111 FERC ¶ 61,299

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

SFPP, L.P. Docket No. IS05-230-000

ORDER ACCEPTING AND SUSPENDING TARIFF, SUBJECT TO REFUND, AND ESTABLISHING HEARING PROCEDURES

(Issued May 31, 2005)

1. On April 28, 2005, SFPP, L.P. (SFPP) submitted a tariff filing with a cost-of-service justification that proposed to increase rates for the transportation of petroleum products on its North Line system.[1] As detailed below, the Commission accepts and suspends the tariff to become effective June 1, 2005, subject to refund, and sets this matter for hearing. This order benefits customers because it timely sets hearing procedures to resolve issues presented by this filing.

SFPP's Filing

2. SFPP replaced a portion of its North Line that runs from Concord to Sacramento, California, at a cost of over $95 million, which became operational in December 2004. SFPP proposes to increase its interstate rates by twenty cents per barrel based on a cost-of-service showing. SFPP states that, in accordance with 18 C.F.R. Part 346 of the Commission's regulations, it submitted cost, revenue, and throughput data supporting the revised rates. SFPP claims that its supporting schedules show a substantial divergence between the actual costs experienced by the carrier from the construction and the rates resulting from application of the oil pipeline annual cost increase index, as required by 18 C.F.R. § 342.4(a) of the Commission's regulations.

[1] From Richmond and Concord (Contra Costa County), California, to Reno/Sparks (Washoe County), Nevada. For both routes, the proposed rate on FERC Tariff No. 111 is 139.34 cents per barrel.

3. SFPP states it used calendar year 2004 as the base period, and January 1, 2005 through September 30, 2005 for the test period. SFPP calculates a cost of service of $20,776,000 for the test period. According to SFPP, test period revenue under the current ceiling rate projects to approximately $16,547,000, resulting in an under-recovery of approximately $4,229,000 per year or 20.4 percent. Under the proposed rate, SFPP states it would still under-recover its test period cost of service by approximately $1,455,000.

4. SFPP makes four test period adjustments to its operating expenses and adjusts its capital structure, as of December 31, 2004, from a 55.18 to 44.82 percent to a 40 to 60 percent debt to equity ratio which would more accurately reflect the long-term capital structure target of its parent company, Kinder Morgan Energy Partners (KMEP). Regarding the income tax component of the cost of service, SFPP recognizes that the Commission's decision on the appropriate tax allowance for entities owning public utility assets was pending in the Docket No. PL05-5-000 proceeding on the filing date and uses a full income tax allowance in the cost-of-service calculation in this filing.

Interventions, Protests, and Responses

5. Timely motions to intervene and protest were filed jointly by BP West Coast Products LLC and ExxonMobil Oil Corporation (BP and ExxonMobil) on May 6, 2005, and by ConocoPhillips Company (ConocoPhillips), Tesoro Refining and Marketing (Tesoro) and jointly by Valero Marketing and Supply Company and Chevron Products Company (Valero and Chevron) on May 13, 2005. SFPP filed an answer to the BP and ExxonMobil protest on May 11, 2005, and another on May 18, 2005, to answer the May 13, 2005 protests of the remaining parties.

6. The protesting parties oppose the proposed rate increase and request the Commission suspend the filing's proposed rates, subject to refund, and set the instant docket for hearing. Further, BP and ExxonMobil and ConocoPhillips request suspension for the maximum statutory seven-month period and Tesoro requests the Commission deny the rate increase and reject the filing.

7. In its responses, SFPP maintains the instant filing's cost of service schedules were calculated in accordance with Part 346 of the Commission's regulations and support the proposed rate increase in proposed FERC Tariff No. 111. SFPP states the protestant's requests that the Commission suspend the filing for the maximum seven-month statutory period are unsupported and inconsistent with Commission policy regarding the suspension of oil pipeline rate filings as FERC Tariff No. 111 simply raises the rate for transportation.

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Positions on Protested Issues

Income Tax

8. All protesting parties object to SFPP's use of a full corporate income tax allowance in support of its cost of service calculation. BP/ExxonMobil[2] states that under the Commission's Policy Statement in Docket No. PL05-5-000,[3] in order to obtain an income tax allowance, the utility seeking the allowance must demonstrate that there is an income tax liability on utility income. ConocoPhillips claims SFPP and its parent companies, Kinder Morgan Operating Limited Partnership "D" and KMEP, do not pay income taxes because the entities are limited partnerships. Tesoro adds that SFPP is not permitted to take any income tax allowance according to a decision by the United States Court of Appeals for the District of Columbia on July 20, 2004 in *BP West Coast Products v. FERC*: "no such [income tax] allowance should be included" in SFPP's cost of service.[4] Valero and Chevron state that because SFPP's proposed tax allowance represents approximately 13 percent of SFPP's proposed test period cost of service, further discovery is appropriate.

