weight is given to each of the three averages.[1141] SFPP witnesses Webb and Bradley testified, and the record reflects, that KMEP is using a traditional, single-tier Mass formula at the KMP Tier to allocate true residual costs among all subsidiaries it operates.[1142]

384. The undersigned concurs with SFPP's position that the shared cost distributions to specific subgroups are *not* properly considered part of KMEP's Mass formula allocation, but rather are simply a vehicle used to directly assign shared expenses to a distinct subgroup of subsidiaries and allocate those shared expenses among the subsidiaries in that subgroup.[1143] Staff concurs that the shared cost distributions to specific subgroups are *not* properly considered part of KMEP's Mass formula allocation and takes no position as to how direct costs should be allocated among the subgroups.[1144] Further, the Commission has found that the use of subgroup direct assignments and shared cost distributions are reasonable and appropriate.[1145] That KMEP utilizes such an approach is not surprising given the complexity of its organizational structure, summarized above, which was comprised of more than 50 subsidiaries during 2003-2004. Moreover, as SFPP points out, the Commission has relied upon such a tiered approach as an example of a proper approach to handling overhead costs in order to match cost incurrence and cost allocation.[1146]

[1138] *K N Interstate Gas Transmission Company*, 88 FERC at 61,848 n. 10.

[1139] *Id*.

[1140] *Id*. (citing *Williams Natural Gas Co.*, 77 FERC ¶ at 62,188).

[1141] *Michigan Gas Storage Co.*, 87 FERC at 61,171 n. 181, 61,171-73.

[1142] Tr. 817-20, 1188-91.

[1143] Tr. 1182-83.

[1144] Staff IB at 46-47.

[1145] *See Williams*, 85 FERC at 62,137 n.31.

[1146] *See, e.g., Williams Natural Gas Co.*, 85 FERC at 62,137 n.31 (supporting its policy that subsidiaries that "[d]o not benefit at all from a particular cost center" are not included in an allocation, the Commission explained that Williams Interstate Natural Gas Systems appropriately allocated costs among a subset of the subsidiaries because only the subset incurred the costs).

E. The Distrigas methodology should be employed with respect to the treatment of KMEP-owned entities that have an element of cost of goods sold.

385. The next Massachusetts formula issue deals with whether the *Distrigas* methodology should be employed with respect to the treatment of KMEP-owned entities that have an element of cost of goods sold. In *Distrigas*, although gross income is typically used to calculate the third allocation factor, the Commission approved the use of net income where the relatively huge gross revenues of an entity would make a substantial difference with respect to the allocations to other entities.[1147] Staff witness Sosnick initially applied the *Distrigas* methodology to Tejas Consolidated since he determined that in 2003, the difference between Tejas Consolidated's gross revenue and net income was about $4.8 billion and that, in 2004, the difference was about $6.3 billion.[1148] He reasoned that this difference, if not removed, "would cause an unreasonable allocation of residual corporate overhead costs to Tejas."[1149] Thereafter, for consistency purposes, Sosnick applied the cost of goods sold in Ex. SFW-55 at 2-3, to the gross revenue so as to consider the net income for all applicable KMEP entities.[1150]

386. ACC Shippers' witness Arthur advocated the use of gross revenues. He asserted there was no evidence demonstrating that the use of gross revenues over-allocates overhead costs to Tejas.[1151] Arthur acknowledged Tejas Consolidated's gross revenues are in the billions of dollars, but asserted that since Tejas is not a regulated subsidiary with a pass-through mechanism of gas purchase costs, it is at risk for those costs.[1152] SFPP witness Bradley agrees with Sosnick that for entities that have an element of cost of goods sold, net income should be used.[1153]

387. The undersigned finds that Staff's position on this issue is the more persuasive and should be adopted in this proceeding, accordingly. The Distrigas methodology should be used in this situation due to the extraordinary level of gross revenues of costs of goods sold. This extreme level of revenues if used would render the traditional or un-modified

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[1147] *Distrigas*, 41 FERC at 61,557.

[1148] Ex. S-7 at 17-18.

[1149] *Id*. at 18.

[1150] Ex. S-25 at 10-11 (referencing Ex. S-26 at 1, 5).

[1151] Ex. ACC-34 at 20.

[1152] *Id*.

[1153] Ex. SFW-43 at 43-44.

Massachusetts formula unrepresentative for purposes of allocating indirect A&G costs in this case.[1154]

F. The retroactive direct assignment of costs to individual subsidiaries or groups of subsidiaries in 2006 has not been supported.

388. SFPP contends that using a 2006 methodology to allocate overhead costs, rather than the methodology used during 2003 and 2004, results in a more accurate cost allocation.[1155] According to SFPP, KMEP didn't "apply a new methodology to a database of unidentifiable historical costs for the purpose of shifting additional overhead costs to its regulated pipeline subsidiaries," but instead directly assigned costs that could be identified to certain groups of subsidiaries.[1156] KMEP is able to review its historical costs due to its system of Responsibility Centers, which is currently the same as it was in 2003 and 2004, to capture and track costs associated with particular activities and entities, SFPP explains.[1157] Additionally, SFPP notes that no party applied the methodology actually used in 2003 and 2004, making the question not about whether the methodology was retroactively applied, but which methodology is more accurate.[1158]

389. The ACC Shippers and Staff provide persuasive arguments to support a finding that SFPP's retroactive direct assignment of costs in 2006 is inappropriate.[1159] While no costs were directly assigned to SFPP contemporaneously in 2003 and 2004, SFPP assigned substantial 2003 and 2004 costs to SFPP in 2006. It is the determination of the undersigned that while SFPP may certainly seek to improve the accuracy of its direct assignment process moving forward, the record does support SFPP's efforts to do so retroactively to 2003 and 2004. While the RCs may have remained the same, the record reflects that employee interviews and such other measures were employed in an effort to support the 2006 re-determination of what would have been the more appropriate direct assignments in 2003 and 2004. It is the determination of the undersigned that SFPP was simply not able to explain the discrepancy between SFPP's direct assignments in 2003-2004 and those that were later made in 2006 with the degree of accuracy and level of

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[1154] Staff IB at 28. Staff names the following entities: North System, OLPC, KMBT, River Engineering Systems, Pinney Dock, CO2, SACROC, Trailblazer, KMIGT, KM Mexico, Casper-Douglas, and Tejas Consolidated. Staff IB at 29 (citing Ex. S-25 at 10-11).

[1155] SFPP IB at 54 (citing Ex. SFW-43 at 27-28; Tr. 875-76).

[1156] *Id*. at 55 (citing Ex. ACC-34 at 25; Tr. 656-61).

[1157] *Id*. (citing Exs. SFW-43 at 10-14, S-44; Tr. 658-61, 870-72).

[1158] *Id*. at 56-57.

[1159] *Id*.

transparency which would be necessary to support its actions in this regard.[1160] Accordingly, the direct assignments actually made in 2003 and 2004 must be considered controlling for purposes of this proceeding.

G. The purchase accounting adjustment amount should be excluded for both regulated and unregulated entities.

390. It is the determination of the undersigned that the purchase accounting adjustment amount should be excluded for both regulated and unregulated entities so that the property, plant, and equipment balances can be properly determined for all entities which will be allocated overhead costs through the Massachusetts formula.[1161] Both Staff and SFPP agree that removing the PAAs from only Commission-regulated entities "could distort the Massachusetts formula, since it allocates corporate overhead expenses to both classes of entities."[1162] The Commission has previously determined that "PAAs in the property of both jurisdictional and non-jurisdictional subsidiaries should be removed."[1163] SFPP correctly notes that while the December 2005 Order required SFPP to remove the PAAs from KMEP's subsidiary plant costs, it did not specify that it was to remove them only for FERC-regulated entities, and later the Commission required that they be removed from non-jurisdictional entities as well.[1164]

H. Direct and indirect capitalized overhead costs should be removed from the residual corporate overhead costs to be allocated under the Massachusetts Formula.

391. The undersigned concurs with Staff's position that SFPP should remove capitalized overhead costs from the residual corporate overhead costs to be allocated under the Massachusetts formula.[1165] "Capitalizing direct overheads related to construction projects allows a company to recover its investment, including associated overhead costs over a period of time through a depreciation expense that is booked and recovered over the project's remaining life, once the project goes into service."[1166] Staff's argument that this treatment should also apply to indirect corporate overhead costs

[1160] Staff IB at 42.

[1161] SFPP IB at 48 (citing Ex. S-7 at 5-6).

[1162] *Id*. (citing Ex. SFW-43 at 21-22).

[1163] Staff RB at 46 (citing December 2005 Order at P 86).

[1164] *Id*. (citing December 2005 Order at P 86; February 2006 Order at P 17).

[1165] Staff IB at 50 (citing Ex. S-7 at 18-19).

[1166] *Id*. (citing Ex. S-25 at 11).

related to capital projects is persuasive.[1167] Allocating corporate overhead costs that either directly or indirectly relate to capital projects through the Massachusetts formula is inconsistent with the goal of cost allocation methodology, which is to match costs with the cost-generating activity.[1168] Shippers do not benefit from capital-related overhead costs prior to a facility going into service, Staff explains, which is when capitalized overhead costs arise.[1169] Therefore, Staff persuasively argues, allowing KMEP to expense capital-related corporate overhead costs in the year incurred would not match the cost recovery with the type of cost.[1170]

392. The undersigned concurs that SFPP should "not be allowed to use the Massachusetts formula as a vehicle by which to expense all of its indirect capitalized overhead costs in the current year, rather than over the life of the projects to which it relates."[1171] Moreover, the undersigned concurs with Staff's position that the Commission's regulations do not preclude oil pipelines from capitalizing indirect overhead costs.[1172] 18 C.F.R. Part 352, Section 3-3 states "[t]he cost of construction property chargeable to the carrier property accounts shall include *direct* and *other costs* as described hereunder."[1173] It is reasonable to conclude that "other costs" includes indirect corporate overhead costs.[1174] To allocate the indirect costs related to capital projects, Staff explains that a simple allocation methodology would have to be derived to spread the costs over the average of the capital projects' remaining lives.[1175]

2. KN Formula

<u>Positions of the Parties</u>

ACC Shippers

393. The ACC Shippers state that they do not address this issue.[1176]

[1167] *Id*. (citing Ex. S-25 at 12).

[1168] *Id*. at 51 (citing Exs. S-25 at 12, SFW-75 at 3, 6).

[1169] *Id*. (citing Ex. S-25 at 13).

[1170] *Id*.

[1171] Staff RB at 48.

[1172] Staff IB at 51.

[1173] *Id*. (citing Ex. S-25 at 14).

[1174] *Id*. at 51-52 (citing Ex. S-25 at 14).

[1175] Staff RB at 48.

[1176] ACC IB at 70.

Indicated Shippers

394. The Indicated Shippers claim that SFPP undermined its own arguments that it fairly allocated overhead when its witness was unable to classify the work that goes on at its various field offices.[1177] Further, as it noted when criticizing SFPP's Massachusetts formula allocation, the Indicated Shippers state that SFPP's use of a different set of books depending on which is advantageous in a specific situation is suspect.[1178] According to the Indicated Shippers, SFPP uses three different numbers of different parts of labor supported by three different witnesses.[1179]

Commission Trial Staff

395. According to Staff, the Kansas-Nebraska ("KN") method is used to allocate administrative and general ("A&G") expenses among divisions or functions after the overhead costs are allocated through the Massachusetts formula.[1180] The costs are allocated, Staff explains, "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."[1181] Opinion 731, which set forth the KN formula originally, requires that A&G expenses first be divided in labor-related, plant-related, and "other" categories.[1182] After the initial division, Staff continues, 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.[1183] The categories are then allocated among SFPP's functions by multiplying the total labor-related A&G by each function's direct labor ratio, and multiplying the total plant-related A&G by each function's direct plant ratio.[1184] Then, within each function, Staff explains that the expenses are added together and the ratio of each total to the total amount allocated is that

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[1177] IS IB at 46 (citing Tr. 1222-24).

[1178] *Id*. at 46-47.

[1179] *Id*. at 46.

[1180] Staff IB at 52 (citing Ex. S-7 at 20).

[1181] *Id*. at 52-53 (citing *SFPP, L.P.*, 86 FERC at 61,082).

[1182] *Id*. at 53 (citing Ex. S-7 at 20; *Kansas-Nebraska Natural Gas Company*, Opinion No. 731, 53 FPC 1691 (1975); *aff'd Kansas-Nebraska Natural Gas Company v. FPC*, 534 F.2d 227 (10th Cir. 1976) ("Opinion No. 731")).

[1183] *Id*. (citing Ex. S-7 at 20).

[1184] *Id*.

function's KN ratio.[1185] The final step, according to Staff, is to multiply each A&G expense by the applicable KN ratios in order to allocate it across the functions.[1186]

396. Staff claims that SFPP incorrectly implemented the KN Method as it was adopted in Opinion 731 by failing to classify the indirect expenses as labor-related, plant-related, or other.[1187] SFPP, according to Staff, instead calculated separate percentages of West and East Line carrier direct plant investment to the total company's direct plant investment and did the same for labor expenses.[1188] SFPP then calculated a simple average of these two ratios for each segment and used the resulting ratios to allocate indirect expenses to the segments.[1189] Using a simple average may result in an allocation of too much labor and too little plant when there is a function with little labor but a large share of plant.[1190] Staff claims that the Commission does not generally permit companies to deviate from the KN Methodology as set forth in Opinion 731 and where it has done so in prior SFPP proceedings, Staff argues, there is no indication that it meant for such deviation to be permanent.[1191]

397. Moreover, when attempting to prove that Staff's approach was not appropriate, SFPP, Staff alleges, used any reason possible to allocate most costs to "other," while Staff more appropriately, it states, allocated them as labor or plant.[1192] SFPP argues that its method is more reasonable than the traditional approach followed by Staff, Staff states, because "many overhead expenses are both labor-related and plant-related."[1193] SFPP essentially took costs that would clearly be classified as plant or labor, Staff contends, and classified them all as 'other," misapplying the methodology as adopted in Opinion No. 731.[1194]

[1185] *Id*.

[1186] *Id*.

[1187] *Id*. (citing Ex. S-25 at 23, S-7 at 21).

[1188] *Id*. at 53-54 (citing Ex. S-7 at 21).

[1189] *Id*. at 54.

[1190] *Id*. (citing Ex. S-7 at 22).

