

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

OPINION NO. 511

SFPP, L.P.

Docket No. IS08-390-002

OPINION AND ORDER ON INITIAL DECISION

(Issued February 17, 2011)

UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

SFPP, L.P.

Docket No. IS08-390-002

OPINION NO. 511

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FEDERAL ENERGY REGULATORY COMMISSION

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

SFPP, L.P.

Docket No. IS08-390-002

OPINION NO. 511

ORDER ON INITIAL DECISION

(Issued February 17, 2011)

1. This order reviews the December 2, 2009 initial decision issued in the captioned docket.<sup>1</sup> The 2009 ID addresses the reasonableness of rates that SFPP, L.P. (SFPP) filed on June 30, 2008 to increase its West Line rates. This order generally affirms the 2009 ID's conclusions regarding good-will, the allocation of costs among SFPP's affiliates and between SFPP's jurisdictional and non-jurisdictional services, and most capital structure, cost of capital and income tax allowance issues. This order also modifies the 2009 ID's findings regarding throughput, purchase accounting adjustments, the allocation of litigation costs, and some rate base and secondary cost of service issues. SFPP must file an enhanced overhead cost recovery analysis, revised tariffs, and an estimated report on refunds that are consistent with the conclusions of this order.

**I. General Background**

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

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<sup>1</sup> *SFPP, L.P.*, 129 FERC ¶ 63,020 (2009) (2009 ID).

current ceiling rates such that the ceiling rates would preclude SFPP from being able to charge just and reasonable rates. The protesting parties raised numerous issues of material fact regarding SFPP's claimed actual costs and proposed rate levels.

3. SFPP supports its proposed rate increase arguing that the rate increase responds to a decline in volumes on SFPP's West Line that are a result of a corresponding increase in throughput to Phoenix from SFPP's East Line. The East Line runs from El Paso, Texas to Phoenix, Arizona, and was expanded in two phases. The second of these was placed in service in December 2007. SFPP claims a 32 percent decrease in throughput on the West Line in the first five months of 2008, from an average of 114,120 barrels per day (bpd) to 77,810 bpd. To offset the reduced throughput, SFPP seeks the following rate increases: a 12.3 percent increase in rates for volumes from the Watson and East Hynes Stations in California to Phoenix, a 26.6 percent increase for volumes transported between Colton Transmix Facility in California to Phoenix, and a 10.6 percent increase for shipments between Watson and East Hynes Stations to an interconnection with Calnev Pipe Line L.L.C. at Colton in San Bernardino County, California.

4. SFPP calculated its cost of service for the test period at \$47,162,000. SFPP's test period revenue under its then-existing rates would have been \$41,988,000, resulting in an under-recovery of approximately \$5,174,000 or 12.3 percent. SFPP projected that the test period revenue under the proposed rates would be approximately \$47,157,000. SFPP used calendar year 2007 as the base period for actual costs, revenue, and throughput data. SFPP used the first nine months of 2008 (January through September) for the test period to adjust the base period for known and measurable changes.

5. By order issued July 29, 2008, the Commission accepted and suspended SFPP's proposed rates for the West Line to become effective August 1, 2008 subject to refund.<sup>2</sup> The issues surrounding the proposed West Line rates were set for hearing and settlement judge procedures. After settlement discussions reached a stalemate, a hearing was held in June 2009. The Presiding Administrative Law Judge (ALJ) issued the 220 page 2009 ID on December 2, 2009. The principal sections of the 2009 ID address: (1) the base and test periods, (2) allowed return, (3) income tax allowance, (4) the level and allocation of operating and maintenance expenses, (5) the throughput volume level for determining rates, and (6) classification of costs for Account No. 590. The 2009 ID concludes that the just and reasonable going-forward rates for the West Line are those rates calculated after all of the adjustments ordered by the ALJ are implemented.

6. Subsequently, the parties filed briefs on exceptions and briefs opposing exceptions. During that post-hearing briefing phase, SFPP filed a motion on February 1,

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<sup>2</sup> *SFPP, L.P.*, 124 FERC ¶ 61,103 (2008).

2010 urging the Commission to reject the ACC Shippers' and Valero's briefs on exceptions because their briefs exceed the page limits contained in the Commission's procedural regulations.<sup>3</sup> SFPP essentially argues that the ACC Shippers and Valero pursued a joint litigation strategy, including the filing of a common protest and the use of the same witnesses, such that they should be considered a single party subject to the page limitations governing briefs on exceptions. The ACC Shippers and Valero replied that regardless of whether they might have a coordinated strategy in some regards, they are nonetheless independent parties and should be treated as such for purposes of the rules. They assert that in this instance they elected to do so given the complexity of the issues and in order to specialize on the issues that they address. The Commission notes that while these parties filed joint interventions, we note that they always retain the right to take different positions as the proceeding progresses where it appears to suit their respective interests. As such, they are reasonably considered to be independent parties notwithstanding some coordination of their litigation strategies, and therefore the Commission denies SFPP's motion to strike and accepts the ACC Shippers' and Valero's briefs on exceptions. The remainder of this Order addresses (1) test year definition and throughput; (2) operating expenses; (3) the allocation of overhead costs; (4) capital structure and the cost of capital; (5) income tax allowance issues; and (6) substantial under-recovery.

## **II. Test Year Definition and Throughput**

7. The issues of test year definition and throughput were addressed as separate topics in the 2009 ID and in some of the briefs on exceptions. However, the 2009 ID selected a test period consisting of actual data from October 1, 2007, through September 30, 2008, based primarily on its reliance on the throughput levels to be adopted in this proceeding. Thus the proper throughput level and the base and test period used to determine that throughput level are inextricably intertwined, and the Commission addresses the exceptions to these issues together.

8. Section 346.2(a) of the Commission's regulations defines the base and test period for oil pipelines as follows:

- (i) A base period must consist of 12 consecutive months of actual experience. The 12 months of experience must be adjusted to eliminate nonrecurring items (except minor accounts). The filing

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<sup>3</sup> The joint interventions were under the caption of the ACV Shippers as defined in paragraph. However Valero filed a separate brief on exceptions and the remaining joint intervenors are captioned the ACC Shippers for the purpose of filing exceptions to the 2009 ID.

carrier may include appropriate normalizing adjustments in lieu of nonrecurring items.

(ii) A test period must consist of a base period adjusted for changes in revenues and costs which are known and are measurable with reasonable accuracy at the time of filing and which will become effective within nine months after the last month of available actual experience utilized in the filing. For good cause shown, the Commission may allow reasonable deviation from the prescribed test period.

In this case, the base period is from January 1, 2007, through December 31, 2007. The nine-month adjustment period for test period changes is from January 1, 2008, through September 30, 2008.

9. The 2009 ID held that all throughput and all related operational and maintenance issues<sup>4</sup> should be calculated using actual data from the 12-month period of October 1, 2007-September 30, 2008,<sup>5</sup> consisting of the last three months of the base period and the nine month adjustment period. The 2009 ID stated that using data from October 2007-September 2008 was consistent with section 346.2(a)(ii) of the regulations<sup>6</sup> and Commission precedent. The 2009 ID acknowledged that the October 1, 2007 – September 30, 2008 data included at least two months of data before the East Line expansion, which caused significant reductions in West Line volumes. However, the 2009 ID also reasoned that the January 1, 2008 – September 30, 2008 throughput data had been depressed due to the recession and was not likely to reflect future volumes. Thus, the 2009 ID concluded that use of a full 12-months of data provided a fairer representation of the factors impacting the West Line. The 2009 ID further concluded that the post-test period throughput data cited by the parties was unclear.

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<sup>4</sup> These issues include: (1) allocation factors between interstate and intrastate service and between jurisdictional and non-jurisdictional service, (2) fuel and power costs, (3) oil losses and shortages expenses and (4) appropriate allocation of expenses to interstate and intrastate service.

<sup>5</sup> 2009 ID, 129 FERC ¶ 63,020, at P 601-612, 854-860.

<sup>6</sup> 18 C.F.R. § 346.2(a)(ii) (2010).



## A. Exceptions

### 1. SFPP

10. SFPP asserts that the Commission should use throughput from the base period of 2007, adjusting throughput levels for deliveries to Phoenix by using annualized data for the five month period of January 1, 2008, through May 30, 2008. SFPP proposes this adjustment due to a 32 percent reduction in volumes on the West Line to Phoenix that occurred following the East Line expansion. SFPP states that its proposal complies with Commission regulations because it contains “known and measurable changes at the time of filing” which would “become effective within nine months after the last month of available actual experience utilized in the filing.”<sup>7</sup> SFPP therefore concludes that the 2009 ID is inconsistent with the Commission’s test period regulations. First, SFPP asserts that the regulations only allow deviations from base period data for known and measurable changes, and that, although the East Line expansion produced a known and measurable change for volumes to Phoenix, the other destinations on the West Line were not subject to this same known and measurable change. Second, SFPP asserts that by incorporating actual data for 2008 that became available only after SFPP’s filing, the 2009 ID violated the regulatory provision that requires all adjustments to be “known and measurable” at the time of filing.

11. In addition to criticizing the 2009 ID’s application of the Commission’s test period regulations, SFPP contests the 2009 ID’s determination that the 12-month actual data for October 2007-September 2008 is a “more representative sampling” than the throughput level proposed by SFPP. As factual support, SFPP asserts that the West Line’s actual deliveries during the nine-month adjustment period January 1, 2008 through September 30, 2008 were within one percent of SFPP’s proposed throughput. SFPP had proposed a throughput level of 196,951 bpd<sup>8</sup> and the West Line actually delivered 198,321 bpd<sup>9</sup> during that nine-month adjustment period.

12. If data outside the test period is considered, SFPP acknowledges that deliveries to Phoenix were higher during the first part of 2009 than SFPP’s proposed throughput levels. However, SFPP asserts that this was because Flying J, Inc. (“Flying J”), the then parent company of Longhorn Pipeline (“Longhorn”) filed for bankruptcy in December of 2008. SFPP contends that in order to avoid Longhorn, which is a feeder pipeline into the East Line, shippers began transporting more volumes to Phoenix via the West Line.

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<sup>7</sup> SFPP Brief on Ex. at 39 (quoting 18 C.F.R. § 346.2(a)(1)(i)-(ii) (2010)).

<sup>8</sup> *Id.* at 40 (citing Ex. SFP-57 at 120).

<sup>9</sup> *Id.* (citing Ex. ACV-235HC at 3).

SFPP avers that after Flying J announced on June 19, 2009 that it had acquired a stalking horse bidder for Longhorn, West Line throughput returned to the levels consistent with SFPP's proposal. SFPP further asserts that the throughput level adopted by the 2009 ID (using throughput from October 1, 2007 – September 30, 2008) incorporated three months of data in its test period before the East Line expansion becoming fully operational.<sup>10</sup>

13. SFPP also asserts that because the East Line expansion caused a 32 percent decline in West Line volumes, these months are not representative of SFPP's future volume levels. SFPP also objects to the 2009 ID's proposal to depart from the 2007 base period data for all throughput, not just the throughput to Phoenix. For the other three interstate West Line destinations (Calnev, Luke, and Yuma), SFPP proposes to use the actual, unadjusted 2007 base period volumes to represent its 2007 base period volume levels. SFPP explains that it only adjusted Phoenix volumes because the East Line expansion only affected Phoenix deliveries and no structural changes occurred affecting future throughput to other destinations. Moreover, SFPP notes that at the time of the West Line tariff filing, the West Line's average daily deliveries to locations other than Phoenix were lower than the average daily deliveries to these locations during 2007.<sup>11</sup>

14. SFPP also objects to the 2009 ID's contention that SFPP incorporated volumes from a "period with reduced levels of demand" in its test period adjustment. SFPP avers that the West Line's throughput is not expected to return to its 2007 levels for a number of years, if ever. SFPP cites U.S. Energy Information Administration (EIA) projections that national consumption of liquid fuels will not return to its 2007 level through at least 2020 and a study by Energy Analysts International, Inc. in December 2008. SFPP also cites statements by the Chief Executive Officers at BP and ExxonMobil that demand for gasoline "has probably peaked" in the United States. SFPP also contests the 2009 ID's statement that SFPP's internal studies indicate an imminent rise in volumes and profitability. SFPP avers that two of the three growth projections cited by the 2009 ID

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<sup>10</sup> SFPP also states that although East Line Phase II was implemented on December 1, 2007, the volume shift from the West Line to the East Line did not begin until January 2008 because of logistical reasons. SFPP Brief on Ex. at 42, n.66 (citing Ex. SFP-185 at 2-3).

<sup>11</sup> *Id.* at 43 (citing Ex. ACV-235HC at 3). SFPP adds that Calnev deliveries for 2008, when adjusted for a leap year were 116,197 bpd, compared to 116,122 in 2007, a variation of less than .06 percent.

are outdated<sup>12</sup> and that a third projection<sup>13</sup> was a qualified prediction for a number of Kinder Morgan Energy Partner (KMEP) assets and not limited to the West Line.

## 2. Shippers

15. The ACC Shippers urge the Commission to adopt the annual throughput to Phoenix of 32,460,787 barrels per year proposed by ACV witness Mr. O'Loughlin.<sup>14</sup> To determine the increase in East Line volumes due to the expansion, Mr. O'Loughlin compared the increase in volumes on the East Line to Phoenix for the first nine months of 2008 to the total volumes shipped on the East Line to Phoenix relative to the first nine months of 2007, which were prior to the expansion. Then, assuming that all of the increased volume on the East Line had previously used the West Line, O'Loughlin deducted on a barrels per day basis the increase on the East Line from the base period volumes for January 1, 2007 through December 5, 2007, the date before the East Line expansion entered into service on December 6, 2007. The ACC Shippers contend that, unlike the volume levels adopted by the 2009 ID, their proposed throughput is consistent with the Commission's regulations, which require use of 12-months of actual base period data adjusted for changes that are "known and measurable" within the following nine months.<sup>15</sup>

16. The ACC Shippers concur with the 2009 ID that the cyclical downturn caused 2008 throughput data, which was used in different ways both by SFPP and the 2009 ID, to be unrepresentative of future volumes. For further support, the ACC Shippers point to the reports issued by the EIA after the recession. The ACC Shippers emphasize that SFPP's own projections indicate rising volumes in the near future, showing a steady 2.5 percent annual growth rate in Phoenix demand between 2008 and 2017.<sup>16</sup> The ACC Shippers also note that increased volumes on the West Line are supported by SFPP's planned expansion of Calnev Pipeline LLC, an increase of 277,000 barrels on Calnev from 2007 to 2008, and SFPP's modeling analysis showing a 2.5 percent annual growth in West Line interstate volumes to Calnev between 2008 and 2017. Based upon the assertion that the downturn depressed 2008 data, the ACC Shippers assert that the 2009 ID and SFPP inappropriately adjust the 2007 throughput levels using anomalous and

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<sup>12</sup> *Id.* (citing Ex. ACV-13; Ex. ACV-252).

<sup>13</sup> *Id.* (citing Ex. ACV-210).

<sup>14</sup> ACC Shippers Brief on Ex. at 70 (citing Ex. ACV-1 at 7-9, 21-24).

<sup>15</sup> *Id.* at 71 (quoting 18 C.F.R. § 346.2(a) (2010)).

<sup>16</sup> *Id.* at 76 (citing Ex. ACV-210; Ex. ACV-252; Ex. ACV-13; Ex. ACV-1 at 12-13; Ex. ACV 7 at 7 n.1).

unrepresentative 2008 volumes. The ACC Shippers state that the incorporation of anomalous data is inconsistent with the purpose of the Commission's base and test period procedures.

17. Tesoro states that the 2009 ID's adoption of data from October 1, 2007 – September 30, 2008 violates the Commission's rules by including three months of the base period and disregards the cyclical character of the severe economic recession in 2008. Tesoro also contends that the October 2007 – September 2008 data improperly include two months before the expansion of the East Line, which altered West Line volume levels. Tesoro urges the adoption of 32,889,676 barrels as the annual throughput level for the West Line to Phoenix. Tesoro witness Mr. Ashton calculated this number by annualizing the first eleven months of 2008 and adjusting this data for the effects of the economic downturn by adding the difference between the 2007 base period volumes for total East and West Line deliveries to Phoenix (4,483,799 barrels) to the annualized deliveries for the first 11 months of 2008 on the West Line to Phoenix (28,405,877). Tesoro adds that even assuming that the 2009 ID correctly used throughput data for the October 1, 2007 – September 30, 2008 period, the 2009 ID incorrectly determined the total throughput volume because the 2009 ID included only the Watson to Phoenix delivery volumes, when the throughput should also include the Colton to Phoenix volumes for a total throughput of 30,224,800.

## **B. Briefs Opposing Exceptions**

### **1. SFPP**

18. In opposing the exceptions proposed by Tesoro and by the ACC Shippers, SFPP reiterates that the proposed volume levels are representative of future West Line deliveries and that the throughput levels proposed by Tesoro and the ACC shippers are not. Furthermore, SFPP asserts that the throughput proposals of the ACC Shippers and Tesoro do not comply with the Commission's regulations. SFPP asserts that the only basis provided by the ACC Shippers and Tesoro for excluding the decline in volumes at Phoenix was an assumption that volumes at Phoenix would immediately rebound once the recession ends, which SFPP characterizes as speculative and contrary to the Commission's regulations. SFPP states these regulations require test period adjustments that are "known and are measurable with reasonable accuracy at the time of filing" and that will "become effective within nine months after the last month of available actual experience." SFPP emphasizes that the record shows continuation of the lower volumes outside the base and test period. SFPP cites several reports and studies that it claims indicate continued lower throughput, for example noting that in April 2009, the EIA projected that national consumption of liquid fuels would not return to 2007 levels

through at least 2025.<sup>17</sup> SFPP argues that the recession had particularly hit Arizona and that there was no reason to believe that Arizona's gasoline consumption would rebound quickly.

19. SFPP states that throughput levels developed by Mr. O'Loughlin and Mr. Ashton failed to distinguish between the volume decline from the recession and the decline from implementation of the East Line expansion. SFPP elaborates that these witnesses merely determined how much the East Line volumes increased during certain periods in 2008 and subtracted that amount from the total decline in West Line volumes during the same period. Moreover, SFPP objects to the contention that the planned expansion of the Calnev system establishes that volumes will increase on the West Line, noting that no physical construction has begun on the expansion, that the expansion is not planned to be operational until sometime in 2011, and that the expansion cannot be considered in any event because it is well beyond the test period.

## 2. Shippers

20. The ACC Shippers assert that SFPP's use of data from the first five months of 2008 is inconsistent with Commission regulations because it discards the 2007 base period data entirely and relying solely on five months of data from 2008. The ACC Shippers assert that if the SFPP's projection and the actual data from the nine-month adjustment period both reflect anomalous conditions, there is no reason to adjust the base period data using either of them. The ACC Shippers emphasize that the record evidence supports the 2009 ID's conclusion that 2008 West Line volume data reflects cyclical economic conditions and is anomalous. They therefore aver that the 2009 data does not support SFPP's claim that the Flying J bankruptcy caused the higher volumes recorded in the first part of 2009 on the West Line. This is because the data cited by SFPP does not include volumes on the East Line or indicate whether any West Line volume changes had any connection to shippers on Longhorn who may move product to Phoenix.

21. The ACC Shippers further assert that SFPP's proposal to adjust West Line deliveries to Phoenix by using annualized data from the first months of 2008 incorrectly includes the economic downturn as well as the structural changes due to the economic downturn. The ACC Shippers represent that SFPP witnesses testified repeatedly that some of the decline in West Line Phoenix throughput reflected in SFPP's proposed adjustment was attributable to the economic downturn, and that SFPP witnesses were unable or unwilling to separate the two effects. The ACC Shippers reject SFPP's argument that national demand for liquid fuels will not reach 2007 levels until 2020 national projections based on a January 2009 report from the Energy Information

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<sup>17</sup> SFPP Brief op. Ex. at 45 (citing Ex. SFP-348 at 2).

Administration (EIA). They assert that EIA projections for the Mountain region (which includes Arizona) projecting demand to revive and exceed 2007 levels by 2010 for motor gasoline and 2011 for liquid fuels.<sup>18</sup> The ACC Shippers further state that Arizona's population has been increasing and is projected to continue to increase significantly in the coming years.<sup>19</sup> The ACC Shippers argue that SFPP disregarded EIA projections taking into account the federal government's American Recovery and Reinvestment Act stimulus package, which estimated that motor gasoline demand would exceed the 2007 level by 2010 in the Mountain region<sup>20</sup> and 2011 nationwide.<sup>21</sup> The same projections showed that liquid fuels demand would exceed the 2007 level by 2011.

22. The ACC Shippers further contend that SFPP's reliance on a study by Energy Analysts International (EAI) largely supports a conclusion opposite to the one that SFPP advocated.<sup>22</sup> In response to SFPP, the ACC Shippers discount the statements of chief executive officers of BP and ExxonMobil as mere opinion. Moreover, the ACC Shippers also state that SFPP's internal studies related to the East Line Expansion project volume increases in the near future. The ACC Shippers state that SFPP's analyses projected a steady 2.5% annual growth rate in Phoenix demand between 2008 and 2017.<sup>23</sup> The ACC Shippers state that SFPP's modeling scenarios from the same expansion also showed steady growth in West Line Phoenix demand in all scenarios.<sup>24</sup> The ACC Shippers also assert that SFPP seeks to improperly dismiss a presentation by one of its executives in January 2009 projecting significant demand growth.<sup>25</sup> The ACC Shippers contend the document accounted for the recession and was not qualified as SFPP claims. Moreover, the ACC Shippers further contend that SFPP's attempt to minimize the relevance of the exhibits because they cover the entire Pacific region is inconsistent with SFPP's usage of nationwide EIA data.

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<sup>18</sup> ACC Shippers Brief op. Ex. at 27 (citing Ex. S-10 at 16; Ex. S-9 at 30; Tr. 1748-51; Ex. ACV-306 at 6).

<sup>19</sup> *Id.* (citing Ex. S-10 at 18; Ex. S-9 at 31).

<sup>20</sup> *Id.* at 30 (citing Tr. 1753-55; Ex. ACV-306 at 14).

<sup>21</sup> *Id.* (citing Tr. 1755-57; Ex. ACV-306 at 11).

<sup>22</sup> *Id.* (citing Ex. SFP-157HC at 191, 193, 199).

<sup>23</sup> *Id.* at 32 (citing Ex. ACV-7 at 7 n.1).

<sup>24</sup> *Id.* (citing Ex. ACV-1 at 12; Ex. ACV-13; Ex. ACV-1C at 16-17; Ex. ACV-18C).

<sup>25</sup> *Id.* (citing Ex. ACV-210).

23. Opposing SFPP's exceptions, Tesoro states that the throughput levels advocated by SFPP are improperly based upon only five months of actual data from 2008. Tesoro further alleges that SFPP's proposed throughput is distorted because SFPP fails to adjust for the 2008 increase in West Line volumes that occurred at Yuma (3.0 percent) and Calnev (3.8 percent) in the first 11 months of 2008. Moreover, Tesoro asserts that SFPP's projected throughput volume (like the throughput proposed in the 2009 ID) failed to adjust for the temporary effects of the economic recession.

### 3. Trial Staff

24. Trial Staff avers that the 2009 ID correctly used data for October 1, 2007 through September 30, 2008 to determine throughput and all issues impacted by throughput amounts. Trial Staff states that the Commission requires the use of actual data from the last twelve months of the test period because this is the best available data.<sup>26</sup> Trial Staff emphasizes that the use of a full test period is particularly appropriate due to the Flying J bankruptcy and the recession. Trial Staff asserts that, contrary to SFPP's assertions, the 2009 ID did not strip SFPP's initial filing of its relevance – SFPP was still permitted to select the end-of-test period date of September 30, 2008. Trial Staff responds to Tesoro, ACC Shippers, and SFPP by asserting that using the last 12-months of data is consistent with Commission regulations and precedent.<sup>27</sup>

25. Regarding SFPP's projections, Trial Staff argues that it is irrelevant that SFPP's projections were close to the actual throughput during the adjustment period because “[i]t is the well-established policy of the Commission to prefer the use of end-of-test period actuals over any other method....”<sup>28</sup> Trial Staff disputes SFPP's claim that including two months prior to completion of the East Line expansion results in unrepresentative data. Trial Staff claims that SFPP would not have expanded if volumes were permanently shifting from the West to the East Line, and, if this in fact occurs, that it would be unfair to charge West Line shippers for the excess capacity. Moreover, Trial Staff stresses that

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<sup>26</sup> Trial Staff Brief op. Ex. at 6 (citing *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077, at P 263 (2006) (Opinion No. 486); *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, at P 49 (2005); *Enbridge Pipelines*, 100 FERC ¶ 61,260, at P 315 (2002); *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,048-49 (2000); *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,027, 62,030 (1999); *Williston Basin Interstate Pipeline Co.*, 72 FERC ¶ 61,074, at 61,360 (1995)).

<sup>27</sup> Trial Staff noted that even in *Iroquois Gas Transmission System, L.P.*, 84 FERC ¶ 61,086, at 61,472 (1998), which was cited by ACC Shippers, the Commission made clear that when available, the use of end-of-test-period actuals was the preferred method.

<sup>28</sup> Trial Staff Brief op. Ex. at 36.

SFPP failed to demonstrate that depressed economic conditions incorporated into its projections will continue, and Trial Staff emphasizes that based upon internal SFPP market studies it is unlikely that the recent decline in volumes to Phoenix is likely to be prolonged.

26. In response to shippers, Trial Staff asserts that Tesoro violated Commission policy by including post-test-period data (October and November of 2008) in its throughput recommendation. Trial Staff further argues that although Tesoro is correct that Colton Transmix to Phoenix volumes were not included in Trial Staff's Phoenix West Line volumes, Colton volumes were included in Trial Staff's fully allocated cost rate calculations.

### C. Discussion

27. The Commission reverses the 2009 ID. The Commission finds that throughput and related cost-of-service items should be derived from a test period using annualized actual data for January 1, 2008 – September 30, 2008. Although the Commission has previously adopted throughput levels derived from actual data consisting of the last three months of the base period and the nine-month adjustment period, the Commission has used this data because it was the most representative of future throughput.<sup>29</sup> However, Commission policy does not support using data that is not likely to be representative of future throughput levels. Regarding the October 1, 2007 – September 30, 2008 data adopted by the 2009 ID, the months of October 2007 and November 2007 were prior to the completion of the East Line expansion, which all parties concede significantly altered West Line throughput by causing shippers to transfer their volumes from the West Line to the East Line. Moreover, the East Line expansion did not begin service until after customers scheduled December throughput, and, thus, West Line volumes were not transferred to the East Line until January 2008. Thus, as the 2009 ID acknowledged, the volumes on the West Line to Phoenix dropped considerably, from an average of 97.7 thousand barrels per day over the last three months of 2007 to 77.5 thousand barrels per day in the first nine months of 2008.<sup>30</sup> The Commission rejects the October 1, 2007 – September 30, 2008 data adopted by the 2009 ID because these data reflect unrepresentative volume levels from October, November and December of 2007.

28. Rather, the Commission adopts as the test period for all volumes to all destinations on the West Line, the annualized throughput data for January 1, 2008, through

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<sup>29</sup> See n.34, *infra*.

<sup>30</sup> 2009 ID, 129 FERC ¶ 63,020 at P 605 (citing Ex. SFP-185 at 3).



September 30, 2008.<sup>31</sup> Within the base and adjustment period, the January 1, 2008, through September 30, 2008 data provides the most comprehensive sample of West Line volumes coinciding with the full operation of the East Line expansion. The use of nine months of actual data by the Commission is preferable to SFPP's proposal to use only five months. SFPP claims that the five months of data were the only data that were "known and measurable" at the time of filing. However, the Commission's regulations allow and Commission precedent permits consideration of the actual data from the entire adjustment period to evaluate the cost-of-service levels proposed by the pipeline.<sup>32</sup> SFPP's position would effectively bar the refinement of test period adjustments using the latter part of the actual data from the adjustment period. Moreover, using this larger sample of representative data should increase the accuracy and confidence in the test period throughput levels.

29. The Commission rejects arguments from the ACC Shippers and Tesoro that it is necessary to adjust 2008 data to account for the effects of the economic downturn.<sup>33</sup> When the record has demonstrated changes in the adjustment period from base period volumes, the Commission has taken these changes into account and used the actual data from the adjustment period in order to obtain more representative data.<sup>34</sup> Rather than adjusting anomalous data, the West Line to Phoenix throughput levels proposed by the ACC Shippers (32,460,787 barrels annually or 88,934 barrels per day) and Tesoro (32,889,676 barrels annually or 90,109 barrels per day) significantly exceed the average West Line to Phoenix volume levels of 77,510 barrels per day experienced during the nine-month adjustment period ending September 30, 2008. On a barrel per day basis, the

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<sup>31</sup> In adopting the annualized 2008 volumes, the Commission is not endorsing Tesoro's argument that when adjusting for known and measurable changes, Commission regulations prohibit the consideration of any actual base period volumes.

<sup>32</sup> See, e.g., *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077, at P 263 (2006) (Opinion No. 486).

<sup>33</sup> The record reflects that the decline in West Line volumes in 2008 as compared to 2007 was not entirely due to the additional capacity on the East Line because the 2008 increase in East Line throughput following the expansion was less than the 2008 declines on the West Line. Ex. ACV-1 at 8.

<sup>34</sup> The Commission has often incorporated actual data from the nine-month adjustment period in its test period. See Opinion No. 486, 117 FERC ¶ 61,077 at P 263; *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, at P 49 (2005); *Enbridge Pipelines*, 100 FERC ¶ 61,260, at P 315 (2002); *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,048-49 (2000); *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,027, 62,030 (1999); *Williston Basin Interstate Pipeline Co.*, 72 FERC ¶ 61,074, at 61,360 (1995).

volume levels proposed by Tesoro and the ACC Shippers exceed the average volume level of every single month in the adjustment period.<sup>35</sup> The ACC Shippers and Tesoro defend their departure from the adjustment period volumes due to various projections and studies that they claim show future volume increases that are inconsistent with the West Line volume levels experienced during the first nine months of 2008.<sup>36</sup> However, the projections in the record are speculative and do not provide a basis to depart from the actual data presented by the adjustment period.<sup>37</sup> Furthermore, the post-adjustment period actual data from October 2008 – September 2009 does not provide “good cause” for departure from the general regulatory practice of limiting consideration to the base and adjustment period data.<sup>38</sup> In sum, there is little evidence that the 2008 economic decline and resultant decreased volumes were an ephemeral occurrence with effects that

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<sup>35</sup> See Ex. SFP-187.

<sup>36</sup> ACC Shippers Brief on Ex. at 76-77 (citing Ex. ACC-13; Ex. ACC-18C; Ex. ACC-210; Ex. ACC-252; Ex. SFP-157HC). The ACC Shippers also contend that EIA projections for the Mountain region from March and April of 2009 show that demand in the Mountain region would revive and exceed 2007 levels by 2010 for motor gasoline and 2011 for liquid fuels. ACC Shippers Brief op. Ex. at 27-28 n.7 (citing Ex. ACV-306 at 6).

<sup>37</sup> To the extent that these studies may be entertained, the Commission notes that more recent official government publications appear to indicate that petroleum and fuel consumption may not rebound any time soon. The Commission takes administrative notice that the more recent 2010 EIA Energy Outlook issued May 11, 2010 projected that the 2008 Mountain Region levels Shippers protest as too low will not be equaled until 2013 for motor gasoline and liquid fuels. The 2007 levels will not be exceeded until 2018 for liquid fuels and 2017 for motor gasoline. Whether or not these projections reflect ultimate usage levels, they demonstrate the uncertain nature of such projections and the reason why the Commission prefers to rely upon actual data. U.S. Energy Information Agency, Energy Outlook 2010, Supplemental Table 8, Mountain Region, available at [http://www.eia.doe.gov/oiaf/archive/aeo10/aeoref\\_tab.html](http://www.eia.doe.gov/oiaf/archive/aeo10/aeoref_tab.html) (Released May 11, 2010).

<sup>38</sup> 18 C.F.R. § 346.2(a)(ii) (2010). In 2009, volumes increased on the West Line. SFPP has presented evidence indicating that the bankruptcy of Flying J, the parent company of a major feeder pipeline onto the East Line, caused shippers to shift temporarily volumes from the East Line to the West Line. However, after Flying J announced in June 2009, that it had acquired a stalking horse bidder for Longhorn, West Line throughput returned to 2008 levels.

disappeared shortly after the adjustment period. Rather, there are indications that the diminished volumes will persist.<sup>39</sup>

30. Finally, the Commission finds that SFPP must adjust its throughput to all West Line destinations, not just Phoenix to reflect the revised test period. Although the East Line expansion may only have affected West Line destinations to Phoenix, to the extent that the Commission uses a particular time period to consider one movement on the system, the Commission prefers to use a similar time frame for determining the total volumes. Such an approach synchronizes volumetric and cost data across the entire cost-of-service, and minimizes the opportunity for manipulation of throughput levels by selectively utilizing different time periods for different destinations.

### **III. Operating Expenses**

#### **A. Litigation Costs**

31. The 2009 ID determined that SFPP could recover a test period regulatory litigation expense of \$1,830,978 to be collected annually for three years for a total recovery of \$5,492,934. The 2009 ID rejected SFPP's proposal to include litigation costs of \$2,200,000 as a regular cost of service item in SFPP's future cost based rate.<sup>40</sup> The 2009 ID determined that the costs relied upon by SFPP are speculative and are not known and measurable with reasonable accuracy at the time of the filing, as defined by 18 C.F.R. Sec. 346.2(b)(2).

32. On exceptions, SFPP advocates the litigation cost proposed by Mr. Ganz, consisting of a test period adjustment of \$2.2 million, which includes (1) \$0.6 million representing the litigation expenses associated with the West Line portion of Docket No. OR03-5-000, amortized over three years and (2) \$1.6 million representing the estimated litigation costs associated with this docket (Docket No. IS08-390-000) amortized over three years. Unlike the surcharge adopted by the 2009 ID, SFPP proposes to retain the litigation charges as a permanent component of its cost-of-service rates. SFPP emphasizes that Mr. Ganz determined that this level was representative after analyzing SFPP's litigation expenses during the prior 20 year period.

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<sup>39</sup> The cost-of-service components adopted by the Commission reflect the realities of the base and adjustment periods. To the extent that shipper claims regarding increased future volumes eventually come to fruition, the Commission's regulations and the Interstate Commerce Act allow the shippers to file a complaint.

<sup>40</sup> 2009 ID, 129 FERC ¶ 63,020 at P 838.

33. SFPP argues that the three year litigation surcharge of litigation costs of \$1.8 million during the test period are not representative of the West Line litigation costs, and thus inconsistent with SFPP's right to recover its full litigation expenses. SFPP emphasizes that the 2009 ID's one-year "snapshot" failed to consider dramatic annual litigation cost fluctuations. Moreover, SFPP notes that the costlier phases of this particular proceeding (most of discovery, the hearing, and subsequent briefs) had not begun by the conclusion of the October 1, 2007 – September 30, 2008 test period adopted by the Initial Decision.

34. Opposing exceptions, the ACC Shippers and Trial Staff contend that the 2009 ID provides a just and reasonable recovery for known and measurable litigation expenses. Tesoro also opposes SFPP's exceptions.<sup>41</sup> Trial Staff, Tesoro, and the ACC Shippers contend that the litigation costs proposed by SFPP are not "known and measurable" as required by section 346.2(a) of the Commission regulations. Trial Staff and the ACC Shippers further assert that it is not appropriate to embed regulatory expenses associated with large-scale litigation into a prospective rate on a permanent basis. In further support of the 2009 ID's conclusion, Trial Staff adds that litigation expenses should be recovered from those shippers who were most directly involved in the litigation. Trial Staff argues that Commission precedent requires such non-recurring regulatory costs to be recovered over a three-year period and then eliminated from the pipeline's rates.<sup>42</sup>

35. Consistent with the Commission precedent, SFPP may recover its regulatory litigation expenses attributable to this proceeding through a three-year surcharge. SFPP will be permitted to develop the surcharge to reflect the costs incurred in this proceeding (Docket No. IS08-390-000) during the hearing, rehearing and compliance phases. A similar litigation recovery surcharge has been previously adopted in complaint

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<sup>41</sup> Opposing exceptions Tesoro states its preference for a test period using the annualized nine-month adjustment period and a five-year amortization period. However, on exceptions, Tesoro failed to raise any objections to the 2009 ID's holdings involving litigation costs, including Tesoro's preference for a five-year surcharge, as opposed to a three-year surcharge. By failing to argue for a five-year amortization period on exceptions, Tesoro waived this objection. 18 C.F.R. § 385.711(d)(2) (2010).

<sup>42</sup> Staff Brief op. Ex. at 33-34 (citing *Tarpon Transmission Co.*, 58 FERC ¶ 61,354, at 62,181 (1992)).

proceedings involving SFPP.<sup>43</sup> Although this matter involves a rate increase proposed by the pipeline, the rationale that applied to the earlier SFPP complaint proceedings remains applicable here. Where significant litigation costs have been incurred and it is uncertain whether those litigation costs will continue into future years, a surcharge based upon actual litigation costs provides an appropriate means to avoid both over-recovery and under-recovery. The protracted litigation that has historically involved SFPP creates unique circumstances rendering it very difficult to determine a representative level for SFPP's future regulatory litigation costs. Under these circumstances, there is little assurance that base period data, test period data, or any other normalization would provide sufficiently representative estimates of future expense levels. The surcharge allows recovery of actual costs without creating a risk of substantial over-recovery in the future.<sup>44</sup> Although prior SFPP decisions have applied a five-year surcharge,<sup>45</sup> the Commission finds that a three-year surcharge is an appropriate time period for recovery of litigation costs in this proceeding because the costs have been incurred over three years of litigation regarding this rate filing.

36. As the ACC Shippers and Staff correctly note, a rate filing leads to a temporary spike in legal costs. However, as SFPP notes, due to the timing of the litigation process and ending dates of the base and adjustment periods, the costliest phase of the litigation will occur after the rate filing and will not be fully reflected in the actual data during the base and adjustment period. Thus, limiting a pipeline to 12-months of actual data in the base/adjustment period: (1) excludes significant expenditures associated with the costliest phase of the rate litigation, and (2) imposes a 12-month time period of relatively lower expenditures for determining litigation costs. The remedial approach advocated by SFPP, however, is also defective as it relies upon speculative, estimated costs, and would cause unrepresentative costs to be included in its cost-of-service and in its West Line rates.

37. The Commission finds that while SFPP may not permanently embed a litigation recovery surcharge in its rates, it may include a limited three-year surcharge to recover reasonable legal costs of the proceeding in Docket No. IS08-390-000, et al. that have been incurred by SFPP. SFPP must include in its compliance filing the litigation costs it

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<sup>43</sup> The Commission applied and the D.C. Circuit upheld a litigation surcharge in the proceedings in Docket No. OR92-8-000, *et al. SFPP, L.P.*, 96 FERC ¶ 61,281 at 62,074-75 (2001) (Opinion No. 435-B), *order on reh'g, SFPP, L.P.*, 100 FERC ¶ 61,353, at P 9-14 (2002), *aff'd in relevant part, BP West Coast Products, LLC v. FERC*, 374 F.3d 1263, 1294 (D.C. Cir. 2004) (*BP West Coast*).

<sup>44</sup> *BP West Coast*, 374 F.3d at 1294.

<sup>45</sup> Opinion No. 435-B, 96 FERC at 62,074-75.

has incurred in this proceeding through its compliance filing and the amount of the surcharge to be charged. The surcharge may be updated to include any changes to the compliance filing required by the Commission and for related pleadings through the completion of the compliance phase.

### **B. Depreciation**

38. SFPP had three main line systems in 2008 (West, East, and Oregon). SFPP has used one depreciation rate for all of its systems that is based on a 1991 depreciation study prepared by the Commission staff.<sup>46</sup> Trial Staff was the only party to challenge SFPP's depreciation rate, asserting that the remaining life of the pipeline extended to 2043, 13 years beyond the 2030 expiration of the remaining economic life projected by the 1991 study. The 2009 ID determined that Trial Staff had the burden to prove that SFPP's existing depreciation rates were not just and reasonable since SFPP has not proposed to change its existing depreciation rates in this proceeding. The 2009 ID held that Trial Staff failed to provide sufficient evidence that the 1991 depreciation study should no longer be used.<sup>47</sup> Specifically, the 2009 ID determined that Trial Staff did not adequately address in sufficient depth issues such as demand projection; whether there are significant changed circumstances since the 1991 study; why a new useful life calculation of 35 years is necessary; and the level of prospective competition.

39. On exceptions, Trial Staff asserts that the 2009 ID erred in upholding SFPP's use of system-wide depreciation rates based upon the 1991 depreciation study to calculate the West Line's depreciation rates. Staff asserts that SFPP has the burden of proof to demonstrate that its proposed rate change is just and reasonable, including the burden to support the depreciation rates incorporated into the cost of service. Trial Staff asserts that this burden exists even if the component in the cost of service is not changed. Trial Staff states that the 2009 ID improperly relied upon complaint proceedings, as opposed to cases in which a pipeline filed for new rates, to assign the burden of proof to Trial Staff.

40. Trial Staff further asserts that that the 1991 depreciation study used by SFPP is outdated and inapplicable. Trial Staff emphasizes that their study includes more recent information and that the analysis presented by Trial Staff witness Pewterbaugh is specific

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<sup>46</sup> Ex. SFP-149.

<sup>47</sup> 2009 ID, 129 FERC ¶ 63,020 at P 815 n.275 (2009) (citing *SFPP, L.P.*, 63 FERC ¶ 61,014, at 61,124-25, *aff'd on reh'g*, 63 FERC ¶ 61,275, *reh'g denied*, 65 FERC ¶ 61,028 (1993); *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 186-87 (D.C. Cir. 1986); *Public Serv. Comm'n of the State of New York v. FERC*, 642 F.2d 1335, 1345 (D.C. Cir. 1980); *see also Atchison, T. & S.F. Ry. v. Wichita Bd. of Trade*, 412 U.S. 800, 812-13 (1973)).

to the West Line, whereas the 1991 depreciation study only provided results on an overall system basis. Trial Staff stresses that relying on system-wide depreciation rates for each individual system is inappropriate because the values that factor into the depreciation rate clearly differ for each line. Trial Staff urges that the different vintages of the various lines should be taken into account for specific depreciation rates for each line.

41. Trial Staff further asserts that their study adequately addressed demand projection beyond 2030, averring that demand for petroleum products is expected to increase so that demand will not negatively impact the remaining economic life of the West Line. Trial Staff further asserts that projected population growth in Arizona supports continued demand for product on the West Line. Trial Staff states that their study also includes twenty years of additional data up to 2030 from the Energy Information Administration (EIA) whereas the 1991 study stopped at 2010. Trial Staff further contends that a new useful life calculation of 35 years is necessary, and that the 35-year remaining economic life is not arbitrary. Trial Staff contends that 35 years is well within the typically accepted norms for oil pipelines.

42. Trial Staff further argues that prospective competition will not shorten the remaining economic life on the West Line. Trial Staff asserts that SFPP greatly overstates the ease with which shippers can shift volumes between lines. Trial Staff asserts that there is no evidence that competition from ethanol will decrease the remaining economic life of the West Line, contending that ethanol could actually increase economic life by providing an additional market for the pipeline. Trial Staff further avers that SFPP's reliance on the effects of a projected refinery is without basis, contending that there is no evidence that the necessary permits to build and to operate the refinery have been obtained.

43. Opposing exceptions, SFPP asserts that Trial Staff possesses the burden of proof because SFPP has not proposed to change its depreciation rates. Moreover, SFPP notes that Trial Staff counsel represented to the Presiding Judge that Trial Staff had the burden of proof regarding Trial Staff's proposed changes to SFPP's West Line depreciation rates. SFPP avers that Staff should not be allowed now, on exceptions, to reverse course after SFPP relied upon Trial Staff's representations in cross-examining Trial Staff's witness on the depreciation rates at issue here. SFPP also argues that Commission regulations only allow a carrier to request that its composite depreciation rates for each account be changed to individual component rates,<sup>48</sup> and that depreciation rates can only

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<sup>48</sup> SFPP Brief op. Ex. at 93-94 (18 C.F.R. Part 352, General Instruction 1-8(b) (2009)).

be revised prospectively from the date of a Commission order changing those depreciation rates.<sup>49</sup>

44. Furthermore, SFPP argues that Staff did not adequately support its proposed depreciation rates. SFPP asserts that when determining whether a new depreciation analysis should be conducted, the appropriate approach is to start with the assumptions underlying the existing depreciation rates and then determine whether new information exists that requires a re-evaluation of those underlying assumptions and a new depreciation analysis. SFPP avers that Trial Staff failed to demonstrate that the EIA Annual Energy Outlook 2009 Early Release projects oil supply and demand for refined petroleum products any differently than the 1991 study projects such supply and demand.<sup>50</sup>

45. In addition, SFPP alleges that Staff failed to support the 13 year extension of remaining economic life underlying its proposed West Line depreciation rates calculated by Trial Staff. SFPP states that the only basis that witness Pewterbaugh provided for expanding the life of SFPP's West Line facilities to 35 years is that any data beyond 35 years is too speculative. SFPP emphasizes that the EIA Annual Energy Outlook 2009 used by Mr. Pewterbaugh treated any estimates beyond 2030 as too speculative, and the Arizona population projections on which Pewterbaugh relies only extend to 2025. SFPP also asserts that the ID correctly held that Staff's depreciation analysis failed to consider the effects of the construction of the East Line expansion. SFPP further argues that Trial Staff failed to adequately address the effects of ethanol and the construction of a refinery outside of Phoenix, Arizona, by the Arizona Clean Fuels project to be completed in 2013.

46. The Commission finds that the 2009 ID erred by assigning the burden of proof to Trial Staff rather than to SFPP as to whether the depreciation rates incorporated by SFPP into its proposed cost-of-service proposal are just and reasonable. Well-established Commission precedent requires that where the pipeline proposes a rate increase, the pipeline has the burden to establish that the depreciation rates included in its cost-of-service are just and reasonable, even if the depreciation rates themselves remain unchanged from prior filings.<sup>51</sup> In those cases, as the Commission explained, each

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<sup>49</sup> *Id.* (citing 18 C.F.R. § 347.1(d)(1) (2009)).

<sup>50</sup> To support this proposition, SFPP compares EIA's 2009 Annual Energy Outlook projected total liquids consumption in 2008 of 20.74 million bpd and 20.92 million bpd in 2030, Ex. SFP-348 at 2, with the 20.74 bpd projected by EIA's 1990 Annual Energy Outlook.

<sup>51</sup> *Williston Basin Interstate Pipeline Co.*, 107 FERC ¶ 61,164, at P 24 (2004); *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,038-39 (1999); *Northern Border*

(continued...)



component of a cost-of-service is integral to any pipeline's proposal to increase rates based upon a proposed increase in its overall cost of service. Thus, the pipeline's burden of showing that a proposed rate is "just and reasonable" necessarily includes the burden of supporting each component of the cost of service, including the unchanged as well as the changed components.<sup>52</sup> In contrast, as the Commission has previously explained, the D.C. Circuit decisions relied upon by SFPP and the 2009 ID involved allocation and rate design. Because the unchanged allocation and rate design methodologies themselves were not cost-of-service components (the sum of which justifies the pipeline's proposed rate change) parties wishing to challenge the unchanged allocation and rate design methodologies were required to proceed with the burden of proof as though those parties had filed a complaint.<sup>53</sup>

47. Thus, contrary to the holding of the 2009 ID and SFPP's briefs opposing exceptions, the fact that SFPP does not propose to change its depreciation rates does not shift the burden of proof away from SFPP. Because SFPP is proposing to increase its transportation rates, SFPP has the burden of proof to support the depreciation rates that are incorporated into its proposed cost-of-service.<sup>54</sup> However, having assigned the burden of proof to SFPP to support its proposed depreciation rates, the Commission finds that the record provides adequate support for the depreciation rates included in SFPP's proposed cost-of-service. In its proposal, SFPP relied upon the Commission's 1991 depreciation study, and applied the system-wide depreciation rates developed in that

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*Pipeline Co.*, 88 FERC ¶ 61,201, at 61,687-88, *order on reh'g*, 89 FERC ¶ 61,185, at 61,574-76 (1999); *Tennessee Gas Pipeline Co.*, 25 FERC ¶ 61,020, at 61,108 (1983), *reh'g denied on this issue*, 26 FERC ¶ 61,109, at 61,263-64 (1984); *BP Pipelines Inc. v. TAPS Carriers*, 123 FERC ¶ 61,287, at P 46 (2008); *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,052 (2000).

