140 FERC ¶ 61,220
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

OPINION NO. 522

SFPP, L.P. — Docket Nos. IS09-437-000, IS10-572-000 (consolidated)

OPINION AND ORDER ON INITIAL DECISION

(Issued September 20, 2012)

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

SFPP, L.P. Docket Nos. IS09-437-000
IS10-572-000
(consolidated)

OPINION NO. 522

APPEARANCES

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CARMEN A. CINTRON, Presiding Administrative Law Judge.

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Before Commissioners: Jon Wellinghoff, Chairman;
Philip D. Moeller, John R. Norris,
Cheryl A. LaFleur, and Tony T. Clark.

SFPP, L.P. Docket Nos. IS09-437-000
IS10-572-000
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OPINION NO. 522

OPINION AND ORDER ON INITIAL DECISION

(Issued September 20, 2012)

1. This order addresses briefs on and opposing exceptions to an Initial Decision (2011 ID) issued on February 10, 2011, by the Presiding Administrative Law Judge related to SFPP, L.P.'s (SFPP) July 31, 2009, and August 16, 2010, filings to change SFPP's East Line rates.[1] As discussed herein, this order generally affirms the 2011 ID's holdings regarding throughput levels and the treatment of short-term debt. Consistent with Opinion Nos. 511 and 511-A,[2] this order modifies the 2011 ID's conclusions regarding the base and test period, litigation costs, general and administrative cost allocation, purchase accounting adjustments, the treatment of interest rate swaps for the purpose of determining the cost of debt, income tax allowance issues, and some rate base and secondary cost of service issues. SFPP must file revised East Line rates consistent with this order within 45 days after this order issues, including a supporting cost of service, workpapers, explanatory statements and any other necessary documentation.

I. General Background

2. SFPP owns and operates the East Line, a common carrier pipeline that transports refined petroleum products – including gasoline, diesel, and jet fuel – in interstate

[1] *SFPP, L.P.*, 134 FERC ¶ 63,013 (2011) (2011 ID).

[2] *SFPP, L.P.*, Opinion No. 511, 134 FERC ¶ 61,121 (2011), *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 (2012).

commerce. Shipments on the East Line originate in El Paso, Texas, or Diamond Junction, Texas, and are delivered to Lordsburg, New Mexico; Tucson, Arizona; Phoenix, Arizona; and various military destinations.[3] Between 2002 and 2007, SFPP invested approximately $350 million to expand the capacity of the East Line. The first phase of the expansion began service in June 2006 (Phase I Expansion) and increased the capacity of the East Line from approximately 90,000 barrels per day to approximately 147,000 barrels per day. The second phase went into service in December 2007 (Phase II Expansion) and increased capacity on the East Line to approximately 207,000 barrels per day.

3. On July 31, 2009, in Docket No. IS09-437-000 SFPP filed FERC Tariff No. 182 to increase the rates for all petroleum products movements on SFPP's East Line from El Paso or Diamond Junction, Texas, to Lordsburg, New Mexico; Tucson, Arizona; and Phoenix, Arizona, to be effective September 1, 2009. SFPP supported the proposed rate increase with a cost of service filing pursuant to section 342.4(a) of the Commission's regulations.[4] Following protests from SFPP's shippers, on August 31, 2009, the Commission accepted and suspended SFPP's proposed rate increase until January 1, 2010, subject to refund, and set the matter for hearing.[5] The hearing commenced on June 29, 2010, and concluded August 2, 2010.

4. On August 16, 2010, in Docket No IS10-572-000, SFPP filed FERC Tariff No. 192 proposing interim rates with a requested effective date of September 1, 2010. The interim rates followed from the parties' stipulation in IS09-437-002 regarding the cost of equity, the related inflation rate, and the real cost of equity. A new cost of service based on this stipulation demonstrated that the rates SFPP initially filed in Docket No. IS09-437-002 should be substantially reduced. SFPP provided interim refunds for the difference between the rates as initially filed in Docket No. IS09-437-002 and those contained in revised filing in Docket No. IS10-572-000. Shipper parties reserved the right for further refunds in both the instant docket and Docket No. IS09-437-002. On September 15, 2010, the Commission issued an order accepting and suspending SFPP's interim rates, effective September 1, 2010, subject to refund, and consolidating Docket Nos. IS10-572-000 and IS09-437-000.

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[3] The military destinations include Alamogordo Junction, Texas, which serves Holloman Air Force Base, New Mexico, and Davis-Monthan Air Force Base, Arizona.

[4] 18 C.F.R. § 342.4(a) (2011).

[5] *SFPP*, *LP*, 128 FERC ¶ 61,214 (2009) (Hearing Order).

5. Following a hearing, on February 10, 2011, the Presiding Judge issued the 2011 ID. Briefs on exception to the 2011 ID were filed by SFPP, CCSV Shippers,[6] NHW Shippers,[7] and Commission Trial Staff. The same four parties also filed briefs opposing exceptions. As discussed below, the briefs on exception raise issues related to: (1) test year definition; (2) throughput; (3) certain operating expenses; (4) the allocation of general and administrative costs; (5) capital structure and the cost of capital; and (6) income tax allowance issues.

6. Following the issuance of the 2011 ID, on February 17, 2011, the Commission issued Opinion No. 511 related to SFPP's cost of service filing to increase its West Line rates in Docket No. IS08-390-002. Opinion No. 511 and the subsequent order on rehearing in Opinion No. 511-A address many of the same issues that have been raised in this proceeding. Consequently, where applicable, the Commission's decisions in this proceeding will reflect our determinations in Opinion Nos. 511 and 511-A.[8]

II. Base and Test Period Regulations

Background

7. Section 346.2(a)(1) of the Commission's regulations define 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 carrier may include appropriate normalizing adjustments in lieu of nonrecurring items.

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[6] ConocoPhillips Company (ConocoPhillips), Chevron Products Company (Chevron), Southwest Airlines Co. (Southwest), and Valero Marketing and Supply Company (Valero) filed a joint brief on exceptions.

[7] Navajo Refining Company, L.L.C. (Navajo), HollyFrontier Refining & Marketing LLC (Holly) and Western Refining Company, L.P. (Western) filed a joint brief on exceptions.

[8] Opinion No. 511 issued on February 17, 2011, prior to the deadline for parties to file briefs on exceptions in this proceeding. Thus, the briefs on exceptions and the briefs opposing exceptions reference the Commission's determinations in Opinion No. 511. However, the Commission's order on rehearing, Opinion No. 511-A, issued December 16, 2011, after the parties filed their briefs opposing exceptions.

(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.

8. In this case, the base period is from July 1, 2008, through June 30, 2009. The nine-month adjustment period for test period changes is from July 1, 2009, through March 31, 2010.

2011 ID

9. The 2011 ID determined that SFPP's entire cost of service should be based upon data from the 12-month period between April 1, 2009, through March 31, 2010. The April 1, 2009-March 31, 2010 period consists of the last three months of the base period plus the nine-month adjustment period. The 2011 ID determined that data from this period most accurately represents the costs that will occur during the period in which the rates will be in effect. The 2011 ID concluded that Commission policy supports the use of data from the most recent 12 month period in the combined 21-month base and adjustment period.[9]

10. The 2011 ID rejected SFPP's proposal to use the base period data as modified for known and measurable changes. Although the 2011 ID concluded that SFPP's proposal was sufficient to meet its initial filing requirements, the 2011 ID stated that Commission policy dictates use of actual data from the last 12-months of the combined 21-month base and adjustment period.

Briefs On Exceptions

11. On exceptions, SFPP states that the 2011 ID erred by calculating the East Line rates based upon the April 1, 2009-March 31, 2010 period data. SFPP states that Commission regulations support calculating rates using July 1, 2008-June 30, 2009 base period data as adjusted for known and measurable changes expected to occur within the

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[9] 2011 ID, 134 FERC ¶ 63,013 at P 28 (citing *High Island Offshore Sys., L.L.C.*, 110 FERC ¶ 61,043, at P 49 (2005) (*High Island*); *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,048-49 (2000) (*Trunkline*); *Kern River Transmission Co.*, Opinion No. 486, 117 FERC ¶ 61,077, at P 263 (2006) (Opinion No. 486); *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,027 (1999) (*Northwest Pipeline*)).

nine-month period ending March 31, 2010. SFPP adds that in Opinion No. 511, the Commission rejected the formulaic use of the most recent data.[10]

12. SFPP also emphasizes that the record does not contain cost information for part of the April 1, 2009-March 31, 2010 period. SFPP asserts that none of SFPP's operating expenses or rate base data for January, February or March 2010 was offered or accepted into evidence.[11] SFPP states that although the Presiding Judge initially asked parties on the first day of hearing to update the actual numbers through the test period, the Presiding Judge later agreed not to require updated operating expense or rate base data because compiling and analyzing such data for anomalies would require extraordinary effort and cause a lengthy delay.[12] Given that information through March 31, 2010, is not entirely in the record, SFPP asserts that the April 1, 2009-March 31, 2010 period data are not representative.

Briefs Opposing Exceptions

13. Opposing exceptions, Trial Staff asserts that the Commission's approach is to evaluate cost of service levels using the most recent 12 months of actual data from the base period/test period absent a showing that this data is not representative of future circumstances on the pipeline. Trial Staff contends the use of the most recent information is the default position and that a party must justify any proposed departure from this approach.[13] Trial Staff contends that SFPP has not shown that the use of the most recent data would result in an unrepresentative forecast of future circumstances on SFPP's East Line. Trial Staff also emphasizes that on the first day of hearing, the

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[10] SFPP Brief on Exceptions at 74 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 27).

[11] SFPP acknowledges that actual throughput data for the 12-month period ending March 31, 2010 is in the record. SFPP Brief on Exceptions at 75 (citing Ex. SPE-126; Ex. SPE-127C). SFPP also states that SFPP witness Dr. Vander Weide calculated the rate of return on equity for the six month period ending March 31, 2010. *Id.*

[12] SFPP Brief on Exceptions at 75 (citing Tr. 117, 160-63, 334-36).

[13] Trial Staff notes that in Opinion No. 511, the Commission cited several cases in which the Commission used a test period consisting of actual adjustment period data. Opinion No. 511, 134 FERC ¶ 61,121, at P 29 n.34 (citing Opinion No. 486, 117 FERC ¶ 61,077 at P 263; *High Island*, 110 FERC ¶ 61,043 at P 49; *Enbridge Pipelines*, 100 FERC ¶ 61,260, at P 315 (2002); *Trunkline Gas*, 90 FERC at 61,048-49; *Northwest Pipeline*, 87 FERC at 62,027, 62,030; *Williston Basin Interstate Pipeline Co.*, 72 FERC ¶ 61,074, at 61,360 (1995)).

Presiding Judge asked the parties to submit cost of service data updated with actual numbers through the end of the base period. Trial Staff states that SFPP resisted providing this data. Trial Staff further notes that when the Commission set the case for hearing, it expressed concern about the accuracy of the test period used by SFPP.[14]

14. Trial Staff also disputes SFPP's and CCSV Shippers' argument that the 2011 ID's holding is inconsistent with the Commission's base and test period regulations.[15] In response to SFPP, Trial Staff states that this regulation does not require that the material provided by the party seeking the rate increase become the data that ultimately supports the derivation of the rate. Trial Staff argues that a test period for rate setting based upon the most recent actual data is superior to using the base period with adjustments. Regarding CCSV Shippers' claim that the use of actual data should be limited to natural gas proceedings where most rates are suspended for the statutory five months, Trial Staff notes that the East Line rates in this proceeding were suspended for four months.

15. Also opposing exceptions, NHW Shippers state that the 2011 ID did not require that each element in the cost of service be based upon the April 1, 2009-March 31, 2010 period data. Rather, NHW Shippers state that the 2011 ID's explication of test and base period principles only related to the use of data up to the end of the nine-month adjustment period where this data was offered into evidence and otherwise was found to be a reasonable basis for setting rates.

<u>Commission Decision</u>

16. The Commission modifies the 2011 ID's determination to use the last 12-months of the 21-month combined base and adjustment period (April 1, 2009 through March 31, 2010) for determining SFPP's cost of service.

17. As an initial matter, the Commission understands the 2011 ID to be requiring SFPP to update every element in its cost of service to use data from the April 1, 2009-March 31, 2010 period. Although NHW Shippers contend that the 2011 ID's test period holding only relates to specific elements in the cost of service such as throughput, the 2011 ID's discussion includes no such limiting language in its discussion of the base and test period issue.[16]

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[14] Trial Staff Brief Opposing Exceptions at 33 (citing Hearing Order, 128 FERC ¶ 61,214 at P 20).

[15] *Id.* at 29-30 (referencing 18 C.F.R. § 346.2(a)(1) (2011)).

[16] 2011 ID, 134 FERC ¶ 63,013 at PP 26-30.

18. The 2011 ID's proposed adoption of April 1, 2009-March 30, 2010 data for the entirety of SFPP's East Line cost of service is unnecessary and inconsistent with an efficient resolution of this rate proceeding. Neither the 2011 ID nor Trial Staff's brief opposing exceptions has demonstrated that for every element in the East Line cost of service, the April 1, 2009-March 31, 2010 period is representative of future costs. Such a showing is impossible because the record does not contain complete cost or rate base information for January, February, and March of 2010.[17] Additionally, if there is no specific objection raised by the litigants to a particular cost of service element proposed by SFPP, the wholesale adjustment proposed by the 2011 ID risks creating inefficient and unnecessary litigation during SFPP's compliance filing.[18]

19. The basis of SFPP's rates shall be the costs filed in SFPP's proposed cost of service, as modified by this proceeding. The Commission's modification of the 2011 ID does not foreclose consideration of adjustments to particular cost of service elements, including modifications that apply the pipeline's actual experience during the 9-month adjustment period. However, by avoiding changes where no disputes exist and by

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[17] The 2011 ID relies upon Commission precedent involving natural gas pipelines. 2011 ID, 134 FERC ¶ 63,013 at P 28 (citing *High Island*, 110 FERC ¶ 61,043 at P 49; *Trunkline Gas*, 90 FERC at 61,048-49; Opinion No. 486, 117 FERC ¶ 61,077 at P 263; *Northwest Pipeline*, 87 FERC at 62,027). The Commission's base and test period regulations for oil and gas pipelines are very similar. *Compare* 18 C.F.R. § 154.303 (2011) *with* 18 C.F.R. § 362.2(a) (2011). However, there is one significant distinction that applies to the 2011 ID's treatment of the base and test period across the entirety of SFPP's cost of service. Under the Commission's natural gas pipeline regulations, the pipeline is required to resubmit an updated cost of service using the last 3 months of the base period and the 9 month adjustment period. 18 C.F.R. § 154.311 (2011). In this context of natural gas rate proceedings, the Commission has expressed a preference for using the updated cost of service in natural gas proceedings. Opinion No. 486, 117 FERC ¶ 61,077 at P 263 (citing *Northwest Pipeline*, 87 FERC at 62,027), *order on reh'g*, Opinion No. 486-A, 123 FERC ¶ 61,056 (2008), *order on reh'g*, Opinion No. 486-B, 126 FERC ¶ 61,034, *order on reh'g*, Opinion No. 486-C, 129 FERC ¶ 61,240 (2009), *order on reh'g*, Opinion No. 486-D, 133 FERC ¶ 61,162 (2010), *order on initial decision*, Opinion No. 486-E, 136 FERC ¶ 61,045 (2011). However, oil pipelines are under no similar obligation to submit a completely updated cost of service, and thus this information is not available here.

[18] At the very least, for those elements of SFPP's cost of service where the base period data were not challenged at hearing, the 2011 ID's approach would force the parties to re-litigate whether the newly submitted, January through March 2010 information in SFPP's compliance filing was just and reasonable.

limiting the additional data that must be filed on compliance, the Commission seeks to encourage an efficient resolution of this proceeding.

III. Throughput

2011 ID

20. The 2011 ID concluded that the East Line cost of service throughput should be based upon the most recent twelve months of actual volumes ending March 31, 2010.[19] This April 1, 2009-March 31, 2010 throughput is the equivalent of 150,073 barrels per day, or 54,776,688 barrels per year.[20] The 2011 ID relied upon its discussion of base and test period principles, which determined that SFPP's entire cost of service should be based upon April 1, 2009-March 31, 2010 data.

Briefs On Exceptions

21. On exceptions, CCSV Shippers contend that the 2011 ID's adoption of April 1, 2009-March 31,2010 throughput departs from section 346.2(a)(1) of the Commission's regulations by establishing one rate component (throughput) based upon the last three months of the adjustment period and the nine month base period. CCSV Shippers state that the 2011 ID improperly relied upon cases involving the Commission's regulations under the Natural Gas Act (NGA), not its regulation of oil pipelines. CCSV Shippers explain that under the Natural Gas Act, the Commission subjects filings to a nearly automatic five-month suspension. CCSV Shippers explain that in these natural gas rate cases, the Commission relies on actual data for the last months of the test period because it reflects the most recent actual data prior to the effective date of the new rates.[21] In contrast, CCSV Shippers assert that oil pipeline rates most often take effect subject to refund on one day's notice.

22. The CCSV Shippers further contend that April 1, 2009 – March 31, 2010 East Line volume levels adopted by the 2011 ID are anomalously low due to cyclical economic conditions. CCSV Shippers cite studies estimating growth in personal income and gasoline sales, projecting both of these factors to return to pre-recession levels at

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[19] 2011 ID, 134 FERC ¶ 63,013 at P 316.

[20] Ex. SPE-228A.

[21] CCSV Shippers Brief on Exceptions at 31 (citing *Williston Basin Interstate Pipeline Co.*, 87 FERC ¶ 61,265, at 62,022 (1999) (*Williston Basin*); *Ozark Gas Transmission, L.L.C.*, 134 FERC ¶ 61,193, at P 22 (2011)).

varying points between 2010 and 2012 in Tucson and Phoenix.[22] CCSV Shippers also cite to various studies regarding Arizona's gasoline demand levels, both regarding future projections and historic recoveries following recessions.[23] CCSV Shippers also assert that the complaint provided by Commission regulations can take several years to reach finality and thus is a limited remedy to address any future over-recoveries by SFPP.

23. For these reasons, the CCSV Shippers support a total throughput volume of 59,549,200 barrels per year (163,148 barrels bpd) as calculated by CCSV Shipper witness O'Loughlin.[24] CCSV Shippers explain that Mr. O'Loughlin determined the 2007 total level of East and West Line deliveries to Phoenix to be 40,840,945 barrels (111,893 barrels per day). CCSV Shippers characterize this 2007 data as representing "normal economic operating conditions."[25] CCSV Shippers stated that Mr. O'Loughlin averaged this 2007 demand level with the actual base period (July 1, 2008, through June 30, 2009) East and West Line deliveries to Phoenix.[26] CCSV Shippers justify using an average of 2007 actual volumes and base period volumes based on their claim that demand for petroleum products is resuming. To determine the East Line throughput to Phoenix, Mr. O'Loughlin subtracted his recommended West Line throughput in the West Line proceeding (Docket IS08-390) from the averaged total Phoenix demand level. CCSV Shippers state that this approach ensures consistency with the West Line proceeding in Docket No. IS08-390.[27] CCSV Shippers state that Mr. O'Loughlin employed a similar method to derive the recommended throughput for Tucson of 16,088,105 barrels per year

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[22] *Id.* at 37 (citing Ex. VCC-78hc at 20 & Fig. 9; Ex. VCC-89).

[23] *Id.* at 38 (citing Ex. VCC-78hc at 18-19, 23, Figs. 8, 11; Ex. VCC-87, Ex. VCC-91hc).

[24] CCSV Shippers recommend 40,840,945 barrels to Phoenix (111,893 barrels per day) and 16,088,105 barrels to Tucson (44,077 barrels per day). CCSV Shippers adopt SFPP witness Kehlet's recommendations for the three smaller East Line destinations: 1,294,849 barrels to Lordsburg (3,548 barrels per day), 919,552 barrels to Davis-Monthan AFB (2,519 barrels per day), and 405,987 barrels to Alamogordo Junction (1,112 barrels per day).

[25] CCSV Shippers Brief on Exceptions at 41 (citing Ex. VCC-78hc at 25-26).

[26] CCSV Shippers state that, apart from a small percentage served by trucking, SFPP's East Line and West Line are the sole source for refined petroleum products in Phoenix. CCSV Shippers state that total Phoenix demand is equal to the sum of East Line and West Line throughput to Phoenix.

[27] The Commission did not adopt Mr. O'Loughlin's proposed West Line throughput level. Opinion No. 511, 134 FERC ¶ 61,121 at P 29.

(44,077 barrels per day), but that he used SFPP's recommended volume levels for the three smaller East Line delivery locations.

24. CCSV Shippers state that the sum of the West Line volumes adopted by the Commission in Opinion No. 511 and the East Line throughput adopted by the 2011 ID result in a depressed level of total throughput to Phoenix of 178,687 barrels per day. Although this sum is derived from East Line data from one base/adjustment period and West Line data from another base/adjustment period, CCSV Shippers emphasize that these will be the going-forward rates that are in effect together. CCSV Shippers assert that the combined Opinion No. 511/2011 ID Phoenix throughput is less than the 187,750 barrels per day delivered via both the East and West Line during the April 1, 2009-March 31, 2010 period used by the 2011 ID. It is also less than the combined volumes of 197,818 barrels per day delivered to Phoenix between January 1, 2008 and September 30, 2008, which was the period used in Opinion No. 511 to derive the West Line throughput.

25. CCSV Shippers states that customers switch between the East and the West Line for various reasons, and that each line's market share has changed. The CCSV Shippers quote Opinion No. 511 that "given the competitive relationship of the West Line and East Line shippers and the rates they pay, the Commission believes that both sets of rates now in litigation before it should be designed on consistent principles as much as possible."[28] As an alternative to its proposal at hearing, CCSV Shippers contend that the Commission should require Phoenix volumes be apportioned between the two lines based upon the ratio between East Line throughput and West Line throughput over the January 1, 2008 through March 31, 2010 period. According to the CCSV Shippers this would lead to an East Line throughput to Phoenix of 107,684 barrels per day and a combined East and West Line throughput of 190,761 barrels per day.

26. Also on exceptions, NHW Shippers assert that the appropriate throughput level to determine SFPP's rates is 164,305 barrels per day or 59,971,266 barrels per year.[29] NHW Shippers state that the 2011 ID did not explain the rejection of its proposal.

27. NWH Shippers contend that based on the actual throughput for the 12 months ending March 31, 2010, the Phase II Expansion is under-utilized by 56,927 barrels per

[28] CCSV Shippers Brief on Exceptions at 32 (quoting Opinion No. 511, 134 FERC ¶ 61,121 at P 141).

[29] NHW Shippers Brief on Exceptions at 59 (citing Ex. WNR-1 at 15:3-6, Ex. WNR-6 at 2).

day, or approximately 95 percent.[30] NWH attributes the under-utilization to possible over-estimation of future market demand at the time Phase II was developed.[31]

28. NWH Shippers assert that shippers should not be solely responsible for the under-utilization of the East Line Phase II Expansion facilities or shoulder 100 percent of the effects of market volatility's effect on pipeline use. NHW Shippers explain that SFPP East Line throughput for the April 1, 2009 through March 31, 2010 period was 150,073 barrels per day or 54,776,688 barrels per year. Thus, NHW explains that its witness, Mr. Eberst, adjusted this figure to account for the underutilization of SFPP's Phase II Expansion, which entered into service on December 1, 2007.[32] NWH explains that Mr. Eberst attributed 50 percent of the shortfall to market conditions and determined that shippers should bear 100 percent of this market shortfall. Mr. Eberst proceeded to split the remaining 28,463 barrels per day equally between shippers and SFPP,[33] which increased SFPP's actual throughput of 150,073 barrels per day to 164,305 barrels per day or 59,971,266 barrels per year.[34] NHW Shippers emphasize that even after this proposed adjustment, shippers would still bear 70 percent of the Phase II capacity shortfall and that SFPP's East Line rates would be set at a load factor of approximately 79 percent.[35]

29. NHW Shippers state that Commission policy and precedent support such an adjustment where expansion capacity is under-utilized. NHW Shippers note that in several declaratory orders involving initial rates for new oil pipelines or expansions of existing oil pipelines, the Commission has held that pipeline must bear the risk of under-

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[30] *Id.* (citing Ex. WNR-1 at 12-13, 15; Ex. WNR-6 at 2; SOE-126 at 14).

[31] *Id.* at 60 (citing Ex. WNR-1 at 16; WNR-6 at 2).

[32] During Phase I of the East Line expansion, which was placed into service on June I, 2006, SFPP increased the capacity of the East Line system from approximately 90,000 barrels per day to approximately 147,000 barrels per day. During Phase II of the expansion, which was placed into service on December 1, 2007, SFPP brought additional 60,000 barrels per day capacity online, increasing the capacity of the East Line system from approximately 147,000 barrels per day to 207,000 barrels per day. Ex. SPE-73 at 3.

[33] NHW Shippers Brief on Exceptions at 60 (citing Ex. WNR-1 at 16; WNR-6 at 2).

[34] *Id.* (citing Ex. WNR-6 at 2).

[35] *Id.* (citing Ex. WNR-1 at 17).

utilization of the new capacity.[36] NHW Shippers state that the Commission requires natural gas pipelines to be at risk for underutilized expansion capacity.[37] NHW Shippers add that the Commission has required the pipeline and its remaining shippers to share the cost of capacity that has been turned-back by firm customers.[38] NHW Shippers state that these cases are animated by: (a) the desire to ensure that pipelines bear the risk of cost under-recovery due to under-utilization of capacity; and (b) to ensure that the pipeline does not over-recover its cost if its volumes are less than its designed capacity. NHW Shippers assert that the proposed adjustments for cases of under-utilization are distinct from prudence. NHW Shippers further contend that prior Commission decisions using the last three months of the base period and the nine-month adjustment period actual volumes is compatible with the Commission's policy of adjusting throughput to account for the risk of under-utilization. NHW Shippers state that in Opinion No. 486, the Commission upheld a condition in Kern River's original certificate proceeding that required rates to be designed based upon volumes equal to 95 percent of its design capacity.[39] However, NHW Shippers assert that consistent with this condition, the Commission held that Kern River should determine its cost of service based on the last three months of the base period and the 9 month adjustment period.

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[36] *Id.* at 61 (citing *White Cliffs Pipeline, L.L.C.*, 126 FERC ¶ 61,070 (2009) (*White Cliffs*); *Enbridge Energy Co.*, 110 FERC ¶ 61,211, at P 44 (2005) (*Enbridge*); *Enbridge Pipelines (Southern Lights) LLC*, 122 FERC ¶ 61,170, at P 10 (2008)).

[37] *Id.* at 62 (citing *Great Lakes Gas Transmission*, 66 FERC ¶ 61,118, at 61,210 (1994) (*Great Lakes*); *Equitrans, Inc.*, 63 FERC ¶ 61,070, at 61,304 (1993) (*Equitrans*); *Arkansas Western Pipeline Co.*, 63 FERC ¶ 61,006, at 61,027 (1993) (*Arkansas Western*)).

[38] *Id.* at 63 (citing *Mississippi River Transmission Corp.*, 95 FERC ¶ 61,460, at 62,658-59 (2001) (*Mississippi River*); *Natural Gas Pipeline Co. of America*, 73 FERC ¶ 61,050, at 61,129 (1995) (*Natural Gas*); *El Paso Natural Gas Co.*, 72 FERC ¶ 61,083, at 61,441 (1995) (*El Paso*)).

[39] *Id.* at 66 (citing Opinion No. 486, 117 FERC ¶ 61,077).

30. NHW Shippers assert that SFPP's volumes increased in the three months following the end of the adjustment period in March 31, 2010.[40] NHW Shippers further contend that under the 2011 ID, SFPP will be able to recover the full costs of the East Line's Phase II Expansion from shippers using only a small percentage of the expanded capacity.

31. NHW Shippers add that due to the settlement of SFPP's initial rate increase filing to recover the costs of the East Line's Phase II Expansion,[41] this is the first rate proceeding to address the recovery of the Phase II Expansion costs. Thus, NHW Shippers argue that the ongoing operation of the East Line expansion does not distinguish the Commission's prior holdings involving new pipelines or new expansions on existing pipelines.

32. NHW Shippers also dispute SFPP's argument at hearing that the Phase II expansion lowered gasoline prices, or, even if this occurred, that Phase II justifies placing the full risk of under-utilization on shippers. They state that even if SFPP witness Dr. Webb is correct and the East Line expansion caused a decrease of $0.15 per gallon in Phoenix, the study does not show that the same benefits could not have been produced with a more modest expansion.[42] Similarly, NHW Shippers dispute the extent to which shippers sought the extra capacity included in the East Line expansions, and argue that shipper support for these expansions does not justify placing the full risk of under utilization on shippers. They state that Navajo voiced opposition to the expansion, and that shipper support for the Phase I Expansion was at lower rates than those resulting from the Phase II expansion. NHW Shippers add that although SFPP claims that the Phase II Expansion was justified by excessive "over-nominations" by shippers, SFPP

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[40] NWH Shippers report that the volumes for April, May and June 2010 averaged 157,824 barrels per day as compared to the 150,932 barrels per day proposed by SFPP. NHW Shippers Brief on Exceptions at 64 n.25 (citing Ex. SPE-228A). NWH Shippers add that in addition the volumes for the last five months of February through June 2010 exceed the volumes for the corresponding months in 2009. *Id.*

[41] *Id.* at 59 (citing *SFPP, L.P.*, 126 FERC ¶ 61,076 (2009) (approving settlement in Docket No. IS08-28-000, *et al.*).

[42] NHW Shippers state that under the ICA, regulation of oil pipelines is solely a matter between pipelines and shippers, and the ICA confers no authority to protect consumer interests. NHW Shippers Brief on Exceptions at 72 (citing *Suncor Energy Mktg., Inc. v. Platte Pipe Line Co.*, 132 FERC ¶ 61,242 at P 104 & n.62 (2010) (citing *Williams Pipe Line Co.*, Opinion No. 154, 21 FERC ¶ 61,260, at 61,584 (1982))).

witness Kehlet conceded that such over-nominations were not reflective of the amount of additional demand for service on the East Line.[43]

33. NHW Shippers also state that although capacity is more fully utilized during some months, the fact that throughput varies does not justify placing the entire cost of unused capacity on shippers. NHW Shippers state that in September 2009, the peak month during the 12-month period, the East Line was under-utilized by 34,563 barrels,[44] the equivalent of 57 percent of the capacity added by the Phase II Expansion.[45] NHW Shipper add that in four months, none of the Phase II Expansion capacity was used.[46] NHW Shippers add that particularly because shippers can shift their volumes over time using storage and adjusting refining output, there is no basis for the position that additional capacity is necessary to accommodate the months of above average throughput.

Briefs Opposing Exceptions

34. In its brief opposing exceptions, SFPP asserts that the throughput levels adopted by the 2011 ID are reasonable. SFPP contends that CCSV Shippers' proposal does not comply with Commission regulations. First, SFPP notes that CCSV's proposal includes volumes that occurred in 2007, well before the base period. Second, SFPP states that CCSV witness Mr. O'Loughlin conceded that his proposed throughput levels would not occur during the 21-month base and adjustment period.[47] SFPP states that the Commission rejected such speculative projections in Opinion No. 511.[48]

35. SFPP also states that the CCSV Shippers' attempt to base rates on throughput levels that may occur in the next three to four years, rather than on the East Line's current throughput, is erroneous. SFPP states that these changes will not be known and measurable within the base and adjustment period as required by Commission regulations. SFPP adds that the studies' projections regarding gasoline demand will actually occur, and, even if gasoline demand increases, that the increase will occur on the

[43] *Id.* at 59 (citing Tr. 1169:5-13; Tr. 1169:5-13).

[44] *Id.* at 72 (citing Ex. SPE-228A at 2).

[45] 34,563/60,000 = 57.6 percent.

[46] NHW Shippers Brief on Exceptions at 73 (citing Ex. SPE-228A at 2).

[47] SFPP Brief Opposing Exceptions at 23 (citing Tr. 2524-25, 2544).

[48] *Id.* (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 29).

East Line as opposed to the West Line. SFPP states that although Opinion No. 511 issued a specific directive to assign certain general and administrative costs in Docket No. IS08-390-000, *et al*., consistent with IS09-437-000, *et al*.,[49] this directive did not address throughput or stand for a more general proposition.

36. SFPP states that NHW Shippers' proposed throughput levels also fail to comply with Commission's base and test period regulations. SFPP emphasizes that its witness Mr. Eberst confirmed on cross-examination that he did not analyze when, if at all, NHW's recommended volume levels would occur.[50] SFPP notes that NHW Shippers' proposed volumes exceed the actual base and adjustment period volumes on the East Line by roughly eight percent, which will cause SFPP to under-recover its cost of service. SFPP characterizes NWH Shippers' arguments as an untimely prudence challenge.

37. SFPP also distinguishes the cases cited by NHW Shippers, noting that these cases either involve natural gas pipelines or new or expanded oil pipelines that were not yet operational. SFPP notes that when a new pipeline or expansion with no historical throughput data seeks a declaratory order authorizing certain rate treatment, the Commission has ordered the pipeline to use its design capacity to protect against the over-recovery. In contrast, SFPP argues that the East Line has been in operation for several years and the East Line Phase II itself has over two years of actual operating experience. SFPP also notes that NHW Shippers made the business decision to settle the first case related to the Phase II Expansion implementation and cannot argue this is their first opportunity to litigate those rates. SFPP adds that the pipeline remains at risk if throughput levels drop below those incorporated into the cost of service.

38. SFPP states that in ten of the last fifteen months of the combined base and adjustment period, shippers on the East Line transported more barrels than was possible prior to the implementation of the Phase II Expansion.[51] SFPP adds that NHW Shippers' approach, if adopted, would establish a policy that would encourage inefficient planning of oil pipeline capacity, deterring pipelines from anticipating higher usage in later years. SFPP states that NHW Shippers would force pipelines to make smaller but more frequent expansions which are less cost-effective. Additionally, SFPP challenges the relevance of Navajo's opposition to the East Line expansions, claiming that the expansion lowered the price that Navajo could charge to Phoenix consumers and that Navajo's opposition is not a reason to force SFPP to under-recover its costs.

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[49] *Id.* (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 141).

[50] *Id.* (citing Tr. 3005).

[51] *Id.* at 28 (citing Ex. SPE-228A).

39. SFPP states that the 2011 ID's rates based upon actual data from the last three months of the base period and the 9-month adjustment period (April 2009 through March 2010) are just and reasonable. SFPP asserts that in Order No. 511, the Commission stated that it is inappropriate to set rates based on predictions of events that may occur two years past the end of the base period. SFPP points to varying projections from the Energy Information Administration (EIA) showing growth in the consumption of liquid fuels will be tepid over the next several years,[52] and SFPP states that some studies show bleak growth predictions for markets served by the East Line.[53] SFPP observes that Mr. O'Loughlin testified that he never asked his clients what they believed would happen to future demand.[54] SFPP states that more recent studies from the spring of 2011 predicted less growth in gasoline consumption that the studies cited by CCSV Shippers.[55] SFPP cites statements from officials with the protesting entities indicating that the recover of demand for refined products will take some time.[56] SFPP also states that CCSV Shippers used out-of-date projections and stale evidence to support their throughput claims.[57] To the extent that SFPP's East Line throughput increases in the future, SFPP suggests that CCSV Shippers may file complaints. SFPP notes that between December 1, 2006, and July 31, 2009, the shippers filed a total of 18 complaints against SFPP and another 15 complaints against SFPP's affiliate Calnev.