[1191] *Id*. at 54-55 (citing *Questar Pipeline Co.*, 74 FERC ¶ 61,126, at 61,454-56 (1996); *Panhandle Eastern Pipe Line Co.*, 46 FERC ¶ 61,183, at 61,165 (1989); *reh'g denied*, 51 FERC ¶ 61,059 (1990); *Transcontinental Gas Pipeline Corp.*, 106 FERC ¶ 61,299, at P 203 (2004); Tr. 2055).

[1192] *Id*. at 55-56 (citing Exs. SFW-106, S-25 at 28-29; Tr. 1323).

[1193] Staff RB at 52 (citing Ex. SFW-106).

[1194] Staff RB at 53.

398. Staff recommends adopting its application of the KN formula because, Staff alleges, it correctly follows Opinion 731.[1195] Staff's KN allocation categorizes all the costs allocated to SFPP through the Massachusetts formula, resulting in labor-related costs of $30,743,115, plant-related costs of $592,116, and "other" costs of $8,311,943 for a total corporate overhead allocation of $39,647,174 in 2003.[1196] For 2004, labor-related costs totaled $31,189,963 while plant-related costs were $1,064,925, and "other" costs were $8,843,752.[1197] The total corporate overhead allocation for 2004 was $41,098,641, according to Staff's implementation of the KN formula.[1198]

399. With regard to the dispute over the definition of "Carrier," Staff states that SFPP would consider "any pipeline transportation service -- whether interstate, intrastate, or military -- a 'carrier' service," while Staff would argue that "carrier" means "an oil pipeline subject to the Commission's jurisdiction under the Interstate Commerce Act."[1199] Staff argues that its definition should be used when SFPP provides information as part of its filings; specifically, Staff contends that SFPP can and should break out FERC jurisdictional data from CPUC jurisdictional and military exclusive lines.[1200] While SFPP maintains that the differences are irrelevant because the end result is the same regardless of the definition, Staff disagrees, stating that using its definition to break out costs as carrier or non-carrier offers greater transparency in SFPP filings with the Commission.[1201]

400. Furthermore, Staff claims that its definition is the "plain meaning" of the Commission's regulation and, in circumstances "where SFPP can provide the relevant data that comports with the 'plain meaning' of the Commission's regulation, it cannot unilaterally apply a contrary definition."[1202]

401. In response to Staff's arguments, SFPP stated that the Commission considers any pipeline transportation service to be a carrier service.[1203] Staff continues, stating that

[1195] Staff IB at 58.

[1196] *Id*. (citing Ex. S-25 at 28, 29).

[1197] *Id*. (citing Ex. S-25 at 30).

[1198] *Id*.

[1199] *Id*. at 58-59 (citing Exs. SFW-58 at 24, S-25 at 19; 18 C.F.R. § 341.0(a)(2008)).

[1200] *Id*. at 59-60 (citing Tr. 2094-95, 2097; Ex. S-30).

[1201] *Id*. at 60-61 (citing Ex. S-54; Tr. 1319).

[1202] *Id*. at 61 (citing Ex. S-25 at 19).

[1203] Staff RB at 54-55 (citing Ex. SFW-58 at 24).

SFPP goes on to argue that 18 C.F.R. § 341.0(a) applies only to rate filings, and not to answers and other submission made by SFPP in the course of this case.[1204] Staff finds "ludicrous" the notion that SFPP would be required to follow the Commission's definition of carrier in all tariff filings, including rate cases, but not when filing testimony or other pleadings in a complaint case.[1205] Further, SFPP argues that it would be inappropriate and inconsistent with the Uniform System of Accounts to classify only its FERC "carrier" services and property as "carrier."[1206] Staff responds by stating: (1) the Commission defines only Commission-regulated oil pipelines as "carrier"; (2) the issues here deal with ratemaking, not accounting; and (3) the Uniform System of Accounts, Staff asserts, cannot dictate ratemaking policies.[1207]

SFPP, L.P.

402. SFPP, when allocating overhead costs among its various functions, uses the KN formula allocation consisting of a simple average of the direct labor ratio and the direct plant ratio to develop a combined direct labor and direct plant ratio for each function which is used to allocate indirect overhead costs to that function.[1208] SFPP contends that Staff suggests a change to this methodology which would require it to prove that the existing methodology is unjust and unreasonable and that the replacement methodology is just and reasonable.[1209] Staff has not made this showing, according to SFPP.[1210]

403. Staff criticizes SFPP's KN formula allocation, stating that SFPP should identify all overhead costs as either plant- or labor-related and then allocate them using only their respective ratios.[1211] SFPP responds, stating that its simple average method is more reasonable than Staff's method because it acknowledges that many overhead costs are both plant- and labor-related, thus more accurately allocating the costs.[1212] It is also the same method used by the Commission in the last decade of SFPP litigation, which, while not exactly the same as that set forth in Opinion No. 731, is reasonable and consistent

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[1204] *Id*. at 55 (citing SFPP IB at 71).

[1205] *Id*. at 56.

[1206] *Id*. (citing SFPP IB at 72).

[1207] *Id*. at 56-57 (citing *Public Systems, et al. v. FERC* 606 F.2d 973, 982 n. 44 (D.C. Cir. 1979)).

[1208] SFPP IB at 69 (citing Ex. SFW-58 at 5).

[1209] *Id*. (citing Ex. S-25 at 23).

[1210] *Id*.

[1211] *Id*. at 69-70 (citing Ex. S-25 at 22-23, 25).

[1212] *Id*. at 70 (citing Exs. SFW-58 at 15-6, SFW-106; Tr. 1374-1384).

with Opinion No. 731.[1213] SFPP points out that the Commission is free to adopt variations of the Opinion No. 731 methodology, or even completely new allocation methodologies.[1214]

404. According to SFPP, Staff bears the burden of proving that SFPP's use of the Commission's existing KN methodology is unjust and unreasonable because Staff proposes a departure from the Commission's current KN methodology.[1215] Staff must also prove that its replacement method is just and reasonable.[1216] Staff has not met this burden, SFPP states, because Staff argued only that the simple-average method will result in "a function that has little labor, but a large share of plant [being] allocated relatively too much labor-related indirect expense and relatively little plant-related indirect expense."[1217] In reality, according to SFPP, the simple average method instead recognizes that many overhead costs are both labor- and plant-related and should not be allocated to only one factor.[1218]

405. SFPP also responds to Staff's criticism of its definition of carrier.[1219] SFPP notes that it considers any pipeline transportation services, interstate or intrastate, to be a carrier service, while it would consider services such as terminal storage services to be non-carrier.[1220] Staff, on the other hand, considers only interstate pipeline transportation services as carrier.[1221] Staff cites Title 18, Section 341.0 of the Code of Federal Regulations as support for its argument, but SFPP claims that this Section only applies to tariff filings by a pipeline company, and thus does not apply in a complaint case.[1222] This section also fails to address how the various types of services offered by a carrier should be classified.[1223] Finally, SFPP notes that, regardless of the definition of carrier, the results of the KN formula allocations will be identical.[1224]

[1213] *Id*. (citing Ex. SFW-58 at 6-8).

[1214] *Id*. at 70-71 (citing *Hope*, 320 U.S. at 602).

[1215] SFPP RB at 70.

[1216] *Id*. at 70-71 (citing *Sea Robin*, 794 F.2d at 186-87).

[1217] *Id*. at 71 (citing Staff IB at 54).

[1218] *Id*.

[1219] SFPP IB at 71.

[1220] *Id*. (citing Ex. SFW-58 at 24).

[1221] *Id*.

[1222] *Id*. (citing 18 C.F.R. §341.0).

[1223] *Id*. at 71-72 (citing 18 C.F.R. §341.0).

[1224] *Id*. at 72 (citing Exs. SFW-58 at 25-26, SFW-64, SFW-107, SFW-125; Tr. 1316-20.

406. Staff, SFPP notes, claims that SFPP's definition of carrier leads to a lack of transparency in SFPP's filings.[1225] However, SFPP argues, one need not calculate the carrier cost allocations for all lines, including those not at issue, as Staff would like, but instead need only isolate the interstate carrier direct labor and investment for the particular line at issue.[1226] SFPP claims that there is no reason to change its definition of carrier or isolate the interstate carrier direct labor and investment for lines other than those at issue in this proceeding as it does not affect the accuracy of the KN formula allocations.[1227]

Discussion and Findings

407. The KN method is used to allocate administrative and general expenses among divisions or functions after the overhead costs are allocated through the Massachusetts formula.[1228] The 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."[1229] As Staff has correctly explained, Opinion 731, which set forth the KN formula originally, requires that A&G expenses first be divided in labor-related, plant-related, and "other" categories.[1230] 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.[1231] The categories are then allocated among SFPP's functions by multiplying the total labor-related A&G by each function's direct labor ratio, and multiplying the total plant-related A&G by each function's direct plant ratio.[1232] 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.[1233] The final step is to

[1225] SFPP RB at 72 (citing Staff IB at 58-61).

[1226] *Id*. (citing Exs. SFW-58 at 25-26, SFW-64, SFW-107, SFW-125; Tr. 1316-20).

[1227] *Id*. (citing Tr. 2051-52).

[1228] Staff IB at 52 (citing Ex. S-7 at 20).

[1229] *Id*. at 52-53 (citing *SFPP, L.P.*, 86 FERC at 61,082).

[1230] *Id*. at 53 (citing Ex. S-7 at 20; Opinion No. 731, 53 FPC 1691 (1975); *aff'd Kansas-Nebraska Natural Gas Company v. FPC*, 534 F.2d 227).

[1231] *Id*. (citing Ex. S-7 at 20).

[1232] *Id*.

[1233] *Id*.

multiply each A&G expense by the applicable KN ratios in order to allocate it across the functions.[1234]

408. SFPP acknowledges that it did not classify its indirect expenses as labor-related, plant-related, or other.[1235] SFPP instead calculated separate percentages of West and East Line carrier direct plant investment to the total company's direct plant investment and did the same for labor expenses.[1236] SFPP then calculated a simple average of these two ratios for each segment and used the resulting ratios to allocate indirect expenses to the segments.[1237] SFPP argues that its simple average method is more reasonable than Staff's method because it acknowledges that many overhead costs are both plant- and labor-related, thus more accurately allocating the costs.[1238]

409. SFPP points out that its simple average method is the same method used by the Commission in the last decade of SFPP litigation, which, while not exactly the same as that set forth in Opinion No. 731, is reasonable and consistent with this Opinion.[1239] SFPP correctly points out that the Commission is free to adopt variations of the Opinion No. 731 methodology, or even completely new allocation methodologies.[1240]

410. While Staff has demonstrated that its proposed application of the KN formula is more consistent with Opinion 731,[1241] Staff has not adequately explained why the Commission has used a KN methodology in the last decade of SFPP litigation which deviates from Opinion 731 or why SFPP should now be required to depart from that method.[1242] Staff acknowledges that the Commission has done so in prior SFPP proceedings, but simply argues that there is no indication that it meant for such deviation to be permanent.[1243] Staff has not shown that there are changed circumstances that would warrant deviating from the existing methodology as it has been followed by the

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[1234] *Id*.

[1235] *Id*. (citing Ex. S-25 at 23, S-7 at 21).

[1236] *Id*. at 53-54 (citing Ex. S-7 at 21).

[1237] *Id*. at 54.

[1238] SFPP IB at 70 (citing Exs. SFW-58 at 15-6, SFW-106; Tr. 1374-84).

[1239] *Id*. (citing Ex. SFW-58 at 6-8).

[1240] *Id*. at 70-71 (citing *Hope*, 320 U.S. at 602).

[1241] Staff IB at 58.

[1242] SFPP RB at 70.

[1243] Staff IB at 54-55 (citing *Questar Pipeline Co.*, 74 FERC ¶ at 61,454-56; *Panhandle Eastern Pipe Line Co.*, 46 FERC at 61,165; *Transcontinental Gas Pipeline Corp.*, 106 FERC ¶ 61,299 at P 203; Tr. 2055).

Commission as to SFPP. Because Staff has not met its burden of proof, the undersigned is constrained to rule in favor of SFPP on this issue.

411. With regard to the dispute over the definition of "Carrier," SFPP would consider "any pipeline transportation service -- whether interstate, intrastate, or military -- a 'carrier' service," while Staff would argue that "carrier" means "an oil pipeline subject to the Commission's jurisdiction under the Interstate Commerce Act."[1244] Staff argues that its definition should be used when SFPP provides information as part of its filings; specifically, Staff contends that SFPP can and should break out FERC jurisdictional data from CPUC jurisdictional and military exclusive lines.[1245] The undersigned concurs that Staff's definition should be adopted for purposes of greater transparency in SFPP filings with the Commission and greater consistency in the interpretation and application of the Commission's regulations.[1246]

B. What is the appropriate depreciation expense?

<u>Positions of the Parties</u>

ACC Shippers

412. The ACC Shippers state that they do not address this issue.[1247]

Indicated Shippers

413. The Indicated Shippers state that they do not take a position on this issue.[1248]

Commission Trial Staff

414. According to Staff, SFPP's depreciation rates, which have been in effect since 1992 are out of date and need to be reexamined in this proceeding.[1249] Since these rates were put into effect, Staff notes, significant changes to the East and West Lines have occurred which will impact the depreciation calculation.[1250] Also, Staff states, a

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[1244] *Id*. at 58-59 (citing Exs. SFW-58 at 24, S-25 at 19; 18 C.F.R. § 341.0(a)).

[1245] *Id*. at 59-60 (citing Tr. 2094-95, 2097; Ex. S-30).

[1246] *Id*. at 60-61 (citing Ex. S-54; Tr. 1319).

[1247] ACC IB at 71.

[1248] IS IB at 47.

[1249] Staff IB at 62 (citing Ex. S-4 at 4, 12-13; Tr. 1914).