<sup>52</sup> *E.g.*, *Northern Border Pipeline Co.*, 89 FERC at 61,575. Although many of the Commission orders involved rate filings under the Natural Gas Act, there is no reason why the underlying reasoning would be any different in the context of the ICA, and the Commission has applied the same distinction to oil pipelines under the ICA. *BP Pipelines Inc. v. TAPS Carriers*, 123 FERC ¶ 61,287 at P 46.

<sup>53</sup> *Id.* For further analysis of this issue *see Kern River Gas Transmission Company*, 133 FERC ¶ 61,162, at P 63-67 (2010) (Opinion No. 486-D).

<sup>54</sup> The 2009 ID is correct that to the extent the Commission rejects SFPP's proposed depreciation rate, the Trial Staff has the burden of proof to establish that Staff's proposed depreciation rates are just and reasonable. However, this does not change SFPP's burden of proof with respect to the depreciation rate that SFPP proposed in the cost-of-service that SFPP is using to justify the rate increase.

study to the West Line. In a prior rate proceeding, the Commission accepted the methodology used in this study as providing just and reasonable depreciation rates for the West Line.

48. The record provides little support for Staff's contention that continued usage of the depreciation rates developed in the 1991 study for determining the West Line cost-of-service is unjust and unreasonable. Staff witness Pewterbaugh states: "The main reason for the difference between SFPP's rates and my recommended rates is the length of time over which those rates would recover SFPP's remaining plant investments."<sup>55</sup> However, Trial Staff witness Pewterbaugh explained that even if the depreciation rate proposed by Staff were adopted, SFPP would recover its current West Line Investment in 25.4 years as opposed to recovering the same investment costs over 23 years.<sup>56</sup> Given that Trial Staff only proposes to extend the 23-year time frame for recovering full depreciation by a mere 2.4 years and because estimates two decades into the future by necessity involve some uncertainty, it is not clear that the depreciation rates proposed by Staff actually serve to enhance intergenerational equity.

49. Furthermore, the Commission notes that the 1991 study incorporated a relatively conservative 40 year economic life, which is at the high end for an oil pipeline<sup>57</sup> and which is actually more conservative than the 35 year economic life advocated by Trial Staff witness Pewterbaugh in this proceeding. Although Trial Staff correctly notes that the passage of time has made more information available regarding the expected economic life of the West Line, the analysis provided by Trial Staff only further supports the proposition that the depreciation rates developed in the 1991 study continue to be within the zone of reasonableness. The Commission thus finds that the depreciation rates developed in the 1991 study remain just and reasonable for application in the West Line cost-of-service.

### **C. Allocation Factors Between Jurisdictional and Non-Jurisdictional Services**

50. The West Line provides intrastate deliveries within California as well as interstate deliveries to Arizona and to Nevada (indirectly through the interconnection with Calnev Pipeline, L.L.C. at Colton, California). Consequently, the costs for West Line facilities providing both intrastate and interstate services (joint-use facilities) have to be separated between these two carrier services. The 2009 ID adopted the allocation percentages for interstate services proposed by Trial Staff:

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<sup>55</sup> Ex. S-9 at 4.

<sup>56</sup> *Id.* at 5.

<sup>57</sup> Ex. SFP-149 at 4.

<u>Segment</u>	<u>Interstate Percentage</u> <sup>58</sup>
CA1 Watson	42.05%
CA2 Watson to Ontario	55.47%
CA3 Ontario to Colton	56.32%
CA4 Colton to Niland	85.74%
CA5 Beyond Niland	100.00%

51. Additionally, both the West Line and the East Line deliver to the Phoenix Terminal. Thus, Phoenix Terminal costs must be separated between West Line and East Line services. The 2009 ID adopted the separation percentages proposed by Trial Staff for the allocation of Phoenix Terminal costs:

	West Line	East Line <sup>59</sup>
Phoenix Terminal – Cost Allocation	42.38%	57.62%

52. As the 2009 ID explains, both SFPP and Trial Staff propose to allocate joint use direct facility investment costs and operating costs on the West Line system using a volumetric route directory. The separation factors in the route directory are developed using volumes which are delivered in interstate and intrastate service, or in the case of cost allocation at the Phoenix Terminal, on the East and West Lines. The separation factors are then applied to the specific West Line facility investment and operating costs to determine the proper allocations.

53. The 2009 ID adopted the allocation percentages proposed by Trial Staff because Trial Staff uses data from the last twelve months of the test period (October 1, 2007 to September 30, 2008), whereas SFPP uses unadjusted 2007 base period data for all West Line destinations except Phoenix. For Phoenix deliveries, SFPP annualized the first five months of throughput for 2008 to calculate its yearly projection.

54. On exceptions, SFPP renews its objections to the 2009 ID's adoption of actual throughput data for the period October 1, 2007, through September 30, 2008, as conflicting with the Commission's base and test period regulations and as not representative of the level of throughput SFPP will experience during the time the West Line rates are in effect. With respect to SFPP's proposed test period adjustment to the route directory volumes to reduce West Line deliveries to Phoenix (and to make a corresponding increase to East Line deliveries), SFPP argues the 2009 ID erred in concluding SFPP's usage of unadjusted base period volumes for all destinations other

<sup>58</sup> 2009 ID, 129 FERC ¶ 63,020 at P 818 (citing Ex. S-17 at 15).

<sup>59</sup> *Id.* P 819 (citing Ex. SFP-17 at 15).

than Phoenix resulted in an inaccurate allocation of costs to the West Line interstate service. SFPP asserts its proposed volume adjustment at Phoenix was a known and measurable change that had a corresponding known and measurable effect on the West Line percentage of total deliveries to Phoenix.

55. In contrast, according to SFPP, the decline in West Line volumes at Phoenix did not have the same corresponding known and measurable impact on the interstate percentage of total volumes transported through the joint-use facilities in California. Citing the testimony of Mr. Ganz, SFPP explains that it is not possible to determine a known and measurable change in the interstate portion of total throughput unless the changes anticipated in SFPP's intrastate throughput are also known and measurable. SFPP states that although the intrastate portion of total West Line volumes decreased in the first five months of 2008 by almost 10 percent, there was no discrete known and measurable change (e.g., a refinery closure) that could be identified to account for any change in intrastate volumes. Thus, SFPP explains that it did not adjust the interstate percentages, but concluded instead that using unadjusted base period throughput would provide reasonable and representative results.

56. Opposing Exceptions, Trial Staff asserts that SFPP's proposed route directory should be rejected because SFPP used the wrong base and test period as addressed elsewhere in this proceeding. Trial Staff concludes that the 2009 ID correctly adopted the route directory proposed by Staff based upon unadjusted throughput for the twelve-month period of October 1, 2007 through September 30, 2008. Tesoro also opposes SFPP's exceptions, averring that the 2009 ID correctly adjusted throughput levels to all locations.

57. Consistent with the Commission's discussion of West Line throughput, both the allocation of expenses between interstate and intrastate costs should use the annualized actual data for January 1, 2008 to September 30, 2008 for all destinations. This will ensure the use of consistent test period data to develop SFPP's cost-of-service, while also ensuring that the data used to determine throughput at Phoenix adequately reflect the effects of the East Line expansion.

#### **D. The Allocation Factors for Certain Operating Expenses**

58. The 2009 ID held that costs in Account 590, "Other Expenses," should be classified as non-distance related costs<sup>60</sup> because Commission regulations provide that

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<sup>60</sup> 2009 ID, 129 FERC ¶ 63,020 at P 862-864.

Account 590 “shall include the cost of expenses expended for administrative and general expenses.”<sup>61</sup>

59. On exceptions, SFPP argues the 2009 ID erred and that the costs in Account 590 are distance related costs. SFPP represents that the costs in Account 590 consist of fees paid to the California Fire Marshall, the Commission, and the United States Department of Transportation (DOT). SFPP states the fees paid to the California Fire Marshall are associated with interstate and intrastate pipeline safety and integrity.<sup>62</sup> SFPP avers that because the fees are directly related to pipeline facilities, the bulk of the costs are assessed by the California Fire Marshall based upon pipeline mileage.<sup>63</sup> Similarly, SFPP states charges paid to DOT are also related to pipeline safety and integrity. SFPP states that the fees to DOT are “based on usage (in reasonable relationship to volume-miles, miles, revenues, or a combination of volume-miles, miles, and revenues) of the pipeline.”<sup>64</sup> SFPP further states the Account 590 regulatory fees paid to the Commission are assessed on the basis of operating revenues, which in turn are based in part on distance and throughput.<sup>65</sup> Finally, SFPP asserts the 2009 ID’s ruling was internally inconsistent. While ruling here that costs contained in the 500 series of accounts (headed “General”) are not distance-related, the 2009 ID held elsewhere that Pipeline Taxes in Account 580 are in fact distance related.<sup>66</sup>

60. Opposing exceptions, Trial Staff, much like the 2009 ID, emphasizes that Account 590 is defined in the Commission’s regulations as an expense account for administrative and general services. According to Trial Staff, Commission precedent holds that such costs are comprised of non-distance related costs. Trial Staff emphasizes that SFPP has presented no justification and otherwise failed to meet its burden of justifying its classification of costs in Account 590 as distance-related.

61. Trial Staff asserts that SFPP witness Ganz agreed that Account 590 is an expense account for administrative and general expenses and that as a general rule, administrative and general expenses are not distance sensitive. Trial Staff also allege that SFPP witness Ganz failed to demonstrate how any of the costs in Account 590 are distance sensitive. Trial Staff contends the fees paid to the California Fire Marshall are administrative

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<sup>61</sup> 18 C.F.R. Part 352 (2010).

<sup>62</sup> SFPP Brief on Ex. at 62 (citing Cal. Gov’t Code § 51010, *et seq.* and § 51019).

<sup>63</sup> *Id.* (citing 19 Cal. Admin Code § 2040).

<sup>64</sup> *Id.* (citing 49 U.S.C. § 60301(a)).

<sup>65</sup> *Id.* (citing 18 C.F.R. § 382.203 (2010)).

<sup>66</sup> *Id.* (citing 2009 ID, 129 FERC ¶ 63,020 at P 863).

expenses and are not typically distance related. Similarly, Trial Staff asserts the fees charged by DOT are “user fees” that are also not distance related. Finally, Trial Staff state the fees assessed by the Commission are based on operating revenues that are determined by volumes and thus are also not distance related. However, to the extent some of the costs in Account 590 might be distance related, Staff argues there is nothing in the record identifying which specific costs are distance related.

62. The Commission affirms the 2009 ID. The Commission’s regulations define Account 590 expenses as “general and administrative costs.”<sup>67</sup> Although SFPP has identified DOT and California State Fire Marshall regulations indicating that a component of some of the fees may be related to mileage, as the 2009 ID determined, such “general and administrative costs” are not considered by the Commission to be distance related. Furthermore, SFPP has not provided sufficient detail in the record to enable the Commission to determine what, if any, portion of SFPP’s Account 590 expenses should be charged on a per barrel-mile basis or, to the extent these charges are directly related to pipeline integrity and safety, how these charges should be treated in relation to SFPP’s other pipeline integrity expenses.

#### **E. Oil Losses and Shortages**

63. Oil losses and shortages are recorded in Account 340 (Oil Losses and Shortages) and include the cost of settlements with shippers for oil losses or undelivered volumes due to operating causes during the course of transportation. The 2009 ID held that it was appropriate to use the actual test period amounts for Oil Losses and Shortages over the twelve-month period October 2007 through September 2008, which results in a gain (or credit to SFPP’s cost of service) of \$897,252. The 2009 ID rejected a gain of \$1.88 million proposed by ACC witness O’Loughlin which was derived using the base period level, and corresponded to actual 2007 West Line data.<sup>68</sup>

64. On exceptions the ACC Shippers aver that the 2009 ID calculated the Oil Losses and Shortages expense using an inappropriate test period adjustment. The ACC Shippers emphasize that no “unique or compelling circumstances” exist to permit the use of actual data from the adjustment period for the Oil Losses and Shortages account. The ACC Shippers contend that no data or analysis exists to suggest that data from October 2007 to September 2008 better represents going-forward levels than the 2007 base period data. Furthermore, the ACC Shippers allege that the 2009 ID’s adoption of actual adjustment

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<sup>67</sup> 18 C.F.R. Part 352 (2010).

<sup>68</sup> 2009 ID, 129 FERC ¶ 63,020 at P 847-851.

period data will incorporate a “cyclical” change, rather than a “lasting” change, which change is best represented by the actual 2007 level.

65. Opposing exceptions, SFPP states that it opposes the 2009 ID’s adoption of data from October 2007 through September 2008 for throughput, as well as, for operational and maintenance expenses (including Oil Losses and Shortages). However, SFPP avers the West Line’s actual Oil Losses and Shortage expense for the base period was a gain that was approximately \$550,000 higher than it was for the test period, annualized. SFPP asserts this difference is material and the ACC shippers have presented no valid basis to ignore the change. SFPP contends the most representative Oil Losses and Shortages expense is the West Line’s actual annualized expense for the adjustment period of January 2008 through September 2008.

66. Consistent with the discussion regarding the appropriate base and test period data to be utilized in this proceeding, the Commission adopts the annualized Oil Loss and Shortage expense level proposed by SFPP for the period January 2008 through September 2008.

#### **F. Environmental Remediation**

67. The 2009 ID determined that the appropriate level of environmental remediation expenses should be no more than \$1,877,610.<sup>69</sup> The 2009 ID concluded that SFPP will continue to incur remediation costs of a similar magnitude on a recurring, long term basis and that such costs have been shown to be directly associated with spills or accidents on the West Line.

68. On exceptions, Trial Staff asserts that the 2009 ID erred by failing to remove costs that Staff alleges result from releases from non-carrier facilities, incurred at sites not currently used in interstate shipments, or associated with non-interstate shipments. Trial Staff contends that the releases from Colton Terminal and Norwalk Defense Fuel Supply Center, which Staff states constitute over 85 percent of total remediation expenses, are not from jurisdictional carrier facilities. Staff also asserts that SFPP witness Hanek was unable to confirm that environmental remediation costs stemmed from the release of interstate shipments. Trial Staff allege that to the extent groundwater contamination occurred at Colton Terminal, it has been commingled with contamination that resulted from historical spills and that to that extent the First Quarter 2009 Groundwater Monitoring Report for Colton Terminal does not address any spills from West Line carrier property. Trial Staff further alleges that SFPP seeks recovery for remediation expenses for events that occurred long ago at facilities which are no longer in service.

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<sup>69</sup> 2009 ID, 129 FERC ¶ 63,020 at P 824.

Staff alleges that SFPP failed to establish that environmental remediation costs can be specifically and exclusively attributable to interstate shipments.

69. SFPP claims that Trial Staff failed to raise the jurisdictional arguments in its initial testimony, and that Trial Staff only asserted that the environmental costs related to non-jurisdictional claims on the last day of hearing after all testimony had been filed and after all of SFPP's witnesses had been cross-examined. SFPP further avers that Trial Staff is incorrect to claim that environmental remediation costs do not relate to jurisdictional facilities or shipments. SFPP explains that SFPP witness Hanek could not identify that a particular barrel was interstate or "military" because the pipeline carries interstate, intrastate, and military movements, and leaks occur gradually over a long period of time and include whatever particular product is being shipped. SFPP states that most of the leaks at Colton resulted from a release at C-18, which is used as a breakout tank for transportation services on the West Line. Moreover, SFPP explains that it applied the West Line interstate volume percentage to the total 2007 Colton expenses and included only the resulting interstate amount in the West Line rates. Regarding the Norwalk facilities, SFPP states that it applied the West Line interstate volume percentage to the total 2007 Norwalk environmental remediation expenses and included only the resulting amount in SFPP's proposed West Line rates.

70. The Commission upholds the 2009 ID. The Commission finds that Trial Staff has not provided substantial evidence that the Initial Decision improperly included non-jurisdictional environmental remediation expenses in the adopted cost figure of \$1,877,610.<sup>70</sup> These facilities on the West Line are not used exclusively for jurisdictional or non-jurisdictional shipments and the Commission is not persuaded that the environmental costs can be attributed exclusively to non-jurisdictional service. Thus, SFPP has properly allocated these costs using the same volumetric methodology used to allocate other costs between interstate and intrastate costs.

### **G. Definition of Carrier Service**

71. On exceptions Trial Staff and SFPP disagree about the definition of "carrier services" and its import for this proceeding. At hearing Trial Staff argued that SFPP should modify its filing to distinguish between jurisdictional and non-jurisdictional services in preparing its rate filing. Trial Staff asserted that SFPP's definition of "carrier services" violates 18 C.F.R. § 341.0(a)<sup>71</sup> because SFPP does not limit its definition to jurisdictional services regulated by the Commission. In contrast, SFPP asserted that the only non-carrier services were unregulated services, which are primarily some of its

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<sup>70</sup> 2009 ID, 129 FERC ¶ 63,020 at P 824.

<sup>71</sup> 18 C.F.R. § 341.0(a) (2010).



terminal storage services. SFPP asserted that Trial Staff's position was based on the definition of "carrier" in 18 C.F.R. § 341.0(a) and that the definition of carrier services is more inclusive. SFPP stated that the *Uniform System of Accounts Prescribed for Oil Pipeline Companies* at 18 C.F.R. Part 352<sup>72</sup> instructs carriers like SFPP to treat all types of pipeline transportation as carrier services except those not associated with pipeline operations. SFPP asserts that the annual report required from pipelines, FERC Form No. 6, draws a similar distinction. It further concludes that there is no practical impact for this proceeding from the point Trial Staff is making.<sup>73</sup> The 2009 ID concluded that Trial Staff's definition should be adopted to provide greater consistency and transparency in oil pipeline filings.<sup>74</sup> On exceptions Trial Staff and SFPP advance the positions they took at the hearing.

72. The Commission finds that the accounting regulations governing oil pipeline record keeping and the FERC Form No. 6 do not precisely distinguish between jurisdictional and non-jurisdictional facilities and services operated by interstate oil pipelines. However SFPP is correct that under current Commission practice, all oil pipeline transportation property, revenues, and expenses are commingled in the pipeline's accounts under the terms of 18 C.F.R. Part 352 if used in oil pipeline transportation.<sup>75</sup> Portions of FERC Form No. 6 also commingle interstate and intrastate balance sheet and expense items under current practice,<sup>76</sup> while in contrast page 700 of Form No. 6 specifically refers to interstate revenues only.<sup>77</sup> Thus the separate reporting of inter- and intrastate data is imperfect at this time. However, given that an industry wide reporting practice is involved, an individual pipeline proceeding is not the place to modify it. This is particularly the case since, as SFPP states, the matter makes no practical difference here because the revenues and expenses are allocated based on the volumetric and mileage factors previously discussed in this order. The 2009 ID is therefore reversed in this regard.

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<sup>72</sup> *Id.* at Part 352.

<sup>73</sup> *See* 2009 ID, 129 FERC ¶ 63,020 at P 529-533.

<sup>74</sup> *Id.* P 813.

<sup>75</sup> *See* 18 C.F.R. Part 352 (General Instructions, 1-1 Classification of Accounts) at p. 971 (Account 30), and at p. 982 (Accounts 620 and 621).

<sup>76</sup> *See* FERC Form No. 6 at p. 114.

<sup>77</sup> *Id.* at p. 700.

#### **IV. Allocation of Overhead Costs**

73. This section reviews the methodology for allocating overhead costs to SFPP as a member of a large group of affiliated enterprises and the related issue of how to allocate those overhead costs between SFPP's jurisdictional and non-jurisdictional functions, and between certain of its jurisdictional functions. The allocation of overhead costs to SFPP as one operating entity within a complex corporate structure is governed by the so-called Massachusetts Formula.<sup>78</sup> The allocation of overhead costs between SFPP's jurisdictional and non-jurisdictional facilities, and among SFPP's different jurisdictional activities, is governed by the so-called KN Method.<sup>79</sup> Neither SFPP nor its owning master limited partnership KMEP has any employees. Instead, as explained below, all operating and administrative services and all related overhead functions are provided by Kinder Morgan, Inc. (KMI)<sup>80</sup> and KinderMorgan General Partner Services (GP Services). Both KMI and GP Services provided overhead services to various KMEP operating units, including SFPP, during the 2007 base year at issue here. Thus, the issue before the Commission is how to allocate overhead costs incurred to support KMEP's operating units among those units. To this end, this part of the order first summarizes the relevant corporate and accounting structures and then analyzes the issues raised by the Massachusetts Formula and the KN Method. A number of cost accounting issues are reviewed to the extent these affect how the calculations would be performed under either the Massachusetts Formula or the KN Method.

##### **A. The Corporate Structure**

74. SFPP's position in the KMI ownership structure reflects the evolution of the KMEP master limited partnership within which SFPP is embedded. While the management and cost accounting structures differ from the ownership structure, a synopsis of the latter is essential to understanding the former. The overall ownership structure is reflected in Exhibit No. SFP-194.<sup>81</sup> SFPP is at the lowest level of the KMI corporate structure and is owned 99.5 percent by a general partner OLP-D.<sup>82</sup> Ninety-nine

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<sup>78</sup> See *Northwest Pipeline Corp.*, 71 FERC ¶ 61,253, at 61,984 (1995).

<sup>79</sup> See *Kansas-Nebraska Natural Gas Co. Inc.*, 53 FPC 1691, 1721-22 (1975).

<sup>80</sup> KMI is now Knight Inc. after KMI became a privately controlled Subchapter C corporation. It is still referred to as KMI here. See Ex. SFP-188 at 42.

<sup>81</sup> See Ex. SFP-39 at 1 for a schematic of Kinder Morgan, Inc. in 2007. See also Ex. SFP-139, Ownership of SFPP, L.P. – 2007, reproduced as Appendix A to this order. See also Ex. ACV-60 for a detailed schematic of KMI's and KMEP's structure.

<sup>82</sup> A .5 percent (.005) limited partnership interest is owned by the partnership which sold SFPP to KMEP in late 1998.

percent of the OLP-D limited partnership interests are owned by KMEP and the remaining one percent general partnership interest is owned by Kinder Morgan General Partners Inc. (KMGP). KMGP also owns a one percent general partner interest in KMEP, as well as a one percent general partner interest in the other OLP entities that own various operating assets. The OLP entities constitute the second level of the KMI ownership structure.<sup>83</sup> KMGP thus owns the general partnership interests of the OLP entities, and KMEP owns the limited partnership interests of the intermediate entities. KMGP and KMEP thus constitute the third level of ownership. KMGP and KMEP are owned at a fourth level as follows. KMI owns 100 percent of KMGP (which controls all general partnership interests) and a portion of the limited partnership interests in KMEP.<sup>84</sup> The remainder of the KMEP limited partnership interests is publicly held. Finally, it should be noted that KMEP does not own all of the operating entities involved in the KMI corporate structure. KMI owns and operates a number of natural gas entities and joint ventures and also operates a number of entities that are included in KMEP's structure.

### **B. The Accounting Structure**

75. This section summarizes the management and accounting structure KMI uses to manage the various entities owned and operated by either KMI or KMEP.<sup>85</sup> This functional structure differs from the ownership structure. SFPP's description of KMI's accounting structure and its purpose are not at issue here. Rather, what is at issue is whether that structure and methodology are appropriate given the goals of Commission regulation, and if so, whether the methodology is sufficiently accurate that it may be adopted in this proceeding as the means for allocating certain overhead costs to SFPP for the purpose of determining its West Line rates.

76. SFPP states that there are four basic types of operating entities within the overall KMI structure: (1) KMEP-Operated Entities; (2) KMI-Operated Entities; (3) KMI-Owned Entities; and (4) Joint Ventures. The KMEP-Operated Entities are owned by KMEP and are operated by GP Services on behalf of KMEP. The KMEP-Operated Entities are grouped into the following three distinct business groups or "tiers": (1) the products pipeline division, of which SFPP is a member (Tier 2); (2) the CO<sub>2</sub> pipelines

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<sup>83</sup> These are OLP-C, OLP-B, and OLP-A, as well as CO<sub>2</sub>. The term OLP stands for operating limited partnership.

<sup>84</sup> This allows KMI to file a consolidated return with KMGP as its 100 percent shareholder and also to receive pass through limited partnership income from KMEP.

<sup>85</sup> The summary is derived from the testimony and materials SFPP submitted at hearing and certain of SFPP's exhibits are included in Appendices A through C.

division (Tier 3); and (3) the terminals division (Tier 4).<sup>86</sup> To the extent possible, GP Services directly assigns the costs incurred on KMEP's behalf to individual entities within these three groups, to a group as a whole, and in the case of products pipelines, by certain geographic areas. The remaining residual costs are allocated to the KMEP-Operated Entities through KMEP's Massachusetts formula. SFPP asserts that the costs generated by GP Services are incurred only by the KMEP-Operating Entities and are not incurred by any other entities in the KMI structure, including eight natural gas pipelines that are owned by KMEP but operated by KMI.

77. The assignment of costs to different operating levels within the KMEP structure is the basis for what SFPP calls the "tier" costing methodology. SFPP states that the use of the tier methodology provides an accurate picture of how expenses are related to the business of KMEP and its subsidiaries, provides an accurate accounting of those costs, and attempts to match cost incurrence with cost allocation. Under this method, Tier 1 encompasses all KMEP-Operated Entities. The costs included in Tier 1 are those applicable to all of the KMEP-Operated Entities, that is, the "residual overhead costs" that cannot be directly assigned to another tier. Tier 2 is comprised of KMEP's products pipeline subsidiaries. SFPP is in Tier 2. Thus the costs included in Tier 2 are those that are incurred on behalf of all of KMEP's products pipelines and related facilities and can be directly assigned to that tier. Tier 2 is further subdivided into four regional groups, and all costs that can be directly assigned to a specific regional group are assigned to that group and then allocated among the subsidiaries in that group.<sup>87</sup> The Tier 2 overhead costs that cannot be attributed to any one of the regional groups are allocated to all of the members of Tier 2. Tier 3 assigns and allocates costs exclusively to KMEP's CO<sub>2</sub> pipeline entities. Tier 4 assigns and allocates costs specific to bulk terminals and the terminals that are not associated with the products pipelines contained in Tier 2.<sup>88</sup>

78. The KMI-Operated Entities comprise eight natural gas pipeline systems that are owned by KMEP but are managed and operated by KMI. SFPP states that most of the KMI-Operated Entities were originally owned by KMI, but were transferred to KMEP for

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<sup>86</sup> 2009 ID, 129 FERC ¶ 63,020 at P 56-56 (citing Ex. SFP-38 at 23-24).

<sup>87</sup> The four regional groups are the Pacific Operations group, the Mid Continent Operations Group, the Eastern Operations Group, and the Southeast Operations Group, each of which controls a group of product pipelines and their related facilities. SFPP is a member of the Pacific Operations Group along with Calnev Pipe Line, LLC and certain pacific coast terminal companies. *See* Ex. SFP-38 at 17; *cf.* 2009 ID, 129 FERC ¶ 63,020 at P 298.

<sup>88</sup> Ex. SFP-38 at 23-24; 2009 ID, 129 FERC ¶ 63,020 at P 56-57.

tax purposes.<sup>89</sup> The fact that these natural gas companies were once owned by KMI is the primary reason that KMI continues to operate and manage them. SFPP states that KMI directly charges four of the KMI-Operated Entities for all operations and maintenance costs where possible. KMI allocates residual amount to these four KMI-Operated Entities through the operation of a KMI Massachusetts Formula. For the remaining four KMI-Operated Entities, KMI is compensated for the general and administrative overhead expenses through fixed fees that those four entities pay to KMI. SFPP asserts that none of these costs are incurred directly or indirectly by KMEP and thus none are allocated or incurred by SFPP.

79. The KMI-Owned Entities are owned and operated by KMI<sup>90</sup> and include several natural gas pipeline systems. The KMI-Owned Entities are assigned costs directly by KMI where possible and the residual costs are allocated through the KMI Massachusetts Formula. The fourth group of entities in the KMI structure are joint ventures in which KMEP is a minority partner or for which all operating and overhead functions are performed and billed by a third party.<sup>91</sup> A relatively new KMEP affiliate is Kinder Morgan Canada (KM Canada), which controls three Canadian entities. SFPP states that these Canadian entities are managed almost exclusively by their own employees pursuant to the requirements of Canadian law.<sup>92</sup> SFPP states that few if any direct or indirect costs of these last three groups are allocated to KMEP, and that in any event it has assured that

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<sup>89</sup> See Ex. SFP-38 at 26, 27-30 and Ex. SFP-129 at 31-32. The eight KMI-Operated Entities (but KMEP owned) in 2007 were Casper-Douglas Natural Gas Gathering and Processing Systems (Casper-Douglas); Tejas Gas LLC (Tejas Consolidated); Kinder Morgan Interstate Gas Transmission (KMIGT); Trailblazer Pipeline Company (Trailblazer); KM North Texas; KM Gas de Natural de Mexico (KM Mexico); TransColorado Gas Transmission Company (TransColorado); and Rockies Express Pipeline (REX).

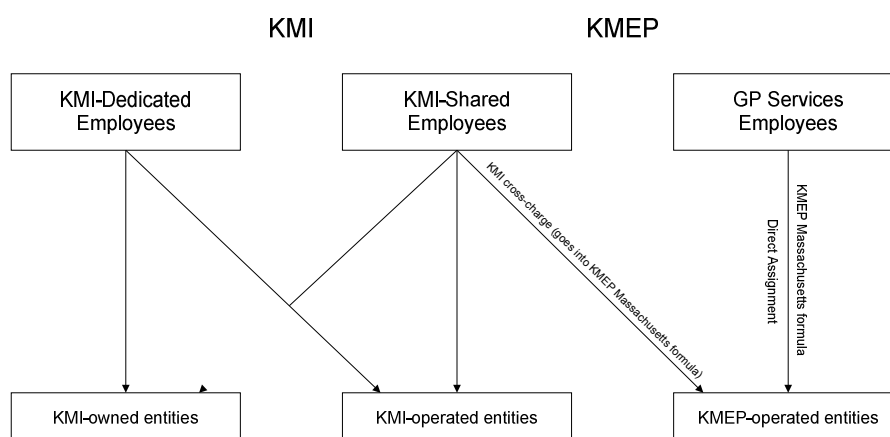
<sup>90</sup> The full list of entities included in the KMI Massachusetts Formula model in 2007 shown in Ex. SFP-44. This list contains 24 separate legal entities, but only the eight KMEP-Owned, but KMI-Operated, entities listed in the previous footnote are relevant to the analysis in this part of the order. As discussed below, there is no rational basis for including all of the KMI-Owned and KMEP-Owned entities in a single Massachusetts Formula calculation.

<sup>91</sup> The joint ventures are Heartland Pipeline Company (Heartland), Red Cedar Gas Treating LLC (Red Cedar), Thunder Creek Gas Services LLC (Thunder Creek), and the International Marine Terminal (Marine Terminal).

<sup>92</sup> KM Canada includes the Vancouver Wharves Terminal, Cochin Canada Pipeline, and Trans Mountain Pipeline Company.

none of their costs flow to SFPP. SFPP concludes that given KMI's accounting methodology and a minor amount costs removed from KMEP's cost structure, the KMI-Operated Entities, the joint ventures, and KM Canada are properly excluded from KMEP's Massachusetts Formula even though KMEP owns them.

80. As discussed, with the exception of KM Canada, only two KMI entities have employees: KMI and GP Services. GP Services employees operate and manage only the KMEP-Operated Entities for KMEP. Thus, GP Services employees perform no work for either KMI-Owned Entities or KMI-Operated Entities. The KMI-Owned Entities and KMI-Operated Entities are operated and managed only by KMI employees. SFPP further explains that all KMI employees fall into one of two categories. The employee is either (1) a KMI-dedicated employee, serving only the KMI-Owned Entities and the KMI-Operated Entities, or (2) a KMI-shared employee serving the KMI-Owned and KMI-Operated Entities, and also the KMEP-Operated Entities. This distribution of responsibility is reflected in the following chart, which is reproduced from SFPP witness Dale D. Bradley's (Bradley) Exhibit No. SFP-39.<sup>93</sup>



The chart demonstrates how costs flow to the KMEP-Operated Entities from two sources: (1) GP Services, whose costs flow down to the KMEP-Operated Entities by direct assignment or through the KMEP's Massachusetts Formula, and (2) KMI-Shared Employees, through a cross charge to the KMEP Massachusetts Formula for the costs incurred on behalf of the KMEP-Operated Entities.<sup>94</sup> As discussed, SFPP is a KMEP-operated entity that would be located below the far right hand box. If additional boxes were shown beneath the KMI-Operated Entities box, the first one down would be that for

<sup>93</sup> Ex. SFP-39 at 2.

<sup>94</sup> An example of a KMI-Shared Employee cross-charge is the charge for costs incurred on behalf of the KMEP-Operated Entities by the office of KMI's chairman.

the Products Pipeline Group, then that for the Pacific Group, and then that for SFPP. The chart does not show the employees for the joint ventures and Canadian entities as SFPP states that the relevant costs are billed by the joint venture partner controlling the employees or by the Canadian entities.

81. SFPP further explains that KMI's accounting system is based on the concept of responsibility centers (RCs). Specifically, costs are captured in responsibility centers and flow to the subsidiaries (including various operating entities) that each responsibility center serves. Thus employees within KMI and GP Services (and their associated costs) are divided into responsibility centers based on their functional duties and the geographic locations of the subsidiaries they support. SFPP states that each responsibility center has its own budget and tracks and assigns costs to the subsidiaries it supports. SFPP further asserts that the use of responsibility centers allows KMEP and KMI to isolate, identify, and control costs by business segment and by region. SFPP claims, within each responsibility center, employees use either time sheets (hourly time recording) or salary splits (percentage-based time recording) to track the time they spend working for various entities or groups.<sup>95</sup>

82. SFPP further asserts that because GP Services' responsibility centers and their employees perform no work for any KMI-Operated Entity or KMI-Owned Entity, the GP Services costs that cannot be directly assigned to an individual KMEP-Operated Entity or Tier are distributed through KMEP's Massachusetts Formula. SFPP asserts that all GP Services' costs incurred for the benefit of a limited group of subsidiaries, such as those in a particular business segment (e.g., products pipelines), are directly assigned to that group of subsidiaries. Those costs are then allocated among the members of that group as a "shared cost distribution" using the three allocators of the Massachusetts Formula derived from the members of the particular group or subgroup involved.<sup>96</sup> SFPP states that the remaining "residual" GP Services costs incurred for the benefit of all KMEP-Operated Entities are allocated among all the KMEP-Operated Entities using KMEP's Massachusetts Formula. Thus, there are three sets of costs that are allocated to SFPP through three different Massachusetts Formulas: the costs assigned or allocated to KMEP, the costs directly assigned to the Products Pipeline Group, and the costs directly assigned to the Pacific Group.<sup>97</sup>

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<sup>95</sup> Ex. SFP-38 at 10-12; Ex. SFP-129 at 8-9.

<sup>96</sup> As discussed in more detail below, the three allocators of the Massachusetts Formula are (1) labor, (2) revenue, and (3) and property, plant, and equipment.

<sup>97</sup> See Ex. SFP-40 at 1, 2, and 5. Line 13 of page 5 shows how the costs are allocated to SFPP under the Massachusetts Formula based on SFPP's relative proportion

(continued...)

83. SFPP states that the KMI employees that work for the responsibility centers managing the individual KMI-Operated Entities and KMI-Owned Entities directly assign their expenses to those entities to the extent possible. SFPP also explains that certain of KMI's corporate overhead costs (such as those of the Office of the Chairman, which provides executive guidance and oversight to the entire KMI organization) cannot be directly assigned to an individual operating subsidiary because such activities benefit multiple entities within the KMI business structure. SFPP asserts that there are three shared-services accounts KMI uses to capture those corporate overhead costs that cannot be directly assigned. It states that SFPP receives those costs from only one of these three shared services account, specifically Account 184601.<sup>98</sup>

84. SFPP states that the other two shared services accounts, 107001 and 184600, involve costs that are distributed only among the KMI-Owned and KMI-Operated Entities and have no impact on KMEP's Massachusetts Formula. It explains that the first shared services account, Account 107001, is used only to capture all of the overhead costs associated with the support of capital projects for the KMI-Operated and KMI-Owned Entities. SFPP states that both KMI-shared employees and KMI-dedicated employees may charge time to Account 107001. SFPP further explains that the expenses in Account 107001 are not charged to KMEP and are not included in the pool of costs allocated through KMI shared-cost allocations or KMEP's Massachusetts Formula. Instead, SFPP asserts, the costs in Account 107001 are distributed among the KMI-Operated and KMI-Owned Entities through a separate allocation methodology based on each entity's level of capital spending.<sup>99</sup>

85. SFPP further states that the second shared services account, Account 184600, is used to capture KMI's corporate overhead costs incurred only for the benefit of the KMI-Owned and KMI-Operated Entities. It asserts that both KMI-shared employees and KMI-dedicated employees may charge time to Account 184600. SFPP also states that the expenses in Account 184600 are not charged to KMEP or allocated through KMEP's shared cost distributions or its Massachusetts Formula. SFPP states that the total costs assigned to Account 184600 are first offset by the fixed fees that four of the KMI-Operated Entities pay to KMI. SFPP asserts that any difference between the amount in the account and the fees paid by those KMI-Operated Entities is allocated among the KMI-Owned Entities and the remaining KMI-Operated Entities through KMI's own Massachusetts Formula allocation. Thus, if there is any shortfall in the recovery of the

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of the residual (unassigned) costs for KMEP, the Products Pipeline Group (PPL General), and the PPL Pacific Group, with a total in the far right-hand column.

<sup>98</sup> Ex. SFP-38 at 7-8, 11-12, 18-19, and 30-31.

<sup>99</sup> *Id.* at 14-15.



costs through the fixed fees from the KMI-Operated Entities paying those fees, none of that shortfall or any other residual costs in Account 184600 flow to KMEP or to SFPP.<sup>100</sup>

86. SFPP explains that the third shared services account, Account 184601, is used only to capture the corporate overhead costs incurred by KMI-shared employees and the related responsibility centers for the benefit of the KMEP-Operated Entities, such as SFPP. SFPP states that the KMI-dedicated employees and their related responsibility centers are not allowed to budget expenses or charge time to Account 184601. SFPP states that unlike the other two shared services accounts which do not allocate costs to KMEP, the costs contained in Account 184601 are assigned to KMEP through a “KMI Cross-Charge,” and then allocated among the KMEP-Operated Entities through KMEP’s Massachusetts Formula allocation.<sup>101</sup> SFPP states that only the portion of KMI’s “shared costs” that are included in Account No. 184601 are assigned to KMEP, and then through KMEP’s Massachusetts Formula to the KMEP-Operated Entities such as SFPP.<sup>102</sup>

87. SFPP states that expenses related to support services from KMI-shared employees that may be allocated to KMEP are subjected to a rigorous accounting review to ensure their accuracy. SFPP further states that KMI uses the Lawson Financials system for its enterprise-wide accounting system. This system uses a ledger and various customized reports to verify the accuracy of the overhead expenses charged to KMEP. The expenses are then subject to an approval process at the local and executive levels at KMI and GP Services. A supervisor or manager of the responsibility center is ultimately responsible for the accuracy of these numbers, and they are compared to the budgeted charges during monthly earnings review meetings. Wherever the expenses materially deviate from the budget, they are discussed and corrections are identified.<sup>103</sup>

88. In this case, the total overhead costs allocated to KMEP through the KMI cross-charge contained in Account 184601 were \$63.312 million.<sup>104</sup> The direct assignments to KMEP-Operated Entities were \$89.243 million and the total allocated to those entities through KMEP’s Massachusetts Formula was \$234.6 million.<sup>105</sup> After revisions, SFPP states that the total overhead costs allocated to SFPP by direct assignment from GP

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<sup>100</sup> Ex. SFP-39 at 2-3.

<sup>101</sup> The KMI cross-charge to KMEP is reflected on page 9, line 16 of Ex. SFP-40 and was \$63,312,015 in 2007.

<sup>102</sup> Ex. SFP-38 at 11-12; Ex. SFP-129 at 12-13.

<sup>103</sup> 2009 ID, 129 FERC ¶ 63,020 at P 52; Ex. SFP-38 at 12; Ex. SFP-129 at 13-14.

<sup>104</sup> Ex. SFP-40 at 9, line 16.

<sup>105</sup> See Ex. SFP-342.

Services, and by the application of the KMEP's Massachusetts Formula (including the indirect costs from GP Services and the KMI cross-charge), were \$41,240,000. Of this, the direct assignment of overhead costs to SFPP from KMEP cost centers was \$9,802,000 and the allocation of overhead costs under KMEP's Massachusetts Formula was \$31,438,000.<sup>106</sup> In contrast, Mr. O'Loughlin would allocate \$19,923,000 in overhead costs to the West Line based on an overhead cost allocation that apparently includes all of the entities owned by KMEP, which includes the KMI-Operated Entities, KMEP-Operated Entities and the Joint Ventures (together the KMEP-Owned Entities) and joint ventures in a single Massachusetts Formula.<sup>107</sup> Daniel S. Arthur, Ph.D., lead witness for the ACV-Shippers, would allocate \$20,366,534 to all of SFPP's operations (including the West Line) by using a single Massachusetts Formula that may include all of the KMI-Owned and KMEP-Owned Entities, although this is unclear.<sup>108</sup>

### C. The Massachusetts Formula

89. The 2009 ID contains a detailed summary of KMI's accounting system based on the testimony of SFPP's witnesses<sup>109</sup> and the protesting shipper parties' and the Trial Staff's criticisms of that system.<sup>110</sup> The Commission concludes that the 2009 ID fairly

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<sup>106</sup> See Ex.SPF-342

<sup>107</sup> See Ex. ACV-3 at 5, line 6. While Mr. O'Loughlin states in his text that he used the same overhead cost allocation method as Dr. Arthur (Ex. ACV-1 at 32), Mr. O'Loughlin's overhead costs for the West Line were almost the same as Dr. Arthur's overhead costs for all of SFPP (n.109 *infra*). This suggests that of Dr. Arthur's two methods, Mr. O'Loughlin may have used the KMEP-wide Massachusetts Formula and not the combined KMI-KMEP Massachusetts Formula Dr. Arthur advances.

<sup>108</sup> Ex. ACV-86 at 1. Pages 3 through 6 thereof provide the detailed calculations for a single combined KMI-KMEP Massachusetts Formula. However, the Joint Initial Brief of the ACV Shipper's states that Dr. Arthur's use of KMEP-wide Massachusetts Formula allocates \$17.6 million in costs to all of SFPP rather than attributing that number to the West Line only. See Joint Initial Brief of Continental Airlines, Inc., Northwest Airlines, Inc., Southwest Airlines Co., US Airways, Inc., Chevron Products Company, ConocoPhillips Company, and Valero Marketing and Supply Company dated September 30, 2009 at 45. This statement does not appear consistent with Ex. ACV-3 at 5, line 6, cited in the previous footnote, nor does the cited brief provide any analysis of the cost allocations to SFPP of Dr. Arthur's proposed combined KMI-KMEP Massachusetts Formula.

<sup>109</sup> 2009 ID, 129 FERC ¶ 63,020 at P 36-74, 236-266, 294-302, 330-334, 451-512.

<sup>110</sup> *Id.* P 693-736, 745-747.

reviewed the testimony regarding KMI's method for applying the Massachusetts Formula to KMI's and GP Services's costs and for assigning and allocating those costs to KMEP and SFPP through that methodology. The Commission also concludes that the 2009 ID fairly summarizes the overall operations of KMI's accounting system.<sup>111</sup>

90. The 2009 ID correctly summarized the Massachusetts Formula,<sup>112</sup> stating that the Massachusetts Formula allocates to subsidiary companies those corporate overhead costs (general and administrative, or G&A) that cannot legitimately be assigned on a direct basis to a specific subsidiary.<sup>113</sup> The Massachusetts Formula allocates corporate overhead costs to a regulated utility subsidiary using an average of three ratios: (1) the regulated utility subsidiary's gross operating revenues to total corporate gross operating revenues; (2) the regulated utility subsidiary's gross property, plant, and equipment to total corporate gross property, plant, and equipment; and (3) the regulated utility subsidiary's gross payroll (or direct labor costs) to total corporate gross payroll.<sup>114</sup> Overhead costs are allocated to the affiliate based upon the average of the three percentages of each of these three items times the total dollar figures for the three accounting items stated in the previous sentence.<sup>115</sup> The three averages are weighted equally.<sup>116</sup> In the instant case, the accuracy of KMI's direct assignments is the key issue concerning KMI's application of the Massachusetts Formula cost methodology to its accounting system.

91. The 2009 ID made seven main findings regarding KMI's accounting system. First, that KMI's accounting structure is consistent with the purpose of the Massachusetts Formula because it directly assigns overhead costs to specific subsidiaries where possible, and then allocates the residual costs through KMEP's Massachusetts Formula.<sup>117</sup> Second that the KMI-Operated Entities, certain Joint Ventures, and the KM

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<sup>111</sup> *Id.* P 748-795.

<sup>112</sup> *Id.* P 693-694.

<sup>113</sup> *Northwest Pipeline Corp.*, 71 FERC ¶ 61,253, at 61,984 (1995) (*Northwest*). The Commission has explained that “[d]irect costs are costs that the parent company can specifically identify and directly assign to the subsidiary that incurred the costs,” and “[s]uch direct-billed corporate services are not considered in the allocation process.” *Michigan Gas Storage Co.*, 87 FERC ¶ 61,038, at 61,171-73 (1999).

<sup>114</sup> *KN Interstate Gas Transmission Co.*, 88 FERC ¶ 61,270, at 61,848 (1999) (citing *Williams Natural Gas Co.*, 77 FERC ¶ 61,277, at 62,188 (1996)).

<sup>115</sup> *Id.* (citing *Williams Natural Gas Co.*, 77 FERC ¶ 61,277, at 62,188).

<sup>116</sup> *Michigan Gas Storage Co.*, 87 FERC ¶ 61,038, at 61,171-73 (1999).

<sup>117</sup> 2009 ID, 129 FERC ¶ 63,020 at P 750-758.

Canada subsidiaries were properly excluded from the KMEP's Massachusetts Formula.<sup>118</sup> Third, KMI's accounting system assigned or allocated costs with reasonable accuracy.<sup>119</sup> Fourth, that year-end plant balances should be used to determine the rate base element used in SFPP's Massachusetts Formula, and thereby rejected SFPP's proposal to use a two-year (semi-annual) average.<sup>120</sup> Fifth, that any purchase accounting adjustments (PAA) should be removed from both jurisdictional and non-jurisdictional entities.<sup>121</sup> Sixth, that it is acceptable to use Tejas Consolidated's net revenues in applying the Massachusetts Formula if the Tejas Consolidated were included in KMEP's Massachusetts Formula.<sup>122</sup> Seventh, the 2009 ID excluded KMI's capitalized overhead costs from the Massachusetts Formula.<sup>123</sup> The 2009 ID therefore rejected the ACC Shippers' proposal that all entities included in the KMI business structure be consolidated in a single corporate-wide "all in" Massachusetts Formula that would include all of the overhead costs of all the KMI-Owned, KMI-Operated, KMEP-Operated, Joint Venture and KM Canada entities.<sup>124</sup> The 2009 ID also rejected ACC Shipper's alternative proposal, which is similar to Tesoro's, that all KMEP-Owned Entities be included in KMEP's Massachusetts Formula. The 2009 ID also rejected Trial Staff's proposal to use a KMEP wide formula on an interim basis.<sup>125</sup>

92. On exceptions, Valero asserts that the 2009 ID erred in permitting KMEP to use direct and shared-cost distributions in allocating overhead expenses to its subsidiaries and by excluding certain subsidiaries from a single-tier Massachusetts Formula. Valero agrees that the 2009 ID incorrectly omitted the subsidiary from that calculation. Trial Staff also asserts that the 2009 ID incorrectly excluded certain subsidiaries from KMEP's Massachusetts Formula, but in less categorical terms. In addition, Valero asserts that the 2009 ID did not apply the correct legal standards, should not have accepted the accuracy and reliability of KMI's accounting methodology, incorrectly permitted the use certain of the cost of service components, and erred by not using gross revenues as the revenue component for all applications of that Formula. SFPP opposes the 2009 ID's conclusion that KMI's capitalized overhead costs should be excluded from the operation of its

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<sup>118</sup> *Id.* P 759-768.