40. SFPP concludes that CCSV Shippers' table comparing the 2011 ID's East Line throughput levels with Opinion No. 511's West Line throughput levels is misleading. To the table proposed by CCSV Shippers, SFPP adds calendar year 2007 data, the throughput levels based upon 2007 data advocated by the CCSV shippers, and the annualized throughput levels for the 9-month adjustment period in this proceeding (July 1, 2009 through March 30, 2009).[58] SFPP states that this table shows a downward trend in throughput. Furthermore, SFPP adds that the annualized (July 1, 2009 – March 31, 2010) actual test period throughput of 183,477 barrels per day for both the

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[52] *Id.* at 29-30 (citing Ex. SPE-98 at 2; Ex. VCC-90 at 5).

[53] *Id.*at 30 (citing Ex. VCC-89 at 1-3; Ex. SPE-73).

[54] *Id.* at 33 (citing Tr. 2545-48; 2551).

[55] *Id.* at 30 (citing http://azeconomy.eller.arizona.edu).

[56] *Id.* (citing Ex. SPE-168 at 19-23; Ex. SPE-181 at 4, 10; Ex. SPE-177 at 2; SPE-268 at 1, 4; Ex. SPE-101 at 1).

[57] *Id.* at 32-34.

[58] *Id.* at 34-35.

East and West Lines is only 2.7 percent higher than the combined throughput level of the 2011 ID and Opinion No. 511.

Commission Decision

41. The Commission affirms the throughput levels adopted by the 2011 ID. The 2011 ID proposed to use the actual throughput transported by the East Line during the last 12 months of the 21-month combined base and adjustment period (April 1, 2009-March 31, 2010). The data from this period supports a total East Line throughput of 54,776,688 or 150,073 barrels per day. This throughput level, derived using actual base and adjustment period data, is consistent with Commission regulations.[59] It is also the most recent data, and thus may account for any trends during the 21-month combined base and adjustment period. On exceptions, there has been no demonstration that this throughput level is not representative. Thus, there is not substantial evidence to overturn the throughput level adopted by the 2011 ID.[60]

42. The alternatives and arguments advanced by the CCSV Shippers and the NHW Shippers on exceptions do not justify a different result. CCSV Shippers' proposed East Line throughput level of 163,148 barrels per day is based upon a flawed methodology. CCSV Shippers propose to calculate throughput by averaging the July 1, 2008 - June 30, 2009 base period data with 2007 data. Contrary to the Commission's base and test period rules, this approach uses 2007 data that was experienced before the base and adjustment period in this case, which began July 1, 2008. Furthermore, to determine the East Line throughput to Phoenix, CCSV Shipper witness O'Loughlin subtracted his recommended West Line throughput in the West Line proceeding (Docket No. IS08-390) from the

[59] Contrary to CCSV Shippers' assertions, as explained in Opinion Nos. 511 and 511-A, Commission policy permits cost of service throughput levels using actual data from last 12-months of the 21-month combined base and adjustment period. Opinion No. 511, 134 FERC ¶ 61,121 at P 27, *order on reh'g,* Opinion No. 511-A, 137 FERC ¶ 61,220 at P 19.

[60] The Commission has reversed the 2011 ID's determination to use the April 1, 2009 through March 31, 2010 data for the entirety of the cost of service because such data is not in the record and because it would unnecessarily complicate this proceeding. However, the throughput for April 1, 2009 through March 31, 2010, is in the record and relates to a contested issue, i.e. the appropriate volume levels, in this proceeding.

averaged total Phoenix demand level. As a result, Mr. O'Loughlin used West Line throughput data that was derived outside the base and test period in this case.[61]

43. Further, as a result of this flawed methodology, the throughput proposed by CCSV Shippers is not reflective of the actual data during the base and adjustment periods. During the base period, actual throughput shipments on the East Line averaged 154,921 barrels per day and during the adjustment period shipments averaged 150,703. During the 9-month adjustment period, total East Line throughput exceeded the 163,148 barrels per day level proposed by the CCSV Shippers only once, in September of 2009.[62]

44. The CCSV Shippers defend this departure from the adjustment period volumes due to various projections and studies that they claim show future volume increases on the East Line.[63] However, as Opinion No. 511 explained, such projections are speculative and do not support a departure from the actual data presented by the adjustment period.[64] Absent good cause, which has not been demonstrated by the CCSV shippers, data from the base and adjustment period are to serve as the basis for the rates in this proceeding. To the extent that the volumes on either the East Line or the West Line cease to be representative, the CCSV Shippers (or any other entity) may file a complaint.

45. The Commission also rejects the alternative proposal offered by the CCSV Shippers on exceptions to require that Phoenix volumes be apportioned between the East and the West Lines based on the ratio of East Line versus West Line throughput, using actual volumes for the period January 2008 through March 2010. As explained in Opinion Nos. 511 and 511-A, Docket Nos. IS08-390 and IS09-437 are two separate proceedings, filed over one year apart and with effective dates one year and five-months

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[61] Additionally, the Commission did not adopt Mr. O'Loughlin's proposed methodology for determining the West Line throughput level in Opinion No. 511, 134 FERC ¶ 61,121 at P 29.

[62] In the entire 21-month combined base and adjustment period, total East Line volumes exceeded the CCSV Shippers' proposed throughput levels five times. Four of those instances occurred during the first five months of the 21-month period. To the extent that there were any trends during the base and adjustment period, these trends were away from the elevated volume levels advocated by the CCSV Shippers.

[63] CCSV Shippers Brief on Exceptions at 37-38.

[64] Opinion No. 511, 134 FERC ¶ 61,121 at P 27.

apart.[65] The base and adjustment periods in the two proceedings are also different.[66] The two proceedings involve separate records and different costs of service. Consequently, the cost-of-service calculations in one case do not correspond to the cost of service calculations in the other. The 2011 ID and this opinion are properly based upon the East Line throughput during the July 1, 2008 – June 30, 2009 base period and the July 1, 2009 – March 31, 2010 adjustment period. The Commission will not reconsider the throughput level adopted by the 2011 ID based upon the volumes adopted for the West Line in Opinion Nos. 511 and 511-A.

46. The Commission is also not persuaded by the exceptions taken by NHW Shippers to modify the 2011 ID. NHW Shippers propose to adjust the April 1, 2009 through March 31, 2010 throughput, for what they claim is the underutilization of SFPP's Phase II Expansion, which increased the capacity of the East Line from approximately 147,000 barrels per day to 207,000 barrels per day effective December 1, 2007.

47. Much like the CCSV Shippers, the NHW Shippers do not base the proposed throughput level of 164,305 barrels per day on shipments during the base and adjustment period. Except for good cause shown, the Commission sets throughput levels based upon what occurred within the combined 12-month base period and the 9-month adjustment period. NWH Shipper's proposal of 164,305 barrels per day significantly exceeds the 154,921 barrels per day moved on the East Line during the base period and the 150,703 barrels moved per day during the 9-month adjustment period.

48. Aside from its inconsistency with base and test period principles, NHW Shippers' proposal penalizes prudent pipeline investment. Unless East Line volumes increase to the average monthly volume levels proposed by NHW Shippers, SFPP will not be recovering its full East Line cost of service. Regardless of the future productivity of the East Line Phase II Expansion in the years and decades ahead, SFPP will never be able to recoup these under-recoveries. NHW Shippers do not argue that the East Line expansion

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[65] Opinion No. 511-A, 137 FERC ¶ 61,220 at P 24. Docket No. IS08-390-000 involves a proposed a rate increase for the West Line to be effective August 1, 2008. Docket No. IS09-437-000 involves a proposed rate increase for the East Line, which was suspended by the Commission to be effective January 1, 2010. Hearing Order, 128 FERC ¶ 61,214 at P 1.

[66] In this proceeding, the base period is from July 1, 2008, through June 30, 2009. The nine-month adjustment period for test period changes is from July 1, 2009, through March 31, 2010. In the West Line proceeding in Docket No. IS08-390, 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.

was either imprudent or not used and useful.[67] Thus, NHW Shippers effectively argue that even though the expansion's size was prudent and even though the expansion capacity is currently being used,[68] the pipeline should be denied some of its investment costs if volumes are not at certain levels within the two years and four months immediately following the expansion.

49. The current and prospective use of the pipeline to provide transportation service and the need to encourage infrastructure investments weigh against restricting recovery on a prudent investment merely because the pipeline is operating at less than full capacity. Commission oil pipeline ratemaking policy recognizes that, to ensure economic efficiency, new capacity must be added in increments that are built to accommodate future circumstances that may be several years away. Imposing the throughput adjustment suggested by NHW Shippers could generally discourage investment in additional capacity, and, to the extent that such capacity is constructed, encourage pipelines to make smaller but more frequent expansions which may be less cost-effective.

50. NHW Shippers' proposal also lacks precedential support. NHW Shippers do not cite a single oil pipeline case in which the Commission has imposed such a throughput adjustment for *existing* oil pipeline capacity. To the extent any cases involving oil pipelines are cited, NHW Shippers rely upon petitions for declaratory order filed by oil pipelines *prior to* the operation of a new facility.[69] Unlike natural gas pipelines, oil pipelines do not need to seek approval from the Commission before beginning construction of a pipeline (or a pipeline expansion), but an oil pipeline may file a petition for declaratory order seeking certain assurances regarding rate treatment and other issues.[70] In the process of providing these special assurances prior to construction, it is appropriate for the Commission to use conservative throughput estimates. Without any data regarding the pipeline's actual operating experience, the Commission imposes safeguards against over-recovery by requiring the pipeline to use its designed capacity to

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[67] NHW Shippers Brief Initial Post-Hearing Brief at 116; Ex. WNR-1 at 12-13.

[68] During the 21-month combined base and adjustment period, the average barrels per day moved by the East Line exceeded the pre-Phase II expansion capacity of 147,000 barrels per day in (a) 7 of the 12 months in the base period, and (b) 6 of the 9 months in the adjustment period. *See* Ex. SPE-228A. The average throughput for the base and adjustment periods also exceeded the pipeline's pre-Phase II expansion capacity.

[69] *White Cliffs*, 126 FERC ¶ 61,070 at P 31; *Enbridge*, 110 FERC ¶ 61,211 at P 44.

[70] *E.g.*, *White Cliffs*, 126 FERC ¶ 61,070 at PP 27-28.

determine throughput.[71] However, in this case, the SFPP's East Line Phase II Expansion has been operational since December 2007, and the Commission has complete base and adjustment period data.[72]

51. For support relating to currently operational facilities, the NHW Shippers rely upon "turn back" capacity decisions, in which customers opted not to renew longstanding firm contracts on *natural gas* pipelines.[73] In contrast to the natural gas pipelines in the turn back cases, the East Line's Phase II Expansion has been operational a short period of time and may not be expected to operate near full capacity for many years. Moreover, the differences between contract carrier natural gas pipelines and oil pipelines are important. As a contract carrier under the NGA, a natural gas pipeline is better able to secure long-term firm service contracts that ensure full use of system capacity. An oil pipeline regulated by the ICA is a common carrier and, as such, SFPP's throughput depends upon shippers' decisions to nominate shipments, or not, on a monthly basis. Thus, whereas it may be appropriate in limited circumstances to place a contract carrier gas pipeline "at risk" for declining throughput, the same requirement applied to a

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[71] *Id.* P 31 (requiring use of designed capacity to calculate throughput because "White Cliffs proposes no safeguards against the over-recovery that could result from using its projected volumes rather than the pipeline's total design capacity in calculating the uncommitted shipper rate"); *Enbridge*, 110 FERC ¶ 61,211 at P 44 (finding Enbridge's cost of service filing did not justify a proposed rate because "Enbridge proposes no safeguards that would prevent the over recoveries that could result from using projected rather than design volumes").

[72] NHW Shippers' citations to the Commission's natural gas pipeline certificate decisions are similarly inapposite. NHW Shippers Brief on Exceptions at 62 (citing *Great Lakes*, 66 FERC at 61,210; *Equitrans*, 63 FERC at 61,304; *Arkansas Western*, 63 FERC at 61,027). Under section 7(c) of the Natural Gas Act (NGA) a natural gas pipeline must obtain a certificate of public convenience and necessity prior to construction or expansion; and the Commission has conditioned its finding of "public convenience and necessity" by requiring the pipeline to be "at-risk" for any unused capacity. *E.g., Great Lakes,* 66 FERC at 61,210. However, under the Intestate Commerce Act (ICA), there is no similar obligation for an oil pipeline to seek Commission certification prior to construction or expansion. Thus, NHW Shippers' analogy conflates two different regulatory regimes which impose different regulatory requirements.

[73] *Mississippi River*, 95 FERC at 62,658-59; *Natural Gas*, 73 FERC at 61,129; *El Paso*, 72 FERC at 61,441.

common carrier oil pipeline inappropriately exposes that pipeline to variations in its shippers' actual use.

52. Thus, the Commission adopts the throughput levels adopted by the 2011 ID and rejects the alternatives proposed on exceptions by the CCSV Shippers and the NHW Shippers.

IV. Operating Costs

A. Fuel and Power Costs

2011 ID

53. Electric energy and drag reducing agent (DRA)[74] are the East Line's primary fuel and power costs. These costs vary with throughput levels. Thus, as throughput levels are adjusted, a commensurate adjustment must also be made to the fuel and power costs.

54. To determine fuel and power costs, the 2011 ID directed SFPP to multiply the East Line average fuel and power cost per barrel[75] by the volume levels adopted by the 2011 ID. The 2011 ID rejected SFPP's proposal to determine fuel costs based upon which of the East Line's six line segments were used to reach each of the East Line's destinations. SFPP supported this proposal by claiming that fuel and power costs for each line segment differ and that East Line shipments to any given destination do not travel through every line segment. The 2011 ID determined that the record undermined SFPP's position. Specifically, the 2011 ID acknowledged SFPP's assertions that only four of the six line segments (1, 4, 5 and 6) [76] are used to transport throughput volumes to Phoenix.[77] However, in rejecting SFPP's proposed methodology, the 2011 ID cited SFPP witness Kehlet's statements that if there is an emergency interruption on

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[74] DRA is a product injected into the pipeline that minimizes friction and, thus, increases transportation efficiency. Ex. SPE-43.

[75] 2011 ID, 134 FERC ¶ 63,013 at P 285.

[76] *Id.* PP 281-282. The six segments are numbered as follows: (1) El Paso Pump Station to El Paso Breakout Facility; (2) 12-inch El Paso Breakout Facility to Deming Pump Station; (3) 12-inch Deming Pump Station to Tucson Pump Station; (4) 16-inch El Paso Breakout Facility to Deming Pump Station; (5) 16-inch Deming Pump Station to Tucson Pump Station; and (6) Tucson Pump Station to Phoenix. *E.g.*, Ex. SPE-212 at 3-4; Ex. SPE-222A at 113.

[77] Ex. SPE-214.

segments 4 and 5, product could be channeled to segments 2 and 3 which are ordinarily used solely for throughput stopping in Tucson.[78] Thus, the 2011 ID determined that it was inappropriate when determining the fuel and power costs related to deliveries to Phoenix to rely upon data for segments 1, 4, 5, and 6 and not segments 2 and 3.

Briefs On Exceptions

55. On exceptions, SFPP states that the 2011 ID presented no basis for using Trial Staff's average per barrel fuel cost for the entire East Line. First, SFPP states that the 2011 ID fails to address the different per-barrel energy cost for each line segment on the East Line. SFPP states that its fuel and power costs are incurred at four significant energy usage points, and that the costs at these four points vary due to the volume levels, the product mix, the cost of energy at each point, the energy used at each point, and the cost and amount of drag reducing agent used at each point.[79] As a result, SFPP states that these variations cause each of the six line segments on the East Line to have a different per-barrel energy cost.[80] SFPP states that its proposal accounts for these differences.[81] SFPP contends that, in contrast, Trial Staff and the 2011 ID inappropriately assume that all of the volumes flowing on the East Line flow through the entirety of the pipeline.[82] SFPP claims the 2011 ID improperly relies upon an indirect method of allocating fuel and power costs even though a more direct assessment of costs is possible.

56. SFPP objects to the 2011 ID's reliance on the proposition that each of the line segments of the East Line could be used, under certain circumstances, to transport product to Phoenix. SFPP emphasizes that line segments 2 and 3 on the East Line were dedicated to Tucson movements only and would continue to be dedicated to Tucson movements. According to SFPP, Mr. Kehlet only stated that these segments would be used to move throughput to Phoenix if some sort of emergency necessitated a change.[83] SFPP states that no such change has occurred, and, even if such a change did occur, SFPP

[78] 2011 ID, 134 FERC ¶ 63,013 at P 285 (citing Tr. 1138-39).

[79] SFPP Brief on Exceptions at 97 (citing Ex. SPE-43 at 5-8).

[80] *Id.* at 98 (citing Ex. SPE-43 at 6; Ex. SPE-212 at 3-5).

[81] *Id.* (citing Ex. SPE-47 at 8-9; Ex. SPE-222 at 110-113).

[82] SFPP explains that deliveries to Alamogordo use Line Segments 1 and 2; deliveries to Lordsburg, Tucson and Davis Monthan use Line Segments 1, 2 and 3; deliveries to Phoenix use Line Segments 1, 4, 5, and 6. *Id.* (citing Ex. SPE-222 at 113).

[83] *Id.* at 99 (citing Tr. 1137-1139).

adds that volumes to Phoenix would never flow through all six segments and would either flow through line segments 1, 2, 3, and 6 or, in the alternative, 1, 4, 5, and 6.[84]

Briefs Opposing Exceptions

57. Opposing Exceptions, Trial Staff states that Mr. Kehlet conceded that an operational change could occur during emergency circumstances and that product could flow through any of the six segments on the line to reach Phoenix. Trial Staff contends that this admission confirms the approach adopted by the 2011 ID. Trial Staff states that by using the average per-barrel cost, Ms. Sherman accounted for the different per barrel cost for each line segment of the East Line.

58. Opposing Exceptions, CCSV shippers state that the 2011 ID properly rejected SFPP's proposed fuel and power levels insofar as the 2011 ID rejected SFPP's proposed throughput for the East Line.

Commission Decision

59. The Commission reverses the 2011 ID on this issue. SFPP presented evidence that each of its pipeline segments had different fuel and power costs.[85] Thus, shipments to Phoenix, which only use some of the segments, will have a different fuel and power cost per barrel than shipments to Tucson, which use other segments. The 2011 ID, by applying a system-wide average of fuel and power costs, did not account for these disparities.

60. Specifically regarding transportation to Phoenix, Trial Staff and the 2011 ID emphasize that in an emergency segments 2 and 3 could be used to transport throughput to Phoenix. However, there is no evidence that this occurred during the base and adjustment period.

61. As a result, the Commission will adopt SFPP's proposed methodology in schedule 17 of its cost of service[86] for determining a fuel and power cost that corresponds to the volume levels adopted by this order.

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[84] *Id.* (citing Tr. 1137-1139; Ex. SPE-222 at 113 (Schedule 17)).

[85] *E.g.*, Ex. SPE-212 at 3-4; Ex. SPE-222A at 113.

[86] Ex. SPE-222A at 113.

B. Litigation Costs

1. Union Pacific Litigation Costs

2011 ID

62. The Union Pacific Railroad (UPRR) litigation relates to the rents for the right-of-way for SFPP's pipelines, including the East Line.[87] This litigation also involves whether SFPP is bound by the American Railway and Engineering and Maintenance-of-Way (AREMA) standards as opposed to the less expensive pipeline safety standards adopted by the U.S. Department of Transportation and the State of California.

63. The 2011 ID concluded that SPFP had allocated AREMA litigation costs for proceedings that do not involve the East Line and concluded that costs related to those proceedings should not be included in SFPP's East Line's cost of service.[88] Regarding the right-of-way litigation, the 2011 ID directed SFPP to allocate 4.87 percent of its UPRR litigation costs to the East Line. The 2011 ID stated that the land valuation of the easements on the East Line represented 4.87 percent of the total land value for all of the SFPP right-of-way UPRR easements, including those on other parts of SFPP's system. The 2011 ID noted that SFPP witness Melle testified that out of 1,477 miles of SFPP pipe on UPRR easements, the East Line comprises 154 miles.[89] The 2011 ID further observed that of the 154 miles, about two-thirds are classified as class four which has the lowest right-of-way fees, and zero miles are in class 1 (the highest fees).[90] The 2011 ID concluded that it is more reasonable to allocate the litigation costs in the same proportion as the rent fees.

Briefs On Exceptions

64. On exceptions, SFPP argues that the Initial Decision's rulings regarding the UPRR litigation costs are flawed. Specifically, SFPP asserts that the 2011 ID erred by allocating UPRR right-of-way litigation costs based upon the *value* of the East Line right-of-way as a percentage of the total value of the SFPP UPRR right-of-way. SFPP states that the allocation of UPRR costs should be based upon the right-of-way *mileage* on the East Line

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[87] Tr. 1677-1679. The right-of-way expenses are described in SFPP's Ex. SPE-47 at 9-12, Ex. SPE-222 (Schedules 15 & 18), and Ex. SPE-39.

[88] 2011 ID, 134 FERC ¶ 63,013 at P 293.

[89] *Id.* P 292 (citing Ex. SPE-222 at 114).

[90] *Id.* (citing Tr. 143:23 to 144:1; 1677:10-14).

compared as a percentage of the total SFPP miles on UPRR right-of-way. SFPP states that a single litigation proceeding was held to determine the rental value of all of the UPRR right-of-way segments. SFPP claims that it did not spend less money litigating the rental value of higher valued property than it did the right-of-way segments on lower valued property.[91] As a result, SFPP claims that the 2011 ID's approach violates principles of cost causation because there is no correlation between the value of the land and the level of UPRR litigation costs. In contrast, SFPP states that an allocation of litigation costs based solely on mileage is a representative measure of the responsibility that each segment has for the total litigation costs. SFPP states that using this methodology, the East Line would be allocated 10.46 percent of the total UPRR litigation costs.

65. SFPP also claims that the 2011 ID erred by disallowing the UPRR litigation costs related to private AREMA standards, i.e. whether state or federal safety standards apply to pipeline relocations and over contractual safety standards for pipeline relocations based upon AREMA Standards. SFPP states that the 2011 ID was wrong to exclude these costs because these holdings are expected to apply to all of the pipelines on the SFPP system.[92]

Briefs Opposing Exceptions

66. Opposing exceptions, NHW Shippers state that the 2011 ID correctly required SFPP to remove the expenses of litigating right-of-way litigation expenses that did not involve the East Line. Opposing exceptions, NHW Shippers argue that SFPP only cites to a data response prepared by SFPP counsel, which NHW Shippers state is mere argument, not evidence.[93] NHW Shippers state that the complaints involve specific portions of pipe and do not involve the East Line.[94] In response to SFPP's argument that

[91] SFPP Brief on Exceptions at 96 (citing Tr. 1678-81).

[92] *Id.* at 97 (citing Ex. NAV-56 at 1-2).

[93] NHW Shippers Brief on Exceptions at 86 (citing Ex. NAV-56 at 2).

[94] *Id.* (citing Ex. NAV-53 at 4; Tr. 1694:7-23 (Turner); Ex. NAV-55 at 2-3; Tr. 1695:20 to 1697:8 (Turner); Ex. NAV-53 at 4 (complaint concerning relocation of SFPP pipeline in Danville, Martinez, Pomona, and Roseville, California); Tr. 1694:7-23 (Turner); Ex. NAV-54 at 6 (complaint concerning relocation of SFPP pipeline in Thousand Palms, California); Tr. 1694:24 at 1695:19 (Turner); Ex. NAV-55 at 2-3 (complaint concerning relocation of SFPP pipeline in Riverside County, California); Tr. 1695:20 to 1697:8 (Turner)).

these cases may have a precedential effect on cases relating to East Line facilities,[95] NHW contends that such arguments are speculative. NHW Shippers add that this is not a reasonable standard to allocate costs to the East Line. NHW Shippers state that SFPP's witness Mr. Turner testified that even though the outcome of a legal proceeding regarding one of SFPP's lines (such as the East Line) could serve as precedent for resolving a later case relating to a different line (say the West Line), the costs of the earlier litigation should not be allocated to shippers in the later proceeding.[96]

67. NHW Shippers acknowledge that one case involved the right-of-way on UPRR land on which all segments of SFPP's system are located. NHW Shippers contend that the 2009 ID correctly allocated the costs related to this right-of-way litigation expenses to the East Line in accordance with the pipeline's rental value, not mileage. NHW Shippers explain that the UPRR litigation concerns the rent for the right-of-way on each of the categories of pipeline,[97] and NHW Shippers state that the allocation of these costs should be proportionate to the right-of-way costs at issue. NHW Shippers explain that a rational litigant will spend more money on a case having more economic significance than on a lower value case. NHW Shippers state that the East Line passes through the lowest cost land, which is "mostly desert."[98] NHW Shippers state that allocating right-of-way on the East line in accordance with mileage treats the cheaper East Line right-of-way as though it is the same as the more expensive right-of-way on other segments. Thus, NHW Shippers state that allocating the UPRR litigation costs according to mileage enables SFPP to allocate over 10 percent of the litigation costs relating to right-of-way despite the fact that the East Line gives rise to only 5 percent of right-of-way costs.

Commission Decision

68. The Commission affirms the 2011 ID on these issues. SFPP did not adequately support its position that two proceedings involving AREMA-related costs should be included in the East Line cost of service. Although litigation relating to other parts of SFPP's system may establish general legal precedent, this does not justify assigning the litigation costs to the East Line when the litigation only directly relates to other parts of

[95] *Id.* at 87 (citing SFPP Brief on Exceptions at 97).

[96] *Id.* (citing Tr. 1700-01).

[97] *Id.* at 89 (citing Tr. 1677-1679).

[98] *Id.* at 88 (citing 2011 ID, 134 FERC ¶ 63,013 at P 292; Tr. 140:20-21; Ex. SPE-39 at 6:2-6; Tr. 1680:4-5).

SFPP's system.[99] Thus, in one AREMA proceeding cited by SFPP, the litigation addressed the "relocation of a 10-mile stretch of SFPP pipeline in California."[100] This relocation could not involve the East Line, which does not go through California. The costs related to that proceeding must be excluded from the East Line cost of service. Regarding the second AREMA proceeding identified by SFPP, SFPP states that:

> SFPP sought a determination that federal standards pre-empted as a matter of law any private standards, but the courts determined that the parties could comply with a different set of standards if they wished to (without determining whether they had). This case related to pipeline relocations and the application of AREMA standards generally and did not involve particular SFPP line segments.[101]

SFPP does not provide further record evidence explaining the context in which this litigation arose or any related relocations of East Line pipe. The limited and ambiguous evidence presented by SFPP fails to support the relationship between these costs and service on the East Line. Thus, these costs must be excluded from the East Line cost of service.

69. The 2011 ID also correctly allocated the right-of-way "rental value" litigation costs based upon land valuation. The low value of the East Line right-of-way land reduced its relative monetary significance to SFPP in this litigation. For allocating litigation costs relating to fair rental value, land valuation provides a more direct estimate for apportioning the litigation benefits and costs than SFPP's proposed mileage approach.

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[99] For example, although this case may set general precedent that applies in future cost of service proceedings involving other parts of SFPP's system, the costs for this rate litigation are assigned exclusively to the East Line.

[100] Ex. NAV-56.

[101] *Id.*

2. **FERC-Related Litigation Charges**

2011 ID

70. The 2011 ID rejected SFPP's proposal and adopted the litigation expense advocated by Trial Staff based upon the $1.167 million in FERC litigation costs incurred during the calendar year 2009. The 2011 ID's determination allowing SFPP to recover $1.167 million annually for the next three years reflected a total litigation cost recovery of $3.2 million. The 2011 ID concluded that three years was a reasonable time to recover these costs to litigate this proceeding. Thus, the ID proposed to remove the litigation costs from SFPP's rates after three years. The 2011 ID determined that SFPP's projections of the costs to litigate this proceeding are not known and measurable with reasonable accuracy. Disputing SFPP's use of its costs in the West Line case in Docket No. IS08-390 to project the costs in this proceeding, the 2011 ID determined that is not reasonable to take the expenses of another litigation proceeding and use them to calculate the expenses in this case. The 2011 ID distinguished the East Line case from the West Line case in Docket No. IS08-390, asserting that the West Line has larger throughput and thus it would be reasonable to assume that the costs of litigating the West Line would be greater because the money involved is more significant. The 2011 ID noted that unlike in the West Line case in Docket No. IS08-390, environmental remediation, depreciation, and ROE were either settled or not issues in this proceeding.

Briefs On Exceptions

71. On exceptions, SFPP asserts that the D.C. Circuit and the Commission have consistently recognized that regulated entities are entitled to recover all of their prudently incurred regulatory litigation expenses.[102] SFPP states that the method adopted by the 2011 ID, which was based upon actual litigation expenses during 2009 includes only those costs incurred by SFPP through the direct testimony phase of the proceeding and ignores significant costs incurred since 2009.[103] SFPP states that its litigation expenses had already exceeded $3 million at the time of hearing.[104] SFPP states that its total costs are expected to significantly surpass that amount, given that SFPP incurred additional costs during the hearing, post-hearing briefing, rehearing, and compliance phases. SFPP

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[102] SFPP Brief on Exceptions at 94 (citing *Iroquois Gas Transmission Sys., L.P. v. FERC*, 145 F.3d 398 (D.C. Cir. 1998) (*Iroquois Gas*); *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263, 1296-97 (D.C. Cir. 2004); *SFPP, L.P.*, Opinion No. 435-A, 91 FERC ¶ 61,135, at 61,512 (2000)).

[103] *Id.* at 95 (citing Ex. SPE-222 at 123).

[104] *Id.* at 94 (citing Tr. 1807).

acknowledges that it has advocated the adoption of litigation expenses included in Schedule 15 of SFPP's cost of service for a total litigation costs litigation expense of $2.4 million annually.[105] However, SFPP states that it supports the subsequent approach adopted in Opinion No. 511 which would allow SFPP to recover its actual litigation costs.[106] SFPP states that this provides an appropriate alternative to its original proposal.

72. On exceptions, CCSV Shippers assert that the 2011 ID's adoption of actual data for the calendar year of 2009 is contrary to the Commission's base and test period regulations. CCSV Shippers state that the pipeline is not guaranteed the recovery of non-recurring costs in its rates, and CCSV Shippers contend the litigation costs adopted by the 2011 ID incorporate non-recurring costs. The CCSV shippers state that the 2011 ID arbitrarily ignored the base period and failed to explain why these costs were not likely to be normal, recurring costs. The CCSV Shippers state that Trial Staff's proposal results in the anomalous situation, where, following its proposed three year recovery period, all legal costs would be removed from SFPP's East Line rates. CCSV Shippers state that there is no justification for treating litigation costs differently from any of SFPP's other operation and maintenance expenses. CCSV Shippers assert that "cost of service ratemaking seeks to establish a representative level of future costs based on historical costs and known and measurable changes. It does not seek to recover particular items of expense."[107] The CCSV Shippers add that "Even if costs increase during the period that the rate case is pending, the normal procedure is for the pipeline to file another case to establish a new test [period] which reflects those additional costs."[108]

73. In contrast, CCSV Shippers advocate using legal costs of $495,981. They explain that this figure excludes costs in Docket No. OR03-5, which can be recovered by the settlement in that docket, and they also emphasize that this figure normalizes an interstate allocated portion of legal costs associated with a cost allocation study over a five-year period.[109] CCSV Shippers state that there is no evidence that SFPP annually or tri-annually files cost of service rate increases. CCSV Shippers state that SFPP went 17 years before filing a cost-based rate increase in 2005 for its North Line. CCSV

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[105] *Id.* (citing Ex. SPE-222 at 110-111).

[106] Order No. 511, 134 FERC ¶ 61,121 at P 37.

[107] CCSV Shippers Brief on Exceptions at 24 (quoting *Enbridge Pipelines (KPC)*, 102 FERC ¶ 61,310, at P 125 (2003)).

[108] *Id.* at 25 (citing *SFPP, L.P.*, 111 FERC ¶ 61,334, at P 46 (2005)).

[109] *Id.* at 23 (citing Ex. VCC-78hc at 27-30).

Shippers state that SFPP did not file a rate increase on its West Line between 1989 and 2008.[110]

74. CCSV Shippers state that Mr. O'Loughlin's recommendation is that oil pipeline general rate cases are not a frequently or ordinarily recurring event on oil pipelines and should not be treated as such in calculating rates. CCSV Shippers state that even if the East Line undertook a rate case every five years, recovering $495,981 every year would provide the pipeline with approximately $2.5 million in recovered litigation or legal costs. CCSV Shippers state that absent making pipelines responsible for their own non-recurring litigation costs, pipelines will lack incentives to follow the ICA or to engage in meaningful settlement discussions.

75. CCSV Shippers further claim that the 2011 ID's reliance on Opinion No. 435-A is inapposite because it involved a complaint proceeding and SFPP did not control the costs incurred during the underlying rate litigation. In contrast, CCSV Shippers argue that this case was initiated by SFPP, and that SFPP controlled the timing of the case and the costs incurred. CCSV Shippers state that unlike in *Iroquois*, [111] no party is seeking to deny entirely SFPP's recovery of some legal costs.

Briefs Opposing Exceptions

76. Trial Staff opposes both the exceptions of SFPP and CCSV Shippers. In response to SFPP, Trial Staff acknowledges that Opinion No. 511 took a different approach from the 2011 ID and ruled that SFPP may include a limited three-year surcharge in its rates to recover reasonable legal costs incurred in the actual proceeding. However, Trial Staff asserts that allowing SFPP to surcharge its customers for litigation costs is an open invitation for the pipeline to maximize its costs without sufficient regulatory scrutiny. Trial Staff emphasize that cost of service ratemaking is to establish a representative level of future costs, not to recover for past costs. Trial Staff states that CCSV Shippers disregard Opinion No. 511. Trial Staff further objects to SFPP's adoption of Order No. 511 because, according to Trial Staff, it casts aside the evidence in this case.

77. Opposing CCSV Shippers' exceptions, SFPP states that Opinion No. 511 sets forth the reasonable approach for recovering prudently incurred litigation costs: allowing recovery of actual regulatory litigation costs through the completion of the compliance phase of the proceeding via a three-year surcharge. SFPP states that Opinion No. 511 alleviates CCSV Shippers' concerns because the costs would be recovered through a surcharge. SFPP states that CCSV Shippers' approach is not consistent with Commission

[110] *Id.* at 24 n.11.

[111] *Iroquois Gas*, 145 F.3d 398.

precedent. SFPP emphasizes that the majority of the approximately $6.5 million in regulatory expenses[112] that will be incurred in this proceeding will be incurred after the test period due to discovery, rebuttal testimony, eighteen days of hearing and four rounds of briefing. SFPP also objects to CCSV Shippers' characterizion of oil pipeline litigation proceedings as unusual events, noting that the CCSV Shipper witness O'Loughlin's curriculum vitae shows that he has filed testimony or affidavits in more than ten SFPP proceedings since 2004.[113] SFPP states that using Mr. O'Louglin's proposed method, it would take SFPP more than six years to recover the $3.0 million in litigation expenses that it had incurred prior to the hearing in this proceeding, which would not allow any recovery for SFPP's other litigation costs.

