UNITED STATES OF AMERICA 125 FERC ¶ 63,018
FEDERAL ENERGY REGULATORY COMMISSION

Chevron Products Co.
v. Docket No. OR03-5-001
SFPP, L.P.

BP West Coast Products LLC
And ExxonMobil Oil Corporation
v.
SFPP, L.P.

ConocoPhillips Co.
v.
SFPP, L.P.

INITIAL DECISION

(Issued November 18, 2008)

Appearances

Elisabeth R. Myers, Gordon Gooch, Shannon Pepin, Shannon Maher Bañaga and *Kevin J. Vaughn* on behalf of BP West Coast Products LLC and ExxonMobil Oil Corporation

Frederick Jauss and *Marcus W. Sisk* on behalf of ConocoPhillips Company

Steven A. Adducci on behalf of Ultramar Inc. and Valero Marketing & Supply Co.

George L. Weber on behalf of Chevron Products Co.

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

Derek L. Anderson, James R. Keegan and *William W. Bennett* on behalf of the Federal Energy Regulatory Commission

EDWARD M. SILVERSTEIN, Presiding Administrative Law Judge

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[1] Issues III.A through III.E are joined together for decision.

[2] Issues III.J.1, III.J.2, III.K and III.L are joined together for decision.

[3] Issues IV.D, IV.D.1 and IV.D.2 are joined together for decision.

[4] By agreement of the parties Issues IV.H and IV.I were jointly briefed and are joined together for decision.

[5] Issues V.D, V.E, V.F and V.G are joined together for decision.

[6] Issues VIII.A, VIII.B, and VIII.C are joined together for discussion and ruling.

Preliminary Statement

1. On February 13, 2006, the Commission issued an "Order Setting Portions of Pending Complaints for Hearing" which impacted the instant docket as well as Docket Nos. OR05-4-000, OR05-5-000, OR92-8-025, and OR03-05-000. *See Chevron Products Co. v. SFPP, L.P.*, 114 FERC ¶ 61,133 (2006). In pertinent part, the Commission severed that part of the complaints in Docket Nos. OR03-5-000, OR05-4-000 and OR05-5-000 challenging SFPP's North and Oregon Line rates and consolidated them in the instant docket. *Id.* at P 4. The Commission, further noting that those rates were grandfathered pursuant to § 1803(b) of the Energy Policy Act of 1992, Pub. L. 102-486, 106 Stat. 2772 (1992), noted that complainants had the burden of proving "that there was a substantial change in the economic circumstances of the oil pipeline which were the basis for those rates." *Id.* at P 3. It added that they must establish "the substantially changed circumstances occurred before the date the complaints were filed." *Id.* at P. 4.

2. The parties requested the appointment of a Settlement Judge, and one was appointed by the Chief Judge on March 16, 2006. *See* "Order of Chief Judge Appointing Settlement Judge and Scheduling Settlement Conference." However, although on April 24, 2006, the Settlement Judge reported that the parties had reached an agreement in principle, *see* "Settlement Judge Status Report," the parties failed to finalize their agreement and, on May 12, 2006, the Chief Judge terminated the settlement procedures. *See* "Order of Chief Judge Terminating Settlement Judge Procedures." Originally assigned to another presiding judge who subsequently left the Commission, the matter was re-assigned to me by the Chief Judge on March 16, 2007. *See* "Substitute Designation of Presiding Administrative Law Judge."

3. On July 18, 2006, the then presiding judge approved the parties' stipulation filed July 10, 2006. The stipulation provided as follows:[7]

A. SFPP will have no obligation to prepare 2002 or 2005 (or any later period) cost-of-service studies for the Oregon Line or the North Line on the express

[7] Complainants reserved the right to argue that the Commission may order reparations for periods prior to the filing date of a complaint, whereas SFPP's view was that the Energy Policy Act of 1992 foreclosed reparations for the period prior to the filing date of a complaint that challenged rates grandfathered under that act.

stipulation that these costs of service and related volumes, revenues, and rate design are not required for any purpose in this case.

B. For complaints filed in 2003, SFPP waives the right to claim that Staff or Complainants failed in their burden of proof or in claims for reparations because they used 2003 calendar year cost-of-service data for the Oregon Line and the North Line rather than cost-of-service data for the 12-month period immediately preceding the date of the complaint. For complaints filed in 2004, SFPP waives the right to claim that Staff or Complainants failed in their burden of proof or in their claim for reparations because they used 2004 calendar year cost-of-service data for the Oregon Line and the North Line rather than cost-of-service data for the 12-month period immediately preceding the date of the complaint. SFPP waives the right to argue that the use of calendar year 2003 and 2004 data modifies or otherwise forecloses the right of any Complainant to receive reparations calculated from at least the filing date of such complaints, if reparations are ordered.

C. Cost-of-service, volumes and revenue presentations for years 2003 and 2004 will serve for all purposes for both (a) calculation of a "substantial change" in "economic circumstances" of SFPP's North Line and Oregon Line rates at issue in this proceeding under Section 1803(b) of the Energy Policy Act of 1992 ("EPAct"); and (b) a determination of whether the North Line and Oregon Line rates at issue are "just and reasonable" under the Interstate Commerce Act ("ICA") and Section 1803(b) of the EPAct. The ultimate burden of persuasion with respect to (a) whether a "substantial change" in "economic circumstances" underlying SFPP's rates has occurred, and (b) a determination of whether the rates are "just and reasonable" under the ICA and Section 1803(b) of the EPAct remains that of Complainants and Staff.

D. The burden of production and of persuasion with respect to any income tax allowance remains that of SFPP, as set forth in the Policy Statement on Income Tax Allowances, 111 FERC ¶ 61,139 (2005) ("Policy Statement"), assuming, *arguendo*, that the Policy Statement survives challenge as being inconsistent with the decision of the Court of Appeals in *BP West Coast Products v. FERC* [374 F.3d 1263 (DC. Cir. 2004), cert. den., 544 U.S. 1043 (2005)]. Staff and other participants are not restricted in any way from gathering and presenting evidence about the appropriate income tax allowances in this case.

E. Impasse occurred with respect to a stipulation relating to whether the costs-of-service found by the Commission in the Phase I decisions in OR96-2 would suffice, without further evidence, to show the "economic basis" of the Oregon and North Line rates for the "basis year," if any, and for 1992. Therefore, discovery will be pursued by one or more complainants on the subject.

F. Staff and all parties reserve the right to contest in whole or in part the costs of service and related data to be provided by SFPP, L.P. pursuant to this stipulation. SFPP reserves the right to contest in whole or in part the costs of service and related data provided by Staff or other parties.

4. On September 5, 2006, at the request of the parties, the Chief Judge suspended the procedural schedule pending a ruling by the United States Court of Appeals for the District of Columbia Circuit in *ExxonMobil Oil Corp. v. FERC*, Case No. 04-1102, *et al.*[8] *See* "Order of Chief Judge Suspending Procedural Schedule."

5. On June 14, 2007, the parties requested that the Chief Judge continue the suspension until October 18, 2007. The following day the Chief Judge issued an order continuing the suspension until October 16, 2007. *See* "Order of Chief Judge Continuing Suspension of Procedural Schedules."

6. On July 12, 2007, at the request of the parties, the settlement judge procedure was re-instituted. *See* "Order of Chief Judge Designating Settlement Judge and Scheduling Settlement Conference." However, this attempt to reach an amicable settlement also failed, and the settlement judge procedure was terminated by the Chief Judge on October 11, 2007. *See* "Order of Chief Judge Terminating Settlement Judge Procedures and Reinstating Procedural Schedule."

7. BP West Coast Products LLC and ExxonMobil Oil Corporation, (jointly "Indicated Shippers") on October 16, 2007, requested that the following two questions be certified to the Commission:

> (1) Are the 1992 rates that underlie the present rates of either or both of SFPP's North and Oregon Line already "de-grandfathered," such that it is unnecessary to try that issue again before Your Honor? If not, will the Commission call upon Your Honor to decide this question as of 1996, not just 2003 and 2004?
>
> (2) Will the 2003 and 2004 complaints be reconsolidated by the Commission, so that before Your Honor will also be SFPP's current rates on the West and East Line, not just the current rates on SFPP's North and Oregon lines?

After answers were filed, I denied the Motion on November 1, 2007. *See* "Order Denying Motion to Certify Two Questions to the Commission."

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[8] The case was decided on May 29, 2007. *See ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945 (D.C. Cir. 2007).

8. Concerned about the magnitude of the protected material which was being pre-filed by the parties, on December 20, 2007, I scheduled an oral argument for April 14, 2008, for the purpose of addressing those concerns. *See* "Order Scheduling Oral Argument."

9. On January 30, 2008, SFPP filed a "Motion . . . to Compel BP West Coast Products LLC, ExxonMobil Oil Corporation, ConocoPhillips Company, Chevron Products Company, Ultramar Inc., and Valero Marketing and Supply Company to Fully Respond to Data Requests." An answer to the Motion was filed by BP West Coast Products LLC, ExxonMobil Oil Corporation, ConocoPhillips Company, and Chevron Products Company, on February 5, 2008. Ultramar Inc. and Valero Marketing and Supply Company, on that same date, filed a "Motion for Approval of Stipulation Regarding Movements of Refined Petroleum Products," in response to the Motion. After a February 7, 2008, oral argument, I denied both motions. *See* "Order Denying Motion to Compel, Motion for Approval of Stipulation, and Striking Issue from Preliminary Statement of Issues," issued February 8, 2008.[9] In addition, as SFPP was relying on its claim that the Commission's jurisdiction over the subject transactions was at issue here, but had failed to raise that issue in its answers until October 2007, I held that that issue was not before me. *Id.*

10. By order issued February 13, 2008, I struck portions of Exhibit No. BPX-15 which consisted of statements of Counsel rather than testimony of a witness. *See* "Order Striking Counsel's Statements from Pre-Filed Testimony."

11. On April 15, 2008, after the submission of briefs and the April 14, 2008, oral argument, I dissolved the protective order insofar as it protected any evidence or testimony which would be introduced at the hearing scheduled to begin on April 29, 2008. *See* "Order, in Part, Dissolving Protective Order and Striking Testimony." In addition, I struck gratuitous statements of counsel from Exhibit Nos. BPX-15, and BPX-21.

12. By order issued April 28, 2008, I granted the requests of SFPP and Staff for leave to revise previously pre-filed testimony. *See* "Order Granting Motions for Leave to File Testimony." On that same day, I denied a motion filed by BP West Coast Products LLC and ExxonMobil Oil Corporation "for Decision on Whether SFPP Is Not Entitled to an Income Tax Allowance as a Matter of Law." *See* "Order Denying Motion for Decision on Whether SFPP Is Not Entitled to an Income Tax Allowance as a Matter of Law."

13. BP West Coast Products LLC and ExxonMobil Oil Corporation, on April 25, 2008, filed a "Motion . . . for Leave to Tender Portions of Tax Returns with Testimony of Christopher P. Sintetos," which I denied on April 28, 2008. *See* "Order Denying Motion for Leave to Tender Portions of Tax Returns," issued on April 30, 2008.

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[9] On February 21, 2008, I denied SFPP's February 20, 2008, "Motion to Permit Interlocutory Appeal."

14. Staff, on April 28, 2008, filed a "Motion in Limine," which I denied on that same day. *See* "Order Denying Motion in Limine."

15. After the April 29, 2008, oral argument, I issued an order striking certain issues from the April 17, 2008, Final Statement of Issues because they constituted a collateral attack on Commission policy. *See* "Order Striking Issues and Combining Issues."

16. The hearing began on April 29, 2008, and lasted until May 9, 2008. At the hearing 14 witnesses testified and 304 exhibits were admitted into evidence.[10] At the end of the hearing, the parties agreed that the issues for decision were as follows:

> I. Grandfathering under the EPAct: Whether there has been a substantial change in the economic circumstances which were a basis for SFPP's North and Oregon Line rates in effect during the twelve (12) months prior to October 24, 1992 ("grandfathered rates") thus removing their "grandfathered" status under the EPAct?
>
> A. Must any decisions on cost[-]of[-]service issues be made if it is found that SFPP's North and Oregon Line rates remain grandfathered?
>
> B. If the North and Oregon Line rates in effect in 1992 are still grandfathered, can the rates be lowered beyond the 1992 level?
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> II. Burden of Proof: Which party or participant bears the burden of proof on the issues including the Income Tax Allowance and Indexed Incremental Rate Increase Issues in this proceeding?
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> III. 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 starting rate base?
>
> C. What is the appropriate inflation-adjusted deferred return?
>
> D. What is the appropriate methodology for calculating each year's deferred return?

[10] Two other exhibits offered into evidence were rejected.

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

F. What is the appropriate treatment of ADIT?

G. What is the appropriate capital structure?

H. What if any are the appropriate Purchase Accounting Adjustments?

I. What is the appropriate cost of debt?

J. What is the appropriate methodology for deriving a rate of return on equity?

1. What is the methodology for applying the Dividend Yield formula (dividend divided by stock market price equals return on equity) if Master Limited Partnerships are included in the proxy group?

2. What are the appropriate Growth Factors to use?

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

L. What is the appropriate place in the proxy group for members of the group used in DCF method for determining the rate of return on equity?

IV. Income Tax Allowance: For each complaint year and for any test year used to determine rates—

A. Struck

B. Whether SFPP is entitled to any income tax allowance based on substantial evidence of record?

C. Struck

D. What is the appropriate income tax allowance?

1. What is the taxable income (the dollars that are multiplied by the income tax rate to calculate an income tax allowance in the cost[-]of[-]service) of SFPP?

2. What is the appropriate income tax rate (to be multiplied by taxable income in order to calculate an income tax allowance) under the Policy Statement on Income Tax Allowances?

E. What is the appropriate treatment of ADIT?

F. Whether the over-funding of SFPP's ADIT account should result in offsets to its income tax allowance or be refunded to shippers as a matter of law?

G. Whether any over-funding of SFPP's ADIT account should result in offsets to its income tax allowance or be refunded to shippers based on substantial evidence of record?

H. Whether full tax depreciation must be taken as an offset to SFPP's income tax allowance, if any, rather than "booked" to an ADIT account?

I. How to determine the "taxable income" of SFPP for purposes of determining the component for an income tax allowance under the Policy Statement on Income Tax Allowances.

J. How to determine the "taxable income" of the relevant partners for purposes of the component on income taxes, including the reclassification of categories of partners, the question of whether allocations of income to the Kinder Morgan Energy Partners general partner should be excluded because it is a management fee, and the question of whether passive loss carry forwards, 743-B depreciation, and tax credits can be ignored in the calculations, each of which operates to lower the amount of "taxable income" flowed through from the Kinder Morgan Energy Partners partnership.

K. Struck

L. Struck

V. 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?

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?

E. What is the appropriate development and allocation of litigation expenses?

F. What is the appropriate fuel and power cost?

G. What reserves, if any, for projected future costs can be included in the cost[-]of[-]service?

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

VII. Just and reasonable rates: What are the just and reasonable rates that SFPP should be allowed to charge?

VIII. Remedies:

A. Are complainants entitled to reparations in this proceeding?

B. What is the appropriate level of reparations?

C. Does EPAct prevent reparations from being awarded to a complainant for the period prior to the date on which the complainant filed its complaint?

D. Is it permissible under the Interstate Commerce Act and Commission precedent for a complainant to recover reparations related to barrels it has not shipped?

17. The omission of any discussion or argument raised by the parties herein does not indicate that it has not been considered. Rather, such matters are found to be irrelevant, immaterial, and/or without merit. In addition, any arguments made on brief which were not supported by reference to evidence in the record or to legal precedent were given no weight. Finally, the testimonial evidence in this case was limited to factual statements of witnesses. Legal argument, conclusions of fact, conclusions of law, and supposition are not evidence and were given no evidentiary weight in this decision.

SUMMARY OF THE EVIDENCE

A. MATTHEW P. O'LOUGHLIN

18. Matthew P. O'Loughlin ("O'Loughlin") is a Principal of The Brattle Group, an economic and management consulting firm. Exhibit No. CC-1 at p. 4. He submitted testimony on behalf of Chevron Products Company ("Chevron") and ConocoPhillips Company ("ConocoPhillips") (jointly "CC Shippers") to evaluate the reasonableness of SFPP's Commission-jurisdictional rates for its interstate movements on SFPP's North Line and Oregon Line. *Id*. at p. 5.

19. O'Loughlin's testimony began with a discussion of SFPP's capital structure. *Id*. at p. 7. In its 2003 cost-of-service data for the North and Oregon Lines, O'Loughlin explained, SFPP calculated a capital structure of 45.93% equity and 54.07% debt. *Id*. He agreed with SFPP's use of its ultimate parent company, Kinder Morgan Energy Partners, L.P.'s ("Kinder Morgan") capital structure,[11] but disagreed with its calculation of Kinder Morgan's December 31, 2003, capital structure, stating that it should be adjusted for purchase accounting adjustments, which would result in a capital structure of 42.37% equity and 57.63% debt. *Id*. at pp. 7-8. According to him, it is necessary to remove the purchase accounting adjustments from Kinder Morgan's regulated assets if they are included because they may cause the account balances to no longer reflect the original costs of the regulated assets, which should not be permitted for ratemaking purposes. *Id*. at p. 8. SFPP's rate base, O'Loughlin continued, should not include artificial increases in assets due to acquisitions. *Id*.

20. O'Loughlin explained that he made four adjustments to Kinder Morgan's reported equity as of December 31, 2003. *Id*. First, he said he removed an increase in equity due to a purchase accounting adjustment when Kinder Morgan acquired SFPP; second and third, he claimed that he added an amount in equity to offset negative purchase accounting adjustments when Kinder Morgan acquired Trailblazer Pipeline Company (sometimes "Trailblazer") and Kinder Morgan Interstate Gas Transmission; and lastly, he noted that he removed an amount in equity due to Kinder Morgan's acquisition of Calnev Pipe Line. *Id*. at pp. 8-9.

21. O'Loughlin asserted that he also adjusted SFPP's capital structure as it relates to its Deferred Return and Allowance for Funds Used During Construction. *Id*. at p. 10. Prior to 2000, he stated, SFPP controlled its own financing, had its own debt outstanding that

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[11] It is appropriate, according to O'Loughlin, to use Kinder Morgan's structure because it provides financing for SFPP's operations, its capital structure represents the amount of debt and equity it has chosen given current market conditions, and it has a similar capital structure to four proxy oil pipelines used by SFPP to calculate return on equity. Exhibit No. CC-1 at p. 8 & n.10 (*citing* Exhibit No. CC-7).

was not secured by Kinder Morgan, and used its own capital structure. *Id*. O'Loughlin also said that he used Kinder Morgan's capital structure, adjusted for purchase accounting adjustments of its regulated companies, from 2000 to 2002, the period during which Kinder Morgan controlled SFPP. *Id*. These adjustments, O'Loughlin noted, which result in 56.78% equity for 2000, 53.59% equity for 2001, and 44.68% equity for 2002, affect SFPP's Deferred Return and Allowance for Funds Used During Construction balances in O'Loughlin's 2003 cost-of-service. *Id.*

22. The appropriate cost of debt for SFPP's North or Oregon Line costs of service, O'Loughlin submitted, is Kinder Morgan's cost of debt. *Id*. While O'Loughlin said that Kinder Morgan's December 31, 2003, cost of debt was 6.15%, he claimed that SFPP used a figure of 6.77%. *Id*. The difference between these two figures, according to O'Loughlin, occurred because he included long term debt, which Kinder Morgan considers short-term in nature, as well as bonds which Kinder Morgan considers to be long-term debt and are used by it in determining its capital structure. *Id*. at pp. 10-11.

23. SFPP used a 2003 nominal return on equity of 13.15% and a real return on equity of 11.27% in preparing its 2003 cost-of-service data for its North and Oregon lines, O'Loughlin explained, which was developed by SFPP witness J. Peter Williamson ("Williamson"). *Id.* at p. 12. Williamson applied a modified version of the Commission's discounted cash flow (sometimes "DCF") methodology to a proxy group consisting of a five-company oil pipeline master limited partnership (sometimes "MLP") sample, O'Loughlin stated. *Id*. at p. 12. O'Loughlin insisted it is necessary to modify this assumed return on equity because, according to him, the Commission's DCF methodology was misapplied in two ways: (1) the distribution yield in the DCF formula was not adjusted to account for the Commission's concern that a distribution yield is not the same as a dividend yield; and (2) in contrast with Commission precedent, the Social Security Administration's long-term Gross Domestic Product (sometimes "GDP") forecast was excluded from the growth calculation. *Id*. at p. 13.

24. O'Loughlin said that he corrected Williamson's 2003 return on equity calculation, which assumes that 100% of the oil pipeline's earnings are paid out as a dividend, creating a proxy dividend yield that is equal to annual net income per unit divided by the limited partner unit price. *Id*. at p. 18. O'Loughlin stated that he excluded the portion of the distribution that does not represent earnings in calculating the dividend yield. *Id*. He said he used the Institutional Brokers Estimated System (sometimes "IBES") earnings growth rates and the Commission-prescribed two-thirds weight in determining the weighted average growth rate for each of the five MLPs in the proxy group. *Id*. O'Loughlin claimed that his use of the IBES earnings growth rates in conjunction with the assumption that 100% of the earnings are being "dividended" to unitholders is a conservative approach that yielded a higher than otherwise rate of return estimate. *Id*. He stated that this is because retained earnings are a significant factor in determining earnings growth rates, but the assumption that 100% of the earnings are dividends implies that no earnings are being

retained and that they are all stable long-term surplus earnings not used for future growth. *Id.* This resulted in a higher dividend yield, O'Loughlin added, than were he to assume a portion was retained to fund future growth. *Id*. O'Loughlin contended that his assumption that proxy dividends will grow at the IBES earnings growth rates even though no earnings are being retained is more reasonable than Williamson's assumption that distributions will grow at the IBES earnings growth rates because there is no basis to assume that MLP distributions will grow at the assumed rate for MLP earnings. *Id*.

25. O'Loughlin indicated that he also altered Williamson's long-term Gross Domestic Product growth rate. *Id*. at p. 19. While Williamson used two sources, Energy Information Administration and Global Insight, O'Loughlin explained that he added the Social Security Administration's long-term GDP growth estimate when calculating the DCF model's growth rate. *Id*. O'Loughlin also alleged that he corrected the Energy Information Administration growth rate used by Williamson because, according to O'Loughlin, Williamson used an incorrect Base Year Nominal GDP figure to calculate his long-term growth rate, causing an overstatement of the implied 2008-2025 annual GDP growth in the Energy Information Administration forecast. *Id*. at pp. 19-20. Using the Commission's DCF methodology with a proxy dividend yield, O'Loughlin insisted that the median nominal rate of return on equity was 11.76% for the five-company proxy group for the period ended December 31, 2003, with a real rate of return on equity of 9.88%. *Id*. at p. 20.

26. O'Loughlin stated that SFPP purportedly calculated its income tax allowance in its 2003 cost-of-service data by implementing the weighted income tax rate calculation called for in the Commission's *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005). *Id*. at p. 21. O'Loughlin also contended that SFPP made errors when calculating weights for SFPP's six categories of unitholders[12] and when determining the federal and state income tax rates. *Id*. at p. 22.

27. According to O'Loughlin, in developing the weights for its proposed tax rates for the 2003 North and Oregon Line costs of service, SFPP attempted to trace its 2003 taxable income to its intermediate parent, Kinder Morgan Operating Limited Partnership "D" (sometimes "OLP-D"), and from OLP-D to Kinder Morgan, and, ultimately, to Kinder Morgan's unitholders. *Id*. He claimed that SFPP incorrectly implemented the calculation by incorporating incentive distributions and calculating the weights for the six unitholder categories from the taxable income data by attempting to demonstrate how the taxable income in 2003 was passed along undiminished, and what proportion was allocated to Kinder Morgan, Inc., and its subsidiaries, and what proportion was allocated to public investors in Kinder Morgan's Common Units. *Id*. at p. 23. Because Kinder Morgan does

[12] O'Loughlin listed the six categories of SFPP's unitholders as Subchapter C corporations, Individuals, Mutual Funds, Pensions/IRAs/Keoghs, Unrelated Business Income Tax Entities, and Non-taxpaying entities. Exhibit No. CC-1 at p. 21.

not track the separate income of its subsidiaries, such an attempt to trace SFPP-related income to the partners of Kinder Morgan is only speculative, O'Loughlin alleged. *Id*.

28. SFPP's calculations, O'Loughlin continued, are also distorted by its implementation of the Kinder Morgan partnership provision which specifies that all income be allocated to the general partner until the amount equals the incentive distributions made to the general partner. *Id*. According to him, "SFPP erroneously relates to its operation $42.8 million of incentive distributions" that Kinder Morgan G.P., Inc., Kinder Morgan's general partner, received in 2003 from Kinder Morgan. *Id*. at pp. 23-24. Incentive distributions, O'Loughlin explained, represent a substantial portion of the distributions Kinder Morgan received from Kinder Morgan G.P., Inc., in 2003. *Id.* This is the reason, O'Loughlin added, according to SFPP, that Kinder Morgan G.P., Inc., receives a proportion of Kinder Morgan's taxable income that is well above the percentage dictated by Kinder Morgan G.P., Inc.'s ownership stake in Kinder Morgan. *Id.* O'Loughlin contended that it does not make sense to establish an income tax allowance for SFPP using the taxable income allocations that are distorted by this "erroneous" application of the incentive distribution provision of Kinder Morgan's partnership agreement because the allowance becomes subservient to Kinder Morgan's cash distribution policy which Kinder Morgan G.P., Inc., has considerable discretion to influence. *Id*. at p. 24.

29. An income tax allowance based on SFPP's proposed methodology allows non-SFPP operations to increase Kinder Morgan's overall income and, therefore, O'Loughlin also claimed, the amount of cash distributions to Kinder Morgan G.P., Inc. *Id*. This causes an increase in income attributable to corporations and an increase in the resulting income tax rate under SFPP's methodology, he alleged. *Id*. Moreover, he added, SFPP "improperly" relies on all Kinder Morgan-subsidiary-generated income flowed into Kinder Morgan's incentive distribution scheme rather than solely SFPP's. *Id*. at p. 26. Because Kinder Morgan's payouts to the general partner depend on the amount of income from Kinder Morgan's subsidiaries, O'Loughlin testified, SFPP "incorrectly" assumed that its income would generate the same proportion of incentive distributions as Kinder Morgan's income. *Id*. Accordingly, O'Loughlin explained, he recalculated the amount of 2003 taxable income that flows from SFPP to Kinder Morgan under Kinder Morgan's incentive distribution scheme when SFPP's taxable income and cash distributions are treated on a stand-alone basis. *Id*. O'Loughlin stated that SFPP's distributions, when taxable income is recalculated, result in no incentive distributions to Kinder Morgan G.P., Inc. *Id*. Additionally, he said he recalculated the 2003 taxable income weights using SFPP's taxable income and accounting for the incentive distribution provision on a stand-alone basis for SFPP. *Id*. at p. 27.

30. Addressing federal and state income tax rates for the six specific categories of unitholders, O'Loughlin repeated his claim that there are two rates identified as rebuttable presumptions: 35% for subchapter C corporations and 28% for all other categories of

unitholders. *Id*. at p. 28. O'Loughlin said he assigned SFPP's assumed rate of 35% to the subchapter C corporate class and a federal income tax rate of zero percent to all other classes. *Id*. According to him, the presence of a 28% federal income tax rate implies that individuals will be the ultimate beneficiaries at the point where tax liability will reside for the other categories of unitholders (Individuals, Mutual Funds, Pensions/IRAs/Keoghs, and Unrelated Business Taxable Income (sometimes "UBTI") Entities). *Id*. at p. 29. SFPP's return on equity, however, already includes a component for such individual income taxes, O'Loughlin testified. *Id*.

31. Stating that there are also additional reasons for assigning a zero percent tax rate to the UBTI and mutual fund categories, O'Loughlin explained that the UBTI entity unitholders have not received unrelated business income that would meet the threshold for liability. *Id*. at pp. 30-31. SFPP's own evidence,[13] according to O'Loughlin, establishes that there is no foundation for claiming or presuming any tax rate associated with the tax exempt UBTI entities. *Id*. at p. 31. O'Loughlin added that he presumed that mutual funds are managed so as to avoid income taxes by passing through 90% of their income as dividends. *Id*.

32. While O'Loughlin claimed that he assigned a zero percent state income tax rate to all non-corporate unitholder categories, he stated that SFPP proposes to calculate a state income tax rate using a hypothetical weighted state income tax rate based on California and Nevada (North Line) and Oregon (Oregon Line) apportionment factors and marginal income tax rates. *Id*. at pp. 31-32. For the Subchapter C corporation category, O'Loughlin said he used the same state income tax rates used by SFPP in its cost-of-service data. *Id*. at p. 32. Further, O'Loughlin stated that he has attempted to calculate a blended rate that reflects the income tax status of the owning interest by using the taxable income percentages and tax rate assumptions for the various unitholders to calculate weighted average state and federal income tax rates of 5.13% for the 2003 North Line cost-of-service and 5.01% for the Oregon Line cost-of-service. *Id*.

33. O'Loughlin next discussed how SFPP's proposed Accumulated Deferred Income Tax (sometimes "ADIT") balances should be handled in the cost-of-service calculations. *Id*. at p. 33. He explained that SFPP has presumably collected revenues to recover an income tax allowance at the top marginal corporate income tax rate for several years in its existing North Line and Oregon Line rates. *Id*. Based on his weighted average state and federal income tax rates of 5.13% and 5.01%, O'Loughlin alleged that the ADIT balance is significantly over funded. *Id*. Apart from the overfunding problem, O'Loughlin

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[13] O'Loughlin referred to ("Exh[ibit No]. – 38g") in Docket No. IS05-230, which is not in the record here. Exhibit No. CC-1 at p. 31. Also, he referred to the testimony of SFPP witness Bullock who, as well as testifying here, apparently testified in that proceeding. *Id.* O'Loughlin attached a small portion of the record in that proceeding to his testimony. *See* Exhibit No. CC-22.

maintained that SFPP has erred in the calculation of its proposed 2003 ADIT balances in its 2003 cost-of-service data. *Id*. at p. 34. He stated that he has a problem with SFPP's calculation of its 2003 ADIT balance because it uses weighted income tax rates from the Commission's *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005), from 1992 to 2003 instead of using the top marginal income tax rate for corporations which is what was being collected during this time. *Id*. at pp. 34-35.

34. O'Loughlin indicated that he disagreed with the method by which SFPP calculated its 2003 balance, but noted that SFPP's use of relatively high weighted income tax rates from 1992 to 2003 leads to 2003 ADIT balance in its cost-of-service data that are only slightly less than what the balance would have been had it used his recommendation of the top marginal income tax rate for corporations. *Id*. at p. 35. According to O'Loughlin, SFPP's smaller ADIT balance results in a slightly larger 2003 rate base and cost-of-service, while his use of slightly larger cost-of-service results in a conservatively high estimate of just and reasonable rates and a conservatively smaller change for substantially changed circumstances purposes than if he had attempted to correct SFPP's ADIT calculation. *Id*. at pp. 35-36.

35. To determine a just and reasonable rate per barrel to Reno, Nevada, on SFPP's North Line, the total Complaint Year 2003 cost-of-service ($12.5 million) is divided by Complaint Year 2003 interstate volumes (13.7 million barrels) deriving a rate of 91.05 cents per barrel, according to O'Loughlin. *Id*. at p. 50. He stated that it is appropriate to use the actual 2003 North Line volumes to determine a just and reasonable rate for Complaint Year 2003 because SFPP's 2003 actual volume of 13.7 million barrels is consistent with the annual volumes occurring over the 2001 through 2004 time period. *Id.* at pp. 50-51 and tbl.8.

36. To determine a just and reasonable rate for the Oregon Line, O'Loughlin explained, he divided the Complaint Year 2003 cost-of-service ($4.7 million) by the Complaint Year 2003 interstate volumes (16.2 million barrels) to derive a just and reasonable per barrel rate of 29.25 cents. *Id*. at pp. 52-53 and tbl.9. It is appropriate to use 2003 actual Oregon Line volumes, O'Loughlin stated once again, because the Oregon Line experienced steady growth between 2001 and 2004, so SFPP's actual Oregon Line 2003 volumes are not at an anomalous level and thus are reasonable to use. *Id*. at p. 53.

37. According to O'Loughlin, the North Line and Oregon Line rates in this proceeding are subject to grandfathering. *Id*. at p. 54. Under the Energy Policy Act of 1992, he related, all oil pipeline rates in effect on the date EPAct became effective, that were not the subject of protest, investigation, or complaint during the twelve months prior to the effective date of EPAct, are "grandfathered" and deemed just and reasonable. *Id*. at pp. 54-55. The North Line rate, established in 1989, and the Oregon Line rate, established in 1985, were in effect for the twelve months prior to the passage of the EPAct, according to O'Loughlin. *Id*. at p. 54.

38. O'Loughlin explained that EPAct created a threshold test for challenging a grandfathered rate, under which a complainant must present evidence which establishes that a substantial change in the economic circumstances which were the basis for the oil pipeline's rate occurred after the EPAct was enacted.[14] *Id*. at p. 54. Based on changes in volume, rate base, allowed return, income tax allowance, and total cost-of-service, O'Loughlin claimed that there is a substantial change in the economic circumstances supporting the challenged rates for the North Line and the Oregon Line. *Id*. at p. 55.

39. The economic basis for the 1989 North Line rate of $1.10/bbl, O'Loughlin asserted, was a cost-of-service study that SFPP provided to the Commission to justify a 1989 rate increase. *Id*. at p. 57. However, he noted, this cost-of-service study was performed on a combined interstate and intrastate basis. *Id*. O'Loughlin opined that an interstate-specific version of the 1989 cost-of-service study developed by SFPP in this proceeding provides a more reliable interstate cost-of-service calculation, and, therefore, he said he relied on this study as the economic basis of SFPP's grandfathered North Line rate. *Id*. at p. 58. He stated that the 1989 rate is the Commission's "A," or Base Period. *Id*.

40. The appropriate cost-of-service data for the 12-months prior to the passage of EPAct (the Commission's "B" period) for use when determining whether there has been a substantial change in the economic circumstances of the 1989 North Line rate, O'Loughlin maintained, is a full cost-of-service analysis for the 12-months ending October 24, 1992, constructed according to the prevailing cost-of-service methodology on the effective date of the EPAct.[15] *Id.*

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[14] According to O'Loughlin, the Commission determines the percentage change in the basis for the rate that has occurred since the passage of EPAct by defining "A" as the Base Period, "B" as the 12-months prior to EPAct or the Pre-EPAct Period, and "C" as the Complaint Period. Exhibit No. CC-1 at p. 56 (*citing SFPP, L.P.*, 106 FERC ¶ 61,300 at P 22-26 (2004)). If there is information on the economic basis of the rate, the Commission uses the formula (C-B)/A; if there is not, the formula (C-B)/B is used, O'Loughlin added. Exhibit No. CC-1 at p. 57 (*citing SFPP, L.P.*, 106 FERC ¶ 61,300 at P 22-26).

[15] O'Loughlin claimed that using the 1992 study data he recommends is more appropriate than using the 1992 cost-of-service data that the Commission relied upon in *SFPP, L.P.*, 91 FERC ¶ 61,135 (2000). Exhibit No. CC-1 at p. 59. He added, inappropriately challenging the Commission's 2000 Order, that the Commission retained the grandfathering of the North Line rate utilizing data that reflected a methodology which was not in effect during the 12-month period prior to EPAct. *Id*. O'Loughlin's unbecoming challenge to the 2000 Order will not be entertained here.

41. For Complaint Year 2003 (the Commission's "C" period), O'Loughlin stated he used his cost-of-service calculation for the period ending December 31, 2003, and the associated volume and revenue data for making comparisons to the Base Period and the Pre-EPAct Period. *Id*. at p. 60.

42. O'Loughlin suggested that evidence of substantially changed circumstances in the economic basis of the North Line rate can be found by performing an analysis using the 1989 Base Period data and Pre-EPAct Period data presented by SFPP and his own Complaint Year 2003 data. *Id*. at pp. 60-61. Using the (C-A)/A comparison required when the value of "B" is less than "A," O'Loughlin asserted that there has been a 16% increase in revenue between the 1989 Base Period and Complaint Year 2003, relative to the 1989 Base Period volumes, and a 19% increase in revenue between the Pre-EPAct Period and Complaint Year 2003, relative to 1989 Base Period volumes. *Id*. at p. 63. There also have been large decreases in major cost-of-service factors which do not appear to be offset by other cost factors, since a total North Line cost-of-service shows a 6% decrease between the Pre-EPAct Period and Complaint Year 2003 relative to 1989 Base Period, O'Loughlin explained. *Id*. Furthermore, he stated, the change in each factor is substantial and the combination of the increase and decrease is greater evidence that there has been a substantial change in the economic circumstances of the North Line rates. *Id*.

43. To establish that a substantial change in circumstances exists, *i.e.*, higher than 15%, O'Loughlin testified he used actual revenue data which shows a combined change in increased revenue and decreased cost-of-service of 22 percentage points, which, he states, is above the Commission's 15% threshold. *Id*. at pp. 63-64.

44. Since, O'Loughlin alleged, SFPP did not provide data regarding the economic basis for the 1985 Oregon Line rate of 45.6 cents/bbl (the Commission's "A" period), he used data from the Pre-EPAct Period relative to Complaint Year 2003, rather than data from the 1985 Basis Period, to analyze whether there was a change in circumstances. *Id*. at p. 64. Relying on SFPP's 1992 Pre-EPAct cost-of-service calculations, O'Loughlin asserted, the appropriate cost-of-service data for the 12-months prior to the passage of the EPAct (the Commission's "B" period) is SFPP's full cost-of-service analysis for the 12-months ending October 24, 1992, constructed according to the cost-of-service methodology that prevailed at the time of the EPAct. *Id*. at pp. 64-65. According to O'Loughlin, for Complaint Year 2003 (the Commission's "C" period), he used his own cost-of-service calculation and the associated volume and revenue data for making comparisons to the Base Period and Pre-EPAct Period rather than the one the Commission used in its 2005 ruling.[16] *Id*. at p. 65-66.

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[16] O'Loughlin referred to *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005). Exhibit No. CC-1 at pp. 64-65. As with regard to the Commission's 2000 Order in *SFPP, L.P.*, 91 FERC ¶ 61,135, which was previously discussed, O'Loughlin collaterally attacked the Commission's 2005 ruling. I previously indicated that his attack on the 2000 order would

45. O'Loughlin suggested that there is evidence of substantially changed circumstances in the economic basis of the Oregon line. *Id*. at p. 66. According to him, his analysis shows that there has been a 36% increase in revenues between the Pre-EPAct Period and Complaint Year 2003 relative to the Pre-EPAct Period revenue. *Id*. Certain other cost factors, O'Loughlin noted, such as rate base, allowed total return, and income tax allowance have all greatly decreased between the Pre-EPAct Period and Complaint Year 2003 relative to the Pre-EPAct Period. *Id*. He further claimed that total Oregon Line cost-of-service between the Pre-EPAct Period and Complaint Year 2003 has also decreased by 11%. *Id*. These substantial changes, O'Loughlin said, are evidence that there has been a substantial change in the economic circumstances of the Oregon Line rates. *Id*. Although information is lacking on the basis of the 1985 Oregon Line rates, according to him, the cost-of-service per barrel is reflected in the rate itself, which, when compared to the cost per barrel in Complaint Year 2003, results in a decrease in cost per barrel of 36% since 1985 and 27% since 1992, indicating a substantial post-EPAct change in the effects of all rate elements when compared with the Base Period of 1985. *Id*. at p. 68.

46. His changed circumstances analysis indicates, O'Loughlin insisted, that SFPP's North and Oregon Line rates should no longer be grandfathered as of August 2003, the date of the Chevron complaint. *Id*. For the two years prior to the complaint date, O'Loughlin noted that he calculated an overpayment as the difference between the collected rate and the grandfathered rate multiplied by the complainant's volume. *Id*. Additionally, for the period after the complaint date, he calculated the overpayments as the difference between the collected rate and his Complaint Year 2003 just and reasonable rate multiplied by the complainant's volume. *Id*. For the North line, O'Loughlin added, overpayments would end on June 1, 2005. *Id*.

47. He estimated Chevron's North Line overpayment for the two years prior to its complaint, O'Loughlin said, as being $1.0 million, based on the difference between the collected rate and the grandfathered rate of $1.10/bbl for the two years prior to Chevron's complaint, and based on the difference between the collected rate and O'Loughlin's Complaint Year 2003 just and reasonable rate from September 2003 through May 2005. *Id*. at p. 69. In addition, O'Loughlin stated that he estimated that ConocoPhillips overpayment of North Line rates for the two years prior to its December 2004 complaint through May 2005 is $400,000, based on the difference between the collected rate and the grandfathered rate of $1.10/bbl for the period January 2003 through August 2003, and based on the difference between the collected rate and O'Loughlin's Complaint Year 2003 just and reasonable rate for the period September 2003 through May 2005. *Id*. at p. 70.

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not be entertained here and, to it, I now add his collateral attack on the Commission's 2005 order.

48. Furthermore, according to O'Loughlin, Chevron's Oregon Line overpayment for the two years prior to its complaint in August 2003 through August 2007 is $1.9 million based on his estimate of the difference between the collected rate and the grandfathered rate of $0.4560/bbl for the two years prior to Chevron's August 2003 complaint, and based on the difference between the collected rate and O'Loughlin's Complaint Year 2003 just and reasonable rate from September 2003 through August 2007. *Id*. at p. 71. He added that ConocoPhillips' overpayment of Oregon Line rates for the two years prior to its December 2004 complaint through August 2007 is $1.8 million, based on the difference between the collected rate and the grandfathered rate of 45.6 cents/bbl for the period January 2003 through August 2003, and based on the difference between the collected rate and O'Loughlin's Complaint Year 2003 just and reasonable rate for the period September 2003 through August 2007. *Id*. at p. 72.

49. O'Loughlin began his Rebuttal Testimony by stating that SFPP's analysis showed that the collected rates in 2003 and 2004 are unjust and unreasonable because the 2003 collected rates exceed the rates resulting from SFPP witness George R. Ganz's ("Ganz") costs of service by 37% on the Oregon Line and 9% on the North Line. Exhibit No. CC-44 at p. 7.[17] Additionally, O'Loughlin testified, the rates resulting from SFPP's analysis are less than the grandfathered rates, and thus the non-grandfathered portions of the collected rates are not just and reasonable. *Id*. at p. 8. Further, O'Loughlin indicated that he disagreed with some aspects of SFPP witness Ganz's 2003 cost-of-service calculations, including his calculations of capital structure, cost of debt, return on equity, and the allocation of overhead expense to SFPP. *Id*. at p. 10. As a result of this disagreement, O'Loughlin proposed corrections which reduce the 2003 costs-of-service, and thus the rates, for both lines. *Id*.

50. Beginning his discussion of capital structure, O'Loughlin contested SFPP witness Williamson's claim that adjusting only the equity balance to remove purchase accounting adjustments can produce "absurd results," stating that this concept is reasonable because debt has the first claim on the value of assets, and equity represents the remaining value of the assets over and above the debt balance. *Id*. at pp. 11-12 (*citing* Exhibit No. SFO-26 at pp. 30-31). He elaborated, explaining that, for assets that are regulated based on original costs, there is a direct relationship between return on the assets and the cost of the assets, assuming the regulated assets' current rates reflect its cost-of-service. *Id*. at p. 12. The

[17] O'Loughlin claimed that only the 2003 calculations, and not the 2004 calculations, are relevant in this proceeding because the Complaint Year 2003 calculations are being used to determine just and reasonable rates and whether a substantial change has occurred in the economic basis of the grandfathered rates. Exhibit No. CC-44 at pp. 8-9. The 2004 cost-of-service also lacks relevance, O'Loughlin continued, because it includes the cost of a December 2004 North Line expansion in the rate base, making it larger than it would be otherwise, and thus making it inappropriate to use to evaluate whether pre-expansion collected rates are reasonable. *Id*. at p. 9.

original cost of the asset is recovered from ratepayers through the depreciation expense included in rates, O'Loughlin continued. *Id*. Moreover, he added, the utility will receive a reasonable return on its investment in the assets through the allowed return component of cost-of-service. *Id*. O'Loughlin testified that the remaining value in an original-cost regulated asset therefore resides in the undepreciated portion of its original cost. *Id*. He also stated that there should be no significant market value premium that is substantially greater than the undepreciated original cost of the assets if the regulated asset is just receiving its historical cost-of-service. *Id*. Contrary to Williamson's claims, according to O'Loughlin, it is only possible for a premium price above the net depreciated original cost paid by an acquiring company to exist in the event of over recovery of historical cost-of-service by the acquired utility asset. *Id*. at p. 13. Such a situation, he noted, is unlikely to persevere. *Id*.

51. Shifting to cost of debt, O'Loughlin accounted for the difference between his recommended 2003 cost of debt of 6.15% and Williamson's recommended 2003 cost of debt of 6.77% by explaining that, while Williamson omits Kinder Morgan's commercial paper debt, Economic Development Revenue Refunding Bonds, Industrial Revenue Bonds, and Kinder Morgan Operating, L.P. "B" ("OLP-B") specific bonds, he included them in determining Kinder Morgan's cost of debt. *Id*. Because, O'Loughlin claimed, Kinder Morgan characterized $428.1 million of commercial paper as long-term debt that is short-term in nature,[18] he included it with long-term debt and thus included it in the cost of debt calculation, while Williamson believes this debt is short-term. *Id*. at p. 14. As for the other debt instruments, O'Loughlin justified their inclusion by maintaining that the bonds are included in determining Kinder Morgan's capital structure, that Kinder Morgan runs its funding in a consolidated or aggregate fashion, and that it treats these bonds as long-term debt in its 2003 SEC Form 10-K. *Id*. at pp. 14-15.

52. In determining return on equity, O'Loughlin stated he used SFPP's allocated return on equity figures from its 2003 cost-of-service studies and (1) capped the pipeline's distribution at the level of earnings when calculating dividend yield for the DCF formula; (2) included the Social Security Administration's long-term GDP growth estimate in his calculation of the DCF model's growth rate; and (3) corrected Williamson's Energy Information Administration growth rate calculation for a spreadsheet error.[19] *Id*. at p. 15. Williamson, according to O'Loughlin, disagreed with capping the dividend yield at the

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[18] O'Loughlin stated that he relied on Kinder Morgan's 2003 SEC Form 10-K, in which Kinder Morgan indicated that it intends to refinance $428.1 million of its short-term debt on a long-term basis under its unsecured long-term credit facility. Exhibit No. CC-44 at p. 14 (*citing* Exhibit No. CC-10 at p. 10).

[19] Williamson, according to O'Loughlin, corrected his analysis for this error and now calculates a real return on equity of 11.10%. Exhibit No. CC-44 at p. 15.

pipeline's level of earnings and instead combined the pipeline MLP's full distribution yield with its Institutional Brokers Estimated System earnings growth rate without any adjustments. *Id*. at p. 16. Additionally, O'Loughlin said he used the 2003 real return on equity (9.88%) which he calculated in his Direct Testimony, which is essentially the same as Williamson's calculation with the Social Security Administration's growth forecast included, except that he capped the distribution yield at the pipeline's level of earnings, which Williamson did not do. *Id*. at p. 17 (*citing* Exhibit No. CC-1 at p. 20 tbl.2).

53. Disagreeing with the Commission's ruling in *SFPP, L.P.*, 121 FERC ¶ 61,240 (2007), O'Loughlin contended that the weighted income tax rates he calculated in his Direct Testimony[20] are correct and reasonable to use when determining SFPP's rates. *Id*. at p. 18 (*citing* Exhibit No. CC-1 at pp. 21-36).[21] Moreover, O'Loughlin said he made additional calculations for the North and Oregon Line costs of service using the 35% weighted income tax rate in order to determine just and reasonable rates for the Complaint Year 2003. *Id*.

54. According to O'Loughlin, he updated his calculations of the North and Oregon Line just and reasonable rates for Complaint Year 2003 using SFPP's cost-of-service analysis, which is only slightly different from the cost-of-service analysis he used in his Direct Testimony. *Id*. at p. 18. According to O'Loughlin, the interstate volumes on SFPP's North Line use the same rate for all three of its destinations, and thus, it is not necessary to separate costs into distance and non-distance categories to derive rates. *Id*. at p. 20. All that is needed, he continued, is a just and reasonable rate per barrel, which O'Loughlin computed as 96.98 cents/bbl by dividing Complaint Year 2003 North Line cost-of-service of $13.3 million[22] by SFPP's actual 2003 volume of 13.7 million barrels. *Id*. For the Oregon Line, O'Loughlin calculated the cost-of-service for Complaint Year 2003 as $4.962 million, which he said he divided by SFPP's actual 2003 volume of 16.2 million barrels in order to derive a just and reasonable Oregon Line rate of 30.72 cents/bbl. *Id*. at pp. 21-22.

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[20] In his Direct Testimony, O'Loughlin noted, he calculated an income tax rate of 5.13% for the North Line and 5.01% for the Oregon Line. Exhibit No. CC-44 at p. 19 (*citing* Exhibit No. CC-1 at p. 33).

[21] As previously noted, collateral attacks on Commission decisions will not be entertained here.

[22] O'Loughlin said he began with SFPP's 2003 North Line cost-of-service of $14.6 million, which incorporates the 35% income tax rate, and made the aforementioned corrections in order to develop North Line cost-of-service of $13.3 million. Exhibit No. CC-44 at p. 20.

55. O'Loughlin claimed that he updated his substantially changed circumstances analysis to reflect the Commission's directives in *America West Airlines v Calnev Pipe Line LLC*, 121 FERC ¶ 61,241 (2007) (sometimes "*Calnev*") and *SFPP, L.P.*, 121 FERC ¶ 61,240 to incorporate a 35% income tax rate, and to use grandfathered revenues. Exhibit No. CC-44 at p. 22. Using his updated analysis, O'Loughlin said he concluded that there are substantially changed circumstances on both the North and Oregon Lines as of 2003. *Id*. at p. 26. Supporting his conclusion, O'Loughlin explained, post-EPAct improvement in the North Line's profit margin relative to the total return embedded in the basis cost-of-service is at least 30%, larger than either the 15% threshold he emphasized in his Direct Testimony or SFPP witness Robert G. Van Hoecke's ("Van Hoecke") proposed 20% threshold. *Id*. The improvement in the Oregon Line's profit margin relative to the total return embedded in the pre-EPAct cost-of-service, according to O'Loughlin, is at least 161% and even larger when measured against the return on equity component embedded in the rate. *Id*.

56. In order to determine substantially changed circumstances for the North Line, O'Loughlin said he reviewed the volume, grandfathered portion of the revenue stream, and cost-of-service for each period: Basis ("A"), Pre-EPAct ("B"), and the 2003 Complaint Period ("C"). *Id*. at p. 27.[23] O'Loughlin stated that he calculated a change in North Line grandfathered revenues of $1.4 million by subtracting the Basis Period grandfathered revenues from the 2003 Complaint Period grandfathered revenues. *Id*. at pp. 28-29. By finding the difference between the 2003 Complaint Period cost-of-service and the pre-EPAct cost-of-service, O'Loughlin said he calculated a post-EPAct change in North Line costs of -$200,000. *Id*. at p. 29. Using the same analysis for the Oregon Line, O'Loughlin maintained that he calculated a post-EPAct change in grandfathered revenues of $1.7 million and a post-EPAct change in Oregon Line resulted in costs of -$300,000.[24] *Id*. at pp. 30-32. O'Loughlin explained that, by determining the change in profit margin by adding the post-EPAct change in revenues to the post-EPAct change in costs, he calculated the change in profit margin as $1.6 million and $2 million for the North and Oregon Lines, respectively. *Id*. at pp. 29, 32. While he compared the North Line change in profit margin to the level of return contained in the basis cost-of-service, O'Loughlin

[23] O'Loughlin noted that he reviewed the same grandfathered portion of the revenue stream figures as Van Hoecke for all three periods, but used a different cost-of-service. Exhibit No. CC-44 at p. 27.

[24] O'Loughlin again claimed that he used the same grandfathered portion of the revenue stream figures as Van Hoecke, with the exception of the Basis Period. Exhibit No. CC-44 at p. 30. SFPP, he testified, has not procured data regarding the economic basis of the Oregon Line rates. *Id*. O'Loughlin stated that his costs of service for the Oregon Line, like the North Line, differ from Van Hoecke's. *Id*.

indicated that he compared the change in the Oregon Line's profit margin to the level of return contained in the pre-EPAct cost-of-service. *Id*.

57. O'Loughlin stated that the return on equity included in the basis cost-of-service, as taken from Ganz's 1989 North Line interstate-only cost-of-service analysis, is $3.8 million. *Id*. at p. 29. Expressed as a proportion of the return on equity, the Post-EPAct change in profit margin is 41% of the underlying return on equity, according to O'Loughlin. *Id*. at p. 30. He suggested that the change in profit margin is 30% relative to the allowed Total Return plus the Amortization of Deferred Earnings figure of $5.1 million. *Id*. Using this same measure for the Oregon Line, with a figure of $1.2 million, O'Loughlin claimed he determined a change in profit margin relative to the Allowed Total Return plus the Amortization of Deferred Earnings of 161%. *Id*. at p. 32. The post-EPAct change in profit margin for the Oregon Line as a proportion of the return on equity contained in the pre-EPAct cost-of-service is 232% of the underlying return on equity, O'Loughlin continued. *Id*. Under either measure of Oregon Line pre-EPAct return, he claimed that there is a substantial pre-EPAct change in profit margin. *Id*. at p. 33.

58. Criticizing Van Hoecke's substantially changed circumstances methodology, O'Loughlin stated that Van Hoecke: (1) ignored the Commission's emphasis on evaluating changes in return relative to the return embedded in the basis rate; (2) inappropriately rejected changes in return by creating a strawman with his gross margin discussion; (3) incorrectly specified the economic basis of the North and Oregon Line grandfathered rates by ignoring the then-current evidence regarding the development of the rates; and (4) incorrectly specified the pre-EPAct costs of service for both lines by ignoring then-current evidence. *Id*. at p. 33.

59. While Van Hoecke's method may indicate that a percentage change is not enough to establish substantially changed economic circumstances, O'Loughlin contended, when an analysis based on change in return is used instead, the result may indicate the opposite, even when the same data is used. *Id*. at pp. 38-39. Looked at from a return perspective, O'Loughlin explained, the change in pre-tax profit margin needs to be compared to the return embedded in the basis rate in order to evaluate whether the change in profit margin is significant. *Id*. Using Van Hoecke's methodology may result in a much higher improvement in profit margin relative to the return included in base rate, O'Loughlin concluded. *Id*. at p. 39. Furthermore, he added, when costs have increased by more than grandfathered revenues in the Post-EPAct Period, there will be a negative change in profit margin and no substantial change. *Id*. However, he continued, given that pipelines may index rates to compensate for cost increases, such a situation is unlikely. *Id*.

60. Discussing his analysis compared with Van Hoecke's, O'Loughlin pointed out that both methodologies computed the same post-EPAct change in revenue and change in cost-of-service, but the manner in which these changes were handled differed. *Id*. at p. 40. While the return approach, as used by O'Loughlin, combined these changes to

determine the change in profit margin which is then compared with the return embedded in the Basis Period rate, Van Hoecke's approach, O'Loughlin contended, diluted the significance of the change in return by comparing a change in return to total cost-of-service because the cost-of-service is comprised of a number of elements beyond return. *Id.* He added, "[c]omparing an improvement in return to a denominator that includes operating expenses, depreciation, and the like is not consistent with the Commission's direction . . . that the improvements be measured against the basis return level." *Id.*

61. Continuing his discussion of Van Hoecke's first alleged error, O'Loughlin pointed out that using dollars to calculate weights with which to add the percentage changes in revenue and cost is insufficient because there is no underlying theoretical foundation for looking at the combined change between the two elements. *Id*. Moreover, he added, "[w]eighting two figures by their relative dollar magnitudes is meaningless if the two elements being measured are of differing importance." *Id*. at p. 41.

62. According to O'Loughlin, Van Hoecke "creates confusion by introducing the term 'gross margin' and referring to it as 'the mathematical difference between two broad-based economic factors, revenue and cost.'" *Id.* (*citing* Exhibit No. SFO-1 at p. 20*).* He added that, in doing so, Van Hoecke ignored the fact that cost (and by "cost," O'Loughlin claimed that Van Hoecke meant cost-of service) contains return is a component of cost-of-service. *Id.* at pp. 41, 43. As a result, O'Loughlin argued, Van Hoecke's "A" period level of return, which ignores the underlying return on equity, is erroneous. *Id.* at p. 43. O'Loughlin added that, unlike Van Hoecke, he does not think that rate base, total allowed return, income tax allowance, operating costs, and capital costs should be ignored when analyzing substantial change. *Id.* at pp. 43-44.

63. As identified by O'Loughlin, Van Hoecke's third error was using the 2008 methodology instead of documentary evidence that existed and was relied upon at the time North and Oregon Lines' grandfathered rates were developed. *Id.* at p. 48. This resulted in figures which do not bear relation to the assumptions underlying the grandfathered rates, according to O'Loughlin. *Id*. at p. 48. With regard to the North Line, he continued, Van Hoecke did not use the 1989 North Line cost-of-service study that was the basis for the rate, but instead used a new 1989 cost-of-service study prepared by Ganz using a 2008 methodology as the basis cost-of-service. *Id*. O'Loughlin continued, stating that Ganz's cost-of-service study cannot be the economic basis for the 1989 North Line rate because the grandfathered revenue is too high to be justified by this cost-of-service. *Id*. at p. 49. Furthermore, added O'Loughlin, SFPP justified its 1989 North Line rate increase by using a methodology to calculate return and income taxes that results in higher figures than if the 2008 methodology were used. *Id*. at p. 50. The method that was used at the time of the rate increase to justify the rate should be used in the substantially changed circumstances analysis, O'Loughlin testified. *Id*.

64. Focusing on the Oregon Line, O'Loughlin disagreed with Van Hoecke's attempt to create a 1985 economic basis from scratch, referring to Ganz's 1985 Valuation cost-of-service study. *Id*. at p. 51. He also alleged that Ganz's cost-of-service is not representative of the economic basis of the Oregon Line rates because it implies that there was a large overrecovery in the first year that the rates were in effect.[25] *Id*. at p. 52. Van Hoecke, O'Loughlin added, is not able to explain the difference between the 1985 grandfathered revenues and Ganz's 1985 Valuation cost-of-service which accounts for the overrecovery. *Id*. Van Hoecke's substantially changed circumstances analysis should not be relied upon, according to O'Loughlin, because Ganz's 1985 Oregon Line cost-of-service is too low. *Id*.

65. O'Loughlin also disagreed with Van Hoecke's argument that the 1985 Oregon Line grandfathered revenue is too low because the Oregon Line did not begin to achieve the rates contemplated in the 1985 expansion rate filing until 1999 and that, therefore, he used "the 1999 Oregon Line volume level of 15.503 million barrels as the 1985 basis and 1992 pre-EPAct values upon which to compare to the 2003 Complaint Period value." *Id*. at pp. 52-53. In response, O'Loughlin argued that this approach "has the erroneous practical effect of reducing the change in grandfathered revenue between the pre-EPAct and Complaint Periods by artificially inflating the pre-EPAct grandfathered revenue level." *Id.* at p. 53. He also claimed that Van Hoecke lacked evidence which shows how the rate was developed. *Id*. The purpose of Van Hoecke's argument, according to O'Loughlin, is to show that the 1999 Oregon Line volume should be used as the 1985 Basis and 1992 Pre-EPAct Periods for comparison with the 2003 Complaint Period value, an approach which O'Loughlin believes reduces the change in grandfathered revenue between the Pre-EPAct and Complaint Periods by inflating the pre-EPAct grandfathered revenue level. *Id*. Furthermore, added O'Loughlin, Van Hoecke's theory that the 1999 volumes should be used is undermined by the large disparity between the 1985 grandfathered revenue and Ganz's 1985 Valuation cost-of-service.[26] *Id*. at pp. 53-54.

66. The final alleged error O'Loughlin noted is Van Hoecke's use of a 2008 methodology to develop his pre-EPAct costs of service, rather than the method or capital structure that SFPP used pre-EPAct. *Id.* at p. 55. This results, he claimed, in lower North and Oregon Line costs of service than SFPP would have developed at the time and an overstatement of the post-EPAct increase in costs from 1992 to the present. *Id*. at pp. 55-56. According to O'Loughlin, Van Hoecke used this approach because he contends

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[25] Citing two sources which were current in 1985, O'Loughlin pointed out that neither suggested the type of overrecovery implied by Ganz's cost-of-service. Exhibit No. CC-44 at p. 52 (*citing* Exhibit Nos. SFO-84 at p 3, SFO-7 at p. 17).

[26] According to O'Loughlin, the 1985 grandfathered revenue level is $7.069 million, while Ganz's 1985 Valuation cost-of-service is $4.002 million, reflecting an overrecovery of approximately $3 million. Exhibit No. CC-44 at pp. 53-54.

that it is logical to use the current interpretation of the Commission's *Williams Pipe Line Co.*[27] methodology for the periods in which it was in effect, namely the Pre-EPAct North and Oregon Line costs of service and the 1989 North Line Basis cost-of-service. Exhibit No. CC-44 at p. 56. O'Loughlin insisted that the correct method to use is the approach which was current at the time. *Id*. Supporting his point of view, O'Loughlin stated that using the 2008 methodology resulted in a 1989 North Line Basis Period cost-of-service which bore no relation to the Basis Period grandfathered revenues. *Id*. at pp. 56-57. Furthermore, O'Loughlin added, by using the 2008 methodology for the North and Oregon Line costs of service, Van Hoecke attributed too much of the changes in cost-of-service to post-EPAct events for both lines. *Id*. at p. 58.

67. Van Hoecke, according to O'Loughlin, also tried to reduce the pre-EPAct costs of service for both the North and Oregon lines by changing the 1983-1989 capital structure assumptions to conform with *SFPP, L.P.*, 86 FERC ¶ 61,022 (1999), which are inconsistent with those being used at the time. Exhibit No. CC-44 at p. 58. O'Loughlin explained that the equity component of capital structure is used to determine the equity portion of the starting rate base write-up that will be included in rate base. *Id*. The higher the equity component, he continued, the larger the rate base. *Id*. When SFPP prepared the then-current ratemaking analysis between 1989 and 1994, O'Loughlin stated, it used two approaches to determine capital structure for 1983-1989: the actual capital structure of its parent and the actual capital structure of its parent for 1983 for all years during the period. *Id*. at p. 59. These approaches, he maintained, both rely on relatively high equity capital structure percentages, which, O'Loughlin explained, resulted in a higher rate base, higher allowed total return, and higher cost-of-service. *Id*.

68. On cross-examination, O'Loughlin stated that he did not contend, on a basic level, that a shipper must demonstrate a substantial change in a pipeline's total cost-of-service in order to get the grandfathered protection of that rate removed. Transcript at p. 406. Instead, O'Loughlin claimed, his analysis measures the magnitude of change in the cost-of-service and that he looked at the post-EPAct change in profit margin and compares that change to the return embedded in the basis circumstances. *Id*.

69. Further, O'Loughlin agreed that, in his Rebuttal Testimony, he expressed concern with Van Hoecke's method of measuring substantial change because it requires full cost-of-service calculations to undertake his evaluation, which may not be available at the time a complainant files a complaint. *Id*. at p. 407. He also added that his concern stems from the Basis Period economic basis of the rate which may or may not be a cost-of-service calculation and would not be available without discovery. *Id*. at pp. 407-08. O'Loughlin agreed, however, that his own test can also only be implemented with discovery. *Id*. at p. 408. The difference, O'Loughlin claimed, between his test and Van Hoecke's, is that O'Loughlin performed a threshold calculation allegedly based on the Commission's

[27] 31 FERC ¶ 61,377.

decision in *Calnev*[28] which uses the page 700 workpapers from FERC Form 6 and compares grandfathered revenues to that cost-of-service for the Complaint Year, without the need for discovery. *Id*. at pp. 407-08.

70. Ganz's 2004 North Line cost-of-service concerns O'Loughlin, he confirmed, because it includes the North Line expansion that went into service and was booked in December 2004, which increases the cost-of-service and the rate significantly above what they would be were it not included. *Id*. at pp. 418-19. Because the rate base calculation involves averaging the beginning-of-year plant value and the end-of-year plant values, half of the effect of the expansion is included in the rate base. *Id.* at p. 419. This concerns O'Loughlin, he testified, because SFPP filed for a rate increase for the expansion at a later date, and therefore, it had not been including the expansion in its rates before that time. *Id*. at p. 420. The average for the entire year is essentially distorted by the timing, he asserted. *Id*. at p. 420-21.

71. Upon further questioning, O'Loughlin confirmed that the substantially changed circumstances analysis presented in his Direct Testimony examined the change in return or profit margin relative to return embedded in the base rate, while the analysis in his Rebuttal Testimony looks at changes in return relative to the Commission's *Calnev* ruling, issued after his Direct Testimony had been filed. *Id*. at pp. 437-38. In his Rebuttal Testimony, O'Loughlin explained, he relied on grandfathered revenue. *Id*. at p. 439.

72. O'Loughlin next testified that, while in his Direct Testimony he calculated a 22% change, in his Rebuttal Testimony, the change increased to 30% or 41% using the same set of data because of "the notion of looking at the change in profit margins relative to the change in return that is embedded in the basis rate." *Id*. at pp. 440-41. O'Loughlin further stated that the new percentages reflected his interpretation of what the Commission is looking for in terms of comparing a post-EPAct improvement in profit margin relative to the return in the basis rate. *Id*. at pp. 441-42.

73. According to O'Loughlin, he used two different measures of return to calculate the percentage improvements in profit margin: return on equity and total allowed return, which includes return on equity, interest, and amortization of deferred earnings. *Id*. at p. 449 (*citing* Exhibit No. CC-44 at p. 28 tbl.4).

74. Regarding methods which measure a variable over time, O'Loughlin testified that whether it is better to measure the variable using the same measurement over the entire study period as opposed to using two measurements of that variable depends upon the question one is trying to answer. *Id*. at pp. 478-79. Specifically, he stated, in this proceeding, he is being asked to assess post-EPAct change, and thus he is trying to assess

[28] 121 FERC ¶ 61,241.

change from 1992 through 2003, relative to the 1989 Basis Period, which dictates the notion of having a numerator that is a multi-year change in the profit margin. *Id*. at p. 479.

75. During continued cross-examination, O'Loughlin testified that, when looking at the post-EPAct change in profit margin, he used two definitions of return, but that there are other definitions of return that could be used in performing the calculation. *Id*. at p. 484. While O'Loughlin said he used return on equity and the larger measure of return on equity plus amortization of deferred return plus interest expense, he stated that in between these measures there also could be return on equity plus interest. *Id.* at p. 485.

76. O'Loughlin acknowledged that he essentially adopts SFPP witness Williamson's 10.02% real return on equity for SFPP's North Line for 2003. *Id*. at pp. 485-86. He asserted that he understood that this figure reflects a median value for Williamson's proxy group, and, by accepting this number, he accepted that SFPP has a risk profile that is, on average, the same as the MLPs included in the proxy group. *Id*. at p. 486. O'Loughlin added, however, that he has not done a study comparing the risk profile of SFPP for 2003 to the risk profile of the MLPs in the proxy group. *Id*. at pp. 487-88. Concerning MLPs, O'Loughlin explained that the 90% gross revenue rule requires that a high percentage of the partnership's business must be from oil and gas related activities, and that, if the MLP fails to meet this requirement, it loses its tax status as an MLP. *Id*. at p. 488. Because SFPP is a limited partnership, not an MLP, O'Loughlin suggested that it does not face the same risk which is faced by the MLPs in the proxy group. *Id*. at p. 489.

77. While, in his Direct Testimony, O'Loughlin stated, he used a weighted income tax rate of approximately 5% in his North and Oregon Line 2003 cost-of-service calculations, during cross-examination, he agreed that, in order to comply with Commission policy, he used SFPP witness Ganz's calculation of a 35% weighted income tax rate in these calculations. *Id*. at pp. 490-91. The disparity between his 5% tax rate and Ganz's 35% tax rate, according to O'Loughlin, is so large because the allowed return on equity is a before individual income taxes return on equity, and he does not include the 28% marginal tax rate in his weighted income tax rate calculation. *Id*. at p. 492. Moreover, O'Loughlin testified, Ganz's tax rate for SFPP is not developed on a stand-alone basis with only SFPP's income, but is affected by SFPP's affiliates. *Id*. at p. 493. The difference between the two, he continued, rests on the fact that O'Loughlin allocated the incentive distribution to the general partner among all Kinder Morgan limited partners, while Ganz included it as part of SFPP's income. *Id*. at p. 494.

78. Responding to my question regarding why he placed the term "dividend" in quotation marks when referring to an MLP, O'Loughlin explained that he does not consider a distribution to be the same as a dividend because, with an MLP, distributions

tend to exceed earnings.[29] *Id*. at pp. 500-01. Using a distribution yield, he continued, is not consistent with the Commission's constant growth DCF formula. *Id*. at p. 502. O'Loughlin testified that, in order to fix the inconsistency, he capped the distribution at 100% of earnings for calculating the yield piece, making the distribution more synonymous with a dividend yield combined with an earnings growth rate for the DCF formula. *Id*. at pp. 502-03. However, O'Loughlin agreed that, if the owner of an individual proprietorship, a partner in a partnership, and a stockholder in a corporation all receive $10,000 from each of their entities, the payments, if they are coming from profits, are essentially the same thing, economically. *Id*. at p. 506. He stipulated that the situation changes when the pay out is something more than the profits in a partnership, particularly for a regulated company. *Id*. at p. 507.

79. In response to my further questions, O'Loughlin explained what he meant by a "before individual income taxes rate of return" in his Direct Testimony. *Id.* at p. 510. He testified that, when one buys a share of stock, he or she will get the stock as well as a stream of dividends. *Id*. at p. 510. Income taxes, he continued, will need to be paid on those dividends, but, when they are used in the DCF formula, these taxes have not yet been paid. *Id*. at p. 511. Therefore, investors will look at their after-individual-income tax return when determining what type of investment to make, according to O'Loughlin, because income taxes serve to dilute the return one is getting from the cash that comes from the dividend or distributions. *Id*. at pp. 511, 517. The same is true for an MLP, he pointed out, because there are tax implications if the return is calculated before individual income taxes. *Id*. at pp. 511-12.

B. DANIEL S. ARTHUR

80. Daniel S. Arthur ("Arthur") submitted testimony on behalf of Chevron and ConocoPhillips regarding the allocation of overhead expenses to SFPP. Exhibit No. CC-56 at p. 4.[30] He is a Principal of The Brattle Group, an economic and management consulting firm. *Id*.

81. SFPP's cost-of-service data, Arthur stated, includes $32.6 million of Kinder Morgan corporate unallocated overhead costs allocated to SFPP, $25.5 million of which is allocated to carrier operations and $7.1 million to non-carrier operations. Exhibit No. CC-1 at p. 36. He added that $1.7 million of the $25.5 million is allocated to SFPP's North

[29] O'Loughlin noted than an MLP may be paying out 100% of its earnings plus cash flow that comes from depreciation because they are not fully investing all of the cash flow back into assets. Transcript at p. 502.

[30] In addition to his comments in Exhibit No. CC-56, at the hearing, Arthur took responsibility for page 36, line 6, through page 50, line 2 of Exhibit No. CC-1, previously submitted as O'Loughlin's testimony. Transcript at pp. 391-92, 520-21.

Line interstate operations, $1.1 million is allocated to its Oregon Line, and that SFPP uses the Commission's Massachusetts formula to allocate Kinder Morgan corporate unallocated expenses to SFPP. *Id*. Arthur said he does not agree with SFPP's methodology for allocating Kinder Morgan's 2003 corporate unallocated expenses to SFPP's North and Oregon Lines. *Id*. at p. 37. First, he stated, it was inappropriate for SFPP to exclude 16 Kinder Morgan subsidiaries from the allocation. *Id*. Second, Arthur disagreed with SFPP's calculation of the total Kinder Morgan overhead to be allocated to Kinder Morgan's subsidiaries, and third, he stated, SFPP's use of ten tiers of overhead expenses contains too many discrepancies to instill confidence that Kinder Morgan is performing a reasonable allocation. *Id*. at pp. 37-38.

82. According to Arthur, SFPP's basis for excluding 16 Kinder Morgan subsidiaries from the Massachusetts formula allocation is that most of the subsidiaries do not require any Kinder Morgan management because they are operated by Kinder Morgan's parent company, Kinder Morgan, Inc., or by another third party. *Id*. at p. 38. However, he continued, $17.5 million of the corporate unallocated expenses represent Kinder Morgan's cost to have Kinder Morgan, Inc., operate these subsidiaries. *Id*. SFPP's basis for excluding these subsidiaries is, Arthur contended, invalid for three reasons. *Id*. First, according to Arthur, under the operating agreements for the Kinder Morgan-subsidiaries operated by Kinder Morgan, Inc., the fixed payments of general and administrative expenses are a predetermined arbitrary amount, not related to the actual expenses in a given year. *Id*. at pp. 38-39. Moreover, he maintained, if the arbitrary amount paid by the excluded entities significantly understates the amount reasonably allocated to the subsidiaries using the Massachusetts formula, this predetermined amount creates the likelihood of cross-subsidization between SFPP, the regulated entity, and the excluded Kinder Morgan, Inc.,-operated subsidiary. *Id*. at p. 39. Second, Arthur stated, because Kinder Morgan was unable to directly assign any general and administrative expense to the 16 excluded subsidiaries in its SEC Form 10-K, it is questionable as to why SFPP is able to directly assign Kinder Morgan's corporate unallocated expenses to any specific subsidiaries for SFPP's cost-of-service. *Id.* Third, according to Arthur, it is inappropriate to exclude any subsidiary from a calculation to allocate overhead expense if the subsidiary benefits from the parent company in any way. *Id*. He contended that the 16 excluded subsidiaries benefit because Kinder Morgan retains some managerial responsibilities and performs accounting and associated legal work involving the Kinder Morgan, Inc.-operated subsidiaries. *Id*. at p. 38.

83. The $17.5 million of Kinder Morgan's corporate unallocated overhead expense attributed to the 16 excluded subsidiaries, Arthur testified, is significantly less than the $32.6 million allocated to SFPP in SFPP's Massachusetts formula. *Id.* at p. 41. Arthur suggested that this disparity is not plausible because the 16 subsidiaries represent higher percentages of Kinder Morgan's total revenue, total gross property, and total direct labor than SFPP. *Id*. at p 41. He insisted that the magnitude of the disparity is evidence that

SFPP's method does not reasonably allocate Kinder Morgan's unallocated overhead expenses among all of its subsidiaries. *Id*.

84. Arthur next explained that SFPP included a total of $140.4 million of overhead expense in its 2003 Massachusetts formula calculation. *Id*. at p. 42. SFPP, he noted, subtracted $17.5 million from the overhead expense for subsidiaries that are excluded from the Massachusetts formula calculation because they are operated by Kinder Morgan, Inc. *Id*. Arthur disagreed with this allocation and with SFPP's allocation of $20.7 million based on the amount SFPP is able, uniquely, to attribute to multiple Kinder Morgan subsidiaries because Kinder Morgan was unable to identify them on its SEC Form 10-K. *Id*. at pp. 42-43.

85. Arthur related his own determination of the amount of the total Kinder Morgan corporate unallocated expense which should be allocated by the Massachusetts formula to Kinder Morgan's subsidiaries. *Id*. at p. 43. He indicated that he does not subtract anything from Kinder Morgan's total overhead expenses of $150.4 million included in the Massachusetts formula because no Kinder Morgan subsidiary, he submitted, should be excluded. *Id*. As SFPP, he added the $28.2 million of capitalized overhead to the $150.4 million for a total of $178.7 million to be allocated by the Massachusetts formula. *Id*.

86. He does not agree with SFPP's use of ten tiers in its Massachusetts formula calculation, Arthur testified, explaining that its use of ten tiers is based on uniquely assigning portions of Kinder Morgan's corporate unallocated expenses to a specific subsidiary or a specific group of subsidiaries. *Id*. at pp. 43-44. According to Arthur, "there are several anomalies and discrepancies in SFPP's use of ten tiers," the first of which is its ability to identify expenses related to specific subsidiaries or groups of subsidiaries contrary to a data response provided by SFPP that states that Kinder Morgan does not maintain its accounts in such a way that this information would be available. *Id*. at p. 44 (*citing* Exhibit No. CC-32). The second anomaly, he stated, is that SFPP's identification of overhead expenses as being specific to individual or groups of Kinder Morgan subsidiaries has changed through time with SFPP's overhead expense allocation methodology, indicating that the methodology is subjective. *Id*. Arthur insisted that the result of these discrepancies is that SFPP's allocation method over-allocates Kinder Morgan overhead costs to SFPP. *Id*. at pp. 44-45.

87. SFPP's methodology of assigning overhead expenses to tiers has been modified over time, according to Arthur. *Id*. at p. 45. He explained that the ten-tier methodology SFPP used in the 2003 cost-of-service studies was developed in 2006. *Id*. The original 2003 Massachusetts formula utilized two tiers, and, he added, the original 2004 formula utilized four. *Id*. The ten-tier methodology, O'Loughlin contended, is an after-the-fact reallocation of overhead expenses that reassigns the historical 2003 overhead expenses to specific Kinder Morgan subsidiaries, contrary to Kinder Morgan's statement that it does not maintain its general and administrative expenses in a manner that reflects expenses

associated with individual business units. *Id*. Arthur also stated that the 2003 overhead expenses that SFPP specifically assigns to a specific Kinder Morgan subsidiary has changed along with its methodology. *Id*. at pp. 45-46.

88. Arthur alleged that there are two problems with SFPP's treatment of gross property in its Massachusetts formula calculations. *Id*. at p. 47. First, he stated, while SFPP excludes purchase accounting adjustments to gross property associated with Kinder Morgan's regulated subsidiaries and unregulated subsidiaries, it does not exclude the purchase accounting adjustment associated with the regulated Calnev pipeline. *Id*. The second problem, he claimed, is that SFPP uses an average of end-of-year 2002 and end-of-year 2003 gross property in its calculations, instead of using only an end-of-year 2003 balance. *Id*. Moreover, Arthur added, the purchase accounting adjustments need not be excluded with respect to Kinder Morgan's unregulated subsidiaries because there is no relationship between the price, revenues, and profitability of these unregulated subsidiaries and the original cost of the subsidiaries' gross property, while there is a direct relationship for subsidiaries that are regulated on an original cost basis. *Id*. As a result, Arthur stated, he removed the purchase accounting adjustments from gross property only for Kinder Morgan's regulated subsidiaries, including the Calnev pipeline, and uses end-of-year 2003 gross property balances in his Massachusetts formula calculation. *Id*. at pp. 47-48.

89. According to Arthur, $178.7 million of total Kinder Morgan corporate unallocated overhead expenses should be allocated to all of Kinder Morgan's subsidiaries without tiers of expenses. *Id.* at p. 48. Moreover, adjustments of the gross property, plant, and equipment of Kinder Morgan's regulated subsidiaries to year-end 2003 balances should be made, Arthur claimed, and the purchase accounting adjustment associated with Calnev pipeline should be removed. *Id*. While SFPP proposes an allocation of $32.6 million, Arthur stated, his calculation results in an allocation of $15.8 million of Kinder Morgan corporate unallocated overhead costs to SFPP, $12.4 million of which is allocated to carrier operations and $3.4 million to non-carrier operations. *Id*. Arthur also asserted that he allocates $800,000 of the carrier amount to SFPP's North Line interstate operations and $600,000 to SFPP's Oregon Line interstate operations, while SFPP allocates $1.7 million and $1.1 million in its 2003 cost-of-service study, respectively. *Id*. at pp. 48-49.

90. In his Rebuttal Testimony, Arthur, discussing the 12 Kinder Morgan subsidiaries that SFPP witness Dale D. Bradley ("Bradley") excluded from the Massachusetts formula calculation, noted that six Kinder Morgan subsidiaries are excluded because they are operated by Kinder Morgan, Inc., and the other six are excluded because they are operated by third parties. Exhibit No. CC-56 at pp. 5-6. Kinder Morgan does not provide any services to the six Kinder Morgan, Inc.-operated subsidiaries, whose overhead costs are charged directly to them or are charged on a pass-through basis, Arthur explained. *Id*. at pp. 7-8. Moreover, the Kinder Morgan, Inc.-operated subsidiaries, he added, paid fixed fees to Kinder Morgan, Inc., in 2003, which covered the overhead costs incurred by Kinder Morgan, Inc., in operating the entities. *Id*. at p. 8.

91. However, Arthur continued, Bradley does not address that Kinder Morgan's operating agreement requires it to retain oversight responsibility of the subsidiaries, or that Kinder Morgan performs several overhead services for the Kinder Morgan, Inc.-operated subsidiaries. *Id*. at p. 8. Likewise, Bradley's conclusion that the fixed fees paid by the Kinder Morgan, Inc.-operated subsidiaries covered any overhead incurred by Kinder Morgan, Inc., also is problematic because, Arthur explained, there is no residual overhead incurred by Kinder Morgan, Inc., being charged to other Kinder Morgan subsidiaries. *Id*. at pp. 9-10 (*citing* Exhibit Nos. SFO-25 at pp. 26-27, SFO-32).

92. Moreover, Arthur testified, Bradley's analysis shows that no expenses associated with a number of overhead services[31] provided by Kinder Morgan, Inc.-shared employees were directly assigned to the Kinder Morgan, Inc.-operated subsidiaries. *Id*. at p. 10. He maintained that a total of $9,000 related to these overhead expenses was assigned to the Kinder Morgan subsidiaries from Kinder Morgan, Inc.; however, Arthur stated, Kinder Morgan, Inc., also simultaneously charged the other Kinder Morgan subsidiaries it does not operate $14.3 million for the same overhead functions. *Id*. Further, according to Arthur, Bradley indicated that the Kinder Morgan, Inc.-shared employees should provide the overhead services to the Kinder Morgan, Inc.,-operated Kinder Morgan subsidiaries, but also implies that these subsidiaries do not require these overhead services. *Id*. at p. 11. Arthur submitted that this is not plausible. *Id*. He contended that some entity must be incurring expenses related to overhead services for the Kinder Morgan, Inc.-operated Kinder Morgan subsidiaries, which could mean one of two situations: either (1) the overhead services are performed by Kinder Morgan, Inc., which charges the expenses to the other Kinder Morgan subsidiaries through the Kinder Morgan, Inc., cross-charge instead of charging Kinder Morgan, Inc.-operated subsidiaries; or (2) Kinder Morgan, Inc., performs the services in the same manner as it does for its other subsidiaries that it operates and includes them in its Massachusetts formula calculation, contrary to Bradley's testimony. *Id*. at p. 12. Both situations will, according to Arthur, result in cross-subsidization of the excluded subsidiaries by the included subsidiaries. *Id*. This would occur, Arthur explained, because either the included entities will be allocated the overhead expenses incurred by Kinder Morgan, Inc., through the Kinder Morgan, Inc., cross-charge, or the excluded entities will not be allocated overhead from Kinder Morgan, which would result in an over allocation to the subsidiaries included in SFPP's Massachusetts formula, including SFPP. *Id*.

93. Bradley excluded six Kinder Morgan subsidiaries, Arthur testified, because they are operated by a third party which, Bradley claimed, provides all overhead services. *Id*. at p. 13. Further, Arthur, asserting that Bradley claimed that Kinder Morgan did not provide oversight or overhead services to these subsidiaries even though it held ownership

[31] Arthur listed the overhead services as treasury, human resources, procurement, income taxes, and information technology. Exhibit No. CC-56 at p. 10.

interests, insisted that this claim is implausible because it suggests that Kinder Morgan is passive and does not oversee each subsidiary's attempts to maximize profit or operate in an efficient manner. *Id*. at pp. 13-14 (*citing* Exhibit No. SFO-25 at pp. 29-33). The operating agreements, according to Arthur, establish that Kinder Morgan is not passive, but has direct oversight responsibilities separate from the operational responsibilities of the third-party operators. *Id*. at p. 14 (*citing* Exhibit Nos. SFO-35 through SFO-40).

94. Arthur suggested that SFPP should not exclude the 12 subsidiaries from its Massachusetts formula calculation because it is clear, he contended, that Kinder Morgan has oversight responsibilities as an owner separate from the operator's responsibilities which generate overhead expenses. *Id*. at p. 19. Additionally, Arthur alleged that SFPP's direct assignment of overhead expenses is flawed and unreliable because the amount of overhead expense that Kinder Morgan, Inc., directly assigned to the Kinder Morgan subsidiaries it operates includes a trivial amount of overhead expense associated with the Kinder-Morgan, Inc.,-shared employees. *Id*.

95. Addressing Bradley's claim that the disparity in the combined three-factor average of gross revenue, gross property, and payroll expense, which exceeds SFPP's combined three-factor average, is almost entirely attributable to the revenues generated by one excluded Kinder Morgan subsidiary, Arthur insisted that revenue is not the only disparity. *Id*. at p. 20. According to Arthur, not only does gross revenue for the excluded Kinder Morgan subsidiaries exceed SFPP's gross revenue as a percent of Kinder Morgan's total revenue, but the same is true for the gross property and direct labor percentages of total Kinder Morgan gross property and direct labor. *Id*. Even though the excluded Kinder Morgan subsidiaries represented larger shares of Kinder Morgan's total revenues, gross property, and direct labor, SFPP's methodology of directly assigning the Kinder Morgan subsidiaries $17.5 million in overhead expense and excluding the subsidiaries from a Massachusetts formula allocation results in an allocation of approximately twice the overhead expense for SFPP, Arthur declared. *Id*. at p. 21.