<sup>119</sup> 2009 ID, 129 FERC ¶ 63,020 at P 775-778.

<sup>120</sup> *Id.* P 779-780.

<sup>121</sup> *Id.* P 781-785.

<sup>122</sup> *Id.* P 786-790.

<sup>123</sup> *Id.* P 791-796.

<sup>124</sup> *Id.* P 769.

<sup>125</sup> *Id.*

Massachusetts Formula. On reply, Trial Staff generally supports the 2009 ID but seeks on exceptions that the Commission require SFPP to include all KMEP-Owned Entities in the KMEP Massachusetts Formula, at least until SFPP can provide additional information supporting its proposed cost assignments and allocations. SFPP generally supported the 2009 ID's conclusions regarding the exclusion of the KMI-Operated Entities and the Joint Ventures.

93. The Commission's review is grouped by five topics: (1) the appropriateness of KMI's accounting methodology; (2) the resolution of certain general legal issues; (3) the proposed exclusion of certain of KMEP-Owned Entities; (4) the reliability of KMI's accounting system; and (5) the use of certain cost and revenue components in KMEP's Massachusetts Formula.

### **1. The Appropriateness of KMI's Accounting Methodology**

94. The 2009 ID concluded that KMI's accounting methodology was appropriate and consistent with the requirements of the Massachusetts Formula because that methodology seeks to maximize the direct assignment of costs to the various operating entities in the KMI system including those owned by KMEP.<sup>126</sup> The 2009 ID also found that the KMI methodology also assigns of costs directly to lowest level in the accounting structure where possible. As stated in *Northwest*, the Massachusetts Formula requires, to the extent is its reasonably possible, the direct assignment of costs to individual entities or operations, i.e., the lowest possible level, which in this case is SFPP.<sup>127</sup> On review, the Commission concludes that the 2009 ID correctly held that KMI's methodology is consistent with the purpose of the Massachusetts Formula. KMI's methodology seeks to assign costs at the lowest possible level of KMI's and KMEP's business structures, and then allocates the residual costs through the Massachusetts Formula to each business entity that benefits from the costs incurred by KMI or GP Services. This means costs that are not directly assigned to SFPP are assigned either to the Pacific Group or to the Products Pipeline Group where possible, which is also consistent with assigning costs at the lowest possible level within KMEP business structure. Importantly, the Products Pipeline, CO<sub>2</sub>, and Terminal Groups each consist of a group of operating entities or facilities having similar operating and commercial characteristics. That similarity is the

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<sup>126</sup> *Id.* P 750-758.

<sup>127</sup> *Northwest*, 71 FERC at 61,984. The Commission has explained that “[d]irect costs are costs that the parent company can specifically identify and directly assign to the subsidiary that incurred the costs,” and “[s]uch direct-billed corporate services are not considered in the allocation process.” *Michigan Gas Storage Co.*, 87 FERC ¶ 61,038, at 61,171-73 (1999).

basis for KMEP's direct assignment of costs to those Groups. However, when overhead costs cannot be directly assigned based on the costs records derived from those differing operating and commercial characteristics, overhead costs are allocated among the three Groups under KMEP's Massachusetts Formula, and there through the Products Pipeline Group and the Pacific Group to SFPP.<sup>128</sup>

95. Regarding this fundamental point, SFPP has presented sufficient evidence that KMI's accounting methodology provides an effective method for isolating the direct and indirect overhead costs that flow from KMI-dedicated employees or from KMI-shared employees to the KMI-Owned Entities. Because KMI's accounting structure rigidly separates KMI employees and GP Services employees, the costs of the KMI-dedicated employees are isolated from those of the GP Services employees providing the bulk of administrative and overhead services to KMEP.<sup>129</sup> Accordingly, including the KMI-Owned Entities in KMEP's Massachusetts Formula would allocate costs to a large number of entities that do not benefit from the costs that flow to KMEP (and the KMEP-Operated Entities) from GP Services, as well as those that are allocated to KMEP from the KMI-shared employees through the KMI crosscharge. Similarly, the costs of the KMI-Owned Entities would flow to the KMEP-Operated Entities even though the latter do not benefit from the costs of the KMI-dedicated employees. Thus, the only purpose for such "all in" approach that combines all of the KMI and KMEP entities, and which would combine all of their overhead costs in a single Massachusetts Formula, is to spread all of KMI's and KMEP's overhead costs over the largest possible number of entities. The ACC Shippers propose doing so without regard to which entities received the benefit of specific cost centers or whether a specific entity had any involvement in the underlying business activity that generated those costs. As discussed below, *Williams II* requires the evaluation of individual cost centers wherever possible, not their commingling.<sup>130</sup>

96. Given *Williams II*, Trial Staff correctly states that ACC Shipper's proposed "all in" method would be the antithesis of matching cost allocation to cost causation and would violate fundamental Commission cost allocation policies.<sup>131</sup> For example, such an "all in" approach would allocate costs from KMEP's CO<sub>2</sub> pipeline operations to the telecommunication units owned and operated by KMI on the assumption that KMI's accounting system is so defective that it is impossible to directly assign overhead costs to KMEP's CO<sub>2</sub> and KMI's telecommunications units. Such an approach would include in

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<sup>128</sup> See Ex. SFP-40 at 1-5, as corrected to exclude PAAs at 6.

<sup>129</sup> Ex. SFP-38 at 7-8; Ex. SFP-39 at 2-3.

<sup>130</sup> *Williams Natural Gas Company*, 85 FERC ¶ 61,285, at 62,139-151 (1998) (Williams II).

<sup>131</sup> Staff Brief op. Ex. at 11, 19-21, 27.

a KMI wide Massachusetts Formula overhead costs that can be directly assigned to the operations of KMEP's CO<sub>2</sub> pipelines, such as the maintenance of the system's compressor and storage facilities, or their scheduling and pricing functions. This would occur even though the overhead costs of GP Services employees supporting the CO<sub>2</sub> pipelines cannot possibly benefit a KMI telecommunications entity whose overhead functions are provided solely by KMI-dedicated employees. Similarly, it is unreasonable to assert that KMI's accounting system is so deficient that KMI-dedicated employees who work only for KMI-Owned and operated interstate gas pipelines provide benefits to the CO<sub>2</sub> pipeline operations owned and operated KMEP, and for which overhead functions are provided solely by GP Services employees. Nothing in the record supports such an unreasonable position given the rigid separation of functions between the KMI and GP Services employees. Given that separation, the legitimate area of inquiry is the reasonableness of the assignment or allocation of costs to KMEP through the KMI cross-charge and the direct assignment of GP Services costs among the KMEP-Operated Entities.

97. Moreover, the Commission further concludes that nothing in this record supports a finding that all GP Services overhead costs must be allocated through KMEP-wide Massachusetts Formula to all of KMEP's operating entities without regard to what costs can be directly assigned to those entities. The organization of the KMEP-Owned Entities into the KMI-Operated gas pipelines, the Products Pipeline Group, the CO<sub>2</sub> Pipelines, and the Terminal Group is a rational structure that collects operations with similar economic and commercial functions into separate accounting centers. This is a sensible basis for directly assigning the overhead costs incurred by GP Services to the Products Pipeline, CO<sub>2</sub> Pipeline, and Terminal Groups. Because SFPP is the entity whose rates are before the Commission, the fundamental issue is whether overhead costs have been appropriately allocated to KMEP through the KMI cross-charge, or directly assigned by GP Services to the Pipeline Products Group, to the Pacific Group, or to SFPP. Thus the Commission will not examine whether costs assigned or allocated to CO<sub>2</sub> Pipeline and Terminal Groups are accurate as long as the costs flowing to the Pipeline Products Group, the Pacific Group, or to SFPP are reasonable.

98. That issue is examined in detail below. But as with the Commission's rejection of a combined KMI-KMEP "all in" Massachusetts Formula, the Commission rejects a theory that would allocate all of GP Services' costs to all of the KMEP-Owned Entities without the regard to whether those costs could be directly assigned to those entities based on their different structural, operating, commercial and staffing characteristics. The Commission will discuss below some limitations in cost data involving the Products Pipeline Group, and to a much lesser extent, the data for the initial operations of KMI Canada. Due to those limitations, the Commission is adopting Trial Staff's recommendation that those be addressed further in this proceeding. However, those limitations do not warrant rejection of a system designed to capture costs of three different groups that have different operating and commercial characteristics and to

whom GP Services has assigned distinct employee groups to support their operations. For example, a supervisory and commercial team for CO<sub>2</sub> pipelines would not in the normal course of business perform supervisory and commercial functions for Products Pipeline Group and the Terminal Facilities given the discreet grouping of the employees assigned to the CO<sub>2</sub> Group within GP Services.<sup>132</sup> The record here does not support a finding that the overhead costs directly assigned to the Products Group, Pacific Group, or SFPP should have been assigned to the CO<sub>2</sub> Group or the Terminal Group. Conversely, the record does not support the allocation of costs assigned to the CO<sub>2</sub> Group or the Terminal Group to Products Group or SFPP, nor is it in the interest of the shippers for this to have occurred. Thus there is no basis here for requiring an “all in” KMEP Massachusetts Formula that negates the direct assignment of GP Services’ overhead costs among the different entities and facilities that KMEP owns and operates where this is reasonable.

99. The Commission thus concludes the appropriate methodological and legal issues to be decided here are: (1) certain generic legal issues; (2) the exclusion of some KMEP-Owned, but KMI or independently operated, entities from a more broadly defined KMEP Massachusetts Formula; (3) whether the supporting data SFPP has provided here is sufficiently accurate and reliable; (4) the definition and use of certain cost elements within the KMEP Massachusetts Formula; and (5) the nature of the revenue inputs to be used in KMEP’s Massachusetts Formula calculations.

## **2. The Generic Legal Issues**

100. Valero’s exceptions contain a number of general objections to KMI’s methodology which are addressed at this point. First, Valero argues that KMI’s methodology for assigning costs directly to certain specific operating groups and entities is invalid because KMEP stated in its 2007 Security and Exchange Commission (SEC) 10-K filing that the aggregated overhead costs are not attributable to specific KMI entities. Valero concludes that SFPP’s presentation in this proceeding is invalid and is at bottom a misrepresentation to the Commission given that SEC filings are made under oath.<sup>133</sup> SFPP replies that overhead costs are aggregated in an SEC annual 10-K filing so the overhead administrative costs are distinguished from the earning power of the assets that determine the operating income and profit of its enterprises. SFPP states that the separation also allows investors to determine on a year to year basis how overhead costs change.<sup>134</sup>

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<sup>132</sup> Ex. SFP-38 at 24.

<sup>133</sup> Valero Brief on Ex. at 29-26.

<sup>134</sup> SFPP Brief op. Ex. at 61 (citing Ex. SFP-179 at 7-9; Ex. SFP-144).



101. The Commission accepts SFPP's explanation of its use of a different presentation in its SEC 10-K filings from that required for cost justifications in a Commission rate proceeding. Different agencies have different regulatory requirements that reflect their different purposes. SFPP's explanation of the SEC format is logical given the emphasis that investors place on the earning power of assets, and the related concern of whether administrative costs are reasonable, or excessive, given the revenue and profits of the underlying assets. It cannot be reasonably contested here that KMI's accounting system is designed to assign and allocate costs for purposes of internal administration as well as for rate design. In contrast, with respect to matters subject to SEC regulation, KMI is incentivized to develop an accurate cost assignment process that enables it to judge the efficiency of its operations and its managers even if this involves a different accounting and reporting method than that used for the SEC.<sup>135</sup> Such a separate effort was also appropriate given the large number of jurisdictional entities owned by both KMEP and KMI. It is also appropriate given KMI's obligation to assure that costs are allocated with reasonable accuracy among those jurisdictional entities, and between jurisdictional and non-jurisdictional functions.<sup>136</sup> There is no discrepancy involved here that discredits KMI's methodology.

102. Valero further asserts that the Commission should not rely on an accounting system that Valero alleges does not conform to the Massachusetts Formula, and that the 2009 ID did so.<sup>137</sup> In reply, Trial Staff and SFPP assert that alternative accounting methods are acceptable if they credibly assign costs directly and fairly allocate any residual costs under the Massachusetts Formula.<sup>138</sup> The Commission reiterates that while certain aspects of KMI's methodology are examined in further detail below, the 2009 ID fairly reviewed KMI's methodology and correctly concluded that it is designed to comply with the requirements of the Massachusetts Formula and that the structure of that system is based on sound accounting principles. As with the difference between the SEC and

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<sup>135</sup> One can reasonably assume that KMI would require the managers of various production and administrative functions to budget and operate in a manner consistent with its internal accounting procedures and that KMEP would desire a system that would provide increased accountability in order to maximize the firm's efficiency.

<sup>136</sup> Valero's arguments in this regard inappropriately imply that KMEP's and KMI's officers would risk perjuring themselves through the use of inconsistent methodologies and terminology for the purpose of assigning an inordinate level of costs to SFPP.

<sup>137</sup> Valero Brief on Ex. at 3-4, 17, 20.

<sup>138</sup> Staff Brief op. Ex. at 14-15, 19, 23; *Williams Natural Gas Company*, 85 FERC ¶ 61,285, at 62,132-33 (1998) (*Williams II*).

business accounting functions, it is irrelevant that KMI's methodology may have been developed in part for business rather than for regulatory purposes. Rather the issue is whether the methodology is sufficiently reliable to be used for the Commission's regulatory purposes.

103. Valero also states that KMI's methodology is self-serving, arbitrary, subjective, and subject to manipulation compared to the objective and time-tested Massachusetts Formula methodology.<sup>139</sup> The Commission assumes that KMI's methodology reflects the desire of a profit driven entity to more effectively control its costs as well as increase the accuracy of assignments and allocations for rate making purposes. The two are closely related in that a more accurate business accounting system provides a sounder basis for cost recovery in a regulatory context. Thus, reliance on an accounting system that also has business functions has long been acceptable to the Commission if the methodology is adequately supported.<sup>140</sup> Moreover, to apply the Massachusetts Formula in a blanket way to costs that can be directly assigned is itself arbitrary. Valero's argument that KMI's methodology is arbitrary and subjective is grounded in certain errors in timesheet classification and coding Valero found through discovery. However, such technical errors alone do not make KMI's methodology necessarily subjective. SFPP has established that KMI has a logical methodology for assigning and allocating its costs and instructs its employees to follow that methodology. SFPP has also established that there are internal protocols for monitoring and correcting errors that may occur within the system and that KMI's system is designed to capture systematically all information necessary to implement KMI's accounting. The Commission finds that inevitable human error involved in the use of any accounting methodology does not in itself render an otherwise reasonable methodology arbitrary and subjective.

104. In a similar vein, Valero argues that KMI has no policies or directives that assure that its employees will conform to the methodology KMI uses to allocate its costs. Valero asserts that SFPP has provided no credible evidence of quality control mechanisms designed to assure the accuracy of KMI's accounting system and that KMI's personnel policy allows employees to be shifted from one function to another within the KMI corporate structure.<sup>141</sup> SFPP replies that the document Valero cites provides KMI with the legal right to move employees as needed throughout the organization, and that there is specific documentation in the record stating that employees must fill out their

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<sup>139</sup> See, e.g., Valero Brief on Ex. at 6, 8, 10, 13.

<sup>140</sup> *Williams II*, 85 FERC at 62,133, 62,138-139.

<sup>141</sup> Valero Brief on Ex. at 21-22 and 23-24.

time sheets accurately.<sup>142</sup> Moreover, SFPP's witness Mr. Brady testified in detail that KMI requires all employees to fill out time sheets and to provide an allocation of their time between the subsidiaries that benefit from their labor. He also explained that KMI has a budgeting and auditing function that is designed to assure the efficient operation of its accounting methodology and provided examples of such time sheets and time splits.<sup>143</sup> The Commission finds that KMI has developed corporate policies and administrative protocols to effectively capture and to assign and allocate its costs; the issue here is the extent it actually does so.

105. Valero raises three additional interrelated legal and evidentiary points that merit greater consideration. All of these turn on relationships among the affiliates to which the overhead costs are to be assigned or allocated. The first involves the relevance of interlocking directors and officers in determining whether affiliates should be included in a Massachusetts Formula calculation, the second whether the receipt of any benefit from an overhead function requires inclusion of the affiliate receiving the benefit in the calculation, and the third whether to apply a minimal standard of benefit under some circumstances. These issues turn in large measure on the interpretation of *Williams II*.

106. Valero asserts that *Williams II* requires the inclusion of subsidiaries in the Massachusetts Formula when directors and officers of the parent company have any responsibility, however nominal, for the operations of the subsidiary. Valero relies heavily on the job descriptions of KMEP's officers and directors to support a conclusion that all of the KMEP-Owned and KMI-Owned Entities should be included in a single Massachusetts Formula calculation.<sup>144</sup> Valero also asserts that the fiduciary obligations of officers and directors compel the conclusion that if such individuals are in a legal chain of control, they necessarily have operating responsibility for a given subsidiary. It asserts that this responsibility is reinforced by KMI's own internal ethics statements which emphasize that all employees must act responsibly and ethically.<sup>145</sup> SFPP replies that *Williams II* applies only to the situations where the directors and officers have active responsibilities for operations and are directly involved in the management of the company. SFPP further states that in KMEP's structure, its officers are necessarily officers of subsidiary companies under basic principles of corporate law, but that it is

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<sup>142</sup> SFPP Brief op. Ex. at 61-62 (citing Ex. ACV-43 at 2-4 as demonstrating that KMI employees must correctly code their time and are instructed to do so).

<sup>143</sup> Ex. SFP-38 at 9, 11-14, 15-17; Exs. SFP-41, 42, and 43; Ex. SFP-129 at 11, 13-14.

<sup>144</sup> Valero Brief on Ex. at 28-30, 59-60, 66.

<sup>145</sup> *Id.* at 29, n.31, 30.

unreasonable to presume that a requirement to act ethically extends to an affirmative obligation to be engaged in the day-to-day operations of a specific subsidiary.<sup>146</sup>

107. The Commission concludes that *Williams II* is not as categorical as Valero asserts. In *Williams II*, the pipeline applying for a rate increase was Williams Natural Gas Company (WNG), a subsidiary of The Williams Companies (TWC).<sup>147</sup> TWC had numerous subsidiaries, many of which were unregulated. On exceptions, the Missouri Public Service Commission (MoPSC) asserted that the overhead functions performed by WNG were those of a stand-alone company and that the same administrative functions at the level of TWC only duplicated those of WNC. MoPSC therefore concluded that many of the overhead functions that TWC proposed to allocate to WNG under the Massachusetts Formula should be excluded from that calculation. MoPSC also argued that TWC did not directly assign as many costs as possible to subsidiaries other than WNG and that those should be excluded from the Massachusetts Formula calculation.<sup>148</sup> The result would have been to allocate costs away from the regulated gas entity, WNG, to unregulated entities thereby reducing the burden on WNG's jurisdictional ratepayers.

108. In *Williams II* the Commission conducted a detailed review of 11 of the 15 cost centers of TWC, the parent company, and held these should be included in WNG's Massachusetts Formula.<sup>149</sup> While relying in part on the stated responsibilities of the directors and officers involved, the Commission was careful in each case to assure there was record evidence supporting the actual involvement of the directors and officers in WNG's affairs.<sup>150</sup> The Commission also relied heavily on a WNG witness's credible testimony that explained the assignment and allocation of responsibilities and costs among TWC's various affiliates.<sup>151</sup> The Commission did reject certain adjustments WNC proposed to make to its total cost of service to reflect the minimal burden of subsidiaries in which TWC had minimal involvement or that were relatively inactive.<sup>152</sup> The Commission also stated that subsidiaries that received more than five or ten percent of their total administrative costs from the parent company should be included in WNG's

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<sup>146</sup> SFPP Brief op. Ex. at 71-72, 73-74.

<sup>147</sup> *Williams II*, 85 FERC at 62,132-33.

<sup>148</sup> *Id.* at 62,135-36.

<sup>149</sup> *Id.* at 62,139-151.

<sup>150</sup> *See, e.g., Williams II*, 85 FERC at 62,141.

<sup>151</sup> *Id.*

<sup>152</sup> *Id.* at 62,137.

Massachusetts Formula.<sup>153</sup> However the Commission also remanded the overhead cost issue for two reasons. First, to more accurately determine whether a benefit was actually received by a subsidiary. Second, to permit WNG to present more detailed evidence supporting cost-of-service adjustments that would mitigate the harshness of failing to include some of TWC's subsidiaries that received minimal benefit from its operations.<sup>154</sup>

109. The Commission concludes that SFPP is correct that *Williams II* need not be construed to require that the presence of the same directors and officers at different levels in an organization chart and listed as such on the related corporate documents conclusively resolves whether an affiliate should be included in an allocation formula. Rather, when examining a TWC cost center the Commission relied on specific record evidence provided by TWC to conclude that there was a benefit to WNG from its parent company's involvement. While the Commission rejected the cost-of-service adjustment designed to address a *de minimis* argument, the Commission still offered WNG an opportunity to pursue the issue if this would result in a more equitable assignment or allocation of costs.<sup>155</sup> This leads to two other points. First, *Williams II* leaves open that it may be reasonable to exclude a subsidiary receiving less than a five percent overlap of costs if inclusion of the affiliate would result in an irrational or excessive allocation to or from the regulated entity.<sup>156</sup> The Commission therefore holds that application of such a standard may be appropriate under some circumstances. The Commission also concludes that the statement in *Williams II* that a subsidiary must be included if it receives any benefit from a cost center should not be applied when the result would be a serious misallocation of costs among related subsidiaries.<sup>157</sup> That historical statement may serve as a bright-line rule with respect to a relatively simple hierarchical corporate structure, such as TWC and WNG. However, with respect to more complex business structures such as KMEP's where there are horizontal and vertical relationships, it is more appropriate to balance whether the benefits received from a cost warrant its attribution to a particular operating entity. Thus the Commission will analyze the benefits and their materiality to determine whether an entity or group of entities should be included in KMEP's Massachusetts Formula.

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<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 62,136-37; SFPP Brief op. Ex. at 69.

<sup>157</sup> *Id.* at 62,137 n.31.

### 3. The Exclusion of Certain Subsidiaries

110. As noted, the 2009 ID excluded from KMEP's Massachusetts Formula the eight KMI-Operated Entities, the four joint ventures in which KMEP has ownership interests, and KM Canada.<sup>158</sup> As discussed, on exceptions, Valero argues that the Commission should adopt a single KMI-wide Massachusetts Formula that combines all of the KMI-Owned, KMI-Operated, and KMEP-Operated Entities, as well as KM Canada and the Joint Ventures. Valero asserts that this preferred "all in" approach is necessary to assure an objective and accurate allocation of KMI's and KMEP's overhead costs given the errors in KMI's and GP Services' time sheets and time splits.<sup>159</sup> As an alternative, Valero would include all of the KMEP-Owned Entities in KMEP's Massachusetts Formula.<sup>160</sup> Tesoro also advances this more limited approach.<sup>161</sup>

111. In contrast, Trial Staff argues that all KMEP-Owned Entities should be included in the KMEP Massachusetts Formula until KMI acts to assure that the costs in the KMI cross-charge were properly assigned or allocated to KMEP.<sup>162</sup> As was previously discussed, Trial Staff argues that Valero's "all in" approach would further distort the probable errors in KMI's accounting methodology.<sup>163</sup> Trial Staff therefore concludes that Valero is incorrect that KMI's effort to maximize direct assignments is improper or necessarily ineffective. Rather, to correct the deficiencies in SFPP's initial presentation at hearing, Trial Staff recommends the SFPP be required to provide information to support its cost assignment and allocations in its compliance filing to assure proper assignment or allocation of costs to SFPP. Alternatively, Trial Staff argues SFPP should be required to include all excluded KMEP-Owned Entities in KMEP's Massachusetts Formula on an interim basis and be required to keep more accurate records on a going-forward basis. This would be done by assuring that the costs of the KMI jointly-shared employees are consistently and accurately allocated or assigned to Account No. 186401, which governs the KMI cross-charge. At bottom, rather than adopting Valero's

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<sup>158</sup> 2009 ID, 129 FERC ¶ 63,020 at P 759-778. The eight KMI-Operated entities were Casper-Douglas, Tejas Consolidated, KMIKT, Trailblazer, TransColorado, KM North Texas, KM Mexico, and REX, plus the Marine Terminal, Red Cedar, Mountain Creek, the Heartland joint ventures, and KM Canada.

<sup>159</sup> Valero Brief on Ex. at 12-13.

<sup>160</sup> *Id.* at 10-11.

<sup>161</sup> Tesoro Brief on Ex. at 3, 13-20. Tesoro's more detailed exceptions on the accounting issues track those of Valero and are subsumed within that discussion.

<sup>162</sup> Staff Brief on Ex. at 6-8; 12-13; Staff Brief op. Ex. at 12-13.

<sup>163</sup> Staff Brief on Ex. at 8; Staff Brief op. Ex. at 12-13, 19-20.

unreasonable “all in” method, Trial Staff asserts that the Commission should deny SFPP’s rate increase unless SFPP meets its burden of proof with regard to direct assignments.<sup>164</sup>

112. The Commission has previously rejected Valero’s “all in” KMI-KMEP wide Massachusetts Formula as lacking any reasonable connection with economic or accounting realities. Turning to the narrower assertions relating to the KMEP owned gas pipeline subsidiaries and joint ventures, the Commission first notes that under KMI’s accounting methodology, residual costs from GP Services that cannot be directly assigned to KMEP-Operated Entities are allocated to those entities under KMEP’s Massachusetts Formula. However, if affiliated entities are excluded from the application of the Massachusetts Formula, any residual overhead costs would be distributed over a smaller number of subsidiaries and the total overhead costs of those remaining entities would be increased. While recognizing that concern, the Commission first notes that under KMI’s accounting structure SFPP is disadvantaged if the costs of the KMI-shared employees are inaccurately allocated to KMEP, but is favored if the costs of such employees are allocated to the KMI-Owned Entities. Thus, in the instant case, the overhead cost allocation issues turn on two points that are discussed more fully below. These are (1) whether the costs of KMI-shared employees are properly assigned or allocated to KMEP through the KMI cross-charge, or (2) whether the GP Services costs are correctly assigned to KMEP’s sub-tiers or subsidiaries such as SFPP. As was previously discussed, the costs the KMI-Owned Entities incurred through the allocation of KMI-dedicated or KMI-shared employees through Account 184600 are not at issue given isolation of the KMI-dedicated employees.<sup>165</sup> SFPP has established that even after a survey and an audit, Valero did not uncover a single situation where the employees of the audited RCs that directly assigned costs to SFPP included the costs of any of the KMI-Owned or the KMI-Operated Entities.<sup>166</sup>

113. Given the exclusion of the KMI-Owned Entities from a KMI-KMEP Massachusetts Formula, there are three categories of KMEP-Owned Entities that require further evaluation given their ownership by KMEP, but their exclusion from KMEP’s Massachusetts Formula. These are: (1) joint ventures for which the administrative and general functions SFPP states are provided by the joint venture partner; (2) two entities, Marine Terminal and KM Canada, which SFPP states provide their own administrative and general services; and (3) the eight KMI-Operated natural gas entities owned by KMEP. The determination of whether these entities are properly excluded from the

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<sup>164</sup> Staff Brief on Ex. at 8-9; Staff Brief op. Ex. at 12, 15, 20.

<sup>165</sup> See Ex. SFP-39 and Ex. SFP-38 at 9.

<sup>166</sup> SFPP Brief op. Ex. at 67-68.

KMEP Massachusetts Formula turns primarily on matters of corporate structure and the existence of some small cost overlaps that may provide benefits to a specific excluded entity.

114. Regarding the joint ventures, the 2009 ID excluded the Heartland, Red Cedar, and Mountain Creek joint ventures from KMEP's Massachusetts Formula.<sup>167</sup> Trial Staff asserts on exceptions that all of KMEP's joint ventures should be included in KMEP Massachusetts Formula, despite the fact that at hearing Trial Staff stated that the exclusion of the Heartland, Red Cedar, and Thunder Creek incur no costs through the KMI cross-charge.<sup>168</sup> Valero argues that SFPP has not established that Heartland is operated exclusively by its 50 percent joint partner, Conoco Pipeline Company. It further asserts that the relevant partnership agreement states that KMEP is the operator of the partnership's pipeline receipt and delivery services and that the management committee has at least one KMEP employee. Valero states that SFPP did not quantify any supervisory costs related to this employee. Valero also asserts that the Heartland employees for which KMEP is reimbursed generate direct costs in excess of \$1 million a year and SFPP provides no quantification of such overhead costs such as human resources, IT and payroll for those employees.<sup>169</sup> Valero further argues that some supervisory costs, such as the Chairman's office and certain stock options, necessarily should be included in Red Cedar and Thunder Creek through the KMI cross-charge.

115. SFPP replies that in the case of all three joint ventures, all administrative and general costs are provided by the joint venture partner, including all human resources, IT and payroll costs, and that no costs from the joint ventures are included in the KMI cross-charge or those from GP Services.<sup>170</sup> SFPP correctly states that its testimony to this effect is contested on brief, but not on the record.<sup>171</sup> The 2009 ID is affirmed.

116. Regarding Marine Terminal, in his reply testimony SFPP's witness Mr. Brady stated that one KMEP employee sits on the Marine Terminal board at an estimated cost of \$7000, which is reflected in KMEP RC 1001 and is not part of the KMI cross-charge to KMEP.<sup>172</sup> Mr. Brady further testified that while RC 1001 is a KMEP responsibility center, costs in RC 1001 are allocated only to subsidiaries in the MidCon geographic

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<sup>167</sup> 2009 ID, 129 FERC ¶ 63,020 at P 760-762.

<sup>168</sup> Ex. S-12C at 24.

<sup>169</sup> Valero Brief on Ex. at 68-70.

<sup>170</sup> *Id.* at 71-73.

<sup>171</sup> SFPP Brief op. Ex. at 81-82.

<sup>172</sup> Ex. SFP-129 at 35-36.



group, and thus are not allocated to SFPP, which is in the Pacific Group.<sup>173</sup> Thus, in his opinion, because all other costs incurred for Marine Terminal are billed directly to the venture partner, there can be no cost allocation to SFPP because the costs incurred by KMEP are directly assigned to another KMEP subsidiary. On exceptions, Trial Staff argues that Marine Terminal should be included in KMEP's Massachusetts Formula, possibly because the source of the overhead costs is unclear.<sup>174</sup> Valero asserts that Marine Terminal must be included in KMEP's Massachusetts Formula because Marine Terminal is shown as part of the terminal group in KMEP's 2007 SEC 10-K Report. Valero also asserts that SFPP included any overhead costs required for billing activities or for the supervisory costs that would be involved in the billing functions related to Marine Terminal.<sup>175</sup>

117. The Commission first concludes that Valero's argument regarding the statements about Marine Terminal in KMI's 10-K is inadequate. SFPP has adequately explained the difference between KMI's ownership structure, which is based primarily on tax considerations, and its operating and accounting structure. The latter structure is what at issue here. Given this, the Commission holds that SFPP's rationale and its analysis of the direct supervisory costs, and the amount, relevant to Marine Terminal is reasonable. The Commission thus affirms the exclusion of the Marine Terminal from KMEP's Massachusetts Formula.

118. The 2009 ID also excluded KM Canada from KMEP's Massachusetts Formula. KM Canada is the Canadian subsidiary of KMEP that operates the Canadian portion of Cochin Pipeline Company, Trans Mountain Pipeline Company, and the Vancouver Wharves Terminal.<sup>176</sup> At hearing SFPP's initial testimony stated that almost all of KM Canada's employees were Canadians, as required by Canadian law, and that KM Canada has its own administrative structure and rates regulated by Canada's National Energy Board. SFPP's witness Mr. Brady stated that in 2007, only a few of KM Canada's costs were incurred within GP Services or KMEP.<sup>177</sup> In contrast, at hearing Trial Staff's witness testified that Cochin Pipeline would be included in the Products Pipeline tier and the Midcontinent sub-tier, Trans Mountain in the Pipeline Products and the Pacific sub-tier, and Vancouver Wharves Terminal in the Terminals tier, and called into question the

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<sup>173</sup> *Id.* at 40-41.

<sup>174</sup> Ex. S-12C at 24.

<sup>175</sup> Valero Brief on Ex. at 70-71.

<sup>176</sup> 2009 ID, 129 FERC ¶ 63,020 at P 63, 467-468, 478-480, 774.

<sup>177</sup> Ex. SFP-38 at 35-37.

supporting detail.<sup>178</sup> Valero asserts that the surveys and time sheets are inadequate to support the dollar figure advanced by SFPP and improperly exclude numerous costs that were incurred on behalf of KM Canada. These include organization and acquisition costs and supervision at the executive level of this acquisition.<sup>179</sup> Valero asserts that SFPP failed to explain the references on various time sheets to services Valero argues were provided to KM Canada by GP Services (i.e. KMEP) employees. Valero concludes this supports its position that KMI did not accurately capture costs incurred by KMEP on behalf of KM Canada.<sup>180</sup>

119. In its rebuttal testimony, SFPP asserted that some of the \$477,000 limited costs incurred to support KM Canada were incurred by employees in responsibility centers that did not budget costs to the KMI cross-charge. Therefore SFPP excluded this entire amount from KMEP's cost structure to avoid any hint of cross subsidization.<sup>181</sup> SFPP states that if KM Canada were allocated costs as Staff and Valero suggest, it will be allocated overhead costs twice. The first would be through the KM Canada responsibility centers for the costs incurred in KM Canada's stand-alone administrative functions. The second would be for the duplicated costs that are allocated to it from the same type of KMEP or KMI responsibility cost centers. It also states that the acquisition costs should be attributed to all of KMI's operations since those costs benefited all entities.<sup>182</sup>

120. The Commission concludes that SFPP has established that KM Canada has its own administrative structure that incurs the bulk of its overhead costs, including human resources, payroll, accounting, and provides most of its own operations supervision. SFPP's Mr. Brady established by his direct testimony that GP Services (and hence KMEP) provides few services to KM Canada, and re-enforced this through his survey. However, Trial Staff's recommendation for inclusion of KM Canada in the KMEP Massachusetts (within the subdivisions previously stated) reflects statements in Mr. Brady's initial testimony that there may be some small amount of costs incurred by KMEP on behalf of KM Canada. It may also be consistent with some portions of footnote 34 of Valero's brief on exceptions asserting that some personnel and units of KMEP appear to have been involved in KM Canada commercial and regulatory matters

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<sup>178</sup> Ex. S-12C at 16.

<sup>179</sup> Valero Brief on Ex. at 50-51.

<sup>180</sup> *Id.* at 52-55.

<sup>181</sup> SFPP Brief op. Ex. at 78-79; Ex. SFP-129 at 36-39 (Brady); Ex. SFP-133 for the KM Canada RCs.

<sup>182</sup> SFPP Brief op. Ex. at 79.

during 2007.<sup>183</sup> Thus, while SFPP's proposed \$477,000 adjustment is less than 2 percent of the \$25.5 million SFPP states were KM Canada's incurred costs, the Commission concludes that SFPP must provide greater clarity for the record regarding the extent to which employees of GP Services, or KMI-shared employees, were involved in KM Canada operations in 2007. This must include a more detailed response to the criticisms contained in Valero's Brief on Exceptions.<sup>184</sup> In addition, the Commission questions whether the acquisition KM Canada, which SFPP argues is a stand-alone entity, will actually benefit SFPP, which operates in the southwestern United States. Therefore SFPP must revisit the issue of the KM Canada acquisition costs to assure that none of these costs flow down to SFPP.

121. The Commission thereby adopts Trial Staff's suggestion that SFPP should provide fuller explanation and documentation of the relevant time sheets or time splits along with supporting work papers related to the KM Canada cost assignments and allocations. Consistent with *Williams II*, SFPP should structure any further analysis on a cost center by cost center basis, and assuming adequate documentation, remove the costs from KMEP's total costs accordingly.<sup>185</sup> For example, if all of KM Canada's human resource activities were handled through its own administrative structure and none by GP Services or KMI, then that particular KM Canadian RC may be excluded from KMEP's Massachusetts Formula. Finally, if portions of KM Canada cost are included in KMEP's Massachusetts Formula this does not mean all of KM Canada's costs must be included.<sup>186</sup> This is because, as *Williams II* requires, the review centers on individual KM Canada RCs, not the overhead costs of that entity in their entirety.

122. The 2009 ID also excluded eight KMI-Operated Entities from the KMEP's Massachusetts Formula, all of which are involved in natural gas pipeline operations or sales.<sup>187</sup> Under KMI's management and accounting structure the KMI-Operated Entities are owned, but not operated by KMEP. Thus, under KMI's accounting methodology they would not be allocated costs from GP Services. Rather they are managed by KMI-

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<sup>183</sup> See Valero Brief on Ex. at 32-34, 33, n.34.

<sup>184</sup> *Id.* at 52-55.

<sup>185</sup> *Williams II*, 85 FERC at 62,138-39.

<sup>186</sup> As discussed below, this would require two KMEP Massachusetts Formula calculations depending on whether particular RCs that benefited KMI Canada were in excess of any de minimis amount.

<sup>187</sup> 2009 ID, 129 FERC ¶ 63,020 at P 760, 775-778. As noted, the eight KMI-Operated Entities are Casper-Douglas, Tejas Consolidated, KMIGT, Trailblazer, TransColorado, KM North Texas, KM Mexico, and REX.

dedicated and KMI-shared employees. The costs of the employees responsible for the KMI-Operated Entities are captured in Account 184600. Four of those entities are billed fixed fees for these costs and any costs that are not recovered through the fees are allocated to the KMI-Owned and KMI-Operated Entities through KMI's Massachusetts Formula.<sup>188</sup> Under KMI's accounting methodology, if the costs of KMI-shared employees are allocated to Account 184600, these cannot be allocated to KMEP or assigned to the Products Pipeline Group, the Pacific Group, or to SFPP. However the converse is true. Thus, the accuracy of the allocation of KMI-shared employee costs flowed to KMEP through the operation of KMI's Massachusetts Formula, or the direct assignment to SFPP, controls the extent to which the KMI-Operated Entities may be excluded from KMEP's Massachusetts Formula, as is discussed in the next section.

123. The Commission discusses here two more generic issues arising in the context of the excluded KMEP affiliates before turning to the accuracy of KMI's accounting methodology. First, Valero argues that KMEP's officers and directors have operating and legal responsibility for the KMI-Operated Entities, and therefore those entities should be included in KMEP's Massachusetts Formula. After reviewing KMEP's personnel structure and the ten RCs it selected during discovery,<sup>189</sup> Valero presents the example of Ms. Armstrong, who serves as the Vice-President for Accounting for KMEP. Valero asserts that her job description includes responsibility for overseeing the accounting for KMEP's subsidiaries.<sup>190</sup> SFPP replies that Ms. Armstrong testified under oath that her day to day responsibilities involve only KMEP's accounting issues, not the subsidiaries. SFPP's Mr. Brady also testified that Ms. Armstrong reviews his role in developing capital investment decisions related to KMEP's activities. Mr. Brady reiterated that as a shared KMI employee he performs accounting for the KMI-Owned Entities and the KMI-Operated Entities as well as the KMEP-Operated Entities, but that Ms. Armstrong only reviews the latter.<sup>191</sup>

124. The Commission concludes that it appears reasonable that Ms. Armstrong does not have responsibility for the accounting functions of the KMI-Operated Entities. KMI and

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<sup>188</sup> Thus, KMI's Massachusetts Formula uses the standard three prong test to distribute the residual costs in Account 184600 to the KMI-Owned Entities.

<sup>189</sup> See Ex. ACV-46 and Ex. ACV-238c at 3-8, 13 for the cost information on RCs that was provided to Dr. Arthur during discovery.

<sup>190</sup> Valero Brief on Ex. at 30, 37-38, 56-60.

<sup>191</sup> Ex. SFP-129 at 20-21. This example therefore presents two distinct issues: (1) how costs should be allocated among the entities that KMEP owns, and (2) how costs should be assigned to KMEP from a KMI shared employee or KMI cost center.

KMEP each have their own accounting group to perform these functions.<sup>192</sup> In an age of specialization it is plausible that the KMI accounting group would be responsible for the accounting functions of the KMI-Operated Entities. The results for the individual KMI-Operated Entities, and the group as a whole, would then be flowed up to KMEP, but those financial results are not reviewed at the KMEP level. The transfer of financial data from a KMI-Operated entity to KMEP's records would be done electronically and the KMEP accounting unit would be responsible for assuring that the numbers that were provided were correctly entered into KMEP's books and ledgers for preparation of annual reports to KMEP's shareholder and the SEC.<sup>193</sup> Consistent with the record developed in *Williams II*,<sup>194</sup> nothing in this record contradicts SFPP's testimony in this regard concerning how KMI's accounting structure actually works or the specifics of how the individuals involved actually function. Valero's arguments to the contrary are based solely on the corporate documents, which are out of the context given this witness's testimony. The Commission has previously concluded such evidence is inadequate given SFPP's explicit witness testimony to the contrary, and therefore such documents do not support the inclusion of the KMI-Operated Entities in KMEP's Massachusetts Formula.

125. Second, Valero also asserts that the fees that are paid to KMI by four of the KMI-Operated Entities do not cover all the costs of those entities, and therefore there is a cross-subsidy of those four entities by SFPP. Valero states that the fees and costs at issue are inadequately documented and that SFPP's analysis does not account for such overhead items as HR, IT and the KMI Chairman's office.<sup>195</sup> SFPP replies that this is not the case, but even if it is true, it is irrelevant. SFPP states that the fees from the four KMI-Operated Entities paying those fees are first charged to the total pool of KMI-Operated Entity costs, including those directly assigned to those entities. SFPP states that any residual costs are then allocated to the KMI-Owned Entities and the KMI-Operated Entities under KMI's Massachusetts Formula. SFPP therefore concludes that any cost-recovery shortfall is contained with KMI's Massachusetts Formula which allocates no costs to KMEP.<sup>196</sup>

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<sup>192</sup> See Ex. ACV-51 at 3-4, 9-10, 25-26, 28-29; see also Ex. SFP-129 at 20-21, 29.

<sup>193</sup> In fact, Ex. ACV-65 at 16-19 contains testimony by a KMI officer that explains how the accounting system works in terms of the relative responsibility of the KMI and KMEP accounting and finance departments.

<sup>194</sup> *Williams II*, 85 FERC at 62,141.

<sup>195</sup> Valero Brief on Ex. at 60-63. The four entities paying fees to KMI are TransColorado, KM North Texas, KM Mexico, and REX.

<sup>196</sup> SFPP Brief op. Ex. at 75-77.

126. The Commission concludes that SFPP's explanation is logical and Valero's argument regarding the fees does not support the inclusion of the four fee-paying operating entities in KMEP's Massachusetts Formula. Valero's argument that the costs of human resources, IT resources, and those of the Chairman's office are inadequately accounted for in the case of the fee-paying entities, is irrelevant, as SFPP states, because those costs are allocated to other KMI-Owned or KMI-Operated Entities through the KMI Massachusetts Formula.<sup>197</sup> Rather, this issue is a more generic one, namely whether the correct amount of KMI shared-employee costs is allocated or assigned to KMI-Owned, KMI-Operated Entities, and to KMEP in the first place. This has nothing to do with whether the fee paying entities cover those types of costs because they cannot be allocated to SFPP through the KMI cross-charge. Thus the 2009 ID was correct to conclude that the fact that four of the KMI-Operated Entities are fee paying entities does not require their inclusion in KMEP's Massachusetts Formula.

127. Finally, Valero does not address two minor issues identified at hearing where two employees in the account payable department worked for both the KMEP-Operated Entities and the KMI-Owned and KMI-Operated Entities. SFPP explained the reasons for the joint assignment and adjusted the costs based on a survey of the time involved.<sup>198</sup> For these two narrow exceptions, the Commission concludes that the quality of the evidence is adequate under *Williams II* and does not support Valero's position that all KMI and KMEP entities, or that all of the KMI-Operated Entities, must be included in a single KMI-KMEP wide Massachusetts Formula calculation. The next section discusses whether a different result is required based on the accuracy of cost assignment by GP Services to KMEP and of the costs assigned or allocated to KMEP and SFPP from the KMI-shared employees included the KMI cross-charge contained in Account 184601.

#### **4. The Accuracy of the KMI's Accounting System**

128. The accuracy of KMI's accounting is relevant here in two ways. The first is whether the costs of joint-employees allocated or assigned to the KMI cross-charge, and thereby to KMEP, were appropriately included in that cross charge.<sup>199</sup> The second is whether the costs incurred by GP Services were correctly assigned to SFPP or to an

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<sup>197</sup> As discussed, the KMI Massachusetts Formula does not allocate costs to KMEP. KMI costs that are appropriately assigned to KMEP are done so through the KMI cross-charge. This is in turn based on the cost assignment of the KMI shared personnel.

<sup>198</sup> Ex. SFP-129 at 21-22; SFPP Brief op. Ex. at 74.

<sup>199</sup> This would occur if costs that should have been allocated or assigned to one of the eight KMI-Operated pipelines were incorrectly included in the KMI cross-charge.

intermediate entity (such as the Pacific Tier) whose Massachusetts formula affects SFPP but not all of the KMEP-Operated Entities.<sup>200</sup> The 2009 ID concluded that KMI's accounting methodology provides sufficiently accurate cost assignments and allocations that rates based on that methodology will be just and reasonable.<sup>201</sup> Trial Staff and Valero assert that there are two fundamental errors in the 2009 ID's analysis supporting this holding. The first is that the 2009 ID unduly relied on the findings of another initial decision in reaching the 2009 ID's conclusions, and as such failed to make the detailed analysis of benefits by cost center required in *Williams II*.<sup>202</sup> The second error was to shift the burden of proof from SFPP to the opposing parties. They state that SFPP submitted a limited sample of time sheets and time splits to establish the costs assigned or allocated to KMEP are accurate and reliable. Trial Staff and Valero therefore conclude that the 2009 ID erred by holding that the opposing parties had not proved the inadequacy of SFPP's system. They assert that it remains SFPP's obligation to prove that its accounting system accurately and reliably assigns and allocates costs among the entities within the KMI/KMEP business structure.<sup>203</sup>

129. However, Trial Staff also asserts that SFPP has demonstrated that KMI can correct its cost assignments and allocations in the instant proceeding to meet the ID's finding, but that it has not done so to date.<sup>204</sup> In contrast, Valero asserts that some 64 percent of time sheets taken from the RCs reviewed at hearing contained errors.<sup>205</sup> Valero further asserts that in several cases employees stated on their timesheets that 100 percent of their time involved work on SFPP issues while their own supervisors had a different allocation, or other evidence indicates that employees were involved in working for other entities. It further states that the fact that a large number of other RCs were not examined in detail does not mean that they are sufficiently accurate; only that they were not examined. Valero posits that the RCs that were not examined are likely to have the same high error rate as SFPP reviewed.<sup>206</sup> SFPP states that it reviewed the overhead cost assignments to SFPP contained in 5 RCs and corrected them as necessary to reduce the costs assigned to

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<sup>200</sup> This would occur if GP Services costs were incorrectly assigned to SFPP instead of another KMEP-Operated Entity, or costs were incorrectly assigned to the Pipeline Tier or the Pacific Tier instead of another intermediate tier, for example the Terminal Tier.