78. Although SFPP was the party that filed the East Line tariff at issue, SFPP also states CCSV Shippers and other protestants heavily influenced the scale and cost of the litigation. SFPP notes that prior to hearing, the shippers presented SFPP with 1,608 data requests, caused SFPP to review more than 46,600 company emails, and caused SFPP to produce 30,635 pages of responsive documents and vast numbers of electronic files.[114]

79. Opposing SFPP's exceptions, CCSV Shippers argue that Opinion No. 511 conflicts with the Commission's base and test period principles. CCSV Shippers state that a pipeline is not allowed to incorporate non-recurring costs into its rates. CCSV Shippers state that the Commission had not justified treating litigation costs differently from SFPP's other operation and maintenance expenses. CCSV Shippers also state that the approach adopted by Opinion No. 511 would guarantee recovery of a particular post-test period cost item, but would not take into account post-test period changes that are unfavorable to the pipeline, such as changes in throughput or other costs.[115] CCSV Shippers state that the Commission only allowed the recovery of non-recurring litigation costs in Opinion No. 435 because SFPP did not commence those proceedings and was not in control of the timing of the underlying complaint litigation that caused the costs to be incurred.[116] CCSV Shippers state that this policy will discourage settlement.

[112] SFPP Brief on Exceptions at 38 (citing Ex. SPE-162 at 17).

[113] *Id.* at 39 (citing Ex. VCC-79, Tr. 2604).

[114] *Id.* (citing Tr. 2583-84; Tr. 2607-2608).

[115] CCSV Shippers Brief Opposing Exceptions at 98-99 (citing *Williston Basin*, 87 FERC at 62,022).

[116] *Id.* at 99 (citing *SFPP, L.P.*, 111 FERC ¶ 61,334 at P 47).

Commission Decision

80. The Commission modifies the 2011 ID's holding that allows SFPP to recover $1.167 million annually for the next three years, reflecting a total litigation cost recovery of $3.2 million. The Commission agrees with the 2011 ID that a three-year surcharge is appropriate. However, the total litigation cost of $3.2 million adopted by the 2011 ID does not adequately represent SFPP's likely East Line litigation costs. Consistent with the Commission's prior orders involving SFPP litigation, SFPP will be permitted to collect via the three-year surcharge the actual litigation costs incurred in this proceeding (Docket Nos. IS09-437-000, *et al*., and IS10-572-000, *et al*.) through the hearing, rehearing and compliance phases.

81. Following the issuance of the 2011 ID, the Commission addressed a similar issue in Opinion Nos. 511 and 511-A,[117] and, in those decisions, the Commission permitted SFPP to include a limited three-year surcharge applicable to West Line rates to recover the actual reasonable legal costs related to litigation in that proceeding. Opinion Nos. 511 and 511-A determined that such a surcharge was consistent with the Commission's prior treatment of SFPP's litigation costs.[118] The Commission observed that 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 expenses.[119] Also, the Commission reasoned that due to the timing of the litigation process and ending dates of the base and adjustment periods, the costliest phase of the litigation will often occur after the rate filing and will not be fully reflected in the litigation costs incurred during the base and adjustment period.[120] It is not efficient to require the pipeline to file yet another rate case for these litigation costs. Under these circumstances, the surcharge allows recovery of actual costs without creating a risk of substantial over-recovery in the future.[121] As determined in Opinion Nos. 511

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[117] Opinion No. 511, 134 FERC ¶ 61,121 at PP 35-37, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 39-42.

[118] Opinion No. 511, 134 FERC ¶ 61,121 at P 35 n.43 (citing *SFPP, L.P*., Opinion No. 435-B, 96 FERC ¶ 61,281, at 62,074-75 (2001), *order on reh'g*, 100 FERC ¶ 61,353, at PP 9-14 (2002), *aff'd in relevant part*, *BP West Coast*, 374 F.3d at 1294).

[119] Opinion No. 511, 134 FERC ¶ 61,121 at P 35 *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 at P 40.

[120] Opinion No. 511, 134 FERC ¶ 61,121 at P 36 *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 at P 40.

[121] Opinion No. 511, 134 FERC ¶ 61,121 at P 35.

and 511-A, the particular circumstances regarding SFPP's litigation costs provide good cause to depart from the base and test period data.[122]

82. The evidence in this case does not support a departure from the Commission's approach in Opinion Nos. 511 and 511-A. The calendar year 2009 $1.167 litigation expense adopted by the 2011 ID concludes five months before SFPP submitted its rebuttal testimony in this case and does not include the considerable costs associated with the hearing or subsequent briefing. SFPP has provided evidence based upon past proceedings that its costs will substantially exceed the total $3.2 million that the 2011 ID would permit SFPP to recover. For example, SFPP witness Turner testified that SFPP's litigation costs had already exceeded $3 million *prior to hearing*,[123] and SFPP's recent litigation experience involving its West Line suggests that costs could exceed $6 million.[124] Pipelines may recover their prudently incurred litigation costs,[125] and the 2011 ID and Trial Staff did not establish that recovery of $1.167 million annually for three years is indicative of the litigation costs associated with this East Line rate case.

83. The alternative advocated by CCSV Shippers is also inadequate. CCSV Shippers on exceptions advocate embedding litigation costs of $495,981 in SFPP's East Line cost of service. This proposal fails to allow SFPP to recover its litigation costs. CCSV Shippers' data only include $27,544 associated with this case, well below any reasonable estimation of the legal costs in Docket No. IS09-437.[126] It is not clear that the other

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[122] 18 C.F.R. 346.2(a)(1) (2011).

[123] Tr. 1807.

[124] Ex. SPE-222 at 122; Ex. SPE-162 at 17. The 2011 ID contended that SFPP's costs in this proceeding were likely to be less than those for litigating the West Line in IS08-390-000, asserting that this proceeding involved fewer issues because the parties stipulated to the cost of equity and environmental costs. 2011 ID, 134 FERC ¶ 63,013 at P 297. However, the issues that have been most extensively briefed related to the income tax allowance and the G&A allocation are also part of this case. Other issues, such as the treatment of debt swaps, are unique to this proceeding and did not appear in the IS08-390 proceeding. Although the 2011 ID emphasized that East Line throughput is less than West Line throughput, it is not clear that, as a result, the East Line litigation costs must be significantly less.

[125] Opinion No. 435-A, 91 FERC at 61,512 (stating "Litigation related to the pipeline's cost of service and the structure of its tariff are part of its normal, ongoing operations, and such costs are recoverable as part of the pipeline's cost of service"); Opinion 511-A, 137 FERC ¶ 61,220 at P 39.

[126] Ex. SPE-162 at 4.

costs that the CCSV shippers include for other proceedings are a reasonable proxy for costs incurred by SFPP to litigate this proceeding. To the extent that CCSV Shippers advocate the use of base and adjustment period data, CCSV Shippers' proposal does not account for the increased East Line legal costs experienced during the 9-month adjustment period.[127] To the extent that a base period and adjustment period cost should be embedded in the cost of service, such increases during the adjustment period could not be ignored.

84. The CCSV Shippers also criticize the adoption of a three-year surcharge. CCSV Shippers acknowledge that the Commission has applied a similar litigation recovery surcharge in complaint proceedings against SFPP,[128] but CCSV Shippers claim that a complaint proceeding is different from a rate filing initiated by a pipeline. In addressing the same argument, Opinion Nos. 511 and 511-A explained that it was appropriate to apply such a surcharge to a rate increase proposed by the pipeline.[129] The principle that pipelines may recover prudently incurred litigation costs applies whether a pipeline is filing a rate increase to recover its costs or responding to a complaint. As observed by Opinion 511-A, although SFPP made the decision to file the rate increase, SFPP does not control the degree to which shippers have litigated the issues raised in this proceeding.[130]

C. <u>Common Carrier</u>

<u>2011 ID</u>

85. The 2011 ID explained that the Commissions Regulations define the term "carrier" as "an oil pipeline subject to the Commission's jurisdiction under the ICA."[131]

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[127] For example, the $1.167 million litigation costs adopted by the 2011 ID based upon calendar year 2009 data significantly exceed the litigation cost level proposed by CCSV Shippers.

[128] The Commission applied and the D.C. Circuit upheld a litigation surcharge in the proceedings in Docket No. OR92-8-000, *et al.* Opinion No. 435-B, 96 FERC at 62,074-75, *order on reh'g,* 100 FERC ¶ 61,353 at P 9-14, *aff'd in relevant part, BP West Coast,* 374 F.3d at 1294.

[129] Opinion No. 511, 134 FERC ¶ 61,121 at P 35, *order on reh'g,* Opinion No. 511-A, 137 FERC ¶ 61,220 at P 40.

[130] Order No. 511-A, 137 FERC ¶ 61,220 at P 41.

[131] 2011 ID, 134 FERC ¶ 63,013 at P 279 (quoting 18 C.F.R. Part 341.0 (a)(1)(2010)).

However, SFPP's witness Turner defines "carrier" as: "SFPP has carrier pipeline transportation services regulated by the FERC and the CPUC, (and services for the military (which are not regulated by the FERC or the CPUC).[132] Agreeing with Staff, the 2011 ID found that SFPP was not appropriately applying the Commission's definition of "carrier" and ordered SFPP to comply with the Commission's definition of carrier.[133]

Briefs On Exceptions

86. On exceptions, SFPP argues the 2011 ID erred by adopting the Staff's definition of "carrier services" as only jurisdictional services regulated by the Commission.[134] SFPP states the Commission addressed this issue on essentially identical facts in Opinion No. 511, finding that the Commission's accounting regulations do not "precisely distinguish between jurisdictional and non-jurisdictional facilities and services operated by interstate oil pipelines," but that, "under current Commission practice, all oil pipeline transportation property, revenues, and expenses are commingled in the pipeline's account under the terms of 18 C.F.R. Part 352 if used in oil pipeline transportation."[135] Accordingly, SFPP claims that the Commission should uphold SFPP's accounting treatment and reject the 2011 ID's holding on this point.

Brief Opposing Exceptions

87. In its brief opposing exceptions, Staff agrees with the 2011 ID's determination that SFPP's definition of "carrier" is inconsistent not only with the Commission's regulations but also SFPP witness testimony in this proceeding.[136] Staff cites to the testimony of witnesses Des Lauriers and Bradley that KMEP's accounting system does identify costs incurred by employees as being related to carrier, non-carrier or military service.[137] According to Staff, the categorization of these costs by type of service would not be

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[132] *Id.* (citing Ex. SPE-47 at 22).

[133] *Id.*

[134] SFPP Brief on Exceptions at 72.

[135] *Id.* at 73 (quoting Opinion No. 511, 134 FERC ¶ 61,121 at P 72).

[136] Trial Staff Brief Opposing Exceptions at 24.

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

necessary if all costs were in fact related to the all encompassing definition "carrier services" as proposed by SFPP.[138]

Commission Decision

88. Staff's and SFPP's positions on this issue are nearly identical to those already addressed by the Commission in Opinion No. 511. In that case, the Commission found 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."[139] Accordingly, the Commission concluded that separate reporting of inter- and intrastate data is imperfect at this time, but that "given that an industry wide reporting practice is involved, an individual pipeline proceeding is not the place to modify it."[140] The parties have presented no new evidence that persuades the Commission to modify its previous finding. Accordingly, the Commission will reverse the 2011 ID in this matter, consistent with Opinion No. 511.

V. General and Administrative Cost Allocation

89. This section addresses the allocation of general and administrative (G&A) costs among SFPP's affiliates within the Kinder Morgan business structure. It also addresses the allocation of costs between the different SFPP pipeline systems (such as the East Line and the West Line) using the KN Methodology.

A. G&A Cost Allocation to SFPP

1. Background

90. SFPP is owned by Kinder Morgan Energy Partners (KMEP), which is part of the Kinder Morgan business structure.[141] KMEP is a master limited partnership consisting of diverse energy industry assets. For the purposes of allocating G&A costs, these assets are organized into five business segments: (1) product pipelines; (2) carbon dioxide (CO2);

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[138] *Id.* at 25.

[139] Opinion No. 511, 134 FERC ¶ 61,121 at P 72 (citing 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)).

[140] *Id.*

[141] The Kinder Morgan business structure is a complex association of various business entities.

(3) bulk terminals; (4) natural gas pipelines; and (5) KM Canada.[142] In addition to the five business segments, KMEP also owns equity interests in two joint ventures, Red Cedar Gathering Company (Red Cedar) and Endeavor Gathering LLC (Endeavor).

91. As SFPP explains, KMEP's: (1) products pipeline; (2) CO2; and (3) bulk terminal business segments are operated by and receive G&A services directly through KMEP (collectively, KMEP-Operated Entities). KMEP itself does not have any employees. As a result, SFPP states that the entity responsible for providing the majority of G&A services to the KMEP-Operated Entities is KMGP Services Company, Inc. (GP Services). In addition to GP Services, SFPP states that another entity within the Kinder Morgan business structure, Kinder Morgan Inc. (KMI), provides a limited level of G&A support to the KMEP-Operated Entities.

92. According to SFPP, the remaining natural gas pipeline and KM Canada business segments are not KMEP-Operated Entities. SFPP asserts that the natural gas pipeline assets (KMI-Operated Entities) are operated by and receive G&A services directly from KMI.[143] SFPP represents that KMEP's KM Canada business segment is supported almost exclusively by Canadian employees, receiving limited G&A support from KMI and KMEP. SFPP states that its joint equity ventures in Red Cedar and Endeavor do not receive any G&A support directly through KMEP.

93. Based upon this business structure, SFPP's proposes a multi-tiered cost allocation methodology for determining the G&A costs that must be allocated to SFPP. First, KMEP seeks to attribute costs to one of the three entities within the KMEP-Operated Entities business segment (i.e., products pipelines, CO2, and bulk terminals sub-groups). If a cost cannot be directly assigned to one of the KMEP-Operated Entity business

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[142] KM Canada includes oil and product pipelines located in the United States of America and Canada as well as terminal operations in Canada. 2011 ID, 134 FERC ¶ 63,013 at P 258.

[143] KMI was the original owner of most of the KMI-Operated Entities. Ownership of the KMI-Operated Entities was subsequently transferred to KMEP for tax purposes; however, when ownership was transferred to KMEP, the KMI employees responsible for management and operations of the KMI-Operated Entities remained with KMI. In certain circumstances, GP Services employees provide additional G&A support to the KMI-Operated Entities. In addition to the KMI-Operated Entities, there are still some entities owned directly by KMI (KMI-Owned Entities). Ex. SPE-57 at 6-7. The KMI-Owned Entities consist of telecommunications, power and natural gas companies.

segments, then KMEP uses the Commission's Massachusetts Formula[144] to determine the allocation of these remaining costs among its products pipelines, CO2, and bulk terminals subsidiaries. Similarly, for the costs directly assigned to the products pipeline business segment, KMEP further seeks to directly assign these costs to one of four different geographically defined subgroups (for example, SFPP is in the Pacific Region). For those costs that could not be directly assigned at this level, KMEP utilizes the Massachusetts Formula to allocate the costs between the four subgroups. Finally, KMEP employs a similar process to allocate costs within the Pacific Region, either directly assigning costs to particular entities (such as SFPP) or using the Massachusetts Formula.

94. KMI employees also provide services to KMEP-Operated Entities, including SFPP. KMI employees assign their labor costs to one of three accounts. One of the three, Account 184601 (KMEP G&A Overhead Pool),[145] includes all of the labor costs that can be assigned from KMI employees to KMEP-Operated Entities (KMI-Cross Charge). The costs in Account 184601 are directly assigned to the KMEP-Operated Entities group and then allocated among the various KMEP-Operated Entities using the combination of direct assignments and the Massachusetts Formula described above.

95. SFPP's filing in this proceeding allocates a total of $46.8 million in G&A costs to SFPP.[146] Of this amount, $36.4 million was directly assigned.[147] The remaining $10.4 million of G&A costs was allocated to SFPP through the Massachusetts Formula.[148]

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[144] 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. Opinion No. 511, 134 FERC ¶ 61,121 at P 90. Overhead costs are allocated to the affiliate based upon the average percentage of each of these three items to total company figures for these three items. An equal weight is given to each of the three averages.

[145] 2011 ID, 134 FERC ¶ 63,013 at P 248.

[146] This is the cost assigned to SFPP. As noted previously, costs are further allocated to the East Line using the KN Methodology.

[147] Ex. SPE-231. These costs would further be allocated among different parts of the SFPP pipeline system.

[148] *Id.*

96. At hearing, the CCSV Shippers advocated the alternative "all-in" methodology. The "all-in" methodology consists of a single, corporate-wide (or single-tiered) Massachusetts Formula. In other words, the "all-in" methodology aggregates all the G&A costs that are not attributed to a particular business segment in KMI and KMEP's SEC Filings and then allocates those costs to all KMEP and KMI business entities using the Massachusetts Formula.[149] CCSV witness Arthur states that this proposal would allocate approximately $16.4 million of G&A costs to SFPP.[150]

2. Summary of the 2011 ID

97. The 2011 ID rejected SFPP's proposal and adopted the "all-in" allocation methodology proposed by CCSV Shippers. The 2011 ID provided four basic reasons for rejecting SFPP's proposed allocation. First, the 2011 ID held that SFPP's proposed methodology was inconsistent with SFPP's SEC filings. Second, the 2011 ID concluded that SFPP's proposed direct allocation of costs failed to accurately reflect cost causation and suffered from methodological flaws. Third, the 2011 ID concluded that SFPP's proposed methodology erroneously excluded from the allocation of GP Services costs: (a) the joint venture subsidiaries of Red Cedar and Endeavor; (b) the natural gas pipelines classified as KMI-Operated Entities; (c) KM Canada; and (d) certain parent-level entities in the Kinder Morgan business structure. Finally, the 2011 ID concluded that comparisons with other KMEP entities indicated that SFPP's proposed G&A allocation methodology over-allocated costs to SFPP.

98. The 2011 ID also made certain findings regarding how KMEP should allocate costs within the "all-in" method. The 2011 ID addressed the treatment of indirect G&A costs related to capital projects. The 2011 ID also determined that SFPP's proposed methodology had incorrectly directly assigned certain insurance and legal costs to SFPP rather than allocating these costs via the Massachusetts Formula. The 2011 ID also made findings regarding the treatment of purchase accounting adjustments (PAAs) and whether to use gross revenue or net revenue for Tejas Consolidated (Tejas) in the Massachusetts Formula.

3. Overview of the Commission's Findings

99. The Commission will reverse the 2011 ID's rejection of SFPP's proposed G&A cost allocation methodology and the 2011 ID's adoption of the "all-in" Massachusetts Formula as proposed by CCSV Shippers witness Arthur. The 2011 ID issued prior to the Commission's decisions in Opinion Nos. 511 and 511-A which affirmed a nearly

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[149] Ex. VCC-1 at 65.

[150] *Id.* at 68.

identical proposal by SFPP to allocate its G&A costs. As explained below, the facts of this proceeding do not support a different conclusion.

100. This case presents the Commission with two cost allocation approaches from which to choose. The first option is SFPP's "multi-tiered" allocation methodology. The second alternative, adopted by the 2011 ID and supported by CCSV Shippers, is the "all-in" methodology. In deciding which cost allocation methodology to apply, the Commission must choose from the cost allocation alternatives available on the record.[151] Thus, the Commission "must sometimes conclude which is the more reasonable of the several [cost allocation] alternatives."[152] To make the decision, the Commission considers which methodology most closely conforms to the Commission's long standing practice of trying to align cost allocation with cost causation.[153]

101. As Opinion No. 511-A explained, in order to align cost allocation with cost causation, the Commission's preferred practice is that pipelines directly assign G&A costs to the maximum extent possible.[154] On this record SFPP has established that there is a uniform time keeping system in place, that it is periodically reviewed to see if there are discrepancies between budgeting and performance, and that the system has protocols for changing an employee's base allocation of time within cost centers if the employee's assignment or function changes.[155] SFPP has submitted evidence to demonstrate that KMEP's methodology for allocating G&A costs was analyzed and improved upon by an outside party, KPMG, LLP (KPMG).[156] The full use of this information corresponds to the Commission's policy of directly assigning costs when possible. As the Commission explained in *Williams Natural Gas Co.*,[157] "the [Massachusetts] formula is intended to

[151] *See Michigan Gas Storage Co.*, 89 FERC ¶ 61,131, at 61,376 (1999) (stating that where the record presents the Commission with three flawed approaches from which to choose, it must choose from the alternatives available on the record).

[152] *Transcontinental Gas Pipe Line Corp.*, 106 FERC ¶ 61,299, at P 190 (2004); *see also Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 589 (1945) (noting "[a]llocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science.").

[153] *Transcontinental Gas Pipe Line Corp.*, 106 FERC ¶ 61,299 at P 190.

[154] Opinion No. 511-A, 137 FERC ¶ 61,220 P 82.

[155] *E.g.*, Ex. SPE-53 at 21; Ex. SPE-55 at 25; Ex. SPE-57 at 17-18.

[156] *E.g.* Ex. SPE-57 at 15-19.

[157] 85 FERC ¶ 61,285, at 62,138 (1998) (*Williams*).

allocate corporate costs to the subsidiaries to the extent that each subsidiary uses or benefits from the services provided by the corporate cost centers. A direct charge is the most accurate way to match the benefit with the cost, and it should be used as the first step where a direct charge can be assessed."[158] The Commission further explained in *Williams*, "only after costs are directly charged where appropriate is the general allocator used."[159]

102. Conversely, under the "all-in" approach adopted by the 2011 ID and CCSV Shippers, KMI's and KMEP's G&A costs would be allocated using the Massachusetts Formula without any regard to which entities benefited from the costs. The "all-in" approach would disregard the more precise cost allocation information contained within the record. The Commission therefore finds that the "all-in" method would result in unjust and unreasonable rates on SFPP's East Line because GP Services and KMI's costs would be inappropriately allocated among a wide range of affiliated entities without regard to actual cost incurrence.

103. Notwithstanding the Commission's preference for direct assignment, the 2011 ID rejected SFPP's proposal in favor of the "all-in" methodology. As discussed below, the 2011 ID's reasons for adopting the "all-in" methodology as opposed to a methodology using a more direct assignment of costs are not persuasive.

4. The Relevance of SEC Financial Statements

2011 ID

104. As support for rejecting SFPP's proposed direct assignment of G&A costs, the 2011 ID concluded that SFPP developed its methodology exclusively for ratemaking purposes. The 2011 ID justified, in part, its rejection of SFPP's proposed methodology based upon the difference between KMEP's SEC filings and SFPP's proposed direct assignments in this proceeding, The 2011 ID stated that KMEP's SEC Form 10-K reports G&A costs of $330.3 million in 2009 and $297.9 million in 2008 that cannot be directly attributed to one of KMEP's subsidiaries. The 2011 ID stated that by comparison, SFPP witness Bradley proposed to allocate only $55.5 million in KMEP

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[158] *Id.* at 62,138.

[159] *Id.* (explaining that direct charges are those charges that have a clearly identifiable beneficial or casual relationship to the product or service provided, but that does not mean the pipeline must engage in an administratively burdensome and expensive process of attempting to allocate directly costs that are not susceptible to direct allocation. Rather practicality may be considered in determining which costs to allocate directly).

G&A costs that could not be directly attributable to one of KMEP's five business segments.[160] Noting these differences, the 2011 ID stated that in this proceeding KMEP had an incentive to manipulate its methodology to shift costs to SFPP.[161]

Briefs On Exceptions

105. On exceptions, SFPP states that the 2011 ID incorrectly relied on KMEP's SEC Form 10-K to invalidate SFPP's G&A allocation proposal. SFPP also states that the allocation methodology is the only methodology that KMEP uses to assign and allocate costs among the KMEP-Operated Entities.[162] SFPP contends that even though the results may be reported differently, this is the methodology used for booking costs in the general ledger. SFPP states that the general ledger is used in reporting to the SEC as well as for preparing its FERC Form No. 6 and other Commission rate filings.

Briefs Opposing Exceptions

106. Opposing exceptions, the CCSV Shippers state the 2011 ID properly determined that SFPP's financial statements were inconsistent with SFPP's proposed methodology. CCSV Shippers state that the Financial Accounting Standards Board (FASB) requires reporting by business segment on financial forms to be done consistent with the methods employed by management to evaluate the performance of subsidiaries.[163] Although these FASB standards allow for more than one measure of segment profit, CCSV Shippers state that this provides no rational explanation for the inconsistency between KMEP's SEC filings and SFPP's litigation position. CCSV Shippers claim that the 2011 ID correctly concluded that SFPP developed its allocation methodology for ratemaking purposes in order to allocate additional costs to regulated entities, such as SFPP.

Commission Decision

107. The Commission finds that KMEP's representations in its SEC Form 10-K do not support the "all-in" method adopted by the 2011 ID. Opinion Nos. 511 and 511-A addressed the differences between SFPP's proposed ratemaking methodology and the

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[160] 2011 ID, 134 FERC ¶ 63,013 at P 242.

[161] *Id.* P 239 n.235.

[162] SFPP Brief on Exceptions at 44-45.

[163] CCSV Shippers Brief Opposing Exceptions at 41 (citing Ex. VCC-170 at 1, 9; Ex. VCC-172 at 2).

accounting used for KMEP SEC filings.[164] What the SEC requires for financial reporting purposes or how KMEP has complied with those requirements is not controlling.[165] Thus, the fact that there are differences between KMEP's SEC Form 10-Ks and its proposed methodology in this proceeding do not invalidate SFPP's proposal,[166] or justify the "all-in" approach. The abandonment of the Commission's preference for the direct assignment of costs requires more than the potential inconsistency between the results reached by different regulatory regimes.[167]

108. Similarly, the Commission gives little credence to the argument that an allocation methodology for the *entirety* of KMEP was devoted to increasing costs toward regulated entities such as SFPP. There is no evidence that KMEP maintains a parallel set of ledger entries, time sheets, or other documents that are designed to capture operating and financial costs in a manner that is inconsistent with the cost assignment methodology SFPP has advanced here. If KMEP's methodology lacked grounding in the realities of the company, such manipulation involving several millions of dollars would collapse under the type of scrutiny imposed by this proceeding. Such a level of distortion is not apparent.

5. <u>Accuracy of KMEP's Allocation Methodology</u>

<u>2011 ID</u>

109. In adopting the "all-in" methodology, the 2011 ID challenged the accuracy of SFPP's direct assignments based on responsibility centers (RCs) which are coded by employees and used to assign labor costs to particular subsidiaries based upon the level of service an RC provides to each subsidiary.[168]

110. Much of the 2011 ID's rationale for rejecting SFPP's methodology relates to the distinction that SFPP advocates between: (a) GP Services employees; and (b) KMI

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[164] Opinion 511, 134 FERC ¶ 61,121 at PP 100-02, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 94-96.

[165] Opinion No. 511-A, 137 FERC ¶ 61,220 at P 96.

[166] *Id.* P 112.

[167] *Id.* P 95.

[168] The flow-through of costs from the RCs to each entity is based either on hourly time records which are documented on time sheets or a percentage-based time record involving salary splits.

employees. As described previously, SFPP states that GP Services employees provide most of the G&A services for KMEP-Operated Entities, i.e. KMEP's: (1) products pipeline (including SFPP); (2) CO2; and (3) bulk terminal business segments. As opposed to GP Services, KMI is primarily responsible for managing KMEP's natural gas pipeline holdings. However, KMI also provides some services to other parts of the Kinder Morgan business structure, such as the KMEP-Operated Entities. KMI employees that provide services to other entities are called KMI-shared employees.[169] To assign costs to KMEP-Operated Entities, KMI-shared employees assign their labor costs to Account 184601.[170]

111. Rejecting the distinction between KMI and GP Services, the 2011 ID states that employees of KMI and GP Services are functionally integrated. The 2011 ID states that cost allocations from KMI and GP Services are not verifiable and that assignment of costs from the RCs is arbitrary, inaccurate and unreliable. As a consequence of this determination, the 2011 ID rejected the validity of the KMI-Cross Charge of $43,972,121 that SFPP proposes to assign to KMEP-Operated Entities.[171]

112. To support this position, the 2011 ID examined the cost assignments for various RCs associated with certain KMI-shared employees. The 2011 ID states that KMI-shared employees in RC 0066 (Income Tax) file tax returns for all KMI and KMEP entities.[172] However, the 2011 ID states that KMI-shared employees in RC 0066 do not allocate or assign costs to every entity receiving services from RC 0066. The 2011 ID states this RC accounted for over $10 million in G&A costs, of which $6 million was assigned to Account 184601 and subsequently assigned to KMEP-Operated Entities (including SFPP).

113. Also in the context of KMI-shared employees, the 2011 ID discussed employees in RC 0010 (the Office of the Chairman).[173] The 2011 ID stated that the Office of the

[169] 2011 ID, 134 FERC ¶ 63,013 at PP 246-260.

[170] *Id.* P 248.

[171] *Id.*

[172] *Id.* P 249.

[173] More specifically, this office relates to corporate-level employees who provide high level executive and generic corporate type functions to all entities within the Kinder Morgan business structure. Ex. SPE-57 at 8.

Chairman overseas the entire Kinder Morgan business structure, but RC 0010 assigns no G&A costs to numerous entities.[174]

114. Regarding KMI-shared employees in RC 0010, RC 0066, RC 0065, and IT related RCs (0070-0092), the 2011 ID expressed concern that these RCs did not include any G&A costs associated with payroll taxes, benefits or bonuses.[175] The 2011 ID explained that such costs are placed in RC 0999. The 2011 ID objected that SFPP failed to provide an explanation for not recording all employee related costs in the same RC. Moreover, the 2011 ID states that SFPP did not allocate the costs in RC 0999 to all the beneficiaries of the associated costs. The 2011 ID explained that roughly $10.3 million from RC 0999 is assigned to KMEP by the KMI-Cross Charge.

115. Similar to the KMI-shared employees, the 2011 ID states that GP Services employees did not properly assign their costs. Analyzing the assignment of GP Services employee costs, the 2011 ID examined RC 1007 (GP Services Accounting). The 2011 ID states that the assignment from this account of $89,170 to KM Canada was "in error."[176] The 2011 ID states that certain supervisory personnel whose time is charged to RC 1007 failed to assign their time to all of the entities for which they provide services.[177]

116. Supporting the fully integrated nature of KMI and GP Services employees, the 2011 ID stated that GP Services employees manage and have oversight responsibilities over entities allegedly operated by KMI employees.[178] The 2011 ID stated that GP Services personnel are officers of Kinder Morgan Management (KMR) which has ultimate control and authority over KMEP and all its subsidiaries. The 2011 ID stated that Meli Armstrong, Thomas Bannigan, Timothy Bradley, James Kehlet, Adam Foreman and Gary Prim are all officers of KMR and play a role in managing and controlling KMEP and all its subsidiaries.

117. Additionally, the 2011 ID objects that Mr. Bannigan (RC 1030 -- President Pipeline Products), Mr. R. Tim Bradley (RC 1029 – President of CO2 Pipelines), and Mr. Jeff Armstrong (RC 1025 – President of Terminals) are principal officers of several

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[174] 2011 ID, 134 FERC ¶ 63,013 at P 251.

[175] *Id.*

[176] *Id.* P 255 (citing Ex. VCC-1 at 40).

[177] *Id.*

[178] *Id.* P 247.

different Kinder Morgan entities with fiduciary duties. Yet, the 2011 ID states that these individuals did not assign time to these responsibilities.[179]

118. The 2011 ID also states that the direct allocation of costs in RC 1030 for Mr. Bannigan to particular subsidiaries in the products pipeline group is inconsistent with SFPP's position in the West Line case in IS08-390-000. In the West Line case, SFPP stated that it could not allocate costs in RC 1030 to particular subsidiaries within the products pipeline group.[180]

119. In addition to examining particular RCs, the 2011 ID also raised methodological objections to SFPP's proposal for assigning GP Services costs. The 2011 ID faulted the assignment of G&A labor costs for 295 GP Services employees based upon interviews of only managers and 21 GP Services employees.[181] The 2011 ID also seeks to dismiss the significance of the KPMG study.[182] The 2011 ID states that Mr. Bradley did not rely on the KPMG study in developing his methodology and that KPMG did not subsequently audit its results.

Briefs On Exceptions

120. On exceptions, SFPP claims that G&A costs are reliably tracked through the Kinder Morgan business structure's accounting system. SFPP challenges the 2011 ID's claim that its costs are unverifiable. To enable full disclosure of its recording practices, SFPP states that it provided opposing parties with extensive discovery.[183] SFPP states that the 2011 ID applies an unreasonable standard. SFPP states that proving beyond a doubt the accuracy of each employee's reported salary distribution is not possible.

121. SFPP emphasizes that the G&A costs incurred by KMI employees on behalf of the KMI-Operated Entities are segregated in Account 184600 from those incurred on behalf of the KMEP-Operated Entities (such as SFPP) in Account 184601.[184] SFPP states that

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[179] *Id.* P 257.

[180] 2011 ID, 134 FERC ¶ 63,013, at P 257.

[181] *Id.* P 253.

[182] *Id.* PP 256-257.

[183] SFPP Brief on Exceptions at 38.

[184] *Id.* at 36.

Opinion No. 511 determined that KMI and GP Services employees operated separately.[185]

122. SFPP states that KMEP is able to directly assign a portion of labor and non-labor G&A costs to SFPP using its system of RCs, time sheets, salary splits, time based survey information, detailed cost data and analysis, unique entity codes, and other information captured by the accounting system.[186] SFPP adds that while KMEP has always utilized direct assignments, KMEP was able to increase its use of direct assignments of G&A costs by following the recommendations of a 2008 study conducted by KPMG..[187]

123. SFPP states that the 2011 ID erroneously determined that salary splits were unreliable because KMEP relied on responses from a supervisor rather than individual employees. SFPP states that supervisors could and did talk to employees as necessary.[188]

124. SFPP states that the 2011 ID unfairly attacks Mr. Bannigan's salary split because his labor costs were allocated among the product pipelines in the West Line proceeding in Docket No. IS08-390-002 using the Massachusetts Formula whereas they were directly assigned in this proceeding.[189] SFPP states, however, that Mr. Bannigan's allocations were effectively the same in each proceeding and that they were supported in this proceeding by interview notes and the survey.[190]

Briefs Opposing Exceptions

125. CCSV Shippers contend that verifying the accuracy and reasonableness of SFPP's methodology is not feasible.[191] However, CCSV Shippers assert that when SFPP's

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[185] *Id.* at 38 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 104).

[186] *Id.* at 39.

[187] *Id.* (citing Ex. SPE-55).

[188] *Id.* at 41 (citing Ex. SPE-139 at 17).

[189] *Id.* (citing Ex. SPE-139 at 17).

[190] SFPP also states that the 2011 ID improperly focused on an error in location code 0002 that was at issue in Docket No. IS08-390-002, but remedied in this proceeding. *Id.* at 41 n.70.

