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113 FERC ¶61,277
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

SFPP, L.P.	Docket Nos.	OR92-8-024 OR93-5-015 OR94-3-014 OR94-4-016
Mobil Oil Corporation v. SFPP, L.P.	Docket No.	OR95-5-013
Tosco Corporation v. SFPP, L.P.	Docket No.	OR95-34-012
ARCO Products Co. a Division of Atlantic Richfield Company, Texaco Refining and Marketing Inc., and Mobil Oil Corporation v. SFPP, L.P.	Docket Nos.	OR96-2-010 OR96-2-011 OR96-10-007 OR96-10-009 OR98-1-009 OR98-1-011 OR00-4-002
Ultramar Diamond Shamrock Corporation, and Ultramar, Inc. v. SFPP, L.P.	Docket Nos.	OR96-2-003 OR96-2-010 OR96-10-008 OR96-10-009 OR96-17-004 OR96-17-006 OR97-2-004 OR97-2-005 OR98-2-005 OR98-2-007

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		OR00-8-005
		OR00-8-007
Tosco Corporation	Docket Nos.	OR98-13-005
v.		OR98-13-007
SFPP. L.P.		OR00-9-005
		OR00-9-007
Navajo Refining Corporation	Docket No.	OR00-7-005
v.		OR00-7-006
SFPP, L.P.		
Refinery Holding Company	Docket No.	OR00-10-005
		OR00-10-006
SFPP, L.P.	Docket No.	IS98-1-001
		IS98-1-002
SFPP, L.P.	Docket No.	IS04-323-002

ORDER ON INITIAL DECISION AND ON
CERTAIN REMANDED COST ISSUES

(Issued December 16, 2005)

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1. This order makes certain determinations for establishing interim just and reasonable rates for SFPP, L.P.'s (SFPP) East and West Line rates pursuant to section 15(1) of the Interstate Commerce Act.[1] The determinations here address (1) ongoing tax allowance and cost-of-service issues stemming from the rulings in the Commission's order dated June 1, 2005,[2] (2) outstanding cost issues involved in the remanded proceedings regarding SFPP's East Line rates at issue in Docket No. OR92-8-000, *et al.,*[3] (3) West Line cost-of-service issues involved in Phase II of Docket No. OR96-2-000, *et al.* now before the Commission on exceptions to an initial decision dated September 9, 2004,[4] and (4) requests for rehearing of the Commission's June 30, 2004 Order in Docket No. IS04-323-000, which accepted SFPP's index filing based on cost increases in the prior calendar year 2003.[5]

2. The rulings here include specific guidance on the procedures and data required for determining whether SFPP will be allowed to include an income tax allowance in its rates, that the calendar year 1999 will be used as the test year in this proceeding, a requirement that SFPP remove its 1998 purchase price adjustment from its balance sheet for ratemaking purposes, the capital structure and cost-of-capital to be used in designing rates for the West and East Lines, the overhead allocation and depreciation methods to be used here, the recovery of regulatory expenses and local taxes, and standards for reparations and refunds. This order also establishes procedures for reviewing the West Line turbine fuel rates now before the Commission as a result of the Remand Opinion. Based on those rulings, the Commission is requiring SFPP to make several compliance filings and to establish new interim rates for its West Line (and if necessary, its East Line) as of March 1, 2006. The Commission denies the requests for rehearing of the 2004 Index Order.

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[1] 49 App. U.S.C. § 15(1) (1988) governs determinations of whether oil pipeline rates are just and reasonable.

[2] *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) (June 1 Order).

[3] *See BP West Coast Products, L.L.C. v. FERC,* 374 F.3d 1263 (D. C. Cir. 2004) (*BP West Coast* or "the Remand Opinion").

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

[5] *SFPP, L.P.,* 107 FERC ¶ 61,334 (2004) (2004 Index Order).

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I. <u>Background</u>

3. The protracted litigation between SFPP and certain of its shippers began in November 1992 and has continued through the filing of additional complaints in the latter part of 2004 and early 2005. Three periods are involved. The first period involves various complaints addressed in the consolidated proceedings in Docket No. OR92-8-000, *et al*., and includes the complaints filed between November 1992 and August 1995 against the East and West Line rates and the Watson Station Drain Dry charges (Watson Station charges). These were the complaints resolved by the Commission's Opinion No. 435 Orders[6] and reviewed by the Remand Opinion in *BP West Coast.* The jurisdictional and most cost-of-service issues involved in the Remand Opinion were addressed by the June 1 Order. The remaining East Line rate issues involve refinements to the income tax allowance policy adopted in the Commission's *Policy Statement on Income Tax Allowances*, dated May 4, 2005.[7] A secondary issue is the specific modifications to the East Line rates required by the reallocation of regulatory costs between the East and West Lines.

4. The second period includes the consolidated proceedings in Docket No. OR96-2-000, *et al.*, and involves the complaints filed against SFPP's East, West, North, and Oregon Lines, and the Watson Station charges filed during the latter part of 1995 through 2000. The ID now before the Commission presents a wide range of cost-of-service issues, including the income tax allowance, if any, to be afforded for this period, the test year to be used in designing a cost-of-service, the size of SFPP's rate base, its capital structure and cost of capital, the allocation of overhead costs, the amount and allocation of regulatory expenses, the recovery of local real estate taxes, the depreciation methodology, and the calculation of reparations and refunds.

5. The third period includes complaints filed against the East, West, North and Oregon Line rates and the Watson Station charges in July 2003, and again in 2004 and 2005 in four additional dockets, all of which have been held in abeyance pending the

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

[7] Id. P 17-27, citing the *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (*Policy Statement*).

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issuance of this order.[8] These complaints involve jurisdictional issues for the North and Oregon Lines and the same range of cost-of-service issues raised by the ID now before the Commission. On August 24, 2005, the ALJ issued an initial decision addressing the complaints against the Sepulveda Line rates in Docket No. OR96-2-012.[9] The complaints filed against the Watson Station charges through August 1995 were set for hearing in a separate proceeding, Docket No. OR92-8-025. The Commission consolidated all issues related the Watson Station charges in that docket.[10]

6. When the first complaints were filed in 1992, SFPP was an oil pipeline limited partnership that had been formed in 1988 by its then railroad owner, the Santa Fe Southern Pacific Railroad (SFSP). After a public offering in 1988, SFSP owned some 47 percent of the limited partnership interests and two different general partnership interests through a series of wholly owned subsidiary companies. By 1994 SFSP was owned by Burlington Northern Santa Fe, Inc. but this did not represent a material change in SFPP's corporate relationships or capital structure. However, in March 1998, SFPP was acquired by KinderMorgan Energy Partnership (KMEP), a master limited partnership controlling several other energy enterprises, a number of them also entities whose rates are regulated by the Commission.[11] KMEP's general partner is Kinder Morgan GP, Inc. (KMPG), a subchapter C corporation that does not provide jurisdictional services. Rather, the jurisdictional services are provided by various entities that KMEP owns in whole or in part. The acquisition of SFPP by KMEP resulted in significant changes to SFPP's capital structure and balance sheet and ownership by a firm with a notably more complicated ownership structure, material factors here.

7. The Commission's June 1 Order contains a more detailed description of the prior proceedings in these dockets,[12] including the Commission's prior orders in Opinion Nos.

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[8] Docket Nos. OR03-5-000, OR04-3-000, OR05-4-000, and OR05-5-000. As discussed below, these dockets will be set for hearing in a separate order.

[9] This proceeding is referenced in a number of other dockets that are included in the case caption, but is generally referred to as the Sepulveda Line proceeding.

[10] *SFPP, L.P.*, 112 FERC ¶ 61,209 (2005).

[11] *See* KMEP's SEC Form 10-K for 1999, Ex. UIT-59.

[12] June 1 Order, P 2-14.

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435, 435-A, 435-B, and a related order on rehearing and compliance.[13] In summary, the June 1 Order reiterated and incorporated the Commission's conclusions regarding income tax allowances. The June 1 Order also concluded that SFPP was entitled to a full income tax allowance if it could demonstrate that it complied with the standards contained in the *Policy Statement*.[14] The Commission also directed the parties to file briefs as a first step in making a determination on that matter.

8. The June 1 Order also reviewed and affirmed the Commission's earlier March 26, 2004 determinations regarding the jurisdictional status of SFPP's West, North, and Oregon lines in Phase I of Docket No. OR96-2-000, *et al.* [15] The Commission held that there had been a substantial change to the economic circumstances of the West Line rates for the years 1995 and 1997, but that there were no such changes to the rates for the North and Oregon Line rates for the years at issue in that docket.[16] The Commission therefore affirmed its prior dismissal of complaints against the North and Oregon Line rates for the years at issue in Docket No. OR96-2-000, *et al*. and retained jurisdiction over the reasonableness of SFPP's West Line rates for Phase II of that proceeding.[17]

9. The June 1 Order also found that the Watson Station charges were not grandfathered under the Energy Policy Act of 1992 because those charges were not in effect more than 365 days prior to the date of the enactment of that Act[18] and set those

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

[14] June 1 Order, P 21-27.

[15] *See SFPP, L.P.*, 106 FERC ¶ 61,300 (2004) (March 2004 Order) for these earlier jurisdictional rulings.

[16] *Id.* P 28-30 and P 37-40.

[17] The Commission's jurisdiction over the reasonableness of SFPP's East Line rates is not at issue in any of these proceedings.

[18] *Id.* P 32-35. *See* section 1803(b) of the Energy Policy Act, Pub. L. 102-486, 106 Stat. 2772 (1992) (EP Act). Section 1803(a)(1) provides that any rate in effect for the 365-day period ending on the date of the enactment of this Act shall be deemed just and reasonable (within the meaning of section 1(5) of the Interstate Commerce Act).

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charges for hearing.[19] The Commission deferred hearing on the reasonableness of SFPP's turbine fuel rates between Los Angeles and certain points to the east in Nevada and Arizona until it resolved (which is does in this order) certain cost methodology matters at issue in the Phase II proceedings.[20] Regarding the East Line rate issues remanded in Docket No. OR92-8-000, *et al*., the Commission concluded that 50 percent of regulatory litigation expenses should be allocated each to the East and West Lines and that SFPP had not adequately justified the inclusion of reconditioning expenses in its base East Line rates.[21] The Commission also accepted SFPP's compliance filing regarding its use of the purchase method of accounting for calendar year 1998,[22] and denied rehearing requests of certain reparation issues discussed in its earlier March 2004 Order.[23]

II. <u>Discussion</u>

A. <u>Income Tax Allowance Issues</u>

10. The Commission's May 4, 2005 *Policy Statement* addressed whether a jurisdictional partnership, or other jurisdictional pass-through entity such as limited liability corporation (LLC), should be allowed to have an income tax allowance embedded in its jurisdictional rates. The June 1 Order concluded that SFPP would be entitled to a full income tax allowance if SFPP could establish that it meets the standards contained in the Commission's *Policy Statement, viz.,* whether the partner, unit holder, or other member of a pass-through entity is subject to an actual or potential income tax liability for the income of a jurisdictional pass-through entity.[24] The Commission directed the parties to file briefs on the status of the record in both the consolidated dockets at issue here, and to state if those records were sufficient to determine if SFPP met the standards contained in the *Policy Statement*, or whether further proceedings

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[19] June 1 Order, P. 75.

[20] *Id.*

[21] *Id.* P 42-44 and P 45-51.

[22] *Id.* P 60-72

[23] *Id.* P 52-59.

[24] *Policy Statement* at P 32.

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might be required.[25] SFPP filed its brief on June 16, 2005, and Opposing Parties filed their reply briefs on July 1.[26]

11. SFPP asserts that the *Policy Statement* establishes certain key elements for compliance with its standards. First, the allowance is to reflect the weighted tax liability of the owners. Second, the tax status of the partners or units holders must be demonstrated by the regulated entity and the tax liability is to be traced to the point of ultimate ownership. Third, that the phrase "subject to an actual or potential income tax liability" is the key concept, and this appears to be related and derived from the principles established in *City of Charlottesville*[27] that an income tax allowance is allowed to reflect "actual or estimated income taxes paid or incurred."

12. SFPP then argues that it meets the requirements of the *Policy Statement*, asserting that information now in the record of both proceedings establishes that virtually all of the limited partners or the unit holders of SFPP and KMEG, its parent master limited partnership, were subject to an actual or potential income tax liability for partnership income in the years at issue. SFPP analyzes several categories of limited partners or unit holders to support this conclusion. The first category is corporations, including Subchapter C and Subchapter S corporations. SFPP notes that a Subchapter C corporation is subject to a tax on all income, including any income received from SFPP. It further states that a Subchapter S corporation is a pass-through entity and the income is recognized and taxed directly to its shareholders. SFPP asserts that for the years at issue mostly individuals and only a limited number of certain estates and trusts were eligible shareholders of a Subchapter S corporation.[28]

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[25] *Id.*, P 76-77.

