UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

INITIAL DECISION

(Issued September 25, 2006)

APPEARANCES

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Gordon Gooch, Esq. and *Elisabeth R. Myers, Esq.* on behalf of BP West Coast Products LLC and ExxonMobil Oil Corporation.

Melvin Goldstein, Esq. and *Matthew Corcoran, Esq.* on behalf of Tesoro Refining and Marketing Company.

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H. PETER YOUNG, Presiding Administrative Law Judge

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I. BACKGROUND/PROCEDURAL HISTORY

1. SFPP, L.P. (SFPP) is a jurisdictional entity that operates various pipelines transporting petroleum products throughout Texas, New Mexico, Arizona, Oregon, California and Nevada. The instant proceeding concerns only SFPP's North Line, which runs between Concord, California and Reno/Fallon, Nevada. In 2001, SFPP undertook to replace a segment of 14" diameter North Line pipe running from Concord to Sacramento, California with 20" diameter pipe. SFPP also relocated most of the new Concord-Sacramento segment to what it determined to be a less populated/less environmentally-sensitive route.

2. On April 28, 2005, SFPP filed tariff FERC No. 111 to increase its North Line rate to reflect the cost of replacing the Concord-Sacramento segment. BP West Coast Products, L.L.C. and ExxonMobil Oil Co. (together, BP/EM), Chevron Products Co., ConocoPhillips Co. and Valero Marketing and Supply Co. (collectively, CCV) and Tesoro Refining and Marketing Company (Tesoro) protested the April 28, 2005 filing on numerous grounds. These include allegations that: (1) SFPP had maintained the North Line imprudently; (2) the new 20" segment does not benefit interstate shippers; (3) the filing reflects inadequate cost support; and (4) SFPP used inappropriate throughput data to calculate the new North Line rate. Instant Docket No. IS05-230-000 is limited to the April 28, 2005 SFPP filing and the specified protests. The issues presented here cannot be resolved in such isolation, however.

3. This case is but one in a protracted series of litigation between SFPP and certain SFPP shipper customers stretching back to November 1992—a number of which remain pending before the Commission in some context or other. These disputes concern various SFPP pipelines (separately or in combination) and different timeframes, but commonly involve the same shippers and issues. The several proceedings impact one another dynamically, rendering their common issues ever more convoluted and inextricable as each persists before the Commission.

4. The additional circumstance that SFPP's capital and ownership structures have morphed markedly over the intervening years of litigation complicates matters further still. SFPP was an oil pipeline limited partnership owned by Santa Fe Southern Pacific Railroad (SFSPR) when the first complaints were filed in 1992. From 1988 through early 1998, the SFPP/SFSPR corporate relationship and capital structure remained materially unchanged: SFSPR maintained two general partnership interests and 47 percent of the limited partnership interests in SFPP through a series of wholly-owned subsidiary corporations. In March 1998, however, SFPP was acquired by KinderMorgan Energy Partnership (KMEP), a master limited partnership (MLP) already controlling several

other jurisdictional entities.[1] KMEP's acquisition of SFPP resulted in significant changes to SFPP's capital structure and balance sheet, as well as a materially different and more complex SFPP ownership structure. These changes/differences are pertinent because they are responsible in significant degree for the enduring intractableness of the issues presented both here and in the other cases with which this proceeding is intertwined.

5. The North Line was among the pipelines subsumed in a set of "global" complaints filed in 1996 against all SFPP pipelines in Docket No. OR96-2, *et al.* Later in 1996 and in 1997, shippers filed additional complaints challenging all of SFPP's FERC-jurisdictional rates and charges, including those of the North Line. *ARCO Products Co. v. SFPP, L.P.*, 82 FERC ¶ 61,043 (1998). The Commission subsequently consolidated these latter complaints into Docket No. OR96-2, *et al.*, but held the entire consolidated proceeding in abeyance because it presented essentially the same or similar issues to those still pending from the original 1992 complaints in Docket No. OR92-8, *et al.* In 2000, amended and new complaints were filed and set for hearing by the Commission. *SFPP, L.P.*, 91 FERC ¶ 61,142 (2000); *ARCO Products Co. v. SFPP, L.P.*, 92 FERC ¶ 61,244 (2000). Two more rounds of "global" complaints against all SFPP pipelines—including the North Line—followed in 2003 and 2004. These complaints were consolidated into a new Docket No. OR03-5-000; issues confined to the North Line and SFPP's Oregon Line were set for hearing in Docket No. OR03-5-001. *Chevron Products Co. v. SFPP, L.P.*, 114 FERC ¶ 61,133 (2006). That docket involves a different test year than the instant docket, but again presents essentially the same issues. The other referenced (and still pending) proceedings present at least some of those issues as well.

6. Compounding the various North Line/SFPP proceedings' entanglement with one another is the fact that a number of opinions not specifically addressing the North Line or SFPP arguably have profound implications for both. The most germane of these to the instant case trace the Commission's evolving tax allowance policy. They include, in chronological order: *City of Charlottesville v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985) (*City of Charlottesville*); *Lakehead Pipeline Co., L.P.*, 71 FERC ¶ 61,338 (1995) (*Lakehead*), *reh'g denied*, 75 FERC ¶ 61,181 (1996) (*Lakehead II*); *SFPP, L.P*, Opinion No. 435, 86 FERC ¶ 61,022 (1999), *order on reh'g*, Opinion No. 435-A, 91 FERC ¶61,135 (2000), *order on reh'g*, Opinion No. 435-B, 96 FERC ¶ 61,281 (2001), *order on reh'g*, Opinion No. 435-C, 97 FERC ¶ 61,138 (2001); *BP West Coast Prods., LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) (*BP West Coast*); *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (*Policy Statement*); *SFPP, L.P*, 111 FERC ¶ 61,334 (2005) (June 1 Order); *SFPP, L.P*, 113 FERC ¶ 61,277 (2005) (December 16 Order).

[1] KMEP's general partner is Kinder Morgan GP, Inc. (KMPG), a non-jurisdictional subchapter C corporation.

7. In *BP West Coast*, the U.S. Court of Appeals reversed and remanded Commission orders in Docket No. OR92-8, *et al.* Though not concerned with North Line rates specifically, those orders had granted SFPP an income tax allowance under the tax allowance policy established in *Lakehead/Lakehead II* despite the fact that SFPP, a limited partnership pass-through entity, did not itself actually pay any income taxes.[2] The court, however, found that granting an income tax allowance to an entity that did not itself pay any costs the allowance was intended to reimburse was impermissible, and remanded the issue to the Commission for further action. The *Policy Statement* was issued in response to the *BP West Coast* remand, and was based in substantial part on comments received by the Commission in response to a general notice of inquiry concerning the appropriateness of granting income tax allowances to regulated utility partnerships or similar pass-through entities.[3] In it, the Commission stated that a pass-through entity legitimately may claim an income tax allowance if its owner(s) can demonstrate an "actual or potential income tax liability on the public utility income earned through the [ownership] interest." *Policy Statement* at P 1.

8. The June 1 Order also was issued in response to the *BP West Coast* remand, and indicated that the Commission would apply the *Policy Statement* instead of *Lakehead/ Lakehead II* in Docket No. OR92-8, *et al.* and Docket No. OR96-2, *et al.* The December 16 Order, in turn, examined whether SFPP had satisfied the *Policy Statement* standard for claiming income tax allowances in those dockets.[4] The Commission concluded the record was insufficient in that regard due to changes made to the applicable legal

[2] The prior policy, established in *City of Charlottesville*, presupposed corporate ownership of a jurisdictional pipeline by a tax-paying subchapter C corporation, and determined the pipeline's tax allowance in accordance with the corporate owner's income tax liability attributable to the pipeline's jurisdictional activities. The policy essentially imputed the income tax liability stemming from the pipeline's jurisdictional activities as a "second-tier" cost to the corporate owner(s), and granted the pipeline a pass-through rate allowance to reimburse the corporate owner(s) for paying a commensurate income tax. The policy did not contemplate jurisdictional pipeline ownership by pass-through entities that themselves paid no tax on the pipeline's jurisdictional activity income. *Lakehead/ Lakehead II* essentially imputed the income tax liability attributable to the pipeline's jurisdictional activities as a "third-tier" cost to the pass-through entity's corporate owner(s) in proportion to percentage ownership interest.

[3] *Inquiry Regarding Income Tax Allowances*, Docket No. PL05-5-000, Request for Comments (December 2, 2004).

[4] The December 16 Order also addressed a number of other relevant cost-of-service issues, including SFPP's return on equity (ROE), capital structure, Purchase Accounting Adjustments (PAA), debt categorization, and overhead and litigation cost allocations.

standard after the record had closed, and directed SFPP to file additional information to assist the Commission in determining the appropriate allowance. The *Policy Statement*, June 1 Order and December 16 Order all were issued during the course of the instant proceeding—the December 16 Order just weeks prior to hearing commencement.[5]

9. The hearing was conducted from January 24, 2006 through February 16, 2006. The evidentiary record closed on March 8, 2006. Initial briefs were filed on April 3, 2006; reply briefs were filed on April 24, 2006.

II. ISSUE ANALYSES

A. Is SFPP's North Line Expansion In California "Used And Useful" To Interstate Service?

<u>Participant Positions</u>

SFPP

10. SFPP contends as a threshold matter that Concord-Sacramento replacement segment costs are recoverable in North Line rates because the new segment is "used and useful" to North Line interstate service. On SFPP's account, the Commission employs the "used and useful" test exclusively to ensure that utility rate base only includes assets that actually have been put into service. SFPP argues the "used and useful" standard has been satisfied insofar as the 20" Concord-Sacramento replacement segment is concerned because the segment has been completed and currently is utilized to ship every barrel transported under the North Line rates at issue in this proceeding.

11. SFPP dismisses Commission Trial Staff (Trial Staff) and BP/EM allegations that the 20" Concord-Sacramento replacement segment fails the "used and useful" test. SFPP first reiterates its contention that the 20" segment necessarily satisfies the "used and useful" standard because every interstate barrel the North Line transports passes through it. In addition, SFPP maintains that it replaced the old 14" segment because the pipe was aging, not to increase capacity. It argues no participant has demonstrated that replacing the 14" segment was unnecessary, and that the 20" replacement segment is "used and useful" on additional bases as well: interstate shippers currently benefit from the 14" to 20" capacity expansion, and population growth trends likely will lead to increased interstate throughput in the future.

12. SFPP argues further that no participant has demonstrated the old 14" Concord-Sacramento segment was imprudently maintained. SFPP states that although Tesoro

[5] No participant requested leave to supplement the record in this proceeding to address the December 16 Order prior to hearing commencement.

introduced U.S. Department of Transportation (DOT) documents discussing releases from various SFPP lines, the documents do nothing to establish SFPP imprudence because they neither evaluate SFPP's management decisions/maintenance practices nor demonstrate that SFPP failed properly to maintain the pipeline.

13. SFPP also contends the underlying decision to construct the 20" Concord-Sacramento replacement segment was prudent. SFPP submits that a party claiming costs to have been imprudently incurred must establish "serious doubt" with respect to prudence by showing some standard of good engineering judgment or some norm of prudent utility behavior was violated. SFPP emphasizes that an affirmative burden to establish prudence is imposed on the utility only after a challenging party establishes such doubt. SFPP maintains no participant has demonstrated that SFPP acted imprudently either in deciding to build or in constructing the 20" replacement segment. According to SFPP, just the opposite is true: the record reflects unrebutted evidence demonstrating it was prudent for SFPP to replace the old 14" pipe with a relocated 20" segment.

Trial Staff

14. Trial Staff asserts SFPP has failed to demonstrate the Concord-Sacramento replacement segment is "used and useful" in providing interstate service. Trial Staff notes the old 14" segment had adequate capacity to satisfy past and present interstate shipper demands, adding SFPP has demonstrated neither that the replacement segment reduces costs to such shippers nor that they receive any benefit from the new segment's expanded capacity. Trial Staff also alleges that SFPP purposefully conflates the "used and useful" test with the "prudence" test in an attempt to support the inappropriately narrow rate recovery inquiry SFPP advocates. On Trial Staff's account, a prudently constructed asset may fail the "used and useful" test, and the fact that an asset is used to provide a service does not necessarily render it useful in providing that service.

BP/EM

15. BP/EM also assert the Concord-Sacramento replacement segment is not "used and useful" in providing North Line interstate service. BP/EM first characterize SFPP's emphasis on prudence as a "straw man" argument intended to divert attention—and the burden of proof—away from the appropriate "used and useful" analysis and SFPP. This point notwithstanding, BP/EM submit that if prudence is to be considered, it should be done in the context of whether SFPP's pre-replacement management decisions, pipeline operations and maintenance practices were responsible for the 14" segment's deterioration in the first place, not whether it thereafter was prudent for SFPP to replace and relocate the deteriorated segment. Turning to the "used and useful" issue, BP/EM underscore the circumstance that replacing the old 14" Concord–Sacramento segment with a 20" segment did not increase North Line capacity east of Sacramento—i.e. the

line's interstate capacity. BP/EM thus claim the new 20" Concord-Sacramento segment leaves interstate shippers in an identical situation to when they shipped on the old 14" segment and, as a consequence, neither the new pipe nor its increased capacity legitimately may be characterized as useful to interstate shippers. BP/EM therefore conclude that any increased cost associated with the new segment cannot be reflected in North Line interstate rates because the segment fails the "used and useful" test. Instead, BP/EM argue that interstate shippers should continue to pay the rates they paid to ship on the old 14" segment.

Tesoro

16. Tesoro initially deferred to other shippers and Trial Staff on this issue, but on reply brief argues the Concord-Sacramento replacement segment fails the "used and useful" test because that test is part of the prudent investment theory, and reasonable utility management would not have incurred the replacement costs at issue. Tesoro concedes that SFPP's decision to construct the 20" replacement segment was motivated by problems on the 14" segment, but attributes those problems to imprudent SFPP pipeline management and maintenance. Moreover, according to Tesoro, SFPP inadequately manages and maintains the 20" replacement segment as well. Tesoro relies on extensive DOT hazardous release documentation to support these claims. This evidence, in Tesoro's view, conclusively demonstrates that SFPP imprudence underlay the need to replace the old 14" segment and, by extension, no part of the 20" replacement segment should be deemed useful to North Line interstate shippers.

Discussion/Analysis

17. The "used and useful" standard is an element of the "prudent investment" theory, and generally prescribes that an asset may be included in utility rate base only if the asset provides current service to the ratepayers who are asked to pay for it. *See, e.g., New England Power Co.*, 42 FERC ¶ 61,016 at 61,078 (1988). Strictly speaking, the "used and useful" standard is subsumed within the broader "prudent investment" standard, not the other way around. This implies that BP/EM is correct in taking the position that prudence is not at issue here. The Joint Stipulation of Contested Issues controlling the parameters of this proceeding supports the same conclusion. It specifies as the threshold issue "Is SFPP's North Line Expansion in California 'Used and Useful' to Interstate Service?" Tr. 74. Nowhere does it suggest a prudence component to the used and useful inquiry.[6] *Id.* at 74-92. Still, it is difficult to conceive how the 20" replacement segment

[6] The Joint Stipulation of Contested Issues addresses prudence in the context of SFPP's *system-wide* security and integrity maintenance history under Issue E. In addition to imposing the entire cost of replacing the 14" Concord-Sacramento segment on SFPP, Tesoro proposes specific disallowances for environmental management and remediation expenses from SFPP's proposed cost of service and a return on equity (ROE) at the low

legitimately could be deemed "used and useful" to current ratepayers if it was unnecessary in the first instance for SFPP to replace/relocate the old 14" segment. The same holds true if imprudent SFPP management, operation or maintenance of the 14" segment compelled SFPP to replace/relocate it. I therefore find and conclude the "used and useful" inquiry here necessarily must be split into three sub-inquiries: (1) whether it was prudent for SFPP to replace/relocate the 14" segment when it elected to do so; (2) if yes, whether SFPP was compelled to replace/relocate the 14" segment due to its own prior imprudent management, operation or maintenance practices; and (3) if SFPP did not imprudently manage/operate the 14" segment, whether the 20" replacement segment is currently "used and useful" to interstate shippers.

18. The Commission's prudence standard is grounded in the principle the Commission should not replace a utility's business judgment with its own through the benefit of hindsight. *See, e.g., Indiana and Mich. Mun. Distrib. Ass'n.*, 62 FERC ¶ 61,189 at 62,238 (1993). Accordingly, a utility requesting a rate increase is not initially required to demonstrate that the underlying costs were prudently incurred. *Id.* at 62,239. Any party challenging the utility's cost incurrence instead bears an initial burden to undermine the presumption that the costs were prudently incurred. *Id.* If the challenger creates "serious doubt" with respect to prudence, the burden shifts to the utility to demonstrate that reasonable management would have incurred the contested costs under the circumstances prevailing at the time. *Id.*; *Midwestern Gas Transmission Co.*, 30 FERC ¶ 61,260 at 61,543 (1985). Trial Staff, BP/EM and Tesoro have failed to create such doubt insofar as SFPP's decision to replace/relocate the 14" Concord-Sacramento segment is concerned. In fact, the record affirmatively demonstrates it was prudent for SFPP to replace/relocate the segment.

19. The 14" Concord-Sacramento segment was placed in service in 1967, and therefore was 34 years old when SFPP decided to replace it in 2001. Ex. SFN-1 at 2. In the interim between 1967 and 2001, the 14" segment's route became much more densely populated; certain sections also ran through areas that at some post-construction point(s) in time were determined to be environmentally sensitive. *Id.* at 3. In addition, the old 14" pipe experienced several releases that, while hazardous to both humans and the environment, also were expensive to remediate and subjected SFPP/KMEP and to criminal and civil penalties. *Id.* at 3-4; Ex. TES-22; Ex. TES-28; Ex. TES-36; Ex. TES-38; Ex. TES-39; Tr. 655-56; 694-702. There is, in fact, evidence the 14" segment was in such poor condition that it presented an imminent threat to life, property and the environment. It is difficult to imagine how SFPP management prudently could have done

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end of the appropriate proxy group under Issue E. Trial Staff advocates excluding criminal or civil penalties or fines associated with imprudent construction or maintenance on the North Line in its entirety under that issue. Neither Tesoro nor Trial Staff addresses prudence in the specific context of either the 20" replacement segment or the old 14" segment under Issue E.

anything but replace and relocate the 14" segment in light of the prevailing circumstances.

20. Tesoro and BP/EM allege the 14" Concord-Sacramento segment's poor condition was attributable to SFPP's imprudent North Line operation and maintenance practices. If true, these allegations would nullify any conclusion that the costs of replacing/relocating the 14" segment were prudently incurred and therefore should be reflected in North Line rates. Although it undoubtedly was prudent for SFPP to replace/relocate the deteriorated 14" pipe in 2001, it would be inappropriate to include the cost of doing so in rates if imprudent SFPP management decisions, pipeline operations and maintenance practices were responsible for the 14" segment's deterioration in the first place. The record before me, however, provides inadequate support for the conclusion imprudent SFPP management decisions, pipeline operations or maintenance practices were the proximate cause of the 14" segment's deterioration, hence the need to replace/relocate it.

21. There is no suggestion the 14" segment was improperly routed in 1967. SFPP therefore cannot reasonably be held responsible for subsequent population growth along the old 14" segment's route. Neither can it reasonably be held responsible for post-1967 determinations that the old 14" segment traversed environmentally sensitive areas. It follows that any incremental costs exclusively attributable to the need to relocate the Concord-Sacramento segment cannot be deemed imprudent—even if the cost of replacing the deteriorated 14" pipe is deemed imprudent.

22. The evidence concerning SFPP's pipeline operation and maintenance practices is suggestive of imprudence but does not establish "serious doubt" with respect to prudence—particularly insofar as the old 14" segment is concerned. Most of the documents submitted to establish imprudent SFPP pipeline operation or maintenance practices implicate the 20" replacement segment, other North Line segments or discrete SFPP pipelines rather than the 14" segment to which the instant inquiry necessarily must be directed. *See generally* Ex. TES-28; Ex. TES-29; Ex. TES-37; Tr. 652-62. *See also* Ex. TES-20; Ex. TES-21; Ex. TES-22. Moreover, the evidence specifically directed to the 14" segment generally documents hazardous releases attributable to outside mechanical force (i.e. third-party) damage or pipeline corrosion. *See, e.g.,* Ex. TES-28 at 2-3. That evidence reflects some criticism of SFPP failures to *detect* such damage and corrosion, but it does not attribute those failures to SFPP neglect, charge any SFPP misfeasance in maintaining or operating the 14" segment or allege any pipeline integrity management rule violations. Ex. TES-28 at 1, 3; Ex. TES-36. As a consequence, it does little to demonstrate SFPP imprudence insofar as the 14" Concord-Sacramento segment is concerned. Even the single relevant event for which SFPP admitted accountability by pleading guilty to two misdemeanor counts of discharging diesel fuel into an environmentally sensitive marsh and two additional misdemeanor counts of failing promptly to report the spill proves nothing more than the empirical facts the discharge

occurred and SFPP conceded it had failed to report the discharge in a timely manner.[7] *See* Ex. TES-28 at 1, 3; Ex. TES-38; Ex. TES-39. I therefore find and conclude the record before me falls far short of establishing "serious doubt" as to whether SFPP's 14" Concord-Sacramento segment operation or maintenance practices were prudent. It follows that the cost of replacing (in addition to relocating) the 14" segment may be included in North Line interstate rates provided SFPP[8] demonstrates the replacement segment is currently "used and useful" to North Line interstate shippers.

23. I reject as overly liberal the "used and useful" interpretation proposed by SFPP. SFPP essentially contends the "used and useful" standard is satisfied if an asset is merely constructed and placed into service. This interpretation is patently incorrect since it would reduce the "used and useful" standard to a single prong (i.e. "used") standard. As Trial Staff correctly points out, an asset may be used to provide service without being useful in providing the service. The question here is not whether the 20" replacement segment is used to provide interstate service on the North Line. The replacement segment is undeniably a *sine qua non* of current interstate service since every interstate barrel shipped over the North Line must first pass through the Concord-Sacramento portion of the pipeline. Ex. SFN-1 at 2; Ex. BPX-45. The question here concerns whether the 20" replacement segment is currently used *and useful* in providing interstate service.

24. BP/EM and Trial Staff emphasize the fact that expanding the Concord-Sacramento segment's capacity from 14" to 20" did not increase the North Line's interstate capacity because SFPP did not expand the capacity of any other North Line segment east of Sacramento.[9] Since each of these segments has less than 14" of capacity,[10] BP/EM and Trial Staff conclude that none of the 20" replacement segment's expansion capacity conceivably may be deemed either used or useful to current interstate ratepayers.

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[7] SFPP claims it entered into a plea bargain on these four counts to avoid further litigation. Ex. SFN-1 at 4. Notably, the permitting process to relocate the Concord-Sacramento segment to its present route was long underway when the discharge occurred in April 2004. *Id.*

[8] In contrast to the preceding prudence inquiries, in which the initial burden of proof fell on those alleging imprudence, the "used and useful" inquiry imposes the burden of proof on the rate inclusion proponent: SFPP.

[9] BP/EM contends that the 20" replacement segment actually reduced North Line interstate capacity because a Sacramento booster station was shut down as unnecessary to serve current interstate demand. *See* Tr. 803. I do not find this contention persuasive.

[10] The North Line segments east of Sacramento have capacities ranging from as little as six inches to as much as twelve inches.

25. SFPP counters that the 20" replacement segment is "used and useful" to interstate shippers because: (1) interstate demand is expected to increase due to projected population growth east of Sacramento; (2) the incremental cost of constructing a 20" replacement segment more than doubled the Concord-Sacramento segment's actual transportation capacity and therefore was more cost-effective than constructing a 14" replacement segment; (3) the 20" replacement segment enhances overall North Line reliability because the 20" segment will require less major maintenance than the original 14" segment; (4) the 20" replacement segment has lower power and drag reducing agent (DRA) costs than the 14" segment; (5) the 20" replacement segment reduces the probability that over-subscription on the intrastate (Concord-Sacramento) segment of the North Line will result in pro-ration to interstate (east of Sacramento) destinations.[11] SFPP adds it would be inequitable—and a windfall to interstate shippers—to impose the entire cost of the 20" replacement segment on intrastate shippers since it is impossible to provide North Line interstate service without using the Concord-Sacramento segment.

26. The applicable standard is whether the 20" replacement segment is presently "used and useful" to interstate shippers. I therefore reject any contention that the 20" replacement segment satisfies the standard on account of anticipated increases in interstate demand or reduced probability that intrastate over-subscription prospectively may result in interstate pro-ration. These are speculative *future* events, and therefore establish no present use or usefulness to interstate shippers.[12] The same holds true for any cost efficiency associated with SFPP's decision to more than double the Concord-Sacramento segment's actual transportation capacity by investing in a 20" replacement pipe instead of a 14" pipe. That investment very well may have secured SFPP and interstate shippers future cost savings. Potential—even probable—future cost/rate savings, however, do not satisfy the present use requirement. Similar reasoning applies to the claim that 20" replacement segment enhances overall North Line reliability because it will require less major maintenance than the original 14" segment. First, this claim begs the question of why a 14" replacement segment would not achieve the same result. Second, the claim is again prospective and speculative: although it seems reasonable to presume a new pipe will have fewer major maintenance problems than a 34-year-old one, there is no way currently to determine whether time will bear out this presumption, and the record suggests just the opposite. *Compare* Ex. TES-31 *with* Ex. TES-32 and *compare* Ex. TES-34 *with* Ex. TES-35. *See also* Ex. TES-37. Finally, it is uncertain whether SFPP's assertion that the 20" replacement segment has lower power

[11] SFPP artfully crafts some of these rationales to create the impression that it is contrasting the 20" replacement segment with a 14" replacement segment when in fact it is contrasting the 20" replacement segment with the old 14" pipe.

[12] There was no history of pro-rationing on the old 14" Concord-Sacramento segment. *See, e.g.*, Ex. TES-26 at 2 **[PROTECTED]**.

and DRA costs than the 14" segment applies to the old segment (which I suspect) or to a hypothetical 14" replacement segment—or if it would make any difference. This uncertainty aside, whatever marginally lower power and DRA costs might be attributable to a 14"/20" Concord-Sacramento segment capacity differential cannot by themselves provide sufficient justification for constructing a 20" segment instead of a 14" one—particularly in light of the fact that power/DRA costs have not been reduced on the interstate segments east of Sacramento.

27. What remains is SFPP's equity argument: it would be unfair, and a windfall to interstate shippers, to impose the entire cost of the 20" replacement segment on intrastate shippers when it is impossible for interstate shippers to receive North Line service without using the Concord-Sacramento segment. With this I agree. I previously ruled the costs associated with replacing and relocating the deteriorated 14" Concord-Sacramento segment were prudent. I therefore ruled those costs could be included in North Line interstate rates to the extent the replacement segment currently may be deemed used and useful to interstate shippers. The record reflects no suggestion the old 14" Concord-Sacramento segment was not "used and useful" to interstate shippers in its entirety. By extension, then, at least 14" of the replacement segment's transportation capacity reasonably may be deemed similarly "used and useful" since 14" of transportation capacity is exactly what the old segment provided.[13]

28. The replacement segment's six inches of incremental capacity is more problematic, but not on account of the "used and useful" standard. The incremental capacity clearly is not used to provide North Line interstate service at this time. Expanding the Concord-Sacramento segment's capacity from 14" to 20" did not increase North Line interstate capacity because SFPP did not concurrently expand the capacity of any other North Line segment east of Sacramento. Since each of these segments has less than 14" of capacity, interstate shippers cannot possibly use any of the replacement segment's six inch expansion capacity.[14] It follows that the costs associated with the expansion capacity may not be imposed on them. Excess capacity investment exaggerates current rate base, thereby producing artificially-inflated rates. This is precisely the result the "used and useful" standard is intended to preclude. It will be appropriate to include SFPP's excess capacity investment in North Line interstate rates

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[13] Any *qualitative* service differential cannot meaningfully be evaluated/quantified on the record before me. In addition, the potential objection that no North Line segment east of Sacramento has more than a 12" capacity was not raised and therefore may be deemed waived.