SFPP's Answer

9. SFPP states its inclusion of a full income tax allowance in the North Line rate filing is fully justified, particularly in light of the Commission's May 4, 2005 issuance of its Policy Statement on Income Tax Allowances.[5] SFPP states that the protestants seek to deny SFPP any income tax allowance. SFPP asserts that these claims are without merit and ignored the Commission's policy because they were filed two days after issuance of the Policy Statement.

Capital Structure

10. BP and ExxonMobil disagree with SFPP's capitalization of 60 percent equity for purpose of ratemaking, based on the long-term capital structure of KMEP. They further challenge SFPP's 2004 year end "actual" equity component of 44.82 percent because SFPP has undergone

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[2] BP and ExxonMobil's protest includes a separate "Offer Of Proof" regarding income tax and cash distribution issues involved in Docket No. OR92-8, *et al*.

[3] 111 FERC ¶ 61,139 (May 4, 2005).

[4] 374 F.3d 1263, 1291 (D.C. Cir. 2004).

[5] 111 FERC ¶ 61,139 (2005).

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two write-ups of its capitalization, once when the corporate pipeline was originally converted to a partnership and again in 1998 when SFPP's then-owner, another master limited partnership, was purchased by KMEP at a premium over book value.[6] They further assert that KMEP has never met the management target capital structure of 60 percent equity and 40 percent debt.

SFPP's Answer

11. SFPP maintains that a 60 percent equity and 40 percent debt capital structure is in line with the long-term goals of its parent, KMEP. Regarding Valero and Chevron's assertion that SFPP should adjust its capital structure should be adjusted to remove PAAs, SFPP replies it has not written up its rate base. SFPP asserts Valero and Chevron's argument that the adjustment for PAAs must be removed entirely from the equity portion of SFPP's capital structure would be contrary to Opinion Nos. 435-A and 435-B.

Return on Equity

12. BP and ExxonMobil state that the supporting schedules indicate SFPP is claiming a nominal rate of return of 13.04 percent, and question the use of KMEP, a master limited partnership (MLP), to support this return. They assert that a MLP provides cash distributions (which are not income or a return on capital, but instead are a return of capital) to the limited partners and not the investors, and as such are not taxed as ordinary income. ConocoPhillips and Valero and Chevron state that SFPP's proposed real equity return of 9.78 percent is not justified. They assert this is not consistent with the Commission's recent *HIOS* decision recognizing that MLP's cash distributions contain a return of capital and are not appropriately used in a discounted cash flow analysis when determining a real return on equity.[7]

SFPP's Answer

13. SFPP states that the *HIOS* order is pending on rehearing before the Commission and that the *HIOS* record was not fully developed regarding MLP distributions, leading the Commission to incorrect conclusions on the propriety of using them in the Commission's discounted cash flow analysis. SFPP continues that MLP unit holders do not view the distributions they receive as "return of capital," but refer to and consider them analogous to dividends. Further, SFPP

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[6] BP/ExxonMobil assert that the Commission has held SFPP cannot include such "write-ups" in its rates, *citing SFPP, L.P.*, 106 FERC ¶ 61,300 (2004).

[7] *High Island Offshore Partner's, L.L.C.*, 110 FERC ¶ 61,043 at P 126 (2005).

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asserts that the bright line the Commission sought to draw between dividends and distributions does not exist and MLP distributions do not contain a "return of capital."

Cost of Debt

14. ConocoPhillips, Tesoro and Valero and Chevron claim that SFPP's 6.57 percent weighted cost of debt was incorrectly calculated as SFPP omits $643 million ($512.8 million of variable rate "other debt" and $130.2 million of interest rate "swaps" to hedge its interest rate risk) or 13 percent of its total year-end 2004 long term debt of $4.9 billion. Further, the protestors note that KMEP's SEC Form 10-K for the period ending December 31, 2004 indicates that SFPP reclassified all its short-term debt as long-term debt (changing the notes from fixed to variable rates) and, therefore, question the effect of these rates on SFPP's proposed cost of service.

SFPP's Answer

15. SFPP states that $417 million of the $643 million of omitted debt cost is one to 30 day commercial paper, of which KMEP's bears a totally non-representative interest rate as it fluctuates significantly from month to month. Although it is classified as long-term debt for accounting purposes, SFPP states that such short-term debt is not appropriate in determining a long-term debt cost. Similarly, $94 million of the $130.2 million of the interest rate swaps is bonds reflecting short-term rates of 1.7 percent or less and are also not appropriate in determining a long-term debt cost.