[191] CCSV Shippers Brief Opposing Exceptions at 56 (citing Ex. VCC-1 at 6-7).

methodology has been challenged, the results have demonstrated arbitrariness, inaccuracies and inconsistencies that undermine the proposal's credibility.[192]

126. The CCSV Shippers support the 2011 ID's rejection of the distinction between KMI and GP Services related costs. CCSV Shippers state SFPP incorrectly focuses on the distinction between Account 184601, which is assigned to KMEP-Operated Entities, and Account 184600, which is assigned to KMI. CCSV Shippers state that whether or not G&A costs are placed in Account 184600 or in Account 184601 establishes nothing as to whether these particular G&A costs are accurately assigned or recorded.[193]

127. CCSV Shippers further state that the 2011 ID was correctly skeptical of the costs associated with KMI employees. CCSV Shippers reiterate the 2011 ID's concerns that several departments were omitted from the allocation of costs from RC 0066 (the Income Tax Department) and RC 0010 (the Office of the Chairman). CCSV Shippers also re-emphasize the 2011 ID's objection to the placement of payroll taxes, benefits and bonuses into a separate RC (RC 0999) for KMI employees which otherwise record their labor costs in RC 0010, RC 0066, RC 0065, and RC 007-0092.[194]

128. Regarding the GP Services related costs, the CCSV Shippers expand upon the 2011 ID's analysis of RC 1007 (GP Services Accounting). CCSV Shippers state that this is one of the largest G&A cost levels at over $5 million. CCSV Shippers explain that under SFPP's methodology almost all of RC 1007 was assigned to the KMEP-Operated Entities. However, SFPP proposed (a) to assign $89,107 from the RC to KM Canada and (b) to remove $27,732 to account for supervision of two KMI employees.[195] CCSV Shippers state that the $89,107 attributed to KM Canada was not supported by adequate documentation. Further regarding RC 1007, CCSV Shippers claim that GP Services employees Ms. Meli Armstrong, Ms. Kae Fowler, and Mr. Richard Miller provide services to KM Canada. Yet, CCSV Shippers complain that Ms. Armstrong and Mr. Miller assigned 100 percent of their time to the KMEP-Operated Entities, which do not include KM Canada.[196] CCSV Shippers add that Mr. Miller is also responsible for maintaining KMEP's general ledger as well as preparing and thus consolidating the

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[192] *Id.*

[193] *Id.* at 51.

[194] *Id.* at 53.

[195] *Id.* at 57.

[196] The KMEP-Operated Entities are KMEP's: (1) products pipeline; (2) CO2; and (3) bulk terminal business segments.

financial statements of KMEP and all of its subsidiaries, including KM Canada and KMEP's natural gas pipeline subsidiaries.[197] The CCSV Shippers also object that no costs for RC 1007 are allocated or assigned to certain natural gas pipelines which have cash management agreements with KMEP whereby KMEP or its subsidiaries manage each of these entities' cash on a daily basis.[198]

129. The CCSV Shippers also state that KMR is a limited partner in KMEP and manages and controls the business and affairs of KMEP. CCSV Shippers state that a review of the principal officers and directors of KMR plainly identifies an integrated set of KMI and GP Services employees responsible for management for the entirety of KMEP, including KMI related entities.[199]

130. Below the GP Services and the KMI-level, the CCSV Shippers state that Mr. Bannigan (RC 1030 -- President Pipeline Products), Mr. R. Tim Bradley (RC 1029 – President of CO2 Pipelines),[200] and Mr. Jeff Armstrong (RC 1025 – President of Terminals)[201] are principal officers of several different Kinder Morgan business structure entities with fiduciary duties.[202] CCSV Shippers reiterate the 2011 ID's finding that these individuals did not assign time to these entities.[203] The CCSV Shippers also state that SFPP has been inconsistent in its treatment of the office of the President for the Products Pipeline Group in RC 1030. Specifically with respect to Mr. Bannigan, CCSV Shippers state that in the West Line case in IS08-390-002, SFPP stated that it could not assign costs in RC 1030 to particular subsidiaries within the products pipeline group.[204] CCSV

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[197] CCSV Shippers note that Ms. Folwer assigned her time 90 percent between Coochin (which includes both U.S. and Canadian portions) and 10 percent to Cypress. CCSV Shippers Brief on Exceptions at 58 (citing Ex. VCC-20 at 4).

[198] *Id.* at 59 n.97.

[199] *Id.* at 55.

[200] CCSV Shippers state that the total amount of G&A costs in RC 1029 is $3,852,907 and that this is assigned to the CO2 tier. *Id.* at 61 n.101 (citing Ex. SPE-230 at 7, line 39)

[201] CCSV Shippers state that the total amount of G&A costs in RC 1025 is $732,341 and that this is assigned to the CO2 tier. *Id.*

[202] *Id.* at 61.

[203] *Id.* at 61 n.104.

[204] *Id.* at 60.

Shippers say this undermines Mr. Bannigan's current claim that he can accurately assign his time on a percentage basis.

131. CCSV Shippers also support the 2011 ID's skepticism that GP Services or KMI supervisors can correctly assign the time of their subordinates. CCSV Shippers state that if supervisors in RC 1007, RC 1030, RC 1029, and RC 1025 cannot properly identify their own responsibilities, it is implausible that they could accurately assign time and costs associated with their subordinates.[205]

132. CCSV Shippers state that SFPP effectively attempts to turn the burden of proof on its head. CCSV Shippers state that the effect of multiple errors on the credibility of the entire methodology cannot be ignored.[206] CCSV Shippers state that merely because SFPP turned over numerous documents in discovery does not establish that SFPP has met its burden to demonstrate that its proposed methodology is reliable and credible.

Commission Decision

133. The analysis provided by the 2011 ID and the CCSV Shippers is not sufficient to undermine SFPP's proposed G&A cost allocation methodology. Although there may be some imprecision related to certain RCs, neither the 2011 ID nor the CCSV Shippers quantified the effect of this imprecision on SFPP's East Line rates. Furthermore, the record in this proceeding does not support a finding that the specific issues relating to RC 0010, RC 0065, RC 0066, RC 1007, RC 1030, RC 1029, RC 0999, RC 1025, and the IT-related RCs (0070-0092) identified by the 2011 ID and the CCSV Shippers significantly affect the SFPP East Line rates. Neither the 2011 ID nor the CCSV Shippers advance such a claim.

134. Rather, the 2011 ID and the CCSV Shippers leap from these instances of imprecision to justify a "broad brush" rejection of the direct assignment of G&A costs. The scale of imprecision identified by the 2011 ID and the CCSV Shippers does not justify such measures. Similarly, the Commission is confident that supervisors may identify the most significant responsibilities of their subordinates. The factual findings of the 2011 ID and the CCSV Shippers do not justify the abandonment of the direct assignment of costs in favor of the less exact "all-in" methodology.

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[205] *Id.* at 62.

[206] *Id.* at 62-63.

6. Comparisons Between SFPP and Other Affiliated Entities

2011 ID

135. To justify the categorical rejection of SFPP's proposed G&A cost allocation methodology, the 2011 ID compared the G&A costs allocated to SFPP under its proposed methodology with those allocated to other KMEP subsidiaries.[207] The 2011 ID stated that under SFPP's proposed methodology, SFPP is assigned approximately $46.9 million in G&A costs. First, the 2011 ID stated that Tejas is allocated $24.6 million, which is much less than SFPP even though the 2011 ID states that Tejas has 20 times the gross revenues of SFPP, twice the property plant and equipment, and more labor. Second, the 2011 ID stated that KM Canada was assigned only $32.2 million in G&A costs, even though KM Canada has double the gross revenues of SFPP and nearly three times the property, plant and equipment of SFPP. Third, the 2011 ID also emphasized that Rockies Express Pipeline (Rockies), which has more gross revenue and nearly four times the level of property, plant and equipment as SFPP, is assigned only $5.4 million in G&A costs – substantially less than SFPP. The 2011 ID stated that the record does not contain a credible explanation for these disparities.

Briefs On Exceptions

136. SFPP asserts that the 2011 ID improperly relied upon an inapposite comparison between the costs allocated to SFPP and the costs allocated to Rockies, Tejas, and KM Canada. SFPP states that indirect G&A costs associated with capital projects were included in SFPP's total G&A costs as required by Commission regulations for oil pipelines. SFPP asserts that Commission regulations require these costs to be excluded for natural gas pipelines such as Tejas and Rockies.[208] SFPP states that these costs were also excluded for KM Canada. SFPP adds that the natural gas pipelines transport only one product – natural gas – whereas SFPP transports 74 different products, requiring more G&A support.[209] Finally, SFPP notes that Rockies was only in-service for a part of the base period, which explains why its G&A costs were particularly low.

Briefs Opposing Exceptions

137. The CCSV Shippers defend the comparisons used by the 2011 ID to suggest that SFPP's proposal over-allocates G&A costs to SFPP. CCSV Shippers state that the record

[207] 2011 ID, 134 FERC ¶ 63,013 at P 266.

[208] SFPP Brief on Exceptions at 57 (citing Ex. SPE-139 at 45-49).

[209] *Id.* (citing Ex. SPE-139 at 33-34).

does not support SFPP's claim that Rockies was not in-service for the entire base period. CCSV Shippers state that the exhibit cited by SFPP refers to an expansion of Rockies in November 2009, but makes no claim that Rockies was operational for only half of the base period. CCSV Shippers state that, in fact, part of the Rockies system was in-service prior to the base period. CCSV Shippers also challenge the relevancy of the number of products shipped on SFPP.

Commission Decision

138. The Commission is not persuaded that the 2011 ID's and the CCSV Shippers' comparisons to other affiliated entities support the rejection of SFPP's proposed allocation in favor of the "all-in" approach. Labor, revenue, and property, which the 2011 ID used in its comparison, are not the only factors that may determine an entity's costs. Direct assignment is more accurate than the "all-in" methodology precisely because each entity is unique and may face different circumstances. For example, in the comparison used by the 2011 ID, SFPP was directly assigned $ 12 million in legal costs.[210] An entity like SFPP may face legal cost levels that differ from those faced by other affiliated entities. There may also be differences between SFPP and a subsidiary with Canadian operations (KM Canada) and natural gas pipelines (such as Tejas and Rockies).[211] Ultimately, this case is about the costs assigned to SFPP, not how costs may have been assigned to other entities. The question is whether the methodology for assigning costs to SFPP is just and reasonable.

7. Exclusion of Entities from the Massachusetts Formula

a. Joint Venture Subsidiaries

139. The 2011 ID concluded that SFPP's proposed methodology improperly excluded the joint ventures Red Cedar and Endeavor. The 2011 ID sated that GP Services employees sit on the boards of directors or managing committees of the joint ventures.[212] Thus, the 2011 ID concluded that the Kinder Morgan business structure retains managerial and oversight responsibility for Red Cedar and Endeavor.

[210] Ex. SPE-139 at 56.

[211] SFPP's system, which transports 74 different products, may require more G&A support than a natural gas pipeline, such as Rockies and Tejas, which move one product.

[212] 2011 ID, 134 FERC ¶ 63,013 at P 247.

Briefs On Exceptions

140. On exceptions, SFPP states Red Cedar and Endeavor are joint ventures, and SFPP acknowledges that KMEP owns equity interests in these joint ventures. However, SFPP emphasizes that GP Services does not perform any G&A services for these entities.[213] SFPP states that in Opinion No. 511, the Commission upheld SFPP's proposal to exclude Red Cedar from the allocation of G&A costs,[214] and that a similar rational applies to Endeavor. SFPP further states that none of the costs associated with the limited oversight of Endeavor by one KMI employee were allocated to SFPP. [215] Rather, SFPP states that these costs were captured in RC 5233, which was charged to Account 184600, not Account 184601. Because these costs were not assigned to Account 184601, these costs could not have subsequently been assigned to the KMEP-Operated Entities, such as SFPP.

Briefs Opposing Exceptions

141. Opposing exceptions, the CCSV Shippers state that the 2011 ID properly rejected the exclusion of Red Cedar and Endeavor from the allocation of KMEP's G&A costs.[216] CCSV Shippers state that it is undisputed that KMI employees sit on the management committees of both Red Cedar and Endeavor. CCSV Shippers state that although the Kinder Morgan business structure may not be responsible for the actual day-to-day operations of these entities, the Kinder Morgan business structure still incurs costs overseeing the ownership interest and related employees.

142. CCSV Shippers raise a second argument, i.e. that SFPP has not identified certain residual costs associated with Red Cedar and Endeavor. Specifically, CCSV Shippers state that there are necessarily human resources, IT or employee benefit costs associated with the managerial employees that sit on the Red Cedar and Endeavor boards of directors. CCSV Shippers state that the Office of the Chairman also incurs costs overseeing the KMI employees sitting on the managerial committees for the joint ventures.

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[213] SFPP Brief on Exceptions at 46.

[214] *Id.* (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 115).

[215] *Id.* at 47 (citing 2011 ID, 134 FERC ¶ 63,013 at P 247).

[216] CCSV Brief Opposing Exceptions at 72-74.

Commission Decision

143. In Opinion Nos. 511 and 511-A, the Commission addressed the treatment of joint venture entities. In Opinion No. 511-A, the Commission explained its approach:

> The question at issue is whether any of these three Joint Ventures benefit from services provided under RCs that are charged to KMEP for allocation via the Massachusetts formula. And, if so, whether the benefits are more than a de minimis amount with five percent being a rebuttable threshold of what constitutes a significant or more than de minimis amount.[217]

144. Both Red Cedar and Endeavor are managed by and receive all G&A services and support from an unaffiliated third party. In Opinion No. 511-A, the Commission rejected the argument that because KMI employees necessarily oversee and supervise ownership interests in these joint ventures, there must be some executive-related supervisory costs that should be allocated to the joint ventures.[218] The time and costs associated with KMI employees serving as board members for joint ventures such as Red Cedar or Endeavor and related HR, IT, and employee benefit costs are comparatively miniscule. SFPP ensured that the costs associated with the RCs of the KMI employees that sat on these committees are removed from the costs allocated to SFPP.[219] There is no evidence in the record that any remaining costs would be more than de minimis, i.e., five percent or more of the total costs within each RC that are subject to allocation via KMEP's Massachusetts Formula.

b. KMI-Operated Entities

2011 ID

145. The 2011 ID determined that SFPP's methodology was flawed because it excluded KMI-Operated Entities from the allocation of G&A costs. Consistent with its prior findings, the 2011 ID concluded that KMEP is the owner of these subsidiaries, and

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[217] Opinion No. 511-A, 137 FERC ¶ 61,220 at P 147.

[218] *Id.* P 150.

[219] Ex. SPE-57 at 43-46.

retains managerial, supervisory, and oversight responsibilities. [220] The 2011 ID further concluded that GP Services employees provide services to these subsidiaries.[221]

146. The 2011 ID also examined the arrangement in which KMI operates TransColorado, KM North Texas, and KM Mexico in return for a fixed fee. The 2011 ID stated that this fixed fee paid to KMI is unrelated to the actual G&A costs incurred on behalf of these subsidiaries. The 2011 ID stated that SFPP conceded as much in a prior proceeding. The 2011 ID states that this arrangement creates an issue of cross-subsidy. The 2011 ID also stated that the Rockies operating agreement lists Kinder Morgan NatGas Operator LLC (KMNG) as the operator.[222] The 2011 ID stated although the evidence demonstrated that KMI-shared employees in RC 0065 are responsible for the daily books and records and accounting for this KMEP subsidiary, no G&A costs were allocated to KMNG.

Briefs On Exceptions

147. SFPP states that KMI-Operated Entities are properly excluded from KMEP's methodology because they receive no G&A services or support from GP Services employees. SFPP states that KMI-Operated Entities are operated and managed entirely by KMI employees.[223] SFPP emphasizes that the G&A costs incurred by KMI-shared employees on behalf of the KMI-Operated Entities are segregated in Account 184600 from those incurred on behalf of the KMEP-Operated Entities (such as SFPP) in Account 184601.[224]

148. SFPP states that the fixed fee arrangement for KMI's management of TransColorado, KM North Texas, and KM Mexico does not affect the costs assigned to SFPP. Rather, SFPP states that the fixed fee payment is credited to Account 184600, not Account 184601 which captures the costs related to KMEP-Operated Entities. Similarly, SFPP states that the costs related to service to TransColorado, KM North Texas, and

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[220] 2011 ID, 134 FERC ¶ 63,013 at P 259.

[221] *Id.*

[222] *Id.* The ID states that KMNG is wholly owned by KMOLP-A, which in turn is wholly owned by KMEP. *Id.* P 259.

[223] SFPP Brief on Exceptions at 47 (citing Ex. SPE-57 at 6, 32-39).

[224] *Id.* (citing Ex. SPE-57 at 12; Ex. SPE-71; Ex. SPE-236).

KM Mexico are charged to either Account 184600 or Account 107001,[225] not Account 184601.

Briefs Opposing Exceptions

149. Opposing exceptions, the CCSV Shippers assert that the 2011 ID properly rejected SFPP's exclusion of the KMI-Operated Entities.[226] CCSV Shippers state that although KMI-Operated Entities are operated and managed entirely by KMI employees, these entities nonetheless cause KMEP and GP Services to incur costs. CCSV Shippers claim that KMEP, as owner, retains managerial responsibilities regarding the oversight of each entity. CCSV Shippers claim that GP Services employees in the accounting department (RC 1007) are working with, handling, and managing cash management agreements for the KMI-Operated Entities.

150. CCSV Shippers also contend that the KMI fixed fee arrangements with TransColorado, KM North Texas, and KM Mexico result in improper cross subsidies.[227] CCSV Shippers state that SFPP concedes that the fixed fee is not necessarily equal to costs. CCSV Shippers state that because the initial split of G&A costs between KMI and KMEP-Operated Entities is inaccurate, the risk of cross-subsidization to KMEP-Operated Entities increases. CCSV Shippers also state that the variable fee paid by Rockies to KMI leads to similar cross-subsidization concerns.

Commission Decision

151. The Commission finds that the issues raised by the 2011 ID involving the KMI-Operated Entities do not support the adoption of an "all-in" methodology or the position that GP Services costs must be distributed among KMI-Operated Entities in addition to the KMEP-Operated Entities.

152. Opinion Nos. 511 511-A rejected the assertion that merely because KMEP's officers and directors have operating and legal responsibility for the KMI-Operated Entities that these entities should be included in the allocation of GP Services costs via the Massachusetts Formula.[228] Similarly, in this proceeding, there is no evidence in the

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[225] *Id.* at 48 (citing Ex. SPE-57 at 36-39; Ex. SPE-72).

[226] CCSV Shippers Brief on Exceptions at 74-77.

[227] *Id.* at 77-78.

[228] Opinion No. 511, 134 FERC ¶ 61,121 at P 122, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 at P 121.

record that these possible benefits and costs arising from KMEP's ownership oversight were more than de minimis, i.e., more than five percent of the total costs within each RC that are subject to allocation via the Massachusetts Formula.[229]

153. Regarding the variable fee arrangement relating to Rockies and the fixed fee arrangement for KMI's management of TransColorado, KM North Texas, and KM Mexico, the Commission addressed this issue in Opinion No. 511.[230] As in Opinion No. 511, the Commission concludes that the fixed fees are irrelevant because the fees and costs associated with these entities are placed in Account 184600 and no portion of the costs from this account are assigned to SFPP.

c. <u>Parent Entities</u>

154. The 2011 ID contends that the exclusion of certain parent entities within the Kinder Morgan business structure from direct assignments and the allocation of G&A costs is a defect in SFPP's proposal.[231] The 2011 ID states that KMI-shared employees performed work for Kinder Morgan entities which have been excluded from the cost allocation. The 2011 ID cites the testimony of SFPP witness Utay, which provided that KMI employees in RC 0066 file tax returns for all KMI and KMEP organizations.[232] The 2011 ID states that the $10 million in G&A costs in this RC are split between Accounts 184600 and 184601, and that there are numerous subsidiaries that are not allocated costs from these accounts. The 2011 ID stated that employees in RC 0066 prepared and filed taxes for KMR, KMOLP-D, KM Mid-Co, LLC, KMI, KMGP, Inc., KM Services, LLC, and KM Nat Gas Operator, LLC. Yet, the 2011 ID noted that none of these entities are assigned or allocated G&A costs associated with RC 0066.

155. The 2011 ID also stated that the costs associated with KMI are also suspect. The 2011 ID stated that it was "incredible" that KMI, an entity with $1 billion gross revenue, would not receive G&A support and services from KMI-shared employee RCs, including those contributing to the KMI-Cross Charge.[233]

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[229] Opinion 511-A, 137 FERC ¶ 61,220 at PP 117, 122.

[230] Opinion No. 511, 134 FERC ¶ 61,121 at PP 125-126.

[231] 2011 ID, 134 FERC ¶ 63,013 at PP 248-251.

[232] *Id.* P 249 (citing Tr. 565; Ex. VCC-30 at 2).

[233] *Id.* P 250.

Briefs On Exceptions

156. On exceptions, SFPP objects to the 2011 ID's inclusion of parent and roll-up entities in the Massachusetts Formula. SFPP emphasizes that the purpose of the Massachusetts Formula is to allocate the G&A costs of a parent to its subsidiaries, not from one parent to another. SFPP states that Opinion No. 511 rejected the inclusion of entities in the Kinder Morgan business structure "above" KMEP.[234] SFPP states that the roll-up and parent entities have no activity apart from those on behalf of their subsidiaries which are already receiving a share of G&A costs. SFFP states that it makes no sense to allocate costs to these roll-up and parent entities, which would then have to be allocated back to the operating subsidiaries. Even if it could be demonstrated that services were provided specifically to these entities, there is no evidence that they exceed the de minimis threshold.

Briefs Opposing Exceptions

157. Opposing exceptions, the CCSV Shippers state that KMI and GP Services employees are performing services for and incurring costs for the benefit of all Kinder Morgan entities, including parents and roll-up entities. CCSV Shippers state that, contrary to SFPP's assertions, Opinion No. 511 never addressed this issue. CCSV Shippers state that even if these parents and roll-up entities do not have their own unique property, labor, and revenue, these entities still cause G&A costs to be incurred and directly benefit from these G&A services, for example, by receiving G&A tax services. CCSV Shippers also raise similar issues regarding RC 1007, which they state is responsible for maintaining the daily books and records of several roll-up and parent entities within the KMEP business structure.[235] CCSV Shippers also contest SFPP's claim that these entities are roll-up entities that have no activity apart from their subsidiaries.[236]

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[234] SFPP Brief on Exceptions at 55 (citing Opinion 511, 134 FERC ¶ 61,121 at P 96). SFPP states that the following are either indirect or direct parents of KMEP: Kinder Morgan Holdco LLC; Kinder Morgan Holdco DC, Inc.; Kinder Morgan Midco, Inc; Kinder Morgan, Inc.; Kinder Morgan (Delaware), Inc.; Kinder Morgan, G.P. Inc.; Kinder Morgan Management LLC; Kinder Morgan Services LLC; KMGP Services Company, Inc.

[235] *Id.* at 59.

[236] CCSV Shippers Brief Opposing Exceptions at 87 (citing Ex. VCC-133 at 1-4; 2011 ID, 134 FERC ¶ 63,013 at P 250).

Commission Decision

158. The Commission will not require the inclusion of parent and roll-up entities in the Massachusetts Formula. G&A costs are not appropriately allocated to an entity that exists mainly for internal business purposes and does not directly generate revenue or have its own customers. KMR, KMI, and other roll-up or parent entities have no activity apart from those on behalf of their subsidiaries, which are already receiving a share of G&A costs.[237] In other words, these parent and roll-up entities would not exist but for the various subsidiaries that do have customers and generate independent revenue. To the extent that an entity such as KMI receives certain services from other Kinder Morgan subsidiaries, the costs for these services should be distributed from KMI via the Massachusetts Formula to those subsidiaries that generate revenue or have their own customers.

d. KM Canada

159. The 2011 ID stated that SFPP incorrectly excluded KM Canada from the G&A cost allocation calculations.[238] The 2011 ID states that all Canadian employees are supervised by U.S. based personnel. The 2011 ID states that SFPP witness DesLauriers testified that an internal time survey corroborated the position that KMI-shared employees could not make meaningful time-based identifications to individual entities or activity levels.[239] The 2011 ID states this undermines the credibility of SFPP's direct assignment of $1,098,121 in KMI-shared G&A costs to KM Canada subsidiaries. The 2011 ID also objected to the exclusion of KM Pipeline USA (KM USA) from the Massachusetts Formula, which employs the individuals who operate the KM Canada assets located in the U.S.

Briefs On Exceptions

160. On exceptions, SFPP contends KM Canada is appropriately excluded from KMEP's allocation methodology. SFPP states that KM Canada is operated and managed almost exclusively by KM Canada employees,[240] and that the Canadian G&A employees provide the same type of services to KM Canada as the services provided by KMI and

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[237] Tr. 915, 1404-05, 1569-71, 1573-74.

[238] 2011 ID, 134 FERC ¶ 63,013 at P 258.

[239] *Id.* (citing Ex. SPE-53 at 18).

[240] SFPP Brief on Exceptions at 51 (citing Ex. SPE-57 at 41-42; Ex. SPE-139 at 34-35).

GP Services, including legal services, accounting, human resources, and information technology.[241] SFFP states that the $30 million in G&A costs incurred on behalf of KM Canada are kept in a separate ledger from KMI and KMEP G&A costs and are not allocated to any KMI-Owned Entity, KMI-Operated Entity, KMEP-Operated Entity, Red Cedar or Endeavor.[242]

161. SFPP states that an internal time survey in mid-2009 showed that KM Canada received $1.6 million in G&A services from KMI-shared and GP Services employees.[243] SFPP states that it removed $1.3 million from the KMEP-Operated Entity level in its Massachusetts Formula[244] and an additional $0.3 million from the bulk terminals tier. SFPP adds that beginning in the year 2009, the costs incurred by GP Services and KMI employees on behalf of KM Canada are to be invoiced directly to each subsidiary.[245]

162. SFPP states that given the relatively few G&A services performed by KMI and GP Services, the 2011 ID's "all-in" approach would allocate excessive costs to KM Canada. SFPP states that due to the direct invoicing, the "all-in" method would also double charge KM Canada's accounts. SFPP adds that including KM Canada entities would also misallocate the $30 million that was directly incurred by KM Canada employees on behalf of KM Canada entities.

163. Responding to the 2011 ID's assertion that KMI employees could not make meaningful time based identifications, SFPP states that these employees were able to identify the time they spent on KM Canada entities because those activities were distinguishable from their regular course of business.[246] Finally, SFPP also states that the 2011 ID's focus on KM USA misses the point. SFPP states that all of the services provided to KM USA were from KM Canada employees.

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[241] *Id.* (citing Ex. SPE-57 at 41).

[242] *Id.* (citing Ex. SPE-57 at 40).

[243] *Id.* (citing Ex. SPE-139 at 35-36; Ex. SPE-230; Ex. SPE-232; Ex SPE-238; Ex. VCC-40).

[244] *Id.* at 52 (citing Ex. SPE-139 at 35-36; Ex. SPE-230).

[245] *Id.* (citing Ex. VCC-156; Tr. 1566, 1568).

[246] *Id.* (citing Ex.SPE-139 at 39, 40).

Briefs Opposing Exceptions

164. Opposing exceptions, CCSV Shippers state that the 2011 ID properly rejected SFPP's proposal to exclude KM Canada from the allocation of G&A costs.[247] CCSV Shippers state that the KM Canada time survey lacks credibility. CCSV Shippers note that the person completing the form in the Office of the Chairman, RC 0010, claimed that no time was spent on four KM Canada subsidiaries. CCSV Shippers states that it is implausible that the Chairman's office could have completely avoided spending any time associated with these entities. CCSV Shippers criticize the survey for including only one person from eight IT departments with $17 million in labor costs. CCSV Shippers also renew their claim that certain GP Services employees in RC 1007 perform G&A services to KM Canada, but assigned 100 percent of their G&A costs to KMEP subsidiaries. CCSV Shippers add that RC 1007 is responsible for the books and records of KM USA.

Commission Decision

165. The exclusion of KM Canada from the G&A cost allocation is supported by the distinction between KM Canada's workforce and GP Services and KMI employees. The testimony of SFPP witness Bradley explains that KM Canada relies primarily upon Canadian employees[248] and that the Canadian G&A employees provide the same type of services to KM Canada entities as the services provided by KMI and GP Services for other parts of the company.[249]

166. The Commission finds that SFPP has adequately supported its internal accounting procedures resulting in a more accurate quantification of the G&A costs incurred by GP Services and KMI for the benefit of KM Canada. To the extent that GP Services and KMI provided limited support to KM Canada, the G&A costs directly assigned to KM Canada are supported by an internal survey undertaken by KMEP.[250] To the extent CCSV Shippers quibble with the charges allocated to KM Canada from the Chairman's Office (RC 0010), accounting (RC 1007) or the IT Department, CCSV Shippers have not demonstrated that KM Canada has received more than a de minimis benefit from the

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[247] CCSV Shippers Brief on Exceptions at 79.

[248] Ex. SPE-139 at 35. Mr. Bradley explains that under Canadian law, it is difficult to recover costs incurred by U.S. employees in entities regulated by the National Energy Board (which is the Canadian equivalent of the FERC). *Id.*

[249] Ex. SPE-57 at 41.

[250] Ex. SPE-139 at 39-40.

parent company or a specific RC.[251] As a result, the Commission in this proceeding will adopt SFPP's proposal to exclude KM Canada in the calculations of the Massachusetts Formula.

8. Indirect G&A Capital Project Costs

2011 ID

167. The 2011 ID required SFPP to capitalize indirect G&A costs related to construction projects.[252] SFPP had proposed to treat these costs as "residual" G&A costs and allocate the costs through the Massachusetts Formula. The 2011 ID stated that "Commission regulations require both direct and indirect costs to be included in the cost of carrier property constructed," and that "it is inconsistent for SFPP to capitalize direct costs and expense indirect costs."[253]

Briefs On Exceptions

168. SFPP states that the 2011 ID erred. SFPP states that capitalizing such costs is inconsistent with the Commission's accounting regulations. SFPP states that the 2011 ID improperly relied upon the Commission's natural gas regulations[254] and not the Commission's oil pipeline regulations for capitalizing costs.[255] SFPP states that its practice of expensing indirect G&A costs is consistent with industry practice. SFPP adds that the 2011 ID failed to provide SFPP with an alternative means for recovery of these prudently incurred costs which have otherwise not been included in SFPP's rate base.

Commission Decision

169. The Commission affirms the 2011 ID's conclusion that SFPP is required to capitalize indirect costs related to capital projects. The 2011 ID incorrectly relied upon the Commission's natural gas pipeline regulations. However, the distinction that SFPP seeks to create between the Commission's oil pipeline regulations and the Commission's natural gas pipeline regulations is not supported. As the Commission explained in Opinion No. 511-A, a plain reading of the Commission's oil pipeline regulations in

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[251] *E.g.*, Opinion No. 511-A, 137 FERC ¶ 61,220 at P 121.

[252] 2011 ID, 134 FERC ¶ 63,013 at PP 269-270.

[253] 18 C.F.R. Part 201 (2011).

[254] *Id.*

[255] *Id.* Part 352 § 3-3.

section 3-3(1) is that any labor performed by the carrier's employees in furtherance of constructing the property at issue is chargeable to the carrier property accounts.[256] Consistent with the holding of Opinion No. 511-A, SFPP is required to capitalize indirect costs related to capital projects.

9. Legal Costs

170. The 2011 ID determined that SFPP failed to substantiate the legal costs that it proposes to directly assign.[257] The 2011 ID cites several examples in which SFPP failed to adequately explain discrepancies between the descriptive terms in the invoice used to identify a specific entity and the actual entity benefiting from the expense. In addition, the 2011 ID determined that SFPP failed to provide sufficient supporting documentation to afford the parties an opportunity to verify the consistency and reliability of SFPP's direct assignments.

Briefs On Exceptions

171. SFPP argues on exceptions that it reviewed all legal invoices over $2,000 and was able to assign most of these costs to specific entities.[258] SFPP contends the 2011 ID's rejection of its proposal due to a lack of sufficient supporting documentation was unreasonable.[259] SFPP states it provided a spreadsheet summarizing the results of its invoice review and provided sample invoices which SFPP claims adequately support its proposed direct assignment of costs.[260]

Briefs Opposing Exceptions

172. Opposing exceptions, the CCSV Shippers argue that SFPP has failed to justify its proposal with adequate supporting documentation. The CCSV Shippers claim the only supporting documentation in the record consists of a spreadsheet providing brief summaries of each legal invoice.[261] According to the CCSV Shippers, their review of this information detected "substantial and unexplained inconsistencies and inaccuracies

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[256] Opinion No. 511-A, 137 FERC ¶ 61,220 at P 227.

[257] 2011 ID, 134 FERC ¶ 63,013 at P 263.

[258] SFPP Brief on Exceptions at 41.

[259] *Id.* at 42.

[260] *Id.*

[261] CCSV Shippers Brief Opposing Exceptions at 64-65.

that render the data produced unreliable regarding the reasonableness of these direct assignments."[262] Accordingly, the CCSV Shippers state SFPP's proposal should be rejected and the legal costs allocated consistent with the Massachusetts Formula.

Commission Decision

173. The Commission will affirm in part and reverse in part the 2011 ID concerning the direct allocation of legal costs. The evidence presented in this proceeding is not sufficient to substantiate the direct allocation of the full $12.3 million in legal costs to SFPP.

174. In order to determine specific cost responsibility by business entity, SFPP undertook an after-the-fact review of each legal invoice over $2,000 paid by KMEP.[263] The review sought to determine the specific entity or entities in the Kinder Morgan business structure for which the costs were incurred. In instances where the costs were not attributable to a specific entity, they were allocated via the Massachusetts Formula. SFPP's review of legal invoices resulted in the direct assignment of approximately $12.3 million in costs to SFPP. Of this amount, roughly $8.2 million is attributable to litigation with the Union Pacific Railroad (UPRR).

175. With respect to the $8.2 million in legal costs involving UPRR, the Commission will accept SFPP's proposed direct assignment for the costs involving the fair rental value litigation subject to the allocation of these costs by land value as described previously.[264] The record demonstrates that these UPRR litigation costs directly relate to proceedings involving SFPP and are therefore appropriately directly assigned to SFPP.[265]

176. The Commission does not believe SFPP has justified its direct assignment of the remaining non-UPRR litigation costs. SFPP has failed to show that its post-hoc review reliably assigns cost responsibility for legal costs to the entity (or entities) associated with those costs. The record demonstrates the legal invoices do not always identify the specific Kinder Morgan entity for which work is being billed or adequately delineate by

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[262] *Id.* at 65 (citing 2011 ID, 134 FERC ¶ 63,013 at P 263 and Ex. VCC-70C).

[263] Tr. 1501-03.

[264] For example, the total of $8.2 million in UPPR right-of-way litigation costs includes approximately $0.5 million associated with the AREMA litigation which the Commission has determined is not appropriately allocated to the East Line in this proceeding. *See* Ex. VCC-174.

[265] *E.g.*, Ex. SPE-47 at 9-11; Ex. SPE-39 at 3-4.

Kinder Morgan entity the costs that could reasonably be attributed to each entity.[266] The parties have challenged the validity of the proposed assignment of costs for certain of these invoices, noting specific discrepancies.[267] While SFPP did provide several examples of the invoices it reviewed, these examples were limited and did not represent an adequate sampling of all invoices. Despite the opportunity to do so, SFPP failed to provide adequate supporting information to enable the Commission to validate the direct assignment of these remaining costs as proposed by SFPP.[268] Accordingly, the Commission is not persuaded that SFPP's review reflects a reliable and consistent allocation of legal expenses among the various Kinder Morgan entities. [269]

10. **Insurance Costs**

2011 ID

177. The 2011 ID rejected SFPP's proposed direct assignment of $2.7 million of insurance costs. In rejecting the direct assignment, the 2011 ID determined that SFPP's proposal was "unreliable and unverifiable and [could] create cross- subsidies if the replacement values of subsidiaries are misstated."[270] Specifically, the 2011 ID found KMEP's SEC filings undermined SFPP's proposed direct assignment because the SEC filings stated that KMEP's insurance costs are not attributable to any business segment or individual entity. Second, the 2011 ID found that the replacement values calculated by SFPP for purposes of allocating the insurance costs were not supported by underlying data.

