121 FERC ¶ 61,240
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Suedeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

SFPP, L.P.	Docket Nos. OR92-8-027, -029 and -031 OR93-5-017 and -018 OR94-3-016 and -017 OR94-4-018 and -019
Mobil Oil Corporation	Docket Nos. OR95-5-015
v.	
SFPP, L.P.	
Tosco Corporation	Docket Nos. OR95-34-014
v.	
SFPP, L.P.	
ARCO Products Co. a Division of Atlantic Richfield Company, Texaco Refining and Marketing Inc., and Mobil Oil Corporation	Docket Nos. OR96-2-015, -017 and 019 OR96-10-012 OR96-17-008 OR98-1-011 and -014 OR00-4-006
v.	
SFPP, L.P.	
Ultramar Diamond Shamrock Corporation and Ultramar, Inc.	Docket Nos. OR97-2-005 and -007 OR98-2-007 and -009 OR00-8-007 and -009
v.	
SFPP, L.P.	

Tosco Corporation	Docket Nos. OR98-13-007 and -009 OR00-9-010 and -011
v.	
SFPP, L.P.	
Navajo Refining Corporation	Docket No. OR00-7-008
v.	
SFPP, L.P.	
Refinery Holding Company	Docket No. OR00-10-008
v.	
SFPP, L.P.	
SFPP, L.P.	Docket No. IS98-1-004
SFPP, L.P.	Docket No. IS04-323-004
SFPP, L.P.	Docket Nos. IS06-215-000 and IS06-220-000

.

ORDER ON REHEARING, REMAND,
COMPLIANCE, AND TARIFF FILINGS

(Issued December 26, 2007)

1. This order addresses a March 7, 2006 compliance filing by SFPP, L.P. (SFPP) in the Docket Nos. OR92-8-027 and OR96-2-015, the lead dockets here, and a related tariff filing of interim rates on the same date filed in Docket Nos. IS06-215-000 and IS06-220-

000.[1] Those filings were in response to two earlier orders issued December 16, 2005[2] and February 13, 2006.[3] Moreover, the Commission's current deliberations are controlled by a decision of the D.C. Circuit dated May 29, 2007, in *ExxonMobil Oil Corporation, et al. v. FERC*.[4] That court decision addressed appeals of two earlier Commission orders dated March 2004[5] and June 2005,[6] both of which were premises for the December 2005 and February 2006 orders. The three issues before the court were: (1) whether a partnership or other pass through entity may be afforded an income tax allowance; (2) how to determine whether there were substantially changed circumstances to certain of SFPP's rates under the Energy Policy Act of 1992;[7] and (3) whether to apply the *Arizona Grocery* doctrine to the refunds or reparations at issue here.[8] Given the

---

[1] Docket No. IS06-220-000 involved a correction to Docket No. IS06-215-000 and would not have normally been issued a separate docket number. These two dockets are referred to here as the March 2006 Tariff Filing or Docket No. IS06-215-000. In addition, certain docket numbers involve only complaints against the Sepulveda Line. These are Docket Nos.OR96-2-000, OR96-10-000, OR96-17-000 and IS98-1-000, which are addressed separately in Docket No. OR96-2-012. *See Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 (2006). All complaints against the Watson Station Drain Dry Charges were also severed to a separate proceeding and most of that litigation has been settled. *See American West Airlines, et al. v. SFPP, L.P.*, 112 FERC ¶ 61,209 (2005) and *SFPP, L.P.*, 114 FERC ¶ 61,133 (2006).

[2] *SFPP, L.P.*, 113 FERC ¶ 61,217 (2005) (December 2005 Order).

[3] *SFPP, L.P.*, 114 FERC ¶ 61,136 (February 2006 Order).

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

[5] ARCO Products Co., a Division of Atlantic Richfield Company, Texaco Refinery and Marketing Inc., and Mobil Oil Corporation v. SFPP, et al., 106 FERC ¶ 61,300 (2004) (March 2004 Order).

[6] *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) (June 2005 Order).

[7] Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776 (1992) (EPAct of 1992).

[8] Arizona Grocery Co. v. Atchison, T. and S. F. Ry., 284 U.S. 370 (1932) (Arizona Grocery).

complexity of these issues the Commission deferred action on the compliance and tariff filings until the court ruled on the appeal of the March 2004 and June 2005 Orders.

2. In this order the Commission: (1) clarifies its methodology for determining whether a partnership or other pass through entity may be afforded an income tax allowance; (2) affirms its conclusions regarding substantially changed circumstances contained in the Commission's March 2004 and June 2005 Orders; (3) explains further the relationship between reparations and the *Arizona Grocery* doctrine; and (4) addresses other cost of service issues raised by SFPP's March 2006 compliance filing. These include: (1) the debt component of SFPP's capital structure; (2) the role of the purchase accounting adjustments (PAA); (3) the allocation of overhead costs between SFPP and its controlling entity, Kinder Morgan Energy Partners (KMEP); (4) the method for recovering SFPP's regulatory litigation costs; and (5) the allocation of right-of-way expenses. The Commission also affirms it will not address here whether it is appropriate to include master limited partnerships in the proxy group used to determine a regulated entity's equity cost of capital. In light of reparations holdings in *ExxonMobil*, the Commission directs SFPP to modify its March 2006 compliance and tariff filings. This order denies the several motions by the protesting shippers filed after the December 2005 and February 2006 Orders issued.

I. Background

3. The filings under review involve the interrelated compliance and tariff filings required by the Commission's December 2005 and February 2006 Orders, as well as the remaining rehearing requests of those orders, which stem from two prior orders that addressed the reasonableness of SFPP's oil pipeline rates between Los Angeles, California, and Phoenix and Tucson, Arizona (the West Line rates) and El Paso and Arizona (the East Line rates). The first of these was the March 2004 Order in Phase I of Docket No. OR96-2-000, *et al.*, addressing whether there were substantially changed circumstances to rates for SFPP's West, North, and Oregon Lines and for its Watson Station Drain Dry Facilities at any time during 1995 through 1999.[9] The March 2004

[9] "Substantially changed circumstances" is a shorthand phrase for the threshold test contained in section 1803(b)(1) of the EPAct of 1992, which provides in part "that no person may file a complaint against a rate that is deemed to be just and reasonable under Section 1803(a) of the EPAct [a grandfathered rate] unless evidence is presented to the Commission which establishes that a substantial change has occurred after the date of the enactment of the Act in the economic circumstances of the oil pipeline which were a basis for the rate; or in the nature of the services provided which were a basis for the rate." Section 1803(a) provides that any oil pipeline rate in effect more than 365 days prior to the enactment of the Act is deemed just and reasonable unless a complainant can meet the test established by section 1803(b)(1).

Order concluded that the Complainants had not established that there were substantially changed circumstances with regard to the North or Oregon Line rates and thus those rates continued to be grandfathered. However the Commission held that the Complainants had established substantially changed circumstances for the West Line rates as a whole beginning in 1995, and for certain specific points on the West Line in 1995 and 1997.[10] Since, the East Line rates were not grandfathered[11] the Commission set the West Line and East Line rates for hearing in Phase II of Docket No. OR96-2-000, *et al.*[12]

4. On July 26, 2004, the U.S. Court of Appeals for the D.C. Circuit remanded the Commission's earlier Opinion No. 435 Orders[13] in *BP West Coast Products, L.L.C. v. FERC.* [14] That decision generally upheld the Commission's determination that the Complainants had not established substantially changed circumstances with regard to the West Line rates for complaints filed between December 1992 and August 1995 except for the Commission's determination of the status of SFPP's Watson Station Drain Dry charges.[15] The court also upheld most of the Commission's rulings regarding the 1994 cost of service used to determine the reasonableness of the East Line rates. However, the court remanded the rationale for awarding SFPP an income tax allowance, the method for allocating regulatory litigation expenses between the East and West Lines, and the denial of the recovery of SFPP's line rehabilitation costs. [16]

---

[10] March 2004 Order at PP 52-53.

[11] Because the first complaints against the East Line were filed within 365 days prior to the effective date of the EPAct of 1992, the East Line rates were not grandfathered under section 1803 of that Act. *See* §1803 (a) of the EPAct of 1992.

[12] March 2004 Order at PP 82-85.

[13] *Opinion No. 435* (86 FERC ¶ 61,022 (1999)), *Opinion No. 435-A* (91 FERC ¶ 61,135 (2000)), *Opinion No. 435-B* (96 FERC ¶ 61,281 (2001)), and an *Order on Clarification and Rehearing* (97 FERC ¶ 61,138 (2001)) (collectively the Opinion No. 435 Orders).

[14] *See BP West Coast Products, L.L.C.* v. FERC, Dec. 22, 1987, 1263 (D. C. Cir. 2004) (BP West Coast).

[15] The latter matter is now moot because the Watson Station proceeding has been settled. See ARCO Products Co., a Division of Atlantic Richfield Company, Texaco Refinery and Marketing Inc., and Mobil Oil Corporation v. SFPP, et al., 116 FERC ¶ 61,166 (2006) (Watson Station Order).

[16] *BP West Coast* at 1285-1302.

5. On September 9, 2004, the Presiding Administrative Law Judge (ALJ) issued an Initial Decision in the Phase II proceeding addressing the reasonableness of both the East and West Line rates for complaints filed between late 1995 and July 2000.[17] The ALJ held that both the East and West Line rates were unjust and unreasonable for the relevant time frames. Thus, in September 2004 the East Line rates were before the Commission in Docket Nos. OR92-8-000, *et al.*, as were the East and West Line rates in Docket No. OR96-2-000, *et al*. on the issue of reasonableness.

6. The Commission's initial response to the *BP West Coast* remand was a December 2004 request for comments on whether a regulated pass-through entity[18] such as SFPP should be granted an income tax allowance. After receiving comments, the Commission issued its *Policy Statement on Income Tax Allowances* on May 5, 2005.[19] The *Policy Statement* concluded that a pass-through regulated entity would be permitted an income tax allowance if its partners had an actual or potential income tax liability on the jurisdictional income of a pass-through entity. On June 1, 2005, the Commission issued an order in the SFPP proceedings that made merits rulings on all the remanded rate issues involving the East Line rates except for the income tax allowance issue. The Commission also reviewed the previous jurisdictional determinations in its March 2004 Order, but did not change them. The Commission reprised its holdings in the *Policy Statement* and requested information on how it should apply the *Policy Statement* in determining SFPP's East Line and West Line rates. [20] The parties filed numerous comments on whether SFPP should receive an income tax allowance in either case.

---

[17] *SFPP, L.P.*, 108 FERC ¶ 63,036 (2004) (Phase II ID).

[18] Pass-through entities include partnerships, certain master limited partnerships that are not taxed as corporations, limited liability corporations (LLC) that are not required to be taxed as Schedule C corporations or have not elected to be so taxed, and Subchapter S corporations. Partnership interests are held by partners or unit holders, LLC interest by unit holders, and Subchapter S interests by shareholders. None of these entities pay federal income taxes directly. A taxable net income figure, or loss, is reflected on the information return filed with the Internal Revenue Service and the income or loss is allocated to the partners, unit holders, or shareholders, reflected on their Form K-1s, and must be reported on their corporate or individual income tax returns.

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

[20] June 2005 Order, *passim.*

7. On December 16, 2005, the Commission issued an order in these proceedings addressing the income tax allowance issues as well as merits rulings on the reasonableness of SFPP's West Line rates.[21] The Commission affirmed it would accord SFPP an income tax allowance if SFPP could establish that its partners had an actual or potential income tax liability on the distributive income that was attributed to them. The December 2005 Order also established how SFPP should address whether it met this standard as well as a framework for further proceedings. Finally, the December 2005 Order addressed reparations and established time frames for the compliance filing and for protests and comments. The Commission extended the date for a compliance filing to March 7, 2006. Several parties filed rehearing requests to the December 2005 Order, which the Commission addressed in the February 2006 Order.

8. SFPP made its compliance filing on March 7, 2006, together with the required related tariff filing in Docket No. IS06-215-000. Interventions, initial comments, and protests were filed on March 22, 2006, by the following Protesting Parties: the Airlines;[22] Navajo Refining Company, L.P. (Navajo); Western Refining Co., L.P. (Western Refining); Chevron Products Company (Chevron), ConocoPhillips and Tosco Corporation (ConocoPhillips and/or Tosco), Ultramar Inc. and Valero Marketing and Supply Company, (Ultramar and/or Valero) filing jointly (CVV Group); and BP West Coast Products LLC, (BP West Coast), ExxonMobil Oil Corporation (Exxon), and Chevron filing jointly (Indicated Shippers). The interventions related to the tariff filing are granted. The same parties also filed more detailed comments on the March 2006 compliance filing on April 21, 2006, including extensive expert testimony and exhibits. Some also filed discovery requests related to the December 2005 order several weeks before filing their comments. SFPP asserted that it responded to many of those requests. On April 28, 2006, the Commission accepted and suspended SFPP's filing, subject to refund.[23] SFPP filed reply comments on May 1 and ConocoPhillips filed additional comments on May 5, 2006. The Commission accepts these additional comments due to the complexity of the issues involved. The Commission deferred further action on SFPP's March 2006 compliance and rate filings until the court could rule on the appeals of the March 2004 and June 2005 orders.

9. While the appeals were pending, the Commission issued a December 8, 2006 Order addressing the reasonableness of SFPP's rates and charges for the shipments over

---

[21] *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005).

[22] American West Airlines, Inc., Continental Airlines, Inc., Northwest Airlines, Inc., and Southwest Airlines Co.

[23] *SFPP, L.P.*, 115 FERC ¶ 61,125 (2006) (April 2006 Order).

its Sepulveda Line,[24] including refinements to its income tax allowance methodology.[25] On May 29, 2007, the D.C. Circuit issued the opinion in *ExxonMobil* addressing the three issues on appeal from the March 2004 and June 2005 Orders. The court upheld the analysis of the *Policy Statement*, holding that the Commission could afford a partnership an income tax allowance if the partners had an actual or potential income tax liability on their distributive income.[26] The court also upheld the Commission's methodology for determining whether there were substantially changed circumstances to SFPP's West, North, and Oregon Line rates and declined to review the Commission's factual determinations on the grounds that the appellant parties had failed to seek rehearing from the Commission before pursuing their appeals.[27] However the court remanded the Commission's holding that complaints filed against SFPP's East Line rates after August 1, 2000, would be subject to *Arizona Grocery* and thus could not receive reparations.[28]

10. In light of the court's holdings and the parties' comments, Part II of this order addresses the more generic issues of: (a) income tax allowances, (b) substantially changed circumstances, (c) reparations, (d) the use of master limited partnerships in the proxy group, and (e) the outstanding procedural motions and certain other generic issues. Part III addresses cost of service issues specific to Docket No. OR92-8-000, *et al*. and Part IV does so for Docket No. OR96-2-000, *et al*. Part V sets the procedures for further filings.

II. General Legal and Policy Issues

11. The generic legal and policy issues raised by the court's decisions in *BP West Coast* and *ExxonMobil*, or that were raised by the parties in their comments on SFPP's March 2006 compliance filing include substantially changed circumstances, income tax allowances, and reparations. The Protesting Parties have also raised the *HIOS* issue regarding the inclusion of MLPs in the proxy group for determining the equity cost of

---

[24] *See Texaco Refining and Marketing, Inc., et al. v. SFPP, L.P.*, 117 FERC ¶ 61,285 (2006) (December 2006 Sepulveda Order).

[25] *Id.* P 49-66.

[26] *ExxonMobil* at 949-955.

[27] *Id.* at 955-962.

[28] *Id.* at 962-969.

capital.[29] There are also outstanding a number of generic procedural motions filed after the December 2005 order issued and some cost-of-service issues common to both dockets that are discussed in this part of the order.

A. Substantially Changed Circumstances

12. The March 2004 and June 2005 Orders concluded that the Complainants had established that there were substantially changed circumstances for most of SFPP's West Line rates in 1995 and for three specific points in that year except for the West Phoenix delivery point, for which there were substantially changed circumstances in 1997. The Commission also concluded that the Complainants had failed to establish that there were substantially changed circumstances to the North Line and Oregon Line rates.[30] The Commission held that the Watson Station Drain Dry charges were not grandfathered,[31] reversing its position in the Opinion No. 435 Orders. The Commission also affirmed its prior conclusion that SFPP's Sepulveda Line rates were not grandfathered.[32] Finally, the Commission rejected arguments that it had unduly relied on cost-of-service rate making in making its determinations on the grandfathering status of the various rates at issue.[33]

13. On appeal the Protesting Parties argued that the Commission did not use the proper cost-of-service theory in determining the status of the North and Oregon Line rates or a proper cost allocation method for determining the year in which the West Phoenix rates ceased to be grandfathered. They also argued that the Commission should have permitted the use of changes in any of several single cost of service factors in making its determinations rather than relying only on the change in SFPP's return. The Protesting Parties further urged that the Commission erred in using a full income tax allowance to compare the returns in the relevant years. SFPP and the Association of Oil Pipe Lines (AOPL) argued that the Commission used the incorrect year in measuring whether there were substantially changed circumstances, that certain of its calculations

---

[29] *Cf. High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 (2005), *orders on reh'g*, 112 FERC ¶ 61,050 (2005) and 113 FERC ¶ 61,280 (2005) (HIOS), *reversed and remanded in part sub nom*. Petal Gas Storage, L.L.C. v. FERC, slip op. dated August 7, 2007, No. 04-1166 (D.C. Cir).

[30] June 2005 Order at P 6, 39-40.

[31] *Id.* at P 32-36

[32] *Id.* at P 6.

[33] *Id.*

were mathematically incorrect, and that the Commission relied too heavily on cost-of-service concepts. However, the Protesting Parties supported the Commission's determination that there were substantially changed circumstances to the West Line rates as a whole. Moreover, to the extent that a cost-of-service approach might be appropriate, SFPP and the AOPL supported the Commission's use of return for determining whether there had been substantially changed circumstances and thus its determinations on the North and Oregon Line rates.

14. On review, the court affirmed all of the Commission's determinations on substantially changed circumstances. First, it concluded that the Commission's emphasis on changes in return was appropriate given that cost-of-service rate making seeks to replicate a competitive rate. Since under competition firms set their prices to recover costs, including a reasonable return, a regulated rate is designed to replicate that competitive situation. Thus, it is reasonable to view a rate in a cost context even if negotiation or other market factors were involved in constructing the rate.[34] Second, the court concluded that the Commission reasonably rejected reliance on changes to one of a number cost-of-service factors since changes in individual cost-of-service factors might be offsetting. For example, relying on only one factor, such as an increase in revenues, without examining the related costs, could lead to a conclusion that profits may have increased when in fact they might have decreased. In that the EPAct of 1992 presumes grandfathered rates are just and reasonable, the court held it would be irrational to hold there were substantially changed circumstances if there were a decreased return.[35] The court's analysis also upheld the Commission's conclusion that a change to the Commission's income tax allowance methodology was not in itself sufficient to support a finding of substantially changed circumstances.[36]

15. The court also rejected all challenges to the specific calculations in the March 2004 and June 2005 Orders because the parties never presented these arguments to the Commission. Even though there is no rehearing requirement under the Interstate Commerce Act (ICA), [37]the court held that sound procedure requires that the agency be given an opportunity to address the parties' concerns and to correct its own errors. This was true even though the Commission conceded that there were errors in its calculations. Thus, the court's rulings affirmed all matters of substantially changed circumstances

---

[34] *ExxonMobil* at 959-60.

[35] *Id.*

[36] *Id.* at 959, 960.

[37] 49 U.S.C. app. § 1-13 (1988) *passim*.

contained in the March 2004 and June 2005 Orders. SFPP moved for reconsideration of certain portions of the court's rulings, but the court denied motion on August 20, 2007.[38]

16. As such, these matters would appear to be closed based on the finality of the court's rulings. *ExxonMobil* not withstanding, on July 11, 2007, Indicated Shippers filed a motion with the Commission raising both grandfathering and income tax allowance issues. On the first point, the motion asserts that Docket No. OR92-8-000, *et al.* remains an open docket and has been before the Commission for some 15 years. They argue that the Commission should provide all shippers an opportunity to examine whether there were substantially changed circumstances to SFPP's West Line rates under a series of original complaints filed in August 1993, January 1994, and April 1995. They also assert that the time has come to resolve the status of the West Line rates challenged in those complaints and to permit shippers to do so using the multiple cost-of-service methodology they urged before the court in its review of the rulings in Docket No. OR96-8-000, *et al.* Indicated Shippers also argue that SFPP failed to establish that it is entitled to an income tax allowance and that this matter should also be set for hearing. SFPP filed an answer on July 26 arguing that the status of the West Line rates for the period before August 5, 1995, was settled by *BP West Coast* and that income tax allowance matters are simply not an issue for the West Line complaints before that date. It noted that implementation of the income tax allowance issue is open with regard to the East Line rates in both dockets and for the West Line in Docket No. OR96-2-000, *et al*., and the motion is superfluous.