96. Arthur testified that Bradley's reference to the amount of capitalized overhead assigned to excluded Kinder Morgan subsidiaries in 2003 should not be relevant in determining whether the $17.5 million in fees paid by the excluded Kinder Morgan subsidiaries is reasonable because, in the Massachusetts formula calculation, the amount of overhead costs that were actually capitalized is considered not to have been capitalized, and is therefore included in the amount allocated. *Id*. at pp. 21-22 (*citing* Exhibit No. SFO-25 at pp. 42-44). Moreover, Arthur added, overhead costs for all subsidiaries are treated as expenses and allocated by the Massachusetts formula because SFPP does not capitalize any overhead expenses for FERC Form 6 reporting purposes, and thus any amount of overhead that was capitalized to the excluded entities, SFPP, or any other Kinder Morgan subsidiary should be treated the same way as any other overhead expense and be included in the total amount of overhead expense to be allocated by the Massachusetts formula. *Id*.

97. While SFPP allocated $139.8 million in overhead for 2003 in its Massachusetts formula calculation, Arthur recommended a 2003 overhead allocation of $178.7 million. *Id*. at p. 23. Arthur stated that $38.2 million of that difference is accounted for by the direct assignment of overhead expenses to certain subsidiaries. *Id*. The remaining difference, he added, can be accounted for as a $90,000 payment from Cochin Pipeline Company ("Cochin") which Bradley subtracted, and the $501,769 for expenses in one responsibility center where Bradley identified work performed for a subsidiary he excluded from the Massachusetts formula calculation. *Id*. (*citing* Exhibit No. SFO-25 at pp. 35-35, 44). Arthur recommended including the total overhead amount of $178.7 million reported by SFPP without the direct assignment of overhead expenses to any subsidiary because he maintained that all Kinder Morgan subsidiaries should be included in the Massachusetts formula allocation. *Id*. at pp. 23-24.

98. Responding to Bradley's argument that it is reasonable for SFPP to use ten tiers in its Massachusetts formula, Arthur recommended including all Kinder Morgan subsidiaries in a single tier and utilizing the Commission's standard Massachusetts formula. *Id*. at pp. 24-25. First, Arthur explained, not all costs allocated by the Massachusetts formula are directly charged to any subsidiary, making it questionable that SFPP can identify $64.9 million in overhead expenses that are directly attributable to a single subsidiary while Kinder Morgan could not do so on its 2003 SEC Form 10-K. *Id*. at p. 24. Further, Arthur contended that SFPP's method is subjective, as illustrated by its shifting assignment of overhead expenses directly to individual subsidiaries or groups of subsidiaries as the methodology changes. *Id*. at pp. 24-25. The subjective nature of SFPP's ability to directly assign overhead expenses in its ten-tier method is further reflected, Arthur added, in its lack of direct assignment of overhead expenses associated with services performed by the Kinder Morgan, Inc.-shared employees to the Kinder Morgan, Inc.-operated subsidiaries. *Id*. at p. 25.

99. While Arthur advocated excluding purchase accounting adjustments from regulated subsidiaries to allow the balance to reflect original cost, he did not advocate excluding purchase accounting adjustments with respect to Kinder Morgan's unregulated subsidiaries. *Id*. at pp. 25-26. Specifically, Arthur stated that the purchase accounting adjustments should not be excluded with respect to unregulated subsidiaries because, unlike regulated subsidiaries, there is no relationship between prices, revenues and profitability of the unregulated subsidiaries and the original cost of the subsidiary's gross property. *Id*. at p. 25. When a purchase accounting adjustment is removed from an unregulated subsidiary's gross property balance, he continued, the resulting amount does not necessarily have any relationship to the original cost of the assets. *Id*.

100. Arthur recommended using end-of-period balances for gross property in the Massachusetts formula calculation because they reflect the changes in gross property that occurred during the year. *Id*. at p. 26. If there are large changes to gross property

balances during the year due to expansions or acquisitions, he continued, there will be overhead expenses associated with these acquisitions or expansions that correspond with the end-of-period balances. *Id.*

101. On cross-examination referring to Responsibility Center 0090, Arthur stated that it appeared to relate to information technology systems supporting the liquids terminals, while Responsibility Center 0091 appeared to relate to information technology services supporting products pipelines. Transcript at pp. 531-32. Liquids terminals, he agreed, relate to products pipelines, rather than natural gas pipelines, and are Kinder Morgan-operated entities. *Id*. at p. 531. Arthur also conceded that the six Kinder-Morgan, Inc.-operated subsidiaries that are excluded from the Massachusetts formula are natural gas pipelines, not products pipelines or liquids terminals. *Id*. at pp. 531-32.

102. Arthur next responded to a series of questions regarding the total cost assigned to Kinder Morgan-operated subsidiaries included in SFPP's Massachusetts formula. *Id*. at pp. 532-33. Kinder Morgan, Inc.-shared employees incur the costs for these entities, according to Arthur, and allocate or assign the costs to Kinder Morgan, although he admitted that it is not clear to him how they charge Kinder Morgan. *Id*. at p. 533. He explained further, stating that the Kinder Morgan, Inc. employees perform services for Kinder Morgan, Inc.-owned and Kinder Morgan, Inc.-operated subsidiaries, as well as Kinder Morgan-owned and Kinder Morgan-operated subsidiaries. *Id*. at p. 534. It is his understanding, Arthur testified, that there is a split of the expenses between the various groups, although it is unclear to him when services are performed for Kinder Morgan-operated subsidiaries, whether the exact time is charged to those subsidiaries. *Id*. Moreover, Arthur agreed that the costs incurred by Kinder Morgan, Inc., on behalf of Kinder Morgan go from Kinder Morgan, Inc., to Kinder Morgan via the Kinder Morgan, Inc., cross charge.[32] *Id*. at p. 535. He added that in SFPP and Bradley's application, the cross charge is allocated among all of the Kinder Morgan-operated entities in the Massachusetts model. *Id*.

103. Moving on to costs which are directly assigned to the Kinder Morgan, Inc.-operated entities, Arthur stated that it is his understanding that they do not include any costs that would have been spread among all Kinder Morgan, Inc.-owned entities. *Id*. at p. 536. Moreover, he explained that there are no costs directly assigned to the Kinder Morgan subsidiaries operated by Kinder Morgan, Inc. *Id*. at pp. 536-37.

[32] SFPP Witness Bradley defined "cross charge" as the costs Kinder Morgan, Inc., incurs in providing services to Kinder Morgan-operated entities, which is paid every month through either a check or wire transfer from Kinder Morgan to Kinder Morgan, Inc. Transcript at p. 856.

104. When questioned regarding his inclusion of direct assignments to certain products pipelines and delta terminals within the Massachusetts formula calculations despite the fact that they were done outside of the Massachusetts formula, Arthur stated that he is of the opinion that a direct assignment to a particular subsidiary must be supported with documentary evidence. *Id*. at pp. 543-44. The direct assignments in this proceeding lack such evidence, he testified, with the exception of the direct assignment to the Kinder Morgan, Inc.-operated subsidiaries, which, Arthur contended, is not a valid assignment. *Id*. at p. 544. Since evidence is lacking, the supposed direct assignments, according to Arthur, are put into the overhead expense pool. *Id*. at p. 545. Therefore, he explained, the direct assignments to certain products pipelines and delta terminals should remain in the allocation because he does not know why they were moved from the overhead expense pool to a specific subsidiary. *Id*. at p. 548.

105. Arthur agreed that the methodology from *Distrigas of Massachusetts Corp.*, 41 FERC ¶ 61,205 at pp. 61,555-56 (1987) (sometimes "*Distrigas*"), is inappropriate for Tejas Gas LLC and its subsidiaries ("Tejas Consolidated"),[33] a Kinder Morgan subsidiary, because it lacks a pass-through mechanism, placing Consolidated at risk for underrecovery, which would result in negative net revenue if it under recovered based on a loss of gas sales or decline in gas sales. Transcript at pp. 554-55. If this were the case, Arthur insisted, a negative amount of revenues would be used in the allocation under the *Distrigas* formula. *Id*. at p. 555. Because it has no pass-through mechanism, if Tejas Consolidated makes a natural gas purchase, it is at risk for its purchase price until it sells, and such sale can be at a loss, according to Arthur. *Id*. at p. 555. In contrast, Arthur pointed out, if Tejas Consolidated were a regulated entity with a pass-through mechanism, it could pass the cost through to its customers. *Id*. at p. 556. There are various risks, such as credit risk and legal fees associated with purchase and sale, which require oversight, according to Arthur, which may not be proportionate to $4 billion. *Id*. at p. 556. However, he continued, the Massachusetts formula would account for a disproportion by weighting gross revenues, gross property, and direct labor. *Id*.

106. Although capitalized overhead is reflected as an expense on FERC Form 6, Arthur contended that this is inconsistent with his statement that capitalized overhead is no longer an expense. *Id*. at p. 558. In support of his contention, Arthur explained that there are multiple books maintained by both Kinder Morgan and SFPP. *Id*. On Kinder Morgan's books, capitalized overhead is included as an asset for SFPP, he stated, while the FERC Form 6 and the regulatory books maintained by SFPP state that the overhead was capitalized is not included on the SFPP books. *Id*. Some of the capitalized overhead costs in SFPP's study are associated with natural gas companies, Arthur agreed, which do not file a FERC Form 6, but instead file a FERC Form 2. *Id*. at p. 559. Arthur contended that even if the FERC Form 2 did not list the capitalized overhead as expenses, SFPP's regulated books would not be impacted. *Id*.

[33] For a list of the subsidiaries of Tejas Gas LLC, *see* Exhibit Nos. S-32, S-33.

107. I asked Arthur to explain the three reasons[34] why he testified that the exclusion from the Massachusetts formula of the 16 Kinder Morgan subsidiaries is invalid. Transcript at pp. 570-71. Explaining the first, Arthur stated that there was an operating agreement established between Kinder Morgan, Inc., and Kinder Morgan when Kinder Morgan, Inc., subsidiaries changed ownership to Kinder Morgan which required, according to him, that Kinder Morgan, Inc., continue to operate the subsidiaries and Kinder Morgan pay it for doing so, including a fixed fee for overhead. *Id*. at p. 571. The amount was fixed at $4.5 million, an arbitrary amount with no reference to actual costs which, therefore, Arthur maintained, should not be included within the Massachusetts formula. *Id*. at p. 572.

108. Secondly, Arthur testified, in 2003, there were general and administrative expenditures of $150.4 million which were not attributable to any operating segment, according to Kinder Morgan's SEC Form 10-K. *Id*. at p. 573. Arthur explained that, within that $150.4 million is the $17.5 million that is directly assigned to the six Kinder Morgan, Inc.,-operated subsidiaries, all of which are natural gas pipelines. *Id*. at p. 573. If it had assigned the $17.5 million directly to these entities, he added, it should not be included in the $150.4 million and should have shown up within Kinder Morgan's operating expenses related with natural gas pipelines. *Id*. Since Kinder Morgan did not attribute the expenses to these entities in the SEC report, Arthur claimed that it is questionable whether it is able to do so in this proceeding. *Id*.

109. With regard to the third reason that exclusion of the subsidiaries from the Massachusetts formula was invalid, Arthur stated that the excluded subsidiaries clearly benefit from the parent company and cited the operating agreements as evidence of this. *Id*. at p. 574. Specifically, he testified, these agreements require that Kinder Morgan provide oversight activities separate and distinct from Kinder Morgan, Inc.-assigned activities. *Id*. at pp. 574-75. The same is true for both the Kinder Morgan, Inc.-operated Kinder Morgan subsidiaries and those operated by third parties, he added. *Id*. Additionally, Arthur cited testimony submitted by SFPP witness Richard L. Bullock

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[34] The three reasons that the exclusion of 16 subsidiaries from the Massachusetts formula is invalid, Arthur stated, are as follows: (1) under the operating agreements for the Kinder Morgan-subsidiaries operated by Kinder Morgan, Inc., the fixed payments of general and administrative expenses are a predetermined arbitrary amount, not related to the actual expenses in a given year; (2) because Kinder Morgan was unable to directly assign any general and administrative expense to the 16 excluded subsidiaries in its 2003 SEC Form 10-K, it is questionable as to why SFPP is able to directly assign Kinder Morgan's corporate unallocated expenses to any specific subsidiaries for SFPP's cost-of-service; and (3) it is inappropriate to exclude any subsidiary from a calculation to allocate overhead expense if the subsidiary benefits from the parent company in any way. Exhibit No. CC-1 at pp. 37-38.

("Bullock") in a prior proceeding that listed the various activities which Kinder Morgan performed on behalf of these subsidiaries, as well as a cash management agreement between Trailblazer Pipeline Company and Kinder Morgan Operating, L.P. "A," an operating arm of Kinder Morgan. *Id.* at pp. 575-76 (*citing* Exhibit Nos. CC-31, CC-61).

C. KATHLEEN L. SHERMAN

110. Kathleen L. Sherman ("Sherman") submitted testimony on behalf of Commission Trial Staff. Exhibit No. S-1 at p. 3. She is employed by the Commission as an Energy Industry Analyst in the Technical Division of the Office of Administrative Litigation. *Id.*

111. To evaluate the issues set for hearing, Sherman said that Staff developed cost-of-service studies for 2003 for the North and Oregon Lines to determine whether there are substantially changed circumstances that would justify eliminating the grandfathering of the rates for service over these lines. *Id.* at p. 6. She used SFPP's cost-of-service studies for the North and Oregon Lines for 2003 and 2004 to prepare Staff's cost-of-service studies. *Id.* at p. 7. Staff, she continued, did not find a substantial change in economic circumstances for the North Line, but did, however, find a substantial change in economic circumstances for the Oregon Line, and has thus developed a just and reasonable rate for that line. *Id.* at pp. 6-7.

112. The economic basis for the present North Line rates is a 1989 cost-of-service study provided by SFPP to justify a rate increase for the North Line, Sherman explained. *Id.* at p. 8. However, she noted, there is no similar economic basis for the Oregon Line rates. *Id.* Sherman testified that, because SFPP had no data regarding the economic basis for the rates, Staff used a 1992 cost-of-service study for its analysis. *Id.*

113. Sherman stated that the grandfathered rate for the North Line to Reno, Nevada, is $1.10/bbl and was established on December 17, 1989. *Id.* In addition, she continued, the Oregon Line rate to Eugene, Oregon, of 45.6 cents/bbl was established on May 23, 1985. *Id.* To evaluate whether the changed circumstances threshold had been met, Sherman explained that Staff used the (C-B)/A formula to compare rate elements for different years. *Id.* at p. 9. If there is no information available for the economic Basis Year ("A"), then the equation (C-B)/B should be used, she added. *Id.* While the 1989 cost-of-service is used for the "A" period for the North Line, Sherman testified, the Oregon Line uses the (C-B)/B equation, because there is no data from the Basis Period available. *Id.* When "B" is greater than "A" for elements such as volumes that are expected to increase over time, the equation (C-A)/A should be used, according to Sherman. *Id.* Of all the rate elements, she contended, changes in return, or profit expectations, ultimately determine whether there has been a change in the economic basis of a rate. *Id.* at p. 10. The Complainants' comparison in dollar amounts, Sherman continued, might be more appropriate than comparing rate elements with different units. *Id.*

114. According to Sherman, Staff conducted cost-of-service studies for 2003 for the North and Oregon Lines and used these studies to determine 2003 profit margins, the "C" element in the formula. *Id*. at pp. 10-11 (*citing* Exhibit Nos. S-2, S-3). Sherman said she included adjustments for taxes and operating expenses which were provided by Staff witness Kenneth A. Sosnick ("Sosnick"). *Id*. at p. 11. Staff adopted O'Loughlin's proposed return on equity, capital structure, and cost of debt, Sherman added. *Id*. According to her, Staff's 2003 cost-of-service for the North Line is $13.263 million and, for the Oregon Line, it is $4.960 million. *Id*.

115. To determine whether there has been a change in economic circumstances, Sherman testified, Staff calculated a profit margin and related percentages for the Base Year ("A"), 1992 ("B"), and the Test Year ("C"). *Id*. at pp. 11-12. For the North Line, the resulting percentages were used in the (C-B)/A formula, Sherman explained. *Id*. at p. 12. For the Oregon Line, she stated, the percentages were used in the (C-B)/B formula because it lacks a study for the Base Year. *Id*.

116. Sherman testified that there were no changed circumstances for the North Line, regardless of whether it used an interstate only 1989 amount or the 1989 cost-of-service study in the Commission's Order in *SFPP, L.P.*, 111 FERC ¶ 61,334 . *Id*. at pp. 13-14. Staff, Sherman stated, used the 1992 cost-of-service study amount for the North Line. *Id*. at p. 14. Were Staff to use O'Loughlin's pre-EPAct 1992 amount in its cost-of-service study instead, according to Sherman, the change in profit margin would increase from 4.09% to 24.88%, which, she contended, would support the finding of a substantial change in circumstances. *Id*. She indicated, however, that Staff does not agree that the pre-EPAct 1992 amount of $13.477 million is the appropriate figure to use. *Id*. Staff's change in economic circumstances analysis for the North Line shows that there has been a change of only 6.64%, which is far below the 15% threshold, Sherman added. *Id*. at p. 15. Based on this study, Staff maintained, according to Sherman, that there was no change in economic circumstances for the North Line in 2003. *Id*. Staff also examined the potential for changed circumstances for the North Line in 2004, Sherman stated, by inserting the cost-of-service proposed by SFPP, and alternatively inserting the cost-of-service developed by Indicated Shippers' witness Elizabeth H. Crowe ("Crowe"). *Id*. at p. 16. The analysis does not show substantially changed circumstances for the North Line in 2004, Sherman explained. *Id*. at p. 17.

117. Based on Staff's analysis, Sherman continued, there was a substantial change in circumstances for the Oregon Line in 2003. *Id.* Consequently, according to her, the rate of 45.6 cents/bbl should no longer be grandfathered and, therefore, Staff developed a proposed rate of 30.70 cents/bbl, calculated by taking Staff's cost-of-service and dividing it by the actual 2003 volumes. *Id*. at pp. 17-18.

118. Sherman explained that witness O'Loughlin's method for determining changed circumstances is similar to Staff's in that it compares revenues and costs. *Id*. at p. 18. She

testified, however, that the methodologies differ in that Staff calculated a profit margin from the difference between revenues and costs and generates profit margin percentages that are used in the two equations to generate a result that can be used to evaluate changed circumstances, while O'Loughlin developed an overall percentage change for revenues and an overall percentage change for costs independently, using the same equations, and subtracted the percentage change generated for the costs from that generated for the revenues. *Id*. at pp. 18-19. Sherman submitted that, while both methodologies have similar results, Staff's methodology is more accurate and more precisely retained the original relationship between the years. *Id*. at p. 19. For the 2003 North Line, she pointed out, under either methodology, the changed circumstances threshold has not been met. *Id*. at pp. 19-20. However, she continued, the changed circumstances test is met under either methodology for the 2003 Oregon Line. *Id*. at pp. 20-21.

119. In her Rebuttal Testimony, Sherman addressed SFPP witness Van Hoecke's critique of the Staff method for evaluating changed circumstances. Exhibit No. S-9 at p. 1 (*citing* Exhibit No. SFO-1). She explained that Staff's method compares costs and revenues for the year that was the economic basis for the rate to evaluate the profitability of the pipeline's operations. *Id*. at p. 2. To do so, Sherman continued, Staff determined a percentage change by using profit margins on a gross percentage basis for each of the relevant years as inputs to the equation. *Id*. at p. 6. In contrast, Sherman noted, Van Hoecke's approach uses the (C-B)/A equation to compute his separate percentage changes for costs and revenues in the relevant years and to compute a net percentage change by subtracting the change in costs from the change in revenues. *Id*. at p. 2. Moreover, she added, he claimed to avoid the issue of comparing bases measured in different units by comparing revenues and costs and by not using volumes as a proxy for revenues, and weighting each percentage based on the arithmetic mean of these factors during the economic Basis Period and only using the grandfathered portion of SFPP's revenue stream. *Id*. at pp. 2-3 (*citing* Exhibit No. SFO-1 at p. 3). Staff's method, she contended, avoids the problem with adding percentages with different bases, and thus does not require any weighting. *Id*. at pp. 6-7. Sherman stated, based on reviewing Van Hoecke's method, that Staff's method provides a more accurate measure of changed circumstances and maintains a more comparable relationship between the years being investigated. *Id*. at p. 3.

120. Because revenues on the North Line were less in 1992 than they were in 1989, Sherman asserted that the equation (C-A)/A should be used instead of (C-B)/A. *Id*. at p. 7. However, she contended, Staff's method avoids having to determine whether to use (C-A)/A instead of (C-B)/B because it does not compare annual revenues directly. *Id*. While there may be a decline in revenue between 1989 and 1992, there is no decline in the profit margin, which is the measure Staff used, according to Sherman, to compare the percentages from year to year. *Id*. at p. 9. Therefore, Sherman insisted, the (C-B)/A formula is appropriate despite a decrease in revenue. *Id.*

121. While Staff and Van Hoecke used different 1992 revenues for the North Line in determining changed circumstances, Sherman maintained that, were Staff to use Van Hoecke's 1992 revenues, the changed circumstances percentage would decline from 9.94% to 6.98%, which would not support a finding of changed circumstances. *Id*. at p. 8.

122. Using only the grandfathered portion of the revenues, according to Sherman, would not change Staff's analysis that changed circumstances exist for the Oregon Line, as there would still be a nearly $3 million difference between the 2003 grandfathered revenues and Staff's cost-of-service.[35] *Id*. at p. 11. Similarly, she added, using only the grandfathered portion of the revenues would not change Staff's conclusion that there were no changed circumstances for the North Line for 2003 because, when only grandfathered revenues are used, the percentage for changed circumstances, according to Sherman, becomes 1.97%. *Id*. at p. 13.

123. Sherman next noted two problems with SFPP's use of the valuation method when calculating the 1985 Oregon Line cost-of-service. *Id*. at p. 14. First, she stated, there is no detail regarding how overhead expenses were allocated from SFPP to the Oregon Line, and there is no detailed description of the methodology used to calculate revenue or the study that generated the results. *Id*. (*citing* Exhibit Nos. S-12 and S-13). Second, Sherman noted, is that the Valuation method is not directly comparable to the methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, which was used to calculate the other cost-of-service studies used for evaluating changed circumstances. Exhibit No. S-9 at pp. 14-15. Therefore, according to Sherman, a 1985 cost-of-service calculated using the Valuation method would be less precise and non-comparable to the costs of service for other years, and should thus be rejected. *Id*. at p. 15. However, she noted, were Staff to use SFPP's 1985 Oregon Line cost-of-service study in determining changed circumstances, its conclusion that changed circumstances exist would not change, as the resulting percentage of 39.04% still supported such a finding. *Id*.

124. She updated income taxes and ADIT and adjusted the net-to-tax multiplier for the 2003 cost-of-service studies for both lines, Sherman testified, based on Sosnick's Rebuttal Testimony in Exhibit No. S-15. *Id*. at p. 16. According to her, the revised North Line cost-of-service for 2003 is $12,982,000, while the revised 2003 Oregon Line cost-of-service is $5,501,000. *Id*. (*citing* Exhibit Nos. S-10, S-11). Sherman added that neither revision changed Staff's opinion that there is no substantial change in economic circumstances for 2003 for the North Line, and that there is a substantial change in economic circumstances for 2003 for the Oregon Line. *Id*. at p. 17. The revised cost-of-service does, however, change Staff's just and reasonable rate for the Oregon Line,

[35] According to Sherman, 2003 grandfathered revenues of $7,366,000 exceed Staff's 2003 cost-of-service of $4,501,000. Exhibit S-9 at pp. 11-12.

Sherman pointed out. *Id*. Sherman calculated the just and reasonable rate for each line by dividing 2003 cost-of-service by 2003 volumes, resulting in a just and reasonable rate of 27.86 cent/bbl for the Oregon Line and 94.58/bbl for the North Line. *Id*.

125. On cross-examination, Sherman agreed that Staff's method could produce an anomalous result when the profit margin percentage declines from the "A" period to the "B" period and then increased again between the "B" period and the "C" period to equal the percentage at the "A" period. Transcript at p. 1129. This situation, she further agreed, could show that there has been a substantial change when in fact, there has been no change between the "A" and "C" periods. *Id*. This is the situation in which, Sherman continued, the formula (C-A)/A would be applied rather than (C-B)/B. *Id*. at p. 1130.

126. Sherman next explained that using a 10.02% real return on equity, rather than Staff's 9.88%, yielded a higher cost-of-service for 2003. *Id*. at p. 1114. She stated, however, that a higher 2003 cost-of-service will not necessarily create less likelihood that substantial change will be found because she looks at profit margin, which compares cost-of-service to revenue, rather than looking at cost-of-service in isolation. *Id*. at p. 1115.

127. On re-direct examination, using the C-A/A formula, instead of C-B/A, to measure substantially changed circumstances on the Oregon Line, Sherman calculated a 32.14% change, which did not affect her conclusion regarding whether there has been a change in the economic basis of the Oregon Line rate at issue. *Id*. at p. 1138 (*citing* Exhibit No. S-44). Furthermore, Sherman contended, the Oregon Line analysis she submitted in her testimony begins with 1992, rather than 1985, because, according to her, the 1985 study was not comparable to studies used for other years as it used a different, less precise method. *Id*. at p. 1138-39.

D. KENNETH A. SOSNICK

128. Sosnick testified on behalf of Commision Trial Staff. Exhibit No. S-4 at p. 1. He is employed by the Commission as an Energy Industry Analyst in the Technical Division of the Office of Administrative Litigation. *Id*.

129. According to Sosnick, SFPP should be required to submit an appropriate state income tax study, and until this submission is made, no state income tax allowance is justified. *Id*. at pp. 10-11. He argued that the overall weighted average state and federal tax rate will change from SFPP current proposed methodology, which will change the overall cost-of-service. *Id*. at p. 11.

130. The appropriate federal tax rate for UBTI entities is 34%, Sosnick suggested, assuming that those UBTI entities who received distributions from Kinder Morgan have a taxable income greater than $335,000 and less than $10 million because they should be taxed at the same rate as taxable corporations. *Id*. at pp. 12. He asserted that this is

contingent upon SFPP demonstrating that the UBTI entities have a taxable base greater than $335,000, and, absent that showing, SFPP should be required to adopt the 28% tax rate assumption. *Id.* If SFPP can prove that the UBTI entities owning units in SFPP had taxable income greater than $10 million, Sosnick stated, then he would accept a tax rate of 35%. *Id*. at p. 13. With these changes to the state and UBTI tax rates, Sosnick suggested that the overall federal and state income tax decreases from 38.23% to 32.83% for the North Line and from 37.26% to 32.83% for the Oregon Line, and the net-to-tax multiplier will decrease from 0.6189 to 0.4887 for the North Line and from 0.5939 to 0.4887 for the Oregon Line. *Id*.

131. According to Sosnick, SFPP did not include the subsidiaries Kinder Morgan Interstate Gas Transmission or Trailblazer in its 2003 corporate overhead allocation, but included Plantation. *Id*. at pp. 15-16. Sosnick testified that Kinder Morgan Interstate Gas Transmission, Trailblazer, and fourteen other subsidiaries[36] should be added to the 2003 corporate overhead allocation calculation because Kinder Morgan has spent time on and provided services for these subsidiaries. *Id*. The existence of operation and reimbursable agreements between a parent company and its subsidiary, according to Sosnick, does not invalidate allocating corporate overhead to that subsidiary. *Id*. He said he is concerned about cross-subsidization of costs which can occur because the agreements between Kinder Morgan and its subsidiaries establish the direct costs that are collected from the subsidiary as well as fix the amount of indirect costs that the entities will pay. *Id*. at pp. 17-18.

132. Sosnick proposed to remove any purchase accounting adjustments from SFPP's average property, plant, and equipment to properly show the balances at the end of 2003 for certain subsidiaries. *Id*. at p. 19. He explained that not all of the entities are regulated by the Commission, and that he considered purchase accounting adjustments for entities that are not regulated in order properly to set the property, plant, and equipment balance for those entities that would be allocated corporate overhead expenses. *Id*. at p. 20. According to Sosnick, generally accepted accounting principles relate to all entities, regulated and unregulated, and purchase accounting adjustments arise due to these principles; thus, Sosnick claimed, the property, plant, and equipment level must be established for all entities. *Id*. Sosnick defined a purchase accounting adjustment write-up as setting the property, plant, and equipment balances at a higher value than net depreciated book level. *Id*. at p. 21.

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[36] The subsidiaries Sosnick identified included: Casper Douglas Natural Gas Gathering and Processing System ("Casper Douglas"), KM Upstream LLC, KM Gas de Natural de Mexico ("KM Mexico"), KM Canada, Coyote Gulf Gas Treating LLC ("Coyote Gulf"), Red Cedar Gas Treating LLC ("Red Cedar"), Thunder Creek Gas Services LLC ("Thunder Creek"), Heartland Pipeline Company ("Heartland"), Port Arthur Bulk Terminals, IMT, and Portland Bulk Terminal. Exhibit Nos. S-4 at pp. 15-16, SFO-25 at pp. 25, 29.

133. The total property, plant, and equipment balance to be used in the Massachusetts formula, Sosnick contended, was $7,803,375,830, while SFPP's was $6,119,508,343. *Id.* The difference between the two, according to Sosnick, is $1,683,867,487, which reflects his inclusion of the 16 subsidiaries left out by SFPP, as well as the elimination of purchase accounting adjustments. *Id.*

134. Sosnick stated that he used SFPP's carrier percentage, based on SFPP's Kansas-Nebraska (sometimes "KN") method[37] and its North and Oregon Line interstate percentage allocation, to arrive at the proportion of Kinder Morgan's overhead to be recovered in SFPP's rates. *Id*. at p. 23. The KN method, Sosnick explained, is used for allocating administrative and general expenses between divisions or functions. *Id*. at p. 24. The expenses are first classified as being labor-related, plant-related, or "other," and then the "other" category, Sosnick continued, is allocated between labor and plant proportionately with their totals. *Id*. According to Sosnick, the category totals get allocated between functions by each function's direct labor and direct plant ratios, which, he testified, are calculated by multiplying the total plant and labor related administrative and general expenses by each function's direct plant and labor ratios. *Id*. Within each function, Sosnick continued, the labor-and plant-related administrative and general expenses are added together and the ratio of these totals to the total amount allocated is that function's KN ratio. *Id.* According to Sosnick, the KN ratio is then multiplied by each administrative and general expense in order to allocate the administrative and general expenses across functions. *Id.*

135. SFPP calculated its North and Oregon Line carrier direct investments, Sosnick testified, to be 7.19% and 2.34% of the company's total carrier direct investment, respectively, while it calculated the North Line carrier direct labor expense to be 6.07% and the Oregon Line carrier direct labor expense to be 6.64% of the company's total carrier direct labor expense. *Id*. at p. 25. SFPP used the simple average of the two ratios for each segment to allocate its indirect expenses, he noted. *Id*. This is inconsistent with the Commission's KN method, according to Sosnick, because SFPP does not differentiate the expenses as labor-or plant-related, and, therefore does not match cost and causality as well as the Commission's traditional method requires. *Id*. Using SFPP's method, Sosnick alleged, a function with too little labor, but a large share of plant, will be allocated too much labor-related indirect expense and too little plant-related indirect expense, which may result in a significant cost allocation difference. *Id*. at p. 26.

136. SFPP, Sosnick testified, has another KN calculation that "it calls the 'K/N Factor,'" which is a ratio that allocates indirect costs between carrier and non-carrier using a method

[37] *Kansas-Nebraska Natural Gas Co.*, 53 FPC 1691, 1721-22 (1975), *aff'd sub nom., Kansas-Nebraska Natural Gas Co., Inc. v. FPC*, 534 F.2d 227 (10th Cir. 1976).

similar to the KN method. *Id*. For 2002 and 2003, Sosnick explained, SFPP subtracted the purchase accounting adjustment from gross carrier and non-carrier property and calculated the ratios for 2002 and 2003, which are then averaged. *Id*. SFPP, he continued, then takes the direct labor portion of carrier and non-carrier and calculated the ratio of each to the total for 2003. *Id.* The resulting property and labor ratios are averaged, which, according to Sosnick, becomes the "KN Factor." *Id*. Sosnick alleged that this method may produce very different results from the KN method. *Id*. He stated that he has not adjusted SFPP's method and, in making his own calculations, only used it as a placeholder. *Id*. at pp. 27-28. Sosnick recommended, based on his calculations, a North Line corporate overhead allocation of $820,660 and an Oregon Line corporate overhead allocation of $555,571. *Id*. at p. 28.

137. In his Rebuttal Testimony, Sosnick stated that, after SFPP witness Ganz modified his procedure for developing the weighted marginal state income tax rate for SFPP's cost-of-service studies, there is adequate support for his weighted state income tax calculations. Exhibit No. S-15 at pp. 3-4. Sosnick also indicated that he accepts SFPP's blended federal and state income tax rate and net-to-tax multiplier, as well as Ganz's change in the tax rate used for UBTI entities. *Id*. at pp. 4-5. He also noted that SFPP's computation of ADIT changed, stating that SFPP used the weighted marginal federal income tax rates for 1992-2003 in the calculation of its 2003 ADIT balance. *Id*. at pp. 5-6. Furthermore, Sosnick contended, Ganz also has changed the income tax allowance component to properly recognize the weighted marginal federal tax rate change Sosnick now accepts. *Id*. at p. 6.

138. In discussing the corporate overhead allocation, Sosnick stated that SFPP witness Bradley did not include Kinder Morgan Interstate Gas Transmission or Trailblazer Pipeline Company in the Massachusetts formula, but included Port Arthur Bulk Terminals, Portland Bulk Terminals LLC, and Painter Plant. *Id*. at pp. 7-8 (*citing* Exhibit No. SFO-25 at p. 36). He included Port Arthur Bulk Terminals, Sosnick explained, because it is a joint venture that, although never active, would be a part of the formula if it were to become active. *Id*. at pp. 8-9 (*citing* Exhibit No. SFO-25 at p. 36). Sosnick noted, however, that Bradley did not include joint ventures which were operated and managed by third parties in the Massachusetts formula. *Id*. at p. 9. Operational control, he continued, should not be the basis of determining whether there should be an allocation of corporate overhead using the Massachusetts formula, and thus he suggested these entities that are operated by a third party should be included in the allocation. *Id*. Moreover, Sosnick argued that, since Kinder Morgan has an equity investment in these entities and receives revenue and records losses, the subsidiaries should be included. *Id*. at p. 10. All joint ventures, in Sosnick's view, should be treated the same because he does not believe that any Kinder Morgan entity would invest in a joint venture and then ignore it. *Id*. In addition, he stated that officers and directors from Kinder Morgan, Inc., and GP Services served on management committees and operating teams for the joint ventures in 2003. *Id*.

139. Sosnick contended that Bradley's testimony in which Bradley stated that Kinder Morgan does not perform general or administrative services on behalf of entities in which it owns an equity interest, is contradictory because Bradley also stated that Kinder Morgan performs these services in rare instances. *Id*. at p. 11 (*citing* Exhibit No. SFO-25 at p. 29).

140. Discussing services performed for Red Cedar, Sosnick noted that Bradley claimed that costs of these services can be recovered through an invoice distributed to the Kinder Morgan entity that was provided a direct service, and the entity would then pay Kinder Morgan, Inc., or GP Services directly. *Id*. at pp. 12-13. Asserting that this is indicative of a direct charge, Sosnick suggested that these are not the type of overhead costs addressed by the Massachusetts formula. *Id*. at p. 13.

141. Another direct charge that should not be addressed by the Massachusetts formula, Sosnick contended, is Kinder Morgan's recovery of $90,000 for costs incurred by Kinder Morgan, Inc., in its proportionate consolidation of monthly joint interest billing statements for Cochin. *Id*. However, Sosnick continued, even were Kinder Morgan, Inc., to directly assign these costs to Cochin, Cochin should be included in the Massachusetts formula. *Id*. at p. 14. In Sosnick's view, he said, the payment of direct costs should not exclude Cochin from the allocation of residual or indirect overhead costs. *Id*.

142. Sosnick included Casper Douglas/KM Upstream LLC, Tejas Consolidated, KM Mexico, and KM Canada in his Massachusetts formula, while Bradley excluded these entities. *Id*. at pp. 14-15. Bradley contended, according to Sosnick, that, if included, they would be charged twice for overhead costs since they are directly charged or pay a fixed fee to Kinder Morgan, Inc., for all corporate overhead costs related to operational and managerial duties. *Id*. at p. 15. As the Massachusetts formula allocates residual costs to affiliated entities based on an average of their proportionate revenue, property, plant and equipment, and labor only after costs which can be directly assigned are assigned, Sosnick suggested that the costs incurred by Kinder Morgan, Inc., and GP Services should be directly assigned to the joint ventures to the extent possible, and then the residual overhead costs should be proportionately assigned. *Id*. at pp. 15-16.

143. While Bradley included capitalized overhead as a category used by Kinder Morgan, Inc., to capture overhead expenses allocated to Kinder Morgan and Kinder Morgan, Inc-owned entities, Sosnick disagreed. *Id*. at p. 16. He stated that capitalized overheads are overhead costs related to construction and are charged to particular jobs or units. *Id*. In response to Bradley's concern that the entities he excluded would be double charged if included in the Massachusetts formula, Sosnick pointed out that the fixed fees represent direct assigned corporate overhead costs which are charged independently, and not unallocated indirect corporate overhead costs. *Id.* at p. 16. Thus, according to Sosnick, the entities are not being double charged. *Id*. He suggested that there is no recovery of residual unallocated corporate overhead costs within the fixed fee, which only includes direct assigned corporate overhead. *Id*. at p. 18. Moreover, Sosnick noted, Bradley

confirmed that Kinder Morgan, Inc.'s fixed payment recovery in 2004 was for direct assigned corporate overhead. *Id.* at p. 19. Sosnick testified that he inferred that Bradley is suggesting that part of the corporate overhead costs in his Kinder Morgan Massachusetts formula might be capitalized overhead based on Bradley's apparent comparison between the costs Kinder Morgan, Inc., assigned to its capital burden pool and the costs Kinder Morgan uses in its Massachusetts formula. *Id*. at pp. 19-20. It would not be correct, according to Sosnick, were Kinder Morgan to pass on capitalized overhead costs in this manner as they are meant to be directly assigned to the capital project, not included in residual overhead collection. *Id*. at p. 20. As far as SFPP is concerned, Sosnick stated, he has no means by which to evaluate whether or not there are capitalized overhead costs in Kinder Morgan's Massachusetts formula for allocation to SFPP. *Id*. at p. 21.

144. Basing his opinion on Kinder Morgan's SEC Form 10-K, Sosnick testified that Kinder Morgan takes the position that capitalized overhead should not be shown as a portion of its corporate overhead. *Id*. (*citing* Exhibit No. SFO-25). He described the calculation, stating that the overhead balances on the 10K are calculated by subtracting capitalized overhead from the initial overhead amount, which Sosnick said he understands to represent expensed overhead. *Id*. (*citing* Exhibit No. SFO-25 at p. 42). The difference between the amount of overhead reflected on the SEC Form 10-K, $150,435,000, and that in Kinder Morgan's Massachusetts formula, $140,438,000, according to Sosnick, is due to direct assignments and capitalized overhead. *Id*. However, he continued, Bradley stated that the amount of overhead allocated through the Massachusetts formula included the amount capitalized, an approach with which Sosnick disagreed, suggesting that Bradley allocated too much indirect overhead. *Id*. at p. 22.

145. Sosnick next discussed purchase accounting adjustments, explaining that, since his Direct Testimony, he revised his list of purchase accounting adjustments and adopted Bradley's purchase accounting adjustments for non-regulated entities. *Id*. at p. 43. In response to Bradley's accusation that Sosnick advocated removing the purchase account adjustments from the 2003 plant balances provided by SFPP in discovery, Sosnick retorted that the balances he used in his direct testimony were the same as the numbers provided in the July 2006 discovery responses by SFPP. *Id*. at p. 24 (*citing* Exhibit No. S-16 at p. 6). He continued, stating that, had Bradley reconciled the year-end 2003 balances used by Sosnick and the balances SFPP provided in the discovery response, there would not have been a difference between Sosnick and Bradley's 2003 end-of-year balances. *Id*.

146. Moving on to gross property in the Massachusetts formula, Sosnick explained that the difference between Staff's balance of $8,073,632,433 and SFPP's balance of $5,374,647,941 also is due to his inclusion of twelve subsidiaries and the exclusion of purchase accounting adjustments. *Id*. at p. 25 (*citing* Exhibit Nos. SFO-30 at p. 10, S-21 at p. 2). Sosnick said he updated Staff's gross revenue and payroll components of the Massachusetts formula based upon Bradley's update to the revenue and payroll

information in the response to a discovery request. *Id*. at pp. 25-26 (*citing* Exhibit No. S-16 at p. 13).

147. Generation of revenue, Sosnick noted, is important as a basis for determining how to allocate indirect costs to subsidies. *Id*. at p. 26. The Commission, in its *Distrigas*[38] methodology, uses net income as the third factor in the corporate overhead allocation instead of gross revenues. *Id*. at p. 27. Sosnick stated that he employed this methodology for evaluating the inclusion of Tejas Consolidated in the Massachusetts formula because Tejas Consolidated's net income appears to him to be a better representation of the actual business activities of the entity than gross revenues. *Id*. at pp. 27-28. The difference between Tejas Consolidated's net income and gross revenues, Sosnick added, represents the cost of gas sold, which is the largest portion of Tejas Consolidated's stated gross revenue, and, if included, would result in an unreasonable allocation of residual corporate overhead costs to Tejas Consolidated. *Id*. at p. 28.

148. Returning to his discussion of Bradley's final overhead allocation amount for SFPP, Sosnick explained that he accepted Bradley's conclusion that the amount for 2003 is $140,437,511. *Id*. at p. 28. Furthermore, Sosnick accepted Bradley's reduction of $90,000 for Cochin and the removal of Responsibility Center 0375, and thus $501,769, from the amount of overhead to be allocated. *Id*. at p. 29 (*citing* Exhibit No. SFO-25 at p. 33). Explaining his acquiescence with Bradley's calculation, Sosnick stated that both the $90,000 and the responsibility center represent direct assignments which should not be included in the residual overhead allocation. *Id*. After these changes are made, Sosnick stated, there will be residual unallocated corporate overhead in the amount of $139,845,742. *Id*.

149. In order for SFPP to allocate the carrier portion of the corporate overhead costs among its functions, Sosnick explained, it would need to show the direct investment in each business unit/function/line/facility and the direct labor associated with each. *Id*. at p. 36. SFPP has completed this break down, but has been using carrier direct investment and carrier direct labor totals that include intrastate costs, which Sosnick suggested is inappropriate. *Id*. at pp. 36-37. He stated that all intrastate costs are non-jurisdictional, or not regulated by the Commission, and should not be included in the carrier interstate plant investment or labor balances used for the KN functionalization. *Id*. at p. 38.

150. SFPP takes a simple average of the direct plant investment and direct labor ratios in order to allocate the corporate overhead costs between carrier and non-carrier functions, according to Sosnick. *Id*. In his view, the corporate overhead costs are not initially broken out by the nature of the cost, and thus there is no rationale behind allocating based on a simple average. *Id*. Additionally, Sosnick continued, a simple average of the ratios

[38] *Distrigas of Massachusetts Corp.*, 41 FERC at pp. 61,555-56.

does not take the dollar value into consideration, and the difference in the magnitude of these values is disregarded. *Id*. at pp. 38-39.

151. Sosnick testified that he used an average of total direct plant investment and direct labor to arrive at the proportion of Kinder Morgan's overhead to be recovered in SFPP's carrier rates. *Id*. at p. 39. To allocate corporate overhead costs between SFPP's carrier and non-carrier functions, Sosnick stated that he added the carrier direct investment and the carrier direct labor and divided the total by the sum of the total carrier and non-carrier direct investment and total carrier and non-carrier direct labor, resulting in an allocation of 68.5920% to the carrier function. *Id*. at p. 40 (*citing* Exhibit No. S-22).

152. However, Sosnick explained, his carrier percentage was not correct because SFPP had not provided information separating intrastate plant investment and labor costs, which would allow him properly to allocate between carrier and non-carrier. *Id*. Sosnick added that, on April 18, 2008, SFPP, in response to Staff discovery requests, provided information related to "interstate/jurisdictional and intrastate property in service, salaries and wages [sic] expenses and revenues for 2003 and 2004." *Id*. at pp. 40-41 (*citing* Exhibit No. S-25 and p. 1. Using this new information, Sosnick said he derived the carrier amount of property in service for the Sepulveda Line and Watson Vapor Recovery lines, which contained interstate property in service, using the percentage of the West Line to the total West Line intrastate and interstate property in service. *Id*. at p. 41. Sosnick claimed that the interstate/jurisdictional percentage for these lines was 75.18%. *Id*. at p. 42. Once he was able to calculate that percentage, Sosnick explained, he was then able to allocate the corporate overhead costs between carrier and non-carrier, finding a new carrier allocation of 35.5382% and a new non-carrier allocation of 64.4618%. *Id*. at p. 42 (*citing* Exhibit No. S-22).

153. For the North and Oregon Lines, Sosnick explained, SFPP reckoned its KN allocation factors by calculating direct investment and direct labor expense for each line and then taking the simple average of the two ratios for each segment, which does not classify the indirect expenses as labor-or plant-related, thus inadequately matching cost and causality. *Id*. at p. 43. Sosnick, on the other hand, said he added the North Line direct investment and the North Line direct labor and divided it by the sum of the total carrier direct investment and total carrier labor, and did the same for the Oregon Line. *Id*. at p. 44. Using SFPP's most recent data requests, Sosnick indicated that he calculated an Oregon Line allocation factor of 4.6786%, which, when applied to the carrier portion of SFPP's allocated corporate overhead, results in a collection of $275,525 from Oregon Line customers. *Id*. at p. 45. Furthermore, Sosnick stated that he calculated a 13.8391% North Line allocation factor which results in a collection of $814,995 from North Line customers. *Id*.

154. On cross-examination, Sosnick stated that because SFPP does not classify costs as either labor-related or plant-related, he is unable to apply the KN formula properly.

Transcript at p. 1057, 1064. As there is no distinction between costs, Sosnick asserted that he accumulated all the costs and thus uses the total direct labor and plant costs as the denominator in the formula. *Id*. at p. 1064.

155. Looking at the SFPP and Staff inputs for the KN formula, Sosnick confirmed that SFPP and Staff's interstate direct plant for 2003 for the North Line are the same, as are the numbers used for the Oregon Line interstate direct plant in 2003. *Id*. at pp. 1072-73. Also, he stated that the North and Oregon Line 2003 direct plant and direct labor ratios appear to be the same for SFPP and for Staff. *Id*. at p. 1074.

156. On re-direct examination, Sosnick explained the disparity between the total amount of overhead expenses and those directly charged to the Kinder Morgan, Inc.-operated Kinder Morgan entities in 2003 as the difference between costs that were recorded for the entities and what they actually paid. *Id*. at p. 1085.

E. KELLYE JENNINGS

157. Kellye Jennings ("Jennings") is an audit partner with Argy, Wiltse & Robinson, P.C., a professional organization that provides accounting and tax services. Exhibit No. BPX-1 at p. 4. Jennings stated that she is a Certified Public Accountant and a Certified Management Accountant and, as an audit partner, is responsible for the administrative and technical aspects of all engagements surrounding financial statements and attestations under the standards set by the American Institute of Certified Public Accountants. *Id*. at pp. 5-6. She testified on behalf of Indicated Shippers. *Id*. at p. 4.

158. Jennings' testimony is based on the assumption that the capital account for all limited partners is positive. *Id*. at p. 6. She said she also was advised to measure return on equity from the current stock market price. *Id*. For purposes of calculating a return on equity each year for an investor, according to Jennings, one needs to know the amount of the dividend per share, if the investment is in a corporation, or the amount of income flowed through to a limited partnership unit, if the investment is a partnership. *Id*. at p. 10. Assuming a corporation paid no dividends in 2004, Jennings stated, the return on equity to the shareholder in that year would be zero. *Id*. at p. 7. The same is true, according to Jennings, if a limited partnership did not flow through any income to the limited partners in 2004. *Id*. For each equation, Jennings explained, the numerator, or the dividend, is zero, so no extra information is needed to do the calculation. *Id*. Jennings indicated that her calculations show that making cash distributions to limited partners without flowing income to them does not change the return on equity because cash distributions are a return of capital, not income. *Id*.

159. Cash distributions do not have any bearing on the equity yield calculation, according to Jennings. *Id*. at p. 8. She explained that she cannot tell, by only knowing the cash distribution amount, if income is flowed through to a limited partner. *Id*. at p. 9. A

cash distribution is not income, Jennings continued, but is a withdrawal of cash, which reduces the amount of an investment. *Id*. at p. 11. A partner receiving a cash distribution from the partnership reduces the asset of his/her/its partnership interest, Jennings maintained. *Id*.

160. There is a difference in the meaning of the words "net income," Jennings explained, when they are used in financial reporting or in Internal Revenue Service ("IRS") tax reporting. *Id*. She stated that allocations of net income to classes of partners in SEC Form 10-Ks are different from allocations of net income to classes of partners for purposes of IRS reporting because the SEC Form 10-K allocations were performed for financial reporting purposes. *Id*. at p. 12. After referring to Kinder Morgan's 2006 SEC Form 10-K, Jennings stated that the net income allocated to the common unitholders in that year was $325,390,000, but that she does not know how much of that amount was flowed through as net income on the IRS Form 1065, Schedule K-1 ("K-1") to common unit holders. *Id*. To determine how much each shareholder or limited partner receives, Jennings continued, one would need to look at the income tax returns of the partnership and the K-1s given to the individual partners. *Id*. at pp. 12-13.

161. Goodwill, stated Jennings, an asset on the balance sheet, is the premium paid by new purchasers of businesses. *Id*. at p. 13. She said that whatever amount of the purchase price that is not otherwise accounted for on the asset side is called goodwill, and an offset entry would show goodwill as additional equity for the owners. *Id*. at pp. 13-14. However, Jennings continued, goodwill does not imply an equal amount of cash that can be spent. *Id*.

162. On cross-examination at the hearing, Jennings testified that, when she does a study on tangible net worth, the calculation is generally in accordance with generally accepted accounting principles, although there could be differences which would be noted. Transcript at p. 271. The treatment of goodwill in such studies, she continued, is identified as part of the general bank definition of tangible net worth, which begins with a financial statement and lists items to be added or subtracted to the net worth in the financial statement to arrive at net worth as defined by the bank. *Id*.

163. Jennings explained that one could decipher income from a return on equity if there were information on the original investment, the income flowed through to a partner over the course of the investment, and the sales price of the investment. *Id*. at p. 290. Such information, she continued, could be found on a partner's K-1, but the K-1 would need to be examined over the course of the holding of the investment. *Id*.

F. CHRISTOPHER P. SINTETOS

164. Christopher P. Sintetos ("Sintetos") is a partner in Argy, Wiltse and Robinson, P.C., where he specializes in taxation. Exhibit No. BPX-5 at p. 1. Sintetos testified on

behalf of The Indicated Shippers. *Id.* He admitted that he has no expertise in either the Commission's Uniform System of Accounts or the Commission's ratemaking methodologies. *Id.* at p. 2.

165. Sintetos indicated that ordinary income, which he defined as income from a trade or business, or the amount that is reportable after consideration of all deductions and credits flowed through from the partnership, is subject to ordinary income tax applied on a progressive scale. *Id*. at pp. 2-3. Other classifications of income, noted Sintetos, such as net income from rental real estate, interest income, and dividend income, may be flowed through to partners, but may or may not be related to the ordinary trade or business activities of the partnership. *Id*. at p. 3. These types of income, he continued, are taxed on the same rate schedule used for ordinary income. *Id*. Sintetos testified that an individual's income tax rate for qualifying dividends is zero to 15% depending on the taxpayer's regular tax bracket and tax year. *Id*.

166. Capital gains, according to Sintetos, can come from the partnership itself, such as from the sale of property or assets used by the partnership in its trade or business or from a sale of a partnership interest to a third party. *Id*. at p. 3. He testified that the particular tax rate for sales of property or assets depends on the holding period and the type of asset. *Id.* at p. 4. For an individual, he added, the rate can be that taxpayer's ordinary tax bracket for net short term gains, the capital gain rates of zero to 15%, or the unrecaptured 1250 depreciation rate of 25% for depreciated real estate. *Id*. When a capital gain is associated with the sale of the partnership unit, Sintetos said, the rate will vary depending on partnership recapture items. *Id*.

167. According to Sintetos, the Internal Revenue Code views the disposition of a partnership unit as the sale of a capital asset even though the tax on capital gains is also called an income tax and can range between all taxation at capital gains rates and all taxation at ordinary income tax rates. *Id*. He testified that there is an exception for taxation of a gain prior to any sale when the partner's interest in the partnership falls below zero. *Id.* Sintetos claimed that this would occur when all a partner receives from the partnership is cash distributions, which are not income, but are a return of capital. *Id*. He went on to define cash distributions as distributions and reductions of the partner's capital account for book purposes and a reduction of a partner's tax basis for income tax purposes, and added that distributions in excess of a partner's basis create taxable capital gains, not taxable operating income. *Id*. at p. 5.

168. Sintetos stated that discussing taxable income or loss is determined at the partnership level, and each partner's share of the taxable income or loss as well as any additional depreciation that a partner gets when writing up his investment in the partnership to the purchase price is reported to the partners. *Id*. at p. 5. The income, he added, is reported on individual partners' returns and is subject to income tax. *Id*. at p. 6.

169. According to Sintetos, taxable income and distributions are two different concepts for tax purposes, but both affect a partner's capital account. *Id*. While income or loss is based on the entity's activities, he testified, distributions are based on the partnership agreement and on the partnership's need for other sources of cash. *Id*. at p. 7. Additionally, he stated, there is no determination that a cash distribution is from income or if it is from capital originally contributed. *Id*. at p. 7. Sintetos noted that positive income flowed through to the partner increases the partner's capital account and tax basis of the investment and offsets the reduction in the investment basis of the partner caused by a cash distribution. *Id*. at p. 6. If a loss of income flows through, he maintained, the partner's capital account will decrease. *Id*.

170. Should a partner sell his partnership interest for a higher price than the investment basis, Sintetos explained, the gain on that sale is the result of the sale of a capital asset, not ordinary income from a trade or business. *Id*. at p. 9. Moreover, he testified, the income tax rules on gains or losses from the sales of assets may tax a gain from the sale of a partnership interest at several different rates. *Id*. Such a sale is treated as a capital asset rather than as operation income, Sintetos asserted, because it is based on market conditions and the value of the partnership interest is only perceived. *Id*.

171. The words "net income," Sintetos noted, have different meanings in the SEC's Form 10-K and on partnership income tax returns. *Id*. at p. 10. He further testified that the numbers are not expected to be the same on both forms, and are reported for different reasons: net income is shown on the SEC Form 10-K to allow readers to compare an entity's activities with investment activities, while IRS Form 1065 shows the taxable income of the entity, based on IRS rules. *Id*. To find out how much net income was actually flowed through to the partners, Sintetos continued, one would need to look at the IRS forms. *Id*. at p. 12.

172. Sintetos stated that the dividend yield to shareholders, the per share dividend divided by the current stock market price, is subject to taxation, unless a shareholder is exempt. *Id*. at p. 14. The same is true, according to him, for the taxable income flowed through to a limited partner, *i.e.*, if a limited partner did not receive taxable income, the return on equity would be zero, and there would be no income tax consequences. *Id*. at p. 15.

173. In his Rebuttal Testimony, Sintetos testified that, as a basis for an income tax allowance, SFPP is using taxable income, *i.e.*, total income, after all IRS deductions are taken, including IRS depreciation. Exhibit No. BPX-21 at pp. 1, 5. Based on SFPP's testimony, Sintetos stated, SFPP's total amount of taxable income is $69,769,749, its net income is $161,220,571, and it has $91,450,822 in net income in excess of taxable income which is thus, not taxable. *Id*. at pp. 2-3 (*citing* Exhibit No. SFO-55A at p. 6). From these numbers, Sintetos said he calculated that 43.28% of SFPP's book income was taxable. *Id*. at p. 3. Further, he explained, the difference between book income and taxable income is

the difference between the allowable deductions claimed and income recognized for tax purposes versus book purposes. *Id*. SFPP, Sintetos continued, has deductions for tax exempt interest and depreciation, among others. *Id*. As he would expect, Sintetos asserted, SFPP's tax depreciation is greater than its book depreciation. *Id*. at p. 4. Explaining this, Sintetos testified that book depreciation is generally straight-line depreciation over the useful life of an asset, while tax depreciation is usually of a shorter duration and can have forms of acceleration where deductions are higher than straight line depreciation. *Id*.

174. In 2003, Sintetos testified, Kinder Morgan's general partner received all of the taxable income plus an additional sum, and, to account for this additional sum, the limited partners were allocated a loss in the amount of the additional sum and were not allocated any taxable income. *Id*. at pp. 7-8. Sintetos explained that the allocated losses in taxable income will carry forward and offset the amount of taxable income that will be allocated to those partners in the future. *Id*. at p. 9. If these carryover losses have not been offset by the time the partner disposes of his or her interest, they can be used to offset the partner's other taxable income, according to him. *Id*. Additionally, he continued, the partners who receive these losses may deduct them against any future income they receive from Kinder Morgan. *Id*. at p. 10.

175. A K-1, Sintetos explained, is the IRS form provided to each partner to show the partner's share of income, deductions, and other reportable items. *Id*. Cash distributions are included on the form, he noted, but are not taxable income. *Id*. They can, however, be taxed if there is a constructive sale or liquidation of part of the partnership unit if they reduce the basis of the investment below zero, Sintetos testified. *Id*. at p. 11. Some partners may receive some taxable income, according to Sintetos, even if Kinder Morgan's taxable income is negative. *Id*. Were this the case, then the number reported on IRS Form 1065 is the net number, he continued, and it could be possible for the total amount of losses to the limited partners to be greater than what was reported on IRS Form 1065. *Id*.

176. Referring to Kinder Morgan's public limited partners' K-1s, Sintetos claimed that there was no taxable income allocated in 2003. *Id*. at p. 12 (*citing* Exhibit No. BPX-24). However, in 2004, Sintetos stated, 6.3181% of the publicly traded partners received approximately $14,070,193 in taxable income, subject to reduction or elimination by passive losses. *Id*. (*citing* Exhibit No. BPX-25). Asked for the "total losses in taxable income suffered by the public limited partners," Sintetos replied that it depended on the source of information used. *Id.* He continued:

> My analysis of the 2004 K-1 information, in Exhibit No. BPX-25, indicates that the net taxable (loss) to all limited partners netted to ($221,743,727). However, the analysis of the taxable income by partner type on page 4 of [Kinder Morgan's] 2004 Form 1065, Exhibit No. SFO-57C . . . indicates that the net (loss) to the [sic] all limited partners netted to ($217,909,933)[.] In

> order to get to the *total* loss for *all public* limited partners, you need to note that the non-publicly traded limited partners as a group had net taxable income of $25,730,085 (this figure is netted in arriving at the above net limited partner (losses)). If you add back the *non-public* limited partners[□] net income to the *public* limited partners[□] net total loss, the net (losses) to public partners would be ($247,473,812) and ($243,639,918) respectively. All of the above amounts are before tax credits that also passed through to all partners.

Id. at pp. 12-13 (emphasis in original).

177. Generally, Sintetos testified, when looking at Kinder Morgan's Analysis of Net Income, the total amount of the General Partner's allocation added to the allocation of negative income to the limited partners should equal Kinder Morgan's net taxable income. *Id.* at p. 13 (*citing* Exhibit No. SFO-55C). However, there is a discrepancy between these two numbers which, Sintetos claimed, Kinder Morgan explains is the result of two factors, a lack of complete information on beneficial owners from the nominees, and the inclusion in the K-1 of Section 743(b) basis adjustments in the capital balances. *Id*.

178. Sintetos explained that 743(b) depreciation is an adjustment a partner gets as a result of adjusting the basis of the partnership's assets for the difference between the purchase price paid for a partner's interest and the basis of the interest purchased. *Id*. The election, he continued, is taken when a partnership has interests that sell for more than the tax book value so that the additional purchase price paid can yield additional tax depreciation associated with the write up of the new partner's interest, and the new partner can start depreciation or amortization of the partnership assets over again. *Id*. at p. 15. According to Sintetos, the additional depreciation under 743(b) operates to reduce the actual or potential income taxes to the partners because the additional depreciation combines with tax depreciation and other deductions and offsets taxable income. *Id*.

179. In response to a proposition stating that investors on the New York Stock Exchange ("NYSE") do not care about income or return on investment, but care only about cash flow, Sintetos asserted that an informed investor is focusing on an after-tax return on his or her investment. *Id*. at p. 17. An investor, he continued, should consider both the returns on an investment, the risks associated with the investment, and his or her own personal tax situation and liquidity needs. *Id*.

180. During his cross-examination, Sintetos was asked about 743(b) depreciation, which he explained typically belongs to a partner and would usually be identified on a partner's K-1, rather than in the body of a return. Transcript at p. 313. While SFPP does not appear to deduct 743(b) depreciation specifically, Sintetos indicated that it can be accounted for either on a K-1 or embodied within depreciation schedules that are flowed through

specifically so that each partner does not see it separately. *Id*. at pp. 313-14. Sintetos stated that he understood that SFPP made a 743(b) election. *Id*.

181. On re-direct examination, in response to questions regarding Kinder Morgan's 2003 IRS Form 1065, Sintetos explained that the page entitled "Partnership Return of Income Disclosures" discusses the analysis of income, explaining items that cause the capital balances to not total, such as 743(b) depreciation. *Id*. at p. 338. This page, Sintetos testified, suggested that the partnership has made an election to use 743(b) depreciation. *Id*. He continued by stating that, while he does not recall where, he has seen references to 743(b), but that the problem with 743(b) is that once the election is made, it is binding until rescinded, and therefore, it is not always referred to in subsequent documents. *Id*. It can be hard to determine, according to Sintetos, whether such an election has been made since it is not shown every year. *Id*. He then noted a portion of the IRS Form 1065 which reflected that the partnership had elected to adjust the basis of the partnership properties under Section 743(b). *Id*. at pp. 338-39.

182. Further, Sintetos indicated that taxable income flowed through an MLP will result in a positive return on equity. *Id*. at p. 316. Moreover, he said he considered it a management decision whether to distribute cash or taxable income, but explained that they are not necessarily connected in the partnership context.[39] *Id*. at p. 316.

183. Continuing the discussion of an MLP, Sintetos testified that, under the 90% rule that applies to MLPs, underlying income has to come from specific activities, such as transporting natural gas or petroleum products, for an entity to be considered an MLP. *Id.* at pp. 318-20. Such a restriction, Sintetos continued, does not apply to a limited partnership. *Id*. at p. 319.

G. ELIZABETH H. CROWE

184. Crowe testified on behalf of Indicated Shippers. Exhibit No. BPX-15 at p. 1. She is the President of Foresite Energy Services, LLC, which provides consulting services to the regulated energy industry. *Id*. SFPP, alleged Crowe, over-recovered its cost-of-service by 12.6% to 36.1% between 1999 and 2006. *Id*. at p. 2.

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[39] Taking a step back, Sintetos defined an MLP as a partnership that would trade on an exchange and yet still retain partnership characteristics; specifically, that it would be a flow-through entity rather than a taxable entity, and thus tax returns are partnership returns rather than corporate returns. Transcript at p. 318. MLPs and limited partnerships are different types of entities, especially, Sintetos noted, when passive loss rules are concerned; in the MLP context, passive losses can be used only against the MLP's income. *Id*.

185. According to Crowe, she accepted that that the three elements critical in the Commission's methodology for calculating a return component for cost-of-service include the debt/equity ratio, the cost of debt, and the rate of return on equity. *Id*. at p. 3. To determine SFPP's debt/equity ratio, Crowe explained, one looks to the responsible parent entity, Kinder Morgan. *Id*. at pp. 3-4. She recommended a debt/equity ratio of 63.8% debt and 36.2% equity, which she calculated by using Kinder Morgan's long-term debt and partners' capital. *Id*. at p. 4. Crowe said she removed two "write-ups" on the asset side of the balance sheet which inflate the equity component on the liability side: (1) purchase accounting adjustments; and (2) goodwill in the amount of $1,076,000, because shippers should not have to provide a higher profit and higher debt coverage based on goodwill premiums paid. *Id*. at pp. 4-5. With respect to these adjustments, Crowe stated that the capital structure's debt component increases from 54.5% to 63.8%. *Id*. at p. 5.

186. Crowe testified that interest rates increase as bond ratings decrease, and vice versa. *Id*. She related that she reviewed bond ratings to determine how they affect Kinder Morgan's cost of debt and stated that Kinder Morgan's ratings were lowered while the takeover of Kinder Morgan, Inc., was pending, and that Moody's downgraded Kinder Morgan's bond rating. *Id*. at pp. 5-6. Crowe added commercial paper to Kinder Morgan's weighted cost senior bonds, 6.48%, to get a total weighted debt cost of 6.26% for SFPP. *Id*. at p. 6. To account for the aforementioned downgrade of Kinder Morgan's credit rating, Crowe recommended lowering the cost of debt for SFPP from 6.26% to 6.19%, which reflects a one-third of a category downgrade by Moody's.[40] *Id*. at pp. 6-7.

187. SFPP, according to Crowe, selected a proxy group which includes nine oil pipeline MLPs. *Id*. at p. 7. The dividend yield of a corporation is calculated, Crowe stated, by dividing the dividend per share by the appropriate stock market price, which results in a percentage of income or earnings that the investor received on his investment, measured against the stock price. *Id*. at pp. 7-8.

188. With respect to MLPs and determining dividend yield, Crowe testified that dividends always represent cash distributions paid to public limited partners divided by average stock market price. *Id*. at p. 9. It is inappropriate, she stated, to substitute cash distributions for dividends in the dividend yield formula because cash distributions are a return of capital; rather, according to her, income or earnings allocated to investors should be used. *Id*. at p. 10. Using cash distributions to all partners, and not just public limited partners, Crowe calculated an average cash distribution yield of 9.21%. *Id*. at p. 12. She contended that this methodology is flawed because it includes the cash distributions that go to the investors instead of to other partners, which is neither income for cash distributions to the public limited partners, nor can it be used to estimate public investors' expected return on equity. *Id*.

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[40] Crowe explained that a downgrade of one full category would result in a cost of debt increase of about 20 basis points. Exhibit No. BPX-15 at p. 6.

189. Crowe referred to the use of earnings or income on an SEC Form 10-K in the DCF formula as dividends, stating that there is no correlation between book income allocated to the limited partners and the amount of income that really went to the public limited partners as reported on the K-1 forms. *Id*. at p. 13. This use of earnings or income as dividends also involves, according to her, the assumption that every partner gets the same amount of income for each unit owned, which is not true. *Id*. at p. 14.

190. The actual taxable income that flowed through to the public limited partners, Crowe submitted, is the proper amount to use for the dividend in the dividend yield formula. *Id*. Without evidence that taxable income actually reaches the public limited partners in an MLP, Crowe said that she cannot calculate SFPP's dividend yield. *Id*. at p. 15.

191. Using a ten-member corporate proxy group that includes only oil and gas corporate entities and not MLPs, Crowe stated that she calculated a range of dividend yields from 0.93% to 3.70%, with an average yield of 2.04%. *Id*. at pp. 15-16. She recommended that only corporations whose dividends represent actual income to the stock market investor be used in a proxy group. *Id*. at p. 16.

192. The theory that there is a positive correlation between growth in earnings and growth in corporate dividends, according to Crowe, would still apply if the Commission used SEC type MLP earnings for the public limited partners or income actually flowed through to the public limited partners as the dividend, but not if cash distributions were used as the dividend in the dividend yield formula. *Id*. at p. 16. She alleged that because cash distributions are not limited to cash derived from earnings, the theory will not work. *Id*. at pp. 16-17.

193. When placing SFPP in the range of a proxy group, Crowe said she focuses on its status as the only refined petroleum product pipeline in Oregon and Arizona and as the only avenue for transporting petroleum products to Nevada. *Id.* at p. 17. According to Crowe, this gives it a virtual monopoly over transporting petroleum products by common carrier pipeline. *Id*. Given this situation, Crowe maintained that SFPP should be at or near the bottom of the range of reasonable returns produced by the proxy group. *Id*. Assuming, giving SFPP the mean which is higher than the median in the corporate proxy group analysis she performed, Crowe recommended a debt/equity ratio of 63.8%/36.2%, a cost of debt of 6.19%, and a nominal rate of return on equity of 10.56%. *Id*.

194. When determining taxable income for an oil pipeline, Crowe testified, there is a real return on equity, a deferred return on equity component,[41] and a deferred earnings component. *Id*. at p. 18. Neither depreciation nor cash distributions are included because, according to Crowe, they are both returns of capital. *Id*. Furthermore, Crowe explained that the annual depreciation allowance for equity, Allowance for Funds Used During Construction, and Depreciation of Investment Tax Credit Basis Reduction, while sometimes added to the calculated return on equity to compute an income tax allowance, are not income. *Id*. at pp. 22-23. Both depreciation and state income taxes are a deduction from income, testified Crowe. *Id*. at p. 19.

195. A flow-through entity, such as SFPP, cannot "normalize taxes," and so, Crowe contended, ratepayers should not have to pay income taxes on more than the taxable income flowed through the partnership. *Id.* at p. 21. Moreover, she suggested, there would be nothing to add to the ADIT account. *Id*. Crowe alleged, however, that SFPP has an ADIT account that is 100% overfunded, since SFPP has always been a flow-through entity for tax purposes. *Id*. at pp. 21-22. SFPP's ADIT account totaled $1.23 million for the Oregon Line and $5.26 million on the North Line at the end of 2004, according to Crowe. *Id*. at p. 22. Crowe recommended that the ADIT account be amortized back to the ratepayers as a credit to the cost-of-service, as she has observed SFPP do in the past. *Id*.

196. To determine an income tax rate to apply in this proceeding, Crowe recommended two adjustments to the taxable income. *Id*. at p. 22. First, she explained, the general partner in an MLP receives income in the form of an incentive for good management, which, according to Crowe, is equal to up to a 50% share of the cash distributions, regardless of whether the partnership has any income, and is credited to the income of the partnership.[42] *Id*. at p. 23. The remainder of the income goes to all partners, she added, including the general partner, and thus Crowe's first adjustment is to deduct the guaranteed payment to the general partner from income. *Id*. Next, Crowe stated, the public limited partners in Kinder Morgan are allowed to write up their tax basis to the amount of the purchase price on the NYSE and start depreciation all over again. *Id*. The depreciation deduction is deducted from income, as well as depreciation and credits that flow through the partnership itself, reducing the actual or potential income taxes of the public limited partners and the income tax rate. *Id*.

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[41] The deferred return on equity component consists of the difference between the real rate of return on equity and the nominal rate of return on equity, according to Crowe. Exhibit No. BPX-15 at p. 22.

[42] This income is a "guaranteed payment to partners" under the IRS code, Crowe stated. BPX-15 at p. 23.

197. In her Rebuttal Testimony, Crowe stated that the formula for the dividend yield factor is the income given to shareholders in the form of dividends divided by the stock market price, which yields a rate of return on equity for this factor. Exhibit No. BPX-32 at p. 2. The cost-of-service does not include an allowance for the income taxes that a shareholder might have to pay on dividends, Crowe added. *Id.* Additionally, Crowe claimed, Williamson did not reflect any income in his calculation of a dividend yield because he used cash distributions, which are not income, according to her. *Id.* at pp. 2-3.

198. When Williamson divides cash distributions by the 2003 stock market price, Kinder Morgan's dividend yield is 6.11%, Crowe asserted. *Id*. at p. 3 (*citing* Exhibit No. SFO-15 at p. 9). She stated that she could also calculate the dividend yield using the total number of units for Kinder Morgan's public limited partners[43] and the net taxable income flowed through to these partners.[44] *Id*.

199. Cash distributions recovered as depreciation in Williamson's DCF analysis are being recovered twice under SFPP's proposed cost-of-service as both a depreciation allowance and an equity return, Crowe contended. *Id*. at pp. 5-6. She explained that, despite what investors in an MLP believe, cash distributions are not a return on their investment, and thus should not be used when measuring the rate of return on investment for SFPP. *Id*. at p. 6.

200. Crowe stated that, because the applicable test period had not yet been determined, she used the most recent information available regarding Kinder Morgan's current capital structure. *Id*. at p. 7. Further, when criticized for removing goodwill from the equity portion of Kinder Morgan's capitalization, Crowe explained that she removed it not because it was directly related to the purchase of SFPP, but because, like a purchase accounting adjustment write-up, goodwill reflects an accounting adjustment that increases the value of an asset above its net depreciated book value. *Id*. at p. 8. Goodwill, Crowe continued, represents the bulk of Kinder Morgan's intangible assets and does not economically benefit SFPP's ratepayers. *Id.*

201. SFPP, Crowe suggested, is considerably less risky than the companies it uses in its proxy group for the rate of return on equity calculations. *Id*. at p. 9. She explained that the proxy companies all operate in competitive markets and some are authorized to charge market-based rates, while SFPP serves areas without available carrier product pipeline alternatives, shielding it from competition. *Id*. at pp. 9-10. She argued, therefore, that

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[43] Crowe explained that, because the stock market price only applies to the limited partners, only they are relevant to the calculation. Exhibit No. BPX-32 at p. 3.

[44] However, Crowe failed to provide a dividend yield based on this methodology. *See* Exhibit No. BPX-32 at p. 3.

SFPP should be placed considerably below the median return in the range of reasonable returns determined in this proceeding. *Id*. at p. 10.

202. Crowe explained that SFPP witness Ganz, in using "the methodology for corporate public utilities, rather than for partnerships . . . ignores the fact that IRS depreciation will lower the amount of SFPP's taxable income that is flowed through every year to the partners." *Id*. at p. 13. His income tax allowance, she continued, is based instead on book income that does not take IRS depreciation into account. *Id.* This causes ratepayers to pay an income tax allowance that is too high until IRS depreciation rates drop below book depreciation rates, according to Crowe. *Id*. She testified that the ratepayers' overpayments are capital which is placed into an ADIT account and deducted from rate base, which reduces the return to the public. *Id*. Furthermore, she added, the account is drawn down as depreciation deductions are used up, and when it has more dollars than needed to pay taxes in the future, ratepayers must be refunded. *Id*. However, Crowe contended, because SFPP and Kinder Morgan are partnerships, not corporations, applying this ADIT methodology results in a double dip because partners get full benefits of tax depreciation despite the fact that shippers pay income taxes for the partners based on the assumptions that the partners do not receive these benefits of tax depreciation. *Id*. at pp. 13-14. To remedy this, she suggested a refund of this contributed capital to the ratepayers by amortizing the ADIT account over a five-year period and crediting it to the taxable income because ratepayers essentially prepaid the limited partners' current income tax liability. *Id*. at p. 14. After such adjustments, she continued, the taxable income is zero, causing the taxable income on which any income tax allowance would be calculating to be zero as well. *Id*.

203. While Ganz calculated SFPP's federal tax component at $23 million by applying a federal weighted tax rate of 33% to taxable income for 2003 of $69,800,000, Crowe claimed that he overlooked $30,000,000 in deductions, which would reduce taxable net income to $39.8 million and result in actual or potential income tax liability of $13.1 million for SFPP's partners. *Id*. at p. 15 (*citing* Exhibit No. SFO-62A). Specifically, she noted, Ganz's income tax rate calculations are overstated because he does not take into account that some partners in Kinder Morgan, allegedly, are entitled to 743(b) depreciation,[45] which is kept track of and flowed through to the partners in their K-1 reports, and reduces taxable income. *Id*.

204. Moreover, according to Crowe, in 2004, only a small portion of Ganz's income tax rate for public limited partners should be included in the calculation of a weighted income

[45] Partners in Kinder Morgan, Crowe explained, are entitled to 743(b) depreciation as the result of an election made by Kinder Morgan that requires partners who buy and sell units of the NYSE to write up the tax basis to the purchase price and then begin depreciation all over again. Exhibit No. BPX-32 at p. 15.

tax rate because when comparing positive income to net losses, Crowe stated, there was only approximately 6% taxable income. *Id*. at p. 17.

205. Crowe claimed that interstate shippers should not have to subsidize income taxes due on profits SFPP was collecting in excess of its claimed cost-of-service from interstate shippers because an income tax allowance should only cover the allowed taxable income. *Id*. at pp. 17-18. Therefore, she contended, book income should be decreased, thus decreasing taxable income. *Id*. at p. 18.

206. Next, Crowe addressed the 2003 situation in which Kinder Morgan's general partner received more income than the partnership itself made. *Id.* This occurred, Crowe explained, because the general partner can receive an incentive distribution which may add up to almost half of the cash distributions on a progressive scale, as well as income in the same amount, regardless of whether the partnership had any income. *Id*. at pp. 18-19. Thus, Crowe submitted, in order to determine Kinder Morgan's general partner's income, one must trace the general partner's cash distribution. *Id*. at p. 19. Because, according to her, Kinder Morgan's general partner's income is a payment for management services, Crowe insisted that the general partner is not entitled to an income tax subsidy from the shippers, and the applicable tax rate should be set to zero. *Id*.

207. Were she to set the general partner's income tax rate to zero and replace the claimed income tax rates for the public limited partners with zero for 2003, then the weighted average federal income tax allowance for 2003 would be decreased from 33.05% to 3.02%, Crowe argued. *Id*. at pp. 19-20 (*citing* Exhibit No. BPX-40). Further, in 2004, while the public limited partners received a small percentage of positive income, Crowe claimed that it would be mostly eliminated by 743(b) depreciation. *Id*. at p. 20.

208. On cross-examination, Crowe testified that SFPP is not as risky as the five members of Williamson's proxy group due to differences in competition. Transcript at pp. 359-60. She explained that, while there are other general risk factors one would consider when assessing financial risk, competition is a major business risk that an entity faces. *Id*. at p. 360. Crowe also agreed, theoretically, that weather patterns and physical environment could potentially affect a pipeline's risk, but contended that the analysis is complicated given the existence of insurance which would allow them to be compensated for any weather-related loss. *Id*. at pp. 361-62. However, when asked, Crowe noted that she has seen self-insurance premiums, in place of third-party insurance, included in cost-of-service. *Id*. at p. 365.

209. Varying economic conditions and the number of markets served, Crowe conceded, also affect risk. *Id*. at p. 362. While she said she is unsure of how the number of refineries connected to a pipeline system would affect risk, Crowe did indicate that, theoretically, were there more refineries attached, there would be less risk attached to an outage or mechanical problem. *Id*. at p. 362-63. Differing regulatory regimes, she

continued, could also theoretically affect risk or cost. *Id*. at p. 363. Moreover, population could affect risk if throughput and volumes are based on the population in the immediate area of the pipeline, Crowe indicated. *Id*. at p. 364. Business diversification could also affect risk, according to Crowe, although she pointed out that the number of businesses that a company is involved in could either increase or decrease the risk, depending on the exact situation. *Id*. at pp. 365-66. Additionally, she added, the same is true of geographic diversification. *Id*. at p. 366. Lastly, Crowe conceded that the ease with which a company can redeploy its assets is a factor affecting risk. *Id*.

210. Crowe stated that she is aware that oil pipelines are permitted to use an indexing method for rate increases that is meant to track inflation increases, but that, to her knowledge, natural gas companies are not subject to similar indexing regulatory benefits. *Id*. at p. 368. This factor on its own, Crowe submitted, would not make SFPP more or less risky than an MLP that included natural gas companies because a natural gas pipeline could go to the Commission for a rate increase at any time, which could exceed the indexing rate that the oil pipeline would have been permitted. *Id*. at p. 369.

211. For 2003, Crowe testified that she calculated Kinder Morgan's cost of debt as 6.26%, but proposed a downward adjustment to 6.19%. *Id*. at p. 373 (*citing* Exhibit No. BPX-17). While she did not develop a growth rate for Kinder Morgan, Crowe stated that, if her cost of debt of 6.19% was higher than the growth rate calculated by Williamson, it would illustrate the inappropriateness of using MLPs in the DCF analysis which, she added, she did not do. *Id*. at pp. 373-74.

212. Crowe asserted that ADIT is inappropriate for SFPP because partnerships do not pay income taxes, so there are no future tax payments to defer. *Id*. at p. 377. Because SFPP is a flow-through entity, Crowe continued, the ADIT be disallowed and any overfunded amounts be flowed back to SFPP ratepayers. *Id*. at p. 378.

H. ROBERT G. VAN HOECKE

213. Van Hoecke is a Principal with Regulatory Economics Group, LLC, which specializes in economic, financial, and regulatory consulting for the pipeline industry. Exhibit No. SFO-1 at p. 1. Van Hoecke testified on behalf of SFPP. *Id*. at p. 2.

214. Based on a comparison between 1995 and 2003 volume and cost-of-service figures, O'Loughlin, Van Hoecke stated, asserted that a substantial change in circumstances has occurred. *Id*. at p. 8. However, Van Hoecke contended, as O'Loughlin makes assumptions that are contrary to established cost-of-service methodology, such as excluding $1 million in income tax allowances, he is only able to show a modest increase in cost-of-service. *Id*. at p. 9. Van Hoecke testified that O'Loughlin stated that a substantial change in circumstances has occurred based on 2003 Oregon Line volumes,

when, in reality, Van Hoecke alleged, the volume only changed minimally between 1999 and 2003. *Id*. at p. 11.

215. Van Hoecke explained that, before a rate can be reduced below the grandfathered level, there must have been a substantial change in the economic circumstances that were the basis for the rate. *Id*. at p. 12. The change in economic circumstances between the Complaint Period and the twelve-month period leading up to the passing of the EPAct is analyzed by adding the percentage change in volumes and the additive inverse of the percentage change in the overall cost-of-service, Van Hoecke continued. *Id*. at pp. 12-13. He added that the significance of changes in these factors are evaluated using the formula (C-B)/A. *Id*. at p. 13. Van Hoecke contended that, when analyzing only a single rate element, one cannot conclude that there has been a substantial change in circumstances, and that changes in both volume and cost-of-service can more reliably indicate the change in a carrier's cost. *Id*. at pp. 13-14.

216. Revenues do not, according to Van Hoecke, provide a superior measure of change compared to volumes. *Id*. at p. 15. Because revenue is a function of both the volume a pipeline moves and the rate it charges to move that volume, Van Hoecke alleged that using them to measure change will obscure the portion of the revenue change associated with the change in the pipeline's economic circumstances. *Id*.

217. It is illogical, claimed Van Hoecke, to use revenues based on the non-grandfathered portion of a rate to determine whether there has been a substantial change in the economic circumstances that were the reason for the grandfathered rate. *Id*. at p. 17. The substantial change in circumstances standard is used to determine whether a rate should be dropped below a grandfathered rate, and thus the revenues generated by the non-grandfathered portion should not be used in the analysis. *Id*. at p. 18. If revenues are going to be used to determine if there is a substantial change in circumstances, Van Hoecke asserted, they should only be grandfathered-rate derived revenue. *Id*.

218. A substantial change in economic circumstances should be evaluated using broad economic measures, asserted Van Hoecke, and thus gross margin,[46] a narrow measure of change, should not be used. *Id*. at p. 20. Using a narrow measure of change can cause confusion between a small fluctuation and a substantial change and will cause the appearance of a substantial change to occur more frequently, stated Van Hoecke. *Id*. at pp. 21, 23. He claimed that using profit margin will pose similar issues. *Id*. at p. 24.

219. Van Hoecke said he performed an independent analysis to determine whether there has been a substantial change in economic circumstances on the North or Oregon Lines.

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[46] Gross margin, Van Hoecke explained, is the difference between revenue and cost, both of which are broad based economic factors. Exhibit No. SFO-1 at p. 20.

Id. at p. 36. He explained that he computed the revenues associated with the grandfathered portion of the rate, found the grandfathered-rate revenue in each period by multiplying current volumes per period by the grandfathered rates, and received cost-of-service calculations for each line as well as an estimate of Oregon Line costs in 1985 using the Valuation methodology that existed when the rates were filed from SFPP witness Ganz. *Id*. at pp. 36-38. While a change of less than 15% does not meet the substantial change threshold, according to Van Hoecke, it does not necessarily follow that a change above 15% will meet this threshold; regardless, he indicated that his calculations result in weighted change levels that are below 15%. *Id*. at pp. 26, 38. He stated that these calculations are based on an overstated grandfathered-rate revenue increase.[47] *Id*. at p. 40.

220. Because O'Loughlin testified that regulatory change should be included in a substantial change in circumstances assessment, Van Hoecke made further calculations using cost-of-service data for the "A" and "B" periods. *Id*. at p. 43. He used the methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, for North Line period "A" and the Oregon Line 1992 and 2003 cost-of-service calculations; for the North Line 1992 period, the Commission's existing methodology was used.[48] *Id*. While, according to Van Hoecke, O'Loughlin did not calculate 1985 cost-of-service using the Valuation method that was used to initially establish the Oregon Line's grandfathered rates, Van Hoecke said that he included an estimated cost-of-service using this methodology. *Id*. at p. 44.

221. Van Hoecke claimed his results show that regardless of which cost-of-service methodology is used, there has been no substantial change on the North or Oregon Lines. *Id*. at p. 45. However, he advocated the use of the Commission's current interpretation of the methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, for the periods in which it was in effect for purposes of changed circumstances analysis because it is important to remain consistent in inputs and methodology when making a calculation. *Id*. Van Hoecke accused O'Loughlin of using cost-of-service methodologies based on inconsistent inputs,[49] which created the risk that a change due to an improper measure of a

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[47] The 1985 rate filing was based upon an expansion plan, Van Hoecke stated, but the volumes used for the rate were not achieved on the Oregon Line until 1999, and thus, he claims, were overstated in 1985. Exhibit No. SFO-1 at pp. 40-41.

[48] Van Hoecke indicated that he chose this methodology for the 1992 period because it was required by the Commission in 1992 when the Commission computed reparations on the East Line, and he claimed it would be inconsistent to use different methodologies for reparations and for evaluating changed circumstances. Exhibit No. SFO-1 at p. 43.