[14] Since both prongs of the "used and useful" standard must be satisfied, there is no need to belabor the analysis by discussing in the alternative why the expansion capacity fails the "useful" prong as well—though I expressly find and conclude that it does for the reasons stated in P 26, *supra*.

only if and when the associated capacity proves "used and useful" to interstate shippers—most likely when SFPP expands capacity on the North Line segments east of Sacramento. In the meantime, if SFPP desires to recover the cost associated with its 6" Concord-Sacramento expansion capacity investment, it must seek to do so from the only ratepayers who could possibly benefit from that investment at this time: intrastate shippers.

29. Problematic is how to quantify the costs attributable to only 14" inches of the replacement segment's capacity when the record has not been developed in a manner consistent with that objective. The simplest option would be to rule SFPP has failed to satisfy its burden of proof on this issue—which is technically accurate since SFPP made a case for including a 20" Concord-Sacramento replacement segment in rates, not a 14" segment—and deny any rate recovery whatsoever. Having determined it was prudent for SFPP to replace and relocate the old 14" Concord-Sacramento segment, however, it hardly seems just or reasonable to impose such a harsh result. A more equitable solution would be to permit only 70% (14/20) of the replacement segment costs to be included in North Line interstate rates. I nevertheless recognize this solution could easily either overcompensate or undercompensate the legitimate cost of replacing/relocating the 14" Concord-Sacramento segment to a significant degree. Accordingly, I believe the best course is to establish a rebuttable presumption that 70% of the replacement segment costs legitimately may be included in North Line interstate rates, and to require SFPP to make a prompt[15] compliance filing reasonably demonstrating the cost SFPP would have incurred had it constructed a 14" replacement segment instead of the 20" segment. I believe it is reasonable to establish a second rebuttable presumption that costs attributable to relocating the segment would not vary based on the 20"/14" capacity differential. And while interstate shippers should have a meaningful opportunity to rebut these presumptions in a concurrent or responsive filing,[16] I am loathe to prolong/complicate yet another SFPP docket's final resolution with further hearing procedures. Instead, the Commission should determine what—if any—adjustment to the 70% presumption is appropriate based on the compliance filings.

[15] Since SFPP failed to make the appropriate record on this issue, I do not consider it unreasonable to require the compliance filing within 45 days of the Commission order (or reconsideration order) concerning this Initial Decision.

[16] Any responsive filing should be required within a maximum of 45 days, and preferably within 30 days.

B. In Determining the Allowed Return in this Case, What is the Appropriate Rate Base?

1. Whether SFPP's Proposed Rate Base For Designing Its North Line Rate Is Justified And Appropriate? If Not, What Are The Appropriate Rate Base Modifications For Designing SFPP's Test Year North Line Rate?

Participant Positions

SFPP

30. SFPP asserts it calculated rate base in accordance with Commission oil pipeline ratemaking precedent. SFPP consequently maintains it has demonstrated its proposed rate base is justified, appropriate and should be used to calculate the North Line interstate rate.

Trial Staff

31. Trial Staff submits the appropriate rate base for oil pipelines is net depreciated trended original cost. On Trial Staff's account, pipelines constructed in 1983 or before are entitled to add new assets to rate base at original cost so long as a one-time adjustment is made to account for a change from the reproduction cost methodology utilized by the Interstate Commerce Commission (ICC) when that agency regulated oil pipelines. The adjustment involves (i) multiplying debt ratio against depreciated original cost and (ii) multiplying equity ratio against depreciated reproduction cost—the sum of the two operations comprising the starting rate base.[17] Except as argued under specific rate base sub-issues, *infra*, Trial Staff accepts SFPP's proposed rate base as justified and appropriate in designing a test year North Line rate.

CCV

32. CCV also accept SFPP's proposed test year North Line rate base, save two exceptions discussed under specific rate base sub-issues: (1) the 1998-2004 capital structure calculations impacting SFPP's deferred return calculation; and (2) the amortization rate calculation.

BP/EM

33. BP/EM address this issue only insofar as they contend the 20" Concord-Sacramento replacement segment fails to satisfy the "used and useful" standard and

[17] The same depreciation percentage is used in both components of the adjustment.

therefore must be excluded from rate base in its entirety. BP/EM instead advocate restoring the costs removed from rate base due to the old 14" segment's retirement.

Discussion/Analysis

34. All but the issue addressed here by BP/EM are discussed subsequently under more specific topics. Insofar as that single issue is concerned, I previously ruled the 20" Concord-Sacramento replacement segment is "used and useful" to interstate shippers—albeit to an indeterminate degree at this stage. I therefore summarily reject BP/EM's contention that the cost of the 20" replacement segment must be removed from North Line rate base and substituted with the cost previously removed due to the old 14" segment's retirement. The appropriate rate base for calculating North Line interstate rates presumptively shall include 100% of the cost associated with relocating the Concord-Sacramento segment and 70% of the cost of associated with constructing the 20" replacement segment, as those figures may be adjusted by the Commission upon consideration of the previously-specified compliance filings.

2. Whether SFPP's Proposed Starting Rate Base For Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Cost-Of-Service Treatment For SFPP's Starting Rate Base In Designing SFPP's Test Year North Line Rate?

35. The Commission adopted a trended original cost (TOC) rate base formula in *Williams Pipe Line Company*, 31 FERC ¶ 61,377 (1985) (Opinion No. 154-B). The TOC formula replaced the valuation formula previously applied to oil pipelines by the ICC. The transition required the Commission to establish a going-forward value or "starting rate base" (SRB) for existing plant by making a one-time upward adjustment. The adjustment essentially multiplies equity rate base by the rate of return inflation factor to derive a rate base "write-up." The pipeline amortizes this write-up over the existing plant's remaining life in the same manner as depreciation; it also is allowed to earn a return on the write-up balance until the balance is fully amortized.

Participant Positions

SFPP

36. SFPP maintains it calculated the SRB write-up in accordance with Opinion No. 154-B.[18] It vigorously disputes the Trial Staff/Tesoro suggestion that the write-up should not be included in rate base simply because it will be fully amortized in late 2008. According to SFPP, the amount of time remaining until the write-up balance fully

[18] SFPP concedes the calculation reflects a $29,000 error identified by Trial Staff. Ex. S-4 at 85-86 **[PROTECTED]**; Ex. SFN-49 at 31-32.

amortizes is crucial in determining whether that rate component should be removed. SFPP stresses that in this case the write-up will not be fully amortized until over three and one-half years after SFPP filed the North Line rate at issue. It submits that excluding the write-up in this circumstance equates to converting a 25 year amortization period into a 21 year period. SFPP adds that the Commission's test period principles contemplate adjustments for known and measurable changes that will occur up to only nine months after the end of the base period, not for changes occurring approximately four years after the base period ends.

Trial Staff

37. Trial Staff opposes including the SRB write-up in rate base. Instead, it advocates imposing a declining annual surcharge on ratepayers to recover the equivalent of the write-up return balance over four years. Trial Staff analogizes the write-up balance to a non-recurring item, also emphasizing it is a comparatively minor and declining rate base component. Trial Staff maintains that including this declining/foreseeably expiring component in rate base will artificially (and indefinitely) inflate North Line rates because the base period balance will continue to generate undiminished return until the line's next rate case—potentially long after the write-up is fully amortized. Trial Staff underscores the fact the Commission adopted a similar surcharge for an expiring East Line rate component in Opinion No. 435-B.

Tesoro

38. Tesoro echoes Trial Staff's suggested imposition of a declining annual surcharge to recover the write-up return balance over four years.[19] Tesoro disputes SFPP's contention that excluding the write-up because it will be fully amortized in late 2008 equates to converting a 25 year amortization period into a 21 year period, claiming the contention ignores Staff's proposed surcharge.

Discussion/Analysis

39. SFPP accepts Trial Staff's $29,000 adjustment to the SRB calculation. Ex. SFN-49 at 31-32. I therefore find and conclude the adjustment is appropriate. In contrast, I consider Trial Staff's proposal to impose a four year declining annual surcharge on ratepayers in lieu of reflecting the SRB write-up in rate base to be inappropriate. Trial Staff's attempt to analogize the write-up to a non-recurring charge is unavailing. It has been reflected in North Line rates for more than 21 years. Tr. 2037-38. The fact that less than four years of the initial 25 year amortization period now remain does not transform the write-up into a non-recurring item. True, the write-up balance declines annually, and this characteristic will inflate North Line return on equity to some degree because the

[19] Tesoro also cites the calculation error referenced in footnote 18, *supra*.

embedded base period figure will remain constant while the write-up continues to amortize. But Trial Staff itself concedes that the embedded write-up is small in any event—indeed, this is Trial Staff's principal justification for removing it from rate base. Moreover, the interim until SFPP will file its next North Line rate case is pure speculation at this point.[20]

40. More important, removing the SRB write-up from North Line rate base at this time would contravene one of the most integral Commission ratemaking principles. The purpose of the Commission's base/test year benchmarks is to provide a reasonable prospective framework to set rates. The framework anticipates that rates may be skewed by future events. It therefore specifies a nine month test period within which reasonably known and measurable future changes may impact rate base/return on equity. *See* 18 C.F.R. § 346.2 (a) (1) (ii) (2006). Known and measurable changes falling outside this nine month period presumptively may not be considered—except, for good cause shown, the Commission may allow reasonable deviation from the nine month limitation. *Id.* Key here is the *reasonable* proscription. A workable ratemaking paradigm requires rate base to be determined at some reasonably fixed point in time. Although it may have been quite reasonable for the Commission to have deviated from the nine month limitation by three months under arguably analogous circumstances in Opinion No. 435-B, the deviation which Trial Staff advocates here is somewhere between 3½ and 4 years. If that is appropriate, why not 5 years? Why not 10? The obvious answer is ratemaking requires some reasonable limitation on taking future events into account. Commission regulations establish the presumptive limitation at nine months. The record before me provides no legitimate basis to deviate from it to the degree Trial Staff advocates. I therefore find and conclude the SRB write-up reflected in SFPP's filing should be used to calculate North Line rates in this proceeding.

[20] I note, however, that the record suggests such a filing will happen sooner rather than later due to projected population growth (and capacity expansion) on the North Line east of Sacramento—particularly in light of this Initial Decision's 6" excess capacity disallowance for the Concord-Sacramento replacement segment. Moreover, the Commission may act *sua sponte* at any time in the future if it believes North Line rates become unjust or unreasonable due to the SRB write-up component.

3. Whether SFPP's Proposed Inflation-Adjusted Deferred Return In Developing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Inflation-Adjusted Deferred Return For Designing SFPP's Test Year North Line Rate?

Participant Positions

SFPP

41. SFPP states Opinion No. 154-B requires the equity return inflation component to be extracted and amortized over the life of the pipeline rather than recovered in the year it was earned, asserting that its North Line deferred return calculation is consistent with the Commission's decisions in Opinion No. 435 and Opinion No. 435-A. SFPP maintains Trial Staff's interpretation of those opinions is flawed, and Trial Staff's recommended inflation rate is incorrect as a consequence. SFPP claims it demonstrated this flaw in rebuttal testimony which Trial Staff made no attempt to rebut through cross-examination.

Trial Staff

42. Trial Staff submits the Opinion No. 154-B ratemaking approach defers a portion of each year's equity return to future periods by applying an inflation factor to three variables: (1) the equity portion of original cost rate base, (2) net SRB write-up, and (3) accumulated net deferred return. On Trial Staff's account, the resulting deferred return is added to a future year's rate base as part of the accumulated net deferred return on which future return is calculated; current deferred return is simultaneously amortized over the pipeline's remaining life. Trial Staff emphasizes that deferred return is calculated by applying the prior year's inflation factor to the equity portion of that year's SRB write-up, but at the start of the current year. The calculus, according to Trial Staff, matches prior year inflation to prior year rate base. Trial Staff contrasts this scenario with SFPP's methodology, which it casts as mechanically miscomputing deferred return by matching current year inflation to prior year equity SRB. Trial Staff alleges that SFPP concedes the inflation factor and SRB write-up years must match, but does not compute inflation-adjusted deferred return in accordance with that concession.

CCV

43. Insofar as SFPP's capital structure relates to deferred return, CCV take the position that it should be adjusted to remove the 1988 PAA resulting from KMEP's acquisition of SFPP. CCV argue SFPP did not dispute this position on initial brief, and therefore should be deemed to have conceded and accepted the CCV position because SFPP was required to "open fully" on initial brief.

Discussion/Analysis

44. CCV's position concerning the 1988 PAA is addressed under Issue C-3. Accordingly, I will not discuss it here except to the extent CCV argue SFPP should be deemed to have conceded and accepted CCV's position because SFPP did not dispute that position on initial brief. SFPP addressed the 1988 PAA in its initial brief under Issue C-3. *See* SFPP IB at 19-20. Moreover, as I previously ruled in response to CCV's April 28, 2006 motion to strike/disregard portions of SFPP's reply brief for the same reason CCV raise here:

> SFPP was under no obligation in its initial brief to attempt to anticipate, address or rebut any testimony, evidence or argument which might have been advanced at hearing or in opposing initial briefs to undercut SFPP's case-in-chief. Bearing the burden of proof, the objective of SFPP's initial brief necessarily was to demonstrate that SFPP had satisfied the burden of affirmatively proving its case, not to answer challenges to that case...The appropriate place for SFPP to address such rebuttal evidence and argument was in its reply brief. This holds true irrespective of whether SFPP knew or reasonably could have anticipated the rebuttal evidence and argument advanced by other participants at hearing or in initial briefs.

Order on Motion to Strike or Disregard Portions of Reply Brief at P 2, Docket No. IS05-230-000 (May 3, 2006). I find and conclude SFPP satisfied its obligation to "open fully" on initial brief for all the preceding reasons.

45. I also reject Trial Staff's contention SFPP erred by not calculating each year's deferred return by multiplying the prior year's trended rate base by the prior year's inflation factor. First, Trial Staff's reliance on Opinion No. 154-B is misplaced. Opinion No. 154-B's *inflation rate discussion specifically states "[w]hat is important is that the* index used to decrease the nominal equity rate of return is also used to increase the equity rate base." 31 FERC at 61,835. Under Trial Staff's approach, however, the annual capitalized return component does not coincide with annual nominal return. Ex. SFN-49 at 34-35. And while Opinion No. 154-B states in a footnote that the prior year's inflation rate would be used as the current year's estimated rate—hence rate base would be written up at the start of the current year rather than the end—the footnote simply expands on the main text discussion concerning ***which*** inflation index should be used in the first place, and applies only if a CPI or GNP deflator is selected. 31 FERC at 61,835, n. 35. It does not mandate the calculus Trial Staff endorses. Further, Opinion No. 435 specifically addresses the inflation rate SFPP should apply—albeit in the context of the East and West Lines. That opinion states the inflation rate used to determine the portion of equity cost of capital that should be capitalized is "the actual inflation rate in the year in which the investment is made." 86 FERC at 61,091. SFPP logically has extended this same methodology to the North Line. Ex. SFN-28 at 9-10; Ex. SFN-49 at 34. It would be

inconsistent to do otherwise. I therefore find and conclude SFPP has applied the proper inflation rate in this case.

4. Whether SFPP's Proposed Methodology For Calculating Each Year's Deferred Return Is Justified And Appropriate? If Not, What Is The Appropriate Methodology For Calculating Each Year's Deferred Return In Designing SFPP's Test Year North Line Rate?

46. The income tax allowance now begins to complicate matters. Although the allowance is discussed in greater detail under subsequent issues, a simplified summary is attempted here. The income tax allowance impacts SFPP's debt/equity ratio (i.e. capital structure) for ratemaking purposes. The allowance skews the true capital structure in a manner that inflates the implied interest expense. This inflation artificially lowers the return on equity. The lower return on equity, in turn, under-recovers the income tax allowance. The Opinion No. 154-B/Opinion 435-A solution to this circular problem is to calculate the debt/equity ratio with deferred return—which has an embedded debt component—transferred entirely to the equity side of the TOC rate base.[21]

<u>Participant Positions</u>

SFPP

47. SFPP contends it calculated deferred return using the methodology prescribed in Opinion No. 154-B/Opinion No. 435-A. SFPP believes the only issue concerning its deferred return calculus not previously addressed under Issue A-3 is Trial Staff's proposal to depart from that methodology insofar as the adjustment to capital structure to account for deferred return is implicated. According to SFPP, Trial Staff proposes to use SFPP's actual capital structure to calculate the weighted cost of capital for determining both the overall return on rate base and the synchronized interest expense for income tax purposes. SFPP maintains Trial Staff's proposal runs contrary to the Opinion No. 154-B/Opinion No. 435-A prescription that deferred return should be treated as 100% equity as SFPP did in the North Line rate filing.

Trial Staff

48. Trial Staff concedes on initial brief that SFPP used the Opinion No. 154-B methodology except as previously discussed. On reply brief, however, Trial Staff adds

[21] The resulting capital structure has the desired effect of imputing the same interest expense for income tax and return on rate base purposes, but it increases both the weighted cost of capital and the overall return on capital. This increased return on capital is exclusively attributable to the income tax allowance and has appreciable rate impacts.

that the use of an adjusted capital structure to determine a cost of service[22] is inappropriate here because SFPP is not entitled to any income tax allowance. Trial Staff maintains denying SFPP's proposed $2,649,000 income tax allowance and adopting Trial Staff's recommended cost of capital—two rate components which Trial Staff characterizes as distinct from deferred return—would moot the instant issue.

Discussion/Analysis

49. I find and conclude Trial Staff concedes that: (1) the Opinion No. 154-B deferred return methodology is appropriate; and (2) SFPP generally has followed that methodology insofar as deferred return is concerned. What Trial Staff disputes is whether SFPP is entitled to incorporate its proposed cost of capital and income tax allowance into the deferred return rate component. Those questions are resolved in accordance with the findings and conclusions reached under Issues C and D of this Initial Decision. I note here, however, that I see no conceptual inconsistency between Trial Staff's proposal and the Opinion No. 154-B/Opinion No. 435-A prescription that deferred return should be treated as 100% equity. SFPP's North Line deferred return is a function of both SFPP's cost of capital and its income tax allowance. If the level of either of those components changes from what is reflected in the filing, the change(s) necessarily will affect the amount of deferred return that would be treated as 100% equity in accordance with Opinion No. 154-B/Opinion No. 435-A because the change(s) simultaneously affect the underlying capital structure on which deferred return is calculated. As I understand it, Trial Staff's proposal removes the income tax allowance, thereby altering the cost of capital and leaving SFPP to use its actual capital structure in applying the Opinion No. 154-B/Opinion No. 435-A methodology. Treating deferred return as 100% equity seems incoherent under these circumstances.[23]

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[22] Which implicitly subsumes the deferred equity component.

[23] I admit I find this issue confusing—a situation which the record does little to alleviate. I explain my understanding to provide the participants and the Commission with as clear a basis as possible for critique if my understanding—hence, the findings and conclusions it supports—is inaccurate.

5. Whether SFPP's Proposed Methodology For Calculating Its Test Period Amortization Rate Is Justified And Appropriate? If Not, What Is The Appropriate Methodology For Calculating Test Period Amortization For Designing SFPP's Test Period North Line Rate?

Participant Positions

SFPP

50. SFPP states it averaged year-end 2003 and end of test period property balances to derive a 3.31% amortization rate for test period AFUDC[24] and deferred return. SFPP submits this methodology "more accurately reflects test period principles" than using a year-end 2004 property balance, as Trial Staff and CCV advocate. Although SFPP concedes the Trial Staff/CCV approach is reasonable if correctly applied, SFPP contends this would require three modifications to CCV's calculations, two of which it notes Trial Staff endorses. SFPP maintains a correctly modified Trial Staff/CCV approach would increase SFPP's test period cost of service by $95,000.

Trial Staff

51. Trial Staff counters that SFPP erred in developing a composite amortization rate by averaging year-end 2003 and end of test period (i.e. September 30, 2005) property balances. On Trial Staff's account, this approach links a relatively high depreciation expense to a relatively low plant balance, thereby exaggerating the amortization rate and, as a consequence, the cost of service. Trial Staff attributes the exaggerated amortization rate to SFPP improperly skipping over the 2004 base period in deriving the rate. Trial Staff relies on what it characterizes as the proper 2004 base period and 2005 test period figures to derive a rate of 2.67%.

CCV

52. CCV echo Trial Staff's criticism that SFPP erroneously averaged year-end 2003 and end of test period property balances to derive the 3.31% amortization rate. CCV nevertheless agree with SFPP that the error's North Line cost of service impact is minimal.

Discussion/Analysis

53. I summarily reject SFPP's claim that averaging year-end 2003 and end of test period property balances to derive the amortization rate for test period AFUDC and deferred return is preferable here because it "more accurately reflects test period

[24] Allowance for Funds Used During Construction.

principles" (Ex. SFN-49 at 28) than using a year-end 2004 property balance. First, the record is devoid of any explanatory or evidentiary support for that claim. More important, Trial Staff/CCV are correct that ignoring the 2004 base period in this case conveniently couples a comparatively high depreciation expense to a comparatively low plant balance, resulting in an artificially exaggerated amortization rate. It is immaterial that the cost of service impact of applying SFPP's methodology may be negligible in this instance. The proper methodology should be used. I therefore find and conclude Trial Staff's methodology should be used to derive the amortization rate here.[25] Ex. S-4 at 88-89 **[PROTECTED]**; Ex. S-5 at 21.

6. Whether SFPP's Proposed Treatment Of Accumulated Deferred Income Taxes ("ADIT") In Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Treatment Of ADIT In Designing SFPP's Test Year North Line Rate?

<u>Participant Positions</u>

SFPP

54. SFPP states the ADIT reflected in its North Line rate filing was developed using the maximum corporate marginal income tax rates for all years. SFPP submits it is now necessary to adjust the ADIT reflected in the filing to conform to the income tax allowance specified in the December 16 Order. According to SFPP, the adjustment needs to be made beginning in 1989—the year the SFPP partnership initially was formed—since that is when SFPP's income no longer was wholly consolidated on a parent company's corporate income tax return, and consequently no longer would have been subject to tax at the presumptive maximum corporate marginal income tax rate under the December 16 Order.[26] SFPP maintains it did not present adjusted ADIT information in this proceeding because it would have been necessary to determine the weighted income tax rates for each year going back to 1989, a task which the December 16 Order directed SFPP to undertake in compliance filings due February 28, 2006.

55. SFPP asserts the required ADIT adjustments would have two effects on cost of service. First, they would increase rate base. This would increase deferred return, amortization of deferred return and allowed return on rate base—all of which would increase cost of service. Second, the adjustments would over-fund the portion of ADIT

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[25] I nevertheless agree with SFPP that Trial Staff's proposed test period amortization on the 2004 deferred return component should be doubled. Ex. SFN-49 at 29-30.

[26] The ADIT balances reflected in the filing are larger than they would be if calculated under the December 16 Order according to SFPP.

accrued at the maximum corporate marginal income tax rates prior to 1989. This is because a lower income tax rate would apply under the December 16 Order when the book tax timing differential reverses. SFPP suggests the over-funded amount should be amortized, with the annual amortization used to adjust the income tax allowance—likely reducing cost of service in SFPP's view. SFPP notes that annual changes to the weighted income tax rate under the December 16 Order could produce additional layers of over/under-funded ADIT depending on whether the rate decreases or increases. These additional layers would need to be amortized and used to adjust the income tax allowance on SFPP's account.

Trial Staff

56. Trial Staff emphasizes ADIT accounts for timing differences between actual tax liability computed using liberalized depreciation and book tax liability computed using straight-line depreciation. Trial Staff takes the position that because SFPP is a partnership which does not itself incur any tax liability, the tax liability timing differential for which ADIT accounts is meaningless insofar as SFPP's cost of service ratemaking for the rate-effective period is concerned. Trial Staff adds that any ADIT adjustments arising out of the December 16 Order's impact on the original SFPP rate filing in this case should be the subject of a compliance filing rather than being presented for the first time on rebuttal, as SFPP has done here.

CCV

57. CCV address this topic exclusively under Issue D-2.

BP/EM

58. BP/EM generally adopt the position that SFPP pays no income taxes, so it has none to defer. BP/EM first focus on the historical differentiation for ratemaking purposes between book depreciation and tax depreciation, noting that the differentiation survives from a time when the public utility model was purely corporate. BP/EM underscore the fact that tax depreciation occurs over a much shorter period than book depreciation and is accelerated even further by other mechanisms. The result, according to BP/EM, is that tax depreciation shelters more income from taxes than book depreciation does. The Commission mitigated this disparity's impact on ratepayers by requiring the differential to be deducted from rate base in the return calculus. It also required the differential to be deposited into an account representing prepaid utility income taxes—i.e. the ADIT account. BP/EM stress the ADIT account was no mere accounting mechanism; it accumulated actual dollars for the corporate utility by virtue of the income tax component embedded in rates. But the utility eventually would exhaust its tax depreciation, thereafter paying its corporate income taxes by drawing down the ADIT account—eventually to zero. BP/EM also point out that if the ADIT account accumulated more

than the corporation eventually would require to cover future income tax payments, the excess had to be flowed back to ratepayers.

59. BP/EM next point out what they characterize as the fatal flaw in SFPP's claim: it is not a corporation. SFPP has been a partnership since 1989. As such, SFPP itself pays absolutely no income taxes and logically cannot have any to defer. In fact, BP/EM argue, the circumstance that SFPP inappropriately has been collecting ADIT through rates since 1989 means a reckoning is required. BP/EM contend: (1) the ADIT account should be restored to its full amount by reincorporating the deductions proposed by SFPP; (2) since the ADIT account is over-funded, the entire account should be credited to income (as a negative) and as an offset to income tax liability (referencing Issue D-2-a); (3) the ADIT account should continue to be deducted from rate base (as it is now) until the account has been amortized sufficiently to offset any taxable income/income tax allowance; and (4) the cost of service should reflect the deduction of tax depreciation from the taxable allowed return proposed by SFPP (referencing Issue D-2-b).

Discussion/Analysis

60. I previously noted the December 16 Order was issued just weeks prior to hearing commencement in this docket. I also noted no participant requested leave to supplement the record here to address the December 16 Order's relevance to this proceeding prior to hearing commencement.[27] These are problematic circumstances for everyone involved. First, neither SFPP's North Line tariff filing nor its direct case in support of that filing accord with the order. This implies one of three alternatives: (1) SFPP's tariff filing and direct case should be evaluated without considering the December 16 Order; (2) SFPP's tariff filing and direct case should be evaluated with full consideration of the order—with which they are patently inconsistent through no fault of SFPP's; or (3) SFPP's tariff filing and direct case, as supplemented by its rebuttal case, should be evaluated in accordance with the December 16 Order. None of these alternatives is entirely satisfactory or equitable.

61. The December 16 Order specifically addresses both SFPP and many of the issues presented in this proceeding. Disregarding it surely will impede any consistent resolution among the various pending proceedings. Still, the December 16 Order was issued almost eight months after the North Line tariff filing and nearly four months after SFPP filed its direct supporting case. May SFPP reasonably be held responsible for failing to conform the tariff and direct supporting case to the order's specifications under these

[27] SFPP extensively referenced the December 16 Order in its January 5, 2006 rebuttal testimony. *See generally* Ex. SFN-43. Although this afforded the other participants no opportunity to challenge SFPP's reliance on the order in accordance with the procedural schedule, the hearing had been underway for two full weeks before anyone disputed its relevance/applicability here. *See* Tr. 1168-69.

circumstances? Clearly not. But should SFPP be permitted to conform its supporting case in a rebuttal context that precludes meaningful opportunity for challenge by other participants? Again, clearly not.