17. On August 3, 2007, Indicated Shippers filed an additional motion requesting the Commission to set the issue of substantially changed circumstances on the West Line for hearing. Clarifying their prior motion, they argued that the court remanded the issue of substantially changed circumstances to the Commission in *BP West Coast*. They assert the court based its remand on the Commission's error in relying on the *Lakehead* income tax allowance methodology in the Opinion No. 435 Orders. Thus, Indicated Shippers argue, the Commission should address the matter since it did not do so in its Opinion No. 435 determinations on remand. SFPP filed a reply to the August 3 motion arguing that the June 2005 Order held that (1) the Commission did not rely on cost of service factors in making the substantially changed circumstances determinations made in Opinion No. 435, and (2) that the Commission specifically affirmed its prior conclusions that that there were no substantially changed circumstances with respect to the West Line rates for the period through August 7, 1994. SFPP further argues that *ExxonMobil* explicitly upheld all of the substantially changed circumstances determinations in the June 2005 Order and rejected Indicated Shippers' argument that changes to the income tax

[38] *Memorandum Order* dated August 20, 2007 in Case No. 04-1102.

allowance methodology alone were grounds to conclude there were substantially changed circumstances to the SFPP's rates.

18. The Commission finds that the motions filed by Indicated Shippers on July 11 and August 3, 2007 are entirely without merit and an unreasonable imposition on the Commission's resources, as are the additional filings in support of Indicated Shipper's motions. In Docket No. OR92-8-000, *et al.*, the Commission held that the Complainants failed to apply the correct standard for determining whether there were substantially changed circumstances to SFPP's West Line rates for complaints filed through August 7, 1995. The court upheld this ruling in *BP West Coast*, but given its holding on the *Lakehead* income tax methodology, remanded to the Commission for further review its determination that the mere allegation of a change in the income tax allowance methodology was insufficient to establish substantially changed circumstances.[39] SFPP is correct that the June 2005 Order held that *Lakehead* was no longer relevant given its adoption of the *Policy Statement* and that the Commission held that it had not based its substantially changed circumstances determinations regarding the West Line rates on cost of service factors.[40] Thus, contrary to Indicated Shippers' argument, the Commission addressed the remanded substantially changed circumstances issue in the June 25 Order and its response, along with its decision not to accept any of a number of individual rate elements, were upheld in *ExxonMobil*.[41] Moreover, issues related to the implementation of the income tax allowance methodology approved by *ExxonMobil* are addressed here, and there will be further opportunity to comment on that implementation in the context of SFPP's revised compliance filing. No further hearing on these matters is necessary.

19. However, given Indicated Shipper's motion, the Commission will confirm the grandfathering status of the various SFPP rates that it addressed in the June 2005 Orders. As of December 31, 2000, all of SFPP's West Line rates were no longer grandfathered, but its North Line and Oregon Line rates remained grandfathered.[42] The East Line and Sepulveda Line rates challenged in that docket were never grandfathered and the issue was settled in the Watson Station proceeding. Indicated Shippers' July 11 and August 3,

---

[39] BP West Coast at 1280.

[40] June 2005 Order at 29-30, *cited* in *ExxonMobil* at 958.

[41] *ExxonMobil* at 958, 960.

[42] As noted, the Commission held that West Line rates for various points were no longer grandfathered as of 1995 and 1997. The text reflects that status of the SFPP's rates at the end of 2000, the last complaint year addressed by this and the prior orders.

2007 motions are denied and any arguments regarding the substantially changed circumstances issue contained in comments on the March 2006 compliance are moot.

B. Income Tax Allowance Matters

20. The December 2005 Order reiterated the Commission's prior conclusions that it would permit SFPP an income tax allowance to the extent its partners had an actual or potential tax on the jurisdictional income generated by the partnership. The December 2005 Order also directed SFPP to separate its partners into six categories, determine the amount of partnership income allocated to each category, and calculate the income tax allowance based on an actual or presumed marginal tax rate of each category. In particular, the order concluded that it would be difficult to obtain information on the marginal tax rate of an individual tax payer and therefore presumed that such a partner would have a 28 percent marginal tax rate unless it was proven otherwise. Similar instructions were provided for five other categories of partners.[43] The December 2005 Order thus provided SFPP an opportunity in its March 7, 2006 compliance filing 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 KMEP, the MLP that owns SFPP.

21. SFPP addressed these matters in its March 2006 compliance filing. SFPP also included in its cost of service a state income tax allowance applying the principles used in developing the federal income tax allowance based on the estimated actual or potential income tax allowance of the partners in three states: California, Arizona, and New Mexico. The Protesting Parties' April 2006 comments on SFPP's March 2005 compliance filing challenged the methodology in the December 2005 Order and SFPP's specific calculations on the following grounds: (1) the legal validity of the Commission's *Policy Statement*; (2) whether an allowance for deferred income taxes (ADIT) was lawful; (3) the definition of an actual or potential income tax allowance, including whether any potential income tax allowance that might be paid by a partner would be at ordinary or capital gains rates; (4) whether any income tax allowance should utilize the marginal or effective tax rate; (5) whether the Commission's approach is consistent with the stand-alone method; (6) whether any income tax liability should be based on the percentage of ownership interests or on the partnership's method for allocating income; (7) the role, if any, of incentive distributions in determining the allowance; (8) whether a state income tax allowance is permissible; and (9) whether SFPP appropriately calculated

[43] December 2005 Order at P 30-32, 45.

its proposed state income tax allowance in each of the consolidated dockets. These issues are discussed below in light of *ExxonMobil* and some recent Commission decisions.[44]

1. The Court's Analysis of the *Policy Statement*

22. *ExxonMobil* upheld the Commission's income tax allowance for partnerships in part because partners have the obligation to pay tax on their distributive share of income even though the partners receive no cash from the partnership to pay the taxes.[45] The court also accepted the formulation that a partnership must establish in individual rate proceedings that a partner has "an actual or potential income tax liability" on partnership income attributed to the partner. However, the court did not address what the phase means because it had no specific example before it. Rather, the court's analysis speaks in terms of an actual or potential income tax liability on the distributive income of the partners. The court also stated that "[W]hile we agree that the orders under review and the policy statement upon which they are based incorporate some troubling elements of the phantom tax we disallowed in *BP West Coast*, FERC has justified its new policy with reasoning sufficient to survive a review."[46] The court further stated that an income tax allowance is permitted: (1) "to the extent that the pipeline's partners – both individual and corporate – paid taxes on income they received from the partnership";[47] (2) "that all partners incur actual or potential income tax liability on the income they receive from the partnership";[48] (3) "to the extent that the pipeline's partners – both individual and corporate – incurred actual or potential tax liability on their distributive share of the partnership income";[49] and (4) "that SFPP will be eligible for a tax allowance only to the extent it can demonstrate – in a rate proceeding – that its partners incur an 'actual or potential' income tax liability on their respective shares of partnership income."[50]

---

[44] *Cf.* December 2006 Sepulveda Order, *supra*, and *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006) (*Kern River*).

[45] *ExxonMobil* at 952, 954.

[46] *Id.* at 948.

[47] *Id.* at 950.

[48] *Id*. at 951.

[49] *Id.*

[50] *Id.* 954.

23. The court thus rejected arguments that its prior ruling in *BP West Coast* compelled a conclusion that a jurisdictional partnership could not be afforded in income tax allowance. The court also rejected arguments that a partnership income tax allowance would constitute a phantom cost, holding this was not the case if SFPP could demonstrate that its partners incur an actual or potential income tax liability on their respective shares of partnership income. The court's ruling also effectively rejected Protesting Parties' argument that SFPP may not include an ADIT in its cost of service because, as a partnership, it has no taxable income. Rather, following *ExxonMobil*, the ADIT calculation should use the weighted marginal tax rate of the partners and apply that to any deferrals generated by SFPP's jurisdictional depreciation accounts.

2. Actual or Potential Income Tax Liability

24. Before *ExxonMobil* the Commission's only detailed discussion of the phrase "actual or potential income tax liability" was in the December 2005 Order. That order ultimately concluded that "[i]f a partner is required to file a Form 1040 or Form 1120 return that includes a partnership income or loss, the Commission concludes that such partner has an actual or potential income tax liability for the partnership income."[51] It did so based on the recognition in the *Policy Statement* and pleadings submitted in the fall of 2005 that income tax deferrals resulting from a reduction in a partner's basis are recaptured as ordinary income when the partnership unit is sold. As stated in the December 2005 Order, the fundamental difference between the position of SFPP and the Protesting Parties turns on the distinction between a partner that is "subject to" an actual or potential income tax liability and a partner that "has" an actual or potential income tax liability. This difference reflects SFPP's position that (1) a partner that holds a partnership interest over the life of the partnership will eventually pay income tax on all distributions that incorporate an income deferral, and that (2) a participating partner has an obligation to file a income tax return disclosing either positive or negative income that the partnership has in a given year.[52]

25. The Protesting Parties in turn argue that the partner must have positive income from the partnership in a given year, or at least have discernable ordinary taxable income liability in the later years the partner holds a partnership interest. The Protesting Parties' central point is that there is no necessary correlation between the taxable income reported by the partnership on its Form 1065 information return and the cash distributions that are made to the partners in any given year. They correctly assert that the cash distributions may exceed the income attributed to some of the partners and that no taxes will be paid in

[51] December 2005 Order at P 28.

[52] *Id.* at P 22-23.

the year of distribution on the difference between the distributive income allocated to partners for tax purposes and the cash that was distributed to them. Thus, the Protesting Parties' argue that this difference in timing means that some partners may never have an actual or potential income tax liability for their distributive income.[53] For this reason they assert that the definition adopted by the December 2005 Order is too broad as it does not require any quantification of when the "potential income tax liability" will be recognized or the amount. They further assert that there is no assurance that ordinary income will be recognized when a unit with a reduced basis is sold.

26. They contrast the holding of the December 2005 Order with the Commission's conclusion in *Trans-Elect*.[54] In that case, the Commission required the corporate partners to demonstrate that they would have actual or potential income that would place each partner in the 35 percent marginal tax bracket based on the income that would be allocated to each partner. They assert in their comments that the Commission should require SFPP to meet the same standard and that it cannot do so for two reasons. The first is SFPP's inability to identify the tax bracket that should be attributed to publicly held limited partnership interests, *i.e.*, those held by individuals or institutions other than the general partner or entities subject to its control. This first point is discussed below in the context of the use of presumptions to establish the marginal tax rate of the limited partners. The second problem is the difficulty in determining when income will actually be recognized and its character, which is addressed here. SFPP argues in response that the *Policy Statement* and its own testimony properly recognize that deferred income and the related income tax liability will be recognized and that this is an issue of timing, not one of whether there will be an eventual liability for any income tax deferrals.

27. On further review, the Commission affirms its prior conclusion that SFPP can establish that a partner has an "actual or potential" income tax liability if the partner is obligated to file a return that recognizes either taxable gain or a loss. The Commission first notes that not all partnership income tax allowance determinations involve such complex issues of deferral. For example, this was not the case in either *Trans-Elect* or *Kern River* since in both cases the regulated entity was controlled by one or more Schedule C corporations. As such, the point at which the tax liability would be incurred

---

[53] *Id. Cf.* Comments of Indicated Shippers *et al.* dated April 21, 2006 at 58-59; Protest and comments of Indicated Shippers dated April 21 at 15-16.

[54] *Trans-Elect NTD Path 15, LLC*, 109 FERC ¶ 61,249 (2004), *order denying reh'g*, 111 FERC ¶ 61,140 (2005), *order denying reh'g*, 112 FERC ¶ 61,200, *order accepting compliance filing*, 113 FERC ¶ 61,162 (2005), *order denying reh'g*, 115 FERC ¶ 61,047 (2006), *order on initial decision*, 117 FERC ¶ 61,214 (2006), *order denying reh'g*, 119 FERC ¶ 61,093 (2007) (*Trans-Elect*).

and the length and amount of any deferrals could be determined with relative certainty. In practical terms, both cases involved taxes that were "actually paid or incurred," the historical standard under *City of Charlottesville v. FERC*.[55] This is because those Schedule C corporate partners would either recognize taxable distributive income in the test year (*Trans-Elect*),[56] or it was possible to quantify the deferral of the taxable distributive income due to accelerated or bonus depreciation reflected in the rate structure (*Kern River*).[57] Thus, in these two cases the result under the *Policy Statement* was similar to Commission practice before the adoption of its *Lakehead* policy in 1995.[58] This is because prior to *Lakehead* most partnership affiliates were controlled by corporations having a 35 percent income tax, such partnerships had few individual partners, and the Commission treated them as corporate subsidiaries that would be included in a consolidated corporate return.

28. The *Policy Statement* recognized that these simpler affiliate relationships might no longer apply in many cases. Thus, the *Policy Statement* discussed a situation in which one partner will never have an income tax liability because the partner is a non-profit entity, such as the municipal partners of the American Transmission Company, LLC.[59] In that case the income tax allowance would be reduced accordingly.[60] Moreover, footnote 35 of the *Policy Statement* explained in detail how tax deferrals can occur if distributions to a partner exceed the distributive income allocated to the partner.[61] The phrase "potential income tax liability" implicitly recognized that income tax liability may be deferred if distributions exceed distributive income due to the partnership's internal

---

[55] *City of Charlottesville, Va. v. FERC*, 774 F.2d 1205 (1995) (*City of Charlottesville*).

[56] *Trans-Elect*, 113 FERC ¶ 61,162 at P 15-16 (2005) and 115 FERC ¶ 61,047 at P 9-10 (2006).

[57] *Kern River* at P 219, 221.

[58] *Lakehead Pipe Line Company, L.P.*, 71 FERC ¶ 61,338 (1995) (Opinion No. 397), *reh'g denied*, 75 FERC ¶ 61,181 (1996) (Opinion No. 397-A) (*Lakehead*).

[59] Policy Statement at P 8-9.

[60] For example, if the were two partners, one with a marginal tax bracket of 35 percent and the other with a marginal tax bracket of zero, the income tax allowance would be based on a 17.5 percent marginal tax rate.

[61] *Policy Statement* at P 37, n. 35.

financial practices, and as such no income would be recognized until the partnership unit was sold and any reduction in the basis was recaptured. However, the *Policy Statement* did not address when recognition would occur and how the present value of tax deferrals would be allocated between the partners and the rate payers. The matters of deferrals and the beneficiary of the present values were left for future determination, as in this case.[62]

29. Even given the postponement of these ultimate issues, footnote 35 of the *Policy Statement* implied that any benefits from tax deferral will flow to the unit holder and not the rate payer under the mechanics of partnership taxation. This result was a departure from the Commission's historical practice of requiring normalization to capture the present value of such deferrals for the rate payers, as in ADIT, or the adjustment to return that the Commission required in the December 2006 Sepulveda Order.[63] As discussed, the matter arises from two common financial practices of MLPs: (1) distributions in excess of earnings, and (2), the allocation of items of income, loss, deduction, and credit in a proportion different from the partner's nominal partnership interests. The genesis of the issue was Congress's enactment of the Tax Reform Act of 1986, which authorized the use of master limited partnerships in energy related businesses, including gas and oil pipelines.[64] While there is no legislative history on this point, the Commission concludes that Congress intended that the partners should benefit from any income tax deferrals. This conclusion reflects the intrinsic characteristics of the tax shelter investment vehicle that resulted from Congress's decision that master limited partnerships should provide incentives for investment in the pipeline industry. Thus, the timing and the certainty of the recapture are matters of tax policy that determine what interests benefit from the present value of tax deferrals that have been resolved by the legislature.

30. At bottom, the Protesting Parties argue that such deferrals create a phantom tax. This conclusion does not necessarily follow since it is the deferral of recognition of the income tax liability that is the basis of a "potential income tax liability." The phrase recognizes that the deferred ordinary income tax liability on distributions will be recognized when the unit is sold and reduction in basis is recaptured. While *BP West Coast* concluded that Congress could not create a regulatory cost that did not otherwise exist in order to encourage investment,[65] the issue here is not the creation of the non-

---

[62] *Id.* at P 42.

[63] December 2006 Sepulveda Order at P 42-48.

[64] Tax Reform Act of 1986, Pub. L. 99-153, 100 Stat. 2085 (1986). Pipeline MLPS were added in 1987. *See* 26 U.S.C. § 7704, Pub. L. 100-203, Title X, § 102119a, 101 Stat. 1330-403 (Dec. 22, 1987).

[65] BP West Coast at 1293.

existent cost, but the point at which the regulatory cost legitimized by *ExxonMobil* must be recognized to meet the "actual or potential income tax liability" standard. It is beyond dispute that a delay in tax recognition will increase the enterprise's return beyond that afforded by a conventional regulatory cost of capital, thus creating incentives for investment as a matter of policy. However, this is not necessarily objectionable. Through basis point adders the Commission has increased the return on equity above that normally generated by the DCF model to encourage investment.[66] Such adders increase the cash flow above that from the normal regulatory return and result in a compounded return over time. Deferred recognition of an income tax liability similarly increases the regulatory return by providing an investment opportunity and the income on the deferred tax payments. Thus, a bonus return increases future value of the equity component and tax deferrals increase the present value of the equity component. Both achieve the same policy goal of creating incentives for investment.

31. The Commission recognizes that there is some risk that recognition may not occur for a substantial period of time if MLP unit holders are investing as long term buy and hold investors. However, the court explicitly recognized the possibility that recognition may be deferred indefinitely in *City of Charlottesville*. The court noted in theory that income generated by a subsidiary might be indefinitely offset by losses generated elsewhere in a corporate structure, but that this in itself was not sufficient to invalidate the Commission's adoption of the stand-alone method for tax calculations rather than continued use of a flow-through methodology allocating the tax savings to the rate payers.[67]

32. This does not mean that one might not imagine conclusions that are closer to the normalization approach the Commission used historically. For example, the Commission might require the jurisdictional entity to establish with a greater degree of certainty the time frame within in which the "potential" income tax liability would be recognized through statistical analysis. All partnership interests and accounts are maintained by computer, and for any interest sold during the test year, KMEP provides the length of the holding period and calculates the basis, any cumulative reduction to basis, the amount of ordinary income recaptured, and the capital gains. Under this approach the pipeline would have to show the percentage of the tax that would likely be recognized by adjusting the deferrals for their present value. The income tax allowance would be reduced by the difference between the nominal income tax liability on the partners,

---

[66] *See ISO New England, Inc., et al*., 106 FERC ¶ 61,280 (2004), *order on reh'g*, 109 FERC ¶ 61,147 (2004), *affirmed sub nom. Maine Public Utilities Commission v. FERC*, 454 F.3d 278 (D.C. Cir. 2006).

[67] City of Charlottesville at 1216.

distributive income and the present value of when the deferrals are projected to be recognized. While this approach might address the matter of when a "potential" income tax liability would be recognized with greater specificity, it suffers from a lack of transparency. It might also be inconsistent with the Congressional intent to allocate the present value of income tax deferrals to the partners to encourage investment.

33. Another possible approach is to require net distributive income on the partner's K-1 before permitting an income tax allowance. This would be closer to the approach adopted in *Trans-Elect* because it requires showing of an actual income tax liability on the return. However this conclusion is inconsistent with the general philosophy of the *Policy Statement*, and specifically footnote 35, which anticipated that the present value issue of income tax deferrals would arise in specific cases and would ultimately be awarded to the partners. As such, this approach effectively reads the word "potential" out of the *Policy Statement* since it would require actual recognition of net distributive income in the test year. This approach is also inconsistent with the Congress's purpose in the Tax Reform Act of 1986. Thus, while *Trans-Elect* cautiously required that type of information to assure that the Schedule C corporate partners met the "actual or potential income tax liability" standard, it did not hold that the method used there was the only possible approach that would comply with that standard.