[26] The Opposing Parties include Chevron Products Company (Chevron), Tosco Corporation (Tosco), Ultramar Inc. (Ultramar), and Valero Marketing & Supply Company (Valero), filing as Joint Shippers, and Navajo Refining Company, L.P. (Navajo).

[27] *City of Charlottesville v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985) (*City of Charlottesville*).

[28] The Commission notes that SFPP did not mention limited liability corporations. However, such corporations are either taxed as Subchapter C corporations, or as pass-through entities similar to partnerships or Subchapter S corporations, depending on their characteristics or by election of the shareholders.

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13. A second category is individuals, including foreign individuals, who are liable for federal income tax on their share of SFPP's income. Two additional categories are estates and trusts, which are legal entities separate from the individuals that may be their beneficiaries. An estate will pay a tax on income from SFPP units unless the income is distributed to the beneficiary of the estate, in which case the income tax liability rests with the beneficiary. In the case of a grantor trust, the trust income is taxed directly to the grantor, or if the trust is not a grantor trust, to the trust. SFPP also notes that partnerships are pass-through entities and that income tax liability is governed by the tax status of the partners.

14. SFPP also discusses several possible categories of unit holders that face a common tax issue, unrelated business taxable income (UBTI). These include mutual funds, tax exempt organizations, such tax sheltering devices a traditional Individual Retirement Accounts (IRAs) and Roth IRAs, Qualified Pension Plans, and Profit Sharing Plans. If income is UBTI, it is taxed directly to the entity and not to the holder or the beneficiary of the investment entity. SFPP therefore concludes that there are strong incentives for these various savings devices not to hold SFPP or KMEP units. In addition, SFPP states that a mutual fund is taxed if it does not distribute at least 90 percent of its income from dividends, interest, and capital gains. Thus, income derived from a mutual fund is normally taxed to the fund's shareholders. Based on the forgoing, SFPP concludes that all of its unit holders are subject to an actual or potential income tax liability.

15. The Opposing Parties first assert that, for various reasons, the *Policy Statement* is inconsistent with the Remand Opinion[29] in Docket No. OR92-8-000, *et al.*, and as such it may not be applied in these proceedings. The Opposing Parties conclude that SFPP has not complied, or is unable to comply, with the standards of the *Policy Statement*, because it has not demonstrated that its partners have an actual or potential income tax liability for income generated by the SFPP's jurisdictional activities. These arguments are discussed below.

1. **Arguments Directed at the Policy Statement**

16. The Opposing Parties first argue: (1) that a partnership may not receive an income tax allowance because it does not pay income taxes; (2) that an income tax allowance will result in over-recovery of a partnership's cost-of-service; (3) that the Commission cannot create a phantom income tax allowance to encourage investment; and (4) that granting an income tax allowance to a pass-through entity will result in ratepayer costs beyond those that are incurred through the corporate ownership form.

[29] *BP West Coast* at 347 F.3d 1285-1293.

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17. These four arguments are outside the scope of the comments requested by the Commission's June 1 Order and as such are inapposite. In any event, the four enumerated arguments are based on the Remand Opinion's rejection of the Commission's *Lakehead* doctrine.[30] The *Policy Statement* and the June 1 Order both addressed these arguments and concluded that the *Lakehead* doctrine should no longer be applied to rate determinations for the jurisdictional entities regulated by the Commission. The four arguments asserted here were analyzed in detail in the *Policy Statement* issued in response to the Remand Opinion and were rejected. Instead the Commission chose to adopt a new policy governing income tax allowances, which is applicable here. Thus, as in the case of the June 1 Order, the Commission relies on the conclusions contained in the *Policy Statement* and will not pursue these four enumerated issues further.

18. The Opposing Parties advance two further arguments based on their interpretation of the Remand Opinion. They assert that SFPP may not obtain an income tax allowance to the extent that any income items or any offsetting expense deductions are allocated among the partners other than in proportion to their ownership percentages. They argue that Commission policy precludes granting the partnership an income tax benefit to the extent of any such allocations, an argument based on a ruling in *Lakehead* to that effect.[31] As has been discussed elsewhere, for the period beginning in March 1998, SFPP was controlled by KMEP. Since the KMEP partnership agreement allocates a portion of partnership income to the KMEP general partner that substantially exceeds the percentage of its partnership interests under various circumstances, they assert that any income tax allowance should be reduced proportionately. Navajo also argues that because the Commission and the court held in the Opinion No. 435 order proceedings that SFPP could not have a full income tax allowance, the law of that case precludes granting SFPP one here.

19. Neither argument has merit. The Opposing Parties are correct that the *Lakehead* doctrine disallowed any portion of an income tax allowance if income or expenses were allocated among the partners other than in proportion to each partner's ownership interests. While this was conceded to some extent by SFPP in its brief on exceptions to the ID,[32] the Commission concludes here that this particular policy is no longer appropriate given the rulings in the *Policy Statement*. The allocation policy in question

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[30] *Lakehead Pipe Line Company, L.P.,* 71 FERC ¶ 61,388 (1995) (Opinion No. 397), *reh'g denied*, 75 FERC ¶ 61,181 (1998) (Opinion No. 397-A) (*Lakehead*).

[31] *Lakehead*, Opinion No. 397-A, 75 FERC at 61,597-99.

[32] SFPP Brief on Exceptions at 45.

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was adopted in Opinion No. 397-A as an element of the Commission's former *Lakehead* doctrine. Since the *Lakehead* doctrine denied an oil pipeline partnership a tax allowance in proportion to the interests not owned by a Schedule C corporation, any allocation of income items and deductions from the individual to the corporate partners would shift any related tax benefits between the two categories of partners and thereby defeat the purpose of the *Lakehead* policy. As the *Lakehead* doctrine no longer applies to any jurisdictional entity, the purpose underlying that ruling is no longer relevant, and therefore the Commission will no longer apply this subsidiary element of its former *Lakehead* policy.

20. Navajo's argument regarding the rule of the case is also incorrect. The Commission's rulings in the Opinion No. 435 Orders preceding the June 1 Order were in the context of the *Lakehead* policy, which the Commission revisited in the *Policy Statement*. The court held that the Commission had not justified the application of the *Lakehead* doctrine on the record before the court at the time of the appeal, but explicitly stated that the Commission was free to explore the issue further.[33] The Commission explored the issue further as permitted by the court and authorized an income tax allowance for pass through entities based on the new record before it in Docket No. PL05-5-000. Therefore, the Commission may apply this new policy in this case since the income tax allowance issue was open on remand and was not precluded by the Remand Opinion.

2. Responses to the Requirements of the June 1 Order

21. The *Policy Statement* reserved for resolution in individual rate proceedings several issues that may depend on the structure of the specific partnership or other pass-through entity involved in a proceeding. These include (1) the application of the phrase "subject to an actual or potential income tax liability," (2) the marginal tax bracket to be used to determine the allowance imputed to the partnership or other pass-through entity; (3) the number of ownership layers to be reviewed in any proceeding; and (4) the possible allocation of any permitted income tax allowance among the various partners or unit holders.[34] The issues are addressed by the parties both in their responses to the June 1 Order and in their respective briefs and reply briefs on exceptions in Phase II of Docket No. OR96-2-000, *et al.* Because the Phase II ID was issued on September 9, 2004, before the *Policy Statement* on May 4, 2005, the tax issues are discussed in the context of the *Policy Statement* and the June 1 Order with references to the various materials

[33] *BP West Coast* at 1288, 1290, and 1293.

[34] *Policy Statement* at P 32, 41, and 42.

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included in the record of Docket No. OR92-8-000, *et al.*, and in Phase II of Docket No. OR96-2-000, *et al*.[35]

a. <u>Subject to an Actual or Potential Income Tax Liability.</u>

22. The *Policy Statement* provides that a tax allowance will be permitted in proportion to the partnership interests (or units) that are subject to an actual or potential income tax liability for the income of a regulated entity, but that the detailed explanation of that concept will be left to specific proceedings.[36] Here SFPP asserts that all partnership income is eventually taxed, either at ordinary income levels or at capital gain rates. It asserts that as such, virtually all, if not all, of SFPP's or KMEP's unit holders are subject to an actual or potential income tax liability on the units they hold.[37] In response, the Opposing Parties argue that SFPP has not established that its unit holders have an actual or potential income tax liability because: (1) individuals holding publicly traded partnership interests may have received distributions that are considered a return of capital and are therefore not taxed; (2) the sale of a partnership interest may result in the partner paying capital gains tax on the sale before any income tax liability becomes due; (3) partnership income allocated to a partner may be offset by deductions and credits that eliminate any tax liability in a given year; and (4) the partner's tax liability may be offset by deductions or credits from other economic activity. They conclude these facts make it is possible for a partner to hold a MLP partnership interest, receive substantial benefits from it, and possibly never pay any income taxes, which, they claim, occurs frequently.

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[35] The only extensive analysis on income tax allowance issues on exceptions to the ID is pages 34 through 46 of SFPP's Brief on Exceptions.

[36] *Policy Statement* at P 42. *See Trans-Elect Path NTD-15* (*Trans-Elect*) , Order Denying Rehearing, 111 FERC ¶ 61,140 (2005), Order Denying Rehearing, 112 FERC ¶ 61,200 (2005) and Order Conditionally Accepting Compliance Filing, 112 FERC ¶ 2002 (2005).

[37] As discussed elsewhere, the unit holders held their units from Santa Fe Pacific Pipeline Partners, L.P. (SFPPP, L.P..), a master limited partnership (MLP) which controlled SFPP, L.P. (the operating limited partnership) for the period before 1998. Thereafter the unit holders were limited partner in Kinder Morgan Energy Partners (KMEP), another MLP which now controls SFPP, L.P., the operating limited partnership. Thus, there was a transfer of control through the acquisition of SFPP (the MLP) by KMEP on March 6, 1998, but the operating partnership remained the same. *See* SFPP's 1998 FERC Form No. 6 at 122, note 1.

23. The fundamental difference between the position of SFPP and that of the Opposing Parties turns on the distinction between a partner that is “subject to” an actual or potential income tax liability and a partner that “has” an actual or potential income tax liability. The former reflects the position advanced by SFPP and recognizes that (1) a partner that holds a partnership interest over the life of the partnership will eventually pay income tax on all distributions and all gains, and that (2), at all times a partner that is participating in the partnership has an obligation to file a return disclosing either positive or negative income that the partnership has in a given year. The second reflects the position advanced by the Opposing Parties, argues that the partner must actually derive positive income from the partnership in a given year, or will have discernable ordinary taxable income in the later years that the partner holds the partnership interest. In this regard, the Opposing Parties’ central point is that there is no necessary correlation between the taxable income reported by the partnership on its 1065 information return and the cash distributions that are made to the partners in any given year. They assert that the cash distributions may exceed the income imputed to the partners, and that no taxes will be paid on the difference between the income imputed to partners for tax purposes and the cash that was distributed to them. Their argument is that this difference in timing means that individual partners may never have an actual or potential income tax liability based on the units they hold.

24. The Opposing Parties’ argument turns on two basic principles of partnership law, either of which could result in the dichotomy between reported income and distributions that Opposing Parties assert here. While actual partnership income (positive or negative) must always be reported by a partner, the difference between the level of the distributions and the amount of reported partnership income may be due to the timing of deductions and credits that are taken by the partnership or allocations of income and expenses items among the partnership.[38] On the first point, net *operating* cash flow is not necessarily congruent with income tax expense items that are based on book expenses such as depreciation, amortization, and investment credits. Thus it is in theory possible, although improbable in the case of a large commercial partnership, that a partnership could generate $100 from operations that none of that income would be taxable in a given year if there was depreciation, amortization, and credits to offset it. In fact, as KMEP’s income figures for 2000 and 20001 and SFPP’s income figures for 1999 and 2000 suggest, the most likely result is that net income would be reduced given that both

[38] Thus, as discussed further below, the difference between the income reported by a partner and the partner’s distribution may also be due to the allocation of income and losses among the partners.