[49] According to Van Hoecke, O'Loughlin admitted that his equity percentage figures for the 1992 cost-of-service calculation are not consistent with the methodology he

pipeline's economic circumstances could be mistaken for a change in actual economic circumstances. *Id*. at pp. 46-47.

222. In assessing substantially changed circumstances, Van Hoecke explained that, while he supported including regulatory change, he thought that O'Loughlin defined it incorrectly. *Id*. at p. 47. O'Loughlin considered Commission clarification of an existing methodology to be a regulatory change, according to Van Hoecke, who testified it is not an entirely new methodology, but instead is meant to clarify an existing methodology and retroactively apply it to prior periods to bring carriers into compliance with the Commission's current methods. *Id.* However, regardless of which definition is used, Van Hoecke still submitted that a substantial change has not occurred on either line. *Id*. at p. 48.

223. Van Hoecke contended that O'Loughlin's analysis overstates the change in revenues because he used the change in total revenue, rather than the change in grandfathered-rate revenue. *Id*. at pp. 49-50. He also suggested that there are multiple errors and inaccuracies in O'Loughlin's cost-of-service calculations. *Id*. at p. 50. First, while O'Loughlin used a rate of 5.13% to compute his 2003 income tax allowance, Van Hoecke asserted, a blended state and federal income tax rate of 35% should have been used. *Id.* at p. 50. Were it substituted into O'Loughlin's calculations, Van Hoecke declared, the 35% rate would drop the alleged economic change to below 20% for the North Line and to 42% for the Oregon Line. *Id*.

224. O'Loughlin's second error, Van Hoecke stated, was using different methodologies to compute cost-of-service in the 1992 and Complaint Periods. *Id*. at p. 52. O'Loughlin also, according to Van Hoecke, employed different capital structure figures for the 1983-88 periods in his 1992 and 2003 cost-of-service calculations, which he claimed is problematic because a higher capital structure leads to a higher amount of deferred earnings and a larger starting rate base write-up. *Id*. at pp. 52-53. Van Hoecke further asserted that O'Loughlin's 1992 equity percent is inappropriately high, overstating his cost-of-service figure, and giving the impression that there was a large cost-of-service decrease between 1992 and 2003. *Id*. at p. 53. Since there is no justification for the differences between cost-of-service calculations in different years for the same time period, testified Van Hoecke, then if one capital structure is correct, the other must be incorrect. *Id*. at p. 55. When the income tax and capital structure errors are "corrected" and the percentage changes are re-calculated by fellow SFPP witness Ganz, Van Hoecke explained that costs on the Oregon Line increased slightly since 1992, making the change

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used for the North and Oregon Line costs of service, that he did not determine how regulatory changes would impact cost-of-service, and did not attempt to determine whether certain calculations were in error. Exhibit No. SFO-1 at p. 46 (*citing* Exhibit Nos. SFO-9, SFO-10, SFO-11).

in economic circumstances on that line fall to 32%, while costs increased on the North Line as well, offsetting the revenue increases so that the change on this line is below the 15% threshold. *Id*. at p. 54.

225. According to Van Hoecke, O'Loughlin erred by failing to reflect the proper level of operating expenses to calculate his 2003 costs-of-service. *Id*. at p. 56. When this "correction" is added to Ganz's prior corrections, the North Line cost increase is heightened and there is less possibility of finding a substantial change in circumstances, Van Hoecke added. *Id*. at pp. 56-57.

226. Van Hoecke declared that he disagreed with five of Sherman's contentions including her use of a 15% threshold, and stated that he considered 20% to be appropriate. *Id*. at p. 63. Second, he contended that grandfathered-rate revenues should be used when computing change, not overall revenues. *Id*. at pp. 63-64. Van Hoecke's third point of disagreement is with Sherman's cost-of-service calculations. *Id*. at p. 64. He stated that, had she substituted Ganz's 2003 cost-of-service for the Oregon Line, the change would be reduced to 12.77%. *Id*. Moreover, had Sherman used the 1985 cost-of-service data in her analysis there would be a decrease of 9% or higher in overall economic circumstances on the Oregon Line, according to Van Hoecke. *Id*. at p. 68. While Sherman's revenue/cost index approach uses a common unit of measure, Van Hoecke's fourth problem with Sherman's testimony is that she does not address the issue of adding percentages that are derived from different sized figures. *Id*. at p. 64.

227. Lastly, Van Hoecke took issue with Sherman's failure to reflect the proper economic basis for computing a change when the carrier has experienced a decline in performance between the Basis ("A") Period and the 1992 Pre-EPAct ("B") Period. *Id*. at p. 63. Here, Van Hoecke explained, Sherman should use the (C-B)/A formula, but substitute the higher performance indicator for the period of lower performance. *Id*. at p. 65. Sherman could also use the (C-A)/A formula to measure the change in her revenue/cost index, he added, but only if she applies the Commission's two-prong approach by also calculating (C-B)/B independently before determining whether there was a substantial change in circumstances. *Id*. at pp. 65, 68-69.

228. With the appropriate changes to Sherman's analysis based on Van Hoecke's points of disagreement, he reported that neither the North nor Oregon Lines experienced a substantial change. *Id*. at p. 66. He maintained that his methodology is superior to hers, but with modifications, hers produces similar conclusions, although it still fails to address the issue of differing base sizes. *Id*. at p. 71.

229. During cross-examination, Van Hoecke testified that, in doing his substantially changed circumstances analysis, he used the current 2008 approach, the methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, and that he did not consider the policy

from *Lakehead Pipe Line Co.*, 71 FERC ¶ 61,338 (1995), *reh. denied*, 75 FERC ¶ 61,181 (1996), to be a regulatory change. Transcript at pp. 597-98.

230. Van Hoecke confirmed that he asked Ganz to prepare a 1985 valuation cost-of-service which, according to him, represents the basis that can be used for purposes of calculating a substantial change in circumstances under his test. *Id*. at p. 600. In this study, Van Hoecke stated, Ganz developed a $4 million 1985 cost-of-service. *Id*. at p. 601. Van Hoecke testified further that grandfathered revenue of $7 million was calculated by multiplying SFPP's actual 1999 volumes by the grandfathered rate on the Oregon Line. *Id*. at pp. 601-02. According to him, if one accepts that the 1999 volumes were equivalent to what was expected at the time of the 1985 expansions, the $7 million grandfathered revenue figure could be considered in looking for substantial change in economic circumstances on the Oregon Line. *Id*. at pp. 603-04.

231. For purposes of calculating the rate base component for use with the methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, Van Hoecke stated that he does not agree with the use of a 70% equity structure for 1983-1988. *Id*. at p. 608. With respect to SFPP's capital structure for its 2003 cost-of-service, Van Hoecke noted that he assumes the equity portion was 39.26%, based on Ganz's calculations. *Id*. at p. 609.

232. Upon further cross-examination, Van Hoecke explained that he based his substantial change in circumstances analysis upon total cost-of-service, and not solely on return. *Id*. at p. 617. When given the 2003 and 2004 total cost-of-service and the total interstate operating revenues from SFPP's FERC Form 6 for each year, Van Hoecke indicated that he calculates that the revenues exceed the cost-of-service by approximately $19.5 million in 2003 and by approximately $17 million in 2004. *Id*. at p. 619. Excess revenues over costs, according to Van Hoecke, are not a part of his substantially changed circumstances test. *Id*. at p. 622.

233. In response to questioning regarding Sherman's testimony, Van Hoecke (1) confirmed that the methodology to use in analyzing substantial changed circumstances is a policy call for the Commission; (2) contended that Ganz's cost-of-service figure was more accurate than Sosnick's cost-of-service figure; (3) disputed Sherman's 15% substantially changed circumstances threshold; and (4) disclaimed any awareness of evidence that there needs to be a case-by-case change to this threshold. *Id*. at pp. 625-27. Van Hoecke stated, however, that if he and Sherman were to both use Ganz's cost-of-service figure in their respective methodologies for the Oregon Line, they would come to the same conclusion. *Id*. at p. 628. Likewise, the impact would be similar for the North Line, although they currently both conclude that there was not a substantial change, Van Hoecke noted. *Id*.

234. Van Hoecke said, unlike Sherman, he used a 1985 Valuation cost-of-service in his Oregon Line analysis. *Id*. at pp. 630-31. When asked, he stated that he was unaware that,

in 2006, SFPP claimed that producing a 1985 cost-of-service study in response to a Staff data request would be unduly burdensome. *Id*. at p. 631. However, Van Hoecke confirmed, SFPP filed the 1985 cost-of-service study with its answering testimony, which Ganz performed the day prior to filing, and which is based in part on estimates. *Id*. at pp. 634-35.

I. J. PETER WILLIAMSON

235. Williamson, a consultant to business and non-profit institutions on matters pertaining to finance and investment, submitted testimony on behalf of SFPP. Exhibit No. SFO-12 at p. 1. According to him, the costs of equity for 1984 through 1994 are derived from the Compliance Filing SFPP made in response to *SFPP, L.P*., 86 FERC ¶ 61,022 and *SFPP, L.P.*, 91 FERC ¶ 61,135. Exhibit No. SFO-12 at p. 4. Williamson testified that, using a test period of 1994, the filing included a DCF analysis with a nominal cost of equity of 14.40%, an inflation factor of 2.67%, and a real cost of equity of 11.73%, which is the same real cost of equity used for each year between 1984 and 1994. *Id*. at pp. 4-5. For the period from 1995 to 2004, Williamson stated, the real cost of equity for each year is the nominal cost minus the inflation factor.[50] *Id*. at p. 5.

236. According to Williamson, he applied Staff's DCF formula, $k = (1 + .5g)y + g$,[51] to each company in a set of proxy companies representing the oil pipeline industry to determine the market required rate of return. *Id*. at pp. 7-8. For each proxy company, Williamson indicated that he calculated the dividend yield, forward looking growth estimates, and used the analysts' earnings growth projection reported by Institutional Brokers Estimated System. *Id*. at p. 9. He added that he used a weighted average of the Institutional Brokers Estimated System forecast to find the dividend growth rate (weighted two-thirds) and a forecast of GDP growth from two different sources (weighted one-third). *Id*. For SFPP's cost of common equity, Williamson said he determined a rate of return based on actual investor expectations that is similar to returns on investments from companies with similar risks. *Id*. SFPP should have a rate of return based on actual investor expectation, since equity capital is supplied by investors, Williamson testified. *Id*. He claimed that his DCF analysis is market-based, *i.e.*, the dividend or distribution yield (y) used in the formula is that which is available in the marketplace for a stock or unit of an MLP, and the growth rate (g), in order to be market-based, must be what is expected by the investment community for the particular company. *Id*. at p. 10.

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[50] The inflation factor, Williamson stated, is the annual rate of change in the Consumer Price Index for the year. Exhibit No. SFO-12 at p. 5.

[51] In Staff's DCF formula, Williamson explained, k = market required rate of return, y = current dividend yield, g = dividend growth rate, and (1 + .5g) = dividend adjustment factor for quarterly dividend payments. Exhibit No. SFO-12 at pp. 7-8.

237. Williamson indicated that he calculated the dividend or distribution yield for each proxy company from 1995 to 2003 by averaging the closing prices over the last six months of each year and for 2004 by averaging the monthly high and low prices over those last six months, and dividing the annualized distribution by the average to find the yield. *Id*. Moreover, Williamson maintained that either method is reliable. *Id*. at p. 11. While finding the dividend or distribution yield is fairly straightforward, Williamson explained that finding the market-based expected growth rate is more difficult because not all investors have the same growth expectations. *Id.* Expectations may vary depending upon the length of the future period to which the growth rate applies, Williamson testified, and there is not an entirely objective way to determine the correct period for the growth rate to be used in the DCF methodology. *Id*. Additionally, he stated, the Institutional Brokers Estimated System publishes long-term growth rate forecasts based on five-year projections which are the most reliable for use in the DCF model, and thus are the best evidence of the rates actually expected by the investment community. *Id*. at pp. 12-13. The Commission, Williamson claimed, uses a two-stage growth DCF model, which gives the Institutional Brokers Estimated System-reported short-term growth forecast a two-thirds weight and the long-term GDP forecast[52] a one-third weight, which he does not believe is a strictly market-based method. *Id*. at pp. 13-14.

238. Because they reflect extreme conservatism, Williamson does not believe that GDP forecasts from the Social Security Administration should be included in determining average long-term GDP for use in the DCF model. *Id*. at p. 14. On average, continued Williamson, the Social Security Administration's forecast was more than a percentage point lower than the average from other sources after 1999[53] and was not included in the DCF model until the forecast was below the average of the other sources. *Id*. at p. 15. Moreover, he asserted, the Social Security Administration's forecasts are made for the purpose of evaluating the Social Security system rather than for business and economic planning, as are the other forecasts. *Id*. at p. 16. Williamson has, however, included the Social Security forecasts in calculating the cost of equity for 1995 through 2004. *Id*. After 2000, including the Social Security Administration forecasts creates a consistent bias, Williamson maintained, adding that the percentage differences that occur translate into a significant number of dollars. *Id*. at p. 18.

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[52] Williamson explained that the GDP forecast is derived from Data Resources, Inc., ("DRI")/McGraw Hill, Energy Information Administration, and Wharton Econometric Forecasting Associates. Exhibit No. SFO-12 at p. 13.

[53] From 1995 through 1999, Williamson testified that the Social Security Administration's forecast fluctuated from higher-than to lower-than the average of Energy Information Administration and DRI forecasts. Exhibit No. SFO-12 at p. 15.

239. Because the market-based DCF model can only be applied to companies for which stock or partnership units are publicly traded, Williamson used proxy companies instead of regulated oil pipelines in his DCF analysis. *Id*. He chose MLPs because they are the only publicly traded firms for which oil pipelines are an important part of their business. *Id*. Williamson stated that, instead of dividends, unitholders in an MLP receive cash distributions, and thus he said he used, as the current dividend yield, the annual distribution per unit by the MLP, rather than the dividend per share paid by the corporation, divided by the average price of a unit rather than the average price of a share. *Id*. at p. 20. He insisted that this is appropriate because cash flows received by unitholders from an MLP's assets are comparable to cash flows received by shareholders. *Id*. Continuing, Williamson contended that corporate dividends and MLP distributions are equivalent in determining yields because in both instances total return to the investor is a series of cash flows and cash proceeds when shares or units are sold, and these cash flows are all that the investor expects to receive on an investment. *Id*. at pp. 20-21.

240. Concluding his discussion of cost of equity, Williamson maintained that SFPP's nominal and real costs of equity for 1995 through 2004, as shown in Exhibit No. SFO-15, are appropriate. SFO-12 at p. 21. Furthermore, Williamson asserted that because there are no circumstances indicating unusually high or low risk, it is appropriate for the median cost of equity to be used for SFPP. *Id*.

241. In response to criticism of his use of distribution per unit to calculate yield, Williamson claimed that the market-based model and CC Shipper witness O'Loughlin's model are inappropriate. *Id*. at p. 22-23. To begin, Williamson stated that rates of return must be based on rates expected by investors in the marketplace, and investors rely on distributions in determining the yield on their investments. *Id*. at p. 23. O'Loughlin's assertion that the lower of earnings and distributions per unit should be used to calculate yield, Williamson declared, is not market-based and would not allow a regulated company to compete for equity capital in the marketplace. *Id*.

242. In contrast with other witnesses, Williamson testified that investors determine yield by dividing the cash distribution by the unit price because cash distributions are a return on their investment. *Id*. at p. 26. Investors seek out high distributions and small allocations of taxable income, he continued. *Id*.

243. Williamson moved on to capital structure, explaining that the ratios for 1984 to 1994 are derived from SFPP's filing in compliance with *SFPP, L.P.*, 86 FERC ¶ 61,022 and *SFPP, L.P.*, 91 FERC ¶ 61,135 the ratios for 1995 to 1999 are taken from Schedule 10 of SFPP's filing in compliance with *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005), and the ratios for the years 2000 to 2004 come from the SEC Forms 10-K filed by Kinder Morgan. Exhibit No. SFO-12 at pp. 28-30 (*citing* Exhibit Nos. SFO-14, SFO-19, and SFO-20). In response to O'Loughlin and Crowe's approach that the equity ratios for 2000 to 2003 should be adjusted for purchase accounting adjustments, he asserted that, while purchase

accounting adjustments can be removed from rate base, one should not reduce the actual equity ratio based on an assumption that the entire purchase accounting adjustment was due to equity financing. *Id*. at pp. 30-31 (*citing* Exhibit Nos. CC-1 at pp. 7-10, BPX-15 at pp. 8-9). Furthermore, Williamson added, Kinder Morgan funded the SFPP acquisition with both debt and equity, so it does not make sense to remove purchase accounting adjustments solely from equity. *Id*. at p. 33.

244. The choice of capital structure and how to finance an acquisition should be left to the judgment of the regulated company, Williamson contended. *Id.* By arbitrarily removing the purchase accounting adjustment from Kinder Morgan's balance sheet, he explained, the capital structure becomes distorted and replaced with a capital structure that is not the actual balance sheet capital structure upon which risk assessment is based. *Id*. On a related note, Williamson stated that he disagreed with Indicated Shippers witness Jennings, who testified that, when one entity buys another, the purchaser "writes up" the book entry from the book value to the market value, and the difference between the two values flows to owner's equity. *Id.* at p. 34 (*citing* Exhibit No. BPX-1 at p. 14).

245. Additionally, Williamson also contested Indicated Shippers witness Crowe's removal of goodwill from equity because, he claimed, she does not provide any support for this removal and there is no connection between goodwill and the acquisition of SFPP. *Id*. at p. 36 (*citing* Exhibit No. BPX-15 at p. 9). He also contended that Crowe used a third quarter 2007 balance sheet in deriving her debt/equity ratio, which he asserted is irrelevant, given that the proceeding involves a potential change in economic circumstances as of 2003 or 2004. *Id*.

246. Williamson testified that the costs of debt for 1984 to 1994 are derived from SFPP's filing in compliance with *SFPP, L.P*., 86 FERC ¶ 61,022 and *SFPP, L.P.*, 91 FERC ¶ 61,135, the costs of debt for 1995 to 1999 are taken from Schedule 10 of SFPP's filing in compliance with *SFPP, L.P*., 113 FERC ¶ 61,277, and the costs of long-term debt for the years 2000 to 2004 come from the Forms 10-K filed by Kinder Morgan. Exhibit No. SFO-12 at pp. 36-37 (*citing* Exhibit Nos. SFO-14, SFO-19, SFO-20). Although O'Loughlin and Crowe include short-term debt when determining cost of debt, and although Kinder Morgan stated that it is capable of and intended to refinance commercial paper[54] into long-term debt, Williamson stated, in disagreement with O'Loughlin and Crowe, that this does not turn short-term into long-term debt for purposes of establishing the cost of the long-term debt. *Id*. at p. 38 (*citing* Exhibit Nos. CC-1 at p. 11, BPX-10 at p. 15). Because it does not support rate base, Williamson said he also excluded the special purpose debt on which the interest is tax exempt, as O'Loughlin did in the debt cost calculation. *Id*. at pp. 38-39 (*citing* Exhibit No. CC-1 at p. 11). Responding to Crowe's suggestion that the cost of debt should be adjusted

[54] Commercial paper, noted Williamson, is a short-term financing instrument that may be issued under a long-term credit facility. Exhibit No. SFO-12 at p. 38.

to account for a downgrade of Kinder Morgan's credit rating by Moody's, Williamson asserted that Crowe offered no evidence to support her recommendation and, he claimed, "[m]ore important[ly]," because the cost of long-term debt is the cost of embedded debt which is on the balance sheet at the time the cost of debt is determined, a subsequent downgrade cannot affect that cost. *Id*. at p. 39 (*citing* Exhibit No. BPX-10 at pp. 9-11).

247. When asked, during cross-examination, about MLPs, Williamson testified that there were a number of ways in which an MLP can increase the growth of limited partner distributions, including selling additional equity shares, engaging in higher growth projects, borrowing money, cutting costs, cutting the general partner distribution, and through the issuance of shares. Transcript at p. 658. Depreciation, however, he stated, would not likely fit into this list unless management increased depreciation by purchasing assets and depreciating them. *Id*. at pp. 659-60. But, if depreciation generated cash and cash flows through the MLP, then that cash is available for distributions, Williamson agreed. *Id*. at p. 661.

248. During further questioning, Williamson stated that it is not impossible for MLPs to continue to invest in infrastructure while continuing to make cash distributions without borrowing money or selling new units, but added that that would require that inflow minus outflow be greater than cash used for investments and distributions. *Id*. at pp. 683, 685. Specifically, according to Williamson, without Kinder Morgan's net cash inflow from financing, it could not maintain the same levels of cash for investments and distributions, with all other numbers remaining the same. *Id*. at p. 684.

249. Williamson contended that, when calculating a return, goodwill is properly includable, in terms of capital structure. *Id*. at p. 691. It would not, however, be included in rate base and there is no return on goodwill, he continued. *Id*. Likewise, purchase accounting adjustments should be excluded from rate base, according to Williamson, and thus there will be no return on them. *Id*.

250. On further cross-examination, Williamson stated that SFPP's 2003 long term debt, in terms of capital structure, includes commercial paper. *Id*. at p. 697. In his recommendation of cost of debt for 2000 to 2004, Williamson continued, he relied on Kinder Morgan's debt, and did not include in the weighted cost of debt calculation, for 2003, commercial paper, economic development revenue refunding bonds, OLP-B bonds, or industrial revenue bonds. *Id*. at p. 697. Furthermore, Kinder Morgan, according to Williamson, converts commercial paper financing into long-term debt on a regular basis. *Id*. at p. 700. Williamson also testified that he agreed that, for 2000-2003, Kinder Morgan's capital structure should be used for setting SFPP's rates. *Id*.

251. As cross-examination continued, Williamson agreed that there is no way to calculate personal income tax from the allowed rate of return. *Id*. at p. 706-707. Turning to return on equity for 2003, Williamson confirmed that he used distribution yields and

expected growth in distributions in an attempt to derive the market's required rate of return. *Id*. at pp. 706-707 (*citing* Exhibit No. SFO-86 at p. 4). He stated that an investor owning a limited partnership unit in an MLP has to pay income taxes on the income he or she receives, which reduces the after-tax return received by the investor to an amount below the nominal rate of return; the DCF model, however, does not adjust for these taxes. *Id*. at p. 708-710.

252. Williamson was next confronted with questions regarding Kinder Morgan's SEC Form 10-K report for 2003,[55] and, with respect to the section entitled "risk factors," claimed that it is a general list of the risks that the business faces which are important enough to be mentioned by the preparers of the SEC Form 10-Ks. *Id*. at p. 715-17. One risk feared by Kinder Morgan's management, Williamson confirmed, was that they would not meet the 90% gross income rule necessary to maintain Kinder Morgan's tax status as a partnership and would then be treated as a corporation for tax purposes. *Id*. at p. 719. He noted that SFPP, on the other hand, did not face this risk because it is not an MLP. *Id*. at pp. 719-20.

253. Kinder Morgan's executives also believed that they faced risks with integrating new operations into the Kinder Morgan Enterprise and with certain demands that could be made on management, according to Williamson. *Id*. at pp. 724-25. While SFPP would not face these same specific risks, Williamson suggested that it faces analogous risks when operating, acquiring, building, selling, and abandoning pipelines. *Id*. at p. 725. SFPP's North and Oregon Lines, Williamson testified, faced competitive risks in 2003 and 2004 because of competition from other pipelines and terminals and due to other means of transporting and storing energy products. *Id*. at p. 726.

254. On re-direct examination, Williamson noted that he intentionally used different amounts of long-term debt to calculate capital structure and cost of debt. *Id*. at p. 731. Explaining the difference, Williamson testified that capital structure is used to evaluate financial risk in an investment, and thus he considers it "important to use, where risk is concerned, the capital structure that appears on the books of the company." *Id.* at p. 732. He added that cost of debt, on the other hand, is more focused toward ratemaking, where separating true long-term debt from true short-term debt is important. *Id*. at p. 733. The difference, Williamson contended, also is due to the removal of tax exempt debt instruments from the cost of debt, but not from capital structure, since investors are interested in whether debt was issued for a tax exempt purpose. *Id*.

[55] In the record as Exhibit No. SFO-86.

J. DALE D. BRADLEY

255. Bradley, the accounting director for Knight, Inc., which was formerly Kinder Morgan, Inc.,[56] stated that Kinder Morgan is a master limited partnership which holds its ownership interests in a number of mid-stream energy assets through five operating limited partnerships, including Kinder Morgan Operating, L.P. "D," which owns 99.5% of SFPP.[57] Exhibit SFO-25 at pp. 1-4. Continuing the description, Bradley testified that Kinder Morgan is owned by its general partner, Kinder Morgan G.P., Inc., the general public through ownership of limited partner common units, Kinder Morgan, Inc., through ownership of common units and Class B units, and Kinder Morgan Management through its ownership of i-units. *Id*. at p. 4.

256. Kinder Morgan G.P., Inc., according to Bradley, is responsible for conducting, directing, and managing Kinder Morgan and the operating limited partnerships' activities. *Id*. Kinder Morgan G.P., Inc., he added, can also enter into agreements with subsidiaries and affiliates to render these services to Kinder Morgan, *e.g.*, Bradley stated that Kinder Morgan G.P., Inc., delegated to Kinder Morgan Management the responsibility of managing SFPP.[58] *Id*. at pp. 4-5. Additionally, Bradley continued, Kinder Morgan has no employees of its own, but instead GP Services and Kinder Morgan, Inc., provide labor to and on Kinder Morgan's behalf. *Id*. at p. 5. Some Kinder Morgan subsidiaries, he said, receive all general and administrative support directly from Kinder Morgan, Inc., and none from Kinder Morgan. *Id*. at p. 6. These subsidiaries, Bradley testified, are referred to as Kinder Morgan, Inc.-operated entities, while subsidiaries that receive support through Kinder Morgan are referred to as Kinder Morgan-operated entities. *Id*. While Kinder Morgan, Inc., employees provide services to both types of entities, GP Services employees only provide services to Kinder Morgan and the entities it operates, Bradley added. *Id*. According to him, GP Services costs are incurred on behalf of Kinder Morgan and are charged to Kinder Morgan through Kinder Morgan Management which, Bradley stated,

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[56] According to Bradley, Kinder Morgan, Inc., indirectly owns all the common equity of Kinder Morgan G.P., Inc., Kinder Morgan's general partner, and owns a limited partner interest in Kinder Morgan. Exhibit No. SFO-25 at p. 4. Kinder Morgan owns OLP-D which owns 99.5% of SFPP. *Id*. at pp. 3-4. Kinder Morgan G.P., Inc.'s preferred shares are publicly owned, and Kinder Morgan G.P., Inc., is the sole owner of the voting shares of Kinder Morgan Management. *Id.* at p. 4.

[57] The other .5% of SFPP, according to Bradley, is owned by Santa Fe Pacific Pipeline, Inc ("Santa Fe"). Exhibit No. SFO-25 at p. 4.

[58] Kinder Morgan G.P., Inc., Bradley explained, has also entered into agreements with Kinder Morgan G.P., Inc., Services Company, Inc., and with Kinder Morgan, Inc., and thus these entities incur expenses related to SFPP. Exhibit No. SFO-25 at p. 5.

acts as an accounting pool and captures GP Services costs that are not directly charged to individual Kinder Morgan subsidiaries. *Id*.

257. Bradley explained that Kinder Morgan, Inc., employees are broken into two subsets, Kinder Morgan, Inc.-dedicated employees, and Kinder Morgan, Inc.,-shared employees. *Id*. Kinder Morgan, Inc.-dedicated employees, Bradley added, support only Kinder Morgan, Inc.-owned entities, and the expenses for these employees are assigned directly to the Kinder Morgan, Inc.-operated and owned entities, with no costs passed down to Kinder Morgan. *Id*. at pp. 6-7. On the other hand, Bradley continued, Kinder Morgan, Inc.-shared employees support both Kinder Morgan, Inc., and Kinder Morgan-operated entities and track their time separately between the two entities. *Id.* at pp. 6-7. The expenses associated with the employees' services to the Kinder Morgan-operated entities result in the Kinder Morgan, Inc., cross-charge to Kinder Morgan, he noted. *Id*. at pp. 6-7.

258. Any corporate overhead costs allocated to SFPP from Kinder Morgan originate with GP Services and Kinder Morgan, Inc., pursuant to service agreements between these entities and Kinder Morgan, explained Bradley. *Id*. at pp. 6-7. Determining how the employee-incurred expenses are distributed among the various entities, he continued, is based on two factors. *Id*. at p. 8. The first factor, according to Bradley, is whether an employee supports the Kinder Morgan, Inc.-operated entities, which is only an issue for the Kinder Morgan, Inc.-shared employees, whose costs are split based on whether they support Kinder Morgan, Inc., or Kinder Morgan-operated entities. *Id*.

259. According to him, costs are also tracked by responsibility centers, which Bradley defined as departmental assignments based on functional duties. *Id*. at pp 8-9. Additionally, Bradley explained, responsibility centers do not overlap, they have their own distinct expenses, and employees can be part of only one at a time. *Id*. at p. 9. Responsibility center budgets, Bradley added, are based on employee estimates of labor and non-labor costs as well as how much time will be spent on Kinder Morgan, Inc.-operated or Kinder Morgan-operated entities and are directly assigned if possible.[59] *Id*. Bradley noted that two shared-services accounts are used if direct assignment is not feasible. *Id*. Furthermore, in passing Kinder Morgan, Inc.-shared employee expenses on to Kinder Morgan, Bradley stated, Kinder Morgan, Inc., uses a general ledger and various customized reports to verify the accuracy of overhead expenses charged to Kinder Morgan.[60] *Id*. at p. 12. In combination with this measure of accuracy, Bradley explained

[59] Time sheets and salary splits are used to track the amount of time that employees spend working for each entity, Bradley testified, depending upon the nature of the work performed. Exhibit No. SFO-25 at p. 10.

[60] Such overhead expenses include, but are not limited to, accounting, tax, office facilities, environmental, safety, benefits, Kinder Morgan, Inc., support, commercial

that the costs are also subject to approval at local, entity, and executive levels, and periodic internal and annual independent audits are conducted. *Id*. at pp. 12-13.

260. Moving on to overhead allocation, Bradley testified that the first step is to assign expenses that can be tied solely to a particular subsidiary or group of subsidiaries. *Id*. at p. 14. Once these costs are assigned, Bradley continued, costs that have not yet been assigned, or residual overhead costs, are allocated among all the Kinder Morgan subsidiaries. *Id*. Therefore, he claimed, only those costs that were incurred for SFPP will be allocated to SFPP. *Id*.

261. Bradley next testified that the Kinder Morgan, Inc., cross-charge is a direct charge representing the assignment of costs in Kinder Morgan, Inc., responsibility centers to Kinder Morgan for work performed on behalf of Kinder Morgan-operated companies, including the costs associated with the Kinder Morgan, Inc.-shared employees. *Id*. at pp. 14-15. The cross-charge, Bradley added, is used in Kinder Morgan's Massachusetts formula allocation, which is used to allocate overhead costs from Kinder Morgan to its subsidiaries. *Id*. at p. 15.

262. The Massachusetts formula, Bradley noted, has three components of equal weight, (1) gross revenue, (2) gross property, plant and equipment, and (3) direct labor, which are averaged to calculate a figure which is used to allocate indirect costs to SFPP. *Id*. While direct assignment is preferable to this type of allocation, Bradley testified, it is necessary to allocate residual overhead costs to all Kinder Morgan-operated entities when direct assignment is not possible. *Id*. at p. 16. The direct assignments and costs are divided by journal entries and are the basis of the tier methodology of the Massachusetts formula, according to him. *Id*. While it would be easier to use the Massachusetts formula for all costs, it is necessary to use the tiered approach, contended Bradley, because it more accurately reflects the way costs are actually incurred across Kinder Morgan. *Id*. at pp. 16-17.

263. In disagreement with CC Shippers witness O'Loughlin's testimony that the Massachusetts formula methodology uses ten tiers, Bradley testified that there are only four: Tier 1 encompasses all Kinder Morgan subsidiaries operated by Kinder Morgan, including those costs that cannot be attributed to any specific entity; Tier 2 includes the Kinder Morgan products pipeline segment;[61] Tier 3 is used to allocate overhead costs exclusively related to Kinder Morgan's CO_2 segment; and Tier 4 allocates overhead costs

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management, legal, business development, engineering, and communications, Bradley testified. Exhibit No. SFO-25 at p. 12.

[61] Tier 2, Bradley added, includes certain liquids terminals. Exhibit No. SFO-25 at p. 18.

specific to all bulk terminals and liquid terminals which are not associated with the pipelines in Tier 2. *Id*. at pp. 17-18. Furthermore, Bradley asserted, Tier 2 is further broken down into three sub-tiers: first, certain costs are direct assigned to certain products pipeline subsidiaries, including SFPP; next, certain other Tier 2 costs that are identifiable to a regional group are assigned to that region and then allocated among the Kinder Morgan-operated subsidiaries in that region;[62] and lastly, those leftover costs which could not be directly assigned to a specific subsidiary or regional group are allocated among all products pipeline subsidiaries in Tier 2. *Id*.

264. Kinder Morgan's overhead costs are booked to the Kinder Morgan Management accounting pool each month, Bradley continued, and are then allocated from the Kinder Morgan Management pool to Kinder Morgan's subsidiaries through the four tiers. *Id*. at p. 19. According to Bradley, each month, costs are booked to the Kinder Morgan Management accounting pool until the account cut-off for a month is reached, at which point the general and administrative expenses associated with the bulk terminals and certain liquids terminals are allocated, using the Massachusetts formula, among all subsidiaries in Tier 4. *Id.* Next, Bradley added, the remaining expenses are separated by accounting department by location, responsibility, and cost type, and overhead costs are grouped into Tiers 1, 2, and 3. *Id*. Furthermore, Bradley testified, within Tier 2, all possible direct assignments are made to individual products pipeline subsidiaries, and then the costs that are identifiable by region are allocated to the three regional groups. *Id*. at pp. 19-20. The residual Tier 2 expenses, Bradley noted, are then allocated among all Tier 2 subsidiaries. *Id*. at p. 20. As the last step, the accounting department runs the Massachusetts formula to determine how much of the month's total overhead cost for the month is to be allocated to each tier, Bradley explained. *Id*.

265. The current allocation method, according to Bradley, differs from that used in the 2003 and 2004 cost-of-service studies provided to the shippers in discovery.[63] *Id*. The current methodology, Bradley contended, is a more accurate method of attributing costs to the subsidiaries than the previous method due to the addition of more tiers. *Id*. at pp. 20-21. Moreover, he said, the application of the 2006 methodology to the 2003 and 2004 periods is done for rate-making purposes on behalf of SFPP, representing the most accurate method of how costs should have been allocated at that time. *Id*. at p. 21.

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[62] Bradley identified the three regional groups as the Pacific Operations group, the Mid Continent Operations group, and the Eastern Operations group. Exhibit No. SFO-25 at p. 18.

[63] The 2003 study used two tiers, Bradley stated, while the 2004 methodology, like the current methodology, used four tiers, albeit different tiers. Exhibit No. SFO-25 at p. 20.

266. For specific cost categories identified by O'Loughlin, the use of the current methodology increased the amount allocated to the products pipeline subsidiaries; Kinder Morgan is not, according to Bradley, intentionally increasing the costs allocated to SFPP for regulatory purposes. *Id*. at p. 23. The current approach more closely aligns overhead costs with cost incurrence and benefit, alleged Bradley, and this realignment resulted in more costs allocated to the products pipeline subsidiaries for certain cost categories. *Id*.

267. Bradley stated that Kinder Morgan did not include, in its Massachusetts formula allocation, either wholly-owned Kinder Morgan subsidiaries that receive all overhead support and services from Kinder Morgan, Inc., or entities in which Kinder Morgan owns an equity interest that receive overhead support and services from a third-party. *Id.* at p. 21. These entities were excluded, according to Bradley, because they do not cause Kinder Morgan to incur overhead expenses, and thus such expenses should not be allocated to them. *Id*. at p. 24. He added that, if either category of excluded entities were charged for these expenses through inclusion in the Massachusetts formula, the result would be a double-charging of overhead because the entities are already charged for the support and services by either Kinder Morgan, Inc., or a third-party. *Id*. at p. 26.

268. Costs associated with the Kinder Morgan, Inc.-operated entities are tracked separately to ensure that they are not charged or allocated to Kinder Morgan, according to Bradley. *Id*. at p. 26. Specifically, he continued, all costs associated with the Kinder Morgan, Inc.-operated entities are directly charged to these entities or charged to Account 184600, which is credited or debited if charges do not exactly equal the amount of the fixed fees in any given month.[64] *Id*. Bradley stated that any charges remaining in Account 184600 are allocated among the Kinder Morgan, Inc.-owned entities through Kinder Morgan, Inc.'s Massachusetts formula allocation, which does not include Kinder Morgan. *Id*. at p. 27. Furthermore, all residual expenses are passed on through this formula, he said, and thus there is nothing left to pass on to Kinder Morgan. *Id*.

269. Addressing concerns that the fixed fees paid by Kinder Morgan, Inc.-operated entities are arbitrary and create the likelihood of cross-subsidization, Bradley testified that: (1) in 2003 and 2004 there was no residual amount left to be charged to Kinder Morgan through the Kinder Morgan, Inc., cross-charge or otherwise; (2) the risk of the fixed fee arrangement is not on Kinder Morgan, but is on Kinder Morgan, Inc., and the Kinder Morgan, Inc.-owned entities, since the expenses not covered by the fixed fees are allocated to these entities through the Kinder Morgan, Inc., Massachusetts formula, which does not include Kinder Morgan; and (3) the costs associated with the Kinder Morgan, Inc.,-operated entities are tracked separately from the Kinder Morgan-operated entities,

[64] In 2003 and 2004, Bradley testified, the fixed fees were sufficient to cover the amounts charged to the Kinder Morgan, Inc.-operated entities and Account 184600 was credited. Exhibit No. SFO-25 at p. 27 (*citing* Exhibit No. SFO-32).

assuring that Kinder Morgan is not charged for these costs. *Id*. at p. 28. Bradley insisted that, based on these three points, there is no potential for cross-subsidization. *Id*.

270. Kinder Morgan, according to Bradley, performs no general and administrative services on behalf of entities in which it owns an equity interest but which are managed by a third party and stated, therefore, that they are excluded from Kinder Morgan's Massachusetts formula.[65] *Id*. at pp. 28-29. He stated further that Kinder Morgan recorded the profit or loss associated with the equity interest on its books in 2003 and 2004. *Id*. at pp. 29-31. Bradley added that Kinder Morgan did not, however, consolidate the books of any of these entities with its own books in 2003 or 2004, with the exception of Cochin. *Id*. at pp. 29-32. According to him, Kinder Morgan performed a proportionate consolidation in which Cochin's books are combined with Kinder Morgan's as a result of Cochin's use of a joint-venture accounting system. *Id*. at p. 32. For the expenses associated with the proportionate consolidation, Bradley stated that Cochin reimbursed Kinder Morgan with an annual payment of $90,000 in 2003 and 2004, which is applied to Kinder Morgan's total overhead expenses and reduced the amount of overhead expenses allocated to other Kinder Morgan entities, including SFPP. *Id*. at p. 33. It is Bradley's contention that this amount is more than sufficient to offset Kinder Morgan's costs of performing the consolidation and contended that this payment reduces the amount allocated to Kinder Morgan-operated entities. *Id*.

271. Despite his statement that Kinder Morgan does not perform services for entities in which it owns an equity interest, Bradley noted that there are two rare situations in which Kinder Morgan might perform such a service: (1) were a Kinder Morgan employee to perform a specific task on behalf of one of these entities; or (2) were a Kinder Morgan, Inc.-shared employee to provide any type of managerial oversight or guidance to an entity in this category. *Id*. at p. 34. Bradley explained, with regard to the first circumstance, a Kinder Morgan employee has only provided such a service once, and the expenses were invoiced directly to the entity by Kinder Morgan, Inc., which recovered its costs in full, and no costs related to the services were charged or allocated to any Kinder Morgan-operated entity. *Id.* In the second situation, Bradley noted, the expenses were charged to a Kinder Morgan, Inc., responsibility center which normally would be charged to Kinder Morgan through the Kinder Morgan, Inc., cross-charge, but which was removed by Bradley to ensure that no expenses could have passed on to the Kinder Morgan-operated entities. *Id*. at pp. 34-35. There are no residual expenses in these situations left to be allocated among the Kinder Morgan-operated entities, he added, because the expenses are directly invoiced to the entity or charged to the responsibility center. *Id*.

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[65] Bradley stated that the subsidiaries that fall into this category are Heartland Pipeline Company, Coyote Gulch Gas Treating LLC, Red Cedar Gas Treating LLC, Thunder Creek Gas Services LLC, International Marine Terminal and Cochin Pipeline Company. Exhibit No. SFO-25 at p. 29.

272. Bradley included entities in the Massachusetts formula allocations in 2003 and 2004 that were excluded from the formula allocation used for the cost-of-service studies provided to the shippers in July 2006. *Id*. According to Bradley, Port Arthur Bulk Terminals is a joint venture that, while inactive, should be included in the Massachusetts formula because it would be a part of the formula if it were active. *Id*. at p. 36. He further stated that Kinder Morgan owned a 10% equity interest in Portland Bulk Terminals LLC and was paid a fee by the majority interest owner to operate the facilities, which, Bradley suggested, should have been included in Kinder Morgan's Massachusetts formula allocation for 2003 and 2004. *Id*. at pp. 36-37. In addition, he said, Painter Plant should be included in the Massachusetts formula allocations for 2003 and 2004 in order to account for limited revenues generated by Kinder Morgan's lease of the entity to BP Amoco. *Id*. at p. 37. The last two entities Bradley indicated should be included, Guilford County Terminal Company LLC and Johnston County Terminal LLC, were not acquired until November 4, 2004, and are thus, he claimed, properly excluded until that time, but should be included for two months in 2004. *Id*.

273. According to Bradley, the excluded entities do not receive a benefit from Kinder Morgan because it neither performs any services for them, nor incurs any cost. *Id*. at p. 38. He maintained that, for the entities in which Kinder Morgan owns an equity interest, all overhead expenses are incurred by the third parties that are responsible for their management and operation. *Id*. Furthermore, he insisted, while the same employees may provide services to both the Kinder Morgan, Inc.-operated entities and the Kinder Morgan-operated entities, the costs associated with these services are tracked and accounted for separately. *Id*. at p. 39-40.

274. Bradley acknowledged that the amount of Kinder Morgan corporate overhead attributed to the excluded entities is less than the amount allocated to SFPP, even though the excluded entities represent 78.2% of Kinder Morgan's total revenue, while SFPP contributes only 4.4%. *Id*. He explained the disparity, noting that it is due to revenues generated by Tejas Consolidated, an entity excluded from the 2003 and 2004 Massachusetts formula allocations. *Id*. at p. 41. Because Tejas Consolidated buys and sells natural gas, Bradley stated, its gross revenues appear higher, but are actually offset by the cost of purchasing the gas, so its sales carry extremely thin margins. *Id*. Using gross revenues in the Massachusetts formula, Bradley maintained, has the effect of over-allocating corporate costs to these entities, and thus does not call into question the amount of Kinder Morgan corporate overhead allocated to SFPP. *Id*.

275. From the information included in its 2003 and 2004 Annual Report and SEC Form 10-K, Bradley testified that Kinder Morgan's total corporate overhead amount was $150.4 million for 2003 and $170.5 million for 2004. *Id*. at p. 42. However, these amounts were not, he claimed, allocated in Kinder Morgan's Massachusetts formula because they reflect

only the net amount of overhead that is expensed to Kinder Morgan each year, while the formula allocations also include the amount capitalized. *Id*.

276. According to Bradley, SFPP was directly assigned $12.871 million of corporate overhead in 2003 and was allocated $19.765 through the Massachusetts formula. *Id*. at p. 44. Moreover, he testified that, in 2004, $9.383 million was directly assigned to SFPP and $26.074 million was allocated through the Massachusetts formula. *Id*.

277. Asked to address problems which O'Loughlin claimed existed in SFPP's treatment of gross property, Bradley first noted that Kinder Morgan removed the purchase accounting adjustments from the property, plant, and equipment accounts for all regulated and non-regulated entities, and its 2003 and 2004 Massachusetts formula allocation reflects the removal of the Calnev purchase accounting adjustment. *Id*. at pp. 44-45. Bradley, noting that he agreed with Sosnick, also claimed that purchase accounting adjustments must be treated the same way for both regulated and non-regulated entities in order to properly set the property, plant, and equipment balances for all entities that will be allocated a portion of corporate overhead expenses through application of the Massachusetts formula.[66] *Id*. at pp. 45-46.

278. According to Bradley, O'Loughlin, erred in using $150.4 million as the total amount that allocated to Kinder Morgan operated entities via the Massachusetts formula in 2003, when in reality this figure was the ending point of charges that were recorded as expense on Kinder Morgan-owned entities for purposes of the Kinder Morgan SEC Form 10-K. *Id*. at p. 47. Bradley explained that Kinder Morgan began with a total gross overhead amount of $178.6 million and subtracted the amounts that were directly assigned to arrive at $140.4 million, which was the actual total amount that was allocated to Kinder Morgan operated entities using the Massachusetts formula, he stated. *Id*.

279. During cross-examination, Bradley testified that, while there are Kinder Morgan, Inc., employees who participate in the operation and management of Kinder Morgan-operated Kinder Morgan subsidiaries, most of this authority has been given to employees of GP Services and Kinder Morgan, Inc., since the Kinder Morgan-operated entities have no employees. Transcript at p. 747. More accurately, Bradley agreed, is that the Kinder Morgan-operated Kinder Morgan subsidiaries are actually operated by Kinder Morgan G.P., Inc. Services. *Id*. at pp. 747-48.

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[66] Bradley added that Sosnick's exclusion of purchase accounting adjustments from property, plant and equipment resulted in removing them twice because they already had been "removed from the Massachusetts formula allocation for 2003 and 2004 that . . . Sosnick had received from SFPP in July 2006." Exhibit SFO-25 at p. 46.

280. The total amount of overhead allocated to Kinder Morgan-operated entities in 2003, according to Bradley, was approximately $139 million, which is representative of the corporation's general and administrative expenses. *Id*. at p. 750. The allocation method involves four tiers, Bradley confirmed, entitled the KMP Tier, General Tier, Pacific Tier, and the SFPP Tier. *Id*. at p. 751. According to Bradley, SFPP has allocated a portion of the dollars that are assigned to the KMP, General, and Pacific tiers, while all the costs for the SFPP tier are assigned to SFPP. *Id*. at p. 751.

281. Between 1998 and 2004, Bradley testified, Kinder Morgan used four different methods for allocating overhead expenses.[67] *Id*. at p. 754. Prior to the four-tier 2006 methodology, Bradley indicated he understood that there was a straight four-tier 2004 Massachusetts formula methodology, which he had no responsibility for developing. *Id*. at p. 752. Looking back further, Bradley noted that, prior to 2004, there was a two-tier methodology and a one-tier methodology which was adopted by SFPP when Kinder Morgan acquired its 99.5% stake in SFPP in 1998. *Id*. at p. 753.

282. With respect to Tejas Consolidated, Bradley explained that, as part of its operations, it is necessary for Tejas Consolidated to buy and sell gas either for system balancing or for compression fuel use. *Id*. at p. 771. Additionally, Tejas Consolidated likely has a profit margin that fluctuates, and the entity, Bradley said, is at risk of not recovering its natural gas purchase costs since it lacks regulatory authority to charge its customers when it experiences an increase in costs. *Id*. at p. 772.

283. Moving back to overhead expenses, Bradley explained that, in 2003 and 2004, the fixed fees paid by Kinder Morgan to Kinder Morgan, Inc., each year represent the general and administrative costs Kinder Morgan paid to Kinder Morgan, Inc., to operate the six excluded subsidiaries. *Id*. at p. 778. Further, he testified that the total overhead expenses associated with Kinder Morgan, Inc.-operated Kinder Morgan subsidiaries do not equal the fixed fees that Kinder Morgan paid to Kinder Morgan, Inc. *Id*. at p. 779. The fixed fees, Bradley continued, changed year to year during the years they were in force. *Id*.

284. On further cross-examination, Bradley agreed that he has excluded Kinder Morgan owned subsidiaries from sharing in Kinder Morgan-related corporate overhead costs in 2003 and 2004, despite the fact that a number of executives and other employees of Kinder Morgan entities held leadership positions in these excluded entities in 2003 and 2004. *Id*. at pp. 788-89.

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[67] Bradley claimed that the methodology changed from a one-tier to a two-tier and eventually to a four-tier methodology in order to more accurately assign corporate overhead as Kinder Morgan evolved into a more complex structure with legal entities existing within other legal entities. Transcript at pp. 856-57.

285. Looking at an organizational chart from October 2004, Bradley noted that Kinder Morgan General Partners delegated authority to Kinder Morgan Management and others because Kinder Morgan General Partners has no employees. *Id*. at pp. 798-99. Kinder Morgan, he continued, also lacks employees, and delegated authority to Kinder Morgan Management to make decisions in running the business, including the Kinder Morgan subsidiaries.[68] *Id*. However, Kinder Morgan Management, Bradley noted, has no employees and its authority, he explained, is delegated to the office of the chairman and executives of Kinder Morgan to execute authority with respect to Kinder Morgan and its subsidiaries. *Id*. at p. 800.

286. Bradley confirmed that senior executives of Kinder Morgan gave managerial oversight to the performance of all Kinder Morgan and Kinder Morgan, Inc., subsidiaries in 2003, including those which he excluded from sharing in corporate overhead. *Id*. at pp. 806-07. Kinder Morgan, moreover, is also responsible for all activities of Kinder Morgan and the operating limited partnerships, including all gas and oil subsidiaries and the subsidiaries excluded from sharing in corporate overhead in 2003 and 2004, he maintained. *Id*. at pp. 807-08.

287. As cross-examination continued, Bradley described Lawson Financials as an enterprise wide financial accounting system where all Kinder Morgan entities keep their books. *Id*. at p. 821. Bradley, in 2003 and 2004, had responsibility for the portions that were under his duties of manager of property according, according to him. *Id*. at pp. 821-22. Continuing, Bradley noted that the entities he excluded from sharing in Kinder Morgan's 2003 and 2004 corporate overhead were supported by Lawson Financials. *Id*. at p. 822. Such information technology architecture used by all of Kinder Morgan's subsidiaries, according to Bradley, is overseen by the Kinder Morgan's chief information officer.[69] *Id*. at pp. 822-23.

288. Bradley, asked to describe how Kinder Morgan's budget process works, stated that the operating budgeting process begins at a lower level in the entity referred to as a responsibility center, each of which has one person who is responsible for putting together its departmental budget. *Id*. at p. 823. Next, the departmental budget is submitted to that person's manager for review, who will finalize it and submit it further up the line, according to Bradley. *Id*. at pp. 823-24. Eventually, he continued, each responsibility center from each organization ends up with the office of the chairman who will review the

[68] These subsidiaries, according to Bradley, include the oil subsidiaries, the operating companies, and the natural gas companies. Transcript at pp. 799-800.

[69] On re-direct examination, Bradley stated that not all of the entities, specifically, joint ventures operated by third parties, which he excluded from the Massachusetts formula, were on the Lawson Financials system in 2003 and 2004. Transcript at pp. 841-42.

budgets on a more global basis and send them back for cuts, starting the process from the beginning again. *Id*. at p. 824. There is no limitation, he noted, on what must be approved. *Id*. Concluding the explanation, Bradley testified that the budgets are submitted to the respective board of directors for each organization for formal approval only after the office of the chairman is convinced that all possible cuts are made. *Id*.

289. Capital budgeting, Bradley explained next, is done on a more regional-type basis by the directors out in the field of operations when there is a small capital budget in a region, or there can be very large capital projects. *Id*. at p. 825. Capital budgets also go up to the chairman for approval. *Id*.

290. Bradley explained the accounting done for services rendered to Kinder Morgan subsidiaries by Kinder Morgan, Inc.-shared employees is accomplished through the use of time sheets. *Id*. at p. 829. An employee, according to Bradley, can do a salary split, which involves an estimate of what percentage of time that employee will spend supporting specific groups of entities or functions. *Id*. at pp. 829-830. The employee, he said, will submit the split by marking the percentage on a time sheet, or will do it by memo that says how the employee wants the time split for a certain year. *Id*. at p. 830. If an employee chooses not to use the salary split, Bradley indicated, the employee can also record actual hours spent on individual projects or entities or groups of entities. *Id.* Employee sick leave or vacation days, according to Bradley, are split proportionately depending on how their time was coded for that period. *Id*. at p. 835.

291. On re-direct examination, Bradley explained how Kinder Morgan was able to retroactively directly assign property, plant, and labor costs to SFPP in 2006 when they were actually booked in 2003. *Id*. at p. 849. In his explanation, Bradley testified that various employees who deal with general and administrative expenses looked to 2003 and 2004 and estimated where their time was spent during that time period, which the employees claim was easy due to physical location and the nature of responsibility centers. *Id*. at pp. 849-50. Kinder Morgan also made direct assignments of general and administrative expenses on a monthly basis in 2003 to Kinder Morgan-owned/Kinder Morgan, Inc.-operated entities, as well as Plantation pipeline, the Cyprus pipeline, and the North System pipeline, according to Bradley. *Id*. at p. 850. None of these amounts, he stated, were included in the Massachusetts formula allocations. *Id*. at p. 851.

292. Bradley explained that, along with the fixed fees paid to Kinder Morgan, Inc., by the Kinder Morgan, Inc.-operated entities, the Kinder Morgan, Inc.-operated entities also receive another layer of overhead costs through an allocation process used by Kinder Morgan, Inc., to allocate general and administrative expenses to all Kinder Morgan, Inc.-operated entities. *Id*. at p. 852. This overhead was the total corporate general and administrative overhead allocated to the Kinder Morgan, Inc.-operated entities in 2004, Bradley testified. *Id*. at pp. 852-53. Further, he stated, the total amount of overhead in 2003 directed to Kinder Morgan, Inc.-operated Kinder Morgan-owned entities was $34.8

million, which one would need to refer to when comparing between the amount of overhead directed to the Kinder Morgan, Inc.-operated entities and the Kinder Morgan-operated entities. *Id*. at p. 853.

K. THOMAS A. TURNER

293. Thomas A. Turner ("Turner"), a Principal of Turner Wetmore Collins, LLC who has experience with SFPP tariff matters, cost-of-service issues, and compliance filings, submitted testimony on its behalf regarding SFPP's application of the Kansas-Nebraska methodology.[70] Exhibit No. SFO-42 at pp. 1-2. Turner stated that SFPP uses the KN methodology to allocate overhead costs between the carrier pipeline transportation services and the non-carrier storage services. *Id*. The carrier pipeline transportation services are further allocated among SFPP's systems, including the North and Oregon Lines, according to him.[71] *Id*. at p. 3. Turner stated that, using the KN formula, SFPP allocated $34.7 million in general and administrative overhead expenses in 2003 and $27.6 million in 2004. *Id*. at p. 4. Furthermore, he added, of these costs, $32.6 million and $35.5 million in 2003 and 2004 respectively were incurred by or on behalf of Kinder Morgan and allocated to SFPP through Kinder Morgan's Massachusetts formula. *Id*.

294. Sosnick, according to Turner, claimed that SFPP did not correctly calculate its KN factor allocations because they were not consistent with *SFPP, L.P.*, 121 FERC ¶ 61,240, in which SFPP allegedly was directed to recalculate its KN factor in a manner consistent with Staff's approach in the prior SFPP proceeding in Docket Nos. OR96-2, *et al*. Exhibit No. SFO-42 at pp. 6, 8 (*citing* Exhibit No. S-4 at p. 23). Accordingly, Turner said he modified the KN factors for the 2003 and 2004 studies to be consistent with SFPP's February 2008 compliance filing, which was consistent with Staff's approach. *Id*. at p. 8. Making such a modification, however, will not address Sosnick's criticisms, Turner admitted, because Sosnick proposed an approach to the KN methodology that, Turner insisted, was not consistent with the Commission's directive. *Id*. at p. 9 (*citing* Exhibit No. S-4 at p. 23). Sosnick, according to Turner, contended that overhead costs should be

[70] For the studies SFPP produced in discovery, Turner testified, its KN formula is a simple average of the carrier and non-carrier gross plant ratios and the respective carrier and non-carrier direct labor ratios, which is used to allocate all applicable overhead costs between its carrier and non-carrier services. Exhibit No. SFO-42 at pp. 4-5.

[71] Turner testified that general and administrative overhead expenses relevant to these lines consist primarily of Kinder Morgan overhead allocated to SFPP through the Kinder Morgan Massachusetts formula and SFPP overhead incurred at Northern Region and maintenance offices in California. Exhibit No. SFO-42 at p. 4.

assigned as either plant-related or labor-related[72] and allocated between carrier and non-carrier services and between pipeline systems on the respective plant and labor ratios. *Id*. SFPP did not characterize each cost in this manner for the 2003 and 2004 cost-of-service studies produced in this proceeding because it would be inconsistent with Staff's approach, according to Turner, and would allocate a greater amount of overhead costs to carrier services, which would raise SFPP's jurisdictional cost-of-service. *Id*. at pp. 10-11.

295. On cross-examination, Turner testified that work on SFPP's pipelines and terminals is performed by Kinder Morgan employees who work solely on SFPP operations because SFPP has no employees of its own. Transcript at p. 876. This includes, for some employees, SFPP's inter- and intrastate pipelines and SFPP's terminaling facilities, Turner added. *Id*. at p. 877. Referred to Schedule 14F of Exhibit No. SFO-44, Turner confirmed that "Direct Labor-Carrier" includes both inter- and intrastate facilities, while "Non-Carrier" refers to the labor associated with SFPP's terminaling operations. Transcript at p. 877.

296. Turner is next referred to the listed terminals, pumping stations, and truck terminals on SFPP's 2003 FERC Form 6, and testified that they are non-carrier operations and investment dollars. *Id*. at p. 878. He continued, stating that non-carrier labor is incurred at these types of facilities, but that he does not know which terminals incur which share of the direct labor. *Id*. at pp. 878-79. Additionally, he said, labor charged to military pipelines is included within carrier operations and labor charged for military terminal facilities is included with non-carrier. *Id*. at p. 879.

297. Asked to list SFPP's various functions, Turner stated he would break them down between carrier and non-carrier. *Id*. at p. 884. Within its carrier function, he continued, are the individual pipeline systems, for example, the East, West, North, and Oregon lines. *Id*. Based on the distinction that carrier pipeline operations are regulated by either the Commission or the California Public Utilities Commission and non-carrier operations are not regulated, Turner disagreed that intrastate pipelines would be considered non-carrier because they are regulated, just not by the Commission. *Id*. at pp. 884-85. Under his Kansas-Nebraska allocation, Turner testified, he allocated costs to non-FERC jurisdictional facilities. *Id*.

298. More specifically describing his KN allocation, Turner maintained that he uses two levels, the first of which allocates SFPP's total indirect overhead to the carrier and non-carrier functions, and second, that he allocates overhead within the carrier function between the lines irrespective of whether they are interstate or intrastate. *Id*. at pp. 885-

[72] If such a determination cannot be made, Turner claimed, Sosnick recommended that they be accumulated and prorated to plant-related and labor-related based on the ratio of the overhead costs that are specifically identifiable as either plant-related or labor-related. Exhibit No. SFO-42 at p. 9.

88. Turner cited an exception, however, stating that, in this proceeding, he is using only the North Line interstate direct costs to allocate indirect expenses to the North and Oregon Lines. *Id*. at p. 888.

299. Turner further testified that his application of the KN method does not require that indirect costs be identified as either plant- or labor-related. *Id*. at p. 891. He agreed that he used a simple average of plant and labor costs under the KN method, which recognizes the function's direct plant relative to total direct plant, and direct labor relative to total direct labor, so, despite the absence of weighted averages, would not result in over- or under-allocation if there were either a relatively small amount of plant or labor. *Id*. at pp. 891-92. Furthermore, Turner stated that he uses gross plant from SFPP's FERC Form 6, but removes the purchase accounting adjustments for purposes of calculating his KN methodology. *Id*. at p. 892. Turner testified, however, that he does not remove construction work in progress, although Ganz removed it when SFPP revised the cost-of-service studies. *Id*. at p. 893.

300. Referring to a spreadsheet he provided which shows carrier property in service, salaries and wages, and revenues for 2003 and 2004 broken down for the SFPP lines based on inter- and intrastate, Turner explained that the interstate jurisdictional row for SFPP's East, West, Oregon, and North lines breaks down the direct properties, salaries, and revenues for the interstate portion of each system. *Id*. at pp. 896-97. Additionally, Turner defined property in service as direct investment at the operational facilities and notes that it does not include purchase accounting adjustments. *Id*. at p. 899. The 2003 jurisdictional total property in service, Turner confirmed, is $314 million, which is slightly more than 50% of the total carrier direct of $616 million. *Id*. at pp. 899-900.

301. On re-direct examination, Turner explained that he made calculations based on Sosnick's method of separating SFPP's indirect overhead costs between plant-related, labor-related, and "other." *Id*. at p. 903. He suggested that Sosnick's method allocates a higher percentage of overhead costs to carrier services than his simple average method because most of the indirect overhead costs are labor-related, and so the direct labor ratio for carrier is greater than the direct plant ratio for carrier. *Id*. at p. 904. Moreover, Turner added, allocating the indirect costs in this manner would also allocate more total indirect costs to the Oregon Line and slightly less to the North Line. *Id*. at p. 905.

L. RICHARD L. BULLOCK

302. Bullock, a Certified Public Accountant and Vice President-Tax of Knight Inc., testified on behalf of SFPP regarding income tax calculations. Exhibit No. SFO-49 at pp. 1-2. He testified that Kinder Morgan Operating, L.P. "D," in 2003 and 2004, was the general partner of SFPP, and Santa Fe was the sole limited partner. *Id*. at pp. 3-4 (*citing* Exhibit No. SFO-50). During that same period, according to Bullock, Kinder Morgan G.P., Inc., was the general partner in Kinder Morgan Operating, L.P. "D" and Kinder

Morgan was the sole limited partner. *Id*. at p. 4 (*citing* Exhibit No. SFO-51). Under both partnership agreements, taxable income was allocated to each partner in accordance with the partner's percentage interest in the partnership and special allocations were made to partners based on particular facts and circumstances. *Id*. at p. 5.

303. In 2003, Bullock stated, Kinder Morgan G.P., Inc., was the general partner in Kinder Morgan, while Kinder Morgan, Inc., Kinder Morgan G.P., Inc., Kinder Morgan Management, KN Gas Gathering, Inc., and other public investors[73] were limited partners. *Id*. at pp. 5-6. Bullock said that KN TransColorado, Inc., and Kinder Morgan TransColorado, Inc., were added as partners in Kinder Morgan in 2004. *Id*. at p. 6. Kinder Morgan had the same partnership agreement, according to Bullock, in both 2003 and 2004. *Id*. (*citing* Exhibit No. SFO-52). There are three ways, Bullock explained, that limited partners hold ownership in Kinder Morgan: (1) through ownership of Common Units; (2) ownership of Class B units, which have the same rights as Common Units except that they cannot be sold on a public securities exchange;[74] and (3) ownership of i-units. *Id*. at p. 7.

304. According to Bullock, Kinder Morgan Management[75] manages Kinder Morgan under the Delegation of Control Agreement.[76] *Id.* (*citing* Exhibit No. SFO-53). It also is a Kinder Morgan limited partner that holds only Kinder Morgan i-units which are not entitled to allocations of income, gains, loss, deduction, or cash distributions until Kinder Morgan is liquidated and, therefore, no taxable income was allocated to Kinder Morgan Management during the base or test period. *Id.* Bullock explained that taxable income was only allocated to the general partner and to limited partners owning Common Units or Class B units. *Id*. As the same is true of cash distributions, Bullock added, an owner of i-

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[73] According to Bullock, "[t]he public investors include individuals, corporations, limited liability corporations, partnerships, trusts, estates, governmental entities, and other entities that purchase Common Units through the New York [S]tock [E]xchange." Exhibit No. SFO-49 at pp. 5-6.

[74] Class B units may be converted to Common Units, Bullock stated. Exhibit No. SFO-49 at p. 7.

[75] Kinder Morgan Management is a publicly held limited liability company electing to be treated as a corporation for income tax purposes, Bullock testified. Exhibit No. SFO-49 at p. 7.

[76] Under cross-examination, Bullock described the Delegation of Control Agreement as an agreement that assigns responsibility for management of Kinder Morgan from Kinder Morgan General Partners, Inc., to Kinder Morgan Management. Transcript at p. 962.

units, like Kinder Morgan Management, does not receive cash distributions, but only receives distributions of additional i-units calculated by dividing the cash distribution to Kinder Morgan Common unitholders by the average closing price of Kinder Morgan Management shares for the ten trading days prior to Kinder Morgan Management's ex-dividend date. *Id*. at pp. 7-8. When calculating incentive distributions to general partners, Bullock continued, the i-unit distributions are treated as if cash had been distributed. *Id.* at p. 8. As cash has not been distributed, Kinder Morgan has cash available for other opportunities that would otherwise have to be financed by issuing debt or selling additional Kinder Morgan Common Units, Bullock added. *Id*. at p. 8.

305. Under the Kinder Morgan partnership agreement, according to Bullock, income is allocated to the partners based on percentage ownership in the partnership, with special allocations made based on particular facts and circumstances, and significant special allocations made pursuant to the Internal Revenue Code to account for book/tax disparities relating to contributed property and to the Kinder Morgan general partner due to incentive distributions. *Id*. Moreover, Bullock stated, income is allocated to the general partner until the amount equals the incentive distributions made to the general partner. *Id*.

306. Bullock further testified that the Kinder Morgan partnership agreement provides for the sharing of cash distributions made by the partnership to its partners. *Id*. at p. 9. As the total amount of cash distributions increases, the general partner receives increasing percentages of total distributions as a reward for managing the partnership operations and producing greater amounts of cash from operations, Bullock continued. *Id*. Bullock stated that the term "Incentive Distribution," as used in the partnership agreement, refers to any amount of cash distributed to Kinder Morgan's general partner in its capacity as general partner that exceeds the amount equal to 1% of the aggregate amount of cash then being distributed pursuant to such provisions. *Id.* The percentage of partnership distributions Kinder Morgan's general partner is entitled to receive increases as distributions made to common unitholders exceed target levels specified in the partnership agreement, Bullock stated. *Id*. Bullock associated this concept with taxes, stating that the general partner receives an allocation of gross income equal to the cumulative amount of all incentive distributions, which is taxable income to the general partner for federal and state tax purposes. *Id*. at p. 10.

307. Bullock next described SFPP's federal taxable income allocation, stating that SFPP's taxable income is allocated to OLP-D and Santa Fe. *Id*. at p. 11. OLP-D's taxable income, he continues, is allocated to its general partner (Kinder Morgan G.P., Inc.,) and its limited partner (Kinder Morgan). *Id*. Kinder Morgan's taxable income is allocated among its partners, Bullock added, and the taxable income allocated to Kinder Morgan's partners (except the public partners) is included in Kinder Morgan, Inc.'s consolidated federal tax return to determine the actual or potential tax liability of all Kinder Morgan, Inc., entities. *Id*. at p. 11. The 2003 and 2004 income tax allowances were calculated from the 2003 and

2004 federal income tax returns. *Id*. at p. 12.

308. According to Bullock, the proper rate for unrelated business taxable income, under the Internal Revenue Code, is the corporate marginal income tax rate of 34%. *Id*. at pp. 12-13. While O'Loughlin contended that an entity receiving unrelated business taxable income from Kinder Morgan files an IRS Form 990-T for that income separate and apart from IRS Forms 990-T filed for all other income qualifies as unrelated business taxable income, Bullock counters that the IRS Form 990-T is used to report cumulative amounts of unrelated business taxable income, so an entity files only one.[77] *Id*. at p. 13.

309. With regard to state taxable income, Bullock explained, companies which operate in multiple states must divide their total taxable income between the states in which they operate, which is achieved by multiplying a company's total taxable income by an apportionment factor. *Id*. While each state has its own requirements for calculating its apportionment factor, Bullock stated, in general, it is calculated by dividing one or more of sales, property, and payroll sources to a particular state by the total sales, property, and payroll of the company. *Id*. at p. 15.

310. On cross-examination at the hearing, Bullock confirmed that Kinder Morgan's public limited partners had losses in income of $429,537,099 in 2003, which includes the partners' 743(b) depreciation. Transcript at p. 920. It is possible, he continued, that some of the common unitholders' 743(b) depreciation reduced their allocated taxable income to a negative number or loss, although some may have taxable income despite their 743(b) depreciation. *Id*. at pp. 920-21. The losses, Bullock agreed, if not used in the current tax year, would be carried forward for use against Kinder Morgan's allocated taxable income, or, will be carried forward until one sells. *Id*. at p. 921. Bullock also agreed with the conclusion that, in 2003, Kinder Morgan's only positive taxable income from a trade or business was $3,344,304 to the non-public limited partners, and that SFPP's income for the transportation and refined petroleum products in interstate commerce would yield ordinary income from the trade or business. *Id*. at p. 923.

311. Explaining the difference between the i-units and i-shares, Bullock stated that Kinder Morgan Management holds ownership in Kinder Morgan through i-units, while the public holds ownership interests in Kinder Morgan Management through i-shares. *Id*. at p. 930. Bullock stated that Kinder Morgan's partnership agreement allocates cash distributions among partners and, once they hit a certain level, the allocations will change. *Id*. at pp. 930-31. Any allocation to the general partner that is above its 1% ownership in Kinder Morgan is considered an incentive distribution, Bullock added. *Id*. at p. 931. He then confirmed that Kinder Morgan Management is technically allocated cash distributions, but receives distributions in i-units instead. *Id*. at p. 931. The value of these

[77] Bullock explains that the "gross income," or total of the unrelated business taxable income, must meet a $1000 threshold. Exhibit No. SFO-49 at p. 14.

i-units is included when determining the total level of cash distributions and how this level affects the incentive distribution to the general partner. *Id*. at pp. 931-32. Moreover, Bullock indicated that the general partner is allocated one dollar of gross income for every one dollar in incentive distributions regardless of whether Kinder Morgan has any income or has negative income. *Id*. at p. 932.

312. The distribution of i-units and i-shares do not create taxable events, Bullock opined. *Id*. at p. 935. Also, he continued, the sale of limited partnership units to the public does not create a taxable event for either the partnership or the partners. *Id*. at p. 935. Cash received from this sale, according to Bullock, as well as cash borrowed from a bank, is available for cash distributions, but only at the rate of 99% to the limited partners and 1% to the general partner, as the cash may not be distributed pursuant to the incentive distribution formula. *Id*. at pp. 935-36.

313. Returning to 743(b) depreciation, Bullock confirmed that Kinder Morgan's limited partners, due to an election made by Kinder Morgan, are entitled not only to the partnership's depreciation deduction, but also to depreciation outside of the partnership. *Id*. at p. 938. Kinder Morgan is required by the IRS, according to Bullock, to provide calculations regarding 743(b) depreciation. *Id*. at p. 939.

314. Referred to SFPP's Schedule M-1 of its IRS Form 1065 for 2003[78] by counsel, Bullock stated that there is a deduction for reserve expenses in going from book income to tax income, which he explained happens when there is a reserve on the books and a deduction taken for book purposes in one period, but not taken for tax purposes until the amounts were actually paid, which could be in a later period. *Id*. at p. 945. Litigation reserve, he added, must be paid at some point in order to be a legitimate deduction. *Id*. at p. 946.

315. Kinder Morgan, Inc., and Kinder Morgan, Bullock affirmed, have operations distinct from one another. *Id*. at p. 951. Further, he continued, costs incurred by Kinder Morgan's general partner will either be reimbursed by Kinder Morgan or paid directly by Kinder Morgan. *Id*. at p. 952. He added that any expense that remains on Kinder Morgan, Inc.'s books which is a deduction for tax purposes would impact Kinder Morgan, Inc.'s tax liability and that expenses allocated to Kinder Morgan from Kinder Morgan, Inc., are not deductible on Kinder Morgan Inc.'s tax return, thus affecting tax liability. *Id*. at pp. 953-54. In the same vein, Bullock explained that any allocation of expense to Kinder Morgan's subsidiaries impacts that subsidiary's tax liability. *Id*. at p. 955. A Kinder Morgan subsidiary's income tax would be reduced by the increase in the amount of expenses allocated to that Kinder Morgan subsidiary, according to Bullock, if it were subject to income taxes as a corporation. *Id*. at pp. 955-56.

[78] In the record as Exhibit No. SFO-55A at p. 6.

M. GEORGE R. GANZ

316. Ganz, a private consultant, also submitted testimony on behalf of SFPP. Exhibit No. SFO-61 at p. 1. He stated that he updated SFPP's 2003 and 2004 cost-of-service studies for the North and Oregon Lines by changing certain inputs to reflect (1) Williamson's rate of return recommendations; (2) Turner and Bradley's revised operating expenses; (3) updates to SFPP's income tax allowance; and (4) a correction to SFPP data. *Id*. at pp. 2-4. Starting with Williamson's recommendations, Ganz indicated that he updated the real equity rates of returns for the years 1995 through 2004 and the cost of long-term debt and capital structure for the years 2000 to 2004. *Id*. at p. 4.

317. According to Ganz, he made two updates to SFPP's operating expenses: (1) he incorporated a revision to the allocation of corporate overhead expenses, based on the Massachusetts formula, from Kinder Morgan to SFPP, and (2) he incorporated a revision to the allocation of indirect expenses, based on the KN formula, between SFPP's carrier and non-carrier operations. *Id*. Additionally, Ganz said he updated SFPP's income tax allowance calculation in an attempt to comply with the most recent Commission directives in SFPP's ongoing proceedings, and he included accounting location codes that were mistakenly excluded from the cost-of-service studies produced in discovery. *Id*. at p. 5.

318. Ganz stated that the 1992 cost-of-service calculations for SFPP's North and Oregon Lines reflect results for the 12-months ending October 24, 1992, which he claimed is "the date of the enactment of the" EPAct. *Id.* at p. 6. He claimed that the calculations reflect the approach followed by the Commission in *Williams Pipe Line Co.*, 31 FERC ¶ 61,377. Exhibit No. SFO-61 at p. 6. According to him, the 1992 cost-of-service required adjustments to income tax allowance and ADIT calculations to reflect the current approach. *Id*. at pp. 6-7. However, Ganz continued, the income tax allowances remain slightly overstated, as adjusting them would affect only less than two of the 12 months represented in the analysis, and some data is not readily available. *Id*. at p. 7. The 1989 cost-of-service, according to Ganz, reflects this same methodological approach. *Id*. at p. 8.

319. At Van Hoecke's request, Ganz calculated a cost-of-service reflecting corrections to the income tax allowance and ADIT, capital structure, and operating expenses for the North and Oregon Lines for 1992 and 2003. *Id*. at pp. 8-9. For the 1992 cost-of-service calculations, Ganz stated that he used the current approach for applying the cost-of-service methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, and compared it to an alternate approach based on the ARCO Pipe Line Company compliance filing implementing rulings issued prior to the enactment of the EPAct in *ARCO Pipe Line Co*., 52 FERC ¶ 61,055 (1990); *ARCO Pipe Line Co*., 53 FERC ¶ 61,398 (1990) (jointly "*ARCO*"). Exhibit No. SFO-61 at p. 10 (*citing* Exhibit Nos. CC-40 and CC-41). Ganz said he calculated that, under the current approach, the 1992 cost-of-service for the North Line is $11.6 million and $4.7 million for the Oregon Line; in contrast, under the approach

from *ARCO* as calculated by O'Loughlin, the 1992 cost-of-service for the North Line is $13.5 million and $5.3 million for the Oregon Line. *Id*.

320. The change in methodology does not, however, account for the difference in cost-of-service results, reported Ganz, which are attributable to the use of inconsistent capital structure data between the two approaches for the years prior to 1988.[79] *Id*. He explained that this capital structure data impacts the 1992 cost-of-service results because it reflects a greater equity percentage which will cause deferred return and rate base for 1992 to be greater, in turn causing cost-of-service to be higher. *Id*. at p. 11. Additionally, according to Ganz, the starting rate base[80] using the approach from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, must be determined as of the end of 1983 and trended for inflation in subsequent years. Exhibit No. SFO-61 at p. 11. The starting rate base, he opined, generally exceeds depreciated original cost, and the difference is called the starting rate base write-up. *Id*. at p. 12. Ganz added that the starting rate base write-up is included in rate base, amortized starting in 1984, and trended for inflation as part of the equity portion of rate base. *Id*. Further, he testified, if the capital structure used to calculate the starting rate base reflects a higher equity percentage, the starting rate base will be higher, in which case the deferred return and rate base for 1992 will be higher, causing a higher cost-of-service. *Id*.

321. When consistent capital structure data is used for the years before 1988, Ganz stated that, under the current approach, the 1992 cost-of-service for the North Line is $11.6 million, while it is $11.9 million under the *ARCO* approach. Exhibit No. SFO-61 at p. 12 (*citing* Exhibit Nos. SFO-69, SFO-78). For the Oregon Line, he stated, the 1992 cost-of-service under the current approach is $4.7 million and $4.8 million when calculated under the approach from *ARCO*. *Id*. (*citing* Exhibit Nos. SFO-70, SFO-79).

322. While, he claimed, there was insufficient information available to prepare a precise 1985 cost-of-service study for the Oregon Line, Ganz testified that he was able to make a reasonable estimate of the cost-of-service under the valuation method.[81] *Id*. at p. 13. For

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[79] The current approach used a rate base developed with a capital structure of 39% equity, according to Ganz, while the rate base used for the *ARCO* approach had capital structures ranging from 74 to 78% equity. Exhibit No. SFO-61 at pp. 10-11.

[80] Ganz explained that "the starting rate base reflects the sum of net carrier property multiplied by the debt portion of capital structure, plus the cost of reproduction new, depreciated by the same ratio as net carrier property, multiplied by the equity portion of capital structure." Exhibit No. SFO-61 at p. 11.

[81] According to Ganz, Exhibit No. SFO-80 contains his Oregon Line 1985 cost-of-service study under the valuation methodology. Exhibit No. SFO-61 at p. 13.

the purpose of comparison to later periods' costs under the substantial change standard, Ganz contended that the 1985 cost-of-service is reasonably accurate, if not conservative, when considered in light of the fact, he alleged, that the higher the 1985 cost-of-service, the more favorable the evaluation of change in cost will be for the complainants. *Id*. at pp. 15-16.

323. Moving on to income tax allowance and ADIT, Ganz stated that his calculations for 2003 and 2004 differ from the income tax allowance used in cost-of-service studies that were the subject of the Stipulation in Exhibit No. CC-37 because he changed the federal marginal corporate income tax rate for certain entities to 34% for the 2003 and 2004 cost-of-service studies, taking into account *SFPP, L.P.*, 121 FERC ¶ 61,240. Exhibit No. SFO-61 at pp. 16-17. Additionally, he claimed that he also changed the methodology for calculating the weighted state income tax rate, which he testified required him to update the ADIT calculations. *Id*. at p. 17.

324. According to Ganz, the amount of 2003 SFPP taxable partnership income is $69,769,749, of which $23,388,929 is allocable to Kinder Morgan limited partners through its six categories of unitholders. *Id*. at p. 19. Due to its ownership in OLP-D and Kinder Morgan, Kinder Morgan G.P., Inc., was allocated SFPP taxable income, Ganz continued, as was Santa Fe.[82] *Id*. at p. 20.

325. Kinder Morgan, Inc., and its subsidiaries' 2003 federal taxable income is $469,914,720, including their share of allocated taxable income from Kinder Morgan and OLP-D, Ganz testified. *Id*. at pp. 21-22. Specifically, Kinder Morgan, Inc., and its subsidiaries, he related, were allocated $328,344,768 in taxable income from Kinder Morgan, $46,413,966 of which is attributable to SFPP. *Id*. Ganz stated that in 2003, Kinder Morgan, Inc,'s federal income tax before deducting income tax credits of $8,460,687 is $164,470,152, and after deducting the credits, none of which were attributable to SFPP, Kinder Morgan, Inc., paid $155,829,465 in federal income tax. *Id*. at p. 22. Concluding his discussion, Ganz testified that the weighted federal income tax rate for 2003 was 33.05%. *Id*.

326. Focusing on the 2004 weighted federal income tax rate, Ganz listed the number of Kinder Morgan units and percentage of total units for each of the six categories, also noting that Kinder Morgan Management's i-units were not included in calculating the number or percent of units. *Id*. at pp. 23-24. As he did for 2003, Ganz explained the allocation of SFPP's 2004 taxable partnership income of $130,278,246, and indicated that Kinder Morgan limited partners are allocated $61,890,570 of taxable income which is then

[82] Ganz indicated that Santa Fe was allocated $2,652,109 of SFPP's taxable income, while Kinder Morgan G.P., Inc., was allocated $677,955 from OLP-D and $43,050,756 from Kinder Morgan. Exhibit No. SFO-61 at p. 20.

distributed among the six categories in accordance with their ownership interests. *Id.* at pp. 24-25. Ganz testified further that $2,728,441 of SFPP taxable income was allocable to Santa Fe, and that the amount allocable to Kinder Morgan G.P., Inc., is $1,288,381 from OLP-D and $64,370,855 from Kinder Morgan. *Id*. at p. 25.

327. The 2004 federal taxable income for Kinder Morgan, Inc., including its subsidiaries and its and their share of allocated taxable income from Kinder Morgan and OLP-D, according to Ganz, is $461,171,278. *Id*. at pp. 26-27. He continued, stating that Kinder Morgan, Inc., and its subsidiaries' total taxable income from Kinder Morgan is $417,120,164, of which $72,765,758 is attributable to SFPP. *Id*. at p. 27. Furthermore, Ganz reported, Kinder Morgan, Inc., has $7,638,438 of tax credits for 2004, none of which is attributable to SFPP, and when deducted from Kinder Morgan, Inc.'s federal income tax of $161,409,947, results in a federal income tax for Kinder Morgan, Inc., of $153,771,509. *Id*. Ganz stated that its weighted federal income tax rate for 2004 was 32.36%. *Id*.

328. Ganz next explained that he revised his income tax rate calculations for 2003 and 2004 as shown in Exhibit Nos. SFO-63 and SFO-64, respectively. Exhibit No. SFO-61 at p. 28. Because Santa Fe and the various Kinder Morgan entities met an income threshold, according to him, he used a 35% federal income tax rate. *Id.* The remainder of the Subchapter C corporations are subject to a rate of 34% because, he continued, SFPP does not have the income tax information to determine that these entities would meet the 35% threshold. *Id*. Furthermore, Ganz stated, he used the 34% rate for the entities receiving unrelated business taxable income,[83] and uses a 28% marginal income tax rate for Individuals, Mutual Funds, and Pensions, IRAs, and Keoghs. *Id*. at pp. 28-29.

329. In order for ADIT balances to be consistent with the level of SFPP's income tax allowance, Ganz testified that he had to update his ADIT calculations.[84] *Id*. Due to changes in SFPP's weighted income tax rate from year to year, Ganz explained, layers of over-funded and under-funded ADIT developed. *Id*. at pp. 33-34. Moreover, he stated, these over- and under-funded amounts are amortized and the annual amortization is used as an adjustment to the income tax allowance in the cost-of-service calculations presented in Exhibit Nos. SFO-65A and SFO-65B for 2003, and Exhibit Nos. SFO-67A and SFO-67B for 2004. Exhibit No. SFO-61 at p. 34.

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[83] Ganz claimed that he follows the Internal Revenue Code, which, in Section 511(a)(1) provides that UBTI is taxed at the corporate rate. Exhibit No. SFO-61 at pp. 28-29.

[84] Ganz stated that his updates to ADIT are found in Exhibit No. SFO-66. Exhibit No. SFO-61 at p. 33.

330. On cross-examination, Ganz explained that, in 2003, the total taxable income reported by Kinder Morgan to the IRS for the class of limited partners whose units trade on the NYSE includes SFPP's taxable income allocated to Kinder Morgan. *Id*. at pp. 981-84. SFPP's taxable income allocated to Kinder Morgan, according to Ganz, does not take 743(b) depreciation for the limited partners into consideration. *Id*. at p. 985.

331. Referred to SFPP's weighted federal income tax allowance for 2003, Ganz explained that the taxable income allocated among various Kinder Morgan entities is different than the regulatory income number that reflects cost-of-service. *Id*. at p. 990. The tax allowance in the cost-of-service, he continued, is intended to cover taxes which would be due based on the allowed return, while the taxable income reported on SFPP's tax returns, according to Ganz, is based upon whatever the revenues and costs were within the year. *Id*. at pp. 990-91. Further differences arise between the treatment of capitalized overhead and reserved expenses for ratemaking purposes and for financial and tax reporting purposes, such as on a tax return, Ganz testified. *Id*. at p. 991.

332. Referred to a 2004 FERC Form 6 for SFPP where there is an excess of revenues over cost-of-service, Ganz stated that he does not believe that there is an income tax allowance associated with these excess revenues. *Id*. at p. 997. Under the regulatory methodology, for the North Line in 2004, there should not be any income tax allowance associated with the recovery of depreciation costs, according to Ganz. *Id*. at p. 997. Further, Ganz agreed that depreciation is a noncash expenditure and, if it generates cash which flows through to an MLP, would be a source of cash available on a cash flow statement for distribution. *Id*. at pp. 1000-01. In response to being questioned as to whether depreciation is charged to the customer twice because it is included in both cash flow, which is used to set the rate of return on equity, and cost-of-service, Ganz stated that included in cost-of-service is a component for book depreciation expense, beyond which, Ganz claimed, he does not see a double charge. *Id*. at p. 1001.