[1250] *Id*.

pipeline's depreciation rates should be reexamined every 3-5 years for ratemaking purposes.[1251] A more accurate remaining life of the pipeline can also be determined due to requirement and salvage data, crude oil production statistics, and reserve data.[1252] Using year-end 2002 data for 2003 and 2004 test periods, Staff determined that the East Line depreciation rate be decreased from 2.76% to 2.15%, while the West Line depreciation rate should be decreased from 2.72% to 2.60%.[1253] Using Staff's recommended depreciation rates and gross plant balances for the East Line as of December 31, 2003 and December 31, 2004, Staff determined that the annual depreciation expense cost of service component for the East Line can be decreased by $365,000 for 2003 and, for 2004, by $480,000.[1254] The West Line annual depreciation expense cost of service component can be decreased by $245,000 for 2003 and $225,000 for 2004.[1255] The primary difference between the existing rates and Staff's recommended rates, Staff explains, is the length of time over which the rates would recover SFPP's remaining plant investment.[1256] Further, Staff notes, it is not necessarily appropriate to use one set of depreciation rates for all four SFPP lines, as they should be determined based on the remaining economic life of each line.[1257] Staff continues, explaining the manner in which its witness determined the depreciation rate for the East and West lines, and explained that, if Staff's recommendations are adopted with respect to these lines, there will be no impact on SFPP's remaining lines.[1258]

415. Staff points out that it was the only party to present a depreciation rate analysis in this proceeding.[1259] SFPP, instead of presenting an analysis, chose to defend its existing depreciation rates and rejected Staff's recommendations through the use of non-engineering testimony.[1260] SFPP argued that its rates cannot be changed unless SFPP requested that that they be changed.[1261] SFPP, according to Staff, bases this argument on the Commission's regulation in 18 C.F.R. § 352, which states that "separate composite annual percentage rates will be prescribed for each depreciable account except that the

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[1251] Staff RB at 58 (citing Ex. S-4 at 12; Tr. 1913).

[1252] Staff IB at 62 (citing Ex. S-13 at 13).

[1253] *Id*. at 63 (citing Ex. S-5 at 4, 20, 21).

[1254] *Id*. (citing Ex. S-4 at 5).

[1255] *Id*.

[1256] *Id*. (citing Ex. S-4 at 5).

[1257] *Id*. at 64 (citing Ex. S-4 at 8).

[1258] *Id*. at 65.

[1259] *Id*. at 68.

[1260] *Id*. (citing Tr. 1120).

[1261] *Id*. at 69.

Commission may authorize use of component rates upon specific request from a carrier."[1262] The problems with this argument, Staff alleges, are that the Commission does not define either "composite" or "component," so SFPP may be using meanings that are different than those used by the Commission, and thus this regulation cannot be relied upon as support for its argument.[1263] Staff asserts that one could infer that the language "simply intends that a composite rate should be charged for all pipe rather than separate rates for each type of pipe."[1264] Further, Staff adds, the 1991 Staff Depreciation Analysis which was the basis for the current SFPP depreciation rates never referred to parts of pipelines as "components."[1265]

416. Next, Staff addresses SFPP's argument that, in a prior proceeding, the Commission stated that it would not change the depreciation rates on SFPP's system unless all SFPP lines were before the Commission.[1266] SFPP argues that the Commission must have all four lines before it in order to consider changing the depreciation rates for one or more of the lines.[1267] Also, here, unlike in that proceeding, Staff asks the Commission to change only the East and West Line depreciation rates, not all SFPP rates.[1268] Further, Staff explains that it limited the proposed changes to only the East and West Lines and did not recommend changes with respect to the North or Oregon Line depreciation rates.[1269] Staff notes, however, that in the OR96-2 Order, the Commission stated that "it is by no means clear that treating [the lines] as separate components for depreciation purposes would be improper."[1270]

417. SFPP also argued that the rates would not go into effect as of January 1, 2003, as proposed by Staff, but could only be changed prospectively, based on Commission regulation 18 C.F.R. § 347.1.[1271] Staff responds to this argument, stating that SFPP misinterpreted the regulation, and that this limitation is only applicable when the company files for new or changed depreciation rates, not in the context of a complaint

[1262] *Id*. (citing Tr. 1846).

[1263] *Id*. at 69-70 (citing Tr. 1848, 1967).

[1264] Staff RB at 60 (citing Tr. 1849-50).

[1265] *Id*. (citing Tr. 1967).

[1266] Staff IB at 70 (citing Ex. SFW-65 at 22; December 2005 Order at P 102).

[1267] Staff RB at 65 (citing SFPP IB at 78).

[1268] Staff IB at 71 (citing Tr. 1859).

[1269] Staff RB at 66 (citing Tr. 1859).

[1270] *Id*. at 70 (citing December 2005 Order at P 102).

[1271] *Id*. at 72 (citing Ex. SFW-65 at 22; 18 C.F.R. § 347.1 (2008)).

proceeding.[1272] A change in the depreciation rate, to the extent that the depreciation expense is part of cost of service, should commence when the new rates based on that cost of service take effect.[1273] Staff notes SFPP's argument that Section 347.1 applies to complaint proceedings, responding that Order No. 571, the Order which promulgated Part 347, envisioned Part 347 as operating in the context of filings by a carrier to change depreciation rates, and not a complaint situation.[1274] Further, Sections 347.1(b) and (e) specifically mentions "carriers."[1275]

418. Staff addresses SFPP's argument that the Commission's regulation that does deal with complaints, 18 C.F.R. § 343.4(b) cannot be involved because none of the complaints challenged SFPP's current depreciation rates.[1276] Staff points out that the complaints, however, challenge depreciation rates to the extent that they are part of the overall cost of service.[1277] Staff also notes that, had SFPP believed that depreciation rates were not part of the instant proceeding, it would have moved to strike Staff's testimony and exhibits on this issue.[1278]

419. SFPP also argues against Staff's conclusion that the East and West Lines should have different depreciation rates, stating that the Commission adopted system-wide rates in 1991.[1279] Staff notes, however, that the 1991 depreciation rate analysis was prepared for book purposes, not litigation purposes, and no party in this proceeding has disputed Staff's assertion that that study is out of date.[1280]

420. Moreover, Staff continues, the Commission did not "reaffirm[] the propriety of its system-wide rates in 2005," as SFPP asserts, and made no determination regarding the merits of depreciation rates.[1281] SFPP also argues that the East and West Line rates of

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[1272] *Id*. (citing Ex. S-22 at 18).

[1273] *Id*.

[1274] Staff RB at 62 (citing *Cost-of-Service Reporting and Filing Requirements for Oil Pipelines*, FERC Stats. & Regs., Regulation Preambles 1991-1996 ¶ 31,006 at 31,173-75 (1994)).

[1275] *Id*. at 63.

[1276] *Id*.

[1277] *Id*. at 63-64 (citing ConocoPhillips Company Complaint, Docket No. OR05-5-000 (December 29, 2004); SFPP IB at 75; Tr. 1971).

[1278] *Id*. at 64.

[1279] Staff RB at 67 (citing SFPP IB at 80).

[1280] *Id*. at 67-68 (citing Ex. SFW-112; Tr. 1969).

[1281] *Id*. at 68 (citing SFPP IB at 80; December 2005 Order at PP 101-02)).

expansion are "relatively consistent" with one another, which supports the continued use of system-wide rates.[1282] Staff contends that SFPP, in its analysis, measures the rate of growth from the end of 1992 until the middle of the test period, while Staff looked at the rate of growth from the end of 1992 to the end of the test period, which results in a much larger difference between the East and West Line growth than SFPP presents.[1283]

421. Staff next explains that it is inappropriate to include the East Line expansion in depreciation rates, stating that the depreciation rates should be based on plant actually in service.[1284] The East Line additions were outside the test period, Staff contends, and it would not be appropriate to include them because they would create an inappropriate mismatch of costs.[1285] Further, Staff asserts, if SFPP had wanted to include the East Line expansion in its rates, it could have made a filing to increase its rates.[1286]

422. Staff bases its depreciation rates for 2003 and 2004 on year-end 2002.[1287] Staff states that it did not include plant additions that went into service in 2003 and 2004 for the West Line analysis because there was little plant added during that time.[1288] The East Line had added plant in 2004, but the total dollar amount was not identified by SFPP until 2006.[1289]

423. According to Staff, depreciation rates should be based on plant actually in service, not on what may happen in the future.[1290] Therefore, Staff continues, the depreciation analysis presented by Staff does not include additions that were outside of the test period or any future additions or retirements.[1291] Considering elements outside the test period, Staff explains, would cause an inappropriate mismatch of costs.[1292]

[1282] *Id*. at 69 (citing SFPP IB at 80).

[1283] *Id*. (citing Ex. S-4 at 12).

[1284] Staff IB at 73 (citing Tr. 1869, 1971-72).

[1285] *Id*. at 73-74 (citing Tr. 1870).

[1286] *Id*. at 74 (citing Tr. 1885, 1974-75).

[1287] *Id*. (citing Tr. 1867).

[1288] *Id*. (citing Tr. 1867).

[1289] *Id*. at 74-75 (citing Tr. 1877).

[1290] Staff RB at 74 (citing Tr. 1869).

[1291] *Id*. (citing Tr. 1871).

[1292] *Id*. at 74-75 (citing Tr. 1971-72).

424. Furthermore, Staff notes that it could have performed studies for both 2003 and 2004 separately, or could have used actual plant as of the end of 2004.[1293] These approaches would allow East Line additions to be considered, but, would also change the average remaining life.[1294] Using 35 years as the average remaining life for 2003 and 2004 "would have mitigated the impact of including the 2004 East Line additions in [Staff's] analysis."[1295]

425. SFPP, Staff explains, asserts that Staff should not have relied on domestic and international crude oil reserve and production statistics when estimating future supply available for transporting over the East and West Lines, and also that Staff failed to explain how the crude oil supply translated into a 35-year economic life for SFPP.[1296] Staff responds, explaining that crude oil is used to make petroleum products, such as those that are transported over SFPP's lines.[1297] Therefore, Staff continues, the crude oil supply "is fundamental to determining the remaining life of SFPP's facilities" because if the supply is exhausted, there will be nothing for SFPP to transport.[1298] The 35-year remaining life, Staff adds, is a conservative estimate and does not include undiscovered oil which would increase the supply life.[1299] Further, Staff links its use of national petroleum product data, arguing that an increasing demand for petroleum products will also be mirrored by a demand for transportation products, and SFPP's demand area would likely follow the national trend.[1300]

426. SFPP argues, according to Staff, that Staff did not have a rational basis for extending the remaining economic life of the East and West lines by seven years, its study did not analyze the oil supply and demand any differently than the 1991 study, and is no more accurate than that study.[1301] However, Staff responds, there has been substantial growth on both lines since 1991, as well as a plethora of new data.[1302] Moreover, Staff's remaining economic life of 35 years is somewhat shorter than that

[1293] Staff IB at 75 (citing Tr. 1878).

[1294] *Id*. (citing Tr. 1957, 1958).

[1295] *Id*. (citing Tr. 1878, 1907-08).

[1296] *Id*. at 76 (citing Ex. SFW-75 at 20).

[1297] *Id*. at 77 (citing Ex. S-22 at 3; Tr. 1209-10).

[1298] *Id*. (citing Ex. S-22 at 3).

[1299] *Id*. (citing Exs. S-4 at 8, 32, 35, S-22 at 4-5).

[1300] *Id*. at 78 (citing Ex. S-22 at 6, 7).

[1301] Staff RB at 70 (citing SFPP IB at 81-83).

[1302] *Id*. at 71 (citing Ex. S-4 at 13).

projected in the 1991 study.[1303] Staff also states that the suggested remaining economic life is conservative, as it did not include undiscovered crude oil in the calculation, which would have increased the number of years of supply life.[1304]

427. Staff advocates the use of the 2003 EIA study for its demand projection, rather than the 2008 EIA study advocated by SFPP, because the 2008 report would not have existed if the study had been performed during the 2003-2004 time frame at issue.[1305] However, Staff adds, the 2008 study would also have predicted demand to increase in the future.[1306] Regardless, SFPP should not be permitted to shop beyond the test period for the least optimistic forecast, Staff maintains.[1307]

SFPP, L.P.

428. SFPP argues that the appropriate depreciation expenses for the Complaint year and test years are those calculated using SFPP's existing depreciation rates and gross plant balances.[1308] These depreciation rates are based on a 1991 depreciation study that was performed by Staff, in which it recommended that SFPP's rates be set on a system-wide basis using gross property balances for SFPP's four lines.[1309] According to SFPP, because Staff has requested a change in these rates, it must prove that the Commission's regulations provide the remedy it seeks; that the existing rates are unjust and unreasonable, and that the rates it proposes are just and reasonable.[1310] SFPP asserts that Staff did not meet its burden.[1311]

429. SFPP argues that only a carrier, such as SFPP, has the right to require that composite, or system-wide, depreciation rates be changed to component, or individual line, depreciation rates.[1312] Because SFPP has not asked that the depreciation rate be

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[1303] *Id*. at 72 (citing Ex. S-22 at 4).

[1304] *Id*. at 72 (citing Ex. S-22 at 4).

[1305] *Id*. (citing Tr. 1950).

[1306] *Id*.

[1307] *Id*. at 72-73.

[1308] SFPP IB at 72 (citing Exs. SFW-67 at 2, SFW-68 at 2).

[1309] *Id*. at 72-73 (citing Ex. SFW-112; Tr. 18-1841).

[1310] *Id*. at 73 (citing *Sea Robin*, 794 F.2d at 186-87; *Tesoro Ref. and Mktg. Co. v. Frontier Pipeline Co.*, 105 FERC ¶ 61,227, at P 24 (2003); *SFPP, L.P.*, 91 FERC at 61,507, 61,512).

[1311] *Id*.

[1312] *Id*. at 73-74 (citing 18 C.F.R. Pt 352, General Instruction 1-8(b) (2008)).

changed to line-by-line component rates, the only way for Staff to do so is to ask the Commission to direct SFPP to update its system-wide rates prospectively.[1313] While the Commission's regulations state that property account depreciation rates in effect at the time of a proposed revision must be used until revised rates are approved or modified by the Commission, Staff, according to SFPP, contends that this applies only when a carrier requests the change in depreciation rates.[1314] SFPP asserts that no such limitation exists.[1315]

430. In response to Staff arguments regarding the definition of composite, SFPP first states that "composite" can mean "both an aggregation of plant within an account and an aggregation of plant, by account, across lines."[1316] Staff, on the other hand, argued that "composite," as used in General Instruction 1-8(b) in Part 352 of the Commission regulations, "means a composite rate for all pipe line, and not a separate rate for each type of pipe.[1317] SFPP contends that this argument does not foreclose the notion that "composite" refers to depreciation rates by account based on an aggregation of plant balances across multiple lines, while component refers to the depreciation rates by account based on plant balances for a single line.[1318]

431. Further, SFPP claims that Staff confuses the record by arguing that Section 347.1(d)(1) does not apply in a complaint case, and all components of the rates are subject to challenge as of the date of the complaints.[1319] To the contrary, under Section 343.4(b) of the Commission's regulations, action on a complaint will be limited to the issues raised in the complaint, and here, no complaint challenged the existing depreciation rates.[1320] Therefore, SFPP contends, the only way in which Staff could have challenged SFPP's depreciation rates is for Staff to have requested that the Commission direct SFPP to change its existing depreciation rates.[1321] Such a change would still be subject to Section 347.1(d)(1), which governs the effectiveness of revised depreciation rates in all instances, according to SFPP, and does not indicate that it does not apply in

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[1313] *Id*. at 74 (citing 18 C.F.R. Pt 352, General Instruction 1-8(b); 18 C.F.R. § 347.1(d)(1)).