178. The 2011 ID also faulted SFPP's proposal to use above-ground replacement values as the means to initially allocate the insurance costs among KMI- and KMEP-Operated Entities. The 2011 ID stated that a significant portion of SFPP's above-ground facilities and resulting insurance costs are related to non-carrier terminal facilities. However, after the initial allocation of insurance costs to SFPP, the 2011 ID determined that these costs are then further allocated between SFPP's jurisdictional and non-jurisdictional facilities by using gross property (both above-ground and below-ground

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[266] Tr. 1511-19.

[267] NHW Shippers Brief Opposing Exceptions at 64-66.

[268] Tr. 1504-05.

[269] The Commission will not permit SFPP to supplement the record in this proceeding as proposed in its Brief on Exceptions.

[270] 2011 ID, 134 FERC ¶ 63,013 at P 261.

facilities) as the allocation factor. The 2011 ID held that this results in an inequitable allocation of the insurance costs to SFPP's jurisdictional facilities, including the East Line.

Briefs on Exceptions

179. SFPP argues on exceptions that its proposal to allocate insurance costs on the basis of above-ground facility replacement values is appropriate. According to SFPP, the use of replacement values appropriately assigns each entity a share of the insurance premium commensurate with the potential exposure of each entity.[271] SFPP claims the 2011 ID's reliance on an internal e-mail written by SFPP witness DesLauriers to reject its proposal is in error. According to SFPP, witness DesLauriers testified at the hearing that the e-mail was written by the witness prior to the completion of SFPP's insurance allocation analysis and that the ultimate completion of the analysis satisfied his initial concerns.[272] SFPP further argues it provided the parties with a full explanation and supporting documentation related to its proposal to use replacement values, as well as, the relationship of replacement values to liability insurance.[273]

Briefs Opposing Exceptions

180. Opposing exceptions, the CCSV Shippers argue that SFPP has failed to fully support its proposal to allocate insurance premiums based on replacement values.[274] The CCSV Shippers states that SFPP has failed to offer sufficient evidence to support the relationship of above-ground replacement values to the incurrence of the insurance premiums which cover not just above-ground facilities but also below-ground facilities and liability insurance.[275]

[271] SFPP Brief on Exceptions at 42.

[272] *Id.* at 43.

[273] *Id.*

[274] CCSV Shippers Brief Opposing Exceptions at 67.

[275] The CCSV Shippers claim the evidence offered by SFPP concerning this issue consists of a single-page work paper which was not made part of the official record at the hearing. *Id.* at 68 (citing SFPP Brief on Exceptions at 43 (citing document Bates Numbered SFPP09 14121)).

Commission Decision

181. The Commission is not persuaded by SFPP's proposal to allocate its insurance costs by utilizing each entity's proportional replacement value. The record in this proceeding does not establish a clear link between the insurance premiums paid by KMEP and the above ground replacement values as determined by SFPP for allocation purposes. Furthermore, SFPP has not established that KMEP's liability insurance costs, which comprise over 50 percent of its total premium, are similarly related to facility replacement values.[276] The record evidence in this proceeding is virtually nonexistent and what is available consists of a single work paper. In this proceeding, SFPP bears the burden of fully justifying its proposal. The Commission finds that the conclusory statements offered by SFPP's witnesses are not sufficient to satisfy its burden of proof on this issue. Accordingly, SFPP is directed to allocate insurance costs utilizing KMEP's Massachusetts Formula.

11. Treatment of PAA Costs

182. The 2011 ID held that when calculating the Massachusetts Formula's allocation factors, SFPP may not remove PAAs from the gross property balances for unregulated entities.[277]

183. On exceptions SFPP argues the 2011 ID erred by failing to find PAAs should be removed from both non-FERC-jurisdictional and FERC-jurisdictional entities. The VCC Shippers oppose SFPP's exceptions and assert that PAAs should only be excluded from FERC-jurisdictional subsidiaries when determining gross property balances.

184. Consistent with the Commission's findings in Opinion Nos. 511 and 511-A,[278] the Commission will reverse the 2011 ID and approve SFPP's proposal to remove PAAs from both its regulated and unregulated entities when calculating its gross plant allocation factors pursuant to the Massachusetts Formula. The Commission's review of the record in this proceeding does not present any new evidence supporting a change from the Commission's previous findings concerning this matter. As the Commission determined in Opinion Nos. 511 and 511-A, failure to remove the PAAs from the non-jurisdictional entities will overstate their relative weight in the asset (rate base) component of the Massachusetts Formula.

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[276] *See* Ex. SPE-152C.

[277] 2011 ID, 134 FERC ¶ 63,013 at P 264.

[278] Opinion No. 511, 134 FERC ¶ 61,121 at P 142, *order on reh'g*, Opinion 511-A, 137 FERC ¶ 61,220, at PP 162-63.

12. Appropriateness of Certain Cost and Revenue Components

185. The 2011 ID rejected SFPP's proposal to use a net revenue factor (gross revenue minus cost of goods sold) instead of a gross revenue factor in the Massachusetts Formula.[279] The 2011 ID determined that SFPP's approach would under-allocate revenues to Tejas resulting in over-allocations of G&A costs to the remaining KMEP subsidiaries (including SFPP).

186. On exceptions SFPP claims that the ALJ erred and that the net revenues should be used.[280] Opposing exceptions, the CCSV Shippers state that the 2011 ID correctly rejected SFPP's proposal.[281]

187. The Commission need not address this issue. Tejas is a KMI-Operated Entity. The Commission in this order has excluded Tejas, along with all of the other KMI-Operated Entities from KMEP's Massachusetts Formula. Thus, the issue of whether, with respect to Tejas, to allow net revenue or gross revenue in the Massachusetts Formula is moot.

B. The KN Method

Background

188. The KN Method is used to allocate G&A costs among a pipeline company's divisions or functions after the G&A costs are allocated from the pipeline's parent company to the pipeline company through the Massachusetts Formula. Under Opinion No. 731,[282] such G&A costs are allocated based on the ratio of direct labor and capital investment of each of the pipeline's functions and services at issue to the total direct labor and capital investment of all divisions involved.[283] Opinion No. 731, which originally set forth the formula for the KN Method, requires that G&A costs first be

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[279] 2011 ID, 134 FERC ¶ 63,013 at P 266.

[280] SFPP Brief on Exceptions at 61.

[281] CCSV Shippers Brief Opposing Exceptions at 91.

[282] *Kansas-Nebraska Natural Gas Co. Inc.*, Opinion No. 731, 53 FPC 1691 (1975), *order on reh'g*, 54 FPC 923, *aff'd*, *Kansas-Nebraska Natural Gas Co. Inc. v. FPC*, 534 F.2d 227 (10th Cir. 1976).

[283] *See SFPP, L.P. et al.*, 86 FERC ¶ 61,022, at 61,082 (1999) (citing *Mojave Pipeline Co.*, 83 FERC ¶ 61,267 (1998)).

divided in labor-related, plant-related, and "other" categories. After the initial division, the "other" category is allocated between the labor- and plant-related categories in proportion to each category's total so that all costs are classified as either plant or labor related. The categories are then allocated among the jurisdictional entity's (in this case SFPP) functions by multiplying the total labor-related G&A by each function's direct labor ratio, and multiplying the total plant-related G&A by each function's direct plant ratio. Then, within each function, the costs are added together and the ratio of each total to the total amount allocated is that function's KN ratio. The final step is to multiply each G&A costs by the applicable KN ratios in order to allocate it across the functions. Opinion No. 731's KN formula has been affirmed by the Commission in numerous decisions.[284]

2011 ID

189. The 2011 ID rejected SFPP's proposed simple average method. Under SFPP's proposed simple average method, SFPP proposed a modified KN Method in which the "other" G&A costs (i.e., those that could not initially be classified as plant or labor) are allocated to each system on the basis a simple average of each system's labor and plant ratios.[285] The 2011 ID determined that SFPP's proposal fails to comply with the Commission's precedent concerning the application of the KN Method as detailed in Opinion No. 731.[286]

Briefs On Exceptions

190. On exceptions, SFPP argues that the simple average method applies the KN Method to allocate costs consistent with the principles of cost causation. With respect to cost causation, SFPP states its method "reflects the reality that the vast majority of G&A costs were not incurred solely in support of, or directly as a consequence of, either SFPP's direct labor or SFPP's operational plant."[287] In contrast, SFPP claims the Trial Staff provided no evidence that the G&A costs that consist of salaries and wages for

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[284] *Idaho Power Co.*, 3 FERC ¶ 61,108 (1978); *Missouri Power and Light Co.*, 5 FERC ¶ 63,003 (1977); *Panhandle Eastern Pipeline Co.*, 46 FERC ¶ 61,183 (1989); *Questar Pipeline Co.*, 74 FERC ¶ 61,126 (1996); *Transcontinental Gas Pipeline Corp.*, 101 FERC ¶ 63,022 (2002); *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077, at P 288-94 (2006).

[285] SFPP Brief on Exceptions at 65.

[286] 2011 ID, 134 FERC ¶ 63,013 at P 276.

[287] SFPP Brief on Exceptions at 65.

G&A personnel support only SFPP's direct labor. SFPP also argues its proposed simple average method is fully consistent with prior Commission decisions issued in two separate SFPP proceedings in Docket Nos. OR92-8, *et al*., and OR96-2, *et al*.[288]

Briefs Opposing Exceptions

191. Trial Staff objects to SFPP's claim that the simple average method better reflects the Commission's cost causation principles. Trial Staff also states that in *Opinion No. 511* the Commission rejected SFPP's proposed simple average method and held that "SFPP must follow the KN method set forth in Opinion No. 731."[289]

Commission Decision

192. The Commission affirms the 2011 ID. In Opinion Nos. 511 and 511-A, the Commission rejected SFPP's proposed simple average approach and directed SFPP to conform its KN Method to that required by Opinion No. 731. Accordingly, SFPP is directed to adopt the Staff's KN Method for purposes of allocating its G&A costs in this proceeding.

VI. Capital Structure

193. All parties agree that the capital structure of KMEP, SFPP's parent company, should be used to determine SFPP's cost of capital. No party disputes the 2011 ID's adoption of March 31, 2010, as the date for determining capital structure. However, SFPP has filed exceptions to the 2011 ID's holding that KMEP's capital structure must be modified to remove the effects of purchase account adjustments (PAAs). SFPP also objects to the 2011 ID's inclusion in the debt component of capital structure of: (1) $950 million of senior notes due to expire within one year; (2) $675 million of borrowings under its revolving credit facility; and (3) $65 million in commercial paper.

A. Purchase Account Adjustments

Background

194. A purchase account adjustment (PAA) is an accounting adjustment that is often applied to newly acquired assets. The PAA writes-up the accounting book value of the acquired asset so that the asset's book value (original cost minus accumulated

[288] *Id.* at 69 (citing *SFPP, L.P.*, Opinion No. 435, 86 FERC ¶ 61,022, at 61,082 (1999); *SFPP, L.P.*, 113 FERC ¶ 61,277, at P 89 (2005) (December 2005 Order))

[289] Trial Staff Brief Opposing Exceptions at 12-13.

depreciation) reflects the asset's market price.[290] It is inconsistent with original cost ratemaking principles for a PAA to enable a pipeline to recover more than a rate of return and deprecation of the asset's original cost.[291] Thus, Commission policy requires adjustments to remove the distorting effects of a PAA from cost of service unless the acquisition either provides a new service or a "substantial benefit to ratepayers."[292] For example, the Commission requires removal of any PAAs from a pipeline's rate base because failure to make such an adjustment would allow the pipeline to recover a rate of return and deprecation on a rate base reflecting more than the pipeline's original cost.

195. No party contends that the PAAs at issue in this proceeding have provided a substantial benefit to ratepayers. SFPP has not sought to include the PAAs in its rate base. The issue in this proceeding is whether and how the capital structure of KMEP must be adjusted to remove any distorting effects caused by certain PAAs related to six acquisitions by KMEP.[293]

2011 ID

196. The 2011 ID determined that the PAAs distorted SFPP's capital structure because removing six PAAs entirely from equity increased KMEP's equity component by 5.14 percent. The 2011 ID also noted changes in KMEP's capital structure following the acquisition of SFPP between 1997 and 1998 to support a finding that the PAAs increased the level of equity in KMEP's capital structure.[294] Acknowledging that KMEP's capital structure without an adjustment was below the 45 percent equity that is considered normal for oil pipelines, the 2011 ID concluded that such an analysis was not helpful for determining whether to further reduce the equity level to remove any effects of the PAAs.

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[290] Opinion No. 511, 134 FERC ¶ 61,121 at P 153 (citations omitted).

[291] *Id.* P 166 (citations omitted).

[292] *Id.* (citing *Longhorn Partners Pipeline*, 82 FERC ¶ 61,146, at 61,543 (1998)).

[293] The PAAs are related to KMEP's acquisition of: SFPP; Kinder Morgan Interstate Gas Transmission Company LLC; Trailblazer Pipeline Company; Kinder Morgan Wink Pipeline, L.P.; Trans Colorado Gas Transmission Co.; and Calnev Pipe Line LLC.

[294] 2011 ID, 134 FERC ¶ 63,013 at P 83 (citing Ex. Nav-33).

Opinion Nos. 511 and 511-A

197. Following the issuance of the 2011 ID, Opinion Nos. 511 and 511-A addressed the same dispute regarding the treatment of PAAs in the context of capital structure.[295] Opinion Nos. 511 and 511-A concluded that no adjustment for PAAs to KMEP's capital structure was warranted in that proceeding. Opinion No. 511 explained that a PAA merely increases the valuation of the asset base of a utility. The asset base including the PAA does not necessarily have a different financing ratio of debt and equity than the smaller asset base that would have existed absent the increased valuation caused by the PAAs.[296] Thus, as Opinion No. 511 concluded, the mere presence of a PAA does not necessarily demonstrate that the PAA has in fact distorted capital structure by rendering the debt to equity ratio different than it would have been absent the PAA.[297] In the case of KMEP, Opinion No. 511 concluded that no distortion had occurred. The Commission determined that with a capital structure of less than 45 percent equity, KMEP's capital structure was actually slightly more favorable to shippers than the typical oil pipeline capital structure.[298]

Briefs On Exceptions

198. Relying on Opinion No. 511, SFPP states that the 2011 ID erred by ordering SFPP to remove the depreciated balances of the PAAs. SFPP states that this proceeding involves the same PAAs considered in Opinion No. 511. SFPP adds that it is proposing capital structure of 42.57 percent equity and 57.43 percent debt, which is almost identical

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[295] Opinion No. 511, 134 FERC ¶ 61,121 at PP 166-75, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 235-241.

[296] Opinion No. 511, 134 FERC ¶ 61,121 at P 169. Opinion No. 511 distinguished between the effect of a PAA on capital structure and the effect of a PAA on rate base. *Id*. PP 167-168. 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. As explained in Opinion No. 511 and in this decision, the effect of a PAA on capital structure is not as straightforward.

[297] *Id*.

[298] *Id*. at PP 170, 175; Opinion No. 511-A, 137 FERC ¶ 61,220 at P 240. The lower level of equity is favorable to shippers because equity typically has a higher rate of return than the interest cost of debt.

to the capital structure of 43.82 percent equity and 56.18 percent debt that the Commission determined was within industry norms in Opinion No. 511.[299]

199. In contrast, SFPP states that the 2011 ID analyzed whether removal of the depreciated KMEP PAA balances from the equity component of KMEP's current capital structure yields a different equity component.[300] SFPP states that this is the incorrect standard. SFPP adds that although the 2011 ID relies upon changes to KMEP's capital structure immediately following the acquisition of SFPP 12 years ago, due to shifting financial strategies,[301] it is impossible to isolate and distinguish the impact of the 12-year old SFPP PAA on KMEP's current capital structure.

Briefs Opposing Exceptions

200. CCSV Shippers state that the 2011 ID correctly removed the PAAs from the equity component of KMEP's capital structure. CCSV Shippers state that Opinion No. 511 erroneously determined that the inclusion of the PAAs did not distort KMEP's capital structure because the unadjusted KMEP capital structure is "within industry norms."[302] CCSV Shippers state that a comparison to industry norms is irrelevant for addressing whether KMEP's capital structure is distorted by the inclusion of PAAs.[303] CCSV Shippers contend that the 2011 ID's finding of a 5.14 percent change in KMEP's capital structure indicates a distortion warranting the removal of the PAAs from KMEP's capital structure.

Commission Decision

201. Consistent with Opinion Nos. 511 and 511-A, the Commission will reverse the 2011 ID. SFPP will not be required to make adjustments to capital structure for the PAAs.

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[299] SFPP Brief on Exceptions at 89 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 169 n.380).

[300] 2011 ID, 134 FERC ¶ 63,013 at P 80.

[301] SFPP Brief on Exceptions at 89 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 169).

[302] CCSV Shippers Brief on Exceptions at 96 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 169).

[303] *Id.* (citing *BP Pipelines (Alaska) Inc.,* Opinion 502, 123 FERC ¶ 61,287, at PP 174, 178-79 (2008)).

202. This proceeding involves the same PAAs and essentially the same KMEP capital structure addressed by the Commission in Opinion Nos. 511 and 511-A. In Opinion No. 511, the Commission rejected an identical proposal to remove the PAAs entirely from the equity component of capital structure.[304] As Opinion No. 511 explained, KMEP's acquisitions are actually funded by a combination of debt and equity.[305] Even if the initial financing of a purchase happened to involve more equity than debt, this would not necessarily justify a proportionate reduction to equity for the PAAs. Opinion No. 511 explained that capital at the parent company level is essentially fungible and, over time, the debt to equity ratio in a particular transaction may be offset or replaced by other financial issuances.[306] Thus, the financing transactions are not easily traceable back to the original acquisition, especially when the original acquisition occurred years earlier.[307] Ultimately, it is not clear that the increased size of the asset base caused by the PAAs alters the ongoing ratio of debt to equity in company financing. There is no evidence on the record in this proceeding that would lead the Commission to reach a result that is different than the result in Opinion No. 511.

203. Given the difficulty of isolating the ongoing effects of the PAAs on capital structure, as in Opinion No. 511 and 511-A, the Commission observes that the percentage of equity in KMEP's unadjusted capital structure is less than the 45 percent to 55 percent considered normal for oil pipelines. Thus, KMEP's capital structure is actually slightly more favorable to shippers than the typical oil pipeline capital structure.[308] This provides an indication that KMEP's capital structure has not been distorted by PAAs and that no adjustment to KMEP's capital structure is necessary.

204. A flawed methodology informed the 2011 ID's contrary conclusion that PAAs distorted KMEP's capital structure because the PAAs caused a 5.14 percent increase in equity as opposed to debt. The 2011 ID based this finding upon a comparison between (a) the unadjusted capital structure and (b) a capital structure in which the PAAs (as

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[304] Opinion No. 511, 134 FERC ¶ 61,121 at PP 171-73.

[305] Opinion No. 511 further noted that KMEP funds many of its purchases with short term debt, and then eventually issues longer term debt and equity to replace this short term debt. *Id.* P 174.

[306] *Id.*

[307] *Id.*

[308] *Id*. PP 170, 175; Opinion No. 511-A, 137 FERC ¶ 61,220 at P 240. The lower level of equity is favorable to shippers because equity typically has a higher rate of return than the interest cost of debt.

adjusted for depreciation) had been solely removed from equity.[309] For the purposes of measuring the affect of the PAAs, the 2011 ID did not justify its assumption that the PAAs should be removed entirely from equity. Instead, the 2011 ID's comparison assumed what it was trying to prove, i.e. that the PAAs served to increase equity and, thus, that the effect of the PAAs should be measured by removing the PAAs entirely from equity. The 2011 ID based this approach upon prior Commission decisions in Docket Nos. OR96-2, *et al*. However, Opinion Nos. 511 and 511-A distinguished these prior orders because they involved unique circumstances related to "push down" accounting on SFPP's balance sheet[310] and that the PAA had created an anomalous equity to debt ratio.[311]

205. The Commission reverses the 2011 ID and will not require SFPP to make adjustments to its capital structure for the PAAs.

B. <u>Appropriate Debt to be Included in the Capital Structure</u>

<u>2011 ID</u>

206. The 2011 ID stated that if the short-term debt is effectively being used as long-term debt, Commission policy requires inclusion of short-term debt (along with long term debt) to calculate the ratio of debt to equity in capital structure.[312] Thus, the 2011 ID required SFPP to include as debt in capital structure three forms of debt that SFPP sought to exclude.

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[309] The 2011 ID's comparison involved the capital structure proposed by SFPP to the capital structures proposed by NHW Shippers and Trial Staff. However, in addition to the issues related to the PAAs, NHW Shippers and Trial Staff included certain forms of debt such as expiring long-term debt that had been omitted by SFPP. Thus, it is unlikely that the entire 5.14 percent discrepancy can be attributed to the treatment of PAAs.

[310] Opinion No. 511, 134 FERC ¶ 61,121 at P 173.

[311] *Id.* P 175. Although these orders also expressed concern that the PAAs had distorted KMEP's balance sheet, Opinion No. 511 stated that based upon the additional considerations and more extensive evidence presented in subsequent proceedings, the Commission could conclude that KMEP's capital structure was not distorted by PAAs. *Id.*

[312] 2011 ID, 134 FERC ¶ 63,013 at P 59 (citing *Transok, Inc.*, 70 FERC ¶ 61,177 at 61,555 (1995); December 2005 Order, 113 FERC ¶ 61,277 at P 69.

207. First, the 2011 ID required SFPP to include $950 million of senior notes due to expire within one year of March 31, 2010, the end of the adjustment period.[313] The 2011 ID concluded that the record establishes that KMEP refinances the senior notes as long-term debt. The 2011 ID observed that when KMEP reported expiring long term debt at the end of years 2000 through 2009, KMEP reported an increase of long-term debt in the following year.[314] The 2011 ID also noted that KMEP has debt that is scheduled to mature every year but one from 2010 through 2021, and then again in every year but two between 2031 and 2039.[315]

208. Second, the 2011 ID also required SFPP to include $675 million of borrowings under its revolving credit facility. The ID observed that KMEP initially funds both its discretionary capital spending and its acquisition outlays from borrowings under its long-term revolving bank credit facility. The ID further noted that KMEP documents indicate that this debt was periodically refinanced as long term debt.[316] The 2011 ID observed that SFPP planned to renew the credit facility following its maturity in August of 2010.[317]

209. Third, the 2011 ID also required SFPP to include $65 million in commercial paper[318] in the debt component of its capital structure. The 2011 ID concluded SFPP uses the commercial paper as an interim financing tool for long-term projects that are periodically refinanced.[319] Thus, the 2011 ID concluded that SFPP had the intent to replace its commercial paper (and the borrowings under the credit facility) with long-term debt.

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[313] *Id.* P 60. The expiring senior notes are divided into two tranches: $700 million at 6.75 percent due March 15, 2011; and $250 million in 7.50 percent senior notes due November 1, 2010.

[314] *Id.* (citing Ex. NAV-32 at 1, lns.17-19).

[315] *Id.* (citing Ex. SPE-109).

[316] *Id.* P 63 (citing Ex. NAV-49 at 147)

[317] *Id.* P 62 (citing Ex. NAV-49 at 144).

[318] *Id.* P 63.

[319] *Id.* (citing Ex. NAV-49 at 147; Tr. 183-184).

Opinion Nos. 511 and 511-A

210. Following the issuance of the 2011 ID, the Commission issued Opinion Nos. 511 and 511-A. In Opinion No. 511, the Commission concluded that KMEP's long term debt expiring within one year should be incorporated into the debt component of KMEP's capital structure.[320] Opinion No. 511 explained that 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.[321]

211. In Opinion No. 511, the Commission also determined that KMEP's commercial paper should be incorporated into the debt component of KMEP's capital structure.[322] Opinion No. 511 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.[323] The Commission further observed that KMEP has maintained significant levels of commercial paper for several years, such that the commercial paper has become a regular presence in KMEP's financial portfolio.

212. No party sought rehearing of the Commission's holdings, and the Commission did not address either issue in Opinion No. 511-A. Neither Opinion No. 511 nor Opinion No. 511-A addressed the proper treatment of the credit facility borrowings because the issue did not arise in that proceeding.

Briefs On Exceptions

213. In its brief on exceptions, SFPP states that the 2011 ID erroneously includes expiring long term debt, commercial paper, and the credit facility borrowings in capital structure. SFPP acknowledges that Opinion No. 511 required SFPP to include KMEP's expiring long-term debt and commercial paper in the debt levels used to determine KMEP's capital structure. However, SFPP states that Opinion No. 511's "discussion of fungibility, or the inability to trace particular forms of capital, is irrelevant to determining the appropriate debt for purposes of capital structure in this proceeding."[324] SFPP states

[320] Opinion No. 511, 134 FERC ¶ 61,121 at P 184.

[321] *Id.*

[322] *Id.* P 183.

[323] *Id.*

[324] SFPP Brief on Exceptions at 92.

that more important consideration is whether and for how long debt will be used to fund long-term assets. Citing KMEP's SEC Form 10-K, SFPP also emphasizes that KMEP lacks the ability and intent to refinance with long term debt the expiring long-term debt and short term debt.[325] SFPP states if KMEP had such intent and ability, it would be required by GAAP to classify this debt as long-term debt.[326] SFPP states that this debt will require payment using the current assets and liquidity of the company.[327] SFPP states that Opinion No. 511 did not consider these constraints on KMEP's intent and ability to refinance. Finally, SFPP states that any refinancing of KMEP's short term debt and expiring long-term debt could include new short-term debt, new long-term debt, new equity, or any combination thereof.

Briefs Opposing Exceptions

214. NHW Shippers and Trial Staff contend that the 2011 ID correctly required SFPP to include in the debt component of its capital structure: (1) $950 million of senior notes due to expire within one year; (2) $675 million of borrowings under its revolving credit facility; and (3) $65 million in commercial paper.

215. NHW Shippers and Trial Staff state that the Commission ordinarily does not require pipelines to include short-term debt in their debt balance for ratemaking purposes, but that it is appropriate to do so when the pipeline company uses short-term debt to finance long-term assets.[328] NHW Shippers and Trial Staff state that Opinion No. 511 applied this standard to require SFPP to include KMEP's commercial paper and expiring long-term debt in its capital structure.[329]

216. NHW Shippers and Trial Staff state that KMEP routinely replaces its expiring long-term debt with new long-term debt. NHW Shippers and Trial Staff reiterate the finding of the 2011 ID that KMEP has repeatedly refinanced its long-term debt due in its last year before maturity.[330] Trial Staff states that in each year from 200 through 2009 in

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[325] *Id.* (citing Ex. SPE-13 at 113; Ex. VCC-6 at 103).

[326] *Id.* at 90 (citing Ex. SPE-107 at 61-62; Ex. SPE-119 at 2; Ex. SPE-216 at 2).

[327] *Id.* at 91 (citing Tr. 173, 176-177).

[328] NHW Shippers Brief Opposing Exceptions at 76 (citing *Transok*, 70 FERC at 61,555; December 2005 Order, 113 FERC ¶ 61,277 at P 69).

[329] *Id.* at 77 (citing Opinion No. 511, 134 FERC ¶ 61,121, at P 183).

[330] *Id.* at 79 (citing Ex. NAV-49 at 74, 144; Tr. 179, 181).

which KMEP has reported having a current portion of long term debt, KMEP has reported an increase in the overall level of debt the following year.[331] As a result all expiring long term debt is replaced by new long-term debt even if one could not directly trace the proceeds of one particular expiring issuance to a new issuance. NHW states that regardless of the characterizations in KMEP's 10-K, NHW Shippers emphasize that such debt was routinely replaced with new debt and thus "has been used as a permanent aspect of KMEP's ongoing funding of capital structure, not temporary financing."[332] Moreover, NHW Shippers state that the financial reports indicate the filer's intent at the time of filing.[333] NHW Shippers elaborate that even if KMEP did not have the present intent and ability to refinance on the date of the 10-K filing, the Commission should focus on KMEP's actions over many years.

217. NHW Shippers and Trial Staff state that the 2011 ID also correctly included commercial paper and credit facility borrowings in the debt component of capital structure. Regarding KMEP's revolving credit facility, Trial Staff states that KMEP uses credity facility borrowings to fund long-term capital assets. NHW Shippers and Trial Staff state that KMEP periodically refinances its credit facility borrowings with senior notes and equity.[334]

218. Regarding commercial paper, NHW Shippers and Trial Staff contend that KMEP uses its commercial paper as an interim financing tool for long-term projects that are periodically refinanced with traditional long-term debt. Trial Staff adds that more fundamentally, KMEP uses commercial paper as a component of its "pool" of financing proceeds. Trial Staff cites the testimony of SFPP witness Vander Weide, which conceded:

> [I]t is always difficult to trace financing to particular uses. Essentially all your financing goes into a pool, and you pay for your various spending needs out of the pool.[335]

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[331] Trial Staff Brief Opposing Exceptions at 37 (citing Ex. NAV-32 at 1).

[332] NHW Shippers Brief Opposing Exceptions at 80 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 184).

[333] *Id.* (citing Tr. 176, 180-181).

[334] *Id.* at 81 (citing Ex. NAV-32 at 1, lns. 17-19; Ex. NAV-49 at 74, 144 (fourth paragraph); Tr. 179-181).

[335] Trial Staff Brief Opposing Exceptions at 41 (citing Tr. 185).

219. Thus, Trial Staff concludes that it is difficult and inconsistent with Commission policy to trace particular short-term debt issuances to particular expenditures in the context of KMEP's overall financing.

Commission Decision

220. The Commission affirms the 2011 ID and will require SFPP to include in the debt component of its capital structure: (1) $950 million of senior notes due to expire within one year; (2) $675 million of borrowings under its revolving credit facility; and (3) $65 million in commercial paper. SFPP is also directed to adjust the capital structure for prior years as used in the 154-B methodology to include all three types of debt (expiring long-term debt, commercial paper, and borrowings under its revolving credit facility) into the debt component of capital structure.

221. Consistent with Opinion No. 511, KMEP's long-term debt due within one year must be included in the debt used to determine capital structure. Although SFPP claims that KMEP does not have the intent or the ability to refinance its expiring debt with long term debt,[336] KMEP's financing practice supports the inclusion of debt expiring within one year in capital structure. As explained in Opinion No. 511, given the continuous issuance of new debt and equity by KMEP, the expiration of long-term debt does not necessarily represent an actual change in the ratio of debt to equity in KMEP's capital structure. As the record in this proceeding demonstrates, every year when KMEP reported expiring long term debt at the end of years 2000 through 2009, KMEP reported an increase of long-term debt in the following year.[337] For a company with KMEP's financing practices, the most reasonable estimate of ongoing long-term debt levels includes the expiring long-term debt.

222. The Commission also will require SFPP to include in the debt used to determine capital structure: (1) $675 million of borrowings under its revolving credit facility; and (2) $65 million in commercial paper. As the parties and the 2011 ID observe, 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.[338] However, in this decision and in Opinion No. 511, the Commission has emphasized the fungible character of KMEP's capital and the infeasibility of tracing particular forms of capital to particular

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[336] SFPP Brief on Exceptions at 90 (citing Ex. SPE-107 at 61-62; Ex. SPE-119 at 2; Ex. SPE-216 at 2).

[337] 2011 ID, 134 FERC ¶ 63,013 at P 60 (citing Ex. NAV-32 at 1, lns. 17-19).

[338] *See, e.g.*, *Cent. Tel. & Utils. Corp.*, 18 FERC ¶ 61,132, at 61,266 (1982).

expenditures.[339] As determined in Opinion No. 511, KMEP's commercial paper historically provides ongoing support for SFPP's business activities.[340] SFPP did not seek rehearing of these findings in Opinion No. 511, and SFPP has not provided sufficient reason to depart from the practice established by Opinion No. 511.

223. SFPP must also include in its debt used to determine capital structure the $675 million of borrowings under its revolving credit facility. SFPP has presented evidence that borrowings under the credit facility have typically been at zero as of December 31 in most years. However, there were significant sums outstanding as of March 31, 2010, the date used to derive the capital structure in this proceeding. In its KMEP SEC Form 10-Q for First Quarter of 2009, KMEP states that it will use its borrowings under its bank credit facility rather than commercial paper for its financing and short-term liquidity needs.[341] Given the findings made in this order regarding the fungible character of KMEP's capital and the inclusion of commercial paper in KMEP's capital structure, the Commission directs SFPP to include in the debt component the $675 million borrowings under the credit facility.

VII. Cost of Debt

224. All parties agree that the debt costs of KMEP, SFPP's parent company, should be used to determine cost of debt. No party disputes the 2011 ID's adoption of March 31, 2011, as the date for determining KMEP's debt cost.

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[339] Order No. 511, 134 FERC ¶ 61,121 at PP 174, 183, 192.

[340] KMEP reported no outstanding commercial paper in December 31, 2008 and December 31, 2009 due to a downgrade in its short-term credit rating that rendered KMEP unable to access commercial paper borrowings. Ex. NAV-48 at 12. On February 25, 2010, KMEP's short-term credit rating was raised, and due to this favorable change, KMEP resumed its commercial paper program. As of March 31, 2010, KMEP reported $65 million dollars in outstanding commercial paper. *Id.* Prior to the credit downgrade, KMEP's balance sheet consistently sustained significant levels of outstanding commercial paper, 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 Exceptions at 80 (citing Ex. SPE-1 at 32; Ex. SPE-5 at 49; Ex. SPE-6 at 60; Ex. SPE-7 at 74; Ex. SPE-8 at 83; Ex. SPE-9 at 123; Ex. SPE-10 at 96; Ex. SPE-11 at 115; Ex. SPE-12 at 116; Ex. SPE-13 at 117; Ex. SPE-109; Ex. SPE-112 at 147; Ex. SPE-113 at 12). These large quantities of outstanding commercial paper would materially alter the historic capital structure that is used for making the calculations required by the Commission's Opinion No. 154-B methodology.

[341] Ex. NAV-48 at 12.

225. Both SFPP and Trial Staff have sought exceptions to the 2011 ID's decision incorporating the effects of interest rate swaps into the cost of debt. SFPP takes exception to the 2011 ID's holding that SFPP must include in its cost of debt: (1) $950 million of senior notes due to expire within one year; (2) $675 million of borrowings under its revolving credit facility; and (3) $65 million in commercial paper. SFPP seeks rehearing of this aspect of the 2011 ID's decision.[342]

A. <u>Interest Rate Swaps</u>

<u>Background</u>

226. KMEP's long-term debt primarily consists of fixed interest rate bonds.[343] As a result, if interest rates decline, KMEP may be required to pay above-market rates. Declining interest rates will also increase the fair value of KMEP's outstanding fixed rate debt. To hedge against interest rate declines, KMEP uses interest rate swap agreements. In an interest rate swap, KMEP agrees to pay a variable interest rate[344] on a stipulated principal to another party in exchange for receiving a fixed interest rate on the same stipulated principle.[345] Payments are made at intervals dictated by the terms of the swap agreement, and the relative payments owed by each party are netted against each other.[346] In its 2010 First Quarter SEC Form 10-Q, KMEP states that "[a]ll of our swap agreements have termination dates that correspond to the maturity dates of the related series of senior notes."[347] In its SEC filings, KMEP states that using the interest rate swaps, it targets and has achieved a mixture of roughly 50 percent fixed-rate debt and 50 percent variable-rate debt.[348] As of March 30, 2010, KMEP reported that its interest

[342] The 2011 ID ordered SFPP to include Special Purpose Debt in the cost of debt calculation. 2011 ID, 134 FERC ¶ 63,013 at P 104. No party challenges this finding on exceptions.