333. Moving on to SFPP's status as a flow-through entity, Ganz stated that it is a tax pass-through entity, meaning that all items, such as income deduction and credit, would be reported on the income tax return for the entity and would also be allocated and reported on each owner's K-1. *Id*. at p. 1003. Money collected from the shippers which is not used for some expense, even though it will go to the owners, is still reported on the company books as part of the financial information and the effects get reported on the tax returns, according to Ganz. *Id*. at p. 1004. SFPP, Ganz confirmed, reports ADIT, and, on FERC's Form 6, reported zero. *Id*. However, he stated that, for ratemaking purposes, he reflected ADIT consistent with the level of income tax allowance he calculated. *Id*. at p. 1005.

334. During further cross-examination, Ganz explained that, when performing a cost-of-service study, he considered the prudency of the costs, which is determined by what a reasonable person would have done at the time making a decision, knowing what they knew. *Id*. at p. 1015. However, he claimed, books and records are presumed valid until

an argument of imprudence has been made. *Id*. at pp. 1015-1016. While he claimed that he does not audit the books, Ganz explained that he does review the records and discusses them with those who have accounting responsibilities to make sure he understands what the financials reflect. *Id*. at p. 1016.

335. Ganz next discussed his 1985 Oregon Line cost-of-service, which he asserted he prepared using the Valuation methodology which preceded the methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377. Transcript at p. 1016. He explained that preparing a cost-of-service study using the Valuation methodology is similar to developing it under the *Williams Pipe Line* methodology, except that instead of using only original cost when developing a rate base, a detailed calculation is used. *Id*. at p. 1017. The main difference between the two methods, he added, is in developing a rate base under trended original costs after developing a transition rate base in 1983 to transition from the Valuation methodology. *Id*. at p. 1018. Also, under the *Williams Pipe Line* methodology, Ganz continued, there is an allowance for funds used during construction included in the interest expenses component of the rate, which was not part of the Valuation methodology. *Id.*

336. The North Line pre-EPAct cost-of-service used the approach from *ARCO*, according to Ganz, which he does not consider the current method for the North Line cost-of-service. *Id*. at pp. 1029-30. One difference between the approach from *ARCO* and what Ganz considers the current approach is its application of capital structure to rate base. *Id*. at p. 1031. The approach from *ARCO* also was used, Ganz testified, for the Pre-EPAct Period cost-of-service for the Oregon Line. *Id*. In the current proceeding, Ganz stated, he developed a North Line cost-of-service calculation, in which he broke out the interstate portion of the total. *Id*. at p. 1034.

337. As cross-examination continued, Ganz was again questioned about his Valuation methodology and testified that he was asked to evaluate the feasibility of doing such a study for the Oregon Line cost-of-service in January of 2008, at which time he was aware that SFPP did not include a 1985 Oregon Line study showing the basis of the 1985 rates. *Id*. at pp. 1039-40. In order to do this study, Ganz stated that he contacted various people to find the data relevant to the study, even though it was over twenty years old. *Id*. at p. 1041. Some data was available concerning the Valuation rate bases of 1983, he explained, but other data, such as that concerning the operating expenses, was more difficult to locate. *Id*. Only a few days before Ganz submitted his data, he testified, did he find a hard copy of a subledger for expenses which provided the source for the data he used in the Valuation study. *Id*. at pp. 1041-42. Moreover, Ganz added, while he did not have information that would be adequate to use his study to set a rate, he considered the study to be a reasonable estimate and adequate for the present proceeding. *Id*. at p. 1043. Ganz agreed, however, that his 1985 study was not the basis for the 1985 Oregon Line rate. *Id*.

338. On re-direct examination, Ganz explained that he did not take 743(b) depreciation into consideration for the limited partners because it is a deduction that belongs to the unitholders, rather than a deduction that comes from SFPP. *Id*. at p. 1045. Under the stand-alone tax approach, he added, the regulated entity's income is what is relevant, not income or deductions for subsidiaries or elsewhere that could add to or offset this income. *Id*. at p. 1045. He also explained that the aforementioned litigation reserve was reserve which was paid out as refunds and reparations in 2003, which is why the deduction appeared on the 2003 tax return. *Id*. at pp. 1045-46.

SUMMARIES OF THE PARTIES' ARGUMENTS AND RULINGS

ISSUE I: Grandfathering under the EPAct: Whether there has been a substantial change in the economic circumstances which were a basis for SFPP's North and Oregon Line rates in effect during the twelve (12) months prior to October 24, 1992 ("grandfathered rates") thus removing their "grandfathered" status under the EPAct?[85]

A. CC Shippers

339. According to the CC Shippers, under the Energy Policy Act of 1992 ("EPAct") a shipper can remove a rate's grandfather protection if it files a complaint and presents evidence establishing that there was a substantial change in the economic circumstances that were the basis for the rate. *Id*. at p. 3 (*citing* Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2772 (1992)). They claimed that the Commission emphasized that changes in return are important when assessing substantially changed circumstances, and a rate only should be de-grandfathered when the rate of return has changed. *Id*. at p. 6 (*citing ExxonMobil*, 487 F.3d at pp. 959-60; *Calnev* 121 FERC ¶ 61,241 at P 8-9). When measuring substantial change, the CC Shippers continued, the Commission uses the formula (C-B)/A[86] to measure the percentage change in the basis for the rate that has occurred since the passage of EPAct, or the formula (C-B)/B if there is no reliable information on the economic basis of the rate. *Id*. at pp. 7-8 (*citing ARCO Products Co. v. SFPP, L.P.*,106 FERC ¶ 61,300 at P 22-26 (2004) ("*ARCO Products Co.*")). Furthermore, as a proxy for changes in return, they added, the Commission combines percentage changes in volumes and costs as a proxy for changes in return. *Id*. at p. 8 (*citing ARCO*

[85] The Indicated Shippers note in their Initial Brief that they defer to the other shipper complainants in this proceeding for Issue I. Indicated Shippers Initial Brief at p. 2.

[86] According to CC Shippers, in the formula, "A" is the Base Period (the time when the grandfathered rate was last established), "B" is the period 12 months prior to EPAct, and "C" is the Complaint Period, or the 12 months prior to the filing of the complaint. CC Shippers Initial Brief at pp. 7-8.

Products Co., 106 FERC ¶ 61,300 at P 56). The CC Shippers asserted that the Commission looks at actual revenues and expenses when calculating a change in profit margin, which is compared to the return implicit in the grandfathered rate.[87] *Id*. at pp. 9-10 (*citing Calnev*, 121 FERC ¶ 61,241 at P 8-9).

340. Based on O'Loughlin's calculations, which used post-EPAct changes in return or profit margin in the Complaint Period relative to the return embedded in the basis rate, the CC Shippers claimed that there was a substantial change in the economic circumstances in the basis of the grandfathered rates for the North and Oregon Lines. *Id*. at pp. 10-11 (*citing* Exhibit Nos. CC-1 at pp. 54-68, CC-44 at pp. 22-61). Even when O'Loughlin tested the calculation by making two additional calculations, one using lower grandfathered revenues and one which assumed a 35% income tax rate when determining income tax allowance for the cost-of-service for the Complaint Period, the CC Shippers asserted, there is still a substantial change in circumstances. *Id*. at p. 11.

341. When calculating the economic basis of the North Line grandfathered rate (the "A" period), according to the CC Shippers, O'Loughlin used the 1989 cost-of-service Top Sheets that SFPP provided for a 1989 rate increase, with changes made by SFPP to reflect an interstate-only cost-of-service. *Id*. at pp. 11-12 (*citing ARCO Products Co.*, 106 FERC ¶ 61,300 at P 59). SFPP, however, they said, "has prepared a 1989 North Line interstate-only cost-of-service study based on the combined (interstate and intrastate) 1989 cost[-]of[-]service study . . . by using the same basic cost and volume data from the original 1989 study, but applied specific interstate/intrastate separation factors to create and interstate-only cost-of-service calculation." *Id.* at p. 12. Continuing, the CC Shippers note that Van Hoecke used this new study as his "A" period cost-of-service, rather than the one which the Commission previously used.[88] *Id.* at p. 13. They also claimed that, according to O'Loughlin, the cost-of-service support was insufficient to justify the revenue level resulting from the proposed rates because the actual 1989 grandfathered revenue of $13.7 million is more than can be justified by the $12.4 million 1989 cost-of-service which results from using the 2008 methodology. *Id*. at pp. 13-14 (*citing* Exhibit No. CC-44 at p. 49).

342. Regarding the Pre-EPAct, or "B," Period, the CC Shippers claimed that, in order to accurately apportion the change that occurred before and after the EPAct, it was necessary

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[87] The CC Shippers noted that the Commission compares the change in profit margin for the "C" period to the profit margin in the "A" period in order to determine whether there has been a substantial change. CC Shippers Initial Brief at pp. 9-10.

[88] In making this argument, the CC Shippers made reference to "the Commission finding in a prior case," but failed to provide a cite to that case or even to identify the "prior case." *See* CC Shippers Initial Brief at p. 13. Their argument, therefore, has little, if any, value.

to use the cost-of-service methodology that existed in 1992 to assess economic circumstances as well as the cost-of-service analysis for the 12-months ending October 24, 1992. *Id*. at pp. 14-16 (*citing ARCO Products Co.*, 106 FERC ¶ 61,300 at P 52-58; *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 39). In contrast, they argued, by applying the 2003 Complaint Period cost-of-service methodology to analyze the pre-EPAct "B" period, Van Hoecke used a cost-of-service that was much lower than that which would have been developed in 1992, understating any post-EPAct change which occurred from 1992 to the 2003 Complaint Period. *Id*. at pp. 15, 17 (*citing* Exhibit No. SFO-1 at pp. 36-37).

343. The CC Shippers also noted that O'Loughlin, according to them, properly takes changes in cost-of-service methodology, or regulatory change, into account in accordance with *ARCO Products Co*, 106 FERC ¶ 61,300 at P 32-33. *Id*. at p. 16. Ignoring regulatory change, they explained, may result in false conclusions that a substantial change in economic circumstances did not occur, when in fact it did. *Id*.

344. Using the aforementioned methodologies for determining the Basis Period ("A") and Pre-EPAct Period ("B"), along with a Complaint Period ("C") value based on SFPP's cost-of-service analysis for the period ending December 31, 2003, and associated volume and revenue,[89] O'Loughlin properly found, the CC Shippers alleged, a substantial change in economic circumstances for the North Line. *Id*. at pp. 18-19. Specifically, O'Loughlin, according to the CC Shippers, used the volumes, grandfathered portion of the revenues, and cost of service for each of the three periods. *Id*. at p. 19 (*citing* Exhibit No. CC-44 at p. 28, tbl.4). When calculating his post-EPAct increase in grandfathered revenues of $1.4 million, O'Loughlin used the formula C-A because the basis revenues exceeded the Pre-EPAct revenues, the CC Shippers explained. *Id*. at p. 20 (*citing ARCO Products Co*, 106 FERC ¶ 61,300 at P 24; Exhibit No. CC-44 at pp. 27-30). O'Loughlin subtracted the Pre-EPAct cost-of-service from the 2003 Complaint Period cost-of-service, or C-B, to find a negative change in costs of -$200,000, according to them. *Id*. at p. 20 (*citing* Exhibit No. CC-44 at pp. 27-30). By adding these figures, the increase in revenues and the decrease in cost-of-service, the CC Shippers asserted, O'Loughlin calculated an increase in profit margin of $1.6 million. *Id*. (*citing* Exhibit No. CC-44 at pp. 27-30).

345. O'Loughlin, the CC Shippers argued, using the increase in profit margin, calculated a 30% improvement in profit margin in the 2003 Complaint Year relative to the total return embedded in the 1989 basis cost-of-service, and an even larger improvement in return of 41% when measured against the return on equity component embedded in the Basis Period rate, a methodology, they claim, directed by the Commission in *Calnev*, 121 FERC ¶ 61,241, which O'Loughlin applied in his Rebuttal Testimony.[90] *Id*. at p. 19

[89] The CC Shippers note that O'Loughlin also assumed that the income tax allowance in the 2003 cost-of-service was at a 35% income tax rate. CC Shippers at p. 18.

[90] According to the CC Shippers, in *Calnev*, the Commission directed that the percentage increase in return be calculated by comparing the post-EPAct improvement in

(*citing* Exhibit No. CC-44 at pp. 27-30). According to the CC Shippers, O'Loughlin's calculation under the *Calnev* methodology confirms his overall conclusion of a substantial change in economic circumstances, as the 41% improvement is higher than the Commission's 15% threshold. *Id*. at p. 21. The substantial change in economic circumstances for the North Line, they maintained, also is confirmed by the 30% post-EPAct improvement in profit margin relative to the Allowed Total Return plus Amortization of Deferred Earnings, a broader measure of return contained in the Basis Period cost-of-service. *Id*. at pp. 21-22. As a final confirmation, in their view, that there were indeed substantially changed circumstances on the North Line, the CC Shippers point out that when O'Loughlin performed the same analysis using Williamson's 10.02% real return on equity, he found a $1.5 million post-EPAct increase in profit margin that represented a 30% increase under the broader return measure and a 40% increase using the Return on Equity. *Id*. at p. 22.

346. Addressing the Oregon Line rate, the CC Shipper pointed out the lack of reliable data with respect to the Basis Period. *Id*. They acknowledged that the Commission uses the (C-B)/B formula when there is a lack of adequate data regarding the economic Basis Period, and noted that O'Loughlin adopted the use of this formula, analyzing changed circumstances for the Oregon Line by using data from the 1992 Pre-EPAct Period relative to the Complaint Year data, rather than using any data for the 1985 Basis "A" Period. *Id*. at pp. 22-23 (*citing ARCO Products Co.*, 106 FERC ¶ 61,300 at P 63-65). Ganz, on the other hand, they claimed, used problematic and limited documentation[91] to develop a 1985 Valuation cost-of-service study, which, the CC Shippers emphasized, he characterized as an approximation and admitted was not the economic basis of the grandfathered Oregon Line rates. *Id*. at pp. 23-24. The Commission, they insisted, has never authorized a cost of service analysis that is unsupported by appropriate documentation. *Id*. at p. 24.

347. In the event that the lack of evidentiary foundation for the 1985 Valuation cost-of-service study is overlooked, the CC Shippers argued that it is neither reliable nor consistent with SFPP's other testimony. *Id*. at p. 25. Specifically, they continue, if the Valuation study cost of service was the economic basis for the Oregon Line rates, there is an implied $1.223 million over-recovery for the first years the rates would have been in effect. *Id*. Furthermore, the CC Shippers argued, because the Oregon Line under-performed and did not experience the volumes anticipated in 1985, Van Hoecke

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profit margin generated by the grandfathered rate in the Complaint Year to the return on equity or profit margin underlying the basis rate in the Basis Year. CC Shippers Initial Brief at p. 19.

[91] The CC Shippers contended that the documents were highly suspect, no documents reflecting SFPP's 1985 expenses or costs were offered, and those costs that were offered were clearly prepared for management review. CC Shippers Initial Brief at p. 24.

illogically used the 1999 Oregon Line volume level to compute the 1985 and 1992 grandfathered revenues for comparison to the 2003 Complaint Period grandfathered revenues. *Id*. at p. 26. They stated that use of the 1999 volume results in a Basis Period grandfathered revenue figure which exceeds Van Hoecke's proposed Basis Period cost-of-service by over $3 million, inflating the overrecovery and demonstrating that neither figure is credible. *Id*. at pp. 26-27.

348. As with regard to his North Line analysis, the CC Shippers claimed that O'Loughlin properly used the cost-of-service analysis for the 12-months ending October 24, 1992, as well as the methodology in effect at that time 1992 for the Oregon Line Pre-EPAct "B" Period. *Id*. at p. 27 (*citing* Exhibit No. CC-41). For the 2003 Complaint Year Period, the CC Shippers also advocated the same approach used for the North Line, *i.e.*, O'Loughlin's cost-of-service calculation for the period ending December 31, 2003, as well as the associated volume and revenue data for making comparisons to the "B" period. *Id*. at p. 28 (*citing* Exhibit No. CC-44 at pp. 30-31).

349. In an argument allegedly supported by O'Loughlin's calculations using the formula (C-B)/B, the CC Shippers maintained that there was a substantial change in economic circumstances underlying the Oregon Line rate, and thus grandfather protection should be removed. *Id*. at pp. 29-30. They claimed that O'Loughlin measured both the change in grandfathered revenues of $1.7 million and the change in cost-of-service of -$300,000 by finding the differences between the data for the 2003 Complaint Period ("C") and the 1992 Pre-EPAct ("B") Period. *Id*. at pp. 29-30 (*citing* Exhibit No. CC-44 at pp. 30-33). Furthermore, they asserted, he calculated an increase in profit margin by adding the increase in revenues to the decrease in costs of service and compared the change in profit margin to the level of return contained in the 1992 pre-EPAct cost-of-service, conforming to the (C-B)/B formula. *Id*. at p. 30 (*citing* Exhibit No. CC-44 at pp. 30-33).

350. The CC Shippers also declared that O'Loughlin's analysis demonstrated an improvement in the profit margin relative to the total return embedded in the 1992 pre-EPAct cost-of-service of at least 161%, and an improvement of 232% when measured against the return on equity component embedded in the rate. *Id*. at pp. 28-29 (*citing* Exhibit No. CC-44 at 30-33). Additionally, they contended, the change in profit margin is 161% when considered relative to the Allowed Total Return plus the Amortization of Deferred Earnings. *Id*. at p. 31. According to the CC Shippers, were O'Loughlin to use SFPP's real return on equity of 10.02%, there is still a post-EPAct improvement in profit margin of 160% when compared with the Allowed Total Return plus Amortization of Deferred earnings, and 230% when compared to return on equity. *Id*.

351. Given O'Loughlin's calculations for both the North and Oregon Lines, the CC Shippers recommended that grandfather protection be removed for each because there was a substantial change in the economic circumstances underlying the rates. *Id*. at pp. 18, 28.

352. Addressing SFPP's criticism of O'Loughlin's methods and setting forth the flaws with Van Hoecke's analysis, the CC Shippers argued that the proper analysis under *Calnev*, 121 FERC ¶ 61,241, compares the change in pre-tax profit margin to the return embedded in the basis rate, and not the percentage change in the grandfathered portion of SFPP's revenues to the percentage change in total cost-of-service. *Id*. at p. 32. They asserted that "Van Hoecke calculated the percentage change in the grandfathered portion of SFPP's revenues and the percentage change in the *total cost[-]of[-]service* and combines the two percentages based on their relative size," violating the Commission's *Calnev* Order which requires, they declared, a comparison "of the change in pre-tax profit margin (return) . . . [with] the underlying return on equity." *Id.* (*citing Calnev* 121 FERC ¶ 61,241). Further, the CC Shippers contended that SFPP violated the Commission's requirement in its *Calnev* Order which, they claimed, requires that "improvements be measured against the *basis return level*." *Id.* at pp. 32-33. Van Hoecke did so by comparing the "change in return" to total cost-of-service, they argued, diluting the importance of the "change in return" because cost-of-service is composed of many elements in addition to return. *Id.* (*citing* Exhibit No. CC-44 at pp. 35-41). Moreover, the CC Shippers maintained that, in proposing "to take the weighted average of the percentage changes by using the relative sizes of the bases of the two factors," SFPP ignored the fact that "weighting two figures by their relative dollar magnitudes is meaningless if the two elements being measured are of differing importance." *Id*. at p. 33 (*citing* Exhibit No. CC-44 at p. 41).

353. Next, the CC Shippers maintained that Van Hoecke's use of the term "gross margin" when applying *Calnev*,121 FERC ¶ 61,241, is not realistic because he defined "gross margin" as the difference between revenue and cost, instead of cost-of-service, which includes a return or profit component along with expenses. *Id*. at p. 33. Van Hoecke, they continued, ignored the return which is included in the cost-of-service used to determine gross margin. *Id*. at p. 34. This led to Van Hoecke's erroneous conclusion, the CC Shippers contended, that a large percentage change in gross margin is inconsistent with the notion that a single dollar of revenue or margin is not a significant change. *Id*. (*citing* Exhibit No. SFO-1 at p. 20).

354. The CC Shippers also argued that Van Hoecke incorrectly categorized rate base, total allowed return, income tax allowance, operating costs, and capital costs as "narrow elements" and improperly ignored them when measuring substantial change. *Id*. (*citing* Exhibit No. SFO-1 at p. 20). They claimed that, in determining whether there was a substantial change on SFPP's West Line, the Commission relied upon changes in volume, rate base, and allowed return, rather than on changes in cost-of-service. *Id*. (*citing SFPP, L.P*., 111 FERC ¶ 61,334). The CC Shippers, therefore, recommended that substantially changed circumstances be evaluated using a comparison of the return authorized in the Basis Year and embedded in the rates. *Id*. at p. 35 (*citing ExxonMobil*, 487 F.3d at pp. 959-61). Using the total cost-of-service to assess changes in profitability, they added, is overly strict and creates anomalous results. *Id*.

355. In their Reply Brief, responding to Staff criticisms of O'Loughlin's analysis, the CC Shippers explained that O'Loughlin used the same raw data used by the Commission for determining a pre-EPAct 1992 cost-of-service, but used the rate base method that prevailed in 1992, rather than the 2000 methodology that did not exist at the time. CC Shippers Reply Brief at pp. 10-11 (*citing* Staff Initial Brief at pp. 8-9; Exhibit Nos. CC-40, CC-1 at p. 59). With regard to the 1989 cost-of-service, the CC Shippers stated that O'Loughlin again used the Commission's raw data, but claimed that he used a more accurate method of separating inter- and intrastate costs. *Id*. (*citing* Exhibit Nos. CC-1 at p. 37, CC-38). They explained that, while Staff applied a revenue ratio to separate costs, O'Loughlin, as well as Ganz, reviewed individual cost components and applied specific interstate/intrastate cost separation factors. *Id*. at p. 12 (*citing* Exhibit Nos. CC-1 at pp. 57-58; S-1 at p. 13). The CC Shippers asserted that a revenue ratio does not take into account the relative costs that should be borne by interstate shippers and would assign unreasonably high interstate costs if interstate revenues were based on unreasonably high rates. *Id.*

356. Addressing what it asserted was Staff criticism of O'Loughlin's comparison of the post-EPAct change in profit margin for 1992 to 2003 with the return reflected in the 1989 economic Basis Period, the CC Shippers claimed that it is a mixing of the change in profit margin over time (numerator) and the annual return (denominator). *Id*. at p. 13 (*citing* Staff Initial Brief at p. 9). When doing this calculation, the CC Shippers responded, O'Loughlin was complying with *Calnev*, 121 FERC ¶ 61,241 at P 8, where the Commission directed shippers to compare change in actual revenues and expenses when determining the change in profit margins. *Id*. According to them, this is done by finding the difference between the Pre-EPAct (1992) Period and Complaint Period (2003) revenues and costs and comparing that difference to the economic basis for the rate. CC Shippers Reply Brief at pp. 13-14. The pre-EPAct change in grandfathered revenues does not reflect the benefit of indexing, as the post-EPAct change in costs does, the CC Shippers contended, and therefore, they argued, if grandfathered revenues grow by more than cost-of-service during the post-EPAct period, the pipeline's profitability has improved relative to its basis level of return, giving O'Loughlin's analysis greater weight. *Id*. at p. 14.

357. Attempting to clear up Staff's confusion with O'Loughlin's use of two measures of return, the CC Shippers explained that O'Loughlin used return on equity as the return factor in his Rebuttal Testimony in accordance with *Calnev*, and then used regulatory return, or total return, in order to confirm his results. *Id*. at p. 15 (*citing* Staff Initial Brief at p. 10; Exhibit No. CC-44 at p. 29; Transcript at p. 438; *Calnev*, 121 FERC ¶ 61,241 at P 14).

358. The CC Shippers also addressed SFPP's argument that the substantial change percentage threshold should be increased because of O'Loughlin's high percentage

changes in return. *Id*. at p. 16 (*citing* SFPP Initial Brief at p. 21). SFPP, they claimed, tried to link the threshold to the Commission's use of revenues and total cost-of-service as the denominator, but, according to the CC Shippers, the Commission did not discuss these elements in *SFPP, L.P.*, 86 FERC ¶ 61,022, where the first discussion of the threshold appeared. *Id*. Regardless of whether the threshold is 15%, as in *Calnev*, or 20%, as SFPP claimed, the CC Shippers contended that O'Loughlin's analysis demonstrated that the change in circumstances exceeds either threshold. *Id*. at p. 17.

359. The CC Shippers explained that, as they understood Van Hoecke's testimony, "he applied the (C-B)/A formula separately and individually to both grandfathered revenues and cost[-]of[-]service, but not to any measure of return[, and] then added his weighted grandfathered revenue change and his weighted cost[-]of[-]service change to produce a combined revenue and cost change . . . by using the relative sizes of the bases of the two factors (grandfathered revenues and cost[-]of[-]service)." *Id.* at pp. 18-19 (*citing* Exhibit No. SFO-1 at pp. 38-39) (emphasis in original). They then denied, contrary to SFPP's contention, they said, that O'Loughlin agreed with Van Hoecke, and further contended that Van Hoecke's method is too simplistic. *Id.* at pp. 19-20.

360. Responding to SFPP's claim that O'Loughlin's approach was too narrow, the CC Shippers argued that the Commission, in *SFPP, L.P.*, 111 FERC ¶ 61,334, determined that elements such as rate base, total allowed return, income tax allowance, and cost-of-service should be looked at when assessing the grandfather issue, rather than just changes in grandfathered revenues and cost-of-service, as alleged by SFPP, which indicates that O'Loughlin's test is not overly narrow. *Id*. at p. 20. The CC Shippers insisted that it is Van Hoecke, not O'Loughlin, who ignored Commission precedent when using his "total cost of service-as-denominator," approach, as, they maintained, the Commission places emphasis on changes in return when analyzing changed circumstances, like O'Loughlin does in his "return-as-denominator" approach. *Id*. at p. 22 (*citing* SFPP Initial Brief at pp. 15-16; Transcript at p. 406).

361. Lastly, responding to SFPP's claim that O'Loughlin's analysis is not reliable since he used different capital structures in the "A," "B," and "C" time periods, the CC Shippers stated that O'Loughlin used a capital structure of 78.45% equity in preparing his analysis for the "A" and "B" periods because it was what SFPP used at the time. *Id.* at p. 25. He used SFPP's current methodology's assumptions for the "C" period capital structure, they added. *Id*. at pp. 25-26 (*citing* SFPP Initial Brief at pp. 26-27). Essentially, the CC Shippers contended, while O'Loughlin did use two different 1983 to 1989 capital structures, they were the same capital structures SFPP used when developing its cost-of-service and rates in those periods. *Id*. at p. 26.

B. Commission Trial Staff

362. Staff began its Initial Brief by explaining its view of the Commission's substantial change methodology and how its witness, Sherman, applied this methodology. Staff Initial Brief at pp. 5-8. According to Staff, the overall effect of changes in revenues and costs on a pipeline's profitability should be taken into account when determining changed circumstances rather than a change in one single element which does not affect the pipeline's overall profits. *Id*. at pp. 5-6 (*citing SFPP, L.P.*, 86 FERC ¶ 61,022; *ExxonMobil*, 487 F.3d 945). Changes in actual revenues and expenses, the net amounts in percentage terms, should be compared when determining the change in profit margins, Staff added. *Id*. at p. 6 (*citing Calnev*, 121 FERC ¶ 61,241 at P 8). According to Staff, it is the only party that followed the Commission's analysis, by comparing actual revenues and expenses to determine the change in profit margins and through use of net dollar amounts in percentage terms to measure changed circumstances in terms of profitability. *Id*. at p. 7. Using this analysis and the most recent Commission guidelines, Sherman, it noted, testified that there were substantially changed circumstances for SFPP's Oregon Line, but not for its North Line. *Id*. at p. 7 (*citing* Exhibit No. S-1 at pp. 6-7).

363. According to Staff, Sherman followed Commission precedent and used the Commission's formula (C-B)/A when analyzing change in profitability. *Id*. at pp. 7-8 (*citing* Exhibit No. S-1 at p. 9; *ARCO Products Co.*, 106 FERC ¶ 61,300). Specifically, Staff insisted, Sherman remains consistent with *Calnev* and computed the net dollar amounts in percentage terms, using these amounts in the formula for measuring profitability. *Id*. at p. 7 (*citing Calnev*, 121 FERC ¶ 61,241). Further, it continued, she subtracted costs from revenues to calculate a profit margin for each period, and divided revenues by costs to convert the profit margin amounts into percentages which are inserted into the (C-B)/A formula. *Id*. at pp. 7-8.

364. Staff contended that neither O'Loughlin nor Van Hoecke followed the Commission's preferred methodology and compared Sherman's method to the methods used by the CC Shippers and SFPP. *Id*. at p. 8. Instead of using the Commission's preferred methodology, it noted, O'Loughlin used revenues in place of volumes in his analyses and compared the revenues to costs to avoid the problem of adding percentages with different units. *Id*. Staff also took issue with O'Loughlin's inputs for both the North and Oregon Lines because his 1989 and 1992 North Line cost-of-service and his 1992 Oregon Line cost-of-service are inconsistent with those approved by the Commission and the Court of Appeals, which accepted the Commission's cost-of-service calculations for those periods. *Id*. at pp. 8-9 (*citing* Exhibit No. S-1 at pp. 12, 65; *SFPP, L.P.*, 111 FERC at pp. 62,479, 62,483 *aff'd, ExxonMobil*, 487 F.3d at 959, 961; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 9, 15, 19). Furthermore, Staff asserted, the methodology from the CC Shippers' rebuttal testimony is flawed because it used inconsistent measures of return to assess change in profitability over the study period. *Id*. at p. 9 (*citing* Exhibit No. CC-44 at p. 29). The correct approach, according to Staff, would be to assess the change in a

variable using a single measure of that variable over the entire study period. *Id*. at p. 10 (*citing* Exhibit No. S-26; Transcript at pp. 481-83).

365. Another issue with the CC Shippers' approach, Staff noted, is that they use the term "return" when referring to return on equity, return on equity plus amortization of deferred return plus interest expense, and return on equity plus interest. *Id*. at p. 10 (*citing* Transcript at p. 485). All three uses, according to Staff, are separate from the CC Shippers' use of "return" as profit margin. *Id*. While a strict definition of return has not been determined in this context, Staff noted, the Commission specifies that "return" refers to changes in profitability or profit margin in percentage terms over time. *Id*. (*citing Calnev*, 121 FERC ¶ 61,241 at P 8).

366. Continuing its comparison of substantially changed circumstances methodologies, Staff claimed that its method is superior to that set forth by Van Hoecke, which it insisted contains a number of flaws, many of which relate to SFPP's Oregon Line 1985 Valuation study. *Id*. at pp. 10-11. First, Staff began, Ganz developed a Valuation study of the 1985 Oregon Line rate which, it insisted, should be disregarded because SFPP was unable to produce any cost-of-service evidence for the Oregon Line for calendar year 1985 in the Phase I proceeding in Docket No. OR96-2. *Id.* at pp. 11-12 (*citing* Exhibit Nos. SFO-1 at p. 38, SFO-61 at p. 13; *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 63-65). Further, Staff continued, SFPP admitted that Ganz's study "was not in fact the basis of the 1985 Oregon Line rate," was developed only a few days prior to filing testimony, and provided an insufficient basis for developing the rate. *Id*. at pp. 11-12 (*citing* Transcript at pp. 1042-43).

367. Other flaws in SFPP's approach, Staff pointed out, include Van Hoecke's use of a 1989 interstate-only cost-of-service for the North Line which, it contended, differs from the Commission-approved 1989 cost-of-service. *Id*. at pp. 13-14 (*citing* Exhibit No. S-10 at p. 1; *ExxonMobil*, 487 F.3d at 959, 961). Yet, incorporating SFPP's improper interstate-only cost-of-service results still leads to the conclusion that there was no change of circumstances for the North Line, Staff maintained. *Id*. at p. 14 (*citing* Exhibit No. S-1 at p. 13). Additionally, SFPP's change of circumstances approach is flawed, according to Staff, due to its exclusive reliance on grandfathered revenues. *Id*. (*citing* Exhibit No. SFO-1 at pp. 38-39). Because grandfathered revenues are less than general revenues, which reflect index-based rate increases from inflation, according to Staff, SFPP applied the lower revenues from the grandfathered rate against volumes to eliminate the effect of inflation. *Id.* (*citing* Exhibit No. S-9 at p. 9). SFPP, however, did not adjust costs downward to eliminate the effect of inflation on them, Staff asserted, creating inconsistencies. *Id*. (*citing* Exhibit No. S-9 at p. 10). Again, Staff noted, even using SFPP's faulty approach, there was a substantial change of circumstances on the Oregon Line and no substantial change on the North Line. *Id*. at pp. 14-15 (*citing* Exhibit No. S-9 at pp. 12-13).

368. Staff next criticized SFPP's use of weighted averages in its change of circumstances analysis, stating that weighting is unnecessary and inconsistent with Commission precedent. *Id*. at p. 15. Van Hoecke, SFPP maintained, took the percentage changes in SFPP's revenues and costs of service, weighted them based on the mean of the factors during the economic Basis Period, and then subtracted the weighted percentages, claiming, according to Staff, that this quantifies the percentage change in the economic basis of the grandfathered rate. *Id*. Staff claimed, however, that following Sherman's method is more accurate, simpler, and more consistent with *Calnev*. *Id*. (*citing* 121 FERC ¶ 61,241).

369. Addressing the threshold for determining what percent change in revenues constitutes substantially changed circumstances, Staff declared that the Commission has not finally decided what the threshold is, but only determined that neither a 10% increase nor an increase of less than 15% are substantial. *Id*. at pp. 15-16 (*citing SFPP, L.P.*, 86 FERC at p. 61,066; *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 40 (2005)). Given these guidelines, Staff stated that it used a 15% threshold when finding there were no changed circumstances on the North Line. *Id*. at p. 16 (*citing* Exhibit No. S-1 at p. 15). SFPP alleged that the threshold should be 20%, Staff noted, but its witness admitted that there is no evidence that SFPP should have a threshold that is either higher or lower than a generic one. *Id*. at pp. 16-17 (*citing* Exhibit No. SFO-1 at pp. 27-28; Transcript at pp. 626-27).

370. Regardless, Staff said that its analysis resulted in a change in circumstances on the Oregon Line that exceeds the 20% threshold, while its North Line analysis shows a less than 10% change. *Id*. at p. 17. Therefore, using either threshold, Staff recommended that there should be a finding of changed circumstances for the Oregon Line and no changed circumstances for the North Line. *Id*. (*citing* Exhibit No. S-9 at p. 17). Also, Staff argued that the just and reasonable rate it developed for the Oregon Line should be adopted for all shippers and used to determine refunds after adjustment for an updated cost-of-service and indexing. *Id*. (*citing SFPP, L.P.*, 97 FERC ¶ 61,138 at P 74 (2001); *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 49; *BP West Coast Products, LLC v. SFPP, L.P.*, 118 FERC ¶ 61,261 at P 8-9 (2007); *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 75).

371. In its Reply Brief, Staff analyzed SFPP's methodology and addressed SFPP's criticism of Staff's methodology. Staff Reply Brief at p. 3. According to Staff, SFPP's claim that it preserved the Commission's methodology for assessing changed circumstances by weighting percentage changes in cost-of-service and revenues when adding them together should be rejected. *Id*. at p. 4 (*citing* SFPP Initial Brief at pp. 8-10). By adding the two percentages, even though they are weighted, Staff claimed that SFPP ignored the Commission's statement that the sum of changes in two percentages as a measure of change when the percentages have different bases should not be used when determining changed circumstances. *Id*. (citing *Calnev*, 121 FERC ¶ 61,241). The Commission instead noted, according to Staff, that the test should find the change in profit margins. *Id*. (*citing Calnev*, 121 FERC ¶ 61,241 at P 8). Staff also contended that it is

more reasonable to look at overall profitability than to consider only the grandfathered portion of the rate, as SFPP did. *Id*. at p. 5. While the Commission, in *Calnev*, adjusted costs and revenues for comparison purposes by taking out the inflation factor, SFPP makes no such adjustment, according to Staff. *Id*. (*citing* 121 FERC ¶ 61,241 at P 12, 13).

372. Addressing SFPP's criticism, Staff contended that, while its method may not show a substantial change when there is a decline in profit margin between the "A" and "B" periods followed by an increase in the "C" period, as argued by SFPP, the substantial change calculation is not meant to make a direct comparison of profit margin amounts. *Id*. at pp. 5-6 (*citing* SFPP Initial Brief at pp. 14-15; Exhibit No. SFO-122; *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 22). It claimed that, even had the amount of profit margin increased in absolute terms, the relationship between revenues and costs may be the same through all three periods. *Id*.

373. In response to SFPP's contention that it should have used the equation (C-A)/A for analysis of the Oregon Line because there was a decline in profit margin from the "A" period to the "B" period, Staff contended that there was no "A" period data available to indicate such a decline because SFPP's 1985 Valuation study for the "A" period is unreliable. *Id*. at p. 7 (*citing* Transcript at pp. 1129, 1139; Exhibit Nos. S-1 at p. 17, S-9 at p. 12; *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 22, 63-65). Additionally, Staff stated that, when it did perform the Oregon Line analysis using the 1985 Valuation study, it still found that there was a substantial change of circumstances. *Id*. at p. 8.

C. SFPP, L.P.

374. In its Initial Brief, SFPP claimed that the Commission, through various orders and decisions, determined that substantial change should be measured by comparing changes in costs of service and revenue (or volume as a proxy for revenue) in order to capture a broad measurement of change in economic performance, or return, associated with a grandfathered rate. SFPP Initial Brief at pp. 2-3. Using this methodology, SFPP asserted that the rates should remain grandfathered because there has not been a substantial change with respect to either the North or Oregon Lines, as the weighted change for both lines is below both the Commission's 20% threshold, as alleged by SFPP, threshold and Staff's and the CC Shippers' recommended 15% threshold. *Id*. at p. 3.

375. According to SFPP, the Commission looks at revenues and total costs to determine a change in a pipeline's profitability. *Id*. at p. 5. Explaining the Commission's process, it stated that the Commission first looks at the change in the economic circumstances at the time the grandfathered rate was established and determines whether they have changed substantially between the time EPAct was enacted in 1992 and the date the complaint was filed. *Id*. (*citing Santee Distributing Co. v. Dixie Pipeline Co.*, 71 FERC ¶ 61,205 at p. 61,754 (1995), *reh'g denied*, 75 FERC ¶ 61,254 (1996)). Substantially changed circumstances, as directed by the Commission, are determined using a full cost-of-service

and revenue (or volumes as a proxy for revenues) comparison, SFPP added, and not individual rate elements which can offset each other. *Id*. at pp. 5-6 (*citing SFPP, L.P.*, 111 FERC ¶ 61,334 at P 38; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 14; *ExxonMobil*, 487 F.3d at 959). The percentage change in overall cost-of-service is then subtracted from the percentage change in volumes in order to determine whether the overall change exceeds a threshold level, SFPP claimed. *Id*. at p. 6 (*citing* Exhibit No. SFO-1 at p. 15). The changes in cost-of-service and revenues/volumes are assessed using the (C-B)/A formula, SFPP noted, which can be altered in order to avoid anomalies. *Id*. at pp. 6-7. Specifically, it asserted, the Commission uses (C-A)/A when the value of "B" is less than "A" for either revenues or cost-of-service, and, if there is a lack of "A" period data, "B" period data may be substituted, changing the formula to (C-B)/B. *Id*. at pp. 6-7 (*citing ARCO Products Co.*, 106 FERC ¶ 61,300 at P 24-26, 64).

376. SFPP further argued that, while the Commission has not stated a precise threshold, precedent indicates that the threshold is greater than 20% and requires that the complainant prove extraordinary circumstances. *Id*. at p. 7 (*citing* Exhibit No. SFO-1 at p. 26; *SFPP, L.P.*, 66 FERC ¶ 61,210 at p. 61,479 (1994)). In support, SFPP noted that the Commission found that, while a 19.79% change in economic circumstances for the West Line to Phoenix in 1996 was not a substantial change, a 26.65% change in 1997 was a substantial change, and claimed that Commission precedent shows that these findings were based on changes in return in excess of 20%. *Id*. at pp. 7-8 (*citing ARCO Products Co.*, 106 FERC ¶ 61,300 at P 53, 58; *Calnev*, 121 FERC ¶ 61,241 at P 9 n.12). Given that the Commission has found changes greater than 15% that do not qualify as substantial, SFPP contended that Staff and the CC Shippers' view that the Commission established a 15% threshold is incorrect. *Id*. at p. 8 (*citing* Exhibit Nos. S-1 at p. 6, S-9 at pp. 15-16, CC-1 at p. 63).

377. According to SFPP, the Commission decided that only the grandfathered portion of revenues should be used in evaluating substantial change. *Id*. at p. 9 (*citing Calnev*, 121 FERC ¶ 61,241 at P 3, 12-13). A grandfathered rate, SFPP explained, can be made up of three elements, all of which can be challenged under a different standard. *Id*. This can cause confusion, SFPP continued, between a change in economic circumstances that was the basis for the grandfathered rate, and a change in revenue having to do with one of the other elements. *Id*. (*citing* Exhibit No. SFO-1 at pp. 18-19).

378. SFPP also suggested that the Commission recognized that it is incorrect to add percentages derived from different-sized bases. *Id*. at pp. 9-10 (*citing Calnev*, 121 FERC ¶ 61,241 at P 9). Because, it claimed, adding such percentages can lead to inaccurate results, SFPP noted that Van Hoecke resolved the issue by using grandfathered revenue as a proxy for volumes, since revenues and costs are both measured in dollars, and by using weighting. *Id*. at p. 11. SFPP, describing Van Hoecke's approach in further detail, stated that he evaluated the relationship between percentage changes in grandfathered revenues and costs in the "A," "B," and "C" periods and then weights the percentage changes by

multiplying them by the relative size of grandfathered revenues and costs in the Base Period. *Id.* By calculating the difference between the weighted cost change and the weight grandfathered-revenue change, SFPP explained, Van Hoecke is able to evaluate whether there has been a substantial change. *Id*. (*citing* Exhibit No. SFO-1 at pp. 38-39). Moreover, SFPP continued, he treated the changes equally by averaging these offsetting factors when developing the weights. *Id*. This method, according to SFPP, resolves concerns from *Calnev* while remaining consistent with the Commission's methodology. *Id*. at p. 12 (*citing Calnev*, 121 FERC ¶ 61,241). Van Hoecke, SFPP pointed out, reached the same conclusions as the Commission in *ARCO Products Co.*, 106 FERC ¶ 61,300, and *SFPP, L.P.*, 111 FERC ¶ 61,334, when he applied his approach, including the weighting, while neither Staff nor the CC Shippers, according to SFPP, are able to show such an objective measure of the accuracy of their results. SFPP Initial Brief at p. 12 (*citing* Exhibit No. SFO-1 at p. 34).

379. Criticizing Staff's approach to measuring return by calculating a revenue-cost index, SFPP noted that using Sherman's profit margin percent, while not unreasonable, has a number of problems. *Id*. at p. 12 (*citing* Exhibit No. S-1 at pp. 16-17; Transcript at p. 1128). First, SFPP took issue with Staff adding percentages of different bases because, allegedly, Sherman's failure to use a weighting approach led to the conclusion that there was no change in economic circumstances even though there was an increase in profit from the "B" period to the "C" period. *Id*. at p. 13 (*citing* Exhibit No. SFO-122; Transcript at pp. 1127-29). Van Hoecke's approach, SFPP contended, results in a more accurate percentage change in economic performance. *Id*. at p. 14. Second, SFPP argued that Staff erroneously applied the Commission's (C-B)/A formula when there was no change in economic performance between the Base Period and the Complaint Period, contrary to *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 24. SFPP Initial Brief at pp. 13-14. SFPP suggested that failing to change the formula in cases of economic decline will result in anomalous results, and noted that Sherman admitted that this could occur. *Id.* at pp. 14-15 (*citing* Exhibit No. SFO-122; Transcript at pp. 1128-29). It contended that this can be fixed by substituting the "A" period grandfathered revenue or costs for the "B" period revenue and costs to calculate only the change between the "A" and "C" periods. *Id*. at p. 15 (*citing* Exhibit No. SFO-1 at pp. 65-69, tbl.25).

380. SFPP next criticized O'Loughlin's approach to evaluating substantial change, stating that he has presented a return-as-denominator approach which is based upon an incorrect definition of return and attempts to correct the issues in *Calnev* with a new methodology which ignores precedent. *Id*. at pp. 15-16. This methodology, according to SFPP, compares the post-EPAct change in profit margin to the return embedded in the basis circumstances, but uses a definition of return which is not consistent with the Commission's definition of return. *Id*. at p. 16 (*citing* Transcript at p. 406). O'Loughlin uses both total allowed return and return on equity in determining the post-EPAct improvement in profit margin, SFPP pointed out, but does not explain when to use which method. *Id*. Moreover, while the Commission defines return as the difference between

revenues and costs, SFPP contended that O'Loughlin instead uses the return component of cost-of-service as the "A" value instead of total cost-of-service or revenue, essentially failing to apply the (C-B)/A test. *Id*. at p. 17 (*citing ARCO Products Co.*, 106 FERC ¶ 61,300 at P 29; *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 38 n.56; *ExxonMobil*, 487 F.3d at 959; *Calnev*, 121 FERC ¶ 61,241 at P 8). Additionally, SFPP alleged, O'Loughlin's use of allowed return for measuring substantial change is undermined by *SFPP, L.P.*, 86 FERC ¶ 61,022 at p. 61,067, in which, it claimed, the Commission was uncertain as to what degree allowed return affects an oil pipeline's revenue requirement. *Id.* at p. 18.

381. O'Loughlin's return-as-denominator approach is unreasonable, according to SFPP, first, because it generates very high percentage changes. *Id*. at p. 19. In a hypothetical, it claimed, O'Loughlin's approach yields a change of 60%, while SFPP and Staff's methods resulted in changes of 15% and 20%, respectively. *Id*. (*citing* Exhibit No. SFO-120). Additionally, SFPP noted, when applying the Commission's established test in his Direct Testimony, O'Loughlin calculated a North Line change of 22%.[92] *Id*. at p. 30 (*citing* Exhibit No. CC-1 at p. 62). This percentage change jumps from 30% to 40% when O'Loughlin applied his return-as-denominator method in his Rebuttal Testimony, which SFPP insisted demonstrates that that this method results in very high percentage changes. *Id*. (*citing* Exhibit Nos. CC-44 at p. 28, CC-68 at p. 2).

382. Given these particularly high percentages, SFPP argued, secondly, that the Commission's 20% substantial change threshold would not be appropriate for use with O'Loughlin's methodology. *Id*. The threshold was established for use with a broad measure of economic performance as the denominator, it contended, and not for use with the narrow factor proposed by O'Loughlin. *Id*. at p. 21. Moreover, SFPP pointed out that even O'Loughlin was uncertain as to whether his 15% threshold could be used if his methodology were adopted. *Id*. (*citing* Transcript at pp. 445-46).

383. As its third issue with O'Loughlin's methodology, SFPP maintained that it discriminated against older pipelines because a pipeline's return is based on its original cost rate base, so an older pipeline would have a relatively smaller rate base than a newer pipeline. *Id*. Therefore, according to SFPP, newer pipelines would have an advantage over older pipelines because O'Loughlin's method would result in different percentage changes based on the difference in the size of a pipeline's rate base. *Id*. at pp. 21-22 (*citing* Exhibit No. SFO-101; Transcript at pp. 466-68). The approach, SFPP continued, also results in different percentages depending upon how capital intensive a pipeline chose to be in 1992, a distinction which EPAct does not support. *Id*. at p. 22. SFPP contended

[92] O'Loughlin's change, according to SFPP, decreases to 11% when he corrected it for updated 2003 North Line cost-of-service and for the use of grandfathered revenue. SFPP Initial Brief at p. 20 (*citing* Exhibit No. CC-68).

that neither Van Hoecke's method nor Sherman's method would produce this type of discrimination. *Id*.

384. SFPP next compared the methods advocated by all parties, asserting that Van Hoecke's method is superior to the alternatives. *Id*. The accuracy of Van Hoecke's methodology, according to SFPP, is proven by changing cost-of-service or revenue when all other inputs are held constant, while Sherman and O'Loughlin's methodologies do not hold up when such a test is administered. *Id*. When the increase or decrease in grandfathered revenue or cost-of-service are changed between the "B" and "C" periods, O'Loughlin's percentage difference changes dramatically, SFPP noted, and Sherman's also becomes inaccurate, while SFPP's percentage remains the same. *Id*. at p. 24.

385. There has been no substantial change with respect to the grandfathered rates for the North Line, according to SFPP, because the weighted change is below even the 15% threshold. *Id*. at p. 26 (*citing* Exhibit Nos. SFO-1 at p. 38; SFO-114 at p. 1, tbl.6). It suggested that Sherman came up with the same result, as did O'Loughlin when he used the Commission's (C-B)/A test (rather than his new return-as-denominator test) when corrected to use grandfathered revenue and the updated North Line 2003 cost-of-service.[93] *Id*. (*citing* Transcript at p. 431).

386. Additionally, SFPP alleged that, when a number of errors with O'Loughlin's costs of service are corrected, a finding of a substantial change in circumstances on the North Line is even less likely. *Id*. Specifically, SFPP contended, O'Loughlin uses different equity capital structures in his 1992 and 2003 costs of service for the period from 1983 through 1988, both of which cannot be correct. *Id*. at pp. 26-27 (*citing* Exhibit No. SFO-1 at pp. 52-53). This error caused the 1992 cost-of-service to be overstated, according to SFPP, and created the inaccurate result that there was a higher change in economic circumstances on each line. *Id*. at p. 27 (*citing* Exhibit No. SFO-1 at p. 53). Addressing O'Loughlin's concern that regulatory change should be included in assessing substantial change, SFPP claimed that Van Hoecke performed his test with cost-of-service calculations using the methodology the Commission would have employed at each relevant time period, and, SFPP argued, still found that no substantial change occurred with respect to the North Line. *Id*. (*citing* Exhibit Nos. SFO-1 at pp. 44-5 & tbl.9, SFO-114 at p. 4 & tbl.9).

387. Regarding O'Loughlin's return-as-denominator test for the North Line, SFPP argued that O'Loughlin assumed the economic basis of the rate included a negative return element, contrary to *Calnev*, 121 FERC ¶ 61,241 at P 9. SFPP Initial Brief at p. 28. In his methodology, it insisted, if revenues were assumed to equal costs in the Basis Period, his

[93] When corrected, according to SFPP, O'Loughlin's use of the Commission's methodology results in a change of only 11%. SFPP Initial Brief at p. 26 (*citing* Transcript at p. 431).

approach would then yield a negative change for the North Line. *Id*. (*citing* Transcript at pp. 471-72). In conclusion, SFPP determined that O'Loughlin's finding of substantial change on the North Line is due to his various errors. *Id*.

388. SFPP argued that there is no substantial change on the Oregon Line because the weighted change level is below the 15% threshold advocated by Staff and the Complainants, even when Van Hoecke takes O'Loughlin's concern with regulatory change into account and performs his test for substantial change using the methodology that would have been used in each relevant time period. *Id*. at p. 29 (*citing* Exhibit Nos. SFO-1 at pp. 39, 43, 45, SFO-114 at pp. 2, 5, CC-1 at p. 59). Accordingly, SFPP stated that both the CC Shippers and Staff are incorrect in asserting that there has been a substantial change for the Oregon Line. *Id*.

389. Contrary to Commission policy, according to SFPP, Sherman did not use grandfathered rate revenues when analyzing substantial change and did not use the Commission's (C-A)/A formula when the Oregon Line cost-of-service in the "A" period was lower than the "B" period cost-of-service, SFPP pointed out. *Id*. (*citing* Exhibit No. SFO-1 at pp. 39-40). Moreover, it claimed, she erred when failing to use Ganz's 1985 Oregon Line cost-of-service study, and her arguments for not doing so, are off base. *Id*. at p. 30. The Commission has decided that an after the fact cost-of-service study, according to SFPP, can provide a basis for determining the economic circumstances that were a basis for the grandfathered rate regardless of how the rate was actually established. *Id*. (*citing ExxonMobil*, 487 F.3d at p. 961). Therefore, SFPP suggested, it is appropriate to use the 1985 Oregon Line cost-of-service study despite the lack of specific basis for the rate. *Id*. While Sherman also contended that the study is less accurate than other studies used by SFPP and is not comparable to the methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377, used to calculate these other studies, SFPP submitted that her contention is without merit because, had the 1985 Oregon Line cost-of-service been developed using the *Williams Pipe Line* methodology, it would have been lower, thus lowering the probability of a finding of substantial change. *Id*. at p. 31 (*citing* Exhibit Nos. S-14; SFO-61 at pp. 15-16). SFPP insisted that there is no rational basis to disregard the 1985 Oregon Line cost-of-service study, and, if Sherman's errors are corrected, then she too would find no substantial change for the Oregon Line. *Id*.

390. SFPP noted that O'Loughlin's errors in his Oregon Line analysis are the same as those it found in his North Line analysis. *Id*. at pp. 31-32. Also, SFPP alleged that O'Loughlin, like Sherman, did not use Ganz's 1985 Oregon Line cost-of-service study. *Id*. at p. 32. If O'Loughlin's cost-of-service errors are corrected and if the Commission's method from his Direct Testimony is used, SFPP contended, then O'Loughlin would not find a change in circumstances for the Oregon Line rate. *Id*.

391. In its Reply Brief, SFPP noted that the CC Shippers, in their Initial Brief, quote a portion of *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 54, which reflected that, in the

grandfathering context, the focus is on "changes in return," but then argued that the Commission means return in the sense of the allowed return component associated with rate base or return on equity embedded in the "A" period cost-of-service. *Id*. (*citing* CC Shippers Initial Brief at p. 9). Moreover, SFPP maintained that, while the CC Shippers contend that allowed return or return on equity should replace the "A" period revenue or total cost figure as the denominator in the (C-B)/A test, the Commission's calculation in previous cases indicate as follows: "The 'Three Cost Factors' are rate base, allowed return, and total cost[-]of[-]service, and the 'Percentage Change' in each is derived by using the '(C-B)/A' test as to each factor, that is, '(Allowed Return in C) – (Allowed Return in B) / (Allowed Return in A),' and so forth." *Id*. at pp. 4-5 (*citing* CC Shippers Initial Brief at pp. 32-33; *Calnev*, 121 FERC ¶ 61,241; *ARCO Products Co.*, 111 FERC ¶ 61,334 at tbl.2). Later, SFPP asserted:

> [I]n the grandfathering setting, when the Commission says "change in return," it means a comparison between the change in costs (with total cost of service being decisive) relative to the "A" period and the change in volumes or revenues relative to the "A" period. Nowhere in the Commission's comparisons does it use one value for period "A" and some completely different value for periods "B" and "C." When measuring the percentage change in volumes, the denominator is *volumes* and the numerator is the change in *volumes* (either from "A" to "C" or from "B" to "C"). When measuring the percentage change in *allowed return* (either from "A" to "C" or from "B" to "C"). Thus Mr. O'Loughlin's return-as-denominator test directly conflicts with the Commission's approach to measuring "change in return."

Id. at p. 7.[94]

392. According to SFPP, the CC Shippers inappropriately rely upon *Calnev* as support for the return-as-denominator test. *Id*. SFPP pointed out that while the CC Shippers argued that the Commission highlighted the importance of a comparison between change in profit margin and the return implicit in the grandfathered rate, they are misinterpreting *Calnev*. *Id*. at pp. 7-8 (*citing* CC Shippers Initial Brief at p. 10). The Commission, SFPP argued, in *Calnev*, does not, as the CC Shippers contend, specify that change in revenues and cost is to be divided by the return on equity component of the "A" period cost-of-service. *Id*.

393. SFPP insisted that, to test O'Loughlin's return-as-denominator test, one must apply it to previous Commission grandfathering rulings to see if it can replicate the outcomes

[94] SFPP loosely referred to "the OR96-2 Orders," but failed to cite to any specific order or to any specific Commission holding.

using the same set of facts, rather than just testing it by varying the inputs, as O'Loughlin has done. *Id*. (*citing* CC Shippers Initial Brief at p. 11). By testing his method in this way, SFPP suggested that it is inconsistent with the Commission's definition of "change in return," which undercuts the CC Shippers' claim that increases in return as compared to return authorized in the Basis Year matter. *Id*. at pp. 8-9 (*citing* CC Shippers Initial Brief at p. 35). SFPP maintained that, using the same facts, O'Loughlin's test produces anomalous results when matched against the Commission's evaluation of North Line economic circumstances for the period 1995 to 1999.[95] *Id*. at p. 10. Moreover, SFPP argued that, while O'Loughlin's approach produces varying fluctuations from the Commission's North Line results, it produces changes on the West Line which are consistently around three times larger than the Commission's change percentages. *Id*. at p. 11.

394. According to SFPP, were O'Loughlin's return-as-denominator test adopted, and applied in future cases, the Commission's treatment of the economic circumstances of other pipelines with grandfathered rates could not be predicted because of fluctuating percentage changes and the disconnect between the denominator and numerator. *Id*. at p. 15. Furthermore, SFPP added, the unpredictability of the return-as-denominator test is compounded by the fact that there are two versions of the test, one based on allowed return and one based on return on equity, both of which cannot be correct because they produce very different results.[96] *Id*.

395. SFPP argued that the CC Shippers' and Staff's criticisms of Van Hoecke's method are without merit and are based on misstatements of the record, of the law, and of Van Hoecke's position. *Id*. at pp. 18-19. SFPP contended that Van Hoecke's variation of the 1989 North Line cost-of-service, in which he recommended applying the current interpretation of the Commission's cost-of-service methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377 to the 1989 North Line data, is based on Van Hoecke's definition of regulatory change. *Id*. at p. 19. Regulatory change, SFPP continued, constitutes a change between two cost-of-service methodologies, for example, from valuation to the *Williams Pipe Line* methodology, rather than a Commission clarification within a cost-of-service methodology which serves the purpose of bringing a carrier's cost-of-service into compliance with the manner in which the Commission originally intended the methodology to be applied. *Id*. (*citing* 31 FERC ¶ 61,377). However, it also suggested that Van Hoecke made substantial change calculations to reflect the use of the different

[95] For example, SFPP noted, for 1995, where the Commission found a positive change of 2.65%, O'Loughlin's test generates a change of only 0.34%. SFPP Reply Brief at p. 10.

[96] The CC Shippers, SFPP claimed, did not specify which test should be used. *Id*. (*citing* CC Shippers Initial Brief at pp. 21-22).

stages of this cost-of-service methodology.[97] *Id*. at pp. 19-20. By "correctly" applying each stage and using the "correct" approach for evaluating substantial change, Van Hoecke's calculations, according to SFPP, revealed no substantial change for either the North or Oregon Lines. *Id*. at p. 20.

396. The CC Shippers, SFPP contended, argued that O'Loughlin's use of the 1992 cost-of-service methodology for the "B" period was employed by the Commission in its decision in the prior case[98] for its analysis of SFPP's West Line, although never affirmed on appeal. *Id*. (*citing* CC Shippers Initial Brief at p. 16). SFPP also stated that the CC Shippers' argument is inconsistent because, while they emphasize their alignment with the Commission on this point, they attempt to distance themselves with rulings regarding the North and Oregon Lines in the same case. *Id*. (*citing* CC Shippers Initial Brief at pp. 3-5). Furthermore, SFPP noted, this argument does not remedy the problem with O'Loughlin's use of different sets of capital structure figures for the 1983-1988 period in his 1992 and 2003 costs of service, which cannot both be correct for the same period. *Id*. at p. 21 (*citing* Exhibit No. SFO-1 at pp. 52-53).

397. SFPP maintained that Van Hoecke did not recommend the approach he put forth in the OR96-2 proceeding, which differs from his definition of regulatory change, but instead advocated applying current clarified methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377. *Id*. Since that time, SFPP stated, Van Hoecke considers that all Commission orders have been clarifications of the *Williams Pipe Line Co.* decision rather than new cost-of-service methodologies, and therefore, SFPP continued, Van Hoecke asked Ganz to apply the Commission's Valuation cost-of-service methodology to the Oregon Line in 1985. *Id*. at pp. 21-22 (*citing* Exhibit No. SFO-1 at pp. 39, 45-48).

398. Responding to the CC Shippers' argument that Van Hoecke used a straw man, SFPP explained that a narrow measure, such as gross margin, will yield a more narrowly defined result and will more frequently lead to the determination of substantially changed circumstances than when broader measures are used. *Id*. at p. 22 (*citing* CC Shippers Initial Brief at p. 34; Exhibit No. SFO-1 at pp. 21-24). Moreover, SFPP added, the Commission determined that a change in economic performance should be determined by broadly defined factors. *Id*. (*citing SFPP, L.P.*, 86 FERC ¶ 61,022 at 61,067; *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 29; *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 38). While the CC Shippers argued that rate elements such as rate base, total allowed return,

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[97] SFPP listed the different stages of cost-of-service methodologies as pre-*ARCO*, *ARCO*, and the current methodology from *Williams Pipe Line Co.*, 31 FERC ¶ 61,377. SFPP Reply Brief at p. 20.

[98] By "prior case," I assume, without knowing for certain, that SFPP refers to *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005).

income tax allowance, operating costs, and capital costs are not narrow and therefore should not be ignored in evaluating substantial change, SFPP maintained that they matter only to the extent that they are not offsetting, which can be assessed by looking at the overall return. *Id*. at p. 23 (*citing* CC Shippers Initial Brief at p. 34). The Circuit Court, SFPP claimed, upheld the Commission's determination that looking at the pipeline's overall return is appropriate. *Id*. (*citing ExxonMobil*, 487 F3d. at pp. 958-59). SFPP insisted that the return-as-denominator approach must therefore be rejected because it looks at only allowed return, an individual cost-of-service factor, and did not account for any offsetting factors, making it inconsistent with the Commission's prior rulings. *Id*. at pp. 23-24.

399. Next, SFPP alleged that, despite the CC Shippers' contention that Van Hoecke weighs two figures of different importance, revenues and costs in the basis economic circumstances are of equal importance. *Id*. at p. 24 (*citing* CC Shippers Initial Brief at p. 33). The Commission, SFPP continued, has found that both revenues and costs should be used when analyzing a pipeline's economic performance, but has not found that either should be given greater emphasis, which is why Van Hoecke weighs them equally. *Id*. Even O'Loughlin acknowledged, according to SFPP, that equivalent changes in costs and revenues have equal impacts on return. *Id*. at p. 25 (*citing* Transcript at p. 403-05).

400. SFPP acknowledged that Staff also takes issue with the weighting approach, stating that the Commission never approved the methodology. *Id*. (*citing* Staff Initial Brief at p. 15). In response, SFPP claimed that the Commission also has not approved methodology similar to Sherman's. *Id*. Van Hoecke's approach is the closest of the three approaches to the Commission's (C-B)/A methodology, SFPP contended, as he modified it only minimally in order to correct for the different-unit issue and the issue of adding percentages with unlike bases identified by the Commission in *Calnev*, resulting in percentage changes that are only slightly different from those the Commission produced using its methodology in OR96-2. *Id*. (*citing* Exhibit Nos. SFO-120, SFO-1 at pp. 24-25, 28-36).

401. According to SFPP, Staff's assertion that it is inappropriate to use grandfathered revenues with total cost-of-service in the substantial change analysis is contradictory to Commission precedent which requires that the grandfathered portion of a pipeline's tariff rate be analyzed differently than non-grandfathered portions, such as the indexed portion of a rate. *Id*. at pp. 25-26 (*citing* Staff Initial Brief at p. 14). It argued that the Commission has stated that changes in cost-of-service could not be used to undermine a pipeline's grandfathering.[99] *Id*. (*citing Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Regulatory Preambles 1991-1996 ¶ 30,985 at p. 30,952

[99] According to SFPP, this has been upheld in subsequent Commission orders, such as *Calnev*. SFPP Reply Brief at pp. 25-26 (*citing Calnev*, 121 FERC ¶ 61,241 at P 3, 8, 12-13).

(1993)). However, SFPP insisted that, if revenues associated with the indexing portion of a rate are included, as Staff suggested, there would be a substantial change in economic circumstances which results in de-grandfathering of the rate, undermining the purpose for EPAct. *Id*. at p. 27.

Discussion and Ruling

402. When determining whether there have been substantially changed circumstances in the economic basis of SFPP's North and Oregon Lines, there are sub-issues that must be resolved. Specifically, these issues include: (1) what methodology should be used when determining substantially changed circumstances; (2) what cost-of-service data should be used for each of the relevant time periods involved; and (3) what threshold percentage does the Commission use when determining whether there has been substantial change.

403. The CC Shippers argued that grandfather protection should be removed from both the North and Oregon Line rates because there have been substantially changed circumstances in the economic circumstances underlying the bases of those rates. CC Shippers Initial Brief at pp. 18, 29-30. In making this argument, the CC Shippers compared the improvement in profit margin from the 1992 Pre-EPAct Period to the 2003 Complaint Period relative to the total return embedded in the Basis Period. CC Shippers Reply Brief at p. 2. They also compared the improvement in return with the return on equity component embedded in the "A" period rates. Exhibit No. CC-44 at pp. 27-30. Moreover, the CC Shippers advocated using both return on equity and Allowed Total Return plus Amortization of Deferred Earnings when analyzing the profit margin or return to confirm O'Loughlin's testimony. CC Shippers Initial Brief at pp. 21-22. When determining that there have been substantially changed circumstances, the CC Shippers argued, a 15% threshold should be applied. *Id*. at p. 21.

404. Staff took the position that there have not been substantially changed circumstances in the economic basis of the North Line, but that there have been changed circumstances in the economic basis of the Oregon Line rate. Staff Initial Brief at p. 4. In making this determination, Staff assessed profitability by computing net dollar amounts in percentage terms. *Id*. at p. 7 (*citing* Exhibit No. S-1 at p. 9). Staff stated that costs must be subtracted from revenues to determine a profit margin for each period, which is then converted into a percentage by dividing revenues by costs for each period. *Id*. at p. 7. The percentages for each period, Staff claimed, should be used in the (C-B)/A formula. *Id*. at pp. 7-8. Staff used a 15% threshold when determining the percent change in revenues that constitute substantially changed circumstances. *Id*. at 15.

405. According to SFPP, there has been no substantial change in circumstances underlying the economic basis of either the North or Oregon Line rates because the weighted change is below 20%, which SFPP argued is the Commission's threshold. SFPP Initial Brief at p. 3. SFPP contended that substantial change should be assessed

using only the grandfathered portion of revenues, and advocated the use of a weighting approach to avoid adding percentages with different sized bases. *Id*. at p. 11. SFPP's analysis evaluated the relationship between grandfathered revenues and costs at the "A," "B," and "C" periods in order to calculate percentage changes in these factors. *Id*. After weighting the percentages by multiplying them by the relative size of the grandfathered revenues and costs in the "A" period, SFPP determined the difference between the weighted grandfathered-revenue change and the weighted cost change to arrive at a combined change which can be used when determining whether there has been a substantial change. *Id*.

406. Under the EPAct, a grandfathered rate can be challenged only if a complainant presents evidence "to the Commission which establishes that a substantial change has occurred after the date of the enactment of [EPAct] in the economic circumstances of the oil pipeline which were a basis for the rate." EPAct § 1803 (b)(1), 42 U.S.C. § 7172 note (2000). When measuring change in the economic basis of the rate, the Commission looks at "changes in return, and hence a pipeline's profit expectations." *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 38.

407. To measure the change in the economic basis of the rate, which must have occurred after the EPAct's effective date, the Commission uses the formula (C-B)/A, where "A" represents the Base Period, or the year in which the grandfathered rate took effect, "B" represents the period 12 months prior to EPAct's enactment (Pre-EPAct Period), and "C" represents the period 12 months prior to the filing of the complaint (Complaint Period). *ARCO Products Co,* 106 FERC ¶ 61,300 at P 19, 22; *SFPP, L.P.*, 86 FERC at pp. 61,067-68.

408. In *ARCO Products Co.*, the Commission determined that there were substantially changed circumstances in the economic basis of SFPP's West Line rates by looking at decreases in cost and increases in volume (as a proxy for revenue). 106 FERC ¶ 61,300 at P 29, 53. The Circuit Court, in *ExxonMobil*, 487 F.3d at pp. 959-60, affirmed the Commission's substantially changed circumstances determinations and held that rates should be de-grandfathered only when the rate of return has changed, regardless of changes in individual rate elements which could offset one another. However, according to the *ExxonMobil* court, the Commission erred by adding changes in two percentages with different bases as a measure of change. *Calnev*, 121 FERC ¶ 61,241 at P 8. The Commission addressed this issue by stating that comparing dollar margins is more appropriate than using the "total swing in percentages" when analyzing changed circumstances. *Id*. The Commission held that change in actual revenues and expenses should be compared "to determine the change in profit margins . . . which are net dollar amounts in percentage terms without mathematical error." *Id*.

409. Staff's methodology most closely follows the Commission's changed circumstances methodology. The Commission, in *Calnev*, determined that a comparison

of the change in dollar margins is appropriate, and the change in actual revenues and expenses should be compared in order to determine the change in profit margin. 121 FERC ¶ 61,241 at P 8. The profit margins should be expressed as "net dollar amounts in percentage terms without mathematical error." *Id*. When determining change in economic circumstances, Staff, unlike the other parties in this proceeding, followed this Commission directive and calculated a profit margin and related percentages for the "A," "B," and "C" periods. *See Calnev*, 121 FERC ¶ 61,241 at P 8. *See also* Exhibit No. S-1 at pp. 11-12. Staff used these percentages in the formula (C-B)/A for the North Line, and (C-B)/B for the Oregon Line, to calculate that that there has been a change in economic circumstances on the Oregon Line, but not on the North Line. Exhibit No. S-1 at pp. 12, 15, 17.

410. When determining substantially changed circumstances for the Oregon Line, Staff correctly applied the (C-B)/B formula because there is a lack of reliable data for the "A" period. *See* Staff Initial Brief at pp. 11-13; CC Shippers Initial Brief at pp. 22-27. As noted, both by Staff and the CC Shippers, the Ganz testimony relied on by SFPP is of dubious value. *Id.* Despite the fact that no 1985 data was available at the time the record was closed in the hearing leading to the Commission's *ARCO Products*[100] decision, and despite the lack of 1985 cost-of-service data in the record leading to its decision in its June 2005 *SFPP*[101] ruling, SFPP purported to have obtained reliable data sufficient to develop a 1985 cost-of-service study for presentation in the hearing of the instant matter. How SFPP managed to find this "ancient" data, which could not be found in the past, and compile a study only days before SFPP pre-filed its testimony, is suspect. Transcript at p. 1040. The study's credibility is also questionable. Ganz, who prepared the study, testified that, at best, it is a "reasonable estimate" and "produces a meaningful result for the purpose that it's being offered in this proceeding." *Id.* at p. 1045. He also admitted that its quality should not be used for setting a rate and was not "the economic basis of the 1985 Oregon Line rate." *Id.* Therefore, (1) because I find the circumstances surrounding the discovery of this data suspect,[102] and (2) because Ganz made it clear that the data was not of a quality upon which the Commission ought to rely, I conclude that his study lacks probity and that it, as well as Ganz's testimony regarding it, lack any probative value.

411. In *ARCO Products*, the Commission noted that no cost-of-service evidence was available for the Oregon Line for 1985, the last time rates were increased and filed with the Commission. *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 63. Given this lack of data, the Commission determined that "in the absence of other evidence that addresses the year in which the rates were established, it might be reasonable to use 1992 as the base

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[100] *ARCO Products Co.*, 106 FERC ¶ 61,300.

[101] *SFPP, L.P.*, 111 FERC ¶ 61,334.

[102] *See also* Transcript at pp. 633-35.

year for measuring whether there was a change in the economic basis for the rate." *Id.* at P 64. To be consistent with the Commission's Order, therefore, since there is no credible evidence establishing what the Oregon Line economic circumstances were in 1985, one must use the (C-B)/B formula for it, as Staff and the CC Shippers did, rather than (C-B)/A.

412. For the "B" and "C" period cost-of-service studies for both lines, Van Hoecke claimed he instructed Ganz to prepare cost-of-service calculations based on the Commission's rulings in *Williams Pipe Line Co.*, 31 FERC at p. 61,836. Exhibit No. SFO-1 at p. 37. O'Loughlin used a 1989 interstate-only cost-of-service study developed by SFPP for this proceeding based on the 1989 cost-of-service study used by the Commission in *ARCO Products Co.*,106 FERC ¶ 61,300, for the economic basis of SFPP's grandfathered 1989 North Line rate. CC Shippers Initial Brief at p. 12. For the 1992 Pre-EPAct Period cost-of-service for both lines, O'Loughlin used the data submitted by SFPP in Docket No. OR96-2 which used 1992 cost-of-service methodology, collaterally attacking the methodology followed by the Commission in *SFPP, L.P.*, 91 FERC ¶ 61,135. CC Shippers Initial Brief at p. 15 (*citing* Exhibit Nos. CC-40, CC-1 at pp. 64-65). Staff uses the 1992 costs of service for the North and Oregon Lines, as well as a 1989 cost-of-service for the North Line that the Commission approved in *SFPP, L.P.*, 111 FERC ¶ 61,334, and was affirmed in *ExxonMobil*, 487 F.3d at pp. 959-60. Staff Initial Brief at pp. 8-9; Exhibit No. S-1 at pp. 12, 65. As both the Commission and the Court of Appeals already have approved the use of the 1992 North and Oregon Line and 1989 North Line cost-of-service studies, and as neither the CC Shippers nor SFPP have given good reason for altering that determination, all collateral attacks to their use are rejected. Thus, I find that Staff's cost-of-service studies for those periods, and not those employed by SFPP and the CC Shippers, should be used to determine changed circumstances for both the North and Oregon Lines.

413. With respect to the substantially changed circumstances methodology used by the CC Shippers, I agree with SFPP that, "O'Loughlin does not provide a single, consistent approach for measuring substantial change, presenting differing methodologies between his Direct and Rebuttal Testimonies, and two approaches for evaluating change *within* his Rebuttal Testimony." SFPP Initial Brief at p. 16 (*citing* Transcript at p. 449). Essentially, O'Loughlin misses the mark with not one, but three substantial change methodologies. His credibility as a witness with regard to this particular issue was undermined by his inability to commit to one single methodology for assessing substantial change, or one definition of return.

414. Rather than using the difference between revenues and overall costs as a measure of return, O'Loughlin used the return component of cost-of-service, *i.e.*, the return embedded in the "A" period cost-of-service. SFPP Initial Brief at p. 17. In using only a portion of the cost-of-service as the "A" period value, O'Loughlin ignores the Commission's statements that full cost-of-service and revenue should be compared when

determining whether there were substantially changed circumstances. Transcript at p. 445; *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 38, n.56.

415. Due to his indecisiveness regarding which substantial change methodology should be applied, O'Loughlin presented two percent changes for each Line in his Rebuttal Testimony: the improvement in profit margin as a percentage of the underlying return on equity and the improvement in profit margin as a percentage of Allowed Total Return plus Amortization of Deferred Earnings. CC-44 at pp. 29-30, 32. O'Loughlin also confirmed that both his Direct and Rebuttal Testimonies can be relied upon in this proceeding and stated that his Direct Testimony should be considered when evaluating substantial change. Transcript at pp. 428-30. Thus, O'Loughlin presented multiple percentage changes for each Line: percentage changes in revenue, volume, rate base, allowed total return, income tax allowance, cost-of-service and cost-of-service per barrel from his direct testimony,[103] and two percentage changes for each Line in his rebuttal testimony using the updated methodology that the CC Shippers claimed is based on *Calnev*, 121 FERC ¶ 61,241. Exhibit Nos. CC-1 at pp. 62, 67, CC-44 at pp. 28, 31.

416. Like O'Loughlin, SFPP witness Van Hoecke also presented an approach which strays from prior Commission precedent. In order to address the Commission's concern with adding percentages with different bases, Van Hoecke used a weighting approach. SFPP Initial Brief at pp. 9-10. SFPP claimed that Van Hoecke's approach corrects the error of adding percentages with different bases, while remaining consistent with the Commission's substantial change methodology. SFPP Initial Brief at p. 10. Van Hoecke, however, could have remained consistent with the Commission's substantial change methodology simply by comparing the change in profit margins, in accordance with *Calnev*, 121 FERC ¶ 61,241 at P 8. Instead, Van Hoecke fabricated a weighting approach in order to correct an issue that the Commission has already solved. *Id.* Staff, on the other hand, was able to avoid the issue of adding percentages with differing bases by comparing percentage changes in revenues with percentage changes in costs, which are each computed using dollars, rather than concocting an entirely new methodology. Exhibit No.

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[103] It should also be noted that, by focusing on percentage changes in individual factors in his Direct Testimony, *e.g.*, Exhibit No. CC-1 at p. 62 tbl.12, p. 67 tbl.13, O'Loughlin ignored the Court of Appeals' holding, in affirming the Commission's *SFPP, L.P.*, 111 FERC ¶ 61,334 ruling, that, in determining whether there has been a substantial change in circumstances, one must determine the change in the overall rate of return, not just a change in one cost element. *ExxonMobil*, 487 F.3d 945 at pp. 959-60. In the *SFPP* case, the Commission had stated: "[I]t is changes in return, and hence a pipeline's profit expectations, that ultimately determines whether there has been a change in the economic basis of the rate." *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 38. In other words, rather than focusing on single factors as O'Loughlin did, one must look at the full spectrum of a pipeline's cost-of-service in order to determine whether there has been a significant change in the economic circumstances serving as the basis for its grandfathered rate.

S-1 at p. 12. I find that Staff's approach is most consistent with the Commission's solution in *Calnev*.

417. Furthermore, both Van Hoecke and O'Loughlin err in their analyses by using only grandfathered revenues, which do not paint an accurate picture of changed circumstances, *i.e.*, rather than using total revenues which include indexing increases due to inflation, both witnesses remove the indexed portion of the rate and used only the grandfathered portion, while leaving cost-of-service as is. I agree with Staff that using grandfathered revenues instead of general revenues while not correspondingly adjusting costs downward to eliminate the effect of inflation upon them produces inconsistent results. *See* Staff Initial Brief at p. 14. As Sherman explained, it is more appropriate to compare SFPP's actual revenues to its actual costs if costs are not likewise going to be adjusted for inflation. Exhibit No. S-9 at p. 10. Here, neither Van Hoecke nor O'Loughlin adjusted their cost-of-service calculation when they used only the revenues arising from the grandfathered portion of the rates. *See* CC Shippers Initial Brief at p. 19; SFPP Initial Brief at p. 9. The Commission considered the concept of using only grandfathered revenues when determining substantially changed circumstances in *Calnev*. *See* 121 FERC ¶ 61,241 at P 12. There, the Commission explained that "increased costs caused by the increase in volume and inflation" must be removed when using the return generated by the grandfather rate when assessing substantially changed circumstances. *Id*. Using only grandfathered revenues, without also adjusting cost-of-service, is inconsistent for purposes of determining substantially changed circumstances; if the effects of inflation are removed from the revenue used for determining substantially changed circumstances, they likewise must be removed from the costs. *See Calnev*, 121 FERC ¶ 61,241 at P 12.

418. The Commission has not finally decided the issue of what percent change in revenues is needed for a change in circumstances to be considered substantial. When determining that there were no substantially changed circumstances on the North Line, the Commission stated that "the percentage increase in volumes after 1992 compared to 1989 was consistently less than 15 percent." *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 61. In the same order, however, the Commission also stated, when analyzing the West Line, that increases in volumes and decline in cost-of-service "establishes there were substantially changed circumstances given a likely impact on return in excess of 20 percent." *Id*. at P 56. In *SFPP, L.P.*, 111 FERC ¶ 61,334, the Commission stated that a less than 15% change is not substantial "given the Commission's prior rejection in Opinion No. 435 [*SFPP, L.P.*, 86 FERC ¶ 61,022] of a threshold of 10 percent or some other similarly low number." The Commission re-visited the issue in *Calnev*, stating that "the 15 percent figure cited by Complainants is a minimum" and "the findings in March 2004 Orders were based on changes in return in excess of 20 percent." *Calnev*, 121 FERC ¶ 61,241 at P 9 n. 12 (*citing ARCO Products Co.*, 106 FERC ¶ 61,300 at P 54-56).

419. I agree with Staff and the CC Shippers that a change of less than 15% is not substantial, in accordance with the Commission's holding that 15% is the minimum.

Calnev, 121 FERC ¶ 61,241 at P 9 n.12. The mere fact that some prior Commission findings of no substantially changed circumstances turned on percentage changes exceeding 20% does not indicate that the threshold also should be 20%. The Commission could have been faced with percentage changes in excess of 50%, but that would not warrant increasing the threshold to 50%. While prior Commission determinations may have been based on percentage changes exceeding 20%, the Commission, on more than one occasion, has plainly indicated that a minimum change of 15% is required.[104] *See Calnev*, 121 FERC ¶ 61,241 at P 7, P 9 n.12; *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 40 n.65).

420. Whether there was a substantial change, exceeding 15%, in the economic circumstances that served as the basis for either of the grandfathered rates at issue here remains for a compliance filing following a final ruling on the remaining issues.

A: Must any decisions on cost-of-service issues be made if it is found that SFPP's North and Oregon Line rates remain grandfathered?

A. CC SHIPPERS

421. According to the CC Shippers, cost-of-service issues must be addressed even if SFPP's 1992 North and Oregon Line rates remain grandfathered. CC Shippers Initial Brief at p. 35. It is necessary, they stated, because, should the just and reasonable rate level be determined to be below the grandfathered rate level, even were protection not removed, the shippers would be entitled to reparations equal to at least the difference between the rates paid and the grandfathered rate level, in accordance with *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 14. CC Shippers Initial Brief at p. 35. Also, the CC Shippers continued, the analysis determines whether SFPP's rate should be lowered to the grandfathered level, even were there no substantial change in economic circumstances.[105] *Id*. at pp. 35-36. Additionally, according to them, the Commission's annual index allowance does not hinder the ability to reduce SFPP's rates to the grandfathered level because, while the Commission allows an annual adjustment in an oil pipeline's rates, it does not determine that the adjusted rate is just and reasonable. *Id.* at pp. 36-37. The CC

[104] However, regardless of the threshold, it would appear that Staff's finding of a 41.94% change on the Oregon Line and 9.94% change on the North Line fall well above and below either a 20% or 15% threshold, making the battle between these two particular thresholds somewhat irrelevant in this proceeding, as long as the proper methodology and cost-of-service inputs are used and assuming the result remains the same. *See* Exhibit No. S-9 at pp. 16, 17.

[105] The CC Shippers claimed that, in *Calnev*, the Commission accepted complaints to the extent that they challenged the portion of the rates which exceeded grandfathered rates. CC Shippers Initial Brief at p. 36 (*citing* 121 FERC ¶ 61,241 at P 5).

Shippers stated, moreover, that the Commission allows for the reasonableness of such rates to be challenged in complaint proceedings. *Id*. at p. 37 (*citing SFPP, L.P.*, 120 FERC ¶ 61,245 at P 10-11 (2007); *BP West Coast Products v. SFPP, L.P.*, 121 FERC ¶ 61,195 at P 5-6 (2007)).

422. On reply, the CC Shippers alleged that, while SFPP argued that Complainants must have expressly articulated a challenge to the indexing adjustments that have been applied to the grandfathered component of the North and Oregon Lines, this argument creates a requirement that does not exist. CC Shippers Reply Brief at p. 26. According to them, when a complainant challenges an oil pipeline rate, it challenges the entire rate, not just the grandfathered portion, and both portions are subject to review. *Id*. at pp. 26-27 (*citing ARCO v. Calnev Pipe Line, L.L.C.*, 97 FERC ¶ 61,057 at p. 61,311 (2001); *Calnev*, 121 FERC ¶ 61,241 at P 3). The CC Shippers claimed that the Commission recognized that a complaint includes a challenge to both portions of the rate when it set the indexed portion of the rate for hearing while giving complainants time to amend their complaints regarding the grandfathered portion in *Calnev*. *Id*. at p. 27 (*citing Calnev*, 121 FERC ¶ 61,241 at P 1, 3, 5-6). Moreover, in prior proceedings initiated because of SFPP's annual index filing, the CC Shippers asserted, the Commission determined that it was appropriate to make the rate increase subject to refund because the underlying rates were subject to review in complaint and tariff proceedings. *Id*. at pp. 27-28 (*citing SFPP, L.P.*, 117 FERC ¶ 61,271 at P 7 (2006)).

423. While the CC Shippers acknowledged that O'Loughlin stated, during cross-examination, that indexing would apply to the North and Oregon Line rates, they claimed he was not conceding that the index adjustments were reasonable, as SFPP asserted. *Id*. at p. 28 (*citing* Transcript at p. 426). Were the charged rates reduced to a level that is just and reasonable, the CC Shippers maintained, then the index adjustment would likewise need to be adjusted. *Id*.

B. INDICATED SHIPPERS

424. The Indicated Shippers stated that they agreed with the CC Shippers, claiming that it must be determined whether the challenged rates are just and reasonable even were they to remain grandfathered. Indicated Shippers Initial Brief at p. 2. This includes, they contended, any increases for annual indexing to the grandfathered North and Oregon Line rates or general rate case increases. *Id.* As they occurred after EPAct's cut off date, the Indicated Shippers argued, they are not grandfathered. *Id*. (*citing ARCO v. Calnev Pipe Line*, 97 FERC at p. 61,311). The rates are subject to review, according to the Indicated Shippers, but cannot be reduced below the grandfathered rate level in effect in 1992 unless substantially changed circumstances are demonstrated. *Id*. at pp. 2-3. Moreover, the Indicated Shippers argued that a just and reasonable rate at the current level of the test year cannot be increased through indexing or other means because no evidence that a higher rate would be just and reasonable has been presented. *Id*. at p. 3.

425. They further argued that, as this is a complaint case, a pipeline public utility cannot increase a rate because the Interstate Commerce Act requires that a rate increase be made pursuant to an application to the Commission. *Id*. (*citing* Interstate Commerce Act, 49 U.S.C. § 6 (1988)).