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partnerships had substantial net income during those periods.[39] In any event, as of such time as the accelerated depreciation, special amortization, or tax credits are exhausted, partnership net income would increase. At that point income taxes would be due on that income from the partners holding units at that time, as well as on any distributions that exceeded the amount contributed to each partner's capital account. Which partners would bear that tax burden, and when, is a matter of timing that depends on the economic and accounting cycle of the partnership's capital investments. While potentially tax free distributions to a partner in a given year are considered particularly objectionable by the Opposing Parties, a difference between partnership net income and the cash flow available for distributions is not necessarily different from the asset and investment cycle of Form 1120 (Subchapter C) corporations. Thus, a corporation may have similar results depending on the cash flow that is generated by its assets and the depreciation, amortization, and tax credit strategy that is adopted by the corporation, and at such times may pay dividends out of retained earnings. [40]

25. On this matter of timing, under *City of Charlottesville,* Commission policy recognizes that there is an imputed tax cost to the corporation of investing and owning regulated assets even if the actual timing of the payment of the taxes on the income generated by those assets may vary depending on the depreciation, credit, and amortization practices that corporation adopts. The fact that a corporation's reported

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[39] In fact, KMEP net income for the six months ended June 30, 2000 was $131,369,000. Of that amount $49, 260,000 was the general partner's interest and $82,109,000 the limited partners' interest. For the six months ended June 30, 2001, net income was $205,893, 000 of which $92,228,000 was the general partner's interest and $113,665,000 the limited partners' interest. *See* Ex. UIT-49. SFPP, L.P., the operating unit whose rates are under review here had operating income of $113,586,418 in 1999 and $107,519,252 in 2000. SFPP's distributions to its general and limited partners (via KMEP) were $78,500,000 in 1999 and $105,900,000 in 2000. *See* SFPP's 2000 FERC Form No. 6 at 110 and 111. The same type of figures for the SFPP parent master limited partnership for the years 1996, 1997, 1998, and 1999 (some of which is for the period before the KMEP acquisition) are contained at page 50 of SFPP's Brief on Exceptions in Docket No. IS98-1-000. It is also possible for a partnership or corporation to have income that is not reported as taxable income because the income is from sources that are exempt from federal or state income taxes.

[40] To the extent either a corporation or a partnership does not pay out all income in dividends, the difference is added to retained earnings. Losses or payment of dividends during a year in which an income loss occurs reduces retained earnings by the amount of the loss.

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income for tax purposes may vary in any given year does not preclude a corporation from obtaining an income tax allowance based on the return component included in its cost-of-service. However, a Schedule C corporation (like a partnership) will eventually pay tax on the income generated by the assets, or the gain that comes from the sale of those assets, with a negative tax impact on the reported income of the corporation and the interests of its investors. Moreover, because the tax allowance is based on the overall tax bracket of the corporation, the regulatory tax allowance does not necessarily turn on whether the components of the corporation's taxable income are characterized as ordinary income or taxable gains; it is sufficient that the ordinary income regularly earned by the corporation is sufficient to place it in the maximum income bracket.[41] The same approach should apply to a Form 1040 tax payer filing an individual return, or that of any other taxable entity. For the same reason, the offsetting of deductions and credits within the partnership return, and on a partner's K-1 and Form 1120 or Form 1040 return, does not affect whether the partners are subject to an actual or potential income tax obligation. Assuming that there is no allocation of items of income, deductions and credits among the partners other than in proportion to their partnership interests, over time a partnership's net income is reflected proportionately on the returns of the individual partners.

26. The Opposing Parties' second argument is that the allocation of income and expense items among the partners may result in the deferral of actual income tax payments and result in distribution of cash to some partners exceeding the income reflected on their tax returns. However, to the extent that income, deductions, and credits are allocated among the partners, this does not affect the total taxable income of the partnership reported on the partnership's 1065 information return it files with the Internal Revenue Service, the annual report it must file with the Commission, or the collective income tax liability of the partners. As SFPP points out, if all income were allocated to KMEP and all losses, deductions, and credits to the other partners, the income allocated to KMEP would equal the partnership's net operating income, KMEP would be subject to an actual or potential tax on that income. Thus, assume that SFFP reported $100 million in net income on its partnership information return. Even if $150 million in gross income was allocated to KMEP and $50 million in losses to the other partners, KMEP would still have a tax liability for 100 percent of that $100 million assuming, as has been discussed,

[41] In determining the income tax allowance component of a costs of service the Commission use a presumption that that most corporations will have the equivalent of a 35 percent income bracket.

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there were no offsetting expenses or deductions from other income sources.[42] A different allocation could lead to different reporting obligations of the partners, but the $100 million in actual net income would be allocated to some, or all, of the non-KMEP partners. However the allocation is made, there is still an imputed tax cost to the partnership, and hence to the partners, for the funds invested in the enterprise. Allocation of income among the partners may affect the marginal tax bracket of the partners involved because the allocation might change the amount of both gross and taxable income that may be reflected on the partners' returns, and therefore influence the weighted income tax allowance to be included in the partnership's cost of service. However a partner that can be identified through the partnership's information return and K-1s will be subject to an actual or potential income tax liability for that income. Each such partner is involved in the allocation and is subject to an actual or potential income tax liability regardless of exactly how the allocation of income and losses occurs.

27. As has been discussed, the Opposing Parties also assert that a partner may have no income tax liability in a given year because there are deductions and credits other than those attributed to the partnership that may negate any investment income from the partnership. However, as explained in the Policy Statement, under the Commission's "stand alone" tax policy, corporations are not denied an income tax allowance because deductions or losses from one subsidiary or operation may act to offset income from the regulated entity if the corporation files a consolidated return.[43] If the partner is a corporation, the income from the partnership likewise becomes part of the corporation's overall income tax return and should be subject to the same result. Similarly, when a Form 1040 taxpayer files a return, all sources of income, including the relevant proportion partnership net income reported on the partner's K-1, are reported on the relevant portions of the Form 1040. These sources of income may be offset by losses from other activities or by itemized deductions included on Schedule C of a Form 1040 return. Consistent application of the "stand alone" policy means that a partner filing a Form 1040 return, and the partnership, should not be penalized because such a partner has losses, deductions, or credits from other sources that may offset income reported on the K-1 of a specific partnership.

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[42] SFPP's Brief on Exceptions dated October 7, 2005 in Docket No. IS98-1-000 indicates at 48 that KMPG had very substantial corporate income in 2000. While the exact number is contained in the protected section of SFPP's brief, it is derived from Ex UIT-104, SF177621-2, in the Docket No. IS98-1-000 proceeding. As discussed below, the determinations to be made here materially simplified if KMPG were to include the same information in Docket Nos. OR92-8-000, *et al* and OR98-6-000, *et al.*

[43] *Id*. P 38.

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28. Thus, for purposes of determining whether a partnership should have an income tax allowance, the impact on a partner filing a Form 1040 return of losses or deductions from other sources should be no different than the impact on a corporate partner that files a Form 1120 corporate return containing the same type of offsets within its corporate structure. Even though the income of a partnership and that attributed to its partners may vary whether a partner has an actual tax liability in a given year is not determinative given the Commission's stand-alone policy. What is relevant is that a partner is subject to an actual or potential liability for any income earned from regulated assets, regardless of whether it is offset by deductions, losses, or other subtractions. This result is consistent with the philosophy in *City of Charlottesville*[44] 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. Therefore, if a partner is required to file a Form 1040 or Form 1120 return that includes a partnership income or loss, the Commission concludes that such partner that has an actual or potential income tax liability for the partnership income.[45] The relationship of this standard to the weighted tax rate, multiple levels of pass-through entities, and the allocation of tax benefits among partners is discussed further below.

b. The marginal tax bracket to be applied.

29. The *Policy Statement* states that the Commission will determine on a case by case basis the marginal tax bracket to be used to determine the tax allowance for pass through entities such as partnerships or limited liability corporations (LLCs).[46] In that regard the *Policy Statement* discusses an example of a partnership consisting of both regulated electric utilities and municipal electric companies. The former pay income taxes but the latter do not. In that instance the partnership was structured to provide an income tax allowance in proportion to the partnership interests owned by the regulated electric companies, but none was provide for those owned by the municipal electric entities. Thus the income tax allowance was based on the weighted average of the marginal tax

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[44] *Policy Statement* at P 15, n. 12, and P 33, n. 28.

[45] While the Commission is not requiring that the regulated entity have actual income that would be taxable to its partners in the relevant test year, as previously stated, having such income, or a pattern of such income, would materially simplify a regulated entity's case. *Cf. Trans-Elect.*

[46] *Policy Statement* at P 32-34.

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brackets of the owning partners.[47] However, the *Policy Statement* did not indicate how the marginal tax rate would be developed in a specific proceeding. The Commission does so here following the categories in SFPP's June 16 brief.

30. The simplest determination of the marginal tax bracket occurs when all the partnership interests are owned by Schedule C corporations, by LLCs that are required to be taxed as Form 1120 corporations, or LLCs that have elected to be taxed as such.[48] The Commission has long held that there is a rebuttable presumption that a Subchapter C corporation owning interests in a regulated entity has a marginal tax bracket equal to the maximum corporate tax bracket because of the size and scale of the operations of most such corporations.[49] Thus, the Commission adopts here a presumption that corporate partners owning interests in SFPP or KMEP pay the maximum marginal tax rate of 35 percent for purposes of calculating any tax allowance that may be granted to SFPP.

31. Determining the marginal tax brackets for partners that are not Schedule C corporations is more difficult. As the Opposing Parties assert, individual taxpayers, or the entities of which individuals are often the beneficiaries,[50] may have a wide range of tax brackets, and in theory any SFPP limited partner or KMEP unit holder could fall in these different brackets. Moreover, since tax returns are confidential, 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 a return. To address this issue, the Commission reviewed two official Internal Revenue Service publications, *Individual Income Tax Rates and Tax Shares, 1994*,[51] and *Individual Income Tax Rates and Tax Shares, 1999,* [52] and takes

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[47] *Id.* PP 8-9. The jurisdictional partnership owned and operated transmission facilities used in interstate commerce. As is discussed further below, the partnership documents allocated the tax benefits in a manner to prevent the non-taxpaying partners from obtaining any of the tax benefits.

[48] *Cf. Trans-Elect, supra.* . In this case all the partnership interests were ultimately controlled by a Schedule C corporation or an LLC that was required to file the Form 1120 tax return as an entity that would be taxed as a Schedule C corporation.

[49] In 1994, 1999 and 2000 the maximum corporate tax bracket was 35 percent. All income over $75,000 had a marginal tax bracket of at least 34 percent. *See IRS Publication 542* for 1994 at 7, for 1999 at 9, and for 2000 at 10.

[50] These include pension funds, IRA Plans of various types, Keogh Plans, mutual funds, and investment clubs.

[51] Individual Income Tax Rates and Tax Shares, 1994 (1994 Tax Data).

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administrative notice of both. Both contain a figure C displaying the marginal tax brackets in effect for each year, the number and percent of returns by each such bracket, the distribution of modified taxable income and percent of such income by each such bracket, and the amount of income tax generated by each bracket and that tax as a percent of total tax generated.[53] The Figure C for 1994 discloses that 29.1 percent of income taxes were paid by individuals in the 36 percent bracket or higher.[54] The Figure C for 1999 states that some 40.3 percent of total taxes were paid by individuals in the 36 percent bracket or higher.[55] In 1994, 74.7 percent of total income taxes were paid by Form 1040 taxpayers in the 28 percent bracket or higher,[56] and in 1999, 79.5 percent of taxes were paid by Form 1040 taxpayers in the 28 percent bracket or higher.[57]

32. Given the high percentage of tax revenues generated by the 28 percent tax bracket or higher in those two years, the Commission will adopt a presumption of 28 percent marginal tax bracket for entities other than those filing an 1120 corporate return.[58] This is 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. Thus, it is likely that the use of the 28 percent bracket actually understates the marginal tax rate of most individuals that have invested in SFPP or KMEP partnership interests. The same presumption will apply to such entities if those entities are deemed to have unrelated business taxable income (UBTI), unless the Internal Revenue Code prescribes a different level.[59] Thus, unless a party provides evidence to the contrary, the marginal tax bracket

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[52] Individual Income Tax Rates and Tax Shares, 1999 (1999 Tax Data).

[53] 1994 is the test year at issue in Docket No. OR92-8-000, *et al.*, and 1999 the principal test year in Docket No. OR96-2-000, *et al.*

[54] 1994 Tax Data at 10.

[55] 1999 Tax Data at 9.

[56] 1994 Tax Data at 10.

[57] 1999 Tax Data at 9.

[58] The next lower, which is the lowest bracket, was 15 percent in both years.

[59] *See* SFPP's June 16 filing at p. 26 for a list of entities that may be subject to UBTI. However SFPP does not address the marginal tax rate that should be attributed to such entities having UBTL. This should be clarified in the compliance filing if the marginal tax bracket would differ from the rebuttable presumption created here.