Throughput Volumes

16. Tesoro states that because to the new 20-inch line replaced the smaller 14-inch line, throughput could add between 40 to 68 percent throughput capacity. Tesoro states SFPP presently over-recovers by charging ceiling prices because of the additional revenues resulting from the expansion. But, as also noted by ConocoPhillips, Valero and Chevron, the likely additional revenues produced by this increase are not recognized in SFPP's cost of service because the expansion did not go into service until December 15, 2004, so SFPP's base and test period volume level contains eleven and a half months of pre-expansion activity and does not represent post-expansion volumes.

SFPP's Answer

17. SFPP states it properly relied on actual 2004 volumes because SFPP did not expect a near-term volume increase in intrastate or interstate volumes as a result of the replacement pipe project. SFPP states it properly included in its cost of service a share of the costs incurred to construct the Concord to Sacramento segment and properly

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determined that share. SFPP states it decided to use a 20-inch pipe to replace the aging 16-inch pipe because, in its reasonable judgment, usage of the North Line (by interstate shippers) will increase over time. Although the 20-inch line now only increases intrastate shippers' capacity, SFPP states that it will not have to expand that portion of the line again if and when an expansion of interstate capacity is facilitated, and will not be subjected to claims of being short-sighted in the future. SFPP asserts its filing at the California Public Utilities Commission (CPUC) to raise its intrastate rates to reflect the cost of the new pipe reflected an appropriate allocation of the costs of the expansion to interstate shippers, specifically by usage of pipe, a long-standing methodology employed by SFPP for interstate-intrastate cost separations, used without challenge in many proceedings before FERC and the CPUC. SFPP asserts that ConocoPhillips and Valero and Chevron have misstated matters in their favor regarding the prior findings of "large over-recoveries" of costs on the North Line for past years. First, SFPP states that its North Line rates from California to Nevada are grandfathered and have therefore been deemed just and reasonable. Also, it asserts that the findings referenced by the protestants do not support their claim here because the large over-recoveries were based on North Line cost of service calculations premised on the Lakehead approach, which the court and the Commission have rejected. SFPP further argues that any past over-recoveries have no relevancy to whether SFPP's proposed rates are just and reasonable.

Operating Expenses

18. Valero and Chevron state that SFPP claims four primary adjustments to its test period operating expenses, including adjustments associated with litigation expenses and environmental remediation costs, which are derived from historical averages, rather than base and test period factors. BP and ExxonMobil also question these adjustments and the accuracy of certain base period amounts, including salaries and wages. Tesoro states that the financial data provided by SFPP indicates the operating expenses excluding depreciation represents 52 percent of its total cost of service in the test period and 59 percent in the base period and question the allocation and time period of these costs. Tesoro claims it determined, by sampling seven pipelines as a proxy group and computing the relationship of operating expenses to total cost of service, that the mean weighted average of these seven companies was 33 percent or 19 percent less than SFPP's 52 percent. ConocoPhillips agrees that SFPP's normalization of the operating expenses is inappropriate and appears to recover past out-of-period costs. It also questions the allocation of corporate overhead expenses to SFPP's operations.

SFPP's Answer

19. SFPP asserts that, because environmental remediation expenses can vary widely from year to year, normalizing them over a five year period is a more accurate picture of

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the level of costs that SFPP will likely incur in the future, and also the intrastate/interstate allocations were proportioned appropriately. Similarly, SFPP defends its allocation of litigation expenses in its cost of service and claims the protestants are trying to deny SFPP prudently incurred regulatory litigation costs. SFPP states it operates its pipelines in a prudent, cost-efficient manner and Tesoro's claim that its operating expenses are disproportionately high when compared to the other "proxy" pipelines is without merit.