426. While SFPP claimed, according to the Indicated Shippers in their Reply Brief, that neither the Indicated Shippers nor the CC Shippers challenged the index rate increase added to the grandfathered rates since 1992, the Indicated Shippers contended that they challenged all rates that were in effect at the time of their Complaint, including all index rate increases and general rate increases. Indicated Shippers Reply Brief at p. 2 (*citing* "Fourth Original Complaint of BP West Coast Products LLC and ExxonMobil Oil Corporation Against SFPP, L.P.," filed December 22, 2004, in Docket No. OR05-4, at p. 1; *Calnev*, 121 FERC ¶ 61,241).

C. COMMISSION TRIAL STAFF

427. Contrary to the Complainants, Staff argued that, were the North and Oregon Line rates to remain grandfathered, there is no reason to evaluate the cost-of-service on those lines. Staff Initial Brief at p. 17. In support, Staff cited EPAct §1803(a) in which, according to Staff, it is provided that a grandfathered rate is just and reasonable unless there is a showing of substantially changed circumstances causing it to lose grandfathered protection. *Id*. at pp. 17-18. Thus, Staff contended that it would be unnecessary to further evaluate cost-of-service.[106] *Id*. at p. 18 (citing *ExxonMobil*, 487 F.3d at 959-60).

D. SFPP, L.P.

428. SFPP agreed with Staff's view that, should the North and Oregon Line rates remain grandfathered, the rates should remain unchanged. SFPP Initial Brief at p. 32. The rates are comprised of both the grandfathered rate and indexing adjustments which have been applied to the rate, SFPP noted. *Id*. The indexing adjustments have not been challenged in this case, according to SFPP. *Id*. (*citing* Transcript at p. 426).[107]

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[106] Staff added nothing to its argument in its Reply Brief. *See* Staff Reply Brief at p. 10.

[107] SFPP did not add to its argument in its Reply Brief. *See* SFPP Reply Brief at pp. 27-29.

Discussion and Ruling

429. This issue is limited to whether cost-of-service must be further evaluated should the North and Oregon Line rates remain grandfathered. Both the CC Shippers and the Indicated Shippers argued that cost-of-service issues must be addressed even were the North and Oregon Line rates to remain grandfathered. CC Shippers Initial Brief at p. 35; Indicated Shippers Initial Brief at p. 2. Staff, on the other hand, claimed that cost-of-service need not be evaluated where rates remain grandfathered. Staff Initial Brief at p. 17. SFPP agreed with Staff. SFPP Initial Brief at p. 32.

430. There is no reason to evaluate cost-of-service on the North and Oregon Lines should the rates remain grandfathered. Under EPAct §1803, a grandfathered rate is deemed just and reasonable. A party cannot challenge a grandfathered rate unless that party establishes that there has been a substantial change in circumstances in the economic basis of the rate. EPAct, Pub L. 102-486 §1803, 106 Stat. 2776, 3010. Only if a substantial change in circumstances is found can the justness and reasonableness of the rate then be challenged. Therefore, if no substantial change is found, the inquiry ends there; the rates remain grandfathered and no further cost-of-service decisions need be made. Given the plain language of EPAct §1803, it is clear that, as Staff claimed, cost-of-service need not be evaluated where rates remain grandfathered.

431. Moreover, the issue of the indexed rates is not before me in this proceeding. The CC Shippers cited *Calnev* as support for their assertion that a complaint includes a challenge to both the grandfathered and indexed portion of a rate. CC Shippers Reply Brief at p. 27 (*citing Calnev*, 121 FERC ¶ 61,241 at P 1, 3, 5-6). However, in that case, the Commission specifically stated that the complainants filed their complaint against both the grandfathered portion of the rates and the non-grandfathered portion. *Calnev*, 121 FERC ¶ 61,241 at P 1. Here, the Complainants only challenged indexing with respect to the East Line, as stated by the Commission in its Order on Complaint setting this proceeding for hearing. *Chevron Products Co.*,105 FERC ¶ 61,142 at P 8 (2003). As only the grandfathered portion of the rate was set for hearing and the indexed portion of the rate is not before me in this proceeding, should the rates remain grandfathered, I lack jurisdiction to further evaluate cost-of-service issues because that issue was not referred to me by the Commission.[108]

[108] *See Sierra Pacific Power Co.*, 104 FERC ¶ 61,223 at P 34-36 (2003).

B: If the North and Oregon Line rates in effect in 1992 are still grandfathered, can the rates be lowered beyond the 1992 level?[109]

A. INDICATED SHIPPERS

432. The Indicated Shippers contended that the current rates can be lowered down to, but not below, the 1992 level. Indicated Shippers Initial Brief at p. 3.[110]

B. COMMISSION TRIAL STAFF

433. In its Initial Brief, Staff explained that, were the North and Oregon Line rates in effect in 1992 still grandfathered, they cannot be lowered at all. Staff Initial Brief at p. 18. Staff noted that, while it is irrelevant whether the 1992 level acts as a refund floor, it would be relevant if the rates are no longer grandfathered. *Id*. According to it, while the Commission in *Lakehead Pipe Line Co.*, 71 FERC at p. 62,319, stated that refund floors are applicable in oil pipeline cases, the case was not dealing with a complaint against a grandfathered rate. *Id*. at pp. 18-19. Staff suggested that limiting refunds in the current situation to the previously grandfathered rate level would unlawfully eliminate any refunds. *Id*. at p. 19. Should a just and reasonable rate lower than the grandfathered rate be established for the Oregon Line, Staff explained, this rate must be established prospectively, and thus, Staff contended, Complainants would be entitled to refunds to the just and reasonable level from the date of the complaints. *Id*. at pp. 18-19 (*citing* EPAct § 1803).[111]

C. SFPP, L.P.

434. SFPP stated that the North and Oregon Line rates cannot be lowered below the grandfathered level unless the Complainants show a substantial change in economic circumstances that were the basis for those rates. SFPP Initial Brief at p. 33.[112]

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[109] According to the CC Shippers, they addressed this issue in Issue I.A. CC Shippers Initial Brief at p. 37.

[110] The Indicated Shippers did not address this issue in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 3.

[111] Staff added nothing to its argument in its Reply Brief. *See* Staff Reply Brief at p. 11.

[112] SFPP added nothing to this argument in its Reply Brief. *See* SFPP Reply Brief at p. 29.

Discussion and Ruling

435. The question presented in this Issue is whether rates can be lowered below the grandfathered level. The Indicated Shippers, Staff, and SFPP agreed that the current rates, should they remain grandfathered, cannot be lowered below the 1992 level. Indicated Shippers Initial Brief at p. 3; Staff Initial Brief at p. 18; SFPP Initial Brief at p. 33. The CC Shippers argued that, if a just and reasonable rate is below the grandfathered level, but remains grandfathered, rates should be lowered to the grandfathered rate. This implies that the CC Shippers also agreed that the current SFPP rates cannot be lowered below the 1992 level. CC Shippers Initial Brief at p. 36.

436. Under the EPAct §1803, in order to change a grandfathered rate, a complainant must prove a substantial change of circumstances in the economic basis of the rate. Otherwise, the rate is presumed to remain just and reasonable. EPAct § 1803. As a rate remains just and reasonable, under the EPAct, if it remains grandfathered, there is no basis to decrease the rate to a level below the grandfathered rate.

ISSUE II: Burden of Proof: Which party or participant bears the burden of proof on the issues including the Income Tax Allowance and Indexed Incremental Rate Increase Issues in this proceeding?

A. CC SHIPPERS

437. The CC Shippers, in their Initial Brief, explained that an oil pipeline's rates must be just and reasonable and not unduly discriminatory, and, should one believe that they are not, that person or entity can file a complaint with the Commission claiming that the rate violates any provision of the Interstate Commerce Act. CC Shippers Initial Brief at p. 37 (*citing* Interstate Commerce Act, 49 U.S.C. app. §§ 1(5), 3(1), 15(1) and 15(7) (1988)). The complainant, according to the CC Shippers, bears the burden of proof and must show that the subject rates are unjust or unreasonable. *Id*. at p. 37.

438. When rates have been grandfathered under EPAct, the CC Shippers further explained, they can still be challenged, but the complainant, they continued, must meet the additional burden of demonstrating that a substantial change in the economic circumstances that were the basis for the rate has occurred after the enactment of EPAct. *Id*. at p. 38 (*citing* EPAct § 1803). Once this burden is met, they continued, the rate is no longer just and reasonable, and thus loses grandfather protection. *Id*. The complainant, however, only carries the additional burden for the grandfathered portion of the rate, the CC Shippers pointed out, while any portion above the grandfathered level may be challenged under the just and reasonable standard. *Id*. (*citing Calnev*, 121 FERC ¶ 61,241 at P 3).

439. They argued that SFPP, on the other hand, bears the burden of proof to demonstrate that its unitholders have actual or potential income tax liability. *Id*. (*citing Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 32 (2005)). Because SFPP, the pass-through entity, is in control of the information needed to determine the unitholders' tax obligation, the CC Shippers maintained, it bears the burden to establish the tax status of its owners in a rate proceeding. *Id*. at p. 39 (*citing Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 42).

440. In their Reply Brief, the CC Shippers stated that SFPP did not acknowledge in its Initial Brief that it has the burden of demonstrating that its classes of unitholders other than corporate partners have actual or potential income tax liability. CC Shippers Reply Brief at pp. 28-29 (*citing* SFPP Initial Brief at pp. 33-34; *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 42). Moreover, the CC Shippers continued, SFPP has the burden of justifying that any rate increase is just and reasonable, including a rate increase made pursuant to indexing. *Id*. at p. 29 (*Revisions to Oil Pipeline Regulation Pursuant to the Energy Policy Act of 1992*, Regulatory Preambles 1991-1996 ¶ 30,985; 49 U.S.C. app § 15(7) (1988)).

B. INDICATED SHIPPERS

441. The Indicated Shippers also maintained that SFPP bears the burden of proving its claims for an income tax allowance and for automatic indexing forward of the rates pursuant to the Commission's index regulations. Indicated Shippers Initial Brief at pp. 3-4. As support, the Indicated Shippers stated that the *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 42, requires that a pass-through entity which wants an income tax allowance on utility operating income must show the tax status of its owners. *Id*. at p. 4. Furthermore, the Indicated Shippers contended that, under *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, FERC Stats. & Regs. ¶ 30,985 at p. 30,965, SFPP has the burden of proving that a rate increase under the Commission's indexing regulations is warranted, and, they noted, this burden does not shift. *Id*. Lastly, the Indicated Shippers noted that the Interstate Commerce Act requires that the pipeline bears the burden of proof with regard to any rate increase. *Id*. at p. 5 (*citing* Interstate Commerce Act, 49 U.S.C. §15(7) (1988)).

442. In their Reply Brief, the Indicated Shippers submitted that SFPP ignored the fact that the pipeline bears the burden of proving that an income tax allowance is justified and that the partners had actual or potential income taxes as indicated in the *Policy Statement on Income Taxes*, 111 FERC ¶ 61,139, at P 32.[113] Indicated Shippers Reply Brief at p. 3.

[113] The Indicated Shippers noted that the *Policy Statement on Income Tax Allowances* was upheld by the Circuit Court in *ExxonMobil*, 487 F.3d at p. 954. Indicated Shippers Reply Brief at p. 3.

443. Even assuming that the shippers had the burden of proof with respect to income taxes, the Indicated Shippers noted, the burden was met through Bullock's testimony which, they claimed, established that Kinder Morgan's limited partners had losses in income in 2003 and 2004 and thus had neither actual or potential income taxes to pay. *Id*. On that basis, the Indicated Shippers stated, no income tax allowance is warranted. *Id*. at pp. 3-4.

C. COMMISSION TRIAL STAFF

444. Staff explained that, under the Interstate Commerce Act and the EPAct, in a complaint proceeding, the complainants bear the burden of proving that existing rates are unjust and unreasonable. Staff Initial Brief at pp. 19-20 (*citing* Interstate Commerce Act, 49 U.S.C. §15(7); EPAct §1803(b)). According to Staff, this burden shifts to the pipeline to defend its rates, however, once the complainants show that the existing rates are no longer grandfathered, or once complainants have made a *prima facie* case challenging existing rates. *Id*. at p. 20 (*citing SFPP, L.P.*, 80 FERC ¶ 63,014 at p. 65,190 (1997)). Staff contended that a pipeline also bears the burden of proving the justness and reasonableness of its rates whenever it submits a new rate methodology, as in the current proceeding, where, Staff continued, SFPP proposed a new methodology for allocating overhead costs. *Id*. (*citing SFPP, L.P.*, 86 FERC at p. 61,082). Staff argued that SFPP did not meet its burden of proof. *Id.*

445. Staff alleged that the new just and reasonable rate that will be established for the Oregon Line should be indexed forward, and, it continued, the burden of suggesting that those index rates be altered in the future is on the proponent. *Id*. at pp. 20-21 (*citing Revisions to Oil Pipeline Regulations Pursuant to Energy Policy Act of 1992*, Regulatory Preambles 1991-1996 ¶ 31,000 (1994)).[114]

D. SFPP, L.P.

446. Given that this is a complaint proceeding and the complainants are challenging existing rates, SFPP alleged, the Complainants bear the burden of proving all of the claims raised against SFPP's rates.[115] SFPP Initial Brief at p. 33 (*citing SFPP, L.P*., 86 FERC ¶ 61,022; Interstate Commerce Act, 49 U.S.C. §15(7); EPAct §1803(b); 18 C.F.R. § 343.2(c)(1)(2007)). Therefore, SFPP argued, the Complainants and Staff cannot prevail

[114] Staff added nothing new to its argument in reply. *See* Staff Reply Brief at p. 11.

[115] SFPP noted that Staff, along with Complainants, bears the burden of proof to the extent that it claimed that SFPP's Oregon Line rates are too high. SFPP Initial Brief at p. 33.

where they have not presented evidence supporting their allegations or where their evidence fails to meet their burden of proof. *Id*. at pp. 33-34. SFPP acknowledged that it bears the burden of proof with respect to its corporate partners meeting the 35% marginal income tax rate, and claimed that it has met this burden. *Id*. at p. 34 n.25 (*citing* Exhibit Nos. SFO-55D, SFO-57D; *SFPP, L.P.*, 117 FERC ¶ 61,285 at P 60 (2006)).

447. In its Reply Brief, SFPP stated that, while there is no dispute that a participant that challenges SFPP's filed rates bears the burden of proof under Section 13 of the Interstate Commerce Act and Section 1803 of EPAct, the Complainants and Staff raised other burden of proof issues in their initial briefs. SFPP Reply Brief at pp. 29-30 (*citing* Staff Initial Brief at pp. 19-20; Indicated Shippers Initial Brief at p. 3; CC Shippers Initial Brief at pp. 37-38). First, SFPP disagreed with Staff's contention that the burden shifts to the pipeline after a participant makes a prima face showing that rates are no longer grandfathered. *Id*. at p. 30 (*citing* Staff Initial Brief at p. 20). Because the EPAct, according to SFPP, did not alter the burden of proof under Section 13 of the Interstate Commerce Act, a complainant or Staff still has the ultimate burden to prove what the just and reasonable rate is and the reparations to which the complainant is entitled even after proving a substantial change has occurred. *Id*.

448. SFPP also rejected the Indicated Shippers argument that SFPP has the burden of proving that the indexing adjustments are just and reasonable because it filed those adjustments pursuant to Section 15(7) of the Interstate Commerce Act. *Id*. at p. 31 (*citing* Indicated Shippers Initial Brief at pp. 4-5). According to it, the issue of SFPP's rate indexing adjustments has not been properly placed into this proceeding, and this proceeding was not initiated by a protest to SFPP's indexing adjustments filed pursuant to Section 15(7), but was initiated pursuant to a complaint, and, therefore, SFPP argued, the Complainants bear the burden of proof. *Id*. (*citing* SFPP Initial Brief at pp. 33-34; *Chevron Products Co. v. SFPP, L.P.*, 114 FERC ¶ 61,133 at P 2).

449. Regarding the actual or potential income tax liability of its unitholders, SFPP admitted it has the burden of proof, and insisted that it had met this burden by presenting the evidence required to claim an income tax allowance. *Id.* at p. 32. SFPP also claimed that it calculated an income tax allowance using the Commission's established procedure. *Id*. Therefore, SFPP contended, the burden shifts to the Complainants to show that SFPP either failed in its proof or in following the Commission's procedures, or that the Commission's presumptions regarding marginal income tax rates should not apply. *Id*.

450. Because, according to SFPP, the Commission noted that it accepts overhead allocations as valid absent evidence to the contrary, SFPP argued that it does not bear the burden of justifying its use of a multi-tiered Massachusetts formula, as alleged by Staff. *Id*. at p. 33 (*citing* Staff Initial Brief at p. 20; *SFPP, L.P.*, 122 FERC ¶ 61,133 at P 15 (2008)).

Discussion and Ruling

451. All parties agree that the burden of proving that the existing rate is unjust and unreasonable is on the Complainants. See CC Shippers Initial Brief at p. 37; Indicated Shippers Initial Brief at p. 3; Staff Initial Brief at pp. 19-20; SFPP Initial Brief at p. 33. For the grandfathered portion of the rate, the CC Shippers argued, a complainant must meet the additional burden of demonstrating a substantial change in the economic circumstances that were the basis for the rate has occurred after the enactment of EPAct. CC Shippers Initial Brief at p. 38. SFPP, however, the CC Shippers contended, bears the burden of justifying that a rate increase is just and reasonable, even if due to indexing. CC Shippers Reply Brief at p. 29. They also alleged that SFPP bears the burden of proving that its unitholders have actual or potential income tax liability. CC Shippers Initial Brief at p. 38. Likewise, the Indicated Shippers argued that SFPP bears the burden of proving its claims for an income tax allowance and rate indexing. Indicated Shippers Initial Brief at pp. 3-4.

452. Staff argued that Complainants bear the burden of proving that existing rates are unjust and unreasonable, and that the burden shifts to SFPP should the Complainants show that the existing rates are no longer grandfathered. Staff Initial Brief at pp. 19-20. Moreover, Staff maintained, whenever a pipeline submits a new rate methodology, such as here, where SFPP proposes a new methodology for allocating overhead costs, the pipeline bears the burden of proving the justness and reasonableness of its rates. *Id*. at p. 20.

453. While SFPP agreed that the Complainants bear the burden of proof, it disagreed with Staff that the burden shifted to it after a showing that rates are no longer grandfathered. SFPP Reply Brief at pp. 29-30. SFPP also argued that it does not bear the burden of proof with respect to indexing adjustments because they are not a part of this complaint proceeding where Complainants have the burden of proof. SFPP Reply Brief at p. 31. Moreover, SFPP acknowledged that it has the burden or proof with regard to its unitholders' actual or potential income tax liability and claimed that it has met this burden. *Id*. at p. 32. SFPP argued that, despite Staff's contentions, it does not bear the burden of justifying its use of a multi-tiered Massachusetts formula because the Commission accepts overhead allocations as valid absent evidence to the contrary. *Id.* at p. 33.

454. Under the Interstate Commerce Act, the burden of proof is on the pipeline to show that a proposed rate change is just and reasonable. 49 U.S.C. app. §15(7). However, in the case of a complaint brought pursuant to Section 13 of that Act, the burden of proof is on the complainants to show substantially changed circumstances in the economic basis of the grandfathered rate. *See Calnev*, 121 FERC ¶ 61,241 at P 3. Once complainants make this showing, the burden shifts back to the pipeline. *See SFPP, L.P.*, 80 FERC at p. 65,190.

455. As this is a complaint case, the burden of proof to show substantially changed circumstances is on the Complainants, the Indicated Shippers and the CC Shippers. Once the Complainants make that showing, the burden shifts to SFPP to defend its rates. *See SFPP, L.P.*, 80 FERC ¶ 63,014 at p. 65,190. Furthermore, in *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 32, the Commission stated that "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." Thus, SFPP has the burden of proving that its unitholders have an actual or a potential tax liability.

456. According to Staff, after the Oregon Line's just and reasonable rate is determined, it should be indexed forward. Staff Initial Brief at p. 20. O'Loughlin also stated that he assumed the rate will be indexed forward. Transcript at p. 516. Staff claimed the burden of proposing a deviation from this indexed rate is on the proponent. Staff Initial Brief at pp. 20-21. I agree with Staff that, if a rate is challenged under Section 13 of the Interstate Commerce Act, the burden of proof is on the complainant. On the other hand, should a pipeline propose to change its rate under Section 15 of the Interstate Commerce Act, the burden of proof is on the pipeline.

457. I also agree with Staff that, as it is submitting a new rate methodology for allocating overhead costs, SFPP bears the burden of proving that the methodology is just and reasonable. Staff Initial Brief at p. 20. In *SFPP, L.P.*, 86 FERC ¶ 61,022 at p. 61,082 (1999), when SFPP presented an alternative method to the KN method for allocating indirect overhead costs, the Commission stated that "the party advancing a method that it believes is more precise has the obligation to establish that the method it proposes is preferable to the method normally applied under Commission policy." The Commission, in *Mojave Pipeline Co.*, 81 FERC ¶ 61,150 at p. 61,678 (1997), also placed the burden on the pipeline to justify the method it used to allocate its indirect overhead costs, stating that since Mojave "has clearly established that an affiliate allocation is involved here, it has met its burden justifying the use of the Distrigas method." Moreover, the Commission accepted the allocations because there was no credible challenge to Mojave Pipeline's use of the *Distrigas* method. *Id.* Here, SFPP is presenting the Commission with its own version of the Massachusetts formula. Therefore, it is clear that SFPP has the burden of justifying its use.

ISSUE III. Allowed Return: For each complaint year and for the test year used to determine rates[116] ---

A. What is the appropriate rate base?[117]

A. CC SHIPPERS

458. The appropriate rate base for calculating the 2003 North and Oregon Line costs of service, according to the CC Shippers, is the Average Net Trended Original Cost Rate Base of $28,630,000 for the North Line and $8,604,000 for the Oregon Line. CC Shippers Initial Brief at p. 39. Because SFPP included the capital costs of the North Line expansion project in the 2004 North Line rate base, the CC Shippers argued, this number would be inappropriate for use in evaluating the rates. *Id*. at pp. 39-40 (*citing* Exhibit No. CC-44 at p. 9). Specifically, they explained, since the expansion was booked in December of 2004, but the average rate base was calculated using beginning of the year and end of the year plant values, the Average Net Trended Original Cost Rate Base for 2004 was inflated relative to the amount of time the project was in service. *Id*. at p. 40.

459. In their Reply Brief, the CC Shippers argued that SFPP's contention that no Complainant has challenged the rate base calculations presented in SFPP's cost-of-service calculations is in error as the CC Shippers claimed to have made that challenge "*in their initial brief*." CC Shippers Reply Brief at p. 29 (emphasis added).

B. COMMISSION TRIAL STAFF

460. Staff noted that the same rate base is used by Staff, SFPP, and the CC Shippers for the period 1983 through 1989. Staff Initial Brief at p. 21 (*citing* Exhibit Nos. S-10 at p. 3, S-11 at p. 3, SFO-65A at p. 3, SFO-65B at p. 3, CC-5 at p. 3, CC-5 at p. 3). It claimed, however, that it used a different rate base for 2000-2003 because it reflected SFPP's Accumulated Deferred Income Taxes and O'Loughlin's adjustment to Allowance for Funds Used During Construction, each of which, according to Staff, reduced SFPP's rate base. *Id*. (*citing* Exhibit Nos. S-10 at p. 4, S-11 at p. 4, SFO-65A at p. 4, SFO-65B at p. 4, CC-5 at p. 4, CC-5 at p. 4). In its Reply Brief, Staff maintained that SFPP's 2000-2003 rate bases are incorrect because they do not reflect this reduction of rate base for the deferred taxes associated with Allowance for Funds Used During Construction. SFPP Reply Brief at p. 11.

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[116] Issues III.A through III.E are joined together for decision.

[117] The Indicated Shippers explained that they do not take a position on this issue and/or they defer to other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 5.

C. SFPP, L.P.

461. While it did not specifically address this issue in its Initial Brief, in reply, SFPP claimed that Staff's assertion that SFPP's rate base for the period 2000 through 2004 should be changed to reflect O'Loughlin's adjustment to Allowance for Funds Used During Construction should be rejected because SFPP has already shown that O'Loughlin's capital structure is flawed. SFPP Reply Brief at p. 33 (*citing* Staff Initial Brief at p. 21; SFPP Initial Brief at pp. 39-43). Moreover, SFPP argued that the CC Shippers' claim that SFPP's 2004 North Line rate base should not be used because it includes capital costs related to SFPP's 2004 North Line expansion also should be rejected because taking an average of the beginning and end of year rate base is reasonable since, it contended, rates should reflect a rate base that is representative of the property in service during the entire year. *Id*. at pp. 33-34. There is no justification, according to SFPP, for ignoring the North Line expansion, which was placed into service in December 2004, just because it was being completed as the complaints were being filed. *Id*.

B: What is the appropriate starting rate base?[118]

A. CC SHIPPERS

462. The CC Shippers stated that they do not dispute SFPP's calculation of the starting rate base for either the North or Oregon Lines. CC Shippers Initial Brief at p. 40 (*citin*g Exhibit Nos. CC-45 at p. 7, CC-46 at p. 7).

B. COMMISSION TRIAL STAFF

463. For its starting rate base, Staff stated that it used SFPP's proposed 1983 starting rate base. Staff Initial Brief at p. 21-22. This issue, according to Staff, is not contested by the participants in this proceeding. Staff Reply Brief at p. 12 (*citing* CC Shippers Initial Brief at p. 40; Indicated Shippers Initial Brief at p. 5; SFPP Initial Brief at p. 35).

C. SFPP, L.P.

464. In its Reply Brief,[119] SFPP stated that no parties contested the rate base used by SFPP in its cost-of-service calculations, and therefore, SFPP claimed, its starting rate base,

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[118] The Indicated Shippers explained that they do not take a position on this issue and/or they defer to other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 5.

[119] SFPP did not separately address Issues III.B, III.C, or III.D in it Initial Brief. *See* SFPP Initial Brief at p. 34.

as reflected in Exhibit Nos. SFO-65A, SFO-65B, SFO-67A, SFO-67B, and SFO-115 through SFO-118, should be adopted. SFPP Reply Brief at p. 34 (*citing* CC Shippers Initial Brief at p. 40; Indicated Shippers Initial Brief at p. 5; Staff Initial Brief at pp. 21-22).

C: What is the appropriate inflation-adjusted deferred return?[120]

A. COMMISSION TRIAL STAFF

465. While explaining that it did not adjust SFPP's inflation-adjusted net deferred earnings for 1983-1999, Staff stated that its capital structure differed from SFPP's for 2000-2003, causing a minor difference between SFPP and Staff's net deferred earnings. Staff Initial Brief at p. 22 (*citing* Exhibit Nos. S-10 at pp. 3-4, S-11 at pp. 3-4, SFO-65A at pp. 3-4, SFO-65B at pp. 3-4). However, Staff noted, no participant in this proceeding contested this issue. Staff Reply Brief at p. 12.

B. SFPP, L.P.

466. In its Reply Brief, SFPP noted that neither the Indicated Shippers nor the CC Shippers addressed this issue, and that Staff, according to SFPP, agreed with SFPP's inflation-adjusted net deferred earnings for the period 1983 through 1999, while acknowledging that the difference between the net deferred earnings advocated by Staff and SFPP for 2000 to 2003 is modest. SFPP Reply Brief at p. 35 (*citing* Indicated Shippers Initial Brief at p. 5; CC Shippers Initial Brief at p. 40; Staff Initial Brief at p. 22). Moreover, SFPP continued, SFPP's inflation-adjusted deferred return[121] should be adopted because, according to SFPP, the capital structure advocated by O'Loughlin and adopted by Staff is flawed. *Id.* (*citing* Exhibit No. S-1 at p. 11; SFPP Initial Brief at p. 39-34; SFPP Reply Brief Sections III.G and III.H).

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[120] The CC Shippers did not address this issue in their Initial Brief. CC Shippers Initial Brief at p. 40. The Indicated Shippers explained that they do not take a position on this issue and/or defer to other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 5.

[121] SFPP stated that its inflation-adjusted deferred return is reflected in Exhibit Nos. SFO-65A, SFO-65B, SFO-67A, SFO-67B, and SFO-115 through SFO-118. SFPP Reply Brief at p. 35.

D: What is the appropriate methodology for calculating each year's deferred return?[122]

A. CC SHIPPERS

467. SFPP's calculation of deferred return for each year, according to the CC Shippers, should correctly apply that year's appropriate capital structure. CC Shippers Initial Brief at p. 40. The CC Shippers asserted that SFPP failed to recognize that the calculation of deferred return is dependent on capital structure and will be correspondingly different when a corrected capital structure is used. CC Shippers Reply Brief at p. 30.

B. COMMISSION TRIAL STAFF

468. Staff noted that it did not adjust SFPP's methodology for calculating each year's deferred return. Staff Initial Brief at p. 22. Moreover, Staff stated that the participants do not contest this issue. Staff Reply Brief at p. 12.

C. SFPP, L.P.

469. While Staff and the Indicated Shippers did not adjust SFPP's methodology for calculating deferred return, SFPP stated, the CC Shippers claimed that this calculation should reflect the proper capital structure, which SFPP stated that it presumes to be that which O'Loughlin advocated. SFPP Reply Brief at p. 35 (*citing* Staff Initial Brief at p. 22; Indicated Shippers Initial Brief at p. 5; CC Shippers Initial Brief at p. 40). SFPP, in response, however, argued that O'Loughlin's capital structure is flawed, and that SFPP's methodology for calculating each year's deferred return should be adopted. *Id*. at pp. 35-36 (*citing* Exhibit Nos. SFO-65A, SFO-65B, SFO-67A, SFO-67B, SFO-115 through SFO-118).

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[122] The Indicated Shippers explained that they do not take a position on this issue and/or they defer to other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 5.

E: What is the appropriate amortization rate and amortization period?[123]

A. COMMISSION TRIAL STAFF

470. Staff stated that it did not adjust the SFPP amortization period. Staff Initial Brief at p. 22 (*citing* Exhibit Nos. S-10 at p. 7; S-11 at p. 7). Moreover, Staff explained that it used SFPP's amortization rate for 1983-1999 and used the CC Shippers' amortization rate for 2000-2003, to the extent that Staff considered that the rate reflected the use of the CC Shippers' capital structure adopted by Staff. *Id*. (*citing* Exhibit Nos. S-10 at p. 12, S-11 at p. 6, SFO-65A at p. 6, SFO-65B at p. 6).

471. In reply, Staff asserted that SFPP's amortization rate for 2000-2003 is in error because it does not remove purchase accounting adjustments from the equity component of Kinder Morgan's capital structure. Staff Reply Brief at p. 13.

B. SFPP, L.P.

472. SFPP, in its Initial Brief, addressed issues III.A, B, C, D, and E collectively. SFPP Initial Brief at p. 34. It explained that its cost-of-service calculations included what it believed is the appropriate rate base, starting rate base, inflation-adjusted deferred return, methodology for calculating the deferred return, amortization rate, and amortization period, all of which have been calculated, SFPP claimed, in accordance with Commission precedent. *Id*. (*citing* Exhibit Nos. SFO-65A, SFO-65B, SFO-67A, SFO-67B, SFO-115 through SFO-118). SFPP argued that, because no party has contested these cost-of-service elements, they should be adopted as set forth in the evidence submitted by SFPP in this proceeding. *Id*. at pp. 34-35 (*citing* Exhibit Nos. SFO-65A, SFO-65B, SFO-67A, SFO-67B, SFO-115 through SFO-118).

473. In its Reply Brief, SFPP explained that, while Staff agreed with SFPP's amortization period and rate for the period 1983 through 1999, SFPP contended, it used the CC Shippers' amortization rate for 2000 through 2003 because Staff maintained that the rate should reflect O'Loughlin's capital structure. SFPP Reply Brief at p. 36 (*citing* Staff Initial Brief at p. 22). SFPP, in reply, argued that capital structure has no bearing on the amortization rate or period, and that, even if it did, Williamson's capital structure is correct. *Id*. (*citing* SFPP Initial Brief at pp. 39-43; Exhibit Nos. SFO-65A, SFO-65B,

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[123] The CC Shippers did not address this issue in their Initial Brief. CC Shippers Initial Brief at p. 40. Indicated Shippers explained that they do not take a position on this issue and/or they defer to other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 5.

SFO-67A, SFO-67B, SFO-115 through SFO-118). Thus Staff's claim, according to SFPP, should be rejected. *Id.*

Discussion and Ruling

474. The issues to be resolved are: when determining allowed return for the complaint and test years, what are the appropriate rate base, inflation-adjusted deferred return, methodology for calculating each year's deferred return, and amortization rate and period?

475. The CC Shippers claimed that the appropriate rate base for use in the 2003 North and Oregon Line costs of service is the Average Net Trended Original Cost Rate Base of $28,630,000 for the North Line and $8,604,000 for the Oregon Line. CC Shippers Initial Brief at p. 39.

476. Staff explained that all parties used the same rate base for 1983 to 1999. Staff Initial Brief at p. 21. For 2000-2003, Staff argued that the rate base should reflect SFPP's ADIT and O'Loughlin's adjustment to Allowance for Funds Used During Construction. *Id*. Staff recommended a North Line 2003 rate base of $28,629,000 and an Oregon Line rate base of $8,604,000. Exhibit Nos. S-10 at p. 4, S-11 at p. 4.

477. SFPP claimed that the appropriate rate base for the North Line in 2003 is $28,640,000, found in its cost-of-service calculation in Exhibit No. SFO-65A at p. 4. SFPP Initial Brief at p. 34. For the Oregon Line, SFPP advocated a 2003 rate base of $8,606,000. *Id*. (*citing* Exhibit No. SFO-65B at p. 4).

478. All parties used the same rate base for the period from 1983 to 1999 for both the North and Oregon Lines, as reflected in SFPP's cost-of-service calculations in Exhibit Nos. S-10 at p. 3, SFO-65A at p. 3, and CC-4 at p. 3, for the North Line, and Exhibit Nos. S-11 at p. 3, SFO-65B at p. 3, and CC-5 at p. 3, for the Oregon Line. As all parties agree that the rate bases for the years 1983 to 1999 are correctly reported in the aforementioned exhibits, it must be concluded that the record supports a conclusion that they are appropriate for determining allowed return.

479. When determining the appropriate rate base, Allowance for Funds Used During Construction is taken into consideration. *See*, *e.g.*, Exhibit No. SFO-65A at p. 4. The Allowance for Funds Used During Construction calculation is dependent partially upon the equity rate of return and SFPP's capital structure. *See*, *e.g.*, Exhibit No. SFO-65A at p. 10. Therefore, in order to determine the appropriate rate base for 2003, the appropriate Allowance for Funds Used During Construction first must be calculated using the 2003 capital structure determined in Issue III.G. Once Allowance for Funds Used During Construction is calculated in accordance with the appropriate capital structure and rate of return on equity, SFPP's appropriate rate base can be calculated. No party has calculated rate base for either line for either 2003 or 2004 using both the correct rate of return on

equity and the correct capital structure in this proceeding. Therefore, SFPP must include the appropriate data in its compliance filing following a final ruling on the merits in this matter.

480. All parties are in agreement that SFPP's starting rate bases, as presented in Exhibit Nos. SFO-65A at p. 7 and SFO-65B at p. 7, are appropriate. Given the parties' acquiescence and the record, SFPP's starting rate bases for all time periods for both the North and Oregon Lines should be as recorded in the cited exhibits.

481. No party contests SFPP's inflation-adjusted net deferred earnings for the period 1983 to 1999. Staff Initial Brief at p. 22; CC Shippers Initial Brief at p. 40; Indicated Shippers Initial Brief at p. 5; SFPP Initial Brief at p. 34; Exhibit Nos. SFO-65A, SFO-65B. In view of the above, SFPP's inflation-adjusted net deferred earnings for the period from 1983 to 1999 should be as reflected in the cited exhibits.

482. However, for the period from 2000 to 2003, Staff used a different capital structure than SFPP, and thus determined net deferred earnings which differed from SFPP's. Staff Initial Brief at p. 22. While the parties did not contest the appropriate methodology for calculating each year's return, the CC Shippers stated that SFPP's calculation of deferred return is dependent upon each year's appropriate capital structure. CC Shippers Initial Brief at p. 40.

483. I agree with the CC Shippers that the methodology for determining net deferred earnings must utilize the appropriate capital structure in order for the net deferred earnings calculation to be correct. The calculation of net deferred earnings is partially dependent upon the equity ratio for the year in question. *See, e.g.* Exhibit No. S-10 at p. 6. Therefore, in order for the 2003 North and Oregon Line net deferred earnings to be correct, SFPP must utilize the equity ratio that I determine in Issue III.G (42.37%), *infra*. Both the CC Shippers and Staff utilized a 2003 equity ratio of 42.37% when determining accumulated net deferred earnings of $5,898,000 for the North Line and $1,834,000 for the Oregon Line. Exhibit Nos. S-10 at p. 6, S-11 at P 6, CC-45 at p. 6, CC-46 at p. 6. Consequently, as their calculations are consistent with my determination regarding capital structure in Issue III.G, SFPP's 2003 net deferred earnings are found to be as Staff and the CC Shippers calculated.

484. The parties do not contest the amortization period in this proceeding. Staff Initial Brief at p. 22; CC Shippers Initial Brief at p. 40; Indicated Shippers Initial Brief at p. 6; SFPP Initial Brief at p. 35. Moreover, no party contested the amortization rate for the 1983 to 1999 period. Staff Initial Brief at p. 22; SFPP Initial Brief at p. 35; CC Shippers Initial Brief at p. 40; Indicated Shippers Initial Brief at p. 6. Staff does, however, indicate that it contests the amortization rate SFPP used for the period 2000 to 2003. Staff Initial Brief at p. 22. However, after comparing the North and Oregon Line amortization rates, it appears that SFPP, Staff, and the CC Shippers are using the same rate for each line. *See*

Exhibit Nos. S-10 at p. 6, S-11 at p. 6, SFO-65A at p. 6, SFO-65B at p. 6, CC-45 at p. 6, CC-46 at p. 6. Moreover, as SFPP pointed out in its Reply Brief, and as confirmed in Exhibit No. SFO-66 at p. 105, the amortization rate is based on carrier property in service and annual depreciation expense, rather than capital structure. SFPP Initial Brief at p. 36. Because all parties are using the same amortization rate unaffected by the use of inappropriate capital structure, the appropriate 2003 amortization rate for the North Line is 2.85%, and the appropriate rate for the Oregon Line is 2.88%. *See* Exhibit Nos. S-10 at p. 6, S-11 at p. 6, SFO-65A at p. 6, SFO-65B at p. 6, CC-45 at p. 6, CC-46 at p. 6.

F: What is the appropriate treatment of Accumulated Deferred Income Taxes?[124]

A. INDICATED SHIPPERS

485. The Indicated Shippers argued that there is no such thing as ADIT for SFPP due to its partnership status. Indicated Shippers Initial Brief at p. 6. Partnerships, they claimed, have no income taxes to pay and accelerated depreciation and other deductions are flowed through to partners each year. *Id*. They alleged that there is nothing for SFPP or Kinder Morgan, as partnerships, to hold back for future taxes because all deductions and credits have been passed on, as has all cash paid to SFPP to cover future income taxes when accelerated depreciation is used. *Id*.

486. With respect to accelerated depreciation, the Indicated Shippers pointed to Sintetos's testimony that a loss in income generated by tax depreciation offsets taxable income in later years. *Id*. at p. 7 (*citing* Exhibit No. BPX-5 at p. 30). Williamson agreed, according to the Indicated Shippers, that flow-through can offset current income or can be carried forward. *Id*. (*citing* Transcript at pp. 669-70, 672-73, 921).

487. The Indicated Shippers contended that, because SFPP's ADIT account is zero since cash is flowed to the partners, shippers and consumers have overpaid SFPP. *Id.* (*citing* Exhibit Nos. BPX-50 at p. 49, SFO-65A at pp. 3-4, SFO-49 at p. 10; Transcript at pp. 934-36, 938). The overpayments, according to the Indicated Shippers, must be returned to shippers and consumers by amortizing the prepayments through rate reductions. *Id*. (*citing* Exhibit No. BPX-15 at p. 20). The Indicated Shippers stated that, through the collection of future income taxes, SFPP's partners are getting a "double dip," *i.e.*, they received allocations of both deductions and credits which offset income taxes while receiving cash to cover present and future income taxes regardless of whether there were taxes to pay. *Id*. at pp. 7-8.

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[124] The CC Shippers discussed this issue with Issue IV.E. CC Shippers Reply Brief at p. 31.

488. Further, the Indicated Shippers, claiming that there are no future taxes to pay with the money in SFPP's ADIT account and that, therefore, it is overfunded, point to SFPP witness Ganz's exhibits which, they maintained, show that shippers have paid in advance for future taxes. *Id.* at p. 8 (*citing* Exhibit Nos. SFO-65A at pp. 3-4, SFO-65B at pp. 3-4). According to them, Ganz's exhibits contradict SFPP's FERC Form 6, which they suggested indicated that zero dollars have been reserved to pay these future taxes. *Id*. at p. 8 (*citing* Exhibit No. BPX-5 at p. 3). The amount of overfunding in the account must be returned to the shippers in the form of lower rates, as required by the Commission, the Indicated Shippers contended. *Id*. (*citing Ozark Gas Transmission System*, 39 FERC ¶ 61,142 at p. 61,513 (1987); *Memphis Light, Gas & Water Div. v. FERC*, 707 F.2d 565, 572-73 (D.C. Cir. 1983)).

489. The Indicated Shippers, in their Reply Brief, acknowledged that SFPP asserted that their argument should be dismissed because in *SFPP, L.P.*, 121 FERC ¶ 61,240, the Commission already has decided the issue. Indicated Shippers Reply Brief at p. 4 (*citing* SFPP Initial Brief at p. 38). However, they asserted, *SFPP, L.P.*, 121 FERC ¶ 61,240, did not address the argument they make here, which is that "[b]ecause the deductions are flowed through each year to the partners, including accelerated depreciation, the partners already have the benefit of tax reductions." *Id*. at pp. 4-5 (*citing* Exhibit Nos. BPX-15 at pp. 27-28, BPX-32 at pp. 13-14). The Indicated Shippers contended that requiring the shippers to pay the same benefit to the partners already provided by tax deductions is a double dip that operates to increase the cash flowing to partners by allowing them to save taxes through flowed through tax depreciation while receiving a subsidy to cover taxes which they did not pay. *Id*. at p. 5 (*citing* Exhibit No. BPX-32 at p. 14).

B. COMMISSION TRIAL STAFF

490. Staff noted that its treatment of ADIT is the same as SFPP's treatment. Staff Initial Brief at p. 23 (*citing* Exhibit Nos. S-10 at pp. 3-4, S-11 at pp. 3-4, SFO-65A at pp. 3-4, SFO-65B at pp. 3-4). In its Reply Brief, Staff discussed the Indicated Shippers argument that SFPP's nature as a flow-through entity makes it unreasonable, for ratemaking purposes, to defer payment of taxes until a future date. Staff Reply Brief at p. 13 (*citing* Indicated Shippers Initial Brief at pp. 6-8). Staff argues that, in *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141, the Commission held that this argument is not sufficient to eliminate ADIT for a regulated oil pipeline. *Id.*

C. SFPP, L.P.

491. ADIT, SFPP began, reflects the timing difference between the accelerated depreciation methodology a pipeline uses for income taxes and the straight-line depreciation methodology the Commission uses for ratemaking purposes. SFPP Initial Brief at p. 35 (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 140). SFPP continued, stating that ADIT is deducted from rate base reflecting the return a carrier can earn on cash

generated by this deferred tax liability. *Id*. (*citing SFPP, L.P*., 121 FERC ¶ 61,240 at P 140)

492. According to SFPP, it calculated ADIT consistent with Ganz's calculation of the income tax allowance included in SFPP's cost-of-service pursuant to the Commission's requirement that ADIT be determined. *Id*. (*citing* Exhibit No. SFO-61 at pp. 17, 33-34). Sosnick, SFPP noted, agreed that the calculations are consistent with the Commission's holding in *SFPP, L.P*., 121 FERC ¶ 61,240. SFPP Initial Brief at p. 36 (*citing* Exhibit No. S-15 at pp. 6-7).

493. While O'Loughlin, SFPP noted, argued that SFPP's ADIT was overfunded and that SFPP was required to calculate its ADIT using the top marginal income tax rates for corporations for the years 1992 through 2003, SFPP claimed that the Commission resolved this question in *SFPP, L.P*., 121 FERC ¶ 61,240. *Id*. (*citing* Exhibit No. CC-1 at pp. 33-34). Further, SFPP asserted, CC Shippers witness O'Loughlin conceded that SFPP witness Ganz's weighted federal and state income tax rates used to determine SFPP's income tax allowance were in accordance with that Commission ruling. *Id*. at pp. 36-37 (*citing* Exhibit Nos. CC-1 at pp. 33-34, CC-44 at p. 18).

494. The Commission's decision in *SFPP, L.P*., 121 FERC ¶ 61,240, also disposed of O'Loughlin's second problem with its ADIT, according to SFPP, by rejecting O'Loughlin's argument and ruling that SFPP had properly used income tax allowances that were determined annually, from 1992 forward. *Id.* at p. 37. As its ADIT is calculated annually in accordance with the *Policy Statement on Income Tax Allowances*, insisted SFPP, the ADIT cannot reflect the top marginal income tax rates for corporations. *Id*. at p. 37 (*citing* 111 FERC ¶ 61,139).

495. According to SFPP, Crowe also contended that SFPP's ADIT were overfunded and should be credited back to shippers and also claimed that SFPP should not calculate ADIT at all because it flows income and deductions through to its partners. *Id*. at p. 38 (*citing* Exhibit Nos. BPX-15 at pp. 19-21, BPX-32 at pp. 13-14). In response, SFPP claimed that these issues already were disposed of in *SFPP, L.P*., 121 FERC ¶ 61,240 at P 141. *Id.*

496. In its Reply Brief, SFPP contended that the Indicated Shippers' argument against the inclusion of ADIT amounts to a collateral attack on Commission policy and precedent and decisions of the Circuit Court. SFPP Reply Brief at p. 37. The Indicated Shippers argued, SFPP contended, that the Commission should reject its income tax normalization policy as it applies to MLPs. *Id*. at p. 38 (*citing* Indicated Shippers Initial Brief at pp. 6, 8-9, 30; Exhibit Nos. BPX-15 at pp. 19-21, 22, BPX-32 at pp. 13-14). In support of their argument, SFPP noted that the Indicated Shippers attempted to use testimony regarding passive loss carry forwards as evidence that ADIT offsets SFPP's income, which, according to SFPP, is untrue, as SFPP does not have any passive losses. *Id*. (*citing* Indicated Shippers Initial Brief at p. 7; SFPP Reply Brief Section IV.J). Moreover, SFPP

continued, the Commission has rejected the idea that SFPP's income should be reduced by losses that originate with an entity other than SFPP, such as Kinder Morgan's partners, direct subsidiaries, or indirect subsidiaries. *Id*. at pp. 38-39 (*citing SFPP, L.P*., 121 FERC ¶ 61,240 at P 41).

497. While SFPP's FERC Form 6 reports zero ADIT, according to SFPP, which the Indicated Shippers argued is the correct treatment for ratemaking purposes, SFPP contended that the Commission nevertheless required SFPP to calculate ADIT in *SFPP, L.P*., 121 FERC ¶ 61,240 at P 141. SFPP Reply Brief at p. 39 (*citing* Indicated Shippers Initial Brief at pp. 8-9).

498. SFPP also responded to the Indicated Shippers' argument that SFPP's partners received both an allocation of deductions and credit that offset income taxes, as well as cash to cover both present and future income taxes. *Id*. (*citing* Indicated Shippers Initial Brief at pp. 7-8). This has not been proven, however, according to SFPP, and the Commission recognized that, despite the manner in which SFPP's taxable income is allocated and regardless of what offsetting adjustments are made at the Kinder Morgan, OLP-D, or public limited partner levels, SFPP has taxable income that will be allocated to those who own SFPP, OLP-D, or Kinder Morgan. *Id*. at pp. 39-40 (*citing SFPP, L.P*., 113 FERC ¶ 61,277 at P 40). SFPP submitted, therefore, that, even were taxable income allocated in one manner and deductions in another, these allocations do not change the total taxable income that SFPP generates, and thus there is no double dip. *Id*. at p. 40 (*citing SFPP, L.P*., 113 FERC ¶ 61,277 at P 43).

Discussion and Ruling

499. The question to be determined is whether a flow-through entity can accumulate deferred income taxes, and, if so, at what rate should they be collected. Further, another determination which must be made is whether SFPP's ADIT account is overfunded.

500. According to the Indicated Shippers, due to its status as a partnership which does not pay income taxes and flows through accelerated depreciation and deductions to its partners, SFPP has no ADIT. Indicated Shippers Initial Brief at p. 6. Because the ADIT account is zero, they contended, the money that shippers and consumers have overpaid must be returned to them by amortizing the prepayments through rate reductions. *Id*. at p 7.

501. Staff argued that SFPP's status as a flow-through entity is insufficient to eliminate ADIT for a regulated oil pipeline. Staff Reply Brief at p. 13.

502. According to SFPP, the Commission and the Circuit Court already have rejected the argument that SFPP cannot have ADIT because it is a partnership that does not pay income taxes. SFPP Reply Brief at pp. 37-38 (*citing SFPP, L.P*., 121 FERC ¶ 61,240 at

P 141; *ExxonMobil*, 487 F.3d at p. 955). SFPP also argued that its ADIT calculations are consistent with its income tax allowance calculations in its cost-of-service and used the same weighted federal and state income tax rates. SFPP Initial Brief at p. 35 (*citing* Exhibit No. SFO-61 at pp. 33-34, 36).

503. The Indicated Shippers are correct in noting that the books and records of SFPP do not reflect any ADIT because SFPP is a pass-through entity.[125] However, in suggesting that, because SFPP's books and records reflect a zero balance in its ADIT account, any monies it collected represent an over-payment which ought to be returned to them by amortizing payments through rate reductions, the Indicated Shippers err by ignoring the legal fiction created by the Commission and approved by the Circuit Court.

504. The Circuit Court, in *ExxonMobil*, 487 F.3d at p. 955, upheld the Commission's determination that granting pipelines an income tax allowance to the extent that the pipeline's partners incur actual or potential income tax liability is just and reasonable.[126] According to the court, "the Commission reasonably determined that such taxes are 'attributable' to the regulated entity, given that partners must pay tax on their share of the partnership income regardless of whether they actually receive a cash distribution." *Id.* The Commission also reflected this in its *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 32, where it permitted an income tax allowance for a pass-through entity if there is actual or potential income tax liability to be paid on the income earned from the entity's assets. According to the Commission, the income taxes paid by the owners of a pass-through entity are a cost of acquiring and operating the assets of that entity, just as if they were owned by a corporation. *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 33.

505. When the Circuit Court, in *ExxonMobil*, 487 F.3d at p. 955, allowed an income tax allowance for partnerships, the Commission recognized that it also resolved the issue of whether a partnership should calculate ADIT. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141. There, the Commission stated that "the partners' marginal tax rate is imputed to the partnership," and this rate is used to determine ADIT. *Id.* Moreover, the Commission noted that the *ExxonMobil* decision resolved the argument that a partnership should not be allowed ADIT because a it does not pay taxes. *Id.*

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[125] As Indicated Shippers witness Sintetos stated, "[a]ll of the income, deductions, and credits flow through each year from the partnership to the partners." Exhibit No. BPX-5 at p. 26.

[126] The background leading to the Circuit Court's affirmation of the Commission's income tax allowance policy is summarized by the Commission in *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 2-14.

506. If SFPP's partners have actual or potential income tax liability, the taxes paid by SFPP's partners are attributable to SFPP despite its status as a pass-through entity. *ExxonMobil*, 487 F.3d at 955. Thus, the argument that SFPP should not calculate ADIT due to its status as a flow-through entity that does not pay taxes has no merit. So long as its partners have tax liability which can be attributed to SFPP, court and Commission precedent requires that SFPP calculate ADIT. *See SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141; *ExxonMobil*, 487 F.3d at 955.

507. The Indicated Shippers claimed that, because SFPP's FERC Form 6 ADIT balance is zero, the cash paid by shippers for future taxes has been flowed through to SFPP's partners, and the ADIT account is overfunded. Indicated Shippers Initial Brief at pp. 7-8. SFPP argued that, because it is a flow-through entity, it does not pay income taxes itself, which explains why the ADIT account would reflect a zero balance on its FERC Form 6. SFPP Reply Brief at p. 39. As stated above, the Commission has required partnerships to calculate ADIT despite their status as a flow-through entity if their partners have actual or potential tax liability. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141. Moreover, the Commission, in *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141, did not require SFPP to adjust its accrued ADIT account or make a full accounting of the amount in the account. While SFPP may report a zero balance on its FERC Form 6 because its partners, and not SFPP as an entity, pay income taxes, SFPP is still required to calculate ADIT.

508. If SFPP used the correct tax rate when calculating ADIT, then its ADIT account is not overfunded and there are no overpayments that need be returned to the shippers. CC Shippers witness O'Loughlin claimed that SFPP's ADIT should be calculated using the top marginal income tax rates for corporations for the years 1992 to 2003. SFPP Initial Brief at p. 36 (*citing* Exhibit No. CC-1 at pp. 34-35). The Commission, however, determined that the partners' weighted marginal tax rate should be used to calculate ADIT. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 23, 141. Moreover, the Commission decided that it was wrong to keep tax rates constant when calculating ADIT from year to year, finding that SFPP was correct in using an income tax allowance component in the ADIT calculation which was adjusted annually. *Id*. at P 143-144.

509. SFPP witness Ganz used the weighted federal and state income tax rates that were used in calculating SFPP's income tax allowance to calculate ADIT. SFPP Initial Brief at pp. 36-37. According to him, as SFPP's weighted income tax rate changes from year to year, ADIT becomes over- or under-funded. Exhibit No. SFO-61 at p. 33. In order to account for the over- and under-funding, Ganz explained, the over- and under-funded amounts are amortized and then used to adjust SFPP's income tax allowance. *Id*. at pp. 33-34. I find that O'Loughlin's claim that SFPP should determine its ADIT using the top marginal income tax rates is inconsistent with the Commission's determination that ADIT should be calculated using SFPP's partners' weighted marginal tax rates. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 23. Ganz complied with the Commission's determination in using the weighted federal and state income tax rates that are used to calculate SFPP's

income tax allowance. Therefore, it must be concluded that SFPP's treatment of its ADIT account is in compliance with Commission precedent.

G: What is the appropriate capital structure?[127]

A. CC SHIPPERS

510. The CC Shippers contended that Kinder Morgan's December 31, 2003, capital structure, which they argued should be adjusted for purchase accounting adjustments to be in compliance with established precedent, should be used for evaluating the North and Oregon Line rates because Kinder Morgan provides the financing for SFPP's operations. CC Shippers Initial Brief at p. 41 (*citing* Exhibit Nos. CC-44 at p. 10, SFO-12 at pp. 29-30; *SFPP, L.P.*, 86 FERC ¶ 61,022 at p. 61,097; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65-67). No adjustments are needed, the CC Shippers continued, for the capital structures prior to 2000. *Id*. (*citing* Exhibit No. CC-44 at p. 10).[128]

B. INDICATED SHIPPERS

511. Regarding capital structure, the Indicated Shippers claimed that it is appropriate to exclude purchase accounting adjustments and goodwill.[129] Indicated Shippers Initial Brief at p. 9. In their Reply Brief, they contended that both purchase accounting adjustments, as held by the Commission in *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65-66, and goodwill make equity on the balance sheet appear larger than it is. Indicated Shippers Reply Brief at p. 6 (*citing* Exhibit No. BPX-1 at pp. 10-11). With their removal, the Indicated Shippers stated, Kinder Morgan's capital structure for 2003 is 65% debt and 35% equity, while, for 2004, the debt/equity ratio is 61% to 39%. Indicated Shippers Initial Brief at p. 10. (*citing* Exhibit Nos. BPX-32 at p. 7, BPX-33). Because SFPP is not a stand-alone entity, they continued, Kinder Morgan's capital structure is used since the Commission determined it is appropriate to use the responsible parent entity's capital structure in this situation. *Id*. (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 100; *ExxonMobil v. Calnev Pipeline*, 120 FERC ¶ 61,075 at P 11-12 (2007)).

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[127] Issues III.G and III.H are joined together for decision.

[128] The CC Shippers added no new arguments in their Reply Brief. *See* CC Shippers Reply Brief at p. 31.

[129] The Indicated Shippers defined goodwill as the amount a purchaser paid for acquiring a company in excess of the market value of the assets written up to market under the purchase accounting adjustments. Indicated Shippers Initial Brief at pp. 9-10 (*citing* Exhibit No. BPX-1 at p. 13). They claimed that purchase accounting adjustments represent "nothing more than the opinion of some 'expert' as to the 'market value' of assets above their depreciated cost on the books of the acquired company." *Id.*

512. In order to determine Kinder Morgan's capital structure, the Indicated Shippers explained, Crowe used the long-term debt and partners' capital reported on Kinder Morgan's 2003 and 2004 SEC Form 10Ks and removed the purchase accounting adjustments and goodwill, both of which are write-ups which inflate the equity portion of the balance sheet, according to the Indicated Shippers, and, they claimed, are thus not permitted by the Commission to be included in an oil pipeline's rate base. *Id*. (*citing* Exhibit No. BPX-15 at p. 4; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65-66).

C. COMMISSION TRIAL STAFF

513. In Staff's Initial Brief, it explained that, for purposes of trended original cost ratemaking, the significant period was 1983 to the earlier of the Complaint Year or the year when the starting rate base is fully depreciated. Staff Initial Brief at p. 23 (*citing Williams Pipeline Company*, 31 FERC at p. 61,836). Staff noted that it, SFPP and the CC Shippers used the same capital structures for 1983-1999, but that beginning in 2000 they differ. *Id*. (*citing* Exhibit Nos. S-10 at pp. 5-6, S-11 at pp. 5-6, CC-4 at pp. 5-6, CC-5 at pp. 5-6, SFO-65A at pp. 5-6, SFO-65B at pp. 5-6).

514. For the years 2000-2003, Staff believed that the appropriate capital structure for calculating SFPP's just and reasonable rate for 2003 is 57.63% debt and 42.37% equity, as set forth by the CC Shippers, which Staff contended properly included the removal of purchase accounting adjustments from the equity component. *Id*. at pp. 23-24 (*citing* Exhibit Nos. S-11 at p 2, S-3 at p. 2, CC-1 at p. 8). Because, according to Staff, Kinder Morgan purchased SFPP in excess of book value net of depreciation of SFPP's assets, it made an upward purchase account adjustment to the net book value of those assets in order to account for that premium it paid. *Id*. at p. 24 (*citing* Exhibit No. CC-1 at p. 9; Transcript at pp. 701-702). This purchase accounting adjustment, Staff continued, is not appropriate for cost-of-service ratemaking unless there is a showing that it benefits ratepayers. *Id*. (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65; *SFPP, L.P.*, 111 FERC ¶ 61,344 at P 67; *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 79-80). Since SFPP did not make such a showing, Staff claimed, the just and reasonable value of the SFPP assets is their net book value. *Id*. Moreover, once the purchase accounting adjustments are removed, a deduction should be made from the equity component of SFPP's capital structure, Staff added, so that balance sheet liabilities and owners equity match assets. *Id*. at pp. 24-25 (*citing* Exhibit No. CC-1 at pp. 9-10).

515. In its Reply Brief, Staff noted that, in a recent SFPP case, the presiding judge found that Commission policy requires that SFPP remove purchase accounting adjustments from the equity component of capital structure for ratemaking purposes. Staff Reply Brief at p. 14 (*citing SFPP, L.P.*, 116 FERC ¶ 63,059 at P 82 (2006)). Staff, addressing SFPP's argument that removing purchase accounting adjustments only from equity does not make sense since a purchase could have been financed with debt, pointed out that the instant

record does not support such an argument since SFPP did not adduce evidence of how the acquisitions were financed. *Id*. at pp. 14-15.

D. SFPP, L.P.

516. SFPP disagreed that purchase accounting adjustments and goodwill should be removed from the equity component of Kinder Morgan's capital structure. SFPP Initial Brief at p. 39. It claimed that Jennings noted, at the hearing, that neither debt nor equity would be affected by an acquisition for cash and that SFPP witness Gary L. Prim had stated that there is no connection between goodwill and Kinder Morgan's acquisition of SFPP. *Id*. at p. 40 (*citing* Transcript at pp. 275, 285; Exhibit Nos. SFO-81 at p. 5, SFO-96, SFO-97, SFO-98). The capital structure ratios advocated by SFPP, according to it, were derived for years 1984-1994 from the Commission-accepted Compliance Filing associated with *SFPP, L.P.*, 86 FERC ¶ 61,022, and from the March 6, 2006, Compliance Filing made in connection with *SFPP, L.P.*, 113 FERC ¶ 61,277. *Id*. at p. 39 (*citing* Exhibit Nos. SFO-12 at pp. 28-29, SFO-14 at p. 2, SFO-19 at p. 1).

517. In its Reply Brief, for the years 1983 through 1999, SFPP asserted, it used the same capital structure as both the CC Shippers and Staff, but Staff used the CC Shippers' capital structure advocated by O'Loughlin for the years 2000 through 2003. SFPP Reply Brief at p. 40 (*citing* Staff Initial Brief at p. 23). This capital structure is flawed, according to SFPP, because it excludes purchase accounting adjustments from the equity component. *Id.* at p. 40. SFPP also noted that the Indicated Shippers removed not only purchase accounting adjustments from the equity component, but also suggested that goodwill should be excluded on Kinder Morgan's balance sheet. *Id*. (*citing* Indicated Shippers Initial Brief at pp. 9-11).

518. According to SFPP, if an oil pipeline does not provide its own financing, the Commission will use the parent company's capital structure, or, if the parent company's capital structure is anomalous to the capital structures of the proxy companies used in the DCF analysis and capital structures approved for other regulated pipelines, then the Commission averages actual market-tested capital structures of comparable firms to determine hypothetical capital structure. *Id*. at p. 41 (*citing BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287 at P 174 (2008)). These capital structures, SFPP continued, are not adjusted for purchase accounting adjustments or goodwill, and whether capital structures are actual or hypothetical, SFPP added, the Commission's model is market-determined. *Id*. (*citing SFPP, L.P.*, 96 FERC ¶ 61,281 at p. 62,068 (2001)). It also suggested that, by removing purchase accounting adjustments and goodwill, the Complainants and Staff argued for abandoning the use of actual capital structures for a hypothetical capital structure determined by arbitrarily reducing equity, SFPP contended. *Id*. at pp. 41-42 (*citing* CC Shippers Initial Brief at pp. 41-43; Staff Initial Brief at pp. 23-26; Indicated Shippers Initial Brief at pp. 9-12). SFPP argued that no hypothetical structure needs to be determined because Kinder Morgan's capital structure is not anomalous, and, SFPP added,

there is no evidence that the purchase accounting adjustments and goodwill were even funded entirely or partially with equity. *Id.* (*citing* SFPP Initial Brief at pp. 41-42). SFPP alleged that Kinder Morgan's capital structure meets a market-determined standard which investors use to determine the risk of investing in or lending to Kinder Morgan. *Id*. By removing purchase accounting adjustments and goodwill from equity, SFPP continued, the market-based standard for determining capital structure is abandoned. *Id*.

519. SFPP explained that the Indicated Shippers' argument that Kinder Morgan records asset balances for goodwill, which is not really an asset, was undermined when their witness contradicted this argument by agreeing with the Financial Accounting Standards Board's definition of goodwill. *Id.* at pp. 43-44 (*citing* Indicated Shippers Initial Brief at pp. 11-12; Transcript at pp. 268, 273-74). The definition, according to SFPP, characterizes goodwill as an asset that represents future economic benefit to a company on whose balance sheet it resides. *Id*. at p. 44 (*citing* Exhibit No. SFO-94 at p. 8; Transcript at pp. 268, 273-74).

520. After testifying that purchase accounting adjustments and goodwill flow directly to equity on the balance sheet, Jennings later acknowledged on cross-examination that neither the debt nor the equity on the balance sheet would be affected by a hypothetical acquisition for cash, SFPP pointed out. *Id*. (*citing* Exhibit No. BPX-15 at p. 5; Transcript at p. 275). Additionally, SFPP noted that the Indicated Shippers did not provide evidence that the goodwill to be removed from equity was funded partially or entirely with equity. *Id*.

521. Lastly, SFPP asserted that the Indicated Shippers failed to cite to any Commission precedent that supports the removal of goodwill from equity because, SFPP contended, the Commission has never required that goodwill be removed from the debt or equity component of capital structure. *Id*. at p. 45.

H: What if any are the appropriate Purchase Accounting Adjustments?

A. CC SHIPPERS

522. While purchase accounting adjustments may be compatible with generally accepted accounting principles, according to the CC Shippers, they noted that they are not compatible with Commission ratemaking principles because they increase the weight of the equity component in the cost-of-service which increases the cost-of-service, and therefore adversely affects the ratepayers. CC Shippers Initial Brief at pp. 41-42 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 64-65; *SFPP, L.P.*, 114 FERC ¶ 61,136 at P 14-15 (2006)). Unless they specifically benefit ratepayers, the CC Shippers continued, the purchase accounting adjustments cannot be included in rates. *Id*. at p. 42 (*citing SFPP, L.P.*, 111 FERC ¶ 61,334 at P 67). Here, the CC Shippers argued, there has been no

showing that they provide a specific benefit to ratepayers and, therefore, four accounting adjustments should be removed. *Id*.

523. The CC Shippers attacked Williamson's argument that removing purchase accounting adjustments distorts the capital structure by suggesting that he focuses on capital structure from an accounting standpoint, which interests investors, rather than on capital structure from a ratemaking standpoint, which is relevant to the Commission. *Id*. at pp. 42-43 (*citing* Exhibit No. SFO-12 at p. 31-33; *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 61, 66, 67; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65 n.93).

524. Lastly, the CC Shippers argued that it is appropriate to make these adjustments only to the equity side of capital structure because debt has first claim on the value of the assets. *Id*. at p. 43. Further, they noted, if a purchase accounting adjustment increases the value of an asset above original cost, then that increase, in its entirety, will impact the equity balance. *Id*. (*citing* Exhibit No. CC-44 at pp. 12-13).

525. In their Reply Brief, the CC Shippers asserted that, while SFPP claimed that Jennings was the only witness to present evidence in support of the removal of purchase accounting adjustments, it ignored CC Shippers witness O'Loughlin's Direct and Rebuttal Testimony regarding this issue, and further noted that SFPP failed to cross-examine him on the issue. CC Shippers Reply Brief at p. 32 (*citing* Exhibit Nos. CC-1 at pp. 7-10, CC-44 at pp. 10-13). Moreover, the CC Shippers explained, as the difference between O'Loughlin and SFPP's capital structures is about 3.5%, removing purchase accounting adjustments does not distort Kinder Morgan's capital stricture to the degree that SFPP suggested. *Id*. (*citing* SFPP Initial Brief at pp. 41-43; Exhibit Nos. SFO-65A at p. 2, CC-45 at p. 2).

526. The Commission, according to the CC Shippers, rejected SFPP's claims that removing purchasing accounting adjustments from capital structure would alter an investor's perceived level of risk and concluded that the purchase accounting adjustment associated with the acquisition of SFPP should be removed from the capital structure, as should any other jurisdictional purchase accounting adjustments because there was no evidence that they were benefitting ratepayers. *Id*. at pp. 32-33 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65; *SFPP, L.P.*, 114 FERC ¶ 61,136 at P 14, 15 (2006)).

B. INDICATED SHIPPERS

527. The Indicated Shippers agreed that purchase accounting adjustments should not be included in SFPP's rates. Indicated Shippers Initial Brief at p. 11. Write-ups, such as purchase accounting adjustments and goodwill, according to the Indicated Shippers, function as internal valuation mechanisms, but do not represent hard asset values dedicated to public utility service, and thus should not be included for ratemaking purposes. *Id*. at p. 11 (*citing* Exhibit No. BPX-1 at pp. 13-14). Ratepayers, they

contended, do not receive an economic benefit from Kinder Morgan's goodwill and will not receive an economic benefit from it in the future. *Id*. at p. 12.[130]

C. COMMISSION TRIAL STAFF

528. Staff argued that purchase accounting adjustments should be removed from the equity component of the capital structure used for SFPP, as was done in the 2000-2003 capital structure used by the CC Shippers to compute 2003 costs of service for the North and Oregon Lines. Staff Initial Brief at p. 25 (*citing* Exhibit Nos. S-11 at p. 2, S-3 at p. 3, CC-1 at p. 8; *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 79-80; *SFPP, L.P.*, 111 FERC ¶ 61,344; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65). Staff did not calculate the level of purchase accounting adjustments because it relied upon the CC Shippers for purposes of developing the capital structure. Staff Reply Brief at p. 15.

D. SFPP, L.P.

529. SFPP argued that there is no evidence to justify removing purchase accounting adjustments from the equity component of Kinder Morgan's capital structure while leaving debt unchanged. SFPP Initial Brief at p. 40 (*citing* Exhibit Nos. CC-1 at pp. 8-10, CC-44 at pp. 10-13, BPX-15 at pp. 4-5, S-1 at p. 11). According to SFPP, the only evidence presented by Complainants on this point was a hypothetical contained in Jennings' testimony which, it claimed, was undermined by her admission during cross-examination "that accounting for an acquisition for cash that includes entries for both goodwill and a purchase accounting adjustment will result in no change whatsoever to the debt and equity amounts on the balance sheet." *Id*. at pp. 40-41 (*citing* Exhibit Nos. BPX-15 at pp. 14-15, SFO-96, SFO-97, SFO-98; Transcript at p. 285).

530. Furthermore, SFPP added, it does not make sense to remove purchase accounting adjustments solely from equity when there is no way to determine whether the purchase accounting adjustments have been funded solely with equity issuances. *Id*. at pp. 41-42 (*citing* Exhibit Nos. SFO-24 at pp. 161, 184, 202, SFO-12 at p. 33). In addition, SFPP maintained that removing the purchase accounting adjustments, in turn decreasing equity, distorts the capital structure so that it is no longer the actual balance sheet capital structure that the investment community uses to assess risk, and contradicts the Commission's policy of relying on the actual balance sheet capital structure of the company. *Id*. at pp. 42-43 (*citing* Exhibit No. SFO-12 at p. 33).

531. Both the CC Shippers and Staff, SFPP argued in its Reply Brief, confused the treatment of purchase accounting adjustments for rate purposes, where they are properly

[130] In their Reply Brief, the Indicated Shippers combined their arguments related to Issue III.H with their arguments related to the previously discussed Issue III.G. *See* Indicated Shippers Reply Brief at pp. 5-6.

excluded, and their treatment for capital structure purposes. SFPP Reply Brief at pp. 45-46 (*citing, e.g.*, CC Shippers Initial Brief at p. 42; Staff Initial Brief at pp. 24-25). The effects of purchase accounting adjustments on rate base and capital structure are not comparable, SFPP contended. *Id*. at p. 46.

Discussion and Ruling

532. All of the parties use the same capital structure for the 1983 through 1999 period. *See* Staff Initial Brief at p. 23; SFPP Reply Brief at p. 40. Moreover, while they agree that the capital structure of SFPP's parent entity, Kinder Morgan, should be used for the year 2003, SFPP contended that purchase accounting adjustments and goodwill should not be excluded from the equity component of Kinder Morgan's capital structure, while the other parties disagree.

533. The CC Shippers argued that Kinder Morgan's December 31, 2003, capital structure, adjusted for purchase accounting adjustments, should be used for evaluating 2003 North and Oregon Line rates because Kinder Morgan provides the financing for SFPP's operations. CC Shippers Initial Brief at p. 41. They recommended using a 2003 capital structure of 57.63% debt and 42.37% equity. *Id*. (*citing* Exhibit Nos. CC-1 at p. 8, CC-6). The Indicated Shippers agreed that Kinder Morgan's capital structure, with purchase accounting adjustments and goodwill excluded, should be used because SFPP is not a stand-alone entity. Indicated Shippers Initial Brief at p. 10. They recommended a 2003 capital structure of 65% debt and 35% equity and a 2004 capital structure of 61% debt and 39% equity. *Id*. (*citing* Exhibit No. BPX-33). Staff recommended the same capital structure as the CC Shippers and also advocated removing purchase accounting adjustments from the equity component. Staff Initial Brief at p. 24. SFPP, on the other hand, argued that purchase accounting adjustments and goodwill should not be removed from the equity component of capital structure. SFPP Initial Brief at p. 39. SFPP's recommended 2003 capital structure is 54.07% debt and 45.93% equity, and its recommended 2004 capital structure is 52.03% debt and 47.97% equity. Exhibit No. SFO-20.

534. In addition to the parties' agreement on this point, the record clearly establishes that Kinder Morgan's capital structure should be used for SFPP. Indicated Shippers witness Crowe explained that a public utility that is not a stand-alone entity, like SFPP, uses the debt/equity ratio of its parent entity, or the entity responsible for the public utility's debts and which "secures or provides the borrowed capital used by the regulated company." Exhibit No. BPX-15 at p. 3. CC shippers witness O'Loughlin and SFPP witness Williamson testified that SFPP's operations were financed by Kinder Morgan, its parent company. Exhibit Nos. CC-1 at pp. 7-8, SFO-12 at p. 30. Commission precedent supports using the capital structure of a parent when a company's own capital structure is not appropriate, if the parent's capital structure is "reasonable when compared to the equity ratios of the proxy companies and equity ratios accepted by the Commission in

other proceedings." *Michigan Gas Storage Company*, 87 FERC ¶ 61,038 at p. 61,157 (1999). According to O'Loughlin, Kinder Morgan's actual capital structure is consistent with the capital structure of four proxy oil pipelines used by SFPP when determining return on equity. Exhibit No. CC-1 at p. 8. It follows, therefore, that Kinder Morgan's 2003 capital structure should be used for evaluating SFPP's North and Oregon Line rates.

535. The CC Shippers, Indicated Shippers, and Staff all argued that purchase accounting adjustments should be removed from the equity component of Kinder Morgan's capital structure. The Commission has held that ratepayers will be impacted if purchase accounting adjustments are not removed. *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 64. Specifically, the debt to equity ratio impacts the total dollars billed to the ratepayers "because a greater equity component increases the relative weight of the equity component in the cost-of-service." *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 64 n.92.

536. While an oil pipeline is required to include purchase accounting adjustments for reporting purposes on its FERC Form 6, including purchase accounting adjustments is impermissible for ratemaking purposes. *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65. The Commission sets forth a standard for including the purchase accounting adjustments, holding that they must be removed unless they provide "new service or substantial benefits" to ratepayers. *Id*. Without a specific showing of benefits to ratepayers, the purchase accounting adjustment may not be reflected in rates. *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 67. The CC Shippers, Indicated Shippers, and Staff argued that, in the instant proceeding, SFPP has not provided evidence of a specific benefit to its ratepayers and that, without this showing, Kinder Morgan's capital structure should be adjusted for purchase accounting adjustments. *See* CC Shippers Initial Brief at p. 42; Indicated Shippers Initial Brief at p. 12; Staff Initial Brief at p. 24. I agree that SFPP has not presented any evidence establishing that its ratepayers received a substantial benefit that would warrant retaining the purchase accounting adjustments included in Kinder Morgan's capital structure and, consequently, has failed to prove that any such benefit exists.

537. The Indicated Shippers advocated removing not only purchase accounting adjustments, but also goodwill. Indicated Shippers Initial Brief at p. 9. They explained that goodwill is a write-up of assets, essentially the same as a purchase accounting adjustment. *Id*. at pp. 10, 12. Because the Commission does not allow a write-up of assets to be included for ratemaking purposes, they argued, goodwill, like purchase accounting adjustments, should be removed. *Id*. at pp. 10, 12 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65-66).

538. Goodwill, however, is not a write-up like a purchase accounting adjustment, but instead, on a balance sheet, represents the acquisition of an additional intangible asset of value that has future economic benefit. Exhibit No. BPX-34 at p. 2. More specifically, as

defined by the Financial Accounting Standards Board,[131] 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." Exhibit No. SFO-94 at p. 8. As an asset, goodwill should not be removed from capital structure in the same manner as a purchase accounting adjustment. The Commission's determinations of the treatment of purchase accounting adjustments cannot be extended to goodwill because purchase accounting adjustments and goodwill are not comparable.

539. In view of the above, Kinder Morgan's 2003 capital structure of 57.63% debt and 42.37% equity should be used for evaluating 2003 North and Oregon Line rates. This capital structure reflects the removal of purchase accounting adjustments from the equity portion of capital structure, but is not adjusted for goodwill. Moreover, for 2004, SFPP's capital structure of 52.03% debt and 47.97% equity should be adjusted for purchase accounting adjustments.

I: What is the appropriate cost of debt?

A. CC SHIPPERS

540. The CC Shippers explained that, because Kinder Morgan's capital structure is used to calculate North and Oregon Line costs of service, its cost of debt should also be used when evaluating SFPP's rates. CC Shippers Initial Brief at p. 43.

541. O'Loughlin calculated a 2003 cost of debt for Kinder Morgan of 6.15%, which included debt instruments[132] that Kinder Morgan treats as long-term debt for determining capital structure on its 2003 SEC Form 10-K, while SFPP, the CC Shippers alleged, erroneously left these out of its calculation. *Id*. at pp. 43-44 (*citing* Exhibit Nos. CC-1 at pp. 10-11, CC-9, CC-44 at pp. 13-15, SFO-12 at pp. 37-40, SFO-23 at p. 1, CC-10 at pp. 9-17). Because, the CC Shippers argued, Kinder Morgan included these amounts as long-term debt in its capital structure, in order to follow Commission decisions, they must be included in SFPP's cost of debt calculation. *Id*. at p. 44 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 69; *SFPP L.P.*, 116 FERC ¶ 63,059 at P 87).

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[131] The Financial Accounting Standards Board is the "designated organization in the private sector for establishing standards of financial accounting and reporting" which "govern the preparation of financial reports." Exhibit No. SFO-93 at p. 1.

[132] The CC Shippers listed these debt instruments as the weighted cost of Kinder Morgan's commercial paper debt, Economic Development Revenue Refunding Bonds, Industrial Revenue Bonds, and OLP-B specific bonds. CC Shippers Initial Brief at pp. 43-44.

542. In their Reply Brief, the CC Shippers contended that the cases SFPP used to support its exclusion of commercial paper as short-term debt are not controlling authority in this proceeding because the Commission has directly addressed the issue of short-term debt as it pertains to SFPP and Kinder Morgan specifically. CC Shippers Reply Brief at p. 33 (*citing Trailblazer Pipeline Co.*, 106 FERC ¶ 63,005 (2004); *Old Dominion Electric Coop.*, 70 FERC ¶ 62,065 (1995)). According to them, the Commission determined that short-term debt which is treated by Kinder Morgan as long-term debt should be included in the rate of return calculation. *Id*. (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 69). Moreover, the CC Shippers added, despite SFPP's claims, Economic Development Revenue Refunding Bonds, OLP-B specific bonds, and Industrial Revenue Bonds should be included as long-term debt because Kinder Morgan treats them as so. *Id*. at p. 34 (*citing* SFPP Initial Brief at p. 46; Exhibit Nos. CC-3, CC-44 at pp. 14-15, CC-10 at pp. 13-15; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 69).

B. INDICATED SHIPPERS

543. In 2007, after the buy-out of Kinder Morgan, Inc., Kinder Morgan's bond rating was downgraded by debt-rating agencies, the Indicated Shippers reported. Indicated Shippers Initial Brief at p. 13. Because a full category downgrade results in a cost of debt decrease of 20 basis points, Kinder Morgan's cost of debt should be decreased from 6.26% to 6.19%, according to the Indicated Shippers. *Id*. (*citing* Exhibit No. BPX-15 at pp. 20-22).

544. According to the Indicated Shippers, debt that has no function in providing a public utility service, when added to debt that does, increases the overall cost of debt. *Id*. at p. 13. Moreover, they continued, ratepayers should not subsidize debt costs that are incurred solely for the benefit of the public utility owner, in this case, to Kinder Morgan, and should not pay more than the interest that would be charged on the public utility debt alone. *Id*. Therefore, the Indicated Shippers suggested, the cost of debt should be decreased to 6.19% to account for the increase in interest rates so that ratepayers do not subsidize the equity investors' debts. *Id*. at p. 14 (*citing Puget Energy, Inc.*, 123 FERC ¶ 61,050 at P 27 (2008)).[133]

C. COMMISSION TRIAL STAFF

545. Staff adopted the CC Shippers' 6.15% cost of debt, which includes short-term commercial paper as long-term debt because Kinder Morgan treats the commercial paper as long-term debt. Staff Initial Brief at p. 26 (*citing* Exhibit Nos. S-10 at p. 2, S-11 at p. 2, CC-1 at p. 11).

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[133] The Indicated Shippers added nothing in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 7.

546. In its Reply Brief, Staff argued that SFPP erred in claiming that Kinder Morgan's representation to the Securities and Exchange Commission that it intends, and is able, to refinance short-term debt on a long-term basis does not mean that the short-term debt is long-term debt for purposes of capital structure. Staff Reply Brief at p. 16 (*citing* Exhibit No. CC-1 at p. 11). According to Staff, "[t]his representation is not about an intention, capability or future event; rather, it is a representation about a then-present fact, namely that in 2003 SFPP in fact considered the short-term debt the same as long-term and in fact treated it as such in its 2003 consolidated balance sheet." *Id*. Based on Kinder Morgan's representation, Staff assumed that the short-term debt does not fluctuate on a yearly basis, and thus recommended that $428 million of debt be considered as part of SFPP's capital structure. *Id*.

D. SFPP, L.P.

547. While the Complainants and Staff supported the inclusion of commercial paper short-term debt in the cost of long-term debt, SFPP contended that it should be excluded in accordance with Commission precedent. SFPP Initial Brief at p. 44 (*citing Old Dominion Electric Coop.*, 70 FERC at p. 64,187). According to SFPP, in that case, the Commission held that all debt having maturities of not more than one year from the date of issuance be considered short-term debt, including commercial paper with a maturity of not more than one year. *Id*.

548. In addition, SFPP insisted that the Complainants erred in including tax-exempt and special purpose bonds in their cost of debt calculations because these bonds were used to finance other projects and were thus unavailable to finance the North or Oregon Line rate bases. *Id*. at p. 46 (*citing* Exhibit Nos. CC-1 at pp. 10-11, CC-44 at pp. 13-15, BPX-15 at p. 6, BPX-17, SFO-12 at pp. 38-39; *SFPP, L.P.*, 116 FERC ¶ 63,059 at P 88 (2006)).

549. Responding to the Indicated Shippers' argument that Kinder Morgan's credit rating downgrade by Moody's in 2007 had an effect on the 2003 and 2004 costs of debt, SFPP contended that a downgrade does not necessarily lead to a higher cost for a subsequent issuance of debt, and it could not affect the cost of debt as far back in time as 2003 and 2004. *Id*. at pp. 46-47 (*citing* Exhibit Nos. BPX-15 at p. 6, SFO-12 at p. 39; Transcript at pp. 695-96).

550. In its Reply Brief, SFPP stated that, because including short-term commercial paper debt in the cost of long-term debt would be contrary to existing precedent, it should be excluded. SFPP Reply Brief at pp. 46-47 (*citing* SFPP Initial Brief at pp. 44-46). Even though the CC Shippers and Staff argued that Kinder Morgan classifies commercial paper as long-term debt, and its 2003 SEC Form 10-K indicated that Kinder Morgan planned to refinance short-term debt on a long-term basis, SFPP asserted that these positions have been rejected by the Commission. *Id*. at p. 47 (*citing* CC Shippers Initial Brief at p. 44; Staff Initial Brief at p. 26; Exhibit Nos. CC-1 at p. 11, CC-44 at p. 14). The commercial

paper at issue in the current proceeding, SFPP noted, has maturity dates of one year or less and interest rates that do not represent long-term debt. *Id*. at p. 48 (*citing* Exhibit Nos. SFO-23, SFO-24 at pp. 223, 240). Moreover, SFPP asserted that commercial paper is not useful in settling future rates because its level and interest rate fluctuate. *Id.* (*citing* Exhibit Nos. SFO-23, SFO-24 at pp. 223, 240).

Discussion and Ruling

551. The appropriate cost of debt depends upon whether commercial paper debt and special purpose bonds should be included in the cost of Kinder Morgan's long-term debt. Also at issue is whether a downgrade of Kinder Morgan's bond rating should affect its cost of debt.

552. According to the CC Shippers, Kinder Morgan's December 31, 2003, cost of debt should be used when calculating the North and Oregon Line costs of service. CC Shippers Initial Brief at p. 43. The cost of debt they recommended is 6.15% and includes certain debt instruments which Kinder Morgan includes as long-term debt in its capital structure. *Id*. at pp. 43-44. Staff adopted the CC Shippers' 6.15% cost of debt, which includes short-term commercial paper as long-term debt, an inclusion Staff supports because Kinder Morgan treats the commercial paper as long-term debt. Staff Initial Brief at p. 26.

553. The Indicated Shippers argued that Kinder Morgan's cost of debt of 6.19% should be used for calculating North and Oregon Line costs of service, a figure which represents the downgrade of Kinder Morgan's bond rating by debt-rating agencies in 2007 and accounts for the increase in interest rates caused to this downgrade. Indicated Shippers Initial Brief at pp. 13-14.

554. SFPP recommended that the same costs of debt as set forth in the *SFPP, L.P.*, 91 FERC ¶ 61,135 and *SFPP, L.P.*, 113 FERC ¶ 61,277, Compliance Filings be used for 1984 through 1994 and 1995 through 1999. SFPP Initial Brief at p. 43. It advocated a 2003 cost of debt of 6.77%. Exhibit No. SFO-23. SFPP contended that neither commercial paper, which is short-term in nature, nor tax-exempt and special purpose bonds should be included in the cost of long-term debt calculations. SFPP Initial Brief at pp. 44-45. Moreover, according to SFPP, Kinder Morgan's bond rating downgrade in 2007 does not necessarily lead to a higher cost of debt, as argued by the Indicated Shippers, and could not affect cost of debt in 2003 and 2004. *Id*. at pp. 46-47.