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for partners that are Schedule C corporations or LLCs filing a Form 1120 return of 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.[60]

c. Multiple Levels of Ownership.

33. The *Policy Statement* also recognized that, like corporations, partnerships and other pass-through entities may have multiple layers of ownership. Thus, 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. As noted, partnership or pass-through LLC interests can also be owned by trusts, pension plans, IRA Plans, Keogh Plans, and mutual funds. There is no objection to such arrangements as long a partner that is subject to an actual or potential income tax level can be identified during the test case year at issue in a particular proceeding. As SFPP noted, 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.

d. Flow of the Tax Allowance Benefits among the Partners.

34. One of the Remand Opinion's criticisms of the Commission's *Lakehead* policy is that it was mathematically impossible for the policy to accomplish its purpose. Specifically, the court stated that even if a partnership were denied an income tax allowance in proportion to the interests not owned by a corporation, the non-corporate partners would still share in a portion of any more limited income tax allowance that was allowed. This is because all partners would continue to share in the benefits that flowed from whatever tax allowance was authorized in proportion to their partnership interests.[61] However, as was also stated in the *Policy Statement*, 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. This 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

[60] A pass-through entity may provide evidence that the marginal tax bracket of any partner or unit holder is greater than 28 percent if the evidence is available.

[61] *BP West Coast* at 1291.

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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.

e. <u>Other Income Tax Allowance Issues.</u>

35. The Opposing Parties raise three additional arguments regarding any income tax allowance for SFPP in Docket No. OR92-8-000, *et al.* The first issue here involves SFP Pipeline Holdings, Inc., which was created as a holding company for SFPP, Inc. in 1990. SFPP, Inc. was owned 100 percent by SFP Pipeline Holdings, Inc., which in turn was owned 100 percent by Santa Fe Pacific Corporation. SFP Pipeline Holdings, Inc. issued $219 million in debentures in a public offering.[62] The interest payments on these debentures were structured to equal, under most circumstances, 100 percent of the distributions received by SFPP, Inc. from its 47.1 percent limited partnership interest in Santa Fe Partners. The argument in the prior proceedings is that this arrangement insulated SFPP, Inc. and all its parent companies from having to pay income tax on any income generated by SFPP, as reflected via the 47.1 percent limited partnership interest held by SFPP, Inc. in Santa Fe Partners. The Commission rejected that conclusion and a related ruling by the ALJ in Opinion No. 435 on the grounds that the Commission's stand-alone policy warranted granting SFPP an income tax allowance because the 47.1 percent interests were owned by corporate partners.[63] Thus, under *Lakehead*, SFPP was granted an income tax allowance as the 47.1 percent limited partnership interest was owned by a corporation.

36. The Opposing Parties renew their previous argument here. They assert that the *Policy Statement* the Commission repudiated the stand-alone argument for purposes of partnerships and other pass-through entities unless an actual income tax liability can be shown. They argue that because an actual income tax liability must be shown, SFPP, L.P. could never meet the standard because the debentures shelter any income that SFPP, Inc. may have received from its 47.1 percent limited partnership interest. Therefore no income tax allowance should be afforded SFPP, L.P. in proportion to those interests. This argument overlooks two critical points. First, the Commission has not repudiated the stand-alone argument for pass through entities. As was previously discussed, the fact that an owning partner may have offsetting credits or losses from sources other than SFPP (or KMEP) on Schedule D of Form 1040 or 1120 does not eliminate the right to an

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[62] *See* Ex. 873 in Docket No. OR92-8-000, *et al.* for the prospectus issued with regard to those debentures.

[63] *Opinion No. 435* at 61,103-04; *Opinion No. 435-B* at 61,509.

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income tax allowance. Nor does the fact that timing issues, or short term losses, may result in a partner's K-1 having negative income in a particular tax year, or income that is other than ordinary income.

37. Second, the payments on the debentures are keyed to *distributions,* which, as Opposing Parties state, are not the same as the *income* that is reported by the partnership for information purposes, and by the individual partners (positive or negative) because of their Form 1040 or Form 1120 return obligations. Because the corporate structure above SFPP, Inc. involved 100 percent ownership, all of those corporations could file a consolidated return, and therefore the intermediate corporate levels would not have paid an income tax on SFPP, Inc.'s income. However, any *income or loss* to SFPP, L.P., a partner, flows up the corporate chain by means of the consolidated return. That income or loss must be reported at the highest level of the consolidated return. In this case this was Burlington Northern Santa Fe Corporation. Under the previous analysis, the imputed tax rate is the maximum corporate tax rate for the 1994 test year at issue, 35 percent. Since interest on the corporate debentures was paid based on *distributions*, not *income*, the income tax impacts of any given year would still fall on the corporate owner filing the consolidated return. As such, the SFP Pipeline Holdings, Inc. debentures are not a barrier to SFPP having an income tax allowance in the 1994 test year.

38. The second issue involves the curative allocation designed to compensate for the contribution of depreciated assets to a partnership by one of the partners. In the Phase II ID in Docket No. OR96-2-000, *et al*., the ALJ held that when such an allocation occurs, the allocation should not be used in determining any income tax allowance because this would unfairly shift income tax cost to the ratepayers. The ALJ then devised a method for correcting the curative allocation to conform to Commission policy based on a methodology developed by Navajo.[64] On exceptions, SFPP conceded that Commission policy supported the ALJ's conclusion that a curative allocation would not be allowed for purposes of the income tax allocation, but objected to the ALJ's method for reallocating the income. While the Opposing Parties did not address this issue on exceptions, they did so in their responses to the June 1 Order. They base their arguments on the prior discussion of allocation issues in the Opinion No. 435 Orders and the underlying discussion of such issues in *Lakehead*, *supra*. The Commission reverses the ALJ in this regard based on its prior discussion of allocation issues and the general relationship of such issues to the Commission's former *Lakehead* doctrine.

39. Curative allocations are a part of partnership law mechanics that address the allocation of income among the partners based on the market value of their capital

[64] ID at P 370.

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contributions. To summarize, the IRS requires that if a partner contributes depreciated property to a partnership, that contribution must be deemed contributed at its fair market value for the purpose of allocating income and expenses among the partners. This assures that all partnership interests are valued for tax purposes at market value when the assets are contributed. For example, assume that one partner contributes $100 in cash and a second contributes property with a depreciated basis of $50, but market value of $100. In the absence of the curative doctrine, the total value of the partnership might be $150 and the allocation of income and expenses between the two partners would be two-thirds and one-third respectively. The application of the IRS curative allocation doctrine results in a total value for tax purposes of $200 and equal allocation of tax items between the two partners. Since the *Policy Statement* holds that any tax allowance should be based on the income tax imputed to the partners, and the IRS doctrine rationally reflects the current economic value of the assets a partner contributes, the IRS income allocation should control.

40. The third additional issue advanced by the Opposing Parties centers on incentive distributions. It is not contested here that many master limited partnership agreements have provisions for income and distributions to be allocated from the limited partners to the general partners as the partnership's economic performance improves. Thus, once distributions to the limited partners reach a certain level, more of the distributions flow to the general partner. SFPP asserts that in its June 15 filing that as distributions are shifted to the general partner, more of the income items are allocated to the general partner. In its June 15 filing, SFPP provides a simple example in which partnership income is $100 million, noting that partnership tax law permits the income and expense items to be allocated among the partners pursuant to the partnership agreement. SFPP posits that $150 million in income items might be allocated to the general partner and $50 million in expense items to the limited partners. The latter would thus obtain the maximum cash distribution of $50 million due them under the partnership agreement plus a tax deduction for the loss included in their Form K-1. SFPP asserts that whatever the impact on the Form 1040 or 1120 returns of the individual partners, there would still be an entity with an actual liability for the $100 million in income reported on the partnership return.

41. The Opposing Parties assert that this example distorts and over-simplifies a complex situation. They assert that their evidence shows that SFPP's distributions greatly increased by the year 2000, that these distributions and the related income shifts greatly distort the income tax cost that should be imputed to SFPP based on its partners' tax liabilities. They further assert that the ALJ found that the payments under the incentive distributions were due in large part to a substantial over-recovery of SFPP's

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operating costs.[65] They also assert that most of the increase in KMEP's income, and therefore the income allocated to the general partner, was due to increased earnings from KMEP operating entities other than SFPP. They therefore conclude that any attribution of a tax allowance to SFPP based on those increases would be unfair to SFPP's rate payers because the income tax allowance would be overstated.

42. As previously noted, this issue was discussed on exceptions to the ID, but was more fully discussed in response to the Commission's June 1 Order. However, the Commission concludes that SFPP has the better part of the argument. First, to the extent that distributions have increased in part to SFPP's rate levels, the historical argument would appear inconsistent with the assertion by the ALJ and the Opposing Parties that SFPP's income was stable or actually declined through 1999. If SFPP's income is the base against which any income tax allocation should be measured, the fact that its past rates may have been high is simply not relevant. Under the Commission's stand-alone policy, if a corporate parent files a consolidated return, the parent's marginal tax bracket is used to determine the income tax allowance even if it is income from other sources that causes the parent company to fall within the maximum tax bracket.[66] The level of SFPP rates in *past* periods is a matter for determining refunds, if appropriate, and does not affect the income tax allowance that would be used for determining a *prospective* rate defined by *projected* income based on the test period.

43. The shifting of the income allocation as a part of providing incentive distributions is a third issue. The *Policy Statemen*t provides that the tax allowance should be based on the weighted marginal tax bracket of the partners. The prior portions of this order concluded that there should be somewhat different tax rates attributed to various types of ownership interests based on the rebuttable presumptions discussed earlier in this order. Given this, if income is shifted from one type of ownership interest to another, the weighted average of the differing partnership interests could change resulting in a different tax allowance for the operating entity, in this case SFPP. The Commission concludes that it is SFPP's prerogative to allocate income and losses among its partners as it determines as long as the maximum tax rate imputed to individuals does not exceed the maximum corporate rate. Given this, under the *Policy Statement* the maximum impact on the ratepayers is the same whether the regulated assets are controlled by a corporation or a partnership. Thus, if all partners are corporations at the maximum tax bracket, then the regulated entity's rates would be based on the maximum possible tax

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[65] *See* ID at P 372-73.

[66] The Remand Opinion did not question this practice.

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allowance. For these reasons the Commission reverses the contrary conclusions in Phase II ID in Docket No. OR96-8-000, *et al.*[67]

3. Further proceedings regarding income tax allowance issues.

44. In the preceding paragraphs the Commission has ruled on a number of basic principles to be used in determining SFPP's income tax allowance in this proceeding. A review of the briefs filed in response to the Commission's June 1 Order indicate that the record in both the proceedings at issue here is oriented toward establishing whether SFPP and KMEP's units holders are Schedule C taxpaying corporations. Giving the narrow focus of the arguments regarding that evidence, the Commission concludes that it is premature to determine if SFPP meets the income tax allowance standards contained in the *Policy Statement*. Further analysis is necessary because much of the information in the record must be reformatted to address the matters at issue here. As in *TransElect*, additional information is required because the legal standards have changed since the record closed in all of the consolidated dockets at issue here. As a result the Commission directs SFPP to file information explaining the interests that SFPP's or KMEP's limited and general partners had in partnership's net income in each of the years at issue here. Because this is not the necessarily the same as the income that may be allocated to limited and general partners in each year, SFPP and KMEP shall also state the amount of the income that was allocated to the limited and general partners for each year, including the amount of taxable income that was allocated between the two types of partners.

45. The Commission also directs SFPP to determine the estimated income tax allowance as follows. Using materials at hand in each proceeding at issue here, SFPP for the years prior to 1998, and KMEP for the year 1998 forward, will separate their respective partners (unit holders) into six broad categories and include supporting detail on the units holders within each category: (1) Subchapter C corporations, (2) individuals, (3) mutual funds, (4) other unit holders such as pension funds, IRAs, Keogh Plans, and other entities that are not normally tax paying entities, but would be expected to have taxpaying beneficiaries or owners, (5) those entities listed in (4) that may be taxpaying entities because income from SFPP or KMEP would be deemed unrelated business income, and (6) those institutions and exempt entities, if any, which have no obligation to pay out income or to declare it, such as municipalities.[68] To the extent that the unit

[67] *Cf.* ID at P 376.