<sup>201</sup> 2009 ID, 129 FERC ¶ 63,020 at P 751-756.

<sup>202</sup> Staff Brief op. Ex. at 12-13.

<sup>203</sup> Staff Brief on Ex. at 8-9 and Staff Brief op. Ex. at 12-13.

<sup>204</sup> Staff Brief on Ex. at 4-5.

<sup>205</sup> *Id.* at 6-8.

<sup>206</sup> Valero Brief on Ex. at 26-27, 32-37, 39-40, 53-54.

SFPP. It asserts that the revised exhibits and information in its rebuttal testimony are reliable.<sup>207</sup>

130. Regarding the burden of proof, the Commission has previously concluded in this order that the 2009 ID's description of KMI's accounting system was accurate and that the 2009 ID correctly supported an analysis based on the direct assignment of costs wherever possible. The 2009 ID appears to have concluded that SFPP provided adequate evidentiary support and that the opposing parties did not effectively discredit that presentation. This would reflect an appropriate allocation of the burden of proof if the evidentiary record supports the conclusion that SFPP made an adequate initial presentation. However, the Commission has reservations in this regard and believes that the opposing parties' evidentiary objections should have been examined in greater detail. Therefore the Commission will conduct a more detailed review than that conducted by the 2009 ID. While the Commission concludes that the overall structure of KMI's accounting methodology is adequate, the Commission concludes that further documentation of some of the details is required. To this extent the Commission reverses the 2009 ID.

131. In reaching its conclusion the Commission reiterates what is at issue here is the reasonableness of the rates in SFPP's latest West Line rate filing. As previously stated, this turns on the reasonableness of the allocation or assignment of costs from a discrete set of cost centers that affect the costs ultimately allocated or assigned to SFPP. However, on exceptions Valero asserts that there may have been critical errors in the RCs that were not examined at hearing and therefore the 2009 ID erred by assuming that if an RC was not examined that it was adequate.<sup>208</sup> This is a logical statement, but it only goes so far. The only RCs that are relevant here are those that directly assign costs to SFPP or flow costs down to it through KMEP's Massachusetts Formula. Given the record before the Commission, the most relevant RCs which Valero criticizes appear to be those that directly assign costs to SFPP, some of which may also directly assign costs to entities that share the Pacific sub-tier or the Pipeline Products Tier with SFPP. Moreover, the questions raised by footnote 34 of Valero's brief on exceptions likewise deal overwhelmingly with market issues which appear to be related to other members of the Pipeline Products Tier, such as Plantation, Cochin, OLP-A, and possibly Cochin Canada.<sup>209</sup> In this regard, many of Valero's examples are from RC 1002 and involve

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<sup>207</sup> SFPP Brief op. Ex. at 64-66.

<sup>208</sup> Valero Brief on Ex. at 20-22.

<sup>209</sup> *Id.* at 33 n.34.



marketing or tariff matters related to the western products pipeline interests, and fall within the supervisory job description of the Vice President for that RC, Mr. Kehelet.<sup>210</sup>

132. It therefore appears that to the extent the evidence is ambiguous, any errors may have been caused because those employees of the Pacific or Products Pipeline Group are performing the same or similar functions for several entities within those groups and may have shifted frequently back and forth among them. According to Valero, these limited examples are sufficient to destroy the integrity of the entire KMI cost accounting methodology. However, the fact there may have been errors in RC 1002 is not relevant to an RC that makes no direct or indirect cost allocations to SFPP, the Pacific Group, or the Pipeline Products since such an RC would have no impact of SFPP. In fact, if errors allocate costs away from KMEP or SFPP, this type of error helps rather than hurts SFPP's rate payers.

133. Valero raises similar concerns about RC 1006 (Logistics KMP Pipelines), arguing that the RC assigns too many costs to SFPP based on the large number of KMEP pipeline and terminal facilities.<sup>211</sup> Valero does not state in its analysis whether RC 1006 deals only with the KMEP-Operated pipelines, or includes the KMI-Operated Entities SFPP proposes to exclude. If RC 1006 is located within GP Services, then the costs would be assigned only to the KMEP-Operated Entities under KMI's accounting methodology. This lack of supporting analysis reduces Valero's argument to a general criticism. Valero makes a similar argument regarding the costs of RC 1040 (Environmental Compliance). Valero argues that the vast majority of environment compliance is allocated to SFPP, which it claims is improbable given the scope of KMEP's operations.<sup>212</sup> But this argument assumes that RC 1040 deals with all of KMEP's operations. In fact it deals only with the costs allocated to certain KMEP-Operated pipelines and their related terminals.<sup>213</sup> Since these are directly assigned costs, the directly assigned environmental costs for the KMEP pipelines that are operated by KMI would fall with a KMI responsibility center and would not fall within one of KMEP's. Thus, a criticism of RC 1040 that is directed to all of KMEP's operations (as Valero's does here) is without analytical foundation. Moreover, the fact is that environmental remediation and compliance has been a hotly contested item in several SFPP cases, including arguments that SFPP's management has been imprudent in dealing with leaks from an aging SFPP

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<sup>210</sup> *Id.* at 33.

<sup>211</sup> *Id.* at 33-34.

<sup>212</sup> *Id.* at 34. Valero's reference is clearly to all of KMEP's operations and not just the KMEP-Operated Entities, thus using an improper base for the comparison.

<sup>213</sup> *See* Ex. ACV- 238c at 13, line RC-1011 and RC-1040.

oil pipeline.<sup>214</sup> Thus, within RC 1040, which deals only with KMEP operated pipelines, the assignment of the bulk of the costs to SFPP appears quite reasonable.<sup>215</sup> Again Valero does not present the full context of the criticism or give a meaningful analysis of the materiality of its criticism. The goal of Valero's broad criticisms appears to be the rejection of KMI's accounting methodology as a whole.

134. By way of contrast, if one delves into the details, such a broad remedy may not be necessary or appropriate. For example, the KMI cross-charge to KMEP from the KMI-shared employees for Environmental is \$375,694 recorded in Account No. 0245, and the charge for Remediation is \$102,367 in Account 0246. According to SFPP, the grand total cross charge to KMEP in 2007 was \$63,312,015 after an adjustment of \$7,681,768 at hearing (an adjustment of 12.13 percent).<sup>216</sup> Accounts Nos. 0245 and 0246 are .59 percent (0.0059) and .16 percent (0.0016) respectively of the revised KMI cross-charge. This indicates that while a large amount (unstated by Valero) of GP Services environmental and remediation services were allocated to SFPP, the amount flowing to SFPP from the KMI shared-employees was extraordinarily small even if SFPP is assigned 13.42 percent of all of the 2007 environment and remediation costs that would flow through the KMI cross-charge to KMEP's Massachusetts Formula.<sup>217</sup>

135. This example demonstrates three points. First, it makes no sense to require inclusion of the KMI-Operated Entities in the KMEP Massachusetts Formula calculation as long as the portion of the KMI-shared costs allocated or assigned to KMEP or directly to SFPP from a particular RC is reasonable and is reasonably well documented. In the case of the previous example, inclusion of the KMI-Operated Entities in the KMEP Massachusetts Formula would simply shift a disproportionate amount of environmental costs to the KMI-Operated Entities even though environmental and remediation

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<sup>214</sup> 2009 ID, 129 FERC ¶ 63,020 at P 824-834, some \$1.8 million per year, a sum the Commission accepted earlier in this order as an ongoing element of SFPP's cost of service for the West Line rates alone; *Chevron Products Co., et al. v. SFPP, L.P.*, 127 FERC ¶ 63,023, at P 466-478 (2008); *SFPP, L.P.*, 116 FERC ¶ 63,059, at P 190-197 (2006) (some \$1,080,000 per year for the North Lines only).

<sup>215</sup> See Ex. ACV- 238c at 13:1011-1040.

<sup>216</sup> Ex. SFP-134.

<sup>217</sup> See Ex. SFP-130. For the two cost figures the result to SFPP would be .08 percent (.0008) and .02 percent (.0002) of the cross-charged environmental and remediation expenses respectively assuming a 13.42 percent Massachusetts Formula allocation to SFPP. Since there are several other KMEP-Operated Entities, both the percentage and dollar amount of the KIM environmental and remedial cross-charge actually allocated to SFPP through KMEP's Massachusetts Formula is much smaller.

components of the 2007 KMI cross-charge to KMEP were miniscule and would have no impact to SFPP's costs.<sup>218</sup> This would be true even if the 2007 KMI environmental and remediation cross-charge to KMEP had an error of 50 percent. Second, the bulk of the environmental costs included in SFPP rates flow from the activities of GP Services, which reflects just how the costs for the KMEP-Operated Entities are to be separated from those of the KMI-Owned or KMI-Operated Entities under KMI's accounting methodology. Third, the example emphasizes the need to examine the shared costs RCs individually: first by identifying those RCs that require the most critical examination; second, by documenting further the details of the costs allocated within the critical RCs.

136. The Commission concludes that there are five RCs that GP Services uses to directly assign costs to SFPP<sup>219</sup> and an additional forty-one that are reflected in the 2007 KMI cross-charge,<sup>220</sup> which could flow costs down to SFPP. Those RCs are the ones providing data to the 2007 KMI cross-charge to KMEP and assigning costs directly to SFPP, the Pipeline Products Tier, and the Pacific sub-tier. The statistical sample initially presented by SFPP was small and had a number of admitted errors, which SFPP claims to have corrected. However, the rationale and scope of those corrections are not clear to the Commission. Nor is it clear to the Commission how SFPP audited the 5 RCs it states provided direct assignments to SFPP, and the basis for any adjustments made, or how it reached the \$7,681,768 in corrections to the 2007 KMI cross-charge reflected in Ex. No. SFP-134. However, the Commission also finds that the Valero's blanket criticisms on exceptions are not particularly helpful for the following reason. Even if one assumes that 100 percent of the time sheets in a particular RC need to be adjusted, it is unclear from Valero's brief or the exhibits it cites what percentage of the hours on each timesheet are in error, and the potential impact of the errors. Valero does assert that the total errors discovered were some \$2 million of the RC's reviewed by Dr. Arthur which assigned away from SFPP.<sup>221</sup> While this is a substantial sum, Valero then extends this beyond the RCs that directly assigned costs to SFPP to the entire KMI system, a second step that is

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<sup>218</sup> KMEP operates the Pipeline Product, Terminals and CO<sub>2</sub> groups, and under KMEP's accounting methodology, environmental costs should be sufficiently site-specific such that the direct environmental costs for each group would be identifiable and supported by the audit required here. Valero's broadside approach does not adequately address the point but implies rather that the costs are willfully misallocated to SFPP. This is an insufficient ground for a wholesale rejection of KMI's accounting methodology without further examination.

<sup>219</sup> See Ex. ACV-238c at 13.

<sup>220</sup> See Ex. SFP-134.

<sup>221</sup> Valero Brief on Ex. at 37 (citing Ex. SFP-134).

of questionable relevancy. Thus, while Valero has stated sufficient concerns that the Commission is requiring a further review of some portions of KMI's accounting methodology, Valero's arguments do not warrant rejection of that methodology in its entirety at this juncture, or the inclusion of the KMI-Operated Entities in KMEP's Massachusetts Formula. This is in large part due to the scattered nature of its criticism rather than an integrated presentation that addresses the relevance and materiality of its criticism, some of which address RCs that appear to have no logical relationship to SFPP's operations.<sup>222</sup>

137. Based on the forgoing the Commission adopts Trial Staff's suggestion that SFPP provide a fuller analysis and explanation of its previous clarifications and adjustments in its compliance filing.<sup>223</sup> SFPP must also provide the source materials for such an audit and the supporting analysis. This approach is consistent with the limited remand adopted in *Williams II* and the importance *Williams II* placed on evaluating individual cost centers in determining how overhead costs should be assigned and allocated.<sup>224</sup> The total number of relevant RCs is limited and some of those displayed in Ex. No. SFP-134 appear to be quite small and of little materiality. Through this ruling the Commission seeks to assure that the costs flowing to KMEP and SFPP from GP Services and the KMI cross-charge are assigned and allocated with reasonable accuracy to KMEP and the KMEP-Operated Entities (including SFPP).<sup>225</sup> The Commission also directs SFPP to make a more detailed response to Valero's criticisms than is contained in its brief opposing exceptions, particularly for assignments and allocations to and within the Products Pipeline Group.

138. The documentation required here must be made available to all parties at the time SFPP makes its compliance filing. Moreover, in its compliance filing SFPP must clearly explain the basis for any deduction from KMEP's cost of service for ambiguous situations based on its review of the time sheets or time split involves. If SFPP's pending assignment and allocation of costs to SFPP involves ambiguous situations, SFPP must explain how these will be resolved. For example, SFPP might determine that the best resolution is to roll some of the costs now directly assigned to SFPP (about \$9.3 million) up to a higher level in its accounting structure, such as the Pacific or the Products Pipeline Group. This would result in some reallocation of costs below the KMEP level,

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<sup>222</sup> Cf. SFPP Brief op. Ex. at 62-64.

<sup>223</sup> Staff Brief on Ex. at 8-9; Staff Brief op Ex. at 12-13, 18-19.

<sup>224</sup> *Williams II*, 85 FERC at 62,139-51, 62,156. The Commission recognizes that SFPP believes it addressed all the issues on rebuttal, but concludes it is wisest to require a fuller explanation and package of supporting materials as was done in *Williams II*.

<sup>225</sup> These are Casper-Douglas, Tejas Consolidated, KMIGT, and Trailblazer. See Ex. SFP-38 at 32-33.

but would not affect the allocation of costs to KMEP-Operated Entities that have nothing to do with product pipeline operations. Similarly, if some elements included in the cross-charge to KMEP are unclear, SFPP could provide documentation that supports eliminating some dollar amount of a specific cross-charge from KMEP's total cost of service, or alternatively, assign or allocate those costs to those entities that are operated by KMI.

138. Thus, in the case of ambiguous situations involving the KMI cross-charge to KMEP, exclusion of such ambiguous costs from that cross-charge would allocate some portion of those costs through the KMI Massachusetts Formula to the eight KMI-Operating Entities SFPP excluded from the KMEP Massachusetts Formula calculation.<sup>226</sup> This would be a more sensible resolution of any accounting ambiguities than the inclusion of eight large natural gas pipelines in the KMEP Massachusetts Formula because the operating costs of those gas pipelines are based on the operating characteristics of the gas pipeline mode. Given that, the costs of those gas pipelines are unlikely to provide any benefit to product pipeline, CO<sub>2</sub> pipeline, or terminal operations, or for that matter, it is unlikely that benefits would flow the other way. Once SFPP completes the analysis required here, it should provide a schematic showing the source of any changes and how those changes flow to the different levels of cost assignment and allocation among the KMEP-Operated Entities and between KMEP and KMI cost allocation functions. Moreover, in preparing its compliance filing SFPP must design its West Line rates based on the overhead analysis it believes is the one best supported by the additional materials required by this order. This will permit the protesting parties, Trial Staff and the Commission to evaluate the compliance filing as a whole and its impact on the rate design. The Commission will determine whether to require a further hearing on this matter after reviewing SFPP's compliance filing.

### **5. The Appropriateness of Certain Cost and Revenue Components**

139. There are also at issue on exceptions how SFPP applied four cost categories and one revenue factor in its calculation of KMEP's Massachusetts Formula. These cost issues include (1) the method for assigning certain employee related costs; (2) the proper method for removing PAAs from the rate base of KMEP-Operated and KMI-Operated Entities; (3) whether to include certain costs KMI incurred to buy out employee pensions when KMI became a privately held corporation; and (4), whether to capitalize or expense certain overhead costs related to capital investment. Regarding these, Valero asserts that the 2009 ID incorrectly adopted SFPP's proposal to allocate ongoing pension and related

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<sup>226</sup> As noted, the eight KMI-Operated Entities are Casper-Douglas, Tejas Consolidated, KMITG, Trailblazer, TransColorado, KM North Texas, KM Mexico, and REX.

employee benefits through its Massachusetts Formula rather than directly assigning those costs as function of its payroll wage costs. Valero also asserts that the 2009 ID incorrectly held that SFPP should remove PAAs from non-jurisdictional as well jurisdictional entities. Valero further asserts that SFPP incorrectly included in KMEP's Massachusetts Formula the costs KMI incurred in buying out the employee pension costs.<sup>227</sup> SFPP opposes the ID's decision to require the capitalization of certain overhead costs incurred as a part of capital projects. Trial Staff and Valero support the 2009 ID's conclusion in that regard.<sup>228</sup> Regarding the revenue factor, the 2009 ID concluded that if Tejas were to be included in KMEP's Massachusetts Formula (which the 2009 ID held it should not), the Tejas contribution to revenue portion of the formula should be determined by the use of its net rather than gross revenues. Valero opposes this finding, which SFPP supports.<sup>229</sup>

140. In this proceeding SFPP assigned wages directly to the entity incurring those wages based on timesheets and time splits to the extent possible. SFPP then allocated the related payroll taxes using only the payroll/labor cost factor in KMEP Massachusetts Formula, but allocated certain other employee related costs using all three elements of KMEP's Massachusetts Formula. Those latter costs included Incentive Plans, Restricted Stock 401K Plans, Health and Welfare, and Pensions. The 2009 ID did not directly address the allocation of these costs. However, Valero asserts that those costs are similar to payroll taxes and that the distinction between payroll taxes and the other employee-related costs is an issue here. Valero states that under SFPP's approach in this case SFPP is allocated 13.42 percent of those costs rather than 8.11 percent. Valero further states that KMEP's Terminal Operations make up about 72.81 percent of KMEP over all payroll/labor inputs, but are allocated only 44.47 percent labor/payroll specific overhead costs. Valero argues that SFPP shifted its position in a subsequent case and now allocates those additional costs only on the payroll/labor factor.<sup>230</sup> SFPP replies that payroll taxes are based solely on payroll costs, but that the other overhead employee costs, such as Health and Welfare costs, are not calculated solely by payroll costs. SFPP further asserts that allocating only by payroll costs would under-allocate costs to SFPP because the benefit costs include costs of the G&A employees as well as the employees of the operating entities.<sup>231</sup>

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<sup>227</sup> Valero Brief on Ex. at 8-9.

<sup>228</sup> SFPP Brief op. Ex. at 45-48.

<sup>229</sup> Staff Brief op. Ex. at 27-29.

<sup>230</sup> Valero Brief on Ex. At 76 (citing Docket No. IS09-437, Ex. SPE-57 at 18).

<sup>231</sup> SFPP Brief op. Ex. at 86 (citing Tr. 1480-81).

141. The Commission concludes that it cannot accept SFPP's position on this issue. As SFPP's own modification to its approach in its pending East Line rate case demonstrates,<sup>232</sup> costs such as health and welfare costs, pension costs, and bonuses are driven primarily by direct payroll wage costs. Given the competitive relationship of the West Line and East Line shippers and the rates they pay, the Commission believes that both set of rates now in litigation before it should be designed on consistent principles as much as is possible. Since the calculation is relatively mechanical, SFPP should be able adjust these employee-related costs based on the information now available to it and which underpins the record. SFPP must prepare its compliance filing accordingly and provide a supporting analysis therewith. The ALJ is reversed on this matter.

142. The 2009 ID also concluded that SFPP properly removed all PAAs from both jurisdictional and non-jurisdictional entities in applying KMEP's Massachusetts Formula.<sup>233</sup> Valero excepts, arguing that the PAAs should be removed only from the jurisdictional entities because this preserves an original cost methodology and precludes passing through to ratepayers the costs of any premiums above book value incurred in the purchase of jurisdictional entities. Valero asserts that this concern is not relevant to non-jurisdictional entities for which it is impossible to trace back any PAAs that may have been involved in prior purchases of regulated entities.<sup>234</sup> SFPP replies that Valero's position is inconsistent with a prior Commission order.<sup>235</sup> SFPP further asserts that G&A costs will be over-allocated to the jurisdictional entities if the PAAs are not removed from the non-jurisdictional entities. The Commission holds that SFPP is correct. Failure to remove the PAAs from the non-jurisdictional entities will overstate their relative weight in the asset (rate base) component of KMEP's and KMI's Massachusetts Formulas. This is true regardless of what may have occurred in any earlier transactions involving the non-jurisdictional entities.

143. SFPP also proposed to include in its cost of service a portion of the \$26.2 million that KMI incurred when that company went private and became Knight, Inc. \$5.572 million was included in KMEP's cost allocation methodology based on SFPP's evaluation of the going-private costs that would have been incurred even if the going-private transaction has not occurred.<sup>236</sup> Valero argues on exceptions that KMEP's

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<sup>232</sup> See Docket No. IS09-437-000, Ex. No. SPE-57 at 15.

<sup>233</sup> 2009 ID, 129 FERC ¶ 63,020 at P 781-785.

<sup>234</sup> Valero Br. on Ex. at 77-78.

<sup>235</sup> SFPP Brief op. Ex. at 87-88 (citing *SFPP, L.P.*, 114 FERC ¶ 61,136, at P 17 (2006)).

<sup>236</sup> The 2009 ID did not address the issue specifically and Valero's exception is directed toward its failure to do so.

2007 SEC Form 10-K states that KMEP would have no obligation for these costs and that the costs were non-recurring.<sup>237</sup> SFPP replies that the Form 10-K regulations require that this cost be allocated to KMEP and that KMEP is required to recognize it. SFPP asserts that Valero misinterpreted KMEP's 2007 Form 10-K and that the only representation is that KMEP would not have cash responsibility for this portion of the going-private costs. SFPP further asserts that the stock options that would have previously been granted to employees were replaced by a cash bonus of approximately the same level and that this evidence was not contradicted. It concludes that the \$5.572 million at issue is a recurring cost because this represents the normal employee bonuses that will be incurred on a going forward basis, and as such are not related to the foregoing private transaction that Valero questions here.<sup>238</sup> The Commission concludes that Valero's argument based on KMEP's 2007 Form 10-K is insufficient to rebut SFPP's specific evidence that the \$5.572 million at issue should be considered a recurring cost. SFPP should not include any of the remaining \$26.2 million buy-out cost in KMEP's service as it recognizes that those costs were non-recurring.

144. The fourth cost-of-service issue involves the capitalization of overhead costs related to capital investments. The 2009 ID adopted Trial Staff's position that SFPP should allocate indirect overhead costs involving capital investments through KMEP's Massachusetts Formula.<sup>239</sup> SFPP excepts to this ruling, arguing that the Commission's oil pipeline regulations preclude the capitalizing of overhead costs and the industry practice is to the contrary.<sup>240</sup> Trial Staff supports the 2009 ID, arguing that the Commission's accounting regulations are to the contrary, and that if industry practice contravenes the regulations, this proceeding should put the industry on notice that they are in violation.<sup>241</sup>

145. The Commission concludes that this is a point that SFPP should address further in its compliance filing. No party disputes here that any direct costs related to capital investments should be allocated to the relevant operating entity, and sound principles of matching cost allocation with cost incurrence require that overhead management costs be allocated where this can be done. However, under KMI's accounting system, significant portions of the overhead costs related to capital expenditures are assigned or allocated

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<sup>237</sup> Valero Brief on Ex. at 73-75.

<sup>238</sup> SFPP Brief op. Ex. at 85-86 (citing Ex. SFP-129 at 48-52; Ex. SFP-138c; and Ex. ACV-82).

<sup>239</sup> 2009 ID, 129 FERC ¶ 63,020 at P 791-795.

<sup>240</sup> SFPP Brief on Ex. at 46-47.

<sup>241</sup> Staff Brief op. Ex. at 27-29.



based on the relevant responsibility centers (RCs) and time splits of the managers responsible for capital budgeting and construction. In this regard, Part 352, Instructions for Carrier Property Accounts, 3-3 contemplates this will be done as it requires charging the carrier property account for “direct and other costs.” The regulation states that the “[c]ost of labor includes the amount paid for labor performed by the carrier’s own employees and officers.” This includes payroll taxes, vacation pay, pensions, holiday pay and traveling, and other incidental expenses of employees. The regulation also states that “No charge shall be ... for the pay and expenses of officers and employees who merely render services incidentally in connection with extensions, additions, or replacements.”<sup>242</sup> SFPP states that it only included such incidental expenses in its Massachusetts Formula and therefore was correct in not capitalizing those expenses if those expenses met the standard in the regulation. However, SFPP has not clearly identified the source of those “incidental” costs, and thus whether they are actually separate from RCs that are dedicated to managing capital investments, or their magnitude. Because the Commission is testing the appropriateness of KMI’s RC based accounting system, SFPP must do more to establish the relevance and strength of its position in its compliance filing.

146. The last issue on exceptions regarding specific inputs to a Massachusetts Formula is whether to use Tejas Consolidated’s gross or net revenues in calculating KMEP’s Massachusetts Formula. The 2009 ID first concluded that Tejas should not be included in KMEP Massachusetts Formula since it is a KMI-Operated Entity, a position the Commission approved earlier in this order.<sup>243</sup> The 2009 ID held in the alternative that if Tejas Consolidated is included in the KMEP Massachusetts Formula, SFPP should use the “Distrigas Formula” which uses net rather than gross revenues.<sup>244</sup> The rationale for that formula is that gross revenues of an entity that buys and sells large amount of gas can distort the revenue proportion of the formula compared to entities that are involved primarily in transportation or storage.<sup>245</sup> However, Valero asserts that the formula applies only to firms that have a gas cost recovery mechanism. Valero also argues that use of net revenues fails to reflect the higher risk of a gas sales business, and that if net revenues were negative, this would distort the Massachusetts Formula.<sup>246</sup> SFPP asserts that the distinction of the gas cost recovery mechanism is not relevant and that the important factor is the disproportionate gross revenue resulting from a firm that is

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<sup>242</sup> See 18 C.F.R. Part 352, Instructions for Carrier Property Accounts, 3-3 (2010).

<sup>243</sup> 2009 ID, 129 FERC ¶ 63,020 at P 786-790.

<sup>244</sup> See *Distrigas of Massachusetts Corp.*, 41 FERC ¶ 61,205 (1987) (*Distrigas*). See also *Williston Basis Pipeline Co.*, 104 FERC ¶ 61,036 (2003).

<sup>245</sup> *Id.*

<sup>246</sup> Valero Brief on Ex. at 78-82.

primarily involved in gas sales. It argues that Tejas Consolidated's gross revenues would result in allocating \$89 million in costs to Tejas Consolidated when the costs of the group responsible for managing risk of all gas transactions was only \$4.2 million. SFPP also states that all of the costs of the related accounting and treasury groups were only \$4.9 million even if it is assumed that Tejas Consolidated required all of their efforts. SFPP states that use of Tejas Consolidated's gross revenues would allocate to Tejas 25.8 percent of all overhead costs under Valero's "all in" approach.<sup>247</sup>

147. The issue of whether to use Tejas Consolidated's net or gross revenues is before the Commission as an alternative ruling, which the Commission will address as to resolve as many issues as possible. The Commission concludes that SFPP's analysis demonstrates that the 2009 ID correctly used Tejas Consolidated's net rather than gross revenue. Gas cost recovery mechanisms have long since been abolished, but this does not change the basic rationale for the use of net rather than gross revenues when an entity's gross revenues are predominately from gas sales. Valero presents nothing that suggests that resources needed to evaluate risk of gas sales is proportionately related to the total sales involved, and in fact, common sense suggests that the resources required would relate more to the number of sales or the customers to be evaluated than to the size of sales. Valero's argument regarding the possibility that a gas sales entity may have no net revenues is appropriately addressed when, and if, that situation occurs. SFPP's analysis demonstrates that there would be a gross over-allocation of overhead costs to Tejas Consolidated if the Commission accepted Valero's arguments.<sup>248</sup>

#### **D. The KN Method**

148. The KN Method is used to allocate a jurisdictional entity's administrative and general (A&G) costs between its jurisdictional and non-jurisdiction functions, and if the

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<sup>247</sup> SFPP Brief on Ex. at 82-86.

<sup>248</sup> Valero challenges SFPP's allocation of liability insurance among KMI's affiliates, but does not appear to make it an exception as such. Rather, the argument is intended as an example of an unsupported or arbitrary assignment of costs. *See* Valero Brief on Ex. at 14-15. SFPP stated that the allocation was based on the relative replacement cost of each asset under KMI's blanket insurance policy. Rather, Valero simply prepared a mileage ratio analysis for the various pipelines and did nothing to analyze whether SFPP's allocation, which is based on its general liability insurances practices, was irrational or imprudent, given the differences in the operating and physical configurations of its pipeline operations. If Valero wanted to pursue the matter on the grounds that SFPP's standing business practice was arbitrary or that the calculation was improper, it should have done so at hearing.

entity has more than one jurisdictional function, among those functions. In this proceeding there is agreement that the KN Method applies, but there is disagreement about how it is to be applied. SFPP asserts that in its prior rate proceedings the Commission accepted a KN analysis based on a simple average of its total Carrier Direct Original Cost Property and its Carrier Direct Labor percentage. Thus, in the instant case SFPP's Direct Original Cost Property to Total Original Cost Property was 77.67 percent and its Carrier Direct Labor was 84.07 percent of total carrier labor. The simple average of those two percentages results in a KN factor of 80.87 percent which is used to functionalize indirect overhead costs (called A&G) costs to SFPP's various jurisdictional and non-jurisdictional functions by multiplying the ratio times the dollar amount in each A&G category.<sup>249</sup> The 2009 ID concluded that SFPP's KN Method does not comply with the KN Method required by Opinion No. 731, but adopted SFPP's method on the ground that method had been accepted in compliance filings involved in prior SFPP rate cases.<sup>250</sup>

149. Trail Staff asserts the 2009 ID correctly found that SFPP's KN Method did not conform to Opinion No. 731, but erred in not requiring SFPP to conform to the Opinion.<sup>251</sup> Trail Staff states that the correct KN Method is as follows. First, all A&G costs are divided in to three categories: labor, plant, and other costs. The labor, plant, and other costs are each summed and the "other costs" are then allocated between the indirect labor and plant costs based on the ratio of those two costs. This gives a separate total dollar amount for A&G labor and plant costs. These two separate total A&G costs are assigned to each division or function using direct labor and direct plant ratios. Those ratios are defined as the ratio of the function's direct labor to total labor costs and the ratio of the function's direct plant to total plant. The total labor-related A&G is multiplied by each function's direct labor ratio and the total plant-related A&G is multiplied by each function's direct plant ratio. Each of these last two calculations results in the dollar figure of the labor and plant A&G costs of each function. The next step is to sum those two dollar cost figures and develop a ratio of those two dollar cost totals for each function. The resulting ratio is the KN ratio for each division or function. The KN ratio for each function is then applied to each category of A&G expense and that resulting dollar amount is allocated to that function. The sum of those allocations to each function becomes the total A&G expense for that function.<sup>252</sup> Trail Staff argues that the 2009 ID incorrectly accepted SFPP's argument that the traditional KN method is too

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<sup>249</sup> See Ex. S-12C at 29-30 for a concise description of SFPP's method.

<sup>250</sup> 2009 ID, 129 FERC ¶ 63,020 at P 776-812.

<sup>251</sup> Staff Brief on Ex. at 9-11.

<sup>252</sup> See Ex. S-12C at 28-29.

complicated, as it is the Commission's method.<sup>253</sup> Trial Staff further argues that the Commission expressly stated in two of the most recent SFPP orders that SFPP was not using the correct KN Method.<sup>254</sup> SFPP supports the 2009 ID's ruling and rationale.

150. Trial Staff is correct that SFPP's proposed KN Method does not conform to Opinion No. 731 and SFPP should be required to do so. Trial Staff correctly argues that the method has been consistently affirmed in other proceedings,<sup>255</sup> and that it is the Commission's method regardless of its complexity. While the parties have various theories why the Commission accepted SFPP's proposed method in a number of past compliance filings,<sup>256</sup> those theories are simply beside the point. None of the compliance filings are final as of this date because those filings were interim filings in three interrelated proceedings, Docket Nos. OR92-8-000 and OR96-2-000 involving SFPP's East and West Line rates,<sup>257</sup> and in Docket No. OR96-2-012 involving SFPP Sepulveda Line rates.<sup>258</sup> Trial Staff is also correct that the most recent orders in both instances explicitly found that SFPP's methodology did not follow the proper KN Method.<sup>259</sup> Trial Staff also correctly asserted at hearing that the simple averaging approach used by SFPP will unduly allocate costs to a jurisdictional function that has unusually large capital costs as the averaging approach dilutes the impact of the capital ratio by combining it with the labor ratio.<sup>260</sup> The 2009 ID is reversed and SFPP is directed to apply the KN Method set forth in Opinion No. 731.

## **V. Capital Structure and the Cost of Capital**

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<sup>253</sup> Staff Brief on Ex. at 9.

<sup>254</sup> Staff Brief on Ex. at 16-17 (citing *SFPP, L.P.*, 113 FERC ¶ 61,277, at P 87-89 (2005) and *SFPP, L.P.*, 121 FERC ¶ 61,204, at P 137 (2007)).

<sup>255</sup> See *Questar Pipeline Co.*, 74 FERC ¶ 61,126, at 61,454-56 (1996); *Panhandle Eastern Pipe Line Co.*, 46 FERC ¶ 61,183, at 61,615 (1989), *reh'g denied*, 51 FERC ¶ 61,059 (1990).

<sup>256</sup> Staff Brief on Ex. at 11-16; SFPP Brief op. Ex. at 89, n.14.

<sup>257</sup> 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 88, and Ordering Paragraph (C) (requiring a compliance filing).

<sup>258</sup> *SFPP, L.P.*, 121 FERC ¶ 61,240, at P 150 (December 2007 Order), and Ordering Paragraph (C) (requiring a compliance filing).

<sup>259</sup> See *SFPP, L.P.*, 113 FERC ¶ 61,277, at P 87-89 (2005) (December 2005 Order); December 2007 Order, 121 FERC ¶ 61,240 at P 137.

<sup>260</sup> Ex. S-12C at 30-31.

151. This part of the order addresses issues related to capital structure and the cost of capital. The issues raised include the role of purchase accounting adjustments (PAA) and goodwill in determining SFPP's capital structure, the treatment of debt in the capital structure, whether cost of certain types of debt should be included in SFPP's debt cost, and matters related to the equity cost of capital. As discussed below, the Commission finds that the cost of capital must be calculated as of September 30, 2008. To be consistent with this determination, the Commission determines that September 30, 2008, is also the appropriate date for determining capital structure.

#### **A. PAA and Goodwill**

152. All parties agree that the capital structure of KMEP, SFPP's parent company, should be used to determine SFPP's cost-of-service. However, the parties dispute whether KMEP's capital structure must be adjusted due to PAAs and goodwill related to acquisitions made by KMEP. The 2009 ID required the removal of all PAAs from the equity component of KMEP's capital structure. However, the 2009 ID did not require any adjustments to remove the effects of goodwill.<sup>261</sup> The briefs on exceptions raise objections to the 2009 ID's treatment of both PAAs and goodwill.

153. By way of background, when an asset is acquired, two adjustments are made to reflect the difference between (a) the acquisition price of an asset and (b) the book value of the asset on the prior owner's balance sheet preceding the sale. First, the asset's value is adjusted for a PAA, an accounting adjustment that writes-up the book value of the acquired asset so that the book value (original cost minus accumulated depreciation) reflects the asset's market price.<sup>262</sup> Commission policy generally requires removal of the effects of PAAs from the rate base component of a pipeline's cost-of-service because inclusion of PAAs would be inconsistent with original cost ratemaking. This restricts a utility's recovery to no more or less than a rate of return and depreciation based upon an asset's original cost.<sup>263</sup>

154. At the time of an acquisition, a second accounting adjustment is often made to the books of the acquiring company for goodwill. Goodwill is based upon the difference

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<sup>261</sup> 2009 ID, 129 FERC ¶ 63,020 at P 629, 642.

<sup>262</sup> Ex. BPW-1 at 12-13; Ex. SFP-171 at 6; *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 65 (2005) (December 2005 Order). If the PAA is negative, then it also will decrease the pipeline's rates below the levels consistent with the Commission's original cost ratemaking policy.

<sup>263</sup> See, e.g., *Longhorn Partners Pipeline*, 82 FERC ¶ 61,146, at 61,543 (1998).

between acquisition price and the market value (the book value plus the PAA).<sup>264</sup> Goodwill is defined by the Financial Accounting Standards Board (FASB) as “an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.”<sup>265</sup> As discussed below, the Commission finds that it is inappropriate to adjust KMEP’s capital structure for either goodwill or the PAAs at issue in this proceeding.

### 1. PAA

155. The 2009 ID adjusted KMEP’s capital structure to remove PAAs from the equity component because the PAAs at issue in this proceeding did not relate to a “new service or substantial benefit” to ratepayers.<sup>266</sup> Moreover, the 2009 ID determined that the evidence failed to support SFPP’s claim that PAAs do not distort rates.

156. The 2009 ID added that if the Commission determined that it was inappropriate to remove the PAAs entirely from equity, the Commission could consider removing the PAA only from the debt component of capital structure for acquisitions that were financed initially with short term debt and, where both debt and equity were used, to remove PAAs from the debt and equity component in accordance with the debt and equity used to fund the acquisitions. Alternatively, the 2009 ID suggested the Commission could deduct the PAA from both the equity and debt components of capital structure using the ratio ultimately used to finance the original acquisition.<sup>267</sup>

157. On exceptions, SFPP asserts that the 2009 ID misapplied Commission precedent by requiring the removal of PAAs from the equity component of capital structure based upon the substantial benefits test. SFPP contends that the Commission’s 2006 Sepulveda Order established a two-part analysis providing that (1) regarding the presence of PAAs in rate base, the effect of the PAA must be removed absent a showing of substantial benefits or new service to ratepayers (substantial benefits standard), and (2) regarding the possible influence of PAAs upon capital structure, the PAA must be removed from the carrier’s capital structure to the extent that the PAA has distorted capital structure.

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<sup>264</sup> Ex. BPW-1 at 11-13; *SFPP, L.P.*, 111 FERC ¶ 61,334, at P 68 (2005) (Order on Remand and Rehearing) (June 2005 Remand Order).

<sup>265</sup> Ex. SFP-174 at 4.

<sup>266</sup> 2009 ID, 129 FERC ¶ 63,020 at P 634 (citing June 2005 Remand Order, 111 FERC ¶ 61,334 at P 67; December 2005 Order, 113 FERC ¶ 61,277 at P 65, *order on reh’g, SFPP, L.P.*, 114 FERC ¶ 61,136, at P 15 (2006) (February 2006 Order)).

<sup>267</sup> 2009 ID, 129 FERC ¶ 63,020 at P 641.

158. SFPP states that it did not include any PAAs in rate base, and, thus, the first part of the analysis is inapplicable. SFPP further claims that KMEP's capital structure was not distorted by the PAAs or the financing of the acquisition that generated the PAAs. SFPP avers that any increase in equity on the balance sheet of an acquired (or target) company resulting from a PAA does not flow through to the acquiring (or parent) company's consolidated balance sheet. SFPP explains that this is because the equity balances of the acquiring company's subsidiaries are eliminated in consolidation.

159. Moreover, SFPP asserts that any impact on an acquiring company's capital structure resulting from an acquisition involving PAA (or goodwill) comes from the type of financing used to fund the acquisition. SFPP states that it has used roughly a 50-50 combination of debt and equity to finance the acquisitions that generated the PAAs. Thus, SFPP avers that the 2009 ID's elimination of the PAAs solely from KMEP's equity balance actually distorts the capital structure. SFPP argues that to the extent the Commission adjusts KMEP's capital structure for PAAs, such an adjustment must be made to both debt and equity in accord with the acquisitions that generated the financing of those PAAs.

160. In contrast, SFPP argues that the methodologies advocated by the shippers yield inconsistent and unreasonable results, and otherwise fail to apply generally accepted accounting principles to determine the impact of PAAs on capital structure. SFPP further emphasizes that the June 2005, December 2005, and February 2006 Orders in Docket No. OR96-2-000 addressed the impact of PAAs on SFPP's capital structure, as opposed to KMEP's capital structure.

161. Opposing exceptions, ExxonMobil/BP, Tesoro, and the ACC Shippers assert that Commission precedent supports the exclusion of PAAs when calculating the debt to equity ratio in capital structure. ExxonMobil/BP and the ACC Shippers argue that Commission precedent provides that PAAs must be removed from all cost of service calculations, including capital structure, absent a showing that the acquisition provides to ratepayers a new service or substantial benefits. The ACC Shippers and ExxonMobil/BP contend that the decision to eschew a PAA adjustment to capital structure in the 2006 Sepulveda Order<sup>268</sup> relied upon a unique factual scenario in which the Commission concluded that a 1988 PAA did not distort the debt to equity ratio. They emphasize that the 1988 PAA discussed in that decision is not at issue here. The ACC Shippers elaborate that this was because the 1988 PAA adjustment to equity was made prior to the creation of SFPP's initial capital structure and could have no impact on the amounts of debt and equity that were sold at the initial public offering.

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<sup>268</sup> 117 FERC ¶ 61,285.

162. ExxonMobil/BP, Tesoro, and the ACC Shippers further argue that the PAA in this proceeding distorted KMEP's capital structure. Those parties allege that SFPP ignores the distinction between the retention of PAAs for GAAP accounting purposes and the removal of PAAs for ratemaking purposes. Those parties claim that SFPP's position that PAAs are not reflected on KMEP's consolidated balance sheet is incorrect because the asset values carried forward onto the consolidated balance sheet of the parent company retain the increases attributable to PAAs. The shippers conclude that the Commission has explicitly recognized that PAAs distort the parent company KMEP's regulatory capital structure, not just SFPP's capital structure.<sup>269</sup>

163. ExxonMobil/BP also asserts that the hypotheticals advanced by SFPP witness Peterson involving acquisitions funded entirely by cash or entirely with newly issued debt lack relevance because the three largest KMEP acquisitions (the acquisition of SFPP, Kinder Morgan Interstate Gas Transmission Co., and Kinder Morgan Wink Pipeline, L.P.) all involved significant issuances of equity by KMEP. ExxonMobil/BP emphasize that none of KMEP's acquisitions of jurisdictional properties included the issuance of new debt, and SFPP only absorbed the pre-existing debt of the acquired entity. ExxonMobil emphasizes that none of SFPP witness Peterson's hypotheticals addressed this precise scenario.

164. Moreover, ExxonMobil/BP argues that there is no basis for reducing the level of debt below the actual level of debt. ExxonMobil/BP states that the debt level held by a pipeline is a set amount, which does not change with the valuation of assets; thus, they claim that the financing purportedly used in the acquisition of an asset is separate from the PAA level. Further, the ACC Shippers and ExxonMobil assert that the level of a PAA is independent from the financing used in the transaction and that SFPP erroneously attributes changes in financing to the impact of a PAA.

165. The ACC Shippers further aver that SFPP's witnesses provide contradictory testimony, with Dr. Williamson arguing that PAAs should be removed from the balance sheet in proportion to the percentage of debt and equity used to finance the transaction. In contrast, the ACC Shippers state that Mr. Petersen repeatedly stresses that the amount of a PAA is not impacted by the type of financing used to acquire a target company. ExxonMobil and the ACC Shippers further note that to the extent the Commission adjusts capital structure for computing return, the same capital structure should be used to compute the net trended original cost rate base and the deferred return.

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<sup>269</sup> The shippers cite the February 2006 Order, 114 FERC ¶ 61,136 at P 14-15 and the December 2005 Order, 113 FERC ¶ 61,277 at P 64-66, n.92.



166. The Commission finds that it is unnecessary to adjust KMEP's capital structure for the presence of PAAs, and, thus, the Commission reverses the 2009 ID. As explained previously, a PAA is an accounting adjustment that occurs when a purchaser pays more than book value (original cost minus accumulated depreciation) for an asset with a resulting increase in the rate base of the regulated entity. Permitting a PAA to distort the cost-of-service and to increase customer rates is inconsistent with original cost ratemaking, which restricts a utility's recovery to no more or less than a rate of return and depreciation based upon an asset's original cost.<sup>270</sup> Therefore the Commission has determined that it is inconsistent with ratemaking principles to allow a PAA to increase a company's recovery either by inflating the rate base or by distorting the equity component of capital structure.<sup>271</sup> Commission policy thus requires adjustments to remove the effects of a PAA from cost-of-service unless the acquisition either provides a new service or a "substantial benefit to ratepayers."<sup>272</sup>

167. If a PAA does not satisfy the substantial benefits test, the Commission must next determine the appropriate adjustments to remove the effects of the PAA from cost-of-service. The purpose of any such adjustment is to remove the distorting effects of the PAA from the utilities' cost-of-service calculations, and such an adjustment must address an actual distortion caused by the PAA.<sup>273</sup> Regarding rate base, the distortions of a PAA are readily apparent. When a PAA is added to rate base, the PAA increases the rate base above book value. If the PAA is not excluded from rate base for ratemaking purposes, the presence of the PAA in rate base would allow the utility to recover depreciation and a return on more than the original investment in the asset.<sup>274</sup>

168. However, the effect of a PAA on capital structure is less straightforward and the mere presence of a PAA does not always establish that a distortion to capital structure has actually occurred. Whereas rate base consists of a sum of asset values, capital structure consists of a ratio of equity and debt in the regulated entity's financing. As the Commission observed in the 2006 Sepulveda Order, a PAA merely increases the size of the asset base of a utility, not necessarily the ratio of debt and equity used to finance the

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<sup>270</sup> See, e.g., December 2005 Order, 113 FERC ¶ 61,277 at P 65.

<sup>271</sup> *Id.*; February 2006 Order, 114 FERC ¶ 61,136 at P 15.

<sup>272</sup> *Longhorn Partners Pipeline*, 82 FERC ¶ 61,146 at 61,543.

<sup>273</sup> 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 31-32.

<sup>274</sup> For the purposes of the discussion here, we assume that the PAA is positive. If the PAA is negative, then it also will decrease the rate base (and consequently the pipeline's rates) below the levels consistent with the Commission's original cost ratemaking policy.

asset base.<sup>275</sup> Thus the mere presence of a PAA does not demonstrate that the PAA has in fact distorted capital structure by rendering the debt to equity ratio any different than it would have been absent the PAA. The 2009 ID and the briefs on exception rely upon the Commissions orders in Docket No. OR96-2-000, et al.<sup>276</sup> However, the Commission's orders in Docket No. OR96-2-000, et al., were premised on the finding that inclusion of the PAA had, in fact, distorted the capital structure by increasing the equity component of the capital structure (without appreciably increasing debt) and, because equity is typically more expensive than debt, the Commission concluded that the PAA imposed an unreasonable cost on ratepayers.<sup>277</sup> As was the case in the 2006 Sepulveda Order, if it is not clear that the debt to equity ratio is materially altered as a result of a PAA increasing the asset base, then the capital structure has not been distorted and there is no need for an adjustment.

169. Applying such reasoning to the record presented here, no party claims that the PAAs at issue satisfy the substantial benefits test. Thus, SFPP correctly removed the PAAs for the purpose of establishing its rate base. Because the PAAs do not satisfy the substantial benefits test, the Commission must also consider possible adjustments to capital structure, and, in assessing these possible adjustments, perform an additional analysis to determine whether the PAAs actually caused a distortion to capital structure. The Commission finds that the PAAs at issue in this proceeding did not distort KMEP's

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<sup>275</sup> 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 32. In the 2006 Sepulveda Order, the Commission considered a PAA resulting from the 1988 sale of assets from the predecessor pipeline to SFPP. The 1988 sale thus increased the size of the asset base when the assets were transferred to the new owner, SFPP. The new owner proceeded to raise financing, resulting in a capital structure of approximately 60 percent debt and 40 percent equity. Under these circumstances, the Commission determined that there was no basis to conclude the PAA had been added entirely to the equity component or that any distortion of capital structure had occurred as a result of the PAA. The Commission explained there is no reason "to believe that this market established debt-equity ratio would have changed if the 1988 asset base resulting from the 1988 sale was the same, smaller, or larger." *Id.* Thus, the Commission rejected arguments that the capital structure should be adjusted for PAAs.

<sup>276</sup> See n.266, *supra*.