34. Protesting Parties' final criticism is that there is no certainty that gain that will be recognized on the sale of the unit is ordinary income because: (1) the unit may be sold at a loss, and (2) any gain may be characterized as capital gains. On the first point, the prospect of a loss is intrinsic to a traded interest, although one would assume that investors are not seeking losses as the goal of investing in MLP units. On the second point, the Commission recognizes that any gain in excess of the initial purchase price may be taxed as capital gains if the timing of sale qualified for that treatment. That is not the issue here. Similarly, if there are distributions in excess of income, once a partner's basis is reduced to zero, such distributions will be treated as capital gains. However, the investment advisory materials that Indicated Shippers included in the Sepulveda Line proceeding make clear that if the partner's basis is reduced by distributions derived from depreciation or amortization, such reductions will be recaptured as ordinary income when

the interest is sold.[68] For these reasons the Commission affirms the conclusion reached in the December 2005 Order that the recognition of ordinary income and the related income tax burden is a timing matter, not a liability issue. Thus, 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.

3. The Use of the Marginal Tax Rate

35. The *Policy Statement* concluded that the income tax allowance for a pass-through entity should be determined through the weighted marginal tax rate of its partners.[69] As discussed in the December 2006 Sepulveda Order, this conclusion is consistent with the stand-alone method that examines the income of a jurisdictional entity and develops a federal income tax allowance based on the statutory, or marginal, tax rate that would apply to that income. As the court noted in *City of Charlottesville,*[70] a corporate tax allowance has almost always been the maximum corporate statutory, or marginal, rate when a corporation is involved.[71] This statement itself presumes that the marginal tax rate is the most appropriate way of measuring the income tax cost of making an investment. This is because investment decisions are made at the margin and the marginal tax rate applied at the end of the tax year will determine how much of the incremental income will be retained by the investor. In light of this basic financial principle the Commission affirms its prior conclusion in the *Policy Statement,* the

---

[68] *See* the pleadings in Docket No. OR96-2-012 Exs. SEP-ARCO-21 at 2 and SEP ARCO-22 at 4-5; *see also* in Docket No. OR92-8-025 Ex. SWTS-18 at 44. This is consistent with the general premise that available cash consists of net cash from operations plus cash from depreciation and amortization. It is possible that cash may also be distributed from capital gains sales or from capital raised by borrowing or sale of additional units and that this could further reduce the partner's basis. However, all of these are conventional distributions of capital gains or capital contributions and thus do not affect the partnership's operating income, and as such would not result in deferred ordinary income.

[69] *Policy Statement* at P 32, 37, 40.

[70] *City of Charlottesville* at 1207.

[71] This recognizes that investors evaluate the commitment of additional dollars based on the likely after tax return on those dollars. This is no different than the argument whether the additional after tax income from a salary increase is worth the additional work required to obtain the increase. In each case the marginal tax rate determines how much of the incremental investment or the income will be retained.

December 2005 Order, and the December 2006 Sepulveda Order that the income tax allowance of a pass-through entity will be determined by the weighted marginal tax rate of the owning partners.

36. As was discussed in the December 2006 Sepulveda Order, the difficulty is determining the marginal tax rate of SFPP's partners. A regulated partnership may have partners whose tax returns are confidential. However, attributing a uniform marginal tax rate to all partners would be arbitrary because they are unlikely to all have the same marginal tax rate. Therefore the December 2005 Order held that corporate partners would be presumed to have a marginal tax bracket of 35 percent and non-corporate partners a marginal tax bracket of 28 percent.[72] The December 2006 Sepulveda Order further expanded the rationale for these conclusions, but reduced the corporate marginal tax bracket to 34 percent if the partnership could not establish that the corporate partner had a 35 percent marginal tax bracket in the test year.[73] The Protesting Parties challenge the use of the presumptions in the December 2005 order through their comments on the compliance filing. They argue that the Commission incorrectly interpreted certain Internal Revenue Service (IRS) information, that such information is not entitled to administrative notice, and that the Commission violated due process by depriving them of an opportunity for evaluation and comment. SFPP supports the Commission's conclusions.

37. The Commission affirms its prior conclusions but will modify the December 2005 Order to follow the December 2006 Sepulveda Order. Thus, the marginal tax rate for corporate partners will be 34 percent unless the partnership can demonstrate that a corporate partner has a higher marginal rate. Moreover, in light of the Protesting Parties' critique, the Commission again reviewed official published Internal Revenue Statistics on the distribution of adjusted gross income and taxable income for the 1999, 1997, and 1994 test years.[74] These reveal that in 1999, the 28 percent marginal tax bracket covered income between $25,750 and $62,450 for an individual tax payer, and that 88.8 percent of all federal adjusted gross income was reported by taxpayers with adjusted gross

---

[72] December 2005 Order at P 30-32.

[73] December 2006 Sepulveda Order at P 60.

[74] Regulatory agencies routinely rely on each other's official data in making policy and adjudicatory decisions. For example, the Commission relies on the PPI index produced by the Department of Labor in implementing its annual oil pipeline index adjustments. *See* 18 C.F.R. § 342.3(d)(2) (2006). The Commission does not calculate the index itself. The reliance on IRS statistics is the same. The URL for the IRS statistics cited here is http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html.

income of more than $25,000.[75] Such taxpayers had 94.7 percent of all taxable income, which is the amount taxed after all deductions and credits.[76] Of the income derived from partnerships and Subchapter S corporations reported on all returns, in 1999, 99.4 percent was from returns that had more than $25,000 in adjusted gross income.[77] For adjusted gross incomes in excess of $40,000 the percent was 97.8 percent in 1999. Since the income from an MLP must be reported as income derived from partnerships, these figures strongly suggest that partnership income is reported and taxes are actually paid or incurred by partners with at least a 28 percent marginal tax bracket. The Shipper parties also argue that investors in MLPs receive much of their return from the payment of capital gains taxes, thus avoiding ordinary income taxes. The same IRS statistics for 1999 reveal that of taxable returns reporting capital gains, 98.9 percent had adjusted gross income of at least $25,000, 97.2 percent in 1997, and 96.3 percent in 1994.[78] For adjusted gross incomes in excess of $40,000, the percentage for returns reporting capital gains was 97.0 percent in 1999, 94.6 percent in 1997, and 91.8 percent in 1994.

38. Thus, even if individuals with less than an adjusted gross income of $25,000, or a couple with less than $40,000 in adjusted gross income, had money to invest in MLP

---

[75] *See* IRS 1999 Tax Rate Schedules. For married taxpayers filing jointly the 1999 figures were $43,050 to $104,050. *Id.* In 1997 the comparable range for single taxpayers was $24,650 to $59,750 and for married filing jointly was $41,200 to $99,600 and in 1994 it was $22,750 to $55,100 for single taxpayers and $38,000 to $91,850 for married taxpayers filing jointly.

[76] *See* IRS Official Web Site, Tax Stats Page, and SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income: Table 1.1--1999 Individual Income Tax Returns, Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income. The comparable figure for 1997 is 93.3 percent. *See* Table 1.1--1997, Individual Income Tax Returns, All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income.

[77] *See* IRS Official Web Site, Tax Stats Page, SOI Tax Stats - All Returns: Sources of Income, Adjustments, and Tax Items: Table 1.4--1999 All Individual Income Tax Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income. The comparable figure for 1997 is 98.9 percent. *See* Table 1.4--1997, Individual Income Tax Returns, All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income; The comparable figure for 1994 is 98.6 percent. Table 1.4--1994, Individual Income Tax Returns, All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income.

[78] *Id.*

units, the IRS statistics support the Commission's conclusion that the 28 percent bracket is a conservative estimate of the marginal tax bracket that would apply to non-corporate investors in SFPP's limited partnership units. While the discussion here speaks in terms of individual tax payers, the Commission (and SFPP) extended the 28 percent marginal tax rate to entities having fiduciary obligations to individuals that cannot be identified. Such entities include mutual funds, various types of trusts, Individual Retirement Accounts and similar devices available to individual taxpayers, and pension funds.

39. Finally, the Commission rejects arguments that Protesting Parties have not had an adequate opportunity to comment on the methodology the Commission has pursued first in the December 2005 Order, then the December 2006 Sepulveda Order, and now in the instant order. Both cases involve the same shipper parties. Moreover, the methodology adopted in the December 2005 Order was critiqued in their comments on SFPP's March 2006 compliance filing[79] and the revised compliance filing affords them another opportunity to address the modifications adopted here. As previously discussed here and in the December 2006 Sepulveda Order, the data upon which the Commission is relying reflects public data of the Internal Revenue Service and is available to all interested parties on the IRS website for their further review and comment.

4. The Stand-alone Methodology

40. The Protesting Parties assert that the Commission's proposed implementation of the *Policy Statement* departs from the Commission's historical stand-alone method for determining an income tax allowance because: (1) it bases any income tax allowance on the partners', not the partnership's income, and, (2) it does not allow for the fact the marginal tax rate may be influenced by items of income and loss on each partner's return. The first concern was resolved by *ExxonMobil*. The second requires a brief review of the stand-alone method and of *City of Charlottesville, Va. v. FERC.*[80] In the regulatory phase of this latter case the Commission held that the stand-alone method provides that the statutory tax rate would be applied to the subsidiary's income even though that income might be sheltered at the parent company level by losses from other subsidiaries or operations. This occurred because the parent company, Columbia Gas Corporation, had no taxable income for IRS purposes even though it had strong positive cash flows

[79] Comments of Indicated Shippers, *et al.* at 13; Protest and Comments of CVV Group at 17-18.

[80] The underlying citations are *Columbia Gas Transmission Co.*, 24 FERC ¶ 61,258 (1983), decided on remand from *City of Charlottesville, Va. v. FERC*, 661 F.2d 945 (D.C. Cir. 1981) (*Charlottesville I*), which reviewed 8 FREC ¶ 61,002 (1979) (*Opinion No. 47*), *order on reh'g*, 9 FERC ¶ 61,355 (1979) (*Opinion No. 47-A*).

and paid dividends on a regular basis. The losses from gas exploration and drilling, caused mostly by special forms of amortization, were sufficient to offset the income earned by Columbia's gas pipeline operations in all of the years at issue.

41. Thus, under the stand-alone method the Commission did not require the flow-through of the tax savings that might be generated by operations that were external to the "stand-alone" operations of the jurisdictional entity. The court affirmed while acknowledging that it was possible that the parent corporation would never pay any income taxes on the income that was derived from the subsidiary pipeline's operations.[81] Moreover, the court specifically concluded that it was not necessary that there be an actual tax payment in a specific year for application of the stand-alone method to be valid.[82] These principles are equally applicable to partners that may have offsetting losses from sources other than those generated by the regulated partnership or whose other sources of gross income may influence the level of the partner's marginal tax rate.

5. The Role of Income

42. The comments on the compliance filing raise four points regarding the role and definition of income. The first is whether the marginal tax rate should be determined by using ratios of the income allocated to the various partners by the ratios of their nominal partnership interests. The second is that SFPP used the wrong partnership income in determining the weighted marginal tax rate to be applied. The third is that it makes no sense to include the income of those partner's that have negative income on their returns in determining the weighted marginal tax bracket. A fourth is that an income tax allowance factor is already built into the return derived from the Commission's discounted cash flow method for determining return on equity.

a. Allocation of Income Among the Partners

43. The December 2005 Order concluded that the weighted marginal tax rate should be determined on the basis of how partnership income is allocated, not on the basis of nominal partnership interests. The Protesting Parties argue that this is inconsistent with statements in the *Policy Statement* that the income tax allowance would be based on the relative weight of the partnership interests.[83] They assert that allocation of income among the partners on a basis other than their nominal partnership interests may result in

---

[81] *City of Charlottesville* at 1215-16.

[82] *Id.* 1214-15.

[83] See Comments of CVV Group at 16-17.

more income being allocated to a corporate partner that has a higher marginal tax rate than the individual partners. This would increase the weighted marginal tax rate at the expense of the rate payers. SFPP replies that its compliance filing followed the December 2005 Order, that if income is allocated away from one partner, then it is allocated to another partner and total taxable income generated by the partnership remains the same, and that Protesting Parties should have filed a rehearing request on this matter.

44. The Commission affirms its earlier conclusion in the December 2006 Sepulveda Order that the assumption in the *Policy Statement* is that income will be distributed in proportion to the partnership interests, which is often not the case with an MLP.[84] Protesting Parties are correct in their literal reading of the *Policy Statement*, which does speak in terms of the partnership interest, but overlook the point that the *Policy Statement* was speaking of partnerships in general. However, the issue at hand is the imposition of the tax cost to the partners, and through them, the tax burden on the partnership's capital. Thus, if income is allocated to a partner in excess of its nominal partnership interest, that income becomes the partner's distributive income for the purpose of applying the *Policy Statement*. It is that income upon which the partner's income tax liability will be based, and as such it is the income that should be used in determining the weighted marginal tax cost to be applied in developing the partnership's income tax allowance. The Protesting Parties' emphasis on the nominal partnership interests undercuts the purpose of the *Policy Statement* and has no practical application in an MLP context.

b. The Relevant Partnership Income

45. The second issue is what partnership income should be used. In this regard, SFPP developed its marginal tax rates from a profile based on the partnership categories required by the December 2005 Order. It then applied the resulting weighted marginal tax rate to SFPP's net income to determine the dollar amount of SFPP's income tax allowance. The Protesting Parties have several problems with this approach. First, they assert SFPP appears to have "traced" SFFP's income through to KMEP to determine the weighted marginal tax rate and that this is inconsistent with the *Policy Statement's* emphasis on the income of the regulated entity. Second, they assert that, assuming that income is properly allocated to KMEP's general partner, Kinder Morgan Inc. (KMI), this distorts the determination of the tax allowance because so much of KMEP's income comes from entities other than SFPP. Third, they appear to argue that SFPP should not have applied the resulting marginal tax rate to SFPP's jurisdictional income, although this point is not entirely clear. SFPP replies that it followed the Commission's instructions.

[84] December 2006 Sepulveda Order at P 64-65.

46. The Commission affirms certain basic principles discussed in the *Policy Statement* and in the December 2005 Order. First, the 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 KMEP's limited partners, Santa Fe Pacific Pipelines Inc., KMGP, Inc. via its general partnership interest in OLP-D, an intermediate partnership, and KMGP, Inc., which receives both incentive distributions and distributions from KMEP based on its one percent general partnership interest.[85] The marginal tax rate is properly determined based on the relative amounts of income allocated to these various partners based on their relative shares. Thus, the first step is to sort out how much income flows up through KMEP and how much does not. The second is to make an allocation within KMEP based on the relative share of KMEP income allocated to each of the different categories of KMEP partners since at that level the tax burden incurred is based on the distributive KMEP income made to the KMEP partners.[86] Thus, SFPP applied the proper methodology assuming that allocation among the KMEP partners is based on their relative allocations of KMEP's income. As just discussed, allocation is based on the partner's relative distributive income, not solely on its nominal partnership interest.

47. Second, the fact that KMEP's income may be generated from many different sources is not relevant in the context of a partnership structure for the same reason. In a partnership context it is the partner's distributive income that is used to determine the weighted marginal tax rate. All items of net income (or losses) by various affiliates SFPP controls are consolidated at the KMEP level and it is at that point that distributive income is determined for income tax purposes. That income can be derived from many sources and if the total income is increased, and thereby the marginal tax rate, this follows logically from the use of the partnership structure. SFPP properly used the KMEP partnership income to determine the distributive income of KMEP's partners.

48. Third, once the weighted income tax allowance is determined, SFPP appropriately applied that weighted income tax rate to SFPP's jurisdictional income since that is the income that is being regulated and where the tax cost of the partner must be compensated. The fact that the income generated at the level of the operating entity may be enhanced or offset by income or losses elsewhere by the owning partnership KMEP does not change the marginal tax rate of the partners for the income contributed by all of KMEP's units. Thus, SFPP's net income increases the potential income tax liability of the partners through its contribution to KMEP's income. By applying the weighted marginal tax rate

---

[85] *See* March 2006 Compliance filing, Income Tax Allowance Work Papers, Tab F, Confidential Protected Work Papers, 1999 Sheets, Pages 1 and 2.

[86] *ExxonMobil* at 952, 954, 955.

of KMEP and the other owning parties to SFPP jurisdictional income, SFPP was not improperly "tracing" SFPP's income through to KMEP. Rather, it was properly applying the partnership taxation methodology approved in *ExxonMobil*. That methodology modifies the Commission's 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 as would be the case for a Schedule C corporate subsidiary.[87]

c. The Relevance of Negative Partnership Income

49. The Protesting Parties' third assertion is that it makes no sense to apply the resulting income allocations to SFPP when so many of the partners have, and when in fact most of the partnership categories reflect, negative partnership income. Thus, they conclude that any weighted marginal tax calculation should attribute positive income to the general corporate partner and negative income to the other partnership categories. SFPP replies that this argument fails to recognize that the December 2005 Order held that the weighted marginal tax is to be determined based on the distributive income allocated to partners.

50. Protesting Parties' argument, which focuses on the negative net income that appears on many of the K-1's that KMEP provides its partners, reprises the difference between an "actual and potential" income tax liability previously discussed. There the Commission explained that an income tax liability may be deferred because the partnership income allocated to a partner may be offset by items of depreciation, loss, or credit that may reduce the partner's basis, thus deferring taxable income that would otherwise be recognized in the absence of allocation of items of income, depreciation, or loss among the partners. It is the deferral of income recognition by such allocations that generates the partnership tax shelter element of the tax policy adopted by Congress.

51. *ExxonMobil* appears to recognize this basic fact when it speaks in terms of partners' distributed income.[88] The distributed income is that which shows as income on the partner's K-1 and is not the net income that would be shown on a corporate return. The latter is net of all items of income and all expenses (including depreciation), credit and loss and reflects net taxable income or loss. Partnership tax law provides that distributive income and distributive items of depreciation, loss, or credit are separately

[87] Ironically, if a stand-alone corporate subsidiary were involved, the marginal rate would almost always be 35 percent. Under the Commission's partnership methodology the weighted marginal tax rate of an MLP is likely to be lower because of the lower rate imputed to the publicly traded limited partnership units.

[88] *ExxonMobil* at 952, 954.

stated on the Form K-1 and the partner's return. Given that income tax liability may be deferred until the deferred income is recognized, SFPP properly based its calculations on the distributive income of the partners and determined the weighted marginal income tax rate accordingly. Requiring SFPP to offset positive general partner income with negative limited partner income reads the concept of "potential" income tax liability out of the *Policy Statement* because it would eliminate that deferred income tax component embedded in the word "potential."

d. The Relationship to the DCF Model

52. The Protesting Parties also argue that allowing a pass-through entity an income tax allowance results in a double recovery of income tax cost through the discounted cash flow model the Commission uses to determine the equity cost of capital. They argue that since the dividends used as input to the model have a tax allowance build into them, that an additional tax allowance for the partners double counts the income tax allowance. The Commission disagrees. It is true that the Commission affords corporations an income tax allowance so that the corporation's after-tax income is adequate to support the dividend stream at a pre-tax return satisfactory to the investor. As the *Policy Statement* describes, after the necessary corporate return is determined, the Commission grosses up the return to cover the tax cost, thus assuring that the after-tax corporate return meets the investor's expectations of the corporation.[89] The dividend stream incorporated into the Commission's DCF model reflects the taxes paid at the corporate level prior to the dividend payment and that the income tax allowance compensates for those taxes.

53. However, as the *Policy Statement* also explains, the relevant taxes are not paid by the partnership on the taxable income earned by the partnership, but are paid by partners to the extent that income is recognized on their returns. As *ExxonMobil* recognizes, the taxes on distributive partnership income are due even if there are no distributions made to the partners. The distributions made to the partners represent pre-tax dollars and without the income tax allowance would not equal the first tier after-tax return of a corporation that receives an income tax allowance on the same amount of net income. Thus, if distributions are utilized in the Commission's DCF model, these are not dividends for which a prior income tax allowance has been included in the cost of service, as is done with the corporate model.[90] Rather, 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

[89] *Policy Statement* at P 21, note 20, and P 36, 37.

[90] *Cf. ExxonMobil* at 954.

model.[91] Therefore the impact on the DCF model of the income tax allowance is neutral, although there may be an additional return to the partners due to the income tax deferral elements of the partnership. However this is not true for all partnerships and the issue here involves the generic relationship between partnership structures and the Commission's DCF model.