[68] The parties have already attempted to do much of this in the context of their arguments about the application of the *Lakehead* doctrine. *See* Docket No. OR92-8-000, *et al.*, Exs. 477, 478, 479, 926, 931; Docket No. OR96-2-000, *et al.*, Ex. Nos. MFM-13, SFPP-79 – 81, UIT-1 at 83. For a more recent example see the filing by Northern Border (continued)

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holders are pass-through entities such as other partnerships, Subchapter S corporations, and pass-through LLCs, SFPP or KMEP should identify the nature of the entity or individual ultimately subject to an actual or potential income tax liability and place that entity or individual in the appropriate category of unit owner. SFPP should identify the percentage of unit holders that falls into each group.

46. SFPP and KMEP will then calculate the percentage of taxable partnership income imputed to each group, which the Commission recognizes 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. SFPP and KEMP will then develop a weighed tax allowance accordingly. The weighted tax allowance so calculated would be used to develop the required cost-of-service and the interim rate for the related rate filing. SFPP shall prepare supporting affidavits explaining the methodology chosen and include work papers in a separate binder, to be available to parties and the Commission, to support this portion of its compliance filing.[69] If a statistical approach is used, SFPP must explain why the sample is statistically valid, and if necessary, explain why any failures to meet the standards discussed here are not statistically significant or relevant.

47. Moreover, in order to implement new interim East and West Line rates as soon as possible, the Commission will require SFFP to develop a cost-of-service for both lines and develop estimated rates, including the estimated income tax allowance component SFPP is to prepare in response to this order.[70] As discussed further below, the Commission directs SFPP to file interim rates based on the related cost-of-service compliance filing it must prepare in response to this order. Interim rates are necessary because the litigation over the current rates has been ongoing since 1995 in the case of

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Pipeline Company dated November 1, 2005, in Docket No. RP06-72-000, Vol. II, Ex. No. NB-16, Schedules 2-4.

[69] The Commission recognizes that there are challenges to the various studies on the income tax allowance issue that SFPP and the Opposing Parties have prepared to date. However, it would be more efficient to address such issues in the context of a filing that focuses more closely on the guidance provided in this order.

[70] The authority to require this filing stems from the Commission's remedial authority in section 15(1) of the Interstate Commerce Act, 49 U.S.C. app 15(1) (1988). The remand opinion affirmed the use of an interim rate and held that such a rate is not a final rate for purposes of the *Arizona Grocery* doctrine. *BP West Coast,* Part III, B. 1. a., *passim*, discussing the relevance of *Arizona Grocery Co. v. Atchison, Topeka, & Santa Fe Railway Co.*, 284 U.S. 370 (1932)(*Arizona Grocery).*

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the complaints in Docket No. OR98-2-000, *et al.,* and even longer for the proceedings in Docket No. OR92-8-000, *et al.* The Commission contemplates that the rates filed in compliance with this order should be less than those now in effect and thus some relief should be accorded shippers given that litigation over the appropriate tax allowance may continue for some time.

B. East Line Rate Issues Remanded in Docket No. OR92-8-000, et al.

48. In addition to its concerns about income tax allowances, the Remand Opinion addressed two other issues regarding the East Line rates established by the Commission's Opinion No. 435 orders. These were the allocation of Commission regulatory costs between the East and West Line rates and SFPP's reconditioning costs. In its June 1 Order the Commission concluded that regulatory costs should be allocated on the basis of relative East and West Line volumes for the period covered by the Opinion No. 435 orders. The Commission determined that it would not modify its prior ruling regarding SFPP's proposed reconditioning costs for its East Line. In preparing a new East Line compliance filing SFPP shall apply those two rulings, together with the tax allowance methodology described in the previous part of this order.

49. In all other matters SFPP shall follow the same compliance methodology developed in the Opinion No. 435 Orders and ultimately defined by the Commission in its *Order on Rehearing and Compliance*.[71] Pursuant to that methodology, SFPP must prepare a revised cost-of-service for the 1994 test year utilized in Docket No. OR92-6-000, *et al.* and prepare a separate tariff filing based on that year. Since the revised East Line rates required here address only the periods addressed in Docket No. OR92-6-000, *et al.* and the Opinion No. 435 Orders, to be consistent with the ruling in those orders, the rate based on the 1994 cost of service will be indexed forward to August 1, 2000. Consistent with the Commission's practice in the Opinion No. 435 Orders, the rate so developed will be an interim rate until such time as any challenges to the income tax allowance portion of the rate can be resolved and a final rate developed. The revised rate will be compared to the indexed rate actually in effect since August 1, 2000 (and retrospectively for reparations two years prior to the filing of the relevant complaints). This will determine whether a new East Line rate should be established for each year since August 1, 2000 depending on the results of the additional calculations required here in response to the Remand Order.[72] Moreover, as the previous discussion suggests, any

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[71] *SFPP, L.P.*, 106 FERC ¶ 61,138 (2001).

[72] The Commission's prior orders ultimately allocated 50 percent of Commission regulatory costs allowed under those orders to the East Line rates. Here the allocation is (continued)

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revised East Line rates to be effective as of August 1, 2000, may be further revised depending on the final resolution of the income tax allowance issue. The analysis here resolves SFPP's argument on exceptions that the ALJ prematurely concluded that its East Line rates are unjust and unreasonable.

C. Cost-of-Service Issues in Phase II of Docket No. OR96-2-000, et al.

50. The second proceeding at issue here is Phase II of Docket No. OR96-2-000, *et al.* As previously discussed, the June 1 Order affirmed the prior jurisdictional determinations made in Phase I of that proceeding regarding the status of the North, Oregon and West Line rates. Thus complaints filed against the Yuma, CalNev, and West Tucson rates in 1996 were valid complaints in that year and all years thereafter, as are complaints against the West Phoenix rates for the year 1997 and for all years thereafter. Complaints that were pending against SFPP's East Line rates in the same years are valid complaints because SFPP's East Line rates were never grandfathered. In addressing those complaints, there are several issues that are common to both the East and West Lines in addition to the income tax allowance issues discussed in the first part of this order. These include: (1) the test year to be used in these proceedings; (2) rate base and capital structure issues; (3) cost of capital issues, (4) overhead cost allocation issues; (5) the recovery of regulatory costs; (6) Arizona real estate tax cost matters; and (7) modification of SFPP's current depreciation methodology. There are other minor points that involve one or both lines, but do not warrant separate itemization here.

1. Test year issues.

51. The ID utilized a 1999 test year with limited changes and certain modifications for the year 2000. The latter included additional capital expenditures made by SFPP in 2000, with a related issue of how depreciation, amortization, and the related allowance for deferred income taxes (ADIT) should be calculated given the inclusion of those capital expenditures in SFPP's cost of service.[73] The ID concluded that if SFPP included 2000 year capital additions in its 1999 cost-of-service, it should depreciate all capital accounts by carrying the deprecation forward through the year 2000. The ID also required SFPP to adjust ADIT through year 2000 if the 2000 capital costs were included in its rate base.[74]

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based on relative volumes, which are notably lower for the East Line rates. This suggests fewer regulatory costs will be allocated to the East Line rates.

[73] ID at P 319-327.

[74] *Id.* P 324.

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The ID also determined that 2000 volumes should be used to construct SFPP's cost-of-service for its East and West Line rates.[75] As discussed further below, the ALJ also addressed certain capital structure factors using 2000 year balance sheet information. However, the ALJ rejected at hearing SFPP's proposal to utilize a full calendar year 2000 test year to develop SFPP's cost of service. The ALJ concluded that this was unfair to complainants who had prepared their complaints and cases-in-chief using a 1999 cost of service. The ALJ also concluded that SFPP's proposed 2000 test year was incomplete.[76]

52. On exceptions SFPP asserts that the ALJ erred in excluding its proposed 2000 test year cost of service, which it claims was the most recent and accurate information available. It further asserts that use of the 2000 year data would not have precluded complainants from updating their cost of services accordingly. SFPP further asserts that the ID erred in requiring it to carry all depreciation and ADIT through the 2000 year and requiring SFPP to utilize 2000 year volumes to develop its cost-of-service. In contrast, Western Refinery and Navajo assert that the ID should have also required allowance for funds used during construction (AFUDC) to be carried forward through the 2000 test year. Staff argues that the ID should have excluded some $3.8 million in 2000 year capital expenditures that the ALJ permitted SFPP to include in the 1999 test year the ID adopted. On reply, Western Refinery and Staff support the ID's conclusion requiring SFPP to carry all depreciation and ADIT through the year 2000. SFPP asserts that the Staff incorrectly urges the exclusion of the $3.8 million in capital costs, arguing that SFPP followed the ALJ's directions to list only the more important items involved in its 2000 capital program and to aggregate the rest. It further asserts that proposals to include more 2000 data in the 1999 test year would result in confusion and supports its argument to use 2000 year cost information.

53. The Commission concludes that the best way to resolve these disputes is to use a 1999 cost-of-service for all items unless a cost issue is sufficiently discreet that it warrants the use of a different year. Given the limitations and confusion regarding the use of some 2000 year cost figures and the fact that such figures were not fully litigated, less rather than greater clarity will result from the use of those figures. All of the complainant's testimony and analysis were based on the use of a 1999 test year, which was the data that was the most consistently tested at hearing. It simply too late to pursue an alternative course here. For these reasons the Commission reverses the ALJ's decision to use a modified 1999 calendar year cost of service that includes some 2000 costs figures. It is important to use all cost-of-service factors from the same year to assure

[75] *Id.* P 320-22.

[76] *Id.* P 314-16.

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internally consistent results. For example, since volumes determine how the costs are distributed on a unit basis, the test years for costs and volumes should be the same to assure that volume sensitive costs are correctly matched to the volumes of the same year. Thus, if the cost of service utilizes 1999 costs, then 1999 volumes should be used, particularly since the SFPP route guide that allocates volumes among the different lines and delivery points on the system is keyed to 1999 volumes.[77] This is true, even though as here, SFPP's West Line volumes increased by 4 to 6 percent in 2000 over 1999 (depending on the methodology used) and East Line volumes declined somewhat. Similarly, the ALJ's instructions regarding the inclusion of some 2000 year capital costs in the 1999 test year only resulted in further debate about the accuracy of those costs based on Staff's assessment, as well as a protracted debate about whether depreciation, ADIT and ADUC should be carried through the year 2000 in light of the inclusion of certain 2000 calendar year capital costs in the 1999 test year. For these reasons the Commission will use the 1999 test year to develop the cost-of-service for the rates at issue here. Finally, given the ruling here, there is no to need address arguments that the 1999 cost-of-service should include 2000 year cost elements.[78]

2. Rate base and capital structure issues.

54. The rate base issues on exceptions are: (1) the inclusion of additional capital items in the rate base of the 1999 year cost-of-service; (2) the inclusion in SFPP's capital accounts of the purchase price adjustment (PPA) involved in KMEP's acquisition of SFPP in 1998; (3) the amount of debt to be included in the capital structure, (4) whether SFPP's capital structure (rather than KMEP's) should be used to calculate the reparations due (if any) for the years 1998 and 1999, (5) the failure of the ID to expressly enforce the proper amortization period for SFPP's starting rate base write-up, and (6) whether certain capital items should be removed from SFPP's 1999 rate base.

55. The first issue, the inclusion of additional capital expenditures in the rate base was discussed in the context of the test year issues and need not be discussed further here. The second issue, the 1998 PPA, involves KMEP's write-up of the equity component of both KMEP's and SFPP's capital structure to reflect the difference between SFPP's book value at the time of its purchase by KMEP and SFPP's value based on the purchase price

[77] *Cf.* Staff Brief Opposing Exceptions at 48-49, *citing* Ex. S-56 and SFPP Brief on Exceptions at 82. *See* SFPP Cost of Service for 1999, Schedule 14-A for the route directory which separates the volumes by pipeline segment.

[78] For example, Navajo's argument that SFPP's debt levels should be carried forward through 2000 to match the equity adjustment made in the ID.

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of the transaction. The ID concluded that the difference between SFPP's existing net book value (cost minus depreciation) at the time of purchase and its book value after the PPA write-up was some $793 million. The ID concluded that this figure improperly inflated the equity component of SFPP's capital structure because the additional dollar value did not commit any new assets to a public use and did not provide any additional benefits to the ratepayers. As such, the PPA write-up violated Commission policy.[79]

56. In addition, the ALJ held that KMEP had improperly classified some $124.5 million of some $209 million dollars of 1999 debt due in one year as short term debt. He concluded this improperly increased the equity component of KMEP's capital structure and hence the overall cost of equity to be used in designing SFPP's rates. Finally, the ALJ held that SFPP's, not KMEP's, capital structure should be used for determining reparations in 1998 and 1999 because KMEP had not guaranteed SFPP's debt in those years. The ID also required KMEP to remove the PPA included in SFPP's equity in 1988 when the pipeline was converted to a publicly traded limited partnership by the Southern Pacific Transportation Company and to use the resulting capital structure to determine reparations for periods before 1998 and 1999.