62. I find and conclude it would be inappropriate to disregard the *Policy Statement*, June 1 Order or December 16 Order for purposes of this proceeding. True, all were issued at inopportune points in this docket's procedural schedule and none specifically concerns the North Line. But the expediency in ignoring these intervening issuances is far outweighed by the fact that each is clearly relevant/arguably controlling here. And while it would be inequitable to penalize SFPP for failing to craft its proposed tariff and direct supporting case in accordance with subsequently issued Commission guidance/directives, it would be similarly inequitable to penalize opposing participants by permitting SFPP to preclude any meaningful opportunity for challenge by using its rebuttal case to make its direct supporting case by proxy. This holding should not be construed as approving SFPP's failure to seek immediate leave to amend its tariff filing/direct case upon issuance of the December 16 Order, or the earlier *Policy Statement* for that matter. Neither should it be construed as approving any challenging participant's failure to seek timely determinations with respect to *Policy Statement*/December 16 Order applicability here. Each side of the issue could (and should) have been more proactive in this regard, thus it would be inequitable to hold either side more accountable than the other.

63. I repeat I am loathe to prolong/complicate yet another SFPP docket's final resolution with further hearing procedures. But there appears to be no equitable alternative, save requiring SFPP to address *Policy Statement*/December 16 Order impacts on its proposed North Line tariff in the context of the compliance filing required under Issue A, *supra.*[28] This solution mitigates the harsh result of ruling SFPP has failed to satisfy its ADIT burden of proof—technically accurate here as well since SFPP filed a tariff and direct supporting case that calculated ADIT using the maximum corporate marginal income tax rates for all years, which is patently inconsistent with the *Policy Statement*/December 16 Order.[29] Moreover, SFPP already should have determined the requisite underlying weighted income tax rates for 1989 forward since the December 16 Order directed SFPP to submit that information in its February 28, 2006 compliance filings in Docket No. OR92-8 *et al.* and Docket No. OR96-2, *et al.* An ADIT compliance filing in accordance with the *Policy Statement*/December 16 Order also would afford opposing participants the meaningful opportunity to challenge SFPP's ADIT claim they

[28] This aspect of the compliance filing would be obviated by a final determination that SFPP is entitled to no income tax allowance.

[29] Even SFPP's rebuttal case fails to cure this deficiency because it lacks any adjusted ADIT data conforming to the December 16 Order. *See* Ex. SFN-43 at 20-21.

have thus far been denied.[30] I therefore find and conclude the ADIT issue should be resolved in the context of the compliance filing required under Issue A, *supra,* and in accordance with the following analyses—assuming SFPP is entitled to an income tax allowance.

64. SFPP maintains any ADIT adjustment grounded in a partnership income tax allowance should relate back to 1989, the first year SFPP operated in partnership form.[31] CCV and BP/EM counter that Commission policy restricts any such adjustments' effective date to the year a regulatory decision is made, in this case 2005. I agree with CCV and BP/EM. The Commission previously rejected an identical SFPP argument in Opinion No. 435, stating "Commission practice is to base its decision on the policy in effect in the year a regulatory decision is made, and then apply that decision to the time frame to which the case applies." 86 FERC at 61,093-94. The *Policy Statement* and December 16 Order both were issued in 2005. It follows that any allowable ADIT adjustments must be made prospectively, beginning on the June 1, 2005 rate effective date.[32]

65. I reject BP/EM's contention that the entire ADIT account should be credited as a negative to income and as an offset to income tax liability because the account is over-funded—at least at this point in the analysis. BP/EM's position implicates the *entire* ADIT account balance. That balance has been accumulating for many years, including years prior to 1989 when SFPP relied exclusively on corporate marginal rates to estimate its income tax liability. This circumstance indicates the account currently must be over-funded to *some* degree. SFPP has not paid income taxes at corporate marginal rates since it became a limited partnership in 1989. Moreover, the ADIT account is specifically designed to over-collect actual income tax liability in earlier years. Prematurely reducing or eliminating whatever total anticipated income tax liability the accelerated accrual was collected to pay in later years necessarily generates a surplus. Quantifying that surplus, however, requires knowledge of the income tax allowance SFPP ultimately will be granted. BP/EM's position is valid only if that allowance is zero. Any non-zero allowance implies income tax liability to be paid out of the ADIT account, therefore precluding the 100% ADIT account credit/offset BP/EM advocate. It follows that a

[30] I see no reason to extend the timeframes specified in footnotes 15 and 16 on account of the additional ADIT issue. I note, however, the December 16 Order establishes rebuttable presumptions which may shift the burden of proof on this issue.

[31] The SFPP limited partnership was formed December 18, 1988.

[32] Whether SFPP's proposed adjustments are quantitatively appropriate necessarily must be determined from the compliance filing since SFPP submitted no data to support the conceptual adjustments proposed in its rebuttal testimony.

ruling on what the appropriate credit/offset should be must be deferred until SFPP's income tax allowance is determined.

66. I agree with BP/EM that the ADIT account should continue to be deducted from rate base until the account has been sufficiently amortized to offset any taxable income/income tax allowance. This ensures shippers will not pay a return on cost-free deferred tax capital—a situation that is exacerbated to whatever degree the ADIT account is currently over-funded.

C. In Determining the Allowed Return in this Case, What Is the Appropriate Cost of Capital?

Participant Positions

SFPP

67. SFPP proposes to calculate its test year cost of capital using a target capital structure comprised of 60% equity and 40% long-term debt, then applying the Commission's DCF methodology to a set of five MLP oil pipelines "approved" as proxy companies in Opinion No. 435. This produces an indicated test period cost of capital totaling 8.63%. On SFPP's account, the 60% to 40% equity to long-term debt ratio reflects its KMEP parent's year-end 2004 business strategy, and that ratio is well within the range previously approved by the Commission. SFPP characterizes the BP/EM, CCV and Tesoro positions on this issue as "effective abandonment" of the DCF methodology.

Trial Staff

68. Trial Staff puts SFPP's appropriate base period capital structure at 41.53% equity and 58.47% long-term debt, and the appropriate test period capital structure at 35.46% equity and 64.54% long-term debt. This produces an indicated test period cost of capital totaling 7.04%. Trial Staff dismisses SFPP/KMEP's target capital structure as irrelevant, unjustified and completely unsupported by legal precedent, emphasizing it is Commission policy to use the actual capital structure of the entity financing the pipeline so long as it produces just and reasonable rates.

BP/EM

69. BP/EM generally confine their discussion of this topic to whether cash distributions legitimately may be substituted for dividends in the DCF methodology's dividend yield formula or for purposes of calculating dividend growth, both of which are specifically addressed under Issue C-5. BP/EM cast as a corollary issue of first impression whether the MLPs included by SFPP in its proxy group are in fact eligible for such inclusion. BP/EM challenge such inclusion, endorsing instead Trial Staff's

alternative proxy group of four dividend-paying partnerships and those entities' earnings growth projections.

CCV

70. CCV describe SFPP's proposed 60% equity and 40% debt capital structure as neither reflective of SFPP's actual capital structure nor supported by relevant Commission precedent. CCV allege SFPP misinterprets test period principles, stressing that the Commission's long-established policy is to use a pipeline's actual capital structure—or its parent's actual capital structure if the parent finances the pipeline—to calculate a cost of service rate. CCV note SFPP advantageously employs its or KMEP's actual capital structure(s) for other purposes in this proceeding (e.g., AFUDC and 1994-2004 deferred return), but here disingenuously proposes an inconsistent target structure to even further advantage. CCV also question the sincerity of SFPP/KMEP's expressed commitment to a 60% to 40% equity to debt ratio in light of an allegedly inconsistent pattern of behavior dating back to 2001. Using SFPP's actual capital structure produces an indicated test period cost of capital totaling 6.95% according to CCV.

Tesoro

71. Tesoro generally emphasizes that SFPP's proposal to use a target or theoretical capital structure consisting of 60% equity and 40% debt instead of its actual capital structure artificially inflates the indicated cost of capital by between 1.62% if Trial Staff's position is adopted to as much as 2.07% if Tesoro's 6.56% cost of capital figure is accepted. Tesoro characterizes the differences as a function of varying views on subsequent sub-issues, including PAA, short-term debt inclusion, and DCF methodological assumptions—most important among these being the actual/hypothetical capital structure disparity.

1. Whether SFPP's Proposed Capital Structure For Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Capital Structure For Designing SFPP's Test Year North Line Rate?

Discussion/Analysis

72. I summarily reject SFPP's proposed use of any "target" capital structure in lieu of the actual SFPP/KMEP capital structure. Using a hypothetical capital structure to calculate cost of capital—or for any other purpose—is wholly inconsistent with base/test period principles. This holds particularly true when the actual capital structure is otherwise known or readily ascertainable. *Accord* Opinion No. 154-B, 31 FERC at 61,836; Tr. 387. Further, the Commission specifically addressed this issue in the December 16 Order, concluding "SFPP's argument that KMEP had a corporate 'goal' of

40 percent debt and 60 percent equity is irrelevant. Since the 40 percent debt and 60 percent equity capital is a subjective goal, it could just as easily have been 35 percent debt and 65 percent equity. . . ." December 16 Order at P 66. The suggestion of arbitrariness is obvious. In addition, the record confirms that SFPP/KMEP behavior since the 60% to 40% equity to debt goal ostensibly was established in 2001 has been discernably at odds with achieving that goal. *See, e.g.,* Ex. CCV-1 at 5-6 **[PROTECTED]**; Ex. CCV-3; Ex. TES-1 at 21 **[PROTECTED]**. *See also* Ex. SFN-28 at 12.

2. Is The Opinion No. 154-B Methodology Appropriate For Determining SFPP's Return On Equity?

<u>Participant Positions</u>

SFPP

73. SFPP states it did not propose this issue, but Opinion No. 154-B and subsequent Commission decisions do not suggest any particular methodology for determining a carrier's return on equity (such as the DCF methodology) is an integral component of the Opinion No. 154-B methodology. SFPP defers further discussion to Issue C-5, where it argues its methodology—including the use of distributions in the DCF formula—is both appropriate and upheld in the December 16 Order.

Trial Staff

74. Trial Staff maintains SFPP's actual capital structure is the appropriate starting point under the Opinion No. 154-B methodology. Since SFPP is entitled to no income tax allowance in Trial Staff's view, SFPP cannot use an adjusted capital structure to determine its cost of service under that methodology.

BP/EM

75. BP/EM address this issue exclusively under Issue C-5.

Tesoro

76. Tesoro claims the Opinion No. 154-B TOC ratemaking methodology includes three separate rate bases in the return computation: (1) the depreciated original cost rate base; (2) the depreciated original cost write-up subsumed in the equity portion of the starting rate base write-up; and (3) the deferred return. Tesoro relies on its Issue B-2 position insofar as starting rate base is concerned. It next characterizes the Opinion No. 154-B rationale for including deferred return as the circumstance that shippers would benefit from dividing the rate of return into a "real' rate and an "inflation" rate, with the

current cost of service reflecting the real rate and the deferred return component reflecting the inflation rate impact on the equity portion of rate base. Tesoro stresses that shippers pay an incremental equity return on the deferred return component until it is fully amortized, stating Opinion No. 154-B explained deferred return as a mechanism to allow new pipelines with high rate bases to compete against older pipelines with much lower rate bases by deferring recovery of front-end costs incurred by new market entrants. Tesoro submits it is time to revisit the blanket application of this aspect of the Opinion No. 154-B methodology—particularly as it applies to pipelines like the North Line, which face neither new market entrants nor any meaningful competition.

Discussion/Analysis

77. There is no claim the general Opinion No. 154-B methodology for determining SFPP's return on equity should not apply here. I therefore find and conclude it is appropriate for SFPP to apply that methodology to the extent its application is otherwise consistent with Opinion No. 154-B. Such consistency is principally examined in the immediately-following sections.[33] I observe here, however, that although Tesoro appears to be correct in its assertion that Opinion No. 154-B adopted the TOC ratemaking methodology primarily to enhance the competitiveness of new pipelines vis-à-vis older ones with lower rate bases, the opinion also specifically references "other modes of oil transport" and "competition generally." *See* 31 FERC at 61,834. Whether the North Line faces competition from other pipelines therefore is not dispositive. And while the hearing transcript reflects some suggestion the North Line does not face significant competition from other modes of oil transport, Tesoro declines to cite even that scant record evidence to support the contention it is permissible to reject the deferred return component of the Opinion No. 154-B methodology in this case, relying instead on a conclusory Initial Decision statement in a discrete proceeding. This falls far short of the Commission standard for changing an established methodology.

[33] Trial Staff's position is addressed under Issue B-4, and more comprehensively under Issue D. Tesoro's position is resolved in accordance with Issue B-2 insofar as starting rate base is concerned.

3. Whether SFPP's Proposed Capital Structure For Designing Its North Line Rate Should Be Adjusted For Purchase Accounting Adjustments ("PAA")? If Yes, What Are The Appropriate PAA Adjustments For Designing SFPP's Test Year North Line Rate?

Participant Positions

SFPP

78. SFPP complains that in testimony filed prior to the December 16 Order, Trial Staff, CCV and Tesoro removed PAA pertaining to KMEP's pipeline acquisitions in their entireties from the equity portion of KMEP's capital structure, thereby artificially deflating the equity portion of that structure. SFPP maintains Paragraph 72 of the order confirms it is solely the PAA equity component that should be removed from the equity component of the acquiring company's capital structure, but Trial Staff, CCV and Tesoro all declined to revise their testimony to reflect that principle despite being offered the opportunity to do so. SFPP also maintains deducting both the equity and debt components from the equity portion of the acquiring company's capital structure leads to absurd results irrespective of the December 16 Order. In addition, it complains that Trial Staff, CCV and Tesoro removed PAA relating to both carrier and non-carrier property, the latter of which is non-jurisdictional. Finally, SFPP asserts Trial Staff's position on this issue is based on an erroneous presumption that PAA are included in SFPP rate base.

Trial Staff

79. Trial Staff counters that PAA are patently unacceptable for ratemaking purposes, characterizing them as accounting adjustments to an asset's book value (original cost minus accumulated depreciation) to reflect an acquisition price exceeding book value. Trial Staff maintains PAA can have a significant effect on the debt/equity ratio reflected in an entity's capital structure, artificially inflating the equity portion of that structure. It contends the Commission's general rule on write-ups therefore requires acquired assets to be included in rate base at no more than depreciated original cost unless it is shown by clear and convincing evidence that the assets produce substantial ratepayer benefits. Trial Staff asserts SFPP has failed to satisfy this requirement here, so the PAA must be removed from KMEP's capital structure. It vigorously disputes SFPP's claim that Paragraph 72 of the December 16 Order establishes that PAA equity components alone should be removed, instead citing the order at Paragraph 65 to support removing the adjustments in their entireties.

CCV

80. CCV rely primarily on the December 16 Order and the February 13, 2006 Order on Rehearing of that order (Order on Rehearing, 114 FERC ¶ 61,136 (2006)) to rebut

SFPP's characterization of the Commission's PAA policy. CCV argue that SFPP completely mischaracterizes the December 16 Order and the rehearing order on this topic, maintaining both orders required SFPP to remove all PAA from the equity component of capital structure because SFPP did not demonstrate there was any debt component to the relevant PAA. CCV paint SFPP's references to a PAA debt component and the non-carrier portion of capital structure as red herrings injected to muddle the facts. Adjusted to remove PAA, the capital structure SFPP should use for ratemaking purposes consists of 34.68% equity and 65.32% debt according to CCV.

Tesoro

81. Tesoro also focuses primarily on the December 16 Order/rehearing order as proof the Commission has ruled SFPP is not permitted to include PAA in developing new rates. Tesoro endorses the adjustments proposed by CCV as best capturing the relevant PAA impacts on SFPP's test period capital structure due to their more thorough consideration of historical data.

Discussion/Analysis

82. SFPP's position on this issue is meritless. The December 16 Order and the rehearing order unequivocally require SFPP to remove all PAA from the equity component of its capital structure for ratemaking purposes. *See* December 16 Order at P 65; Order on Rehearing, 114 FERC ¶ 61,136 at P 15. Moreover, there is nothing in Paragraph 72 of the December 16 Order that reasonably suggests—let alone "makes clear" as SFPP alleges—that only some PAA equity sub-component should be removed from the equity portion of SFPP's capital structure. Paragraph 72 directs SFPP "to remove the PPA [sic] from the Form 6 accounts . . . and reconstitute the relevant balance sheet, income statements, and cash flow statements for rate making purposes. This means removing those portions of the increase in rate base and equity accounts attributable to the PPA [sic]. . . ." December 16 Order at P 72. There is no disjunction between this language and that reflected in Paragraph 65, which states: "the use of a PPA [sic] is consistent with generally accepted accounting principles and is acceptable under Commission accounting practices for booking, *but not rate-making*, purposes. . . . [A] PPA [sic] write-up may not be used for rate-making purposes." *Id.* at P 65 (emphasis added). Further, the record in this proceeding clearly establishes that the PAA at issue are all equity adjustments; they subsume no debt components.[34] See Ex. CCV-6 at 5, 7 **[PROTECTED]**; Ex. CCV-44 at 2. Accordingly, I find and conclude the following

[34] The "absurd results" SFPP illustrates (Ex. SFN-46 at 3-4) might be valid, but they are entirely hypothetical. In addition, the record reflects no support for analogizing those results to the PAA at issue because, in contrast to SFPP's hypothetical equity/debt financing scenario, there simply is no evidence here that the financing for any relevant acquisition subsumed a debt component.

adjustments must be made to the SFPP/KMEP capital structure for ratemaking purposes: (1) remove the $788 million PAA increase in equity attributable to KMEP's acquisition of SFPP; (2) add $272 million in equity as an offset to negative PAA attributable to KMEP's acquisition of Trailblazer Pipeline Company and KMIGT; (3) remove the $6.4 million PAA increase in equity attributable to KMEP's acquisition of TransColorado Gas Transmission Company; (4) remove the $61.2 million PAA increase in equity attributable to KMEP's acquisition of Kaston Pipeline Company, L.P.; (5) remove the approximately $65 million PAA increase in equity attributable to KMEP's acquisition of Calnev Pipe Line.[35]

4. Whether SFPP's Proposed Cost Of Debt For Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Cost Of Debt For Designing SFPP's Test Year North Line Rate?

Participant Positions

SFPP

83. SFPP maintains it followed Commission precedent to calculate a 6.57% cost of North Line debt. It criticizes Trial Staff, CCV and Tesoro for including in their debt cost calculi $416,900,000 in commercial paper and certain tax-exempt/special purpose bonds (including industrial revenue bonds). According to SFPP, including debt maturing in less than one year runs contrary to the Commission's general historical practice of only including debt with maturities exceeding one year. Including money raised through issuance of industrial revenue bonds is likewise inappropriate in SFPP's view because those bonds are purpose-specific and consequently could not have been be used to finance North Line rate base.

Trial Staff

84. Trial Staff challenges SFPP's proposed cost of debt, arguing SFPP mischaracterized $513 million worth of long-term debt as short-term debt. It contends KMEP used the debt at issue to meet long-term financial needs and also reported the debt to the Securities and Exchange Commission (SEC) as long-term debt. In addition, Trial Staff notes KMEP was SFPP's surrogate for DCF analysis purposes, asserting that all KMEP bond debt should be included as a consequence. Trial Staff casts doubt on SFPP's claim that tax exempt/special purpose bonds were unavailable for North Line financing, emphasizing that KMEP concentrates all operating partnership/subsidiary cash assets in joint accounts and places no restrictions on moving cash among those entities. Trial Staff

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[35] I am unable to determine on the evidentiary record before me whether the carrier/non-carrier distinction SFPP cites is meaningful and, if so, in what amount. No participant—including SFPP—adequately addresses PAA rate base inclusion/exclusion.

maintains these assets should be included in the debt cost calculation in this proceeding because the bond proceeds are available to finance any KMEP operation, including the North Line. It therefore advocates a base period debt cost of 6.09% and a test period cost of 5.96%.

CCV

85. CCV maintain both the commercial paper and tax-exempt/special purpose bonds at issue should be included in SFPP's cost of debt, producing a 5.97% figure as of June 30, 2005. CCV assert the December 16 Order directly addresses how SFPP should treat the short-term debt at issue, concluding it should be treated as long-term debt because KMEP treats it that way. CCV makes a similar argument concerning the bonds, claiming KMEP not only treats them as long-term debt, but also consolidates the bond proceeds into joint cash accounts with no entity-specific restrictions or accounting mechanisms.

Tesoro

86. Tesoro maintains SFPP's proposed 6.57% test period cost of debt relies on an overstated long-term debt component and therefore produces an inflated cost of capital. Tesoro instead endorses a base period KMEP debt cost totaling 6.09% and a test period cost totaling 5.96% based on KMEP's own SEC filings. According to Tesoro, those filings clearly demonstrate KMEP treats commercial paper as long-term debt—which Tesoro states is consistent with SFPP's position in the dockets underlying the December 16 Order. Tesoro also underscores the fact that KMEP concentrates all operating partnership/subsidiary cash assets in joint accounts and places no restrictions on the ability to move cash between entities, dismissing as a consequence SFPP's claim that those assets cannot be used for North Line purposes. Tesoro notes in addition that SFPP was unable to differentiate SFPP-related/secured bond issuances from any other KMEP debt.

<u>Discussion/Analysis</u>

87. The debt component of a pipeline's capital structure generally excludes commercial paper with a one year or less maturity from issuance.[36] *See, e.g., Trailblazer Pipeline Co.*, 106 FERC ¶ 63,005 at P 82, *vacated as moot,* 107 FERC ¶ 61,008 (2004). Because debt levels/interest rates attributable to short-term instruments like commercial paper fluctuate constantly, those instruments generally are not useful debt cost indicators for ratemaking purposes. In this case, however, the record establishes KMEP itself

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[36] I construe this standard to mean debt with an *initial* maturity from issuance of more than one year constitutes long-term debt. It follows there may be instances where a debt instrument maturing in less than one year legitimately may be characterized as long-term debt because its maturity date is more than one year from issuance.

classified $621.2 million in debt maturing in less than one year as long-term debt on its December 31, 2004 Form 10-K consolidated balance sheets on the basis that it "intended and had the ability to refinance all of [its] short-term debt on a long-term basis under [its] unsecured long-term credit facility." Ex. CCV-4 at 24 **[PROTECTED]**. *Accord* Ex. SFN-24 at 13; Tr. 264-67; 394-97. Moreover, the December 16 Order suggests the key inquiry in categorizing SFPP debt for ratemaking purposes is how debt is treated or used rather than when it matures. *See* December 16 Order at P 69. The record before me indicates KMEP treated and used the commercial paper at issue as long-term debt. I therefore find and conclude SFPP must re-categorize the commercial paper as long-term debt for debt cost purposes.

88. There is inadequate record basis to include tax-exempt or special purpose/ industrial revenue bonds in SFPP's cost of debt. By definition, any cash generated by those instruments must be used for the specified purpose(s). This obligation stands apart from ratemaking concerns. Moreover, the fact KMEP concentrates all operating partnership/subsidiary cash assets in joint accounts and places no restrictions on moving cash among those entities does not relieve KMEP of any underlying bond condition(s). All KMEP cash may be fungible, but that circumstance does not excuse KMEP from satisfying those conditions; it simply requires KMEP to dedicate the appropriate *equivalent(s)* to that end. It follows that those amounts are not available for any other purpose.

5. Whether SFPP's Proposed Methodology For Deriving A Rate Of Return On Equity, Including Whether "Cash Distributions" Can Be Substituted For "Dividends" (i) In The "Dividend Yield" Calculation And (ii) In The Calculation For Growth In Dividends, In Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Methodology For Deriving A Rate Of Return On Equity For Designing SFPP's Test Year North Line Rate?

<u>Participant Positions</u>

SFPP

89. SFPP generally contends its methodology for deriving the proposed 13.04% nominal rate of return on equity, including use of partnership distributions in the DCF formula, is both appropriate and supported by the December 16 Order. SFPP also states its methodology is aligned with that of Trial Staff.

90. SFPP notes at the outset that no party claims the DCF formula should not be used to determine the cost of equity in this proceeding. SFPP then emphasizes its proxy group is identical to the group accepted in the December 16 Order and approved by the Commission in Opinion No. 435, adding that the group differs by only one member from

the group Trial Staff endorses. SFPP also underscores the fact that Trial Staff agrees SFPP should be placed at the proxy group median to determine its return on equity, dismissing other participant recommendations to place SFPP at the bottom of the range as patently inconsistent with the December 16 Order. Turning to distributions, SFPP stresses the DCF formula relies on an equity investment's cash payments to investors to ascertain the investors' projected return. On SFPP's account, these payments are dividends *in the corporate context and* distributions *in the case of* MLPs. SFPP asserts the December 16 Order expressly accepted this correspondence and, as a consequence, it was appropriate for SFPP and Trial Staff to substitute distributions for dividends in their DCF calculations. SFPP vigorously disputes any claim that distributions are fundamentally different from dividends because distributions constitute a return *of* capital rather than the return *on* capital that dividends represent. SFPP maintains it is appropriate to use distributions in a DCF return calculation in any event because market-driven MLP investment yields are lower than those of comparable corporations.

Trial Staff

91. Trial Staff supports substituting cash distributions for dividends in the DCF dividend yield calculation and for calculating dividend growth in this proceeding. It relies principally on the December 16 Order finding there is no practical alternative to this approach insofar as MLPs are involved. Trial Staff stresses that while it presents an alternate return on equity based on a proxy group consisting of natural gas pipeline corporations, the alternative is not intended to advocate that the Commission cease using an MLP proxy group for oil pipelines. Instead, it is intended as a hypothetical approach in the event the Commission determines it is inappropriate to use an MLP proxy group here based on a finding that cash distributions are returns *of* capital rather than returns on capital. Trial Staff disputes BP/EM's claim this is a case of first impression insofar as MLP proxy group inclusion is implicated, citing Opinion No. 435 and the December 16 Order as proof to the contrary. It also challenges any claim that *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 (*HIOS*), *reh'g denied*, 112 FERC ¶ 61,050 (2005) stands for the proposition that MLP cash distributions cannot be utilized in a DCF analysis. Although Trial Staff excludes one member of the proxy group proposed by SFPP because it ceased to be publicly owned as of July 1, 2005, it otherwise endorses that proxy group and places SFPP at the group median—which produces a 12.27% nominal return on equity for SFPP in this proceeding.

BP/EM

92. BP/EM address this issue at length and in extensive detail. To summarize, they argue: (1) cash distributions cannot sensibly be substituted for dividends in the DCF dividend yield formula; (2) cash distributions are unrelated to earnings, and therefore to growth in dividends; and (3) the appropriate methodology to derive the rate of return on equity for SFPP in this proceeding is to use Trial Staff's alternate proxy group, and to

place SFPP at the low end of the zone of reasonableness within that group due to the low business risk it exhibits. BP/EM characterize MLP proxy group inclusion for determining rate of return on equity as an issue of first impression due to the absence of a final Commission decision. They also assert SFPP provided no evidence of the income amounts flowed to public partners, which on BP/EM's account properly equate to corporate dividends.