[1314] *Id*.

[1315] *Id*. (citing 18 C.F.R. § 347.1(d)(1)).

[1316] SFPP RB at 75.

[1317] *Id*. at 74-75 (citing Staff IB at 69-70).

[1318] *Id*. at 75.

[1319] SFPP IB at 75.

[1320] *Id*. (citing 18 C.F.R. § 343.4(b) (2008); Tr. 1916)).

[1321] *Id*. at 75-76 (citing 18 C.F.R. Pt. 352, General instruction 1-8(b)(2)).

complaint proceedings, nor does it specifically state that the section applies only to carriers.[1322]

432. SFPP claims that limiting Staff to a prospective change in the existing depreciation rates results in a more equitable outcome than Staff's suggested remedy.[1323] Staff could have challenged the depreciation rates at any time, and, if it had, the rates could have been reset prospectively in 2003.[1324] Staff, however, chose to wait to challenge the rates as of December 31, 2002 on August 5, 2008.[1325] By changing the East and West Line depreciation rates retroactively, SFPP contends, known and measurable changes in 2003, 2004, and beyond will be ignored, which would result in inaccurate and unjust and unreasonable depreciation rates for the locked-in periods.[1326] Allowing participants, but not the carrier, to make retroactive changes to a carrier's depreciation rates is, according to SFPP, seemingly arbitrary and capricious.[1327]

433. Further, SFPP points out that the Commission has already rejected a similar request made by Staff to change the system-wide depreciation rates to component depreciation rates on the same lines.[1328] It did not make the change because, like here, the North and Oregon Lines were not before the Commission; so, SFPP claims, there is no reason that the same conclusion should not be reached.[1329] Changing the system-wide rates to separate rates would require "reallocating the depreciation costs for the entire system" which would "require the Commission to address assets and costs" that are not before it.[1330]

434. SFPP argues that Staff has not carried its burden of proving that the depreciation rates should be changed.[1331] It has not proven, according to SFPP, that the existing system-wide rates are unjust and unreasonable.[1332] Staff claims that it is inappropriate to use the same depreciation rates for all four SFPP lines, which are of different vintages;

[1322] *Id*. at 76; SFPP RB at 76.

[1323] SFPP IB at 76.

[1324] *Id*. (citing Tr. 1930-31; Ex. S-22 at 17).

[1325] *Id*. at 76-77.

[1326] *Id*. at 77 (citing Tr. 1874-75, 1877-78).

[1327] SFPP RB at 75.

[1328] SFPP IB at 77 (citing December 2005 Order at P 101).

[1329] *Id*. at 77-78.

[1330] *Id*. at 78 (citing December 2005 Order at P 102).

[1331] *Id*. at 79.

[1332] *Id*.

SFPP attempts to refute this claim, pointing out that Staff recommended using system-wide depreciations rates for SFPP back in 1991 and has not indicated what is different between then and now that would render the rates inappropriate.[1333] Staff claims that the departure from system-wide depreciation rates is justified because the East and West Lines have grown at different rates since 1992.[1334] SFPP argues, in contrast, that their growth rates were actually consistent with one another, which supports the use of system-wide depreciation rates.[1335] It is also unclear, SFPP notes, why the system-wide rates are appropriate for the North and Oregon Lines, but not for the East and West Lines because Staff has not provided a rational basis for why this is so.[1336]

435. Additionally, Staff has not shown that the depreciation rates it suggests are just and reasonable, according to SFPP.[1337] It has not provided a rational basis for extending the remaining economic life of the lines by 7 years, SFPP claims.[1338] Further, SFPP maintains, Staff has not shown that the data it relies upon in this proceeding is any different from that relied upon in 1991.[1339] Moreover, Staff has not shown that its projections for demand for refined petroleum products are more accurate than the projections used in 1991.[1340] SFPP concludes that all Staff has shown is that oil supply will be available into the future and there will be demand for the products that SFPP ships.[1341] Staff, SFPP continues, arbitrarily cut the remaining economic life at 35 years based on speculation, with no reason why the cut off could not just as well have been 30 years or fewer.[1342]

436. SFPP believes that the 1991 Study which underlies SFPP's existing system-wide depreciation rates is more reliable than the new study presented by Staff in this proceeding, which is based on a less thorough supply and demand analysis and lacks record support for projections of demand beyond 2025.[1343] The 1991 study considered the future supply of crude oil and future demand for refined petroleum products, as well

[1333] *Id*. at 79-80 (citing Ex. SFW-112 at 1-2; December 2005 Order at P 102).

[1334] *Id*. at 80 (citing Ex. S-4 at 12).

[1335] *Id*. (citing Ex. SFW-68 at 127-30).

[1336] *Id*. at 81 (citing Tr. 1861-62, 1925-26).

[1337] *Id*.

[1338] *Id*. at 81-82.

[1339] *Id*. at 82 (citing Tr. 1950-53).

[1340] *Id*.

[1341] *Id*. at 83.

[1342] *Id*. (citing Ex. S-4 at 8).

[1343] SFPP RB at 77.

as the refining capacity of SFPP's lines, which was not considered in the new study.[1344] Further, Staff uses a 2003 EIA estimate for demand projections through 2025, SFPP notes, which Staff assumes can be extrapolated out to 2037, despite the fact that the more current 2008 EIA estimate only projects to 2030.[1345] Staff bases its 35-year remaining economic life on its assumption, SFPP contends.[1346] SFPP asserts that the demand projections underlying the 1991 Study are more consistent with the projections of future demand in the 2008 EIA study, indicating that expectations of future supply and demand have not changed and neither should the remaining economic lives of the facilities.[1347]

437. SFPP next points out that Staff admitted to achieving lower depreciation rates by excluding additions to and retirements of plant beyond December 31, 2002.[1348] While 2003 and 2004 are test years in this proceeding, SFPP notes that Staff excluded the 2003 and 2004 plant additions and retirements, even though it does not dispute that they should be included in the calculation of depreciation rates.[1349] The plant additions and retirements were known and measureable in 2008, when Staff conducted its depreciation analysis, and thus, because of this exclusion, Staff's recommended rates are unjust and unreasonable.[1350] Additionally, SFPP continues, all plant additions and retirements between 2002 and 2007 were known at the time that Staff conducted its analysis, so it is only appropriate that the rates accurately reflect the plant in service during the locked-in periods.[1351] Had Staff included the additions and retirements in its depreciation rate calculations, the resulting rates would have been higher, SFPP alleges.[1352]

438. Staff, according to SFPP, claims that the West Line additions and retirements were minimal, while those additions to the East Line made in 2004 were not identified until 2006.[1353] SFPP points out that the retirements and additions were, however, known at the time that Staff conducted its analysis and should have been included.[1354] While Staff

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[1344] *Id*. (citing Exs. SFW-12 at 6-8, 15-16, S-4 at 23-35).

[1345] *Id*. at 77-78 (citing Exs. SFW-118, S-4 at 33-34, SFW-119; Tr. 1936-37, 1953-54).

[1346] *Id*. at 78 (citing Tr. 1926-27; Ex. S-4 at 35).

[1347] *Id*. at 78-79 (citing Exs. SFW-112, SFW-119).

[1348] SFPP IB at 83-84 (citing Tr. 1867, 1892-93, 1932, 1956-57).

[1349] *Id*. at 84 (citing Tr. 1877).

[1350] *Id*. (citing Tr. 1839-40).

[1351] *Id*. at 85.

[1352] SFPP RB at 80 (citing Tr. 1864-66).

[1353] *Id*. (citing Staff IB at 74-75).

[1354] *Id*. at 81 (citing Tr. 1874, 1877).

claims that future, out of test period additions should not be included in the depreciation analysis, SFPP responds, arguing that "when the Staff recommends depreciation rates in a non-complaint case context, it [the Commission] considers future additions to be appropriately included in the depreciation analysis."[1355] Staff claims that SFPP could file to adjust its depreciation rates if it believes they need to be adjusted to reflect future additions and retirements, but SFPP notes that it can only change them prospectively, and would have no ability to correct them for the period from January 1, 2003 to the present.[1356]

Discussion and Findings

439. According to Staff, SFPP's current depreciation rates are out of date.[1357] Staff argues that while a depreciation study should be done every 3-5 years, SFPP's most current depreciation study was done 17 years ago, in 1991.[1358] SFPP, on the other hand, recommends that the existing depreciation rates, which are based on a 1991 depreciation study performed by Staff, continue to be used.[1359] Further, according to SFPP, because Staff proposes changing the rates, it must prove that the Commission's regulations provide this remedy, and that the existing East and West Line rates are unjust and unreasonable while the new proposed rates are just and reasonable.[1360] Staff, SFPP argues, has not met this burden and the rates should not be changed.[1361]

440. Staff did not provide sufficient evidence that its 1991 depreciation study, included in the record as Exhibit No. SFW-112, should no longer be used as the basis for SFPP's depreciation rates. When a party files a complaint against a pipeline's rates pursuant to Section 13(1) of the Interstate Commerce Act, that party has the burden of showing that the rates currently on file are unjust and unreasonable.[1362] As determined in Issue I.A, Complainants bear the burden of proof in this proceeding. The depreciation rate is part of a pipeline's cost of service and can therefore be considered when determining whether

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[1355] *Id*. at 82 (citing Tr. 1883-84, 1890-92; Ex. SFW-116).

[1356] *Id*. at 82-83 (citing Tr. 1915).

[1357] Staff IB at 62.

[1358] *Id*.

[1359] SFPP IB at 72.

[1360] *Id*.

[1361] *Id*.

[1362] *See SFPP, L.P.*, 66 FERC ¶ at p. 61,479, n. 10; Order No. 561, Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992, FERC Stats. & Regs. ¶ 30,985 at 30,955).

the rates at issue are just and reasonable.[1363] Here, however, the Complainants did not choose to address the issue of depreciation rates. Staff, as the only participant that challenged SFPP's existing depreciation rates directly, takes on the burden of proving that the existing depreciation rates are unjust and unreasonable and has failed to do so for the numerous reasons advanced by SFPP in its initial and reply briefs as summarized above and hereby adopted by the undersigned.

C. What are the appropriate allocation factors for investment and operating expenses?

Positions of the Parties

ACC Shippers

441. The ACC Shippers state that they do not address this issue.[1364]

Indicated Shippers

442. The Indicated Shippers state that they do not take a position on this issue.[1365]

Commission Trial Staff

443. Staff explained that it used the allocation factors advocated by SFPP.[1366]

SFPP, L.P.

444. SFPP refers to Section IV.A.2 for discussion of this issue.[1367]

Discussion and Findings

445. The appropriate allocation factors for investment and operating expenses are determined with Issue IV.A.2.

[1363] *Williston Basin Interstate Pipeline Company*, 107 FERC ¶ 61,164, at PP 23-25 (2004).

[1364] ACC IB at 71.

[1365] IS IB at 47.

[1366] Staff IB at 79.

[1367] SFPP IB at 85.

D. What is the appropriate development and allocation of environmental remediation expenses?

<u>Positions of the Parties</u>

ACC Shippers

446. The ACC Shippers state that they do not address this issue.[1368]

Indicated Shippers

447. According to the Indicated Shippers, SFPP did not use the data that was provided by its own environmental witness.[1369] Further, they allege that SFPP's witness must not have reviewed the environmental remediation information used in SFPP's cost of service because, if he had, he would have seen the errors in the amounts used.[1370] The Indicated Shippers feel that the data used by SFPP for environmental remediation expenses is not trustworthy if SFPP's expert did not supply or review this data.[1371]

Commission Trial Staff

448. Staff asserts that SFPP's Account No. 320 should be reduced so as to eliminate the East Line 2003 remediation expenses of $17,446 and the 2003 West Line expenses of $2,353,353, as well as the 2004 remediation expenses of $1,777,708 for the East line and $1,808,516 for the West Line.[1372] Staff notes the following issues that would warrant the elimination: (1) SFPP's failure to remediate petroleum products spills in a timely fashion and to collect expenses from ratepayers at that time; (2) SFPP's failure to recover expenses from other sources; (3) SFPP's failure to adhere to its own standard for the timing of clean-up; and (4) whether SFPP has offset its claimed remediation expenses with a credit from an environmental reserve that the ratepayers have already paid.[1373] Further, Staff questions whether SFPP's actions with regard to spills in California were legal.[1374]

[1368] ACC IB at 71.

[1369] IS IB at 47 (citing Tr. 941).

[1370] *Id*. at 48.

[1371] *Id*.

[1372] Staff IB at 79-80.

[1373] *Id*. at 80 (citing Exs. S-1 at 12-13, S-18 at 4, 6-11).

[1374] *Id*.

449. According to Staff, a utility is presumed to be running prudent operations unless a participant raises a "serious doubt" about the prudency of expenses, at which time the utility must prove that such expenses were just and reasonable.[1375] While Staff states that it presented evidence which raises such "serious doubt" about SFPP's actions with respect to petroleum products' spills, SFPP, according to Staff, did not attempt to present evidence to the contrary.[1376]

450. Staff wishes to remove SFPP's environmental remediation expense first because it should have been recovered in an earlier time period.[1377] A typical clean-up time frame is six years, indicating that, according to Staff, clean-up of the spills should have been complete by 2002, seeing as the final spill occurred in 1996.[1378] Staff cites *Pennsylvania Power & Light Co.*, 77 FERC ¶ 63,012, at 65,034 (1996) for the matching principle, which requires "customers receiving a service to pay for the costs attendant to providing the service," and for the concept of intergenerational equity, which assures that customers pay for costs today, rather than shifting that cost responsibility on to future customers.[1379] Staff states that, contrary to these principles, SFPP attempts to remediate and expense in 2003 and 2004 costs incurred as early as 1965.[1380] SFPP misses the point of Staff's arguments and attempts to "assume away" Staff's concerns that the expenses violate principles of matching and intergenerational equity and are not just and reasonable.[1381] However, Staff maintains, the concern is not whether the expense was finally incurred in 2003 and 2004, as SFPP paints the picture, but is that SFPP is attempting to charge ratepayers for events that occurred prior to 2003 and 2004 which should have been sought in earlier rate filings.[1382]

451. Next, Staff claims that SFPP should be responsible for those spills that it knew or should have known had occurred before it bought the pipeline in 1998, at which time it assumed risk and responsibility for any spills that had not been properly cleaned up.[1383] SFPP's current ratepayers should not be responsible for costs that SFPP should have

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[1375] *Id*. (citing *Anaheim v. FERC*, 669 F.2d 799, 809 (D.C. Cir. 1981)).