57. On exceptions SFPP asserts that the ID's conclusion is inconsistent with the Commission's prior Opinion No. 435 Orders in which the Commission permitted a 1988 PPA to be included in SFPP's equity component.[80] It further argues that the ID applied the wrong test for determining whether the PPA is appropriate, asserting that the Commission's prior orders only preclude using a PPA to increase the rate base and are not applicable to changes in the capital structure. SFPP further asserts that the ID ignored uncontroverted evidence that retention of the 1998 PPA in KMEP's capital structure would not result in a higher weighted average cost of capital. It also argues that the ID fails to explain why removal of the 1998 PPA amount should affect only the equity component of KMEP's capital structure. SFPP further asserts that the Commission has traditionally treated short term debt as equity in determining the equity component of the capital structure. As such, the determination by KMEP's accountants and financial experts that some $124.5 million of SFPP's long term debt should be reclassified as short time debt was appropriate. Given this professional advice, SFPP asserts that KMEP's determination of what its capital structure should be is appropriate and should be affirmed on exceptions.

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[79] ID at P 335-40

[80] *Opinion No. 435-A*, 91 FERC at 61,506-507. There the Commission reversed its earlier conclusion in *Opinion No. 435*, 86 FERC at 61,096-97.

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58. SFPP advances several additional arguments to support the use of KMEP's book capital structure in designing a 1999 cost of service. It asserts that the record strongly controverts the conclusion that SFPP was independently financed as late as 1999. SFPP asserts that KMEP advised all interested financial parties that after 1998 they should look only to KMEP for the ultimate payment of debts and for the management of the pipeline. It argues that KMEP had large lines of credit in place as early as 1999 and was therefore able to fully control SFPP's finances and its capital structure. Since SFPP had no independent financing in 1999, SFPP asserts that its parent company's capital structure should be used to determine SFPP's capital structure. SFPP asserts that KMEP has a long term capital structure goal of 40 percent debt and 60 percent equity, a goal it asserts that is only 2 to 4 percentage points more than the 56 to 58 percent equity ratio of the sample group of products pipelines used to determine cost of capital issues in this proceeding.

59. SFPP further asserts that in any event the financing used to acquire SFPP in 1998 was 35 percent debt and 65 percent equity and that this capital ratio should be honored. It also asserts that, while SFPP accounted for some 70 to 80 percent of its operations in 1998, KMEP has had other transactions involving a PPA. SFPP states it is therefore difficult to trace precisely which portions of the PPA included in KMEP's balance sheet should be attributed to the SFPP acquisition, and what part of that PPA should be attributed to other transactions. SFPP further argues that the Commission held that the inclusion of a PPA in SFPP's equity in 1998 was warranted given the lack of proof by the opponents and the fact that failure to do so would result in negative equity for SFPP. It argues that this precedent should control here and the 1988 PPA should be used to determined reparations before 1998.

60. Staff and Western Refinery support the ID on all points. Western Refinery asserts that the Commission generally requires that the costs of acquired assets be set no higher than their net book value, which is original cost minus accumulated depreciation.[81] It asserts the only exceptions to this rule are situations in which both the assets are put to new public use, and the ratepayers will reap substantial, quantifiable benefits from the sale they would not otherwise enjoy and which would exceed the increased costs they would have to bear if the PPA were recognized for ratemaking purposes.[82] While

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[81] Citing *Northern Border Pipeline Co. v. FERC*, 129 F.3d 1315, 1318 (D.C. Cir. 1987).

[82] *Citing Enbridge Pipelines (KPC)*, 109 FERC ¶ 61,042 (2004); *Rio Grande Pipeline Co.*, 78 FERC ¶ 61,020 at 61,082 (1997), *reh'g denied,* 82 FERC ¶ 61,147 at 61,545-49 (1998), *remanded on other grounds, Rio Grande Pipeline Co. v. FERC*, 178 F.3d 533 (D.C. Cir. 1999).

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acknowledging that the Commission has usually applied this rule to pipelines that attempt to write up their rate base, Western Refinery asserts that the Commission expressly prohibited SFPP from using the PPA to write up its depreciation expense or to thicken the equity component of its capital structure.[83] It asserts that SFPP has failed to explain why these principles should not apply here and has not demonstrated that it has met the standard. The Staff reaches the same conclusion regarding the PPA.

61. Western Refinery further argues that KMEP's desire to have a 40 percent debt and 60 percent equity structure for corporate purposes is irrelevant for rate-making purposes. It asserts that if KMEP wanted SFPP to have a 60 percent equity structure for rate making purposes, it could first remove the PPA from SFPP's equity and then make sufficient equity contributions to the pipeline's capital structure to obtain that result. Western Refinery further asserts that the ID properly required KMEP to remove the PPA entirely from the equity component of its capital structure since this is how the PPA was reflected in the partner's capital accounts. It further asserts that the ID properly required the PPA to be removed entirely from the jurisdictional portion of SFPP's assets since no part of the PPA should be used to increase SFPP jurisdictional rates. Staff's Brief on Exceptions reaches similar conclusions.

62. Western Refinery and Staff also conclude that the ID correctly required the use of SFPP's own capital structure for determining reparations for the years 1998 and 1999. They assert that KMEP did not provide any formal guarantees of SFPP's debt until 2000, and formal, not informal, guarantees control in this regard. The fact that SFPP had no financial employees of its own after 1998 and that KEMP notified various interests that it had taken control at that time are insufficient to support a finding that SFPP's debt was guaranteed by KEMP in 1999. They assert that the record indicates that SFPP was using third-party external financing in 1998 and 1999 and was not relying on the KMEP guarantee in doing so. They support the ID's conclusion that there was virtually no change in SFPP's capital structure from that adopted in the Opinion No. 435 Orders once the PPA was netted out, and it is within the range of proxy companies adopted by SFPP's own witness Williamson.

63. Finally, both Western Refinery and the Staff assert that the ID correctly rejected SFPP's efforts to reclassify certain long term debt as short term debt. They assert that SFPP does not a cite single case to support this proposition, but relies on a case in which the Commission stated it would reclassify short-term debt as long-term debt when short

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[83] Citing *ARCO Products Company v. SFPP, L.P.*, 106 FERC ¶ 61,300 at 62,152 (2004).

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term debt is a permanent part of the company's capital structure.[84] Western Refinery further argues that SFPP does not dispute the KMEP issued more than enough long term debt to replace all of the long-term debt that was maturing in 1999 and 2000. Western Refinery notes that while SFPP asserts that KMEP had a corporate strategy of 40 percent debt and 60 percent equity, the debt reclassification would result in an equity ratio of 64 percent based on an assumption that all the maturing long-term debt could be classified as short term debt. Western Refinery asserts that the 40 percent debt figure would then be reached by issuing or classifying sufficient debt to reach the 40 percent debt component.

a. The PPA

64. The PPA is an accounting adjustment that adjusts the book value of the entity's assets (original cost less accumulated depreciation) to reflect an acquisition price that exceeds that value. This is done by stating the purchase price of the assets as the gross plant as of the time of purchase and reducing prior depreciation to zero. The company then begins a new depreciation or amortization curve based on the restated gross plant as valued by the purchase. Both changes can materially affect the entity's property accounts and its debt and equity ratios.[85] For example, Ultramar's witness O'Loughlin calculates that SFPP's 1999 capital structure would be 53.43 percent debt and 46.57 percent equity without the PPA.[86] Navajo's Witness Horst's initial testimony asserts it would be 59.5 percent debt and 41.5 percent equity,[87] and his reply testimony puts the debt at 51.1 percent and equity at 48.9 percent in 1999.[88] Staff asserts that it should be 59.90 percent debt and 41.10 percent equity.[89] In contrast, with the PPA included in its capital

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[84] *Transok, Inc.*, 70 FERC ¶ 61,177 at 61,555 (1995).

[85] In designing rates the company does include the PPA in its rate base but continues to use the historical rate base as adjusted for historical depreciation and additions and deletions based on the addition of and deletion of assets in the company's rate base. *See* Ex. 105 at 11.

[86] Ex. UIT-1 at 78.

[87] Ex. NAV-1 at 10.

[88] Ex. NAV-10.

[89] Ex. S-64 at 10. The calculation assumes, as discussed below, that the certain long term debt due in one year and characterized by SFPP as short term debt should be considered long term debt.

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structure, SFPP's debt ratio drops to 25 percent and its equity ratio increases to 75 percent.[90] However, even with these different perceptions on the amount of the PPA, without the PPA SFPP's capital structure are well within the norms of the oil and products pipeline industry, and results in more appropriate debt and equity ratios.[91] Thus, while the witnesses disagree on how the PPA should be calculated and the debt and equity percentages that would result, the potential impact on the rate payers of retaining the PAA is clear.[92]

65. As discussed in the June 1 Order, the use of a PPA is consistent with generally accepted accounting principles and is acceptable under Commission accounting practices for booking, but not rate-making, purposes. In fact, it is required for reporting purposes in an oil pipeline's FERC Form No. 6 annual report, but a PPA write-up may not be used for ratemaking purposes.[93] The ALJ, Western Refinery, and Staff therefore have made the correct analysis regarding the PPA and the application of Commission policy. Thus, to prevent an unwarranted increase in the cost-of-service to the ratepayers, the PPA must be removed unless it meets the new service and benefits to ratepayer standards. SFPP has not shown that it provided new service or substantial benefits to its ratepayers that exceeded the additional cost. Given that its operations were unchanged and there would be no material change in its capital structure without the PPA, it could hardly do so.[94]

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[90] *See* NAV-10 for a numerical and graphic depiction of the difference.

[91] It should be noted that if the 1998 PPA is removed from KMEP's capital structure, the results are comparable. *See* Ex. NAV-1 at 17; NAV-10.

[92] In this regard SFPP argues that the ID overlooks uncontroverted evidence that the PPA had no impact of KMEP's equity cost of capital. The argument is irrelevant. The issue with the PPA is the impact of the debt to equity ratio on the total dollars billed the ratepayers because a greater equity component increases the relative weight of the equity component in the cost-of-service. That fact that the PPA may not affect the price that KMEP must pay for every dollar of equity on its balance sheet (*i.e.* whether the cost is 11 percent or 12 percent per dollar) is irrelevant since that price can be constant whether the equity component is 70 percent or 30 percent. The impact on the ratepayers comes from the total dollars in the equity component.

[93] *See* June 1 Order at P 61, 66, and 67. The Commission required SFPP to maintain its records so that alternative costs could be used for ratemaking purposes.

[94] See the discussion *infra* about the stability of SFPP's long term debt.

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b. Capital structure Issues

66. This conclusion regarding the PPA raises the second question: which capital structure should be adjusted since the 1998 PPA is reflected both in KMEP's balance sheet and capital structure and SFPP's. The record here strongly suggests that KMEP's 1999 capital structure cannot be used here. First, to the extent that KMEP's capital structure contained PPAs from other transactions in 1999, the test year adopted here, such PPAs introduce the same type of distortions as discussed in the preceding paragraphs. This is because if other assets owned by KMEP were purchased at a price exceeding their book value, the write-up of the equity component would likely modify the debt to equity ratio in KMEP's capital structure by increasing the equity component. This would also increase the weighted cost-of-capital attributed to SFPP if KMEP's capital structure is imputed to SFPP, and to SFPP's ratepayers. 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 given SFPP's own statement that this was the ratio used to finance its purchase by KMEP.

67. Second, SFPP's assertions that KMEP has access to substantial amounts of equity and credit lines, and that KMEP's capital structure is one that could and should be reached at KMEP's discretion, simply highlight the degree of control that KMEP has over SFPP's finances. This further emphasizes the ability of KMEP has the ability to manipulate SFPP's partnership structure to obtain its corporation goals. In this context, SFPP's argument that the 40 percent debt and 60 percent equity capital structure is close to the average structure of the proxy group (give or take some 2 to 4 points) is both irrelevant and of questionable accuracy, and as such appears contrived. The matter of KMEP's 1999 capital structure is further complicated by the fact that SFPP itself asserts that it is impossible to determine how much of its and KMEP's long term debt due in 1999 was refinanced in 2000 by debt and how much by equity. This statement suggests that it is difficult to determine if KMEP's capital structure has any reasonable correlation to SFPP's jurisdictional operations and finances.