<sup>277</sup> December 2005 Order, 113 FERC ¶ 61,277 at P 64-65. In Docket No. OR96-2-000, *et al.* the Commission addressed the treatment of KMEP's 1998 purchase of SFPP and the related PAAs in SFPP's capital structure, which was being used as the capital structure in that proceeding. Based upon the record present there, it was clear that the PAAs had been added entirely to the equity component of capital structure, skewing the capital structure toward equity.

debt to equity ratio, and thus no adjustment to capital structure for the PAAs is warranted. In assessing the existence of distortions to capital structure, the primary question to consider is not the financing of any particular transaction, but whether the increased asset base resulting from the presence of the PAAs is distorting capital structure.<sup>278</sup> This is because capital is fungible. For this reason the financing related to a particular purchase must be considered as a part of the overall pool of funds used to finance the assets of the company. Moreover, over time, financial strategies shift, debt retires, and new issuances of debt and equity are made even as the asset base continues to include the residual effects of PAAs.<sup>279</sup> Thus, for KMEP, an MLP with multiple subsidiaries that regularly makes new issuances of debt and equity, it is not possible to isolate and distinguish the ongoing impact of a PAA on the capital structure's debt to equity ratio. Moreover, without making any adjustment for PAA, KMEP's capital structure remains within industry norms.<sup>280</sup> As a result, the evidence does not support a finding that the increase to KMEP's asset base resulting from the PAAs has distorted capital structure. Rather, the most accurate description of the ratio of debt to equity that KMEP uses to define its regulatory rate base is the debt to equity ratio reported in KMEP's financial statements.

170. Consideration of the possible adjustments to remove the purported effects of PAAs on capital structure only further supports the decision to use KMEP's actual debt to equity ratio. The record provides inadequate justification for the 2009 ID's deduction of the PAAs entirely from equity. As an initial matter, the PAAs involving KMEP related to acquisitions financed by both debt and equity.<sup>281</sup> Thus, even if the Commission accepted the proposition that the ongoing effect of a PAA can be linked to the financing of a particular transaction years previously, there is no support for removing the PAAs entirely from equity. ExxonMobil claims that for transactions involving most of the PAAs, KMEP merely assumed the debt of the acquiring companies and did not issue any new debt. Because no new debt was issued, ExxonMobil contends that the PAA cannot be viewed as increasing debt levels and should be removed entirely from equity. This argument is not persuasive. Even assuming that the ongoing effect of a PAA can be

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<sup>278</sup> 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 32.

<sup>279</sup> However, the Commission notes that as value of the asset depreciates, it would be inconsistent to view the effect of the PAA on asset base as not also declining over the life of the asset.

<sup>280</sup> Without removing PAAs, KMEP's capital structure is 56.18 percent debt and 43.82 percent equity as of September 30, 2008. *See* Ex. TES-3 at 9.

<sup>281</sup> Together, the PAA and goodwill represent the additional cost to KMEP of the acquisition above the asset's book value. There is no evidence that capital markets required KMEP to raise the additional cost represented by the PAA solely from equity.

traced to the financing of the original acquisition, whether or not KMEP assumed debt or issued debt is not relevant. KMEP's debt level increased as a result of the acquisition. From the perspective of KMEP, the increase in the level of debt was part of the financing for the entire acquisition, including the portion of the asset base involving the PAAs. Had KMEP not assumed the debt, then it likely would have needed to obtain additional financing in order to compensate parties that remained responsible for the debt of the acquired company.

171. For these reasons prior Commission decisions do not necessarily support deducting the PAAs entirely from the equity component. In deciding to remove the PAAs solely from the equity component, the 2009 ID relied upon Commission orders in Docket No. OR96-2-000, et al. However, unlike the facts considered in Docket No. OR96-2-000, et al.,<sup>282</sup> the PAAs at issue in this proceeding cannot entirely be attributed to equity. In Docket No. OR96-2-000, et al., the Commission was using the subsidiary SFPP's capital structure rather than the parent KMEP's capital structure, which is the capital structure at issue here.<sup>283</sup> Those orders addressed PAAs resulting from "push down" accounting on the books of SFPP following its acquisition by KMEP. Under "push down" accounting, the difference between the purchase price and the book value of the company acquired was "pushed down" to the books of the acquired company, SFPP. In this case there was a dramatic increase in equity on the SFPP balance sheet because the debt component of its existing capital structure was unchanged.<sup>284</sup> This "push down" therefore raised concerns that such an increase in equity component of the capital structured was unrelated to any issuance of any "new" equity, debt, or other financing by SFPP. Thus, the resulting capital structure was not reflective of SFPP's actual cost of capital. Therefore, under the circumstances presented in Docket No. OR96-2-000, et al., it was appropriate to remove the PAA entirely from the equity component because the PAA had distorted that capital structure by increasing the equity component without increasing the debt component.

172. As the parties note, as part of its rationale for adopting SFPP's capital structure in Docket No. OR92-8-000, et al., the Commission expressed concern that KMEP's capital structure could also be distorted by PAAs.<sup>285</sup> However, neither the December 2005 nor the February 2006 Orders concluded that the marginal increase in acquisition cost related to the PAA should be attributed solely to equity regarding KMEP.

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<sup>282</sup> February 2006 Order, 114 FERC ¶ 61,136 at P 14.

<sup>283</sup> *Id.* at P 15.

<sup>284</sup> *Id.* at P 14.

<sup>285</sup> December 2005 Order, 113 FERC ¶ 61,277 at P 66; February 2006 Order, 114 FERC ¶ 61,136 at P 15.

173. In supporting the removal of PAAs solely from equity, ExxonMobil/BP further argue that debt levels are “fixed” and that any fluctuations in asset values must thereby be removed from equity. As a matter of accounting, it is true that if an asset is revalued, this revaluation does not reduce a utility’s debt level. However, the Commission’s adjustments to exclude the effect of a PAA from capital structure are not analogous to an actual write down of an asset’s value. Rather, as was made clear by the 2006 Sepulveda Order, the Commission’s evaluation concerns how the increase of the asset base associated with the PAA ultimately altered the debt to equity ratio in KMED’s capital structure.<sup>286</sup>

174. Therefore, removing the PAA solely from the equity component does not reflect the actual impact of the PAA on capital structure. Neither the 2009 ID nor the briefs opposing exception provide justification for removing the PAAs entirely from equity. Rather than removing the PAAs entirely from equity, the 2009 ID presented as an alternative that the PAAs could be removed from debt and equity in the same ratios that were used to finance the various acquisitions involving the PAAs. However, as explained above, this approach is flawed because capital at the parent company level is essentially fungible and the debt to equity ratio in a particular transaction may be offset by other financial issuances. Moreover, the particular adjustment in this proceeding is difficult to determine. SFPP funds many of its purchases with short term debt, and then eventually issues longer term debt and equity to replace this short term debt. Thus, the financing transactions are not easily traceable back to the original acquisition.

175. The Commission notes that KMED’s capital structure without any modification for the PAA is consistent with the capital structure of other pipelines and does not indicate any excess in the equity component.<sup>287</sup> This is another distinction with the facts in Docket No. OR96-2, where inclusion of the PAA created a capital structure of 25 percent debt and 75 percent equity for SFPP.<sup>288</sup> As noted previously, the proceedings in Docket No. OR96-2, et al., the Commission stated that PAAs may have distorted KMED’s capital structure because “the write-up of the equity component would likely modify the debt to

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<sup>286</sup> 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 32. Although in a sense it is true that the PAA is separate from the financing of a transaction, the financing of the transaction ultimately reflects the total cost of the acquisition, which includes the “cost” attributed to a PAA for accounting purposes.

<sup>287</sup> See n.280, *supra*.

<sup>288</sup> In deducting the PAA solely from equity, the Commission noted that once the PAA was removed, “SFPP’s capital structure [is] well within the norms of the oil and products pipeline industry, and results in more appropriate debt and equity ratios.” December 2005 Order, 113 FERC ¶ 61,277 at P 64.

equity ratio in KMEP's capital structure by increasing the equity component.”<sup>289</sup> However, based upon the factors considered in this decision and the more extensive evidence presented by the parties in this proceeding, the Commission concludes that KMEP's capital structure is not distorted by PAAs.

## **2. Goodwill**

176. The 2009 ID found that goodwill should not be removed for purposes of determining capital structure. The 2009 ID emphasized that goodwill is not a write-up of assets. Rather, the 2009 ID concluded that goodwill represents the acquisition of an additional intangible asset which has real value and future economic benefit to ratepayers. Thus, the 2009 ID concluded that goodwill<sup>290</sup> is appropriately included in the determination of capital structure.<sup>291</sup>

177. On exceptions, ExxonMobil/BP assert that the 2009 ID erred by failing to remove goodwill from KMEP's capital structure. ExxonMobil/BP argue that the effect of an acquired company's goodwill on the consolidated balance sheet is reflected in a higher equity amount than would exist if there had been no goodwill. As a result, they argue that goodwill, like a PAA, artificially inflates the equity component of capital structure and will result in higher rates. To justify the increased costs, ExxonMobil/BP contend that Commission precedent requiring the removal of PAAs unless they provide “new service or substantial benefits” to ratepayers should also be applied to goodwill. ExxonMobil/BP claim the 2009 ID simply found that goodwill provides “future economic benefit” but made no showing that such benefit will accrue to ratepayers.

178. Opposing exceptions, SFPP asserts that contrary to ExxonMobil/BP's claim, goodwill does not affect either debt or equity balances. Rather, the impact on an acquiring company's capital structure results solely from the type of financing used to fund the acquisition. SFPP argues the evidence in this proceeding shows that the amount of debt of an acquiring company is not fixed and in fact increases to the extent the acquiring company issues debt to finance its acquisition. SFPP contends, therefore, that the notion that goodwill inflates a company's equity balance is unsupported.

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<sup>289</sup> December 2005 Order, 113 FERC ¶ 61,277 at P 66.

<sup>290</sup> In its definition of goodwill, the Financial Accounting Standards Board (FASB) explains that goodwill is an “asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.” Ex. SFP-174 at 4.

<sup>291</sup> 2009 ID, 129 FERC ¶ 63,020 at P 642.

179. The Commission finds that there is no justification for adjusting capital structure for goodwill. Although the Commission arrives at the same conclusion as the 2009 ID, the Commission does so on a different basis. Much like a PAA, goodwill is unrelated to the original cost of the assets used to provide jurisdictional service and emerges when more is paid than the book value (original cost minus depreciation) of an asset. These types of accounting adjustments that depart from original cost cannot be permitted to distort rates by being included in the pipeline's asset base. However, because the Commission found that capital structure need not be adjusted for PAAs, the Commission also determines that it is not necessary to alter the capital structure to remove goodwill. However, for the same reasons that a PAA does not necessarily alter the debt to equity ratio in capital structure, it is not clear that the additional cost above the book value that is attributed to goodwill distorts capital structure in a company with the characteristics of KMEP. If the debt to equity ratio is not distorted by the goodwill, there is no justification for adjusting capital structure.

### **B. Appropriate Debt to be Included in the Capital Structure**

180. On exceptions, SFPP and ExxonMobil/BP agree that the 2009 ID did not make a clear ruling on whether KMEP's Current Portion of Long-Term Debt<sup>292</sup> should be included in calculating the appropriate capital structure. They note that this issue was included in the joint statement of issues.<sup>293</sup> Moreover, on exceptions, SFPP notes the 2009 ID addressed only the issue of how commercial paper should be treated for purposes of calculating the cost of long-term debt, not how such debt should be treated for determining the appropriate capital structure, and that in this the 2009 ID erred.

181. SFPP asserts that both the commercial paper and the long-term debt set to expire within one year should be excluded from capital structure. SFPP states that KMEP neither intends nor has the ability to refinance either of these near-expiring types of debt on a long-term basis. SFPP thus concludes that the use of commercial paper to finance KMEP's acquisitions is temporary and that the permanent financing of its acquisitions is through a combination of long-term debt and equity. SFPP therefore seeks to distinguish the December 2005 Order, which had included long-term debt due in less than one year in the debt component of capital structure because "SFPP was borrowing so called short-term funds from KMEP but treating those funds like long-term debt by continuing to

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<sup>292</sup> Commercial paper and long-term debt expiring within one year are collectively referred to as "Current Portion of Long-Term Debt."

<sup>293</sup> Issue II(e) of the Joint Statement of Issues provides "What, if any, are the appropriate adjustments to capital structure for the current portion of long term debt."

carry them as sums due affiliates for several years on SFPP's balance sheet."<sup>294</sup> SFPP states that the facts in this proceeding are different in that KMEP had no outstanding commercial paper at the end of 2008, and the issuance of new long-term debt cannot be categorized simply as a replacement of maturing debt.

182. ExxonMobil/BP argue on exceptions that the 2009 ID correctly held that commercial paper should be included in the determination of capital structure, but failed to address the issue of how long-term debt expiring within one year should be treated for calculating capital structure. ExxonMobil/BP contend that since KMEP routinely rolls-over its Current Portion of Long-Term Debt into new issuances of long-term debt there is no rational basis to treat commercial paper and long-term debt expiring within one year differently. In opposing SFPP's exceptions, ExxonMobil/BP again argue that there is no basis to treat the Current Portion of Long-Term Debt, both commercial paper and long-term debt expiring within one year, differently for cost of debt and capital structure purposes. It argues that KMEP's commercial paper was supported by a five-year credit facility which credit facility assures the holders of the commercial paper that KMEP would be able to rollover that debt. ExxonMobil/BP further argue that KMEP has acknowledged that it uses commercial paper to fund long-term acquisitions and intends to refinance its short-term commercial paper. Further, ExxonMobil/BP state the lower cost of the commercial paper versus SFPP's other long-term debt is not a reason to exclude commercial paper from the calculation of the cost of long-term debt.

183. The Commission finds that commercial paper should be incorporated as debt into KMEP's capital structure for the years in which that debt existed. The Commission generally does not use short term debt to determine capital structure because short term debt typically does not support the pipeline's rate base.<sup>295</sup> However, in this order, the Commission has emphasized the fungible character of the capital for an entity such as KMEP and the infeasibility of tracing particular forms of capital to particular expenditures.<sup>296</sup> More fundamentally, KMEP has maintained significant levels of commercial paper for several years, such that the commercial paper became a continual presence in KMEP's financial portfolio.<sup>297</sup> Thus, given that it was a basic component of KMEP's financing, KMEP's commercial paper must be reflected as debt in capital

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<sup>294</sup> SFPP Brief on Ex. at 36 (citing December 2005 Order, 113 FERC ¶ 61,277 at P 69).

<sup>295</sup> See, e.g., *Cent. Tel. & Utils. Corp.*, 18 FERC ¶ 61,132, at 61,266 (1982) (*Western Power Div.*).

<sup>296</sup> See P 165, *supra*.

<sup>297</sup> The Commission notes that after the end of the adjustment period on



structure. KMEP had no outstanding commercial paper recorded as of September 30, 2008, the date the Commission has adopted for determining capital structure. However, KMEP's previous use of commercial paper must be included in historic capital structure for purposes such as determining the deferred return.

184. As with commercial paper, the Commission finds that KMEP's long-term debt due within one year should be included in capital structure. Although due to mature during the test period, this expiring long-term debt has been used as a permanent aspect of KMEP's ongoing funding of capital structure, not as temporary financing. Moreover, despite the debt's approaching expiration, as SFPP states, "Large, publicly traded companies, including KMEP, consistently issue long-term debt and equity to finance their acquisitions and their infrastructure investments."<sup>298</sup> Thus, given the continuous issuance of new debt and equity, it is not clear that the expiration of particular long-term debt necessarily represents a change in the ratio of long-term debt to equity in KMEP's capital structure. For a company with KMEP's financing practices, the most reasonable estimate of ongoing long-term debt levels includes all long-term debt, even the long-term debt due to expire within one year.<sup>299</sup>

### **C. The Cost of Debt**

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September 30, 2008, KMEP reported that it had no outstanding commercial paper due to a revision to its short-term credit rating and the conditions in the market at the time. KMEP SEC Form 10-Q for Third Quarter of 2008 at p. 34. However, this contrasts to the sustained levels of commercial paper maintained by SFPP in the years preceding the financial crises, including \$591 million in 2001, \$220 million in 2002, \$426 million in 2003, \$417 million in 2004, \$566 million in 2005, \$1098 million in 2006, and \$589 million in 2007. SFPP Brief on Ex. at 31. These amounts are relevant because they affect the capital structure that is used for those years in making the calculations required by the Commission's Opinion No. 154-B methodology. These large amounts of short term debt would materially affect the debt to equity ratio used to determine the weighted cost of capital if they were excluded from the capital structure.

<sup>298</sup> SFPP Brief on Ex. at 37.

<sup>299</sup> The magnitude of KMEP's maturing debt is such that excluding that debt from KMEP's capital structure could materially affect the debt-equity ratio used to compute the weighted cost of capital. This was not the case for companies that have modest or nominal amounts of long term debt maturing in single year.

185. All parties agree that the cost of debt for SFPP's parent, KMEP, should be used.<sup>300</sup> However, as has been discussed, there are exceptions regarding the components to be incorporated into the calculation of KMEP's cost of debt. These include the role of commercial paper in determining debt costs and whether to include certain industrial bonds in KMEP's debt cost structure.

### **1. The Cost of Commercial Paper**

186. The 2009 ID adjusted KMEP's cost of debt to incorporate the lower interest levels of KMEP's outstanding commercial paper.<sup>301</sup> The 2009 ID noted that while the Commission has previously held that only debt with a maturity date of more than one year is typically classified as long-term debt, there have been exceptions when the pipeline utilizes short-term debt as long-term debt.<sup>302</sup> In this proceeding, the 2009 ID found that the testimony of Mr. O'Loughlin supports the conclusion that KMEP treats commercial paper as long-term debt.<sup>303</sup> This position was supported by Tesoro and ExxonMobil while SFPP excepts from that decision. The Commission has determined here that the most appropriate date for determining SFPP's cost of capital is September 30, 2008. As KMEP had no outstanding commercial paper on that date, the cost of such debt is moot in this proceeding.

### **2. Industrial Revenue Bonds**

187. The 2009 ID determined that SFPP properly excluded Economic Development Revenue Refunding Bonds, Industrial Revenue Bonds, and OLP-B specific bonds (special purpose and tax exempt bonds) from the calculation of the cost of SFPP's long-term debt. The 2009 ID also determined, referencing Professor Williamson's testimony, that the special purpose and tax exempt bonds, were not available to finance the West

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<sup>300</sup> When a subsidiary uses its parent company's capital structure, as all parties agree SFPP should do here, the use of the parent company's cost of debt necessarily follows. This issue here is what portion of that debt to use.

<sup>301</sup> 2009 ID, 129 FERC ¶ 63,020 at P 646.

<sup>302</sup> *Id.* (citing December 2005 Order, 113 FERC ¶ 61,277 at P 69 (noting "SFPP was borrowing so called short term funds from KMEP but treated those funds like long term debt by continuing to carry them as sums due affiliates for several years on SFPP's balance sheet.")).

<sup>303</sup> *Id.* P 647.

Line rate base and are therefore, appropriately excluded from the calculation of the cost of long-term debt.<sup>304</sup>

188. On exceptions, the ACC Shippers assert that the 2009 ID erred by excluding the special purpose and tax exempt bonds. The ACC Shippers argue that it is inconsistent for SFPP to treat the special purpose and tax exempt bonds as long-term debt for purposes of determining KMEP's capital structure while excluding this debt from its determination of the cost of debt. According to the ACC Shippers, exclusion of the special purpose and tax exempt bonds will create an artificially high cost of debt, inflating the cost of service. Moreover, the ACC Shippers state that KMEP funds its operations in a consolidated manner and treats the special purpose and tax exempt bonds as long-term debt for purposes of capital structure.

189. The ACC Shippers also assert that SFPP witness Professor Williamson excluded the special purpose and tax exempt bonds on the basis of an arbitrary and inconsistent "dollar tracing test." According to the ACC Shippers, the "dollar tracing test" would exclude the cost of debt if that debt was used to pay for a company other than SFPP, but if the debt was issued by KMEP to pay distributions, then that debt would be included. The ACC Shippers contend that such dollar tracing has been previously rejected by the Commission for ratemaking purposes.<sup>305</sup>

190. Opposing exceptions, SFPP states that its cost of debt should only reflect the actual cost of KMEP's debt financing available to fund its pipeline operations and any debt not used for such purposes should be excluded. First, SFPP asserts the evidence shows that these special purpose and tax exempt bonds were issued to finance other projects and were not otherwise available to finance SFPP's West Line rate base.<sup>306</sup> Second, SFPP asserts that it is appropriate to exclude the special purpose bonds from the determination of debt costs while including them in the debt component of capital structure. SFPP claims that whereas investors look at the balance sheet capital structure to ascertain financial risk, the cost of debt is an after-the-fact calculation made for purposes of Commission proceedings. SFPP further argues that, to determine the cost of debt, the Commission relies on actual debt cost and that investor decisions are not considered. Finally, SFPP argues that there is no record evidence to support the ACC Shippers' position that excluding special purpose and tax exempt bonds will require

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<sup>304</sup> 2009 ID, 129 FERC ¶ 63,020 at P 647.

<sup>305</sup> ACC Shippers Brief on Ex. at 14 (citing *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077, at P 193, 195 (2006)).

<sup>306</sup> SFPP Brief op. Ex. at 41 (citing Ex. SFP-75 at 39).

“dollar tracing.” SFPP argues that Professor Williamson only excluded debt that was clearly unavailable to finance the rate base of KMEP’s jurisdictional activities.

191. The Commission finds that the 2009 ID incorrectly permitted the removal of industrial revenue bonds from KMEP’s cost of debt. Although SFPP avers that certain issuances of debt by KMEP or its subsidiaries were used for particular purposes, such issuances of debt and equity are interchangeable aspects of the overall financing of KMEP. As the Commission explained in Kern River:

[A]fter a company engages in a financing, whether debt or equity, the proceeds from the financing are commingled with other liquid assets, derived from other financings and/or internally generated funds, which are then used to pay the company's operating and non-operating expenses. Thus, there is no way to tell which dollars are used to pay which expenses.<sup>307</sup>

192. The Commission concludes that “dollar tracing” of debt to particular expenses is impossible.<sup>308</sup> The Commission notes that the fungible nature of KMEP’s financing provided support to the Commission’s determination not to adjust KMEP’s capital structure to account for PAAs. Thus, even if the issuance of a particular bond was rendered tax exempt because KMEP (or a subsidiary) was expending money for a particular purpose at a given time,<sup>309</sup> that bond ultimately formed a component of the overall pool of capital available to KMEP to finance its operations and lowered the overall costs of KMEP’s indebtedness. Therefore the so-called special purpose and tax exempt bonds should be reflected in debt costs.

#### **D. The Cost of Equity Capital**

193. This section addresses issues raised on exceptions related to the derivation of a rate of return on equity. On the issue of the appropriate rate of return on equity, the 2009 ID rejected the use of equity component data beyond the test period and, with respect to the proxy group, excluded one company, Enterprise Products Partners, and included one company, Sunoco Logistics Partners, L.P. The 2009 ID also found that the position

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<sup>307</sup> Opinion No. 486, 117 FERC ¶ 61,077 at P 195.

<sup>308</sup> *Id.*

<sup>309</sup> Moreover, SFPP failed to establish that all of the debt that Professor Williamson excluded was tax exempt (*see* Tr. 449), further discrediting SFPP’s unpersuasive contention that legal obligations segregated this debt from KMEP’s overall pool of capital.

advocated by ExxonMobil which resulted in an approximate median rate of return for the proxy group (before adjusting for the inflation component) at or about 12.53 percent, as compared to SFPP's proposed 13.01 percent rate of return, to be appropriate, subject to re-calculation based upon the other related findings in the 2009 ID. The parties raise exceptions regarding the following two determinations in the 2009 ID: (1) with respect to the proxy groups, that Enterprise Products Partners, L.P. (Enterprise) should be excluded and Sunoco Logistics Partners, L.P. (Sunoco Logistics) should have been included as a proxy group member and (2) SFPP may not use post-test period equity component data.

### 1. Composition of the Proxy Group

194. SFPP argues on exceptions that the ID erroneously adopted for the base and test period a non-representative oil pipeline proxy group that excluded Enterprise but included Sunoco Logistics.

#### a. Exclusion of Enterprise

195. The 2009 ID found that "Enterprise should not be included in the proxy group used to determine SFPP's appropriate rate of return on equity because it does not have an investment grade bond rating and because it was involved in a merger."<sup>310</sup> In reaching this decision, the Presiding Judge relied on the Commission's decision in *Kern River*<sup>311</sup> to exclude Enterprise from Kern River's proxy group.

196. SFPP proposes to include Enterprise as a member of the proxy group for 2007 and the six-month period ending September 20, 2008.<sup>312</sup> SFPP argues that the 2009 ID's basis for excluding Enterprise from the proxy group, its non-investment grade bond rating and involvement in a merger, are incorrect. According to SFPP, Enterprise regained its investment-grade bond rating in December 2006<sup>313</sup> and the merger referenced in the 2009 ID was completed in September 2004. Thus, SFPP argues that these issues were removed prior to the base and test period, and therefore, are not legitimate reasons for excluding Enterprise.

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<sup>310</sup> 2009 ID, 129 FERC ¶ 63,020 at P 652 (citing *Kern River Gas Transmission Co.*, 126 FERC ¶ 61,034, at P 79-81 (2009) (Opinion No. 486-B)).

<sup>311</sup> Opinion No. 486-B, 126 FERC ¶ 61,034.

<sup>312</sup> Ex. SFP-75 at 3, 7-10.

<sup>313</sup> SFPP acknowledges that Enterprise's bond rating was non-investment grade during 2004 (the period at issue in the *Kern River* proceeding) but that in 2007 and 2008 (the period at issue in this case) Enterprise had an investment grade rating.

197. ExxonMobil/BP assert that SFPP's justification for including Enterprise is misplaced. According to ExxonMobil/BP, the principle reason for excluding Enterprise is that Enterprise is subject to substantial commodity risk, which significantly differs from SFPP's commodity risk level.<sup>314</sup> ExxonMobil/BP argue that Enterprise's September 2004 merger with Gulf Terra did not reduce Enterprise's commodity risk or change its commercial characteristics.

198. Because the significant role *Kern River* plays in the 2009 ID as well as the parties' reliance on it in their exceptions, the Commission provides the following summary of the relevant part of that order. In *Kern River*, the Commission excluded Enterprise from Kern River's proxy group for two reasons. First, Enterprise's merger with Gulf Terra Energy Partners, L.P. was completed near the end of Kern River's 2004 test year (the 12 month period ending in October 2004), which merger effected Enterprise's financial profile. Second, prior to the merger, and thus for much of the 2004 test year, Enterprise was predominately a gas liquids pipeline with only 10 percent of its revenues were generated by its gas transmission business while 73 percent were from its natural gas liquids pipelines, which led the Commission to conclude that Enterprise had differing commercial characteristics than Kern River.<sup>315</sup>

199. Despite the fact that Enterprise has held an investment grade rating since 2006 and that its merger activity ended in 2004, one of the more significant reasons that the Commission excluded Enterprise from Kern River's proxy group appears to be unchanged. Specifically, its commodity risk. In *Kern River*, the Commission noted that prior to the September 2004 merger, Enterprise was dominated by gas liquids<sup>316</sup> and that the record showed that Enterprise's natural gas liquids transmission business is particularly vulnerable to commodity risk due to the pricing mechanism it utilizes to transport natural gas liquids and related interest risks. This appears to continue to be the case. Enterprises' 2007 10-K indicates that approximately 77 percent of its revenues were from natural gas liquids pipelines.<sup>317</sup> Moreover, Enterprise's Form 10-K for the period ending December 31, 2007 states that Enterprise continues to have a material level of commodity price risk.<sup>318</sup> SFPP fails to disprove this as its only witness on the issue,

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<sup>314</sup> ExxonMobil/BP Brief op. Ex. at 11 (citing Opinion No. 486-B, 126 FERC ¶ 61,034 at P 78).

<sup>315</sup> Opinion No. 486-B, 126 FERC ¶ 61,034 at P 78-81.

<sup>316</sup> *Id.* at P 78 (noting that Enterprise's SEC Form 10-K indicates that during 2004 only 10 percent of its revenues were from the natural gas business, while 73 percent were from its natural gas liquids pipelines).

<sup>317</sup> Ex. SFP-15 at 71.

<sup>318</sup> Ex. XOM-29.

Dr. Williamson, testified that he did not “know” whether Enterprise’s “vulnerability to commodity risk” is the same today as it was during 2004.<sup>319</sup> Proxy group members must be representative and have reasonably comparable risks.<sup>320</sup> Based on Enterprise’s continuing and significant commodity risk, the Commission affirms the 2009 ID’s conclusion that Enterprise should not be included in the proxy group.<sup>321</sup>

### **b. Inclusion of Sunoco Logistics**

200. The 2009 ID found that Sunoco Logistics should be included in the proxy group based on the testimony of ExxonMobil’s witness, Dr. Horst. Specifically, the 2009 ID found compelling Dr. Horst’s testimony that Sunoco Logistics derives 96 percent of its revenues and 64.7 percent of its assets from its Western Pipeline System, which owns and operates 3,200 miles of crude oil trunk pipelines, and approximately 500 miles of crude oil gathering pipelines in Texas and Oklahoma. SFPP argues on exceptions that inclusion of Sunoco Logistics in the proxy group is inconsistent with the Proxy Group Policy Statement as Sunoco Logistics was not covered by Value Line during the time period relevant to SFPP’s rate case. SFPP states that no party has justified including in the proxy group a company that was not covered by Value Line during the relevant time period.<sup>322</sup>

201. While ExxonMobil/BP agree that there is no evidence in this record that Sunoco is included in the Value Line reports, ExxonMobil/BP state that under the Proxy Group Policy Statement coverage by Value Line is a relevant consideration, but not an absolute requirement. ExxonMobil/BP support inclusion of Sunoco Logistics stating that 96 percent of Sunoco’s revenues are derived from crude oil trunk and gathering pipelines and that it has been in operation as an MLP for over five years. ExxonMobil/BP therefore conclude that Sunoco’s inclusion in the proxy group is consistent with the Commission’s inclusion of TC Pipelines in Kern River’s proxy group even though TC Pipelines also was not covered by Value Line.<sup>323</sup>

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<sup>319</sup> See Ex. SFP-75 at 9, 10-12.

<sup>320</sup> *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, at 24 (2008) (Proxy Group Policy Statement) (citing *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695 (D.C. Cir. 2007)).

<sup>321</sup> 2009 ID, 129 FERC ¶ 63,020 at P 652 (citing Opinion No. 486-B, 126 FERC ¶ 61,034 at P 79-81).

<sup>322</sup> SFPP Brief on Ex. at 17 (citing Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 79).

<sup>323</sup> ExxonMobil/BP Brief op. Ex. at 13 (citing Opinion No. 486-B, 126 FERC

202. In the Proxy Group Policy Statement, the Commission declined to determine which particular corporations and/or MLPs should be included in the gas or oil proxy groups, and instead left that determination to each individual rate case.<sup>324</sup> The Commission provided further guidance stating that “when developing its proxy group, a pipeline should select MLPs that are well established and have assets that are predominantly gas and oil pipelines,” because such pipelines are most likely to have risk comparable to the pipeline at issue. The Proxy Group Policy Statement further notes that there may be particular MLPs that do not satisfy these criteria, but are still appropriate for inclusion in the proxy group. In such a case, the pipeline must justify including such MLP in its proxy group.<sup>325</sup> The Commission also agreed in principle with a commenter that with respect to the Commission’s practice of using the five-year growth forecasts reported by IBES to determine the short-term growth rates for each proxy company, IBES forecasts should only be used for an MLP that is tracked by Value Line. However, the Commission made clear that these are guidelines, not necessary conditions, for including a particular MLP in the proxy group.<sup>326</sup>

203. The Commission finds that SFPP has already identified a sufficiently large proxy group for the base and test period that it is not necessary to include Sunoco Logistics. Notwithstanding ExxonMobil/BP’s argument regarding TC Pipelines, the inclusion of a company in another proxy group in an unrelated proceeding is not a compelling reason to move beyond the guidelines in the Proxy Group Policy Statement where no evidence was presented in this record that Sunoco Logistic is followed by Value Line, particularly because an adequately sized proxy group has already been identified. The Commission has previously concluded that a proxy group should consist of at least four, and preferably at least five members, if representative members can be found. In *Kern River*, the Commission noted that while “adding more members to the proxy group results in greater statistical accuracy, this is true only if the additional members are appropriately included in the proxy group as representative firms.”<sup>327</sup> In *Kern River*, TC Pipelines was included to achieve a five member proxy group. However, in this case, adequacy of the size of SFPP’s proxy group is not an issue as SFPP’s proxy group is comprised of seven

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¶ 61,034 at P 66).

<sup>324</sup> Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 51.

<sup>325</sup> *Id.* P 79.

<sup>326</sup> *Id.*

<sup>327</sup> Opinion No. 486-B, 126 FERC ¶ 61,034 at P 104 (finding that a five firm proxy group, including three MLPs, is sufficient to avoid concerns about too small a proxy group resulting in a distorted sample).



members after excluding both Enterprise and Sunoco.<sup>328</sup> Given that an adequately sized proxy group has been identified, the Commission does not find that it is necessary to include an entity such as Sunoco Logistics, for which there is no evidence in the record that it meets the preferred guidance criteria set forth in the Proxy Group Policy Statement, namely that the entity be covered by Value Line.

## **2. Use of Post-Test Period Data for DCF Analysis**

204. The 2009 ID rejected SFPP's proposed use of post-test period equity component data. The 2009 ID determined that the April 2009 post-test period data is anomalous in that it reflects a period in American economic history that has not existed since the Great Depression and is unlikely to exist for the foreseeable future. The 2009 ID thus concluded it would be serious error to design SFPP's prospective rates, and specifically to calculate the discounted cash flow (DCF), using such anomalous data.

205. SFPP argues on exceptions that the 2009 ID erroneously adopted the September 2008 return on equity data, which SFPP states is obsolete. SFPP urges the Commission to instead adopt more recent return on equity data in the record: either the April 30, 2009 data, or alternatively the January 31, 2009 data. SFPP states that the use of the most recent return on equity data in the record is required by *Hope*,<sup>329</sup> the market-based cost of capital model, and long-standing Commission policy. SFPP further states that the 2009 ID's conclusion that "the Commission uses post-test period data only when that data demonstrates that the test period data will be seriously in error" is incorrect. According to SFPP, the Commission instead prefers to use the most recent six months of data in the record to derive the current dividend yield because updated data more accurately reflects current investor needs.<sup>330</sup> SFPP argues in the alternative that, if the Commission rejects the updated January or April 2009 DCFs, then the Commission must also reject the September 2008 DCF and instead designate a real rate of return that reflects the Commission's best judgment regarding the future based on data from past DCF periods.

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<sup>328</sup> In this case, after excluding Enterprise and not including Sunoco Logistics, SFPP's proxy group is comprised of five companies in 2004 and 2005, six entities in 2006, and seven entities in 2007 and 2008.

<sup>329</sup> *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (*Hope*).

<sup>330</sup> SFPP Brief on Ex. at 12-13 (citing *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,117 (2000); *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036, at P 17-18, 20 (2003); and *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶ 61,084, at 61,427 (1998)).

206. ExxonMobil/BP, the ACC Shippers, and Tesoro disagree with SFPP and urge the Commission to uphold the ID's determination that it is inappropriate to use post-test period data to calculate SFPP's return on equity (ROE). These Shippers state that the Commission's regulations and precedent require that the carrier's rate filing be based on 12 months of costs reflecting actual experience (the base period) which can be adjusted for certain changes that are known and measureable within the following nine months (together, the test period). Further, data beyond the end of the test period can only be used if the test period data would reflect a substantial error or would produce unreasonable results. Moreover, Shippers argue that the Commission has found that modification of test period data should only reflect "a change that is a significant, lasting change, not a cyclical change."<sup>331</sup>

207. The ACC Shippers argue that looking beyond the test period in this case would be contrary to Commission precedent, noting that the Commission will only look to post-test period data when it is more reliable and representative than test period data for setting prospective rates. Shippers note that the January and April 2009 data is anomalous as it reflects a negative or flat inflation rate, is indicative of a temporary low point in the American economy, and would allow SFPP to achieve windfall profits as the economy recovers. Last, the ACC Shippers argue that the Commission should reject SFPP's argument that if the Commission rejects using the updated 2009 data, then it should also reject using the test period data and instead develop a composite ROE based on historical data. The ACC Shippers state that this argument must be rejected as it was first raised on exceptions and SFPP failed to develop a supporting record in this case.

208. The Commission upholds the 2009 ID's determination on this issue and rejects SFPP's proposed use of post-test period data for purposes of the DCF analysis, but on somewhat different grounds. As the Commission has stated previously, the Commission uses the most recent data, even if such data is from outside the test period, "because the market is always changing and later figures more accurately reflect current investor needs."<sup>332</sup> Unlike cost of service and capital structure data, the Commission prefers the most recent financial data in the record for calculating a pipeline's ROE,<sup>333</sup> recognizing

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<sup>331</sup> ACC Brief on Ex. at 5 (citing *Texaco Ref. & Mktg., Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285, at P 69 (2006)).

<sup>332</sup> *Trunkline Gas Co.*, 90 FERC ¶ 61,017 at 61,117 (2000) (citing *Panhandle Eastern Pipe Line Co.*, 74 FERC ¶ 61,109 at 61,363-63 (1996); and *Boston Edison Co. v. FERC*, 885 F.2d 962, 966 (1<sup>st</sup> Cir. 1989)). *Williston Basin Interstate Pipeline Co.*, 72 FERC ¶ 61,074 at 61,373 and 61,375 (1995).

<sup>333</sup> See *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036 at P 20 (2003) (*Williston II*) (permitting updated cost of equity figures over Trial Staff's objections);

(continued...)

that updates are not permitted once the record has been closed and the hearing has concluded.<sup>334</sup> However, any updating of the record is subject to the more fundamental principle of ratemaking that that cost of service adopted in rate proceeding be a reasonable forecast of the pipeline's future cost of service; this is that the costs are representative of the costs that the pipeline is likely to incur over period that the rates at issue are in effect.

209. Financial information SFPP has included in this docket and other ongoing SFPP proceedings before the Commission establishes that the updated cost of equity data SFPP included in this proceeding is not representative of its long term equity cost of capital. That cost applies to the entire firm regardless of what facilities and rates are at issue. SFPP's October 16, 2008 rate filing in the instant docket contained an equity cost of capital of 7.20 percent for 2007,<sup>335</sup> as updated to 7.64 percent for September 2008,<sup>336</sup> the figure adopted by the 2009 ID, SFPP updated those ROEs in January 2009 and April 2009. The ROE for January 2009 was 14.30 percent<sup>337</sup> and the figure for April 2009 was 14.83 percent.<sup>338</sup> The 6.66 point increase in the cost of capital for the four months October through January and of 7.79 percent for the seven months October through April reflects the collapse of the stock market in late 2008 and early 2009 and the use of a negative inflation rate in calculating SFPP's ROE. SFPP's proposed West Line rates in this proceeding will be in effect indefinitely into the future. Neither the collapse of the stock prices (which increased the dividend yield used in the DCF calculation) nor the minimal or negative inflation rate (which establishes the real rather than the nominal cost of capital) would have so continued. SFPP's proposed ROE based on data for the six months ended February 2010 was 9.09 percent and for the six months ended March 2010

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*Williston Basin Interstate Pipeline Co.*, 84 FERC ¶ 61,081 I at 61,382 (1998) (“It is true that the Commission prefers to use dividend yield data from the most recent six-month period available”).

<sup>334</sup> See *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260 at PP 379-86 (2002), *reh'g denied*, 102 FERC ¶ 61,310 (2003), denying the pipeline's motion to reopen the record after the hearing had concluded to consider the effects of Enron's bankruptcy on pipeline capital costs. See also *Office of Consumers' Counsel v. FERC*, 783 F.2d 206, 232 (D.C. Cir. 1986) (“In relying on ex parte submissions appearing in a post-hearing brief, the Commission violated fundamental canons of due process.”).

<sup>335</sup> Ex. SFP-5 at 8.

<sup>336</sup> *Id.* 9

<sup>337</sup> Ex. SFP-76.

<sup>338</sup> Ex. SFP-323 at 1.

was 8.72 percent.<sup>339</sup> Therefore, the ROEs resulting from a DCF analysis based on data for the six months ending January 2009 or April 2009 are not representative of SFPP's cost of capital during the future periods the rates proposed in this case may be in effect. Accordingly, it would be unreasonable to design a long term rate for the West Lines using an ROE based on financial data from those six month periods. For the foregoing reasons, the Commission affirms the 2009 ID's use of record data for the six months ended September 30, 2008 in the instant docket.

### **E. Rate Base Issues**

210. This section addresses issues raised on exceptions related to the rate base determinations. With respect to the rate base, the 2009 ID held that the appropriate test year rate base depends upon the calculation of deferred return, the calculation of KMEP's capital structure, and whether SFPP's depreciation expense rate needs to be adjusted.<sup>340</sup> The 2009 ID found that while arguments raised by ExxonMobil/BP regarding potential error in SFPP's 1984 calculation of deferred return have merit, the Commission has previously accepted SFPP's deferred return calculation. Thus the 2009 ID determined that SFPP appropriately calculated the rate base and inflation-adjusted deferred return in its filing. However, the 2009 ID rejected SFPP's proposed changes to the inflation-adjusted deferred return using post-test period data.

#### **1. Determination of Deferred Return**

211. The 2009 ID notes that, according to ExxonMobil's testimony, it appears that SFPP's calculation of deferred return deviates from the standard deferred return calculation methodology.<sup>341</sup> The 2009 ID states the deferred return is calculated each year by multiplying the inflation factor from the applicable year by the equity portion of the pipeline's rate base from that same year. The pipeline is permitted to add a starting rate base (SRB) write-up to its rate base. According to ExxonMobil, SFPP did not apply the equity ratio to the starting rate base write-up before adding it to the equity portion of SFPP's trending rate base. Notwithstanding this deviation, the 2009 ID concludes:

[T]he Commission seems to have approved SFPP's deferred return methodology when it accepted SFPP's compliance filings in the proceeding underlying Opinion No. 435. The

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<sup>339</sup> See Docket No. IS09-437-000, Ex. SPE-108 at 2, 3 respectively. The materials cited in this and the preceding footnote are incorporated into the instant record.

<sup>340</sup> 2009 ID, 129 FERC ¶ 63,020 at P 613.

<sup>341</sup> *Id.* P 619-621.

Commission is free to permit deviations from its own established methodology as long as the resulting rate is just and reasonable, and that appears to be the case here, as determined previously by the Commission. Therefore, since the Commission previously approved the deferred return methodology employed by SFPP in this case, and since Staff takes no position adverse to SFPP on this issue, and because the Shippers have not produced a study demonstrating the rate-impact of SFPP's deferred return methodology, the undersigned finds that SFPP's deferred return methodology was appropriately calculated in this proceeding. If the Commission believes it inadvertently allowed the aforementioned deviations to take place, it may adopt Exxon's position and should require SFPP to recalculate in accordance with its directives.<sup>342</sup>

212. On exceptions, ExxonMobil/BP, joined by Valero, argue that the 2009 ID erred by permitting SFPP to depart from Commission precedent by improperly calculating the deferred return on its SRB write-up. ExxonMobil/BP urge that the Opinion No. 154-B methodology, which provides that deferred return should be computed on the basis of only the equity portion of the net SRB write-up, is the only lawful way to calculate deferred return and should be followed in this case. ExxonMobil/BP note that in the prior SFPP case cited by the 2009 ID, nothing in the order reflects an intent by the Commission to approve a departure from the previously established method for computing deferred return under Opinion No. 154-B; rather, SFPP's calculation error in that proceeding simply went undetected.

213. SFPP states that it correctly calculated its deferred return under the Opinion No. 154-B. SFPP claims that ExxonMobil/BP have misread SFPP's statements showing the deferred return calculation. Specifically, SFPP states that it only included the equity portion of the SRB write-up in rate base and its deferred return calculation. SFPP stated that it derived the equity portion of SRB write-up by multiplying the full SRB write-up amount (\$31,004,000 from line 13) by the equity ratio (39.26% from line 14) which results in an equity portion of SRB write-up in the amount of \$12,173,000. Moreover, SFPP notes that its SRB write-up has been fully amortized and is no longer a factor in SFPP's rate base.<sup>343</sup>

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<sup>342</sup> *Id.* P 621.

<sup>343</sup> *See* Ex. SFP-57 at 16 (Statement E4) (showing that the starting rate base write-up was fully amortized as of 2004).

214. A review of SFPP's supporting work papers, specifically, Ex. SFP-57, at 15-16 (Statement E4 – West Line Starting Rate Base and Amortization Calculation) confirms that SFPP correctly calculated deferred return consistent with the Opinion No. 154-B methodology.<sup>344</sup> There is no evidence to support ExxonMobil/BP's assertion that SFPP has perpetuated a prior error in performing its calculation. Specifically, the Commission finds that SFPP calculated its deferred return using only the equity portion of its SRB write-up rather than the entire SRB write-up. ExxonMobil/BP's sole witness on this issue, Dr. Horst, states that "I have no objections to the calculations shown in SFPP's Statement E-4."<sup>345</sup> Dr. Horst's concern is that 100 percent of the net SRB write-up is included on Line 9 of SFPP's Statement E2. Dr. Horst argues that "for consistency, SFPP should have included at Line 9 of Statement E-2 not 100 percent of the Net Starting Rate Base Write-Up, but rather the product of the equity ratio shown on Line 3 of Statement E-2 multiplied by the net SRB write-up."<sup>346</sup> The Commission finds that the amount SFPP included on Line 9 of Statement E-2, \$12,173,000 is the product of the equity ratio shown on Line 3 of Statement E-2 (39.26 percent) multiplied by the net SRB write-up (\$31,004,000) as shown on Lines 13-15 of SFPP's Statement E4.<sup>347</sup> ExxonMobil/BP's additional arguments on exceptions regarding this issue, specifically the arguments that SFPP failed to properly calculate the SRB,<sup>348</sup> appear at a minimum to conflict with its expert witnesses' testimony, and at best are conjecture on ExxonMobil/BP's part.

## **2. Calculation of the Inflation Adjustments**

215. SFPP sought to substitute inflation rates for the first four months of 2009 in place of the actual inflation rate during the test year ending September 30, 2008, for purposes of computing its deferred return. Specifically, SFPP sought to update the inflation factor

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<sup>344</sup> ExxonMobil/BP's confusion may lie with the description used in the statements showing the calculation of deferred return refers to "net starting rate base write-up." ExxonMobil/BP state that "The SRB Write-Up, net of amortization, is referred to as the Net SRB Write-Up" and further state that "only the equity portion of the Net SRB Write-Up that is added to the equity portion of the rate base." Exxon/BP Brief on Ex. at 41-42. A review of SFPP's Statement E4 – Starting Rate Base and Amortization Calculation, shows that "Net Starting Rate Base Write-Up" as used in Statement E4 refer to the equity portion of the SRB Write-Up minus the amortized amount of the SRB Write-Up.

<sup>345</sup> Ex. XOM-1 at 27:13.

<sup>346</sup> Ex. XOM-1 at 30:13-16.

<sup>347</sup> *Id.*

<sup>348</sup> ExxonMobil/BP Brief on Ex. at 44.

it uses to calculate its deferred return with the inflation rate it provides in Exhibit No. SFP-323, the April 2009 DCF. The 2009 ID rejected SFPP's proposed changes to the inflation-adjusted deferred return beyond the test period ending September 30, 2008.<sup>349</sup> The Presiding Judge found that SFPP is not permitted to rely on the April 2009 DCF. Rather, SFPP must use the inflation factor from the end of the test period, as it is neither necessary nor useful to look beyond the test period and apply an anomalous inflation factor to SFPP's prospective rates.<sup>350</sup> Simply put, the 2009 ID rejected the use of post-test period data for the same reasons discussed in the Equity Cost of Capital section above.