[1376] *Id*. at 80-81.

[1377] *Id*. at 83 (citing Ex. S-1(A) at 12).

[1378] *Id*. at 83-84 (citing Ex. S-1 at 12).

[1379] *Id*. at 84

[1380] *Id*. (citing Tr. 983; *Columbia Gas Transmission Corp.*, 75 FERC ¶ 61,017, at 61,061 (1996)).

[1381] Staff RB at 82 (citing Tr. 2171).

[1382] *Id*.

[1383] Staff IB at 85 (citing Ex. S-18 at 4).

known about back in 1998, Staff argues.[1384] Staff continues, explaining that SFPP should have known about the various spills, citing specific examples of how SFPP had been informed of the spills or how it could have been informed with a degree of due diligence.[1385] SFPP should not be allowed "to recover the remediation costs at issue on the theory that SFPP was an innocent, bona fide purchaser for value without knowledge of the spills."[1386] Further, Staff points out, because the merger was essentially the addition of a partner to an ongoing business, SFPP cannot argue that the merger was an arms-length purchase and it would not have been aware of the spills.[1387]

452. According to Staff, the risk of the pre-1998 spills should have been accounted for in Kinder Morgan's negotiations to merge with Santa Fe Pacific Pipeline in 1998 and Kinder Morgan should have negotiated a discounted purchase price due to the expense resulting from the spills.[1388] Kinder Morgan's unitholders should have already received the benefits of a discount from taking this risk, and SFPP should then not be able to pass those already accounted-for risks on to current ratepayers by recovering additional clean up costs.[1389] Staff believes it is clear, despite SFPP's contentions, that Kinder Morgan's purchase price is relevant in this proceeding for these reasons.[1390]

453. Furthermore, Staff contends that SFPP should be denied recovery because it did not show that it exhausted all other remedies for recovering the expenses, such as self-insurance, third parties, and outside insurance.[1391] Customers, Staff continues, "should only be charged rates that fairly track the costs for which they are ultimately responsible."[1392] Staff explains, first, that SFPP is self-insured for environmental remediation expenses, which means that the ratepayers already pay for these expenses and it would be inequitable to make them pay for this expense a second time.[1393] SFPP,

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[1384] *Id*.

[1385] *Id*. (citing Ex. S-36 at 8).

[1386] *Id*. at 86.

[1387] *Id*. (citing *In re Kinder Morgan Energy Partners, L.P. For Authority To Acquire Control of SFPP, L.P.*, 1998 Cal. PUC LEXIS 192, 78 CPUC2d 291 (1998)).

[1388] Staff RB at 82-83 (citing Ex. S-36 at 7-8).

[1389] *Id*. at 83.

[1390] *Id*. at 83-84.

[1391] Staff IB at 86-87 (citing Ex. S-1 at 13).

[1392] *Id*. at 87 (citing *Town of Norwood v. FERC*, 962 F.2d 20, 25 (D.C. Cir. 1992); *Union Elec. Co. v. FERC*, 890 F.2d 1193, 1198 (D.C. Cir. 1989)).

[1393] *Id*. (citing Ex. S-1 at 12).

Staff points out, has millions of dollars in reserve to pay for these expenses, and should not be allowed to recover additional expenses in this proceeding.[1394]

454. Staff also argues that SFPP did not prove the amount of its actual remediation expenses, and Staff believes that the expenses are overstated.[1395] The amount that SFPP claims to have spent, according to Staff, appears to more likely be the amount of the amortization of the contributions to the aforementioned reserves, an amount SFPP requested, but was denied by the Commission.[1396] That amount, $764,500, represented contributions to reserves through SFPP's cost of service.[1397] Staff compares that to the $784,610 that SFPP claims it spent on environmental remediation in 1994, and finds the similarity between the expenses suspicious.[1398]

455. With respect to contributions from third parties, Staff argues that SFPP should, but has not, sought recovery from any other responsible parties; it has sued only insurance companies.[1399] SFPP claimed it did not know who else to sue, but Staff claims that SFPP did not fully consider the options and appears to have been unwilling to do so.[1400] Moreover, ratepayers pay for insurance premiums and would be paying twice if covered expenses were not offset with insurance proceeds; SFPP, however, has not shown that it has pursued private insurance remedies, Staff asserts.[1401] SFPP, on the other hand, claims that it exhausted its insurance coverage for all but three sites in a Settlement Agreement with the insurance companies in which it waived any rights to pursue recovery under its policies.[1402] Staff notes that SFPP claims that it already credited its shippers the proceeds of these settlements.[1403] Staff, however, is unsure as to why SFPP chose to waive the benefits of its policies even though its ratepayers paid the premiums and is also unsure as to why SFPP settled for less than the full amount it claimed.[1404] Most importantly, according to Staff, SFPP limited the insurance companies' future liability for spills.[1405]

[1394] *Id*. at 88.

[1395] *Id*. (citing Ex. BPX-52).

[1396] *Id*. (citing *SFPP, L.P.*, 80 FERC ¶ 63,014, at 65,170 (1997)).

[1397] *Id*. at 89.

[1398] *Id*. (citing Ex. BPX-52).

[1399] *Id*. (citing Exs. S-38, S-18 at 9).

[1400] *Id*. at 89-90 (citing Ex. S-37 at 5).

[1401] *Id*. at 90 (citing Ex. S-36 at 9-10, 12-14).

[1402] Staff RB at 85 (citing SFPP IB at 87; Exs. SFW-140 at 1, SFW-129 at 14)).

[1403] *Id*. at 86.

[1404] *Id*. (citing Ex. BPX-52, S-1 at 13).

[1405] *Id*. (citing Ex. S-36 at 9).

456. Regarding the insurance policies, Staff states that SFPP has failed to produce those that were in effect prior to 2000, when most of the spills occurred.[1406] The missing policies are crucial to the support of SFPP's actions regarding the Settlement, and thus, based on the adverse inference rule, according to Staff, SFPP has not met its burden of demonstrating that the costs to shippers resulting from its waiver of its insurance interest are just and reasonable.[1407] SFPP does not provide proof that it under recovered from the insurance companies, does not state that it resolves claims with *all* insurance carriers, and did not offer witness testimony to explain the limited proof that it did offer with regard to the amounts it recovered under the Settlement.[1408]

457. Staff finds that SFPP provided data responses which lacked useful information with which to challenge its lack of evidence with respect to third-party contributions.[1409] Staff cites as an example a request asking for the names of the party responsible for each spill, to which SFPP responded with only a list of the spills and their causes.[1410] Staff also contends that SFPP's claim that lessees at Colton Terminal ("Colton") are responsible for remediating their own releases is a misinterpretation; in reality, according to Staff, the lessees and SFPP have joint and several liability, and thus SFPP can sue the lessees for contributions.[1411]

458. SFPP should be denied recovery of some environmental remediation costs, according to Staff, because it violated environmental laws when it (or its predecessor) spilled petroleum products and failed to clean them up.[1412] SFPP, Staff notes, even admitted that it caused the spills and failed to clean them up.[1413] Staff contends that SFPP has not proven that it is optimizing environmental compliance costs, even though the economic detriment from the spills, according to Staff, is clear.[1414] SFPP did not do a

[1406] *Id*. at 87.

[1407] *Id*. (citing *Town of Highlands, N.C. v. Nantahala Power & Light Co.*, 37 FERC ¶ 61,149, at 61,357 (1986)).

[1408] *Id*. at 87-89 (citing Exs. SFW-129 at 14, SFW-140; SFPP IB at 86-87; Tr. 2210).

[1409] *Id*. at 91.

[1410] *Id*. (citing Ex. S-37 at 5).

[1411] *Id*. at 92 (citing Tr. 1003).

[1412] Staff IB at 90 (citing *Mountain States Telephone & Telegraph Co. v. FPC*, 939 F.2d 1035 at 1043 (D.C. Cir. 1991)).

[1413] *Id*. at 90-91.

[1414] *Id*. at 91 (citing Ex. BPX-52; *Iroquois Gas Transmission System v. FERC*, 145 F.3d 398, 402 (D.C. Cir 1998)).

cost/benefit analysis showing that the customers would be better off paying for clean up than avoiding spills, and admitted it would be less expensive to make pipelines that do not corrode enough to leak large amounts of petroleum product than to remediate and pay penalties for spills.[1415]

459. SFPP was found to have violated Division 7 of the California Water Code for its spills at Colton and failure to remediate them.[1416] With respect to SFPP's other California sites, Staff asserts that SFPP has not justified why it has delayed in remediating the spills.[1417] Staff makes the inference that SFPP's delay caused it to violate Division 7 and that the spills are being remediated because otherwise SFPP's violations of Division 7 would continue.[1418]

460. Staff next argues that SFPP's imprudence should bar its recovery of environmental remediation costs.[1419] SFPP, Staff contends, did not demonstrate that it properly maintained and operated its pipelines at the time of each spill, and it has not shown that it is just and reasonable to pass the costs on to the ratepayers.[1420] In fact, Staff states that SFPP admitted to causing most, if not all, of the spills.[1421] SFPP did not, however, introduce evidence that it is "typical or otherwise reasonable for a Petroleum Products pipeline in similar circumstances to cause spills of this number and magnitude for reasons such as corrosion."[1422] SFPP's response to these spills, Staff continues, was delayed, which may have caused further pollution, thus increasing recovery costs.[1423] Staff argues that SFPP was unable to indicate any cause for the delay, why it waited so long to clean up spills, and why the clean-up is still ongoing today if early clean-up would have been more cost effective.[1424]

[1415] *Id*. at 91.

[1416] *Id*. (citing Ex. S-52 at 5).

[1417] *Id*. at 92 (citing Ex. S-1 at 12).

[1418] *Id*. (citing *Highlands v. Nantahala*, 37 FERC at 61,357).

[1419] *Id*.

[1420] *Id*. at 93 (citing *Cleveland Electric Illuminating Co.*, 19 FERC ¶ 63,013, at 65,088 (1982); *Midwestern Gas Trans. Co.*, 36 FPC 61, 70 (1996), *reh'g denied*, 36 FPC 599, *aff'd*, *Midwestern Gas Trans Co. v. FPC*, 388 F.2d 444 (7th Cir. 1968), *cert. denied*, 392 U.S. 928 (1968)).

[1421] *Id*.

[1422] *Id*. at 94.

[1423] *Id*.

[1424] *Id*. (citing Ex. S-1 at 12).

461. According to Staff, SFPP has not shown that it exercised reasonable care in creating and amending spill response programs or security measures.[1425] While SFPP claims that spills could have been caused by third parties, it does not provide the security measures it considered or installed after a spill which would prevent the amount of future spills or protect the environment nearby.[1426]

SFPP, L.P.

462. SFPP argues that it prudently incurred the 2003 and 2004 environmental remediation expenses that are parts of its East and West Line cost of service studies.[1427] No party, SFPP states, was able to provide evidence on the subject of SFPP's supposed imprudence.[1428]

463. SFPP first argues that it had no ability to recover the 2003 and 2004 environmental remediation costs from an insurance company or a known, liable, third party.[1429] SFPP explains that it entered into a Settlement Agreement with various insurance carriers, and all claims related to releases prior to March 1, 1999 were settled under that agreement and all proceeds were already credited to SFPP's shippers.[1430] The Colton Terminal is one of the sites included in this Settlement, SFPP states, so SFPP cannot seek reimbursement from insurance carrier for any pre-March 1, 1999 Colton releases.[1431] There were further releases after March 1, 1999, but they cost less than $1,000,000 to remediate, which is SFPP's insurance policy retention amount, and thus SFPP was unable to make any claim for the environmental remediation work with respect to those releases.[1432] There were also no known liable third parties involved in the Colton spills.[1433] Further, the remediation costs for any releases caused by lessees at the Colton

[1425] *Id*. at 95.

[1426] *Id*. (citing Ex. S-37 at 5).

[1427] SFPP IB at 85-86 (citing Exs. SFW-67 at 141, SFW-68 at 146, SFW-74 at 6-11, 13).

[1428] *Id*. at 86.

[1429] *Id*. (citing Exs. SFW-67 at 141, SFW-68 at 146; Tr. 1005-06, 1010).

[1430] *Id*. at 86-87 (citing Exs. SFW-134, SFW-140 at 1, SFW-129 at 14; Tr. 1005, 2191-92).

[1431] *Id*. at 87 (citing Ex. SFW-134 at 5; Tr. 996-97).

[1432] *Id*. at 87-88 (citing Exs. SFW-136 at 4, SFW-137 at 3, SFW-139).

[1433] *Id*. at 88.

facilities are not included in SFPP's environmental remediation costs, and were incurred by the lessees, not by SFPP.[1434]

464. SFPP also states that the following sites are covered by the Settlement: Liberty, Roll, La Habra, Coachella, Norwalk, and Lone Butte.[1435] For post-1999 releases at these sites, SFPP states that it produced evidence explaining why it was unable to collect under an insurance policy and that there are no known liable third parties at these sites.[1436] With respect to environmental remediation costs of $3,408 related to Watson Station, SFPP explains that this amount is the portion of the total that was expended by SFPP for testing, which confirmed that SFPP was not a contributor to pollution on adjacent property.[1437] Because SFPP was not a contributor, and because the total amount spent at Watson Station in 2004 was only $7,269 (policy retention amount is $1,000,000), there is no insurance policy under which SFPP can make a claim for this testing.[1438] Like the other sites, SFPP notes that there are costs included that were related to releases potentially caused by third parties.[1439] SFPP did similar analyses for the releases at Yuma Booster, Benson Arizona, and El Paso Suction Line, all of which showed that SFPP could neither make claims under insurance polices or collect from third parties.[1440]

465. Staff voiced a series of additional concerns with respect to the 2003 and 2004 environmental remediation costs.[1441] First, Staff claims that the remediation projects should have been completed in 1-6 years, but SFPP points out, and Staff agreed, that this is not a reason for excluding the costs when the work occurred in 2003 and 2004.[1442] Next, in response to Staff's argument that, if SFPP received money from its parent or from third parties, its ratepayers should be credited, SFPP states that there is no evidence that this concern is valid.[1443] Staff's statement that Kinder Morgan's purchase price for SFPP should have reflected a discount for SFPP's remaining remediation expenses, according to SFPP, is irrelevant because SFPP's rate base does not reflect this purchase

[1434] *Id*. at 88-89 (citing Ex. S-52).