6. The Relevance of Incentive Distributions

54. The Protesting Parties again assert that incentive distributions made to Kinder Morgan General Partners Inc. (KMGP) in its role as general partner should be excluded from the determination of the income tax allowance. Incentive distributions are made under a partnership agreement that provides a larger portion of available cash flow will be distributed to the general partner with the growth in cash flow available for distribution.[92] This provides an incentive for the general partner to increase the available cash flow. Such distributions may be as much as high as 50 percent of the available cash distributed. Since the general partner normally starts with only a one percent general partnership interest, an incentive distribution equal to 50 percent of available cash flow is significantly different from the general partner's entitlement under its nominal partnership interest and would increase its total distribution to as much as 51 percent. Most MLPs also provide that once the distribution of available cash flow exceeds the general partner's nominal share, the general partner will be allocated income equal to the dollar amount of available cash allocated to it as an incentive distribution.[93] If available cash flow is $30,000 and the general partner is allocated 50 percent of available cash, $15,000 of the partnership's gross operating income will be allocated to the general partnership.

55. Thus, if gross operating income is $20,000, the $15,000 will be deducted from the gross operating income leaving net operating income of $5,000 to be distributed as

---

[91] Partners have the benefit of not paying an additional tax on the dividends received. However, the DCF model has never taken this additional level of taxation into account since it is the after-tax return of the first tier entity that is reflected in inputs of the DCF model. The *Policy Statement*'s approach is consistent with this approach in that it equalizes the tax impact on the DCF at the first tier level. *See ExxonMobil* at 954-55.

[92] *See* in Docket No. PL05-5-000, Comments of Indicated Shippers and ExxonMobil dated January 21, 2005, Ex. A, *MLPs: Recognizing the Value of the General Partner*.

[93] *Id*.

follows: 99 percent to the limited partners and 1 percent to the general partner through its 1 percent general partnership interest.[94] However, all expenses would still be allocated (and distributed) based on the general and limited partner's nominal partnership interests with the following consequences. First, the distribution of partnership gross income and the related marginal tax rates are: $15,000 to the general partner at 35 percent, $4,950 to the limited partners at 28 percent, and $50 to the general partner at 35 percent. If the income were distributed solely based on the partnership interests, the result would be $19,800 to the limited partners (at 28 percent) and $200 to the general partner (at 35 percent). Clearly the resulting weighting of the marginal tax rate is significantly different if incentive distributions are involved. However, incentive distributions are permitted under limited partnership law and are part of the structure authorized by Congress.

56. Thus, SFPP is correct that if the partnership has gross operating income of $20,000, which is income after inclusion of all revenues and expenses, then $20,000 will be distributed as actual or potentially taxable distributive income. In this regard there was no error in SFPP's March 2006 compliance filing. However, the example stated here should be pursued somewhat further to explain Protesting Parties' concerns. As discussed, distributive net income has been allocated $15,050 to the general partner and $4,950 to the limited partners. However, total distributions were $30,000 allocated as follows: (1) $15,000 to the general partner as an incentive distribution; (2) $150 to the general partner based on its one percent general partner interest; and (3) $14,850 to the limited partners based on their 99 percent interest. Thus, the general partner is assigned $15,050 in net income and receives $15,150 in distributions, and in practice has an income tax liability on almost all of the cash received. In contrast, the limited partners have net income assigned to them of $4,950 and distributions of $14,850. Thus, the limited partners would pay tax on income of $4,950 and would receive cash of $9,800 on which the limited partners would have no income tax liability. While all of the $20,000 in partnership gross operating income has been recognized, much of the tax burden has

[94] This simple example assumes that the partnership had gross revenues of $100,000 and total operating expenses of $80,000, or gross operating income of $20,000. As the example explains, the allocation of cash distributions to the general partner in excess of its nominal partnership interest results in the reduction of gross operating income to a net operating income figure for purposes of determining how the partnership's operating income will be distributed for income tax purposes. It does not change the partnership's income in the sense of revenues that exceed all operating costs, including depreciation. If partnership distributions are in proportion to partnership interests, the partnership's gross operating income and its net operating income for tax purposes are the same.

been shifted to the general partner.[95] Moreover, it is possible that the limited partners will have negative net taxable income depending on how the allocations are determined and thus that no taxable income may be recognized until the partnership interest is sold.

57. The Protesting Parties also assert that so much of KMEP's income comes from sources other than SFPP 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. They argue that the amount of income allocated to the general partner is open to manipulation, that incentive distributions provide incentives to maximize the partnership's available cash flow and distributions, at the expense of service quality and pipeline safety. The Commission recognizes that available cash used to make the incentive distributions comes from many sources, but this is a lawful function of a complex MLP structure. Incentive distributions may provide incentives for excessive distributions, but this is not a regulatory income tax allowance matter. Rather, it is a cash management or service issue that is more appropriately addressed in a venue other than a rate proceeding.[96] For these reasons the Commission affirms the conclusions of the December 2005 Order that incentive distributions do not improperly distort the income tax allowance calculation.

58. Finally, Indicated Shippers asserts that incentive distributions are guaranteed income payments and should be treated as an expense that is deducted from KMEP's income. SFPP replies that the Commission held that incentive distributions are appropriate and that the matter should have been raised on rehearing. It argues that the issue of guaranteed payments is imported from Docket No. IS06-230-000 and inappropriately raised here. It also asserts that incentive distributions vary with income and as such are not guaranteed payments. The Commission holds that SFPP correctly argues that the issue of guaranteed payments was not raised at hearing and is inappropriate in the context of a compliance proceeding. In any event, it is clear that

---

[95] The limited partners will have reduction in basis of $9,850, which one would assume is taxed at capital gains since all of the partnership's gross operating income has been recognized under this example and taxed in the year earned. However, this does not invalidate the Commission's analysis in the *Policy Statement* since in this example ordinary income of the partnership has been recognized, albeit at a higher marginal tax rate. The general partner is assuming a higher tax burden in exchange for a greater share of available cash, thus leveraging the one percent partnership interest in the example.

[96] *See BP West Coast Products, LLC v. SFPP, L.P.*, 119 FERC ¶ 61,241 (2007), ordering par. A and *ExxonMobil Oil Corporation* v. Calnev Pipe Line, LLC, et al., 120 FERC ¶ 61,075 (2007); Cf. *BP West Coast Products, LLC et al.* v. *SFPP, L.P., et al.*, 121 FERC ¶ 61,239 (2007).

incentive distributions are a function of income since income is a major source of such distributions, and of course income is not guaranteed. Moreover, the partnership tax forms included in Indicated Shippers' filing make no mention of guaranteed payments in any part of the relevant forms.[97] Indicated Shippers' argument is specious and is rejected.

7. State Income Tax Allowances

59. The Protesting Parties' April 2006 comments assert that the *Policy Statement* did not authorize SFPP to include in its cost of service a cost element for state income taxes. They further assert that SFPP did not adequately justify the state marginal income tax rate for the income tax allowance included in its March 2006 compliance filing. The first point is without merit. State income taxes are a traditional cost-of-service element. If SFPP establishes that it should receive a federal income tax allowance, it is entitled to a state income tax allowance if its methodology is reasonable.[98]

60. SFPP's method for determining the state income tax allowance was relatively complex and: (1) assumed that SFPP income should be used for determining the state in which the income tax is incurred; (2) estimated what percentage of state income tax payers would fall in the upper brackets under the presumptions established by the Commission for federal taxpayers; (3) determined the state marginal tax rate for three states, Arizona, New Mexico, and California; and, (4) applied that marginal tax rate to SFPP's income derived from those three states based on the allocation provisions of state tax law. The Protesting Parties assert that SFPP has established no logical nexus between the three states that it chose to develop the state weighted marginal tax rate included its compliance filing since the income tax allowance is based on the marginal tax rates of the partners, not SFPP. SFPP replies that the December 2005 Order stated that it is SFPP's income that is relevant and the income upon which the income tax allowance will be determined.

61. The Commission concludes that SFPP has not adequately justified the methodology it proposed for calculating a state income tax allowance. It is true that the dollar amount of the income tax allowance is determined by looking at the dollar amount of the equity return of the regulated firm, in this case SFPP, and by marking up the income to compensate for the marginal tax rate developed under the *Policy Statement*. However, as has been discussed, the weighted marginal tax rate is determined by evaluating the marginal tax rate of KMEP's partners. Thus, the relevant marginal tax rate is the weighted marginal tax rate of all KMEP partners that are required to declare KMEP's income, not SFPP's, in the states where KMEP operates. As the Commission

[97] *See* Comments of Indicated Shippers, *et al.*, Ex. IS-N at 1, 5, 6, 8, 13.

[98] *See Kern River* at 222-23.

understands it, a partner may be resident in one state and be required to declare all KMEP income in that state. If the KMEP income allocated to a second state is sufficiently high, the same partner may be required to file an income tax return in that second state and then seek a credit in the first state for the income taxed in that second state. The Commission cannot resolve this issue here, but agrees with the Protesting Parties that SFPP must modify its procedure for developing the weighted marginal state income tax rate.

C. Reparations and Refunds

62. Reparations are available under the ICAct[99] if the Commission determines that a carrier rate is unjust and unreasonable and establishes a new rate. The carrier may be required to repay funds collected in excess of any just and reasonable rate established by the Commission from between the date of the complaint and the effective date of the new rate, as well as for two years prior to the date of the complaints. However there are limitations on the Commission's authority under the *Arizona Grocery* doctrine, the third generic issue addressed by *ExxonMobil*. The court's ruling on that issue requires some modifications to the reparation calculations previously ordered by the Commission.

1. The *Arizona Grocery* Doctrine

63. The *Arizona Grocery* doctrine addresses the point at which a Commission established rate becomes a just and reasonable final rate. In this regard, the critical distinction is between a rate that becomes effective without a Commission determination that the rate is just and reasonable, and a rate for which the Commission sets the just and reasonable level. Thus, if the rate is based solely on the filing of the carrier and is effective on a date selected by the carrier, the rate is a legal rate because the carrier has complied with the requirement that it file all rates that apply to its jurisdictional services. However, such a rate has not been adjudicated to be just and reasonable by the Commission and may be challenged. If that rate is challenged and is found to be unjust and unreasonable and a new rate is established by the Commission, reparations are due.[100]

64. Once the Commission establishes a final rate, then the resulting rate is a lawful rate. Because there has been a final Commission determination that the resulting rate is just and reasonable, the rate may only be modified prospectively because the carrier has

[99] 49 U.S.C. App. § 13 (1988).

[100] However, if the rate is grandfathered, reparations are due only from the date of the complaint if the Commission finds there are substantially changed circumstances. *See* section 1803(b) of the EPAct of 1992.

relied on the agency determination. This reliance bars the Commission from ordering further reparations after the date of a final order.[101]

2. The Commission's Prior Rulings

65. The Commission's Opinion No. 435 Orders established new rates for the East Line that became effective on August 1, 2000 after the review of several compliance filings.[102] In each of those orders the Commission modified SFPP's East Line rates, but after Opinion No. 435, consistently stated that the revised East Line rates would be effective on August 1, 2000. However, it was not until June 3, 2003, that the Commission made its final rulings on various requests for rehearing and directed SFPP to file the final version of its new East Line rates and to make reparations.[103] SFPP complied and paid the reparations but argued that *Arizona Grocery* precluded the Commission from establishing interim rates and thereafter modifying them to be effective at the earlier date of August 1, 2000. The court held in *BP West Coast* that the *Arizona Grocery* doctrine did not apply until the Commission established a final rate to be effective August 1, 2000, and that this did not occur until it issued its June 3, 2003 letter order.[104]

66. Based on *BP West Coast*, the June 2005 Order held that *Arizona Grocery* would apply to the remanded East Line rates as of August 1, 2000, once those rates were revised in response to the remand opinion.[105] The Commission reasoned that the effect of a remand is to reopen for further modification of the rate that was final at the time the appeal was filed with the court. Thus, once the corrections were made on remand, the corrected East Line rates would also be final as of August 1, 2000 without this being retroactive ratemaking. Since it held that any revisions to the East Line rates on remand would be final on August 1, 2000, and would be *Arizona Grocery* rates as of that date, the Commission concluded that the East Line rates that it revised on remand and placed in effect on August 1, 2000, could be further modified only prospectively.

---

[101] BP West Coast at 1304.

[102] *Opinion No. 435-B*, 96 FERC at 62,079 (2001).

[103] *See SFPP, L.P.*, 103 FERC ¶ 61,287 (2003).

[104] *BP West Coast* at 1304-05.

[105] June 2005 Order at PP 52-59.

67. A similar issue was whether rate complaints filed against the East Line rates after August 7, 1995, would be eligible for reparations if an evaluation of those complaints determined that lower East Lines rate would be justified on that date. Having concluded that the August 1, 2000 rates would be A*rizona Grocery* rates, the Commission further explained how the August 1, 2000 rate was designed. SFPP was first required to develop just and reasonable East Line rates for the calendar year 1994 based on the Commission determined of cost-of-service for that year. The 1994 rates were then indexed forward to August 1, 2000, were effective on that date, and applied to all shippers thereafter. The Commission also ordered reparations for two years back from the date and forward to August 1, 2000 for all eligible complaints. This would be done be measuring in each year of the reparations period the difference between the new East Line base rates developed for 1994 and indexed East Line rates as of August 1, 2000.

68. While the June 2005 Order did not literally say so, the Commission held that East Line rates that were effective August 1, 2000, created a rate floor below which it was not lawful to set a lower rate given the Commission's interpretation of *Arizona Grocery*.[106] The Commission thus concluded that (1) if a shipper filed a valid complaint against SFPP's East Line rates after August 7, 1995, but before August 1, 2000, (2) and the rate paid was in excess of the rate floor established by the Commission for the complaint year at issue, and (3) the shipper had not previously received a remedy, then the complainant might be able to obtain reparations, but that such complaints could not obtain reparations from a cost-of-service that resulted in a rate lower than the rate floor.

3. The Holding in *ExxonMobil*

69. *ExxonMobil* reversed the Commission's conclusions, holding that the Commission had established interim, not final rates, as of August 1, 2000, in the remand proceedings that followed *BP West Coast*. The court stated that "critical to our analysis is the fact that when FERC accepted this [August 1] interim rate, its methodology had not yet been established for determining the final rate."[107] The court thus concluded that these "yet-to-be-finalized rates, which the shippers paid to use SFPP's East Line, do not receive *Arizona Grocery* protection."[108] The court also noted that the court vacated the Commission's prior determination of the rate level because of the application of the *Lakehead* policy, that the Commission had not completed proper calculations when the *ExxonMobil* appeal was heard, and that any rate determined to be just and reasonable in

[106] June 2005 Order at P 57-58.

[107] *ExxonMobil* at 963.

[108] *Id.*

response to the July 2004 remand would be applied retroactively to August 1, 2000.[109] The court then analyzed the distinction between refunds and reparations, concluding that once the Commission establishes the new August 1, 2000 rate on remand, SFPP will have to "refund any amount in excess of the new calculations."[110] Thus, the court was not troubled by the fact that when a final rate is finally established as of August 1, 2000, the previous refund obligation will be revisited, and, one would assume, as will the initial reparations that had been paid based on the Commission's June 3, 2003 Letter order.

70. Rather, the issue was whether the setting of the August 1, 2000 East Line rates after SFPP and the Commission had worked out the implications of *BP West Coast* would preclude reparations for the additional East Line complaints filed during calendar year 2000 if these later complaints should result in a rate that was less than the August 1, 2000 level. The court posited this issue by stating "[the] limited question before us is whether the final rate, which will be determined at the completion of the [pending] compliance proceedings, is entitled to *Arizona Grocery* protection."[111] The court held that it would not be because "the Commission cannot properly be considered to have prescribed a just and reasonable rate until the proposed tariff is approved at the completion of the compliance proceedings. Consequently, we hold that *Arizona Grocery* does not preclude reparations in this case."[112] Thus, under the court's holding, the fact that August 1, 2000 East Line rates based on the 1994 cost-of-service are open to further revision on remand means that those rates will not be final until the Commission completes the instant compliance proceedings related to the East Line rates. Since reliance by the carrier is the basis for *Arizona Grocery*, the protection it provides against retroactive ratemaking does not apply until a final order. The court re-enforced this conclusion by holding that *Arizona Grocery* is not to be applied broadly given that the purpose of the ICA is to assure shippers have just and reasonable rates.[113] It therefore concluded that the Commission erred when it denied reparations for complaints against the East Line rates after August 1, 2000.

---

[109] *Id.* at 964, 965.

[110] *Id.* 966.

[111] *Id.* 967.

[112] *Id.* 968.

[113] *Id.* 968-69.

4. Implementation of the Remand

71. The court's remand in *ExxonMobil* requires changes to Commission's prior holdings on reparations. First, the Commission will revisit the methodology used in its prior orders to determine the level of the reparations for both the East and the West Lines. Second, it will revisit the eligibility of the East Line shippers for reparations by a further review of the language contained in the specific complaints, not just the language summarizing the complaints in the Commission's prior orders. Because reparations issues are so entwined in the two lead dockets at issue here, it is most efficient to examine those details on a geographic basis. Finally, the court's holding moots the outstanding rehearing requests and comments regarding the *Arizona Grocery* doctrine.

5. East Line Reparations

a. Calculation of the Reparations

72. The court's holding in *ExxonMobil* complicated the calculation of reparations that may be due the East Line complainants in Docket No. OR92-8-000, *et al.* First, there are at least three cost-of-service test years that are relevant to determining the amount of East Line reparations due. Second, there are presently two interim rate levels involved. Third, there are a series of complaints involved that under the court's theory may establish dates from which reparations may be due. Moreover, the time frames for the test periods and the interim rates are not coterminous, which may impact the calculations.

73. In the Opinion No. 435 Orders, the Commission utilized a 1994 test year and established what has now been held to be interim East Line rates that were effective August 1, 2000. While this determination was under way, further complaints were filed against SFPP's East Line rates in October 1997, in April and May of 1998, and in January and August of 2000. These complaints were consolidated in Docket No. OR96-2-000, *et al.*, which also included additional complaints against the West Line rates filed in the same time frame. In this latter docket the Commission used a 1999 cost of service to evaluate both SFPP's East and West Line rates. The Commission required SFPP to develop a new West Line rate for the 1999 test year and index that rate forward to May 1, 2006. However, the Commission declined (1) to reduce the East Line rates below the August 1, 2000 level even if granting the 1997 and 1998 complaints might have resulted in a lower rate for that year or (2) to reduce the level of the East Line rates derived from the test year 1999 even if these rates were lower than the East Line rates derived from the test year 1994. Since the Commission relied on its interpretation of *Arizona Grocery* to reach these conclusions, this was in error.

74. This requires the following adjustments. Because the Commission has concluded that review of the additional 1997 and 1998 complaints filed against the East Line in Docket No. OR96-2-000, *et al.* should be based on a 1997 cost-of-service, the

Commission requires SFPP to develop an East Line cost of service for that year using the same cost of service methodology as for the 1999 East Line cost-of-service required in that docket. If an eligible shipper paid a rate in excess of that derived from the 1997 cost-of-service, as indexed through August 1, 2000, reparations will be due as long as the 1997 cost-of-service based rate is less than the 1994 East Line cost-of-service based rate developed in Docket No. OR92-8-000, *et al.* For example, assume the existing East Line rate in 1994 was $1.00 and had been indexed to $1.10 through August 1, 2000. Pursuant to the Opinion No. 435 Orders, this rate was reduced to 90 cents as of January 1, 1994 and the resulting indexed rate was 99 cents as of August 1, 2000. Also assume that an eligible shipper filed a valid complaint against the East Line rates for the period to be covered by the 1997 test year. This results in a further reduction of the East Line rate to 85 cents, which when indexed forward results in August 1, 2000 indexed rate of about 93 cents. The shipper may obtain additional reparations for the difference between indexed East Line rate of 99 cents derived from the 1994 test year and the 93 cent indexed rate derived from the 1997 test year. Since the additional 1997 test year rate required here is established during a time frame when the revised East Line 1994 rates were interim rates under *ExxonMobil*, reparations would also be due for two years back from the eligible complaints by (1) reverse indexing the 1997 East Line cost of service rate required here, and (2) comparing it to the indexed 1994 test year cost-of-service rate for the same two-year time frame.