216. SFPP argues that the 2009 ID erred by refusing to calculate the deferred return using the updated, post-test period inflation factor offered by Dr. Williamson. The ACC Shippers support the Presiding Judge's conclusion that SFPP's rate base and inflation-adjusted net deferred earnings should use the test period inflation factor. ExxonMobil/BP note that SFPP's argument in support of using a post-test period inflation factor relies on the Commission's acceptance of SFPP's argument regarding the use of a post-test period equity component data to calculate SFPP's return on equity. ExxonMobil/BP urge the Commission to reject the use of post-test period inflation data for two reasons. First, Commission precedent rejects the use of post-test period data unless SFPP demonstrates that the test period data will be in serious error<sup>351</sup> and ExxonMobil/BP note that SFPP has not proffered any evidence that the September 2008 data are seriously in error. Second, ExxonMobil/BP state there is no precedent for permitting a pipeline to employ a negative inflation rate to compute its deferred return, which would be the case if SFPP used the April 2009 inflation rate. ExxonMobil/BP correctly note that the effect of calculating a pipeline's deferred return using a negative rate of inflation would be to increase its ROW. Thus ExxonMobil/BP assert that if there is zero or negative inflation in a given year then there should be no deferred return for that year, otherwise the result would yield to the pipeline an ROE in excess of that required to attract capital in the market.<sup>352</sup>

217. For the reasons discussed the Commission upholds the 2009 ID's ruling that SFPP may not use post-test period inflation rate for the same reasons the Commission rejected SFPP's request to use post-test period equity component data.

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<sup>349</sup> 2009 ID, 129 FERC ¶ 63,020 at P 614.

<sup>350</sup> *Id.* P 622.

<sup>351</sup> Exxon/BP Brief op. Ex. at 28 (citing 2009 ID, 129 FERC ¶ 63,020 at P 650; *Williston Basin Interstate Pipeline Co.*, 87 FERC ¶ 61,265, at 62,022 (1999)).

<sup>352</sup> Exxon/BP Brief op. Ex. at 29.

## **VI. Income Tax Allowance Issues**

218. This part addresses income tax allowance issues raised on exceptions in the instant docket. The 2009 ID held: (1) that SFPP was legally entitled to an income tax allowance;<sup>353</sup> (2) that SFPP properly calculated the income tax allowance following the guidance in prior Commission orders;<sup>354</sup> (3) that SFPP properly calculated the taxable income of SFPP and its partners;<sup>355</sup> (4) that SFPP used the correct marginal tax rate for those partners;<sup>356</sup> (5) that there should be no adjustments to reflect the benefits of tax deferrals occasioned by a master limited partnership (MLP);<sup>357</sup> (6) that there was no income tax allowance for future capital gains included in SFPP's cost of service;<sup>358</sup> (7) that there were no unintended consequences from the application of the Commission's Income Tax Policy Statement to SFPP;<sup>359</sup> and (8) that no adjustment should be made to SFPP's rate of return on equity to reflect any benefits that may flow to SFPP's limited partners from SFPP's income tax allowance.<sup>360</sup>

219. All of the 2009 ID's conclusions regarding SFPP's income tax allowance are opposed by the ACC Shippers and by ExxonMobil/BP. SFPP supports the 2009 ID's conclusions in all regards. The ACC Shippers and ExxonMobil/BP assert on exceptions in this case the same arguments they have raised in numerous prior SFPP rate proceedings, but are presented here in their most complete form to date. Accordingly, this review relies on certain aspects of the Commission's prior SFPP orders where appropriate, but will address any refinements or modifications to the ACC Shippers' and ExxonMobil/BP's arguments advanced in this proceeding. The exceptions fall into five broad categories: (1) the legality of an income tax allowance, (2) whether SFPP complied with the Commission's protocols for implementing an income tax allowance, (3) certain proposed adjustments to the rate of return on equity to prevent an alleged double recovery of the income tax allowance, (4) whether the allowance was properly

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<sup>353</sup> 2009 ID, 129 FERC ¶ 63,020 at P 670.

<sup>354</sup> *Id.* P 671-682 (citing *SFPP, L.P.*, 121 FERC ¶ 61,240, at P 20-61 (2007); *SFPP, L.P.*, 117 FERC ¶ 61,285, at P 49-66 (2006), and *SFPP, L.P.*, 113 FERC ¶ 61,277, at P 10-46 (2005)).

<sup>355</sup> *Id.* P 684.

<sup>356</sup> *Id.* P 685.

<sup>357</sup> *Id.* P 688.

<sup>358</sup> *Id.* P 689.

<sup>359</sup> *Id.* P 692.

<sup>360</sup> *Id.* P 669.



calculated, and (5) related accumulated deferred income tax (ADIT) issues. The parties' arguments are addressed in turn below.

### **A. Legality of an Income Tax Allowance**

220. Both the ACC Shippers and ExxonMobil/BP assert that SFPP is not entitled to an income tax allowance as a matter of law.<sup>361</sup> All arguments regarding the fundamental legality of the income tax allowance for master limited partnerships (MLP) are addressed here. To summarize, with regard to the legality of applying an income tax allowance to SFPP, a limited partnership, the ACC Shippers and ExxonMobil/BP assert that the 2009 ID erred by: (1) failing to recognize that *BP West Coast*,<sup>362</sup> as clarified by *ExxonMobil*,<sup>363</sup> is controlling authority; (2) failing to consider whether the Commission had violated its statutory authority and the intent of Congress; and (3) failing to examine whether the income tax policy could be appropriately applied to SFPP. The following background section provides context for the Commission's review of the legality of an income tax allowance under the Income Tax Policy Statement.<sup>364</sup>

#### **1. Legal Background**

221. The Commission's current income tax allowance policy for partnerships in general, and MLPs specifically, was occasioned by the court's rejection in *BP West Coast* of the so-called *Lakehead* policy.<sup>365</sup> The *Lakehead* policy provided that a limited partnership would be permitted to include an income tax allowance in its rates equal to the proportion of its limited partnership interests owned by corporate partners, but could not include a tax allowance for its partnership interests that were not owned by corporations. On review of four Commission orders addressing various rate issues

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<sup>361</sup> ExxonMobil/BP present this argument as an alternative argument if the Commission declines to adjust SFPP's rate of return to correct an alleged double recovery of the income tax allowance in SFPP's equity return.

<sup>362</sup> *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) (*BP West Coast*).

<sup>363</sup> *ExxonMobil Oil Corporation v. FERC*, 487 F.3d 945 (D.C. Cir. 2007) (*ExxonMobil*).

<sup>364</sup> *Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (Income Tax Policy Statement).

<sup>365</sup> *BP West Coast*, 374 F.3d 1263, 1285-1293 (analyzing and reversing the Commission's income tax allowance conclusions in *Lakehead Pipeline Company, L.P.*, 71 FERC ¶ 61,338 (1995), *reh'g denied*, 75 FERC ¶ 61,181 (1998) (*Lakehead*)).

pertaining to SFPP,<sup>366</sup> the U.S. Court of Appeals for the D.C. Circuit reviewed the Commission's application of the *Lakehead* policy to SFPP in *BP West Coast*.

222. The court held that the Commission had not justified two central aspects of the *Lakehead* policy. First, the Commission failed to explain adequately why a partnership should be afforded an income tax allowance on the partnership interests owned by corporations but not on those owned by individuals.<sup>367</sup> Second, the Commission could not grant a regulated entity organized as a partnership an allowance for income taxes when the Commission itself had concluded that partnerships incur no income tax costs.<sup>368</sup> Holding that the Commission could not grant an income tax allowance for a phantom tax cost,<sup>369</sup> the court reversed the Commission's decision to rely on *Lakehead* in awarding SFPP a partial tax allowance and remanded the proceeding to the Commission.<sup>370</sup>

223. In light of the potentially broad implications of the court's determination in *BP West Coast* regarding income tax allowances, the Commission opened a generic proceeding seeking industry comment on income tax allowances. After the receipt of numerous comments, the Commission issued the Income Tax Policy Statement.<sup>371</sup> In formulating the Income Tax Policy Statement, the Commission determined that the *Lakehead* policy "mistakenly focused on who pays the taxes rather than on the more fundamental cost allocation principle of what costs, including tax costs, are attributed to regulated service, and therefore properly included in a regulated cost of service."<sup>372</sup> The Commission found the realities of partnership law is such that:

[J]ust as a corporation has an actual or potential income tax liability on income from the first tier public utility assets it controls, so do the

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<sup>366</sup> *SFPP, L.P.*, 86 FERC ¶ 61,022 (1999) (Opinion No. 435), *SFPP, L.P.*, 91 FERC ¶ 61,135 (2000) (Opinion No. 435-A), *SFPP, L.P.*, 96 FERC ¶ 61,281 (2001) (Opinion No. 435-B), *order on clarification and rehearing*, 97 FERC ¶ 61,138 (2001) (collectively the Opinion No. 435 Orders).

<sup>367</sup> *BP West Coast*, 374 F.3d at 1289-90.

<sup>368</sup> *Id.* at 1291-92.

<sup>369</sup> *Id.* at 1288, 1291.

<sup>370</sup> *Id.* at 1312.

<sup>371</sup> Income Tax Policy Statement, 111 FERC ¶ 61,139.

<sup>372</sup> *Id.* P 33.

owners of a partnership or LLC on the first tier assets and income that they control by means of the pass-through entity.<sup>373</sup>

Thus, the Commission found that while a partnership entity does not pay taxes on its income from its public utility operations, that income is distributed to its partners who are liable for income taxes on that income, just as a corporate entity must pay taxes on its public utility income.<sup>374</sup> The Commission further concluded that the responsibility of a regulated utility's partners for payment of taxes on partnership income is the payment of taxes on first tier income, just as a corporation's income tax obligations represent taxes on first tier income.<sup>375</sup> The Commission ultimately adopted an income tax policy permitting "an income tax allowance for all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets."<sup>376</sup>

224. Regarding the SFPP orders remanded by *BP West Coast*, on remand the Commission applied the newly formulated Income Tax Policy Statement and held that SFPP was entitled to an income tax allowance to the extent the owners of its partnership interests had actual or potential income tax liability during the periods at issue.<sup>377</sup> The June 2005 Remand Order was appealed to the U.S. Court of Appeals for the D.C. Circuit by the shipper parties – a group that comprises most of the protesting shipper parties in this proceeding.

225. On appeal, the court noted that in reviewing the June 2005 Remand Order, it necessarily must also review the Income Tax Policy Statement because the June 2005 Remand Order explicitly relied on the Policy Statement.<sup>378</sup> Addressing the shipper parties' arguments that *BP West Coast* precludes a partnership, including MLPs, from

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<sup>373</sup> *Id.* P 34.

<sup>374</sup> *Id.* P 33.

<sup>375</sup> *Id.* P 22, 33-36, 38.

<sup>376</sup> *Id.* P 32.

<sup>377</sup> June 2005 Remand Order, 111 FERC ¶ 61,334 at P 27 (or in *ExxonMobil*, the Remand Order). The other order that the court in *ExxonMobil* reviewed dealt with other issues. See *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) (modifying an initial decision on substantially changed circumstances under section 1803(a) of the Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776 (1992) (EPAct of 1992)).

<sup>378</sup> *ExxonMobil*, 487 F.3d at 951.

obtaining an income tax allowance, the court stated that “[a]t the outset, we note that *BP West Coast* did not categorically prohibit the Commission from granting income tax allowances to pipelines that operate as limited partnerships.”<sup>379</sup> In upholding the Commission’s Policy Statement and the June 2005 Order that implemented that policy, the court noted that income tax liability for partnership income occurs at the partner level, and that it is the partner that is responsible for any tax liability that may accrue on distributive income derived from the partnership.<sup>380</sup> The court stated:

In the Policy Statement and the Remand Order, the Commission resolved the principal defect of the *Lakehead* policy, which was the unexplained differential treatment of individual and corporate partners. FERC then determined that it would be “just and reasonable” to grant regulated pipelines an income tax allowance to the extent that all of the pipeline’s partners – whether individual or corporate – incur actual or potential tax liability. The Commission reasonably determined that such taxes are ‘attributable’ to the regulated entity, given that partners must pay tax on their share of the partnership income regardless of whether they actually receive a cash distribution. Additionally, the Commission reasonably relied upon evidence that a full income tax allowance is necessary to ensure that corporations and partnerships of like risk will earn comparable after-tax returns.<sup>381</sup>

226. In reaching its conclusion, the court reviewed a comparison of the pre- and after-tax returns of a corporation and the partners of a limited partnership absent an income tax allowance, stating:

In the Policy Statement, FERC concluded that it would be inequitable to grant a full income tax allowance to corporations while denying a similar allowance to limited partnerships. For example, if the corporate tax rate is 35%, then a pipeline that operates as a corporation is permitted to charge a rate of \$154 in order to earn after-tax income of \$100. As several commenters pointed out, ‘if an income tax allowance is not allowed the

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<sup>379</sup> *Id.* at 953.

<sup>380</sup> *Id.* at 951-52, 954 (finding that under the principles of partnership law “investors in a limited partnership are required to pay tax on their distributive shares of the partnership income, even if they do not receive a cash distribution”).

<sup>381</sup> *Id.* at 955.

partnership, then the partners must pay a \$35 income tax on \$100 of utility income, leaving them with only an after-tax return of \$65.<sup>382</sup>

The court continued:

Based on these comments, the Commission has determined that pipelines operating as limited partnerships should receive a full income tax allowance in order to maintain parity with pipelines that operate as corporations. This conclusion was not unreasonable and we defer to FERC's expert judgment about the best way to equalize after-tax returns for partnerships and corporations.<sup>383</sup>

227. In response to the argument that limited partnerships do not pay entity-level income taxes, the court stated that this argument was not without force, but held that it could not prevail.

[A]s FERC explained in the Policy Statement and the Remand Order, the income taxes for which SFPP will receive an income tax are real, albeit indirect. SFPP will be eligible for a tax allowance only to the extent it can demonstrate – in a rate proceeding – that its partners incur ‘actual or potential’ income tax liability on their respective shares of the partnership income.<sup>384</sup>

Having thus again concluded that partnerships have the equivalent of an entity level tax, albeit indirect, on public utility income, the court continued:

And there is at least one aspect of partnership law that supports FERC's conclusion but was not advanced by the Commission in *BP West Coast* – investors in a limited partnership are required to pay tax on their distributive shares of the partnership income, even if they do not receive a cash distribution. As explained above, this supports FERC's determination that taxes on the income received from a limited partnership should be allocated to the pipeline and included in the regulated entity's cost-of-service. In this sense, petitioners' likening of partnership tax to shareholder dividend tax is

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<sup>382</sup> *Id.* at 953 (interior citations omitted). *See also* Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 10-15.

<sup>383</sup> *ExxonMobil*, 487 F.3d at 953.

<sup>384</sup> *Id.* at 954.

inapposite because a shareholder of a corporation is generally taxed on the amount of the cash dividend actually received.<sup>385</sup>

The court thereby rejected the argument that an allowance for income taxes should not be included in an MLP's cost-of-service and held that the income taxes to be paid by the partners were properly attributed to the MLP as an entity-level regulatory cost.<sup>386</sup> The court thus upheld the Income Tax Policy Statement's two fundamental conclusions regarding income tax allowances for partnerships. First, that the income taxes paid on partnership income are real costs of acquiring and operating the pipeline assets, and therefore the income tax allowance does not recover a phantom cost.<sup>387</sup> Second, that the income tax allowance is appropriate and lawful if the partners incur an actual or potential income tax liability on the distributive income they receive.<sup>388</sup>

228. Finally, it is important to emphasize that the Income Tax Policy Statement, as upheld by the court in *ExxonMobil*, compares the after-tax returns of the regulated entity that incurs the taxable net income, and thus is attributed, either directly or indirectly, liability for taxes on the income from its jurisdictional operations. As such, the relevant comparison when examining the policy rationale for an income tax allowance is between a jurisdictional partnership together with its partners, which are jointly treated as the public utility entity, and a jurisdictional corporation. As the numerical example cited in *ExxonMobil* indicates, the appropriate analysis is for first tier income that occurs at the level of the operating entity. For that reason, the tax rate used is that of the corporation, not the tax rate on dividends, which may be lower. The correct comparison of after-tax income and cash returns is not between the after-tax return of a partnership's partners and a corporation's shareholders because corporate shareholders have second tier dividend income on which they pay taxes as a function of the double taxation of corporate income. As the above-quoted text establishes, *ExxonMobil* recognized this fact.<sup>389</sup>

229. The ACC Shippers and ExxonMobil/BP' exceptions advanced here on the legality of the income tax allowance occur in this legal framework. In addressing the arguments raised on exceptions, the Commission will address here those that go to the central holdings of *ExxonMobil* and the Income Tax Policy Statement, specifically: (1) whether *BP West Coast* remains controlling legal authority, (2) whether the application of the

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<sup>385</sup> *Id.* (citations omitted).

<sup>386</sup> *Id.* at 954.

<sup>387</sup> *Id.* at 952, 954.

<sup>388</sup> *Id.* at 951-52, 955.

<sup>389</sup> *Id.* at 954. *See also* Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 27.

Income Tax Policy Statement results in a double recovery of a partner's actual or potential income tax liability, and (3) whether the 2009 ID should have re-examined whether to apply certain elements of the Commission's implementing methodology. This order also discusses the implementing protocols adopted in the Commission's December 2005, 2006 Sepulveda, and December 2007 Orders in section B below. This includes the issue of whether SFPP has complied with the relevant regulatory standards and the various proposals to adjust the rate of return if SFPP is afforded an income tax allowance.

## **2. Whether BP West Coast Remains Controlling Authority**

230. The ACC Shippers and ExxonMobil/BP assert that the 2009 ID erred in failing to recognize *BP West Coast* as the controlling authority on income tax allowances. They further assert that *ExxonMobil* only clarified the basic holding of *BP West Coast*, but did not overrule it. The Commission concludes that *BP West Coast* is not the controlling authority on the issue of whether SFPP is entitled by law to an income tax allowance. Rather, *ExxonMobil*, which upheld the Income Tax Policy Statement, is the prevailing authority on this issue. Addressing the same argument shippers present here, whether *BP West Coast* is the law of the case, the court in *ExxonMobil* distinguished its ruling in *BP West Coast* stating:

At the outset, we note that *BP West Coast* did not categorically prohibit the Commission from granting income tax allowances to pipelines that operate as limited partnerships.

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Shipper petitioners also emphasize that in *BP West Coast* we rejected SFPP's argument that the Commission should have adopted a full income tax allowance for limited partnerships. Petitioners argue that this holding is now the 'law of the case,' because the instant case involves the same issue that was litigated – and resolved in the shippers' favor – in the earlier proceeding. Again, we disagree. In *BP West Coast*, SFPP cross-petitioned for review of the Lakehead policy. ... SFPP argued that FERC should have granted a *full* ITA to pipelines operating as limited partnerships. We rejected SFPP's argument in *BP West Coast*, but petitioners now read too much into our holding with respect to this issue. All we held in *BP West Coast* is that the Commission was not *required* to grant a full income tax allowance to pipelines that operate as limited partnerships. Petitioners' argument

assumes that ‘not required’ is synonymous with ‘prohibited.’ To the contrary, when an agency has broad discretion to choose among different policy options, the fact that any one option is not required certainly does not mean that it is prohibited.<sup>390</sup>

In short, the court in *ExxonMobil* addressed and rejected the precise argument that the shippers again advance in this case.

231. The ACC Shippers further assert that the analysis presented by Judge Peter Young in a 2006 Initial Decision in an SFPP rate complaint proceeding is the correct analysis regarding income tax allowances for MLPs and should have been followed in the 2009 ID. In 2006, Judge Young concluded that the Income Tax Policy Statement failed the standards of *BP West Coast* because SFPP, the utility, would never pay any income taxes.<sup>391</sup> The ACC Shippers assert that the 2009 ID erred by not addressing these arguments or attempting to distinguish Judge Young’s 2006 Initial Decision. The Commission notes that Judge Young’s Initial Decision is of no precedential value for the purposes of this case.<sup>392</sup> Moreover, the basis of Judge Young’s conclusion was subsequently addressed and rejected in *ExxonMobil*. The court in *ExxonMobil* distinguished its ruling in *BP West Coast* and upheld the Commission’s determinations that (1) the income tax liability of the partners for the partnership income is properly attributed to a regulated partnership,<sup>393</sup> and (2) attributing that tax liability to the partnership does not result in phantom taxes if the partners have an actual or potential income tax liability.<sup>394</sup> Given this, the 2009 ID was correct to summarily reject the ACC Shipper’s argument.<sup>395</sup>

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<sup>390</sup> *ExxonMobil*, 487 F.3d at 953, 955.

<sup>391</sup> 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 23-24.

<sup>392</sup> See, e.g., *Illinois Power Co.*, 62 FERC ¶ 61,147, at n.17 (1993); and *Southern Company Services, Inc.*, 61 FERC ¶ 61,339, at n.56 (1992) (noting that a case subsequently settled prior to Commission review does not constitute binding precedent).

<sup>393</sup> *ExxonMobil*, 487 F.3d at 951-54.

<sup>394</sup> *Id.* at 954-55.

<sup>395</sup> Presiding Administrative Law Judge Cianci specifically noted in the 2009 ID that “[t]he omission from this initial decision of any argument raised by the Parties at the hearing or in their briefs does not mean that it has not been considered; rather, it has been evaluated and found to either lack merit or significance such that inclusion would only tend to lengthen this initial decision without altering its substance or effect.” 2009 ID,

(continued...)



### 3. Issues Resolved by ExxonMobil

232. Continuing their attack on the legality of the Income Tax Policy Statement, the ACC Shippers further assert that (1) the Income Tax Policy Statement does not have the force of law, and (2) the 2009 ID erred by ruling that SFPP was entitled to an income tax allowance by law. SFPP counters that these issues were resolved by *ExxonMobil* and that the ID properly relied on *ExxonMobil* and subsequent Commission decisions as binding precedent.

233. Regarding whether the Commission's income tax allowance policy, as articulated in the 2005 Income Tax Policy Statement, has the force of law, the answer lies in the ACC Shippers' own discussion of this issue in its Brief on Exceptions. The ACC Shippers quote extensively from the Commission's decision in *Marathon*.<sup>396</sup> Specifically, in *Marathon*, the Commission in addressing the effect of its Alternative Rate Policy Statement, quoted extensively from the seminal court decision on agency policy statements:

In *Pacific Gas and Electric Company v. FPC*, the Court stated that:

An administrative agency has available two methods for formulating policy that will have the force of law. An agency may establish binding policy through rulemaking procedures by which it promulgates substantive rules, **or through adjudications which constitute binding precedents**. A general statement of policy is the outcome of neither a rulemaking nor adjudication; it is neither a rule nor a precedent but is merely an announcement to the public of the policy which the agency hopes to implement in future rulemakings or adjudications. A general statement of policy, like a press release, presages an upcoming rulemaking or announces the course which the agency intends to follow in future adjudications.<sup>397</sup>

In *Marathon*, the Commission affirmed that a policy first articulated through a policy statement does not become binding precedent; i.e., carry the force of law, until the

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129 FERC ¶ 63,020 at P 867.

<sup>396</sup> ACC Brief on Ex. at 21.

<sup>397</sup> *Id.* (quoting *Marathon Oil Company v. Trailblazer Pipeline Co.*, 111 FERC ¶ 61,236, at P 57 (2005) (quoting *Pacific Gas and Electric Company v. FPC*, 506 F.2d 33, 38 (D.C. Cir. 1974) (emphasis added))).

Commission addresses the issue in an adjudicated proceeding.<sup>398</sup> Indeed, the U.S. Court of Appeals for the D.C. Circuit has recognized that many agencies choose to adopt interpretations through adjudications rather than through rulemaking, and that this process has been widely approved by the courts.<sup>399</sup>

234. After issuance of the Income Tax Policy Statement on May 4, 2005,<sup>400</sup> the Commission applied the newly articulated policy in an adjudicated proceeding -- the June 2005 Remand Order in the complaint proceedings against SFPP in Docket No. OR92-8-024 *et al.*<sup>401</sup> The Commission concluded in the June 2005 Remand Order that “[g]iven

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<sup>398</sup> See *Marathon Oil Company v. Trailblazer Pipeline Co.*, 111 FERC ¶ 61,236, at P 56 (2005).

<sup>399</sup> *Int’l Union, UAW v. Brock*, 783 F.2d 237, 248 (D.C. Cir. 1986) (citing *SEC v. Chenery*, 332 U.S. 194, 202-03, 67 S. Ct. 1575 (1947); *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144, 1166 (D.C. Cir. 1985)). The court in *Int’l Union, UAW* held: “When an agency uses an adjudication as a vehicle for announcement of a new rule, therefore, the effect of the adjudication can go far beyond its immediate effect on the parties involved in the specific adjudication.” *Id.* at 248.

<sup>400</sup> The Commission explicitly stated in the Income Tax Policy Statement that the policy being adopted would be applied to *pending* and future rate proceedings. Income Tax Policy Statement, 111 FERC ¶ 61,139 at Ordering Paragraph.

<sup>401</sup> The SFPP proceedings in Docket No. OR92-8-024 *et al.* constitute “adjudicated proceedings.” As it applies here, an adjudication means an adjudication under section 554 of the APA in which the position of the United States is represented by counsel or otherwise. On the issue of what is an adjudication, the U.S. Court of Appeals for the D.C. Circuit has held:

APA section 554 “applies . . . in every case of adjudication required by statute to be determined on the record after opportunity for an agency hearing” with some enumerated exceptions not applicable here. 5 U.S.C. § 554. If an adjudication is governed by section 554, it must feature the following procedural components: an impartial and unbiased presiding officer, *id.* § 556(b); notice and an opportunity to participate in the hearing, *id.* § 554(c); the right of the parties to appear with counsel, *id.* § 553(b); the right to present oral and written evidence (including rebuttal evidence) and to conduct such cross-examination as is required for a full and true disclosure of the facts, *id.* § 556(d); the right to submit proposed findings, conclusions and exceptions, *id.* § 557(c); the compilation of an exclusive record upon which the agency must base its decision, *id.*

(continued...)

the Commission's [Income Tax] Policy Statement and the application of its policy in this opinion, the Commission concludes that SFPP, L.P. should be afforded an income tax allowance on all of its partnership interests to the extent that the owners of those interests had an actual or potential income tax liability during the periods at issue."<sup>402</sup> As articulated in *Pacific Gas and Electric Company v. FPC*, as a result of the June 2005 Remand Order, a final order in an adjudicated proceeding, the Income Tax Allowance Policy became binding precedent giving that policy the "force of law." Moreover, in *ExxonMobil*, the U.S. Court of Appeals reviewed the June 2005 Remand Order along with the Income Tax Policy Statement.<sup>403</sup> The court in *ExxonMobil* clearly upheld the Income Tax Policy Statement as reasonable and affirmed its application to SFPP.<sup>404</sup>

235. It is well settled that "an agency must adhere to its precedents in adjudicating cases before it."<sup>405</sup> As discussed *supra*, the applicable precedent on the issue of income tax allowances for regulated utilities organized as partnerships is *ExxonMobil* and the June 2005 Remand Order. This precedent establishes the legality of allowing an income tax allowance for pipelines organized as general partnerships, limited partnerships, MLPs, or other pass-through entities. The 2009 ID therefore correctly concluded that SFPP, a limited partnership owned by KMEP, is entitled to an income tax allowance based upon established legal precedent.

236. In addition to the ACC Shippers' failed argument that *BP West Coast* remains controlling authority, the ACC Shippers also assert the more basic proposition that the Income Tax Policy Statement and *ExxonMobil* are simply incorrect. The ACC Shippers put forth two arguments to support this position. First, that the funds for any income-tax payments are included in the distributions that the Commission's discounted cash flow (DCF) model uses to calculate a pipeline's return on equity. They assert that this results in a double recovery of any income taxes that an MLP's partners may pay on distributive income. Second, the ACC Shippers assert that Congress did not authorize the Commission to create an income allowance for MLPs and that providing an income tax allowance does not equalize the cash and income returns of the limited partner owners

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§ 556(e); and limitations on *ex parte* communications and on the combination of prosecutorial and adjudicative functions, *id.* § 554(d).

*St. Louis Fuel & Supply Co. v. FERC*, 890 F.2d 446, 448 (D.C. Cir. 1989).

<sup>402</sup> June 2005 Remand Order, 111 FERC ¶ 61,334 at P 27.

<sup>403</sup> *ExxonMobil*, 487 F.3d at 951.

<sup>404</sup> *Id.* at 951, 953, 955.

<sup>405</sup> *Consolidated Edison Company of New York, Inc. v. FERC*, 315 F.3d 316, 323 (D.C. Cir. 2003) (quoting *Hatch v. FERC*, 654 F.2d 825, 835 (D.C. Cir. 1981)).

and of corporate shareholders. The ACC Shippers therefore conclude that the 2009 ID erred by relying on prior Commission and other initial decisions involving SFPP and thereby failing to address those arguments in detail.

237. As discussed *supra*, the Income Tax Policy Statement and *ExxonMobil* compared the cash and income returns of the corporation and MLP as regulated utilities and as taxable entities after imputing the partner's income tax liability to the latter.<sup>406</sup> Thus, the ACC Shippers' argument that the comparison should be between the MLP partner and the corporate shareholder, is clearly inconsistent with the Income Tax Policy Statement and *ExxonMobil*. Accordingly, the Presiding Judge properly rejected this position in the 2009 ID given the controlling precedent. Only the Commission may determine whether to revise the Income Tax Policy Statement given the arguments presented in the ACC Shippers' and *ExxonMobil/BP*'s exceptions. The Commission does so below.

#### **4. Should the Income Tax Policy Statement be Revised?**

238. This section addresses the arguments that underlie the *ExxonMobil/BP*'s attack on the fundamental income tax allowance policy as articulated in the Income Tax Policy Statement. *ExxonMobil/BP* make the following arguments in support of their conclusion that the Commission's Income Tax Policy Statement is incorrect and therefore should be revised to eliminate the income tax allowance for public utilities organized as partnerships. *ExxonMobil/BP*'s overarching contention is that providing an income tax allowance to an MLP over-recovers any income taxes that the partners may actually pay and gives MLPs a competitive advantage over corporations at undue cost to the ratepayers. For this reason, *ExxonMobil/BP* assert that the Income Tax Policy Statement should be revised.

239. *ExxonMobil/BP*'s characterization of the issue is incorrect. The issue presented is whether the Income Tax Policy Statement should be revised to deny MLPs an income tax allowance because the MLP unit holder will have higher after-tax distributed income and after-tax cash return than a corporate shareholder if both an MLP and a corporation obtain an income tax allowance. This after-tax difference is the result of the double taxation of corporate income. Accordingly, if neither the MLP nor the corporation obtains an income tax allowance, the MLP unit holder will still have greater after-tax income and after-tax cash return than the corporate shareholder. In both cases the MLP will have a competitive advantage over the corporation in the equity market. Thus, all other things being equal, the imputed MLP unit and corporate share prices and the after-tax income and cash returns on the equity component of the respective rate bases will be the same only if the MLP does not obtain an income tax allowance but the corporation

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<sup>406</sup> *ExxonMobil*, 487 F.3d at 952-53.

does. Put another way, the competitive advantage that a MLP enjoys over a corporation can be eliminated only if the Commission accords the MLP different treatment than the corporation.

240. As discussed in the previous section, ExxonMobil/BP's argument fails as a matter of law. ExxonMobil/BP's argument relies on the erroneous assumption that the taxes that the MLP partner pays on the pipeline income are "investor level" taxes. This assumption is contrary to the Commission's determination, as upheld by the court in *ExxonMobil*, that taxes on the income received from a regulated pipeline organized as a partnership should be attributed to the pipeline and included in the regulated entity's cost-of-service.<sup>407</sup> The court thus held that "petitioners' likening of partnership tax to shareholder dividend tax is inapposite because a shareholder of a corporation is generally taxed on the amount of the cash dividend actually received."<sup>408</sup> Notwithstanding the foregoing, ExxonMobil/BP's argument raises the policy issue of whether an income tax allowance is needed to ensure that an MLP will obtain a level of equity return necessary to attract capital to the pipeline industry. In examining this, the Commission explains below the mechanics of the DCF model, the Congressional purpose in allowing energy-based MLPs, the capital attraction standard, and the regulatory structure of an income tax allowance.

#### a. The DCF Model

241. The issue as framed by ExxonMobil/BP and the ACC Shippers is that the rate of return on equity for MLPs, as established using the Commission's DCF model, includes a "built-in" tax allowance. According to ExxonMobil/BP, this "built-in" tax allowance is a reflection of the fact that the DCF model yields a rate of return that will be high enough for investors to net their required rate of return even after they pay income taxes.<sup>409</sup> ExxonMobil/BP conclude that if an MLP pipeline receives an "[income tax allowance] that is intended to cover investor level taxes (since there are no pipeline level taxes) and receives an ROE derived from the DCF methodology utilizing an MLP-only proxy group, there is a *double recovery of investor level income taxes*."<sup>410</sup> Or put another way, an income tax allowance is not needed to ensure that a MLP will receive a level of return necessary to attract capital. As the following description of the DCF model shows, this assertion is a collateral attack on the conclusions in the Income Tax Policy Statement, Proxy Group Policy Statement, and Opinion No. 486-B that tax factors are assumed to be

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<sup>407</sup> *Id.* at 954.

<sup>408</sup> *Id.*

<sup>409</sup> ExxonMobil/BP Brief on Ex. at 6-8.

<sup>410</sup> *Id.* at 6-7.

reflected in the unit prices and resulting dividend yields, and thus reflect the relative after-tax advantage of MLP over corporations in issuing equity securities.<sup>411</sup>

242. The objective of the Commission's DCF model is to determine the return that must be earned by the regulated entity for the entity to obtain equity capital from investors. The DCF finds that return by examining the percentage returns on equity the market requires for members of a proxy group. The members of the proxy group must fall with a reasonable range of comparable risks and have publically traded securities. The Commission's DCF model uses three fundamental variables. The first is the stock or unit price and the second is the distribution or dividend yield on the security. These two variables are used to determine a current return measured both in dollars and the percentage yield. The third variable is the projected dividend or distribution growth to a terminal point in time using two different time frames – short-term and long-term. The first is the projected short term growth rate of five years. The second is the long term growth rate which is equal to the projected long term growth for gross domestic product in the case of corporations, and one half of that for an MLP. The short-term and long-term growth rates are combined with the short-term component weighted at two thirds and the long term component weighted at one third.<sup>412</sup> Since the dividend or distribution growth is based on the dollar value in the first year and the estimated growth to the end of the investment time frame, the result is the estimated total cash flows that will be returned to the investor over the time frame of the analysis. The model discounts the cash flows back to the first year using the percentage yield for each security during that first year. Because of the growth factor, the resulting percentage return on equity is higher than the percentage yield in the first year. In most cases, the median percentage return on equity of the sample is what is deemed necessary to attract investors.<sup>413</sup> The DCF model is the same for MLPs and corporations except for a different long term growth rate.<sup>414</sup>

243. Significantly with respect to the issue raised by ExxonMobil/BP, the Commission's DCF model starts with the stock price of the securities in the proxy group, observes the distribution or dividend, and then calculates the yield (the percentage return) by dividing the dollar amount of the distribution by the stock price. The dollar amount of

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<sup>411</sup> Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 40, n.6; *Kern River Gas Transmission Company*, 123 FERC ¶ 61,056, at P 186-187 (2008) (Opinion No. 486-A); Opinion No. 486-B, 126 FERC ¶ 61,034 at P 113-117.

<sup>412</sup> See Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 35.

<sup>413</sup> The sample must normally consist of at least five members. See Opinion No. 486-B, 126 FERC ¶ 61,034 at P 102-105.

<sup>414</sup> *Id.* P 45-50 (dividends and distributions), P 119-124 (short term growth), and P 125-130 (long term growth).

the distribution in the first year, as increased by the growth rate, is applied over the long-term growth horizon and is discounted back at the first year's percentage yield to obtain the return on equity required to attract capital to the firm. However, an investor uses the opposite approach in applying a DCF model. Rather than solving for the required return on equity, an investor first determines the required return on equity of securities of comparable risk. The investor then looks at the current dollar yield and estimates growth of that yield, which, as with the Commission's DCF model, determines the total cash flows to be generated over the life of the investment. The investor's DCF model then determines the stock price that will yield the required percentage return given the current and projected cash flows of the security involved. Thus, the Commission's DCF model and that of the investor are reciprocal applications of the same methodology. Both are driven by the level of distributions anticipated by the investor. Under the Commission's model, a greater cash flow will be reflected in a higher dollar yield, but the return of equity will be the same. For the investor, a higher distribution means a higher stock price, but again the return on equity will remain the same. This is because the percentage return on equity for securities of similar risk is established by the market whether viewed from the investor's or the Commission's perspective.

244. The central role of the distributions or dividends is reflected in the following example. The investor desires a 6 percent after-tax return and has a 25 percent marginal tax rate.<sup>415</sup> Thus, the security must have an ROE of 8 percent to achieve an after-tax yield of 6 percent. Assume that the distribution or dividend is \$8. The investor will price the security at \$100. Conversely, if the security price is \$100 and the yield is \$8, the Commission determines that the required return is 8 percent. If the dollar distribution increases to \$10, the investor will price the security at \$125 because \$10 is 8 percent of \$125. The Commission would note that the security price is \$125 and that the yield is \$10, or a return of 8 percent. If the distribution is \$6, the security price will drop to \$75, a return of 8 percent. The Commission would observe a \$75 dollar security price, a \$6 yield, and a return of 8 percent. In all cases the ROE is 8 percent and the after-tax return is 6 percent based on the market-established return.

245. Following on the previous example, the Commission now recapitulates and expands the example by comparing the after-tax returns of an MLP and a corporation presented in the Income Tax Policy Statement and repeated in *ExxonMobil*.<sup>416</sup> That example compares the after-tax returns of a jurisdictional MLP and a jurisdictional corporation that owned the same assets with the assumption that the MLP is imputed the

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<sup>415</sup> The examples used here omit the growth factor to simplify the math. This does not change the fundamental mechanics of the DCF model.

<sup>416</sup> *ExxonMobil*, 487 F.3d at 953.

income tax liability of its owing partners. Thus, if the MLP partners and the corporation both have a marginal tax rate of 35 percent and the entity has net income of \$100, without a tax allowance, the MLP partners would have an after-tax income of \$65 and the corporation would have an after-tax income of \$100. If the MLP is given an income tax allowance, then the MLP (and its partners) and the corporation would both have an after-tax income of \$100. If both entities distribute the entire income as a cash distribution, the after-tax cash to the individual unit holders is \$100 and the after-tax cash and income to the corporate shareholders is \$90 to \$65 depending on what assumptions are made regarding the corporate shareholders' marginal tax rates. Since the securities trade on the after-tax value of the distribution and income, in the last example the MLP unit will have a higher imputed price under a DFC analysis. Similarly, if neither entity has an income tax allowance (an option suggested by *ExxonMobil*),<sup>417</sup> the after-tax income and cash distribution are as follows: the MLP partners after-tax income and cash distribution is \$65 per unit at the 35 percent bracket; the corporate shareholder realizes after-tax income and cash distribution of \$58.50 to \$44.25 per share depending on the marginal tax rate of the corporate shareholder. Note that the prices of both securities will drop, but the corporate share will still have lower imputed price than the MLP unit.<sup>418</sup>

246. The implications of the proceeding example for after-tax income and cash returns, and the imputed security price, are examined in more detail in Exhibits SFP-98 and SFP-99, which have been adopted by both sides in this proceeding.<sup>419</sup> These exhibits analyze a pipeline with the same operating and financial data except for the presence or absence of the MLP income tax allowance. The same rate base, capital structure, debt and equity cost of capital, operating revenues and operating expenses are used for the analysis in both exhibits. The analysis uses a 32 percent marginal tax rate for the MLP unit holder and the corporate shareholder.

247. Given the foregoing, Ex. SFP-98 assumes that the MLP is given an income tax allowance. The pre-tax income available to the MLP unit holder is \$13.5397 and \$9.2070 for the corporate shareholder after the payment of entity-level taxes by the corporation, but with no entity-level taxes paid by the MLP. The after-tax income to the marginal investor is \$9.2070 for the MLP unit holder and \$6.2608 for the corporate

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<sup>417</sup> *Id.* at 955.

<sup>418</sup> *Cf.* Ex. SFP-75 at 21-23.

<sup>419</sup> *Cf.* ACC Shipper Brief on Ex. at 39, 45 (citing for the respectively, Ex. SFP-98 “Oil Pipeline Under Corporate and MLP Organizational Structures (32% MLP Tax Allowance; 32% Marginal Investor Tax Rate)” and Ex. SFP-98 “First Alternative Hypothetical Example of an Oil Pipeline Under Corporate and MLP Organizational Structures (0% MLP Tax Allowance; 32% Marginal Investor Tax Rate)”).



shareholder after both pay the 32 percent marginal tax rate resulting in an implied MLP unit price of \$100 and an implied corporate share price of \$68. In both cases the after-tax return on equity is 9.207 percent and the regulatory ROE is the 13.540 percent posited as part of the exhibit's cost-of-service assumptions. The only difference is the business format. As the risk is the same for both business models, the higher MLP unit price reflects its higher after-tax dollar income and cash returns as compared to the corporation.

248. Ex. SFP-99 presents the same example as Ex. SFP-98, but assumes there is no MLP tax allowance. In Ex. SFP-99, the pre-tax income available to both the MLP unit holder and the corporate shareholder is \$9.2070 after the corporation pays entity-level taxes but the MLP does not. The after-tax income to the marginal investor for both the MLP unit holder and the corporate shareholder is \$6.2608 after both pay a 32 percent marginal tax rate. This results in an implied MLP unit price of \$68.00 and an implied corporate share price also of \$68.00. For both ownership formats the after-tax return on equity is 9.207 percent and the regulatory ROE is the 13.540 percent posited as part of the exhibit's cost-of-service assumptions. The unit and share prices are the same as the after-tax dollar income and cash returns are the same for both business models given the assumption of their identical risk.

249. As shown by Exs. SFP-98 and SFP-99, the after-tax dollar income and cash returns of the unit holder and the shareholder on the equity component of the rate base will be the same only if the MLP is denied an income-allowance and the corporation is granted one.<sup>420</sup> Thus, as SFPP argues, the ACC Shippers seek a return to the *Lakehead* regulatory protocol which provides an income tax allowance only on those partnership interests owned by a corporation, a position repudiated by *BP West Coast*. Moreover, the analysis in Exs. SFP-98 and SFP-99 demonstrates that it is simply not true that the income taxes of the MLP partnership are recovered twice because in fact they are paid only once and compensated only once. Rather, in all cases there is cash from the distributions (which may be reflected in income) that is available to pay the taxes, which is in turn reflected in the capitalized value of the security price. This is the fundamental objection the ACC Shippers present here. At bottom, it is the resulting drop in the relative MLP unit price from the denial of an income tax allowance that led the Commission to conclude, as summarized in *ExxonMobil*, that "termination of the allowance would clearly act as a disincentive for the use of the partnership format, because it would lower the returns of partnerships vis-à-vis corporations, and because it would prevent certain investors from realizing the benefits of a consolidated income tax return."<sup>421</sup> In fact, as SFPP establishes, a drop in the prices of partnership interests

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<sup>420</sup> See Ex. SFP-98; Ex. SFP-99, reproduced as Appendix B and Appendix C.

<sup>421</sup> *ExxonMobil*, 487 F.3d at 952-53 (affirming the Commission's rationale).

occurred immediately after the announcement of the *Lakehead* doctrine.<sup>422</sup> The practical consequence of the *Lakehead* doctrine for the price of the Lakehead units was completely consistent with the basic financial theory under discussion here.

250. As discussed, ExxonMobil/BP's argument ultimately fails because (1) it erroneously considers the taxes that the MLP partner pays on the MLP pipeline income to be "investor level" taxes rather than taxes that are imputed to the entity under *ExxonMobil*, and (2) it seeks to reinstall the *Lakehead* policy through the door of the DCF model. The ExxonMobil/BP's and the ACC Shippers' entire double-recovery argument, and its implications for the Commission's DCF model, hinges on these erroneous assumptions. Since the argument of a double recovery is mathematically incorrect, their position that there is double payment or over-recovery from ratepayers of an MLP partner's income taxes can be sustained only if the court's analysis in *ExxonMobil* upholding the validity of the Income Tax Policy Statement was incorrect. This order next turns to the Congressional purpose in authorizing energy firms to use the MLP business format and whether Congress placed any limits on the Commission's authority to implement that purpose.

#### **b. Congressional Purpose Regarding Energy MLPs**

251. ExxonMobil/BP's and the ACC Shippers' next argument is that the Commission's income tax allowance policy exceeds the Commission's statutory authority and is contrary to Congressional intent. ExxonMobil/BP and the ACC Shippers assert that the Commission's historic analysis in *Lakehead* properly reflected Congressional purpose on the taxation status of public utility partnerships by not providing a partnership's individual partners with an income tax allowance.<sup>423</sup> They further reiterate the ruling in

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<sup>422</sup> See Ex. SFP-75 at 30.

<sup>423</sup> ACC Shippers Brief on Ex. at 23. The ACC Shippers cite to *Lakehead*, 75 FERC at 61,596, in which the Commission stated:

[FERC] is denying Lakehead this particular tax allowance because that tax expense does not exist. Congress did not endorse phantom taxes in enacting section 7704 of the I.R.C. It simply endorsed this particular form (partnership) in connection with taxing an enterprise. That form should be advantageous on its own merits without the addition of phantom taxes in a cost-of-service just as it is advantageous for companies without a cost of service that are covered by section 7704's exception.

The Commission notes that this language was itself an earlier interpretation of section 7704 by the Commission because, as the ACC Shippers correctly state, Congress did not

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*BP West Coast* that in exempting pipeline limited partnerships from taxation Congress “did not empower FERC to do any thing, let alone to create an allowance for fictional income taxes.”<sup>424</sup> The ACC Shippers further argue that the Commission does not have the statutory authority to modify Congress’ tax legislation, specifically section 7704 of the I.R.C.<sup>425</sup> through which Congress exempted oil and gas pipelines organized as partnerships from being treated as corporations for income tax purposes.<sup>426</sup>

252. ExxonMobil/BP and the ACC Shippers also assert that the 2009 ID erred by failing to address their contention that when Congress enacted Section 7704 of the Internal Revenue Code,<sup>427</sup> it intended to provide all energy companies – both regulated and non-regulated, incentives to invest by allowing them to organize as partnerships. ExxonMobil/BP assert that Congress could have authorized an income tax allowance for regulated entities but did not do so. They also argue that in one prior instance when Congress created investment incentives for certain energy companies that it specifically prohibited the Commission from including those benefits in a regulated entity’s rates.<sup>428</sup> The ACC Shippers further argue that certain purported legislative history SFPP presented at hearing and on initial briefs below consists of materials created long after the relevant

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address the matter explicitly. The Commission was therefore exercising its discretion in interpreting the meaning of section 7704. As discussed, *BP West Coast* rejected the Commission’s *Lakehead* analysis, and thus implicitly rejected the language that the ACC Shippers rely on here. See *BP West Coast*, 374 F.3d at 1289-91. *ExxonMobil* in turn rejected the argument that providing an income tax allowance results in a “phantom cost.” See *ExxonMobil*, 487 F.3d at 949, 951, 953, 955. The quote from *Lakehead* shows that the ACC Shippers’ citation is inapposite to the issue at hand.

<sup>424</sup> ACC Shippers Brief on Ex. at 17-18 (quoting *BP West Coast*, 374 F.3d at 1293).

<sup>425</sup> Section 7704 of the Internal Revenue Code treats certain publicly traded partnerships as corporations for income tax purpose, but exempts from taxation income from certain energy-related activities, including “income and gains derived from transportation (including pipelines transporting gas, oil, or products thereof) . . . of any mineral or natural resource . . .” See Pub. L. No. 100-203, § 10211, 101 Stat. 1330 (1987).