[1435] *Id*. at 90-91.

[1436] *Id*. at 90-92.

[1437] *Id*. at 92 (citing Ex. SFW-74 at 11).

[1438] *Id*. at 92-93.

[1439] *Id*. at 93.

[1440] *Id*. at 93-95.

[1441] *Id*. at 96.

[1442] *Id*. (citing Ex. SFW-74 at 6-8, 9-11; Tr. 2163-71).

[1443] *Id*. at 96-97.

price.[1444] Staff also argued that the remediation costs should not include amounts for civil penalties, but SFPP notes that these amounts do not include civil penalties and there is no evidence to the contrary.[1445]

466. Referring back to the Watson Station expenditure, Staff claims that it was a one-time occurrence.[1446] SFPP responds that no other remediation would be needed at Watson Station in the future, and the amount of $3,408 is a reasonable representation of expected future annual environmental remediation costs at Watson, based on past average annual costs from 1994-2004 of $4,470.[1447] There is no evidence showing that a recurrence of expenditures at Watson is unlikely, SFPP states, and the amount should not be treated as a non-recurring expense.[1448]

467. No party in this proceeding, according to SFPP, raised a valid prudency challenge to SFPP's 2003 and 2004 environmental remediation costs.[1449] These costs, SFPP continues, should be considered "prudently incurred unless and until a participant presents 'concrete evidence' casting a 'serious doubt' as to the prudence of SFPP's conduct in incurring the disputed costs."[1450] Serious doubt, SFPP notes, must be "raised in the context of the information that was available at the time the carrier became committed to incurring the challenged expenses."[1451] No party met this standard, SFPP asserts, and thus the burden did not shift to SFPP to prove that its costs were prudently incurred.[1452]

468. Staff, according to SFPP, attempted to raise its prudence claim for the first time in its initial brief, which fails to put SFPP on notice so that it may present evidence

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[1444] *Id*. (citing Tr. 2171-72).

[1445] *Id*. at 96-97 (citing Tr. 2176-77).

[1446] *Id*. at 96 (citing Tr. 2152-53).

[1447] *Id*. at 97.

[1448] *Id*. at 97-98; SFPP RB at 83.

[1449] SFPP RB at 84.

[1450] *Id*. (citing *Iroquois Gas Transmission System, L.P.*, 87 FERC ¶ 61,295 at 62,168 (1999)).

[1451] *Id*. at 86 (citing *New England Power Co.*, 31 FERC ¶ 61,047, at 61,084 (1985), *aff'd sub nom, Violet v. FERC*, 800 F.2d 280 (1st Cir. 1986)).

[1452] *Id*. (citing Tr. 2144, 2166, 2170, 2214; *Indiana and Michigan Municipal Distributors Association v. Indiana Michigan Power Co.*, 62 FERC ¶ 61,189, at 62,239 (1989)).

regarding this claim.[1453] However, Staff does not present evidence supporting its allegations.[1454] Further, Staff's unsupported assumptions from its initial brief do not, SFPP alleges, constitute evidence that can create "serious doubt."[1455] Staff did not, as it claims, question its witness on SFPP's failure to remediate the spills in a timely fashion and collect from ratepayers, nor did it ask questions regarding SFPP's failure to follow its own clean-up timeline.[1456] Further, the questions Staff asked regarding the legality of SFPP's spill responses were not based on concrete evidence, SFPP contends, and the record does not show that SFPP engaged in any illegality.[1457] And, SFPP notes, regardless, a violation of environmental laws is not sufficient to raise serious doubt.[1458] According to SFPP, "the Commission permits pipelines to recover the costs of remediating such releases, which by their very nature often violate at least one environmental law."[1459] SFPP further asserts that the "findings of fact" in Staff's brief are not based on record evidence and do not constitute "concrete evidence."[1460]

469. Staff also failed to provide evidence of any delay that resulted in additional environmental remediation costs for 2003 and 2004.[1461] Moreover, SFPP continues, Staff made an erroneous conclusion that SFPP did not remediate any sites until 1991, which is based on Staff's incorrect assumption that SFPP did not perform remediation activities until Cleanup and Abatement Orders ("CAO") were issued.[1462] SFPP also points out that Staff did not identify any claims regarding SFPP's supposed untimeliness or any delay at hearing.[1463]

470. SFPP next responds to Staff's question as to whether SFPP optimized its environmental compliance costs.[1464] According to SFPP, the record does not show that

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[1453] *Id*. at 85 (citing *Iroquois Gas Transmission System, L.P.*, 87 FERC at 62,168).

[1454] *Id*. at 86 (citing Tr. 2168-71).

[1455] *Id*.

[1456] *Id*. (citing Exs. S-18 at 4, SFW-74 at 3-4, SFW-132 at 5, SFW-129 at 2; Tr. 2163-71, 2207-09).

[1457] *Id*. at 86-87 (citing Staff IB at 80; Exs. SFW-132 at 2-4, SFW-74 at 6-11; Tr. 979).

[1458] *Id*. at 87.

[1459] *Id*.

[1460] *Id*. at 87-88.

[1461] *Id*. at 88.

[1462] *Id*. (citing Staff IB at 81-82; Exs. S-50 at 2, S-36 at 4, BPX-52).

[1463] *Id*. at 89 (citing Tr. 2138-53).

[1464] *Id*.

SFPP failed to do so or that SFPP failed to follow industry standards.[1465] Further, SFPP points out that it may not know what the optimal environmental remediation method is until remediation efforts have already begun, and then it optimizes the cleanups as new information arises.[1466] Staff, SFPP states, also questioned SFPP's maintenance and operation of its pipeline, but SFPP explained that it properly maintains and operates the pipeline and that the releases on its system are similar to what other systems experience.[1467]

471. Staff, according to SFPP, assumes that releases should have been remediated in one to six years and also assumes that only customers at the time of a release should be responsible for the then-present and future remediation costs.[1468] SFPP, however, states that a pipeline is permitted to recover all costs it prudently incurs within the test period, which, in this case, includes environmental remediation costs incurred in 2003 and 2004.[1469]

472. In response to Staff's claim that KMEP assumed responsibility for releases prior to the date it acquired SFPP and also agreed to forgo the right to recover through rates for those releases, SFPP argues that it is entitled to recover operating costs regardless of who owns the pipeline.[1470] Moreover, SFPP continues, the amount that KMEP paid for SFPP is irrelevant as to the issue of SFPP's operating costs in 2003 and 2004; the purchase price did not change the amount of environmental remediation performed, nor did it change SFPP's rate base.[1471]

473. The Indicated Shippers also argued against SFPP's environmental remediation costs.[1472] According to them, SFPP notes, SFPP's cost of service studies did not utilize the data provided by SFPP's witness, Michael A. Hanak ("Hanak").[1473] However, SFPP responds, all costs were included except the 2003 costs for Benson.[1474] The Indicated Shippers also claimed that SFPP's witness was unable to identify whether remediation

[1465] *Id*.

[1466] *Id*. (citing Tr. 945-46; Tr. 1016-17).

[1467] *Id*. at 89-90 (citing Staff IB at 92-94; Tr. 953, 2166; Ex. SFW-74 at 12-13).

[1468] *Id*. at 90-91.

[1469] *Id*. at 91 (citing Ex. SFW-67 at 141, SFW-68 at 146).

[1470] *Id*. at 92.

[1471] *Id*. at 93 (citing Tr. 2172).

[1472] *Id*. at 95.

[1473] *Id*.

[1474] *Id*. (citing Exs. SFW-139, SFW-67 at 141).

expenses he described in his testimony were subtracted from SFPP's environmental reserve.[1475] SFPP explains, stating that the amounts identified in his testimony were actual expenditures, not the reserve expenditures or estimates, and there is no ratepayer-funded reserve to be credited.[1476]

Discussion and Finding

474. There is a presumption that a public utility is operating in a prudent manner;[1477] however, if a participant in a proceeding "creates a serious doubt as to the prudence of an expenditure, then the applicant [utility] has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent."[1478] It is well established that "the extent of evidence necessary to trigger the utility's obligation to establish prudence needs to be more than a 'bare allegation of imprudence.'"[1479] In the instant proceeding, Staff asserts that "the record is replete with evidence that raises serious doubt about SFPP's actions (or inaction) with respect to Petroleum Products' spills."[1480] Staff stands alone in its position that SFPP should be denied recovery of its environmental remediation costs for 2003 and 2004. Staff offers Exhibit Nos. S-1 at 13-14 and S-37 at 9-10 in support of its position; however, a review of the referenced exhibits, particularly when considered in association with the testimony offered by Staff on this issue, fails to create serious doubt that SFPP acted imprudently in incurring the remediation costs. It is the determination of the undersigned that SFPP should be permitted to recover the environmental remediation expenses it incurred in 2003 and 2004 that are part of its East and West Line cost of service studies.[1481]

475. Staff also argues that SFPP should be denied recovery because it has not shown that it has exhausted all remedies for recovering costs from self-insurance, third parties, and outside insurance.[1482] SFPP, in response, provided persuasive testimony explaining that all releases in question are either covered by Settlements or Insurance Policies with retention amounts that are higher than the expenses incurred, and thus SFPP cannot collect reimbursement in this manner. Also, for each spill, there is either no known liable third-party, or SFPP has already collected from these third parties.

[1475] *Id*. at 96 (citing IS IB at 48; Tr. 932).

[1476] *Id*. (citing Tr. 932).

[1477] *Anaheim v. FERC*, 669 F.2d at 809.

[1478] *Id*.

[1479] *Iroquois Gas Transmission System, L.P.*, 87 FERC at 61,268.

[1480] Staff IB at 80.

[1481] See Exs. SFW-67 at 141, SFW-68 at 146.

[1482] Staff IB at 86.

476. According to Staff, if SFPP is self-insured for environmental remediation expenses, then SFPP's ratepayers are already paying for this expense and should not be charged again for clean-up.[1483] The Commission addressed this principle in *Tennessee Gas Pipeline Co.*, 70 FERC ¶ 61,076, at 61,199 (1995), where it required Tennessee Gas Pipeline to supply information regarding its insurance settlements in order to determine whether insurance proceeds covered certain costs. A pipeline "should only be able to recover environmental costs that are not covered by insurance," and the Commission will only allow the collection of environmental costs if they are credited or offset by the recovery of insurance proceeds.[1484]

477. SFPP has already credited ratepayers for proceeds from a 1999 Settlement with a number of insurance carriers for claims relating to a number of sites on SFPP's facilities.[1485] These sites include Colton Terminal, Liberty, Roll, La Habra, Coachella, Norwalk, Lone Butte, and Watson Station.[1486] Colton also had two additional releases, but SFPP cannot make a claim for these releases because the environmental remediation costs incurred by SFPP were less than the policy retention amount for pollution liability in the insurance policies.[1487] The same is true for a June 1995 release at Yuma Booster, which cost SFPP $210,897, which is less than $250,000, the lowest policy retention amount SFPP has ever had.[1488] Likewise, the release at Benson, Arizona cost $400,000 in environmental remediation, while the insurance policy had a retention amount for pollution liability of $1,000,000.[1489] Further, SFPP is not able to collect from known liable third parties for its 2003 and 2004 remediation costs.[1490]

478. The Indicated Shippers do not challenge SFPP's environmental remediation costs to the extent that Staff does, but they do argue that SFPP did not use the data provided by Hanak, its environmental remediation witness, and also argue that Hanak did not review the data utilized by SFPP witness Ganz in his cost of service calculations.[1491] Therefore,

[1483] *Id*. at 87.

[1484] *Tennessee Gas Pipeline Co.*, 70 FERC at 61,199.

[1485] SFPP IB at 86.

[1486] Ex. SFW-134; SFPP IB at 86.

[1487] SFPP IB at 87; Exs. S-53 at 4, SFW-136 at 4, SFW-137 at 3,

[1488] SFPP IB at 93; Ex. SFW-139; Tr. 2006.

[1489] Exs. SFW-130, SFW-138, SFW-129 at 9; Tr. 1010.

[1490] See SFPP IB at 86-95.

[1491] IS IB at 47-48.

they do not believe that SFPP's data is trustworthy.[1492] However, as explained by SFPP and supported by the record, Ganz did in fact use the data provided by Hanak for determining the 2003 cost of service at issue.[1493] The only issue was that Ganz did not include Benson in his calculations, the exclusion of which helped Complainants, rather than hurt them.[1494] Also, on cross-examination, while Hanak first stated that he had not seen Ganz's cost of service in Exhibit No. SFW-67, he then corrected himself, stating that he had in fact seen the document prepared by Ganz, contrary to the Indicated Shippers' claims.[1495]

V. Throughput Volume – for each complaint year and for the test year used to determine prospective rates, what is the appropriate throughput volume level?

<u>Positions of the Parties</u>

ACC Shippers

479. According to the ACC Shippers, actual volumes for both 2003 and 2004 were used by the ACC Shippers and SFPP in this proceeding.[1496]

Indicated Shippers

480. The Indicated Shippers state that they do not take a position on this issue.[1497]

Commission Trial Staff

481. Staff states that it used actual 2003 and 2004 throughput for both lines at issue.[1498]

[1492] *Id*. at 48.

[1493] SFPP IB at 95; Tr. 941, 1019-20; Ex. SFW-65 at 2.

[1494] SFPP IB at 95-96; Tr. 1447-48.

[1495] Tr. 940.

[1496] ACC IB at 71 (citing Exs. ACC-1 at 3-4, ACC-69 at 16, ACC-70 at 16, ACC-71 at 16, ACC-72 at 16, SFW-67 at 150, SFW-68 at 158).

[1497] IS IB at 48.

[1498] Staff IB at 98.

SFPP, L.P.