75. The December 2005 Order required SFPP to develop East Line rates based on a 1999 cost-of-service and index it forward to May 1, 2006, establishing new interim East Line rates prospectively on that date. This part of that order is unchanged and a new rate applicable to all shippers based on a new 1999 cost of service was correctly made effective on a prospective basis. However, *ExxonMobil* drew a careful distinction between the rates that are applicable to all shippers on a given date and the rights of shippers that filed complaints against the same rates prior to the effective date of new East Line rates on May 1, 2006. Thus, to the extent that the 1999 indexed East Line rates effective May 1, 2006, were less than the August 1, 2000 interim rate previously in effect, eligible complaints filed after August 1, 2000 may obtain reparations for the difference between those two indexed rates. Thus, continuing the prior example, again assume that the East Line rate in effect on August 1, 2000, was 99 cents based on the indexed 1994 cost-of-service rate. If the East Line rate based on the 1999 cost of service would have been 81 cents on January 1, 1999, eligible shippers may obtain reparations to May 1, 2006, based on the difference between the indexed rate based either on the 1994 cost of service or the additional 1997 indexed rate required here, whichever is lower. In addition, such East Line shippers are eligible for reparations two years back from the dates of their 2000 complaints to the extent that the East Line rates derived from the 1999 cost-of-service are less than those derived from the 1994 or 1997 cost-of-services developed under those earlier complaint years. Finally, refunds may be due all East Line shippers depending on the relative values of the August 1, 2000 and May 1, 2006 final East Line rates required here.

b. Eligibility Issues

76. The determination of which East Line shippers are eligible for reparations in Docket No. OR92-8-000, *et al.* has a complex history. The Opinion No. 435 Orders in Docket No. OR92-8-000, *et al.* first held that only Navajo was entitled to reparations from East Line shipments, but later expanded eligibility to Chevron, Western, ConocoPhillips, and ExxonMobil. Chevron's eligibility was limited to its August 3, 1993 complaint and certain of Valero's and Indicated Shippers' claims were denied, as well as Navajo's request for reparations before November 23, 1993. *BP West Coast* upheld all of the Commission's determinations.[114] In its prior determinations the Commission relied primarily on a review of the relevant suspension and investigation orders. Given that all the relevant rates have been held to be interim rates, the Commission has conducted a review of the original complaints in the Docket No. OR92-8-000 *et al.* consolidated proceeding given SFPP's challenges to some of the Commission's determinations.

77. The West Line turbine rates excepted, only the East Line rates are relevant in Docket No. OR92-8-000, *et al.* because all other West Line rates remained grandfathered in that docket. With the turbine fuel rates noted, the East Line complaints were as follows:

> 1. Docket No. OR92-8-000, the lead docket, was filed by El Paso Refining Company (El Paso) in August 1992. El Paso was the sole complainant in this docket and its complaint was subsequently settled. This docket number has been retained only because it is the lead docket.
>
> 2. Docket No. OR93-5-000 was filed by Chevron on August 3, 1993. In a series of orders the Commission concluded that Chevron had successfully complained against SFPP's East Line rates and its West Line rates, including the turbine fuel rates transported under Tariff 18.[115] However, upon review of the August 3, 1993 complaint, the Commission concludes that this complaint only challenged SFPP's West Line rates, the Sepulveda Line charges, SFPP's pro-rationing policy, and a preference claim based on the reversal of the previously western flow from Phoenix to Tucson to an easterly direction. Contrary to the Commission's conclusion in the Opinion

---

[114] *BP West Coast* at 1303, 1308-1312.

[115] *See SFPP, L. P.*, 65 FERC ¶ 61,028 (1993) and 66 FERC ¶ 61,210 (1994). These orders also rejected Chevron's claim that its protests in an earlier docket were sufficient to remove SFPP's West Line rates from the grandfathering provisions of the EPAct of 1992.

No. 435 Orders and the court's affirming of this conclusion in *BP West Coast*, Chevron did not challenge the actual level of the East Line rates in this complaint.[116] Therefore Chevron is not eligible for East Line reparations under this complaint. Any holdings in the cited orders to the contrary are reversed.

3. Docket No. OR94-3-000 was filed by Navajo on December 22, 1993. It is undisputed that this complaint was against the East Line rates although the reparations are limited to the period after November 23, 1993 because of a settlement limiting the scope of the reparations.[117]

4. Docket No. OR94-4-000 was filed jointly by ARCO Products Company, a Division of Atlantic Richfield Company (ARCO), and Texaco Refining and Marketing Inc. (TRMI) on February 14, 1994. The Commission concludes these complaints did not attack the East Line rates. The complaint lies against the turbine fuel rates.[118]

5. Docket No. OR95-5-000 was filed by Mobil Oil Corporation (Mobil) on April 3, 1995. On further review, this complaint does not mention the East Line rates and relies on the complaint in Docket No. OR94-4-000. No East Line reparations are due under this complaint. The complaint lies against the turbine fuel rates.

6. Docket No. OR95-34-000 was filed by Tosco Corporation on August 7, 1995. The complaint clearly challenges the East Line rates and the turbine fuel rates.

78. Complaints filed against SFPP's East Line rates after August 7, 1995, through December 1999, and which were consolidated in Docket No. OR96-2-000, *et al*., include: Docket No. OR98-1-000 filed on October 22, 1997 by ARCO; Docket No. OR98-21-000 filed on October 22, 1997 by Ultramar; and Docket No. OR98-13-000 filed on April 24, 1998 by Tosco. Further complaints filed after January 1, 2000 include: on January 10, a joint Third Original Complaint filed by ARCO, Equilon Enterprises LLC (Equilon), TRMI, and Mobil in Docket No. OR00-4-000, as well as amended complaints by those

---

[116] *BP West Coast* at 1311-12. The precise ruling is that Chevron could not use a relating-back theory to support a complaint against the West Line rates. Thus, the holding here does not directly contradict the court's ruling on this latter point.

[117] *Id.* at 1308-09.

[118] *Id.* at

parties and Tosco; an August 17 complaint by Ultramar in Docket No. OR00-8-000; an August 21complaint by Tosco in Docket No. OR00-9-000; an August 28 compliant by Navajo Docket No. OR00-7-000; and an August 28 complaint by Refinery Holding Company in Docket No. OR00-10-000.

6. West Line Complaints Filed after August 5, 1995

a. Calculation of the Amounts Due

79. The calculation of the West Line reparations is more straightforward. First, no West Line reparations are due in Docket No. OR92-8-000, *et al.* except for those due for the West Line turbine fuel rates, as described in the December 2005 Order. In Docket No. OR96-2-000, *et al.*, the December 2005 Order required SFPP to make reparations based on the 1999 cost-of service through May 1, 2006. The December 2005 Order also required reparations to be made based on a 1995 cost of service for several complaints that were filed between late 1995 and 2000. This was done to eliminate the need to reverse index the 1999 cost of service for four years to 1995, the first year in which West Line reparations appeared to be due in Docket No. OR96-2-000, *et al*.

80. As detailed below, the first complaints against the West Line rates in Docket No. OR96-2-000, *et al.* that attacked rates other than the Sepulveda and Watson Station rates were filed in October 1996, and in late 1997 and early 1998. Because only the Sepulveda and Watson Station rates were at issue before those dates, the December 2005 Order's requirement that SFPP use a 1995 cost of service to calculate West Line reparations was not appropriate because the bulk of these intermediate complaints were well after that date. Therefore, as with the additional complaints against the East Line rates, the Commission will modify its December 2005 Order and use a 1997 cost-of-service to establish the reparations that are due for the eligible West Line complaints filed October 1996, in late 1997 and early 1998, exclusive of those may be due for the Sepulveda Line and Watson Station proceedings.[119] Thus, SFPP must design revised West Line rates as of January 1, 1997 applying the methodology of the1999 cost of service required in this docket and index those rates to December 31, 1998, at which point the 1999 cost of service applies. For the period after January 1, 1999, reparations will be determined based on the cost of service developed for that year and applicable to the 2000 complaints filed in Docket No. OR96-2-000, *et al.* For the complaints filed in 1997 and 1998 reparations are only due forward from the date of the complaints since prior to the review of those complaints the West Line rates to points east of California were grandfathered. However, any rate levels based on the 1997 cost of service would not be *Arizona Grocery*

[119] As noted, the complaints against these rates were consolidated in separate dockets and the litigation was based on a cost of service appropriate to those dockets.

rates under *ExxonMobil*. Thus reparations will be due two years back from the date of the 2000 complaints and forward to May 1, 2006 to the extent that rates developed under the 1999 cost of service prove to be less than those developed under the 1997 cost of service required here.

b. Eligibility

81. As has been discussed, the Commission rejected all complaints against the West Line (except for the turbine fuel complaints) filed through August 7, 1995 and was affirmed.[120] The Commission's determinations in Docket No. OR96-2-000, *et al.* that there were no substantially changed circumstances to the North and Oregon Line rates were upheld in *ExxonMobil* and therefore these are not discussed further here.[121] As stated, the West Line rates at issue here were grandfathered when the following complaints were filed and thus reparations are due only forward from the complaint date.

1. The complaints filed in Docket Nos. OR96-2-000 (December 1995), OR96-10-000 (January 1996), and OR96-17-000 (October 1996) were directed either at the Sepulveda Line rates, the Watson Station Drain Dry charges, or both, but did not attack any other West Line rates. As such, reparations in those dockets are governed by the severed proceedings for those rates and are no longer relevant here. Any findings in the December 2005 order to the contrary are reversed. The Docket No. OR96-2-000 caption has been retained because it is the lead docket.

2. Docket No. OR97-2-000 was filed by Ultramar on October 21, 1996, against SFPP's West Line rates, Tariff Nos. 15, 16, 17, and 18 from Watson Station to points in Arizona and to intermediate points. Reparations for this complaint are to be calculated using a 1997 cost-of-service indexed back to the complaint date. However, the West Phoenix rates are grandfathered through December 31, 1996. Thus this complaint is not eligible for reparations to that delivery point.

3. Docket No. OR98-1-000 was filed on October 22, 1997 by ARCO against all of SFPP's rates, including the East, West, Oregon, North, and Sepulveda Line rates and the Watson Station charges. Only the West Line reparations are relevant here, the East Line reparations having been discussed.

---

[120] The last such compliant was filed August 7, 1995 in Docket No. OR95-34-000.

[121] *ExxonMobil* at 29, 31.

4. Docket No. OR98-2-000 was filed on November 21, 1997 by Ultramar against all of SFPP's rates, including the East, West, Oregon, North, and Sepulveda Line rates and the Watson Station charges. Only the West Line reparations are relevant here, the East Line reparations having been discussed.

5. Docket No. OR98-13-000 was filed on April 24, 1998 by Tosco against all of SFPP's rates, thus attacking the East, West, Oregon, North, and Sepulveda Line rates and the Watson Station charges. Only the West Line reparations are relevant, the East Line reparations having been discussed.

6. On January 10, 1999, Ultramar amended and expanded certain of its existing complaints. This did not change any reparation rights under its prior filings.

82. As with the East Line rates, on January 10, 2000, most of the foregoing complaints were amended, but this did not extend the scope of the original complaints beyond the parties that were stated on the face of the original complaints in those dockets. Further complaints filed after January 2000 include: on January 10, 2000, a joint Third Original Complaint filed by ARCO, Equilon, Texaco Refining and Marketing, Inc. (TRMI), and Mobil in Docket No. OR00-4-000; on August 17 by Ultramar in Docket No. OR00-8-000; and on August 21 by Tosco in Docket No. OR00-9-000. These are new complaints for which reparations are due two years back from the date of the complaint based on the 1999 cost of service required in this docket, as well as going forward to May 1, 2006, because any interim rates based on the 1999 cost of service are not grandfathered rates. The Commission reiterates that only those complaints filed against the West Phoenix rates after December 31, 1996 are eligible for reparations since those rates were grandfathered prior to that date.[122]

7. Issues Related to Specific Shippers

83. In addition to the more general reparation issues in Docket No. OR96-2-000, *et al.* just discussed, there are specific matters related to three shippers: Circle K, TRMI, and VMSC. These are discussed below.

a. Circle K

84. Circle K is a subsidiary of an affiliate of Tosco Corporation, for which Tosco asserts reparations are due. SFPP denied this claim for reparations on the ground that Circle K was inadequately identified in Tosco's initial April 28, 1998 complaint. SFPP

[122] February 2006 Order at P 13.

asserts that Tosco thereby failed to meet the strict standards for reparations required by the ICAct. It further argues that Tosco improperly claimed to have paid the invoice on Circle K's behalf, and as such reparations are due neither firm. Tosco argues in its initial comments on the March 2006 compliance filing, and in a answer filed May 5, 2006, that the undisputed evidence of record shows that Tosco made the payments in its own name on behalf of Circle K. Thus, as the party actually paying the invoices, it is an injured party and is entitled to reparations. Tosco concedes that the original 1998 complaint only referred to its affiliates and subsidiaries, but asserts that the amended complaint it filed on January 10, 2000 specifically included each shipper name, including Circle K. Tosco also argues that contrary to SFPP's assertions, it included the specific invoices in the record bearing the name Circle K and that SFPP was on notice accordingly. Finally, Tosco asserts that SFPP is raising this defense only in the compliance phase, some five years after Tosco presented evidence that Circle K was a legitimate complainant.

85. The Commission finds Tosco's pleadings in the compliance phase, and the exhibits reference therein, persuasive. Thus, the Commission first holds that SFPP should have raised this defense at hearing. Alternatively, on the merits the Commission finds that Tosco established its claim on behalf of Circle K when it filed its amended complaint in January 2000. Stating the complainant name is necessary to establish eligibility for reparations under the ICAct. The Commission also requires that complainants be specifically identified so that the carrier can examine its records and prepare an answer. Tosco did so when it amended its complaint, clarified that Circle K was a shipper, and established that Tosco made the payments on its behalf. SFPP had no disadvantage in terms of notice because the original 1998 complaint was held in abeyance prior to the amendments in January 2000. SFPP had a full opportunity to respond at that time and at the hearing. Given the protection afforded shippers by the ICAct, the equities lie with Tosco and with its subsidiary Circle K.

b. TRMI

86. The issue here is whether Chevron or Equilon was the successor to certain transportation interests, and hence reparation claims, on the part of TRMI. The December 2005 Order affirmed the ALJ's conclusion at hearing that Chevron had not established its claim. However, the ALJ later reversed his conclusion based on a further investigation and evidence presented during the Sepulveda Line proceeding. TRMI shipped over the Sepulveda Line in order to reach SFPP's main pipeline at Watson Station. The December 2006 Sepulveda Order affirmed this conclusion.[123] The prior results are inconsistent and must be resolved here.

[123] December 2006 Sepulveda Order at P 86-87.

87. Here SFPP and Chevron reprise the same arguments they presented in the Sepulveda Line proceeding. As there, the Commission concludes that Chevron has the better argument. The most salient facts include that Equilon never shipped over the Sepulveda Line, that Equilon had its own line and had no need for TRMI's transportation capacity opportunities or rights, and TRMI continued to ship in its own name after TRMI and Equilon were no longer affiliated. Moreover, in January 2000 the same counsel filed a joint compliant on behalf several parties, including both Equilon and TRMI. Equilon has not pursued a reparations claim at this point, including this compliance phase, which is certainly not for lack of notice given that TRMI and Equilon once had the same counsel. While the corporate history of these parties is convoluted, the most common sense solution is to conclude that Chevron succeeded to TRMI's interests given the litigation history and the actual transportation course of dealing.[124] Chevron states that it is not attempting to extend the time frame of the complaints it attempted to file before it acquired TRMI's interest, but only to assert its position as a successor in interest to TRMI's claims. The findings to the contrary in the December 2005 Order are reversed.

c. VMSC

88. VMSC is the successor in interest to complainants Ultramar and Ultramar Diamond Shamrock Corporation. VMSC asserts that SFPP improperly calculated the reparations due, while SFPP claims it did not. At bottom, this argument turns on the *Arizona Grocery* issue previously discussed and would appear to be resolved. Thus, the Commission will defer any further ruling until SFPP makes its revised compliance filing.

D. MLPs and the Composition of the Proxy Group

89. As discussed, the Protesting Parties have raised the so-called HIOS cost-of-capital issue in their comments on SFPP's March 2006 compliance filing. At bottom, the *HIOS* issue involves the use of MLPs in a proxy group to determine the equity cost of capital of a jurisdictional entity. As discussed in *HIOS*[125] and *Kern River*,[126] the Commission's

---

[124] The conclusion here is re-enforced by the settlement in the Watson Station proceeding, which awarded the TRMI claims to Chevron. *See* May 17, 2006 filing in Docket No. OR92-8-025, Attachment 1 at 5. While technically not binding in other dockets, it makes no sense to reach a different conclusion given this concession on SFPP's part and the ALJ's analysis in the Sepulveda Line proceeding.

[125] *HIOS,* 110 FERC ¶ 61,043 at P 126-27 and 112 FERC ¶ 61,050 at P 53-54 and 62-67.

[126] *Kern River* at P 149-154.

concern centered on the fact that MLPs may make cash distributions to their partners in excess of income. The Commission concluded that its current constant dividend discounted cash flow (DCF) model was premised on the payment of dividends based on a corporation's income as well as the reinvestment of retained earnings for future growth. The Commission also concluded that if an MLP's distributions exceeded income, the use of such distributions as the dividend component of the DCF model could double count the depreciation cash flow as a portion of the return to the investor and thus overstate the equity cost of capital.[127] The Commission therefore concluded that if a MLP was to be included in the proxy group to determine a regulated entity's equity cost of capital, it must establish that the MLPs included in the proxy group have distributions that are equivalent to a corporate dividend.

90. The *HIOS* issue was not before the ALJ at the time the Opinion No. 435 Orders issued and in those orders the Commission accepted the use of a proxy group consisting only of oil pipeline master limited partnerships.[128] Thereafter the same group of oil pipeline limited master partnerships was used in the Phase II Proceedings addressed by the March 2004 Order.[129] The ALJ did not even address this issue in the Phase II Proceedings, although he eliminated Kinder Morgan Energy Partnership (KMEP) from the 1999 cost-of-service proxy group on the grounds (1) that it was not proper to include the parent of the regulated entity in the proxy group, and (2) that KMEP's short term growth rate was too high.[130] On review, the December 2005 Order concluded that KMEP could be included in the proxy group and declined to modify the proxy group based on

[127] *Id.* at P 224-31.

[128] The make up of the proxy group was not raised on appeal of the Opinion No. 435 Orders. Therefore the issue is closed with regard to Docket No. OR92-8-000, *et al.*

[129] In the Remand Proceeding the 1994 six member proxy group consisted of Buckeye Partners, L.P. (Buckeye), Enron Liquids Pipeline, L.P. (Enron), Kaneb Pipe Line Partners, L.P. (Kaneb), Lakehead Pipe Line Partners, L.P. (Lakehead), Santa Fe Pacific Pipeline Partners, L.P. (SFPPP), and Teppco Partners, L.P. (TEPPCO). In the Phase II proceeding, the 1999 test year five member proxy group consisted of Buckeye, Kaneb, Kinder Morgan Energy Partners (KMEP), Enbridge Energy Partners (formerly Lakehead) (Enbridge), and TEPPCO. The difference in the groups also reflects the conversion of Enron Liquids Pipeline to KMEP in 1997 and the latter's purchase of SFPP, L.P. in 1998.

[130] *See* Phase II ID at P 349.

the record before it.[131] While Protesting Parties supported these findings in their December 2004 briefs on exception, even Indicated Shippers concluded in the Phase II Proceeding leading to the December 2005 order held that it was not necessary to address the *HIOS* issue.[132] The other shipper parties and the Commission staff did not to address the matter.

91. It was only in early 2005 that the *HIOS* proxy group issue began to emerge during the tail end of the hearings in the Sepulveda Line proceedings in Docket No. OR96-2-012. Before that the issue was not raised in that proceeding. In fact, the first testimony addressing the appropriateness of using cash distributions in the DCF model issue in detail was that provided by SFPP on December 2004, which did not mention the proxy group issue.[133] Review of that record indicates that prior thereto Mr. O'Loughlin, principal witness for the Complainants, did not address the proxy group issue in any of his prepared testimony, including that filed as late as January 28, 2005.[134] Thus, it is clear that the proxy group issue arose only after the first *HIOS* decision on January 24, 2005,[135] long after the record had closed and over one year after briefs on exception were filed in the Phase II proceeding. It is only in the context of the March 2006 compliance filing that the Protesting Parties now urge the Commission to reject the MLP proxy group used in the Remand and Phase II proceedings, or to reduce SFPP's equity return to the lower end of the range of reasonableness as the ALJ did in the Sepulveda Line proceeding.

---

[131] December 2005 Order at P 67-68.

[132] See Brief Opposing Exceptions of BP West Coast Products LLC, and ExxonMobil Oil Corporation in Docket No. OR96-2-000, *et al.*, dated December 17, 2004 at 14.