<sup>426</sup> MLPs were thus permitted to pass their tax liability through to the member partners and therefore, are referred to as “pass-through” entities.

<sup>427</sup> Public L. No. 100-203, Title X, § 10211(a), Dec. 22, 1987, 101 Stat. 1330-1403, (1987).

<sup>428</sup> ExxonMobil/BP Brief on Ex. at 11.

statutes were passed and as such it has little, if any, weight.<sup>429</sup> They also argue that the December 2007 Order provided no legislative history to support an allowance.<sup>430</sup>

253. In light of this debate the Commission has revisited the legislative history of section 7704. In doing so, the Commission concludes that MLPs were specifically designed as a tax advantaged form of investment compared to a corporation and have two important distinctions. The first is the avoidance of the tax on dividend distributions (double taxation of income) and the second is the ability to defer the recognition of ordinary income at the partner level. Regarding both points, Congress specifically designed the MLP business model to have certain advantages to facilitate the investment of equity capital.<sup>431</sup> As noted in the prior orders, the legislative history is limited and hard to find.<sup>432</sup> However there are three sources of legislative history for section 7704 that support the conclusions of the December 2007 Order.

254. First, the Staff of the Joint Committee on Taxation produced a pamphlet report for a hearing held by the Senate Subcommittee on Taxation and Debt Management.<sup>433</sup> The pamphlet report provides that an MLP is a creative new technique for investment.<sup>434</sup> It states that the driving force behind the use of an MLP is the appeal of the tax savings that can be effected by conducting a business in partnership form (with one level of tax) rather than in corporate form (with two levels of tax). Use of an MLP gives the investor an opportunity to realize a better after-tax yield on current cash return[s] than corporate stock because of tax savings.<sup>435</sup> Then as now, the MLP was a type of partnership rather than a corporation. The issue before the Subcommittee was whether the MLP should

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<sup>429</sup> ACC Shippers Brief on Ex. at 26-28.

<sup>430</sup> *Id.* at 26 n.11.

<sup>431</sup> As discussed, MLPs are governed by statute. *See* Certain Publicly Traded Partnerships Treated as Corporations, 26 U.S.C. § 7704 (2006). Section 7704 was contained in the Omnibus Budget Reconciliation Act of 1987, H.R. 3545, 100th Cong., 101 Stat. 1330, 403 (1987).

<sup>432</sup> December 2007 Order, 121 FERC ¶ 61,240 at P 29.

<sup>433</sup> Staff of the Joint Committee on Taxation, *Taxation of Master Limited Partnerships*, JCS-19-87 (1987) (prepared for a hearing before the Subcommittee on Taxation and Debt Management of the Senate Subcommittee on Finance on July 21, 1987) (Staff Report).

<sup>434</sup> *Id.* at 3.

<sup>435</sup> *Id.* at 16.

continue to enjoy partnership status or be considered a corporate entity.<sup>436</sup> Congress answered this question when it passed House Bill 3545 and affirmed the partnership status of an MLP.

255. Second, the report from the July 21, 1987 Senate Subcommittee hearing provides insight into information provided the Senate prior to going to Conference on the bill.<sup>437</sup> The Subcommittee hearing included testimony from one administration witness and seven public witnesses. The administration witness and one public witness supported corporate tax treatment of MLPs.<sup>438</sup> The balance of the witnesses, consisting of business executives and attorneys, supported the continuation of partnership treatment of MLPs for tax purposes. The witnesses who supported partnership treatment of MLPs cited the financial benefits enjoyed by investors as the main force behind their use and stated that those benefits encourage potential investors to invest. Thus, Mr. John P. Neafsey, who was the chief financial officer for an energy company, testified that the need for capital from investors was best met through the use of an MLP. Mr. Neafsey cited the use of an MLP as the best way to attract investors when compared to the alternatives of selling shares of stock or issuing a debt instrument.<sup>439</sup> The advantages of a MLP were also repeated by the other five witnesses who supported partnership treatment of a MLP.<sup>440</sup>

256. Third, a House Committee Report shows the Congressional intent behind section 7704 through the benefits provided to MLPs at that time.<sup>441</sup> While the Committee Report does not expressly state Congress' intent behind its support of MLPs, the Report does implicitly demonstrate Congress' support of MLPs. The first evidence of support is the fact that the MLP provision, which became section 7704, survived the Conference agreement between the House and the Senate.<sup>442</sup> The second evidence of support is that the Conference agreement afforded MLP investors a greater tax benefit by allowing a loss deduction that could be used to offset income generated from sources other than the

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<sup>436</sup> *Id.* at 21.

<sup>437</sup> Master Limited Partnerships: Hearing on H.R. 3545 Before the Subcomm. on Taxation and Debt Mgmt. of the S. Comm. on Fin., 100th Cong., S. Rep. No. 100-485 (1987) (S. Rep.).

<sup>438</sup> *Id.* at 58, 180.

<sup>439</sup> *Id.* at 84-86.

<sup>440</sup> *Id.* at 93, 145, 169.

<sup>441</sup> H.R. Rep. No. 100-495 (1987) (Conf. Rep.).

<sup>442</sup> *Id.* at 419-22.

MLP. Previously the loss deduction from an MLP could only be used to offset income from the same MLP,<sup>443</sup> but this did not invalidate the general purpose for creating MLPs.

257. The ACC Shippers' further argue that while Congress created an incentive for energy companies to develop energy infrastructure by changing the tax laws, Congress did not change the Commission's statutory authority to allow regulated companies to recover investment incentives in their rates,<sup>444</sup> but this is inapposite. Congress does not need to grant such affirmative permission through legislation. Rather, silence more likely implies that all the partnership entities involved could be accorded the same status. The legislative history discussed above emphasizes that the tax incentives Congress provided MLPs have important practical financial consequences. The MLP limited partners enjoy certain tax advantages particularly due to the avoidance of the double taxation of corporate earnings and the tax deferrals derived from allocation of income and losses among the partners. For this reason they will pay a relatively higher price to purchase the limited partnership interests, which gives the partnership a cost of capital advantage and implements the purpose for Congress' endorsing the MLP business model.

258. As Exs. SFP-98 and SFP-99 indicate, eliminating the income tax allowance for MLPs would reduce the incentive to invest in such partnerships because there is no material financial incentive to do so from the viewpoint of an individual investor. While the incentives to use partnerships within corporate structures, with the resulting administrative efficiencies, would remain, the Income Tax Policy Statement rejected this more limited purpose<sup>445</sup> and was affirmed by *ExxonMobil*.<sup>446</sup> In this regard, the ACC Shippers are simply incorrect in citing *BP West Coast* for the proposition that the Commission cannot create an income tax allowance to implement the investment goals of section 7704. The relevant holding in *BP West Coast* was premised on the court's conclusion that the Commission had not justified partnership income taxes as an element of the partnership's regulatory cost-of-service, and therefore investment incentives could not create a cost if one did not exist independently of the incentive. That ruling no longer applies because *ExxonMobil* explicitly held that income taxes were a legitimate, albeit indirect, part of a jurisdictional cost-of-service. The Commission therefore concludes that Congress did not preclude granting MLPs an income tax allowance and in fact intended the contrary. The Commission's prior interpretation of section 7704 in *Lakehead* was incorrect because it improperly distinguished the partnership from the

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<sup>443</sup> *Id.* at 951-52. As discussed *supra*, at this time the previous limitation applies.

<sup>444</sup> ACC Shippers Brief on Ex. at 22-23.

<sup>445</sup> Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 15-16.

<sup>446</sup> *ExxonMobil*, 487 F.3d at 952.

corporate model. Thus the Commission over-ruled its holding in *Lakehead* that section 7704 does not authorize granting jurisdictional partnerships an income tax allowance.

### c. The Capital Attraction Standard

259. The ACC Shippers also assert that the providing SFPP an income tax allowance fails the capital attraction standard set forth in *Hope Natural Gas*.<sup>447</sup> As discussed in both *BP West Coast* and *ExxonMobil*, the Commission has an obligation to provide a regulated entity an opportunity to earn an equity return that will attract capital to the firm. *BP West Coast* held that the Commission had erroneously concluded that allowing any income tax allowance was necessary to meet the capital attraction standard because under the Commission's own cost accounting theory partnerships did not pay income taxes, and therefore had no cost in that regard.<sup>448</sup> Addressing the same point in *ExxonMobil*, the court concluded that the Commission had adequately explained that income taxes were a cost to a partnership, albeit indirect, and therefore an income tax allowance was necessary. The court specifically described the capital attraction standard and concluded that the Commission's adoption of an income tax allowance for partnerships was reasonable under that standard.<sup>449</sup> The ACC Shippers' argument in this regard is flatly inconsistent with the holding of *ExxonMobil*. At bottom, their argument approaches the issue of the difference in the after-tax cash and income return of an MLP unit holder and a corporate shareholder from a different angle. The Commission has previously explained why the higher after-tax cash and income return received by the MLP unit holder is reasonable under the Interstate Commerce Act and consistent with the purpose of section 7704. The 2009 ID was correct to reject this argument.

### d. Regulatory Purpose for an Income Tax Allowance

260. The remaining question regarding the legality of granting an income tax allowance to a MLP is whether the Commission should deny the allowance for regulatory reasons, i.e., to create a "fairer" result for the ratepayers. The ACC Shippers and *ExxonMobil/BP* further assert that the equity advantage enjoyed by MLPs comes from the inclusion of an unnecessary "phantom" cost in the pipeline's rates, which results in unjust and unreasonable rates. They assert that in *Lakehead* the Commission correctly concluded

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<sup>447</sup> ACC Shippers Brief on Ex. at 50-53 (citing *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944)).

<sup>448</sup> *BP West Coast*, 374 F.3d at 1290-91.

<sup>449</sup> *ExxonMobil*, 487 F.3d at 951 (stating that just and reasonable rates are "rates yielding sufficient revenue to cover all proper costs, including federal income taxes, plus a specified return on invested capital").

that the investment incentives created by section 7704 should not include a cost that is not actually incurred by a regulatory utility partnership – the “phantom” tax cost issue.<sup>450</sup> The ACC Shippers conclude that the additional cash flow to the pipeline generated by the income tax allowance is a windfall at the expenses of the rate payers. SFPP replies that the Income Tax Policy Statement rejected the phantom tax issue and expressly repudiated by *Lakehead*.<sup>451</sup> SFPP concludes that because there is no phantom income tax liability, the income tax allowance policy does not result in improper subsidization by ratepayers of the investor tax benefits Congress granted MLPs.

261. The *Lakehead* policy has been rejected by both the Commission and the court. The Commission, in overruling *Lakehead*, specifically concluded that income taxes are a cost of raising a partnership’s capital because the partners have a liability for the income generated by the partnership’s public utility operations.<sup>452</sup> Under both the Income Tax Policy Statement and *ExxonMobil*, the comparison of relative returns was between the MLP as a regulated entity, including the imputed income tax liability, and the corporation as a regulated entity, with its explicit income tax liability. The comparison was not between the individual unit holder and the corporate shareholder as the ACC Shippers urge here. The Income Tax Policy Statement recognizes that unlike corporate income, MLP income is not subject to double taxation. Thus granting an income tax allowance to MLPs results in an adjustment in the relative investment price of an MLP’s and a corporation’s securities to the former’s advantage.<sup>453</sup> *ExxonMobil* accepted the Commission’s determination that elimination of the allowance would create a disincentive for using partnerships because it would lower the relative returns for partnerships as compared to corporations.<sup>454</sup> Thus the difference in dollar returns resulting from an income tax allowance was addressed in the examples provided in the Income Tax Allowance Statement and was affirmed by *ExxonMobil*. Further, the price advantage MLPs hold over corporations was recognized in the Income Tax Policy Statement and was upheld by the court. This precedent forecloses the ACC Shippers’ and ExxonMobil/BP’s arguments.

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<sup>450</sup> ACC Shippers Brief on Ex. at 22-23; ExxonMobil/BP Brief on Ex. at 8-10.

<sup>451</sup> SFPP Brief op. Ex. at 7-10.

<sup>452</sup> See Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 33. This conclusion was affirmed in *ExxonMobil*, 487 F.3d at 951-54.

<sup>453</sup> *Id.* P 6 n.6. The footnote states that the investor equalizes prices to reflect the pre-tax return. The more correct statement would be that the investor adjusts the price for the same after-tax return because not all investors have the same marginal tax rate.

<sup>454</sup> *ExxonMobil*, 487 F.3d at 952-53.



262. Notwithstanding the foregoing, given that the ACC Shippers questioning the equity of the Income Tax Policy Statement, the Commission will revisit the policy rationale that underlies the Policy Statement. The Commission's Income Tax Policy Statement is consistent with Congress' decision to give MLPs an equity price advantage through section 7704 of the Internal Revenue Code. As Ex. SFP-99 shows, a MLPs' equity price advantage is lost if MLPs are denied an income tax allowance and causes the MLPs to lose the additional cash flow supporting the investment incentives Congress created by authorizing the MLP format. In short, as discussed above, if the income tax allowance is eliminated for MLPs, the impact of the MLP tax incentive granted by Congress would be voided. It is true that the ratepayers will pay a higher rate if an MLP has an income tax allowance. However, shippers' rates will be no higher than if the pipelines that are MLPs shift to the corporate form and thereby obtain an income tax allowance,<sup>455</sup> and might actually be lower.

263. Moreover, denying MLPs an income tax allowance would apply different regulatory accounting and policy standards to regulated MLPs than to regulated corporations. This becomes apparent by examining the role an income tax allowance performs in the Commission's cost-of-service methodology. Under the cost-of-service methodology, the pre-tax operating and capital costs of the regulated entity are calculated to establish the revenue required to cover those costs, including the equity return. The income taxes on the return are then grossed-up and added to the revenue requirement to assure an adequate after-tax return. The point is that a regulated firm's pre-tax gross revenue is capped based on its capital and operating costs. This differs from an unregulated entity, which must earn enough revenue and return from sales to cover all operating and capital costs and to pay the related income taxes in order to obtain the same after-tax return on equity as a regulated entity. In short, an unregulated entity does not gross up its revenue through a regulatory markup in order to earn the after-tax return. Rather, an unregulated entity earns the equivalent income through its sales. The purpose of regulation is to replicate a competitive market.<sup>456</sup> Accordingly, with respect to income taxes, the Commission replicates the competitive market by using an income tax allowance as a gross-up mechanism in lieu of the additional sales volume that an entity in a competitive market would need to generate the required after-tax equity return.

264. Without an income tax allowance, a jurisdictional MLP would not be able to replicate an unregulated MLP's after-tax return because the jurisdictional MLP does not make sufficient sales to cover the imputed income taxes of its unit holders. Thus, under the scenario advocated by the ACC Shippers, a jurisdictional corporation may obtain an

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<sup>455</sup> See Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 37.

<sup>456</sup> *ExxonMobil*, 487 F.3d at 961.

income tax allowance that replicates the sales and revenues of a non-jurisdictional corporation, but a jurisdictional MLP would not be permitted to replicate the sales and revenues of a non-jurisdictional MLP.<sup>457</sup> This would restore the irrational distinction between partnerships and corporations that the court rejected in *BP West Coast* and which the Commission rectified in the Income Tax Policy Statement.<sup>458</sup> The ACC Shippers' position that MLPs should be denied an income tax allowance discriminates against MLPs vis-a-vis corporations and would undercut the incentives embedded in the MLP business format.

265. Finally, the ACC Shippers and ExxonMobil/BP both again argue that the December 2007 Order creates a tax benefit or cost where none exists in the regulatory structure established by the ICA. They assert that this violates the holding in *BP West Coast* that Congress cannot create a tax liability where none otherwise exists simply to create an investment incentive.<sup>459</sup> But this argument misconstrues the issue at hand. Here, the Commission is not creating a tax liability where none otherwise exists. An MLP pipeline does incur a tax cost, albeit indirectly.<sup>460</sup> Thus, the issue here is whether the benefits of Congress' elimination of double taxation should accrue to the MLP pipeline, or should be passed back to the ratepayers by denying MLPs an income tax allowance. The Commission again concludes that Congress intended to encourage pipeline investment by authorizing tax incentives for MLPs. To achieve this, it is appropriate to grant regulated MLPs an income tax allowance and equalize the return of the MLP and the corporation at the entity level. The Commission therefore affirms its previous conclusions in the Income Tax Policy Statement as affirmed in *ExxonMobil*.

##### **5. Did the ID Err by not Addressing Certain Implementing Regulatory Protocols?**

266. The ACC Shippers and ExxonMobil/BP both assert that the 2009 ID erred in failing to address whether SFPP established that its partners had an actual or potential income tax liability. More specifically, they assert that the 2009 ID: (1) incorrectly concluded that SFPP met the standard simply by establishing that its limited partners had an obligation to report either positive or negative taxable income on their returns; (2) erroneously accepted the presumed 28 percent marginal tax rate without critical

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<sup>457</sup> The ACC Shippers essentially state this in their Brief on Ex. at 23, 28.

<sup>458</sup> Income Tax Policy Statement, 111 FERC ¶ 61,139; and *BP West Coast*, 374 F.3d at 1292.

<sup>459</sup> ACC Shippers Brief on Ex. at 18, 49 (citing *BP West Coast*, 374 F.3d at 1292-93); ExxonMobil/BP Brief on Ex. at 9-10.

<sup>460</sup> *ExxonMobil*, 487 F.3d at 954.

analysis; and (3) failed to consider evidence that effectively rebutted the application of the 28 percent marginal tax rate to mutual funds and the 35 percent marginal tax rate to unrelated business income. At bottom, the ACC Shippers and ExxonMobil/BP assert that the 2009 ID incorrectly relied on the precedent established by the December 2007 Order in which the Commission granted SFPP an income tax allowance holding that if a partner receives a K-1 and must report distributive ordinary income or loss on the partners' annual income tax return, that partner has an actual or potential income tax liability. The ACC Shippers and ExxonMobil/BP argue that the 2009 ID should have independently analyzed the evidence on whether SFPP met its obligation to demonstrate that its partners have an actual or potential income tax allowance.<sup>461</sup>

267. In response to the ACC Shippers' and ExxonMobil/BP's challenge, SFPP asserts that the 2009 ID correctly held that SFPP established that its partners incurred actual or potential income tax liability and properly calculated the income tax allowance.<sup>462</sup> SFPP replies that the Commission's prior decisions are binding on the Presiding ALJ. SFPP further asserts that the ACC Shippers and ExxonMobil/BP do not have the right to repeatedly litigate the same issues.<sup>463</sup> While a Presiding ALJ may revisit a Commission decision if the facts warrant it, in the instant case, the ACC Shippers and ExxonMobil/BP mainly challenge well-established regulatory standards set by the Commission in decisions involving the same litigants, e.g., the December 2007 Order. The Commission concludes that based on the precedent established by the December 2007 Order, the 2009 ID correctly held that SFPP met the Commission's standards and protocols for determining whether an MLP partner has an actual or potential income tax liability. However, as the December 2007 Order has not been judicially reviewed, the Commission will revisit those standards and protocols below.

### **B. The Implementing Regulatory Protocols**

268. The ACC Shippers challenge the 2009 ID's application of the regulatory protocols that the Commission adopted in its December 2005, 2006 Sepulveda, and December 2007 Orders<sup>464</sup> to implement the Income Tax Policy Statement. The 2009 ID concluded that SFPP established that its partners had an actual or potential income tax liability based on the standards and protocols established in the December 2005, 2006 Sepulveda, and

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<sup>461</sup> ACC Shippers Brief on Ex. at 31-36; ExxonMobil/BP Brief on Ex. at 22-26.

<sup>462</sup> SFPP Brief op. Ex. at 24.

<sup>463</sup> *Id.* at 22.

<sup>464</sup> December 2005 Order, 113 FERC ¶ 61,277 at P 40-47; 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 52-65; December 2007 Order, 121 FERC ¶ 61,240 at P 24-61.

December 2007 Orders.<sup>465</sup> This part of the order addresses the doubt cast by the ACC Shippers on SFPP's fulfillment of its obligation under the Income Tax Policy Statement and *ExxonMobil* to establish that its partners have an "actual or potential" income tax obligation for the pipeline's public utility income attributable to them. The specific issues raised include (1) whether SFPP must establish that there is taxable income in the base or a subsequent year; (2) whether the Commission's protocols incorrectly permit recovery of taxes on downstream gains through the income tax allowance; (3) the role and character of incentive distributions; (4) the 28 percent marginal rate for mutual funds and unrelated business taxable income (UBTI); and (5) the use of presumptions to establish the partners' marginal tax rates.

**1. Must Income be Recognized in the Base Year or by a Known Period?**

269. On exceptions the ACC Shippers and ExxonMobil/BP assert that SFPP does not qualify for an income tax allowance because the individual limited partners of KMEP<sup>466</sup> collectively have negative distributive income in all the relevant years of this proceeding. Moreover, the ACC Shippers and ExxonMobil/BP assert that KMEP's partners are likely to have negative income for many years.<sup>467</sup> Thus, they assert, SFPP has not established that KMEP's individual limited partners have actual or potential income tax liability. In sum, both the ACC Shippers and ExxonMobil/BP contest the Commission's prior conclusion that the deferral of ordinary income is central to the concept of a potential income tax liability under the standard approved by *ExxonMobil*.<sup>468</sup> SFPP responds that the Commission has previously recognized that deferral of income tax recognition is an intrinsic and acceptable feature of MLPs. SFPP further asserts that as a matter of basic tax law, the limited partners' deferred ordinary income will be recognized when the limited partnership interest is sold and that the Commission has accepted this type of income recognition delay.<sup>469</sup>

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<sup>465</sup> 2009 ID, 129 FERC ¶ 63,020 at P 683-694.

<sup>466</sup> KMEP is the MLP that indirectly owns the majority of the partner interests in SFPP.

<sup>467</sup> ExxonMobil/BP Brief on Ex. at 22-23; ACC Shippers Brief on Ex. at 31-32.

<sup>468</sup> See December 2005 Order, 113 FERC ¶ 61,277 at P 23-28; December 2007 Order, 121 FERC ¶ 61,240 at P 28-32; *ExxonMobil*, 487 F.3d at 954-955.

<sup>469</sup> SFPP Brief op. Ex. at 26.

270. The Commission has consistently recognized that an MLP's limited partners may have negative distributive income in any particular year.<sup>470</sup> Moreover, even before the issue of whether negative or deferred income qualifies as potential income tax liability arose in the context of partnerships, the deferral of income tax liability was a well recognized under FERC regulation and was expressly discussed and affirmed in *City of Charlottesville*.<sup>471</sup> Notwithstanding the court's holding in *City of Charlottesville*, the ACC Shippers again question whether taxable income must be recognized in the test year or in a known period, or if income recognition is deferred, whether the possibility of a long deferral period is reasonable. The Commission addresses these questions below.

**a. Must there be Known Income Recognition?**

271. ExxonMobil/BP argue that the 2009 ID erred in granting SFPP an income tax allowance where the distributive income of SFPP's limited partners is negative in all the known years at issue here.<sup>472</sup> They conclude that because there is no known date by which income recognition will occur, SFPP has not established as a matter of fact that there is an actual or potential income tax liability. Essentially, ExxonMobil/BP assert that the actual income tax liability must occur in the base year, or the timing of the potential income tax in future years must be known with some degree of certainty to satisfy the actual or potential income tax liability standard under the Income Tax Policy Statement. SFPP replies that this issue was resolved by the Commission's prior orders that accepted a more open-ended time frame for the recognition of limited partners' actual income tax liability.<sup>473</sup> To date, no reviewable order has addressed this issue; therefore the Commission once again addresses these arguments.

272. ExxonMobil/BP's argument that there must be actual taxable income distributed to the partners in the base year, or in a known future year, ignores the conclusion to the contrary in the long standing "actual taxes paid" analysis in *City of Charlottesville*.<sup>474</sup>

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<sup>470</sup> Income Tax Policy Statement, 111 FERC ¶ 61,139 at 35; December 2007 Order, 121 FERC ¶ 61,240 at P 24, 49-51.

<sup>471</sup> *City of Charlottesville v. FERC*, 774 F.2d 1205, 1215-16 (D.C. Cir. 1985) (*City of Charlottesville*). The court also explained how Commission policy has allowed or denied the deferral of income tax liabilities based on its view of the importance of actual tax recognition. *Id.* at 1213-14, 1216.

<sup>472</sup> ExxonMobil/BP Brief on Ex. at 22.

<sup>473</sup> It is unchallenged that KMPG's, the corporate partner's, actual income tax liability can be determined since its returns are available in a specific rate proceeding. What is contested and discussed further below is how KMPG's income is determined.

<sup>474</sup> *City of Charlottesville*, 774 F.2d 1205.

The court in *City of Charlottesville* reviewed, with respect to a jurisdictional entity that was part of a consolidated group of companies, the Commission's decision to use a "stand-alone" methodology to determine the entity's pipeline's tax allowance rather than the "flow-through" methodology.<sup>475</sup> Under the flow-through method, the effective tax rate paid by the consolidated group of companies<sup>476</sup> is applied to the affiliate jurisdictional entity at issue. Conversely, under the stand-alone method, the Commission, for tax purposes, segregates the affiliated entity from the rest of the consolidated group; i.e., the utility's tax base is determined using only the taxable income and deductions that is attributable to the entity's jurisdictional activities.<sup>477</sup> At issue in *City of Charlottesville* was whether the stand-alone methodology is unlawful under the "actual taxes paid" principle. In *City of Charlottesville*, the court rejected the "actual taxes paid" limitation stating:

We conclude . . . that the imprecision of the "actual taxes paid" formulation is exceeded only by the name of the Holy Roman Empire: two out of the three words are wrong. Taxes, yes. But not necessarily *actual* taxes, since inexact estimations are often allowed, e.g., a nationwide tax allowance applied to all individual utilities, *see Tenneco Oil*, 571 F.2d at 844. . . And not necessarily *taxes paid*, since tax liability incurred by current activities but in fact not paid currently can be charged to present rate payers, e.g., taxes deferred by reason of accelerated depreciation but passed to current ratepayers through normalization, *see Public Systems*, 709 F.2d at 81-82. So the principle should be expressed "actual or estimated taxes paid or incurred" -- whereupon it ceases to constrain the Commission with regard to taxes any more than the Commission is constrained with regard to its treatment of other expenses. Which is as it should be.<sup>478</sup>

273. The December 2007 Order built on the court's holding by concluding that the "actual or potential income tax liability" requirement recognizes that a potential income tax liability may be incurred, but not recognized, when there is a distribution of cash to the partner that is in excess of ordinary income distributed to that partner. There will

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<sup>475</sup> *Id.* at 1206.

<sup>476</sup> When a jurisdictional entity is part of a consolidated group, the group files a single tax return and pays taxes computed on the consolidated revenues and deductions of all the affiliates and the parent.

<sup>477</sup> *City of Charlottesville*, 774 F.2d at 1207.

<sup>478</sup> *Id.* at 1215 (emphasis in the original; footnotes omitted).

normally follow from this a reduction in basis that reflects the partnership's depreciation or amortization expense.<sup>479</sup> The Income Tax Policy Statement adopted the phrase "actual or potential income tax liability" precisely because the actual payment of income taxes on distributed partnership income may be deferred for some time, as was explicitly recognized in the Policy Statement.<sup>480</sup> The December 2007 Order thus concluded that requiring positive income on a partner's Form K-1, or the recognition of distributed income in the base year is inconsistent with the phrase "actual or potential income tax liability."<sup>481</sup> Income recognition is a matter of timing. The key issue in determining whether there is "potential income tax liability" is the relative certainty of whether, not when, ordinary income will be recognized upon the sale of the partner's interest.<sup>482</sup> Thus there is no need for taxable income in the base year and no requirement that the MLP establish a known time for income recognition under the potential income tax liability standard.

274. ExxonMobil/BP also argue that the partner may sell the partnership interest at a price that is less than the original basis, and that under such scenario, the deferred income will never be recaptured. There are two answers to this argument. As the materials submitted by a shipper party in an earlier SFPP proceeding, the Sepulveda Line case, and previously cited in this order, make clear, deferred ordinary income must be recognized at the time of sale.<sup>483</sup> The investor must always recognize the income that would be recaptured before recognizing any long term capital gains, although the recognition may only serve in some cases to reduce the loss involved. Second, the possibility that

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<sup>479</sup> See December 2007 Order, 121 FERC ¶ 61,240 at P 28, 34. There are two significant discussions of MLPs that were entered by a Shipper Party in the Sepulveda Line rate proceeding, Docket No. OR96-2-012. These are SEP ARCO-22, captioned "Wachovia Securities, *Master Limited Partnerships: A Primer*" (Primer) dated November 18, 2003, at 4-5; and SEP ARCO-21, Publically Traded Partnerships, *PTP FAQs* (FAQs) at 2. Both were also filed as Ex. BP-19 in Docket No. RP04-274-000. These exhibits, which will be included in the record here, are also discussed in the December 2007 Order, 121 FERC ¶ 61,240 at P 30 and n.68.

<sup>480</sup> Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 37 n.35 (emphasis added).

<sup>481</sup> December 2007 Order, 121 FERC ¶ 61,240 at P 27 (emphasis added).

<sup>482</sup> *Id.* at 27-29, 34. *City of Charlottesville* recognized that deferrals could be for as long as 15 years. See *City of Charlottesville*, 774 F.2d at 1215.

<sup>483</sup> *Primer* at 4-5. The numerical example, which is quoted in full at n.522, *supra*, contains positive long term capital gains, but applies equally well to a situation where the investor recognizes deferred ordinary income, but has a capital loss. See also FAQs at 2.

recapture may not occur appears to be within the scope of the risks analyzed in *City of Charlottesville*. In *City of Charlottesville*, the court recognized, and accepted, that there could be a sale of assets by a corporate parent before the tax deferrals were exhausted, and that such a sale would maximize the tax benefits to the selling party and avoid the potential recapture of the parent corporation's deferred income.<sup>484</sup> While the Commission is addressing partnership's here, the same principle applies to the partner's that have the obligation to pay the taxes on income generated by a partnership.

**b. The Delay of Income Recognition**

275. ExxonMobil/BP further assert that the 2009 ID erred by holding that a partner has an actual or potential income tax liability so long as the partner files an income tax return reflecting distributive income, either positive or negative. ExxonMobil/BP argue that cash distributions to limited partner unitholders, while not taxed at the time of distribution, increase the potential gain on a future sale by reducing the unitholders' basis in their units, thus creating a deferred income tax liability. ExxonMobil/BP argue that unlike current income, which is always likely to have some actual or potential tax liability, there is no guarantee that some or all of a partner's gain will be taxed, thus actual taxes may never be paid.

276. The issue is whether a substantial or indefinite delay in recognition of income or an actual tax payment is unreasonable. In the December 2007 Order, the Commission recognized that MLP partnership interests often are held for long periods of time precisely because distributions in excess of distributed income reduce the partner's capital account. The reduced capital account, combined with the allocation of distributive income away from the limited partners, defers ordinary income recognition.<sup>485</sup> The Commission thus has acknowledged that the partner has tax incentives to delay the sale of its partnership interest and defer tax liability on the deferred income.<sup>486</sup> In this instance the answer turns on the combined effect of the court's decisions in *ExxonMobil* and *City of Charlottesville*.

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<sup>484</sup> *City of Charlottesville*, 774 F.2d at 1216.

<sup>485</sup> December 2007 Order, 121 FERC ¶ 61,240 at 31.

<sup>486</sup> In *ExxonMobil* the court stated "that [while] the orders under review and the policy statement upon which they are based incorporate some of the troubling elements of the phantom tax we disallowed in *BP West Coast*, FERC has justified its new policy with sufficient reasoning to survive our review." *ExxonMobil*, 487 F.3d at 948. The Commission recognizes the possibility of an extended period before deferred income is recognized and taxes are paid may have been one of the elements that troubled the court.



277. *City of Charlottesville* affirmed the Commission's use of the stand-alone methodology for determining tax allowances, which method explicitly recognizes delays in the recognition and payment of deferred income tax liability, perhaps for as much as fifteen years.<sup>487</sup> The court recognized how tax deferrals contain the possibility that taxes many never be paid:

This speculation whether consumption of the tax losses represents a real economic detriment is reminiscent of the dispute, in the context of normalization, of whether taxes deferred by reason of accelerated depreciation will in fact *ever* be paid, or will as a practical matter be postponed forever. Just as the courts have left that call to the Commission, permitting it to conclude either way – first allowing normalization and later disallowing it because of indefinite postponement of tax liability – so also we think this matter is one for the Commission's judgment.<sup>488</sup>

Under the MLP ownership format it may also be uncertain when, or if, recognition of the deferred income will occur. However, the fact that recognition may be deferred at the level of the limited partner rather than the regulated entity does not change the fact that any deferred taxes on ordinary income are a real, if indirect, cost to the partnership of raising capital.<sup>489</sup> Thus, as income recognition will almost always occur when the partnership interest is sold,<sup>490</sup> the filing of an income tax return declaring negative or positive income from the partnership is sufficient to establish that there is either (1) an actual tax liability because the return reflects positive partnership income in the current year, or (2) a potential income tax liability that will be recognized when the partnership unit is sold and

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<sup>487</sup> *City of Charlottesville*, 774 F.2d at 1216. Of note, Dr. Horst, ExxonMobil/BP's expert witness, estimated that the average holding period for a KMEP limited partnership interest was 8 years, considerably less than the 15 year tax loss carry forward period noted in *City of Charlottesville*. See Ex. XOM-10.

<sup>488</sup> *City of Charlottesville*, 774 F.2d at 1216 (italicized emphasis in the original; underlining emphasis added; citations omitted). The analysis in *City of Charlottesville* involved income tax deferrals generated by accelerated depreciation or amortization in excess of the straight line depreciation method required under the Commission's rate making protocols. *Id.* at 1215-16.

<sup>489</sup> *ExxonMobil*, 487 F.3d at 950-52, 955.

<sup>490</sup> While there is some potential of infinite deferral, for example by charitable contribution or the step up in basis of an estate, this is no different than the avoidance of recognition that may occur for other types of depreciated assets under IRS regulation.

the deferrals are recognized.<sup>491</sup> Accordingly, the Commission concludes that the 2009 ID correctly applied Commission precedent on the issue of potential income tax liability.

## **2. The Possible Recovery of Taxes on Downstream Gains**

278. On exceptions, ExxonMobil/BP argue that the 2009 ID incorrectly assumes that all income from the sale of a partnership interest will be ordinary income. ExxonMobil/BP state that some income from the sale of a partner's units may be taxed as capital gains which tax should not be recovered in an income tax allowance.<sup>492</sup> They further assert that ordinary income may be offset by accumulated losses from the same partnership or from other such interests. Last, they assert that at the time of the sale of a partnership interest, the income being taxed is not income from the partnership, but rather is income from the purchase price paid by the new purchaser.<sup>493</sup> SFPP replies that its income tax allowance does not include any taxes that may be due on the sale of an investment by a partner.<sup>494</sup>

279. The Commission's rate making methodology does not allow recovery through a public utility's rates of capital gains that may occur from that sale of corporate assets, nor does it do so here. The Commission has long since recognized that there are different types of income that will be recognized on the sale of an MLP partnership interest.<sup>495</sup> As summarized in the *Wachovia Primer*,<sup>496</sup> to the extent the sale results in income in excess of partner's original basis, this income is taxed as a capital gain except for those items of depreciation and amortization that are recaptured as ordinary income. The Commission's income tax allowance is applied only to the equity return component of a pipeline's

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<sup>491</sup> The court noted that the sale of assets that generated a deferred income tax liability might be structured to benefit the parent company, the point at which the tax losses were accrued, rather than the ratepayers. The possibility of tax loss carry forwards sheltering income from recognition is explicitly discussed, noting that asset sales may occur to maximize the benefits to the regulated entity, not the ratepayers. Moreover, the fact that the tax losses might be carried forward as much as fifteen years was not objectionable. *City of Charlottesville*, 774 F.2d at 1215-16.

<sup>492</sup> ExxonMobil/BP Brief on Ex. at 27.

<sup>493</sup> *Id.* at 28.

<sup>494</sup> SFPP Brief op. Ex. at 13.

<sup>495</sup> See Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 37 n.35, which states that on sale of the interest any gain in excess of basis may have differing characteristics.

<sup>496</sup> Primer at 5; FAQs at 2.

regulatory costs; i.e., its net operating income calculated by applying the equity rate of return against the equity component of the pipeline's rate base. The dollar amount of that income is derived using the Commission's DCF model. Thus a pipeline's cost-of-service does not recover capital gains tax from the disposition of either the pipeline's assets or an MLP partnership interest.

280. If, at the time a partner's interest is sold, there is recognition of deferred income, this income reflects the recapture of deferred ordinary income. As discussed above, income deferral is caused by a reduction in basis (i.e. the partners' capital account) from distributions in excess of distributed ordinary income to the extent the reduction reflects prior depreciation of the partnership's depreciation or amortization accounts. A limited partnership's capital gain derived from depreciation that is not subject to recapture, or gain above the initial purchase price, is no different than the capital gain resulting from reduction in a corporation's basis due ordinary depreciation or the appreciation a corporation may recognize on the sale of the asset.

281. Further, ExxonMobil/BP's argument that ordinary incomes from the sale of a partnership interest comes from the purchaser and does not reflect the seller's deferred income is incorrect. Any capital gain income from the sale of the partnership interest in excess of its original basis, or in excess of basis as reduced by amortization of that interest under a section 743(b) election, is profit recognized upon sale to the purchasing party and may be taxed at capital gain rates.<sup>497</sup> Income recognition from the recapture of deferred income reflects ordinary income generated in prior years by the partnership that was not distributed to the partner in the year it was earned. Thus, if the sale triggers income recapture, the purchaser provides the cash for the sale and triggers the taxable event, but is not the "source" of the income recognized by the selling party.

282. Finally, it is true that ordinary income from the recapture of deferred income may be set off against accrued losses in ordinary income that are not subject to the recapture provisions. Like a corporation, it is quite possible for a partner to have some accrued ordinary losses that reflect accrued negative distributed income. Such accrued ordinary losses are similar to the tax loss carry forwards accrued by a corporation that might have otherwise had profitable book operations. Thus, in practice, there is no assurance that any pipeline will earn its cost-of-service in any given year and, as such, tax loss carry-forwards may occur even for a jurisdictional corporation. If such a corporation is sold, gains from its sale may be offset against such tax loss carry-forwards without recapture of the income tax allowance provided the corporation. This is consistent with the principle that there is no assurance that that recognition will immediately occur, or that the cash

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<sup>497</sup> There may also be a recapture at ordinary income rates of the amortization of the section 743 interest if that amortization method exceeded straight-line depreciation.

generated by the income tax allowance will be paid in actual taxes.<sup>498</sup> In this regard, the sale of an MLP partnership interest is no different from the sale of an interest in a corporation. The Commission agrees with the holding in the 2009 ID that the receipt of a K-1 that reports income or loss for income tax purposes sufficiently establishes a partner's actual or potential income tax liability.

### **3. The Role of Incentive Distributions**

283. The ACC Shippers assert the 2009 ID erroneously permitted incentive distributions to be used in determining SFPP's income tax allowance. They assert the inclusion of incentive distributions in the general partner's income violates the stand-alone doctrine. SFPP replies that including incentive distributions in the general partner's income reflects how the tax burden is distributed and is consistent with Commission precedent.

284. To answer this exception it is necessary to reprise some basic features of the MLP business model. MLPs make distributions based on available cash, which is normally defined as cash from operations less maintenance and capital expenditures,<sup>499</sup> plus residual cash from the sale of assets and external financing. Available cash includes the cash generated by depreciation and amortization, and in the case of a Commission regulated entity, the income tax allowance. Thus, a basic MLP model defines available cash as net cash from operations after all operating expenses and debt payments plus cash flow from depreciation and the income tax allowance.<sup>500</sup> Most incentive distribution

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<sup>498</sup> *City of Charlottesville*, 774 F.2d at 1215-16.

<sup>499</sup> These are capital expenditures necessary to maintain the asset at the same level of utility, but which may not be expensed under normal accounting rules. Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 11-12; Primer at 8.

<sup>500</sup> While MLPs usually distribute more of their available cash than corporations, this is not necessarily objectionable. See Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 11-13; Primer at 6. In *City of Charlottesville*, the appellant City argued that pipelines should not be permitted to use internally generated funds to finance non-jurisdictional activities. The court affirmed the Commission's contrary holding, noting:

The Commission disagreed because the use of the funds (consisting of profits, depreciation, and deferred taxes) did not in its view burden the ratepayers, i.e. did not affect their rates. "[W]hat the pipelines' shareholders do with this cash is largely their own business," the Commission said. "They may reinvest it in the pipelines or they may invest it in other business ventures." *Id.* Assuming that to be true (which petitioner has not contested) the Commission's conclusion represents a reasonable application of the benefits/burdens test.

(continued...)

provisions provide for the general partner to obtain an increasing proportion of available cash as the organization's cash flow grows. Incentive payments usually begin as a relatively low percentage of available cash, but can reach as much as 50 percent of distributions as the organization's available cash increases.<sup>501</sup> That growth can come from numerous sources including revenue from increased sales, more efficient operations, and additional capital investment, or acquisitions. However, as indicated by the MLP annual reports included in the record in this case, the increase in available cash is most likely a function of improved revenues and margins from ongoing operations.<sup>502</sup>

285. Of particular importance here, when the general partner receives an incentive distribution, the general partner is allocated partnership income in the same dollar amount as the incentive distribution. Put another way, a general partner receiving an incentive distribution is not allocated partnership income based on the general partner's nominal partnership interests. This, in turn, shifts income away from the limited partners as they will receive less income than would be allocated to them based on their nominal interests. If the allocation to the limited partners of items of expense and deductions is unchanged, this may be one factor that causes an income tax loss and deferred income recognition.

286. The ACC Shippers therefore assert that SFPP's income tax allowance is artificially inflated because SFPP allocates income to the general partner through incentive distributions. In support of this argument, the ACC Shippers first assert that the incentive distributions are based on KMEP's total cash flow from all its subsidiaries and affiliates -- not just SFPP. They claim this violates the stand-alone method for establishing a subsidiary's rates. The ACC Shippers further argue that the allocation of income to KMPG inflates the proportion of total income that is distributed to the corporate general partner KMPG, Inc., and unfairly burdens SFPP's ratepayers by substantially increasing the marginal rates used to determine the income tax allowance.<sup>503</sup> They thus conclude (1) that only SFPP's income may be used in allocating income to the partners, and (2) that the income tax allowance should be calculated as if partnership income were allocated among the partners on nominal partnership interests. SFPP asserts that the first conclusion is faulty because it does not include all of KMEP's income in the calculation as it excludes some of the partner's income from the calculation. SFPP asserts that the second conclusion has been rejected by the Commission.

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*City of Charlottesville*, 774 F.2d at 1218 (emphasis added; citations and footnotes omitted).

<sup>501</sup> See Primer at 7-8; MLPs II at 4, 14.

<sup>502</sup> See Primer at 6; MLPs II at 4-5.

<sup>503</sup> ACC Shippers Brief on Ex. at 56-61.

287. The first issue is whether the effect of incentive distributions vis-a-vis the Commission's income tax allowance policy violates the stand-alone method approved in *City of Charlottesville*.<sup>504</sup> The ACC Shippers' argument turns on the fact that with regard to corporations, the marginal rate is determined only on the jurisdictional entity's net income, which includes only the regulated entity's public utility income and deductions. In turn, the statutory tax rate is applied only to the corporation's net jurisdictional income.<sup>505</sup> Therefore, an essential element of the traditional stand-alone method is that only jurisdictional income and expenses are used in determining the operating income to which the income tax allowance applies. In past, this bright line approach was applied to partnerships at the partnership level based on an assumption that most pipeline partnerships were owned by corporations, which meant the 35 percent maximum statutory tax rate applied to the partnership's jurisdictional income.<sup>506</sup> The ACC Shippers' argument is that the stand-alone test is violated because SFPP's incentive distributions are based on cash flows, and thus includes a general partner's income from sources other than the regulated utility SFPP.

288. As discussed in *ExxonMobil*,<sup>507</sup> a partner's income tax liability may be attributed to the partnership for regulatory purposes and the statutory (marginal) tax rate is to be used under *City of Charlottesville*.<sup>508</sup> Under basic tax law, the marginal tax rate can only be determined once partner's income for all sources is included and the related deductions and exclusions applied.<sup>509</sup> Incentive distributions are derived from all sources of available cash, which are commingled at the KMEP level, as is the income that must be allocated among the partners based on the distribution of the available cash. Both

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<sup>504</sup> *City of Charlottesville*, 774 F.2d at 1207.

<sup>505</sup> *Id.*

<sup>506</sup> *Cf. Ocean State Power*, 38 FERC ¶ 61,140, at 61,379; *Kuparak Transp. Co.*, 45 FERC ¶ 63,006, at 65,083-84, *affirmed in part and modified in part*, 55 FERC ¶ 61,122 (1991) (*Kuparak*); Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 32.

<sup>507</sup> *ExxonMobil*, 487 F.3d at 952-53.

<sup>508</sup> *City of Charlottesville*, 744 F.2d at 1207.

<sup>509</sup> Moreover, the June 2005 Order stated that income taxes are paid by the partner on partnership income. It did not say that such taxes paid are only on the distributed partnership income or that only such income should be used to determine a partnership's income tax allowance. See June 2005 Remand Order, 111 FERC ¶ 61,334 at P 22-23. The Income Tax Policy Statement also contains no such limitations. See Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 32-33, 40. That all of a partnership's and the partners' income, items of deduction and expense must be included in adjusted gross income is a basic point of federal income tax law.

SFPP and KMEP are pass-through entities and KMEP prepares its individual partners' K-1s based on the level of KMEP's distributive income. For this reason, the historical stand-alone approach, which assumed that partnerships are equivalent to corporations for tax purposes, is no longer appropriate as MLPs have both corporate and non-corporate partners. This is the central point addressed in *BP West Coast* and which the Commission resolved through the Income Tax Policy Statement.<sup>510</sup> Under the Policy Statement, although the marginal tax rate may vary among partners, the marginal tax rate of the various partners is derived from their total income, and thus includes that income derived from the general partner's incentive distributions. Therefore, the marginal tax rate reflects the actual tax cost of raising capital for the partnership. Assuming, as here, that the income tax allowance is appropriate, the weighted marginal tax rate is still less than thirty five percent which is the rate that would apply if the corporate form was applicable to all of KMEP's distributed income.

289. Thus, the stand-alone method described in *City of Charlottesville* is not exactly reflected here because of the difference between first and second tier ownership that exists under the corporate business model does not apply to partnerships. Under the regulated corporate model there is always a clear distinction between a corporate subsidiary's net income and the parent corporation's income because the parent files a consolidated return with its own items of deduction that may serve to offset the regulated corporate subsidiary's net income and income tax liability. Conversely, the Commission develops the marginal tax rate for regulated utilities that are pass-through entities by determining all of the income and items of deduction at the partner level, which results in the inclusion of items of income and deduction that are not generated by the regulated entity. Further, it is a fundamental principle of income tax law that a partner must include income from whatever source derived (and all the related deductions) in preparing a return. At bottom, the fact that SFPP, and its parent partner KMEP, are pass-through entities requires modification of the stand-alone doctrine. Since KMEP is the source of the net income available for distribution to the partners, the ID correctly included all of KMEP's income in determining SFPP's income tax allowance.

290. The ACC Shippers also argue allocating partnership income based on incentive distributions distorts the weighted marginal cost calculation because partnership income is allocated to the general partner in a dollar amount equal to the cash distribution to the general partner. More specifically, they claim that allocating some 50 percent of the income to KMPG, Inc. means that some 50 percent of SFPP income flowed through KMEP's income will be attributed a 35 percent marginal tax rate compared to the 2.0202 percent that would bear that rate if nominal partnership interests are used to determine the

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<sup>510</sup> Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 32-33; *ExxonMobil*, 487 F.3d at 952, 955.

weighted marginal tax rate. They conclude distribution of income based on the nominal partnership interests more fairly reflects the interests of the ratepayers. They further argue that the Commission has improperly delegated its rate making responsibilities to private parties by accepting the incentive distribution agreement embedded in the KMEP limited partnership agreement.