93. BP/EM focus primarily on whether distributions constitute a return on capital analogous to corporate dividends or, in contrast, a return *of* capital—submitting the latter is in fact the case. From this, they rely on *HIOS* to support a conclusion that MLPs must be excluded from any DCF proxy group. BP/EM characterize the December 16 Order's acceptance of an MLP proxy group for SFPP as a "temporary expedient" required because no alternative had been proposed in the underlying dockets. BP/EM submit the practical alternative here is to use Trial Staff's alternate return on equity based on a proxy group consisting of natural gas pipeline corporations, which produces a 10.42% nominal rate of return on equity.

94. BP/EM stress that the objective of the Commission's rate of return on equity methodology is to determine the percentage of *income* paid to owners in comparison to the current stock market price. That percentage is the major component of the rate of return on equity calculation as BP/EM describe it. Distilling BP/EM's argument, while corporate-derived income in dividend form has but one source (taxable ordinary business income from corporate operations), MLP distributions customarily have more than one source—some or all of which cannot legitimately be considered income, taxable or otherwise. BP/EM therefore contend the proper focus in determining income for rate of return on equity calculation purposes lies with KMEP's public limited partners. Since those partners receive no income whatsoever, the indicated return on equity is zero and growth becomes a meaningless concept if MLPs comprise the DCF proxy group.

CCV

95. CCV take the position that while both they and SFPP support using the DCF model to calculate the rate of return on equity in this proceeding, a difference exists as to whether MLP presence in the proxy group requires some alteration to the DCF model as it is applied to corporations. CCV answer this question in the affirmative, citing both *HIOS* and prior Commission decisions concerning SFPP. CCV contrast their position with SFPP's, which they describe as ignoring Commission concerns that MLP distributions are not comparable to corporate dividends and a distribution yield is not comparable to a dividend yield. They address these concerns by recommending SFPP be allowed to use its proposed MLP proxy group, but that SFPP be placed at the low end of that group's range of reasonableness to compensate for the yield inflation resulting from using MLP distributions as corporate dividend surrogates. This methodology produces a 10.87% nominal rate of return on equity for SFPP. CCV note this figure is comparable to

the 10.42% nominal rate produced under Trial Staff's hypothetical alternative and stands in stark contrast to a 14.40% nominal test period rate produced by simply treating distributions as identical to dividends in the DCF model as SFPP proposes. CCV maintain SFPP's proposal relies on the December 16 Order in error because that order was premised on a lack of practical alternatives, which is not the case here.

Tesoro

96. Tesoro focuses primarily on the *HIOS* concern that MLP distributions are not comparable to corporate dividends insofar as they constitute returns *of* capital rather than returns on capital. Tesoro maintains the record in this proceeding is clear that MLP distributions are in fact returns of capital, and this fact disqualifies any rate of return on equity proposal that simply substitutes distributions for dividends in the DCF model. Accordingly, Tesoro endorses any of three proposed alternatives: (1) the CCV and Tesoro proposals to use an oil pipeline MLP proxy group, excluding KMEP and placing SFPP at the low end of the group's range of reasonableness (Ex. CCV-1 at 11-12 **[PROTECTED]**; Ex. TES-1 at 39-40 **[PROTECTED]**); (2) the Tesoro proposal to use an oil pipeline MLP proxy group, but eliminating the MLP distributions' return of capital components by focusing exclusively on earnings per unit and placing SFPP at the median of the group's range of reasonableness (Ex. TES-1 at 33-35 **[PROTECTED]**; Tr. 1798-99); or (3) the Trial Staff alternative based on a proxy group consisting of natural gas pipeline corporations.

Discussion/Analysis

97. This issue is not technically one of first impression, but it has yet to be definitively resolved by the Commission. The *HIOS* opinion expresses concern with respect to the comparability between dividends and distributions, specifically noting that distributions may "include a return of a portion of the partners' original investment." 110 FERC ¶ 61,043 at P 126. Because such inclusion skews DCF results by inflating dividend yield, the opinion continues, "the Commission will not consider including an MLP in the proxy group unless the record demonstrates that the distribution used as the "dividend" includes only a payment of earnings and not a return of investment." *Id.* Although I cannot agree that *HIOS* is necessarily limited to natural gas pipelines in this respect as SFPP suggests, neither can I ignore the fact *HIOS* unambiguously acknowledges that oil pipeline proxy groups necessarily must consist of MLPs because those entities comprise the entire oil pipeline sector at this point:

> The Commission's decision in *SFPP* to employ MLPs as a comparison group is limited to oil pipelines as there no longer existed sufficient companies in that industry to provide a satisfactory reference group, so that the only entities in the oil pipeline business that could be included in the proxy group were MLPs.

Id. at P 129 (referencing Opinion No. 435). It is this industry circumstance—not the absence of participant-proposed proxy group/range of reasonableness alternatives in the underlying dockets—that compelled the December 16 Order to conclude with respect to SFPP "there is no practical alternative to treating distributions as the equivalent of dividends and using distributions in the conventional discounted cash flow (DCF) formula."[37] December 16 Order at P 77, n. 104. Unfortunately, it is an enduring circumstance.

98. Although not dispositive, the record before me strongly suggests distributions subsume at least some return of capital component.[38] If so, using them as dividend surrogates in the DCF formula violates *HIOS*. The record in this proceeding is divided—if not outright confused—on the subject. This is not surprising since the expert witnesses seem to be similarly divided/confused. I therefore find and conclude that while distributions present an issue of crucial importance—and one in need of prompt/definitive resolution—it would border on arbitrary for me to attempt such resolution based on the record developed in this proceeding. The better course would be for the Commission either to initiate an expedited rulemaking or convene a technical conference[39] of industry, legal and financial experts to present/vet evidence on the subject that could serve as the basis for a definitive policy statement—perhaps one addressing the MLP business structure in general. As things stand, oil pipeline industry evolution and structural innovation have outmoded the historical DCF rate of return on equity paradigm.

99. The preceding analysis compels me to find and conclude there still remains no practical alternative to treating distributions as the equivalent of dividends in the DCF formula. Though not a completely satisfactory result, it at least preserves ratemaking consistency among the various SFPP pipelines and proceedings.[40] In further accord with Opinion No. 435 and the December 16 Order, I also find and conclude SFPP should be placed at the median of the four member MLP oil pipeline proxy group endorsed by Trial

[37] In *HIOS*, by contrast, the Commission was able to resort to a non-MLP natural gas pipeline proxy group for the natural gas pipeline at issue. *See* 110 FERC ¶ 61,043 at P 129.

[38] I expressly find and conclude *HIOS* is not dispositive on this question either, stating only that distributions *may* include a return of investment. *See* 110 FERC ¶ 61,043 at P 126.

[39] On the record.

[40] It also acknowledges that distributions are the primary means by which ordinary investors determine the capitalized value of publicly-traded MLP interests.

Staff.[41] *See* Ex. S-1 at 30-33. That group constitutes the comparable universe of MLP oil pipelines and no party has made a persuasive case that SFPP's risk is materially different from the risk exhibited by the group's members. *Accord HIOS*, 110 FERC ¶ 61,043 at PP 128-29; *Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279 at 61,926 (2000), *reh'g denied*, 94 FERC ¶ 61,066 (2001). Applying these inputs to the DCF formula yields a 12.27% nominal return on equity, which I find is justified and appropriate for SFPP in this proceeding.

6. Whether SFPP's Proposed Rate Of Return On Equity In Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Rate Of Return On Equity For Designing SFPP's Test Year North Line Rate?

100. This issue is resolved in accordance with Issue C-5.

7. Has SFPP Prudently And Properly Maintained The Security And Integrity Of Its Pipeline System? If Not, What Should Be The Regulatory Consequences With Respect To The Rate That SFPP Can Properly Charge?

101. This issue is resolved in accordance with Issue A.

D. What is the Appropriate Income Tax Allowance in this Case?

1. Is SFPP's Proposed Income Tax Allowance Justified and Appropriate For Determining Its North Line Rate? If Not, What Is The Justified and Appropriate Income Tax Allowance For Designing SFPP's Test Year North Line Rate?

102. SFPP argues it is entitled to an income tax allowance based on a weighted tax rate of 37.92%. Every other participant argues that SFPP is entitled to no tax allowance whatsoever or, at best, a minimal allowance based on marginal income tax rates ranging from 1.23% to 4.50%.

[41] I endorse Trial Staff's rationale for excluding Kaneb Pipeline Partners, L.P. from the group approved in Opinion No. 435 and the December 16 Order. And while I consider it undesirably circular to include KMEP in the SFPP proxy group, I defer to the Commission's Opinion No. 435/December 16 Order determinations that excluding KMEP from the available pool of oil pipeline MLPs removes a significant segment of the oil pipeline industry from consideration, thereby skewing market perception of the industry as a whole.

a. Whether SFPP Is Entitled To Any Income Tax Allowance At All As A Matter Of Law?

Participant Positions

SFPP

103. SFPP asserts it is entitled to an income tax allowance as a matter of law. According to SFPP, the *Policy Statement* expressly reverses *Lakehead/Lakehead II* and permits any entity or individual owning public utility assets to claim an income tax allowance provided only that it has an actual or potential income tax liability to be paid on income generated by its utility assets. SFPP argues that both the June 1 Order and the December 16 Order apply the *Policy Statement* standard to SFPP in the context of individual rate proceedings, as the *Policy Statement* contemplates, and that the *Policy Statement* cannot properly be applied in this case without applying those orders as well. SFPP emphasizes the December 16 Order specifies the precise manner by which SFPP should prove actual or potential income tax liability to satisfy the *Policy Statement* standard, contending that the income tax allowance reflected in the North Line tariff filing is appropriate because it conforms to the December 16 Order's specifications.

104. SFPP focuses on the meaning of "actual or potential income tax liability" as the key element here. On SFPP's account, that term is derived from the *City of Charlottesville* principle that an income tax allowance may reflect "actual or estimated taxes paid or incurred." SFPP submits that the emphasis on a tax-pass-through entity partner/member's actual or potential income tax liability arises from the circumstance that some such partners/members are themselves governmental entities (e.g., municipalities or cooperatives) that have no actual or potential income tax liability because they pay no taxes. SFPP also maintains *City of Charlottesville* makes clear the income tax determination is no different in principle from any other expense, thus the determination must focus on when liability for the expense is incurred even though the actual payment may be made at some future point in time. In addition, SFPP contends the December 16 Order's reliance on *City of Charlottesville* forecloses any argument that SFPP fails to satisfy the "actual or potential income tax liability" standard because it cannot demonstrate that every SFPP partner actually pays taxes on SFPP's regulated utility income. SFPP emphasizes the December 16 Order found it sufficient in this regard if a partner is required to file a Form 1040 or Form 1120 reflecting a partnership income or loss. SFPP defends this finding's legitimacy on the basis that the *Policy Statement*, June 1 Order and December 16 Order all were issued in response to the *BP West Coast* remand order and therefore constituted legitimate exercises of Commission discretion/authority.

Trial Staff

105. Trial Staff disputes SFPP is entitled to an income tax allowance as a matter of law. It emphasizes that SFPP did not move for partial summary judgment on this issue, adding there are at least two genuine issues of material fact concerning SFPP's income tax allowance claim: (1) whether KMEP's public limited partners actually received taxable income from SFPP in 2004; and (2) whether SFPP's public limited partners have actual or potential income tax liability for income generated by SFPP's regulated utility assets. Trial Staff pointedly declines to address whether *City of Charlottesville*, *BP West Coast* and subsequent Commission issuances apply here, characterizing that debate as a collateral attack on the hearing order in this proceeding.[42] Trial Staff nevertheless takes issue with SFPP's recitation of the *Policy Statement* standard as limited to "actual or potential income tax liability," stressing that the pertinent language is "actual or potential income tax liability on the public utility income earned through the interest."

BP/EM

106. BP/EM not only contest SFPP's claim it is entitled to an income tax allowance as a matter of law, they maintain *BP West Coast* affirmatively precludes SFPP from claiming any such allowance as a matter of law. BP/EM argue that one of the grounds cited by the *BP West Coast* court in rejecting the Commission's application of the *Lakehead/Lakehead II* tax allowance policy was the allowance's benefits were not restricted to corporate partners. According to BP/EM, the record here confirms SFPP has no mechanism either to restrict tax allowance benefits to corporate partners or to apportion the benefits between corporate partners at the corporate rate and individual partners at their lower individual rate(s). BP/EM raise as a corollary question whether the *Policy Statement* and December 16 Order are consistent with the *BP West Coast* remand order. BP/EM submit that they are not, and question the Commission's authority to "trump" the U.S. Court of Appeals in this manner. In contrast to the December 16 Order, BP/EM cite with approval the Commission order in *Trans-Elect NTD Path 15, LLC*, 113 FERC ¶ 61,162 (2005) (*Trans-Elect*), which requires the utility to tender evidence of actual or potential partner tax liability on utility income to qualify for an income tax allowance.

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[42] This is inaccurate. Trial Staff vigorously disputes the December 16 Order's applicability to this proceeding under Issue D-1-b, *infra*. It does the same to a lesser degree insofar as the *Policy Statement* is implicated.

CCV

107. CCV[43] summarize the rationale for an income tax allowance as follows: a regulated company subject to income taxes should have the opportunity to earn its allowed return on a post-income tax basis. CCV distinguish this situation from SFPP's, stressing that SFPP is not subject to income taxes. CCV therefore rely on *BP West Coast* to argue SFPP should not have the benefit of an income tax allowance because such allowance is unnecessary for SFPP to earn its allowed return. According to CCV, *BP West Coast* confirms that income taxes must be treated as any other cost would be, and neither hypothetical taxes nor any other hypothetical expense legitimately may be included in a cost of service. CCV maintain *BP West Coast* also confirms that the Commission's *Lakehead/Lakehead II* income tax policy wrongly focused on income tax liability/costs at an ownership level rather than at the regulated utility level. CCV criticize the *Policy Statement* for repeating this mistake, concluding as a consequence SFPP's reliance on the *Policy Statement* is unavailing.

Tesoro

108. Tesoro relies on *BP West Coast* for the proposition SFPP is not entitled to an income tax allowance as a matter of law. Tesoro submits that if *BP West Coast* is controlling, the consequence is unambiguous: SFPP cannot include an income tax allowance in its cost of service because it is an MLP which pays no taxes. Assuming SFPP's status is not an absolute bar to claiming an income tax allowance, Tesoro argues in the alternative that the *Policy Statement* entitles SFPP to an allowance only insofar as it demonstrates actual or potential tax liability on income earned. Tesoro maintains the *Policy Statement* indicates this should be achieved through a "blended rate that reflects the owning interest," which Tesoro quantifies at 4.50%.

Discussion/Analysis

109. I find and conclude as a threshold matter of law that *BP West Coast* is both applicable and controlling here. That decision, while not specifically concerned with the North Line, directly addresses both the Commission's income tax allowance policy and that policy's application to SFPP. Moreover, the *Policy Statement*, June 1 Order and December 16 Order all were issued consequent to the *BP West Coast* remand—and in full accordance with it in the Commission's view. It therefore would be utterly senseless to evaluate SFPP's compliance with the *Policy Statement*, June 1 Order or December 16 Order without regard to whether those issuances are consistent with the remand order that precipitated them. SFPP is entitled to rely on its compliance with the *Policy Statement*, June 1 Order and December 16 Order to support an income tax allowance only insofar as those issuances are consistent with *BP West Coast*. Accordingly, I reject SFPP's implied

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[43] ConocoPhillips does not join in this position. CCV IB at 19, n. 3.

suggestion that the legitimacy of its income tax allowance turns exclusively on compliance with the *Policy Statement*, June 1 Order and December 16 Order. I reject Trial Staff's suggestion that evaluating SFPP's income tax allowance in light of *City of Charlottesville*, *BP West Coast*, the *Policy Statement*, June 1 Order or December 16 Order constitutes a collateral attack on the hearing order in this proceeding for the same reason.

110. Turning to the main issue,[44] I note first that SFPP's assertion it is entitled to an income tax allowance as a matter of law is undermined by its own argument. SFPP maintains the *Policy Statement* permits any entity owning public utility assets to claim an income tax allowance provided it has an actual or potential income tax liability to be paid on income generated by its utility assets. SFPP then emphasizes that the *Policy Statement* contemplates such liability will be demonstrated in the context of individual rate proceedings. What SFPP fails to reconcile, however, is the sole purpose of such proceedings is to present, challenge and evaluate demonstrative evidence—i.e. ostensible facts. In this case, SFPP must establish a number of facts to satisfy the *Policy Statement*. These include demonstrating that it—or in SFPP's view, its owner partners—has/have an actual or potential income tax liability to be paid on income generated by SFPP's utility assets. But no matter how easily SFPP might be able to prove these facts (vigorously disputed here), the proof cannot be made as a matter of law.[45] SFPP acknowledges as much when it touts compliance with the December 16 Order's evidentiary specifications as satisfying the *Policy Statement*'s "actual or potential income tax" liability standard. Those specifications require SFPP to identify its various partner owners, factually establish their characteristics and their respective interests, demonstrate their respective income tax liabilities and that those liabilities are attributable to SFPP utility income, etc. December 16 Order at PP 44-46. Whether SFPP has satisfied those requirements in this proceeding implicates matters of fact, not of law.

111. SFPP's emphasis on the meaning of "actual or potential income tax liability" is similarly unavailing. Although I agree the meaning of this phrase is crucial to resolving the income tax allowance issue in a broader context, it does not support SFPP's contention that it is entitled to an income tax allowance as a matter of law. I grant for the sake of argument SFPP's assertion that the phrase is derived from the *City of Charlottesville* principle that an income tax allowance may reflect any "actual or estimated taxes paid or incurred." SFPP then proceeds to claim *City of Charlottesville*'s

[44] I assign no weight to Trial Staff's emphasis on SFPP's failure to seek summary judgment on this issue. Failure to seek summary judgment does not constitute a waiver of the right to have an issue decided as a matter of law, nor does it diminish the force of any argument(s) advanced to that end.

[45] The *Policy Statement* expressly states this is a fact-specific issue. *Policy Statement* at P 42.

emphasis on a tax-pass-through entity partner/member's actual or potential income tax liability arises from the circumstance some such partners/members may be governmental entities (e.g., municipalities or cooperatives) which have no actual or potential income tax liability because they pay no income taxes. This implies that while such entities should not be included in calculating an income tax allowance because they are legally exempted from paying income taxes, all other entities/individuals necessarily *should* be included because they do not enjoy the exemption. The reasoning is sensible, but flawed. It presupposes a tax-pass-through entity partner/member ultimately pays income taxes simply because it cannot claim the governmental exemption. One of the principal attractions of the partnership business structure is it provides income tax advantages—both to the partnership and to its partners/members. It therefore is immaterial from an "actual or potential income tax liability" perspective whether the partnership or its partners/members is/are exempted from income taxation by virtue of government entity status or by virtue of other favorable income tax laws and regulations. The key is whether income taxes ultimately are *paid*. There is absolute certainty a government entity will never pay any income taxes. But there is equal certainty a tax-pass-through entity like SFPP will never pay any income taxes either. More important, there is an extremely high probability—albeit less than certainty—that tax-pass-through entity partners/members ultimately will escape income taxation on at least *some* of the partnership income flowed-through/attributed to them. The flaw in SFPP's interpretation of the *City of Charlottesville* "actual or estimated taxes paid or incurred" standard is it *presupposes* every dollar of income tax liability attributable to utility income ultimately will be paid by someone at some time. The complex partnership structures erected by MLPs like SFPP/KMEP, however, are specifically designed to virtually ensure this will not occur. Presumably, that is one reason the *Policy Statement*, June 1 Order and December 16 Order impose the factual burden of quantifying the appropriate income tax allowance on SFPP. Regardless, it clearly constitutes a reason SFPP cannot claim an income tax allowance as a matter of law.

112. SFPP counters that *City of Charlottesville* confirms the income tax allowance determination is no different in principle from that of any other expense, thus it must focus on when liability for the expense is incurred even though the actual payment may be made at some future point in time. I agree, but this is beside the point. SFPP again uncritically *presupposes* every dollar of tax liability attributable to its utility income ultimately will be paid by someone at some time. The preceding discussion illustrates this is not necessarily true, and SFPP has not factually demonstrated it is true in this case.[46] I observe that SFPP is careful not to use the term "cost" here and throughout. This may seem inconsequential, but it is not. "Cost" is a term of art in utility ratemaking. All "costs" are expenses paid by the utility itself at the utility level. Income taxes or

[46] SFPP emphasizes the December 16 Order deems proof sufficient in this regard if a partner is required to file a Form 1040 or Form 1120 reflecting a partnership income or loss. This topic is addressed in more detail *infra*.

income tax liability (e.g., deferred income taxes) legitimately may be characterized as "costs" insofar as the utility bears the ultimate responsibility to pay them. But however one might characterize financial liabilities for which the utility itself does not bear ultimate responsibility, they cannot legitimately be designated "costs." It follows that while all actual/potential utility "costs" may be characterized informally as expenses, all actual/potential expenses attributable to utility operations may not be characterized formally as "costs." In contrast to previous discussion, where the key is whether *anyone* must make a particular payment at some time, the key to a "cost"-based analysis is whether the *utility* must make that payment at some time.

113. The *BP West Coast* remand order confirms this conclusion. The order criticizes the Commission's *Lakehead/Lakehead II* income tax allowance policy/application on numerous grounds, but its central criticism concentrates on the ratemaking fundamental that the income tax allowance is no different than the allowance for any other cost, and it may be included in cost of service only because it is a *cost*. *See, e.g., BP West Coast*, 374 F.3d at 1288 (emphasis in original). As I read it, the court's entire income tax allowance analysis turns on this fundamental. To illustrate, the court initially confirms "[t]here is no question that as a general proposition a pipeline that pays income taxes is entitled to recover the costs of the taxes paid from its ratepayers." *Id.* at 1286 (referencing *City of Charlottesville*). The court then confirms "[t]axes, including federal income taxes, are costs." *Id.* (citing *City of Charlottesville*, 774 F.2d at 1207). What the court expressly finds problematic in applying these straightforward principles to a utility limited partnership subsumed within a consolidated group, however, are the circumstances that (i) it is difficult to segregate the taxable income specifically attributable to the utility's jurisdictional activities and (ii) a limited partnership operating jurisdictional pipelines incurs no income tax liability. *Id.* (citing *City of Charlottesville*, 774 F.2d at 1207; 26 U.S.C. § 7704 (d)(1)(E)). The court consequently rejects: (1) SFPP's contention it should be granted a tax allowance based on a supposition that SFPP itself was responsible for paying 100% of the income tax attributable to its jurisdictional income at the corporate rate; and (2) the Commission conclusion SFPP should be granted a tax allowance based on the 42.7% corporate interest in the SFPP limited partnership. *Id.* at 1288. The court concludes that, consistent with ratemaking principles and governing law, SFPP is entitled to no allowance for income taxes SFPP did not itself pay.[47] *Id.* at 1288. Notably, the court criticizes the Commission's "reasoning" to the contrary at some length, finding the Commission order on review merely recites separately unassailable premises to reach a conclusion that does not follow from them. *Id.* at 1288-90 (emphasis marks in original). The court also criticizes in this regard the Commission's reliance on *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (*Hope*), ultimately holding *Hope* supports a conclusion "where there is no tax generated by the regulated entity, either

[47] The court indicates this conclusion is based "on the record before [it]" (*Id.*), a point the Commission emphasizes in the *Policy Statement*.

standing alone or as part of a consolidated corporate group, the regulator cannot create a phantom[48] tax in order to create an allowance to pass through to the ratepayer." 374 F.3d at 1291.

114. I previously noted the *Policy Statement*, June 1 Order and December 16 Order all were issued consequent to the *BP West Coast* remand—and in full accordance with it in the Commission's view. I also noted that while SFPP relies on its compliance with the *Policy Statement*, June 1 Order and December 16 Order to support an income tax allowance here, it is entitled to do so only insofar as those issuances are consistent with *BP West Coast*. What remains is to determine whether the *Policy Statement*, June 1 Order and December 16 Order are consistent with the *BP West Coast* remand order.

115. The *Policy Statement* expressly acknowledges at the outset that *BP West Coast* concludes an income tax allowance may recover "only the costs of the regulated entity..."[49] *Policy Statement* at P 3. The *Policy Statement* also expressly acknowledges that *BP West Coast* rejects the proposition that a regulated utility partnership may be granted an income tax allowance to encourage capital flow to public utility industries regulated by the Commission. *Id.* at P 5. The *Policy Statement* summarizes the court's reasoning on this point as "[t]hus, if a partnership paid no income taxes, or had no potential income tax liability, no cost was incurred and therefore an income tax allowance would reimburse the entity for a phantom cost." *Id.* These preliminary statements are fully consistent with *BP West Coast.*

116. The *Policy Statement* explains that while the *BP West Coast* remand order addressed only the Commission's Order No. 435 Opinions, it was apparent the order had implications for other proceedings and regulated utilities as well. *Id.* at P 6. In light of these broader implications, the Commission sought public comment concerning whether *BP West Coast* applied only to the specific facts of the Order No. 435 proceedings or extended to other capital structures involving partnerships and other forms of pass-through ownership. *Id.* The Commission specifically asked if *BP West Coast* precluded

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[48] This characterization apparently was coined by the Administrative Law Judge who issued the Initial Decision with which the Commission order on review disagreed regarding SFPP's tax allowance. *See* 374 F.3d at 1287. In my view, however, the term "phantom" implies at least some appearance of reality. A limited partnership does not exhibit the slightest appearance of actual income taxation at the partnership level. Accordingly, I adopt the Court of Appeals' alternate characterization of income taxation at the partnership level as being "fictitious." *Id.* at 1293.

[49] The *Policy Statement* immediately thereafter characterizes *BP West Coast* as also concluding that "taxes are but one cost paid by a corporate partner as part of its cost of doing business." *Id.* (citing *BP West Coast,* 374 F.3d at 1288). This characterization does not appear to be entirely accurate.

an income tax allowance under a number of partnership permutations, and whether such preclusion would result in inadequate infrastructure investment incentives. *Id.* Each of the 42 sets of comments received advocated one of four general positions. *Id.* at P 7. Although none argued to preserve the *Lakehead/Lakehead II* policy, three favored preserving certain existing income tax allowances; three favored an allowance for partnerships wholly owned by taxpaying corporations filing consolidated returns; 24 endorsed a tax allowance for all entities (to assure tax factors would not control investment vehicle selection); and 10 opposed any tax allowance for non-tax-paying entities such as MLPs. *Id.* The group of 10 opposing any tax allowance for non-tax-paying entities cited *BP West Coast* to support its position. *Id.* at P 20. The group of 24 endorsing a tax allowance for all entities argued the *BP West Coast* court did not have before it the realities of partnership taxation and therefore did not consider them in reaching its tax allowance conclusions. *Id.* at P 21.

117. Based on the comments provided, the *Policy Statement* concludes an income tax allowance should be granted to:

> all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets. Thus a tax-paying corporation, a partnership, a limited liability corporation, or other pass-through entity would be permitted an income tax allowance on the income imputed to the corporation, or to the partners or the members of pass-through entities, provided that the corporation or the partners or the members have an actual or potential income tax liability on that public utility income.

Id. at P 32.

118. The *Policy Statement* continues:

> Given this important qualification, any pass-through entity seeking an income tax allowance in a specific rate proceeding must establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income. To the extent that any of the partners or members do not have such an actual or potential income tax obligation, the amount of any income tax allowance will be reduced accordingly to reflect the weighted income tax liability of the entity's partners or members.[50]

[50] The *Policy Statement* here adds a footnote characterizing this as a "[t]echnically complex issue that would be addressed in individual rate proceedings. . . ." *Policy Statement* at n. 27. As discussed *infra*, the December 16 Order addresses the issue in the context of SFPP's East and West Line rate proceedings.