[133] Prepared Answering Testimony of J. Peter Williamson dated December 10, 2004, Ex. No. SEP SFPP-25 at 4-5. SFPP had alluded to the issue as early as April 4, 1995 in earlier testimony by Dr. Williamson. *See* his Prepared Direct Testimony dated April 4, 1995, Ex. No. 197 in Docket No. OR92-8-000, *et al*.

[134] *See* Prepared Direct Testimony of Matthew P. O'Loughlin dated October 26, 2004, Ex. No. SEP U/CT-1 at 15-16, Answering Testimony of Matthew P. O'Loughlin dated December 10, 2004 at 15, and Prepared Testimony of Matthew P. O'Loughlin dated January 28, 2005, Ex. No. SEP U/TR/T-32 at 30-33.

[135] *HIOS*, 110 FERC ¶ 61,043 (2005).

92. The Commission affirms its prior conclusion in the December 2005 Order that these proceedings are not the ones to develop a new methodology for addressing rate of return issues involving MLPs or similar pass-through entities. Any changes to the proxy group or modification of the current DCF methodology in Docket No. OR96-2-000 *et al.* would require that the case be remanded due to the lack of a record at hearing. As noted, this MLP issue was specifically disclaimed as relevant in the merits phase of this proceeding. It is not appropriate to raise the issue now in a compliance proceeding unless it was reserved by the Commission, as was the case in the July 2005 Order, or if a court so requires, as was done it the July 2004 and May 2007 remands. Neither exception applies here. The Commission does not find that another remand would be useful given the urgent need to close these proceedings that are between fifteen and twelve years old and the Protestant's urgent desire for the payment of their reparations.

93. As it is, SFPP's East, West, North, and Oregon Line rates are all subject to challenge in further proceedings.[136] In this regard, the Commission notes that the December 2005 Order stated that "[T]he Commission agrees with the ID that in this proceeding there is no practical alternative to treating distributions as the equivalent of dividends and using distributions in the conventional discounted cash flow (DCF) formula."[137] (Emphasis added). As discussed, the compliance phase here is part of "this proceeding," given the record upon which the December 2005 Order is based. The additional complaints against SFPP's rates provide another opportunity to modify SFPP's rates, if warranted, based on a more recent record. Thus, the issue should be addressed in other proceedings, such the North Line rate case now before the Commission.[138]

E. Related Motions and Other General Issues

94. Subsequent to the December 2005 Order the Protesting Parties made a number of motions in these proceedings relating to discovery, requests for interim reparations, and for additional hearings. Turning first to some evidentiary points, the Protesting Parties' comments on SFPP's March 2006 compliance filing advanced arguments against the *Policy Statement* as well the technical protocols required by the December 2005 Order.

---

[136] *E.g.* Docket Nos. OR03-5-000, OR05-4-000, and OR05-5-000 (consolidated) (pending complaints against East, West, North, and Oregon Line rates); Docket No. IS05-130-000 (the investigation of newly filed North Line rates in 2005); Docket No. OR96-2-012, *et al.* (complaint against SFPP's Sepulveda Line rates); and Docket No. IS06-283-000 (the investigation of the new East Line rates SFPP filed in 2006).

[137] December 2005 Order at P 77, *citing* Staff's Reply Brief on Exceptions at 13.

[138] *See* Initial Decision in Docket No. IS05-230-000, 116 FERC ¶ 63,059 (2006).

In its May 1 reply comments SFPP asserts that those arguments should have been raised through a rehearing request to the December 2005 Order and the Commission should reject them. SFPP also objected to the inclusion in this record of much of these materials as untimely. The Commission notes that this is the first case in which a detailed record is available to address how an MLP might justify an income tax allowance issue. As such, the Commission will accept for filing the April 2006 comments filed by the Protesting Parties even though some have been mooted by *ExxonMobil*. In addition, Indicated Shippers, Chevron, and ExxonMobil also incorporated in their joint comments extensive portions of the testimony that they had filed in the North Line Proceedings in Docket No. IS05-230-000 to which SFPP objected. The Commission holds that the materials from Docket No. IS05-230-000 should be excluded as untimely.

1. Discovery Motions

95. Protestant Shippers made two sets of discovery requests in their comments regarding SFPP's March 2006 compliance filing. The first was filed on January 30, 2006 in anticipation of that filing and requested additional information on volumes for the years after the 1999 test year and on income tax allowance matters. SFPP replied to the motion on February 3, arguing that the request was premature and the requested information would be available once its compliance filing was completed. Shipper Protesting Parties filed an answer, which provided no additional argument, and therefore will be rejected pursuant to Rule 213.[139] In various comments dated March 22 and March 28, 2006, the Protesting Parties renewed their discovery requests, arguing that the complex nature of the March compliance filing required access to certain volumes relating to reparations and tax information in SFPP's possession, particularly the K-1s of KMEP's limited and general partners. They also requested that the March 2006 compliance filing be set for hearing. SFPP replied that the volumetric information was available, but reiterated the income tax information was irrelevant given the methodology adopted by the December 2005 Order.

96. The Commission denies the pending discovery requests. Discovery and hearing in the context of a compliance filing is unusual since the carrier is already required to provide all supporting information on a voluntary basis. SFPP states it has done so with regard to the volumetric information supporting the reparation and refund portions of the compliance filing. The request for information regarding the income tax allowance issue is moot given the need for new compliance filing, the Commission's substantive rulings here, and the opportunity for additional comments on SFPP's revised compliance filing.

---

[139] *See* 18 C.F.R. § 213(a)(2) (2007).

2. Interim Refunds

97. On April 16, 2006 Indicated Shippers filed a motion requesting that SFPP be ordered to pay interim reparations. The December 2005 Order established new interim rates effective May 1, 2006 in recognition that a reduction in SFPP West Line rates was warranted, but that the exact amount of the new rate was dependent on cost-of-service issues that were unlikely to be fully resolved when the filing was made. Indicated Shippers interpreted the December 2005 Order to require interim reparations as well as interim rates. To the contrary, paragraph 113 of the December 2005 Order unequivocally states that "SFPP must prepare reports on estimated reparations that are consistent with the analysis of issues earlier in this order." (Emphasis added). This requirement is consistent with the Commission's Opinion No. 435 Orders which required estimated reparations but did not require the payment of reparations until it accepted a final compliance filing.[140] Indicated Shippers' interpretation is completely without merit.

98. Indicated Shippers filed a subsequent motion on November 21, 2006 that renewed the request for interim refunds and requested that the Commission direct SFPP, L.P. and/or Kinder Morgan GP, Inc. and/or Kinder Morgan, Inc. (KMI) to place the interim damages in escrow. At bottom, Indicated Shippers' motion asserts that SFPP's short term liabilities exceeded its short term assets, that SFPP is insolvent, that it can raise capital only by leave of its general partners, that its cost of capital might be unduly high due to SFPP's insolvent position, that the general partner KMI is going private with greater risk to SFPP's financial position, that KMI was draining all surplus cash from SFPP, and that SFPP has been managed irresponsibly in terms of its safety and operating efficiency. Indicated Shippers also assert that KMI was denying any liability for SFPP's obligations and should be required to stand behind them. The motion was supported by Navajo on December 6, 2006, simultaneously with an initial response by SFPP and a motion in support of Indicated Shippers by Airlines. Both support an investigation of SFPP's finances. Airlines also argue that the Commission should accelerate the investigation of the complaint they filed against SFPP's West Line and Watson Station Drain Dry Charges in Docket No. OR03-5-000.

99. SFPP filed a second response on December 21, 2006 that was similar to its first response in all important regards. SFPP asserts that SFPP is solvent and has more than adequate income and resources to meet its obligations. It states that KMI does not drain SFPP's cash, but KMEP, the controlling partnership, places all the cash of its various subsidiaries in a common account. It also asserts that distributions from SFPP and KMEP are only made after the required determination by a board of directors that has a

---

[140] *See Opinion No. 435*, 86 FERC at 61,117; *Opinion No. 435-B*, 96 FERC at 62,079; *SFPP, L.P.*, 97 FERC ¶ 61,138, Ordering Paragraph (D); Letter Order dated June 3, 2003, 103 FERC ¶ 61,287 at P 14.

majority of independent directors. Moreover, because SFPP is a limited partnership, neither KMEP nor KMI have responsibility for SFPP, L.P.'s debts except under unusual conditions of fraud. SFPP asserts that at bottom the moving parties are requesting the escrow of reparations and refunds that have not been determined with finality and for which SFPP has no such current obligation. It states that SFPP promptly paid $45 million in reparations in response to the Commission's Opinion No. 435 Orders and that KMEP has created a reserve of some $100 million to meet its potential obligations in these proceedings.

100. The Commission will deny these motions for two reasons. First, as previously held, SFPP has no reparation or refund obligation pursuant to the December 2005 Order at that time because it was only required to prepare an estimate of reparations. Second, to the extent that the moving parties are calling for a general investigation of SFPP's financial condition, this is inappropriate on two grounds. First, this proceeding is in its compliance, not its hearing phase. The only matters at issue here are those raised or preserved by the Commission's December 2005 Order or required by the court's June 2004 and May 2007 remands. As such, the general assertions contained in the December motions are wholly out of time. Second, the various assertions are inadequately supported and are not appropriate in a rate context. As discussed in the Commission's July 20, 2007 Order in Docket No. OR07-05-000,[141] SFPP's relationships with its owning partnership, KMEP, and the latter's general partner KMGP, are similar to that of a subsidiary corporation. The parent company is not liable for the subsidiary's debts absent fraud or fundamental unfairness that warrant piercing the corporate veil, which moving parties have not adequately alleged here.[142] SFPP correctly states that the fact that KMI has gone private will not change the fact that KMEP, a master limited partnership, owns SFPP, or the terms under which it does so. The fact that KMEP uses a consolidated cash account is a common corporate practice for firms managing multiple operating entities. More evidence than the allegations here is necessary to justify an investigation given the high standard required to pierce the veil between the parent and affiliated firms.

101. In any event a further exploration of these broader financial concerns is not required on the merits. First, there are two basic definitions of insolvency. The first is that total liabilities exceed total assets. This definition does not apply given the excerpts from SFPP's fourth quarter FERC Form No. 6 contained in Attachment E to Airline's December 6 motion. Total assets far exceed total liabilities and it is the overall balance

---

[141] *See ExxonMobil v. Calnev Pipeline, et al.*, 120 FERC ¶ 61,075 (2007).

[142] Id. *See also BP West Coast, LLC, et al. v. SFPP, L.P., et al.*, 121 FERC ¶ 61,239 (2007).

sheet ratio, not the ratio of current assets to liabilities which controls on this point. Moreover, some $391.6 million of the current liabilities is owned to SFPP's affiliates (Line 48) which would have little incentive to bankrupting it given the net book equity of $1.1 billion reflected on Line 76 of Attachment E of Airlines' motion. The second definition of insolvency is that the entity cannot meet its obligations as they come due. The moving parties fail to produce even a scintilla of evidence that this is the case. To the contrary, Attachment F containing the cited FERC Form No. 6 materials indicates that SFPP had generated some $25.38 million from net operating income and $48.94 million from deprecation in the relevant year, or a total of $74.32 million of cash flow from operations that could be used to meet its regulatory and financial obligations. Finally, the investment in SFPP's North Line in 2005[143] and the expansion of the East Line that began in 2006[144] belie the assertion that SFPP is insolvent. If any such risk was realistically present, it is difficult to see why the controlling partnership would have made such an extensive investment. The motions to escrow reparations and to investigate SFPP's financial condition are denied as untimely and unfounded on the record here.[145]

3. Indexing Procedures

102. The Protesting Parties also assert that SFPP has not established that it is entitled to index the rates established in the compliance filing to the maximum amount permitted in each year. The protests do not clearly state whether this issue is directed to both consolidated dockets involved in the March 2006 compliance filing or only to the portion dealing with Docket No. OR96-2-000, *et al.*, but in any event the result is the same.

---

[143] *Cf.* Docket No. IS05-203-000, which several shippers are contesting.

[144] *Cf.* Docket No. IS06-283-000, which shippers are also contesting.

[145] The Commission has two observations with regard to Airlines' motion to accelerate their complaint in Docket No. OR03-5-000. First, the litigation over the Watson Station Drain Dry Charges was settled by a final order of the Commission in August 2, 2006, over four months before Airlines' motion. *See ARCO Products Co., a Division of Atlantic Richfield Company, Texaco Refinery and Marketing Inc., and Mobil Oil Corporation v. SFPP, et al.*, 116 FERC ¶ 61,166 (2006). Second, the relevant complaint was filed on September of 2004. An interim, lower West Line rate has been in effect since May 1, 2006, thus providing some initial relief. Moreover, that rate is based on an indexed 1999 cost of service and the new West Line rates for that year. Thus, it was not possible to know whether reparations would be due Airlines for the two year period before and after the complaint was filed until (1) the level of the new 1999 West Line rates are known with greater certainty, and (2) legal issues regarding reparations were resolved by *ExxonMobil* on this point in Airlines' favor.

There are pending challenges to SFPP's application of the Commission's indexing methodology for the rates effective July 1, 2005, 2006, and 2007. These challenges will remain extant when the indexing methodology is applied to the revised rates required by this order. Otherwise the matter is closed for the prior years because further challenges would be out of time. For those prior years the percentage index increase that SFPP actually took will be applied to the revised rates required by this order. In this regard, the Protesting Parties assert that SFPP did not use the proper index for the years 2001 and 2002 by applying a PPI index in those years instead of PPI-1, the index they claim was in effect in those years. SFPP replies that it applied the Commission's indexing regulations in effect at the time of the December 2005 Order, as directed. The Commission clarifies that in calculating the index for each year SFPP must apply the index methodology applicable to each year.

III. Docket No. OR92-8-000, *et al.* Rulings

103. This part of the order addresses a limited number of issues still before the Commission on remand in Docket No. OR92-8-000, *et al.* from the court review resulting in *BP West Coast*, or which were raised by the parties' comments on the May 2006 compliance filing. Such matters include: (1) certain narrow aspects of the income tax allowance methodology; (2) recovery of administrative litigation costs; (3) other cost-of-service issues; and (4) the modifications to reparations. All matters regarding the Watson Station Drain Dry Charges relevant to the *BP West Coast* remand have been settled.

A. Income Taxes

104. The more generic income tax allowance issues were discussed in Part II of this order. However, there are two additional points with regard to the East Line rates addressed by Docket No. OR92-8-000, *et al*. First, to the extent the comments raise issues related to KMEP's ownership of SFPP, those comments are irrelevant to that docket since KMEP did not own SFPP during the 1994 test year. Second, the Protesting Parties assert that SFPP has not established the accuracy of its assignment of ownership units to the six categories of unit holders established by the December 2005 Order. This determination of which units were owned by corporations, and which were not, was litigated to finality in the Opinion No. 435 Orders and was not raised on appeal. Thus the matter is final. SFPP appropriately used the ownership distribution developed in the Opinion No. 435 Orders in its March 2006 compliance filing and the matter is closed.

B. Administrative Litigation Costs

105. As has been discussed, Docket No. OR92-8-000, *et al.* involved only SFPP's East and West Line rates and none of the other services that are at issue in the Docket No. OR96-2-000, *et al*. proceedings or later cases. In the Opinion No. 435 Orders, the Commission held that the complainants had not established that there were substantially

changed circumstances for the West Line for the complaints filed before August 7, 1995. For this reason the Opinion No. 435 Orders only addressed the reasonableness of SFPP's East Line rates using a 1994 test year to make that determination. Thus, only the East Line regulatory litigation costs were at issue when the Commission determined that those rates were not just and reasonable, ordered SFPP to establish new rates beginning in 1994, as indexed through August 1, 2000, and to pay reparations.

106. In the Opinion No. 435 Orders, the Commission concluded that SFPP should use the following method to recover its administrative litigation costs. First, it should calculate the total reparations that would be due for the period beginning two years before the first valid complaint for which relief was granted in those orders through August 1, 2000, the date which the Commission proposed would ultimately be the date for setting a final rate in those proceedings. SFPP was also directed to determine the difference between the total reparations pool established by that ruling and the East Line rate reparations that were actually to be due to complainants, which resulted in so-called surplus revenues. Once SFPP calculated those surplus revenues, SFPP was then required to first offset the East Line litigations costs it had incurred in the years 1994 through 1998 against the total of those surplus revenues. If any East Line administrative litigation costs remained after the offset was determined, SFPP could file to recover these through a five year surcharge.[146]

107. SFPP argued on appeal that the Commission's ruling provided benefits to shippers who were not complainants, thus violating the doctrine that reparations are limited only to shippers that had filed complaints. Noting the high level of the litigation costs involved in the proceeding, the court held that the Commission could reasonably conclude that because SFPP had reaped a windfall by charging rates in excess of those ultimately determined to be just and reasonable in the same past years for which it was claiming supplemental expenses above those actually incurred, SFPP should be required to fund its litigation expenses out of the excess revenues before beginning to charge those costs to customers anew.[147] However the court held that the Commission had not adequately explained why litigations costs should be allocated between the East and West Lines based on the relative amount of litigation involved in their respective rates. The court noted that the Commission's determination of how to allocate the litigation costs between the East and West Line rates might affect the level of any five year surcharge.[148]

---

[146] *See SFPP, L.P.*, 96 FERC ¶ 61,281 at 62,073-74 (2000) (Opinion No. 435-B) and 100 FERC ¶ 61,353 at P 9-14 (2002).

[147] BP West Coast at 1294.

[148] *Id.*

108. On remand the June 2005 Order held that the administrative litigation costs SFPP incurred in Docket No. OR92-8-000, *et al.*, must be allocated by the relative volume of the East Line rates[149] and the West Line rates during the test year. The December 2005 Order also held that the Opinion No. 435 Orders' methodology should be applied up to August 1, 2000 (*i.e.* through July 31, 2000), the point at which the new East Line rates were effective. The December 2005 Order noted that thereafter there would be no gross reparations to offset the administrative litigation costs associated with the East Line. For this reason the December 2005 Order authorized SFPP to recover any subsequent litigation costs incurred in Docket No. OR92-8-000, *et al.*, between August 1, 2000 and April 30, 2006 through a five year surcharge based on the relative test year volumes of the East and West Lines developed for the 1999 test year.[150] The more recent test year was used to assure that the costs would be allocated on the basis of the most recent volumetric information available.[151] Any surcharge was to be prospective on the May 1, 2006 effective date of the East and West Line rates required by the December 2005 Order.

109. In its comments Navajo raised two concerns regarding the calculation of the reallocated administrative litigation costs for the period before August 1, 2000. It asserts that it is unclear whether SFPP reallocated the costs correctly because certain of the costs appeared to have disappeared for the year 1993. In its reply SFPP asserts that it recalculated the administrative litigation costs appropriately based on relative volumes. SFPP provides a technical explanation that Navajo can comment on further when SFPP makes its revised compliance filing. Navajo is also concerned that East Line shippers have paid a surcharge to recover any additional administrative litigation expenses that were due from East Line shippers under the 50 percent allocation method rejected by the court. Since the December 2005 Order reduces the amount of the expenses to be paid by

---

[149] June 2005 Order at P 42-44.

[150] December 2005 Order at P 94.

[151] The Commission notes that amended complaints were filed in the Docket No. OR96-2-000, *et al.*, proceeding in January 2000 and further complaints were filed against all of SFPP rates in August 2000 and consolidated with that docket. *See ARCO Products Company, a Division of Atlantic Richfield Company, et al. v. SFPP, L.P.*, 92 FERC ¶ 61,244 (2000). By that date SFPP had completed two rounds of compliance filings with the Opinion No. 435 Orders (Opinion No. 435-A, 91 FERC ¶ 61,135 (May 17, 2000)) and 92 FERC ¶ 61,166 (August 16, 2000)). Thus, this complex litigation involving SFPP was increasingly focused on all of SFPP rates, or in the appellate phase, issues that applied to all rates. Thus, the broader cost allocation method adopted here is appropriate.

the East Line shippers, refunds may be due for any surcharges paid under the Opinion No. 435 Orders. SFPP must explain the amount of the surcharges that were collected through the five year surcharge adopted by those orders and whether the revised allocation includes a related determination of any refunds that may be due.