291. *ExxonMobil* unequivocally affirmed the Commission's prior finding that the amount of the marginal tax rate is determined by the partner's taxable income, not that of the partnership.<sup>511</sup> This allocation of income is a function of the incentive distribution provision of the KMEP partnership agreements, which provide for a different allocation of distributions, and thus the allocation of partnership income based on the partnership agreement.<sup>512</sup> There is nothing illegal about such an agreement among an MLP's limited and general partners as a matter of IRS regulation or partnership law. As such, the agreements are controlling for the purpose of income allocation and reflect how the actual or potential income tax burden is allocated among KMEP's partners. A different protocol would not reflect that the actual or potential income tax cost is incurred by those who buy the partnership interests or contribute assets to the partnership and the conditions under which they did so. Moreover, as previously discussed, if the partnership income tax allowance itself is valid, then the weighted marginal rate will be lower due to the lower rate attributed to the partnership interests that are not owned by corporations. Thus, the Commission upholds the inclusion of incentive distributions in determining the allocation of distributive income and in calculating SFPP's income tax allowance.

#### **4. Marginal Rate for Mutual Funds and UBTI**

292. The ACC Shippers assert that the 2009 ID did not adopt the proper marginal tax rates for mutual funds or the unrelated business taxable income (UBTI). The ACC Shippers further argue that the 2009 ID erroneously attributed a 28 percent marginal tax rate to distributions received by mutual fund unit holders since most mutual funds distribute more than 90 percent of income to their shareholders and therefore pay no taxes. The ACC Shippers conclude that because mutual funds are pass-through entities

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<sup>511</sup> *ExxonMobil*, 487 F.3d at 951-55.

<sup>512</sup> See Primer at 6-7; Comments of BP West Coast Products LLC and ExxonMobil Corporation dated January 25, 2005 in Docket No. PL05-5-000 (*Inquiry Regarding Income Tax Allowances*), Ex. A thereto, Wachovia Securities – MLPs – *Recognizing the Value of the General Partner* (MLPs II) at 2-10 (providing a description of incentive distribution mechanics and the relative risks of the limited and general partners). The cited materials have been added to the record based on the previous use by all the parties in earlier SFPP rate proceedings involving income tax allowance issues.



that rarely pay income taxes, the correct marginal rate is the marginal tax rate that the mutual funds' shareholders pay on the dividends they receive. Thus, the ACC Shippers assert the correct marginal tax rate for SFPP's mutual fund unit holders is 15 percent. In support of the 15 percent rate, the ACC Shippers state that by 2004 there was a distinction between dividends that qualify for a 15 percent rate rather than the higher rate previously in effect for the 1999 base year addressed by the December 2007 Order.

293. SFPP replies that the distributions KMEP makes as a MLP do not lose their character simply because the unit holder, a mutual fund, passes the distributions through to its shareholders, citing 26 U.S.C. § 854(b)(1)(C)(ii) (2009). Thus, the distributions reduce the basis of the mutual fund, or its shareholder, and are not necessarily qualifying dividends with the lower 15 percent marginal tax rate. The Commission first notes that to the extent KMEP does not have access to the ownership categories of a mutual fund's shareholders,<sup>513</sup> SFPP shall treat all distributive income to mutual funds as if the beneficiaries were individuals. SFPP must also determine for each year at issue whether its distributions to mutual funds would be treated as qualifying or ordinary dividends, if at all, when the mutual fund distributes KMEP's distributions to the mutual fund shareholders. SFPP should then apply the proper marginal rate to those distributions. If the distributions are not treated as qualified dividends, the proper marginal tax rate for calculating SFPP's income tax allowance is 28 percent.

294. The ACC Shippers also assert that SFPP improperly imputed a 35 percent marginal tax rate to UBTI that might be incurred by a mutual fund or other pass-through entity with restrictions on the type of income it can distribute. In support of their argument, the ACC Shippers assert that the 35 percent rate only applies if the UBTI is more than \$1000 for such pass-through entities. The ACC Shippers state that there is no indication on the 1994 or 1999 K-1s issued by SFPP that any recipient had more than \$1000 in UBTI. In response, SFPP states that the ACC Shippers misstate the law with respect to UBTI. SFPP notes that an exempt organization must report all its UBTI on a single tax form and it is the *cumulative* amount of reported UBTI that must meet the \$1,000 threshold.<sup>514</sup>

295. The issue is whether the UBTI threshold applies to the amount reported on individual K-1s or to the *total* UBTI of the recipient mutual fund that must be reported on

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<sup>513</sup> This data may be available from the mutual fund's reports on the character of its shareholders.

<sup>514</sup> SFPP Brief op. Ex. at 32.

a different form, Form 990-T.<sup>515</sup> The correct answer is the latter. However, to justify applying a 35 percent marginal tax rate to the UBTI, SFPP must establish that a unit holder that received UBTI from KMEP was subject to the 35 percent rate because the Form 990-T reported more than \$1,000. If SFPP cannot provide this supporting documentation then the prudent result is to apply a 28 percent marginal tax rate to any unit holder with UBTI because any UBTI income would be included in ordinary income without a tax penalty at that rate and would fall within the presumptions governing non-corporate ordinary income. SFPP must adjust its cost-of-service accordingly.

### **5. The Role of Presumptions**

296. Last, the ACC Shippers argue that the 2009 ID erred by not addressing their rebuttal of the 28 percent presumption used to establish the marginal tax rate for individuals. The ACC Shippers argue that their testimony establishes that there is a double recovery of the income tax allowance through the equity rate of return generated by the Commission's DCF model. Therefore, they conclude that the marginal tax rate for individual unit holders should be zero when calculating a partnership's income tax allowance. The Commission has previously reviewed and rejected this argument. The ACC Shippers' "rebuttal" of the 28 percent tax rate has nothing to do with the underlying rationale for the 28 percent presumption. The ACC Shippers would advance the same argument if the marginal tax rate presumption were 10 percent, 20 percent, or 35 percent. Moreover, they say nothing about the statistical foundation for the 28 percent presumption, and in fact accept it. Accordingly, the Commission finds that the ACC Shippers' argument that the 28 percent presumption has been rebutted is without logical or analytical foundation. Rather, the underlying issue raised by the ACC Shippers' "rebuttal" argument is whether an MLP unit holder may lawfully have a higher after-tax dollar income and cash return than a corporate shareholder of a pipeline firm of the same risk. The Commission previously concluded that Congress contemplated this in creating the MLP business format. The 2009 ID is affirmed on this issue.

### **C. Proposed Adjustments to SFPP's Equity Rate of Return**

297. This part of the order discusses the ACC Shippers' three proposed adjustments to SFPP's equity rate of return to compensate ratepayers for the benefits that may flow to SFPP individual unit holders as a result of the income tax allowance. First, the ACC Shippers propose adjusting SFPP's return on equity to eliminate the alleged over-recovery of the income tax allowance. Second, the ACC Shippers propose an adjustment to compensate for the time value of income tax deferrals that may flow to KMEP's

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<sup>515</sup> The Commission notes that the amount of KMEP income at issue is less than 1 percent, and as such, a proportionate amount of the tax allowance is at issue here.

limited partners from any delayed income recognition. Third, the ACC Shippers propose adjusting SFPP's equity rate of return to reflect the amortization that may be taken under section 743(b) of the Internal Revenue Code that KMEP's limited partners are required to take under the governing partnership documents.

### **1. Adjustment of the Return for any Alleged Income Tax Over-Recovery**

298. ExxonMobil/BP urge the Commission to reduce SFPP's equity rate of return so that the after-tax return to an MLP unit holder is no greater than the after-tax return to a corporate shareholder.<sup>516</sup> ExxonMobil/BP assert that Dr. Horst's testimony supports decreasing SFPP's return on equity to mitigate the alleged double recovery of income taxes. Dr. Horst developed a gas corporate pipeline sample and a gas MLP pipeline sample and compared their returns on equity. After adjusting for what he concluded was the relative risk of the two samples, Dr. Horst calculated that the average return on equity of the MLP sample was 3.41 percent (341 basis points) higher than the return of the corporate sample. Assuming that the two samples were properly adjusted for risk, Dr. Horst concludes that the difference in the two samples' percentage return on equity is due to the ownership format, and that the controlling factor was that the MLP partnership was given an income tax allowance "as if it were a corporation."<sup>517</sup>

299. SFPP argues that there are fatal errors in Dr. Horst's analysis. SFPP asserts that Dr. Horst's analysis ignores the basic premise of corporate finance that securities of companies of like risk will yield the same percentage equity returns under a DCF analysis that solves for the stock price -- a point SFPP states Dr. Horst conceded.<sup>518</sup> SFPP further attacks Dr. Horst's risk analysis as seriously flawed for two reasons. First, the analysis did not allow for stock volatility and other factors that would cause the returns to fluctuate within his proposed statistical range. Second, SFPP asserts that both the gas pipeline and the MLP sample included entities that do not fall within the acceptable risk profile for a properly structured Commission proxy group sample. SFPP asserts this error involves companies of unusual risk or anomalously low returns or stock prices indicating that the firms are unrepresentative (such as El Paso Natural Gas), or including firms having significantly different business profiles (such as extensive local gas distribution operations) from the more pipeline-oriented firms included in the sample. SFPP argues these errors undercut the 3.41 percent differential found by Dr. Horst.

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<sup>516</sup> ExxonMobil/BP Brief on Ex. at 12-14.

<sup>517</sup> ExxonMobil/BP Brief on Ex. at 14 (quoting Ex. XOM-12 at 5:12-19).

<sup>518</sup> SFPP Brief op. Ex. at 17 (citing Ex. SFP-322 at 119-20, 143).

300. SFPP also asserts that Dr. Horst used the wrong marginal tax rate to determine the after-tax return of a corporate shareholder he used to compare the MLP unit holder's and corporate shareholder's after-tax returns. SFPP's witness Dr. Schink modified Dr. Horst's analysis to suggest that even under the latter's assumptions of an average 10 percent marginal tax rate on dividends, all things being equal, the relative after tax price of the corporate share would be \$90 and of the MLP unit \$100. However, what is of greater importance here is that Dr. Horst testified, and ExxonMobil/BP argue on exceptions, that the most efficient way to equalize the after-tax return on equity of MLP unit holders and corporate shareholders is to remove the double recovery of the income tax cost they assert is embedded in the equity return of the MLP unit holders. ExxonMobil/BP would resolve the difference in the cash and dollar income returns (and thereby equalize the MLP unit and corporate share prices) by eliminating the income tax allowance for partnerships.<sup>519</sup> SFPP asserts that Dr. Horst would agree that if the percentage returns on equity equalize, this is a function of market forces and not the cash flow that is generated by an income tax allowance.<sup>520</sup>

301. The Commission previously addressed the purported double recovery of the taxes through the equity return, which essentially resolves ExxonMobil/BP's issue. However, the Commission will analyze the further nuances of ExxonMobil/BP's argument. While the Commission agrees that granting an income tax allowance results in the MLP unit having a higher price than a corporate share of the same risk, the Commission has concluded that there is no double recovery of the income tax cost by providing an income tax allowance to the MLP unit holders. Rather, eliminating the corporate double-taxation burden by organizing as an MLP means that more additional after-tax cash flow (and income if it is recognized) flows to the MLP unit holder. As discussed *supra*, that results in an increase in the relative price of the MLP units compared to corporate shares because the equity returns equalize due to competitive market forces. While this is a function of the tax benefits Congress gave MLPs, it is also wholly consistent with the emphasis that the Income Tax Policy Statement and *ExxonMobil* place on the comparing the after-tax returns of a partnership (and its partners) to a corporation's when both are assumed to be paying first-tier income taxes.<sup>521</sup> Since the Commission resolves the issue of whether an income tax allowance is appropriate based on policy considerations, the Commission

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<sup>519</sup> This point was discussed in the earlier analysis the relationship between the income tax allowance and the DCF model, as exemplified by Ex. SFP-98 and Ex. SFP-99, which are reproduced in Appendices B and C.

<sup>520</sup> SFPP Brief op. Ex. at 21.

<sup>521</sup> See *ExxonMobil*, 487 F.3d at 953-54; Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 22-23, 36-38.

need not address SFPP's criticisms of Dr. Horst's methodology. Thus the Commission will not adjust the MLP equity returns as advanced by ExxonMobil/BP and Dr. Horst.

## **2. Whether to Adjust for the Benefits on Deferred Income Recognition**

302. The ACC Shippers also seek to adjust SFPP's return on equity to reflect the tax deferral aspects of the MLP business model. By way of background, the Commission notes that no one disagrees that the MLP business model results in the deferral of income tax recognition which potentially benefits the MLP unit holder.<sup>522</sup> The example in footnote 521 explains the income tax consequences of the sale of a MLP equity unit after a three year holding period, which results in the recognition of capital gains of \$2.05, and the recapture in the year of sale of \$4.00 in ordinary income. The conventional approach of evaluating those savings is to discount the principal amount of the tax deferral savings through a present value calculation that reflects the taxpayer's required rate of return. Thus, this value is reflected in the price the investor will pay for the MLP equity unit. In other words, the investor bids up the price of the unit to reflect the present value of the additional after-tax cash flow resulting from the ability to reinvest the deferred payment of the taxes. As with the income tax allowance, if the only difference is the ownership format, the after-tax returns generated by the MLP unit interest and the corporation's shareholder interest will equalize. However, the price of the MLP unit will be higher as a result.

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<sup>522</sup> The mechanics of these deferrals were clearly explained as early as February 28, 2005 in a shipper party exhibit introduced in the Sepulveda Line proceeding, Docket No. OR96-2-012. Primer at 1, 4-5. The latter two pages have a clear example of when and how there is deferred income recognition:

Therefore, when the investor sells the security for \$22.05 per unit at the end of year 3, he/she would realize a total gain of approximately \$8.00 per unit in addition to having received \$4.41 per unit in cash distributions over the three year period. This includes a capital gain of \$2.05 (the difference between the selling price of \$22.05 and the purchase price of \$20.00 per unit) and ordinary income of about \$4.00 per unit (the difference between the purchase price of \$20.00 per unit and the adjusted cost basis of \$16.03 per unit) which is the recapture of depreciation and amortization deductions. (emphasis added).

The description here is exactly what the Commission described would occur in the Income Tax Policy Statement. See Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 37 n.35.

303. At bottom, the ACC Shippers assert that the benefits of the deferral should accrue to the ratepayer by adjusting SFPP's rate of return to reflect the present value of the deferrals. They cite the Commission's 2006 Sepulveda Order for the proposition that this adjustment should be made for the benefit of the ratepayers.<sup>523</sup> The ACC Shippers further assert that the Commission's December 2007 Order improperly reached the opposite conclusion and held that the present value benefit of the deferrals should accrue to the pipeline.<sup>524</sup> They again argue that *BP West Coast* held that the Commission cannot invent a tax cost savings to encourage investment where no tax cost actually exists.<sup>525</sup> On the mechanics, the ACC Shippers would adjust SFPP's return by determining the estimated average holding period of SFPP's limited partnership common interests. Under ExxonMobil's analysis the average holding period was 8 years.<sup>526</sup>

304. As the Commission understands it, the present value of those deferrals would be determined by calculating the total amount of deferrals during an average holding period, determining the tax savings at the marginal tax rate used under the Commission's income tax allowance methodology, and then discounting the value of the deferrals by the amount of SFPP's equity rate of return. This results in a present dollar amount of the savings in the base year. It is not clear from the testimony what would happen at this point, but it appears that the dollar savings are deducted from allowed equity dollar return in the base year. This in turn reduces the percentage return on the equity rate base and a leads to a lower dollar equity cost embedded in the pipeline's cost-of-service.<sup>527</sup> Alternatively, the discounted tax savings could be deducted from the income tax allowance, thus reducing that component of the pipeline's cost-of-service and the after-tax cash flow generated by the allowance. This alternative approach would have the added affect of adjusting the percentage after-tax return on equity since less after-tax

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<sup>523</sup> 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 39-40, 45-48.

<sup>524</sup> December 2007 Order, 121 FERC ¶ 61,240 at P 29, 32-33.

<sup>525</sup> *BP West Coast*, 374 F.3d at 1292-93.

<sup>526</sup> See Prepared Answering Testimony of Thomas Horst on Behalf of ExxonMobil Oil Corporate dated January 26, 2009, Ex. XOM-1 at 35-36 and Ex. EOX-10. BP West Coast's witness calculated that the average holding period was longer, some 13.8 years. See 2009 ID, 129 FERC ¶ 63,020 at P 175.

<sup>527</sup> Thus, if the equity rate base is \$100 and the allowed percentage return is 8 percent, the allowed dollar return is \$8. If the present value of the deferred tax benefits is \$1, then the allowed dollar return becomes \$7, or an equity return of 7 percent. In the initial year the dollar return and the percentage return are the same, but in theory as the equity rate base changes, the percentage equity return could remain at 7 percent, but the dollar return reflected in, or returned by, the cost-of-service would change accordingly.

income and cash flow would be measured against the equity rate base embedded in the base year cost-of-service. SFPP answers that the Commission correctly determined in the December 2007 Order that any tax savings should accrue to the pipeline<sup>528</sup>

305. The Commission again notes that the income and tax payment deferrals generated at the partnership level through the allocation of losses among the partners are purposefully distinct from the tax advantages generated by accelerated depreciation at the level of an operating partnership.<sup>529</sup> Thus, normalization at the partner level would undercut the deliberate distinction Congress created between corporate and MLP pipeline ownership formats by increasing the cash and income after-tax return for the limited partners. This effect results from normalizing an MLP's tax advantages, which reduces the cash available for distributions, and thereby the dollar return on an MLP's equity rate base. This in turn would reduce the price advantage for an MLP's equity units that Congress created when it authorized tax advantages for the MLP pipeline ownership format. As such, the ACC Shippers' argument that the equity return must be adjusted to reflect the tax deferrals is essentially subsumed under the prior analysis of (1) whether there is a double recovery of the income tax allowance, and (2) whether there must be some clearly identifiable time frame in which any deferred income taxes must be actually recognized.

306. On the first point, the Commission previously concluded that the legislative history reflects Congressional intent that any benefits from the elimination of corporate double-taxation accrue to the MLP pipeline as an investment incentive. On the second point, the Commission concluded that the possible indefinite postponement of income recognition was within the general bounds of *City of Charlottesville v. FERC*. However, this scenario is unlikely given the average holding periods advanced by the ACC Shippers. Pursuing the same analysis here, the Commission concludes that the tax savings that occur from tax deferral are also investment incentives embedded in the MLP model. This means that the present value of any tax benefits would be reflected in relative price of the MLP equity units as compared to the price of corporate shares issued with the same after-tax dollar value at the operating level of a jurisdictional utility.

307. The 2006 Sepulveda Order erred by not recognizing Congress' purpose in permitting energy partnerships to have an income tax allowance. The 2006 Sepulveda Order acknowledged that an MLP's higher unit price permits the pipeline to raise the same amount of capital as a pipeline organized as a corporation while issuing fewer

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<sup>528</sup> SFPP Brief op. Ex. at 7.

<sup>529</sup> See *City of Charlottesville*, 774 F.2d at 1205-06, 1215-16.

shares.<sup>530</sup> However, the 2006 Sepulveda Order incorrectly held for the ratepayers finding that the higher stock price comes at ratepayers' expense.<sup>531</sup> Subsequently, in the December 2007 Order, the Commission reached the correct conclusion on this issue. However, because the issue was not discussed in detail in that Order a fuller analysis was called for here. At bottom, neither order fully addressed the fundamental point that an investor will equalize the after-tax returns. As a result, the benefits of any income tax deferrals that may flow to the MLP's limited partners are incorporated in the price of the MLP's equity units, which lowers the equity cost of capital used for investments.<sup>532</sup> The analysis in this order corrects these oversights and affirms the December 2007 Order.<sup>533</sup>

308. Finally, the ACC Shippers again argue that the earlier December 2007 Order creates a tax benefit or cost where none exists in the regulatory structure established by the ICA.<sup>534</sup> They assert that this violates the holding in *BP West Coast* that the Commission cannot create a tax liability where none otherwise exists simply to create an investment incentive.<sup>535</sup> The ACC Shippers' argument misconstrues the current situation. As was previously discussed, the Commission is not creating a "phantom" tax liability. As is explicitly stated in *ExxonMobil*, "the income taxes for which SFPP will receive an income tax allowance are real, albeit indirect."<sup>536</sup> Thus, the issue is not whether SFPP incurs an actual tax liability. Rather, the issue is whether benefits from the deferral of the income tax cost should be allocated to the partners or the ratepayers. The Commission again concludes the Commission's policy decisions should support Congress' intent to encourage pipeline investment. Thus there should be no normalization of tax benefits that accrue to a limited partner under a MLP partnership agreement. The 2009 ID is affirmed on this issue.

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<sup>530</sup> 2006 Sepulveda Order, 117 FERC ¶ 61,285 at P 45.

<sup>531</sup> *Id.* P 45-46.

<sup>532</sup> Again, the Income Tax Policy Statement did so, although it incorrectly used the phrase pre-tax rather than after-tax return. *See* Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 4 n.6. Thus the issue was raised to the court when it decided *ExxonMobil*.

<sup>533</sup> December 2007 Order, 121 FERC ¶ 61,240 at P 29, 32-33.

<sup>534</sup> Shippers also raised this argument in the CCV Group January Request for Rehearing and Clarification at 16-17; Navajo January 2008 Request for Rehearing at 13.

<sup>535</sup> *Citing BP West Coast*, 374 F.3d at 1292 n.9.

<sup>536</sup> *ExxonMobil*, 487 F.3d at 954.



### 3. The Role of Section 743(b) Depreciation

309. On exceptions ExxonMobil/BP assert that the 2009 ID erred by not adjusting SFPP's equity rate of return for the amortization that may be taken on a partnership interest under section 743(b) of the Internal Revenue Code.<sup>537</sup> They assert that this form of amortization by a partner is similar to amortization in excess of straight line depreciation, and therefore SFPP's equity rate of return should be adjusted through a mechanism similar to the Commission's accumulated deferred income tax methodology (ADIT). They argue that there is no merit to SFPP's argument at hearing that section 743(b) depreciation is not related to SFPP's operations and therefore cannot be attributed to SFPP without violating the stand-alone doctrine. ExxonMobil/BP further assert that SFPP itself states that the additional depreciation is determined by the difference between the purchase price on a limited partner interest and the *pro rata* book value of SFPP's rate base.<sup>538</sup> SFPP replies that it admitted no such thing, that ExxonMobil/BP has distorted the record, and that the section 743(b) depreciation component is not related to the amortization of SFPP's rate base.<sup>539</sup>

310. Section 743(b) of the Internal Revenue Code provides that a partner of any partnership (not just an MLP) may elect to amortize the portion of a partnership interest for which the price paid was greater than the per unit book basis of that partnership interest, i.e., when the unit is purchased at a premium.<sup>540</sup> This essentially "writes up" the partner's basis and creates an asset that may be amortized in addition to the depreciation of the assets that are amortized on the partnership's books when the interest is purchased. Since partnerships are pass-through entities, the partnership items of depreciation are allocated to and separately stated for each partner as part of the items of partnership income and deduction that are reported on their K-1s. With regard to the section 743(b) depreciation item, KMEP (SFPP's owner MLP) requires its unit holders to take this

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<sup>537</sup> 26 C.F.R. § 743(b) (2010) (section 743(b) provides for an optional basis adjustment that typically affects incoming partners).

<sup>538</sup> ExxonMobil/BP Brief on Ex. at 33-34.

<sup>539</sup> SFPP Brief op. Ex. at 26-27.

<sup>540</sup> The book value of the depreciable assets per unit is gross investment less accrued depreciation and amortization (i.e. net assets) divided by the units outstanding at the time of purchase. The nature of the firm's capital structure is not relevant to the calculation as depreciation is allocated to the partners as an annual expense from operations. This is different from the equity each unit has in a venture which is a function of net assets, less debt and other more senior claims, divided by the number of units outstanding.

election, which thereby generates an additional depreciation component. The resulting dollar value is unique to each unit holder because it reflects the price paid by each limited partner on the date of the purchase of the KMEP interest and reflects the difference between the purchase price (the partner's basis) and the partner's depreciation basis in all the assets owned directly or indirectly by KMEP. Thus this differential is not a function of the depreciation factors derived from SFPP's rate base and embedded in its rates.

311. ExxonMobil/BP appear to agree that the additional depreciation afforded a limited partner under section 743(b) may be the cause of much of the tax loss leading to deferred income recognition. Thus, the assertion that there should be adjustment to SFPP's return to reflect the section 743(b) depreciation is unrelated to SFPP's rate base, and does not give rise to an ADIT issue since the dollar depreciation rate is unique to each KMEP unit holder.<sup>541</sup> Aside from the sheer technical impossibility of tracing such an ADIT type calculation back to SFPP's rate base, ExxonMobil/BP's analysis has no legal foundation and would violate the stand-alone doctrine as it would attribute the unit holder's amortization to SFPP as an operating expense. If an adjustment were required, it would be an adjustment to the unit holder's return on equity to reflect the present value of the tax savings from the limited partner's deferral of income recognition through the partner's ownership of its KMEP units. The Commission rejected any such adjustments earlier in this order.

#### **D. Is the Income Tax Allowance Properly Calculated?**

312. This section addresses the ACC Shippers' and ExxonMobil/BP's various arguments regarding whether the proposed income allowance was properly calculated. One such argument is that SFPP's income tax allowance must be adjusted to account for the alleged double recovery of the income tax cost in the equity rate of return and for the deferral of the income recognition.<sup>542</sup> The Commission previously rejected these assertions earlier in this order and therefore the 2009 ID is affirmed in this regard. ExxonMobil/BP also assert the portion of the income tax allowance that reflects state taxes should be adjusted to reflect an alleged overstatement of weighted state tax rates.<sup>543</sup> Specifically, ExxonMobil/BP argue that the weighted state income tax rates for KMEP's

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<sup>541</sup> The Commission assumes that the depreciation rate is controlled by IRS regulation and is constant for all the partners to which it applies. However, the dollar amount would depend on the spread between per unit book value and purchase price of the individual units. Even if the rate varies, this would not change the result here.

<sup>542</sup> ExxonMobil/BP Brief on Ex. at 29-32.

<sup>543</sup> ExxonMobil/BP Brief on Ex. at 37.

unit holders should be reduced to eliminate any source-state taxation; i.e., the income tax allowance should only reflect state income tax from the unit holder's state of residence.

313. ExxonMobil/BP's argument is inconsistent with actual tax practice. A standard K-1 includes disclosure of the portion of ordinary income attributable to the each state, when required, not just tax from the resident state.<sup>544</sup> The income is typically declared with an offset against the state of residence as the Commission discussed in the December 2007 Order.<sup>545</sup> The exception is denied.

#### **E. Accumulated Deferred Income Taxes**

314. The ACC Shippers and ExxonMobil/BP challenge the determination in the 2009 ID that SFPP properly calculated the accumulated deferred income taxes (ADIT). They assert that SFPP used an overstated marginal tax rate resulting in an artificially high ADIT.<sup>546</sup> Specifically, ExxonMobil/BP argue that the ADIT adjustment is too high because the blended federal and state tax rate is too high as a result of (1) use of source-state taxation and (2) the retention of the time value of the tax deferral.<sup>547</sup> Both of these arguments have been addressed and rejected above. ExxonMobil/BP also assert that SFPP erred by not including the state income tax component of its cost-of-service in its ADIT calculation.

315. The ACC Shippers assert that SFPP's time frame for applying the ADIT adjustment is incorrect. At bottom, they assert that SFPP incorrectly applies the lower marginal tax rate of an MLP beginning in 1992. They assert that between 1992 and 1996, SFPP collected ADIT using the top marginal corporate income tax rate (35 percent) in its existing West Line rates at the statutory 35 percent rate and that the going-forward ADIT calculation here should reflect this fact. ACC Shippers conclude that the correct date for applying the lower tax rate is the base and test year used to define the rates at issue here, i.e., the adjusted 2007 base year. They argue their position is consistent with the Commission practice of applying its current policy and rulings at the time the decision is made.<sup>548</sup> SFPP replies that the Commission held in the Opinion No. 435 Orders that

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<sup>544</sup> See Ex. BPW-9 at 3 of 4; Ex. BPW-12 at 4 of 6.

<sup>545</sup> December 2007 Order, 121 FERC ¶ 61,240 at 61.

<sup>546</sup> See ACC Shippers Brief on Ex. at 61-64; ExxonMobil/BP Brief on Ex. at 37.

<sup>547</sup> ExxonMobil/BP Brief on Ex. at 37.

<sup>548</sup> ACC Shippers Brief on Ex. at 63 (arguing against "SFPP's retroactive application of the Income Tax Policy Statement in the development of ADIT balances").

SFPP became a partnership in 1992,<sup>549</sup> and therefore the current partnership rate should be applied beginning with that year. SFPP asserts that there is no such thing as a fund that reflects the over- or under-recovery of ADIT and that only issue is the proper calculation of the necessary adjustment to the rate base for the years at issue.

316. These arguments require a brief summary of the how the ADIT adjustment works.<sup>550</sup> The Commission's cost-of-service methodology assumes the straight-line depreciation of the pipeline's assets. Thus the depreciation rate is a constant rate embedded in the pipeline's cost-of-service reflecting a composite rate based on the useful life of all the assets. This depreciation rate is a non-cash expense that reduces the taxable income of the pipeline, and hence its income tax allowance. However, in practice, most pipelines depreciate their assets more rapidly (i.e., accelerated depreciation) than would be the case under straight-line depreciation. In such a case, the pipeline has less taxable income than would be the case if it were using straight-line depreciation. Accordingly, the income tax allowance will generate more cash in such a year than the taxes that are actually paid. This effectively increases the pipeline's after-tax return. To mitigate this result, the Commission requires the pipeline to determine the amount of unpaid income taxes that accrues and then to adjust the pipeline's rate base so eliminate the additional return that the pipeline can earn on the deferred payments. This is done by reducing the equity component of the pipeline's rate base by the amount of the accumulated deferred income taxes. Because the equity portion of the rate base is reduced, there is less cash flow from the allowed equity rate of return, which offsets the additional cash flow generated if the tax allowance is in excess of the actual taxes paid.

317. Over time, as the pipeline's accelerated depreciation declines, the pipeline generates more taxable income than is included in its cost-of-service and begins to pay more taxes than the income tax allowance covers. As this occurs, the rate base adjustment declines and the return on equity increases over the remaining useful life of the assets involved. This is called the "turn around" of the ADIT account. If the pipeline's equity rate of return or marginal tax rate changes in a subsequent rate case, the original schedule for calculating the "turn around" may become inaccurate. To correct any inaccuracies, the Commission requires the pipeline to adjust the ADIT schedule to correct for the over- or under-recovery of the ADIT adjustment. This adjustment is the issue raised here.

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<sup>549</sup> SFPP Brief op. Ex. at 33-35.

<sup>550</sup> For a fuller analysis of ADIT, *see* Opinion No. 486, 117 FERC ¶ 61,077 at P 224-233; Opinion No. 486-A, 123 FERC ¶ 61,056 at P 269-276.

318. SFPP is technically correct that there is no “overfunding” at issue here. Rather, the issue is the amount of the ADIT adjustment going forward for the rates established in this case and the impact of the ADIT on the adjusted rate base. On a going forward basis, the ADIT adjustment is properly based on the marginal tax rate established here. SFPP’s rate base should be adjusted to reflect the difference between the taxable income to which that rate would apply under straight-line depreciation and the taxable income earning under other types of depreciation rates. The ACC Shippers’ dispute is with the rate to be applied for the period beginning 1992 through 1996.<sup>551</sup> The ACC Shippers advocate using the maximum “corporate” statutory rate. Applying a higher marginal rate for the period 1992 through 1996 would further reduce the rate base for that time frame resulting in a lower rate base going forward than would otherwise be the case. Applying a lower marginal tax rate means a higher rate base going forward and a higher cash equity return. This is a function of how accrued depreciation works in the context of the ADIT adjustment.

319. The ACC Shippers argue that if SFPP designs its going-forward rates using the partnership marginal tax rate beginning in 1992, its rates will be higher than if the higher marginal tax rate is applied to period beginning 1992. They therefore conclude that the Opinion No. 435 Orders, including the December 2007 Order, incorrectly endorsed using a “retroactive approach” to ADIT<sup>552</sup> and further, the December 2007 Order’s holding was of limited precedential value because it involved a small number of shippers in a reparation case. SFPP asserts that the Commission correctly rejected ACC’s retroactivity argument in the December 2007 Order because the policy in place at the time Opinion No. 435 was decided was overturned by *BP West Coast*.<sup>553</sup>

320. The Commission first concludes that the Opinion No. 435 Orders erred in applying the partnership marginal tax rate to a reparations year in which the marginal tax rate was actually the 35 percent corporate rate. In the proceeding underlying the Opinion No. 435 Orders, the base and test year at issue was 1994 and SFPP’s rates were established based on the cost of service in that year. Those rates were properly applied

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<sup>551</sup> The period before 1992 is not at issue because all parties agree that prior to 1992 SFPP paid the maximum statutory rate and that this was the proper rate for the ADIT calculations.

<sup>552</sup> The ACC Shippers’ reference to “retroactive approach” refers to SFPP’s retroactive application of the 2005 Income Tax Policy Statement in the development of ADIT balances. The application of the Income Tax Policy Statement resulted in SFPP using the partnership tax rate in lieu of the higher corporate tax rate in the ADIT calculations.

<sup>553</sup> SFPP Brief op. Ex. at 34.

retrospectively to 1992 under the reparation provisions of the ICA. However, it was incorrect to apply to the 1992 year a retroactive application of only one of the cost of service elements embedded in the 1994 cost-of-service. The ACC Shippers are correct that the ADIT adjustment is modified under a special convention<sup>554</sup> to assure that the ADIT account going forward accurately reflects the amount of the future “turn around” to be achieved. Since the rate of the “turn around” is based on the cost of equity capital and the marginal tax rate, the adjustment must reflect the amount of the ADIT adjustment that has occurred to date. Therefore, in calculating the rate base to be used to design the new rates at issue here, the rate base must reflect how the ADIT account actually functioned in the prior years. Thus, the ACC Shippers are correct that SFPP must use the actual marginal tax rate in effect from 1992 to the current test year in designing the rates at issue here. The Commission will not revisit the Opinion No. 435 Orders because the ADIT portion of those orders is final. However, with respect to ADIT, the Opinion No. 435 Orders should not be followed in the future.

321. Finally, ExxonMobil/BP is correct that the state income tax component of SFPP’s cost-of-service is to be included in its ADIT calculation. This simply reflects the full amount of the marginal tax rate involved in making the ADIT adjustment and reflects the Commission’s practice in all rate making proceedings regardless of the ownership format.

## **VII. Substantial Under-recovery**

322. This section addresses whether SFPP has established that it was substantially under-recovering its West Coast line rates at the time it made its June 30, 2008 filing pursuant to 18 C.F.R. § 342.4(a). As an interstate oil pipeline SFPP is subject to the Commission’s oil pipeline indexing regulations contained at 18 C.F.R. Part 342 – Oil Pipeline Rate Methodologies and Procedures.<sup>555</sup> While oil pipelines must normally recover cost increases by using the indexing procedure contained in section 342.3,<sup>556</sup> an oil pipeline may file to increase its existing rates under section 342.4. However, to do so the pipeline must establish that “there is a substantial divergence between the actual costs experienced by the carrier and that rate resulting from the application of the index such that the rate at the ceiling level would preclude the carrier from being able to charge a

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<sup>554</sup> The “South Georgia” convention.

<sup>555</sup> 18 C.F.R. Part 342 (2010).

<sup>556</sup> *Id.* § 342.3.

just and reasonable rate within the meaning of the Interstate Commerce Act.”<sup>557</sup> This means that before filing under section 342.4 a carrier must first determine whether it can recover its current costs by raising its rates to the maximum level permitted by the Commission’s indexing methodology. If the carrier cannot recover its costs by maximizing the increase permitted by the indexing methodology, it may then file a rate case under provided it shows that the divergence between the maximum permitted rate under the indexing mechanisms and its actual costs is such that application of the indexing mechanism does not produce a rate that is just and reasonable.

323. When SFPP made its June 30, 2008 tariff filing, several intervenors asserted that SFPP had not established that it met the standard in section 342.4.<sup>558</sup> However, the Commission concluded that SFPP had made an adequate initial showing that its filing met the requirements of a cost of service filing under 18 C.F.R. § 346.1 of the Commission’s regulations, but also stated that there was insufficient data to resolve the disputes.<sup>559</sup> This is still the case at the time of this order because to make a final finding under section 342.1 requires two pieces of information. The first is the ceiling rate for the West Line at the time SFPP made its June 30, 2008 filing. The second is the rate calculated pursuant to this order, which will not be known until SFPP completes its compliance filing. Therefore, if any of the protesting shipper parties wish to pursue this issue further, they may do so in their comments on SFPP’s compliance filing. The Commission will make its ruling on whether SFPP has met the standard in section 342.2 as part of its review of SFPP’s compliance filing when all the required information is available.

The Commission orders:

(A) The exceptions to the 2009 ID are resolved as stated in the body of this order. Any exception not specifically discussed should be considered denied.

(B) SFPP shall file revised rates consistent with this order within 45 days after this order issues, including the supporting explanatory statements and documentation for the overhead cost allocations required in the body of this order, and an estimate of refunds.

(C) Comments on the compliance filing are due 75 days after this order issues and reply comments 90 days after this order issues.

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<sup>557</sup> *Id.* § 342.4.

<sup>558</sup> *See SFPP, L.P.*, 124 FERC ¶ 61,103, at P 6 (2008).

<sup>559</sup> *Id.* P 11.

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By the Commission.

( S E A L )

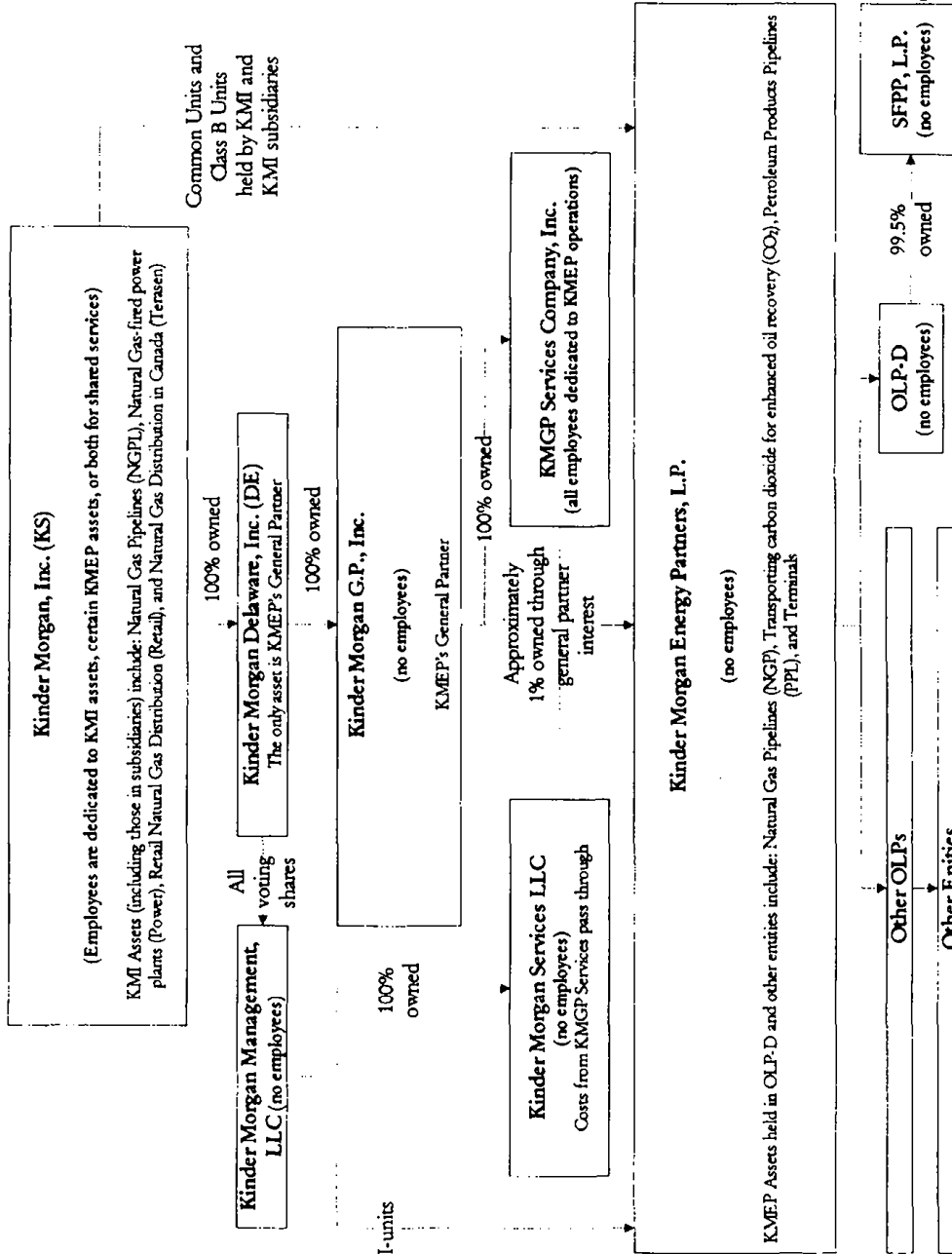
Nathaniel J. Davis, Sr.,  
Deputy Secretary.



Appendix A

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## Appendix B

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Hypothetical Example of an Oil Pipeline  
Under Corporate and MLP Organizational Structures: Scenario 1  
(32% MLP Tax Allowance; 32% Marginal Investor Tax Rate)

Line	Description	Source	Alternative Organizational Structures	
			(4) 1 MLP	(5) 2 C-Corporation
<b>Assumptions.</b>				
Case Pipeline structure				
1 Tax rate for marginal investor and return on equity				
1	a Required after-tax equity return of the marginal investor	Assumption	9.384%	9.384%
2	b Tax rate for the marginal investor	Assumption	32%	32%
3	c Required return on equity (ROE)	Ln 1 / ( 1 - Ln 2 )	13.800%	13.800%
4	2 Marginal tax rate for calculation of income tax allowance	Assumption	32%	35%
5	3 Other pipeline costs and share/units outstanding			
6	a Operating costs	Assumption	\$4,000,000	\$4,000,000
7	b Rate base	Assumption	\$100,000,000	\$100,000,000
8	c Equity in capital structure	Assumption	50%	50%
9	d Debt in capital structure	1 - Ln 8	50%	50%
10	e Cost of debt	Assumption	6%	6%
11	f Share/units outstanding	Assumption	735,294	735,294
12	Income tax rate of pipeline entity	Assumption	0%	35%
<b>Calculations.</b>				
13	Equity return on rate base	Ln 3 * Ln 8 * Ln 7	\$6,900,000	\$6,900,000
14	Income tax allowance	Ln 14 * ( Ln 4 / ( 1 - Ln 4 ) )	\$3,247,059	\$3,715,385
15	Interest expense	Ln 10 * Ln 9 * Ln 7	\$3,000,000	\$3,000,000
16	Operating costs	Assumption	\$4,000,000	\$4,000,000
17	Revenue requirement	Sum ( Ln 13 to 16 )	\$17,147,059	\$17,615,385
Less:				
18	Operating costs	Assumption	\$4,000,000	\$4,000,000
19	Interest expense	Ln 15	\$3,000,000	\$3,000,000
20	Income taxes paid by pipeline entity	( Ln 17 - Ln 18 - Ln 19 ) * Ln 12	\$0	\$3,715,385
21	Income available to share/unit holders after entity taxes and before investor taxes	( Ln 17 - Ln 18 - Ln 19 - Ln 20 )	\$10,147,059	\$6,900,000
22	Income per share/unit after entity taxes and before investor taxes	Ln 21 / Ln 11	\$13.8000	\$9.3840
23	Tax rate for the marginal investor	Ln 2	32%	32%
24	After tax income per share/unit for the marginal investor	Ln 22 * ( 1 - Ln 23 )	\$9.3840	\$6.3811
25	Implied market price per share/unit	Ln 24 / Ln 1	\$100.0000	\$68.0000
26	Resulting after-tax equity return of the marginal investor	Ln 24 / Ln 25	9.384%	9.384%
27	DCF Method estimate of the ROE for the pipeline	( Ln 22 / Ln 25 )	13.800%	13.800%
<b>Addendum</b>				
28	Income taxes paid by pipeline entity	Ln 20	\$0	\$3,715,385
29	Taxes paid by the marginal investor	Ln 21 * Ln 23	\$3,247,059	\$2,208,000
30	Income taxes paid by entity and investor	Ln 28 + Ln 29	\$3,247,059	\$5,923,385

## Appendix C

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**First Alternative Hypothetical Example of an Oil Pipeline  
Under Corporate and MLP Organizational Structures: Scenario 2  
(0% MLP Tax Allowance, 32% Marginal Investor Tax Rate)**

Line	Description	Source	Alternative Organizational Structures	
			(4)	(5)
(1)	(2)	(3)	(4)	(5)
<b>Assumptions.</b>				
Case Pipeline structure			1 MLP	2 C-Corporation
1 Tax rate for marginal investor and return on equity				
1	a Required after-tax equity return of the marginal investor	Assumption	9.384%	9.384%
2	b Tax rate for the marginal investor	Assumption	32%	32%
3	c Required return on equity (ROE)	Ln 1 / ( 1 - Ln 2 )	13.800%	13.800%
4	2 Marginal tax rate for calculation of income tax allowance	Assumption	0%	35%
5	3 Other pipeline costs and share/units outstanding			
6	a Operating costs	Assumption	\$4,000,000	\$4,000,000
7	b Rate base	Assumption	\$100,000,000	\$100,000,000
8	c Equity in capital structure	Assumption	50%	50%
9	d Debt in capital structure	1 - Ln 8	50%	50%
10	e Cost of debt	Assumption	6%	6%
11	f Share/units outstanding	Assumption	735,294	735,294
12	Income tax rate of pipeline entity	Assumption	0%	35%
<b>Calculations.</b>				
13	Equity return on rate base	Ln 3 * Ln 8 * Ln 7	\$6,900,000	\$6,900,000
14	Income tax allowance	Ln 14 * ( Ln 4 / ( 1 - Ln 4 ) )	\$0	\$3,715,385
15	Interest expense	Ln 10 * Ln 9 * Ln 7	\$3,000,000	\$3,000,000
16	Operating costs	Assumption	\$4,000,000	\$4,000,000
17	Revenue requirement	Sum ( Ln 13 to 16 )	\$13,900,000	\$17,615,385
Less:				
18	Operating costs	Assumption	\$4,000,000	\$4,000,000
19	Interest expense	Ln 15	\$3,000,000	\$3,000,000
20	Income taxes paid by pipeline entity	( Ln 17 - Ln 18 - Ln 19 ) * Ln 12	\$0	\$3,715,385
21	Income available to share/unit holders after entity taxes and before investor taxes	( Ln 17 - Ln 18 - Ln 19 - Ln 20 )	\$6,900,000	\$6,900,000
22	Income per share/unit after entity taxes and before investor taxes	Ln 21 / Ln 11	\$9.3840	\$9.3840
23	Tax rate for the marginal investor	Ln 2	32%	32%
24	After tax income per share/unit for the marginal investor	Ln 22 * ( 1 - Ln 23 )	\$6.3811	\$6.3811
25	Implied market price per share/unit	Ln 24 / Ln 1	\$68.0000	\$68.0000
26	Resulting after-tax equity return of the marginal investor	Ln 24 / Ln 25	9.384%	9.384%
27	DCF Method estimate of the ROE for the pipeline	( Ln 22 / Ln 25 )	13.800%	13.800%
<b>Addendum</b>				
28	Income taxes paid by pipeline entity	Ln 20	\$0	\$3,715,385
29	Taxes paid by the marginal investor	Ln 21 * Ln 23	\$2,208,000	\$2,208,000
30	Income taxes paid by entity and investor	Ln 28 + Ln 29	\$2,208,000	\$5,923,385

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