68. Thus there are several reasons that the Commission should use SFPP's capital structure to establish a cost-of-service for the 1999 test year. As the annual FERC Form No. 6 filed by SFPP indicates, SFPP has its own balance sheets, income statements, and capital structure. Since balance sheet changes are mechanical and prescriptive under the Commission's regulations, it is more realistic to use SFPP's financial and capital structure and to utilize SFPP's FERC Form No. 6 for the years 1997 through 2000 to resolve a number of other basic balance sheet and accounting issues that are in dispute. In that regard, the Commission reiterates that it is *not* regulating KMEP; it is regulating SFPP, a jurisdictional entity with a different legal status than KMEP.

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69. The third capital structure issue raised by the parties is the role of long term debt in designing the capital structure. As noted, SFPP asserts that some $124.5 million of long term debt coming due in 2000 should be classified as short term debt on SFPP's (KMEP's) balance sheet. SFPP's Form 6 for the years 1997 through 2001 belie this argument. These reports, as summarized in Table 1, demonstrate that SFPP refinanced all long term debt that came due in each year.[95] SFPP utilized long term debt during the years 1997 through 1999 and utilized so called short term debt in the years 2000 and 2001. However, the sharp increase in the net sums due affiliates from $14,651,890 to $272,980,742 in 2000 establishes that SFPP was borrowing so called short term funds from KMEP but treated those funds like long term debt by continuing to carry them as sums due affiliates for several years on SFPP's balance sheet. In fact, both KMEP and SFPP were treating SFPP's affiliated obligations as long term debt that was being used to finance SFPP's capital plant.[96] Even in 2001 the sums SFPP owed affiliates remained at $258,203,692. Therefore the Commission concludes that SFPP's 1999 debt due in one year was long term debt.

70. The issue then becomes how the various adjustments required here should be accomplished. The ID required a reduction in SFPP's cost of service of some $734.4 million after concluding that the PPA should be reduced by $793 million less the level of depreciation taken by KMEP/ SFPP in 1999, some $55.6 million. This was derived from the numbers contained in Ex. Nav-20, an exhibit that was ultimately relied on by Staff in reaching its final recommendation.[97] However, as was noted, the PPA adjustment recommended by the ID was based on KMEP's financials, which the Commission has concluded should not be relied on here. An alternative source is SFPP's 1998 FERC Form No. 6 report, the year in which the 1998 acquisition PPA became effective. The impact of the PPA is reflected on pages 120 and 121, which contain the sources and uses of funds that cause the modifications to the company's balance sheet in any calendar year. Line 64 on page 121 of SFPP's 1998 FERC Form No. 6 shows an increase in partnership equity of $787,990,983 due to purchase accounting adjustment and contributions by the general partner interests. Line 29 of the same report shows an adjustment to carrier property of $734,052,370, consisting of an increase of $642,740,093

[95] *See* SFPP FERC Form No. 6 for the years 1998 through 2001 at 110-13.

[96] *Cf.* the observation in NAV-1 at 11 and supporting tables, which discusses the substitution of KEMP debt for SFPP long term debt coming due in 2000.

[97] Staff Brief Opposing Exceptions at 15, *referencing* Ex. S-26 at 10-11, Tr. 12410.

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in the purchase accounting price adjustment to reflect the assets and a reduction of $91,312,277 in the accrued depreciation adjustment.

Table 1

Analysis of Long Term Debt Repayments by SFPP 1997 - 2001

Sources of Funds for Payment of Long Term Debt Due

Year	1997	1998	1999	2000	2001
Long Term Debt Due at Year End	$0	$0	$206,470,000	$39,500,000	$42,500,000
Proceeds from Long Term Debt	$28,500,000	$32,500,000	$62,970,000	$0	$0
Net Increase in Short Term Debt	$0	$0	$0	$235,966,000	$39,477,000
Long Term Debt Paid	$28,500,000	$32,500,000	$62,970,000	$235,966,000	$39,477,000
Total External Sources	$28,500,000	$32,500,000	$62,970,000	$235,966,000	$39,477,000
The above shows that long term debt was refinanced but the source was short term external resources in 2000 and 2001.					
Sums Due Affilates	$862,699	$15,601,405	$31,826,668	$360,540,429	$446,879,820
Sums Due from Affiates	$0	$8,889,725	$17,174,778	$87,559,686	$188,676,128
Net sums due Affiliates	$862,699	$6,711,680	$14,651,890	$272,980,743	$258,203,692
The above shows that long term debt was paid from continuing loans from affiliates during the years 2000 and 2001.					
Sources: SFPP FERC Form No. 6, 1999-2001 - Pages 110-113.					

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71. This difference between the adjustment to the partnership equity (the right side of the balance sheet) and the adjustment to the carrier property and depreciation accounts (the left side of the balance sheet) is $53,983,613, a significant difference that does not appear to have been accounted for in the ID's analysis. To the extent those contributions were used for SFPP's jurisdictional activities, they could represent a legitimate increase in the pipeline's assets. Whether this is the case cannot be determined with certainly given the level of detail in the cash flow and balance sheet statements contained in the FERC Form No. 6. Finally, the ID used a 1999 depreciation figure of $55.6 million to adjust the PPA based on KMEP's depreciation for the year 1999, but the depreciation figure reported in SFPP's 1999 FERC Form No. 6 is $28,260,844. This again demonstrates the significant cost and accounting differences that occur at the SFPP and KMEP levels, the differing impact that the two sets of accounting data can have on rate design and the differing perceptions of the most reliable accounting information for ratemaking purposes.[98]

72. Given the decision that SFPP's capital structure and the related internal balance sheet, income, and cash flow accounting records are the most reliable source of financial data in this proceeding, SFPP is directed to develop a second set of books for ratemaking purposes for the years 1998 and 1999. While the Commission may not instruct SFPP to refile its FERC Form No. 6 reports for those years since the reports as filed conform to the reporting requirements, it may direct SFPP to remove the PPA from the Form No. 6 accounts for 1998 and 1999 and reconstitute the relevant balance sheet, income statements, and cash flow statements for rate making purposes.[99] This means removing those portions of the increase in rate base and equity accounts attributable to the PPA and developing year end statements that reflect the carrier accounts and depreciation methodology that was in effect in 1997. SFPP may adjust the balance sheet (including the equity component) and cash flow statements to reflect any cash or other asset contributions to the partnership's balance sheet, and any allocation between jurisdictional and non-jurisdictional uses. SFPP must include an explanation of any resulting changes to the other accounts that appear in the FERC Form No. 6 balance sheet, income, and cash flow statements, including increases or decreases in current and long term liabilities and amounts due to and from affiliates.

73. There are two additional rate base issues that are raised on exceptions. Western Refinery asserts that the ID erred by explicitly requiring SFPP to amortize its starting rate base over 16.8 years. It states that SFPP acknowledges that Opinion No. 435-B required

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[98] The ID does not explain the reason for the discrepancy.

[99] *See* June 1 Order at P 61, 66, and 67, which impose this obligation.

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that the amortization period be 16.8 years but chose to rely on the 20.6 year period contained in Opinion No. 435. The Commission affirms that SFPP must use the 16.8 period to amortize its starting rate base. Second, Staff asserts that some $3.8 million of rate base items should be excluded from SFPP's 1999 rate base. Since this dispute is grounded in the inclusion in the 1999 rate base of certain 2000 capital items, the exception is no longer relevant given the Commission's decision to utilize only a 1999 cost-of-service.

3. Cost of Capital Issues

74. Cost of capital issues the cost of debt, the cost of equity, and the weighted cost of capital based on the two elements. The ID used KMEP's capital structure and therefore used KMEP's cost of debt in 1999, equal to 7.335 percent.[100] Since the Commission has concluded that it cannot use KMEP's capital structure to establish SFPP's rates, it is not possible to utilize this debt cost. However, the ID also determined that SFPP's 1999 capital structure should be used to determine reparation calculations for that year. The ID concluded that SFPP's debt cost for 1999 was 8.54 percent, which the Commission adopts here.[101] The ID also developed a cost-of-equity to be used in designing SFPP's East and West Line rates. In doing so, the ID accepted the use of a proxy group consisting of oil and gas pipeline master limited partnerships, but excluded KMEP for two reasons. First, the ID concluded that it makes no sense to include KMEP because it is the entity whose rates are under review. The second reason was that the KMEP used a short term growth rate of 15 percent that was much higher than that of the other members of the group. After reviewing the information submitted by the differing parties, the ID adopted a 13.69 nominal equity rate based on 2000 calendar year data and concluded that SFPP has less than average risk based on its monopoly transportation position in the southwest and its strong growth prospects. The ID then adjusted this rate by removing an inflation factor based on the average of 1999 and 2001 factors since there was no 2000 year inflation factor in the record.

75. On exceptions SFPP asserts that the ID erred in removing KMEP from the pipeline proxy group sample. It argues that this is inconsistent with the Commission's earlier rulings in the Opinion No. 435 Orders, which included SFPP in the proxy group.[102] It also argues that the Commission has never excluded the parent company

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[100] ID at P 347.

[101] *Id.* P 610.

[102] As previously discussed, SFPP was not owned by KMEP at that time.

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from the proxy group on the grounds of circularity and this could result in the averaging of risks that does not properly reflect the industry group as a whole. SFPP further asserts that in 1999, KMEP had at least five product pipelines and excluding KMEP from the proxy group would deprive the Commission of information regarding the financial market's view of a significant segment of the oil pipeline industry. SFPP also excepted to the ID's conclusion that SFPP has less than average risk and that therefore the nominal rate for equity should be placed at the lower end of the proxy group. It asserts that the Commission has a strong presumption in favor of placing a pipeline in the median of the proxy group range. SFPP then argues that this presumption can only be overcome by highly unusual situations and only through the presentation of detailed evidence regarding (1) the pipeline's risks; (2) the risks of other pipeline companies in the proxy group; (3) the need for a downward adjustment; and (4) the rationale for placing the return at a particular point below the median.[103]

76. SFPP argues that the ID did not even address these standards and that no evidence was presented that would change the Commission's prior conclusions that SFPP faces average risk. To the extent Staff witness Manganello claimed the contrary, SFPP asserts that he was unable to identify any risk not analyzed by the Commission in Opinion No. 435. SFPP further asserts that even companies with a higher equity percentage have been found to have medium risk. It further argues that no evidence exists that KMEP risks are different from those of the proxy companies, and that the stock buy and sell recommendations that Staff relies on are not necessarily evidence of business risk but reflect an opinion of whether the stock will increase in value. SFPP also rejects Staff's argument that adopting KMEP's risks imposes on SFPP's ratepayers the return required for KMEP's aggressive growth strategy. It then cites a May 1999 Standard & Poors report evaluating KMEP's acquisition strategy, which concluded that KMEP warrants an overall credit rating of A- because it has average business risk, a very good track record, stable cash flows, limited commodity price risk, and conservative financial policy. It claims that nothing in the record contravenes this conclusion that KMEP has neither unusually high risk nor unusually low risk.

77. The Commission will revise the ID's determinations of SFPP's cost of equity. First, as in the other portions of this order, the Commission will use calendar year 1999 data, including the 1999 inflation rate of 2.68 percent to develop the real equity cost of capital.[104] Second, the Commission concludes that KMEP should be included in the

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[103] SFPP Brief on Exceptions at 31-32, *citing Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279 at 61,926 (2000) (*Transco).*

[104] The Commission agrees with the ID that in this proceeding there is no practical alternative to treating distributions as the equivalent of dividends and using distributions

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proxy group of master limited partnerships for the reasons asserted by SFPP. While KMEP's short term growth rate may be higher growth rates than other members of the proxy group, this does not preclude its use in a proxy group of master limited partnerships, and no party argues otherwise here. KMEP is one of the major entities involved in that portion of the equity market and its exclusion would distort the average cost of equity for similar firms.

78. The Commission also concludes that the median cost of capital should be used to determine SFPP's cost of capital based on KMEP's average business risk. First, the test for departing from the use of the median cost of capital was explained in *Transco, supra,* and further reiterated in *High Island Offshore System, L.L.C.*[105] The Commission stated that it is skeptical of its ability to make carefully calibrated adjustments within the zone of reasonableness to reflect the generally subtle differences in risk among pipelines. Thus, unless a party makes a very persuasive case in support of the need for an adjustment and the level of the adjustment proposed, the Commission will set the pipeline's return at the median of the range of reasonable returns.[106] Second, SFPP had no publicly traded equity in 1999 and the expectations for equity investors in SFPP in that year are governed by their perceptions of the risk and return from investing in KMEP. The record here does not support a conclusion that SFPP's risks are materially different from those of KMEP or materially different from those discussed in the Opinion No. 435 Orders. As SFPP asserts, its operations, market, and financial position were unchanged since the discussion of these risk factors in the Commission's earlier decisions. For these reasons, there is no persuasive case here that the Commission should change the use of the median that was adopted in the prior proceeding. Moreover, unless there are clear grounds to conclude that SFPP's risk is different than KMEP's,[107] KMEP's cost of equity capital should be used as KMEP is the funding source for SFPP's equity, either through its control of reinvestment decisions of SFPP cash flows or its access to capital markets.