[343] Ex. NAV-7 at 90, 107.

[344] The variable interest rate is based upon the London Interbank Offered Rate (LIBOR) plus a spread. Ex. NAV-7 at 309.

[345] Ex. SPE-107 at 52.

[346] The principal amount is notional because there is no need to exchange actual amounts of principal. Ex. NAV-7 at 109.

[347] Ex. NAV-48 at 19.

[348] *E.g.*, Ex. NAV-7 at 109, 200; Ex. NAV-48 at 19.

swaps covered a notional principal of $5.2 billion[349] compared to a total of $11.0164 billion of debt.[350] Although KMEP remains responsible for paying its original creditor for the fixed rate debt, the cash flows associated with fixed rate borrowings for the sum of the notional principle are effectively converted into variable rate cash flows. By effectively shifting some of its debt costs to variable cash flows using the interest swaps, KMEP protects itself from falling interest rates which would leave KMEP paying above-market rates,[351] and hedges against the resulting increase in the fair value of its outstanding bonds.

<u>2011 ID</u>

227. The 2011 ID determined that KMEP's cost of debt should be adjusted to reflect the effect of the interest rate swaps. The 2011 ID concluded that a cost of debt incorporating interest rate swaps corresponds to KMEP's actual debt costs as required by Commission policy.[352] The 2011 ID explained that SFPP's proposed exclusion of interest rate swaps is the primary explanation for the disparity between the 4.32 percent cost of debt reported in KMEP's First Quarter 2010 SEC Form 10-K and SFPP's proposed cost of debt of 6.48 percent.[353] While noting that future variable debt costs are speculative, the 2011 ID rejected assertions by SFPP that the variable and fixed interest rates associated with the interest rate swaps are the same over the long term. The 2011 ID stated that the interest rate swaps consistently provide KMEP with overall cost savings. The 2011 ID stated that over the past eight years, KMEP's actual cost of debt was lower than its fixed-rate cost of debt in every year except 2007.[354] The 2011 ID also

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[349] Ex. NAV-48 at 19.

[350] *Id.* at 11. The $11.0164 billion includes debt classified by KMEP as long-term debt and also debt classified by KMEP as short-term debt.

[351] Ex. NAV-7 at 90 ("We use interest rate swap agreements to transform a portion of the underlying cash flows related to our long-term fixed rate debt securities (senior notes) into variable rate debt in order to achieve our desired mix of fixed and variable rate debt, and *in periods of falling interest rates, these swaps result in period-to-period decreases in our interest expense*.") (emphasis added).

[352] 2011 ID, 134 FERC ¶ 63,013 at P 94 (citing *Transok*, 70 FERC at 61,555).

[353] *Id.* P 96 (citing Ex. NAV-48 at 11).

[354] *Id.* Ex. NAV-32 shows the percentage differences between KMEP's actual cost of debt (which reflects cost savings attributable to Interest Rate Swaps) and fixed-rate cost of debt (which does not reflect cost savings attributable to Interest Rate Swaps)

(continued…)

emphasized that during the base and adjustment period, KMEP reported that unwinding certain interest rate swaps led to several hundred million dollars of profits for KMEP.[355] The 2011 ID added that the pipeline may file a rate change at any time if its revenues and costs deviate from the cost of service adopted by this proceeding.

Briefs On Exceptions

228. Both Trial Staff and SFPP filed exceptions to the 2011 ID's adjustment to the cost of debt to account for interest rate swaps. SFPP claims that at the initiation of an interest rate swap agreement, the parties assume that the overall average interest rate for the fixed and variable sides of the swap will equalize over the life of the swap.[356] SFPP states that the Commission's practice has been to set the ratemaking cost of debt without regard to the transitory costs incurred or savings achieved through interest rate swap agreements. SFPP contends that if cost reductions associated with interest rate swap agreement were included in the cost of debt, rates must also (perhaps via a tracker) reflect future cost increases associated with the interest rate swap agreements. SFPP states that rate payers should not be subjected to risks associated with hedging arrangements, including the potential for higher debt costs in the future.

229. On exceptions, Trial Staff also objects to the 2011 ID's adjustment to the cost of debt for the interest rate swaps. Trial Staff asserts that the Commission has consistently calculated cost of debt using only the actual interest rates of the pipeline's long-term debt. Trial Staff states that the Commission has never addressed the effect of interest rate swaps on the interest rate used to determine cost of debt. Trial Staff states that the 2011 ID's decision is inconsistent with Opinion No. 486 and the Commission's decision on rehearing in Opinion No. 486-A.[357] In that proceeding, Kern River proposed adjust its cost of debt to recover a return on equity for debt issuance fees and its payments to cancel

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for the years 2000 through 2009. Ex. NAV-32 at 5. KMEP's actual cost of debt was below its fixed-rate cost of debt by 1.97 percent in 2009, 1.10 percent in 2008, 0.00 percent in 2007, 0.27 percent in 2006, 1.30 percent in 2005, 1.95 percent in 2004, 2.18 percent in 2003, and 2.00 percent in 2002. Ex. NAV-32 at 5, ln. 20.

[355] 2011 ID, 134 FERC ¶ 63,013 at P 96 (citing Ex. NAV-49 at 81 (second bullet); Tr. 210-11).

[356] SFPP Brief on Exceptions at 84 (citing Ex. SPE-107 at 54; Tr. 191-92, 199, 308-09).

[357] Trial Staff Brief on Exceptions at 9 (citing Opinion No. 486-A, 123 FERC ¶ 61,056 at PP 251-57).

interest rate swaps.[358] Trial Staff explains that the Commission rejected Kern River's proposal, finding that while the pipeline may recover such financing costs over the life of the underlying debt, the pipeline may not earn a return (or recover carrying costs) for these types of payments.[359]

230. Trial Staff states that Commission regulation requires that pipelines calculate rates using "a weighted cost of capital, combining the rate of return on debt capital and the real rate of return on equity capital."[360] Trial Staff state that Commission regulations make no provision for the inclusion of derivatives, swaps, or any other related financial instruments. Trial Staff emphasize that even the 2011 ID conceded that "Interest Rate Swaps are fundamentally contractual agreements, not separate debt issuances," because swap participants still retain their respective original debt obligations.[361] Thus, Trial Staff distinguishes *Transok*,[362] which Trial Staff states only required the utility to include actual "sources of debt funding," not separate contractual agreements. Trial Staff further argues that the swaps are inherently speculative and that rate payers should not be subjected to risks associated with interest rate swaps.

231. Trial Staff emphasizes the difficulty of measuring the effects of an interest rate swap. Trial Staff contrasts the notional principal of $5.2 billion with the balance sheet value of $332.5 million. Trial Staff states that if interest rate swaps must be treated as actual debt, this would substantially alter KMEP's capital structure.

232. Trial Staff also contends that if the Commission affirms the 2011 ID, the Commission should specify a methodology for adjusting the cost of debt for interest rate swaps. Trial Staff asserts that the interest cost percentage reported by KMEP in its SEC Form 10-Q is unreliable. Although Trial Staff acknowledges the statement in KMEP's SEC Form 10-Q that the weighted average interest rate on all of KMEP's borrowings was approximately 4.32 percent during the first quarter of 2010. However, Trial Staff contends that there is no explanation for how the 4.32 percent was derived or how that number incorporates interest rate swaps. Trial Staff adds that FERC ratemaking and financial accounting have different methods and different goals. Trial Staff states that the Financial Accounting Standards Board proposes three potential ways that a company can

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[358] *Id.* (citing Opinion No. 486, 117 FERC ¶ 61,077 at P 201).

[359] *Id.*

[360] *Id.* at 13 (quoting 18 C.F.R. § 346.2(c)(3)).

[361] *Id.* at 14 (quoting 2011 ID, 134 FERC ¶ 63,013 at P 92).

[362] *Transok*, 70 FERC at 61,555.

account for the changes in value resulting from cash flow hedging instruments such as interest rate swaps.[363] Trial Staff asserts that Dr. Horst did not explain the accounting methodology used by KMEP.

Briefs Opposing Exceptions

233. Opposing exceptions, NHW Shippers contend that the 2011 ID correctly required SFPP to reflect the cost of KMEP's interest rate swaps in the cost of debt.

234. NHW Shippers state that SFPP failed to rebut evidence that KMEP consistently lowers its overall cost of debt by entering into interest rate swaps. NHW Shippers emphasize that for seven of the past eight years, KMEP saved money compared to its fixed-rate only debt cost. NHW Shippers assert that SFPP witness Dr. Vander Weide failed to support his assumption that parties would not enter into swaps unless the parties expect the variable and the fixed interest rates to be the same over the long run, and NHW Shippers state that even if Dr. Vander Weide's statement is true, the actual variable interest rates that occur may differ from the parties' expectations.

235. In response to the argument that customers should not bear the risk of the swaps, NHW Shippers emphasize that fixed rate debt is also associated with the inherent risk that market interest rates will fall below the fixed rate. NHW Shippers emphasize that interest swaps are a basic tool for hedging and are an integral part of KMEP's ongoing financial strategy.[364] NHW Shippers state that failure to include the interest rate swaps in the cost of debt effectively places the *shippers* at risk and unable to benefit from NHW's hedging via the interest rate swaps.

236. NHW Shippers state that contrary to SFPP's arguments, accounting for the effect of interest rate swaps does not require the institution of a tracker.[365] NHW states that the fact that variable interest rates change does not distinguish this cost from other aspects of the cost of service. NHW Shippers state that if SFPP's overall costs increase, SFPP is free to file another rate case. NHW Shippers state that if a pipeline's rate swaps increase

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[363] Trial Staff Brief on Exceptions at 18 (citing *Statement of Financial Accounting Standards ASC 815-30-25, Subsequent Recognition and Measurements of Gains and Losses on Hedging Instruments*).

[364] NHW Shippers Brief Opposing Exceptions at 61 (citing Ex. NAV-7).

[365] *Id.* at 68-69.

(as opposed to decrease) debt costs in a future rate case, barring imprudence, then the cost of service should reflect the increased costs associated with the swaps.[366]

237. Contrary to Trial Staff, NHW Shippers contend that Opinion Nos. 486, 486-A, and 486-C support incorporation of interest rate swaps into the cost of debt. NHW Shippers acknowledge that Opinion No. 486 and 486-A held that Kern River was not entitled to earn a return on equity or its cost of debt interest on the swap cancellation costs. However, NHW Shippers state that the Commission permitted Kern River to recover the cancellation costs by raising the effective cost of debt for its series A notes from the fixed coupon rate of 6.676 percent to 8.455 percent.[367] In other words, NHW Shippers state that the termination costs incurred by Kern River were amortized over the remaining life of the canceled swaps and incorporated into the computation of Kern River's cost of debt.

238. NHW Shippers state that the 2011 ID is consistent with Opinion Nos. 486, *et al*. NHW Shippers emphasize that the 2011 ID did not, as prohibited by those orders, require that SFPP reduce its debt or equity rate base to reflect the savings from interest swaps. Rather, NHW Shippers state the 2011 ID only required that SFPP reflect the lowereffective interest rate applicable to its debt as a result of savings from the swaps. NHW Shippers state that if the Commission permits a pipeline to increase its effective cost of debt by amortizing the cost of unwinding an interest rate swap, as occurred in Opinion No. 486 et al., there is no reason why the Commission should exclude *gains* resulting from the unwinding of an interest rate swap or performing under an un-terminated cost swap agreement that has not been terminated. NHW Shippers assert that a regulated entity should not be permitted to shelter its interest rate swaps from consideration simply because the regulated entity received a gain as opposed to a loss.

239. NHW Shippers add that the 2011 ID and Opinion No. 486 have taken an approach that is consistent with the California Public Utilities Commission which makes clear that the cost of debt for ratemaking purposes should reflect the lower cost of debt attained by swapping fixed rate debt for variable rate debt.[368] NHW Shippers state that the only

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[366] *Id.* at 69-70.

[367] *Id.* at 64 (citing Opinion No. 486-C, 129 FERC ¶ 61,240 at PP 210, 211, 218-20; Opinion No. 486, 117 FERC ¶ 61,077 at P 195 (shipper witness stating that "the impact of Kern River's debt issuance and swap costs were already reflected in the cost of Kern River's long-time debt")).

[368] *Id.* at 65-66 (citing *Southwest Gas Corp.*, 1992 WL 596550, at *9 (Finding of Fact #6), D.92-05-016 (Cal. P.U.C. May 8, 1992); *Golden State Water Co.*, 2007 WL 570571, at *4, D.07-02-014 (Cal. P.U.C. Feb. 15, 2007); *Pacific Gas & Elec. Co.*, 2004 WL 2533627, at *17 (Finding of Fact #19), D.04-10-037 (Cal. P.U.C. Oct. 8, 2004).

distinction between KMEP and Kern River is that Kern River's termination resulted in a loss and KMEP's termination resulted in a gain.

240. NHW Shippers assert that *Transok* supports incorporating the effect of interest rate swaps into the cost of debt. In *Transok*, the Commission stated that the cost-of-debt should be set at the "true cost at which [the pipeline] could obtain debt financing."[369] Although *Transok* did not directly address the issue of interest rate swaps, NHW state that the same principles apply here. NHW Shippers contend that in this case KMEP obtains debt financing at 4.32 percent under its policy using interest rate swaps to "borrow funds using a mix of fixed rate debt and variable rate debt."[370] In response to SFPP's argument that it is inappropriate focus on short-term costs and risks when determining rates,[371] NHW Shippers contend that SFPP fails to address the finding by the 2011 ID that KMEP's savings from interest rate swaps are long-standing and consistent.[372]

241. NHW Shippers also dispute Trial Staff's claim that interest rate swaps are not actual debt instruments and thus *Transok* does not apply. NHW agrees that interest rate swaps do not create additional debt, but NHW states that these swaps transform the effective cost of KMEP's existing debt and turn approximately 50 percent of KMEP's existing fixed debt obligations into variable debt obligations.

242. NHW Shippers state that Trial Staff's reliance on the FASB documentation and the Commission's policy on cash flow hedges is irrelevant to interest rate swaps designed to hedge fixed rate debt risk.

243. NHW Shippers state that Trial Staff provides no reasoned basis to doubt the validity of the 4.32 percent debt cost. NHW Shippers note that SFPP never objected to the validity of the 4.32 percent figure. NHW Shippers state that Trial Staff never sought additional information regarding the calculation of this number in testimony or at

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[369] *Id.* (citing *Transok*, 70 FERC at 61,555). NHW Shippers state that the Commission has applied a similar principle in determining SFPP's cost of debt. *Id.* at 68 (citing December 2005 Order, 113 FERC ¶ 61,277 at P 69; Opinion No. 511, 134 FERC ¶ 61,121 at PP 183-184).

[370] *Id.* at 66 (citing Ex. Nav-7 at 200; Ex. NAV-39).

[371] SFPP Brief on Exceptions at 84 (citing *Pub. Serv. Comm'n of N.Y. v. FERC*, 813 F.2d 448, 461 (D.C. Cir. 1987)).

[372] NHW Shippers Brief Opposing Exceptions at 67 (citing 2011 ID, 134 FERC ¶ 63,013 at P 96 (citing Ex. NAV-39; Ex. NAV-32 at 3)).

hearing. Moreover, NHW Shippers state that contrary to Trial Staff's argument, the record contains a clear explanation regarding the computation of the interest rate swaps, stating that both those that have been terminated and those that remain in effect, are included in the 4.32 percent interest rate KMEP reported to the SEC.[373]

Commission Decision

244. The Commission finds that the 2011 ID erred by requiring SFPP to incorporate KMEP's interest rate swaps into the cost of debt to be used in SFPP's cost of service. SFPP does not provide its own financing. Thus, to obtain a representative cost of debt for SFPP, the parties have used the cost of debt of SFPP's parent company, KMEP. When using the parent company's cost of debt, the Commission has historically relied upon the parent company's actual debt issuances and the Commission has not consulted the parent's hedging activity, such as interest swaps.[374] The record in this proceeding does not justify a departure from this practice.

245. The Commission finds that KMEP's interest rate swap activity is separate from the type of financing necessary for the operation of SFPP's East Line. As every party recognizes, KMEP is a master limited partnership with many subsidiaries.[375] KMEP's activities create exposure to a variety of risks, including changes in interest rates but also fluctuations in the market price of natural gas, natural gas liquids, and crude oil.[376] As a

[373] *Id.* at 70.

[374] Neither the 2011 ID nor NHW Shippers cite to a single case in which the Commission required an adjustment to the cost of debt in a subsidiary's cost of service to include the interest swap hedging activities of a parent company.

[375] As KMEP's 2009 SEC FORM-10K states:

> We own an interest in or operate approximately 28,000 miles of pipelines and 180 terminals, and conduct our business through five reportable business segments….Our pipelines transport natural gas, refined petroleum products, crude oil, carbon dioxide and other products, and our terminals store petroleum products and chemicals and handle bulk materials like coal and petroleum coke. We are also the leading provider of carbon dioxide, commonly called "CO2," for enhanced oil recovery projects in North America. Ex. NAV-7 at 8.

[376] Ex. NAV-7 at 192, 198.

result, KMEP engages in derivative and hedging activity, including interest rate swaps and commodity derivatives.[377]

246. The confusion in this proceeding arises because KMEP's SEC financial statements report that the interest rate swaps, "convert the interest expense associated with certain of [KMEP's] senior notes from fixed rates to variable rates…."[378] KMEP uses these interest rate swaps to maintain an "overall target mix of approximately 50% fixed rate debt and 50% variable rate debt."[379] The 2011 ID and the NHW Shippers rely heavily upon these and similar statements.

247. However, the accounting rules that guide KMEP's statements in the SEC Forms 10-K and 10-Q are not necessarily appropriate for the ratemaking purpose of determining a representative cost for SFPP's debt.[380] KMEP's capital needed to finance its assets is obtained through the principal from traditional debt instruments such as senior notes and commercial paper. It is the costs associated with these debt instruments which are relevant for the SFPP East Line. Once the fixed interest rate financing for KMEP's assets has provided the necessary principal, KMEP's interest rate swaps serve the completely different purpose of hedging against changing interest rates. In contrast to the principal provided by KMEP's debt instruments, the swaps provide no such support for KMEP's asset base.[381]

248. Thus, it is the parent, KMEP, whose viability is affected by gains or losses[382] from the swaps, not SFPP's East Line service. As a result, interest swaps by the parent KMEP should not be included in SFPP's East Line's cost of service, and the parent KMEP, not SFPP's East Line ratepayers, should be the party that assumes the risks and receives the

[377] *Id.* at 192, 198-200.

[378] *Id.* at 200.

[379] *Id.* at 109.

[380] *See* Opinion No. 511-A, 137 FERC ¶ 61,220 at P 94 ("The SEC and the Commission serve different regulatory purposes and as such, have different accounting and financial reporting requirements for jurisdictional entities.").

[381] The interest rate swaps only involve a "notational" principal that provides the basis for determining the payments under the swap based upon interest rate fluctuations. Ex. NAV-7 at 109.

[382] As a consequence of these swaps, in its 2009 10-K, KMEP warned that the variable interest rates make it vulnerable to interest rate increases. Ex. NAV-7 at 48.

benefits associated with this hedging activity. In this context, the 2011 ID's emphasis upon the interest swaps' purported profitability[383] is misplaced because the swaps are not providing the type of financing necessary to operate the SFPP East Line.

249. Contrary to the assertions of the NHW Shippers, Opinion No. 486 does not support the inclusion of the interest rate swaps in SFPP's cost of debt. In Opinion No. 486, the Commission addressed a proposal by Kern River to incorporate into its cost of debt a return on equity for certain debt financing costs.[384] These financing costs included costs related to the cancellation of certain interest swaps. Opinion No. 486 rejected Kern River's proposal, finding that while the pipeline may recover debt financing costs over the life of the underlying debt, the pipeline may not earn a return (or recover carrying costs) for these types of payments.[385] Thus, Kern River was permitted to adjust its cost of debt to include the financing costs, but Kern River could not earn an additional return on the financing costs. However, Opinion No. 486 did not address whether it was appropriate for Kern River to include in financing costs the cancellation of certain interest swaps because no party raised this issue. Thus, Opinion No. 486 does not support NHW Shippers' position.

250. It is neither necessary nor appropriate to adjust the cost of debt to account for KMEP's interest rate swaps. KMEP's outstanding senior notes, commercial paper, and credit facility borrowings provide a representative cost of debt for the financing of

[383] The 2011 ID's analysis is somewhat incomplete, and appears to exaggerate the extent to which the swaps may lower KMEP's costs. First, KMEP's 2009 SEC Form 10-K explains that the variable interest rate swaps have been profitable during periods of falling interest rates, which occurred between 2007 and 2009. Ex. NAV-7 at 90. This may not always be the case, and KMEP's 2009 SEC Form 10-K warns it is at risk for higher costs if interest rates increase. Ex. NAV-7 at 48. Second, to support the assertion that interest rates had lowered KMEP's borrowing costs the past several years, the 2011 ID compared SFPP's proposed interest rates, which do not include either commercial paper and credit facility borrowings or the effects of interest swaps, with interest rates in SFPP's 10-K that appear to be lowered *both* by the inclusion of: (1) commercial paper and credit facility borrowings; and (2) the inclusion of interest rate swaps. Thus, the 2011 ID did not appear to isolate the effects of the interest swaps. Finally, the record does not explain how the cost of debt in the KMEP's SEC forms is calculated to incorporate interest rate swaps. This lack of detail makes any comparison uncertain.

[384] Opinion No. 486, 117 FERC ¶ 61,077 at P 201.

[385] *Id.*

SFPP's East Line.[386] There is no indication that this cost of debt is imprudent or that KMEP has paid more than market rates for its outstanding senior bonds, commercial paper, and credit facility borrowings. Thus, this proposed cost of debt based upon these debt issuances appears to be a reasonable reflection of debt costs for financing a pipeline such as SFPP.

B. Other Cost of Debt Issues

2011 ID

251. Consistent with its holdings regarding capital structure, the 2011 ID held that SFPP must include in its cost of debt: (1) $950 million of senior notes due to expire within one year; (2) $675 million of borrowings under its revolving credit facility; and (3) $65 million in commercial paper.

Briefs On Exceptions

252. On exceptions, SFPP argues that debt expiring within one year, borrowings under the credit facility, and commercial paper should be excluded from debt costs. SFPP states that it did not use expiring long-term debt and short-term debt to fund long-term assets. Regarding the expiring long-term debt, SFPP emphasizes that it did not have the intent and ability to refinance its long term debt and disputes that it continually replaces its expiring long-term debt with new long-term debt.

253. SFPP also states that the bank borrowings under KMEP's line of credit should be excluded from the cost of debt. SFPP states that KMEP did not use borrowings from the credit facility for long-term financing of its long-term assets.[387] SFPP states that for 2001 through 2008 and in 2010, KMEP did not have any outstanding debt under its line of credit at year end.[388] SFPP reiterates that it does not have the intent and ability to

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[386] This cost of debt should be between 6.00 and 6.48 percent. SFPP calculated a cost of debt of 6.48 percent as of March 31, 2010. However, this cost of debt does not include the lower interest rates associated with KMEP's commercial paper and the revolving credit facility. As explained *supra*, the Commission directs SFPP to include its commercial paper and credit facility borrowings in the determination of its cost of debt.

[387] SFPP Brief on Exceptions at 82 (citing Ex. SPE-107 at 61-62; Ex. SPE-13 at 113; Ex. VCC-6 at 103).

[388] *Id.* (Ex. SPE-5 at 48; Ex. SPE-6 at 60; Ex. SPE-7 at 72; Ex. SPE-8 at 81; Ex. SPE-9 at 122; Ex. SPE-10 at 94; Ex. SPE-11 at 113; Ex. SPE-12 at 115; Ex. SPE-13 at 116; Ex. SPE-113 at 11).

refinance its short term debt. SFPP claims that the issuance of long-term debt is not refinancing of debt under the credit facility.

254. SFPP states that the evidence in this proceeding establishes that KMEP did not have any outstanding commercial paper throughout the entire base period and the majority of the test period. SFPP states that only in the last three months of the test period did KMEP acquire $65 million in commercial paper. SFPP states that there is no evidence to indicate that this small amount of commercial paper was for the purpose of acquiring long term assets. SFPP relies upon a vacated initial decision which held that the cost of commercial paper should not be included in the cost of debt because the commercial paper: (1) had a maturity date of one year or less; (2) an interest rate that was not representative of long-term debt; and (3) the interest rates fluctuate for commercial paper frequently. SFPP contends that these factors support its position here. SFPP states that *Trailblazer's* explanation applies here. SFPP states that the levels of outstanding commercial paper and the commercial paper interest rates vary substantially from year to year.[389] SFPP states that between 2000 and March 30, 2010, the interest rate on KMEP's commercial paper ranged from 0.49 percent to 7.02 percent while the interest rates for long term debt varied between 6.39 percent and 7.73 percent.[390] SFPP states that the level of outstanding commercial paper has also fluctuated from a high of one billion dollars in 2006 to zero dollars in 2008 and 2009. SFPP adds that if commercial paper is included in SFPP's cost of debt, the imputed interest rate should be adjusted to be should be adjusted to consistent with that of long-term debt.[391]

<u>Briefs Opposing Exceptions</u>

255. NHW Shippers and Trial Staff addressed their comments regarding the treatment of debt costs in the section of their briefs addressing capital structure. As such, these parties support the 2011 ID's decision regarding the inclusion in the cost of debt of : (1) $950 million of senior notes due to expire within one year; (2) $675 million of borrowings under its revolving credit facility; and (3) $65 million in commercial paper. As summarized in the comments regarding capital structure, NHW Shippers and Trial Staff state that the Commission ordinarily does not require pipelines to include short-term debt in their debt balance for ratemaking purposes, but that it is appropriate to do so here when KMEP uses short-term debt to finance long-term assets.

[389] *Id.* at 80 (citing Ex. SPE-1 at 31).

[390] *Id.* at 80-81.

[391] *Id.* at 81 (citing Ex. SPE-1 at 31) (imputing the average interest on Moody's Baa-rated utility bonds as of the balance sheet date to the commercial paper that KMEP classifies as long-term debt).

256. NHW states that the Commission should adopt the cost of debt proposed by Dr. Horst in Exhibit NAV-32 at 3, line 18 for the years 2000 through 2009.[392] NHW states that the cost of debt proposed by Dr. Horst reflects both the interest rate swaps discussed *supra* and the inclusion of expiring debt, commercial paper, and borrowings from KMEP's credit facilities.

257. Trial Staff also state that SFPP cannot rely upon vacated initial decision in *Trailblazer*[393] to include commercial paper in the cost of debt. Trial Staff emphasizes the findings in Opinion No. 511 that commercial paper should be incorporated into KMEP's capital structure based on its role in KMEP's overall long-term asset financing strategy.[394]

Commission Decision

258. For the same reasons that the Commission required SFPP to include these forms of debt in capital structure, the Commission will require SFPP to include in its cost of debt: (1) $950 million of senior notes due to expire within one year; (2) $675 million of borrowings under its revolving credit facility; and (3) $65 million in commercial paper. Additionally, SFPP should adjust the cost of debt for 2000 through 2009 in Statement F1 for the calculation of AFUDC to include commercial paper, credit facility borrowings, and expiring long-term debt.

259. Specific to the cost of debt, SFPP raises additional arguments involving commercial paper. However, these arguments do not persuade the Commission to reach a different result. Regarding SFPP's reliance upon *Trailblazer*, an initial decision by an administrative law judge is not binding Commission precedent.[395] Second, the *Trailblazer* decision was vacated due to settlement.[396] Additionally, neither commercial

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[392] NHW Shippers explain that the cost of debt for prior periods is used on Statement F1 to calculate the allowance for funds used during construction (AFUDC).

[393] *Trailblazer Pipeline Co.*, 106 FERC ¶ 63,005, at P 82 (2004) (*Trailblazer*).

[394] Trial Staff Brief Opposing Exceptions at 43 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 183).

[395] *Texas New Mexico Power Company v. El Paso Electric Company*, 110 FERC ¶ 61,258, at P 10 (2005); *KeySpan Energy Development Corporation v. New York Independent Sys. Operator, Inc.*, 108 FERC ¶ 61,201, at P 4 (2004).

[396] *Trailblazer Pipeline Co.*, 107 FERC ¶ 61,008 (2004). Reliance upon a vacated decision is inappropriate. *KN Wattenberg Transmission Limited Liability Company*, 85 FERC ¶ 61,204, at 61,852 n.8 (1998).

paper's relatively low interest rate nor its fluctuating interest rates justify excluding it from the weighted average of debt costs. Other components of SFPP's cost of service, such as the return on equity or throughput, may also vary over time. To the extent that debt costs associated with commercial paper (or the borrowings under KMEP credit facility) change in the future, SFPP may file another rate case. Consistent with the Commission's holdings in Opinion No. 511 and 511-A, the interest rates KMEP is paying on its commercial paper holdings must be reflected in the cost of debt.

VIII. Starting Rate Base

2011 ID

260. The 2011 ID determined that SFPP failed to correctly apply the proper methodology under Opinion 154-B for determining the equity portion of the SRB write-up, resulting in an overstatement of its deferred return amount.[397] The 2011 ID describes the Commission's policy as follows:

> Under Commission policy, only the equity portion of the SRB Write-Up is used to calculate the deferred return. Specifically, oil pipelines must multiply the SRB by the equity percentage of their capital structures in a given year to calculate the equity portion of the SRB for that year. This amount is then multiplied by the inflation factor to yield the deferred return or the SRB Write-Up portion of the rate base.[398]

261. However, the 2011 ID explained that SFPP's proposed methodology for calculating deferred return multiplies the entire SRB write-up by the inflation factor, instead of merely utilizing the equity portion of the SRB write-up as prescribed by Opinion No. 154-B. The 2011 ID, therefore, required SFPP to correct the SRB write-up calculations consistent with the following discussion:

> [T]the SRB equals the DOC rate base times the debt ratio plus the reproduction portion of the ICC valuation rate base times the equity ratio. Second, the final calculation to derive the deferred return also accounts for the equity ratio. The deferred return or SRB Write-Up equals the SRB times the equity ratio, and then times the inflation rate.[399]

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[397] 2011 ID, 134 FERC ¶ 63,013 at P 48.

[398] *Id.* P 38.

[399] *Id.* P 48.

Briefs On Exceptions

262. On exceptions, NHW Shippers state that the 2011 ID erroneously determined that "SFPP must multiply the SRB by the equity percentage, and then multiply the product by the inflation rate to calculate "the deferred return or the SRB-Write-Up." According to NHW Shippers, the correct computation involves computing the deferred return *on* the SRB write-up. NHW Shippers state that the difference between the starting rate base and net depreciated original cost is known as the write-up in starting rate base. NHW Shippers state that consistent with the methodology adopted by the Commission in Opinion No. 154-B, the SRB write-up is then multiplied by the equity ratio to determine the equity portion of the SRB write-up. Next, NHW Shippers explain that the equity portion of the SRB write-up is multiplied by the inflation rate to determine deferred return.

263. On exceptions, SFPP argues the 2011 ID erred in finding that its methodology for calculating its SRB, SRB write-up, rate base, and inflation-adjusted deferred return were incorrect. SFPP also takes exception to what it argues is a new methodology imposed by the 2011 ID for calculating these components. SFPP cites to the Commission's recent finding in Opinion No. 511 where the Commission found SFPP had not departed from Commission precedent in calculating deferred return and that its calculations were consistent with the Opinion No. 154-B methodology.

Briefs Opposing Exceptions

264. Opposing NHW Shippers' exceptions, SFPP states Opinion No. 511 has already explicitly rejected NHW Shippers' proposed methodology for calculating deferred return. Opposing SFPP's exceptions, NHW Shippers claim that SFPP's continued reliance on prior Commission decisions to justify its calculation of deferred return on its SRB write-up is without merit. NHW Shippers claim the record in this proceeding clearly demonstrates SFPP's calculations do not comport with Commission precedent.

Commission Decision

265. In Opinion No. 511-A, the Commission recently addressed the same issue involving SFPP's SRB write-up.[400] Consistent with our holdings in that order, the Commission affirms the 2011 ID's finding that SFPP did not calculate deferred return on

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[400] Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 262-265. Opinion No. 511-A reversed the Commission's earlier holding in Opinion No. 511. Thus, SFPP's reliance on Opinion No. 511 is no longer valid.

its SRB write-up correctly. However, the Commission finds that the 2011 ID did not adopt the proper remedy.

266. As the Commission determined in Opinion No. 511-A, SFPP should have multiplied the depreciated original cost (DOC) rate base (SFPP's Statement E4, Line 12) by the debt ratio, and the ICC valuation rate base (Statement E4, Line 11) by the equity ratio, then add the two results together.[401] Next, SFPP should have subtracted the DOC rate base from the result of the first equation, which would have yielded the SRB write-up.[402] The SRB write-up should then be multiplied by the equity ratio before calculating SFPP's deferred return. Instead of following the above-calculation, SFPP subtracted the DOC rate base from the ICC rate base and multiplied the result by the equity ratio, yielding a number that SFPP labeled as the "equity portion" of the SRB write-up, when it was actually the full SRB write-up.[403] Accordingly, SFPP is directed to recalculate its deferred return on its SRB write-up utilizing the methodology discussed above.

IX. Income Tax Allowance

267. This part addresses income tax allowance (ITA) issues raised on exceptions to the 2011 ID. The 2011 ID held the following: (1) SFPP is entitled to an ITA because the evidence in this proceeding shows that SFPP partners incur an actual or potential income tax liability;[404] (2) SFPP must calculate the appropriate ITA pursuant to the findings set forth in the 2011 ID;[405] (3) SFPP's Accumulated Deferred Income Tax (ADIT) calculation does not comport with Commission policy because it does not reflect state income taxes, and must be adjusted to reflect the deferral of federal and state income tax costs associated with accelerated depreciation;[406] (4) SFPP proposes a weighted average income tax rate that does not accurately reflect the income tax rates of SFPP partners, and must therefore adjust its allocation of SFPP income to calculate the weighted average

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[401] Ex. NAV-1, at 102-03.

[402] *Id.*

[403] NHW Shippers Brief Opposing Exceptions at 96-97.

[404] 2011 ID, 134 FERC ¶ 63,013 at P 125.

[405] *Id.* P 173.

[406] *Id.* P 180 (requiring SFPP to also calculate the marginal income tax rate for the ADIT calculation pursuant to the findings regarding the marginal income tax rate for the ITA calculation elsewhere in the 2011 ID).

federal and state income tax used to determine the ITA;[407] (5) SFPP must give zero-percent weight for the tax rate for unrelated business taxable income (UBTI) and mutual funds, must reclassify 13 unitholders, and must use a taxable rate of 34 percent for Subchapter C corporations;[408] and (6) SFPP must modify its tax rate to reflect the benefits of income tax deferrals associated with 743(b) Depreciation Deductions in the ITA.[409]

268. At the outset, it is important to note that since the issuance of the 2011 ID, the Commission has issued Opinion No. 511 and Opinion No. 511-A, both of which addressed the substantive issues raised here.[410] While the 2011 ID addressed proposed rates for SFPP's East Line facilities, Opinion Nos. 511 and 511-A subsequently addressed proposed rates for SFPP's West Line facilities. Almost all of the ITA issues raised on exceptions here and discussed in the 2011 ID were addressed by the Commission in Opinion Nos. 511 and 511-A. Accordingly, while we briefly summarize relevant portions of the 2011 ID, as well as the arguments contained in briefs on and opposing exceptions, we do not "reinvent the wheel" by setting forth the extensive discussion of the Commission's ITA policy contained in Opinion Nos. 511 and 511-A. Because the two proceedings involve the same pipeline and many of the same parties, and reflect similar record evidence as well as near-identical legal and policy arguments, we simply refer to the relevant portions of Opinion No. 511 and 511-A that respond to the arguments raised here, and adopt the reasoning and conclusions by reference. Weframe the discussion this way to ensure a consistent treatment of the ITAs for SFPP's East Line and West Line facilities.