555. All parties agreed that Kinder Morgan's cost of debt should be used when calculating the North and Oregon Line costs of service. When a subsidiary uses its parent company's capital structure, as SFPP does, it is Commission policy to also use the parent company's cost of debt. *Enbridge Pipelines*, 100 FERC ¶ 61,260 at P 97 (2002); *Michigan Gas Storage Co.*, 87 FERC ¶ 61,038 at p. 61,166.

556. Debt having a maturity date of not more than one year from the date of issuance is considered short-term debt, while debt having a maturity date beyond one year from the date of issuance is considered long-term debt. *Old Dominion Electric Coop.*, 70 FERC ¶ 62,065 at P 64,187. The cost of debt used in a rate proceeding is usually limited to long-term debt, although there are exceptions. *Pacific Gas Transmission Co.*, 43 FPC 837 (1970). While commercial paper debt is short-term in nature, Kinder Morgan treats some commercial paper as long-term debt.[134] Exhibit No. CC-10 at p. 10. Therefore, according to O'Loughlin, he considered $428.1 million of commercial paper debt to be long-term debt when determining Kinder Morgan's cost of debt. Exhibit No. CC-1 at p. 11.

557. Despite SFPP's protestations, it is rather clear that Kinder Morgan considers these debts to be long-term in nature, else why would it report that to the Securities and Exchange Commission[135] knowing that making false statements to a federal agency could result in criminal liability?[136] Moreover, in 2005, the Commission held that SFPP's claim that debt was short-term, while treating it as long-term debt on its balance sheet, should be considered long-term debt. *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 69.[137]

558. The CC Shippers argued that certain special purpose and tax-exempt bonds, specifically Economic Development Revenue Refunding Bonds, Industrial Revenue Bonds, and OLP-B specific bonds, all of which Kinder Morgan treats as long-term debt, should be included in SFPP's cost of debt calculation. CC Shippers Initial Brief at pp.43-44. SFPP, on the other hand, claimed that, because these bonds were issued for other projects and were not available to finance the North and Oregon lines, they should not be included in rate base. SFPP Initial Brief at p. 46 (*citing* Exhibit No. SFO-12 at pp. 38-39). According to Williamson, only the debt available for financing rate base is relevant. Exhibit No. SFO-12 at p. 38. He suggested that "it would be illegal to divert

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[134] Kinder Morgan stated on its 2003 SEC Form 10-K, that it "intends and has the ability to refinance $428.1 million of [its] short-term debt on a long-term basis under [its] unsecured long-term credit facility. Accordingly, such amount has been classified as long-term debt in [Kinder Morgan's] accompanying consolidated balance sheet." *See* Exhibit No. CC-10 at p. 10.

[135] *See* Exhibit Nos. CC-1 at p. 11, CC-10.

[136] *See* 18 U.S.C. § 1001. *See also* the Knight, Inc., Kinder Morgan "Code of Business Conduct and Ethics" which commits them, in pertinent part, to "Promote full, fair, accurate, timely, and understandable disclosure in reports and documents that the Companies file with the Securities and Exchange Commission and in other public communications made by the Companies." Exhibit No. S-36 at p. 1

[137] *See also SFPP, L.P.*, 116 FERC ¶ 63,059 at P 87.

. . . funds that were borrowed for a specific purpose that justified tax exempt interest" to investment in SFPP's rate base. *Id*. at pp. 38-39. Because these bonds have specific purposes and could not have been used to finance the North and Oregon Line rate base, I agree with SFPP that the special purpose and tax exempt bonds should not be included in the cost of long-term debt calculations. *See SFPP, L.P.*, 116 FERC ¶ 63,059, on appeal to the Commission.

559. The Indicated Shippers argued that Kinder Morgan's cost of debt should be decreased because debt-rating agencies downgraded Kinder Morgan's bond rating in May 2007 after the buy-out of Kinder Morgan, Inc. Indicated Shippers Initial Brief at p. 13. According to them, the cost of debt should be decreased because ratepayers should not have to pay debt costs which benefit only the public utility owners, such as acquisitions and buy-outs. *Id*.

560. SFPP witness Williamson explained that the cost of long-term debt in the ratemaking context is that which is "outstanding and on the balance sheet at the time the cost of debt is determined," meaning that the debt on the balance sheet at the end of 2003 determines the cost of debt for 2003. Exhibit No. SFO-12 at p. 39. Therefore, a credit rating downgrade in a subsequent year would not affect the cost of debt in 2003 or 2004. *Id*. The Indicated Shippers' argument that Kinder Morgan's credit rating downgrade in 2007 should decrease its cost of debt in 2003 is therefore without merit. Kinder Morgan's bond rating downgrade in May 2007 would only affect the cost of debt for time periods which are not at issue in this proceeding. Therefore, it is irrelevant to the case at bar.

J. What is the appropriate methodology for deriving a rate of return on equity?[138]

1. What is the methodology for applying the Dividend Yield formula (dividend divided by stock market price equals return on equity) if Master Limited Partnerships are included in the proxy group?

A. CC SHIPPERS

561. The CC Shippers did not contest SFPP's proposed 2003 real return on equity of 10.02%. CC Shippers Initial Brief at p. 44 (*citing* Exhibit No. SFO-86 at p. 4). According to the CC Shippers, the methodology for determining the return on equity is set forth in the Commission's Policy Statement on the *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 (2008).[139] *Id*. at pp. 44-45.

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[138] Issues III.J.1, III.J.2, III.K, and III.L are joined together for decision.

[139] *See also SFPP, L.P.*, 123 FERC ¶ 61,116 (2008).

There, they continued, the Commission determined that MLPs should be included in a proxy group and that there should be no cap on the level of distributions. *Id*. at p. 45. Moreover, the CC Shippers explained, the Policy Statement concluded that the basis for the short-term growth forecast in the DCF calculation should remain the Institutional Brokers Estimated System forecasts. *Id*. They further stated that the long-term growth rate used to calculate the equity cost of capital for an MLP, on the other hand, should be adjusted to equal half of the Gross Domestic Product as drawn from three sources.[140] Finally, the CC Shippers added, the Commission decided that the current respective two-thirds and one-third weightings of the short- and long-term growth factors need not be modified. *Id*. (*citing Composition of Proxy Groups for Determining gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 2, 6 n.7).[141]

B. INDICATED SHIPPERS

562. When a proxy group includes MLPs, according to the Indicated Shippers, the taxable income allocated to the public limited partners whose units trade on the NYSE must be divided by the stock market price to yield the true return on equity. Indicated Shippers Initial Brief at p. 14. The Indicated Shippers explained that the DCF formula should be used to formulate a just and reasonable rate of return on equity. *Id*. When an MLP is involved, they continued, the DCF formula must be applied to the public limited partners that buy and sell on the NYSE because their earnings correlate with the stock market price to calculate a dividend yield, which is necessary to determine a fair level of earnings or return on investment. *Id*. at pp. 14-15 (*citing* Exhibit No. BPX-15 at p. 8; Transcript at p. 689). However, the Indicated Shippers noted, there is an issue as to what constitutes a dividend when applying the DCF formula to an MLP, since dividends are income flowed to shareholders by a corporation. *Id*. at p. 15. They maintained that a cash distribution cannot be used in the dividend yield formula because it is a return of capital to the unitholder in a partnership which is never taxed as income when received. *Id*. (*citing* Exhibit Nos. BPX-32 at p. 2, BPX-5 at p. 5). Substituting these distributions for dividends would yield a return of capital, the Indicated Shippers stated, which would be collected through a pipeline's depreciation expense. *Id*. at p. 16. Depreciation, they continued, is not treated as income. *Id*.

563. The Indicated Shippers contended that *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, does not control

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[140] According to the CC Shippers, the three sources are Global Insight: *Long-Term Macro Forecast – Baseline (U.S. Economy 30-Year Focus)*; Energy Information Administration, *Annual Energy Outlook*; and the Social Security Administration. CC Shippers Initial Brief at p. 45.

[141] The CC Shippers added nothing to their argument in their Reply Brief. *See* CC Shippers Reply Brief at p. 34.

the present case because a policy statement does not have the force of law. *Id*. at p. 17. They continued, before it can be implemented, the Commission must provide a reasoned decision based on substantial evidence to support the policy statement and its implementation. *Id*. (*citing Indicated Shippers v. Columbia Gulf Transmission Co.*, 123 FERC ¶ 61,150 at P 85 (2008)). Therefore, they noted, the Commission may not apply a policy statement in the present case as binding precedent. *Id*.

564. According to the Indicated Shippers, the use of MLPs for the dividend yield portion of the DCF methodology is permissive. *Id*. at pp. 17-18 (*citing* Transcript at p. 645, 384). Also, they added, there is no evidence that shows that a return of capital, or cash distribution, is comparable to a return on capital, or income, so there is no evidence supporting a determination that a return of capital, or cash distributions, can be used in the dividend yield formula. *Id*. at p. 18.

565. The Indicated Shippers claimed that there is a conflict between the *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity,* 123 FERC ¶ 61,048 and the *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139. *Id*. While, according to them, the *Policy Statement on Income Tax Allowances*, as interpreted in *SFPP, L.P.*, 121 FERC ¶ 61,240, assumes that limited partners receive taxable income from the partnership because they receive a K-1, even if that K-1 shows a loss in taxable income and no income tax liability, the Indicated Shippers explained, the *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity* policy statement assumes that limited partners do not receive taxable income from the partnership, but receive income from third persons in the future. *Id*. The Commission, they argued, is therefore calling upon shippers to pay a current income tax allowance as if there were taxable income, while at the same time calling for them to subsidize capital gains taxes as well. *Id*. at pp. 18-19. These inconsistent presumptions, when combined, result in a high rate of return on equity measured by cash distributions, which cause, according to the Indicated Shippers, a high claim for an income tax allowance even though cash distributions are not taxed as ordinary income. *Id*. at p. 19. The Indicated Shippers asserted that the only place to measure return on equity is the limited partners who buy and sell on the NYSE. *Id*. (*citing* Transcript at p. 689). Continuing, they stated that cash distributions cannot be used to measure return on equity even were they considered deferred earnings on which capital gains taxes should be paid "because the cash that provides the 'income' does not come from the partnership at all but from a third-party new purchaser." *Id*. at p. 20.

566. According to the Indicated Shippers, the tax basis is reduced by income flowed through to a partner. *Id*. (*citing* Transcript at pp. 666-67). Therefore, they asserted, losses, like cash distributions, increase potential capital gains, and yet shippers are not asked to subsidize capital gains taxes which could occur due to losses in income. *Id*. Positive income increases the tax basis, which offsets reductions in the tax basis due to cash distributions, the Indicated Shippers stated, making it difficult to predict whether cash

distributions will result in higher capital gains taxes if units are sold in the future. *Id*. at pp. 20-21. (*citing* Transcript at p. 666). The Indicated Shippers claimed that this is another reason that cash distributions should not be used as a measure of return on equity. *Id*. at p. 21.[142]

C. COMMISSION TRIAL STAFF

567. The discounted cash flow methodology, according to Staff, is appropriate for deriving a rate of return on equity. Staff Initial Brief at p. 27. Return on equity under this methodology, Staff explained, is a function of dividend yield and a combination of long- and short-term growth, and applies even when a proxy group is made up of only MLPs. *Id*. (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 3-7).

568. While Staff noted that it did not calculate its own dividend yield variable for SFPP's 2003 return on equity, it explained that the appropriate methodology for applying the dividend yield variable of the DCF analysis is to use publicly available information; specifically, the amount of cash distributions paid to Kinder Morgan's partners in 2003 for the numerator and the price of partnership units for use as the denominator. *Id*. (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 2).

569. Kinder Morgan's 2003 taxable income would not be an appropriate numerator because it was negative, and thus, Staff contended, would result in a dividend yield variable of zero. *Id*. at p. 28 (*citing* Transcript at pp. 370, 372). If this were the case, the return on equity would be based on only the growth variable, which, Staff explained, would be lower than Kinder Morgan's cost of debt, resulting in equity capital costing less than debt capital. *Id*. (*citing* Transcript at pp. 371-74). Furthermore, using taxable income in developing the numerator would be difficult because the Commission would have to rely on private tax records in processing rate applications, which may not be available, and would become even more difficult, Staff continued, when dealing with an MLP which has numerous public limited partners. *Id*. at pp. 28-29.

570. In its Reply Brief, Staff declared that cash distributions are the appropriate data to use as the numerator when determining the dividend yield, not taxable income, as the Indicated Shippers argued. Staff Reply Brief at p. 17 (*citing* Indicated Shippers Initial Brief at p. 14). The Indicated Shippers' argument that cash distributions are a return of capital and are thus not what an investor would consider when making the decision to invest in an MLP, Staff explained, is undermined by the Commission's *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC

[142] The Indicated Shippers added no new arguments in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 7.

¶ 61,048 at P 2, 42, 58, 63, which provides that uncapped cash distributions should be used in the numerator regardless of whether they are returns of or returns on capital. *Id*. at pp. 17-18 (*citing* Indicated Shippers Initial Brief at pp. 15-16). Indicated Shippers witness Sintetos, testifying that investors are concerned with getting cash out of the partnership, confirmed the Commission's statement that investors do not distinguish between returns of and returns on investments when deciding whether to invest in an MLP, Staff asserted. *Id*. at pp. 18-19 (*citing* Transcript at pp. 324-25; *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 57-59). Therefore, according to Staff, cash distributions are appropriate for use in the numerator of the dividend yield formula. *Id*. at p. 19.

D. SFPP, L.P.

571. According to SFPP, the Commission requires that *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, be applied to all currently pending proceedings before the Commission or a presiding judge if the return on equity has not already been determined with finality. SFPP Initial Brief at p. 47. Accordingly, SFPP stated:

> Thus, for the years 1984 through 1994, the appropriate methodology for deriving rate of return on equity in this proceeding is the methodology the Commission required SFPP to use in the OR92-8 proceeding and that is reflected in the rates of return on equity set forth in the Opinion 435-A Compliance filing (Ex. SFO-14) for those years. Exs. SFO-12 at 4:19-5:6; SFO85 at 3:20-4:5. For the years 1995 through 1999, the appropriate methodology is the one required by the Commission in the OR96-2 proceeding and that is reflected in the return on equity calculations set forth in Ex. SFO-15A. Ex. SFO-85 at 3:20-4:5.

SFPP Initial Brief at p. 48 (footnote omitted).

572. For 2004, SFPP stated, it used the methodology from the Commission's *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048. *Id*. It argued that the proxy groups it used in this calculation are appropriate, and asserted that it complied with the Commission's requirement that it provide information regarding the proxy group companies' business activities as well as their SEC filings and investor service analysis of the firms. *Id*. at pp. 49-50 (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 79). SFPP also claimed that it complied with the Commission's requirement that a proxy group MLP's assets are primarily gas and oil pipelines, as shown in Value Line reports for each company and excerpts from their SEC Form 10-Ks. *Id*. at p. 50 (*citing* Exhibit Nos. SFO-86, SFO-87, SFP-88, SFO-92).

573. When determining the dividend yield for the years 2000 through 2004, SFPP argued that *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 57, 63, contradicts the positions taken by the CC Shippers and the Indicated Shippers regarding the use of MLP distributions in the DCF methodology. SFPP Initial Brief at pp. 50-51. According to it, *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 62, provides that using an MLP's full distributions will not cause a double recovery of the depreciation component included in a pipeline's cost-of-service rates, as Crowe contended. SFPP Initial Brief at p. 51 (*citing* Exhibit No. BPX-32 at p. 5).

574. In its Reply Brief, SFPP contended that, in *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, which must be applied in all pending proceedings, according to SFPP, the Commission determined that MLPs may be included in a proxy group, and if they are, uncapped distributions are to be used in the DCF formula. SFPP Reply Brief at p. 51 (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 63, 116). Despite this directive, SFPP alleged, the Indicated Shippers contended that distributions are not appropriate to use in the DCF methodology because they are a return of capital rather than a return on capital, and taxable income allocated to public limited partners should be used instead. *Id*. (*citing* Indicated Shippers Initial Brief at pp. 15-18). The Commission, however, SFPP noted, rejected this argument and concluded that an investor would not distinguish between a return of capital and a return on capital, and all cash flows contribute to the value of stock. *Id*. at pp. 51-52 (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 32, 57).

575. SFPP also claimed that the Commission rejected the Indicated Shippers' argument that MLP public unitholders double recover income tax liability, quoting the Commission's statement that "the income tax allowance compensates the partners for the tax cost of the distributions they receive and thus equalizes the after-tax cash flows that would be available from a corporation and are used as inputs to the DCF model." *Id*. at pp. 52-53 (*citing* Indicated Shippers Initial Brief at pp. 18-19; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 52-53). The Commission, SFPP continued, also dispelled the argument regarding a double dip with respect to the depreciation component of rates, stating that a double recovery of the depreciation component of cost-of-service will not result from using an MLP's full distribution when determining return on equity. *Id*. at p. 53 (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 62).

2. What are the appropriate growth factors to use?

A. CC SHIPPERS

576. Given that the CC Shippers do not oppose SFPP's return on equity calculation, they also stated that they do not oppose the growth factors set forth in *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048. CC Shippers Initial Brief at p. 46. They reiterated that short-term growth factors, based on the IBES forecasts, should be weighted two-thirds, while long-term growth factors, with an adjustment equivalent to half of the GDP for MLPs, should be weighted one-third. *Id*.[143]

B. INDICATED SHIPPERS

577. The Indicated Shippers argued that the current methodology for calculating "growth in earnings" factors for the return on equity applies if income, rather than cash distributions, is used when calculating the rate of return on equity. Indicated Shippers Initial Brief at p. 21. They added that, when cash distributions are used, the methodology has no meaning because there may not be a correlation between earnings and the source used for cash distributions since managers of MLPs have the ability to manage the cash distributions. *Id*. (*citing* Transcript at p. 660).[144]

C. COMMISSION TRIAL STAFF

578. The appropriate growth factors for use in the DCF formula, according to Staff, are a short-term growth factor from the IBES forecasts, weighted two-thirds, and a long-term growth factor, weighted one third. Staff Initial Brief at p. 29 (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 2). Under the Policy Statement, Staff continued, when an MLP is used, the long-term growth component for equity cost of capital should be 50% of the long-term GDP, which, Staff noted, is derived from Global Insight, Energy Information Agency, and the Social Security Administration. *Id*. (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 6 n.7).

579. In its Reply Brief, Staff explained that the Indicated Shippers claimed that there is no correlation between cash distributions and earnings in the case of MLPs, so it is improper to use cash distributions when determining the growth variable and dividend

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[143] The CC Shippers added nothing to their argument in their Reply Brief. *See* CC Shippers Reply Brief at p. 34.

[144] The Indicated Shippers added nothing to their argument in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 9.

yield in the DCF analysis. Staff Reply Brief at pp. 19-20 (*citing* Indicated Shippers Initial Brief at p. 21). Because the Commission concluded that the IBES short-term growth rates are the best data reflecting the relationship between dividend yield and the IBES short-term growth factor, regardless of whether that factor is derived from earnings or cash distributions, Staff maintained that cash distributions are reasonable to use in the numerator. *Id*. at p. 20 (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 76). Moreover, Staff added, using cash distributions does not result in an IBES short-term growth rate that is very different from one based upon earnings. *Id*.

D. SFPP, L.P.

580. For 2000 to 2004, the growth factors, according to SFPP, should be those required by the Commission's *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048. SFPP Initial Brief at p. 52 (*citing* Exhibit Nos. SFO-85 at pp. 1-5, SFO-86).

581. In its Reply Brief, SFPP noted that it, Staff, and the CC Shippers endorse the Commission's *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity* with respect to growth forecasts. SFPP Reply Brief at p. 54 (*citing* Staff Initial Brief at p. 29; CC Shippers Initial Brief at pp. 45-46). SFPP responded to the Indicated Shippers' arguments regarding growth forecasts, explaining that the Commission found that, for MLP proxy companies, the average long-term growth forecast should be reduced by 50%. *Id*. (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 42).

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

A. CC SHIPPERS

582. The CC Shippers explained that they do not oppose SFPP's 2003 return on equity calculations which yield a real return on equity of 10.02%. CC Shippers Initial Brief at p. 46.[145]

B. INDICATED SHIPPERS

583. According to the Indicated Shippers, 10.56% is the appropriate rate of return on equity if SFPP is placed at the mean of the range of returns on equity; however, they

[145] CC Shippers did not address this issue in reply. CC Shippers Reply Brief at p. 34.

argued, SFPP should be at the lower end of this range. Indicated Shippers Initial Brief at p. 22 (*citing* Exhibit No. BPX-15 at p. 17).[146]

C. COMMISSION TRIAL STAFF

584. For 2003, Staff stated that it used the CC Shippers' 9.88% real return on equity for developing costs of service and just and reasonable rates for the Oregon Line. Staff Initial Brief at pp. 29-30 (*citing* Exhibit Nos. S-1 at p. 11, S-10 at p. 2, S-11 at p. 2, S-2 at p 3, S-3 at p. 3). While SFPP used a 10.02% real return on equity based on the median value of his proxy group of MLPs, Staff argued that the 9.88% used by the CC Shippers is consistent with the finding that SFPP is less risky than the five MLPs in Williamson's proxy group. *Id*. at p. 30 (*citing* Exhibit No. SFO-86 at p. 4; Transcript at p. 715). Because, according to Staff, SFPP is less risky than the MLPs in the proxy group, and the real return on equity for SFPP must come from a comparison of its risk profile relative to the proxy group, Staff insisted that the real return on equity for 2003 rate purposes should be 9.88% and no higher. *Id*. at pp. 30-31 (*citing Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d. 695, 701 (D.C. Cir. 2007); *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 ¶ FERC 61,048 at P 7).[147]

D. SFPP, L.P.

585. The appropriate return on equity for the years 1984 through 1995, according to SFPP, is that which can be found in SFPP's filing in compliance with *SFPP, L.P.*, 91 FERC ¶ 61,135, which, it claimed, the Commission approved. SFPP Initial Brief at p. 52 (*citing* Exhibit No. SFO-14). For 1996 through 1999, SFPP continued, Exhibit No. SFO-15A sets forth the appropriate return on equity calculations, which are in accordance with prior Commission methodology, according to it. *Id*. (*citing* Exhibit No. SFO-85). Additionally, SFPP added, the appropriate rate of return for 2000 to 2004 is in Exhibit No. SFO-86 in which, it asserted, it used the methodology from *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048. *Id*.

586. In its Reply Brief, SFPP asserted that Staff argued against using a real rate of return at the median because it considered that SFPP is less risky than the MLPs included in the proxy group. SFPP Reply Brief at p. 55 (*citing* Staff Initial Brief at p. 30). Despite this contention, SFPP explained, Staff adopted O'Loughlin's use of the median rate of return in its cost-of-service, which was derived from the same set of proxy companies used by Williamson. *Id*. (*citing* Exhibit Nos. SFO-15 at p. 9, SFO-15A at p. 9, SFO-86 at p. 4, CC-1 at p. 20 tbl.2, CC-13). Moreover, SFPP claimed that Staff witness Sherman

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[146] Indicated Shippers did not address this issue in reply. Indicated Shippers Reply Brief at p. 7.

[147] Staff added no new arguments in its Reply Brief. *See* Staff Reply Brief at p. 21.

advocated that SFPP's rate of return be set at the median of the range of returns for purposes of determining return on equity, and asserted that this discredits Staff's position on brief. *Id*. at p. 56 (*citing* Exhibit Nos. S-1 at p. 11, S-2 at p. 3, S-3 at p. 3, S-10 at p. 2, S-11 at p. 2).

L: What is the appropriate place in the proxy group for members of the group used in DCF method for determining the rate of return on equity?[148]

A. INDICATED SHIPPERS

587. Because SFPP lacks competition as a transporter of refined petroleum products, it is less risky than the MLPs in the proxy group, the Indicated Shippers contended. Indicated Shippers Initial Brief at p. 22. According to them, therefore, it should be located near the bottom of the range of reasonable returns produced by the proxy group. *Id.* (*citing* Exhibit Nos. BPX-15 at p. 17, BPX-32 at p. 9). The MLPs in the proxy group, the Indicated Shippers continued, are in highly competitive markets which keep market rates in check, and some charge market-based rates, which alleviates risk. *Id*. (*citing* Exhibit Nos. BPX-38 at pp. 3, 7, BPX-32 at p. 10).[149]

B. COMMISSION TRIAL STAFF

588. Staff explained that SFPP's 2003 real return on equity depends upon how its risk compares with the risk of others in Williamson's proxy group of MLPs, as required in *Petal Gas Storage v. FERC*, 496 F.3d. at p 701, and in *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 7. Staff Initial Brief at p. 31. SFPP, according to Staff, is less risky compared with the proxy group members because MLPs face the risk of losing their partnership status, and thus being taxed as a corporation, if 90% of their revenues do not come from the extraction and transportation of natural resources. *Id*. at pp. 31-32 (*citing* Transcript at p. 719; Exhibit No. S-31 at p. 47). If an MLP loses its tax status, taxes could no longer be passed through to the partners, and the MLP would have to pay an income tax on its taxable income, Staff stated. *Id*. at p. 32. Staff contended that SFPP's real return on equity for 2003 should be no higher than 9.88% because it does not face this risk. *Id*. at p. 33.

589. While SFPP argued that because it also is affected because it is dependent upon Kinder Morgan's debt financing and Kinder Morgan faces the risk of losing partnership

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[148] The CC Shippers did not address this issue on brief. CC Shippers Initial Brief at p. 46; CC Shippers Reply Brief at p. 34.

[149] The Indicated Shippers did not add anything of substance in their Reply Brief. Indicated Reply Brief at p. 9.

taxation status due to the 90% rule, Staff claimed that SFPP would have no problem raising capital on a stand-alone basis, based on SFPP witness Bullock's testimony. *Id*. at pp. 33-34 (*citing* Transcript at p. 965). Further, Staff added, Kinder Morgan paid a premium above SFPP's net book value when it purchased the entity in 1998, which indicates that SFPP would not have a problem raising debt capital on a stand-alone basis in 2003 if Kinder Morgan lost its partnership tax status due to a violation of the 90% rule. *Id*. at p. 34 (*citing SFPP, L.P.*, 111 FERC ¶ 61,334 at P 35).

590. Next, Staff explained that SFPP does not face competition as do the companies in the proxy group, and therefore is less risky. *Id*. (*citing* Exhibit Nos. BPX-32 at pp. 9-10, BPX-36). Furthermore, Staff argued, while the five proxy companies were confronted with competition from barges, railroads, and other pipelines in their geographical markets, the Commission has found that SFPP has monopoly status with respect to certain lines which indicates that, in 2003, it faced less risk than they did. *Id*. at pp. 34-35 (*citing* Exhibit Nos. SFO-89 at p. 35, SFO-92 at pp. 61-62, 65, 69, SFO-90 at pp. 45-45, SFO-91 at p. 36; *SFPP, L.P.*, 86 FERC at p. 61,081).

591. In addition, Staff contended that SFPP faces lower risk than the natural gas pipeline proxy companies because it is a Commission regulated oil pipeline with rate indexing available to it, which means that it can recover incremental costs due to inflation in its rates more easily than the natural gas proxy companies which do not have this same ability. *Id*. at p. 36 (*citing* 18 C.F.R. § 385.3420 *et seq.* (2003)). There is no rate indexing scheme for natural gas companies that allows them to readily recover their increased costs due to inflation, according to Staff, while oil pipelines, such as SFPP, have this ability and thus face a less risky rate regulatory environment. *Id*. at pp. 36-37 (*citing* 18 C.F.R. § 342.4).

592. In its Reply Brief, Staff maintained that the three decisions[150] cited by SFPP as support for its assertion that SFPP should be at the median of the proxy group are not persuasive because none of them "involved ascertaining investor expectations in a 2003 test year to determine a just and reasonable rate of return on equity for the Oregon Line using the proxy group of master limited partnerships used here by . . . Williamson." Staff Reply Brief at pp. 21-22 (*citing* SFPP Initial Brief at pp. 52-53).

593. According to Staff, the record contains substantial evidence which establishes that SFPP is less risky than the companies in Williamson's proxy group and its real return on equity should thus be no more than 9.88%. *Id*. at p. 22. This evidence is contained mainly within the "Risk Factors" section of Kinder Morgan's 2003 SEC Form 10-K, Staff asserted, which sets forth risks faced by Kinder Morgan, an MLP within the proxy group, which are not faced by SFPP. *Id*. at pp. 22-23. Specifically, Kinder Morgan faced the risk

[150] Staff stated that the three decisions cited by SFPP are: *SFPP, L.P.*, 113 FERC ¶ 61,277; *SFPP, L.P.*, 121 FERC ¶ 61,240; and *SFPP, L.P.*, 96 FERC ¶ 61,281 (2001).

of losing partnership taxation status if it received less than 90% of its revenue from qualified sources, Staff related, a risk faced by the MLPs in the proxy group, but not by SFPP. *Id*. at pp. 23-24 (*citing* Exhibit No. S-36). Additionally, Staff continued, Kinder Morgan faced the risk of integrating new operations into the Kinder Morgan enterprise so that it could continue to achieve expected benefits, a risk also faced by TEPPCO Partners, L.P., another MLP in the proxy group. *Id*. at pp. 24-25 (*citing* Exhibit No. S-31 at p. 45). SFPP does not, according to Staff, face this same risk. *Id*. at p. 25.

594. Despite the Commission's request that parties provide specificity as to the risks faced by a regulated entity when compared to a proxy group, Staff noted, SFPP did not counter specific evidence that it was less risky than the proxy group and did not ask its witness to perform a risk analysis. *Id*. at p. 26 (*citing* Transcript at p. 729; *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Petal Gas Storage v. FERC,* 496 F.3d 695; *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity,* 123 FERC ¶ 61,048 at P 7).

C. SFPP, L.P.

595. For purposes of determining return on equity, SFPP argued that it should be placed at the median of the proxy group range, where the Commission has placed it in the past. SFPP Initial Brief at pp. 52-53 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277). In prior Orders, SFPP claimed, the Commission rejected SFPP's placement at the bottom of the range of reasonableness, found that protesting parties failed to overcome the presumption that SFPP was of average risk, and placed SFPP in the median range despite its lower commercial risks and lack of meaningful competition. *Id*. at p. 53 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 77-78; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 125; *SFPP, L.P.*, 66 FERC ¶ 61,022 at p. 61,101; *SFPP, L.P.*, 96 FERC ¶ 61,281 at p. 62,067).

596. In the instant case, SFPP argued, Complainants have not overcome the presumption that SFPP is of average risk and thus should be placed at the median of the proxy group range. *Id*. at pp. 53-54. SFPP continued, in order to overcome the presumption that pipelines fall within a broad range of average risk, the Complainants would have to show that there are "highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines . . . ." *Id*. at p. 53 (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 7; *Transcontinental Gas Pipe Line*, 90 FERC ¶ 61,279 at pp. 61,927-28, 61,936 (2000)). According to SFPP, both CC Shippers witness O'Loughlin and Staff witness Sherman testified that SFPP should be placed at the median level, while only Indicated Shippers witness Crowe presented superficial arguments that SFPP should be at the bottom of the range of reasonableness, similar to those which have already been rejected in prior

Orders.[151] *Id*. at p. 54 (*citing* Exhibit Nos. S-1 at p. 11, BPX-15 at p. 17, BPX-32 at pp. 8, 10; Transcript at p. 360; *SFPP, L.P.*, 86 FERC ¶ 61,022; *SFPP, L.P.*, 96 FERC ¶ 61,281).

597. Additionally, SFPP asserted, Staff failed to provide a risk analysis, and its risk discussion is not supported by any expert witness testimony. SFPP Reply Brief at p. 58. In its analysis of competition, Staff relied, according to SFPP, on Indicated Shippers witness Crowe's analysis of competition, as well as SEC Form 10-K excerpts which, SFPP contended, indicate nothing about SFPP's risks. *Id*. at p. 59 (*citing* Staff Initial Brief at p. 34). Contrary to the views of the Indicated Shippers and Staff, Williamson, SFPP noted, testified that SFPP faces competition on both the North and Oregon lines. *Id*. (*citing* Transcript at p. 726).

598. Staff claimed, according to SFPP, that SFPP has different risks because MLPs can lose their partnership status for income tax purposes and SFPP cannot. *Id*. (*citing* Staff Initial Brief at p. 31). Despite this, SFPP pointed out, it was placed at the median in prior Commission proceedings. *Id*. at p. 58. Moreover, SFPP argued, since only MLPs are available for use as proxies for oil pipelines, under Staff's logic, all pipelines should be placed at the lower end of the range of reasonableness. *Id*. (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 43). Additionally, SFPP continued, MLPs are aware of the 90% rule and therefore have the power to ensure that they comply with this rule. *Id.* SFPP also is indirectly affected by the rule, according to it, because it uses Kinder Morgan's financing and would be dramatically affected if Kinder Morgan were to lose its partnership status. *Id*. at p. 59 (*citing* Transcript at p. 737).

599. SFPP next addressed Staff's argument that SFPP is less risky than the proxy group companies because, unlike natural gas pipelines, it can make adjustments to its rates pursuant to the Commission's oil pipeline indexing methodology. *Id*. at p. 59 (*citing* Staff Initial Brief at p. 36). However, SFPP explained, the Commission has found gas pipelines to be less risky than oil pipelines, even with the indexing methodology in place. *Id*. at pp. 59-60 (*citing Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077 at P 152 n.248 (2006)). SFPP alleged that Staff isolated a single factor and failed to consider other related factors which also impact an oil pipeline's risk when compared to a gas pipeline or other entity. *Id*. at p. 60.

[151] It must be noted that the CC Shippers, on whose behalf O'Loughlin testified, did not address this issue on brief and that Staff, on whose behalf Sherman testified, took the position on brief that SFPP's risk was lower than the members of the proxy group and that its real return on equity should be no more than 9.88%. *See* CC Shippers Initial Brief at p. 46; CC Shippers Reply Brief at p. 34; Staff Initial Brief at pp. 31-38; Staff Reply Brief at pp. 21-26.

Discussion and Ruling

600. SFPP's appropriate rate of return on equity depends upon the methodology that should be used for deriving the rate of return on equity when master limited partnerships are included in the proxy group. In turn, this is subject to the Commission's recent policy statement regarding the use of MLPs when determining oil pipeline return on equity. The return on equity also depends upon the growth factors that should be used in the DCF formula and how the short- and long-term growth factors should be weighted, as well as where among the range of proxy companies SFPP should be placed, depending upon its relative risk level.

601. On April 17, 2008, the Commission issued *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, which must be applied in all pending proceedings where the return on equity issue has not been finally resolved. 123 FERC ¶ 61,048 at P 116. Pursuant to that policy, despite the inclusion of MLPs in proxy groups, the Commission will continue to use its DCF methodology when determining return on equity. *See Id.* at P 57-66. Under the DCF formula, return on equity is determined by adding the projected dividend growth rate to the current dividend yield. *Id*. at P 5. The dividend yield is determined by dividing dividends by share price. *Id*. When MLPs are used in proxy groups, their full cash distributions will be substituted for dividends in the dividend yield formula. *Id*. at P 62-63.

602. The CC Shippers and SFPP agreed that the 2003 return on equity should be 10.02%, based on Williamson's calculations in Exhibit No. SFO-86 at p. 4. CC Shippers Initial Brief at p. 44; SFPP Initial Brief at pp. 48-49.

603. Staff adopted the 9.88% return on equity that CC Shippers' witness O'Loughlin calculated prior to the issuance of *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048.[152] Staff Initial Brief at pp. 29-30. However, after the Commission's ruling, O'Loughlin adopted Williamson's 10.02% real return on equity figure for 2003.[153] Transcript at pp. 397, 485-86. He claimed that he would have computed the same percentage had he re-calculated his return on equity in accordance with the Commission's policy statement. *Id*. at p. 486. As Staff admitted, Sherman did not perform her own DCF analysis to derive the 9.88% rate of return on equity she recommended, but relied instead on O'Loughlin's testimony. Staff Initial Brief at pp. 29-30. As O'Loughlin and the CC Shippers no longer support 9.88%, and as Staff has not adduced independent evidence supporting that number, I find that Staff's position

[152] O'Loughlin's calculation can be found in Exhibit No. CC-13.

[153] *See also* the statement on brief of O'Loughlin's sponsor, the CC Shippers, at CC Shippers Initial Brief at pp. 44-45.

is not supported by the record. Indeed, it would appear that Staff chose 9.88% only because it is lower than Williamson's median of 10.02%, based on its claim that SFPP is less risky than members of the proxy group.[154] This is an insufficient cause to rule as Staff recommended.

604. The Indicated Shippers calculated a 2003 rate of return on equity of 10.56%, which assumes that SFPP is placed at the mean of the range of returns on equity. Indicated Shippers Initial Brief at p. 22. Unlike the proxy group advocated by SFPP and Staff, the Indicated Shippers use a ten-member corporate proxy group for its DCF calculation. Exhibit No. BPX-19. Also, unlike the rates of return on equity that SFPP, the CC Shippers, and Staff recommended, the Indicated Shippers performed their analysis using 2007 data[155] which is irrelevant when determining the 2003 rate of return on equity. Exhibit No. BPX-19. Therefore, it must be concluded that the Indicated Shippers' recommendation that SFPP's 2003 rate of return on equity be 10.56% is not supported by the record.

605. SFPP and the CC Shippers, in O'Loughlin's return on equity calculation adopted by Staff in this proceeding, use the same five-member MLP proxy group in their DCF analyses.[156] I agree with SFPP that the proxy group used by SFPP, the CC Shippers, and Staff, since it adopted O'Loughlin's DCF analysis, is appropriate for determining SFPP's rate of return on equity. [157]

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[154] *See* Staff Initial Brief at p. 30.

[155] The Indicated Shippers' DCF Calculation uses a dividend yield based on the six months ending in November 2007 and uses 2007 data from Energy Information Agency, *Annual Energy Outlook*, and the Social Security Administration for determining its GDP growth rate. Exhibit No. BPX-19.

[156] The proxy group is made up of the following entities: Buckeye Partners, L.P., Kaneb Pipe Line Partners, L.P., Enbridge Energy Partners, L.P., Kinder Morgan Energy Partners, L.P., and TEPPCO Partners, L.P. Exhibit Nos. CC-1 at p. 17, 20, CC-13, SFO-86 at p. 4. SFPP noted that no party has challenged these proxy companies. SFPP Initial Brief at p. 49.

[157] Crowe used a different proxy group than the CC Shippers and SFPP. However, I already have ruled that she improperly used 2007 data to calculate a 2003 return on equity for SFFP. It follows, therefore, that Crowe's DCF analysis is irrelevant to this proceeding. That obviates the need to consider whether the ten-member corporate proxy group she used for her DCF calculation, *see* Exhibit No. BPX-19, is more appropriate than the proxy group used by CC Shippers and SFPP, or whether her ten-member corporate proxy group adequately satisfies the Commission's requirements as provided in

606. The Commission requires that, when a party recommends a proxy group, the party "should provide as much information as possible regarding the business activities of each firm they propose to include in the proxy group, including their recent annual SEC filings and investor service analyses of the firms." *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 51. In order to comply with this Commission directive, SFPP submitted into the record Value Line reports and SEC Forms 10-K for each MLP. SFPP Initial Brief at p. 50; Exhibit Nos. SFO-87, SFO-88, SFO-89, SFO-90, SFO-91, SFO-92. Based on this evidence, I find that the proxy group was appropriately formed and includes MLPs that "are well established and have assets that are predominantly gas and oil pipelines," consistent with the Commission's requirements in *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 79.

607. When MLPs are included in the proxy group, the Indicated Shippers argued, the taxable income allocated to the public limited partners whose units trade on the NYSE should be used as the numerator in the dividend yield formula, where dividends per share, or income, would normally be used. Indicated Shippers Initial Brief at pp. 14-15. They claimed that there is an issue, when MLPs are used, as to what would qualify as dividends. *Id*. at p. 15. Furthermore, the Indicated Shippers stated that an MLP's cash distributions are not taxed as income and are simply a return of capital to a partnership unitholder. *Id*. Staff argued against the Indicated Shippers, stating that using only taxable income in the numerator of the dividend yield formula for Kinder Morgan[158] is unreasonable because Kinder Morgan's public limited partners showed a loss in 2003. Staff Initial Brief at p. 28. Due to this loss, the numerator of the dividend yield formula, according to Staff, would be zero, resulting in an anomalous return on equity consisting of only the growth variable. *Id*. Moreover, Staff argued against the use of taxable income in the numerator of the dividend yield formula because the Commission would need to use private tax records when processing rate applications, which would be an especially difficult task. *Id*. at pp. 28-29. Staff instead advocated the use of cash distributions in the numerator of the dividend yield formula. Staff Reply Brief at p. 17. Likewise, SFPP argued that uncapped cash distributions should be used when MLPs are included in a proxy group. SFPP Reply Brief at p. 51.

608. I do not find the Indicated Shippers' argument persuasive. In *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, the Commission

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Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity, 123 FERC ¶ 61,048 at P 79.

[158] Kinder Morgan is a member of the proxy group used for determining SFPP's return on equity.

acknowledged the difference between corporate and MLP cash flows,[159] but explained that, if the DCF analysis is performed correctly, "these differences do not preclude inclusion of MLPs in the proxy group." *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 52. Moreover, the Commission stated that distinguishing between return *on* capital and return *of* capital, as the Indicated Shippers have done, "improperly conflates cost-of-service rate-making techniques with the market-driven DCF method." *Id*. at P 57. When determining that an MLP's cash distributions should not be capped at earnings for use in the DCF formula, the Commission stated that "use of a proxy MLP's full distribution is necessary for the DCF analysis to accurately determine the percentage return on equity required by the equity markets." *Id*. at P 62. While the Indicated Shippers do not suggest capping cash distributions at earnings, they do suggest using a numerator that is less than full cash distributions, in contradistinction with Commission policy which allows uncapped cash distributions to be used as the numerator in the dividend yield formula. *Id*. at P 63.

609. The dividend growth rate in the DCF formula is determined by averaging short- and long-term growth estimates. *Id.* at P 6. When averaging the growth estimates, the short-term forecast is weighted two-thirds, while the long-term forecast is weighted one-third. *Id*. However, when MLPs are used in proxy groups changes must be made to the short- and long-term growth components used to project the growth rates for use in the DCF formula. *Id.* at P 66. The Commission concluded that the IBES five-year growth forecast should be used as the short-term growth factors for MLPs included in a proxy group for purposes of the DCF calculation. *Id*. at P 75. With respect to the long-term growth factors, the Commission determined that, when MLPs are included in proxy groups, the long-term growth rate should be adjusted to the equivalent of 50% of long-term GDP growth.[160] *Id*. at P 96. The short- and long-term growth factors will continue to be weighted two-thirds and one-third, respectively. *Id*. at P 2.

610. Consistent with the Commission's stated policy, the CC Shippers, Staff, and SFPP agreed that short-term growth factors should be based on the Institutional Brokers

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[159] According to the Commission, pipeline MLPs distribute approximately 90% of their cash flow to their general and limited partners as cash distributions. *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 11, 12. MLP cash flow consists of both an operating profit component and a depreciation component, causing cash distributions to normally exceed reported earnings, unlike corporate dividends. *Id*. at P 12.

[160] The Commission uses three sources for determining the GDP growth forecast: Global Insight: *Long-Term Macro Forecast – Baseline (U.S. Economy 30-Year Focus)*; Energy Information Agency, *Annual Energy Outlook*; and the Social Security Administration. *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 6 n.7.

Estimated System forecasts and weighted two-thirds, while long-term growth factors, with an adjustment equivalent to half of the GDP for MLPs, should be weighted one-third. CC Shippers Initial Brief at p. 46; Staff Initial Brief at p. 29; SFPP Reply Brief at p. 54. Contrariwise, because they argued that income, rather than cash distributions should be used when calculating return on equity, the Indicated Shippers recommended that the current methodology for calculating "growth in earnings" factors for the return on equity, rather than the new methodology set forth in *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity* be used. Indicated Shippers Initial Brief at p. 21. According to the Indicated Shippers, when cash distributions are used, the methodology has no meaning because there may not be a correlation between earnings and the source used for cash distributions since managers of MLPs have the ability to manage the cash distributions. *Id*.

611. As I have already rejected the Indicated Shippers' argument that taxable income be used when calculating SFPP's rate of return on equity, it follows that I also reject their proposed methodology for determining the growth factors. According to them, this methodology applies when income is used for calculating return on equity, and would not make sense if cash distributions were used in the dividend yield formula. Indicated Shippers Initial Brief at p. 21. While cash distributions, and not income, will be used in the dividend yield formula, the Indicated Shippers need not be concerned that the current methodology "has no meaning when cash distributions are substituted for income in the dividend yield formula." *Id.* The Commission already has considered this and determined that "the IBES short-term growth projections provide the best estimate of short-term growth rate for MLP distributions." *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 76. Staff suggested, and I agree, as follows:

> A straight forward application of the *Policy Statement*, then, in this case is to use cash distributions in the numerator of the dividend variable along with an IBES short-term growth rate. Such an application is reasonable, particularly since [the Indicated Shippers have] not shown in this case that an IBES short-term growth rate based on earnings is remarkably different than such a rate based on cash distributions.

Staff Reply Brief at p. 20. It should be further noted that, to avoid any anomalous occurrence, the Commission further determined that, when MLPs are used as proxy companies for purposes of determining return on equity, and cash distributions are used as the numerator of the dividend yield formula, the long-term growth factor should be adjusted so that it would equal 50% of long-term GDP. *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 96.

612. When determining their recommended return on equity for SFPP, both the Indicated Shippers and Staff argued that SFPP is less risky than the MLPs in SFPP's

suggested five-member proxy group. Indicated Shippers Initial Brief at p. 22; Staff Initial Brief at pp. 31. Because SFPP is less risky, they alleged, its rate of return on equity should be below the median value in the range of returns on equity of the MLPs in the proxy group. Staff Initial Brief at p. 30; Indicated Shippers Initial Brief at p. 22. They claimed that SFPP does not face the same level of competition as the MLPs used to determine its rate of return on equity. Indicated Shippers Initial Brief at p. 22; Staff Initial Brief at p. 34. The Indicated Shippers contended that, while the proxy group members operate in competitive markets, SFPP has a monopoly on transporting refined petroleum products in the areas it serves. Indicated Shippers Initial Brief at p. 22. Staff also maintained that SFPP had monopoly status and cited statements from the proxy group companies' SEC Form 10-Ks as proof that those companies faced competition in the markets they serve. Staff Initial Brief at pp. 34-35. Further, Staff set forth arguments claiming that SFPP is less risky because it has rate indexing available to it, while the natural gas pipelines included in the proxy group do not and because it does not face the risk of losing partnership taxation status like an MLP which faces the risk of losing such status for income tax purposes if 90% of its revenues do not come from certain qualifying activities. *Id*. at pp. 31-32.

613. In contrast with Staff and the Indicated Shippers, for purposes of determining return on equity, SFPP argued that it should be placed at the median of the range of the proxy group. SFPP Initial Brief at p. 52. According to SFPP, the burden was on Staff and the Indicated Shippers to overcome the presumption that a pipeline is of average risk by providing evidence that highly unusual circumstances existed which indicate that SFPP has much lower risk than the pipelines in the proxy group. SFPP Reply Brief at pp. 60-61. SFPP maintained that they did not overcome the presumption, and their risk related claims should be rejected. *Id*. at p. 61.

614. The Commission assumes that pipelines "fall into a broad range of average risk, absent highly unusual circumstances that indicate an anomalously high or low risk as compared to other pipelines." *Transcontinental Gas Pipeline Corp*., 90 FERC ¶ 61,279 at P 61,936. "Unless a party makes a very persuasive case in support of the need for an adjustment and the level of the adjustment proposed, the Commission will set the pipeline's return at the median of the range of reasonable returns." *Id*. With respect to SFPP specifically, the Commission concluded both in *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 78 and in *SFPP, L.P.*, 121 FERC ¶ 61,240, that the median cost of equity capital was appropriate for SFPP, and a party must have "exceptional reasons" as to why SFPP would not fall within a wide range of risk. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 125. The Commission most recently reiterated its position in *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, stating that "the Commission has historically presumed that existing pipelines fall within a broad range of average risk," and a "party has to show highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines to overcome the presumption." 123 FERC ¶ 61,048 at P 7.

615. Neither Staff nor the Indicated Shippers have overcome the presumption that a pipeline is of average risk. The Indicated Shippers limited their analysis of SFPP's risks to competition, while Staff limited its analysis to competition, the risk of an MLP losing its partnership status, and rate indexing.[161] Indicated Shippers Initial Brief at p. 22; Staff Initial Brief at pp. 31-38. Focusing on only a few areas where SFPP may have lower risk than the members of the proxy group does not amount to "highly unusual circumstances that indicate anomalously high or low risk" which would warrant ruling that SFPP should not fall within a range of average risk. *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 7. Both Staff and the Indicated Shippers also focused on all the risks that MLPs face that SFPP does not, ignoring any potential risks that SFPP, and not the MLPs, may face. On cross-examination, Indicated Shippers witness Crowe agreed that a variety of factors, other than competition, could affect SFPP's risk level. Transcript at pp. 360-66. These factors, which were not addressed by either Staff or the Indicated Shippers, included weather patterns, physical environment, varying economic conditions, the number of markets a pipeline serves, differing regulatory regimes, enforcement cultures, the population of the location where the pipeline is located, business diversification, geographic diversification, and the ease with which a company can redeploy its assets. *Id*. Additionally, Crowe agreed that the type of substance a pipeline carries could potentially affect risk, but that such an analysis would involve many factors, including markets, prices, and customer base. Transcript at pp. 364-65. Neither Crowe nor any other Indicated Shippers or Staff witness performed such an analysis.

616. In any event, Staff adjusted SFPP and the CC Shippers' recommended rate of return on equity of 10.02% downward by only 14 basis points to 9.88%. Staff Initial Brief at p. 38. On cross-examination, when moving from his original recommended return on equity of 9.88% to SFPP's 10.02% figure, CC Shippers witness O'Loughlin explained that he did not find 10.02% to be distinct from 9.88%. Transcript at p. 486. The Commission has found that equity cost of capital estimates that were very close despite differences in the perceived level of SFPP's risk supported the conclusion that SFPP should be placed around the median. *SFPP, L.P.*, 86 FERC at pp. 61,101-02. Given the minimal difference between the two figures and the high burden required in order to adjust a pipeline's return away from the median of the range of reasonable returns, I see no reason to stray from the Commission's assumption that a pipeline is of average risk for a decrease of 14 basis points, a difference that an expert witness claimed lacked any distinction. Further, the Indicated Shippers failed to even offer an adjusted recommended return on equity figure based on SFPP's allegedly low level of risk. Indicated Shippers Initial Brief at p. 22. SFPP should be placed at the median of the proxy group and its rate of return on equity should be set at 10.02% because neither Staff nor the Indicated Shippers met their burden

[161] It should be noted that no Staff witness testified on the question of risk analysis.

to overcome the presumption that SFPP is of average risk and should be placed at the median.

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

A. Struck

B: Whether SFPP is entitled to any income tax allowance based on substantial evidence of record?

A. CC SHIPPERS

617. The CC Shippers contended that, in order for the Commission to implement its *Policy Statement on Income Tax Allowances*,[162] which focuses on whether partnership unitholders have actual or potential tax liability, it must provide a reasoned decision based on substantial evidence in the record. CC Shippers Initial Brief at p. 47 (*citing Pacific Gas and Electric Co. v. FPC*, 506 F.2d 33, 38-39 (D.C. Cir. 1974)). According to them, the Commission has placed the burden of proof on the pipeline. *Id.* (*citing* 111 FERC ¶ 61,139 at P 42). However, the CC Shippers argued, SFPP did not provide any evidence of its partners' tax liability and instead merely relied on the Commission's policy and observations in prior cases, where there was never a hearing as to whether the unitholders had actual or potential tax liabilities. *Id.*

618. Because, they alleged, the *Policy Statement on Income Tax Allowances* does not address the component for income taxes already included in the allowed rate of return on equity, the CC Shippers contended that, by relying on it, SFPP's claimed income tax allowance provides a double recovery of income taxes with regard to non-corporate Kinder Morgan entities. *Id* at p. 48 (*citing* Exhibit No. CC-1 at pp. 29-30).

619. The return on equity to individual investors calculated through the use of the DCF methodology, according to the CC Shippers, is a before-individual-income-taxes rate of return. *Id*. (*citing* Transcript at pp. 510-18). The individual investor, the CC Shippers continued, receives a stream of future distributions which are used to calculate rate of return and the market price of the stock using the DCF methodology. *Id*. Moreover, this investor, they stated, pays income taxes on the income he or she receives from the pipeline MLP. *Id*. The CC Shippers explained that this income is ignored by the DCF methodology, and thus the calculated rate of return is before individual income taxes. *Id*. at pp. 48-49. Therefore, if additional income taxes were included through an income tax allowance for such individual unitholders, the CC Shippers argued, partners would receive double compensation for the same tax expense. *Id*. at p. 49 (*citing Texaco Refining and*

[162] 111 FERC ¶ 61,139.

Marketing, Inc. v. SFPP, L.P., 117 FERC ¶ 61,285 (2006)). Further, they noted, the Circuit Court also recognized that the taxes are already considered in the dividends used to determine the dividend yield for the DCF methodology. *Id*. (*citing BP West Coast Products v. FERC*, 374 F.3d at p. 1290).

620. The Commission, in *SFPP, L.P.*, 121 FERC ¶ 61,240, failed to recognize that the DCF methodology is used on a pre-tax basis, the CC Shippers argued. *Id*. Investors are looking for a return on equity based on actual dividends or distributions, and are not, the CC Shippers contended, expecting the pipeline to get an additional allowance to pay taxes above and beyond what is included in the cash distribution; therefore, they insisted, the Commission permitted partnership unitholders a double recovery of taxes. *Id*. at p. 50 (*citing Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 38 (1997); *SFPP, L.P.*, 121 FERC ¶ 61,240).

621. Continuing, the CC Shippers stated that the Commission's stand-alone principle provides that a tax allowance for a regulated entity is determined by looking at the net income of the regulated entity and is not increased or decreased by non-jurisdictional income, deductions, or losses of affiliated or parent companies. *Id*. at p. 50 (*citing Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 56; *Columbia Gulf Transmission Co.*, 23 FERC ¶ 61,396 (1983); *City of Charlottesville v. FERC*, 774 F.2d 1205, 1207-08 (D.C. Cir. 1985), *cert. denied*, 475 U.S. 1108 (1986); *SFPP, L.P.*, 86 FERC at p. 61,103). However, according to them, the Commission agreed that the stand-alone principle was not violated when income allocated to Kinder Morgan's general partners was inflated by incentive distributions generated by Kinder Morgan's subsidiaries, other than SFPP. *Id*. at pp. 50-51 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 43; *Texaco Refining and Marketing, Inc., v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 374 (2004)). SFPP assumed, the CC Shippers opined, that its taxable income would flow from SFPP to Kinder Morgan on a dollar for dollar basis. *Id*. at p. 51. However, they continued, this calculation is distorted because SFPP implemented Kinder Morgan's provision which specifies that all income must first be allocated to the general partner until that amount equals the amount of the general partner's incentive distribution. *Id*. SFPP, the CC Shippers contended, had no basis to assign itself incentive distributions that Kinder Morgan's general partner received from Kinder Morgan in 2003. *Id*.

622. The CC Shippers argued that establishing SFPP's income tax allowance using taxable income allocations which include the application of Kinder Morgan's incentive distribution provision is unreasonable because the amount of the allowance becomes subservient to Kinder Morgan's cash distribution practices. *Id.* at pp. 51-52. These practices, the CC Shippers claimed, give Kinder Morgan's general partner, who has influence over the cash distribution policy, the authority to set SFPP's income tax allowance. *Id.* at p. 52 (*citing* Exhibit No. CC-1 at p. 24). Non-SFPP operations, according to them, increased Kinder Morgan's overall income and the amount of cash

distributions to Kinder Morgan's general partner, causing the income attributable to corporations, as well as SFPP's income tax rate, to rise. *Id*. at p. 52.

623. SFPP attempted to use the same proportion of 2003 total income used for incentive distributions for both Kinder Morgan and SFPP, the CC Shippers explained. *Id*. at p. 53. However, they continued, Kinder Morgan's incentive distribution provision does not work proportionally, which renders SFPP's method incorrect. *Id*. (*citing* Exhibit No. CC-1 at p. 26). When calculated in a manner that they consider correct, the CC Shippers stated, SFPP's distributions result in no incentive distribution to Kinder Morgan's general partner. *Id*. (*citing* Exhibit No. CC-1 at p. 24). The CC Shippers added, when the 2003 taxable income weights are recalculated using SFPP's taxable income, correctly accounting for the incentive distribution provision on a stand-alone basis, the percentages of corporate and individual unitholders are changed significantly, which the CC Shippers contended practically reversed their relative weights, impacting the ultimate result. *Id*. at pp. 53-54 (*citing* Exhibit No. CC-1 at p. 28).

624. According to the CC Shippers, SFPP claims its income tax allowance by relying on the *Policy Statement on Income Tax Allowances* and the Commission's observations in the prior case which was completed before the Policy Statement was issued and therefore there was never a hearing which explored the issue of actual or potential tax liability. CC Shippers Reply Brief at p. 35.

B. INDICATED SHIPPERS

625. The Indicated Shippers argued that SFPP is not entitled to any income tax allowance based on substantial record evidence in this proceeding, as it did not attempt to meet its burden of proof that Kinder Morgan's partners had actual or potential income tax liability on SFPP's taxable income. Indicated Shippers Initial Brief at p. 23. They added that Kinder Morgan's general partner took all of Kinder Morgan's 2003 taxable income, and the limited partners were allocated losses in income. *Id*. (*citing* Exhibit Nos. BPX-5 at p. 11, BPX-23).

626. The Indicated Shippers stated that both the Commission's *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 42, and the Circuit Court in *ExxonMobil*, 487 F.3d at p. 954 (*citing SFPP, L.P.*, 111 FERC at p. 62,456), placed the burden of proof on SFPP to show Kinder Morgan's partners' actual or potential income taxes, and they contended that SFPP has not met this burden. *Id*.

627. As indicated on Kinder Morgan's 2003 IRS Form 1065, no taxable income was allocated to the limited partners, according to the Indicated Shippers, who were instead allocated losses on which there is no current tax liability. *Id*. at p. 24 (*citing* Exhibit Nos. SFO-55C at pp. 1-54, BPX-21 at p. 17). This loss can, however, be carried forward to offset future income allocated to the limited partners or until the limited partner sells his or

her shares, the Indicated Shippers added. *Id*. at pp. 24-25 (*citing* Exhibit No. BPX-21 at p. 9; BPX-23; Transcript at p. 921).

628. The Indicated Shippers alleged that SFPP's witness Ganz did not present any evidence in his calculations that SFPP's income actually flowed through to the partners. *Id*. at p. 25. Moreover, they continued, Ganz did not attempt to show that the limited partners had income and admitted that SFPP's income was embedded in the losses in taxable income. *Id*. (*citing* Transcript at p. 984). The Indicated Shippers maintained that if there is no income, then there is no income tax liability to subsidize. *Id*.

629. Due to 743(b) depreciation, the limited partners, according to the Indicated Shippers, had more losses in income than were necessary to offset the income paid to the general partner as a management fee. *Id*. at pp. 25-26. Because the general partner was allocated income that was above the MLP's total taxable income, they added, this must be offset by an equal amount of losses in taxable income to the limited partners. *Id*. at p. 26 (*citing* Transcript at p. 942). However, the limited partners are entitled to 743(b) depreciation, which results in more negative income being shown for the limited partners, the Indicated Shippers explained. *Id*. at pp. 26-27 (*citing* Exhibit No. SFO-55C at p. 6). Conversely, they added, had there been no 743(b) depreciation, the income tax return would likely have shown that positive income taken by the general partner and the losses allocated to the limited partners balanced out to Kinder Morgan's income. *Id*. at p. 27.

630. The Indicated Shippers explained that 743(b) depreciation, which is material when determining actual or potential income taxes, is tracked by the partnership, which applies the 743(b) depreciation to each partner's K-1. *Id*. However, they added, SFPP witness Bullock claimed that he could not identify the 743(b) depreciation on a K-1, while SFPP witness Ganz, the Indicated Shippers pointed out, admitted that he did not consider 743(b) depreciation when he allocated income to the limited partners. *Id*. (*citing* Transcript at pp. 939, 943, 984). Additionally, the Indicated Shippers stated, Ganz presumed positive income going to the limited partners when the partners actually had losses. *Id.* at p. 28.

631. The Indicated Shippers contended that because the general partner took more than all of the taxable income as a management fee, "it is beyond reasonable to assume that any income from SFPP was given to the limited partners, much less taxable income on which income taxes would have to be paid." *Id*. They noted that the Commission has recognized that there are many cases in which partners do not get taxable income. *Id*. (*citing Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 14). Here, the Indicated Shippers argued, SFPP has not proven that Kinder Morgan's partners have actual or potential income taxes to pay on SFPP's income. *Id*. at p. 29. Kinder Morgan's limited partners, therefore, have a tax rate of zero, cutting the weighted federal income tax allowance to 3.02%, according to the Indicated Shippers. *Id*. (*citing* Exhibit Nos. BPX-32 at p. 20, BPX-40).

632. In their Reply Brief, the Indicated Shippers stated that Kinder Morgan's limited partners received losses in income in both 2003 and 2004 and thus do not have actual or potential income taxes to pay, as SFPP contended, because there would not be actual or potential taxes on negative income, which carries forward and offsets taxes in future years. Indicated Shippers Reply Brief at p. 10 (*citing* SFPP Initial Brief at p. 57; Exhibit Nos. BPX-5 at pp. 13, 16, BPX-23; Transcript at pp. 920-21). Moreover, they noted, Ganz conceded that income from SFPP was embedded in the losses incurred by the limited partners. *Id*. (*citing* Transcript at p. 984). No income tax allowance has been justified by SFPP, the Indicated Shippers asserted, because there was no income for the limited partner class. *Id*. (*citing* Exhibit Nos. SFO-55C at p. 6, SFO-57C at p. 6).

C. COMMISSION TRIAL STAFF

633. Staff stated that SFPP must show that partners in its chain of ownership had actual or potential tax liability on regulated income generated by SFPP in 2003 in order to be entitled to an income tax allowance. Staff Initial Brief at p. 38 (*citing Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 1, 32). Therefore, Staff explained, because SFPP's primary partner in 2003 was OLP-D and Kinder Morgan, an MLP with a general partner and thousands of public limited partners, was OLP-D's primary partner, SFPP must show that Kinder Morgan's partners had actual or potential tax liability on the regulated income generated by SFPP. *Id*. (*citing* Exhibit No. BPX-49).

634. While SFPP had taxable income in 2003 and allocated taxable income to OLP-D, Kinder Morgan allocated only losses to its public limited partners, Staff asserted. *Id*. at p. 39 (*citing* Exhibit Nos. SFO-55A at p. 19, BPX-23; Transcript at p. 1044). However, according to it, under the *Policy Statement on Income Tax Allowance*, 111 FERC ¶ 61,139 at P 1, 32, SFPP can demonstrate that Kinder Morgan's partners had potential tax liability from 2003 regulated income even if they did not receive any taxable income, but were only allocated losses. *Id*. at pp. 39-40. Moreover, Staff noted, SFPP did not present evidence as to when Kinder Morgan's partners would dispose of their units or as to whether the proceeds from this disposal would be taxable. *Id.* at p. 40. Therefore, Staff argued, one could say that Kinder Morgan's partners had potential liability of 2003 regulated taxable income of SFPP. *Id*. Continuing, Staff stated that Kinder Morgan need only show that its Schedules K-1 for 2003 show allocations of losses or taxable income. *Id*. (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 27, 30, 34). According to Staff, it presumed that Kinder Morgan's partners will at some point dispose of their partnership units, and thus, potentially, will have tax liability on SFPP's 2003 regulated income. *Id*. at pp. 40-41.

635. In its Reply Brief, Staff contended that, while the Indicated Shippers argued that SFPP is not entitled to an income tax allowance because it has not met the burden of proving facts which show that taxable income reached Kinder Morgan's public limited partners, SFPP's submission of Kinder Morgan's public limited partners' Schedules K-1

provided substantial record evidence supporting a finding that they have potential tax liability. Staff Reply Brief at p. 27 (*citing* Indicated Shippers Initial Brief at pp. 23-29; Exhibit No. SFO-49 at pp. 11-12; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 27, 30, 34).

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636. Given, according to SFPP, that it has provided evidence sufficient to show that its partners have an actual or potential income tax liability, SFPP submitted that it is entitled to an income tax allowance in its cost-of-service in accordance with the Commission's *Policy Statement on Income Taxes*, 111 FERC ¶ 61,139. SFPP Initial Brief at p. 55.

637. In the *Policy Statement on Income Taxes*, as well as in subsequent orders, SFPP stated, the Commission required that SFPP must show that its owners have actual or potential income tax liability and how the partnership calculated its income tax allowance. *Id*. SFPP explained that it complied with the instructions from these orders, first by separating its Kinder Morgan unitholders into six categories depending on their nature as a pass-through entity subject to an actual or potential income tax liability and calculated the percentages of the unitholders in each category as well as the percentage of taxable income imputed to each group. *Id*. at p. 56 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 45-46). Furthermore, SFPP continued, it took this information and calculated a weighted income tax allowance using the marginal income tax rate established for each type of partner. *Id*.

638. Additionally, SFPP contended that it is entitled to state income taxes in its income tax allowance if it is able to establish that SFPP is entitled to a federal income tax allowance, under *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 59. *Id*. at p. 57. SFPP claimed that it recalculated its weighted state income tax rate because the relevant marginal tax rate is the weighted marginal tax rate of all of Kinder Morgan's partners who are required to declare Kinder Morgan's income, and not SFPP's income, in the states where Kinder Morgan operates. *Id*. (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 61).

639. SFPP insisted that it presented evidence required to demonstrate that Kinder Morgan's partners had actual or potential income tax liability of the SFPP income allocated to them in 2003 and 2004. *Id*. Specifically, according to SFPP, SFPP's witness Bullock presented its IRS Form 1065 for SFPP, OLP-D, and Kinder Morgan, which reported the partnerships' taxable income for each year, as well as Kinder Morgan, Inc.'s IRS Form 1120 which shows Kinder Morgan, Inc.'s taxable income and the income tax it paid on that taxable income. *Id*. at p. 58 (*citing* Exhibit Nos. SFO-55A, SFO-55B, SFO-55C, SFO-55D, SFO-57A, SFO-57B, SFO-57C, SFO-57D). Also, SFPP noted, Bullock presented SFPP, OLP-D, and Kinder Morgan's partnership agreements, which govern the allocation of income among the partners of each entity; state income tax returns; and state income apportionment factors used for calculating the weighted state

income tax rates for the Kinder Morgan limited partners. *Id*. (*citing* Exhibit Nos. SFO-59, SFO-60).

640. Using the information provided by Bullock, SFPP stated that Ganz calculated its income tax allowances for 2003 and 2004. *Id*. (*citing* Exhibit No. SFO-61 at pp. 18, 33). He did this, according to SFPP, by determining the number of limited partner units by category and the percentage of units in each category. *Id*. at pp. 58-59 (*citing* Exhibit Nos. SFO-61 at pp. 18-19, 23-24, SFO-62A at p. 2, SFO-62B at p. 2). Further, SFPP continued, Ganz traced SFPP's taxable income through each level of ownership to determine how much was allocated to each individual or category of partners and the percentage received by each category. *Id*. at p. 59 (*citing* Exhibit Nos. SFO-61 at pp. 19, 22, 24-27, SFO-62A at p. 3, SFO-62B at p. 3). Further, SFPP contended, the Commission has identified appropriate marginal rates for each category, which Ganz applied in order to compute the federal income tax rate for each year. *Id*. at pp. 59-60 (*citing* Exhibit Nos. SFO-62A at p. 1, SFO-61 at pp. 22, 27, SFO-62B at p. 1; Transcript at pp. 989, 992).

641. Finishing its argument, SFPP asserted that Ganz calculated SFPP's weighted 2003 and 2004 federal and state income tax rates and developed a net-to-tax multiplier used to calculate the income tax allowance used in the North and Oregon Line costs of service for both years. *Id*. (*citing* Exhibit Nos. SFO-61 at p. 33, SFO-63 at p. 1, SFO-64 at p. 1, SFO-65A at p. 1, SFO-65B at p. 1, SFO-67A at p. 1, SFO-67B at p. 1, SFO-115 at p. 1, SFO-116 at p. 1, SFO-117 at p. 1, SFO-118 at p. 1). The CC Shippers and Staff both agreed with SFPP's calculations, which, according to SFPP, are in compliance with Commission requirements.[163] *Id*. (*citing* Exhibit Nos. S-4 at pp. 7-9, 14, S-15 at pp. 3-7, CC-44 at p. 18).

642. SFPP claimed that it calculated its income tax allowances in accordance with the Commission's requirements, and any arguments raised by the Complainants amount to collateral attacks on the Commission orders. SFPP Reply Brief at p. 61 (*citing* SFPP Initial Brief at pp. 55-73). According to SFPP, the CC Shippers attacked *SFPP, L.P.*, 121 FERC ¶ 61,240 by relying on their witness O'Loughlin's Direct Testimony, which was filed prior to the Order, and by failing to acknowledge that O'Loughlin testified that SFPP had calculated its income tax allowance in accordance with *SFPP, L.P.*, 121 FERC ¶ 61,240. SFPP Reply Brief at p. 62 (*citing* CC Shippers Initial Brief at pp. 46-63; Exhibit No. CC-44 at p. 18). According to it, the CC Shippers argued that SFPP relied on Commission policy rather than submitting evidence demonstrating actual or potential income tax liability, which SFPP pointed out, is a rejection of *SFPP, L.P.*, 121 FERC

[163] The Commission's requirements, according to SFPP, are set forth in the *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 10-46; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 49-66; and *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 20-61. SFPP Initial Brief at p. 60.

¶ 61,240. *Id*. (*citing* CC Shippers Initial Brief at p. 47). The Indicated Shippers also argued that SFPP did not attempt to meet its burden of proof, SFPP continued, when in actuality, SFPP submitted what was considered satisfactory evidence by the Commission in the *SFPP, L.P.*, 121 FERC ¶ 61,240. *Id*.

643. SFPP contended that the CC Shippers acknowledged that the Commission's rejection of their argument in *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 52-53, that the DCF model results in the double recovery of income tax liability. *Id*. at pp. 62-63 (*citing* CC Shippers Initial Brief at pp. 48-50). It added that the CC Shippers' argument that *SFPP, L.P.*, 121 FERC ¶ 61,240 violates the Commission's stand-alone tax policy was considered and rejected as well. *Id*. at p. 63 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 42-43; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 45-47).

644. The Indicated Shippers argued, SFPP stated, that Kinder Morgan's limited partners received losses and therefore did not have actual or potential income tax liability. *Id*. at pp. 63-64. However, SFPP continued, they undermined their argument by citing to Ganz's testimony that SFPP's income is embedded in the losses that Kinder Morgan allocates. *Id*. at p. 64 (*citing* Indicated Shippers Initial Brief at pp. 23-29, 25). SFPP explained further, stating that it allocates positive taxable income to the partners that is offset by losses, deductions, and credits of other entities, which is irrelevant to the determination of SFPP's income tax allowance. *Id*. at p. 64. The Commission, SFPP continued, has rejected arguments, such as the Indicated Shippers', which claim that SFPP's taxable income is offset by losses, deductions, or other offsets which originate with other Kinder Morgan entities. *Id*. (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 40-41; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 56-57; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 28; *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 31-32).

645. In another collateral attack, SFPP contended, the Indicated Shippers claimed, contrary to *SFPP, L.P.*, 113 FERC ¶ 61,277, that SFPP failed to show an actual or potential income tax liability because the general partner received income greater than that of the limited partners and Kinder Morgan. *Id*. (*citing* Indicated Shippers Initial Brief at pp. 25-26, 28). However, SFPP stated, the Commission has found that the general partner's incentive distribution does not eradicate the actual or potential tax liability of the partners, who will still have tax liability for 100% of SFPP's taxable income, unless there are offsets. *Id*. at pp. 64-65 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 26). The Indicated Shippers, moreover, argued that the incentive distribution to Kinder Morgan's general partner should not be considered when determining SFPP's income tax allowance because it is a management fee, despite that fact that, according to SFPP, the Commission already determined that the incentive distribution is properly included in the income tax allowance calculation and is not a management fee. *Id*. at p. 65 (*citing* Indicated Shippers Initial Brief at pp. 25-26, 28, 36-37; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 58). Additionally, SFPP asserted, the Commission has also already rejected the Indicated

Shippers' contention that the general partner is paid on a guaranteed basis, which they "erroneously" derived from Bullock's testimony. *Id*. (*citing* Indicated Shippers Initial Brief at p. 36; Transcript at p. 932; *SFPP, L.P*., 121 FERC ¶ 61,240 at P 58).

Discussion and Ruling

646. The issue is whether SFPP has met its burden of proof regarding its entitlement to an income tax allowance for the years 2003 and 2004. In order to meet its burden of proof and be entitled to an income tax allowance for the years in question, SFPP must show that its partners have actual or potential income tax liability. *SFPP, L.P*., 121 FERC ¶ 61,240 at P 20.

647. The CC Shippers contended that SFPP has not presented any evidence that demonstrates that its unitholders have actual or potential income tax liability. CC Shippers Initial Brief at p. 47. They also argued that SFPP's claimed income tax allowance provides a double recovery of income taxes with regard to non-corporate Kinder Morgan entities. *Id.* at p. 48. Moreover, the CC Shippers maintained, establishing SFPP's income tax allowance using taxable income allocations which include the application of Kinder Morgan's incentive distribution provision is unreasonable because the amount of the allowance becomes subservient to Kinder Morgan's cash distribution practices, which give Kinder Morgan's general partner, who has influence over the cash distribution policy through the authority to set SFPP's income tax allowance. *Id.* at pp.51-52 (*citing* Exhibit No. CC-1 at p. 24).

648. The Indicated Shippers argued that SFPP is not entitled to any income tax allowance based on substantial record evidence in this proceeding because it did not attempt to meet its burden of proof that Kinder Morgan partners had actual or potential income taxes on SFPP's taxable income. Indicated Shippers Initial Brief at p. 23. They added that Kinder Morgan's general partner took all of Kinder Morgan's 2003 taxable income, and the limited partners were allocated losses in income which can be carried forward to offset future income allocated to the limited partners, or until the limited partner sells his or her shares. *Id*. at pp. 23-25. The Indicated Shippers alleged that SFPP did not present any evidence that SFPP's income actually flowed through to the partners, and maintained that, if there is no income, then there is no income tax liability to subsidize. *Id*. at p. 25. Also, the limited partners, according to the Indicated Shippers, had more losses in income than were necessary to offset the income paid to the general partner as a management fee due to 743(b) depreciation. *Id*. at pp. 25-26. No income tax allowance has been justified by SFPP, the Indicated Shippers asserted, because there was no income for the limited partner class. Indicated Shippers Reply Brief at p. 10.

649. Staff argued that SFPP must show that the partners in its chain of ownership had actual or potential tax liability on regulated income generated by SFPP in 2003 in order to be entitled to an income tax allowance. Staff Initial Brief at p. 38. According to Staff,

SFPP can demonstrate that Kinder Morgan's partners had potential tax liability from 2003 regulated income even if they did not receive any taxable income, but were only allocated losses. *Id*. at pp. 39-40. Moreover, Staff noted, SFPP did not present evidence as to when Kinder Morgan's partners would dispose of their units or as to whether the proceeds from this disposal would be taxable. *Id*. at p. 40. It, therefore, argued that Kinder Morgan's partners had potential liability of 2003 regulated taxable income of SFPP, presuming that they will dispose of their partnership units at some point in time. *Id*. at pp. 40-41. Furthermore, Staff contended that SFPP's submittal of Kinder Morgan's public limited partners' Schedules K-1 provided substantial evidence supporting a finding that they have potential tax liability. Staff Reply Brief at p. 27.

650. SFPP claimed that it is entitled to an income tax allowance in its cost-of-service because it provided evidence sufficient to show that its partners have an actual or potential income tax liability on the SFPP income allowanced to them in 2003 and 2004. SFPP Initial Brief at p. 55.

651. The Circuit Court, in *ExxonMobil*, 487 F.3d at p. 955, upheld the Commission's determination that granting pipelines an income tax allowance to the extent that the pipelines' partners incur actual or potential income tax liability is just and reasonable. According to the Circuit Court, "the Commission reasonably determined that such taxes are 'attributable' to the regulated entity, given that partners must pay tax on their share of the partnership income regardless of whether they actually receive a cash distribution." *Id.* at p. 955. This also is reflected in the *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 32, in which the Commission permitted an income tax allowance for a pass-through entity if there is actual or potential income tax liability to be paid on the income earned from the entity's assets. The income taxes paid by the owners of a pass-through entity are a cost of acquiring and operating the assets of that entity, much the same as if they were owned by a corporation. *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 33. The burden of proof is on the pass-through entity 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." *Id*. at P 42.

652. SFPP is permitted an income tax allowance if it can demonstrate that its individual and corporate partners "had an actual or potential tax on the jurisdictional income generated by the partnership." *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 20, 22. In *SFPP, L.P.*, 113 FERC ¶ 61,277 and *SFPP, L.P.*, 121 FERC ¶ 61,240, the Commission addressed the meaning of "actual or potential" income tax liability. First, the Commission explained that a partner has actual or potential income tax liability if that partner files a Form 1040 or Form 1120 which shows that the partner received either income or a loss. *SFPP, L.P.*, 113 FERC ¶ 61,277 at p. 28. The Commission affirmed this determination, stating that if a partner must file a return recognizing taxable gain or loss, this establishes the partner's actual or potential income tax liability. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 24.

Moreover, the Commission explained 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." *Id*. at P 34.

653. In 2003 and 2004, according to Bullock, SFPP's general partner was OLP-D and its limited partner was Santa Fe. Exhibit No. SFO-49 at p. 3. Under SFPP's partnership agreement, OLP-D and Santa Fe are allocated taxable income in accordance with the percentage interest in the partnership. Exhibit Nos. SFO-49 at p. 5, SFO-50 at p. 29. Moreover, SFPP's taxable income is ultimately allocated to Kinder Morgan, Inc., and Kinder Morgan's partners, Bullock noted. Exhibit No. SFO-49 at p. 10. Specifically, he explained, a portion of SFPP's income is allocated to OLP-D whose income is allocated to Kinder Morgan and Kinder Morgan GP, Inc. *Id*. Kinder Morgan's income, including OLP-D's income (which includes a portion of SFPP's income), is then allocated among its partners and its public partners. *Id*. at pp. 10-11. Kinder Morgan, Inc., he added, includes the taxable income allocated to Kinder Morgan's partners, except its public partners, in its federal tax return, which determines the actual or potential tax liability of all Kinder Morgan, Inc. entities. *Id*. at p. 11. Essentially, SFPP's taxable income eventually flows to Kinder Morgan, Inc. and Kinder Morgan's partners. *Id*. at p. 11.[164] This issue previously was addressed by the Commission, which had allowed SFPP to "justify an income tax allowance factor designed to recover the actual or potential income tax of its partners based on their limited partnership interests in [Kinder Morgan], the MLP that owns SFPP." *SFPP, L.P.*, 121 FERC ¶ 61,240 at p. 20. Therefore, SFPP's burden is to show the actual or potential income taxes of Kinder Morgan's partners, where SFPP's "ultimate tax liability lies." *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at P 42; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 47.

654. SFPP submitted into evidence SFPP, Kinder Morgan Operating, L.P. "D," and Kinder Morgan's 2003 and 2004 IRS Forms 1065, federal tax returns, which include Schedule K-1s for their general and limited partners. *See* Exhibit Nos. SFO-55A, SFO-55B, SFO-55C, SFO-57A, SFO-57B, SFO-57C. Additionally, SFPP filed Kinder Morgan, Inc.'s IRS Forms 1120 for 2003 and 2004. Exhibit Nos. SFO-55D, SFO-57D. The Schedule K-1s alone are sufficient, according to the Commission, to show that a partner has an actual or potential income tax liability. *SFPP, L.P.*, 121 FERC ¶ 61,240 at p. 34. Therefore, it is clear that SFPP has met its burden of showing that its partners have actual or potential income tax liability on the income flowed through to them from SFPP to OLP-D to Kinder Morgan.

655. Both the CC Shippers and the Indicated Shippers argued that SFPP has not provided any evidence that its partners had actual or potential income tax liability. CC Shippers Initial Brief at p. 47; Indicated Shippers Initial Brief at p. 23. The Indicated Shippers contended that Kinder Morgan's partners were allocated only losses and no

[164] *See also* Exhibit No. BPX-49.

income, and thus there was no income, and no income tax liability to subsidize. Indicated Shippers Initial Brief at pp. 24-25. Both parties are essentially rejecting, or attacking, the Commission's order in *SFPP, L.P.*, 121 FERC ¶ 61,240, which only required that SFPP establish its partners' actual or potential gain *or loss*, which it can prove by showing its partners received a K-1. *Id.* at P 24, 34. Contrary to the Complainants' arguments, the record reflects that SFPP has met its burden of proof by offering the K-1s from its partners, OLP-D's partners, and Kinder Morgan's partners into evidence.

656. The Indicated Shippers also claimed that "the amount of the 743(b) depreciation is material to the determination of whether there are actual or potential income taxes to pay." Indicated Shippers Initial Brief at p. 27. However, this argument is irrelevant to whether SFPP has met its burden of showing that its partners have actual or potential income tax liability because, again, all SFPP needed was to show is that its partners filed a return recognizing gain or loss, which SFPP has done in this proceeding. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 24.

657. The CC Shippers argued that SFPP's claimed income tax allowance provides a double recovery of income taxes with regard to non-corporate Kinder Morgan entities because the allowed rate of return on equity already includes a component for individual income taxes. CC Shippers Initial Brief at p. 48 (*citing* Exhibit No. CC-1 at pp. 29-30). They maintained that the dividends or distributions used in the Commission's DCF formula already account for tax considerations. *Id*. at p. 49. SFPP replied that the Commission has already disposed of this issue, and I agree with it. *See* SFPP Reply Brief at pp. 62-63. The Commission addressed the purported double recovery of income taxes when a pass-through entity is allowed an income tax allowance. *See SFPP, L.P.*, 121 FERC ¶ 61,240 at P 52-53. Distributions used in the DCF formula are unlike dividends in that, for them, there is no income tax allowance included in the cost-of-service. *Id*. at P 53. According to the Commission, "the income tax allowance compensates the partners for the tax cost of the distributions they receive and thus equalizes the after-tax cash flows that would be available from a corporation and are used as inputs to the DCF Model." *Id*. The Commission further explained that, therefore, the income tax allowance has a neutral impact on the DCF model. *Id.* In view of the Commission's holding in that matter, the CC Shippers argument, to the extent that it is, or is not, a collateral attack on *SFPP, L.P.*, 121 FERC ¶ 61,240, is without merit.

658. Furthermore, the CC Shippers contended that allowing SFPP an income tax allowance violates the Commission's stand-alone tax policy which, they claimed, requires that the tax allowance be based on the net income of the regulated entity, in this case, SFPP. CC Shippers Initial Brief at p. 50. According to them, the income tax allowance cannot be based on the income or losses generated by the parent. *Id*. Moreover, the CC Shippers argued that SFPP attributed $42.8 million of Kinder Morgan's incentive distributions to SFPP's operations, which, they stated, violates the stand-alone tax policy. *Id*. at p. 51. They maintained that it does not make sense for SFPP's income tax allowance

to be established based on taxable income allocations that were distorted by Kinder Morgan's incentive distribution provision from its partnership agreement. *Id*. at pp. 51-52.

659. The CC Shippers' argument has already been addressed by the Commission, which concluded that SFPP's approach does not violate the stand-alone principle. *See SFPP, L.P.*, 113 FERC ¶ 61,277 at P 43; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 57. Specifically, the Commission affirmed *SFPP, L.P.*, 113 FERC ¶ 61,277, holding that incentive distributions do not improperly distort the income tax allowance calculation. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 57. More specifically, the Commission stated that, while incentive distributions may provide incentives for excessive distributions, this is a cash management or service issue, not a regulatory income tax allowance matter, which would be "more appropriately addressed in a venue other than a rate proceeding." *Id*. Because the Commission has already concluded that SFPP's incentive distributions do not distort the income tax allowance calculation, this argument by the CC Shippers, to the extent that it is, or is not, a collateral attack on *SFPP, L.P.*, 113 FERC ¶ 61,277 and/or *SFPP, L.P.*, 121 FERC ¶ 61,240, is without merit.

C: Struck

D: What is the appropriate income tax allowance?[165]

A. CC SHIPPERS

660. The CC Shippers submitted that all six categories of unitholders[166] should be assigned a zero percent federal income tax rate, with the exception of the subchapter C corporate class, which should be assigned a 35% rate. CC Shippers Initial Brief at p. 55. The weighted average state and federal income tax rate for SFPP's owners, the CC Shippers insisted, should be 5.13% for the North Line and 5.01% for the Oregon Line, and should be used when calculating the income tax allowance component of cost-of-service in implementing the *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139. *Id*. (*citing* Exhibit No. CC-1 at p. 32).

661. SFPP, the CC Shippers asserted, incorrectly used a 28% marginal income tax rate for all non-corporate unitholders in its 2003 cost-of-service, and also incorrectly applied the *Policy Statement on Income Tax Allowances* by using improper weights for each category of unitholders. *Id*. at p. 56 (*citing* Exhibit No. CC-1 at pp. 21-35). Further, they

[165] Issues IV.D, IV.D.1, and IV.D.2 are joined together for decision.