482. SFPP claims that the actual 2003 and 2004 volumes for both lines should be used for those test years to determine prospective rates and that no party disputes that these volumes should be used.[1499]

Discussion and Findings

483. All parties agree that actual volumes should be used when determining prospective rates for 2003 and 2004. The undersigned agrees that actual volumes are appropriate for use when determining just and reasonable rates in this proceeding.

VI. What are the just and reasonable rates that SFPP should be allowed to charge for the periods covered by the complaints in this proceeding?

Positions of the Parties

ACC Shippers

484. The ACC Shippers suggest that the just and reasonable rates SFPP should be allowed to charge for the periods covered by the complaints in this proceeding are based on SFPP's actual volumes and the cost of service calculations made by their witness which were based on SFPP's cost of service, with some adjustments.[1500] The 2001-2004 just and reasonable rates are based on the 2003 rates for both the East and West Lines, the ACC Shippers state, while the just and reasonable rates for 2004-2008 are based on the 2004 rates for the East and West Lines.[1501]

485. The rates that SFPP collected for 2003 and 2004 produce revenues in excess of cost of service and are thus unjust and unreasonable, the ACC Shippers allege.[1502] SFPP acknowledged that this was so.[1503] SFPP's 2003 collected rates, the ACC Shippers specify, exceeded the rates that result from SFPP's 2003 cost of service by 23% to 31% on the East Line and 40% to 59% on the West Line.[1504] The 2004 over-collections are

[1499] SFPP IB at 98 (citing Exs. S-16 at 5, ACC-1 at 31, SFW-67 at 150, SFW-68 at 158); SFPP RB at 96 (citing ACC IB at 71; IS IB at 48; Staff IB at 98).

[1500] ACC IB at 71 (citing Ex. ACC-1 at 30).

[1501] *Id*. at 72 (citing Ex. ACC-1 at 34-41 and Tables 11-12 (East), 13-18 (West)).

[1502] *Id*.

[1503] *Id*. at 73 (citing Tr. 1763-64).

[1504] *Id*. at 74 (citing Ex. ACC-68 at 5, 6 and Tables 1 and 2).

similar in magnitude.[1505] When using the costs of service recommended by the ACC Shippers, the discrepancies are even larger.[1506]

486. While the difference between the rates calculated by SFPP and the ACC Shippers are relatively small, they are still important, the ACC Shippers state.[1507] According to them, the differences are due to income tax allowance, allowed return, and corporate overhead expense allocations.[1508] The ACC Shippers summarize the issue as not whether SFPP's rates were unjust and unreasonable, but by how much.[1509] They point out that, while the difference may be small, it represents millions in reparations.[1510]

487. The ACC Shippers allege that SFPP takes a contradictory position with respect to just and reasonable rates for purposes of reparations.[1511] SFPP asserts that it may be appropriate to use rates that depend on the result of an earlier proceeding, rather than the cost of service rates determined in this proceeding.[1512] According to the ACC Shippers, the just and reasonable rates cannot be both those that are determined in this proceeding as well as rates determined in a different proceeding.[1513] The just and reasonable rates in this proceeding are those that are developed under the test period in this proceeding.[1514]

Indicated Shippers

488. The Indicated Shippers state that they defer to the other shipper Complainants on this issue, but also note that the appropriate 2004 cost of service calculations for SFPP's East and West Lines are set forth in Exhibit No. BPX-23.[1515]

[1505] *Id*. (citing Ex. ACC-68 at 5, 6 and Tables 1 and 2).

[1506] *Id*. (citing Ex. ACC-68 at 19-22 and Tables 3 (East) and 4 (West)).

[1507] *Id*.

[1508] *Id*. at 75.

[1509] *Id*.

[1510] *Id*.

[1511] ACC RB at 60.

[1512] *Id*. at 61.

[1513] *Id*.

[1514] *Id*.

[1515] IS IB at 48.

Commission Trial Staff

489. Staff explains that it calculated just and reasonable 2003 and 2004 rates for both the East and West Lines using actual volumes and the 2003 and 2004 costs of service calculated by its witness.[1516]

SFPP, L.P.

490. SFPP states that the just and reasonable rates that SFPP should be allowed to charge for 2003 and 2004 on the East and West Lines are calculated in Exhibit Nos. SFW-67 and SFW-68.[1517] SFPP alleges that neither Complainants nor Staff have proven that their proposed 2003 and 2004 rates are just and reasonable.[1518]

Discussion and Findings

491. As discussed in Issue V, all participants in this proceeding agree that actual 2003 and 2004 volumes for SFPP's East and West Lines should be used for determining just and reasonable rates; however, the participants disagree as to the cost of service that should be used for determining the just and reasonable rate level. The ACC Shippers, Indicated Shippers, Staff, and SFPP each argue that the appropriate costs of service to be used are those calculated by their respective witnesses.[1519] The just and reasonable rates determined in this proceeding depend upon the final determinations on income tax allowance, allowed return, and operation and maintenance expenses[1520] set forth in this decision *supra*. These findings will determine which proposed 2003 and 2004 costs of service should be used to determine the just and reasonable East and West Line rates.

[1516] Staff IB at 98-99 (citing Exs. S-35 at 1a, 1b, S-16 at 5, S-35 at 1a, 2, 3a).

[1517] SFPP IB at 98.

[1518] SFPP RB at 96-97.

[1519] ACC IB at 71; IS IB at 48; Staff IB at 98-99; SFPP IB at 98.

[1520] The issue of operation and maintenance expenses includes: (A) corporate overhead cost allocation; (B) depreciation expense; (C) allocation factors for investment and operating expenses; and (D) development and allocation of environmental remediation expenses.

VII. What are the Proper Remedies?

A. Are complainants entitled to reparations in this proceeding?

<u>Positions of the Parties</u>

ACC Shippers

492. The ACC Shippers contend that the Complainants are entitled to reparations, which should be calculated as the difference between SFPP's collected rates during the "locked-in" periods and the rates determined in this proceeding to be just and reasonable.[1521]

493. The "locked-in" reparations periods, as explained by the ACC Shippers, are as follows: (1) September 21, 2002 through January 31, 2008 for the Airlines, whose complaint was filed on September 21, 2004 against the West Line rates; (2) July 2, 2001 through May 31, 2006 on the East Line and through July 31, 2008 on the West Line for reparations due pursuant to the Chevron complaint, filed July 2, 2003; and (3) December 29, 2002 through May 31, 2006 for the East Line and through July 31, 2008 on the West Line for the ConocoPhillips complaint, filed on December 29, 2004 against rates on both lines.[1522] The rates and reparations, according to the ACC Shippers, should be calculated solely on the basis of the 2003 and 2004 complaints and their costs of service.[1523]

494. With regard to West Line Reparations, the ACC Shippers state that this is Valero's first proceeding in which it claims reparations for West Line shipments.[1524] For Chevron, this is the only proceeding in which it can recover reparations for its West and East Line shipments for the specific time period involved in this proceeding; Chevron was not a complainant in the OR96-2 proceedings because it did not file a formal complaint.[1525] ConocoPhillips, on the other hand, will receive reparations from prior proceedings which would need to be accounted for in determining the reparations amount ordered in this proceeding during the two years prior to the date of its complaint.[1526] For the East Line, Complainants' status with regard to reparations is the same as for the West Line, except

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[1521] ACC IB at 76.

[1522] *Id*. at 77-78.

[1523] *Id*. at 79.

[1524] *Id*.

[1525] *Id*. 79-80.

[1526] *Id*. at 80 (citing December 2007 Order at P 74; *SFPP, L.P.*, 100 FERC ¶ 61,353, at P 13 n. 13 (2002)).

for the Airlines, the ACC Shippers note, who did not address the East Line in their complaint.[1527]

495. SFPP, the ACC Shippers note, asserts that reparations are not mandatory in this proceeding, while the ACC Shippers claim that the Commission's general principle is that reparations are due when a complainant is required to pay more for transportation than a reasonable rate, as is the case in this proceeding.[1528] Furthermore, it is undisputed, the ACC Shippers allege, that SFPP over-recovered its costs for the period at issue in this proceeding.[1529] The equities, they continue, require that SFPP pay full reparations and that there be no additional delay in the return of the overpayments, given the considerable delay that Complainants have already faced.[1530]

496. Moreover, according to the ACC Shippers, SFPP should not be able to retain the full amount it collected from non-complainants (who are not entitled to reparations), but should instead be required to offset the legal fees it proposes to recover from shippers against these over recoveries.[1531]

Indicated Shippers

497. The Indicated Shippers state that, as per Commission rulings, reparations are due for two years prior to the date that complaints were filed for the shippers that filed those complaints.[1532] They continue, noting that Complainants are entitled to reparations plus FERC interest, compounded quarterly, as a result of rate reductions to be ordered.[1533]

Commission Trial Staff

498. Staff states that it does not take a position on this issue.[1534]

[1527] *Id*. at 81.

[1528] ACC RB at 62 (citing SFPP IB at 98; *SFPP, L.P.*, 91 FERC at 61,515-17).

[1529] *Id*. at 63.

[1530] *Id*. at 63-64.

[1531] *Id*. at 64-65.

[1532] IS IB at 48-49 (citing 2006 Sepulveda Order at P 77; 49 U.S.C. App. ¶ 16(3)).

[1533] *Id*. at 49.

[1534] Staff IB at 99.

SFPP, L.P.

499. SFPP claims that reparations are not mandatory in this proceeding and that no Complainant has established that the Commission should use its discretion in granting reparations in this proceeding.[1535]

Discussion and Findings

500. At issue is whether Complainants are entitled to reparations in this proceeding. The ACC Shippers and the Indicated Shippers argue that Complainants are eligible for reparations, while SFPP claims that reparations are not mandatory in this proceeding.[1536]

501. According to the Commission, "[t]he basic rule is that only parties that have filed a complaint are eligible for reparations if an existing rate is found to be unjust or unreasonable, and the burden is on the shipper to establish that the rates are unjust and unreasonable."[1537] Under the Interstate Commerce Act, reparations are permitted when the justness and reasonableness of existing rates is successfully challenged.[1538] So long as rates are determined to be unjust and unreasonable, "[t]here is no dispute that reparations are available to some degree;" however, it is within the Commission's discretion whether to award reparations. [1539] When rates are found unjust and unreasonable, only those shippers that filed complaints will be entitled to reparations, and the carrier's obligation to provide those reparations extends only to those who filed a complaint.[1540]

502. While reparations are an equitable remedy within the Commission's discretion, the equities in this case lie in favor of allowing reparations for Complainants. The ACC Shippers, in their initial brief, explore the various equitable considerations at stake here, and their analysis is persuasive on this point.[1541] First, the ACC Shippers point out the delayed resolution in this proceeding;[1542] while the complaints were filed in 2003 and

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[1535] SFPP IB at 98 (citing *SFPP, L.P.*, 86 FERC at 61,112); SFPP RB at 97 (citing *SFPP, L.P.*, 86 FERC at 61,112).

[1536] ACC IB at 76; IS IB at 48-49; SFPP IB at 98.

[1537] *SFPP, L.P.*, 91 FERC at 61,514; *see also SFPP, L.P.*, 121 FERC ¶ 61,163 at P 5.

[1538] 49 U.S.C. app. § 15 (3) (1988).

[1539] *SFPP, L.P.*, 86 FERC at 61,112.

[1540] *ExxonMobil*, 487 F.3d at 962; *SFPP, L.P.*, 121 FERC ¶ 61,163 at P 5.

[1541] ACC RB at 63.

[1542] *Id*. at 63-64.

2004, they were not set for hearing until 2008.[1543] Moreover, SFPP would be required to pay reparations to only those parties that filed complaints in this proceeding, and thus retains a portion of its surplus revenues.[1544]

503. Also necessary for consideration is which Complainants are eligible for reparations. Under Commission precedent, only shippers that have filed a complaint against a specific rate are entitled to reparations if that rate is found unjust and unreasonable.[1545] Chevron, ConocoPhillips, and the Indicated Shippers each filed their respective complaints against both East and West Line rates, and thus are entitled to reparations based on overpayments of rates on both lines. The Airlines' complaint, however, was filed only against the West Line rates. Therefore, the Airlines are only entitled to reparations stemming from overpayments of West Line, and not East Line, rates.

B. What is the appropriate level of reparations?

<u>Positions of the Parties</u>

ACC Shippers

504. According to the ACC Shippers, the appropriate level of reparations is the difference between the just and reasonable rates and the rates that the shippers actually paid, plus interest compounded on a quarterly basis.[1546] The appropriate 2003 and 2004 costs of service which were developed in this proceeding should be used to set the 2003 and 2004 just and reasonable rates, which should then be used when calculating reparations.[1547]

505. To determine West Line reparations, the ACC Shippers subtract the 2003 and 2004 just and reasonable rates from SFPP's collected rates for the applicable reparations period and multiply the differences by the volumes for each period for each of the complaints.[1548] Then, they continue, the reparations must be adjusted for interest.[1549]

[1543] *See Chevron Products Co. v. SFPP, L.P.*, 122 FERC ¶ 61,052 (2008) (Order Setting Complaints for Hearing).

[1544] ACC RB at 64-65; *ExxonMobil*, 487 F.3d at 962; *SFPP, L.P.*, 121 FERC ¶ 61,163 at P 5.

[1545] *ExxonMobil*, 487 F.3d at 962; *SFPP, L.P.*, 121 FERC ¶ 61,163 at P 5.

[1546] ACC IB at 81.

[1547] *Id*.

[1548] *Id*. at 83

[1549] *Id*.

The reparations must be updated in a compliance filing to include volumes for the entire complaint period and also to accommodate changes to the just and reasonable rates determined in this proceeding, the ACC Shippers add.[1550]

506. East Line reparations should be calculated in the same manner as West Line reparations and will need to be adjusted to account for final rates that result from SFPP's February 2008 compliance filing.[1551] If, the ACC Shippers note, the East Line rates in this proceeding are less than those resulting from the compliance filing, then reparations on that difference will be due.[1552] Assuming these rates are unchanged, the ACC Shippers state that they used the same methodology to calculate East Line reparations as was used for the West Line, and, like the West Line reparations, they must be updated in a compliance filing to include volumes for the entire complaint period and also to accommodate changes to the just and reasonable rates determined through this proceeding.[1553]

507. According to the ACC Shippers, SFPP has not supported its claim that there would be any post-2004 rate increases, indexed or otherwise.[1554] While SFPP files annual index adjustments, the Commission only accepts them subject to refund and such index adjustments and resulting rates are not to be considered just and reasonable.[1555]

508. The ACC Shippers note that SFPP generally agreed with their method of calculating reparations, with three differences.[1556] The ACC Shippers list those differences as follows: (1) SFPP recommends using its own cost of service calculations rather than those advocated by the ACC Shippers; (2) SFPP recommends using 1999 rates indexed forward instead of the rates found to be just and reasonable in this proceeding; and (3) SFPP asserts that the just and reasonable rates for use in calculating reparations should be determined by indexing forward and backward the rates established in this proceeding.[1557]

[1550] *Id*. at 84 (citing Exs. ACC-68 at 22, SFW-65 at 29; Tr. 1688).