269. Accordingly, in this order, the Commission affirms the 2011 ID's determination that SFPP is entitled to an ITA. At the same time, this order rejects the 2011 ID's specific findings regarding the effect of an ITA on an MLP's recovery of costs through its ROE. With respect to the more specific issues regarding the manner in which SFPP calculated its ITA, this order does the following: (1) generally affirms the 2011 ID's finding that SFPP miscalculated the weighted average tax rate, but requires some changes to the methodology adopted by the 2011 ID; (2) reverses the 2011 ID's determination to adjust the relevant tax rate for both UBTI and mutual funds to zero percent; (3) affirms the 2011 ID's determination to require the re-categorization of thirteen large unitholders challenged by shippers; (4) reverses the 2011 ID's determination that SFPP must reduce

[407] *Id.* P 213.

[408] *Id.* P 214.

[409] *Id.* P 228.

[410] Opinion No. 511, 134 FERC ¶ 61,121, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220.

the marginal income tax rates of KMEP unitholders by 80.4 percent to reflect the deferral of state and federal income taxes; and (5) affirms the 2011 ID's determination that the ADIT calculation should be modified to reflect state income taxes, as well as other revisions to the marginal tax rate required by the 2011 ID, as well as this order.

A. Whether SFPP Is Entitled to an ITA

2011 ID

270. The 2011 ID determined that SFPP was entitled to an ITA based on "clear previous Commission pronouncements on these issues."[411] The 2011 ID explained that the *ITA Policy Statement*,[412] June 2005 Order,[413] *ExxonMobil*,[414] December 2005 Order,[415] 2006 Sepulveda Order,[416] and December 2007 Order[417] permit SFPP an ITA to the extent that SFPP demonstrates that its partners incur an actual or potential income tax liability.[418] The 2011 ID further determined that, as a matter of fact, the evidence presented by SFPP demonstrated that SFPP's partners incur an actual or potential income tax liability.[419] Therefore, the 2011 ID held that SFPP is entitled to an ITA.[420]

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[411] 2011 ID, 134 FERC ¶ 63,013 at P 171.

[412] *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (*ITA Policy Statement*).

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

[414] *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945 (D.C. Cir. 2007) (*ExxonMobil*).

[415] December 2005 Order, 113 FERC ¶ 61,277.

[416] *Texaco Ref. & Mktg., Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 (2006) (2006 Sepulveda Order).

[417] *SFPP, L.P.*, 121 FERC ¶ 61,240 (2007) (December 2007 Order).

[418] 2011 ID, 134 FERC ¶ 63,013 at P 125. The December 2005 Order, 2006 Sepulveda Order, and December 2007 Order are collectively referred to as the "Modification Orders."

[419] *Id.*

[420] *Id.* PP 125, 171.

271. Notwithstanding this holding, the 2011 ID then examined testimony, which the Presiding Judge described as suggesting two conclusions: (1) MLP investors with an ITA receive approximately 50 percent more money than is necessary to pay investor-level income taxes and to earn the required after-investor-tax return; and (2) the equity market value of the MLP with an ITA is approximately 50 percent greater than the original cost equity rate base.[421]

272. In support of these conclusions, the 2011 ID discussed a hypothetical developed by the parties that compares a corporate pipeline with an ITA, an MLP pipeline with an ITA, and an MLP pipeline without an ITA.[422] After reviewing the record evidence examining the effect of an ITA on hypothetical corporate and MLP pipelines, the 2011 ID stated that it was not clear whether the Commission has considered such evidence in its prior policy decisions.[423] Nonetheless, the 2011 ID acknowledged that the Commission had previously established the following principles: (1) that an ITA does not cause a pass-through entity to double-recover its income tax cost; (2) the ITA recovers corporate-level taxes; and (3) the ITA has a neutral impact on the discounted cash flow (DCF) model.[424]

273. The 2011 ID thereafter found that the evidence demonstrated that the Commission's DCF return on equity (ROE) (pre-tax to investors) will be set to a level sufficient to attract investor capital, or stated another way, the DCF ROE will be sufficient after investor income taxes, to attract investor capital.[425] The 2011 ID also found that ITAs cause MLPs to double recover their taxes.[426] In light of these findings, the 2011 ID concluded that: (1) MLP investors with an ITA receive approximately 50 percent more money than is necessary to pay investor-level income taxes and to earn the required after-investor-tax return; and (2) the equity market value of the MLP with an ITA is approximately 50 percent greater than the original cost equity rate base.[427] The

[421] *Id.* P 145 (citing Ex. NAV-25 at lns. 18, 23).

[422] *Id.* PP 144-64.

[423] *Id.* P 165.

[424] *Id.* P 165 (citing December 2007 Order, 121 FERC ¶ 61,240 at PP 52-53).

[425] *Id.* P 171.

[426] *Id.*

[427] *Id.* The 2011 ID explained that an MLP with an ITA has a substantially higher revenue requirement than a MLP without an ITA because the MLP with an ITA is charging both an ITA and a DCF ROE. The greater revenue requirement drives up stock

(continued…)

2011 ID further found that the evidence demonstrated the ITA for MLPs does not equalize the after-tax returns from a corporation and investors in an MLP.[428] However, based on clear previous Commission pronouncements on these issues the 2011 ID resolved the matter in SFPP's favor.[429]

Briefs On and Opposing Exceptions

274. Both NHW Shippers and CCSV Shippers (collectively, Shippers) contend that the 2011 ID improperly allows SFPP an ITA by relying on prior Commission decisions that Shippers contend are contrary to the evidence and factual findings in this case.[430] Shippers argue that evidence in this proceeding showed that providing an ITA to an MLP eliminates the parity between investors in corporate and MLP pipelines, results in double recovery of investor income taxes, artificially inflates the MLP unit price, and unreasonably inflates the MLP's ROE.[431] NHW Shippers point to the 2011 ID's finding that ITAs result in a double recovery of an MLP's tax liability and argue that such a finding should have resulted in a determination that SFPP is not entitled to an ITA. NHW Shippers contend that all pipelines recover their investor-level income tax liability through the ROE set by the Commission's DCF methodology, regardless of the business form.[432] NHW Shippers further explain:

> Corporations require a separate allowance to cover the taxes paid at the pipeline level, but because MLPs incur no additional taxes, they need no additional allowance. By adding an income tax allowance to MLPs' cost of service and allowing them to recover two levels of income tax expenses as

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prices until equilibrium is reached (the point at which the before and after-tax ROEs to investors are equal to the level required by investors). These higher rates are borne by ratepayers. *Id.* n.184.

[428] *Id.* P 171.

[429] *Id.*

[430] CCSV Shippers Brief on Exceptions at 6-9 (referencing ITA Policy Statement, 111 FERC ¶ 61,139; December 2005 Order, 113 FERC ¶ 61,217; 2006 Sepulveda Order, 117 FERC ¶ 61,285; December 2007 Order, 121 FERC ¶ 61,240); NHW Shippers Brief on Exceptions at 5-9, 11-16.

[431] CCSV Shippers Brief on Exceptions at 7-8; NHW Shippers Brief on Exceptions at 7, 11-16.

[432] NHW Shippers Brief on Exceptions at 11.

> if they were corporations, the Commission's policy ensures that MLPs recover their investors' tax liability twice.[433]

275. Shippers contend that Opinion No. 511 recognizes that an ITA gives partnerships a competitive advantage over corporate pipelines, and that parity between corporate and MLP pipelines is achieved only if the MLP pipeline does not obtain an ITA.[434] CCSV Shippers further contend that Opinion No. 511 reverses prior pronouncements on the issue by recognizing that investors in MLP pipelines already recover their income tax liability associated with partnership cash flow and income through their pre-tax ROE derived from the discounted case flow (DCF) model.[435] Accordingly, Shippers challenge the relevance of the Commission's prior decisions to the instant case, especially in light of Opinion No. 511, which was decided after the 2011 ID.[436]

276. Shippers also disagree with the Commission's determination in Opinion No. 511 that the "*ExxonMobil* court addressed and rejected the precise argument that the shippers advance in this case."[437] NHW Shippers argue that *ExxonMobil* did not confront the double recovery issue presented here.[438] CCSV Shippers argue that *ExxonMobil* did not overrule or modify the principle in *BP West Coast* that there can be no allowance for an ITA to an MLP utility for nonexistent or "phantom" taxes.[439]

277. CCSV Shippers argue that because the 2011 ID found that MLP investors recover their full income tax cost through the ROE, there is no additional tax liability to be

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[433] *Id.* at 6.

[434] CCSV Shippers Brief on Exceptions at 9 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 239); NHW Shippers Brief on Exceptions at 7 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 249).

[435] CCSV Shippers Brief on Exceptions at 10 (citing Opinion No. 511, 134 FERC ¶ 61,121 at PP 243-44).

[436] *Id.* at 9 (referencing Opinion No. 511, 134 FERC ¶ 61,121, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220); NHW Shippers Brief on Exceptions at 9-11.

[437] NHW Shippers Brief on Exceptions at 10 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 230).

[438] *Id.*

[439] CCSV Shippers Brief on Exceptions at 11 (citing *ExxonMobil*, 487 F.3d at 949).

recovered, and the ITA would constitute a double recovery, and allow for the imposition of a non-existent or "phantom tax" in violation of *BP West Coast*.[440] Additionally, CCSV Shippers argue that their position here is consistent with *ExxonMobil* because the court in that case found that SFPP's investors had a real tax liability on income received from SFPP that was not already compensated for in another manner. In contrast, CCSV Shippers assert here that the 2011 ID found that the MLP investor already recovers its income tax liability pursuant to the Commission-authorized ROE.[441]

278. CCSV Shippers argue that the 2011 ID correctly found that the evidence showed that granting an ITA to an MLP violates the principle of "parity" between the treatment of corporate and MLP pipelines, and therefore they argue that the 2011 ID erred in authorizing an ITA for SFPP.[442] NHW Shippers argue that the Commission decisions relied on by the 2011 ID, as well as Opinion No. 511, inappropriately seek to establish parity between pre-investor-tax returns for corporations and after-investor-tax returns for MLPs, which NHW Shippers argues result in an double recovery of income tax costs for MLPs that is inconsistent with the capital attractions standards set forth in *Hope*.[443]

279. NHW Shippers also argue that Congress, in exempting certain MLPs from entity level taxes, did not authorize the Commission to grant a regulatory advantage to MLPs regulated under the Interstate Commerce Act.[444] NHW Shippers argue that the Commission's inference, in Opinion No. 511, that Congress intended for MLPs to recover extra revenues in light of this tax advantage oversteps the Commission's authority.[445]

280. CCSV Shippers next contend that the 2011 ID failed to apply the burden of proof set forth in the ITA Policy Statement, which requires the following: "any pass-through entity desiring an [ITA] on utility operating income must be prepared to establish the tax

[440] *Id.*

[441] *Id.* at 12-13 n.4 (noting that *ExxonMobil* did not have before it the issue of whether the MLP's income tax liability was recovered in the ROE because that issue was reserved for a future Commission order).

[442] *Id.* at 12.

[443] NHW Shippers Brief on Exceptions at 32-33 (citing *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (*Hope*)).

[444] *Id.* at 37-39.

[445] *Id.* (citing Opinion No. 511, 134 FERC ¶ 61,121 at PP 253-57).

status of its owners, or if there is more than one level of pass-through entities where the ultimate tax liability lies and the character of the tax incurred."[446] CCVS Shippers argue that the 2011 ID instead relied on the rebuttable presumption established in the Modification Orders, and determined that SFPP met its burden of proof by presenting IRS Forms 1065 (including the K-1s) and 1120.[447] CCSV Shippers argue that because *ExxonMobil* relied on the affirmative evidentiary burdens set forth in the ITA Policy Statement that were revised in the Modification Orders but never reviewed on appeal, the 2011 ID erred by employing the Modification Orders' standard without consideration of the evidence requirements in the ITA Policy Statement.[448]

281. CCSV Shippers argue that the 2011 ID erred by not analyzing the inconsistency between its conclusion that SFPP met its burden of proof by simply presenting tax documents and its finding that granting SFPP an ITA would result in a double recovery of its investors' income taxes.[449] CCSV Shippers claim that the "double recovery" finding rebuts the presumption (established in the Modification Orders) that without an ITA, individual investors would not be compensated for their income taxes.[450] CCSV Shippers argue that once the 2011 ID found that the ITA caused a double recovery of investors' income taxes, the "prior pronouncements" by the Commission were no longer on point, and the 2011 ID erred by relying on them.[451]

282. SFPP does not object to the 2011 ID's determination that SFPP is entitled to an ITA; however, SFPP does take exception to the 2011 ID's findings that the ITA would lead to a double recovery of SFPP's income tax liability.[452] SFPP argues that Opinion No. 511 analyzed essentially the same evidence and rejected the theories of double recovery that the 2011 ID found to be persuasive.[453] SFPP further contends that the

[446] CCSV Shippers Brief on Exceptions at 16 (citing ITA Policy Statement, 111 FERC ¶ 61,139 at P 42).

[447] *Id.* at 16-17 (citing 2011 ID, 134 FERC ¶ 63,013 at P 130).

[448] *Id.* at 17.

[449] *Id.* at 18.

[450] *Id.*

[451] *Id.*

[452] SFPP Brief on Exceptions at 29.

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

theories advanced by Shippers' expert witnesses are irrelevant and inaccurate and that SFPP provided evidence that showed that MLP oil pipelines will not have a higher DCF-method ROE than would the same oil pipeline organized as a corporation.[454]

Commission Decision

283. The Commission affirms the 2011 ID's holding that SFPP is entitled to an ITA, consistent with Commission policy. Although certain factual findings in the 2011 ID can be seen as at odds with this holding, the holding was appropriately based on the policy established in prior Commission decisions and affirmed in *ExxonMobil*. Specifically, the 2011 ID held, and the Commission affirms, that "SFPP demonstrates that its partners incur an actual or potential income tax liability on SFPP income, thus entitling SFPP to an ITA."[455]

284. Notwithstanding this holding, the 2011 ID discussed the effect of an ITA on MLP and corporate pipelines by examining a comparison of ROEs earned by hypothetical corporate pipelines and MLP pipelines, with and without an ITA.[456] From this comparison of hypothetical pipelines, the 2011 ID drew the following conclusions: (1) the DCF ROE will be sufficient after investor income taxes, to attract investor capital; (2) ITAs cause MLPs to double recover their taxes; (3) MLP investors with an ITA receive approximately 50 percent more money than is necessary to pay investor-level income taxes and to earn the required after-investor-tax return; (4) the equity market value of the MLP with an ITA is approximately 50 percent greater than the original cost equity rate base; and (5) the ITA for MLPs does not equalize the after-tax returns from a corporation and investors in an MLP.[457] The 2011 ID made these findings after determining that it was unclear whether the Commission had considered evidence similar to that adduced from the lengthy discussion of the hypothetical comparison of corporate versus MLP pipelines.[458]

285. Subsequent to the 2011 ID, the Commission issued Opinion Nos. 511 and 511-A. Opinion No. 511-A, in particular, contained a detailed explanation of the Commission's

[454] *Id.* at 29-30 (citing Ex. VCC-111 at 7, 14; Ex. SPE-107 at 48).

[455] 2011 ID, 134 FERC ¶ 63,013 at P 129.

[456] *Id.* PP 144-64.

[457] *Id.* P 171.

[458] *Id.* P 165.

DCF methodology,[459] a comparative analysis of the returns generated by corporate and MLP pipelines,[460] and an explanation as to how allowing MLP pipelines to recover an ITA is consistent with the capital attraction standard described in *Hope*.[461] In these sections, the Commission responded to the same "double recovery" argument advanced by Shippers and adopted in the 2011 ID, as well as other arguments advanced by Shippers and adopted in the 2011 ID that allege MLP income taxes are accounted for in the MLP pipeline's ROE, that ITAs for MLPs result in over-recoveries of revenue, inflated unit prices, and a lack of parity when compared to corporate pipelines, as well as general requests to revisit the Commission's ITA policy. After considering these arguments and rebutting them at length, Opinion No. 511-A concluded:

> [T]he Income Tax Allowance Policy Statement correctly concluded that the returns of MLP and corporate pipelines should be compared at the entity level, not the investor level. The Commission therefore again concludes here "that a full income tax allowance is necessary to ensure that corporations and partnerships of like risk will earn comparable after-tax returns" and to recover the income tax costs that are properly included in their regulatory costs-of-service. As Opinion No. 511 states, the Shipper Parties' double recovery argument fails because it erroneously considers the taxes an MLP partner pays on the MLP distributed income to be the financial and cost of service equivalent of the taxes a shareholder pays on dividends. *ExxonMobil* recognized that . . . they are not equivalent because an MLP is a pass-through entity and therefore the partner's income taxes are properly imputed to an MLP's regulatory cost of service.[462]

The Commission further determined that "[d]enying a jurisdictional MLP an income tax allowance creates a rate design that precludes it from having a reasonable opportunity to recover its cost of service contrary to *Hope*."[463]

286. Furthermore, Opinion No. 511-A analyzed the different taxation status of corporate pipelines and MLP pipelines, and explained how MLP's tax-advantaged status impacts the price of its equity interests.

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[459] Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 289-96.

[460] *Id.* PP 297-330.

[461] *Id.* PP 331-38 (referencing *Hope*, 320 U.S. 591).

[462] *Id.* P 340 (internal citations omitted).

[463] *Id.* P 339 (referencing *Hope*, 320 U.S. at 603).

> [A]n MLP's financial advantage stems from the avoidance [of] the tax on dividends that must be paid by a corporation's shareholders. This means that the corporation's equity interests are priced lower than those of the MLP because neither the corporation nor the MLP can charge higher rates nor obtain lower costs than the other. Because the corporation cannot obtain higher gross revenues or lower costs than the MLP, the corporation's gross revenues will never be sufficient to cover the income tax on the dividends it distributes to its shareholders. Thus, as long as there is [a] tax rate on dividends, the after-tax cash flow to the shareholder and the value of the shareholder's interest is always less than that of [an] MLP partner even though both the dollar and the percentage returns on rate base are the same at the entity level.[464]

287. The Commission explained the difference between the MLP partner's direct interest in partnership assets that are reflected in the partner's partnership account and the corporate shareholder's more indirect interest in corporate assets, and the lack of an asset account that replicates the entity's rate base.[465] In light of these differences, the Commission found that Shippers were incorrect that the Commission should equalize the returns of partners and shareholders, noting that *ExxonMobil* affirmed the Commission's decision to equalize the *after-tax* returns at the level of the jurisdictional entity.[466]

288. Additionally, the Commission scrutinized Congressional purpose with respect to energy MLP taxation, finding that the limited legislative history associated with section 7704 of the IRC shows no intent to deny jurisdictional MLPs a regulatory ITA.[467] The Commission determined that because an MLP pipeline with an ITA obtains no regulatory advantage over a corporate pipeline, interpreting section 7704's silence on the regulatory ITA issue as prohibiting such an allowance would create a regulatory structure that would make it impossible for a jurisdictional MLP to recover its cost of service.[468] The Commission addressed other shipper arguments related to Congressional purpose in Opinion No. 511-A.[469] In this case, the Commission finds that Opinion No. 511 and

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[464] *Id.* P 317.

[465] *Id.* P 318.

[466] *Id.* P 319.

[467] *Id.* P 345.

[468] *Id.*

[469] *Id.* P 346.

511-A address all of the arguments raised by Shippers here and we therefore adopt the conclusions and reasoning of those decisions here.[470]

289. For the reasons set forth in these post-2011 ID determinations, we find that the 2011 ID, while correctly granting SFPP an ITA, incorrectly made a number of findings that run counter to the holding. The Commission therefore rejects these findings, as inconsistent with Commission policy.

290. Finally, because we find that there is no "double recovery" of SFPP's income tax liability through the ITA, CCSV Shippers' argument that SFPP has not met its evidentiary burden falls apart. This argument was based on what CCSV Shippers indicated was a failure of the 2011 ID to analyze the tax form evidence showing that SFPP had an actual or potential tax liability in light of the 2011 ID's finding that granting SFPP an ITA would result in a double recovery of SFPP's income tax liability. However, as the Commission explained at length in Opinion Nos. 511 and 511-A,[471] which the Commission adopts here, the ITA does not result in a double recovery of SFPP's tax liability.

291. As the 2011 ID made clear, the Commission's policy on the required evidentiary burden is that "if the partner receives a K-1 and must report distributive ordinary income or loss on the partners' annual income tax return, that partner will have an actual or potential income tax liability."[472] This policy was explained at length in the December 2007 Order,[473] a discussion we adopt by reference here. Accordingly, we affirm the 2011 ID's determination that SFPP has met its evidentiary burden to show an actual or potential income tax liability, consistent with Commission policy.

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[470] Opinion No. 511, 134 FERC ¶ 61,121 at PP 251-58, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 342-53.

[471] Opinion No. 511, 134 FERC ¶ 61,121 at PP 241-50, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 281-340.

[472] 2011 ID, 134 FERC ¶ 63,013 at P 130 (citing December 2007 Order, 121 FERC ¶ 61,240 at P 34).

[473] December 2007 Order, 121 FERC ¶ 61,240 at PP 24-34.

B. Weights Used to Develop the Weighted Average Tax Rate for the ITA 2011 ID

292. In this proceeding, SFPP set forth its proposed 2008 taxable income on line one of its 2008 Form 1065 and proposes a 36.11 percent weighted average federal income tax rate to calculate the ITA.[474] Shippers opposed SFPP's calculation of the weighted average income tax rate in two respects: (1) they contended that SFPP improperly calculated the weighted average income tax rate by using a provision in the KMEP partnership agreement that allocates incentive distributions to KMEP's general partner (KMGP); and (2) they contended SFPP incorrectly classified the KMEP unitholders to determine the weighted average income tax rate.[475] NHW Shippers also proposed to adjust the weighted average income tax rate to account for the deferral of federal and state income taxes by public KMEP unitholders.[476]

293. By way of background, the 2011 ID explained that SFPP is a limited partnership, and does not pay taxes. SFPP allocates taxable income to Kinder Morgan Energy Partners (KMEP) limited partners; Kinder Morgan General Partner (KMGP) from KMEP; KMGP from Kinder Morgan Operating L.P. (OLP-D) and Santa Fe Pacific Pipelines, Inc. (SFPP Inc.).[477] The 2011 ID further explained that KMEP is a master limited partnership, which does not pay taxes, but instead KMEP unitholders pay taxes on their allocated share of SFPP income and deductions.[478] The 2011 ID further found that KMGP is the general partner of both OLP-D and KMEP.[479]

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[474] 2011 ID, 134 FERC ¶ 63,013 at P 183.

[475] *Id.*

[476] *Id.*

[477] *Id.* P 184.

[478] *Id.*

[479] *Id.*

294. The 2011 ID states that pursuant to an incentive distribution provision,[480] SFPP allocated more than 100 percent of SFPP 2008 taxable income to SFPP Inc. and KMGP.[481] In turn, SFPP allocated negative percentages of SFPP 2008 taxable income to the six unitholder categories.[482] The 2011 ID found SFPP's allocation of income to be founded on an incorrect assumption that the amount of taxable income allocated to SFPP Inc. and KMGP exceeds 100 percent of SFPP's income.[483] The 2011 ID further found that by allocating 100 percent of SFPP taxable income to KMGP and SFPP Inc., SFPP improperly assigned a 35 percent tax rate (the highest federal income tax rate) to all SFPP income, i.e., all the SFPP income is treated as corporate unitholders.[484]

295. The 2011 ID found SFPP's determination of the weighted average tax rate to be flawed, noting that: (1) SFPP's allocation method assigns KMGP and SFPP Inc. more than 100 percent of SFPP taxable income and causes SFPP to assign improperly a zero percent tax rate to all other KMEP unitholders; and (2) SFPP improperly based the allocation of SFPP income on SFPP taxable income earned *and* taxed in 2008, while excluding SFPP income earned in 2008 and taxed in a subsequent year.[485] The 2011 ID found that the use of only 2008 SFPP taxable income in the allocation method and KMEP unitholders' deferral of their tax cost on 2008 SFPP taxable income enabled SFPP to disregard KMEP unitholders' lower income tax rates in the weighted average income tax calculation.[486] The 2011 ID therefore determined that SFPP severs the connection between the allocation method and the SFPP income on which the ITA is calculated, and fails to give weight to the weighted average income tax rate of the public unitholders,

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[480] The 2011 ID explains that SFPP uses an "incentive distribution" provision in the KMEP partnership agreement to determine the weights used to calculate the weighted income tax rate. That provision states that KMEP shall allocate income to the general partner (KMGP) "until the amount equals the 'incentive distributions' made to the general partner." *Id.* P 185.

[481] *Id.* PP 185-86.

[482] The 2011 ID explains that because the allocation to SFPP Inc. and KMGP exceeds 100 percent, SFPP allocates 100 percent of SFPP 2008 taxable income to SFPP Inc. and KMGP and zero percent to the six unitholder categories. *Id.* P 186.

[483] *Id.* P 188.

[484] *Id.*

[485] *Id.* P 189.

[486] *Id.* P 190.

many of whom are individuals and entities that have marginal tax rates below the 35 percent of corporate partners such as SFPP Inc. and KMGP.[487]

296. Accordingly, the 2011 ID determined that SFPP's allocation method conflicted with Commission policy, and that the method proposed by Navajo better accounted for the actual and potential income tax liability of all KMEP unitholders or all categories of investors because it more accurately allocates SFPP income in proportion to the distributions received by SFPP unitholders and recognizes that cash distributions from SFPP exceed its taxable income on those distributions in a given year.[488] The 2011 ID therefore ordered SFPP to follow Navajo's methodology for allocating taxable income for the purpose of determining the weighted average tax rate to apply to the ITA.[489] Importantly, Navajo's witness apportioned OLP-D taxable income from SFPP to KMGP and KMEP limited partners in proportion to their *actual* cash distributions (based on the KMEP 2009 SEC Form 10-K).[490]

Briefs On and Opposing Exceptions

297. On exceptions, SFPP argues that the key determinations in the 2011 ID: (1) that SFPP's allocation of taxable income in accordance with the incentive distributions to KMGP provided for in KMEP's partnership agreement results in an allocation of more than 100 percent of SFPP's taxable income to the corporate categories; and (2) that the allocation of SFPP's income is erroneously based on 2008 taxable income—are inconsistent with Commission precedent as well as the record in this proceeding.[491]

298. First, SFPP objects to the 2011 ID's ruling that the taxable income allocation related to incentive distributions presented by SFPP should be disregarded when assigning the weights of the six categories of unitholders to develop SFPP's weighted average tax rate.[492] SFPP claims that the approach it used to allocate taxable income is

[487] *Id.*

[488] *Id.* PP 191, 193.

[489] *Id.* PP 192-93.

[490] *Id.* P 192.

[491] SFPP Brief on Exceptions at 13-14.

[492] *Id.* at 14 (citing 2011 ID, 134 FERC ¶ 63,013 at P 188).

consistent with Commission policy.[493] SFPP cites the December 2005 Order in support of its position:

> [I]f income is shifted from one type of ownership interest to another, the weighted average of the differing partnership interests could change resulting in a different tax allowance for the operating entity, in this case SFPP. The Commission concludes that it is SFPP's prerogative to allocate income and losses among its partners as it determines as long as the maximum tax rate imputed to individuals does not exceed the maximum corporate rate. Given this, under the *Policy Statement* the maximum impact on the ratepayers is the same whether the regulated assets are controlled by a corporation or a partnership. Thus, if all partners are corporations at the maximum tax bracket, then the regulated entity's rates would be based on the maximum possible tax allowance.[494]

299. SFPP further states that the Commission again affirmed its treatment of the taxable income allocation related to incentive distributions in Opinion No. 511, in which the Commission stated that partnership agreements with incentive distributions (such as KMEP's partnership 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."[495] SFPP contends that it applied the Commission's ITA methodology in this proceeding and that the methodology did not result in a weighted marginal income tax rate that exceeds the corporate income tax rate or that would have been generated had SFPP been a corporation.[496] SFPP therefore argues that, contrary to the 2011 ID, SFPP properly assigned a 100-percent weighting to the corporate categories and used the marginal income tax rate for corporations.[497]

300. SFPP also argues that it should not be required to develop a weighted marginal tax rate based on the allotted taxable income that results from applying KMEP's incentive distribution solely based on SFPP's income level for the relevant year, as was urged by

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

[494] *Id.* at 15 (quoting December 2005 Order, 113 FERC ¶ 61,277 at PP 40-43).

[495] *Id.* (quoting Opinion No. 511, 134 FERC ¶ 61,121 at P 291).

[496] *Id.*

[497] *Id.* at 15-16.

VCC Shippers in the proceeding below.[498] SFPP again argues that the Commission has rejected this approach before and after the 2011 ID, and it should do so here.[499]

301. Second, SFPP argues that the 2011 ID ruled that SFPP incorrectly based the allocation of SFPP's income on 2008 taxable income, reasoning that the allocation inappropriately excluded income earned in 2008 and taxed in a subsequent year, including the sale of units.[500] SFPP contends that the 2011 ID is wrong, and that the Commission rejected its reasoning in both the December 2007 Order and Opinion No. 511.[501] SFPP argues that it is appropriate to use its 2008 taxable income to develop the weights for its income tax rate because the Commission requires the use of taxable income for this purpose, and at the time of filing, the 2008 income tax return was the most current information available.[502]

302. SFPP also argues that the 2011 ID inappropriately adopts an entirely new methodology for developing the weights proposed by Navajo witness Horst—i.e., use of the proportion of cash distributions received by unit holders in 2009 because cash distributions generally result dollar-for-dollar in ordinary income when the distributions are received or when MLP units are ultimately sold.[503] In addition to its argument that this is a novel methodology and therefore not consistent with Commission principles, SFPP argues that cash distributions do not generally result dollar-for-dollar in ordinary income when the distributions are received and the only way to reach such a conclusion is to inappropriately blur the distinction between cash distributions and income.[504]

303. NHW Shippers contend that to the extent SFPP is granted an ITA, the 2011 ID correctly required SFPP to adjust its income tax rate by weighting its unitholder categories in proportion to cash distributions rather than allocations of current taxable

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[498] *Id.* at 16 (citing 2011 ID, 134 FERC ¶ 63,013 at PP 199, 213).

[499] *Id.* (citing December 2007 Order, 121 FERC ¶ 61,240 at P 41; Opinion No. 511, 134 FERC ¶ 61,121 at P 289).

[500] *Id.* at 16 (citing 2011 ID, 134 FERC ¶ 63,013 at PP 189-90).

[501] *Id.* (citing Opinion No. 511, 134 FERC ¶ 61,121 at PP 269-83).

[502] *Id.* at 16-17.

[503] *Id.* at 17 (citing 2011 ID, 134 FERC ¶ 63,013 at PP 191-93).

[504] *Id.*

income.[505] NHW Shippers argue that the Commission has not previously addressed the argument, adopted by the 2011 ID, that the most accurate way to allocate taxable income for ITA purposes is in accordance with the level of cash distributions received by each category of unitholders rather than the taxable income allocated to each in the current year.[506] NHW Shippers urge the Commission to affirm the 2011 ID in this respect, arguing that it most accurately implements the Commission's policy of accounting for both actual and potential income taxes.[507]

304. NHW Shippers argue that the allocation methodology advanced by SFPP—in which the only income that is reflected in the weighted average tax rate is the income earned in 2008 that is taxable in 2008—has two fundamental problems: (1) it is based on the notion that the amount of taxable income allocated to SFPP and KMGP exceeds 100 percent of SFPP Inc.'s income, requiring the tax rate attributed to other unitholders to be adjusted to zero; and (2) the use of 2008 taxable income limits the analysis to income taxes borne by SFPP Inc. and KMGP in the year the income was earned, thereby ignoring taxable income recognized by public unitholders at the time of sale of the units.[508] In contrast, NHW Shippers argue that the only way to account for the current taxes on SFPP's income as well as the deferred taxes paid by unitholders when they sell their units is to weight the tax rates in proportion to cash distributions.[509] NHW Shippers assert that there is a real, albeit future, tax liability on SFPP's income that can be traced directly to cash distributions paid to unitholders and it is therefore proper to weight the tax rates of the various unitholder categories in proportion to their cash distributions, including the incentive distributions received by SFPP's corporate parents.[510]

Commission Decision

305. Notwithstanding Shipper arguments to the contrary, the Commission finds that it is appropriate for SFPP to calculate its weighted average tax rate consistent with the incentive distribution provisions in the KMEP partnership agreement. In Opinion

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[505] NHW Shippers Brief Opposing Exceptions at 40-46.

[506] *Id.* at 41.

[507] *Id.*

[508] *Id.* at 42-43.

[509] *Id.* at 43.

[510] *Id.* at 44.

No. 511, the Commission addressed arguments regarding the effect of the incentive distributions provision in the KMEP partnership agreement:

> *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. 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. 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. . . . Thus, the Commission upholds the inclusion of incentive distributions in determining the allocation of distributive income and in calculating SFPP's income tax allowance.[511]

306. In Opinion No. 511-A, the Commission again affirmed the appropriateness of calculating the weighted average tax rate in light of the incentive distributions provision of the KMEP partnership agreement.[512] Accordingly, the Commission finds that it is appropriate for SFPP to calculate its weighted average tax rate with respect to the incentive distributions provision of the KMEP partnership agreement.

307. However, as the Commission explained in Opinion No. 511-A, "the weighted tax calculation is based on the *income distributed* to the six partnership categories used to develop the jurisdictional entity's weighted marginal tax rate, not the taxable income of a partner that results after all costs and credits that may offset distributed income when a partner prepares an IRS return."[513] The 2011 ID recognized this principle:

> [T]he use of only 2008 SFPP taxable income in the allocation method and KMEP unitholders' deferral of their tax cost on 2008 SFPP taxable income enable SFPP to disregard KMEP unitholders' lower income tax rates in the weighted average income tax calculation. Thus, [NHW Shippers are] correct that SFPP severs the connection between the allocation method and the SFPP income on which the ITA is calculated. SFPP in effect ignores the taxable income recognized by public unitholders at the time of the sale

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[511] Opinion No. 511, 134 FERC ¶ 61,121 at P 291 (internal citations omitted).

[512] *Id.* PP 356-59.

[513] *Id.* P 357 (emphasis added).