[166] The six Commission-specified categories of unitholders, according to the CC Shippers, are Subchapter C corporations, Individuals, Mutual Funds, Pensions/IRAs/Keoghs, UBTI Entities, and Non-taxpaying entities. CC Shippers Initial Brief at pp. 54-55 (*citing* Exhibit No. CC-1 at p. 21).

contended, SFPP cannot trace taxable income once it leaves SFPP, which is what it attempted when developing weights for its proposed tax rates, according to the CC Shippers. *Id*. (*citing* Exhibit No. CC-1 at p. 23). Specifically, they continued, SFPP was unable to show that its 2003 taxable income was passed along undiminished from SFPP to OLP-D to Kinder Morgan to Kinder Morgan, Inc., and its subsidiaries. *Id*. at p. 57. While acknowledging that SFPP calculated that a large proportion of its 2003 taxable income was allocated to Kinder Morgan, Inc., and its subsidiaries with the remainder going to investors in Kinder Morgan's common units, the CC Shippers contended that SFPP was unable to prove that Kinder Morgan separately tracked the income of its subsidiaries, and thus, the CC Shippers argued, SFPP's efforts to trace its income to Kinder Morgan's partners was merely a hypothetical exercise. *Id*. (*citing* Exhibit No. CC-1 at p. 23).

662. The UBTI ownership category should be assigned a zero percent tax rate, the CC Shippers argued, because SFPP's evidence shows, according to them, that UBTI entity unitholders have not received the IRS's threshold amount of unrelated business income of $1000 or more, which triggers UBTI liability, and thus there is no foundation for claiming any tax rate associated with these tax-exempt entities. *Id*. at pp. 57-58 (*citing* Exhibit Nos. CC-1 at pp. 30-31, CC-21; 26 C.F.R. §§ 1.6012-2(e) and 1.6012-3(a)(5) (1999)). Additionally, mutual funds, the CC Shippers explained, will not be taxed so long as they pass through at least 90% of their income to investors as dividends. *Id*. at pp. 58-59 (*citing* Exhibit No. CC-23). Presuming that mutual funds are managed so as to avoid income taxes because SFPP has not offered any evidence to the contrary, the CC Shippers stated that that they should be assigned a zero percent tax rate. *Id*. at pp. 57, 59.

663. The CC Shippers argued that SFPP did not meet its burden of proof, and that the record evidence is sufficient to rebut the Commission's presumption that non-corporate unitholders should be assigned a 28% tax rate for use in calculating the appropriate income tax allowance. *Id*. at p. 59.

664. In their Reply Brief, the CC Shippers stressed that, while their witness O'Loughlin stated in his rebuttal testimony that SFPP witness Ganz calculated a weighted income tax rate of 35% in a manner consistent with *SFPP, L.P.*, 121 FERC ¶ 61,240, he was not insinuating that the 35% rate is his recommendation. CC Shippers Reply Brief at p. 38 (*citing* Exhibit Nos. CC-1 at pp. 21-22, CC-44 at p. 18; SFPP Initial Brief at p. 60). Moreover, they continued, O'Loughlin does not agree that Ganz complied with the *Policy Statement on Income Tax Allowances*. *Id*. at p. 39 (*citing* Exhibit Nos. CC-1, CC-44 at p. 18). SFPP, the CC Shippers stated, insisted that some categories of non-corporate unitholders had tax liability when they did not, which trickled down into errors in SFPP's calculations of the percentage of unitholders in the categories, the percentage of taxable income to be imputed to each, and the weighted income tax allowance. *Id*. (*citing* Exhibit No. CC-1 at pp. 28-33).

665. Staff, according to the CC Shippers, was incorrect in concluding that all SFPP needed to do to prove it was entitled to an income tax allowance was to present Kinder Morgan's 2003 K-1s into evidence. *Id*. at p. 40. The CC Shippers asserted that Staff concluded both that it was not necessary for SFPP to trace its income and that the character of Kinder Morgan's unitholders was not relevant to their potential tax liability. *Id*.

B. INDICATED SHIPPERS

666. According to the Indicated Shippers, while Ganz properly noted the amount of taxable income that SFPP reported to the IRS, after deducting depreciation (including tax depreciation) and after taking expense deductions, this taxable income included $19,543,679 in revenues in excess of cost-of-service. Indicated Shippers Initial Brief at pp. 29-30 (*citing* Exhibit Nos. SFO-62A, SFO-62B, BPX-50 at p. 67, BPX-54).[167]

C. COMMISSION TRIAL STAFF

667. Staff stated that it adopted SFPP's 2003 income tax allowance. Staff Initial Brief at p. 41 (*citing* Exhibit Nos. S-10 at p. 1, S-11 at p. 1). In its Reply Brief, Staff stated that the income tax allowances it proposed for both lines should be used. Staff Reply Brief at p. 28 (*citing* Exhibit Nos. S-10 at p. 1, S-11 at p. 1). According to Staff, the income tax allowance need not be reduced by "excess profits," as the Indicated Shippers contended because they did not show that these "excess profits" translate into an inappropriate income tax allowance amount, nor did they show, it alleged, how they relate to a proper income tax allowance. *Id.* (*citing* Indicated Shippers Initial Brief at p. 29; Exhibit Nos. BPX-50 at p. 67, SFO-65A at p. 1, SFO-65B at p. 1).

D. SFPP, L.P.

668. SFPP maintained that the appropriate income tax allowance for 2003 and 2004 is that which was calculated by Ganz for use in his cost-of-service. SFPP Initial Brief at p. 61. Specifically, SFPP elaborated, Ganz calculated a weighted federal and state income tax rate of 35% for 2003 and 34.48% for 2004. *Id*. (*citing* Exhibit Nos. SFO-61 at pp. 28-31, SFO-64 at p. 1). Moreover, he calculated a net-to-tax multiplier for each year and used them to determine SFPP's income tax allowance as part of his cost-of-service calculations, SFPP added. *Id*. (*citing* Exhibit Nos. SFO-61 at p. 29, SFO-63 at p. 1, SFO-64 at p. 1, SFO-65B at p. 1, SFO-67A at p. 1, SFO-67B at p. 1, SFO-115, SFO-116, SFO-117, SFO-118).

669. In its Reply Brief, while claiming that it calculated the appropriate income tax allowance in accordance with the Commission's requirements, SFPP alleged that the CC

[167] Indicated Shippers did not address Issue IV.D in its Reply Brief.

Shippers assigned tax rates that are contrary to these requirements. SFPP Reply Brief at p. 66 (citing SFPP Initial Brief at pp 55-73). The CC Shippers, according to SFPP, assigned a 35% tax rate to corporations, while the Commission assigns a 34% rate unless a corporation exceeds certain minimum standards. *Id.* (*citing* CC Shippers Initial Brief at p. 55; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 29-32; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 52-55, 60; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 35-39). Further, SFPP stated that the CC Shippers assigned a zero percent marginal rate to non-corporate unitholders without evidence rebutting the Commission's presumption of a 28% rate. *Id*. at p. 67 (*citing* CC Shippers Initial Brief at p. 55; Exhibit No. CC-1 at pp. 29-31). The CC Shippers also presented arguments that UBTI entities and mutual funds should be assigned a marginal income tax rate of zero percent, despite the Commission's rebuttable presumption of a marginal income tax rate of 28% for each, SFPP stated. *Id*. Lastly, the CC Shippers claimed that SFPP is unable to trace taxable income once it leaves SFPP, but SFPP disagreed, stating that the Commission found that SFPP is in fact able to trace its taxable income and has properly done so. *Id*. at p. 68 (*citing* CC Shippers Initial Brief at pp. 56-57; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 46). Moreover, SFPP maintained that the Indicated Shippers' argument, that SFPP's income tax allowance should be disallowed because of excess profits, has been rejected by the Commission in *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 42. *Id*. at p. 69.

1. What is the taxable income (the dollars that are multiplied by the income tax rate to calculate an income tax allowance in the cost-of-service) of SFPP?

A. CC SHIPPERS

670. SFPP's taxable income, according to the CC Shippers, is $69,769,749.[168] CC Shippers Initial Brief at p. 59 (*citing* Exhibit Nos. CC-19 at p. 2, SFO-62A at p. 3). In their Reply Brief, the CC Shippers stated that they challenged the reasonableness of SFPP's rates using 2003 as the test year and demonstrated that SFPP's rates were unjust and unreasonable, thus discharging their burden of proof. CC Shippers Reply Brief at p. 41. Because SFPP argued that a separate cost-of-service should be used for 2004, according to the CC Shippers, SFPP had the burden to prove that the 2004 cost-of-service it presented negates the results of the 2003 cost-of-service study. *Id.* Furthermore, they declared that SFPP failed to carry its burden of proof and, thus, the CC Shippers contended, the 2004 data is immaterial. *Id*.

[168] SFPP's taxable income comes from its IRS Form 1065. Exhibit No. SFO-55A at p. 6

B. INDICATED SHIPPERS

671. SFPP's taxable income in this proceeding, according to the Indicated Shippers, due to conversion of book income to taxable income and amortization of the ADIT account, is zero. Indicated Shippers Initial Brief at p. 30. While Ganz deducted tax depreciation and made other deductions from income before calculating a tax rate on taxable income, he did not do so, the Indicated Shippers contended, when calculating cost-of-service. *Id*. at pp. 30-31. Therefore, they argued, the taxable income used to calculate an income tax allowance should be reduced by tax depreciations and other deductions so that ratepayers do not pay income taxes on income that is never taxed. *Id*. at p. 31.[169]

C. COMMISSION TRIAL STAFF

672. For calculating an income tax allowance, Staff explained that it adopted SFPP's "2003 taxable income allowance . . . and the associated taxable income." Staff Initial Brief at p. 41 (*citing* Exhibit Nos. S-10 at p. 1, S-11 at p. 1). In its Reply Brief, Staff claimed that the Indicated Shippers have not supported their claims that SFPP's 2003 taxable income should be zero because they do not demonstrate how SFPP failed to take into account a properly depreciated or net rate base when developing its income tax allowance. Staff Reply Brief at pp. 28-29 (*citing* Indicated Shippers Initial Brief at p. 31; Exhibit Nos. SFO-65A at p. 1; SFO-65B at p. 1).

D. SFPP, L.P.

673. SFPP, like the CC Shippers, stated that its taxable income for 2003 is $69,769,749, while its 2004 taxable income is $130,278,246. SFPP Initial Brief at p. 62 (*citing* Exhibit Nos. SFO-55A at p. 6, SFO-57A at p. 6; Transcript at p. 985). In its Reply Brief, SFPP responded to the Indicated Shippers' argument that SFPP's taxable income should be reduced to zero, stating that the Indicated Shippers failed to support their argument with evidence and relied solely on Ganz's cross-examination, which, SFPP claims, does not support their argument. SFPP Reply Brief at pp. 69-70 (*citing* Indicated Shippers Initial Brief at pp. 30-31; Transcript at p. 1045). Moreover, according to SFPP, the Indicated Shippers also claimed that the Kinder Morgan unitholders' 743(b) deductions reduce SFPP's taxable income, an action which, SFPP asserted, violates Commission policy. *Id*. at p. 70 (*SFPP, L.P.*, 113 FERC ¶ 61,277 at P 28; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 56; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 41).

[169] The Indicated Shippers added nothing of substance in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 11.

2. What is the appropriate income tax rate (to be multiplied by taxable income in order to calculate an income tax allowance) under the Policy Statement on Income Tax Allowances?

A. CC SHIPPERS

674. The CC Shippers submitted that the appropriate weighted average state and federal income tax rate for SFPP's owners should be 5.13% for the North Line and 5.01% for the Oregon Line.[170] CC Shippers Initial Brief at p. 60 (*citing* Exhibit No. CC-1 at p. 32).[171]

B. INDICATED SHIPPERS

675. The Indicated Shippers claimed that the issue of what rate to use to multiply against the taxable income in order to calculate a subsidy is not material because there is no taxable income for purposes of calculating an income tax allowance. Indicated Shippers Initial Brief at p. 32. However, they nevertheless argued that zero should be substituted as taxable income to the limited partners because the partners were allocated losses in all relevant years and because the limited partners' 743(b) depreciation was not taken into consideration. *Id*. (*citing* Exhibit Nos. BPX-5 at p. 11, BPX-23; Transcript at pp. 921, 984). Kinder Morgan, the Indicated Shippers asserted, claimed that it cannot provide information to the IRS regarding the amount of 743(b) depreciation flowed through to the partners, which is needed, according to them, to explain why positive and negative income does not balance at the amount of the taxable income of the partnership, as required by the IRS. *Id*. at p. 33 (*citing* Exhibit No. SFO-55C at pp. 18-19). The Indicated Shippers argued that the income tax rate cannot be calculated and SFPP failed to carry its burden of proof because the amount of actual or potential income taxes cannot be calculated without taking 743(b) depreciation into consideration. *Id*.

676. In their Reply Brief, the Indicated Shippers responded that SFPP's argument regarding tax rates for determining an income tax allowance is based solely on the Commission's *Policy Statement on Income Tax Allowances*, which they claimed does not have the force of law, so its application must be justified in each case. Indicated Shippers Reply Brief at pp. 11-12 (*citing* SFPP Initial Brief at p. 62). Furthermore, they continued, SFPP has not shown, even under the *Policy Statement*, that Kinder Morgan's partners had actual or potential income tax liability. *Id*. at p. 12.

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[170] The manner in which the CC Shippers arrived at their suggested weighted average state and federal income tax rates is explained in Issue IV.D.

[171] The CC Shippers added nothing of substance in their Reply Brief. *See* CC Shippers Reply Brief at p. 41.

C. COMMISSION TRIAL STAFF

677. Staff stated that it used the 2003 income tax allowance of SFPP and associated income tax rate. Staff Initial Brief at p. 41 (*citing* Exhibit Nos. S-10 at p. 1, S-11 at p. 1). In its Reply Brief, Staff stated that the Indicated Shippers' argument that an income tax rate need not be calculated because there is no taxable income in this case indicated that SFPP did not prove potential tax liability. Staff Reply Brief at p. 29 (*citing* Indicated Shippers Initial Brief at p. 32). However, according to Staff, SFPP needed only to present Schedules K-1 for Kinder Morgan's public limited partners in order to show potential tax liability in 2003 on regulated SFPP income. *Id*. (*citing SFPP, L.P*., 121 FERC ¶ 61,240 at P 27, 30, 34).

D. SFPP, L.P.

678. The weighted federal and state income tax rates of 35% for 2003 and 34.48% for 2004 are, according to SFPP, the appropriate income tax rates to use when calculating cost-of-service rates.[172] SFPP Initial Brief at p. 62 (*citing* Exhibit Nos. SFO-61 at pp. 28-33, SFO-63 at p. 1, SFO-64 at p. 1). SFPP noted that Staff and the CC Shippers agreed with these calculations. *Id*. at p. 63. According to SFPP, the marginal income tax rates it used to calculate its income tax allowance, however, are challenged by the Indicated Shippers which, it claimed, were unable to prove their contention. *Id*. at p. 63 (*citing* Exhibit No. BPX-5 at pp. 16-25). Instead, SFPP continued, the Indicated Shippers mounted an impermissible collateral attack on Commission decisions on marginal income tax rates by attempting to prove that the use of marginal income tax rates is improper. *Id*. (*citing SFPP, L.P*., 113 FERC ¶ 61,277 at P 31-32; *Texaco Refining and Marketing, Inc. v. SFPP, L.P*., 117 FERC ¶ 61,285 at P 59-63; *SFPP, L.P*., 121 FERC ¶ 61,240 at P 35-39). SFPP added that this attack should be rejected. *Id.*

679. In its Reply Brief, SFPP contended that the CC Shippers' income tax rate calculations should be rejected because, allegedly, their calculations are flawed. SFPP Reply Brief at p. 71. In support of its argument, SFPP explained that O'Loughlin admitted that his weighted income tax rates are inconsistent with Commission determinations and calculated his North and Oregon Line costs of service using SFPP's weighted federal and state income tax rate instead of his own. *Id*. (*citing* Exhibit No. CC-44 at p. 18).

680. SFPP insisted that the Indicated Shippers' attempt to show that SFPP's weighted federal and state income tax rates are wrong failed because they start with the false premise that there is no taxable income for calculating an income tax allowance. *Id*. (*citing* Indicated Shippers Initial Brief at pp. 32-33). The Indicated Shippers' arguments that the tax allowance should not reflect Kinder Morgan's taxable income, rather than

[172] SFPP explained how it arrived at these rates in Issue IV.B.

SFPP's, and that 743(b) deductions of Kinder Morgan partners' 743(b) deductions should be taken into account, according to SFPP, amount to a collateral attack on Commission policy. *Id*. at p. 72.

Discussion and Ruling

681. These issues address the question of SFPP's appropriate income tax allowance. SFPP's income tax allowance depends upon SFPP's taxable income and income tax rate.

682. The CC Shippers, Staff, and SFPP agreed that SFPP's taxable income for 2003 is $69,769,749. CC Shippers Initial Brief at p. 59; Staff Initial Brief at p. 41; SFPP Initial Brief at p. 62. As explained by SFPP, this figure is found on SFPP's 2003 IRS Form 1065, under Analysis of Net Income, on line 1, Net Income. SFPP Initial Brief at p. 62; Exhibit No. SFO-55A at p. 6. SFPP advocated taxable income of $130,278,246 for 2004. SFPP Initial Brief at p. 62 (*citing* Exhibit No. SFO-57A at p. 6).

683. The Indicated Shippers, conversely, claimed that SFPP's 2003 taxable income, due to conversion of book income to taxable income and amortization of the ADIT account, is zero. Indicated Shippers Initial Brief at p. 30. However, the ADIT issue has already been addressed in Issue III.F. There, it was determined that SFPP's ADIT was correctly calculated and its ADIT account is not overfunded. Therefore, the Indicated Shippers' argument here is without merit.

684. Because no party has successfully proven otherwise, SFPP's taxable income for 2003 is that which it reported on its 2003 IRS Form 1065, $69,769,749. Exhibit No. SFO-55A at p. 6. Likewise, for 2004, the appropriate taxable income is $130,278,246, as reported on its 2004 IRS Form 1065. Exhibit No. SFO-57A at p. 6. SFPP's recommended taxable income should be used in determining its income tax allowance.

685. The Commission, in *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 45, directed SFPP as to the manner in which it should determine its income tax allowance. There, the Commission directed SFPP to separate its unitholders into six categories: (1) subchapter C corporations; (2) individuals; (3) mutual funds; (4) other unit holders, such as pension funds, IRAs, Keogh Plans, and other entities that do not normally pay taxes, but would be expected to have taxpaying beneficiaries or owners; (5) entities from (4) that receive unrelated business taxable income from SFPP or Kinder Morgan ("UBTI Entities"); and (6) non-tax paying entities. *Id*. Further, if a unitholder is a pass-through entity, a subchapter S corporation, or a pass-through LLC, Kinder Morgan or SFPP "should identify the nature of the entity or individual ultimately subject to an actual or potential income tax liability and place that entity or individual in the appropriate category of unit owner." *Id*. SFPP then should determine the percentage of unitholders within each category and the percentage of taxable income imputed to each of the categories. *Id*. at P 45, 46. The Commission noted, however, that "the percentage of taxable partnership

income imputed to each group . . . 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." *Id*. at P 46.

686. Additionally, the Commission adopted presumptive tax rates for SFPP and Kinder Morgan unitholders to be used unless a party is able to provide evidence to the contrary. *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 32. It set the marginal tax bracket for tax-paying partners that are not Schedule C corporations at 28%. *Id*. Non-tax paying entities are presumed to have a marginal tax bracket of zero. *Id*. According to the Commission, UBTI Entities are subject to the presumptive 28% tax rate, unless the Internal Revenue Code provides otherwise. *Id*. The Internal Revenue Code does provide otherwise in 26 U.S.C. § 511 (2008), which extends the corporate tax brackets listed in Section 11 of the Internal Revenue Code to UBTI Entities.[173] 26 U.S.C. § 11 (2008). Moreover, while the Commission, in *SFPP, L.P.*, 113 FERC ¶ 61,277, presumed a marginal income tax rate of 35% for subchapter C corporations, in *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 37, it changed the presumptive rate to 34%, absent a showing that a corporate partner has a higher marginal rate.

687. SFPP maintained that it followed the Commission's steps in developing its income tax allowance. SFPP Initial Brief at p. 50. First, in his Direct Testimony, Ganz determined the number of limited partner units in each of the six categories of unitholders. Exhibit No. SFO-61 at pp. 18, 23. He then determined the percentage of total Kinder Morgan units for each group. *Id*. at pp. 18-19; 23-24. Using SFPP's taxable income for 2003 and 2004, as found on its 2003 and 2004 IRS Forms 1065, Ganz determined the amount and percent of SFPP taxable income allocated to Kinder Morgan's limited partners and to each category of Kinder Morgan unitholders. *Id*. at pp. 19-20, 25-26. Additionally, he calculated what amount and percent of SFPP's income was allocated to SFPP's partners (Santa Fe and OLP-D) and OLP-D's partners (Kinder Morgan and Kinder Morgan General Partners). SFPP Initial Brief at p. 59; Exhibit No. SFO-61 at pp. 20, 25.

688. Next, in order to determine each year's weighted federal income tax rate, Ganz applied the Commission-specified presumptive marginal income tax rate of 28% for individuals, mutual funds, and pensions, IRAs, and Keoghs. SFPP Initial Brief at pp. 59-60; Exhibit Nos. SFO-61 at p. 29, SFO-63 at p. 1, SFO-64 at p. 1. Also, Ganz applied the 34% presumptive rate to Subchapter C Corporations other than Santa Fe and Kinder Morgan General Partners. Exhibit Nos. SFO-63 at p. 1, SFO-64 at p. 1. He applied a 35% rate to Santa Fe and Kinder Morgan general partners because, according to Ganz, they meet the income threshold needed to justify the rate. Exhibit No. SFO-61 at

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[173] The Internal Revenue Code provides that corporations will be taxed at a rate of 34% if their taxable income is greater than $75,000 but less than $10,000,000, and, if a corporation's taxable income exceeds $10,000,000, that corporation will be taxed at a 35% rate. 26 U.S.C. § 11 (2008).

p. 28. Moreover, instead of applying the Commission's presumptive 28% rate to the UBTI Entities, Ganz applied an income tax rate of 34%, which, according to SFPP, is in accordance with the Internal Revenue Code. SFPP Initial Brief at p. 59, n. 45 (*citing* Exhibit Nos. SFO-49 at p. 13, SFO-61 at pp. 28-29).

689. According to the CC Shippers, all six categories of unitholders should be assigned a zero percent federal income tax rate, with the exception of the subchapter C corporate class, which should be assigned a 35% rate. CC Shippers Initial Brief at p. 55. According to them, there is sufficient evidence to overcome the Commission's rebuttal presumption that non-corporate unitholders should be assigned a 28% marginal tax rate. *Id*. at p. 55, 59 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 32). Specifically, they cited to O'Loughlin's Direct Testimony in their attempt to rebut the Commission's presumption. *Id*. at p. 55. There, O'Loughlin explained that using the Commission's presumed 28% tax rate for individuals, mutual funds, pensions/IRAs/Keoghs, and UBTI Entities implies that individuals are the ultimate beneficiaries and where tax liability will lie. Exhibit No. CC-1 at p. 29. However, a component for individual income taxes is already embedded in SFPP's allowed rate of return on equity, according to him, so SFPP should not also recover a 28% income tax allowance to provide its owners with an after-individual-income-tax return consistent with public capital markets. *Id*. at pp. 29-30. Further, the CC Shippers argued that the UBTI entity unitholders have not received the level of unrelated business income needed to trigger UBTI liability. CC Shippers Initial Brief at p. 58. As evidence regarding mutual funds, they rely on O'Loughlin's presumption that mutual fund managers manage in such a way as to avoid income taxes. *Id*.

690. SFPP is correct in applying the Commission's presumptive 34% marginal tax rate for Subchapter C corporations and 28% for non-corporate unitholders. Moreover, SFPP correctly applied the corporate rate to UBTI Entities, in accordance with the Internal Revenue Code. *See* 26 U.S.C. §§ 11, 511. The CC Shippers have not provided sufficient evidence to overcome the Commission's presumption that individuals, mutual funds, pensions/IRAs/Keoghs, and UBTI Entities will be taxed at a 28% marginal income tax rate. I do not find that O'Loughlin's testimony, the only evidence they presented, adequately rebuts the Commission's presumptive rates and replaces them with a zero percent rate. For example, O'Loughlin tries to replace the Commission's presumption with his own supposition regarding mutual funds and how they are managed. Exhibit No. CC-1 at p. 31. However, his opinion, without more, is hardly sufficient evidence to overcome the Commission's expertise in assigning income tax rates to these six categories of unitholders.

691. The CC Shippers took issue with the weights SFPP applied to the six categories of unitholders because, according to them, SFPP cannot trace its taxable income through its intermediate parent, OLP-D, to Kinder Morgan, and through to Kinder Morgan's unitholders. CC Shippers Initial Brief at p. 56 (*citing* Exhibit No. CC-1 at p. 23). SFPP,

they argued, is unable to prove that its 2003 taxable income was passed from SFPP, to OLP-D to Kinder Morgan, and on to Kinder Morgan, Inc., and could not show that Kinder Morgan tracked the income from its subsidiaries, such as SFPP, separately. *Id*. at p. 57. The CC Shippers do, however, accept SFPP's use of taxable income percentages for calculating the weights. *Id*.

692. The CC Shippers' argument that SFPP cannot trace its income through multiple levels to Kinder Morgan's unitholders runs contrary to the Commission's holding in *SFPP, L.P.*, 121 FERC ¶ 61,240. There, the Commission explained:

> [T]he proper distributive income to be used in determining the weighted marginal tax cost is that of the partners that ultimately received that income. In this case, SFPP has identified those partners as [Kinder Morgan's] limited partners, Santa Fe Pacific Pipelines Inc., [Kinder Morgan General Partners] via its general partnership interest in OLP-D, an intermediate partnership, and [Kinder Morgan General Partners], which receives both incentive distributions and distributions from [Kinder Morgan] based on its one percent general partnership interest. The marginal tax rate is properly determined based on the relative amounts of income allocated to these various partners based on their relative shares . . . The second [step] is to make an allocation within [Kinder Morgan] based on the relative share of [Kinder Morgan] income allocated to each of the different categories of [Kinder Morgan] partners since at that level the tax burden incurred is based on the *distributive* [Kinder Morgan] income made to the [Kinder Morgan] partners.

SFPP, L.P., 121 FERC ¶ 61,240 at P 46 (emphasis in original)(footnotes omitted). The Commission determined that, so long as the allocation among Kinder Morgan's partners was based on their relative allocations of Kinder Morgan's income, then SFPP's allocation was proper. *Id*. Moreover, it held that SFPP was not improperly tracing its income through to Kinder Morgan when it applied Kinder Morgan's weighted marginal tax rate to SFPP's income, but was properly applying partnership taxation methodology.[174] *Id*. at p. 48.

693. SFPP and O'Loughlin's use of allocated income percentages for calculating weights for use in determining the income tax allowance is consistent with Commission precedent. The Commission, in *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 64, noted that, in *SFPP, L.P.*, 113 FERC ¶ 61,277, it permitted SFPP to use the allocated income percentage of the partners when determining the weighted marginal tax bracket for use in calculating the income tax allowance, despite its emphasis

[174] The Commission explained that the partnership taxation methodology, as approved in *ExxonMobil*, 487 F.3d at pp. 952, 954, "modifies [its] stand alone method by applying the marginal tax rate of the various partners rather than using the marginal rate on the subsidiary partnership's income . . ." *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 48.

on ownership interests in the *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139. According to the Commission, income "establishes the financial cost imposed on the income and capital of the partnership by the partner's actual or potential income tax liability at such time as it is recognized." *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 65. Also, according to the Commission, its intention in the *Policy Statement on Income Tax Allowances* is to follow the weighted marginal income tax rate of the owning partners, and the conclusion that the allocated income percentages should be used reflects a practical application of that intent. *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 65. Therefore, SFPP was correct when it utilized allocated income percentages for determining the weighted marginal tax bracket.

694. In determining its weighted income tax rate, SFPP included state income taxes. SFPP Initial Brief at p. 57. According to the Commission, "[s]tate income taxes are a traditional cost-of-service element" and SFPP is entitled to a state income tax allowance if it establishes that it should receive a federal income tax allowance. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 59. However, SFPP must establish that its methodology for determining a state income tax allowance is reasonable. *Id*. at P 59, 60. In *SFPP, L.P.*, 121 FERC ¶ 61,240, the Commission stated that SFPP incorrectly used SFPP's income when determining the state in which the income tax is incurred, finding that "the relevant marginal tax rate is the weighted marginal tax rate of all [Kinder Morgan] partners that are required to declare [Kinder Morgan's] income, not SFPP's, in the states where [Kinder Morgan] operates." *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 60-61. The methodology used by SFPP in determining its state income tax rates takes the Commission's concerns from *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 59-61, into consideration by using Kinder Morgan's partners, rather than SFPP's. *See* Exhibit Nos. SFO-61 at pp. 29-33, SFO-63. This methodology is reasonable for purposes of determining a state income tax rate. *See* Exhibit Nos. SFO-61 at pp. 29-33, SFO-63. Moreover, no party has argued that SFPP should not be allowed a state income tax allowance, and, in fact, the CC Shippers also included state income taxes in their recommended weighted income tax rate. Exhibit No. CC-1 at pp. 28-33.

695. The Indicated Shippers argued that an income tax rate cannot be calculated because actual or potential taxes cannot be determined without taking 743(b) depreciation into account, which Kinder Morgan, they claimed, has not done. Indicated Shippers Initial Brief at p. 33. Because Kinder Morgan's actual or potential taxes cannot be calculated, they continued, the income tax rate cannot be calculated. *Id*.

696. 743(b) depreciation does not belong to SFPP, but belongs to Kinder Morgan's unitholders. *See* Transcript at p. 1045. SFPP witness Ganz explained that only SFPP's income, the income of the regulated entity, is relevant, not the income and deductions of subsidiaries. *Id.* When determining SFPP's income tax allowance, Ganz used positive income from SFPP's IRS Form 1065 and traced it through, unchanged by either income or

deductions. *See* SFPP Initial Brief at p. 75 (*citing* Exhibit Nos. SFO-55A at p. 6, SFO-57A at p. 6, SFO-62A, SFO-62B). Ganz was correct in doing so; as noted, the deductions do not belong to SFPP, but belong to Kinder Morgan's partners, and thus cannot be included in the income tax allowance calculations. *See SFPP, L.P.*, 121 FERC ¶ 61,240 at P 40-41; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 56-57. Under the Commission's stand-alone methodology:

> [T]he tax allowance for a regulated entity will be determined by looking at the net income of the regulated entity, but excludes non-jurisdictional income or losses generated by the regulated entity and all the losses and income of any affiliate or the corporate parent. The fact that a jurisdictional operating entity may have losses from other activities that offset its jurisdictional income or that the operating entity's income may be offset by losses on the part of a parent company or an affiliate will not affect the amount of an income tax allowance.

Texaco Refining and Marketing, Inc. v. SFPP, L.P., 117 FERC ¶ 61,285 at P 56. In accordance with the Commission's methodology, 743(b) depreciation belonging to Kinder Morgan's unitholders should not be taken into account when determining SFPP's income tax rate.

697. The CC Shippers recommended a weighted average state and federal income tax rate for SFPP's owners of 5.13% for the North Line and 5.01% for the Oregon Line to be used when calculating the income tax allowance of SFPP's cost-of-service. CC Shippers Initial Brief at p. 60 (*citing* Exhibit No. CC-1 at p. 32). However, these figures include their zero percent marginal income tax rate for non-corporate unitholders, which I have rejected. Accordingly, the weighted average state and federal income tax rates recommended by the CC Shippers are inappropriate. SFPP, on the other hand, with the support of Staff, suggested a 2003 weighted federal and state income tax rate of 35%, and a 2004 rate of 34.48%. SFPP Initial Brief at p. 62 (*citing* Exhibit Nos. SFO-61 at pp. 28-33, SFO-63 at p. 1, SFO-64 at p. 1). In view of this, based on the instant record, it is clear that the income tax rates used by SFPP are appropriate for purposes of determining its income tax allowance.

E: What is the appropriate treatment of ADIT?[175]

A. CC SHIPPERS

698. The CC Shippers explained that ADIT allows a pipeline to normalize the income tax allowance collected in its rates since there is a difference between the income tax collected from shippers and the amount actually paid by a pipeline. CC Shippers Initial Brief at p. 60. Because the ADIT account is funded by ratepayers, they continued, the balance is deducted from the rate base used to determine the pipeline's return. *Id*. (*citing SFPP, L.P.*, 86 FERC ¶ 61,022 at p. 61,029; *SFPP, L.P.*, 80 FERC ¶ 63,014 at pp. 65,135-37; *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077 at P 228). If tax rates are changed, the ADIT account can become overfunded, the CC Shippers stated. *Id*. (*citing* Exhibit No. CC-1 at pp. 33-34). Claiming that SFPP's ADIT balances are overfunded due to the disparity between SFPP's revenues resulting from North and Oregon Line rates which incorporate the corporate income tax rate of 35%, the CC Shippers recommended income tax rates of 5.13% and 5.01% for the North and Oregon Lines, respectively. *Id*. at pp. 60-61.

699. According to the CC Shippers, overfunded ADIT balances should be amortized back to shippers in prospective rates. *Id*. at p. 61 (*citing* Exhibit No. CC-1 at p. 34). Had this amortization been included by O'Loughlin in his recommendations, according to the CC Shippers, the resulting just and reasonable rates would have been lower and the changed circumstances on both lines would be more substantial. *Id*. The CC Shippers recommended that SFPP be directed to submit a compliance filing amortizing the over-funded portion of ADIT prospectively by reducing the income tax allowance for future taxes. *Id*. at p. 62. The filing should, they added, also accumulate ADIT balances from 1992 to 2003 at the top marginal rate for corporations, the income tax rate embedded in the collected rates for that period. *Id*.[176]

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[175] On this issue, the Indicated Shippers referred to the argument it made on Issue III.F. *See* Indicated Shippers Initial Brief at p. 34. They did not address this issue in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 12.

SFPP also did not address this issue in its Initial Brief, referring instead to its argument on Issue III.F. *See* SFPP Initial Brief at p. 63. In its Reply Brief, SFPP responded to an argument made by CC Shippers, *see* SFPP Reply Brief at p. 72, which I consider a collateral attack on the Commission's decision in *SFPP, L.P.*, 121 FERC ¶ 61,240, and which will not be addressed here.

[176] The CC Shippers added nothing of substance in their Reply Brief. *See* CC Shippers Reply Brief at pp. 42-43.

B. COMMISSION TRIAL STAFF

700. Staff stated that it used SFPP's 2003 ADIT. Staff Initial Brief at p. 41 (*citing* Exhibit Nos. S-10 at pp. 1, 3-4, S-11 at p. 1, 3-4). Responding to the contention that SFPP was not entitled to ADIT because SFPP was a pass-through entity for income tax purposes, Staff argued that the Commission has found this to be an insufficient basis to defeat the allowance of ADIT treatment for SFPP. *Id*. at pp. 41-42 (*citing* Transcript at pp. 378, 381; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141).[177]

Discussion and Ruling

701. The parties' arguments on the appropriate treatment of ADIT for income tax allowance purposes are similar to their arguments regarding the treatment of ADIT in terms of allowed return. Accordingly, the questions contained in Issue IV.E were previously considered in Issue III.F, with a few exceptions.

702. According to the CC Shippers, if tax rates are changed, the ADIT account can become overfunded. CC Shippers Initial Brief at p. 60. (*citing* Exhibit No. CC-1 at pp.33-34). SFPP's ADIT balances are overfunded, the CC Shippers claimed, because SFPP's revenues are based on North and Oregon Line rates which incorporate an income tax rate of 35%. *Id*. at pp. 60-61. The income tax rate should only be 5.13% for the North Line and 5.01% for the Oregon Line, the CC Shippers contended. *Id*.

703. The CC Shippers' suggested tax rates of 5.13% and 5.01% have already been rejected in Issue IV.D. There, SFPP's recommended 35% tax rate was found to be appropriate for determining SFPP's income tax allowance. Accordingly, given these prior determinations, the CC Shippers' argument that SFPP's ADIT account is overfunded because it improperly used a 35% tax rate is without merit. It must be concluded, therefore, that SFPP is calculating its ADIT in accordance with the Commission's Rules and Regulations, as well as Commission precedent.

[177] Staff added nothing of substance in reply. *See* Staff Reply Brief at pp. 29-30.

F: Whether the over-funding of SFPP's ADIT account should result in offsets to its income tax allowance or be refunded to shippers as a matter of law?[178]

A. INDICATED SHIPPERS

704. The Indicated Shippers claimed that when an ADIT account is overfunded, a public utility must flow the amount by which it is overfunded back to shippers and consumers. Indicated Shippers Initial Brief at p. 34.[179]

B. COMMISSION TRIAL STAFF

705. Staff stated that it adopted SFPP's over-funding of ADIT treatment. Staff Initial Brief at p. 42 (*citing* Exhibit Nos. S-10 at p. 1, S-11 at p. 1). In its Reply Brief, Staff, responding to the Indicated Shippers' suggestion that refunding should reflect SFPP's status as a flow-through entity, stated that this rationale is not a sufficient basis on which to adjust over-funding ADIT for a regulated oil pipeline partnership. Staff Reply Brief at p. 30 (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141).

C. SFPP, L.P.

706. No party, according to SFPP, disputes that, were its accumulated deferred income taxes over-funded, then the over-funded amounts must be amortized. SFPP Initial Brief at p. 63; SFPP Reply Brief at p. 73.

Discussion and Ruling

707. All parties and I agree that, as a matter of law, if SFPP's ADIT account is overfunded, then the overfunded amounts must be amortized. CC Shippers Initial Brief at p. 61; Indicated Shippers Initial Brief at p. 34; Staff Initial Brief at p. 42; SFPP Initial Brief at p. 63.

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[178] The CC Shippers did not address this issue. CC Shippers Initial Brief at p. 63; CC Shippers Reply Brief at p. 42.

[179] The Indicated Shippers did not address this issue in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 12.

G: Whether any over-funding of SFPP's ADIT account should result in offsets to its income tax allowance or be refunded to shippers based on substantial evidence of record? [180]

A. CC SHIPPERS

708. According to the CC Shippers, any overfunding of SFPP's ADIT should be amortized back to the shippers in prospective rates. CC Shippers Initial Brief at p. 63 (*citing* Exhibit No. CC-1 at p. 34).[181]

B. COMMISSION TRIAL STAFF

709. Staff stated that it adopted SFPP's over-funding of ADIT treatment. Staff Initial Brief at p. 42 (*citing* Exhibit Nos. S-10 at p. 1, S-11 at p. 1). In its Reply Brief, Staff added that there does not appear to be any disagreement that the treatment of over-funding should be based on substantial record evidence and that any over-funding of SFPP's ADIT account should result in a cost-of-service reduction, not a straight refund. Staff Reply Brief at p. 30. However, Staff stated that it does not argue that SFPP's ADIT was over-funded. *Id.* at pp. 30-31.

[180] In both their Initial Brief and their Reply Brief, the Indicated Shippers referred to their argument on Issue III.F. Indicated Shippers Initial Brief at p. 35; Indicated Shippers Reply Brief at p. 12.

[181] The CC Shippers did not address this issue in their Reply Brief. *See* CC Shippers Reply Brief at p. 43.

C. SFPP, L.P.

710. According to SFPP, because Ganz "used appropriate income tax rates and tracked all over-funded and under-funded accumulated deferred income taxes, there is no unamortized over-funding of [its] deferred income taxes." SFPP Initial Brief at p. 64. SFPP added that Sosnick agreed that Ganz correctly calculated accumulated deferred income taxes. *Id.* (*citing* Exhibit No. S-15 at pp. 6-7). SFPP further claimed that, in his Rebuttal Testimony, CC Shippers witness O'Loughlin agreed that SFPP witness Ganz's calculations were consistent with the Commission's ruling in *SFPP, L.P.*, 121 FERC ¶ 61,240. SFPP Initial Brief at p. 64 (*citing* Exhibit No. CC-44 at p. 18). According to it, also, Indicated Shippers witness Crowe's "view that SFPP is a flow-through entity with no income taxes to defer," was dismissed by the Commission in the same ruling. *Id.* at p. 65 (*citing* Exhibit Nos. BPX-15 at pp. 21-22; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141).[182]

Discussion and Ruling

711. While there may be a disagreement on how this would be accomplished, there does not appear to be any dispute that, were SFPP's ADIT over-funded, the over-funded amounts would have to be returned to those who overpaid. But, as I determined, in Issue III.F, that SFPP's ADIT account is not overfunded, the issue is moot. I do note, however, that, were there overfunding to SFPP's ADIT account, the most logical remedy would be a cost-of-service reduction, as suggested by Staff, rather than a straight refund.

H: Whether full tax depreciation must be taken as an offset to SFPP's income tax allowance, if any, rather than "booked" to an ADIT account?[183]

I: How to determine the "taxable income" of SFPP for purposes of determining the component for an income tax allowance under the Policy Statement on Income Tax Allowances.[184]

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[182] SFPP did not specifically address this issue in its Reply Brief, but instead referred to its arguments on Issues III.F and IV.D.1. SFPP Reply Brief at p. 73.

[183] By agreement of the parties, Issues IV.H and IV.I were jointly briefed and are joined together for decision.

[184] The CC Shippers did not address these issues. CC Shippers Initial Brief at p. 63; CC Shippers Reply Brief at p. 44.

A. INDICATED SHIPPERS

712. According to the Indicated Shippers, full tax depreciation should be taken as an offset to SFPP's income tax allowance rather than booked to an ADIT account. Indicated Shippers Initial Brief at p. 35. Furthermore, they continued, it is not necessary to determine SFPP's taxable income because SFPP failed to show that the partners whose income taxes are to be subsidized have actual or potential income taxes. *Id*. They added that, were this issue present, the actual or potential income taxes would have to be calculated for each class of partner for its share of taxable income, after deductions and credit, including 743(b) depreciation. *Id*.

713. In their Reply Brief, the Indicated Shippers stated that income tax allowance is based on SFPP's adjusted taxable income, after all deductions including tax depreciation. Indicated Shippers Reply Brief at p. 12. SFPP, according to the Indicated Shippers, would compute an income tax allowance on cash distributions, rather than taxable income, despite the fact that cash distributions have no correlation to taxable income and are never taxable as income from a trade or business. *Id*. at p. 13 (*citing* Exhibit No. BPX-5 at p. 5). The Indicated Shippers further argued that partnerships cannot normalize income tax liability in this way because their income and deductions are flowed through, so nothing is held back to pay partners' future taxes because they get their deductions each year and can carry forward anything that is not needed to wipe out current income tax liability. *Id.* (*citing* SFPP Initial Brief at p. 66; Exhibit No. BPX-5 at p. 3; Transcript at p. 921).

B. COMMISSION TRIAL STAFF

714. Staff stated that it adopted SFPP's over-funding of ADIT treatment and the ADIT treatment of SFPP. Staff Initial Brief at p. 42 (*citing* Exhibit Nos. S-10 at pp. 1, 3-4, S-11 at pp. 1, 3-4). In its Reply Brief, Staff responded to the Indicated Shippers' argument that full tax depreciation should be an offset to SFPP's income tax allowance, rather than booked to ADIT, because the benefits have already been flowed through to the partners. Staff Reply Brief at p. 31. Staff explained that the Commission has previously stated that such an argument is insufficient to eliminate ADIT. *Id.* (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 141).

C. SFPP, L.P.

715. According to SFPP, Ganz calculated the income tax allowance starting with SFPP's taxable income as it is reported on its IRS Form 1065. SFPP Initial Brief at p. 65 (*citing* Exhibit Nos. SFO-55A at p. 6, SFO-57A at p. 6). It claimed that "[i]t would be inappropriate and contrary to long-standing Commission policy requiring normalization of income taxes to use full tax depreciation as an offset to [its] income tax allowance." *Id.* at p. 66 (*citing Columbia Gulf Transmission Co.*, 23 FERC ¶ 61,396 at p. 61,858 (1983)). Because, SFPP claimed, it has proven it has actual or potential income tax liability in 2003

and 2004, it must normalize its depreciation accounts like a corporation because partnerships that do not use straight-line depreciation must normalize depreciation. *Id*. at pp. 66-67 (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 140-141; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 58).

716. SFPP further noted that the Indicated Shippers argued that SFPP's tax depreciation should be taken as an offset rather than being booked to an ADIT account. *Id*. at p. 67 (*citing* Exhibit No. BPX-32 at p. 14). According to SFPP, this position was rejected by the Commission in favor of normalization. *Id*. at p. 67 (*citing Columbia Gulf Transmission Co.v. SFPP, L.P.*, 23 FERC at p. 61,858; *Regulations Implementing Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes*, FERC Regs & Preambles 1977-1981 at ¶ 30,254 (1981)).[185]

Discussion and Ruling

717. The question here is whether SFPP must take depreciation as an offset to SFPP's income tax allowance or book that depreciation to an ADIT account under a normalization policy. Additionally, the parties set forth arguments regarding what should be taken into consideration when determining SFPP's taxable income for income tax allowance purposes, including 743(b) depreciation.

718. The Indicated Shippers argued that depreciation should not be booked to an ADIT account, but should be taken as an offset to SFPP's income tax allowance. Indicated Shippers Initial Brief at p. 35. Contrariwise, both SFPP and Staff contended that SFPP must normalize its depreciation accounts like a corporation. SFPP Initial Brief at p. 66; Staff Initial Brief at p. 42.

719. Taking depreciation as an offset to SFPP's income tax allowance is contrary to Commission policy which requires that, when a partnership does not use straight-line depreciation, it is required to normalize depreciation accounts like a corporation. *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 58. Moreover, the Commission has held that, when determining income tax allowance, a normalization policy, rather than a flow-through policy, should be followed. *See Columbia Gulf Transmission Co. v. SFPP, L.P.*, 23 FERC at p. 61,858. There, the Commission explained that, under a flow-through policy, expense burdens and tax benefits are mismatched, but are matched under a normalization policy. *Id*. Moreover, it noted, under a normalization policy, "[t]he tax reducing effects of the deductions that are not used to reduce the cost[-]of[-]service in the early years are accumulated in a deferred account, deducted from rate base, and used to reduce the cost of service in the later years." *Id*. Thus, while the

[185] SFPP did not add anything of substance in its Reply Brief. *See* SFPP Reply Brief at pp. 73-74.

Indicated Shippers argued that SFPP should be utilizing a flow-through methodology, the Commission already has rejected that argument. *Id*. at p. 61,858. *See also Texaco Refining and Marketing, Inc. v. SFPP, L.P*., 117 FERC ¶ 61,285 at P 58; SFPP, L.P., 121 FERC ¶ 61,240 at P 141. Therefore, since the Commission requires that SPFF normalize its depreciation accounts, it must be concluded that the Indicated Shippers' argument, that SFPP should take depreciation as an offset to its income tax allowance is wholly without merit.[186]

720. With respect to how SFPP's taxable income should be determined for purposes of determining the component for an income tax allowance, the Indicated Shippers argued that SFPP has not shown that its partners have actual or potential income tax liability, and thus, this question need not be determined. Indicated Shippers Initial Brief at p. 35. This argument is rejected. As explained in Issue IV.B, SFPP has met its burden of proving that its unitholders have actual or potential income tax liability.

721. In the alternative, in anticipation of rejection of their argument, the Indicated Shippers argued that SFPP's taxable income must be adjusted for deductions and credits, including 743(b) depreciation. Indicated Shippers Initial Brief at p. 35. Conversely, SFPP maintained that its taxable income can be found on its IRS Form 1065 and need not be adjusted. SFPP Initial Brief at p. 65 (*citing* Exhibit Nos. SFO-55A at p. 6; SFO-57A at p. 6). As explained in Issues IV.D., IV.D.1, and IV.D.2, SFPP is correct in its argument that 743(b) depreciation should not be used to adjust its taxable income.

J: How to determine the "taxable income" of the relevant partners for purposes of the component on income taxes, including the reclassification of categories of partners, the question of whether allocations of income to the Kinder Morgan general partner should be excluded because it is a management fee, and the question of whether passive loss carry forwards, 743-depreciation, and tax credits can be ignored in the calculations, each of which operates to lower the amount of "taxable income" flowed through from the Kinder Morgan partnership.[187]

[186] It also must be noted that this issue was indirectly addressed in Issues III.F and IV.E, where it was determined that SFPP can include ADIT in its cost-of-service and income tax allowance

[187] The CC Shippers did not address this issue. CC Shippers Initial Brief at p. 63; CC Shippers Reply Brief at p. 44.

A. INDICATED SHIPPERS

722. The Indicated Shippers pointed out that the questions within Issue IV.J have been addressed in the prior sections, with the exception of whether allocations of income to the Kinder Morgan's general partner should be excluded because such income is a management fee. Indicated Shippers Initial Brief at p. 36. They noted that the general partner is allocated over $100,000,000 more in taxable income than the partnership made, proving that the general partner is not receiving an allocation of the partnership's income, but is receiving an incentive distribution. *Id*. (*citing* Transcript at pp. 331-33). For regulatory purposes, according to them, the term "management fee" is used, and such a management fee should not be subsidized by ratepayers. *Id*. at p. 37. The Indicated Shippers insisted that the income allocated to the general partner should not be considered in the determination of SFPP's income tax allowance. *Id*.

723. In their Reply Brief, the Indicated Shippers argued that shippers should not be required to subsidize the income taxes on a management fee paid to Kinder Morgan's general partner because it has nothing to do with taxable income as it is paid off the top before income is allocated. Indicated Shippers Reply Brief at p. 14 (*citing* Exhibit No. BPX-32 at pp. 18-19, BPX-15 at p. 31; Transcript at pp. 930-31). Moreover, they contended, the general partner is paid this fee at the expense of the limited partners, regardless of whether Kinder Morgan has income or not. *Id*. (*citing* Transcript at p. 932).

724. While Ganz did not take 743(b) depreciation into consideration when determining actual or potential income taxes, the Indicated Shippers maintained that it must be considered because it would shelter any income flowed through from SFPP. *Id*. at p. 15 (*citing* Transcript at p. 984; Exhibit Nos. BPX-5 at pp. 35-37, BPX-21 at p. 15). Moreover, the Indicated Shippers argued, Bullock claimed that 743(b) depreciation could not be quantified, in which case Ganz was unable to take it into account when calculating the tax rate. *Id*. at pp. 15-16 (*citing* Transcript at pp. 939, 941-943).

B. COMMISSION TRIAL STAFF

725. According to Staff, the questions of whether passive loss carry forwards and whether 743(b) depreciation can offset income are irrelevant because SFPP submitted the 2003 Schedules K-1 of the Kinder Morgan partners in this proceeding. Staff Initial Brief at pp. 43-44 (*citing* Exhibit No. SFO-49 at pp. 11-12; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 27, 34). In its Reply Brief, while not determining whether allocations of taxable income from Kinder Morgan to its general partner are a management fee, Staff argued that if it is, it would be appropriate to adjust SFPP's income tax allowance. Staff Reply Brief at p. 32. Moreover, Staff asserted that the Indicated Shippers have not shown how it would be appropriate to reduce SFPP's income tax allowance by 743(b) depreciation or passive loss carry forwards. *Id*. (*citing* Exhibit Nos. SFO-65A at p. 1, SFP-65B at p. 1; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 27, 34).

C. SFPP, L.P.

726. SFPP asserted that it correctly categorized its unitholders in accordance with *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 45. SFPP Initial Brief at p. 68 (*citing* Exhibit No. SFO-61 at pp. 16-33). Further, it claimed that the Commission concluded that the incentive distributions received by Kinder Morgan G.P., Inc., should be taken into account when developing the weighted marginal income tax rate. *Id*. (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 54-58; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 64-65; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 43). SFPP noted that, according to the Commission, SFPP can allocate income and losses among its partners in any way it chooses so long as the maximum tax rate imputed to individuals does not exceed the maximum corporate rate. *Id*. at pp. 68-69 (*citing SFPP, L.P.*, 113 FERC ¶ 61,277 at P 43).

727. Additionally, it pointed out that, in his Rebuttal Testimony, CC Shippers witness O'Loughlin conceded that SFPP prepared its income tax allowance, which includes the incentive distribution, in accordance with *SFPP, L.P.*, 121 FERC ¶ 61,240, where the Commission found that "incentive distributions are a function of income since income is a major source of cash distributions, and of course income is not guaranteed." *Id*. at p. 69 (*citing* Exhibit No. CC-44 at p. 18; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 58). As asserted by, Indicated Shippers witness Sintetos, SFPP explained, no guaranteed payments were reported on Kinder Morgan's income tax returns, and the IRS would not likely change Kinder Morgan's income tax returns to treat incentive distributions as guaranteed payments. *Id*. at p. 70 (*citing* Transcript at p. 336).

728. In order to determine the share of SFPP taxable income allocated to each category of partners, SFPP explained, its witness Ganz traced SFPP's taxable income through each level of ownership and did not include any passive loss carry forwards, 743(b) depreciation deductions, or income tax credit which did not pertain to SFPP on a stand-alone basis. *Id*. This approach, SFPP stated, was set forth in the orders addressing the calculation of SFPP's income tax allowance, and in *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 40-41 specifically. *Id*. at pp. 70-71. Witnesses in this proceeding, SFPP continued, were only able to identify passive loss carry forwards, 743(b) deductions, or income tax credits which were attributable to Kinder Morgan, not SFPP, which, therefore, cannot be used to offset SFPP's taxable income under the Commission's stand-alone policy. *Id*. at pp. 71-72.

729. In its Reply Brief, SFPP stated that the Indicated Shippers claimed that SFPP's income should be offset by passive losses, while Staff, according to SFPP, submitted an argument that Kinder Morgan's income should be offset by passive losses. SFPP Reply Brief at p. 74 (*citing* Indicated Shippers Initial Brief at pp. 24-25, 32; Staff Initial Brief at pp. 43-44). Staff witness Sosnick, according to SFPP, however, testified that SFPP

calculated its income tax allowance in accordance with the Commission's requirements. *Id*. (*citing* Staff Initial Brief at pp. 43-44). SFPP pointed out that only SFPP's income, and not Kinder Morgan's, is relevant to the income tax allowance calculation, and SFPP itself has no passive loss carry forwards and no evidence has been put forth by either Staff or the Indicated Shippers indicating otherwise. *Id*. at pp. 74-75 (*citing SFPP, L.P*., 121 FERC ¶ 61,240 at P 40-41). It continued, stating that 743(b) deductions, although considered by the Indicated Shippers, are not relevant to the determination of actual or potential tax liability because they are not deductions of SFPP and cannot be included in the income tax allowance under the Commission's stand-alone method. *Id*. at p. 75 (*citing* SFPP Initial Brief at pp. 70-72; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 56-57; *SFPP, L.P*., 121 FERC ¶ 61,240 at P 40-41).

Discussion and Ruling

730. The issue is how to determine taxable income of the relevant partners for purposes of the component on income taxes. Included in this issue is the appropriate reclassification of categories of unitholders. Also, there is the issue of whether the allocation of income to Kinder Morgan's general partner is a management fee, and, if so, should the allocations be excluded for that reason. Moreover, when determining taxable income, there is the question of whether passive loss carry forwards, 743(b) depreciation, and tax credits may be ignored in the calculations, or whether they should be used to lower the amount of taxable income.

731. SFPP argued that it categorized its unitholders in accordance with Commission precedent. SFPP Initial Brief at p. 68 (*citing SFPP, L.P*., 113 FERC ¶ 61,277 at P 45; Exhibit No. SFO-61 at pp. 31-33). This issue has already been addressed in Issue IV.D, where it was determined that SFPP correctly calculated its income tax rate by first categorizing its unitholders into the six Commission-specified categories.

732. According to the Indicated Shippers, Kinder Morgan's general partner does not receive an allocation of income, but instead receives a guaranteed payment as an incentive to manage, to which it is entitled regardless of whether the partnership has any income. Indicated Shippers Initial Brief at p. 36 (*citing* Transcript at pp. 930, 932). They argued that this incentive distribution, or management fee, is not a return on the partner's investment and should not be subsidized by ratepayers through inclusion in the determination of SFPP's income tax allowance. *Id*. at p. 37; Indicated Shippers Reply Brief at p. 14 (*citing* Exhibit No. BPX-32 at p. 18). Responding, SFPP maintained that income allocated to Kinder Morgan's general partner should be taken into account when developing the weighted marginal income tax rate. SFPP Initial Brief at p. 68.

733. SFPP's contention that Kinder Morgan's general partner's incentive distribution should be taken into account when developing SFPP's income tax rate is consistent with Commission precedent. *See SFPP, L.P*., 113 FERC ¶ 61,277; *SFPP, L.P*., 121 FERC

¶ 61,240. In the former of the two cited cases, the Commission noted that SFPP may choose the manner in which it allocates its income and losses among its partners, so long as the "maximum tax rate imputed to individuals does not exceed the maximum corporate rate." *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 43. Two years later, the Commission addressed, and rejected, the argument that "it is inequitable for the regulated entity's tax rate to be influenced by the income that stems from incentive distributions to the general partner." *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 57. It stated that, while "[i]ncentive distributions may provide incentives for excessive distributions," this is a cash management or service issue, not a regulatory income tax allowance matter, which would be "more appropriately addressed in a venue other than a rate proceeding." *Id.* The Commission concluded that incentive distributions do not distort the income tax allowance calculation. *Id.*

734. In addition, the Commission addressed the Indicated Shippers' argument that incentive distributions are guaranteed payments which should be deducted from Kinder Morgan's income. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 58. According to the Commission, "it is clear that incentive distributions are a function of income since income is a major source of such distributions, and of course income is not guaranteed." *Id.* In view of this, it is clear that SFPP's inclusion of the incentive distribution when determining its taxable income for income tax allowance purposes is appropriate. Therefore, the Indicated Shippers' arguments against such inclusion, which previously were rejected by the Commission, are without merit.

735. When SFPP traced its taxable income through the levels of ownership, it did not include passive loss carry forwards, 743(b) depreciation, or income tax credits which did not concern SFPP on a stand-alone basis. SFPP Initial Brief at p. 70. According to it, passive loss carry forwards, 743(b) depreciation, and income tax credits belong to Kinder Morgan unitholders or other Kinder Morgan entities and cannot offset SFPP's taxable income. *Id.* at pp. 71-72.

736. The issue of 743(b) depreciation has already been decided. The Indicated Shippers argued that 743(b) depreciation must be considered when determining whether Kinder Morgan's limited partners had actual or potential income taxes on income flowed through from SFPP. Indicated Shippers Reply Brief at p. 15. However, I determined, in Issues IV.D, IV.D.1, IV.D.2, and IV.H-I, that 743(b) depreciation should not be considered because the deduction belongs to Kinder Morgan's unitholders, not to SFPP. The Indicated Shippers have offered no evidence or argument on this particular issue which would cause me to alter that view.

737. No party has provided any evidence of passive loss carry forwards attributable to SFPP. SFPP Initial Brief at p. 72. Moreover, no party has argued that passive loss carry forwards should offset SFPP's taxable income. Staff claimed that this issue is irrelevant. Staff Initial Brief at pp. 43-44. SFPP also stated that there are no SFPP tax credits. SFPP

Initial Brief at p. 73. Neither the Indicated Shippers nor Staff addresses tax credits in their briefs. As there was no evidence introduced into the record on this matter, and as the Complainants appear to have abandoned any claims regarding passive loss carry forwards, I am compelled to rule that this issue is rendered moot.

K. Struck

L. Struck

ISSUE V: 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?[188]

A. CC SHIPPERS

738. The CC Shippers contended that SFPP excluded substantial amounts of gross revenues, gross plant levels, and payroll associated with some Kinder Morgan subsidiaries when it implemented the Massachusetts formula to allocated corporate overhead expenses. CC Shippers Initial Brief at p. 64. They added that SFPP also failed to include all Kinder Morgan subsidiaries when applying the Massachusetts formula, which resulted in a shift of overhead expenses to the remaining entities, including SFPP. *Id*. (*citing Williams Natural Gas Co.,* 85 FERC ¶ 61,285 (1998)).

739. Using $150.4 million in corporate overhead expenses as reported on Kinder Morgan's 2003 SEC Form 10-K plus $28.2 million in capitalized overhead, the CC Shippers stated that their witness Arthur allocated $178.7 million in corporate overhead costs, $15.9 million of which is allocated to SFPP. *Id*. at p. 65 (*citing* Exhibit No. CC-1 at p. 43). He did not use tiers in his formula, they continued, and he removed what he claimed were inappropriate purchase accounting adjustments from gross property, plant and equipment. *Id*. (*citing* Exhibit No. CC-1 at pp. 46-48).

740. The CC Shippers contended that SFPP erroneously excluded, from its Massachusetts formula allocation, Kinder Morgan subsidiaries operated by Kinder Morgan, Inc., over which Kinder Morgan has managerial oversight and responsibility, as well as subsidiaries operated by third parties that require Kinder Morgan's oversight. *Id*. at p. 66. These two categories of subsidiaries, the CC Shippers claimed, should receive a proportional allocation of overhead expenses, consistent with Commission precedent and

[188] The Indicated Shippers explained that they took no position and/or deferred to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 37.

policy. *Id*. (*Mojave Pipeline Co.*, 81 FERC at p. 61,677 (1997); *Williams Natural Gas Co.*, 85 FERC ¶ 61,285).

741. Six of the twelve excluded subsidiaries, the CC Shippers explained, are operated by Kinder Morgan, Inc., and have overhead costs which are directly charged to the entity or reimbursed to Kinder Morgan, Inc., through a fixed fee, or so SFPP claimed. *Id*. at pp. 66-67 (*citing* Exhibit No. SFO-25 at pp. 25-26). The CC Shippers, however, asserted that SFPP has not presented evidence that would rebut Arthur's conclusion that Kinder Morgan has significant oversight over the operations of these subsidiaries and that the fixed fee is not large enough to cover the amount of overhead services provided to them by either Kinder Morgan, Inc., or Kinder Morgan. *Id*. at p. 67 (*citing* Exhibit No. CC-56 at pp. 7-13).

742. Moreover, while SFPP asserted that overhead expenses for these entities are more than covered by fixed fees of $17.507 million, the CC Shippers disagreed, stating that the $14.445 million in directly assigned overhead expenses could not cover all overhead expenses incurred while managing the Kinder Morgan, Inc.-operated Kinder Morgan subsidiaries because it included almost no expenses associated with treasury, human resources, procurement, income taxes, or information technology. *Id*. at pp. 68-69 (*citing* Exhibit No. CC-56 at pp. 9-12). The CC Shippers argued that, therefore, either Kinder Morgan, Inc., performed these services for a minimal amount and charged the balance to the Kinder Morgan subsidiaries it does not operate, or Kinder Morgan is providing these overhead functions. *Id*. at p. 69. Under either scenario, they continued, SFPP's methodology over-allocates corporate overhead expenses to Kinder Morgan-operated subsidiaries, such as SFPP. *Id*.

743. Kinder Morgan also has significant oversight responsibilities over the second group of Kinder Morgan subsidiaries, those operated by third parties, according to the CC Shippers, despite SFPP's contentions. *Id*. The operating agreements, under which the third parties operate the subsidiaries, reveal that Kinder Morgan is more than a passive owner, the CC Shippers claimed. *Id*. at p. 70 (*citing* Exhibit No. CC-56 at pp. 13-14). Specifically, they added, Kinder Morgan has oversight responsibilities such as budget approvals, direct payment of certain expenses, and involvement in the management committees and operating teams of the various entities. *Id*. (*citing* Exhibit Nos. SFO-35 at pp. 11-14, CC-56 at pp. 14-19, SFO-36 at p. 12, SFO-37 at p. 1, SFO-38 at pp. 7-11, SFO-39 at pp. 19-34, SFO-40A at pp. 18-24, SFO 40B at pp. 17-23). Therefore, the CC Shippers argued, the entities' exclusion from the Massachusetts formula is unwarranted. *Id*. at p. 71.

744. According to the CC Shippers, SFPP's use of a ten-tier allocation methodology lacks a credible foundation, is inconsistent with the Commission's one-tier model, and does not properly allocate a corporate parent's administrative costs among its affiliates. *Id*. (*citing Mojave Pipeline Co.*, 81 FERC at p. 61,677). The use of ten tiers is also

inconsistent with SFPP's statement that Kinder Morgan does not maintain business records in a manner which reflects general and administrative expenses associated with individual business units, the CC Shippers added, and the evolution of the tier system has resulted in inconsistent amounts of overhead costs being assigned to the same entities for the same time period in various proceedings. *Id*. at pp. 71-72 (*citing* Exhibit Nos. CC-32, CC-26 at p. 2). For example, the CC Shippers stated, between the allocation method SFPP used in 2003 and the method it used in this proceeding, there could be an increase in the overhead allocated to SFPP, which increases SFPP's cost-of-service. *Id*. at p. 72 (*citing* Exhibit No. CC-1 at pp. 45-46).

745. The CC Shippers argued that the inconsistent and arbitrary nature of SFPP's overhead allocations is further exemplified by its removal of purchase accounting adjustments from the gross property of unregulated entities. *Id*. at p. 73. The Commission required that the purchase accounting adjustments be removed in order to preserve original cost ratemaking, the CC Shippers stated, a goal which unregulated subsidiaries do not affect. *Id*. (*citing* Exhibit No. SFO-25 at pp. 45-46; *SFPP, L.P*., 113 FERC ¶ 61,277 at P 85-86). Removing the purchase accounting adjustments associated with the unregulated subsidiaries, the CC Shippers continued, would produce anomalous results. *Id*. (*citing* Exhibit No. SFO-25 at pp. 45-46).

746. In their Reply Brief, the CC Shippers alleged that SFPP's application of its current multi-tiered Massachusetts formula is a retroactive allocation of costs that were incurred in 2003, at which time Kinder Morgan was unable to attribute them to particular business units or segments. CC Shippers Reply Brief at p. 44 (*citing* SFPP Initial Brief at pp. 74-75; Exhibit Nos. CC-26 at p. 2, CC-1 at pp. 46-47, CC-56 at pp. 24-25). They asserted, therefore, that the claim that SFPP could now, years later, make these allocations is highly questionable. *Id*. at p. 45 (*citing* Exhibit Nos. CC-1 at pp. 46-47, CC-56 at pp. 24-25). Moreover, the CC Shippers contended, SFPP's modifications to the Massachusetts formula have undergone many forms over the years, demonstrating that the methodology was not created for objective accounting purposes. *Id*. at pp. 45-46. For example, the CC Shippers noted, the change from two to four tiers was likely due the income tax implication of the amount of Kinder Morgan overhead expenses allocated to Kinder Morgan's bulk terminal subsidiaries, while the change from four to ten tiers was a response to criticism of the four-tier method. *Id*. at pp. 45-46 (*citing* Transcript at pp. 757-58; Exhibit No. CC-27 at p. 3).

747. The CC Shippers continued, stating that SFPP's ten-tier methodology lacks consistency with Commission precedent. *Id*. at p. 46 (*citing* SFPP Initial Brief at pp. 76-77). According to them, the Commission uses the Massachusetts formula when it is unable to directly assign costs to the specific subsidiary that incurred the costs. *Id*. (*citing SFPP, L.P*., 121 FERC ¶ 61,240 at P 134). SFPP's method, the CC Shippers alleged, did not directly assign expenses to any Kinder Morgan subsidiary in 2003. *Id*. (*citing* Transcript at pp. 754-55). Moreover, they contended, the cases SFPP cited for

support do not support the use of direct assignments within the Massachusetts formula as a substitute for proper accounting of costs. *Id*. (*citing* SFPP Initial Brief at pp. 76-77). The CC Shippers pointed out that, in *Michigan Gas Storage Co.*, 87 FERC ¶ 61,038 at p. 61,173, a case cited by SFPP, the Commission rejected a modification of the Massachusetts formula and stated that a utility should attempt to develop proper accounting procedures that would enable it to directly assign costs, and then, only if this was too burdensome, could the utility indirectly assign the costs through the Massachusetts formula. *Id*. at pp. 46-47.

748. With regard to SFPP's exclusion of Kinder Morgan, Inc.-operated entities from the Massachusetts formula, the CC Shippers stated that SFPP's statements that Kinder Morgan, Inc., bears a risk with regard to overhead expenses related to these entities is irrelevant because the fixed fees paid to Kinder Morgan, Inc., were more than the costs billed to the Kinder Morgan, Inc.-operated entities in 2003 and 2004. *Id*. at p. 48 (*citing* Exhibit Nos. SFO-25 at pp. 26-28, SFO-32). Moreover, the CC Shippers added, Arthur claimed that the amounts within the fixed fees are misleading and that a large portion of overhead expenses are unaccounted for in SFPP's model, an allegation which SFPP failed to rebut. *Id*. (*citing* Exhibit No. CC-56 at pp. 11-13). They contended that the only explanation is that Kinder Morgan actually provided support to these entities, as it was bound to do in its operating agreements, and thus the Kinder-Morgan, Inc.-operated entities should be included within the Massachusetts model. *Id*.

749. For the excluded entities which are operated by third parties, according to the CC Shippers, SFPP claimed that any overhead costs related to them are invoiced to the third-party or excluded, but was only able to present evidence for certain expenses related to only two of the entities. *Id*. at p. 49 (*citing* Exhibit Nos. SFO-25 at pp. 29-33, CC-56 at pp. 13-14). These entities, as they claimed the record shows, must be included in the Massachusetts formula allocation because they benefit from Kinder Morgan's managerial oversight. *Id*. (*citing Williams Natural Gas Co.*, 85 FERC at p. 62,133).

750. According to the CC Shippers, Arthur's recommendation to remove purchase accounting adjustments associated only with regulated entities is not "results-oriented" and would not result, as SFPP contended, in larger allocations to unregulated entities when compared with regulated entities such as SFPP. *Id*. at p. 50 (*citing* SFPP Initial Brief at p. 84). Instead, because the sum of unregulated entities' purchase accounting adjustments is negative, the CC Shippers explained, removing the purchase accounting adjustments for the unregulated entities would decrease, not increase, the allocation of Kinder Morgan overhead to SFPP. *Id*.

751. The CC Shippers noted that both Bradley and Staff advocated using net revenue instead of gross revenues in the Massachusetts formula for Tejas Consolidated, one of Kinder Morgan's subsidiaries, because there was a large difference between Tejas Consolidated's gross revenue and profit margins, and using gross revenue over-allocates

corporate costs to it. *Id*. at p. 51 (*citing* Staff Initial Brief at p. 53; Exhibit No. SFO-25 at p. 41). They disputed these claims, stating that subsidiaries such as Tejas Consolidated which generate greater revenue have the potential to generate greater profit and losses, with which greater overhead expense and management overhead naturally correlate. *Id*. If Tejas Consolidated were a subsidiary with a regulated pass-through mechanism, the CC Shippers explained, there would be no potential for increased profits or losses associated with greater revenues, and then net revenues would be used when allocating overhead. *Id*. at pp. 51-52 (*citing Distrigas of Massachusetts Corp.*, 41 FERC at pp. 61,555-56; *Williston Basin Interstate Pipeline, Co.*, 104 FERC ¶ 61,036 at P 74 (2003)). Since Tejas Consolidated is not such an entity, and has the opportunity to increase profit such that greater management oversight will be expended, the CC Shippers claimed that Staff and SFPP's recommendation to use net revenue instead of gross revenue is not justified. *Id*. at p. 52.

B. COMMISSION TRIAL STAFF

752. Staff submitted that SFPP incorrectly excluded certain Kinder Morgan-owned subsidiaries from its Massachusetts formula allocation of overhead costs. Staff Initial Brief at pp. 44-45 (*citing* Exhibit No. SFO-25 at pp. 25, 29). Corporate overhead costs, Staff stated, include the costs of a company's directors and officers, and must be shared among all companies for which the directors and officers are responsible. *Id*. at p. 45 (*citing SFPP, L.P*., 121 FERC ¶ 61,240 at P 131). A number of officers and directors of the dominant firms in the Kinder Morgan family of companies, according to Staff, are also officers and directors of subsidiaries which have been excluded by SFPP from sharing in Kinder Morgan's corporate overhead, and therefore these subsidiaries must be included in the allocation of the costs of these officers and directors. *Id*. at pp. 45-46 (*citing* Exhibit No. CC-76 at pp. 1-31, 47-61; Transcript at pp. 788-89; *SFPP, L.P*., 121 FERC ¶ 61,240 at P 131). In addition, Staff noted, SFPP included specific examples of senior executives overseeing the excluded subsidiaries, such as Kinder Morgan's highest level executive's involvement in Kinder Morgan's investment in the Monterrey pipeline, operated by the excluded entity KM Mexico and also linked with Tejas Gas, L.L.C, another excluded subsidiary. *Id*. at pp. 46-47 (*citing* Exhibit Nos. S-31 at p. 27, 28, 62, CC-76 at p. 4; Transcript at pp. 790-92, 805). Kinder Morgan's executives in 2003 and 2004 also oversaw all Kinder Morgan-owned subsidiaries as managers, Staff stated, including those which were excluded by SFPP, and had specific concerns about the flat earnings of three of the excluded joint ventures. *Id*. at pp. 47-48 (*citing* Transcript at pp. 806-08; Exhibit No. S-31 at p. 62).

753. Excluded subsidiaries, Staff claimed, also benefit from the common function and assets of the Kinder Morgan companies, such as the Lawson Financials accounting software and systems which cost $4 million and supported virtually all of the excluded

subsidiaries,[189] and the efforts of the tax department to handle all property tax issues relating to physical assets, including assets of the excluded subsidiaries. *Id*. at pp. 48-49 (*citing* Transcript at pp. 822, 960-61; Exhibit No. SFO-49 at p. 1).

754. While SFPP claimed that all Kinder Morgan related corporate overhead costs, including those which could be directly assigned and those that could not, are properly accounted for in the allocation process due to its record keeping system, it could not present contemporaneous 2003 and 2004 documents showing alleged salary/time splits of executives and managers, Staff pointed out. *Id*. at pp. 49-50. Staff maintained that the Commission requires that SFPP preserve all relevant records for litigation, including these documents, from the time the complaints were filed. *Id*. at p. 50 (*citing* 18 C.F.R. § 356.2(k) (April 1, 2003); 18 C.F.R. § 356.2(k) (April 1, 2004)). It further submitted that an exclusive list of responsibility centers through which overhead costs were recorded in 2003 and 2004, which SFPP claimed are also critical in tracking corporate overhead costs, was never presented in this proceeding, further indicating, Staff argued, that SFPP's record keeping system has not been shown to be reliable or accurate. *Id*. at pp. 50-51. Staff's final point regarding SFPP's alleged faulty record keeping is that while the fixed fee paid by the excluded Kinder Morgan-owned subsidiaries was supposed to accurately capture corporate overhead costs for them, it actually resulted in an overpayment of more than 20% of the direct charged amount. *Id*. at pp. 51-52 (*citing* Exhibit No. S-40 at p. 3). This overpayment amount, according to Staff, lowers the corporate overhead allocated through the Massachusetts formula, which, it contended, meant that excluded Kinder Morgan-owned subsidiaries subsidized Kinder Morgan, Inc.-owned entities' corporate overhead costs. *Id*. at p. 52 (*citing* Exhibit No. S-40 at p. 2; Transcript at p. 1086).

755. Staff argued that SFPP has not proven that its modified four-tier Massachusetts formula is just and reasonable. *Id*. (*citing SFPP, L.P.*, 86 FERC ¶ 61,022 at p. 61,082). The methodology has been changed several times, contended Staff, lending to its conclusion that SFPP is uncertain and unreliable in its approach to corporate overhead allocation. *Id*. Moreover, Staff noted, the variations were responses to past shipper litigation criticisms, but SFPP could not indicate when the criticisms which led to changes in 2003 and 2004 were made. *Id*. at pp. 52-53 (*citing* Transcript at p. 869). According to Staff, the traditional Massachusetts formula, an average of a gross plant factor, a direct labor factor, and a revenue factor, is the appropriate formula to use in this proceeding.[190] *Id*.

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[189] Staff noted that, because the Lawson Financials software experienced problems in 2003 which affected all subsidiaries supported by this system, all subsidiaries should also share in the cost of fixing these problems. Staff Initial Brief at p. 49 (*citing* Transcript at pp. 836-37).

[190] However, Staff noted that Sosnick used a modification of the traditional formula for Tejas Consolidated because, in 2003, it showed a substantial difference between its

756. In its Reply Brief, Staff insisted that SFPP's claim that its tiered Massachusetts formula is consistent with Commission policy is erroneous. Staff Reply Brief at p. 33. SFPP stated that its tiers allow it to directly assign expenses to a specific geographic region or line of business, Staff contended, while the Commission directs that they be assigned to a specific entity. *Id*. Moreover, Staff stated that it doubted that Kinder Morgan could even allocate to the extent it claimed, given the manner in which it maintained its accounts. *Id*. (*citing* Exhibit No. CC-32).

757. While, according to Staff, SFPP mischaracterized its testimony to make it appear that Staff considered that an entity should include a joint venture in the Massachusetts formula allocation just because it receives revenue from the joint venture, in actuality, Staff asserted, the testimony indicated that costs should be allocated to those entities because, along with the profit sharing aspect, they require oversight and management. *Id*. at p. 34 (*citing* SFPP Initial Brief at p. 83).

758. Regarding entities SFPP excluded from the Massachusetts formula allocation, Staff stated that Kinder Morgan management focused time and energy on activities related to these entities that would warrant inclusion. *Id*. at p. 35. Moreover, Staff claimed that the fact that Kinder Morgan has no employees is irrelevant given the involvement of Kinder Morgan's management in the leadership of the excluded entities. *Id*. at p. 36.

C. SFPP, L.P.

759. SFPP explained that Kinder Morgan tracks various types of overhead expenses using salary splits, responsibility centers, and the Lawson Financials accounting system, which ensure that the cost assignment and allocation processes are accurate and allows Kinder Morgan to identify which overhead expenses benefit which subsidiaries or sets of subsidiaries. SFPP Initial Brief at p. 74 (*citing* Exhibit No. SFO-25 at pp. 7-13, 17-20; Transcript at pp. 842-50). Once that is determined, Kinder Morgan uses tiers to target specific subsidiaries and allocate these costs accordingly, SFPP continued. *Id*. (*citing* Exhibit No. SFO-25 at pp. 15-18; Transcript at pp. 846-49). In response to what it considers meritless claims made by the Complainants regarding Kinder Morgan's ability to match the subsidiaries with expenses in this manner, SFPP explained that the multiple tiers take account of readily identifiable costs which are applicable to only certain subsidiaries based on region or line of business, which allows for a more accurate allocation of overhead expenses than a single tier would provide. *Id*. at pp. 74-75 (*citing* Exhibit Nos. CC-1 at pp. 43-47, CC-56 at pp. 24-25, SFO-25 at pp. 17-21; Transcript at pp. 847-49).

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gross revenues and profit margins such that using gross revenues was unreasonable. Staff Initial Brief at p. 53 (*citing* Exhibit No. S-15 at p. 28).

760. While CC Shippers witness Arthur criticized Kinder Morgan's multi-tiered methodology because the number of tiers increased over time, SFPP contended that each time a tier is added to account for newly identified costs attributable to only certain groups, the process becomes more accurate and reliable. *Id*. at p. 75 (*citing* Exhibit Nos. CC-1 at pp. 44-45, CC-56 at pp. 24-25, SFO-25 at p. 21). Furthermore, SFPP continued, Arthur supported using a single tier methodology and eliminating Kinder Morgan's 2003 and 2004 direct assignments outside of the Massachusetts formula, against Commission policy which requires that all directly assignable costs be assigned prior to performing any allocations, as Kinder Morgan did. *Id*. at p. 76 (*citing* Exhibit Nos. CC-1 at p. 43, CC-56 at pp. 23-24, SFO-25 at pp. 42-43; Transcript at pp. 543-44, 850-51; *Northwest Pipeline Corp.*, 71 FERC ¶ 61,253 at p. 61,984 (1995); *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 134). Additionally, a single tier methodology, according to SFPP, would cause Kinder Morgan subsidiaries to bear portions of costs from cost centers regardless of whether they have received a benefit, also in violation of the Commission's policy of ensuring that costs are allocated in a manner which reflects the relative benefit received by the subsidiary to the greatest possible extent. *Id*. at p. 77 (*Michigan Gas Storage Co.*, 87 FERC ¶ 61,038 at p. 61,173).

761. SFPP alleged that Kinder Morgan excluded Kinder Morgan, Inc.-operated subsidiaries from the Massachusetts formula allocations because they receive all overhead support directly from Kinder Morgan, Inc., for which they pay a fixed fee. *Id*. at p. 78 (*citing* Exhibit Nos. SFO-25 at pp. 23-28, SFO-32 at p. 1; Transcript at p. 779). According to SFPP, Kinder Morgan, Inc., directly charges general and administrative expenses to each entity when possible to recover the fixed fee and also directly charges an amount of capitalized overhead to each Kinder Morgan, Inc.-operated entity. *Id*. (*citing* Exhibit Nos. SFO-25 at pp. 26-27, SFO-32 at p. 1, SFO-107; Transcript at pp. 851-53).

762. In order to determine whether Kinder Morgan performs overhead services for the Kinder Morgan, Inc.-operated entities, as Staff and the Complainants alleged, SFPP explained that, because Kinder Morgan has no employees and provides services only through Kinder Morgan, Inc., and GP Services employees, one must look to which employees perform the services and how they track and charge their time and expenses. *Id*. (*citing* Exhibit Nos. CC-56 at pp. 8-10, S-4 at pp. 16-17, SFO-25 at pp. 5-7). According to SFPP, only Kinder Morgan, Inc., employees perform services for Kinder Morgan, Inc.-operated entities, and these employees use time sheets, salary splits, and responsibility centers to track the costs of services performed for Kinder Morgan, Inc.-operated entities and Kinder Morgan, Inc.-owned entities separately from those related to services provided for Kinder Morgan-operated entities. *Id*. at p. 79 (*citing* Exhibit No. SFO-25 at pp. 7-13, 25-28; Transcript at pp. 842-45). Further, SFPP continued, if expenses are directly identifiable to a specific entity, then Kinder Morgan, Inc., employees directly assign overhead expenses to the individual Kinder Morgan, Inc.-operated and Kinder Morgan, Inc.-owned entities, and charge any other overhead

expenses to their shared services account for the Kinder Morgan, Inc.-operated and Kinder Morgan, Inc.-owned entities, Account 184600. *Id*. at pp. 79-80 (*citing* Exhibit No. SFO-25 at pp. 9-10; Transcript at pp. 842-43, 853-54). The overhead expenses associated with the Kinder Morgan-operated entities are charged to Account 184601, the Kinder Morgan shared services account, which is charged to Kinder Morgan by Kinder Morgan, Inc., through the Kinder Morgan, Inc., cross-charge, SFPP explained. *Id*. at p. 80 (*citing* Exhibit No. SFO-25 at p. 7; Transcript at pp. 855-56). Because Kinder Morgan, Inc. performs all the services for and bears the costs related to the Kinder Morgan, Inc.-operated entities, SFPP contended, the claim that Kinder Morgan provides these services lacks merit. *Id*. at p. 80.

763. SFPP next noted that Staff and Complainants maintained that the fixed fees are insufficient to recover the total overhead costs associated with the management of the Kinder Morgan, Inc.-operated entities and that the amount of overhead expenses charged to the Kinder Morgan-operated entities will be increased to cover this difference. *Id*. at pp. 80-81 (*citing* Exhibit Nos. CC-56 at pp. 11-12, S-4 at p. 17-18). However, SFPP asserted, the fixed fees paid to Kinder Morgan, Inc., by the Kinder Morgan, Inc.-operated entities are not related to the overhead expenses charged to the Kinder Morgan-operated entities, but would be shared among the Kinder Morgan, Inc.-owned entities through the Kinder Morgan, Inc., Massachusetts formula if they were insufficient to cover the costs of the services performed by Kinder Morgan, Inc. *Id*. at p. 81 (*citing* Transcript at pp. 853-55; Exhibit Nos. SFO-25 at pp. 26-27, SFO-33, SFO-34). The risk of underrecovery, SFPP maintained, is on Kinder Morgan, Inc., not on the Kinder Morgan-operated entities. *Id*. (*citing* Exhibit Nos. SFO-25 at p. 27, SFO-33, SFO-34).

764. SFPP explained that Kinder Morgan excludes joint ventures in which it owns an equity interest from its Massachusetts formula allocations because they are operated by third parties and Kinder Morgan does not provide services on their behalf, and, in the rare instance that it does provide a service, the joint venture, according to SFPP, is invoiced for those expenses. *Id*. at pp. 81-82 (*citing* Exhibit No. SFO-25 at pp. 28-35; Transcript at pp. 841-42). Additional costs associated with this limited managerial oversight are included in Responsibility Center 0375, which is removed from the Kinder Morgan, Inc. cross-charge and thus excluded from the Massachusetts formula, SFPP asserted. *Id*. at p. 82 (*citing* SFO-25 at p. 35). Therefore, Staff and Complainants' claim that Kinder Morgan performs overhead services and must therefore receive an allocation of overhead expenses, according to SFPP, are baseless. *Id*. (*citing* Exhibit Nos. S-15 at pp. 10-15, CC-56 at pp. 13-19). No overhead expenses should be allocated to the joint ventures via the Massachusetts formula, SFPP maintained, because they have either been removed from the costs allocated through the formula or have been directly assigned. *Id*. at pp. 82-83 (*citing* Exhibit No. SFO-25 at pp. 34-35; Transcript at pp. 841-42).