Id.

119. In reaching the preceding conclusion, the *Policy Statement* expressly reverses the income tax allowance policy established in *Lakehead/Lakehead II*, explaining that "*Lakehead* mistakenly focused on who pays the taxes rather than on the more fundamental cost allocation principle of what costs, including tax costs, are attributable to regulated service, and therefore properly included in a regulated cost of service." *Id.* at P 33 (footnote omitted). The *Policy Statement* expressly dismisses any assertion that its newly articulated/explained income tax allowance policy is premised on fictitious taxes in violation of the *BP West Coast* remand order. According to the *Policy Statement*, the comments received demonstrate the remand order's fictitious tax "assumption was incorrect" because "[w]hile the pass-through entity does not itself pay income taxes, the owners of a pass-through entity pay income taxes on the utility income generated by the assets they own via the device of the pass-through entity." *Id.* (footnote omitted). The *Policy Statement* also notes that numerical examples reflected in the comments "establish that the return to the owners of pass-through entities will be reduced below that of a corporation investing in the same asset if such entities are not afforded an income tax allowance on their public utility income."[51] *Id.*

120. The *Policy Statement*'s plain language compels me to conclude it suffers many of the same deficiencies criticized by the court in the *BP West Coast* remand order. Most notably, it completely disregards the court's central holding: an income tax allowance may be included in a utility's cost of service only insofar as it reflects an actual/potential *cost to the utility*. *See BP West Coast*, 374 F.3d at 1288; 1291-92. As previously noted, "cost" is a term of art in utility ratemaking. Costs are expenses paid by the utility itself at the utility level. Income taxes or income tax liability legitimately may be characterized as costs only insofar as the *utility* bears the ultimate responsibility to pay them. The *BP West Coast* remand is clearly rooted in this proposition insofar as the income tax allowance is concerned. The *Policy Statement* attempts to finesse its failure to accede to it—and to the corollary conclusion that deviating from it imputes fictitious taxes to the utility—by asserting "[w]hile the pass-through entity does not itself pay income taxes, the owners of a pass-through entity pay income taxes on the utility income generated by the assets they own via the device of the pass-through entity." *Policy Statement* at P 33 (footnote omitted). This assertion serves the *Policy Statement* no better than it served SFPP's interpretation of the *City of Charlottesville* "actual or estimated taxes paid or incurred" standard, examined *supra* at P 111. The common flaw is the *presupposition* that every dollar of income tax liability attributable to utility income ultimately will be paid by someone at some time. As previously illustrated, this result does not necessarily follow, and the complex partnership structures erected by MLPs like SFPP/KMEP are

[51] The *Policy Statement* here adds a footnote emphasizing that the comment record in the *Policy Statement* docket suggests there is a substantial amount of existing investment at issue. *Id.* at n. 30.

specifically designed to virtually ensure it will not. The *Policy Statement*'s inconsistency with the remand order on this central point, then, is two-fold: (1) it permits an income tax allowance at a non-utility level; and (2) it does not ensure the allowance reflects actual and equivalent income tax payments at some point in time.

121. The *Policy Statement* attempts to legitimize its deviation from *BP West Coast* in this regard by first casting doubt on the court's understanding of partnership taxation, then relying on its own record to impliedly conclude the court's "assumption was incorrect" insofar as what expenses properly may be included in a regulated cost of service is concerned.[52] *Policy Statement* at PP 33-34. Tellingly, the *Policy Statement* expressly concludes "*Lakehead* mistakenly focused on who pays the taxes rather than on the more fundamental cost allocation principle of what costs, including tax costs, are attributable to regulated service, and therefore properly included in the cost of service." *Id.* at P 33. This conclusion is inconsistent with *BP West Coast* in two fundamental respects. First, *BP West Coast* itself focuses on who has ultimate liability to pay the tax on regulated utility income—its central holding is that the utility itself must be liable to pay the tax in order to receive a rate allowance for that purpose. Second, the *Policy Statement* quote conflates expenses with costs. *BP West Coast*'s fundamental proposition is that expenses constitute costs for utility ratemaking purposes only if they ultimately are paid at the utility level.

122. The *Policy Statement* deviates from *BP West Coast* in other respects as well. It focuses in substantial portion on protecting existing infrastructure investment and encouraging additional investment. *Id.* at PP 8-10, 12-14, 24-28, 30 (summarizing comments); 33, 36-37 (discussion). Principal among the Commission's concerns is the disincentive to partnership—particularly MLP—investment/ownership structures. The *Policy Statement* emphasizes that failing to grant the same tax allowance to both

[52] The *Policy Statement* directs its critique to comments relying on *BP West Coast* and the ostensible inadequacy of the record before the court. *Id.* at PP 13, 21, 33-34. My review of *BP West Coast*, however, reveals no support for either conclusion. The remand order's income tax allowance discussion confirms throughout that the court had a clear understanding of both partnership taxation and the types of expenses that properly may be included in a utility's regulated cost of service. I note, moreover, that the record in the *Policy Statement* docket consists exclusively of public comments. *Id.* at P 42. And while I decline to offer an opinion with respect to the evidentiary weight such comments should carry, I observe that they were not subjected to rebuttal or cross-examination in the *Policy Statement* proceeding. Whatever their persuasiveness/evidentiary weight, they cannot legitimize a policy patently inconsistent with a decision rendered by the U.S. Court of Appeals on the record before it. The Commission may disagree with the court. Its disagreement may even be well-founded. But that does not grant it the authority to ignore the court's conclusions/directives and proceed to the contrary.

partnerships and corporations reduces the overall partnership return below that of a similarly situated corporation, the implication apparently being that such disparate treatment either will discourage investment or is in some way unjust, unreasonable or unduly discriminatory. Whether this structural concern is valid or not,[53] it is inconsistent with *BP West Coast* because the *Policy Statement* discusses it at a *second-tier* ownership level instead of at the first-tier regulated utility level *BP West Coast* requires. The *Policy Statement* is here premised on an assumption that because *BP West Coast* supports an income tax allowance for first-tier corporate utilities/consolidated group subsidiaries, it similarly supports an income tax allowance for first-tier partnership utilities if those utilities are owned by corporate partners. Proceeding from this faulty assumption, the *Policy Statement* concludes there is no logical reason to restrict the pass-through allowance to corporate partners. Instead, it should be apportioned *pro rata* among all owners—i.e. to any entity or individual having an actual or potential income tax liability attributable to regulated utility income. The flaw in this reasoning is the premise. *BP West Coast* restricts the income tax allowance benchmark to the utility level. The utility may include an income tax allowance in rates only if the utility itself has actual/potential income tax liability. A corporate utility/consolidated group subsidiary satisfies this requirement. A utility operating as a tax pass-through entity does not. Why? Because while a corporate utility's income is taxed at the utility or consolidated group level, and therefore constitutes a real cost to the utility, the pass-through entity's income is flowed to its owners untaxed, and consequently does not represent a real cost at the utility level. Quoting *BP West Coast* slightly out of context, in this instance the *Policy Statement*:

> may well be correct that if such an allowance were allowable at all, it should have been allowed for the imputed taxes potentially incurred by all [owners] who realized taxable income from the untaxed profits of the limited partnership of the pipeline. For the reasons set forth above, we hold that the first step of this analysis is erroneous—that is, we hold that no such allowance should be included.

374 F.3d at 1291.

123. The *Policy Statement*'s emphasis on the concern that failing to grant the same tax allowance to both partnerships and corporations reduces the overall partnership return below that of similarly situated corporations highlights other inconsistencies as well. Chief among these is the remand order's admonition that it is not the "business of the Commission to create a tax liability when neither an actual or estimated tax is ever going to be paid or incurred on the income of the utility. . . " *Id.* at 1292. The *Policy Statement* addresses this criticism as follows: "Because public utility income of pass-through

[53] I recognize the Commission and the venture capital community have crucial substantive interests in the broader objectives of encouraging, rewarding and protecting investment in essential energy infrastructure.

entities is attributed directly to the owners of such entities and the owners have an actual or potential income tax liability on that income, the Commission concludes that its rationale here does not violate the court's concern that the Commission has created a tax allowance to compensate for an income tax cost that is not actually paid by the regulated utility." *Policy Statement* at P 34. To adopt the court's observation elsewhere in *BP West Coast*, the *Policy Statement* "is once again simply declaring" that pass-through entity owners have an actual or potential income tax liability on the public utility income, and "[t]o rephrase a proposition is not the same as supplying supporting reasoning." 374 F.3d at 1290.

124. In addition, the *Policy Statement*'s corporation/partnership disparity concern focuses on overall return rather than *rate* of return inasmuch as the income tax allowance is implicated. *Hope* stands for the ratemaking fundamental that a utility must have the opportunity to earn its allowed equity return. Simplistically stated, that return consists of rate base multiplied by rate of return, plus costs. The income tax allowance never influences rate base or rate of return, and only influences overall return insofar as it represents a legitimate cost to the utility. Granting a fictitious income tax allowance to a utility therefore permits it to exceed—by the tax allowance amount—its allowed return. It follows that if partnerships somehow constitute disadvantaged energy infrastructure investment vehicles vis-à-vis corporations, the appropriate regulatory solution lies in their allowed *rates* of return rather than in their overall returns.[54]

125. It also follows that any partnership charging rates subsuming an income tax allowance has, from rate inception, reaped a windfall at ratepayer expense. This inevitably implies refunds are due. But while it strains credibility to presume

[54] Or in restructuring the utility as a corporation. As the court similarly observed in *BP West Coast*, the corporation/partnership income tax allowance disparity is a product of the business form selected, "not of the regulated or unregulated nature of the pipeline or any comparable investment or of the risks involved therein." 374 F.3d at 1291. Presumably, pipelines like SFPP changed from corporate to partnership structure in the first place because a partnership structure was more attractive. If, solely by virtue of eliminating an illegitimate income tax allowance, the partnership structure is rendered less attractive than a corporate one, the rational pipeline response would be to switch back to a corporate structure. If that switch still would provide inadequate investment incentive to achieve Commission objectives, the indicated regulatory solution would seem to be to increase partnership rates of return to levels capable of attracting the desired investment. In contrast to indirectly inflating the return rate through an illegitimate income tax allowance, this solution should fall squarely within the Commission's legitimate authority/discretion and be wholly consistent with *BP West Coast*. As I read it, *BP West Coast* in no way prohibits the Commission from encouraging, rewarding or protecting infrastructure investment by legitimate means (e.g., increased rates of return)—only from doing so through illegitimate ones.

sophisticated entities like SFPP/KMEP have failed to recognize their partnership income tax allowances constitute windfalls, I do not see how they fairly may be held accountable for acting in full accordance with Commission policy. That opinion aside, matters before me are confined to SFPP's 2005 North Line rate filing. It has been necessary for me to examine *Policy Statement* consistency with *BP West Coast* for the sole purpose of determining whether SFPP is entitled to rely on the *Policy Statement* to claim an income tax allowance *in this case.*[55] The *Policy Statement* was issued during the course of this proceeding, and I pointedly have underscored the Commission's commitment to basing final determinations on the policy in effect when a pertinent regulatory decision is made and applying that decision to the time frame to which a particular case applies. Accordingly, no refunds would be implicated here even if *BP West Coast* prohibits SFPP from including an income tax allowance in its North Line rates pursuant to the 2005 *Policy Statement.*

126. My final observation concerning the *Policy Statement* is that it seems internally inconsistent as well. It specifies that "any pass-through entity seeking an income tax allowance in a specific rate proceeding must establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income." *Policy Statement* at P 32. This language imposes the burden of proof on the pass-through entity (i.e. rate applicant), as it should. Immediately thereafter, however, the *Policy Statement* indicates "[t]o the extent that any of the partners or members do not have such an actual or potential income tax obligation, the amount of any income tax allowance will be *reduced* accordingly to reflect the weighted income tax liability of the entity's partners or members." *Id.* (emphasis added) (footnote omitted). This language suggests the *Policy Statement presumes from the outset* that 100% of the pass-through public utility income is taxable to partners/members, thereby standing the burden of proof on its head by eliminating the pass-through entity's threshold obligation to make an affirmative case for partner/member tax liability.[56] The *Policy Statement* does not expressly acknowledge this presumption. Neither does it provide any guidance with respect to how the technically complex issue of developing a pass-through entity's marginal tax rate should

[55] I do not suggest that my analysis has no implications for the *Policy Statement* in general. BP/EM have indicated they consider this proceeding to be the vehicle through which the entire income tax allowance policy issue ultimately will be resolved—presumably before the Commission and Court of Appeals.

[56] As previously noted, the omitted footnote characterizes this as a "[t]echnically complex issue that would be addressed in individual rate proceedings. . . ." *Policy Statement* at n. 27.

be addressed in individual rate proceedings[57]—which requires a discussion of the December 16 Order at this point.[58]

127. Before engaging in that discussion, however, I am compelled to find and conclude the *Policy Statement* is fatally inconsistent with *BP West Coast*. The fundamental inconsistency lies in the fact that the *Policy Statement* completely disregards the court's central tenet that an income tax allowance may be included in a utility's cost of service only insofar as it reflects an actual/potential cost to the utility. SFPP exhibits no actual/potential liability to pay tax on any income attributable to its regulated utility operations. Accordingly, *BP West Coast* precludes SFPP from reflecting an income tax allowance in its North Line rates irrespective of whether SFPP has satisfied the *Policy Statement*. I therefore find and conclude *as a matter of law* that SFPP is precluded from reflecting any income tax allowance in North Line rates.[59]

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[57] The *Policy Statement* elsewhere indicates that "any pass-through entity desiring an income tax allowance on utility operating income must be prepared to establish the tax status of its owners, or if there is more than one level of pass-through entities, where the ultimate tax liability lies and the character of the tax incurred." *Id.* at P 42.

[58] The June 1 Order concluded SFPP would be entitled to a full income tax allowance in Docket No. OR96-2, *et al.* and Docket No. OR96-2, *et al.* if SFPP could establish that it satisfied the *Policy Statement*. The December 16 Order examines that question.

[59] This ruling logically obviates the need to address subsequent income tax allowance topics. I do so in the alternative to provide the Commission with analysis it may require in the event it rejects my primary ruling.

* * *

Returning to the ADIT ruling deferred at Paragraph 65, I also find and conclude at this point in the analysis that SFPP's entire ADIT account balance should be credited as a negative to income and as an offset to income tax liability because the account is 100% over-funded. How that should be accomplished is discussed under Issues D-2-a and D-2-b, *infra*.

b. To The Extent SFPP Is Entitled To An Income Tax Allowance, What Is The Appropriate Methodology For Developing An Income Tax Allowance For SFPP In Designing A Test Year North Line Rate?

Participant Positions

SFPP

128. SFPP maintains the appropriate methodology for it to use in developing an income tax allowance is specified in the December 16 Order. SFPP states the order directed it to separate its respective unit-holders into six broad categories: (1) Subchapter C corporations; (2) individuals; (3) mutual funds; (4) pension funds, IRAs, KEOGH plans and other entities that customarily do not pay income taxes but would be expected to have taxpaying owners/beneficiaries; (5) pension funds, IRAs, KEOGH plans and other entities that customarily do not pay income taxes but might be required to pay taxes on SFPP/KMEP income deemed "unrelated business taxable income" (UBIT); and (6) institutions or exempt entities such as municipalities, having no obligation to pay out/declare income. The order further directed it to provide supporting detail on the unit-holders within each category and to categorize pass-through entities such as partnerships based on the entity ultimately subject to an actual or potential income tax liability. It was then required to identify the unit-holder percentage falling into each category, calculate the percentage of partnership income imputed to each group, and use those percentages to develop a weighted tax allowance.

129. SFPP also argues that the stand-alone principle and tax normalization procedure it followed in the North Line filing accurately reflects the methodology specified in the December 16 Order. Under SFPP's approach, the income tax allowance is equal to the tax SFPP, on a stand-alone basis, would pay on its allowed equity return. SFPP emphasizes the December 16 Order directs it to develop the income tax allowance at the partnership/entity level rather than at the partner/individual level advocated by opposing participants, emphasizing further that the order directs it to then calculate the percentage of partners in each of the six specified categories as well as the percentage of taxable partnership income allocated to each category. SFPP contends the December 16 Order also specifies how to calculate the appropriate tax rate for each type of partner and how to weight each type's tax rate to derive the weighted average rate. Following this procedure produces the weighted income tax rate of 37.92% reflected in SFPP's rebuttal testimony.[60]

[60] SFPP acknowledges it normally would be defending the allowance reflected in the April 28, 2005 North Line rate filing and supporting case-in-chief, but the circumstance that the *Policy Statement*, June 1 Order and December 16 Order all were issued during the course of this proceeding compelled it to change positions on rebuttal

Trial Staff

130. Trial Staff vigorously disputes that SFPP is entitled to seek an income tax allowance in accordance with the *Policy Statement*, June 1 Order and December 16 Order in this proceeding. Trial Staff contends the December 16 Order was explicitly confined to its underlying dockets, and it therefore must be presumed the Commission did not intend the order to have broader applicability—particularly to a case with an imminent hearing commencement date.[61] In addition, Trial Staff complains it would be fundamentally unfair to participants opposing an income tax allowance in this proceeding to mechanically apply the December 16 Order under these circumstances. Trial Staff instead emphasizes the *Policy Statement*'s "actual or potential tax liability" requirement, focusing on the level of actual income eligible for taxation from KMEP to each of its limited partners. This methodology yields a weighted federal income tax rate of 1.23%.[62]

131. Trial Staff underscores the fact that SFPP's interpretation of the December 16 Order imposes rebuttable presumptions concerning marginal income tax rates that shift the burden of proof from SFPP—the rate applicant—to its opponents. It is manifestly unfair in Trial Staff's view to impose this new burden on income tax allowance opponents after their affirmative cases already had been filed. Equally important in Trial Staff's view is SFPP's interpretation of the December 16 Order forecloses the question of whether SFPP is entitled to any income tax allowance at all because taxable income is "imputed" to partner groups without requiring proof that those groups actually received taxable regulated income from SFPP. Trial Staff stresses the hearing order in this proceeding set *all* issues raised by the North Line rate filing for hearing, and those issues necessarily include a threshold question of whether SFPP partners satisfy the Policy Statement requirement of "actual or potential tax liability." In addition, Trial Staff distinguishes the December 16 Order on the basis that the East Line/West Line rates involved in the underlying dockets were established as early as 1992, when the law governing the merits of the income tax allowance component of cost of service differed from current law. Trial Staff further distinguishes the December 16 Order on the bases

(filed January 5, 2006) to reflect an income tax allowance conforming to the *Policy Statement*, June 1 Order and December 16 Order. SFPP IB at 33-34.

[61] The hearing commencement date was January 24, 2006.

[62] This figure was derived using the 2004 tax year. *See* Ex. S-4 at 79 **[PROTECTED]**; Ex. S-7A **[PROTECTED]**. Although Trial Staff apparently did not compute a composite income tax rate reflecting a state marginal tax rate component, it advocates using a similar methodology for that purpose instead of simply applying the 8.84% California corporate rate SFPP uses. Trial Staff IB at 23-24; Trial Staff RB at 29 and n. 99.

that: (1) the evidentiary records in most, if not all, of the underlying dockets were closed prior to *Policy Statement* issuance, so the order established rebuttable presumptions to accommodate this unique circumstance/facilitate calculating allowances that already had been approved on the merits in the various underlying dockets; and (2) the state income tax portion of the composite tax rate would likely differ here because while the East and West Lines implicate Arizona and New Mexico tax rates, the North Line filing implicates California tax rates.

BP/EM

132. BP/EM criticize SFPP's mechanical reliance on the December 16 Order, summarizing the appropriate income tax allowance methodology in this proceeding as a five part process. First, the amount of North Line taxable income must be determined. This is achieved on BP/EM's account by identifying and subtracting all non-ADIT-related offsets and deductions to "taxable allowed return on equity." Second, full test year tax depreciation must be offset against taxable income rather than being booked to the ADIT account. Third, a composite federal/state income tax rate must be determined. BP/EM characterize this as a function of interrelationship between taxable income and tax rates, contending that the *Policy Statement* yields a *de minimis* rate if fairly applied.[63] Fourth, the "Net to Tax Multiplier" should be eliminated because the calculation awards an incremental income tax allowance on the income tax allowance itself. Fifth, any remaining income tax allowance must be offset by credits from the ADIT account because that account is already over-funded.

CCV

133. CCV argue the December 16 Order must be applied in conjunction with the *Policy Statement* and the June 1 Order to derive the appropriate SFPP income tax allowance. According to CCV, this requires SFPP's ownership percentages to be traced back through its intermediate parent (Kinder Morgan OLP-D), and its ultimate parent (KMEP), to the owners of KMEP's limited partnership units. CCV generally rely on a 2004 SFPP ownership study for this purpose, but depart from the study insofar as it excludes i-share interests accounting for approximately 26% of SFPP's partner ownership and 25% of its total capital investment.[64] CCV assign a zero percent tax rate to i-share interests because they are ownership vehicles "not entitled to allocations of income, gain, loss, deductions

[63] BP/EM maintain the state rate component should be zero because Nevada imposes no income tax.

[64] CCV highlight the fact that SFPP includes i-share capital in its return on equity calculation, but excludes i-share ownership interests from its weighted federal income tax calculation.

or cash distributions until such time as KMEP is liquidated."[65] In addition, CCV assign a zero percent tax rate to all other non-corporate unit-holders based on what CCV characterize as SFPP's complete failure to provide any evidence regarding their income tax liabilities. CCV accept SFPP's proposed 40.3% composite federal/state income tax rate for corporate unit-holders (i.e. KMI and its subsidiaries),[66] resulting in a blended income tax rate of 4.50% based on their weighted ownership interests. CCV maintain its methodology is not inconsistent with the December 16 Order because the order must be construed in conjunction with the *Policy Statement* and June 1 Order that preceded it. Construing the December 16 Order in isolation as support for using taxable income for weighting purposes, as SFPP does, has nonsensical consequences on CCV's account.

Tesoro

134. Tesoro supports CCV's position, emphasizing that CCV's approach properly interprets the December 16 Order by focusing on ownership weights rather than taxable income weights. Tesoro argued in the alternative under Issue D-2-a that the *Policy Statement* entitles SFPP to an allowance only insofar as it demonstrates actual or potential tax liability on income earned, adding the *Policy Statement* indicates this should be achieved through a "blended rate that reflects the owning interest." As previously outlined, CCV quantify that rate at 4.50% based on ownership weights.[67]

Discussion/Analysis

135. The December 16 Order expressly purports to supplement the *Policy Statement* insofar as the methodology for developing the marginal tax rate for pass-through entities is concerned.[68] Accordingly, I am compelled to reject Trial Staff's threshold contentions that (i) the December 16 Order was explicitly confined to its underlying dockets and (ii)

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[65] CCV IB at 22 *citing* Ex. CCV-1 at 33 **[PROTECTED]**; Tr. 1706. CCV also claim SFPP conceded on the record that i-shares have no foreseeable actual or potential tax liability. CCV IB at 22 (citing Tr. 1706).

[66] Ex. CCV-1 at 33 **[PROTECTED]**.

[67] Tesoro also states it supports the income tax rate calculation presented by BP/EM, presumably referring to BP/EM's five part methodology.

[68] The December 16 Order strongly suggests it is not confined to the captioned dockets, SFPP's East and West Lines or SFPP in general. *See* December 16 Order at PP 3, 21-23, 29-34. This lends additional support to my prior ruling that it would be inappropriate to disregard the *Policy Statement*, the June 1 Order or the December 16 Order for purposes of this proceeding. See P 62, *supra*.

the Commission did not intend the order to have any broader applicability to SFPP. I instead find and conclude the December 16 Order is applicable—if not controlling—here to the extent it is consistent with the *Policy Statement.* The qualifier should assuage Trial Staff's legitimate concern that it would be inappropriate to mechanically apply the December 16 Order without considering the concomitant *Policy Statement* requirement that SFPP demonstrate actual or potential income tax liabilities for the public utility income KMEP limited partners earn through their derivative interests in SFPP.[69]

136. The December 16 Order generally concludes that any flow-through entity "partner...required to file a Form 1040 or Form 1120 return that includes a partnership income or loss . . . has an actual or potential income tax liability for the partnership income." December 16 Order at P 28 (footnote omitted).[70] The order then addresses this standard's relationship to the weighted tax rate, multiple levels of pass-through entities, and the tax benefit allocation among partners. It first cites the Commission's long-held presumption that a Subchapter C corporation owning a regulated utility interest is taxed at the maximum corporate rate of 35%, adopting on this basis a rebuttable presumption that SFPP/KMEP corporate partners pay the maximum marginal tax rate of 35% for purposes of calculating SFPP's income tax allowance. *Id.* at P 30. Turning to the "more difficult" task of determining the marginal tax rates for partners other than Schedule C corporations, the order notes that while such partners "may have a wide range of tax brackets, and in theory any SFPP limited partner or KMEP unit holder could fall into these different brackets . . . it would be very difficult for a regulated pass-through entity to obtain actual tax data on the marginal tax rates of the entity filing the return." *Id.* at P 31. To address this difficulty, the Commission takes "administrative notice" of two IRS

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[69] Although I am sympathetic to Trial Staff's corollary complaint concerning the unfairness of imposing rebuttable marginal income tax rate presumptions on income tax allowance opponents after their affirmative cases had been filed in this proceeding, the December 16 Order—not SFPP—is the source of any such unfairness. And as previously noted, neither Trial Staff nor any other participant requested leave to supplement the record in this proceeding to address the December 16 Order's implications during the more than five week interim between its issuance and hearing commencement, and the hearing had been underway for an additional two weeks before Trial Staff questioned the order's relevance/applicability. *See* Tr. 1168-69. Trial Staff clearly could have been more proactive in this regard. I therefore find and conclude any claim of unfairness based on the December 16 Order's timing must be rejected.

[70] The omitted footnote confirms "the Commission is not requiring that the regulated entity have actual income that would be taxable to its partners in the relevant test year. . . ." *Id.* at n. 45.

publications,[71] relying on the publications' individual income tax data compilations indicating 74.7% of total 1994 federal income taxes and 79.5% of total 1999 federal income taxes were paid by Form 1040 taxpayers in the 28% bracket or higher to adopt a rebuttable presumption of a 28% marginal tax rate for all entities not filing a Form 1120 corporate return. *Id.* The order characterizes this as a "conservative estimate of the marginal tax bracket of individuals holding SFPP or KMEP interests, either directly or indirectly, given that the complainants argue that KMEP serves mostly as a tax shelter for wealthy individuals." *Id.* at P 32. It concludes "[t]hus, it is likely that the use of the 28 percent bracket actually understates the marginal tax rate of most individuals who have invested in SFPP or KMEP partnership interests." *Id.* The order also applies the 28% presumption to entities/individuals with UBIT. *Id.* Summarizing, the December 16 Order states: "Thus, unless a party provides evidence to the contrary, the marginal tax bracket for partners that are Schedule C corporations or LLCs filing Form 1120 return of [sic] 35 percent, *for partners that are tax payers other than a Schedule C corporation* the marginal tax bracket is 28 percent, and for municipalities and other exempt entities the relevant marginal tax bracket is zero." *Id.* (footnote omitted).