110. SFPP's March 2006 compliance filing provides the required schedules for the administrative litigation costs in the OR92-8-000, *et al.*, consolidated proceeding by showing the total costs by year and the allocating those costs between the East and West Lines. The compliance filing properly uses the 1994 cost of service volumetric ratio through 1998 and the 1999 volumetric ratio thereafter. The filing also demonstrates that SFPP continued to incur litigation costs in this consolidated docket in the early part of 2006[152] and undoubtedly continued to do so in defending its 2006 compliance filing and the appellate litigation in *ExxonMobil*. The compliance filing further demonstrates the incorrectness of the December 2005 Order's conclusion that reparations would not be available to offset administrative litigation costs after July 31, 2000. In fact, the additional costs from 1999 through early 2006 were not enough to exhaust the surplus revenues generated by the gross reparations pool that was accumulated through July 31, 2000. Given the continuing nature of the litigation and the mitigating purpose of the reparations pool, the Commission will modify the December 2005 Order as follows. First, SFPP shall update its accumulated administrative litigation costs through December 31, 2006, a logical calendar year breakpoint given the status of the litigation as of the December 31, 2006.[153] It must then recalculate the surplus reparations in light of the changes in the 1994, 1997 and 1999 cost-of-services that are required here and determine whether a surcharge is necessary to recovery its administrative litigation costs in Docket No. OR92-8-000, *et al*. through December 31, 2006. Any such surcharge will be effective prospectively on the same day as the revised rates required here.

C. Other Cost of Service Issues

111. The remaining cost of service issues on remand were the recovery of SFPP's East Line reconditioning costs and the design of the turbine fuel rates. The June 2005 Order concluded that the East Line reconditioning costs were subsumed by SFPP's use of the annual indexing method for recovering cost increases, since SFPP did not provide adequate test period information in that regard. As such, these costs could not be

[152] See Tab A, Schedule 33 of the 1994 test year filing.

[153] This includes the first part of the compliance phase and the briefing and oral argument on the appeals of the March 2004 and June 2005 Orders.

recovered through a separate cost factor.[154] There were no rehearing requests filed in this regard and the Commission considers that matter closed.

112. The West Line turbine fuel rates were remanded on the ground that the Commission improperly concluded that those rates were grandfathered. The June 2005 Order did not institute a separate proceeding regarding those rates because of the very small volume transported during the 1994 test year but deferred that issue as a subset of the more general litigation involving the West Line rates.[155] The December 2005 Order first held that the Opinion No. 435 Orders adequately allocated costs of the 1994 cost-of-service between the East and West lines and that certain technical matters related to the West Line cost-of-service were not challenged. The Commission therefore directly SFPP to use the 1994 West Line cost-of-service and to allocate costs to the West Line turbine fuel based on relative volumes. The rate was to be indexed forward to December 31, 1998, and thereafter the rate would be subsumed within the 1999 West Line rate cost-of-service developed in Docket No. OR96-2-000, *et al.*[156] The Protesting Parties April 2006 comments did not challenge this approach. The Commission will affirm the methodology previously used subject to corrections to the 1994 cost-of-service required by this order.

113. In addition, the Protesting Parties in their April 2006 comments seek to extend the *HIOS* equity cost-of-capital issue to new rates developed in this docket. The matter was not an issue at hearing on the 1994 test year and there is no contemporaneous record on the point since all parties accepted the use of a partnership based proxy group. As such, the matter is out of time in the context of this compliance filing. As with Docket No. OR92-8-000, *et al.*, the Commission again concludes that it is more important to bring this litigation to a close rather than to reopen the record for further litigation on the equity cost of capital issue. This is particularly true for the 1994 test year since SFPP was not a master limited partnership at the time and its income per unit substantially exceeded its distributions per unit in that year.[157] Therefore SFPP will continue to use the equity cost

---

[154] June 2005 Order at P 45-51.

[155] *Id.* at P 75.

[156] December 2005 Order at PP 106-08. The February 2006 Order clarified that beginning January 1, 1999, the 1999 test year volumes would be used to design the West Line turbine fuel rate. *See SFPP, L.P*, 114 FERC ¶ 61,136 at P 22 (2006).

[157] *See* Ex. No. SEP SFPP-58 at page 110 of 127 filed in Docket No. OR96-2-012, *et al.*, which is expressly incorporated herein.

of capital developed for the test year 1994 in its Docket No. OR92-8-000, *et al.*, revised compliance filing.

IV. Docket No. OR96-2-000, *et al*

114. The issues addressed here include: (1) the recovery of administrative litigation costs; (2) certain rate base issues; (3) certain narrow points involving the equity cost of capital; (4) the allocation of overhead costs; (5) ADIT; and (6) recovery of Arizona right-of-way taxes. The income tax allowance issues were fully addressed earlier in the order.

A. Litigation Expenses

115. The litigation in Docket No. OR96-2-000, *et al.*, involved numerous complaints against six of SFPP's services: the West, East, North, Oregon and Sepulveda Line rates, and the Watson Station Drain Dry charges. These consolidated complaints were filed at different times[158] and as the litigation advanced different procedural schedules developed depending on the service and issues involved. For this reason the December 2005 Order required that the administrative litigation costs incurred in that docket be allocated among SFPP's West, East, North and Oregon Lines based on the relative volumes of those services in the 1999 test year cost of service. The Commission also held that any recovery of the Sepulveda Line litigation costs and those for the Watson Station Drain Dry Charges would be addressed in the severed proceedings for those rates and charges.[159] The Commission applied its Opinion No. 435 method for the recovery of litigation costs to the complaints against the West Line in Docket No. OR96-2-000, *et al*., but did not extend that methodology to administrative litigation costs related to the East Line rates for complaints filed after 1999. The Commission did so because it held that reparations would not be due under those complaints because the rates at issue would be *Arizona Grocery* rates effective August 1, 2000 once a final decision was rendered.

116. Joint Shippers filed a rehearing request of the December 2005 Order arguing that the Commission erred in permitting SFPP to recover by means of a surcharge the East Line administrative litigation costs incurred after the 1999 test period. They asserted that the Commission had established new final rates for the East Line as of August 1, 2000. They also argued that since the Commission held that these rates could only be changed prospectively under *Arizona Grocery*, the imposition of a prospective surcharge violated the test period concept of rate making and the filed rate doctrine. On February 13, 2006,

---

[158] *Cf. ARCO Products Company, a Division of Atlantic Richfield Company, et al. v. SFPP, L.P.*, 92 FERC ¶ 61,244 (2000).

[159] December 2005 Order at P 95-96.

the Commission issued an order rejecting this analysis. The Commission held that it was unreasonable to deny SFPP a means to recover its post-test period litigation costs when the Commission had refused to include in the new East Line rates a cost factor that would afford SFPP an opportunity to do so. The Commission held that its ruling did not violate the filed rate doctrine because (1) shippers were on notice that administrative litigation costs would be recovered by means of a surcharge, and (2) the Commission was not modifying the newly established East Line rates by changing their rate design. Rather, the Commission was seeking to exclude what would be an unpredictable non-recurring cost from being embedded in the East Line rates. In addition, the Commission amended the Opinion No. 435 Orders that were before it on remand to make clear its intentions.[160]

117. *ExxonMobil* held that the East Line rates at issue were not *Arizona Grocery* rates, and as such they are still before the Commission for final action at this time.[161] This materially changes the context of the arguments addressed by the February 2006 Order. First, since reparations may be due under the various complaints up to May 6, 2006, the date of the latest interim rates, the methodology adopted in the Opinion No. 435 Orders for the recovery of administrative litigation costs may now, and will be, applied through that date. Thus, SFPP must calculate the total reparations that would have been due under the 1997 and 1999 cost of services required in Docket No. OR96-2-000 *et al.* Thus, for the shippers that had filed complaints in those periods, SFPP must apply that approach to the East Line rates as well as the West Line rates and determine the difference. If the offsetting methodology fails to recover SFPP's additional East Line administrative litigation costs through December 31, 2006, it may propose a five year surcharge to recovery the remaining costs on a going forward basis, effective the same day as the revised rates required by this order. The conclusion here nullifies one ruling in the February 2006 Order. That order adopted Shipper Protestant's suggestion that if the indexed East Line *Arizona Grocery* rates for the same period exceeded the indexed East Line 1999 rates for the same period, the difference should be applied to the East Line administrative litigation costs incurred in Docket No. OR96-2-000, *et al.* This no longer applies as the rate floor concept applied by that case to the East Line rates was rejected in *ExxonMobil*.

118. To assure there is no misunderstanding, the Commission further explains that the use of a prospective surcharge to recover administrative litigation costs incurred in response to a complaint is consistent with Commission practice even if the surcharge becomes effective after those costs were incurred. In *Tarpon Transmission Company*[162]

---

[160] *See SFPP, L.P.*, 114 FERC ¶ 61,136 at PP 3-11 (2006).

[161] *BP West Coast* at 1293-94.

[162] *Tarpon Transmission Company*, 58 FERC ¶ 61,354 at 62,181-84 (1994).

the Commission permitted Tarpon to recover some $2 million in non-recurring administrative litigation costs by means of surcharge. *Tarpon* contains an extensive discussion of the difference between recurring and non-recurring costs and concludes that the use of the surcharge to recover even deferred litigation costs is appropriate because these costs were incurred in the design of future, not past, rates.[163] Moreover, Tarpon was permitted to develop the surcharge in phases to reflect the costs incurred in the hearing, rehearing and compliance phases. The Commission is applying that precedent here. Moreover, the application of the Opinion No. 435 methodology assures that SFPP will not bill all of its administrative litigation costs through a surcharge and provides some incentive for controlling the costs it incurs in the numerous proceedings filed against it.[164]

119. SFPP's March 7 compliance filing for Docket No. OR96-2-000, *et al.*, separated its administrative litigation costs by providing separate costs for the West and East Lines and a combined cost for the North and Oregon Lines. No mention was made of the Sepulveda Line administrative litigation costs or those attributed to the Watson Station proceedings. The impression is that those costs were excluded from the totals on Line 1 of Page 1 of Schedule 33. While the methodology is generally correct, SFPP must clarify this point in it revised compliance filing and to make sure that any duplicate costs have been removed. Moreover, SFPP is in litigation over its North and Oregon Line rates in other dockets. To make sure there is no confusion which dockets are involved at what time, SFPP's revised compliance filing must modify Schedule 33 to show an allocation of its Docket No. OR96-2-000, *et al.* costs (exclusive of the Sepulveda Line litigation) separately to the East, West, North, and Oregon Lines and the Watson Station Drain Dry facilities.

120. Finally, further review of the March 2006 compliance filing discloses that the surplus revenues for the West Line displayed on Schedule 34 indicate a substantial over recovery of SFPP's West Line costs for the period January 1, 2000[165] through early 2006 even after the payment of reparations and the offset of the relevant administrative litigation costs related to that docket. These remaining revenues are approximately $99 million. Thus, there were sufficient revenues in excess of the West Line cost-of-service to offset the some $11,568,421 in litigation costs that SFPP attributed to the West Line

[163] *Id.* at 61,184.

[164] *Cf. BP West Coast* at 1294.

[165] The costs before January 1, 2000, appear to be included in the total for that date. If they are not, the allocation rules should be provided for the balance of the costs incurred in the earlier period.

rates in Docket No. OR92-8-000, *et al.*[166] SFPP should have had no difficulty recovering all of its West Line litigation costs (exclusive of Watson Station or the Sepulveda Line) regardless of the consolidated docket in which the West Line administrative costs were incurred. As in Docket No. OR92-8-000, *et al.*, the relevant costs should be updated through December 31, 2006, with any additional costs to be addressed in future orders.

B. Rate Base Issues

121. SFPP used the Opinion No. 154-B oil pipeline rate making methodology in preparing its compliance filing. That methodology includes a starting rate base for the pipeline that reflects the change from the former Interstate Commerce Commission's method for determining carrier rate base to that adopted by the Commission in 1984. The starting rate base includes a write up above book value that reflects the difference between the two methodologies and is designed to cushion the transition from the higher valuation method used by the ICC to the lower one adopted by this Commission. The amortization period for the starting rate base premium is the remaining useful life of the pipeline's asset base when authority over oil pipeline rates was transferred to the Commission. The formula starts with the remaining life of the carrier's property on December 31, 1983, based on the ratio of net carrier property to gross carrier property as divided by the carrier's composite depreciation rate for 1984.[167] SFPP used an amortization rate of 20.9 years in its compliance filing. SFPP also include the deferred equity return component of the rate base required by the Opinion No. 154-B methodology. This part of the methodology defers the inflation component of the return

[166] *See* March 2006 compliance filing, 1994 cost of service, Tab A, Schedule 33, page 1 of 2.

[167] *SFPP, L.P.*, 96 FERC ¶ 61,281 at 62,076 (2001).

on equity by accruing this cost component and amortizing it based on the composite depreciation rate of the assets to which it applies.[168]

122. The Airlines object to SFPP's selection of 20.9 years as the remaining life of the starting rate base, asserting that SFPP should have used an 18.85 year figure, which they assert is analogous to the 16.8 year figure adopted for the East Line rates in the Opinion No. 435 Orders. They also assert that the deferred equity return component is an anachronism in SFPP's case and that SFPP should be required to adopt a traditional depreciation schedule in which the full equity return is applied to the rate base at the time investments in the rate base are made. They argue that the reason for the deferred equity component is to assure ease of entry by new oil pipelines entering a market. They assert that SFPP is a monopoly and an incumbent pipeline, not one that is entering a market, and as such has no need for the deferred equity component in its rates. CVV Group also asserts that SFPP used the wrong amortization period, but assert that the analogous figure is 19.4 years. Navajo has a different concern. It asserts that SFPP used the entire starting rate base write up, rather than the equity portion of the starting rate base write up, in calculating the deferred return. It asserts that this overstates the amount of the deferred return, and given the compounding effect of the deferrals, significantly increases SFPP's rate base and hence the dollar size of the equity return that would be embedded in its rates.

123. SFPP replied to both points. It states that the language previously cited reflects a literal reading of Opinion No. 435-B that is not applicable here. It states that while 1983 figures were available for the relevant rate base calculations, there was no 1983 depreciation expense available to determine the amortization period. Thus, Opinion No. 435-B used a composite 1984 depreciation rate in lieu of a 1983 depreciation rate. It asserts that a 1983 rate was developed from this proceeding and that the calculation

---

[168] Thus, for example, if the carrier makes an investment of $100, the nominal return on equity is $8, and the inflation component is $2, or twenty-five percent of the equity return, $2 is deferred and added to the rate base. A return is allowed on the deferral. In the next year an additional return of 8 percent would be added to the $2 deferral plus the equivalent of 25 percent of the rate base in effect in the second year less a partial amortization of initial deferral based on the composite depreciation rate of the assets to which the return applies. In the initial year the additional deferral and the compounding effect exceed the amortization of the deferral. However, as the rate base declines over time, the amount of the deferred equity and the compounding return decline and eventual the amortization rate exceeds the additional deferrals. At the end of the useful life of the assets the deferred equity component is eliminated. In theory the carrier's total return is the same as a method based on a full equity return on the rate base in the initial years.

establishing that rate is unchallenged. It asserts that the proper protocol is to apply a 1983 depreciation rate to a 1983 rate base if the relevant number is available. Finally, it asserts that Navajo misread the March 2006 compliance filing. SFPP asserts that Schedule 1 that shows for 1999 an entire starting rate base of $20,942, but that only 39.26 percent of that amount, or $8,222, is included in the rate base and in the deferred equity component. It asserts this is the method used in the Opinion No. 435 Orders and related compliance process and that it was not contested.

124. The Commission agrees that the 1983 starting rate base should be amortized using a depreciation rate for the same year if available, and that in any event, the argument is being raised for the first time in the compliance filing. It is the type of technical issue that should have been addressed at hearing and on exceptions. For this reason the Commission accepts SFPP's explanation on both points. Finally, the Commission rejects Airlines argument that the starting rate base methodology should be not be applied to SFPP. SFPP may face only limited prospects of competition at this point and for most of its assets is the incumbent firm. However, deferred equity component methodology is now applied uniformly across the oil pipeline industry and consistency of regulation advances the regulatory simplification goals of the EPAct of 1992 by reducing potential litigation regarding possible exceptions to that methodology.

C. Equity Cost of Capital

125. Four equity cost of capital issues were raised by the comments on the compliance filing relevant to Docket No. OR96-2-000, *et al.* The first is that the Commission should apply the *HIOS* standards to this proceeding. The Commission addressed this contention above and declined to do so. Second, the Protesting Parties point to a computation error in the Commission's December 2005 Order which overstated the equity cost of capital to be used by 1 percent. This is correct and SFPP should have made the adjustment in its compliance filing and noted the error accordingly rather than waiting for the opposing parties to force the correction. A third comment asserts that SFPP should be placed at the middle or the lower range of reasonableness on the grounds that it has less than average risk. The December 2005 Order concluded that the Shipper Protesting Parties had not established that SFPP's risk was sufficiently less than oil pipelines as a group, and therefore concluded that the use of the median cost of equity capital was appropriate. This finding was reflected that in the fact that there has been little change in SFPP's operations and competitive position since the Commission's similar determination in the Opinion No. 435 Orders. The December 2005 Order also explained that any party arguing that the pipeline at issue does not fall within the wide range of risk must demonstrate exceptional reasons why this is so. Protesting Parties failed to do so at hearing and any additional efforts to do so in a compliance phase are inappropriate. The December 2005 Order is affirmed.

126. Fourth, Navajo asserts that SFPP did not comply with the December 2005 Order's instructions to remove the PAA from the 1999 cost of service. It asserts that the December 2005 Order requires SFPP to keep a separate set of books for regulatory costs and to document how it adjusted its 1999 cost-of-service to reflect removal of the PAA. Navajo asserts that SFPP provided no proof that it has a separate set of books and did not address in detail how the PAA was removed. SFPP did not file with the Commission a "second set of books," but it did remove some $973 million from its equity side of its 1999 balance sheet in making the compliance filing. This achieves the goal of the December 2005 Order regardless of whether SFPP proves that it established a separate set of accounts for rate making purposes. However, when SFPP makes its new compliance filing it must provide a marked-up copy of its 1999 FERC Form No. 6 report displaying the adjustments made pursuant to the Commission's directives in the December 2005 Order.

D. Allocation of Overhead and Common Expenses

127. In its compliance filing SFPP allocated overhead and common expenses among KMEP's various subsidiaries and affiliates using the *Massachusetts* formula. It also allocated overhead costs between SFPP's jurisdictional and non-jurisdictional services using the *KN* formula. Both methods are required by the Commission. However the Protesting Parties assert that SFPP improperly applied both methods.

1. The *Massachusetts* Formula

128. The *Massachusetts* formula is used to allocate residual overhead costs among subsidiary and affiliated firms when the parent company cannot directly assign those costs to a specific subsidiary or affiliate. The December 2005 Order affirmed the ALJ's conclusions and required SFPP to include Red Lightning Energy Services (Red Lightning), Plantation Pipeline Company (Plantation), Kinder Morgan Interstate Gas Transmission (KMIGT), and Trailblazer Pipeline Company (Trailblazer) in the cost allocation process. While SFPP later admitted that there was no legal basis to exclude Red Lightning,[169] it requested rehearing of the December 2005 Order arguing that the exclusion of Trailblazer, KMIGT, and Plantation is appropriate. It asserted that it excluded Trailblazer because a separate partnership owns the pipeline and because Trailblazer separately reimburses KMI for the corporate overhead costs associated with

[169] *See* Tr. 6616-6617, where SFPP admits that GP Inc., KMEP's general partner, performs oversight and support activities for Red Lightning.

its operation of the pipeline[170] and KMIGT because it is operated by KMI.[171] SFPP also excluded Plantation because it is a stand-alone operating company with its own employees and management group.[172]

129. SFPP further argued that including these entities in the *Massachusetts* formula would foil the proper functioning of the allocation. It claimed there are operations and reimbursement agreements between KMI and these entities, indicating that KMEP separately reimburses KMI for the overhead costs associated with its operation of the pipelines. Since these corporate overhead expenses are paid separately and independently of the *Massachusetts* formula allocation, SFPP insists that including these entities results in two errors. First, SFPP claims that the expenses of Plantation, Trailblazer, and KMIGT would be reimbursed twice, once through the direct payment of their administrative costs and additionally through their allocated share under the *Massachusetts* formula. Second, if it includes the three subsidiaries, SFPP argues that this understates the pool of corporate overhead expenses requiring allocation because it does not reflect the overhead costs assigned to these subsidiaries through the separate agreements that are outside of the *Massachusetts* formula for allocating indirect costs. The February 13, 2006 Order granted rehearing, concluding that Plantation, KMIGT and Trailblazer could be excluded from the formula but stating that "[w]hile SFPP's proof was only marginally adequate" on the overhead cost allocation issue, its argument was reasonable.[173]

130. Ultramar and Tosco Corporation filed a joint request for rehearing of the Commission's February 13 Order. They assert that the record evidence in this proceeding establishes that KMEP actively oversees and exercises managerial control over each of the subsidiaries and there are common indirect costs allocated to these companies in the exercise of those management functions. Thus, SFPP must include the subsidiaries (*i.e.*, Plantation, Trailblazer, and KMIGT) in the *Massachusetts* formula to properly allocate corporate overhead, consistent with Commission precedent. They point to the record in this proceeding and argue that SFPP failed to provide any documentary evidence to support the existence of the management relationships or an alleged 2000 Operations and Reimbursement Agreement between KMI and KMIGT.