765. That Kinder Morgan may profit from an investment in a joint venture, SFPP contended, does not indicate that that joint venture must have received a benefit from

overhead costs incurred by Kinder Morgan, contrary to assertions made by Staff witness Sosnick. *Id*. at p. 83 (*citing* Exhibit No. S-15 at p. 10; Transcript at pp. 853, 862). According to SFPP, the Commission considers whether a subsidiary actually received a benefit from its parent company when evaluating what costs should be allocated to a subsidiary, not whether a parent company benefits from an investment by receiving a portion of a subsidiary's profits. *Id*. (*citing Williams Natural Gas Co.*, 85 FERC ¶ 61,285).

766. SFPP insisted that Kinder Morgan properly removed purchase accounting adjustments from both its regulated and non-regulated subsidiaries. *Id*. at p. 84 (*citing* Exhibit No. SFO-25 at p. 45). Arthur, on the other hand, according to SFPP, supported removing the purchase accounting adjustments from only the regulated entities, which, SFPP claimed, has no basis and would result in a larger allocation to the unregulated entities than the regulated entities, such as SFPP. *Id*. (*citing* Exhibit Nos. CC-56 at pp. 25-26, S-15 at pp. 26-28. Transcript at pp. 561-62; *SFPP, L.P.*, 114 FERC ¶ 61,136 at P 16-17 (2006)).

767. In its Reply Brief, SFPP contended that Kinder Morgan's exclusion of the Kinder Morgan, Inc.-operated entities and joint ventures from the Massachusetts formula allocation is appropriate. SFPP Reply Brief at p. 76. According to SFPP, Staff and the CC Shippers argued that Kinder Morgan had significant oversight over the operations of the entities, so they must be included. *Id*. (*citing* Indicated Shippers Initial Brief at p. 67; Staff Initial Brief at pp. 45-48). SFPP further argued that the officers and directors who provided this oversight were Kinder Morgan, Inc.-shared employees, whose costs are tracked through the system and kept separate from the costs associated with the services provided to the Kinder Morgan-operated entities. *Id*. at pp. 76-78 (*citing* Exhibit No. SFO-25 at pp. 6-13, Transcript at pp. 867-68). Due to this tracking, SFPP contended, no costs associated with oversight of the excluded Kinder Morgan, Inc.-operated entities are allocated through Kinder Morgan's Massachusetts formula. *Id*. at p. 78 (*citing* Exhibit Nos. SFO-25 at pp. 7, 14-15, 26-27, SFO-106; Transcript at pp. 776-78, 842-45). The same is true, SFPP added, for joint ventures because their costs were removed from the Kinder Morgan, Inc. cross-charge. *Id*. (*citing* Exhibit No. SFO-25 at pp. 28-35; Transcript at pp. 841-42).

768. SFPP next responded to Staff's argument that joint ventures and Kinder Morgan, Inc.-operated entities should be included in the Massachusetts formula allocation because they benefited from the common function and assets of Kinder Morgan, such as the Lawson Financials system. *Id*. at pp. 78-79 (*citing* Staff Initial Brief at p. 48). SFPP argued that the Lawson Financials system was purchased in a year not at issue in this proceeding, was not used to support the joint ventures, and when the costs of the system were incurred, they were directly charged or divided among the Kinder Morgan-operated entities, the Kinder Morgan, Inc.-operated entities, and the Kinder Morgan, Inc.-owned

entities. *Id*. at p. 79 (*citing* Staff Initial Brief at pp. 49-50; Transcript at p. 827-28, 841-42; Exhibit No. SFO-25 at pp. 9-11, 34-35).

769. Staff contended, according to SFPP, that Kinder Morgan's ability to track costs associated with the services to the Kinder Morgan-operated entities separately from the Kinder Morgan, Inc.-operated and owned entities is questionable because SFPP was unable to present evidence of every salary split and time sheet for every Kinder Morgan employee for 2003 and 2004. *Id*. at pp. 79-80 (*citing* Staff Initial Brief at p. 50). While agreeing that this is a rational reason to question the reliability of Kinder Morgan's system of records, SFPP explained that it provided examples of salary splits and time sheets showing how the costs were separated, none of which were challenged or questioned for accuracy, and Bradley explained how the system works. *Id*. at p. 80 (*citing* Staff Initial Brief at p. 50; Exhibit Nos. SFO-25 at pp. 10-12, 34, SFO-28, SFO-29, SFO-106; Transcript at pp. 829-30, 842-45). Kinder Morgan, SFPP added, is able to track costs associated with Kinder Morgan-operated entities separately from those associated with the Kinder Morgan, Inc.-operated and Kinder Morgan, Inc.-owned entities. *Id*. at pp. 80-81 (*citing* Exhibit No. SFO-25 at pp. 8-15; Transcript at pp. 841-45).

770. SFPP also pointed out what it claimed to be an inconsistency in Staff's arguments regarding the fixed fees paid by the Kinder Morgan, Inc.-operated entities to Kinder Morgan, Inc., stating that Staff's witness testified that the fixed fees did not cover the overhead costs, while Staff argued on brief that the fees were an overpayment of these expenses. *Id*. at p. 81 (*citing* Exhibit No. S-15 at pp. 16-18; Staff Initial Brief at pp. 51-52).

771. The CC Shippers, SFPP added, argued that the fixed fees did not cover the overhead costs associated with the services provided to the Kinder Morgan, Inc.-operated entities. *Id*. (*citing* CC Shippers Initial Brief at pp. 68-69). It contended that the CC Shippers relied on Arthur's comparison between directly assigned Kinder Morgan, Inc., responsibility centers with amounts from those same responsibility centers allocated through the Massachusetts formula, a comparison which SFPP contended is misleading because overhead costs can benefit multiple entities and so may not be specifically assigned. *Id*. (*citing* CC Shippers Initial Brief at pp. 68-69; Exhibit Nos. CC-56 at pp. 10-11, SFO-25 at pp. 13-16; Transcript at pp. 849-53). SFPP added that costs in responsibility centers that provide corporate-type services will rarely be capable of being directly assigned and must be allocated among various entities. *Id*. at pp. 81-82.

772. SFPP insisted that Arthur's comparison ignored shared costs and only compared costs directly assigned to Kinder Morgan-operated entities with the total amount of overhead expenses allocated among all Kinder Morgan-operated entities. *Id*. at p. 82 (*citing* Exhibit Nos. CC-56 at p. 11, CC-70 at pp. 1-2). Due to the nature of the responsibility centers, SFPP added, Arthur's comparison resulted in the amount allocated among the group of entities exceeding the amount directly assigned to any individual

entity, and would have been more accurate had he also looked at the amount of capitalized overhead directly assigned to each entity and the amount allocated to each through Kinder Morgan, Inc.'s Massachusetts formula. *Id*. (*citing* Transcript at pp. 849-53).

773. The Commission did not, according to SFPP, order it to include Kinder Morgan Interstate Gas Transmission and Trailblazer in Kinder Morgan's Massachusetts formula allocations in all proceedings for all purposes, despite Staff's contentions, but instead stated, in *SFPP, L.P*., 121 FERC ¶ 61,240 at P 134, that SFPP, in years not applicable here, had not produced sufficient evidence to justify their exclusion. SFPP Reply Brief at pp. 82-83 (*citing* Staff Initial Brief at p. 49;). According to SFPP, Bradley distinguished the present case from the facts on which the SFPP, L.P., 121 FERC ¶ 61,240 were based. *Id.* at p. 83. SFPP also noted, the Commission, on rehearing, ruled that SFPP could continue to exclude these entities. *Id*. (*citing SFPP, L.P.*, 122 FERC ¶ 61,133 at P 13-16).

774. In SFPP's view, Kinder Morgan's multi-tiered methodology is the most accurate and reasonable allocation methodology. *Id*. at pp. 83-84 (*citing* SFPP Initial Brief at pp. 74-77; *see also* Exhibit No. SFO-25 at pp. 16-18, 21; Transcript at pp. 846-49). A single tier model, SFPP asserted, is less precise and would result in the allocation of costs to SFPP from which it received no benefit. *Id*. at p. 84 (*citing* Exhibit No. SFO-25 at pp 17-21). A single tier is also inconsistent with Commission precedent, SFPP suggested, because it would allocate costs to a subsidiary when the parent company has knowledge that the subsidiary does not receive a benefit from these costs, contrary to *Williams Natural Gas Co.*, 85 FERC at p. 62,139, and the principle that cost allocation should follow cost causation. *Id*. at pp. 84-85. In response to the argument that the multi-tier methodology is unreliable due to the changes it has gone through over time, SFPP argued that there is no evidence showing that the cost allocations to SFPP are less accurate, only evidence showing the opposite. *Id*. at p. 85 (*citing* SFPP Initial Brief at pp. 74-77; Exhibit No. SFO-25 at pp. 16-21; Transcript at pp. 846-50).

775. It is contrary to Commission precedent, according to SFPP, to remove purchase accounting adjustments from only FERC-regulated entities, as the CC Shippers argued should be done. *Id*. (*citing* CC Shippers Initial Brief at p. 73; *SFPP, L.P.*, 114 FERC ¶ 61,136 at P 16-17). All purchase accounting adjustments, SFPP added, should be treated equivalently. *Id*. at p. 86 (*citing* Exhibit No. S-15 at pp. 26-28).

Discussion and Ruling

776. It is undisputed that the appropriate allocation of Kinder Morgan's general and administrative expenses should be determined by applying the Massachusetts formula. At issue is what methodology should be used for allocating these costs among Kinder Morgan's subsidiaries, and which subsidiaries should be allocated a portion of the corporate overhead costs. In order for the costs to be properly allocated, whether purchase accounting adjustments should be removed from gross property of unregulated entities and

whether capitalized overhead should be included in the total amount allocated also must be determined.

(1) What methodology should be used for allocating Kinder Morgan's general and administrative expenses?

777. The Massachusetts formula is used to allocate administrative and general costs among corporate subsidiaries when the costs cannot be directly allocated to specific subsidiaries. *Northwest Pipeline Corp.*, 71 FERC at p. 61,984. Costs which benefit each of the parent's subsidiaries should be allocated using the formula. *Williams Natural Gas Co.*, 77 FERC ¶ 61,727 at p. 62,188 (1996). In order to allocate these costs, the Massachusetts formula averages three ratios: (1) the regulated subsidiary's operating revenue to its parent's total operating revenue; (2) the subsidiary's gross plant to its parent's total gross plant; and (3) the regulated subsidiary's gross labor to the parent's total gross labor costs. *Id*. Equal weight is given to each. *Michigan Gas Storage, Co.*, 87 FERC ¶ 61,038 at p. 61,171 n.181 (1999). The average percentage of each of the three ratios to the total company figures is used to allocate the overhead costs to the subsidiary. *Williams Natural Gas Co.*, 77 FERC at p. 62,188. According to the Commission, for overhead costs to be properly allocated, "the denominator of [the gross plant to total corporate gross plant] ratio must include all the costs of all the affiliates. . . ." *KN Interstate Gas Transmission Co.*, 88 FERC ¶ 61,270 at p. 61,848 (1999).

778. In allocating costs through the Massachusetts formula, SFPP groups Kinder Morgan's subsidiaries into four tiers because it claimed it could attribute certain costs to certain groups of subsidiaries based on region or industry. SFPP Initial Brief at pp. 74-75. According to SFPP and its witness, Bradley, this method is more accurate than broadly allocating costs to all entities. *Id*. at p. 75; Exhibit No. SFO-25 at p. 17. The Commission has held that, when a party claims to use a more precise method for allocating indirect overhead costs, the party has the burden of proving that the method is preferable to the method normally applied by the Commission. *SFPP, L.P.*, 86 FERC ¶ 61,022 at p. 61,082. SFPP has not proven that its four-tier Massachusetts formula is just and reasonable.

779. According to Bradley,[191] SFPP has used four different methods for allocating costs in the past ten years. Transcript at p. 754. SFPP's method has been constantly changing, indicating that the method is uncertain and unreliable. It began, in 1998, with a one-tier methodology, then switched to a two-tier methodology in 2002. Transcript at pp. 753-54.

[191] The CC Shippers noted that Bradley is the only witness to testify regarding SFPP's Massachusetts formula, but had no role in developing the methodology, nor was he aware of documentation supporting the four-tier model. CC Shippers Initial Brief at p. 71 (*citing* Transcript at pp. 748-50).

The four-tier methodology used by SFPP in this proceeding was adopted in 2006 and applied retroactively to 2003. Transcript at p. 752. Moreover, retroactive to 2006, Kinder Morgan's overhead costs were directly assigned to SFPP. *Id*. at p. 754-55.[192] To justify these changes, Bradley claimed, without any specificity, that they were in response to shipper criticisms made during litigation in either 2005 or 2007. *Id*. at p. 869. However, I do not see how testimony submitted in either 2005 or 2007 could have caused changes to SFPP's methodology occurring in either 2003 or 2004. Therefore, I am compelled to conclude that SFPP has not justified changing its Massachusetts formula methodology multiple times since 1998.

780. The changing number of tiers also results in inconsistent levels of overhead costs assigned to the same entities for the same time periods. CC Shippers' witness Arthur explained this issue:

> For several cost categories, the amount specifically assigned by the 2006 methodology to the 6 products pipeline subsidiaries included in the second tier of the 2003 methodology is greater than the amount that was assigned to [them] in the 2003 methodology. For example, in 2003, there was $4,238,008 of overhead expenses . . . assigned to the 6 products pipelines in the second tier, however, in the 2006 methodology, there is $4,335,141 of these overhead expenses that are directly assigned to SFPP and Calnev pipeline, which are only two of the six subsidiaries that were in the second tier in the 2003 methodology.

Exhibit No. CC-1 at p. 46. By using the 2006 methodology, the amount allocated to SFPP is higher than the amount allocated to SFPP under the two-tier methodology that was actually in place in 2003. *Id*. This inconsistency is a further indication that SFPP's method is arbitrary and littered with discrepancies.

781. Furthermore, the CC Shippers argued that, since Kinder Morgan did not maintain its books in a manner in which overhead expenses can be distinguished between groups of entities, "then there can be no objective rationale for SFPP's using any multi-tier allocation methodology." CC Shippers Initial Brief at p. 72. I agree. A review of the record reflects that SFPP's record keeping system is not sufficiently reliable to allocate all Kinder Morgan corporate overhead costs accurately. *See, e.g.,*Transcript at p. 867; Exhibit Nos. CC-32, CC-76. First, SFPP admitted that Kinder Morgan "does not maintain its accounts in such a manner as to reflect [general and administrative] costs associated with individual business units." Exhibit No. CC-32 at p. 2. However, SFPP argued that its system uses salary and time splits for executives and managers to properly allocate costs. SFPP Initial Brief at p. 79 (*citing* Exhibit No. SFO-25 at pp. 7-13; Transcript at pp. 842-45). Yet, SFPP did not enter into evidence documents created in 2003 or 2004

[192] *See also* Exhibit Nos. SFO-30 at p. 12, SFO-31.

which show the time splits of executives and managers.[193] Instead, the record contains only an exhibit, which was not created until 2007, showing the splits of one executive. Exhibit No. SFO-106; Transcript at pp. 783, 870-71. SFPP also failed to enter into evidence a list of responsibility centers which were used in 2003 and 2004. The only list of responsibility centers is not limited to the responsibility centers that were operable in 2003 and 2004, making it unclear as to which centers were relevant in 2003 and 2004. Exhibit Nos. SFO-25 at pp. 8-9, SFO-27; Transcript at p. 836.

782. SFPP also was required to submit contemporaneous records under the Commission's retention regulations. *See* 18 C.F.R § 356.2(k) (2003); 18 C.F.R. § 356.2(k) (2004). 18 C.F.R. §365.2(k) provides that, "[n]otwithstanding the minimum requirements, if an oil pipeline company is involved in pending litigation, complaint proceedings, proceedings remanded by the court, or governmental proceedings, it must retain all relevant records." SFPP has failed to demonstrate, here, that it has complied. "Negative inferences may be drawn when a party fails to produce relevant evidence within its control." *Consolidated Gas Transmission Corp.*, 42 FERC ¶ 61,209 at p. 61,719 (1988). As noted, SFPP did not provide records regarding the responsibility centers which were operable in 2003 and 2004, nor did it provide evidence of time and salary splits. A failure to produce these records leads to the conclusion that these records may not have existed, or did not accurately portray this information. SFPP's failure to submit contemporaneous documents into evidence with regard to the determination of how to allocate overhead costs leads to the conclusion that SFPP's record keeping systems are unreliable.

783. SFPP has not proven that its four-tier Massachusetts formula methodology should be used in this proceeding to allocate 2003 and 2004 corporate overhead costs to Kinder Morgan's subsidiaries. Instead, the Commission's traditional one-tier Massachusetts formula should be used, which takes the average of the gross plant, direct labor and revenue ratios. *Williams Natural Gas Co.*, 77 FERC at p. 62,188. This formula should only be modified with respect to Tejas Consolidated, a Kinder Morgan subsidiary that both buys and sells natural gas. Staff Initial Brief at p. 53; Exhibit No. SFO-25 at p. 41. For Tejas Consolidated, a modified version of the Massachusetts formula, which uses net revenues rather than gross revenues, should be used because of the difference between its gross revenues and profit margins in 2003. Exhibit Nos. S-15 at pp. 27-28, S-16 at p. 13. In *Distrigas of Massachusetts Corp.*, 41 FERC at p. 61,556, the Commission determined that a ratio of net revenues is more accurate when a large amount of revenues come from purchase gas costs. Tejas Consolidated's revenues appear high because of gas sales, so the *Distrigas* method, instead of the traditional Massachusetts formula, should be applied with regard to this subsidiary. Exhibit Nos. SFO-25 at p. 41, S-15 at p. 28.

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[193] I reject out-of-hand any suggestion that SFPP could not do so without violating an employee's confidentiality. The employee's confidentiality could have been protected through appropriate excision of the employee's personal information.

(2) Which subsidiaries should be allocated a portion of the corporate overhead costs?

784. SFPP also improperly excluded 12 Kinder Morgan subsidiaries from its allocation of corporate overhead costs. In *Williams Natural Gas Co.*, 85 FERC at p. 62,136, the Commission determined that small, unregulated subsidiaries should not be excluded from a cost allocation if they received benefits, despite the fact that that little time or resources were spent on them. There, the Commission stated that spending only 5% to 10% of time on small subsidiaries is "not such an insignificant amount that it should simply be ignored." *Williams Natural Gas Co.*, 85 FERC at pp. 62,136-37. The Commission applied this principle to SFPP in *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 134, where it stated that, even had Kinder Morgan's employees spent only 5% of their time on excluded subsidiaries, the subsidiaries should not be precluded from paying their portion of shared services. Consequently, the Commission determined that SFPP must include three of its subsidiaries, Plantation, Kinder Morgan Interstate Gas Transmission, LLC, and Trailblazer, in its Massachusetts formula allocation. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 134.

785. Here, as in *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 134, SFPP has excluded both Kinder Morgan Interstate Gas Transmission and Trailblazer, along with other Kinder Morgan subsidiaries, from its allocation of general and administrative expenses. These subsidiaries are divided into two groups – those which are owned by Kinder Morgan, yet operated by Kinder Morgan, Inc., and those which are operated by a third-party. CC Shippers Initial Brief at p. 66; Exhibit No. SFO-25 at p. 24. According to SFPP witness Bradley, the six excluded Kinder Morgan, Inc.-subsidiaries[194] are either directly charged for overhead costs or reimburse Kinder Morgan, Inc., for these costs by paying a fixed fee. Exhibit No. SFO-25 at p. 26. Bradley also explained that Kinder Morgan does not perform services for the third-party operated entities,[195] and, if it does, those costs are reimbursed outside of the Massachusetts formula. *Id*. at p. 29.

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[194] The six subsidiaries which are owned by Kinder Morgan, but operated by Kinder Morgan, Inc. are: Casper-Douglas Natural Gas Gathering and Processing Systems, Tejas Consolidated, KM Gas de Natural de Mexico ("KM Mexico"), Kinder Morgan Interstate Gas Transmission, Trailblazer, and TransColorado Gas Transmission Company ("TransColorado"). Exhibit No. SFO-25 at p. 25.

[195] The six third-party operated entities are 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. Exhibit No. SFO-25 at p. 29.

786. First, because the Commission ordered that they be included in Kinder Morgan's overhead cost allocation in the past, Trailblazer and Kinder Morgan Interstate Gas Transmission should share in Kinder Morgan's corporate overhead costs. *See SFPP, L.P.*, 121 FERC ¶ 61,240 at P 134. As directed in that order, since nothing has changed, SFPP should have included these entities in its Massachusetts formula allocation.

787. Next, the operating agreements between Kinder Morgan, Inc., and the Kinder Morgan subsidiaries which it operates indicate that Kinder Morgan has managerial responsibilities related to the oversight of the subsidiaries. Exhibit Nos. CC-1 at p. 40, CC-28, CC-29, CC-30. CC Shippers' witness Arthur explained the documents, stating:

> Each of the operating agreements specifies that [Kinder Morgan], as the 'owner' of the subsidiary, has managerial and administrative responsibility with respect to: (1) administering transportation contracts; (2) approving the permanent assignments of capacity regarding transportation and storage agreements; (3) negotiating and executing contracts with a term of more than one year or creates a liability of greater than $250,000; and (4) approving operating budgets and capital expenditure budgets.

Exhibit No. CC-1 at p. 40 (footnotes omitted). As Kinder Morgan retains certain responsibilities over Kinder Morgan Interstate Gas Transmission and TransColorado pursuant to their operating agreements, these subsidiaries should be included in Kinder Morgan's cost allocation. SFPP erroneously excluded these Kinder Morgan, Inc.-operated subsidiaries when allocating its corporate overhead costs through the Massachusetts formula.

788. The Commission previously determined that Plantation, a Kinder Morgan subsidiary, received benefits from Kinder Morgan's corporate overhead service activities, including its board of directors, financial statement responsibilities, and accounting and treasury functions. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 131. It also followed its prior ruling that, where directors and officers are responsible for an entity's activities, then that entity should be allocated corporate overhead costs. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 131 (*citing Williams Natural Gas Co.*, 85 FERC at p. 62,140). The same principle is applicable here where the record indicates that officers and directors of Kinder Morgan, Kinder Morgan Management, Kinder Morgan General Partners Services, Kinder Morgan, Inc., and Kinder Morgan General Partners, L.P., also act as officers and directors for the excluded subsidiaries. Exhibit No. CC-76; Transcript at pp. 788-89. More specifically, as explained by Staff, top executives from the Kinder Morgan family of companies reviewed various pipeline investments, reviewed capital projects, had managerial oversight over certain interstate assets, and were involved in an SEC investigation of one subsidiary. Staff Initial Brief at pp. 46-47 (*citing* Exhibit Nos. S-31 at pp. 11, 12, 27, 28, CC-76 at p. 4, S-38; Transcript at pp. 790-92, 805, 824-27). Moreover, in 2003, Kinder Morgan executives' bonuses were tied to the performance of all of Kinder Morgan's subsidiaries,

which would cause them to be especially concerned with the earnings from the excluded subsidiaries. Exhibit No. S-31 at pp. 11, 62, 63. Their managerial oversight also was required when Kinder Morgan's executives employed a Kinder Morgan business strategy of integrating 2003 acquisitions into the overall Kinder Morgan enterprise, which benefitted all subsidiaries and joint ventures. Exhibit No. S-31 at pp. 45-46. Given this overlap, and inasmuch as SFPP has failed to prove that circumstances have changed since the issuance of the Commission's 2007 Order, overhead costs related to the officers and directors should be allocated to the excluded subsidiaries through the Massachusetts formula. *See SFPP, L.P.*, 121 FERC ¶ 61,240 at P 131-34.

789. The excluded subsidiaries which are owned by Kinder Morgan but operated by third parties also should be included in the allocation of Kinder Morgan's overhead costs. SFPP submitted operating agreements for these entities which indicate that Kinder Morgan retains oversight responsibility. *See* Exhibit Nos. SFO-35 through SFO-40. For example, Kinder Morgan has authority over budget approvals and direct payment of some expenses for Heartland, has managers sitting on Red Cedar's management committee,[196] and has a role in the management committees or operating teams of Thunder Creek, Marine Terminal, and Cochin. Exhibit Nos. CC-56 at pp. 14-19, SFO-35 at pp. 5, 11-14, SFO-36 at p. 12, SFO-38 at pp. 7-11, SFO-39 at pp. 19-34, SFO-40A at pp. 18-24, SFO-40B at pp. 17-23.

790. SFPP argued that the subsidiaries operated by Kinder Morgan, Inc., were excluded because they receive all overhead support directly from Kinder Morgan, Inc., for which the subsidiaries pay a fixed fee with the risk of underrecovery of Kinder Morgan, Inc. SFPP Initial Brief at p. 78 (*citing* Exhibit Nos. SFO-25 at pp. 23-28, SFO-32 at p. 1; Transcript at p. 779). Both the CC Shippers and Staff take issue with SFPP's argument. Exhibit No. S-40; CC Shippers Initial Brief at pp. 68-69; Staff Initial Brief at pp. 51-52. Both parties pointed out that the amount of the fixed fee charged to Kinder Morgan's subsidiaries was $14,445,362, while the subsidiaries paid Kinder Morgan $17,507,158, resulting in an overpayment to Kinder Morgan, Inc., of $3,061,796. Exhibit No. S-40; CC Shippers Initial Brief at p. 68; Staff Initial Brief at p. 52. This over-payment lowers the amount of overhead allocated to the subsidiaries of Kinder Morgan, Inc., suggesting that Kinder Morgan-owned subsidiaries subsidized the corporate overhead costs of Kinder Morgan, Inc.-owned entities. Transcript at p. 1086. The discrepancy between the amount Kinder Morgan, Inc., charged Kinder Morgan's subsidiaries and what was paid to Kinder Morgan, Inc., indicates that the fixed fee had no relationship to the costs which it was supposed to cover. It also undermines SFPP's argument that the subsidiaries should be excluded.

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[196] Through its role in Red Cedar's management committees, Kinder Morgan has indirect management oversight responsibility over Coyote Gulch because Red Cedar operates and controls Coyote Gulch through a lease. Exhibit Nos. CC-56 at p. 16, SFO-37 at p. 1.

791. Further, SFPP claimed that no overhead expenses should be allocated to the joint ventures via the Massachusetts formula because they have either been removed from the costs allocated through the formula or have been directly assigned. SFPP Initial Brief at pp. 82-83 (*citing* Exhibit No. SFO-25 at pp. 34-35; Transcript at pp. 841-42). It argued that the third-party operated Kinder Morgan subsidiaries are excluded because Kinder Morgan does not provide services on their behalf, and, if it does, it invoices the joint venture for those expenses. SFPP Initial Brief at pp. 81-82 (*citing* Exhibit No. SFO-25 at pp. 28-35; Transcript at pp. 841-42). Then, if there are additional costs associated with this managerial oversight, according to SFPP, they are included in Responsibility Center 0375, which, they stated, is removed from the Kinder Morgan, Inc., cross-charge and thus excluded from the Massachusetts formula. *Id*. at p. 82 (*citing* Exhibit No. SFO-25 at p. 35). However, SFPP did not provide contemporaneous records which would instill confidence that Kinder Morgan has the ability to track these costs.

792. As the Commission in the past has found, based on this record, I also must conclude that SFPP has not provided adequate evidence to prove that 12 Kinder Morgan subsidiaries should be excluded from the Massachusetts formula allocation. *See SFPP, L.P.*, 121 FERC ¶ 61,240 at P 134. Rather, the record establishes that SFPP's accounting systems are not reliable enough to demonstrate that Kinder Morgan's subsidiaries did not receive support from Kinder Morgan. *Id.* Therefore, "[t]o avoid the possibility that some unallocated costs may have been excluded by SFPP," it is required to include all of the Kinder Morgan, Inc.-operated subsidiaries "in calculating its allocation of overhead costs." *Id.*; *see also SFPP, L.P.*, 113 FERC ¶ 61,277.

(3) Should purchase accounting adjustments be removed from the gross property of unregulated entities?

793. The parties next addressed the issue of removing purchase accounting adjustments from the gross property of unregulated and regulated entities. SFPP insisted that Kinder Morgan properly removed purchase accounting adjustments from both its regulated and unregulated subsidiaries. *Id*. at p. 84 (*citing* Exhibit No. SFO-25 at p. 45). CC Shippers' witness Arthur, on the other hand, supported removing the purchase accounting adjustments from only the regulated entities, which, SFPP claimed, has no basis and would result in a larger allocation to the unregulated entities than the regulated entities, such as SFPP. *Id*. (*citing* Exhibit Nos. CC-56 at pp. 25-26, S-15 at pp. 26-28; Transcript at pp. 561-62; *SFPP, L.P.*, 114 FERC ¶ 61,136 at P 16-17 (2006)). According to the CC Shippers, the Commission's purpose in removing purchase accounting adjustments from regulated entities does not translate into a reason for removing them from the gross property of unregulated entities. CC Shippers Initial Brief at p. 73.

794. Gross plant, according to the Commission, is the "net book value of plant," or "the original plant cost less accumulated depreciation of the facilities." *SFPP, L.P.*, 113 FERC

¶ 61,277 at P 85. Previously, it required that SFPP remove purchase accounting adjustments from Kinder Morgan and SFPP's gross plant calculations because, were they included, the ratio of overhead costs would be inflated. *Id*.

795. Only purchase accounting adjustments should be removed from the regulated entities. The Commission does not allow the purchase price of a facility to be recognized for ratemaking purposes. *Williams Pipe Line Co.*, 21 FERC ¶ 61,260 at p. 61,636 (1982). There, the Commission stated that "[t]he purpose of rate regulation is to inhibit strategically situated sellers of goods and services from exploiting market power that Congress has found excessive. That end is achieved by imposing rates lower than those that would prevail absent regulation." *Id*. at p. 61,634. When purchase price is taken into consideration, the goal of inhibiting the strategically situated sellers of goods from exploiting market power is frustrated. *Id*. However, with respect to unregulated entities, this goal is not frustrated by including purchase accounting adjustments from gross property of unregulated entities because this goal does not exist. In other words, as explained by the CC Shippers, purchase accounting adjustments are removed in order to preserve original cost rate making. CC Shippers Initial Brief at p. 73. It is not necessary to exclude purchase accounting adjustments from unregulated subsidiaries because there is no relationship between purchase accounting adjustments and the original cost of the assets.

(4) Should capitalized overhead be included in the total amount allocated?

796. Capitalized overhead should not be included in the total amount of overhead costs to be allocated through the Massachusetts Formula. Staff witness Sosnick defined capitalized overhead as "overhead costs related to construction . . . which are charged to particular jobs or units on the basis of the amounts of such overheads reasonably applicable." Exhibit No. S-15 at p. 16. Because capitalized overheads relate to a specific project, they can be directly assigned to that specific project. The Massachusetts formula is used to allocate overhead costs when they cannot otherwise be directly assigned to specific subsidiaries. *Northwest Pipeline Corp.*, 71 FERC at p. 61,984. By their nature, capitalized overhead can be directly assigned to a specific subsidiary and are therefore inappropriate for inclusion in the costs to be allocated by the Massachusetts formula. *See* Exhibit No. S-15 at p. 20.

B: What is the appropriate depreciation expense?[197]

A. COMMISSION TRIAL STAFF

797. Staff stated that it used the depreciation expense calculated by SFPP witness Ganz. Staff Initial Brief at p. 54 (*citing* Exhibit Nos. SFO-65A at p. 1, SFO-65B at p. 1, S-10 at p. 1, S-11 at p. 1).[198]

B. SFPP, L.P.

798. Because, it claimed, a party that challenges a regulated entity's costs bears the burden of showing that those costs are unjust and unreasonable, and no party has carried this burden, SFPP contended that there is no basis on which its depreciation expense may be changed. SFPP Initial Brief at pp. 84-85 (*citing Xcel Energy Services, Inc.*, 121 FERC ¶ 61,284 at P 45 (2007); *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 186-87 (D.C. Cir. 1986)).[199]

Discussion and Ruling

799. For purposes of determining SFPP's rates, the issue is what depreciation expense should be used. No party has contested SFPP's depreciation expense. *See* Staff Initial Brief at p. 54; Indicated Shippers Initial Brief at p. 37; CC Shippers Initial Brief at p. 73; SFPP Initial Brief at pp. 84-85. Both Staff and SFPP used a carrier depreciation expense of $1,235,000 when calculating their 2003 North Line cost-of-service. Exhibit Nos. S-10 at p. 1, SFO-65A at p. 1. For the Oregon Line, $426,000 in carrier depreciation expenses were included by both Staff and SFPP in their cost-of-service calculations. Exhibit Nos. S-11 at p. 1, SFO-65B at p. 1. As, it appears, all parties agree that these amounts are correct, a position supported by the record, they should be used by SFPP to calculate its costs of service for the respective Lines.

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[197] The CC Shippers did not discuss this issue. CC Shippers Initial Brief at p. 73; CC Shippers Reply Brief at p. 52. The Indicated Shippers explained that they took no position and/or defer to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 37; Indicated Shippers Reply Brief at p. 37.

[198] Staff added no new arguments in its Reply Brief. *See* Staff Reply Brief at p. 37.

[199] SFPP's North Line carrier depreciation expense for 2003 is $1.235 million. Exhibit No. SFO-65A at p. 1. Its Oregon Line carrier depreciation expenses for 2003 is $426,000. Exhibit No. SFO-65B at p. 1.

C: What are the appropriate allocation factors for investment and operating expenses?[200]

A. COMMISSION TRIAL STAFF

800. After Kinder Morgan's corporate overhead costs are allocated, Staff explained that the Kansas/Nebraska formula is then used to assign those costs to the North and Oregon Lines for 2003. Staff Initial Brief at p. 54 (*citing* Exhibit No. S-4 at pp. 23-24). Under the KN formula, Staff continued, costs are first separated into three categories, property, labor, and "other," classifications which Staff claimed SFPP failed to make. *Id*. at pp. 54-55 (*citing* Exhibit Nos. S-4 at pp. 23-25, S-15 at p. 30). Furthermore, it asserted, SFPP's KN formula application was flawed in that, when forming the allocation factors for the North and Oregon Lines, it used a simple average of the ratio of plant to total plant and labor to total labor during the test year. *Id*. at p. 55 (*citing* Exhibit No. S-15 at pp. 31-32, 38-39). Using a simple average, Staff argued, allows one of the ratios or factors to have too much influence when it is greater than the other. *Id*. (*citing* Exhibit No. S-15 at pp. 31-32, 38-39). Staff claimed that its method, using a weighted average of the plant and labor factors to corporate overhead costs, after separating the costs into plant, labor, and "other" categories, is the better method. *Id*. at pp. 55-56 (*citing* Exhibit No. S-15 at pp. 31-32, 38-39).

801. Staff also claimed that SFPP's inclusion of both intrastate and interstate pipeline costs in its carrier costs was erroneous because only interstate costs are relevant when assigning corporate overhead costs to SFPP's North and Oregon Lines. *Id*. at p. 56 (*citing* Exhibit No. S-15 at pp. 36-37). According to it, therefore, "SFPP should be directed in a compliance filing to assign the Massachusetts formula allocated corporate overhead costs to the North and Oregon Lines by initially separating intrastate costs from jurisdictional 'carrier' costs." *Id*. It suggested that SFPP's carrier costs be adjusted to take into account the intrastate costs associated with the North and Oregon Lines and generate an interstate carrier cost allocation for each. *Id*. at p. 57 (*citing* Exhibit No. S-15 at pp. 40-42).

802. SFPP conceded, Staff stated, that purchase accounting adjustments should be removed from gross plant accounts before employing the Massachusetts formula and before assigning the allocated corporate overhead costs to the North and Oregon Lines

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[200] With regard to this issue, the Indicated Shippers stated that they took no position and/or deferred to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 37; Indicated Shippers Reply Brief at p. 16. According to the CC Shippers, they "did not present an independent analysis of the appropriate allocation factors for investment and operating expenses," but instead used SFPP's allocation factors as presented in Exhibit No. SFO-66. CC Shippers Initial Brief at p. 73; CC Shippers Reply Brief at p. 52.

using the KN formula. *Id*. at pp. 57-58 (*citing* Exhibit No. S-15 at pp. 23-24; Transcript at p. 829).

803. In its Reply Brief, Staff argued that SFPP should adopt the Commission's traditional KN methodology as established in *Kansas-Nebraska Natural Gas Co., Inc*., 53 FPC 1691. Staff Reply Brief at p. 38 (*citing* Exhibit Nos. S-4 at p. 24, S-20 at p. 1).

804. While SFPP claimed that the Commission ordered it to use a simple average, Staff argued that this methodology was rejected in *SFPP, L.P*., 121 FERC ¶ 61,240. *Id*. at pp. 37-38 (*citing Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 406). Since SFPP used a method which is different from the Commission-approved methodology, Staff maintained, the burden is on SFPP to support this method, which, Staff asserted, it failed to do in this proceeding. *Id*. at pp. 38-39.

805. Staff, responding to SFPP's claim that Staff witness Sosnick had to revise his testimony twice before taking the stand, explained that Sosnick wanted the record to most accurately reflect the KN formula and found it necessary to make revisions due to data that was submitted by SFPP at the last minute. *Id*. at p. 39. Moreover, although admitting that Sosnick's method is not exactly the Commission's traditional method, Staff asserted that it is closer to the Commission's method than SFPP's approach. *Id*. Sosnick, Staff continued, was unable to reasonably perform the KN computation because SFPP provided him with insufficient data.[201] *Id*. He has otherwise indicated, according to Staff, the way in which the KN methodology should be used. *Id*. at p. 40 (*citing* Transcript at p. 1089).

B. SFPP, L.P.

806. SFPP claimed that it used the KN formula to allocate overhead expenses between its carrier pipeline transportation services and non-carrier terminal storage services as well as among its various pipelines, including the North and Oregon Lines. SFPP Initial Brief at p. 85 (*citing* Exhibit No. SFO-42 at p. 3; Transcript at pp. 884-85). To do so, SFPP asserted, it used a simple average of the direct labor ratio and the direct plant ratio to develop a combined direct labor and direct plant ratio, a process which, according to it, is consistent with the KN formula SFPP used at the Commission's direction in the cost-of-service studies filed in Docket No. OR96-2. *Id*. at pp. 86-87 (*citing* Exhibit No. SFO-42 at pp. 4-6; Transcript at pp. 890, 892; *SFPP, L.P*., 113 FERC ¶ 61,277 at P 89; *SFPP, L.P*., 121 FERC ¶ 61,240 at P 139). Because, SFPP contended, it used a simple average as condoned by the Commission, Staff's assertion that SFPP should instead categorize all overhead expenses as labor-or plant-related and then allocate them using

[201] The data that SFPP provided to Sosnick, Staff contended, was insufficient because it did not categorize overhead costs as labor-related, plant-related, or "other." Staff Reply Brief at p. 39.

their respective ratios lacks merit. *Id*. at p. 86 (*citing* Exhibit Nos. S-4 at pp. 23-24, SFO-42 at pp. 4-6; *SFPP, L.P*., 86 FERC ¶ 61,022 at pp. 61,082-83). Moreover, SFPP argued that, while it seeks to use the formula that the Commission previously approved, Staff is attempting to change this methodology. *Id.* at p. 87 (*citing* Exhibit No. S-15 at pp. 31-33; *SFPP, L.P*., 113 FERC ¶ 61,277 at P 89; *SFPP, L.P*., 121 FERC ¶ 61,240 at P 139). Therefore, SFPP contended, Staff bears the burden of proving that the existing methodology is unjust and unreasonable and that its new methodology is just and reasonable, which it claimed Staff has failed to do. *Id*. (*citing Sea Robin Pipeline Co. v. FERC*, 794 F.2d at pp. 186-87).

807. In response to Staff's contention that SFPP inappropriately included intrastate direct labor and intrastate investment in the balance it used when performing the KN formula allocation, SFPP stated that, in actuality, it just combined two steps into one. *Id*. at pp. 88-89 (*citing* Exhibit No. S-15 at pp. 36-38). In its KN formula, SFPP explained, it allocated the carrier portion of overheads costs between interstate and intrastate functions within the same step in which it allocated between various lines. *Id*. at p. 88 (*citing* Transcript at pp. 885-89). Staff's argument as to this step in the process is confused, according to SFPP, as was illustrated when Sosnick had to revise his KN formula exhibits twice prior to taking the stand. *Id*. at p. 89 (*citing* Exhibit No. SFO-119; Transcript at pp. 1075-76).

808. SFPP claimed that Staff's KN formula, and not its own, is inconsistent with the Commission-approved methodology. *Id*. at p. 90. Between filing Sosnick's Direct and Rebuttal Testimonies, according to SFPP, Staff asked that SFPP provide a schedule showing the percentages and dollar amounts of 2003 and 2004 overhead costs that were labor-related, plant-related, or "other," which SFPP provided. *Id*. (*citing* Exhibit No. SFO-108 at pp. 2, 4). It insisted that this should have been sufficient for Sosnick to calculate his KN formula allocations. *Id*. However, SFPP continued, Sosnick did not use this data in his Rebuttal Testimony, claiming that SFPP had not provided him with the information needed, and instead used a modified KN formula in which he summed the dollar amounts of carrier direct investment and carrier direct labor and divided that total by the sum of the total carrier and non-carrier direct investment and direct labor. *Id*. at pp. 90-91 (*citing* Exhibit Nos. S-15 at pp. 39-40, S-22). Although he gave other unconvincing arguments, according to SFPP, SFPP submitted that Sosnick did not use SFPP's data because, using Staff's approach, that data would allocate more overhead costs to carrier operations than under SFPP's approach. *Id*. at p. 91 (*citing* Exhibit Nos. SFO-108, SFO-42 at p. 11; Transcript at pp. 903-04).

809. Sosnick's proposal to add together total dollar amounts for direct labor and gross property is not supported by Commission precedent, SFPP maintained, and does not give appropriate weight to each factor. *Id*. at pp. 91-92 (citing Exhibit No. S-15 at pp. 39-40; Transcript at pp. 892, 1067). According to SFPP, Sosnick admitted that the Massachusetts formula cost allocation properly uses a simple average of three factors so that they are

given equal weight; likewise, SFPP stated, a simple average must be used in the KN formula if the factors are to be given equal weights. *Id*. at p. 92 (*citing* Transcript at pp. 892, 1059-60).

810. In its Reply Brief, SFPP stated that its KN formula methodology is reasonable and in compliance with the Commission's regulations, despite Staff's claim otherwise. SFPP Reply Brief at p. 86. According to SFPP, it allocated overhead costs using a simple average of the direct labor and direct plant factors rather than first categorizing all overhead costs as either labor-related, plant-related, or "other" in accordance with the Commission's traditional KN formula because it was directed to do so by the Commission in Docket Nos. OR92-8 and OR96-2. *Id*. at pp. 86-87 (*citing* Staff Initial Brief at p. 54; Exhibit No. SFO-42 at pp. 4-7). This method also has been approved by the Commission, SFPP added. *Id*. at p. 87 (*citing SFPP, L.P*., 113 FERC ¶ 61,277 at P 89; *SFPP, L.P*., 121 FERC ¶ 61,240 at P 139).

811. In response to Staff's argument that its simple-average method gives too much influence to one of the factors, SFPP countered that it is actually Staff's method which does this. *Id*. at pp. 87-88 (*citing* Staff Initial Brief at pp. 55, 91-93). Staff's method, which, according to SFPP, is not supported by Commission precedent, added together the dollar amounts of direct labor and gross property. *Id*. at p. 88 (*Citing* Exhibit Nos. S-15 at pp. 39-40, S-22). By doing so, Staff's method essentially removes labor as a factor in allocating expenses, SFPP argued, because direct investment dollar amounts will always greatly outweigh labor dollar amounts. *Id*. Thus, SFPP contended, the two-factor methodology becomes a single-factor methodology. *Id*. (*citing* SFPP Initial Brief at pp. 91-92). Its method, on the other hand, gives equal weight to each factor, SFPP explained, by applying the average of the two factors to all expenses. *Id*.

812. SFPP contended that its KN formula, instead of separating inter- and intrastate investment and then, in a second step, separating interstate investment between all SFPP lines, completed both within a single step and reaches the same result. *Id*. at p. 89 (*citing* Transcript at pp. 886-89). Staff tried to undermine this argument, SFPP claimed, by stating that Staff and SFPP's methods result in different allocations, but SFPP argued that the differing allocations are due to their different treatment of direct labor and investment, not SFPP's alleged use of intrastate direct labor and investment. *Id*. at pp. 89-90. Both SFPP and Staff use the same interstate-only direct labor and investment for the North and Oregon Lines in developing KN factors, SFPP pointed out, and, had Staff used a simple-average approach as SFPP did, both approaches would result in identical allocations. *Id*. at p. 90 (*citing* Exhibit No. SFO-113; Transcript at pp. 886-89, 1069-73).

813. While Staff claimed it was necessary to calculate the interstate carrier cost allocation for all SFPP lines in order to determine the cost allocations for the North and Oregon Lines, SFPP contended that this can be done by isolating the interstate carrier direct labor and investment for one particular line and dividing this amount by the

combined interstate and intrastate carrier direct labor and investment totals of all SFPP lines. *Id*. (*citing* Transcript at pp. 885-89). The ratio which results, SFPP continued, is applied to total carrier overhead expenses to determine the overhead allocable to the North Line interstate cost of service. *Id*.

Discussion and Ruling

814. Staff and SFPP[202] agreed that the Kansas/Nebraska formula should be used when determining the appropriate allocation factors for investment and operating expenses. However, SFPP and Staff disagreed with the manner in which the KN formula should be implemented.

815. The KN formula allocates a jurisdictional entity's costs between its jurisdictional and non-jurisdictional operations. *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 135. It does this by "allocating labor and plant costs based on the relative percentages of the jurisdictional and non-jurisdictional operations and plant," or, in SFPP's case, between carrier and non-carrier. *Id*. When determining the allocation, costs are first split between labor-related, plant-related, or "other," and the costs in the "other" category are then divided among the labor and plant categories. *See Kansas-Nebraska Natural Gas Co., Inc*., 53 FPC 1691.

816. Staff admitted that its KN analysis does not use the Commission's exact traditional KN formula and claimed that there is no data available which categorizes overhead costs as being either labor-or plant-related. Staff Reply Brief at p. 39. Staff asserted, however, that its formula is closer to the traditional methodology than SFPP's analysis. *Id*. Sosnick explained that, under the Commission's traditional methodology, the costs which were allocated through the Massachusetts formula are categorized as either labor-related, plant-related, or other. Transcript at p. 1089. Once the costs are divided, the plant- and labor-related costs are allocated between the carrier and non-carrier functions based on the proportionate percentages of plant investment and direct labor within the functions. Transcript at p. 1089; Exhibit No. S-15 at p. 36.[203]

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[202] The CC Shippers agreed with SFPP. *See* CC Shippers Initial Brief at p. 73; CC Shippers Reply Brief at p. 52.

[203] Staff stated:

> Under the K/N methodology, corporate overhead costs should be separated into three categories: property, labor and other. The labor-related costs are then allocated based on the percent that each line's labor costs comprise of the total labor costs. The property costs are similarly allocated. The "other" category of costs is allocated to labor an property based on the ratio that each (labor and property) bears to the total of labor plus property costs.

817. The record reflects that SFPP did not classify its corporate overhead costs as either plant-related, labor-related, or "other" as required by the Commission's traditional methodology. See *Kansas-Nebraska Natural Gas Co., Inc*., 53 FPC 1691 at Appendix C. Moreover, in *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 80, the Commission affirmed the presiding judge's determination[204] that SFPP improperly combined plant and labor rates and did not identify the nature of the costs. Because, in the instant proceeding, SFPP did not categorize its costs, neither SFPP nor Staff could correctly implement the Commission's traditional KN formula. Instead, both Staff and SFPP essentially had to treat all corporate overhead costs as if they were classified as "other."

818. When performing its allocation without the costs categorized as plant-related or labor-related, Staff more closely followed the Commission's traditional KN methodology. Sosnick explained that he used an average of total direct plant investment and direct labor to find the proportion of overhead costs that should be recovered in SFPP's rates. Exhibit No. S-15 at p. 39. To allocate corporate overhead costs to the carrier function without having the costs categorized as plant-or labor-related, Sosnick divided the combined carrier direct plant investment and the carrier direct labor by the sum of the total carrier and non-carrier plant investment and carrier and non-carrier direct labor. Exhibit Nos. S-15 at p. 40, S-22.

819. As previously noted, SFPP took a simple average of the carrier and non-carrier direct labor ratio and the direct plant ratio to develop a combined direct labor and direct plant ratio. Exhibit No. SFO-42 at pp. 4-5; Transcript at p. 892. Staff criticized this method, stating that it "allows too much influence to one of the ratios or factors, when it may be markedly greater than the other." Staff Initial Brief at p. 55. SFPP defended its method, analogizing the KN method to the Massachusetts formula. SFPP Initial Brief at p. 92 (*citing* Transcript at p. 892). It argued that each factor in the Massachusetts formula is given equal weight when the ratios, not dollars, are averaged, and, therefore, the KN formula is also analyzed properly when the ratios are averaged, equally weighting the factors. *Id*. However, SFPP's argument ignores the presiding judge's determinations on the KN formula in *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 406. There, the ALJ's ruling is exactly opposite to SFPP's argument:

> [I]n contrast with the Mass[achusetts] Formula which melds the three components together to arrive at a simple-average ratio, the Commission has ordered the KN Formula to take into account the nature (character) of the costs – whether plant or labor – so that if the character can be reasonably

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Staff Initial Brief at p. 54 (footnotes omitted).

[204] *See Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 408.

> identified the costs are assigned only to that component without blending the two components together into a simple-average.

Id. at P 406 (citation omitted). The presiding judge's determinations on the KN Formula were affirmed in the same Commission order which SFPP erroneously claimed supports its KN methodology. *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 80, 89. There, rather than using the formula on which SFPP claimed it based its KN Methodology, the Commission "concur[red] with the ALJ's finding that SFPP's . . . use of a combined labor and plant ratio to allocate [administrative and general] costs between its carrier/non-carrier functions was not appropriate." *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 89. SFPP's use of a simple average remains inappropriate for use in this proceeding.

820. Based on the above, were it necessary for me to choose between SFPP's proposal and Staff's, I would have adopted Staff's weighted average methodology which, while not precisely identical, is a closer application of the Commission's method in *Kansas-Nebraska Natural Gas Co., Inc*., 53 FPC 1691 at Appendix C, than SFPP's use of the previously Commission-rejected simple average.[205] However, I am not satisfied that either of the two proposals meets the Commission's requirements as set forth in *Kansas-Nebraska Natural Gas Co.* Staff's position is that, while Sosnick presented Staff's alternative approach because SFPP failed to provide the data it needed to comply with the Commission's *Kansas-Nebraska Natural Gas Co.* ruling, SFPP should comply with it "in all future proceedings." Staff Reply Brief at pp. 37-40. *See also* Transcript at pp. 1057-58, 1064-65. Furthermore, Staff suggested that SFPP should be "directed in a compliance filing to properly apply the Commission's KN methodology." Staff Reply Brief at pp. 39-40. I agree with Staff's last suggestion.

821. Without question, SFPP has been ordered to properly apply the Commission's KN methodology more than once before. *SFPP, L.P*, 113 FERC ¶ 61,277 at P 87-89; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 135-39. While it pretends that it has complied, *see e.g.* SFPP Initial Brief at p. 85, it is clear to me that it continues to fail to obey the Commission's orders.[206] In its 2005 ruling, the Commission directed SFPP, *inter alia*, to stop using "a combined labor and plant ratio for all [administrative and general] costs without considering the nature of those costs, . . . to recalculate its KN allocation formula consistent with Staff's allocation procedures based on SFPP cost-of-service data (as corrected for Staff's mathematical errors)," and to "use direct labor costs to allocate the

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[205] *See SFPP, L.P.*, 113 FERC ¶ 61,277 at P 80-89.

[206] *See, e.g.,* Exhibit No. SFO-48 at p. 1 in which Sosnick indicated that SFPP provided him with, about, 54,000 expense transaction records in which it failed to identify, for the indirect expenses, whether they were related to labor, plant or "other", and that this failure prevented him from generating "a proper KN allocation using" them.

appropriate [administrative and general] costs to its carrier and non-carrier operations." *SFPP, L.P* 113 FERC ¶ 61,277 at P 88-89.[207] The instant record does not support a conclusion that it has complied. *See* Exhibit No. SFO-42 at pp. 4-5; Transcript at p. 892.

822. In view of the above, in the compliance filing which it must make following a final decision in this matter, SFPP must classify the allocated indirect corporate costs resulting from application of the Massachusetts formula as labor-related, plant-related, or "other." These classified indirect overhead costs can then be assigned to carrier and non-carrier operations and further allocated to the Oregon and North Lines. The labor-related costs should be assigned using the known direct labor ratios, and the plant-related costs should be assigned using the plant investment ratios using the KN methodology. The remaining costs, assigned to the "other" category, should be split using the weighted average of the associated and previously determined labor and plant costs resulting from application of the Massachusetts formula. Once split, the other related costs should be assigned in accordance with the respective labor or plant ratios to complete the KN calculation. *See* Exhibit Nos. S-15 at pp. 35-36, S-20, SFO-45.

823. Sosnick also criticized SFPP for including both intrastate and interstate pipeline costs in its carrier costs when only interstate costs are relevant in assigning corporate overhead costs. Staff Initial Brief at p. 56 (*citing* Exhibit No. S-15 at pp. 36-37). In response, SFPP claimed that it allocated the carrier portion of overhead costs among inter- and intrastate functions in the same step that it made allocations among its various lines. SFPP Initial Brief at pp. 88-89. Staff's criticism is without merit. SFPP illustrated that, regardless of whether intrastate costs are removed in the same step as the costs are allocated among the North and Oregon lines or whether this is done in two steps, the results are the same. Exhibit No. SFO-113; Transcript at pp. 886-89. Although Staff used two steps and SFPP used only one, both calculated the same percentages of total direct costs for the North and Oregon Line. Exhibit No. SFO-113. Additionally, on cross-examination, Sosnick acknowledged that both Staff's two-step method and SFPP's one-step method produce the same results. Transcript at pp. 1069-73. Each method appears to be a means to the same end. Therefore, Staff's suggestion in this regard is rejected.

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[207] In *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 139, the Commission found that "SFPP's KN method is contrary to the Commission's approved method for determining allocation factors among a pipeline's various functions. For this reason, ". . . [it required] SFPP to recalculate its KN allocation formula consistent with Staff's allocation procedures based on SFPP's 1999 cost-of-service data, as corrected for Staff's mathematical errors." There is nothing in the instant record to indicate that, even after three years from first being ordered to do so, SFPP has complied, or intends to comply, with the Commission's Order. I think that it has had more than sufficient opportunity to do so and that it must do so not later than making the compliance filing following a final ruling in this matter.

824. When making the KN allocation, Staff correctly removed purchase accounting adjustments from gross plant. In *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 89, the Commission directed SFPP to remove purchase accounting adjustments from its gross property balance, stating that "proper application of the KN method requires the calculation of the carrier and non-carrier allocation percentages by reducing the gross property balances by the [purchase accounting adjustments]." *See also Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 407. Further, SFPP's witnesses conceded that purchase accounting adjustments should be removed from gross plant, and stated that SFPP "removed the purchase[] accounting adjustments from the FERC Form 6 plant numbers for purposes of calculating [its] KN methodology." See Transcript at pp. 829, 892. Accordingly, in its compliance filing, SFPP should remove them.

D: What is the appropriate development and allocation of environmental remediation expenses?[208]

A. COMMISSION TRIAL STAFF

825. Staff stated that it used SFPP's 2003 environmental remediation expenses in this proceeding. Staff Initial Brief at p. 58 (*citing* Exhibit Nos. SFO-66 at p. 120, S-10 at p. 12, S-11 at p. 12); Staff Reply Brief at p. 40.

B. SFPP, L.P.

826. SFPP discussed this issue as part of its discussion of Issue V.G. SFPP Initial Brief at p. 93.

E: What is the appropriate development and allocation of litigation expenses?[209]

[208] Issues V.D, V.E, V.F, and V.G are joined together for discussion and ruling.

The CC Shippers did not address this issue. CC Shippers Initial Brief at p. 74. Likewise, the Indicated Shippers explained that they took no position and/or deferred to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 38.

[209] The Indicated Shippers explained that they took no position and/or deferred to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 38.

A. CC SHIPPERS

827. The CC Shippers addressed this issue only to note that SFPP is authorized by the Commission to recover its litigation costs in all prior cases from the funds it generates by overcharges on shippers who were not complainants in those cases, or through a surcharge on rates for all shippers, if needed. CC Shippers Initial Brief at p. 74 (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 110).[210]

B. Commission Trial Staff

828. Staff explained that it used SFPP's 2003 litigation expenses. Staff Initial Brief at p. 58 (*citing* Exhibit Nos. SFO-66 at p. 120, S-10 at p. 12, S-11 at p. 12); Staff Reply Brief at p. 40.

C. SFPP, L.P.

829. SFPP discussed this issue as part of its discussion of Issue V.G. SFPP Initial Brief at p. 93.

F: What is the appropriate fuel and power cost?[211]

A. COMMISSION TRIAL STAFF

830. While Staff stated that it did not independently develop fuel and power costs in this proceeding, it did modify the costs determined by SFPP by using Staff's KN assignment of costs to the North and Oregon Lines, which resulted in minimal differences of $377 for the North Line and $307 for the Oregon Line. Staff Initial Brief at pp. 58-59 (*citing* Exhibit Nos. SFO-66 at p. 119, S-10 at p. 11, S-11 at p. 11). However, in its Reply Brief, Staff stated that it adopted the data from SFPP's testimony. Staff Reply Brief at p. 40.

B. SFPP, L.P.

831. SFPP discussed this issue as part of its discussion of Issue V.G. SFPP Initial Brief at p. 93.

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[210] The CC Shippers added nothing in their Reply Brief. CC Shippers Reply Brief at p. 53.

[211] The CC Shippers did not address this issue. CC Shippers Initial Brief at p. 74; CC Shippers Reply Brief at p. 53. The Indicated Shippers explained that they took no position and/or defer to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 38; Indicated Shippers Reply Brief at p. 16.

G: What reserves, if any, for projected future costs can be included in the cost of service?[212]

A. COMMISSION TRIAL STAFF

832. Staff maintained that it used SFPP's figures for any reserves associated with litigation expenses. Staff Initial Brief at p. 59 (*citing* Exhibit Nos. SFO-66 at pp. 120, 127, S-10 at p. 12, S-11 at p. 12); Staff Reply Brief at p. 40.

B. SFPP, L.P.

833. Because, it contended, a party that challenges a regulated entity's costs bears the burden of showing that those costs are unjust and unreasonable, and no party has provided evidence regarding SFPP's environmental remediation expenses, litigation expenses, fuel and power costs, or reserves, SFPP maintained that there is no basis for making an adjustment to its cost-of-service on these bases. SFPP Initial Brief at pp. 93-94 (*citing Xcel Energy Services, Inc.*, 121 FERC ¶ 61,284 at P 24; *Sea Robin Pipeline Co. v. FERC*, 795 F.2d at pp. 186-87).

Discussion and Ruling

834. These issues collectively involve SFPP's appropriate expenses and costs and include: (1) development and allocation of environmental and remediation expenses; (2) development and allocation of litigation expenses; (3) fuel and power costs; and (4) reserves for projected future costs that may be included in SFPP's cost-of-service.

835. No party contests SFPP's environmental remediation expenses, litigation expenses, or reserves. Therefore, because these expenses have not been challenged, and the record supports it, I find that SFPP's 2003 environmental remediation expenses, litigation expenses, and the reserves associated with those litigation expenses are just and reasonable. *See* Exhibit Nos. SFO-66 at pp. 120, 127, S-10 at p. 12, S-11 at p. 12.

836. Staff, however, did not use SFPP's fuel and power costs in its calculations, but instead modified those costs using Staff's assignment of costs to each line through the KN formula. Staff Initial Brief at p. 58 (*citing* Exhibit Nos. SFO-66 at p. 119, S-10 at p. 11, S-11 at p. 11). While adopting Staff's fuel and power costs allocated to the North and

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[212] The CC Shippers did not address this issue. CC Shippers Initial Brief at p. 74; CC Shippers Reply Brief at p. 53. The Indicated Shippers explained that they took no position and/or defer to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 38; Indicated Shippers Reply Brief at p. 17.

Oregon Lines via the KN methodology results in a *de minimis* change,[213] any determination regarding these matters must be consistent with application of the Commission's established KN methodology as required in the discussion of Issue V.C, *supra.*

ISSUE VI: Throughput volume: For each complaint year and for the test year used to determine prospective rates, what is the appropriate throughput volume level?[214]

A. CC SHIPPERS

837. The CC Shippers stated that they did not dispute SFPP's 2003 volume data regarding North and Oregon Line shipments for 2003, or the data for the 2001 through 2004 periods. CC Shippers Initial Brief at p. 75. They indicated that the actual volume data for 2003 is the only data that reasonably reflects SFPP's shipments. *Id.* The CC Shippers claimed that it is reasonable to use 2003 volumes since the parties agreed to use 2003 for the cost-of-service review. *Id*. It was inappropriate to use 2004 volumes for the North Line because the capacity of the line, the CC Shippers insisted, was expanded at the end of that year. *Id.* The 2003 volumes, they added, also reasonably reflect the volumes for the period from 2001 through 2004 on the North Line. *Id.* According to them, the same is true for the Oregon Line. *Id.*[215]

B. COMMISSION TRIAL STAFF

838. Staff maintained that the volumes in the 2003 North and Oregon Line complaints and test years are the actual volumes (16,154 Mbbls for the Oregon Line and 13,726 Mbbls for the North Line) for that year. Staff Initial Brief at p. 59 (*citing* Exhibit Nos. S-1 at p. 18, S-9 at p. 13, S-83, CC-1 at pp. 53-54,). In its Reply Brief, Staff stated that it adopted the data reflected in SFPP's testimony and used 2003 volumes as the test year volumes. Staff Reply Brief at p. 41.

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[213] This modification results in a $377 difference in the North Line costs and a $307 difference in Oregon Line costs. Staff Initial Brief at pp. 58-59 (*citing* Exhibit No. SFO-66 at p. 119, S-10 at p. 11, S-11 at p. 11).

[214] The Indicated Shippers explained that they took no position and/or defer to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 38.

[215] The CC Shippers added no new arguments in their Reply Brief. CC Shippers Reply Brief at p. 53.

C. SFPP, L.P.

839. SFPP explained that the North and Oregon Line cost-of-service studies show the throughput for 2003 and 2004 for each line, and no participant disputed these figures. SFPP Initial Brief at p. 94 (*citing* Exhibit Nos. SFO-66 at pp. 130-31, SFO-68 at pp. 132-33). In its Reply Brief, SFPP claimed that the CC Shippers submitted that 2003 throughput is representative of SFPP's volumes during the 2001 through 2004 period. SFPP Reply Brief at p. 91 (*citing* CC Shippers Initial Brief at p. 75). SFPP responded, arguing that the issue of whether 2003 throughput volumes are an appropriate proxy for 2001 and 2002 is irrelevant because the North and Oregon Lines are grandfathered, so reparations would not be available for any period prior to the date of the complaint. *Id*. at pp. 91-92. SFPP concurred with the CC Shippers that 2003 throughput volume should be used if just and reasonable rates must be determined for 2003. *Id*. at p. 92. Likewise, if just and reasonable rates must be determined for 2004, then Ganz's 2004 cost-of-service calculation should be used, it added. *Id*. at p. 92 (*citing* Exhibit Nos. SFO-117, SFO-118).

Discussion and Ruling

840. This Issue requires a determination of the appropriate level of throughput volume to be used to determine SFPP's rates. All parties agree, or do not contest, that the actual 2003 volumes should be used for both the North and Oregon Lines. The 2003 North Line volumes were 13,726 Mbbls and the Oregon Line volumes were 16,154 Mbbls. Exhibit No. SFO-66 at pp. 130-31. Moreover, as explained by the CC Shippers, it is inappropriate to use 2004 volumes for the North Line because the capacity of the line was expanded at the end of that year. CC Shippers Initial Brief at p. 75. Instead, 2003 volumes should be used for the period from 2001 through 2004 on the North Line.

ISSUE VII: Just and reasonable rates: What are the just and reasonable rates that SFPP should be allowed to charge?[216]

A. CC SHIPPERS

841. Based on O'Loughlin's recommended income tax rates, the CC Shippers asserted that the just and reasonable rates are 90.8 cents/bbl for the North Line and 29.11 cents/bbl for the Oregon Line. CC Shippers Initial Brief at p. 76 (*citing* Exhibit No. CC-44 at pp. 20, 22). Had SFPP carried its burden of proof under the *Policy Statement on Income Taxes,* 111 FERC ¶ 61,139, and was entitled to an income tax allowance, they added, the just and reasonable rates using SFPP's income tax rate of 35% would be 96.98 cents/bbl

[216] The Indicated Shippers stated that they defer to the other shipper complainants in this proceeding. Indicated Shippers Initial Brief at p. 38.

for the North Line and 30.72 cents/bbl for the Oregon Line. *Id*. (*citing* Exhibit No. CC-44 at pp. 20-22).

842. In their Reply Brief, the CC Shippers explained that, when determining the rate he considered to be just and reasonable, O'Loughlin used his recommended 2003 cost-of-service which included income tax rates of 5.13% for the North Line and 5.01% for the Oregon Line, with a 9.88% real return of equity. CC Shippers Reply Brief at p. 54.

B. COMMISSION TRIAL STAFF

843. Contending that only the Oregon Line is de-grandfathered, Staff stated that the just and reasonable rate can be determined by dividing Staff's proposed 2003 cost-of-service by the 2003 volumes of 16,154,000 barrels.[217] Staff Initial Brief at p. 59 (*citing* Exhibit No. SFO-83). If one did need to develop a just and reasonable rate for the North Line, Staff added, Staff's 2003 cost-of-service should be divided by 2003 volumes of 13,726,000 barrels.[218] *Id*. at p. 60 (*citing* Exhibit No. SFO-83). Although Staff developed rates for both lines, it stated that all rates will need to be based upon the most recent cost-of-service data. *Id*. (*citing* Exhibit Nos. S-9 at p. 17; S-42).[219]

C. SFPP, L.P.

844. SFPP argued that, since its lines were grandfathered under EPAct § 1803(b), they can only be challenged if a party presents evidence that a substantial change in the economic circumstances underlying the basis of the rate occurred. SFPP Initial Brief at p. 96. Because the Complainants have not met this burden, according to SFPP, SFPP's North and Oregon Line rates remain just and reasonable. *Id.*

845. In its Reply Brief, SFPP agreed with Staff that the North Line rates should remain grandfathered, so just and reasonable rates need not be determined. SFPP Reply Brief at p. 92 (*citing* Staff Initial Brief at p. 59). SFPP disagreed that just and reasonable rates need to be set for the Oregon Line, since it claimed that the Oregon Line rates should remain grandfathered. *Id*. at p. 93. (*citing* SFPP Initial Brief at pp. 39-54, 73-83). Were it necessary to determine just and reasonable rates for either line, SFPP argued, they should be calculated using its witness Ganz's cost-of-service calculations which, according to SFPP, are (1) consistent with the *Policy Statement on Income Tax Allowances*, 111 FERC

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[217] Staff's recommended 2003 Oregon Line cost of service is $4,501,000. Exhibit No. S-11 at p. 1.

[218] Staff's recommended 2003 North Line cost-of-service is $12,982,000. Exhibit No. S-10 at p. 1.

[219] Staff added no new argument in its Reply Brief. Staff Reply Brief at p. 41.

¶ 61,139 and Commission orders interpreting it; (2) include a return on equity which is consistent with *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048; and (3) are consistent with "other cost-of-service elements that have been determined in a manner consistent with the Commission's ratemaking policies." *Id*. at pp. 93-94 (*citing* Exhibit Nos. SFO-115 through SFO-118).

Discussion and Ruling

846. The just and reasonable rates SFPP should be allowed to charge depend upon whether the North and Oregon Line rates are de-grandfathered in this proceeding. This decision depends upon the compliance filing SFPP is directed to make.

847. In the event the rates are de-grandfathered, the just and reasonable rates for the Oregon Line should be determined by dividing the 2003 cost-of-service calculated in SFPP's compliance filing by the 2003 volumes of 16,154 Mbbls. Likewise, if needed, the rates for the North Line should be determined by dividing the 2003 cost-of-service calculated in SFPP's compliance filing by the 2003 volumes of 13,726 Mbbls.

ISSUE VIII: Remedies

A: Are complainants entitled to reparations in this proceeding?[220]

A. CC SHIPPERS

848. The CC Shippers asserted that, if a complainant can establish that there was a substantial change in economic circumstances that would degrandfather a grandfathered rate and deem it unjust and unreasonable, the complainant is entitled to refunds, with interest, and any related tariff reductions prospectively from the date of the filing of the complaint. CC Shippers Initial Brief at p. 77 (*citing* EPAct § 1803 (b)). For rates which are not grandfathered, they continued, if a complainant shows that the challenged rate is unjust and unreasonable, the complainant is entitled to reparations and refunds beginning two years prior to the filing of the complaint.[221] *Id*.

[220] Issues VIII.A, B, and C are joined together for discussion and ruling.

[221] The CC Shippers added nothing of substance in their Reply Brief. *See* CC Shippers Reply Brief at p. 55.

B. INDICATED SHIPPERS

849. The Indicated Shippers stated that the Complainants are entitled to reparations plus Commission interest, compounded on a quarterly basis, if rate reductions are to be ordered. Indicated Shippers Initial Brief at p. 39.[222]

C. COMMISSION TRIAL STAFF

850. According to Staff, the Complainants are entitled to refunds flowing from the date of their complaint, but not to reparations prior to that date. Staff Initial Brief at p. 60 (*citing* EPAct § 1803; *SFPP, L.P.*, 80 FERC ¶ 63,014 at p. 65,202; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 527-529).

851. In its Reply Brief, Staff contended that, if a rate is grandfathered and no changed circumstances have been shown, there can be no refunds because a grandfathered rate is considered just and reasonable. Staff Reply Brief at p. 42. Even were the rates de-grandfathered, reparations cannot be due, according to Staff, because the rates were just and reasonable for the two years prior to becoming de-grandfathered. *Id*. Under the EPAct, Staff continued, refunds resulting from a complaint are prospective from the date the complaint was filed. *Id*. (*citing SFPP, L.P.*, 80 FERC at p. 65,202; *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 527-529). Staff maintained that Complainants are thus not entitled to reparations before the date of their complaints. *Id*. at p. 43.

D. SFPP, L.P.

852. According to SFPP, the Complainants are not entitled to reparations because neither the Complainants nor Staff have proven that a substantial change in economic circumstances has occurred that would de-grandfather either the North or Oregon Line rates. SFPP Initial Brief at p. 96.

853. In its Reply Brief, SFPP agreed with Staff and the Indicated Shippers that reparations are allowed only if Complainants have established that rates are no longer grandfathered, and then they are only calculated from the date of the complaint forward. SFPP Reply Brief at p. 94 (*citing* Staff Initial Brief at p. 60; Indicated Shippers Initial Brief at p. 39). SFPP disagreed with the CC Shippers that Complainants are entitled to reparations for the period beginning two years prior to the date of their complaints for the portion of the North and Oregon Line rates that result from indexing because no participant has challenged the rate indexing adjustment. *Id*. at p. 95 (*citing* CC Shippers Initial Brief at p. 77).

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[222] The Indicated Shippers did not address this issue in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 17.

B: What is the appropriate level of reparations?

A. CC SHIPPERS

854. The CC Shippers stated that the overpayment should be calculated by taking the difference between the collected rate and the grandfathered rate and multiplying that figure by the complainant's volume for the two years prior to the date the complainants filed their complaint. CC Shippers Initial Brief at p. 78. For periods after August 2003, they added, "the difference between the collected rate and the just and reasonable rate for the 2003 Complaint Year[] multiplied by the complainant's volume," should be used. *Id*. (*citing* Exhibit No. CC-1 at pp. 66-67). According to them, because SFPP requested that a rate increase be put into effect on June 1, 2005, due to its North Line expansion, the just and reasonable rate would apply only up to that date. *Id*.

855. O'Loughlin, the CC Shippers stated, calculated Chevron's and ConocoPhillips' overpayments on the North Line by finding the difference between the collected and grandfathered rates for the two years prior to their respective complaints and on the difference between the collected rate and the just and reasonable rate. *Id*. at pp. 78-79 (*citing* Exhibit Nos. CC-1 at pp. 67-69, CC-44 at pp. 20-21). According to them, O'Loughlin calculated that Chevron's overpayment was $1 million while ConocoPhillips' was $400,000 for the North Line. *Id.* For the Oregon Line, the CC Shippers continued, using the same methodology, O'Loughlin calculated that Chevron's overpayment was $1.9 million while ConocoPhillips' overpayment was $1.8 million. *Id*. at pp. 79-80. In his calculations, O'Loughlin used the rate levels from his rebuttal testimony, the CC Shippers noted. *Id*. at pp. 78-80.[223]

B. INDICATED SHIPPERS

856. The appropriate level of reparations, according to the Indicated Shippers, is the difference between the just and reasonable rate and the rate paid by the shippers, plus FERC interest, compounded on a quarterly basis. Indicated Shippers Initial Brief at p. 39.[224]

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[223] The CC Shippers did not address this issue in their Reply Brief. *See* CC Shippers Reply Brief at p. 55.

[224] The Indicated Shippers did not address this issue in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 17.

C. COMMISSION TRIAL STAFF

857. Staff stated that refunds are calculated as the difference between the newly established just and reasonable rates as reflected in Staff's testimony, indexed forward, and the rates in effect from the date of the filing of the complaints multiplied by the number of barrels shipped by each complainant. Staff Initial Brief at p. 61 (*citing SFPP, L.P.*, 97 FERC ¶ 61,138 at P 74; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 49; *SFPP, L.P.*, 118 FERC ¶ 61,261 at P 8-9 (2007); *SFPP, L.P.*, 121 FERC ¶ 61,240; *SFPP, L.P.*, 91 FERC ¶ 61,135).[225]

D. SFPP, L.P.

858. In its Initial Brief, on this issue, SFPP only stated: "The appropriate level of reparations is none." SFPP Initial Brief at p. 96. It repeated this thought in its Reply Brief, adding that Complainants have failed to prove that circumstances had changed substantially. SFPP Reply Brief at p. 95. Further, SFPP contended, there are also no reparations for rates that remain grandfathered because Complainants have not properly challenged SFPP's rate indexing adjustments. *Id.* Reparations are also, according to SFPP, not available prior to the date of a complaint that results in a rate being de-grandfathered. *Id*. at p. 96.

C: Does EPAct prevent reparations from being awarded to a complainant for the period prior to the date on which the complainant filed its complaint?

A. CC Shippers

859. The CC Shippers stated that the Commission ruled reparations are due for two years before the filing of complaints to the shippers who filed those complaints. CC Shippers Initial Brief at p. 80 (*citing SFPP, L.P.*, 117 FERC ¶ 61,285 at P 77; *SFPP, L.P.*, 118 FERC ¶ 63,033 at P 65-66 (2007)). The rate floor for the calculation of reparations provided by grandfathered rates, they continued, is lost as of the date of the first complaint which established a substantial change in circumstances. *Id*. (*citing SFPP, L.P.*, 111 FERC ¶ 61,334; *ARCO Products Co.*, 106 FERC ¶ 61,300).[226]

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[225] Staff added nothing of substance in it Reply Brief. *See* Staff Reply Brief at p. 43.

[226] The CC Shippers added nothing of substance in their Reply Brief. *See* CC Shippers Reply Brief at pp. 55-56.

B. INDICATED SHIPPERS

860. The Indicated Shippers explained that EPAct limits reparations to the date of complaint for rates that have been de-grandfathered, but, for rates that were never grandfathered, reparations may start two years prior to the date of the complaint. Indicated Shippers Initial Brief at p. 39.[227]

C. COMMISSION TRIAL STAFF

861. Under the Interstate Commerce Act, according to Staff, reparations are available if the Commission determines that a carrier's rate is unjust and unreasonable and thus establishes a new rate. Staff Initial Brief at p. 61. In that case, Staff continued, a carrier may be required to refund the amount collected in excess of the new just and reasonable rate for the period beginning on the date the complaint was filed through the effective date of the new rate, as well as for two years prior to the filing of the complaint if the rates were not grandfathered. *Id.* On the other hand, if the rate was grandfathered and the Commission finds that substantially changed circumstances exist, Staff explained, refunds are due from the date of the complaint. *Id*. at pp. 61-62 (*citing* EPAct §1803(b); *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 81 & n.100).[228]

D. SFPP, L.P.

862. Under EPAct, SFPP stated, refunds or a tariff reduction resulting from a complaint are to be prospective from the date the complaint is filed. SFPP Initial Brief at p. 97 (*citing* EPAct §1803(b)). The Commission confirmed this proposition, according to SFPP. *Id.* (*citing SFPP, L.P.*, 121 FERC ¶ 61,240 at P 81).

863. In its Reply Brief, SFPP contended that the CC Shippers are contradictory in their view of Section 1803 of EPAct because they first claim, in Section VIII.C of their Initial Brief, that the Commission allowed reparations for the two-year period prior to the date on which complaints were filed, but argue to the contrary in Section VIII.A, admitting that Section 1803 provides that reparations must be prospective from the date of the complaint. SFPP Reply Brief at pp. 96-97 (*citing* CC Shippers Initial Brief at pp. 77, 80). The cases the CC Shippers cited involved situations, SFPP alleged, in which the Commission found that the rates at issue were never grandfathered under EPAct. *Id*. (*citing SFPP, L.P.*, 117 FERC ¶ 61,285 at P 80; *SFPP, L.P.*, 118 FERC ¶ 63,033).

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[227] The Indicated Shippers did not address this issue in their Reply Brief. *See* Indicated Shippers Reply Brief at p. 17.

[228] Staff added nothing of substance in its Reply Brief. *See* Staff Reply Brief at p. 44.

864. Continuing, SFPP stated that the Commission previously has found that the North and Oregon Line rates were grandfathered under EPAct. *Id*. at p. 97 (*citing Chevron Products Co. v. SFPP, L.P.*, 114 FERC ¶ 61,133 at P 3-4). Moreover, according to SFPP, EPAct § 1803 provides that reparations will be prospective from the date of the complaint filing. *Id*. SFPP also reiterated that rate adjustments made pursuant to the Commission's rate indexing methodology have not been challenged in this proceeding, and thus are not subject to a claim for reparations. *Id*. at p. 98.

Discussion and Ruling

865. At issue is whether complainants are entitled to reparations, and, if so, the level of reparations to which they are entitled. The level of reparations also depends upon whether EPAct prevents reparations from being awarded to a complainant for the period prior to the date on which the complaint was filed.

866. Whether Complainants are entitled to reparations depends upon whether there has been a substantial change in economic circumstances that would warrant de-grandfathering either the North or Oregon Line rates. *See* EPAct § 1803(b); 49 U.S.C. app. § 15(7). If the rates on either one or both of the lines are de-grandfathered, then the Complainants are entitled to reparations. *See* EPAct § 1803(b); 49 U.S.C. app. § 15(7). Whether there was a substantial change in the economic circumstances that served as the basis for either of the grandfathered rates at issue here remains for a compliance filing following a final ruling on the remaining issues. All parties agree that, where there is a substantial change in circumstances, reparations are due to the Complainants. CC Shippers Initial Brief at p. 77; Indicated Shippers Initial Brief at p. 39; Staff Initial Brief at p. 60; SFPP Reply Brief at p. 94.

867. The CC Shippers calculated overpayments by finding the difference between the collected and grandfathered rates for the two years prior to the filing of their complaints and on the difference between the collected rate and what they consider the just and reasonable rate to be. CC Shippers Initial Brief at p. 78. Both the Indicated Shippers and Staff recommended that reparations be determined by finding the difference between the newly established just and reasonable rate and the rates in effect from the date of the filing. Indicated Shippers Initial Brief at p. 39; Staff Initial Brief at p. 61.

868. Under the EPAct, should a rate be found to be unjust and unreasonable pursuant to a complaint filed under section 13 of the Interstate Commerce Act, then "[a]ny tariff reduction or refunds that may result as an outcome of such a complaint shall be prospective from the date of the filing of the complaint." EPAct § 1803(b). As Judge Zimmet explained:

> Reparations are a means of redress to compensate persons who have suffered injury, loss, or wrong at the hands of another . . . a common carrier oil pipeline is liable for reparations -- termed "damages" -- when complainants have shown that the pipeline has charged unjust and unreasonable rates under §§ 13(1) and 15(1) of the Act. Section 16(3)(b) authorizes damages to be recovered starting from the time the cause of action "accrues" (i.e., comes into existence), which is generally no more than two years immediately preceding the filing of a complaint . . . . [EPAct] § 1803(b) has modified in part the [Interstate Commerce Act's] treatment of reparations. Using the label "refunds" rather than "damages" in regard to reparations, § 1803(b) implicitly disallows the two-year recovery period immediately preceding the filing of a complaint that is authorized by § 16(3)(b) of the [Interstate Commerce Act] -- but only with regard to a grandfathered rate that has been found to be unjust and unreasonable.

Texaco Refining and Marketing, Inc. v. SFPP, L.P., 108 FERC ¶ 63,036 at P 527-528. When a grandfathered rate is found unjust and unreasonable, refunds are prospective from the date of the complaint. *Id*. at P 528; *see also SFPP, L.P.*, 121 FERC ¶ 61,240 at P 81. Only when a non-grandfathered rate is found unjust and unreasonable do refunds accrue starting two years preceding filing of the complaint. *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 529.

869. If the North or Oregon Line rates are de-grandfathered, then reparations will be due Complainants. These reparations should be calculated as the difference between the just and reasonable rate established in this proceeding, which will be indexed forward, and the rates in effect from the date of the filing. According to the Commission, in order to calculate reparations or refunds, a new just and reasonable rate must first be calculated "by developing the cost[-]of[-] service for the test year . . . and dividing the costs by the relevant test period volumes for each class of service." *SFPP, L.P.*, 91 FERC at p. 61,516. The Commission added:

> [T]he 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. The purpose 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. . . . the gross reparation level due for each year is the difference between the revenues generated in that year under the old rates and the revenue level that would have been generated under the new rates . . .

Id. at p. 61,516. Moreover, the new rate should be indexed forward for the level of the index that SFPP has been allowed for each year since 2003. *Id.*; *see also SFPP, L.P.*, 113 FERC ¶ 61,277 at P 49; *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 75.

870. The CC Shippers argued that reparations should be due for two years prior to the filing of the complaint for the shippers that filed the complaints. CC Shippers Initial Brief at p. 80. They base this claim on *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 at P 77, where the Commission stated that "[r]eparations will be due for the Complaint proceeding for two years before the complaints for the shippers that filed those complaints." The CC Shippers erroneously applied the Commission's decision. The rates at issue there were not grandfathered, as are the North and Oregon Line rates at issue in this proceeding. When a non-grandfathered rate is found unjust and unreasonable, refunds accrue two years preceding filing of the complaint, but when a *grandfathered* rate is found unjust and unreasonable, refunds are prospective from the date of the complaint. *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 108 FERC ¶ 63,036 at P 528-29. When a *grandfathered* rate is at issue, EPAct prevents reparations from being awarded to a complainant for the period prior to the date on which the complainant filed its complaint. *See* EPAct § 1803(b). Any reparations due to the Complainants in this proceeding should be calculated from the date of the complaint.

D: Is it permissible under the Interstate Commerce Act and Commission precedent for a complainant to recover reparations related to barrels it has not shipped?[229]

A. CC SHIPPERS

871. According to the CC Shippers, the jurisdictional status of SFPP's shipments on the Oregon Line is not within the scope of the issues in this proceeding. CC Shippers Initial Brief at p. 81. The issue, they added, in their Reply Brief, "is moot with respect to the CC Shippers." CC Shippers Reply Brief at p. 56. The CC Shippers added that SFPP acknowledged that the only issue regarding volume shipped by Chevron has been resolved. *Id.* (*citing* SFPP Initial Brief at p. 98).

B. COMMISSION TRIAL STAFF

872. Staff stated that it cannot base an opinion on this issue at this time because there is no argument of law or statement of fact upon which to do so in this proceeding. Staff Initial Brief at p. 62. In its Reply Brief, Staff contended that the issue is beyond the scope of the proceeding. Staff Reply Brief at pp. 44-45.

[229] The Indicated Shippers stated that they do not take a position on this issue and/or defer to other shipper complainants. Indicated Shippers Initial Brief at p. 39.

C. SFPP, L.P.

873. According to SFPP, it is not permissible for a complainant to recover reparations related to barrels it has not shipped, as only shippers or other parties that are in privity with a pipeline may recover reparations. SFPP Initial Brief at p. 97 (*citing Big West Oil Co. v. Frontier Pipeline Co.*, 106 FERC ¶ 61,171 (2001)). The Complainants in this proceeding, SFPP stated, have only presented evidence of the volumes that they themselves shipped, leaving SFPP without a basis to confirm whether these volumes include barrels shipped by third parties. *Id*. at pp. 98-99. If they did include such barrels, then a claim for reparations must be denied, SFPP asserted. *Id*. at p. 99. In its Reply Brief, SFPP stated that it has not raised this jurisdictional issue in briefing. SFPP Reply Brief at p. 98.

Discussion and Ruling

874. The parties have either not addressed this issue or have agreed that it is not within the scope of this proceeding. CC Shippers Initial Brief at p. 81; Indicated Shippers Initial Brief at p. 39; Staff Initial Brief at p. 62; Staff Reply Brief at pp. 44-45; SFPP Reply Brief at p. 98. Accordingly, the record presents no basis on which to consider it.

ORDER

875. 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 of the Commission in this proceeding, SFPP, L.P., shall file revised Tariff sheets in accordance with the findings and conclusions of this Initial Decision, as adopted or modified by the Commission.

876. IT IS FURTHER 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 of the Commission in this proceeding, SFPP, L.P., shall calculate and distribute reparations and refunds in accordance with the findings and conclusions of this Initial Decision, as adopted or modified by the Commission.

EDWARD M. SILVERSTEIN
Presiding Administrative Law Judge

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