137. Turning to multi-level ownership structures, the December 16 Order observes "it is not unusual for a partnership or LLC to be owned by another partnership or LLC, and for that entity in turn to be owned by Form 1040 or 1120 partners." *Id.* at P 33. It then states "[t]here is no objection to such arrangements as long a [sic] partner that is subject to an actual or potential income tax level can be identified during the test year at issue in a particular proceeding." *Id.* The order specifies "it is the obligation of the regulated entity to identify who has the ultimate responsibility for income that is subject to an actual or potential income tax liability." *Id.*

138. The December 16 Order notes that one of *BP West Coast*'s criticisms of the *Lakehead/Lakehead II* income tax allowance policy was it did not achieve its goal of precluding an allowance for non-corporate partners because those partners still shared ratably in the partial corporate partner allowance according to their limited partnership interests rather than their ultimate income tax liabilities. *Id.* at P 34. The order states "this issue can be resolved in the instant case by using the weighted marginal tax bracket of the different unit holders to determine the tax allowance. This reflects the cost to the partnership of the marginal tax brackets of the partners, thus assuring that *ratepayers* are not charged more than the income tax cost imputed to the partnership." *Id.* at P 34 (emphasis in original). The order continues, "[t]his is the same methodology the Commission uses when computing weighted cost of capital which reflects the fact that debt and equity instruments are imputed different costs . . ." concluding "[t]he same logic applies to the determination of the income tax allowance." *Id.*

[71] Individual Income Tax Rates and Tax Shares, 1994; Individual Income Tax Rates and Tax Shares, 1999.

139. The December 16 Order ultimately defers deciding whether SFPP satisfies the *Policy Statement,* instead requiring SFPP to provide additional information because the *Policy Statement* changed the applicable legal standard after the records closed in all of the underlying dockets at issue. *Id.* at P 44. Specifically, the order directs SFPP to separate its respective unit-holders into six broad categories and to include supporting detail on the unit-holders within each of these categories: (1) Subchapter C corporations; (2) individuals; (3) mutual funds; (4) pension funds, IRAs, KEOGH plans and other entities that customarily do not pay income taxes but would be expected to have taxpaying owners/beneficiaries; (5) pension funds, IRAs, KEOGH plans and other entities that customarily do not pay income taxes but might be required to pay taxes on SFPP/KMEP income deemed UBIT; and (6) any institutions or exempt entities such as municipalities, having no obligation to pay out/declare income. *Id.* at P 45. The order further directs SFPP to provide supporting detail on the unit-holders within each category and to categorize pass-through entities such as partnerships based on the entity ultimately subject to an actual or potential income tax liability. *Id.* Finally, the order requires SFPP to identify the unit-holder percentage falling into each category, calculate the percentage of partnership income imputed to each group, and use those percentages to develop a weighted tax allowance.[72] *Id.* at PP 45-46.

140. SFPP relies on compliance with the December 16 Order to claim the weighted income tax allowance of 37.92% reflected in its rebuttal testimony. Accordingly, the issues here are: (1) whether SFPP is entitled to rely on compliance with the December 16 Order; (2) if so, whether SFPP has satisfied the December 16 Order in this case; and (3) if not, what are the implications of SFPP's failure to satisfy the December 16 Order?

141. I previously ruled the December 16 Order is applicable, if not controlling, in this proceeding to the extent it is consistent with the *Policy Statement.*[73] The December 16 Order expressly supplements the *Policy Statement* insofar as the methodology for developing SFPP's marginal tax rate is concerned, and it would be non-sensical to apply the *Policy Statement*/December 16 Order to SFPP's East and West Lines but not to its North Line. The issue here is the SFPP/KMEP marginal income tax rate. That rate is not line-specific; it should be uniform for all SFPP pipelines. I therefore find and conclude SFPP is entitled to rely on compliance with the December 16 Order to prove it is entitled

[72] The order states "the Commission recognizes [the percentage of taxable partnership income imputed to each group] may not be the same as the percentage of the actual units held by each group depending on how expenses, deductions and income are allocated among the partners." *Id.* at P 46.

[73] I see no need to belabor the point that I consider the *Policy Statement* to be patently inconsistent with the *BP West Coast* remand order in certain fundamental respects, except to underscore the fact that the December 16 Order necessarily exhibits the same flaw insofar as it adopts/expands upon those inconsistencies.

to an income tax allowance in this case—provided the December 16 Order is consistent with the *Policy Statement*.

142. The *Policy Statement* concludes an income tax allowance should be granted to:

> all entities or individuals owning public utility assets, *provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets*. Thus a tax-paying corporation, a partnership, a limited liability corporation, or other pass-through entity would be permitted an income tax allowance on the income imputed to the corporation, or to the partners or the members of pass-through entities, provided that the corporation or the partners or the members, [sic] have an actual or potential income tax liability on that public utility income. Given this important qualification, *any pass-through entity seeking an income tax allowance in a specific rate proceeding must establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income.*

Policy Statement at P 32 (emphasis added). This language clearly imposes an *affirmative* burden of proof on any pass-through entity seeking an income tax allowance in a specific rate proceeding: the entity must establish the actual or potential income tax liability on public utility income for each partner or member interest reflected in the claimed allowance. Unbundled, the *Policy Statement* burden of proof imposes at least two discrete obligations. First, the pass-through entity must establish the fact and magnitude of each partner/member's actual or potential income tax liability. Second, the entity must conclusively link that liability to its public utility income from regulated service. The December 16 Order deviates from these requirements.

143. The December 16 Order summarily concludes any flow-through entity "partner...required to file a Form 1040 or Form 1120 return that includes a partnership income or loss . . . has an actual or potential income tax liability for the partnership income." December 16 Order at P 28 (footnote omitted). Proceeding from this conclusion, the order adopts rebuttable presumptions that: (1) SFPP/KMEP corporate (Form 1120) partners pay the maximum marginal income tax rate of 35%; and (2) all SFPP/KMEP entities not filing a Form 1120 corporate return pay income taxes at a 28% marginal tax rate. *Id.* at PP 30-31. These presumptions are problematic for a number of reasons. Most important, they reverse the *Policy Statement* burden of proof. The *Policy Statement* imposes the burden of proof on the pass-through entity seeking an income tax allowance. This not only accords with the fundamental ratemaking tenet that the rate proponent bears an affirmative burden to prove its case, it also reflects the circumstance that the rate proponent is in a privileged position insofar as the pertinent information is concerned. As the *Policy Statement* recognizes: "This is a fact specific issue for which the relevant data is uniquely within the control of the regulated entity." *Policy Statement*

at P 42. It follows that the rebuttable presumptions adopted in the December 16 Order not only improperly reverse the burden of proof, but at the same time make it virtually impossible for tax allowance opponents to rebut the presumptions because they do not have the requisite data.[74]

144. The December 16 Order's inconsistency with the *Policy Statement* is further confirmed by briefly revisiting *City of Charlottesville*. SFPP is no doubt correct that the *Policy Statement* derives its "actual or potential income tax liability" standard from the *City of Charlottesville* principle that an income tax allowance may reflect any "actual or estimated taxes paid or incurred." SFPP—and the December 16 Order—apparently concentrate on the standard's "estimated" and "incurred" components to conclude it covers *theoretical* as well as actual tax liability. The more logically-consistent interpretation is that *City of Charlottesville* was concerned with ensuring a tax allowance for both current and future *actual* tax liabilities—that is, that the standard's "estimated" and "incurred" components were intended to cover tax payments (i.e. costs) actually made, but at some future point in time.[75] In contrast to SFPP's reading (see discussion at P 111, supra), this interpretation squares with the *City of Charlottesville* distinction between governmental entities having no actual or potential income tax liability because they are legally exempt from paying income taxes and non-exempt entities/individuals. The former would never be required to pay income taxes; the latter might or might not. Again, the standard is keyed to whether income taxes ultimately will be *paid*. Abstract or theoretical tax liabilities do not in themselves satisfy this key requirement. That is why the *Policy Statement* necessarily imposes the burden of proof on "any pass-through entity seeking an income tax allowance in a specific rate proceeding [to] establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income." *Policy Statement* at P 32. The December 16 Order's presumptions eviscerate and reverse this burden by (i) uncritically presupposing every dollar of tax liability attributable to regulated utility income ultimately/necessarily will be

[74] Although each presumption is procedurally troubling in that it reverses the burden of proof, the 35% corporate rate presumption seems less so on substantive grounds than the 28% non-corporate rate presumption because the corporate rate would not vary from one Subchapter C corporation to another. Any corporate allowance nevertheless would have to be discounted to reflect the circumstance that non-corporate partners share ratably in the corporate allowance according to their limited partnership interests.

[75] The December 16 Order implicitly acknowledges this point when it defends the conclusion that offsets for deductions, losses or other subtractions are irrelevant as being "consistent with the philosophy in *City of Charlottesville* that the actual or potential tax liability test does not require that actual cash tax payments be paid by an entity on regulated income *in a particular fiscal year*." December 16 Order at P 28 (emphasis added).

paid by someone at some time and (ii) imposing a burden to demonstrate the contrary on tax allowance opponents.

145. The December 16 Order's reliance on the 1994 and 1999 IRS publications is problematic as well. First, the order takes "administrative notice" of these taxpayer data compilations to support its 28% marginal tax rate presumption for all entities not filing a Form 1120 corporate return. December 16 Order at P 31. Research reveals scant reference to—and no discrete definition of—administrative notice. I therefore proceed from the premise the December 16 Order uses the term in lieu of either "judicial notice" or "official notice"—most likely the latter since Commission regulations expressly provide the Commission[76] may take official notice "of any matter that may be judicially noticed by the courts of the United States or of any matter about which the Commission, by reason of its functions, is expert." 18 C.F.R §385.508 (d) (1) (2006). Individual income tax rates obviously do not fall within the category of matters about which the Commission is expert by reason of its functions. As a consequence, the Commission may take official notice of them only insofar as they may be judicially noticed. Judicially-noticeable facts fall into one of two categories: adjudicative facts or legislative facts. Adjudicative facts relate directly to the immediate parties to a specific proceeding; legislative facts are established truths of universal applicability that cannot reasonably be questioned and are not party/case-specific. *See generally* Richard J. Pierce, Jr. ADMINISTRATIVE LAW TREATISE (4th ed. 2002) §§ 10.5-10.6. The individual income tax data on which the 28% presumption is based indisputably falls into the legislative fact category. They are raw data compilations covering the universe of taxpayers filing Form 1040 returns for the years 1994 and 1999. The validity of the data itself cannot reasonably be questioned and it clearly is neither specific to the December 16 Order's underlying dockets nor to the parties involved in those dockets.[77] And therein lies the problem. In extrapolating from the general (legislative fact data) to the particular (adjudicatory fact presumption), the December 16 Order misuses judicial notice by conflating legislative facts with adjudicatory ones. There simply is no way to determine from the compiled data whether any individual KMEP partner actually fell within the 28% bracket in 1994 or 1999,[78] let alone in the relevant base/test periods.[79] Neither is

[76] 18 C.F.R §385.508 (d) (1) (2006) references "[a] presiding officer." The regulations define "presiding officer" to include "one or more Members of the Commission." 18 C.F.R §385.102 (e) (1) (2006).

[77] The same obviously holds true for the instant proceeding.

[78] The data confirms the *maximum probability* of this being the case was only 74.7% in 1994 and 79.5% in 1999. Moreover, the December 16 Order itself concedes such partners "may have a wide range of tax brackets, and in theory any SFPP limited partner or KMEP unit holder could fall into these different brackets. December 16 Order at P 31.

there any way to determine from the data (i) whether or how much of such partners' declared incomes actually was/were attributable to SFPP's jurisdictional activities or (ii) how much tax liability actually attached to such income. And while the December 16 Order premises its resort to the IRS data on the conclusion "it would be very difficult for a regulated pass-through entity to obtain actual tax data on the marginal tax rates of the entity filing the return" (December 16 Order at P 31), such difficulty cannot supersede the Commission's obligation to establish policy on a rational basis.[80] The December 16 Order's acknowledgment that "it is likely that the use of the 28 percent bracket actually understates the marginal tax rate of most individuals who have invested in SFPP or KMEP partnership interests" (*Id.* at P 32) is problematic for the same reason. It is no more rational to intentionally under-compensate SFPP's legitimate tax liability in the face of difficulty than it is to inject unsubstantiated presumptions in that circumstance.[81]

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[79] The data varies by almost 5% from 1994 to 1999, and is now between seven and twelve years old.

[80] The Administrative Procedure Act expressly entitles parties to an opportunity to demonstrate the contrary when an agency decision rests on official notice of a material fact not appearing in the evidentiary record. See 5 U.S.C. § 556 (e) (2006). It is unknown whether opposing parties were afforded such opportunity prior to the December 16 Order's issuance, or whether they raised the matter in a request for reconsideration of the order.

[81] The December 16 Order defends relying on the weighted marginal tax bracket of different unit holders to determine the tax allowance based in part on the rationale that "[t]his is the same methodology the Commission uses when computing weighted cost of capital which reflects the fact that debt and equity instruments are imputed different costs of capital. That is, once the weighted cost of capital is determined, the Commission does not go further and determine whether the purchaser of a particular instrument may be earning more or less than the weighted cost of capital. The same logic applies to the determination of the income tax allowance." December 16 Order at P 34. The order's logical extension is unsound. First, it completely ignores the fact that any income tax allowance must be determined in accordance with the *Policy Statement*, which requires pass-through entities affirmatively to prove both the legitimacy and magnitude of their income tax allowance claims. Second, in contrast to the December 16 Order's imputed 28% income tax rate, the imputed cost of capital constitutes a genuine cost to the utility itself and is readily quantifiable. I am at a loss to understand how imputing a 28% marginal tax rate to SFPP's non-corporate partners either "reflects the *cost to the partnership* of the marginal tax brackets of the partners" or protects ratepayers from being overcharged, as the December 16 Order claims. *Id.* (emphasis added). Moreover, the equity/debt cost of capital differential corresponds to identifiable and quantifiable risk differentials between equity and debt financing instruments. It follows that the December

146. The preceding analysis compels me to find and conclude SFPP is not entitled to rely on compliance with the December 16 Order to justify its income tax allowance claim. Accordingly, I need not address whether SFPP has satisfied the December 16 Order in this case, or if not, what that failure implies—except to find and conclude: (1) SFPP has provided inadequate evidence in this proceeding to satisfy the December 16 Order's requirements in any meaningful way;[82] and (2) that failure implies either that SFPP is entitled to no more than a 4.50% income tax allowance based on SFPP's proposed 40.3% composite federal/state income tax rate for its corporate unit-holders alone,[83] or SFPP must be required to make a compliance filing in this docket similar to the one required in the dockets underlying the December 16 Order.[84] *See* December 16 Order at PP 44-47.

c. Whether SFPP's Proposed Income Tax Allowance For Designing Its North Line Rate Is Justified and Appropriate? If Not, What Is The Appropriate Income Tax Allowance For Designing SFPP's Test Year North Line Rate?

147. This issue is resolved in accordance with Issues D-1-a and D-1-b.

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16 Order's suggestion that the methodology for deriving a utility's imputed cost of capital is analogous to the order's methodology for imputing the 28% non-corporate income tax rate is specious.

[82] *See generally* Ex. SFN-43. In addition, I find and conclude SFPP failed to comply with the December 16 Order in developing the weighted tax rate underlying the rebuttal case income tax allowance claim. The *Policy Statement*, December 16 Order and the evidentiary record in this proceeding indicate SFPP should have developed the weighted tax rate using actual ownership interests rather than allocated taxable income. *See, e.g., Policy Statement* at P 42; December 16 Order at P 28; Ex. CCV-1 at 29-32 **[PROTECTED]**; Tr. 1799-1804.

[83] KMI and its subsidiaries, based on their 35% maximum corporate income tax rates. I am unable to determine from the record whether this figure discounts for the circumstance non-corporate partners share ratably in any partial corporate partner allowance according to their limited partnership interests.

[84] Although I do not endorse the compliance filing alternative in this instance, requiring SFPP to make a compliance filing in meaningful accordance with the December 16 Order would not be inconsistent with the order.

2. Is SFPP's Proposed Treatment Of ADIT Justified And Appropriate? If Not, What Is The Appropriate Treatment?

148. This issue was substantially resolved under Issue B-6, *supra*. Only those specific ADIT sub-issues that have not been resolved elsewhere are addressed here, and only in the alternative since my primary ruling under Issue D-1-a was that *BP West Coast* precludes SFPP from receiving any income tax allowance.

a. Whether The Over-Funding, If Any, Of SFPP's ADIT Account Should Result In Offsets To SFPP's Income Tax Allowance?

Participant Positions

SFPP

149. SFPP states there is general consensus among itself, Trial Staff, BP/EM and CCV that the ADIT calculation should be consistent with SFPP's income tax allowance. It acknowledges that every other participant maintains SFPP is entitled to no income tax allowance, but assumes they are wrong for the purpose of addressing ADIT-related issues. Building on that assumption, SFPP proposes to adjust the ADIT reflected in its North Line rate filing in a compliance filing similar to the one mandated by the December 16 Order. SFPP asserts the required adjustments would have two effects on North Line cost of service. They would: (1) increase rate base, thereby increasing cost of service; and (2) over-fund the portion of ADIT accrued prior to 1989 due to the lower applicable income tax rate after the book tax timing differential reverses. SFPP proposes to amortize the over-funded amount, with the annual amortization used to adjust SFPP's income tax allowance. SFPP notes that potential annual changes to the income tax allowance in accordance with the December 16 Order may produce additional layers of over/under-funded ADIT depending on whether the tax rate decreases or increases. These additional layers also would be amortized and used to adjust the income tax allowance under SFPP's proposal.

Trial Staff

150. Trial Staff agrees any over-funded ADIT should offset SFPP's income tax allowance, assuming some allowance is appropriate. Trial Staff adds that any attending rate base increase/over-funded ADIT amortization should be time-synchronized over the same period(s)—presumably in the context of compliance filings.

BP/EM

151. BP/EM also agree any over-funded ADIT should offset SFPP's income tax allowance, assuming an allowance is appropriate.

CCV

152. CCV challenge SFPP's over-funded ADIT amortization proposals as completely unsupported by the record in this proceeding. CCV similarly criticize SFPP's reliance on a future compliance filing to satisfy a burden of proof it failed to satisfy here—particularly since such a filing would not be subject to discovery or cross-examination. In addition, CCV vigorously oppose adjusting the ADIT account retroactively to 1989 in accordance with whatever income tax allowance SFPP is granted in this proceeding. CCV maintain Commission policy precludes SFPP from modifying the North Line ADIT balance prior to the date of its 2005 North Line rate application in this proceeding. And since SFPP no longer incurs/is subject to deferred taxes, CCV support the BP/EM position that the entire ADIT account balance should be returned to ratepayers because it constitutes excess ratepayer-supplied capital.

Discussion/Analysis

153. I agree that ADIT must be consistent with whatever income tax allowance is granted—both prospectively and retroactively to 1989. The ADIT account accumulates actual dollars for SFPP through the income tax component embedded in North Line rates. The rationale underlying this accumulation is that once SFPP has exhausted its accelerated tax depreciation, it must satisfy any annual income tax liabilities by drawing down the accumulated ADIT account—ultimately to zero at the end of the pipeline's longer book depreciation period. If the account is over-funded, the excess must somehow be returned to the ratepayers who provided it. This requires both quantifying the over-funded amount and determining the proper mechanism through which to return it.

154. Although SFPP itself has neither incurred nor been subject to deferred income taxes since 1989, the *Policy Statement*/December 16 Order permit it to impute income tax liability to corporate partners at a 35% rate and to non-corporate partners at a 28% rate. This almost certainly means the ADIT account has been over-funded in significant degree since 1989 because (i) the account over-collected in its earlier years in anticipation of under-collecting SFPP's presumed 35% marginal corporate income tax liability in later ones and (ii) SFPP's imputed post-1989 income tax liability under the December 16 Order is necessarily less than the amount actually collected after 1989 to cover SFPP's presumed 35% marginal corporate tax liability due to the SFPP weighted rate's overwhelmingly predominant 28% non-corporate partner tax liability component. *See generarlly* Ex. SFN-43 at 20. The December 16 Order's imputed 35% corporate partner

rate should approximate SFPP's pre-1989 marginal corporate income tax rate,[85] and so should have a relatively minor/constant impact on post-1989 ADIT over-funding. The imputed 28% non-corporate partner rate, in contrast, not only implies a significant ADIT differential, but also apparently varies annually to an appreciable degree in accordance with SFPP/KMEP income allocations. *See* Ex. SFN-43 at 19-20; Tr. 1319; 1325-27. This rate would have a more profound impact on post-1989 ADIT over-funding. Unfortunately, the record in this proceeding is devoid of any quantitative evidence concerning these impacts. Whatever they may be, I find and conclude any ADIT account over-funding must be flowed-back through ratepayer offsets/credits to whatever income tax allowance the Commission may grant SFPP. Consistent with the Opinion No. 435 principle that "Commission practice is to base its decision on the policy in effect in the year a regulatory decision is made, and then apply that decision to the time frame to which the case applies" (86 FERC at 61,093-94), these and any other ADIT adjustments must be made prospectively, beginning on the June 1, 2005 rate effective date. It follows that SFPP's ADIT retroactive adjustment/amortization proposals must be rejected.

155. I once again note the December 16 Order was issued just weeks prior to hearing commencement in this docket, and that no participant requested leave to supplement the record here to address the December 16 Order's relevance to this proceeding prior to hearing commencement. And once again, these are problematic circumstances for everyone involved. None of (i) SFPP's North Line tariff filing (ii) its direct case in support of that filing or (iii) its rebuttal case addressed to the December 16 Order satisfies the order insofar as income tax allowance impacts on ADIT are implicated.[86] This is understandable to some degree since the December 16 Order itself found it necessary to require SFPP to provide significant additional or reformatted information to address the income tax allowance policy changes articulated in the *Policy Statement* and December 16 Order by means of a February 28, 2006 compliance filing in Docket No. OR92-8, *et al.* and Docket No. OR96-2, *et al.*[87] *See* December 16 Order at PP 44-47. Consistent with my rulings under Issue B-6, I find and conclude SFPP should be required to quantify the income tax allowance implications for the ADIT account here in the context of the compliance filing initially required under Issue A. This solution accords with the procedure adopted in the December 16 Order, and SFPP already should have compiled

[85] The match is not perfect due to under-funded deferred taxes prior to 1974 and a 1987 federal income tax rate change. Tr. 1328.

[86] I say "implicated' because neither the *Policy Statement* nor the December 16 Order specifically discusses ADIT consequences.

[87] It is unknown whether/to what degree the February 28, 2006 compliance filing addressed ADIT, and in any event that filing neither pertains to the North Line nor legitimately may be considered a part of the evidentiary record in this docket.

much of the necessary post-1989 information for purposes of its February 28, 2006 compliance filing. As previously stated, any compliance filing in accordance with the December 16 Order also must afford opposing participants a meaningful opportunity to challenge SFPP's ADIT-related information.[88]

b. Whether Full Tax Depreciation Must Be Taken In The Test Year As An Offset To SFPP's Income Tax Allowance, If Any, Rather Than "Booked" To An ADIT Account?

Participant Positions

SFPP

156. SFPP asserts this issue contemplates a change to its ADIT calculation methodology, which SFPP maintains is both an established approach and consistent with Commission precedent. SFPP argues that any participant proposing to change an established methodology bears a burden to prove not only that the methodology is unreasonable, but also that its proposed alternative is just and reasonable. SFPP claims there is no record support for either conclusion.

Trial Staff

157. Trial Staff addresses this topic only to the extent SFPP is not entitled to an income tax allowance.

BP/EM

158. BP/EM contend full tax depreciation must be taken in the test year for two reasons. Because there is no tax at the partnership level: (1) all tax depreciation necessarily is flowed-through to partners in the tax year rather than being held in any kind of reserve account; and (2) there consequently can be no deferred income taxes. It follows there can be no ADIT account, which BP/EM submit is confirmed by the fact that SFPP's annual report, Form 6, reflects zero ADIT. BP/EM emphasize SFPP nevertheless has collected ratepayer/consumer dollars and "booked" those dollars into an ADIT account for the entire duration of its existence in partnership form. In BP/EM's view, this is inappropriate and SFPP rates should reflect full tax depreciation.

[88] Again, I see no reason to extend the timeframes specified in footnotes 15 and 16 on account of the additional ADIT issue.

Discussion/Analysis

159. I agree with SFPP that BP/EM ordinarily would bear a dual burden to prove SFPP's ADIT calculation methodology unreasonable insofar as tax depreciation is concerned and also to prove that BP/EM's proposed alternative is just and reasonable. *See, e.g., Sea Robin Pipeline Co.*, 795 F.2d 182, 186-87 (D.C. Cir. 1986). But while I agree BP/EM have not proven their proposed alternative just and reasonable, I disagree that there is no record evidence SFPP's ADIT calculation methodology is unreasonable. SFPP's entire underlying income tax allowance claim is premised on compliance with the December 16 Order. SFPP nevertheless expressly acknowledges it did not present any adjusted ADIT information whatsoever in conformity with that order. Ex. SFN-43 at 20. It cannot persuasively rely on December 16 Order compliance in the main, only to resort to some other "established" approach when the order proves inconvenient. And while this appears to be another issue exclusively dependent on whether SFPP *qua* partnership is entitled to an income tax allowance, that conclusion does not seem to be entirely dependent in this limited instance. The record indicates tax depreciation impacts SFPP's rates and regulated utility income in ways that are driven by the income tax allowance, but are not entirely dependent on it. In addition, since all of SFPP's annual tax depreciation necessarily flows to its partners because SFPP itself has no income taxes to pay or offset,[89] it certainly seems unreasonable for SFPP to pretend otherwise and "book" that depreciation to its ADIT account—particularly when doing so impacts rate base, deferred return, allowed return and, ultimately, cost of service. I therefore find and conclude SFPP's ADIT calculation methodology is unreasonable insofar as tax depreciation is concerned. This deficiency must be addressed in the compliance filing as well.

3. Is It Necessary To Determine The "Taxable Income" Of SFPP For Purposes Of Determining An Income Tax Allowance? If So, How Would It Be Determined?

Participant Positions

SFPP

160. SFPP contends it is not necessary to determine its taxable income here because that income already has been determined and reported to the IRS on Form 1065. Citing the December 16 Order, SFPP states it is beneficial to know SFPP had positive taxable income for the purpose of confirming actual or potential income tax liability. It also is necessary on SFPP's account to know its precise test year taxable income for the limited purpose of tracing that income through "several layers of pass-through entities to

[89] *See* Ex. BPX-3 at 39-40 **[PROTECTED]**; Ex. BPX-51 at 65.

determine the percentage of income allocated to the various categories of partners, and then develop a weighted average of the corresponding marginal income tax rates" because those percentages are used to calculate a weighted federal and state income tax rate which, in turn, is used to calculate the net-to-tax multiplier used to calculate the income tax allowance. SFPP maintains no step beyond development of the income percentages allocated to SFPP partner categories involves SFPP's taxable income.

Trial Staff

161. First characterizing the term "taxable income" as a misnomer for SFPP except at the partner level, Trial Staff argues that if an income tax allowance is to be granted in this case, it is necessary to determine SFPP's tax year 2004 regulated ordinary business income as a step in developing the allowance. Trial Staff summarizes the relevant inquiry under the *Policy Statement* as whether an owner of an interest in the regulated partnership has an "actual or potential income tax liability on the public utility income earned through the interest." In Trial Staff's view, common sense indicates the first step in determining such owners' income tax liabilities is to determine what amount of public utility income is eligible to become taxable income to the owners. Trial Staff disputes whether SFPP actually traced its 2004 regulated ordinary business income through its chain of ownership to KMEP's limited partners, however, arguing SFPP did not demonstrate it had the accounting capability to differentiate SFPP income from other commingled and unregulated OLP-D/KMEP income. Instead, Trial Staff emphasizes, SFPP simply allocated income among various categories of KMEP partners/taxpayers. Trial Staff underscores that SFPP acknowledged the difficulty of tracing SFPP's regulated income on the record at hearing, a difficulty Trial Staff attributes to a complicated-by-design business organizational structure. Trial Staff concludes SFPP failed to satisfy the burden to prove its owners' actual or potential income tax liabilities here because it could not factually trace SFPP's regulated income to them.