Grandfathered Rates & Substantial Divergence

20. BP and ExxonMobil state that because of the instant filing to increase the rates by 20 cents from $1.1934 to $1.3934, SFPP now waives any claim it may have for "grandfathering" of the interstate rates from California to Reno/Sparks, Nevada, and therefore the Commission should roll back below the level of the "grandfathered" rate of $1.10 to $0.92. Also, BP and ExxonMobil state that SFPP's North Line cost of service increased from $12,770,000 in 1999, to a claimed $17,929,000 in 2004 (base period), and to $20,776,000 for the instant filing's test period without adding any interstate capacity. Valero and Chevron and ConocoPhillips note that SFPP's North Line rates were previously challenged in Docket Nos. OR96-2, *et al*., by complaints filed in 1996, 1998, and 2000. They assert that, while the Commission found that SFPP had large over-recoveries of its North Line costs in 1995, 1996 and 1997, the Commission ruled that the complainants failed to satisfy the threshold requirement of establishing substantially changed economic circumstances under the Energy Policy Act of 1992.[8] ConocoPhillips states it also filed a complaint in Docket No. OR05-5-000 against SFPP's system-wide interstate rates, including the North Line rates, which the Commission has held in abeyance pending the outcome of earlier related proceedings.[9]

SFPP's Answer

21. SFPP states the Commission found that its North Line interstate rates are grandfathered[10] and SFPP has not "now waived any claim" to any degree of grandfathering protection by increasing rates in the instant filing. SFPP claims there is no basis for BP and ExxonMobil's assertion that the North Line rates, on a cost of service

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[8] 106 FERC ¶ 61,300, at PP 60-62.

[9] 110 FERC ¶ 61,183.

[10] *ARCO Products v. SFPP, L.P.*, 106 FERC ¶ 61,300 at PP 59-62.

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basis would fall below the immediately pre-existing level ($1.19/barrel), let alone its 1989 rate level ($1.10). SFPP argues that its showing of a substantial divergence cannot provide a basis for ordering refunds of grandfathered rates.

Double-Recovery

22. Tesoro also claims that SFPP is attempting to obtain a double-recovery for its replacement of the Concord to Sacramento line because these very same construction costs are before the CPUC in which SFPP seeks to raise its intrastate rates. Tesoro notes a $0.7 million difference in allocated costs to interstate service between SFPP's application to the CPUC ($29.3 million for the Concord to Sacramento project) and to the instant filing ($30 million), and claims this shows that SFPP asks the Commission to permit it to raise interstate rates to recover the same costs.

SFPP's Answer

23. SFPP states the $29.3 million (an estimate for the intrastate construction costs) in CPUC's application were incremental costs related only to the intrastate project, whereas the $30 million in the instant filing represents SFPP's total North Line interstate net capital additions for 2004, which it developed later and more accurately reflect the actual intrastate construction costs.

Discussion

24. The Commission finds that SFPP has made an adequate initial showing that its filing meets the requirements of a cost-of-service filing, under 18 C.F.R. § 346.1 of the Commission's regulations based on the cost figures provided in its filing. Accordingly, the Commission denies Tesoro's request that the Commission reject the filing summarily. Additionally, we deny BP and ExxonMobil's and ConocoPhillips' request to suspend the filing for the maximum statutory seven-month period. The protestants' interests are fully protected as the rate increase is subject to refund and revision at the conclusion of the hearing.[11]

25. The issues of this case pertain to the data and methods that SFPP uses to determine its proposed rates. The resolution of these factual disputes will have a rate impact on the protestants and on other shippers using SFPP's North Line. However, there is

[11] *See Buckeye Pipe Line Company*, 13 FERC ¶ 61,267 (1980).

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insufficient data at this time to resolve these disputes. Therefore the Commission will establish hearing procedures to examine all the issues raised by the filing.

Suspension

26. Based upon a review of the filing, the Commission finds that SFPP's FERC Tariff No. 111 has not been shown to be just and reasonable and may be unjust, unreasonable, unduly discriminatory, or otherwise unlawful. Accordingly, the Commission will accept the tariff for filing and suspend it, to be effective June 1, 2005, subject to refund.

The Commission orders**:**

(A) SFPP's FERC Tariff No. 111 is accepted for filing and suspended, to become effective June 1, 2005, subject to refund and subject to further order of the Commission.

(B) Pursuant to the authority of the Interstate Commerce Act, particularly section 13(1) and 15(1) thereof, and the Commission's regulations, a hearing is established to address the issues raised by SFPP's filing.

(C) A Presiding Administrative Law Judge (ALJ), to be designated by the Chief Administrative Law Judge, for the purpose pursuant to 18 C.F.R. § 375.302 (2005), shall convene a prehearing conference in this proceeding to be held within 20 days of the issuance this order in a hearing or conference room of the Federal Energy Regulatory Commission, 888 First Street, N.E., Washington, D.C. 20426. The prehearing conference shall be held to clarify the positions of the participants, and for the ALJ to establish any procedural dates for the hearing. The ALJ is authorized to conduct further proceedings pursuant to this order and the Commission's Rules of Practice and Procedure.

By the Commission.

(S E A L)

Linda Mitry,
Deputy Secretary.