> of their units and as a result does not give weight to the weighted average income tax rate of the public unitholders, many of whom are individuals and entities that have marginal tax rates below the 35 percent of corporate partners such as SFPP Inc. and KMGP.[514]

308. The Commission affirms the 2011 ID on this point, as well as its conclusion that NHW Shippers' "allocation method better accounts for the actual and potential income tax liability of all KMEP unitholders or all categories of investors because it more accurately allocates SFPP income in proportion to the distributions received by SFPP unitholders."[515] However, while NHW Shippers' proposed allocation methodology better accounts for SFPP's actual and potential tax liability, it is not perfect. NHW Shippers' method, which was adopted by the 2011 ID and which SFPP was ordered to follow, is based on actual cash distributions.[516] As indicated above, however, the Commission requires that the weighted average tax rate be calculated on the partner's distributed income, not on actual distributions, which could include amounts that are received from non-jurisdictional activities. Accordingly, while the Commission generally affirms the 2011 ID with respect to the manner in which the weighted average tax rate is to be calculated, we do not adopt NHW Shippers' proposed methodology in full and will instead require SFPP to follow NHW Shippers' proposed methodology, using distributed income, rather than actual cash distributions as the basis for calculating the weighted average tax rate. This change should align the calculation of SFPP's weighted average tax rate in this proceeding with the West Line proceeding.

C. Marginal Tax Rates for Mutual Funds and UBTI

2011 ID

309. The 2011 ID explains that, in the Modification Orders, the Commission created rebuttable presumptions regarding the federal income tax rates for six Commission specified categories of unitholders—a 35 percent rate for subchapter C corporations and a 28 percent rate for all other categories of owners or non corporate unitholders (beneficiaries of all other ownership categories would most likely be individuals).[517] In

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[514] 2011 ID, 134 FERC ¶ 63,013 at P 190.

[515] *Id.* P 191.

[516] *Id.* PP 192-93.

[517] *Id.* P 205 (citing December 2005 Order, 113 FERC ¶ 61,277 at P 32).

the proceeding below, VCC Shippers argued that evidence rebuts the 28 percent marginal income tax rate for tax-exempt entities receiving UBTI and mutual fund categories.[518]

310. The 2011 ID described evidence provided by VCC Shippers that suggests that 73 percent of tax-exempt entities with UBTI that filed returns in 2006 had an income tax liability below 28 percent, leading VCC Shippers to conclude that tax-exempt entities with UBTI should be assigned a zero percent tax rate.[519] VCC Shippers also provided evidence that the K-1 data for 2008, for KMEP unitholders shows that for approximately 98 percent of the entities receiving UBTI the amount was less than $1000 from KMEP.[520] The 2011 ID found this evidence to be persuasive and further found that the evidence submitted by SFPP in response did not contradict VCC Shippers' evidence.[521] Accordingly, the 2011 ID found the presumption to be rebutted and determined that the UBTI category should be assigned a zero-percent tax rate.[522]

311. The 2011 ID also described VCC Shippers' objections to SFPP's assignment of a 28 percent income tax to mutual funds.[523] VCC Shippers argued that the Commission looks to the mutual fund, not the mutual fund beneficiaries, to determine the appropriate tax rate for the relevant partner, and that mutual fund beneficiaries are therefore not "owning partners" of KMEP.[524] VCC Shippers further argued that even if the Commission looks to the mutual fund beneficiaries to determine the tax rate for the relevant partners, the 28 percent income tax rate is an inaccurate presumption because it does not account for 2003 tax cuts that reduced dividend and capital gains rates to 15 percent, and it incorrectly assumes that the IRS taxes distributions to mutual fund beneficiaries at the beneficiaries' ordinary income tax rate.[525] The 2011 ID found VCC

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[518] *Id.* P 207.

[519] *Id.*

[520] *Id.*

[521] *Id.* P 208.

[522] *Id.*

[523] *Id.* P 210.

[524] *Id.*

[525] *Id.* P 211 (referencing 26 U.S.C. § 1(h) (2010); IRS Tax Topic 404; Jobs Growth and Tax Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752; Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345).

Shippers' evidence to be persuasive and not contradicted by SFPP.[526] Accordingly, the 2011 ID concluded that the presumption has been rebutted, and the weighted average tax rate for mutual funds is zero percent.[527]

Briefs On and Opposing Exceptions

312. SFPP argues that the 2011 ID erred and that the evidence it presented showed that the marginal tax rate of 34 percent should be used for exempt organizations that receive UBTI because the IRC requires the use of the corporate rate.[528] SFPP argues that the evidence relied on by the 2011 ID to rebut the presumption of a 28-percent rate relates to a year not at issue in this proceeding, was based on "estimates based on samples," and does not provide any information about KMEP unitholders, much less what percentage of KMEP unitholders that are exempt organizations had less than $1,000 or more of UBTI.[529] SFPP urges the Commission to adopt the same approach it used in Opinion No. 511, in which it ruled that SFPP should apply a 28-percent marginal income tax rate to any unitholder with UBTI from KMEP that was subject to the 35-percent rate because the Form 990-T reported more than $1,000.[530]

313. SFPP also objects to the 2011 ID's adoption of a zero-percent marginal tax rate for mutual funds.[531] SFPP states that arguments advanced by VCC Shippers—that the appropriate tax rate for mutual funds are based on the mutual fund itself and not on the mutual fund's beneficiaries—were rejected by the Commission in Opinion No. 511.[532] SFPP argues that the 2011 ID fails to recognize that the share of income allocated to mutual funds would retain its basic characteristics and would be subject to tax in the hands of the mutual fund or the mutual funds taxable investors upon the mutual fund's distribution to them.[533] SFPP also notes that since the qualified dividends that KMEP

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[526] *Id.* P 212.

[527] *Id.*

[528] SFPP Brief on Exceptions at 19.

[529] *Id.* at 20.

[530] *Id.* at 20-21 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 295).

[531] *Id.* at 21.

[532] *Id.* (citing Opinion No. 511, 134 FERC ¶ 61,121 at PP 292-93).

[533] *Id.*

received were not generated by SFPP, it is not appropriate to take them into account in determining the marginal income tax rate for unitholders that are mutual funds, and that 28 percent is the appropriate marginal tax rate.[534]

Commission Decision

314. The Commission reverses the 2011 ID's determination to adjust the relevant tax rate for both UBTI and mutual funds to zero percent. These issues were reviewed and decided in Opinion No. 511. With respect to the UBTI tax rate, the Commission determined:

> [T]o 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.[535]

Moreover, we agree with the arguments set forth by SFPP, that the evidence provided by shippers below is not sufficient to overcome this 28 percent tax rate presumption, because is consists of sample data based on a year not at issue here.

315. Furthermore, the Commission examined the appropriate mutual fund tax rate in Opinion No. 511:

> The Commission first notes that to the extent KMEP does not have access to the ownership categories of a mutual fund's shareholders, 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

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[534] *Id.* at 21-22.

[535] Opinion No. 511, 134 FERC ¶ 61,121 at P 295.

> qualified dividends, the proper marginal tax rate for calculating SFPP's income tax allowance is 28 percent.[536]

The Commission affirmed this determination in Opinion No. 511-A.

> [P]ass-through entities such as mutual funds or pension trustees make distributions to institutions and individuals that pay income taxes on the distributions. The marginal tax rates of the beneficiaries are reflected in the price they pay for the mutual funds and in the benefits from their pensions or trusts. Thus the marginal tax rates of the beneficiaries are properly reflected in the income tax cost of an MLP's regulatory cost of service."[537]

316. As described above, the Commission has repeatedly found mutual funds to be pass-through entities for the purpose of the ITA and that SFPP must use the appropriate marginal tax rate for mutual funds depending on whether distributions from the mutual funds are qualifying dividends.[538] Accordingly, we reverse the 2011 ID's determination that the appropriate marginal tax rate for mutual funds is zero percent and instead we require that SFPP use the appropriate rate depending on whether distributions are qualifying dividends (15 percent) or not (28 percent), consistent with Opinion Nos. 511 and 511-A.

D. <u>Re-categorization of KMEP Unitholders</u>

<u>2011 ID</u>

317. The 2011 ID found that SFPP's classification of certain KMEP unitholders skewed the weighted average income tax rate towards unitholder categories with higher income tax rates.[539] The 2011 ID explained that to classify KMEP unitholders, SFPP and PricewaterhouseCoopers (PWC) reviewed the unitholder data provided in some instances by the brokerage firm, bank, or other nominee that purchased the units for a particular unitholder, and in other instances, by the actual unitholder.[540] SFPP's witness Utay

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[536] *Id.* P 293 (internal citations omitted).

[537] Opinion No. 511-A, 137 FERC ¶ 61,220 at P 367 (citing December 2007 Order, 121 FERC ¶ 61,240 at P 35, 38; Opinion No. 511, 134 FERC ¶ 61,121 at PP 294-95).

[538] Opinion No. 511, 134 FERC ¶ 61,121 at P 293.

[539] 2011 ID, 134 FERC ¶ 63,013 at P 202.

[540] *Id.*

acknowledged that the information used to classify KMEP unitholders may contain some errors.[541]

318. As described by the 2011 ID, NHW Shippers' witness Meyer proposed to reclassify nineteen KMEP unitholders owning 100,000 units or more.[542] SFPP's witness Utay agreed that the reclassifications of six of the unitholders are correct, and the 2011 ID ordered SFPP to reclassify these unitholders.[543] However, SFPP's witness Utay disagreed with thirteen of these re-classifications.[544] The 2011 ID held that SFPP failed to properly categorize the remaining thirteen KMEP unitholders identified by NHW Shippers' witness Meyer.[545] The 2011 ID found that the names of these thirteen unitholders indicate that they are not corporations.[546] Accordingly, the 2011 ID determined that SFPP failed to carry its burden to categorize properly KMEP unitholders for purposes of calculating the weighted average income tax rate used to determine the ITA.[547] SFPP was therefore ordered to reclassify the thirteen KMEP unitholders, and to correct its ownership percentages and weighted average income tax rate to reflect these corrections.[548]

319. The 2011 ID also put SFPP on notice that the evidence in this case demonstrated that there are large unitholders whose self-categorization appears erroneous (the name of the unitholder in KMEP's records is inconsistent with the self-categorization) and SFPP has not undertaken to verify this information.[549] The Presiding Judge held that it was

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[541] *Id.*

[542] *Id.* P 200.

[543] *Id.* P 203 (referring to the six KMEP unitholders on lines 1, 2, 6, 12, 13, and 14 as shown in Ex. NAV-45C).

[544] *Id.* P 201.

[545] *Id.* P 204 (referring to the thirteen KMEP unitholders on lines 3, 4, 5, 7, 8, 9, 10, 11, 15, 16, 17, 18, and 19 in Ex. NAV-45C).

[546] *Id.* (citing Ex. NAV-45C at 1-2, lns. 3, 4, 5, 7, 8, 9, 10, 11, 15, 16, 17, 18, and 19).

[547] *Id.* (citing ITA Policy Statement, 111 FERC ¶ 61,139 at P 42).

[548] *Id.*

[549] *Id.* P 204 n.203.

unacceptable for a company to take advantage of its mistakes, and that SFPP should have protocols in place to verify at least large unitholders when the information appears suspect.[550]

Briefs On and Opposing Exceptions

320. SFPP argues that the 2011 ID erred in requiring SFPP to recategorize these thirteen unitholders, explaining that the unitholder study conducted by its witness Utay was conducted in precisely the same manner as studies approved by the Commission in prior proceedings.[551] SFPP further argues that the only source data for identifying and separating KMEP's unitholders into Commission-specified categories are the data provided to KMEP by its nominees (e.g., brokerage firms holding units on behalf of unitholders), and that the Commission should regard this data with a heavy presumption that the categorization information can be relied upon.[552]

321. SFPP contends that absent evidence in the name and address information provided for each investor showing that the investor's self-identification is inaccurate, it is inappropriate to second-guess the investor.[553] SFPP states that the thirteen unitholders that the 2011 ID required SFPP to re-categorize over witness Utay's objection did not meet this evidentiary standard.[554] SFPP argues that simply because a unitholder does not include the terms "corporation" or "LLC" in its name does not necessarily mean that the unitholder is not a corporation or limited liability company, as the 2011 ID assumes.[555] SFPP also disputes that there was any "advantage" it took in its categorization of

[550] *Id.* P 204 n.203.

[551] SFPP Brief on Exceptions at 26.

[552] *Id.* at 26-27.

[553] *Id.* at 27.

[554] *Id.*

[555] *Id.* at 28 (citing 2011 ID, 134 FERC ¶ 63,013 at P 204).

unitholders because the proposed re-classifications have little to no effect on the ITA, much less the "material effect" asserted by the 2011 ID.[556]

322. NHW Shippers support the 2011 ID's re-classification of all nineteen unitholders at issue, arguing that such re-classifications will lower the effective tax rate.[557] NHW Shippers emphasize that SFPP carries the burden to properly categorize unitholders, and where there are potential errors identified, such as those identified by NHW Shippers' witness Meyer, SFPP cannot treat its initial study as infallible and instead should be required to make reasonable inquiry into the accuracy of its classifications.[558] NHW Shippers argue that the Commission should not accept SFPP's study simply because it previously accepted a similar study, pointing out that the difference here is that this is the first time the study has been challenged.[559] NHW Shippers also contend that the fact that SFPP is not required to be perfect, and that some human error is tolerated in classification studies does not absolve SFPP from responding to specific allegations of error, such as those presented by Meyer in this case.[560] Finally, if SFPP believed that witness Meyer's searches were unreliable or otherwise insufficient, it should have rebutted his conclusions with evidence, rather than by levying vague assertions that his searches were unreliable.[561] Finally, NHW Shippers state that where witness Meyer challenged the classification of certain unitholders that appeared to be individuals (rather than corporations as SFPP classified them), SFPP cannot simply respond that he is not necessarily correct, and instead had the burden to rebut such challenges with evidence.[562]

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[556] *Id.* at 28-29 (stating that the ownership percentage for Subchapter C Corporations, other than KMGP and related entities, would be reduced by approximately 1.1 percent, while the Individuals and Mutual Funds categories would be increased by approximately 0.5 and 0.6 percent respectively, which collectively would cause a 0.07 percent reduction in the weighted average income tax rate).

[557] NHW Shippers Brief Opposing Exceptions at 46-47.

[558] *Id.* at 51.

[559] *Id.*

[560] *Id.* at 52.

[561] *Id.* at 53.

[562] *Id.* at 53-54.

Commission Decision

323. We affirm the 2011 ID's determination requiring SFPP to reclassify the thirteen large unitholder's identified by witness Meyer as being improperly categorized. One cannot ignore relevant evidence suggesting that thirteen large unitholders classified as corporations (and therefore subject to the highest marginal tax rate) are not, in fact, corporations. We therefore reject SFPP's contention that it is entitled to ignore such evidence rather than undertaking further inquiries to determine the proper category for these entities. Requiring further support in response to reasonably challenged unitholder categorization was reasonable. In this case, the classification of these thirteen large unitholders as corporations was properly challenged because the unitholders' names gave no indication they were corporations. Because SFPP provided no evidence in response to this challenge, it failed to support its proposed classification. We therefore affirm the 2011 ID's requirement that SFPP reclassify these unitholders. SFPP must correct its ownership percentages and weighted average tax rate accordingly.

E. Marginal Tax Rate Adjustments to Account for Income Tax Deferrals

2011 ID

324. In the proceeding below, SFPP argued that no adjustments to the ITA were necessary for the deferral of state and federal income taxes.[563] NHW Shippers, on the other hand, proposed that SFPP reduce the average marginal income tax rates for the KMEP unitholder categories to reflect tax savings associated with the deferral of state and federal income tax liability.[564] SFPP argued that reflecting such benefits violated the

[563] 2011 ID, 134 FERC ¶ 63,013 at P 215.

[564] *Id.*

Commission's stand-alone tax policy.[565] NHW Shippers disagreed, arguing that reflecting such benefits does not violate the stand-alone tax policy because KMEP's public unitholders do not pay income taxes until they sell their units and during the deferral period they benefit from the time value of money, by lowering their tax burden.[566]

325. The 2011 ID found that KMEP unitholders typically do not pay income taxes on SFPP income in the same year that SFPP generates the income.[567] The 2011 ID further explained that SFPP and KMEP elect to calculate depreciation pursuant to section 743(b) of the IRC,[568] and that the associated depreciation deductions give rise to large losses, which are allocated to KMEP unitholders.[569] The 2011 ID found that public unitholders receive losses pursuant to section 743(b) depreciation that more than fully offset any SFPP income allocated to the unitholders.[570]

326. SFPP and NHW Shippers disputed whether reflecting tax deferral benefits associated with 743(b) Depreciation Deductions in the weighted average income tax rate used to calculate the ITA violates the Commission's stand-alone tax policy.[571] In resolving this dispute, the 2011 ID found that the relevant inquiry is whether the 743(b)

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[565] *Id.* The 2011 ID explained the stand-alone tax policy was designed to ensure that a regulated pipeline reflects only its own tax liabilities and deductions in rates, and not any tax liabilities or deductions of non-jurisdictional activities or pipeline affiliates, even if those liabilities and deductions impact the actual taxes liability of the regulated pipeline. *Id.* P 220 (citing *Columbia Gulf Transmission Co.*, Opinion No. 173, 23 FERC ¶ 61,396, at 61,851 (1983), *aff'd City of Charlottesville v. FERC*, 774 F.2d 1205, 1215-16 (D.C. Cir. 1985) (*City of Charlottesville*); Modification Orders).

[566] *Id.* P 215.

[567] *Id.* P 218.

[568] 26 C.F.R. § 1.743(b) (2011). 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 (referred to here as "743(b) Depreciation Deductions"). Opinion No. 511, 134 FERC ¶ 61,121 at P 310.

[569] 2011 ID, 134 FERC ¶ 63,013 at P 218.

[570] *Id.*

[571] *Id.* P 220.

Depreciation Deductions, and the resulting tax deferral benefits, are attributable to SFPP's jurisdictional operations and assets, as opposed to non-jurisdictional operations or the assets of an SFPP affiliate.[572] SFPP argued that the benefits associated with the 743(b) Depreciation Deductions are not properly reflected in the ITA because the deductions and underlying costs are not in the SFPP cost of service.[573] Conversely, NHW Shippers proposed to reflect tax deferral benefits from 743(b) Depreciation Deductions directly related to unitholders' share of the depreciation of the value of the partnerships' own assets.[574]

327. The 2011 ID agreed with NHW Shippers, finding that the evidence indicates that the 743(b) Depreciation Deductions, and resulting tax deferral benefits, are attributable to SFPP's jurisdictional assets.[575] The 2011 ID found that the 743(b) Depreciation Deductions are related to SFPP activities and operations because they relate to the value of SFPP assets—specifically, the tax basis of SFPP assets is being depreciated.[576] The 2011 ID also found that the fact that the adjustment applies only to the income taxes paid by a partner that purchases the partnership interest is not important because each partner has a proportional ownership interest in all partnership assets, which are at the heart of SFPP operations.[577]

328. The 2011 ID also addressed NHW Shippers' proposal to require SFPP to normalize tax deferral benefits associated with 743(b) Depreciation Deductions in a manner similar to the normalization of tax deferral benefits associated with accelerated depreciation.[578] The 2011 ID determined that NHW Shippers' proposal does not violate the stand-alone tax policy and is consistent with Commission policy because the 743(b) Depreciation Deductions directly relate to SFPP assets.[579] The 2011 ID held that SFPP cannot claim an ITA based on its ultimate investors while arguing that the depreciated

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[572] *Id.* P 221.

[573] *Id.* P 222.

[574] *Id.* P 223.

[575] *Id.* P 224.

[576] *Id.*

[577] *Id.*

[578] *Id.* PP 225-28.

[579] *Id.* P 228.

value of these investors cannot be accounted for in the rate base.[580] The 2011 ID therefore ordered SFPP to reduce the marginal income tax rates of the KMEP unitholder categories to reflect the deferral of state and federal income taxes and adopt Navajo witness Horst's recommended 80.4 percent reduction of the marginal average income tax rate.[581]

Briefs On and Opposing Exceptions

329. SFPP objects to the 2011 ID's requirement that SFPP reflect the deferral of state and federal income taxes and reduce its marginal average income tax rate by 80.4 percent.[582] SFPP contends that in decisions before and after the 2011 ID, the Commission rejected claims that the benefits of any tax deferrals due to 743(b) Depreciation Deductions should be credited to ratepayers, instead finding that the value of any such deferrals are already included in both the prices of the MLP units and in the DCF-method ROE.[583] SFPP contends that because these deferrals are already accounted for in the ratemaking context, it would be inappropriate to further reduce the marginal tax rate of KMEP's unitholders.[584]

330. SFPP argues that the 2011 ID mischaracterizes the Commission's stand-alone tax policy by incorrectly focusing on whether 743(b) Depreciation Deductions "are attributable to SFPP's jurisdictional assets" or "related to SFPP's assets and operations," rather than focusing on whether such deductions are a cost incurred to operate SFPP and included in SFPP's cost of service.[585] SFPP explains that neither the 2011 ID nor any participant in this proceeding claim that 743(b) Depreciation Deductions are included, or includable, in SFPP's cost of service.[586]

331. SFPP argues that the 80.4 percent reduction of the marginal average income tax rate adopted by the 2011 ID is improper because it was calculated using 5.3-year-

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[580] *Id.*

[581] *Id.*

[582] SFPP Brief on Exceptions at 22-26.

[583] *Id.* at 22-23 (citing Opinion No. 511, 134 FERC ¶ 61,121 at PP 302-05; Opinion No. 486-B, 126 FERC ¶ 61,034 at P 116).

[584] *Id.* at 23.

[585] *Id.* at 24.

[586] *Id.*

average-holding period based on more than 29 million units sold in 2008 that were purchased before 2008, but which excluded more than 86 million units purchased and sold in 2008.[587] SFPP argues that even if it were appropriate to reduce SFPP's ITA to reflect 743(b) Depreciation Deductions, the 80.4 percent reduction required by the 2011 ID is an inappropriate reduction.[588]

332. NHW Shippers disagree, arguing that to the extent the Commission finds that SFPP is entitled to an ITA, the allowance should be reduced in accordance with the 2011 ID.[589] NHW Shippers state that most of KMEP's public unitholders are not allocated taxable income, but instead are allocated large losses each year, which are generally attributable to 743(b) Depreciation Deductions.[590] NHW Shippers further state that each time a KMEP unit is sold, KMEP writes up the tax basis of its assets to reflect the new unitholder's purchase price of KMEP's units and then allocates 100 percent of the additional tax depreciation from that write-up to the new unitholder.[591] NHW Shippers assert that this depreciation is then allocated to the unitholder on its K-1, generally offsetting whatever income is allocated to the unitholder.[592] NHW Shippers claim that the result is that, as a class, public unitholders generally are allocated losses by reason of the 743(b) Depreciation Deductions that more than fully offset any income allocated to the public unitholders, thereby enabling them to enjoy a time-value-of-money savings.[593]

333. NHW Shippers assert that SFPP's argument that the benefits of tax deferral are factored into the MLP unit price, and therefore the DCF ROE, directly undermines its more general claim that MLP pipelines do not double recover investor-level income taxes by reason of the ITA built into the DCF ROE.[594] NHW Shippers argue that if the Commission grants SFPP an ITA, it must logically find that a separate allowance is needed because the DCF ROE does not already compensate SFPP for its investors'

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

[588] *Id.* at 25.

[589] NHW Shippers Brief Opposing Exceptions at 27-28.

[590] *Id.* at 29.

[591] *Id.*

[592] *Id.* at 30.

[593] *Id.*

[594] *Id.*

income tax expenses.[595] NHW Shippers contend, however, that if this is the case, the Commission cannot claim that the benefits of deferral are covered by the DCF ROE; rather, any reductions in investor tax expenses must be accounted for in the ITA.[596]

334. NHW Shippers next argue that requiring SFPP to pass through the benefits of tax deferral does not violate the Commission's stand-alone doctrine.[597] NHW Shippers contend that once the investor level taxes are imputed to the pipeline, investors cannot logically be separated from the pipeline when applying the stand-alone principle.[598] NHW Shippers further argue that SFPP cannot plausibly assert that investor tax *liability* should be imputed to the partnership (and properly chargeable to ratepayers through an ITA), but that investor tax *deferral* belongs solely to the investors and cannot be imputed to the partnership.[599] Furthermore, NHW Shippers argue that SFPP is inappropriately attempting to expand the stand-alone doctrine to include not only the taxes on the pipeline entity's income, but on the pipeline investors' income as well.[600]

335. NHW Shippers also object to the SFPP's reliance on the December 2007 Order, which stated the Commission's conclusion "that Congress intended that the partners should benefit from any income tax deferrals."[601] NHW Shippers assert that there is no legal basis for this conclusion and argue changes in the tax code (such as the exemption from corporate taxation for MLPs) do not create benefits to be apportioned between pipelines and ratepayers.[602] NHW Shippers also allowing SFPP and its unitholders to collect the full amount of deferred taxes from ratepayers and to invest those sums during the deferral period runs counter to the Commission's express goal of equalizing the post tax return experienced by pipeline corporations and MLP unitholders.[603]

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[595] *Id.* at 31.

[596] *Id.*

[597] *Id.* at 31-35.

[598] *Id.* at 33.

[599] *Id.*

[600] *Id.*

[601] *Id.* at 35 (citing December 2007 Order, 121 FERC ¶ 61,240 at P 29).

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

[603] *Id.* at 36-37.

336. NHW Shippers also object to SFPP's contention that units bought and sold in 2008 should have been accounted for in witnesses Meyer and Horst's recommended reduction in the marginal average income tax rate.[604] NHW Shippers argue that including such units would have resulted in their double-counting.[605] NHW Shippers explain that if a unit sold multiple times in 2008 and was counted each time and given weight as a separate unit at each sale, the income tax effect attributable to the unit would be overweighted.[606]

<u>Commission Decision</u>

337. The Commission finds that Opinion Nos. 511 and 511-A address the issues related to the appropriate treatment of 743(b) Depreciation Deductions. In light of the Commission's determinations there, we reverse the 2011 ID's requirement that SFPP reduce the marginal income tax rates of the KMEP unitholder categories by 80.4 percent to reflect the deferral of state and federal income taxes.

338. In the Opinion No. 511 and 511-A proceeding, shippers sought for the Commission to reduce SFPP's ROE to account for the pipeline's 743(b) Depreciation Deductions.[607] The Commission declined to do so in light of the incongruity between the jurisdictional partnership entity's cost-of service and the individual partner's depreciation deferrals. Specifically, in Opinion No. 511, the Commission explained the manner in which tax deferrals such as 743(b) Depreciation Deductions are treated vis-à-vis accelerated depreciation at the partnership level: "[I]ncome 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."[608] In Opinion No. 511-A, the Commission explained:

> [T]he section 743(b) depreciation does not even [affect] the calculation of the income tax allowance because the latter is calculated on the allocations of distributed partnership income. The section 743(b) deduction offsets distributed income at the level of the individual partner and thus may lead to negative taxable income and income tax deferrals at that level.

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[604] *Id.* at 37.

[605] *Id.*

[606] *Id.* at 37-39.

[607] Opinion No. 511, 134 FERC ¶ 61,121 at P 309.

[608] *Id.* P 305 (internal citations omitted).

> Therefore, any adjustment to reflect benefits that may flow from the section 743(b) deduction is not properly grounded in the stand-alone doctrine because the so-called tax savings are not reflected in the jurisdictional entity's cost of service.[609]

339. In this case, the issue arises not in the context of a reduction of SFPP's ROE, but instead in the context of a reduction of the marginal average tax rate used to determine SFPP's ITA. The distinction, however, is without a substantive difference. In both instances, the Commission's key policy determinations—that a pipeline's 743(b) Depreciation Deductions are not reflected in a jurisdictional entity's cost of service and that such deductions offset income at the individual partner, rather than the jurisdictional partnership level—require that the tax deferrals resulting from 743(b) Depreciation Deductions not be factored into the calculation of the ITA.

340. Under the Commission's stand-alone policy, "when an expense is not included in the cost of service (because the company did not incur that expense in providing service), the deduction created by that expense is not allocated to the ratepayers."[610] Neither the costs associated with 743(b) Depreciation Deductions, nor the deductions themselves are included in SFPP's cost of service. This is because these tax deferrals apply to individual partnership interests, not the jurisdictional partnership. Accordingly, as the Commission explained in Opinion Nos. 511 and 511-A, 743(b) Depreciation Deductions do not affect jurisdictional rates, and should not be reflected in the marginal tax rate used to determine SFPP's ITA. The 2011 ID erred by focusing on the notion that SFPP's 743(b) Depreciation Deductions are related to its jurisdictional assets, and disregarding the fact that such deferrals apply to the partner (through its purchase of the partnership unit), rather than the jurisdictional partnership.

341. NHW Shippers contend that if the Commission bases an ITA on the partner's tax liability (rather than the partnership's tax liability), then logic would require it to incorporate any partner level deferrals in that calculation of the ITA as well. This argument, however is inconsistent with previous Commission determinations that these deferrals are already accounted for in the MLP unit price and do not necessarily affect the ITA or rates paid by jurisdictional ratepayers.[611] Moreover, the "logic" asserted by NHW Shippers is illusory. The ITA is based on the jurisdictional entity's (in this case the MLP's) tax liability.

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[609] Opinion No. 511-A, 137 FERC ¶ 61,220 at P 362.

[610] Opinion No. 173, 23 FERC at 61,851.

[611] Opinion No. 486-B, 126 FERC ¶ 61,034 at P 116.

F. Accumulated Deferred Income Taxes (ADIT)

2011 ID

342. The 2011 ID explains that ADIT represents the tax effects of timing differences between straight-line depreciation used by the Commission for ratemaking purposes and accelerated depreciation used by pipelines for income tax purposes.[612] Because these different accounting treatments result in lower actual income tax liability than the amount recovered in the ITA, pipelines accumulate the difference in their ADIT accounts.[613] The 2011 ID explains that the Commission requires pipelines to subtract ADIT from rate base because ratepayers fund the ADIT account.[614] The 2011 ID further states that the Commission recognizes that the ADIT calculation accounts for federal and state income taxes as follows—timing differences, *multiplied by appropriate Federal and state tax rates*, represent ADIT and a rate base reduction.[615] In this manner, the ADIT normalizes the ITA collected through a pipeline's rates.

343. In the proceeding below, NHW Shippers stated that SFPP includes state and federal income taxes in the ITA; however, it does not include state income taxes in the ADIT calculation.[616] NHW Shippers argued that the absence of state taxes results in an understated ADIT calculation, and that SFPP never explained why state taxes were excluded from the calculation.[617] NHW Shippers proposed adjusting SFPP's ADIT calculation by replacing SFPP's weighted-average federal income tax rate with a weighted-average combined (federal and state) tax rate.[618]

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[612] 2011 ID, 134 FERC ¶ 63,013 at P 175 (citing December 2007 Order, 121 FERC ¶ 61,240 at P 140; 18 C.F.R. §§ 346.2(c)(4)-(5) (2011)).

[613] *Id.*

[614] *Id.* (citing *Kern River Gas Transmission Co*., 123 FERC ¶ 61,056 at P 269 (2008) ("Commission policy requires a regulated firm to adjust its rate base to reflect the timing difference between the receipt of cash flows generated by the income tax component of its rates and the timing of its actual tax payments."); Opinion No. 486, 117 FERC ¶ 61,077 at P 228; *SFPP, L.P*., 86 FERC ¶ 61,022 at 61,092 (1999)).

[615] *Id.* (citing Opinion No. 486, 117 FERC ¶ 61,077 at P 224 n.330).

[616] *Id.* P 176.

[617] *Id.*

[618] *Id.* P 177.

344. The 2011 ID found that SFPP's ADIT calculation did not comport with Commission policy because it did not reflect state income taxes, and therefore directed SFPP to adjust its ADIT calculation to reflect the deferral of federal and state income tax costs associated with accelerated depreciation.[619] SFPP was further directed to calculate the marginal income tax rate for the ADIT calculation pursuant to the findings regarding the marginal income tax rate for the ITA calculation (an issue discussed below).[620]

Briefs On and Opposing Exceptions

345. SFPP does not object to the 2011 ID's holding that it must adjust its ADIT calculations to reflect state income taxes.[621] SFPP does, however, object to the ruling that it must calculate ADIT using a marginal income tax rate that has been adjusted to reflect the 2011 ID's findings discussed in Issues III(B) to III(G) of that decision (issues discussed in the sections below).[622]

346. With respect to the inclusion of state income taxes in the ADIT calculation, SFPP states that it is unclear whether the 2011 ID adopts witness Horst's approach for reflecting state income taxes in the ADIT calculations for historical period.[623] SFPP urges the Commission not to adopt Horst's approach, arguing that the relevant states did not all adopt the same tax depreciation elections under the IRC (some have chosen a less accelerated depreciation method), and that the use of current rates would misstate historical balances.[624]

347. Furthermore, SFPP states that in Opinion No. 511, the Commission ruled for the first time that SFPP should account for state income taxes in its ADIT calculations.[625] SFPP states that it is evaluating how best to incorporate state taxes into the ADIT

[619] *Id.* P 180.

[620] *Id.*

[621] SFPP Brief on Exceptions at 18.

[622] *Id.*

[623] *Id.* at 18-19 (referencing 2011 ID, 134 FERC ¶ 63,013 at P 178).

[624] *Id.* at 19.

[625] *Id.*

calculation, and urges the Commission to require SFPP to incorporate state taxes in the ADIT calculation in the same manner in both the Opinion 511 proceeding and here.[626]

348. NHW Shippers argue that the Commission should affirm the 2011 ID's requirement that SFPP adjust its ADIT calculation to include state income taxes.[627] NHW Shippers state that their witness Horst was the only witness to propose a method for SFPP to include state income taxes in the ADIT calculation, in which he grossed up ADIT balances by a factor of 1.032 percent—which is equal to the ratio of the composite federal and state weighted average tax rate to the federal-only weighted average tax rate.[628] In the absence of any method proposed by SFPP, NHW Shippers argues that the method advanced by Horst should be accepted.[629] NHW Shippers argue that in not setting forth a method to incorporate state taxes in the ADIT calculation, SFPP failed to carry its burden of proof in this proceeding, and it should not be given an opportunity to devise a method after the hearing has concluded.[630]

Commission Decision

349. The Commission affirms the 2011 ID's determination that the ADIT calculation should reflect relevant state income taxes, a proposition to which none of the parties object, and which is consistent with Opinion No. 511.[631] Furthermore, we affirm the 2011 ID that the marginal tax rate should be adjusted to reflect the 2011 ID's findings. However, such adjustments should only reflect the 2011 ID's findings to the extent they are not modified herein; where this order does modify the calculation of the marginal tax rate, those determinations control.

350. We therefore order SFPP to make a compliance filing setting forth the ADIT calculation so as to reflect state taxes, and in a way that is consistent with the Commission's determinations in Opinion No. 511 and Opinion No. 511-A.[632] Because the requirement that SFPP incorporate state taxes in its ADIT calculation is a new

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[626] *Id.*

[627] NHW Shippers Brief Opposing Exceptions at 54.

[628] *Id.* at 54-55.

[629] *Id.* at 55.

[630] *Id.* at 56.

[631] Opinion No. 511, 134 FERC ¶ 61,121 at P 321.

[632] *Id.* PP 314-21; Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 383-92.

requirement, we do not hold against SFPP the fact that it did not propose a method to incorporate state taxes in its ADIT calculation, and we will not at this time adopt NHW Shippers' approach simply because it was the only one proffered. Instead, our intent is to align the manner in which the ADIT calculation is performed with the West Line cases and the requirements set forth in Opinion No. 511 and 511-A.

The Commission orders:

(A) The exceptions to the 2011 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 East Line rates consistent with this order within 45 days after this order issues, including a supporting cost of service, workpapers, explanatory statements, and any other necessary documentation.

(C) Comments on the compliance filing are due 75 days after this order issues and reply comments are due 90 days after this order issues.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

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