BP/EM

162. BP/EM maintain it is essential to determine SFPP's taxable income if an income tax allowance is to be granted. BP/EM also maintain the amount reported to the IRS on Form 1065 is inadequate to this end.

<u>Discussion/Analysis</u>

163. All participants agree it is necessary to determine the amount of income on which any income tax allowance is based. I concur. An income tax allowance presupposes an income tax liability, which in turn is a function of an underlying income. Whether the income tax allowance reflects a true cost to the utility itself,[90] or a pass-through liability

[90] I have determined this is not the case with respect to SFPP.

to its owners, the underlying cost/liability must be quantified in some manner that is neither arbitrary nor capricious. A true cost is readily quantifiable, and is by definition appropriately allocated to the utility that pays it. Pass-through liabilities, in contrast, demonstrate no such certainty *in themselves*. It follows that such liabilities not only must be reasonably quantified, but rationally allocated/distributed as well.

164. Trial Staff's concern over referencing SFPP's "taxable income" reflects crucial insight. Speaking in such imprecise shorthand confuses the simple circumstance that SFPP has no taxable income. It is a partnership and as such pays no income taxes; it therefore has no taxable income. It has regulated ordinary business income—100% of which is passed-through to owners at multiple levels. Those owners may or may not have actual or potential income tax liability for the public utility income earned through their interests. Any that do properly may be said to have taxable income derived through their ownership interest(s) in SFPP, but not a share of "SFPP taxable income." The material underlying income figure for *Policy Statement* purposes, then, is not necessarily the total regulated ordinary business income SFPP passes through to its owners. It is instead the amalgamated amount of SFPP-derived regulated ordinary business income for which SFPP can demonstrate its owners have actual or potential income tax liabilities.

165. The *Policy Statement* addresses the underlying income determination only by implication. It contemplates that any pass-through entity's income tax allowance will be determined in accordance with the entity owners' total actual or potential income tax liabilities on regulated public utility income. Quoting the *Policy Statement*:

> any pass-through entity seeking an income tax allowance in a specific rate proceeding must establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income. To the extent that any of the partners or members do not have such an actual or potential income tax obligation, the amount of any income tax allowance will be reduced accordingly. . . .[91]

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[91] I cite this language for the sole purpose of illustrating the *Policy Statement* requires each pass-through owner contributing to the utility's total income tax allowance *to demonstrate the fact and magnitude of its proportionate income tax obligation for the* pass-through entity's total public utility income. As previously noted, in my view the second sentence of the cited language suggests a presumption with respect to the total pass-through owner income tax liability which is both impermissible in that it implicitly reverses the threshold burden of proof, and inconsistent with the immediately preceding *Policy Statement* mandate that the pass-through entity must affirmatively establish its partner/members' actual or potential income tax obligations on the pass-through entity's public utility income.

Policy Statement at P 32. *BP West Coast* concerns notwithstanding, I find and conclude this standard facially satisfies the requirement that Commission policy be established in a manner which is neither arbitrary nor capricious. It is at least rational to assume that somewhere up the ownership chain SFPP/KMEP partners/members ultimately receive some indeterminate amount of SFPP-derived regulated utility income and also incur some degree of actual or potential tax liability for it.[92] It does not necessarily follow, however, that every (or any particular) partner/member actually receives such income. Neither is it self-evident how much SFPP-derived income in fact reaches any particular partner/member. These uncertainties must be eliminated and conclusively quantified in order to derive the composite taxable income figure material to the tax allowance.

166. A conclusion the *Policy Statement* was crafted with consideration to the preceding uncertainties is supported by the fact that it expressly defers to individual rate proceedings the "technically complex" task of establishing the fact and magnitude of each individual actual or potential partner/member income tax liability supporting the pass-through entity's total income tax allowance claim. *Id.* and n. 27. Although the *Policy Statement* begs the question of precisely how these demonstrations must be made in the context of individual rate proceedings, the logical implication is that they must be factual/evidentiary. What other reason could there be to defer them to individual rate proceedings?

167. Conversely, there is no logical basis on which to *presume* in any individual rate proceeding that every flow-through entity "partner...required to file a Form 1040 or Form 1120 return that includes a partnership income or loss . . . has an actual or potential income tax liability for the partnership income." December 16 Order at P 28 (footnote omitted). Nor is there any logical basis on which to *presume* in such evidentiary proceedings either a 28% tax rate for all Form 1040 filers or that SFPP/KMEP income allocations reflect actual SFPP-derived partner/member incomes and income tax

[92] I note here that whether such owners have taxable income-reducing offsets (e.g., unrelated losses, credits, 743(b) depreciation, etc.) should be immaterial to their actual or potential tax liability on SFPP income—so long as that liability can be established/ quantified before the offsets are applied. I do not see how this situation differs from the long-accepted corporate utility practice of reducing otherwise taxable income through non-cost offsets, thereby reducing the utility's ultimate income tax *payment* in a particular year as distinguished from the pre-offset tax *liability* on which its income tax allowance was based. Moreover, it smacks of confiscation to require SFPP/KMEP pass-through partners/members essentially to subsidize SFPP rates by reducing the partner/members' tax liabilities for SFPP-derived income—hence, the tax allowance reflected in rates—by the value(s) of whatever non-utility-related offsets, credits or deductions the partner/members otherwise might have.

liabilities. *Compare Policy Statement* at P 42 *with* December 16 Order at PP 32, 43-46. These presumptions reverse the burden of proof which the *Policy Statement* rationally imposes on the pass-through entity seeking an income tax allowance. They also disregard the ratemaking axiom that rate proponents bear the affirmative burden to prove their cases, as well as the circumstance that the rate proponents have a virtual monopoly on the requisite evidence.[93] Most important, the December 16 Order presumptions directly contravene the *Policy Statement's* evidentiary requirement that "any pass-through entity seeking an income tax allowance in a specific rate proceeding must establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income." *Policy Statement* at P 32. As previously illustrated, the *Policy Statement* requires the pass-through entity seeking a tax allowance to make this factual demonstration in the context of an evidentiary rate proceeding. The December 16 Order arbitrarily supplants this requirement with evidentiary *presumptions* concerning the existence, magnitudes and distributions of pass-through entity partner/member tax obligations for the entity's public utility income. These presumptions impute a composite taxable income figure by extension. And irrespective of whether the presumptions may be deemed to have the minimum required rational bases—which I previously concluded they do not—they clearly had no legitimate factual bases in the underlying records. *See* December 16 Order at PP 31-32. Accordingly, I find and conclude that while the general standard for demonstrating SFPP-derived taxable income articulated in the *Policy Statement* is rational, the same does not hold true for the supplemental guidance provided in the December 16 Order.

168. What remains is to determine whether SFPP has in this proceeding factually established the income material to its tax allowance claim in accordance with the *Policy Statement*—that is, whether SFPP has demonstrated the total of its pass-through owners' individual actual or potential income tax liabilities on SFPP-derived regulated public utility income. The answer clearly is no. The *Policy Statement* required SFPP factually to demonstrate the actual or potential income tax liability on SFPP-derived income for each partner/member ownership interest subsumed in the claimed allowance. It therefore was incumbent on SFPP (i) to establish the fact and magnitude of each discrete partner/member's actual or potential income tax liability and (ii) to conclusively match that liability to SFPP-derived public utility income from regulated service. *Accord Trans-Elect*, 113 FERC ¶ 61,162. SFPP did neither. Instead, it relied exclusively on the net income figure reflected on line 1 of its 2004 Form 1065 partnership return and simply allocated/imputed that amount among the various partner/unit-holder categories specified in the December 16 Order. *See* Ex. SFN-36 at 6; Ex. SFN-41; Ex. SFN-41-A **[ALL PROTECTED]**. *See also* December 16 Order at PP 44-46. All the net income figure reflects, however, is the total income SFPP initially sent up the partnership chain. There

[93] To reiterate, the *Policy Statement* characterizes this evidence as "uniquely within the control of the regulated entity." *Policy Statement* at P 42.

is no evidence in the record before me that SFPP or any other Kinder Morgan entity has the accounting capability to trace SFPP-derived income up that chain to "where the ultimate tax liability lies," let alone to establish the ultimate "character of the tax incurred" as the *Policy Statement* requires. *Policy Statement* at P 42. SFPP expressly concedes as much. *See* Tr. 1190-93.

169. The preceding analysis compels me to find and conclude that although SFPP was required to establish the composite partner/member taxable income figure material to its tax allowance claim through demonstrative evidence, it has completely failed to do so in this proceeding. This ruling notwithstanding, SFPP clearly relied on the December 16 Order and arguably complied with it in substantial degree. Here again, it would be unduly harsh to penalize SFPP for good faith reliance on the SFPP-specific guidance reflected in the December 16 Order irrespective of whether that guidance comported with the *Policy Statement*. SFPP therefore should be granted a supplemental opportunity to factually establish the composite partner/member taxable income figure material to a tax allowance claim in accordance with the *Policy Statement* in the context of a compliance filing. Opposing participants also should be granted a meaningful opportunity to challenge that filing.

a. How To Determine The "Taxable Income" Of SFPP For Purposes Of Determining The Component For An Income Tax Allowance?

170. This issue is resolved in accordance with Issue D-3.

4. Is It Necessary To Determine The "Taxable Income" Of The Relevant Partners For Purposes Of Determining An Income Tax Allowance? If So, How Should It Be Determined?

171. This issue is resolved in accordance with Issue D-3.

a. How To Determine The "Taxable Income" Of The Relevant Partners For Purposes Of The Component On Income Taxes, Including The Reclassification Of Categories Of Partners, The Question Of Whether Allocations Of Income To The KMEP General Partner Should Be Excluded Because It Is A Management Fee, And The Question Of Whether Passive Loss Carryforwards, 743-B Depreciation, And Tax Credits Can Be Ignored In The Calculations, Each Of Which Operates To Lower The Amount Of "Taxable Income" Flowed Through From The KMEP Partnership?

172. This issue is resolved in accordance with Issue D-3.

5. How Should The "Tax Rate" Applicable To The Relevant Partners Be Determined?

173. This issue is resolved in accordance with Issue D-3.

a. How To Determine The "Tax Rate" For The Relevant Partners, Including The Question Of "Stand Alone" Versus Consideration Of Assumed Outside Income And Including The Question Of Whether Presumptions Of Tax Rates Are "Arbitrary And Capricious"?

174. This issue is resolved in accordance with Issue D-3.

b. Should It Be Presumed That The Tax Rate On Individuals For Income Received From SFPP Partnership Affiliates Is 28% When The Maximum Tax Rate On Qualified Dividends Is 15%?

175. This issue is resolved in accordance with Issue D-3.

E. What Is the Appropriate Level of Operation and Maintenance Expenses in this Case?

1. Whether SFPP's Allocation of General And Administrative (*i.e.*, Overhead) Expense In Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Allocation Of General And Administrative Expense For Designing SFPP's Test Year North Line Rate?

Participant Positions

SFPP

176. SFPP summarizes the participant disputes under this issue as: (1) whether SFPP's use of targeted allocations within the so-called "Massachusetts" formula is reasonable; (2) whether to include all KMEP subsidiaries in the allocation; and (3) how to determine the overhead expenses to be allocated after resolving the first two questions; and (4) whether and how PAA should be included in the allocation.

177. SFPP states KMEP uses the Massachusetts formula to allocate overhead expenses incurred on behalf of its general partner (KMGP) among KMEP's subsidiaries, including SFPP. SFPP describes the Massachusetts formula as equally weighting gross revenues, labor costs and gross plant to allocate overhead costs for ratemaking purposes to properly

reflect the parent relationship, adding that the allocation should reflect the relative focus a parent company gives to each subsidiary. KMEP overhead expenses arise from two sources according to SFPP—KMEP's reimbursement to its parent (KMI) for certain corporate-type services reflected in a "KMI Cross-Charge" and costs incurred by entities to which KMGP has delegated management responsibility (KMGP Services—a KMGP subsidiary and KM Services—a KMR subsidiary). To determine the 2004 overhead expenses to be allocated, the $170.5 million total corporate overhead reflected on KMEP's Form 10-K must be adjusted twice. First, overhead costs identified with specific operations or entities must be directly assigned to them rather than allocated through the Massachusetts formula. Second, since each KMEP entity capitalizes a portion of its allocated KMEP overhead for financial reporting purposes, KMEP must consolidate those amounts and add the total to the overhead it reports in its Consolidated Statement of Income to reconcile with overhead allocated through the Massachusetts formula. These two adjustments increase the allocation total to $178.5 million.

178. KMEP makes two more adjustments when applying the Massachusetts formula to allocate the $178.5 million figure. It first excludes certain subsidiaries whose inclusion KMEP deems contrary to the formula's objective due to a lack of KMEP management involvement. KMEP then identifies certain cost categories which it matches to four specific subsidiary groups ("tiers"), allocating these cost categories on group-specific bases rather than individually across the board. In SFPP/KMEP's view, this "targeted tier" allocation better satisfies the Commission preference for direct cost assignment prior to resorting to socialized allocation among all subsidiaries. SFPP/KMEP characterize "targeted tier" allocation as a "refine[ment]" to the Massachusetts formula that more closely aligns cost allocation with cost incurrence. They also maintain it is appropriate to increase the gross property amounts associated with six KMEP subsidiaries—including SFPP—to reflect PAA associated with those entities, thereby modifying the indicated overhead cost allocation percentages for all KMEP subsidiaries under the Massachusetts formula.

Trial Staff

179. Trial Staff argues SFPP's four tier overhead cost allocation scheme is inconsistent with the Massachusetts formula, and SFPP has not established the propriety of its formula deviations/modifications. It levies the same criticism on SFPP's inclusion of PAA in the underlying gross plant factors, which Trial Staff maintains both overstates and distorts the appropriate overhead cost allocation under the Massachusetts formula. Trial Staff criticizes SFPP for including PAA in its carrier/non-carrier overhead cost allocation under the so-called "Kansas/Nebraska" formula on similar grounds. In addition, it disputes whether SFPP established the propriety of excluding nineteen[94] subsidiaries

[94] SFPP initially proposed to exclude nineteen subsidiaries, but reduced that number to seventeen at hearing. *See* Tr. 1602-03.

from the overhead cost allocation pool. Finally, Trial Staff contends SFPP did not convincingly demonstrate it did not double-count certain overhead costs, noting that some such costs appear to be both capitalized and expensed in developing the North Line rate.

CCV

180. CCV once again take issue with SFPP's ostensible failure to "open fully" in its initial brief, arguing SFPP should be deemed to have conceded any CCV testimony or hearing position(s) on this topic not addressed there. Turning to substance, CCV first argue SFPP's exclusion of any KMEP subsidiary from the Massachusetts formula overhead cost allocation pool unreasonably shifts overhead costs to the remaining entities—including SFPP—and lacks any legitimate foundation. CCV contend SFPP presented no credible evidence to support excluding such subsidiaries, and could neither cite nor explain any analysis, process or documentation providing the bases for the exclusions—save three operating agreements applying to only five of the seventeen excluded entities. On CCV's account, even these few operating agreements do not avail SFPP because the agreements themselves confirm KMEP continues to exercise management responsibility and oversight in each case.

181. CCV challenge SFPP's four tier Massachusetts formula modification on substantially the same grounds. They charge in addition that SFPP's Massachusetts formula application methodology vacillates from year-to-year/proceeding-to-proceeding depending on SFPP's primary objective at the time, citing various Commission and CPUC proceedings and SFPP's disparate applications of the formula in those proceedings. This charge aside, CCV characterize the four tier method as arbitrary, self-serving and internally inconsistent, extensively citing the record in this proceeding to support the characterizations.

Tesoro

182. Tesoro states it has three major points of disagreement with SFPP regarding its overhead cost allocation under the Massachusetts formula: (1) whether to include all KMEP subsidiaries in the formula; (2) whether SFPP's four tier formula modification is acceptable; and (3) whether PAA should be excluded in performing the allocation. Tesoro submits that Commission precedent, including SFPP-specific decisions, is directly dispositive in Tesoro's favor on the first and third points, and there is absolutely no basis to accept SFPP's four tier Massachusetts formula modification. Tesoro cites *Williams Natural Gas*, 85 FERC ¶ 61,285 at 62,137 (1998) (*Williams*) for the proposition that even minor benefits derived from a parent entity require a subsidiary's inclusion in the Massachusetts formula calculus. Tesoro maintains each KMEP subsidiary excluded by

SFPP satisfies this criterion and, consequently, the exclusions were impermissible. Tesoro next emphasizes SFPP was unable to state the four tier modification's analytic basis, or to explain how SFPP determined which subsidiaries should be grouped together and why. It also echoes CCV's charge that SFPP's Massachusetts formula application methodology varies dramatically from proceeding-to-proceeding to demonstrate the current iteration's arbitrariness. Last, Tesoro contends Commission precedent is conclusive that PAA must be excluded in performing the Massachusetts formula allocation in order to reflect the correct amount of gross property plant and equipment of KMEP's regulated subsidiaries.

Discussion/Analysis[95]

183. The Massachusetts formula originates with *Distrigas of Massachusetts Corp.*, 34 FERC ¶ 63,034 (1986), *aff'd in part and modified in part on other grounds*, 41 FERC ¶ 61,205 (1987) (*Distrigas*). Essentially, it is the mechanism established by the Commission for a parent entity to equitably allocate residual (i.e. non-directly assignable) costs incurred to provide generalized benefits to its subsidiaries among those subsidiaries. The allocation test is whether the subsidiary receives a benefit from the parent cost center(s). If so, it receives an allocation; if not, it does not. It follows that excluding any subsidiary from the allocation pool increases the amount allocated to every subsidiary remaining in the pool. Since *Distrigas* permits any amount allocated to a subsidiary pipeline under the Massachusetts formula to be included in the pipeline's rates, excluding other subsidiaries from the parent's allocation pool increases the pipeline rate.[96] Accordingly, the Commission requires even marginal beneficiaries to be included in the allocation pool. *See Williams*, 85 FERC at 62,137.

184. The preceding summary reflects the Massachusetts formula endorsed by the Commission. It is incumbent on any rate applicant deviating from or proposing to modify that formula affirmatively to demonstrate its deviation/modification is just and reasonable. SFPP proposes to deviate from the Massachusetts formula by excluding seventeen KMEP subsidiaries from the cost allocation pool. It also proposes to modify the formula by establishing a four-tiered cost allocation scheme instead of the

[95] I have adequately addressed CCV's objection to SFPP's alleged failure to "open fully" in its initial brief under Issue C-3.

[96] Excluding seventeen subsidiaries from KMEP's overhead cost allocation pool, as SFPP proposes, requires allocating an additional $29.1 million among the remaining subsidiaries. Ex. Ex. SFN-33 at 5-12 **[PROTECTED]**; Ex. CCV-1 at 44-46 **[PROTECTED]**. A substantial portion of this sum would be allocated to SFPP, with a derivative amount reflected in the North Line rate. *See* Ex. SFN-29, Schedule 18 **[PROTECTED]**; Ex. SFN-30 at 5 **[PROTECTED]**.

undifferentiated one established in *Distrigas*. It follows that SFPP bears an affirmative burden to prove that each of these proposals is just and reasonable. *See, e.g., Olympic Pipe Line Co.*, 100 FERC ¶ 63,005 at P 21, *aff'd*, 101 FERC ¶ 61,245 (2002). The record before me, however, is conclusive SFPP has failed to do so on both counts.[97]

185. SFPP has demonstrated no legitimate basis to exclude any KMEP subsidiary from the Massachusetts formula calculus. Its sole justification lies in a single witness's assertions that (i) KMEP management has no involvement in the operation of the excluded subsidiary asset (ii) KMEP has only a percentage equity ownership and does not operate the excluded subsidiary asset, or (iii) KMEP has no equity ownership of the excluded subsidiary asset but is paid a fee to operate it. Ex. SFN-3 at 10-11; Ex. SFN-33 at 6 [**PROTECTED**]. These assertions' inappropriately narrow focus on operational control aside, the witness demonstrated no knowledge whatsoever with respect to their analytic underpinning(s). Tr. 1572-73, 1575-76. In fact, the assertions find their only evidentiary support in three operating agreements covering five of the seventeen excluded subsidiaries. Ex. SFN-3 at 11-12; Ex. SFN-7; Ex. SFN-8; Ex. SFN-9. On cross-examination, however, the sponsoring witness conceded he knew little about those agreements. Tr. 1573, 1607. He also acknowledged that KMEP provides various management/accounting services to all seventeen excluded subsidiaries—including the five covered by the operating agreements. Tr. 1608-14, 1625. *Accord* Ex. CCV-1 at 43 [**PROTECTED**]. *Also see generally* Ex. CCV-25 [**PROTECTED**]. Moreover, the operating agreements expressly reserve to the designated "Owner" managerial oversight and authority with respect to transportation contract administration, permanent capacity assignments, all contracts exceeding one year, as well as operating and capital expenditure budgets. Ex. SFN-7 at 7-10; Ex. SFN-8 at 8-10; Ex. SFN-9 at 7-9; Tr. 1616-25, 1630-32. Although none of the designated owners is KMEP, the record confirms the reserved managerial oversight and authority must reside with KMEP/KMR[98] because none of the entities designated as "Owner" in the agreements has any employees. Tr. 1620-22, 1625, 1632. In sum, I find and conclude SFPP has failed to satisfy its burden of

[97] The December 16 Order/rehearing order are similarly conclusive that PAA must be excluded in performing the Massachusetts formula allocation in order to reflect the correct value for gross property plant and equipment. December 16 Order at P 85 and n. 114; Order on Rehearing, 114 FERC ¶ 61,136 at P 17 and n. 22. The same holds true for including PAA in the carrier/non-carrier overhead cost allocation under the Kansas/ Nebraska formula. December 16 Order at P 89. Although SFPP's PAA position may have some merit insofar as non-jurisdictional entities are concerned (*see* Order on Rehearing, 114 FERC ¶ 61,136 at P 17), that possibility cannot be addressed here because the record contains no relevant evidence.

[98] KMEP delegates its management functions to KMR—which may in turn delegate them to certain KMR subsidiaries. Tr. 1617-19.

proof insofar as the seventeen excluded subsidiaries are concerned.[99] SFPP must include the seventeen excluded subsidiaries in its Massachusetts formula calculus. *Accord* December 16 Order at P 85.

186. SFPP has similarly failed to satisfy its burden of proof insofar as it proposes a four tier modification to the Massachusetts formula. Here again, SFPP's sole justification lies in a single witness's[100] assertion that a four tier scheme better satisfies the Commission preference for direct cost assignment by more closely aligning cost allocation with cost incurrence. I observe as a threshold matter that although SFPP's desire to advance Commission objectives by devising/implementing methodological enhancements is laudable in the abstract, there is no evidence any enhancement is necessary in this regard. My review of Commission opinions discussing *Distrigas* and the Massachusetts formula reveals no indication that the formula's undifferentiated approach is in any way inadequate. Moreover, the record reflects no evidence SFPP's four tier approach better aligns cost allocation with cost incurrence. To the contrary, the record confirms that the approach's sponsoring witness: (1) had no role in either its development or any underlying analyses; (2) did not supervise those activities; and (3) could not explain the criteria for developing, differentiating among, or assigning subsidiaries to the four tiers. Tr. 1567-72; 1574-76. The record also contains evidence that KMEP may not have the ability accurately to segregate overhead costs by individual entity or business unit. *See, e.g.*, Ex. CCV-25 at 14 **[PROTECTED]**; Ex. CCV-70 at 15. It also suggests a number of entities were improperly categorized here in any event. *See* Ex. CCV-1 at 48-49 **[PROTECTED]**. For all these reasons, I am compelled to find and conclude SFPP has failed to satisfy its burden of proof insofar as it proposes to use a modified four tier Massachusetts formula. SFPP must allocate overhead costs in accordance with the undifferentiated approach adopted in *Distrigas*.

187. In general, I find and conclude the appropriate Massachusetts formula overhead cost allocation is reflected in Exhibit CCV-1 at 51-53 & Table 13 **[PROTECTED]**. I do not accept the "capitalized overhead" adjustment recommended at pages 46-47 of that exhibit. CCV-1 at 46-47 **[PROTECTED]**. The record confirms KMEP does not allocate capitalized overhead through the Massachusetts formula. Tr. 1590-96 **[Tr. 1591-96 PROTECTED]**.

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[99] I reject any SFPP suggestion that some of these subsidiaries should be excluded in any event because they do not meet the "marginal benefit" threshold referenced in *Williams*. The appropriate way to allocate overhead costs under the Massachusetts formula is to reflect the relative focus KMEP gives to each individual subsidiary, not to transfer the costs associated with comparatively minor attention levels to others. To this end, I endorse the allocations reflected in Exhibit CCV-26 at 1-2 **[PROTECTED]**.

[100] The witness proposing the seventeen subsidiary exclusions.

2. Whether SFPP's Proposed Depreciation Expense For Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Depreciation Expense For Designing SFPP's Test Year North Line Rate?

188. This issue is uncontested. I therefore accept the amortization and depreciation expense reflected in Exhibit SFN-28 at 34.

3. Whether SFPP's Proposed Investment And Operating Expense Allocation Factors for Designing Its North Line Rate Are Justified and Appropriate? If Not, What Is The Appropriate Investment And Operating Expense Allocation Factors For Designing SFPP's Test Year North Line Rate?

189. This issue is resolved in accordance with Issue E-1 and footnote 97.

4. Whether SFPP's Development And Allocation Of Environmental Remediation Expense In Designing Its North Line Rate Are Justified And Appropriate? If Not, What Is The Appropriate Development And Allocation Of Environmental Remediation Expenses For Designing SFPP's Test Year North Line Rate?

Participant Positions

SFPP

190. SFPP proposes a normalizing adjustment to its environmental remediation expense to address the circumstance that such costs vary considerably from year to year. The adjustment reflects SFPP's average annual environmental remediation expense over the five year period from 2000 to 2004, and increases the base period North Line environmental remediation expense from $1,008,000 to $1,412,000. In SFPP's view, the adjustment results in a more representative amount being reflected in rates than would strict adherence to base/test period principles.

Trial Staff

191. Trial Staff criticizes SFPP's approach as ignoring the Commission's "known and measurable" change(s) standard and not being reflective of actual and current experience. It argues the appropriate methodology to determine North Line environmental remediation expense is to average actual 2004 costs with eight months of annualized

actual cost data from 2005. Trial Staff contends this produces a $1,612,000[101] annual North Line environmental remediation expense.

CCV

192. CCV accept SFPP's $1,008,000 base period environmental remediation expense figure, but oppose any normalizing adjustment. CCV maintain the adjustment violates base/test period principles because it considers costs falling far outside the base period. They also cite lower environmental remediation expense figures from the first eight months of 2005, as well as 2006-2007 projections, to criticize any upward adjustment to the base period expense, claiming those figures support a downward adjustment if anything.

Tesoro

193. Tesoro stresses that normalizing adjustments only may be applied to non-recurring costs. Since SFPP treats environmental remediation expense as a recurring item, its normalization approach is invalid—a situation which is compounded on Tesoro's account by the fact that five year averaging necessarily includes pre-base period costs in the test period amount. Tesoro adds that replacing/rerouting the Concord-Sacramento segment should cause base period North Line environmental remediation expenses to decline on a permanent basis rather than increase as the normalization adjustment implies. It relies on eight months of annualized 2005 data indicating a $109,000 decline in base period expense to support this position, endorsing an $899,000 test period test period environmental remediation expense for the North Line.