[1551] *Id*. at 84.

[1552] *Id*. at 85.

[1553] *Id*. (citing Exs. ACC-68 at 22, SFW-65 at 29).

[1554] *Id*.

[1555] *Id*. (citing Order No. 561, Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992, FERC Stats. & Regs. ¶ 30,985 at 30,956).

[1556] ACC RB at 66 (citing SFPP IB at 98-100).

[1557] *Id*. at 66-68.

509. Indexing the 1999 rates forward instead of using those rates found to be just and reasonable in this proceeding is, the ACC Shippers claim, inconsistent with the Commission's methods of calculating reparations and a violation of the test period principle.[1558] SFPP has asserted no basis for using the 1999 rates indexed forward.[1559]

510. With respect to applying the indexing procedure to reparations in this case, the ACC Shippers state that it would be inappropriate with respect to 2005 and premature with respect to 2006 and 2007.[1560] They state that "allowing an index adjustment for 2005 would allow an inappropriate over-recovery because 2005 rates will be based on actual costs."[1561] For 2006 and 2007, it is not possible to evaluate whether it is appropriate at this stage because the index adjustments will be applied to the yet-to-be-established rates determined by the Commission.[1562]

511. SFPP incorrectly asserts, according to the ACC Shippers, that Complainants have not supported their finding against indexing the 2003 and 2004 rates.[1563] An evaluation of the appropriateness of proposed index adjustments to the reparations in this proceeding should take place at the compliance filing stage, they argue, based on the Commission's "evaluation of a proposed index-based rate increase on Page 700 of the pipeline's annual FERC No. Form 6 report," which will not be available in an accurate form until that time.[1564] At that point, the ACC Shippers state, SFPP will have the opportunity to provide re-calculated Form 6 Page 700s based on the outcome of this proceeding, if it wishes to claim index adjustments in calculating reparations.[1565] Without recalculated Form 6 data, the index increases are "automatic and immune from challenge," the ACC Shippers claim.[1566]

[1558] *Id*. at 67-68 (citing *BP West Coast*, 374 F.3d at 1307, 1310).

[1559] *Id*. at 68.

[1560] *Id*. at 68-69.

[1561] *Id*. at 69 (citing *SFPP, L.P.*, 117 FERC ¶ 61,271 at P 5; *SFPP, L.P.*, 120 FERC ¶ 61,245, at PP 6-12 (2007)).

[1562] *Id*. (citing *SFPP, L.P.*, 91 FERC at 61,516).

[1563] *Id*. (citing SFPP IB at 2-3).

[1564] *Id*. at 70 (citing *SFPP, L.P.*, 111 FERC ¶ 61,490, at 62,735 (2005)).

[1565] *Id*. at 71.

[1566] *Id*.

Indicated Shippers

512. The appropriate level of reparations, the Indicated Shippers argue, is the difference between the just and reasonable rate and the rate the shippers paid for the periods in question, plus interest.[1567]

Commission Trial Staff

513. Staff states that it does not take a position on this issue.[1568]

SFPP, L.P.

514. If reparations are awarded for the East Line, SFPP claims, the appropriate level for the period starting two years prior to the filed date of the complaint through May 31, 2006, would be the difference between the East Line rates charged by SFPP and the just and reasonable rates that the Commission sets in this proceeding, multiplied by actual volumes moved by the Complainant during the time period covered by the complaint.[1569] The just and reasonable rates for the earliest date covered by the complaint through 2003, SFPP continues, should be determined by using the 2003 rate calculated by SFPP, indexed backward to the earliest date covered by the complaint.[1570] For the 2004 through May 31, 2006 East Line rates, the 2004 rate calculated by SFPP should be used and then indexed forwarded to May 31, 2006.[1571]

515. The same calculation, according to SFPP, would be used for the West Line rates, but would be for the period starting two years prior to the filed date of the complaint through May 31, 2008.[1572] Further, the rates for 2004 through July 31, 2008 should be set by using the 2004 rate calculated by SFPP for 2004, and then indexed rates for the following years through July 31, 2008.[1573]

[1567] IS IB at 49; IS RB at 42 (citing *SFPP, L.P.*, 91 FERC at 61,516).

[1568] Staff IB at 99.

[1569] SFPP IB at 99.

[1570] *Id*. (citing Ex. SFW-67 at 150).

[1571] *Id*. (citing Ex. SFW-68 at 158).

[1572] *Id*.

[1573] *Id*. at 100 (citing Ex. SFW-68 at 158).

Discussion and Findings

516. After determining which shippers are eligible for reparations in this proceeding, the appropriate level of reparations must then be decided. The ACC Shippers claim that the appropriate level of reparations is the difference between the just and reasonable rates and the rates that the shippers actually paid, plus interest compounded on a quarterly basis.[1574] The Indicated Shippers agree.[1575] SFPP also makes the argument that the appropriate level of reparations is the difference between the rates SFPP actually charged and the just and reasonable rates that the Commission will set in this proceeding.[1576] However, while all participants appear to agree on the methodology for calculating reparations, differences exist among the parties due to cost of service methodologies and indexing.

517. With respect to calculating reparations, the Commission stated that "the proper method for determining reparations or refunds is to measure the new lawful unit rate against the older rate now determined to be unlawful, and pursuant to which the pipeline has already collected the revenues."[1577] Further, the Commission explained that the purpose behind the reparation "is to place the shipper in the same situation the shipper would have been in if the proper rate per unit of throughput had been in effect during the period to which reparations apply."[1578] If the rates paid by shippers were unjust and unreasonable, shippers are entitled "to the difference between the rates they paid and the rates the Commission retrospectively determines to be just and reasonable."[1579] Moreover, the reparations period generally includes the period two years prior to the filing of a complaint at issue.[1580] All participants agree that this method is appropriate for determining reparations in this proceeding, and thus they should be calculated as the difference between the just and reasonable rates and the rates that the shippers actually paid, as set forth by the Commission, as applied to actual throughput, plus interest.[1581]

[1574] ACC IB at 81.

[1575] IS IB at 49.

[1576] SFPP IB at 99.

[1577] *SFPP, L.P.*, 91 FERC at 61,516.

[1578] *Id*.

[1579] *ExxonMobil*, 487 F.3d at 962; 49 U.S.C. app § 16(3).

[1580] *ExxonMobil*, 487 F.3d at 962; *BP West Coast*, 374 F.3d at 1305-06.

[1581] Section 15(7) of the Interstate Commerce Act requires that refunds be paid, with interest, to parties which paid rates which were not justified. In *SFPP, L.P.*, 91 FERC at 61,516, the Commission granted clarification that "interest is due on any reparations at the rate required for refunds under the Commission's regulations."

518. Here, the appropriate 2003 and 2004 cost of service data determined to be just and reasonable in this proceeding should be used for calculating all reparations. As noted in Issue VI, the just and reasonable rates that SFPP should be allowed to charge depend upon the final determination on income tax allowance, allowed return, and operation and maintenance expenses[1582] as made by the undersigned in this proceeding and set forth in this decision *supra*.

519. The ACC Shippers and SFPP disagree as to the manner in which to use the 2003 and 2004 East and West Line data when calculating reparations. The ACC Shippers argue that the 2003 costs of service should be used to calculate refunds for the 2001-2003 time frame, while the 2004 costs of service should be used for calculating refunds for the 2004-2008 time frame.[1583] The 2003 and 2004 rates should not be indexed forward or backward, according to the ACC Shippers, when calculating reparations. SFPP, on the other hand, argues that the rates determined in this proceeding to be just and reasonable should be indexed forward and backward for reparations purposes.

520. In *BP West Coast*, the D.C. Circuit which held that "[t]he Commission also properly determined that rates based on the test period could be used to calculate reparations for the two years prior to the filing of the complaints . . . There is no basis to conclude that test period rates that are just and reasonable for all future years do not provide a just and reasonable basis for determining reparations in the two years prior to the complaints."[1584] The Court emphasized the use of a test period approach, but did so in the context of its explanation of how to calculate reparations, which included indexing a rate that reflected the cost of service for that test year and "apply[ing] the indexed rate to designated volumes . . . for each calendar year for which an indexed rate had been developed."[1585]

521. The ACC Shippers' argument rests on the notion that there are not yet set rates to index in this proceeding. According to them, it is premature to determine whether an index adjustment is appropriate at this stage.[1586] While it is true that no rates have yet been set as a result of this proceeding, it does not change the manner in which reparations will be determined once those rates are set. Regardless of the outcome on the issues of

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[1582] The issue of operation and maintenance expenses includes: (A) corporate overhead cost allocation; (B) depreciation expense; (C) allocation factors for investment and operating expenses; and (D) development and allocation of environmental remediation expenses.

[1583] ACC IB at 82.

[1584] *BP West Coast*, 374 F.3d at 1307.

[1585] *BP West Coast*, 374 F.3d at 1302.

[1586] ACC IB at 87.

income tax allowance, operation and maintenance expenses, and allowed return, the just and reasonable rates determined in this proceeding for 2003 and 2004 are still test years that are being used to determine reparations for periods ranging from 2001 to 2003 and 2004 through 2008. Essentially, when agreeing to strike all 2007 cost of service data, all parties in this proceeding agreed to use 2003 and 2004 as test years,[1587] and implicit in the use of test years is the use of indexing when determining reparations.[1588]

522. While the ACC Shippers argue that "the Presiding Judge and the Commission have not yet ruled on the costs of service at issue in this proceeding, and the just and reasonable rates have not yet been established," it is the determination of the undersigned that, once just and reasonable rates *are* established, those just and reasonable rates should be indexed forward and indexed backward and multiplied by the actual throughput in order to calculate the correct amount of reparations due to Complainants in this proceeding, as suggested by SFPP.[1589]

523. It is important to note that reparations are an equitable remedy, and it is within the Commission's discretion whether to award them and to what degree.[1590] The calculation of reparations is not an exact science. Reparations are meant to "place the shipper in the same situation the shipper would have been in if the proper rate per unit of throughput had been in effect during the period to which reparations apply."[1591] By failing to index the 2004 rate forward, Shippers would not be placed in the same situation that they would have been in had the proper rate been in effect, but would instead be in a better position; likewise, they would be in a worse position if the 2003 rates are not indexed backward. Further, the goal of indexing is administrative simplicity, which would be achieved through the use of the 2003 and 2004 test years in this proceeding.[1592] While using indexed rates as a basis for reparations in a particular year may not be exact, it is more representative and therefore more appropriate to do so than using rates which do not reflect the effects of inflation. Indexing is a Commission sanctioned approach for oil pipeline rate making and is reasonably applied to the equities of calculating reparations in complaint proceedings.

524. For the foregoing reasons, the undersigned accepts SFPP's argument that the 2003 and 2004 rates determined in this proceeding should be indexed forward and backward

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[1587] *See Chevron Products Company*, Order Ruling on Motion to Strike and Granting Request to Withdraw Evidence, Docket No. OR03-5-000 (July 21, 2008).

[1588] *See BP West Coast*, 374 F.3d at 1302-07.

[1589] ACC RB at 69.

[1590] *SFPP, L.P.*, 86 FERC at 61,112.

[1591] *SFPP, L.P.*, 91 FERC ¶ at 61,516.

[1592] *SFPP, L.P.*, 119 FERC 61,330, at P 7 (2007); SFPP, L.P., 117 FERC ¶ 61,271.

for the purpose of calculating reparations.[1593] Reparations should be calculated as the difference between the indexed just and reasonable rates and the rates that the shippers actually paid, multiplied by actual throughput, plus interest. The actual level of reparations cannot be calculated until SFPP comports with this decision based on the undersigned's determinations regarding income tax allowance, allowed return, and operation and maintenance expenses as set forth in this decision *supra*.

ORDER

525. The omission from this Initial Decision of any argument raised by the Participants at the hearing or in their briefs does not mean that it has not been considered; rather, it has been evaluated and found to either lack merit or significance such that inclusion would only tend to lengthen this Initial Decision without altering its substance or effect. Accordingly, all arguments made by the Participants which have not been specifically discussed and/or adopted by this decision have been considered and are rejected.

526. IT IS ORDERED, subject to review by the Commission on exceptions or on its own motion, as provided by the Commission's Rules of Practice and Procedure, that within thirty (30) days of the issuance of the Final Order in this proceeding, all parties shall take appropriate action to implement all the rulings in this decision.

Bobbie J. McCartney
Presiding Administrative Law Judge

[1593] However, because the 2004 just and reasonable rates in this proceeding are based on actual costs, an indexing adjustment in the following year, 2005, is not permitted. *SFPP, L.P.*, 117 FERC ¶ 61,271 at P 5; *SFPP, L.P.*, 120 FERC ¶ 61,245 at PP 6-12.

APPENDIX

INDEX OF ABBREVIATED TERMS

Abbreviation	Term
A&G	Administrative and General
ADIT	Accumulated Deferred Income Tax
CAO	Cleanup and Abatement Orders
CPUC	Public Utilities Commission of the State of California
DCF	Discounted Cash Flow
EIA	Energy Information Agency
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IBES	Institutional Brokers Estimated System
KMEP	Kinder Morgan Energy Partners
KMGP	Kinder Morgan G.P., Inc.
KMI	Kinder Morgan, Inc.
KMIGT	Kinder Morgan Interstate Gas Transmission, LLC
MLP	Master Limited Partnership
NYSE	New York Stock Exchange
OLP-A	Kinder Morgan Operating Limited Partnership “A”
OLP-B	Kinder Morgan Operating Limited Partnership “B”
OLP-D	Kinder Morgan Operating Limited Partnership “D”
PAA	Purchase Accounting Adjustment

RC	Responsibility Center
ROE	Return on Equity
SEC	Securities and Exchange Commission
SSA	Social Security Administration
UBTI	Unrelated Business Taxable Income

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