---

[170] *Citing* Ex. SFPP-84 at 2 (see note); Tr. 6615:14-19.

[171] *Citing* Ex. SFPP-84 at 2 (see note); TR. 6615:14-20.

[172] *Citing* Tr. 6600:2/6.

[173] February 2006 Order at P 18.

131. Regarding Plantation, Ultramar, and Tosco refer to Plantation's 1999 FERC Form No. 6, which shows that KMEP held at least 50 percent of the Board of Director's positions evidencing KMEP's level of managerial responsibility of Plantation. Citing to *Williams*, they argue that the Commission has held that "where directors and officers are responsible for the activities of an entity, that entity is properly included in the general allocation of corporate overhead costs."[174] They state that the Commission also held that "a stand-alone company does not in itself lead to the conclusion that the entity does not benefit from the activities of the corporate parent."[175] They point to record evidence that establishes that Plantation benefits from KMEP's corporate overhead service activities with respect to its board of directors, financial statement responsibilities, and accounting and treasury functions which manage Plantation-related revenues.[176]

132. Ultramar and Tosco assert that Trailblazer also benefited from the actions of KMEP's services during the test period. They claim that Trailblazer is 66.66 percent owned by Kinder Morgan Operating L.P. "A" (KMOLP-A), an intermediate operating partnership which, in turn, is wholly owned by KMEP, and that KMEP's consolidated financial statements for 1999 list approximately $30.0 million of Trailblazer-related facilities as the debt of KMEP.[177] Further, they note that it is undisputed that Trailblazer had no employees in 1999,[178] that KMOLP-A, the next entity up the ownership chain from Trailblazer, had no employees in 1999,[179] and that KMEP included information regarding Trailblazer's financial results in its own consolidated financial statement for calendar year 1999. Ultramar and Tosco contend that the preparation of such consolidated financial statement necessarily requires KMEP corporate overhead activities and involves KMEP's financial reporting group.[180] Ultramar and Tosco also point to

---

[174] *Citing Williams Natural Gas Co.*, 85 FERC ¶ 61,285 at 62,140 (1998), *quoting Northwest Pipeline Corp.,* 71 FERC ¶ 61,253 at 61,985 (1995).

[175] *Id*. at 62,140-141.

[176] *Citing* UIT-1122 at 5 of 5; UIT-96 at SF-167682.

[177] *Citing* Ex. 342 at SF-0044877.

[178] *Citing* Trailblazer's 1999 FERC Form No. 2 at page 122.2, attached as Appendix B to the rehearing request.

[179] *Citing* KMOLP-A's 1999 FERC Form No. 6 at page 351, attached as Appendix C to the rehearing request.

[180] *Citing* Ex. SFPP-342 at SF-0044853.

KMEP's 1999 Form 10-K filed with the Securities and Exchange Commission, which shows KMEP's active involvement in the management of Trailblazer;[181] as well as KMEP's 1999 annual report which shows that KMEP, and not a third-party, sought to expand the Trailblazer pipeline, and that KMEP actively engaged in obtaining commitments for additional capacity on behalf of the pipelines.[182] They argue that the record thus substantiates that Trailblazer was much more than a "marginal activity subsidiary" for KMEP in 1999, that Trailblazer benefited from KMEP's corporate overhead services and incurred KMEP corporate overhead costs in 1999, and that Trailblazer meets the *Williams* standard for inclusion in the *Massachusetts* formula.[183]

133. They likewise assert that SFPP should include KMIGT in its *Massachusetts* formula allocation for corporate overhead costs. Citing to the Phase II ID, U-T notes that the ALJ held that SFPP should include KMIGT in the allocation formula because: (1) in 1999, KMEP held a majority ownership interest in KMIGT;[184](2) although SFPP attempted to claim that KMI operated KMIGT under an agreement, the only agreement submitted in support of this claim (the Operations and Reimbursements Agreement by and between KMI and KMIGT), failed to negate the argument that KMEP provides corporate and managerial oversight and support services for KMIGT.[185]

134. The Commission first reiterates that it uses the *Massachusetts* formula to allocate residual overhead costs among subsidiary companies when the parent company cannot directly assign those costs to a specific subsidiary. Direct costs are costs that the parent

---

[181] *Citing* Ex. UIT-59 at SF-110286, where KMEP states that it owns 66.66 percent of Trailblazer with the remaining 33.33 percent owned by a subsidiary of Enron Corporation, and that a committee consisting of representatives for each of the partners manages Trailblazer.

[182] *Citing* Ex. SFPP-342 at SF-0044842.

[183] *Id.* at 62,137.

[184] *Citing* Ex. SFPP-84, at 2; *also* Ex. SFPP-342 at SF-0044841.

[185] *Citing* Ex. SFPP-349, *e.g.*, section 2.1(e) of the 2000 O&R Agreement, which requires KMI as "Operator" to obtain approval of the "owner" before undertaking certain actions, including approval of permanent assignments of capacity, consenting to the amendment of such agreements, or filing any agreement at FERC. This agreement also reserved to the "Owner", management and decision-making responsibilities concerning annual operating and capital expenditure budgets. *Citing* Ex. SFPP-349 at sections 3.1 and 3.2.

company can specifically identify and directly assign to the subsidiary that incurred the costs. Such direct-billed corporate services are not considered in the allocation process. In a rate proceeding, the burden is on the pipeline to prove the legitimacy of claimed overhead costs by identifying the shared service(s) rendered by the parent, verifying the related cost(s), and showing the direct-billed costs and the residual costs. Based on its further review of the pleadings and record, the Commission again concludes that SFPP failed to provide the necessary documentation to verify the total amount of overhead costs that KMI direct-billed to KMIGT, Plantation, and Trailblazer and the remaining amount for allocation among the subsidiaries. SFPP admits to a level of shared services that are provided by KMI on behalf of those subsidiaries, but does not quantify the amount of those residual costs. Even if KMEP's employees only expended 5 percent of their time on any of the three noted subsidiaries, under *Williams* such an insignificant amount does not preclude the subsidiaries from paying their portion of the shared services.[186] Further, SFPP's overhead costs and allocation method are obscured by inconsistencies in its testimony regarding its affiliates' data. To avoid the possibility that some unallocated costs may have been excluded by SFPP, the Commission adopts here the conclusions of the December 2005 Order. Therefore the Commission reverses the holding of the February 2006 Order and requires SFPP to include Plantation, KMIGT, and Trailblazer in calculating its allocation of overhead costs.[187]

2. The *KN* Formula

135. The *KN* formula is used to allocate common costs between the jurisdictional and non-jurisdictional operations of the jurisdictional entity whose rates are under review. The formula operates by allocating labor and plant costs based on the relative percentages of the jurisdictional and non-jurisdictional operations and plant. In this case, SFPP allocates costs between its carrier and non-carrier functions. Protesting Parties assert that SFPP improperly applied the formula by using the average of the beginning-of-year and the end-of-year balances and by combining the labor gross plant and labor percentages in contravention of Commission policy. Protesting Parties assert that the December 16 Order explicitly required SFPP to separate the direct labor and the direct plant percentages.[188] Navajo asserts that SFPP should allocate only on the property factor because the direct labor component is unreliable. Navajo's argument parallels the ALJ's

[186] *Williams Natural Gas Co.*, 85 FERC ¶ 61,285 at 62,136-62,137 (1998) (the Commission found that, even if the parent company's employees only expended 5 percent of their time on a subsidiary, such an insignificant amount of time should not be ignored for cost allocation purposes.).

[187] As noted above, SFPP agreed to include Red Lightning in its Mass Formula.

[188] *Citing* December 2006 Order at P 89.

criticisms of the 1994 cost-of-service study. Navajo further contends, and Western Refinery agrees, that SFPP's use of a simple combined average over allocates costs to the East Line. SFPP concludes that SFPP should be required to revise its compliance filing to separately allocate indirect property and labor costs, as directed in the Commission's December 16, 2005 Order. If SFPP is unable to do so, Navajo asks that the Commission direct SFPP to allocate those costs based on the weighted average of the gross property and direct labor factors, not the simple average.

136. SFPP replied that its use of the average of the beginning-of-year and the end-of-year balances for the 1999 cost-of-service is consistent with the 1994 KN formula used throughout the Opinion No. 435 compliance filings. It further argues that it properly used the labor-only and plant-only method and that the sub-accounts are no longer relevant for some of these accounts after 1998, because the relevant overhead expenses are allocated using the *Massachusetts* formula. As for the reliability of the labor data, SFPP notes that its 1999 data was not challenged at hearing and that Navajo's argument turns solely on 1994 data. It further asserts that if Navajo was dissatisfied with the treatment of this issue by the Commission's December 2005 Order, Navajo should have sought rehearing on this issue or appealed to federal court.

137. The Commission agrees with SFPP, that Navajo should have raised its arguments on this issue on rehearing of the December 2005 Order. However, Navajo's failure to request rehearing does not abrogate the Commission's findings in the December 2005 Order. The December 2005 Order specifically rejected SFPP's use of a combined labor and plant ratio to allocate A&G costs between its carrier and non-carrier functions, and directed SFPP to recalculate its KN allocation formula consistent with Staff's adopted allocation procedures. The December 2005 Order also required SFPP to document its compliance with the Commission's finding. As noted by Navajo, SFPP continues to incorrectly use average plant and labor ratios, which results in erroneous carrier/non-carrier allocation factors.

138. Further, SFPP continues to rely upon the 1994 KN formula used throughout the Opinion No. 435 compliance filings to calculate its carrier/non-carrier allocation factors. Navajo contends that SFPP's use of the 1994 KN formula is contrary to the ALJ's rejection of that formula in SFPP's earlier OR92-8 rate case. SFPP asserts that the ALJ's ruling applied to allocating corporate overhead and addressed whether the study supported the allocations for various corporate departments. SFPP states that the use of direct labor at joint-use facilities was not at issue.

139. The Commission finds SFPP's interpretation of the ALJ's ruling in OR92-8 inaccurate. The ALJ specifically stated that SFPP's methodology to allocate overhead or corporate unallocated costs between SFPP's carrier and non-carrier operations, was

flawed.[189] As noted in that proceeding, SFPP's actual business record allocations were not in the evidentiary record and were not audited. The Commission finds 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, the Commission reiterates its finding in the December 2005 Order requiring 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.

E. ADIT

140. SFPP included in all of its cost-of-services an allowance for deferred income taxes (ADIT). ADIT arises when the jurisdictional pipeline uses an accelerated depreciation or amortization method for income tax purposes that varies from the Commission's straight line methodology. For example, if the pipeline accelerates depreciation, this increases operating expenses in the early years of an investment and reduces the carrier's income and the tax liability that is incurred in that year for IRS purposes. However, the income tax allowance embedded in the carrier's rates is constant and therefore that particular year would generate more cash flow than is actually required to meet the income tax liability created by the carrier's IRS income. The results in an income tax deferral until the rate base declines to a point where the depreciation rate in later years is less than the regulatory rate, at which time there is more IRS income than income under the Commission's accounting methodology. At that point the income tax deferral is amortized as the income tax payments accelerate. The Commission requires the carrier to reduce its rate base by the amount of the deferred tax income liability to recapture the additional return the carrier can earn on the cash generated by the deferred income tax liability.

141. Protesting Parties make several arguments regarding SFPP's calculation of ADIT. First, as noted, they argue there should be no ADIT because the partnership does not pay taxes. This point was resolved by *ExxonMobil* in that the partners' marginal tax rate is imputed to the partnership. This rate becomes the basis for determining the tax component of the ADIT calculation. Indicated Shippers further argues that there must be an adjustment of SFPP's accrued ADIT account and a full accounting of the amount. These two arguments assume that a partnership does not pay taxes and therefore a partnership should have not ADIT. This matter has been resolved by *ExxonMobil* and there is no need to pursue these two subsidiary issues. SFPP's reply is similar to this ruling.

142. CVV Group advances a more substantive concern. They assert that the calculation for ADIT should begin in 1995, not 1992, the year SFPP used. They cite Opinion No.

[189] *See* 80 FERC ¶ 63,014 at 65,148.

495 for the proposition that the Commission's practice is to apply the policy in effect in the year the decision was made and to apply that policy to the time frame in which the case applies. They assert that the time frame is 1995, the year in which the first complaints were filed against the West Line rates at issue. They further assert that in preparing the ADIT calculation, SFPP erred by adjusting the calculation to reflect a different income tax allowance factor for each year for which the calculation is performed. They refer to Mr. O'Loughlin's testimony for the proposition that the tax component of the ADIT calculation should be based on the 1995 and 1999 cost-of-services in the record and held constant in the intervening years. They assert that the tax allowance in the rates does not vary from year to year and that the tax rate used in the ADIT calculation should be consistent. Finally, they assert SFPP's ADIT amortization model does not appear to properly track the actual depreciation of the related underlying assets and that fully depreciated assets are being improperly included in the ADIT rate.

143. SFPP replied that it properly applied the ADIT calculation by beginning the calculation in 1992, the first year in which complaints were filed. It further argues that the West Line ADIT model for 1994 is relevant to the current proceedings and was applied in Docket No. OR92-8-000, *et al.* SFPP also argues that Chevron *et al.* suggestion not to change the income tax allowance component of the ADIT is inconsistent with the annual change to the cost of capital component, which reflects the standard convention, as are annual additions to property or changes in the depreciation rate. Finally, it asserts that criticism of the depreciation and amortization schedules inside the model are too vague to be credible and that shippers had almost two months to review the calculations. In light of a lack of any specific allegation of error and the fact that Chevron *et al.* has access to all the relevant data, SFPP claims its calculations should be accepted.

144. The Commission concludes that SFPP properly used 1992 as the basis for determining its ADIT calculations. Prior to 1992 SFPP would have included a full income tax allowance marginal tax rate in its ADIT calculations. However, in 1992, the first year of the series of complaints at issue, the Commission applied its *Lakehead* income tax allowance methodology, the policy in effect at the time the Opinion No. 435 Orders were adopted. The *Lakehead* methodology was rejected by *BP West Coast Products* and was overruled by the *Policy Statement*. Given this, all ADIT calculations previously performed by SFPP for the period beginning in 1992 were invalid and the Commission's current policy is to be applied as of that year on a going forward basis. Having incorrectly applied *Lakehead* to the complaints filed in 1992, the Commission corrected that error by applying its current policy to that year in the December 2005 order. The ADIT calculation covers a continuous span of years and should be applied consistently in the subsequent years, including 1995. SFPP was correct to begin the revised ADIT in 1992 and to carry it forward. The Commission also agrees that SFPP's annual adjustment to the income tax allowance component of the ADIT account is consistent with the annual adjustment to the other factors. It further concludes that the

criticism of the depreciation schedules is too vague to pursue further here and can be further addressed in the context of the revised compliance filing required here.

F. Right-of-Way Expenses

145. SFPP incurs expenses related to the right-of-way on which its pipeline is located. While some expenses such as state real estate taxes can be allocated between different portions of the right-of-way based on location, the allocation of the rent SFPP pays the Union Pacific Railroad is contested here. For the 1999 test year SFPP's compliance filing based the allocation on mileage alone. The ALJ adopted a method based on relative valuation of the land through which the right-of-way passes. Western Refinery and Navajo protest SFPP's use of the mileage factor, arguing that SFPP did not except to the ALJ's determination in this regard, and Navajo asserts that SFPP in fact accepted the ALJ's approach. This would reduce the allocation of the rental expense to 4.8 percent of the Southern Pacific right-of-way located on the East Line. In addition, Navajo filed an exception arguing that no more than 2 percent of the rental costs should have been allocated to the East Line given recent changes in assessments and litigation about the proper value of the real estate constituting the right-of-way SFPP leases from the two railroads. Western Refinery notes that SFPP's change to a mileage-based approach increased the rental costs to the East Line by 400 percent compared the 1994 test year.

146. SFPP replies that it properly allocated expenses to the East Line. It asserts that the values urged by the commenters are based on obsolete across-the-fence values that became obsolete after the expiration of the existing rental contracts in 1994. It asserts that the values Western Refinery advances are over 20 years old and the method and the amount of litigation are in dispute in state court. It further asserts that the values advanced by Navajo are drawn from materials submitted by SFPP's opponent and are therefore unreliable.

147. The Commission concludes that SFPP must continue to use the 1994 methodology to allocate the right-of-way costs. First, SFPP did not file an exception to the ALJ's determination and is only advancing the issue in the context of a compliance filing. This is not sound practice since the arguments are only now before the Commission. It may be true that the 1994 contracts have expired and therefore the rental valuation method is in dispute. However, SFPP does not state what method was being used as an interim method during the 1999 test year. One would assume, but cannot establish, that it did not have use of the right-of-way without any form of interim payment. In the absence of such critical information in the decisional phase the Commission will uphold the ALJ's determination and not review that decision further in a compliance proceeding.

V. Further Proceedings

148. The Commission has revised certain portions of the method SFPP used to design its 1994 cost-of-service in Docket No. RP92-8-000, *et al.* and its 1999 cost-of-service in Docket No. OR98-2-000, *et al.*, as well as the reparations methodology in the December 2005 Order. Therefore SFPP must make a new compliance filing consistent with the rulings here. As such, SFPP must prepare a new 1994 cost-of-service for its East Line rates and a parallel cost of service for the West Line turbine fuel rates. Given the court's ruling on the *Arizona Grocery* doctrine, a new East Line rate must be established for 1997 using the methodology of the 1999 cost-of-service if, as the record indicates, this would have resulted in lower rates than those derived from either the 1994 or 1999 costs of service. As discussed in the reparations section, the calculation of reparations for complaints does not turn of the effective date of interim rates that are applicable to all shippers, but on the difference between the rates that were in effect on a given date and the rates determined to be appropriate for the complaint year. In addition, refunds may be due to all shippers based on the changes required here to the interim rates established by the prior orders.

149. As part of its compliance filing, SFPP must provide the supporting information to the Commission and all parties on a CD with the source calculations for any income tax allowance calculations as well as a summary of the categories established in the prior orders. Moreover, SFPP must provide the revised litigation information discussed earlier in this order with an explanation of why the costs claimed in the inter-related Docket No. OR96-2-000, *et al.* proceedings do not duplicate one another and explain how any prospective surcharge relates to the total reparations pool required by this order. SFPP must also make all work papers used to develop the revised rates available upon request and provide by sworn testimony explaining how the revised rates were developed.

150. The compliance filing and related rate filing required by this order shall be made within 45 days after this order issues.[190] Protests and comments will be due 90 days after this order issues and SFPP reply comments will be due 120 days after this order issues. SFPP's filing and all protests must be supported by affidavits to the extent any party chooses to rely on specific facts included in a filing.

The Commission orders:

(A) The requests for rehearing in the instant consolidated dockets are granted and denied for the reasons stated in the body of the order.

[190] The revised interim rates may be made effective on short notice.

(B) The comments and reply comments to SFPP's May 1, 2006 compliance filing are resolved as stated in the body of this order.

(C) Within 45 days after this order issues SFPP shall make a revised compliance filing conforming to the requirements of this order.

(D) Comments will be due within 90 days after this order issues and SFPP's reply comments will be due 120 days after this order issues.

(E) The revised interim rates required by this compliance filing will be effective as of August 1, 2000 for East Line rates based on the 1994 cost of service used in Docket No. OR92-8-000, *et al.*, and May 1, 2006 for the revised East and West Line interim rates based on the 1999 cost of service used in Docket No. OR96-2-000, *et al*. If SFPP elects to further index its East and West Line rates forward beyond May 1, 2006, those rates will be interim rates and will be effective the first day of the first full calendar month after the date of the revised compliance filing and tariff filings required by this order.

(F) All explanatory or supporting materials included in the revised compliance filing or in any comments must be supported by sworn affidavits.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.