Discussion/Analysis

194. Excepting Trial Staff, all participants accept $1,008,000 as the appropriate base period North Line environmental remediation expense. Where they disagree is whether and how that expense should be adjusted to reflect test period changes.

195. I reject the SFPP proposal to increase the figure to $1,412,000 to reflect the North Line's average annual environmental remediation expense over the five year period from 2000 to 2004. This proposal is patently inconsistent with the base/test period principles

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[101] Ex. S-4 at 110, 112 **[PROTECTED]**. I cannot ascertain this figure's provenance. SFPP's base period environmental remediation expense is $1,008,000, and it proposes to normalize that amount to a test period figure totaling $1,412,000. *See* Ex. SFN-28 at 30.

reflected at 18 C.F.R. § 346.2 (a) (i), (ii) (2006) in a number of respects.[102] It normalizes recurring costs, egregiously exceeds the specified base/test periods and is backward-looking instead of prospective. It does not reflect reasonably known and measurable changes and fails to demonstrate good cause to deviate from the presumptive nine month test period limitation. In addition, the record confirms the $1,412,000 figure results primarily from aberrational expenses in 2001. *See* Ex. SFN-28 at 30. SFPP therefore has failed to demonstrate any upward adjustment to the $1,008,000 base period environmental remediation expense is appropriate.

196. Tesoro, conversely, has failed to demonstrate any downward adjustment is appropriate. Relying on eight months of annualized 2005 environmental remediation cost data is inconsistent with the test period principles specified at 18 C.F.R. § 346.2 (a) (ii) (2006). In addition, it seems disingenuous for Tesoro to emphasize SFPP's continuing inability to stem the need for North Line environmental remediation despite replacing/ relocating the Concord-Sacramento segment in order to question the prudence of SFPP's underlying capital investment (*see, e.g.,* Ex. TES-28; Ex. TES-29; Ex. TES-37; Tr. 652-62), but to argue here that SFPP successfully has reduced its North Line environmental remediation costs by an indicated $109,000 per year.

197. I find the just and reasonable North Line environmental remediation expense in this proceeding to be the unadjusted base period amount of $1,008,000.

5. Whether SFPP's Development And Allocation Of Litigation Expense In Designing Its North Line Rate Are Justified And Appropriate? If Not, What Is The Appropriate Development And Allocation Of Litigation Expense For Designing SFPP's Test Year North Line Rate?

<u>Participant Positions</u>

SFPP

198. SFPP contends it has demonstrated in this proceeding that it is subject to rigorous regulatory litigation and that it has incurred significant expenses related to that litigation. It therefore proposes to include $540,000 in the North Line cost of service, which amount SFPP maintains accounts for actual past period litigation costs and reflects the portion of those costs properly attributable to the North Line. SFPP does not support recovering its litigation costs through a surcharge as other participants advocate. It nevertheless submits if litigation costs must be recovered in this docket through the same type of five

[102] It also is inconsistent with SFPP's general insistence on strict adherence to base/test period principles elsewhere.

year surcharge approved in other SFPP proceedings, the appropriate annual North Line surcharge would be $1,027,000.

Trial Staff

199. Trial Staff challenges SFPP's litigation expense development/allocation methodology. It states SFPP proposes a $129,000 adjustment to its $2,786,000 base year figure for a litigation expense in this proceeding totaling $2,916,000. It represents that SFPP allocates litigation expense equally among its four pipelines if SFPP believes its entire system is affected, arguing instead that relative throughput volumetric allocations are the appropriate way to reflect SFPP's system-wide litigation costs/benefits and putting the North Line share of those costs at 8.89%. Trial Staff opposes any allocation whatsoever for litigation expenses connected to SFPP proceedings not specifically addressing or affecting the North Line. In Trial Staff's view, it is impossible to develop a normalized litigation cost to include in the North Line cost of service due to the multi-faceted nature of the various on-going rate proceedings, adding that SFPP's proposed normalization also violates base/test period principles because it relates back over 13 years. Finally, Trial Staff opposes indefinitely embedding litigation costs in the North Line rate, recommending instead that the costs be amortized over a five year period.

CCV

200. CCV emphasize the December 16 Order allocates litigation costs attributable to all SFPP lines on a volumetric basis. They advocate applying the same procedure here to set the North Line share of those costs at 8.89%. CCV oppose any North Line allocation whatsoever for litigation expenses exclusively attributable to other lines, arguing this exclusion would be consistent with the December 16 Order as well and noting SFPP seeks full litigation cost recovery in those dockets. According to CCV, this methodology produces a test period North Line litigation expense totaling $192,000.

Tesoro

201. Tesoro cites various Commission decisions as support for allocating litigation costs attributable to all SFPP lines on a volumetric basis, deriving a North Line share for those costs of 8.89%. Tesoro opposes any North Line allocation for litigation expenses exclusively attributable to other lines based on the December 16 Order. Applying this methodology, Tesoro maintains, produces a test period North Line litigation expense totaling $399,000.

<u>Discussion/Analysis</u>

202. Like seemingly every other SFPP proceeding, this case has been an expensive one. The record puts SFPP's actual litigation costs in this docket from May to November 2005

alone at $1.2 million. Ex. SFN-50. It credibly estimates SFPP's total cost for the entire proceeding to approach $5 million. *Id.* This cost magnitude indisputably is due in substantial degree to opposing parties including and litigating a number of issues here in test case detail rather than in any conceivable proportion to the modest overall rate impact the underlying filing will produce. That is their right and prerogative. But, having elected to take SFPP so thoroughly to task here, opposing parties cannot legitimately complain about SFPP recovering the litigation costs it was compelled to incur—whether through the surcharge they advocate or embedded in rates as SFPP requests. The question is not whether SFPP is entitled to recover the entire regulatory litigation expense associated with this docket; it clearly is entitled to do so. *See, e.g., BP West Coast*, 374 F.3d at 1293 (citing *Iroquois Gas Transmission System v. FERC*, 145 F.3d 398 (D.C. Cir. 1998)). The question is how much of the litigation expense associated with this proceeding SFPP is entitled to recover through the North Line rate.

203. Were this an ordinary rate case, there is little question SFPP would be permitted to embed North Line base/test period regulatory litigation expense in the pipeline's cost of service and recover it on an annual basis as a recurring item. *See, e.g., Amerada Hess Corp.*, 71 FERC ¶ 61,040 at 61,169-71 (1995). As noted, however, this proceeding's ostensible importance has been elevated far above that of an ordinary rate case. That elevation merely exacerbates the circumstance that this docket is but the latest[103] of many in which virtually identical issues common to all SFPP pipelines have been exhaustively litigated, appealed, re-litigated, etc.—with no end in sight. Indeed, the myriad SFPP litigations have become so intertwined and inextricable from one another that the Commission has been compelled to resort to allocating SFPP litigation expenses on a volumetric basis through a surcharge mechanism in a number of cases. Trial Staff, CCV and Tesoro advocate the same procedure here. SFPP opposes it.

204. The December 16 Order seems to construe Opinion No. 435 and Opinion No. 435-A as precluding SFPP from embedding any regulatory litigation expense whatsoever in its cost of service rates, instead requiring SFPP to recover such expenses only through volumetric surcharges amortized over five years. *See* December 16 Order at PP 90-93 (citing 86 FERC at 61,105-06; 91 FERC at 61,512-13). I do not interpret the orders that way. Opinion No. 435-A expressly acknowledges that "[l]itigation 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." 91 FERC at 61,512 (citation omitted). Further, Opinion No. 435 and Opinion No. 435-A were complicated by both non-regulatory litigation costs and a significant "reparations" issue—neither of which is pertinent here. More important, Opinion No. 435 and Opinion No. 435-A had to address over five years worth of additional litigation costs SFPP had incurred litigating the underlying dockets in the intervening period between 1994 and

[103] Even this characterization no longer applies, as recently-instituted Docket No. OR03-5-001 demonstrates.

1999/2000. As I read the opinions, the amortized surcharge was intended to recover those extraordinary/non-recurring costs (offset by reparations) only, with no restriction on SFPP's ability to include recurring regulatory litigation expenses in future cost of service or to recover those expenses on a prospective basis through rates. *See* 86 FERC at 61,105; 91 FERC at 61,512. *Accord* Opinion 435-B, 96 FERC at 62,074-75. I therefore see no Opinion No. 435 *et al.* rationale for compelling SFPP to recover any indicated test period regulatory litigation expenses properly attributable to the North Line through an amortized surcharge. Instead, I find and conclude SFPP is legally entitled to embed those expenses in the North Line cost of service and recover them through the North Line rate.[104]

205. I also find and conclude there is inadequate basis to allocate any indicated test period regulatory litigation expenses on a volumetric basis in this docket. First, the record indicates doing so would violate *Hope* because it would deprive SFPP of any opportunity to recover a significant portion of those costs. The record confirms that accepting the 8.89% volumetric allocation indicated for the North Line (Ex. SFN-50) and advocated by Trial Staff (Ex. S-4 at 115 **[PROTECTED]**), CCV (Ex. CCV-57) and Tesoro (Ex. TES-15 **[PROTECTED]**) enables SFPP to recover a maximum total *regulatory litigation expense of only $1,996,000 amortized over five years—and nothing* thereafter. Ex. SFN-49 at 5-6; Ex. TES-15 **[PROTECTED]**. But the record strongly suggests SFPP's actual regulatory litigation expense in this docket will be markedly higher (*see* Ex. SFN-50), and I find that suggestion reasonable based both on the litigation expense figures cited in the December 16 Order[105] and the vigor demonstrated by opposing parties in the proceeding conducted before me. Opinion No. 435-A is instructive on the latter topic, concluding:

> there appears to be no necessary connection between relative historical throughput and the relative volume of litigation generated by a particular group of shippers. It is quite possible that one group would have substantially less throughput, yet generate the greater portion of a given litigation based on the complexity of the issues and how aggressively the issues are pursued.

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[104] Since the parties have elected to make this North Line proceeding a test case in a number of respects—thereby guaranteeing protracted litigation on rehearing and at the Court of Appeals—they cannot plausibly argue the regulatory litigation expenses related to the North Line cost of service/tariff structure proposed in this docket will be anything but recurring for years to come.

[105] *See* December 16 Order at P 93.

91 FERC at 61,513. The various issues North Line shippers have elected to litigate in test case detail in this docket are exceedingly complex, and characterizing shippers as "aggressive" discredits their efforts here. Finally, in contrast to the proceedings underlying the December 16 Order, it is clearly possible for SFPP to develop a normalized test period regulatory litigation expense in this docket, as the direct case in support of the North Line rate filing demonstrates. Ex. SFN-26 at 9-14; Ex. SFN-28 at 33. I therefore accept as just and reasonable the method by which SFPP developed its North Line normalized test period regulatory litigation expense, except insofar as it incorporates litigation expenses exclusively attributable to other lines. Those expenses should be excluded and full cost recovery sought in the relevant dockets. *Accord* December 16 Order at P 96.

6. Whether SFPP's Proposed Fuel And Power Cost For Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Fuel And Power Cost For Designing SFPP's Test Year North Line Rate?

Participant Positions

206. SFPP proposes a $345,000 test period adjustment to reflect lower power and drag reducing agent (DRA) costs attributable to replacing the 14" Concord-Sacramento segment with a 20" pipe and certain mainline pump upgrades. Trial Staff agrees this adjustment was appropriate, but contends SFPP should have made an additional test period adjustment to reflect an incentive payment of over $1 million it received for reducing North Line power consumption by replacing the 14" segment. Trial Staff submits SFPP should reduce the North Line cost of service by this additional amount. Tesoro maintains SFPP achieved approximately $735,000 in test period cost savings by replacing the 14" segment with 20" pipe, attributing the savings to lower power and DRA costs, as well as the elimination of its Elmira pump station. SFPP responds that Trial Staff's proposed incentive payment adjustment is inappropriate because SFPP received the payment three months outside the test period and it was a non-recurring item. SFPP dismisses Tesoro's $735,000 test period cost savings estimate as based on outdated 2000/2001 data, underscoring that SFPP presented actual 2005 data confirming the $345,000 figure's accuracy.

Discussion/Analysis

207. I accept SFPP's proposed $345,000 test period adjustment. The record establishes SFPP based that figure on actual 2004 data and confirmed its accuracy with annualized 2005 data. Ex. SFN-26 at 14-15; Ex. SFN-28 at 31; Ex. SFN-49 at 22. The record also confirms Tesoro's $735,000 estimate is based on outdated information. *Compare* Ex. TES-17 *with* Ex. SFN-49 at 21-22. I reject Trial Staff's proposed incentive payment adjustment because it is inconsistent with the base/test period principles reflected at 18

C.F.R. § 346.2 (a) (i), (ii) (2006). The payment was a one-time item and fell three months outside the applicable test period. Trial Staff made no attempt to demonstrate good cause to deviate from the indicated test period insofar as the incentive payment is concerned.

F. What is the Appropriate Throughput Volume in this Case?

1. Whether SFPP's Proposed Throughput Volume Level For Designing Its North Line Rate Is Justified And Appropriate? If Not, What Is The Appropriate Throughput Volume Level For Designing SFPP's Test Year North Line Rate?

Participant Positions

SFPP

208. SFPP proposes to use a base period 2004 throughput volume of 13,865,807 barrels to calculate the North Line rate. SFPP maintains it had no basis to know actual throughput would deviate from 2004 volumes when it filed the North Line tariff in April 2005. It states actual North Line interstate deliveries have remained largely flat from 2000-2005 despite a 2.4% annual population growth in Reno and Sparks, Nevada during that period, contending this circumstance illustrates the unreliability of basing test period adjustments on population growth projections. SFPP also challenges the validity of using April-September 2005 average daily volumes to project an annual volume figure because April-September is peak travel season and North Line volumes are always greater during that period than in other months. In fact, according to SFPP, actual North Line interstate throughput was slightly lower in 2005 than it was in 2004. SFPP dismisses any suggestion that operational problems or pro-rationing artificially suppressed actual North Line throughput. It contends the pipeline did not experience an unusual number of outages in 2005 and any pro-rationing is attributable to shipper over-nominations rather than the pipeline's inability to transport actual volume tenders.

Trial Staff

209. Trial Staff argues SFPP's reliance on base period North Line throughput ignores significant known and measurable changes requiring an upward test period adjustment. Trial Staff asserts there is significant evidence North Line interstate transportation demand increased over the final six months of the test period. It emphasizes the pipeline was "frozen" in May and July 2005 because nominations had reached or exceeded total capacity and that the pipreline's Roseville-Reno segment was in pro-ration in August and September 2005 for the same reason. Trial Staff maintains these nomination increases demonstrate a known and measurable increase in interstate transportation demand that requires North Line throughput volume to be adjusted upward for ratemaking purposes.

It relies on economic growth projections within the North Line service territory to corroborate this conclusion, claiming in addition that actual North Line test period throughput was constrained by service interruptions that should not occur in the future. On these bases Trial Staff advocates annualizing the last six months of test period throughput data to derive the appropriate ratemaking volume. Applying this methodology results in an annualized North Line throughput totaling 14,036,098 barrels.

CCV

210. CCV stress SFPP's anticipated need to expand North Line capacity in the future as the rationale to increase the base period throughput volume. They cite annual population growth in a number of areas within the North Line service territory, as well as SFPP's $95 million investment in the expanded Concord-Sacramento segment, to support an inference that greater volumes will flow over the North Line than base period throughput indicates. This would generate an SFPP windfall at current shipper expense according to CCV. They therefore suggest basing North Line rates on the pipeline's post-expansion capacity rather than pre-expansion throughput in order to shift some expansion-related risk away from pre-expansion shippers. Notwithstanding this suggestion, CCV calculate the just and reasonable North Line rate using the base period throughput volume.

Tesoro

211. Tesoro proposes a test period throughput volume of 14,120,038 barrels. It bases this proposal primarily on population growth and throughput studies/projections, underscoring SFPP was aware of these studies/projections before it filed the North Line tariff. Tesoro challenges SFPP's contention the pipeline's 2005 actual test period throughput was not suppressed by unusually frequent peak-season outages, as well as its focus on nominations rather than tenders, asserting that nominations constitute an appropriate demand indicator.

Discussion/Analysis

212. SFPP acknowledges that anticipated increased demand was a contributing factor in its decision to increase the Concord-Sacramento segment capacity from 14" to 20". Ex. SFN-1 at 4-5. The record, moreover, strongly suggests North Line interstate transportation capacity eventually will be expanded to accommodate population growth at various locations served by the pipeline. *Id.* at 5, 7. These circumstances, however, are immaterial to the issue at hand. First, I rejected under Issue A any contention the 20" replacement segment satisfies the "used and useful" standard due to anticipated increases in interstate demand or a reduced probability that intrastate over-subscription prospectively might result in interstate pro-ration, finding instead these are speculative future events and consequently provide no present use or usefulness to interstate shippers. Similar reasoning applies here—but this time in SFPP's favor. Although SFPP

ultimately may elect/be compelled to expand the North Line segments east of Sacramento, it has yet to do so and there is no record evidence as to when such expansion might occur. It therefore would be entirely speculative to inflate North Line base period interstate throughput volumes based on economic/population growth projections. There is no necessary correlation between the two, and the record indicates North Line interstate throughput has not increased commensurate to actual population growth within its interstate service territory—if at all. *See* Ex. SFN-31 at 2, 4; Ex. SFN-49 at 41; Ex. SFN-54 **[PROTECTED]**; Tr. 770-71. Second, I excluded under Issue A the costs associated with the 6" of Concord-Sacramento expansion capacity from North Line interstate rates on the basis that anticipated future demand did not satisfy the "[*currently*] used and useful" requirement. Opposing participants cannot equitably receive the rate benefit of that exclusion and simultaneously be permitted to claim the 6" of excluded capacity supports inflating base period North Line interstate throughput, thereby securing the additional per barrel rate benefit the inflation implies. Moreover, the 6" capacity exclusion assuages any concern SFPP might reap a windfall at current interstate shipper expense, so there is no merit to the suggestion North Line interstate rates should be based on the pipeline's post-expansion capacity rather than its throughput.[106] Excluding the 6" capacity expansion eliminates any possibility expansion-related risk will be imposed on interstate shippers—at least until SFPP expands North Line capacity east of Sacramento.

213. I am compelled to reject the Trial Staff, CCV and Tesoro suggestions that the new Concord-Sacramento replacement segment will increase interstate throughput because it will cause fewer service interruptions/pro-rations than the old 14" segment. Once again, the reasoning is sensible but the conclusion does not necessarily follow and runs contrary to the record evidence. *Compare* Ex. TES-31 *with* Ex. TES-32 and *compare* Ex. TES-34 *with* Ex. TES-35. *See also* Ex. TES-37. This circumstance may be unflattering to SFPP, but it militates against inflating North Line base period interstate throughput volumes based on fewer anticipated service interruptions/pro-rations. The circumstances the pipeline was "frozen" in May and July 2005 and pro-rated in August and September 2005 because nominations reached or exceeded total pipeline capacity are similarly unavailing to Trial Staff, CCV and Tesoro in this regard. Nominations do not correlate to actual shipments, and there is no evidence SFPP ever failed to accommodate any actual North Line interstate tender(s). *See* Tr. 638-41, 644-49. Additionally, extrapolating a test period throughput volume by annualizing the last six months of test period data (i.e. April-September 2005 throughput), as Trial Staff and Tesoro propose, necessarily overstates actual throughput because North Line volumes are always greater during that period than in other months. Ex. SFN-31 at 2; Ex. SFN-54 **[PROTECTED]**.

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[106] Replacing the 14" pipe with 20" pipe did not increase post-expansion interstate capacity in any event because no North Line segment east of Sacramento is more than a 12" in diameter.

214. The foregoing analysis demonstrates there is no legitimate basis to make any test period adjustment to the 2004 North Line interstate base period throughput volume of 13,865,807 barrels, except in accordance with the findings/conclusions under Issue F-2, *infra*. I therefore find and conclude that volume is justified and appropriate for ratemaking purposes in this proceeding.

2. Whether adjustments are appropriate to the factors used to separate SFPP's North Line jurisdictional costs from non-jurisdictional costs?

Participant Positions

215. SFPP uses 2004 base period volumes to calculate the factors applied to separate jurisdictional costs from non-jurisdictional costs in its "Route Directory." Trial Staff proposes to adjust the Route Directory (i) to reflect its proposed test period throughput volume adjustment, (ii) to include "Richmond Station and Pipelines" category intrastate volumes and (iii) to reflect intrastate volumes associated with a new West Sacramento Airport connection. The first adjustment is mooted under Issue F-1, *supra*. SFPP concedes the second adjustment's reasonableness,[107] but disputes the appropriateness of reflecting the airport volumes. SFPP maintains it had no reasonable basis to know/ measure the volumes that might be delivered to the airport when it filed the North Line tariff in April 2005.

Discussion/Analysis

216. I find and conclude the West Sacramento Airport connection should be reflected in the Route Directory. Although the connection did not become operational until September 15, 2005 (Ex. S-20), that date falls within the test period. Moreover, SFPP concedes it contracted for the connection prior to the April 2005 North Line tariff filing. Ex. SFN-31 at 6; Ex. SFN-49 at 42. I therefore find good cause in this limited instance to deviate from the prescribed test period in accordance with 18 C.F.R. §346 (a) (ii) (2006) and rely on the post-test period data reflected in Exhibit S-8 at 17-19, Exhibit S-21 and Exhibit S-22 **[ALL PROTECTED]** to determine the appropriate volumes and jurisdictional/non-jurisdictional apportionment percentages.

G. What is the Just And Reasonable North Line Rate in this Case?

217. This issue is generally resolved in accordance with all other findings and conclusions reflected in this Initial Decision.

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[107] *See* Ex. SFN-49 at 45-47. I accept that concession.

1. Whether SFPP Has Shown A Substantial Divergence Between Its North Line Costs And The Current Ceiling Rate Revenue Which Precludes The Pipeline From Charging A Just And Reasonable Rate?

218. All participants link the answer to this issue to the findings and conclusions reached under the amalgam of other issues and do not address it on a discrete basis. This issue therefore is generally resolved in the affirmative in accordance with all other findings and conclusions reflected in this Initial Decision.

2. Whether The Voluntary Filing Of A Rate Increase By SFPP Operates To Terminate "Grandfathered" Status Under The Energy Policy Act Of 1992, With The Result That The North Line Rate May Be Rolled-Back Below The Previously Existing Rate Including Any Previously Existing "Grandfathered" Rate Level?

Participant Positions

SFPP

219. SFPP asserts the Commission determined in *ARCO Products v. SFPP, L.P.*, 106 FERC ¶ 61,300 at PP 59-62, *reh'g denied*, 111 FERC ¶ 61,334 (2004) (*ARCO*) that the North Line interstate rate in effect prior to the April 2005 tariff filing in this docket was grandfathered. It disputes any claim the April 2005 filing waived/extinguished that protection or allows the Commission to set a North Line interstate rate in this proceeding that falls below the prior grandfathered rate of $1.19/barrel. In addition, SFPP maintains the Energy Policy Act of 1992 (EPAct) confirms Congressional intent that rate filings should not affect the grandfather protection established in EPAct. It vigorously disputes any claim the Commission has not previously addressed this issue, citing Order No. 561-A[108] to demonstrate the contrary.

BP/EM

220. BP/EM devote considerable attention to this issue, which they characterize as another "of first impression." Reducing their position to bare bones, BP/EM contend: (1) the presiding judge and Commission have authority to reduce North Line interstate rates below the $1.19/ barrel index-adjusted 2004 rate, as well as the initially-grandfathered $1.10/barrel rate; (2) EPAct does not preclude reducing the 2004 rate—or any other index-adjusted rate—because that/those rate(s) was/were not in effect in 1992 and therefore is/are not grandfathered under EPAct; and (3) SFPP's voluntary rate filing

[108] *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Order No. 561-A, FERC Stats. & Regs. ¶ 31,000 (1994).

in this docket removes the $1.10/barrel rate's grandfather protection and, as a consequence, that rate no longer establishes a minimum North Line interstate rate. BP/EM cite *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984) (*Chevron*) and *United States v. Mead Corp.*, 533 U.S. 218 (2001) (*Mead*) to support a two-prong argument that (i) the Commission must comply with the unambiguous Congressional intent reflected in EPAct (*Chevron*) and (ii) the Commission cannot exercise any interpretive authority concerning EPAct because the statute expressly grants no such authority (*Mead*). They conclude proper application of *Chevron/Mead* doctrine to EPAct restricts any post-1992 grandfather protection to ICC § 13 *complaint* filings and does not cover protests because only "complaint" is referenced there, underscoring that the statute elsewhere references "protest, investigation or complaint."[109]

CCV

221. CCV submit the presiding judge is free to prescribe a North Line rate at any just and reasonable level supported by substantial evidence. In CCV's view, this necessarily includes a rate below any previously-existing rate ostensibly grandfathered under EPAct. They note the Commission set the North Line tariff filing for investigation and hearing pursuant to ICA §§ 13(1) and 15(1), the latter of which grants the Commission broad power and authority to determine and prescribe just and reasonable rates. CCV contend as a consequence that no prior or existing rate constitutes a "rate floor" if the Commission determines it is unjust or unreasonable. Since the instant proceeding was not initiated by shippers, as contemplated in ICA §13, EPAct is simply inapplicable here on CCV's account. It does not limit Commission power and authority under ICA § 15(1) to prescribe just and reasonable rates at whatever level is supported by the record.

Discussion/Analysis

222. This issue is moot. I have predominately upheld SFPP's North Line interstate tariff filing—albeit with important exceptions. Although my various rulings make it impossible for me to determine with precision what the indicated North Line interstate rate is, I cannot imagine how those rulings could possibly suppress it below the prior index-adjusted rate of $1.19/barrel, let alone below the ostensibly grandfathered rate of $1.10/barrel.

223. As framed by SFPP and BP/EM, this issue also is purely a question of law. Although I am flattered by the parties' repeated confidence in my ability to resolve test case issues/matters of first impression in such a limited context—which I have attempted

[109] BP/EM indicate they intend to make an even more comprehensive case on this issue in pending Docket No. OR03-5-001, referenced *supra* at footnote 102. *See* BP/EM IB at 52.

to do to the extent required to decide this case—I decline to accommodate SFPP and BP/EM in this instance, providing their position summaries solely in the interest of completeness and for Commission/Court of Appeals convenience. CCV has adequately and accurately described the Commission's authority in this proceeding and I see no reason or need to add anything further.

3. What Is The Just And Reasonable Rate That SFPP Should Be Allowed To Charge On The North Line?

224. This issue is generally resolved in accordance with all other findings and conclusions reflected in this Initial Decision.

4. Are Interstate North Line Shippers To Receive Refunds, With Interest, And, If So, What Level?

225. This issue is generally resolved in the negative in accordance with all other findings and conclusions reflected in this Initial Decision.

III. MATTERS NOT DISCUSSED

226. This Initial Decision's failure to discuss any matter raised by the participants, or any portion of the record, does not indicate it has not been considered. Rather, any such matter(s) or portion(s) of the record has/have been determined to be irrelevant, immaterial or meritless. Arguments made on brief which were otherwise unsupported by record evidence or legal precedent have been accorded no weight.

IV. ORDER

227. Wherefore, it is ordered, subject to review by the Commission on exceptions or on its own motion, as provided by Commission Rules of Practice and Procedure, that within thirty (30) days of the issuance of the final Commission order in this proceeding, SFPP shall comply with the findings and conclusions reflected in this Initial Decision, as adopted or modified by the Commission.

H. Peter Young
Presiding Administrative Law Judge