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in the conventional discounted cash flow (DCF) formula. As the ID states, the distributions are what investors use to determine the capitalized value of the publicly traded limited partnership interests. *Cf.* Staff's Brief on Exceptions at 13.

[105] *High Island Offshore System, L.L.C.,* 110 FERC ¶ 61,043 (2005) (*HIOS*).

[106] *Id.* at P 154, *citing Transco* at 61,936.

[107] *Cf. Transco, supra*.

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79. For these reasons the Commission will adopt the average of the equity cost of capital for 1999 suggested by Staff and Ultramar-Tosco. The former used a range with a low of a 13.27 percent return to a high of an 18.86 percent return and a median of a 15.27 percent return. The latter used a range from a 13.31 percent to an 18.46 percent return with a median of 15.42 percent.[108] Averaging the two results in a 15.36 percent nominal return, which results in a 13.68 percent real return after the inflation component is removed. The Commission notes that the ID relied on 2000 estimates and some parties included 2001 estimates, both of which resulted in lower equity returns, notably so in the case of 2001. However 2001 numbers are far outside the test period and the Commission will not adopt them. The calculation of the weighted cost of capital to be included in SFPP's cost-of-service for the East and West Line rates to be developed in Docket No. OR96-2-000, *et al.* must be based on the capital structure required by this order.

4. Allocation of Overhead Costs

80. During the test period (calendar year 1999), SFPP maintained operating personnel, but no administrative, financial, or legal employees of its own. All of these overhead functions were provided by, and consolidated with, KMEP, which performs such functions for all of its operating subsidiaries. The Commission's standard ratemaking practice requires an allocation of these costs among the affiliates controlled by the parent, KMEP, and within each affiliate, among their different operations. The Massachusetts and KN Formulas are respectively used for these purposes. For the reasons discussed below, the Commission affirms the ALJ with respect to adopting Staff's KN formula to functionalize indirect overhead costs from KMEP to SFPP, but reverses the ALJ's ruling that denies SFPP's inclusion of overhead expenses in its rates.[109]

a. The Massachusetts Formula

81. The Massachusetts formula allocates indirect or residual overhead costs from a parent company to a subsidiary or an affiliate. The ALJ found that the general partner, Kinder Morgan Inc. failed to provide its total overhead costs for its organization, or how any of its subsidiaries or divisions determined the amount of that overhead for assignment to KMEP. The ALJ cited to SFPP's subsequent admission to its failure to provide the requisite data. Further, the ALJ notes SFPP's non-compliance with an element of the Commission's ratemaking policy through the use of 13-month averages

[108] ID at P 352-53.

[109] ID at P 322-24.

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for gross plant and labor expenses, rather than using end-of-period data.[110] Consequently, the ALJ concluded that SFPP presented no credible evidence supporting its proposed allocation of overhead costs from KMEP and concluded that no overhead costs should be included in SFPP's rates due to this failure of proof.[111]

82. On exceptions, SFPP argues that the ALJ ignored all record evidence and Commission precedent in eliminating all overhead costs and that it properly applied the Massachusetts Formula. SFPP asserts that: (1) it properly used its gross revenue figures to allocate costs rather than volumes; (2) the ALJ erred by requiring the removal of the PAA attributable to SFPP and included in KMEP's capital structure for the purpose of determining gross plant; and (3) it properly applied the labor allocation required by the formula. SFPP further asserts that the ALJ improperly excluded SFPP's proposed 13-month average for gross plant because the 13-month average provides a more accurate result.

83. In its opposing exceptions, Staff took no position on whether SFPP should have overhead costs included in its rates or in the gross revenue component of the Massachusetts factor. However, Staff generally supports the ALJ's conclusions that no PAAs should be included in the gross plant allocation factor within the Massachusetts formula, that the payroll figures used to calculate the labor factor were unreliable, and that the use of a 13-month average to calculate gross plant is inconsistent with Commission practice. Staff concludes that its allocation of the overhead accounts was correct and the ID should be upheld. Western Refining supports the Staff position regarding the role of the PAAs in determining the allocation of overhead costs.

84. Based on a review of Commission policy and the record on this issue, the Commission will allow SFPP to include a portion of KMEP's overhead costs in its rates if SFPP recalculates its overhead expenses based on the following. First, while SFPP revised its initial data and allocation procedures in response to Staff testimony and corrected many of the mathematical errors contained in Staff's testimony,[112] SFPP's revised use of the Massachusetts formula remains flawed. In general, the formula uses three components to calculate allocation factors: (1) gross revenues, (2) gross property

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[110] *See Midwestern Gas Transmission Co.*, *Opinion No. 444*, 32 FPC 993 (1964), as reaffirmed in *Tennessee Gas Pipeline Co.*, *Opinion No. 240*, 32 FERC ¶ 61,086 (1985).

[111] ID at 322.

[112] S-18, p. 12-17.

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plant and equipment costs, and (3) direct labor costs. For each factor, ratios are calculated based on the subsidiary's costs to the parent's costs. The three ratios are averaged and the resulting allocation factor is applied to the indirect costs assigned by the parent to the subsidiary. A variation of the Massachusetts formula uses a net revenue factor (gross revenues less cost of goods sold, or in this case, transportation revenues).[113]

85. With respect to SFPP's reported level of gross revenues, the Commission denies the Opposing Parties' assertions that the revenues are overstated because they are based on rates subject to pending litigation that may not just and reasonable. The Commission finds that SFPP appropriately calculates the gross revenues using its currently effective tariff rates because a different level of revenues cannot be established until the overhead allocations are determined on the basis of historical information available to the Commission. However, for gross plant, SFPP fails to include all of KMEP's subsidiaries (e.g., Red Lightning, Plantation Pipeline Co., Kinder Morgan Interstate Gas Transmission, and Trailblazer Pipeline Co.) and includes the PAAs for other KMEP subsidiaries, including SFPP. Gross plant is the net book value of plant – the original plant cost less accumulated depreciation of the facilities. SFPP's use of the purchase premiums in its calculations of gross plant for KMEP and itself results in an inflated ratio of overhead costs.[114]

86. Accordingly, the Commission requires SFPP to recalculate its Massachusetts Formula allocation factors based on Staff's calculation of gross plant. This adds the costs attributable to the additional KMEP subsidiaries acquired during the test period (calendar year 1999), and removes the PAAs from KMEP's subsidiary plant costs. The Commission will allow SFPP to use its stated gross revenues and direct labor costs to determine its allocation factors for each component.

b. The KN Formula

87. The KN formula allocates administrative and general (A&G) overhead costs (or jointly used assets) between the subsidiary's jurisdictional and non-jurisdictional activities (or geographically separate jurisdictional activities) within the company. In this case, SFPP allocates costs between its carrier and non-carrier functions. The ALJ found

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[113] *See* Opinion No. 240, *Tennessee Gas Pipeline Co*., 32 FERC ¶ 61,086 (1985) at 61,232.

[114] *See Williams Pipe Line Co*., 21 FERC ¶ 61,260 at 61,636 (1982) (the Commission found that the purchase price of a facility is not entitled to any recognition for ratemaking purposes).

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that SFPP combined the gross plant and labor costs contrary to Commission policy, which requires that the KN formula take into account the nature (character) of the costs whether plant or labor. Consequently, the ALJ adopted Staff's KN-allocation formula which correctly applies the allocation factors derived from the subsidiary's direct costs to properly allocate such costs to its carrier and non-carrier operations.

88. On exceptions, SFPP argues that it properly applied the KN allocation procedures consistent with Commission practice. SFPP claims that the ALJ improperly rejected its inclusion of the PAA in SFPP's gross property balance for purposes of allocating costs between SFPP's carrier and non-carrier functions. In its opposing exceptions, Staff objects to SFPP's KN allocation factors in two respects: (1) SFPP uses the property balances that include the PAAs, similar to its gross plant allocations under the Massachusetts formula; and (2) SFPP uses a combined labor and plant ratio for all A&G costs without considering the nature of those costs. Refinery Holding and Navajo support the ALJ and Staff.

89. The Commission concurs with the ALJ's finding that SFPP's inclusion of the PAA in SFPP's property balances and its use of a combined labor and plant ratio to allocate A&G costs between its carrier/non-carrier functions was not appropriate for the reasons discussed earlier in this order. Given that conclusion, in this case proper application of the KN method requires the calculation of the carrier and non-carrier allocation percentages by reducing the gross property balances by the PAAs, and using the direct plant costs and labor costs reported by SFPP in its cost of service data. Accordingly, the Commission directs SFPP to recalculate its KN allocation formula consistent with Staff's allocation procedures based on SFPP cost-of-service data (as corrected for Staff's mathematical errors)[115] to: (1) eliminate the PAA from its gross property balance; and (2) use direct labor costs to allocate the appropriate A&G costs to its carrier and non-carrier operations. The compliance filing must document how SFPP had complied with the Commission's ruling on the allocation of overhead costs.

5. Recovery of Regulatory Litigation Costs.

90. SFPP has been in rate litigation with its shippers since November 1992 when the first complaints were filed against the East and West Lines rates. The Opinion No. 435 Orders established new just and reasonable rates only for the East Line and therefore addressed cost-of-service issues only for that Line. As discussed in greater detail in those Orders, the Commission permitted SFPP to recover its Commission regulatory costs

[115] *See* Ex. SFPP-106.

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attributable to the East Line litigation through 1998.[116] The Commission required SFPP to first estimate the reparations that would be due all East Line shippers for the period through August 1, 2000, whether or not they had filed complaints, *i.e.,* the gross reparations. After subtracting the reparations due the East Line shippers that had filed complaints for the years prior to August 1, 1995, the Commission required SFPP to apply the difference (the net gross reparations) to Commission East Line regulatory costs for the period between the first East Line complaint in 1992 and the end of 1998. If any Commission regulatory costs remained, SFPP was authorized to recover those costs through a surcharge amortized over 5 years. The Commission did not authorize SFPP to embed any Commission regulatory expenses in the East Line rates that become effective on August 1, 2000.[117] This approach, the net gross reparations methodology, was affirmed on appeal subject to any adjustments that might be required on remand.[118]

91. The prior determinations must be modified as a result of the Remand Opinion. First, as has been discussed, the regulatory costs attributed to the East Line rates through 1998 have been revised in light of the remand. Second, litigation has proceeded on the East, West, North, Oregon, Watson Station and Sepulveda Line rates since 1999, the cost of service year used here, and some of the complaints at issue in Docket No. OR98-2-000, *et al.* antedate that year. In the instant case the ID combined and averaged the regulatory costs incurred in these proceedings for the years 1999 and 2000, allocated those costs among the various lines, and permitted them to be amortized over five years. The ID did not permit any regulatory cost to be embedded in the rates at issue and recommended that SFPP not be allowed to recover any regulatory costs in these or other proceedings after 2003.

92. SFPP objects to these rulings, arguing that they do not recognize its ongoing costs in other proceedings and argues that those proceedings have continued well beyond any 1999-2000 test year. It asserts that the failure to embed at least some of these costs in its base rates precludes it from recovering those costs, as would the attempt at normalization by other parties based on the year 1999 and various years preceding it. Western Refinery supports the ID's conclusions regarding the years 1999 and 2000 and that SFPP must

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[116] As discussed earlier in the order, this required SFPP to allocate a certain proportion of the regulatory costs incurred in the Docket No. OR92-8-000, *et al.* to the East Line rates. The other regulatory costs incurred in that proceeding through 1998 were effectively allocated to rates that were not under review by the Commission.

[117] *Opinion Nos. 435*, 86 FERC at 61,105-06, and *435-A*, 91 FERC at 61,512-13.

[118] Remand Opinion at 1293-94.

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institute a new proceeding to recover its legal costs in subsequent years. Staff did not take a position on this issue.

93. Given the multi-faceted nature of this ongoing rate litigation, it is impossible to develop a normalized cost to be included in the 1999 cost-of-service. In fact, overall litigation costs were lower in 1999 than in 2000 and the costs attributed to the three major proceedings varied in their relative weight in those years. For example, with regard to the three major regulatory proceedings underway in 1999, the costs attributed to Docket No. OR92-8-000, *et al.* were $464,036 in 1999 and $189,315 in 2000, a total of $653,351. The costs attributed to Docket No. OR96-2-000, *et al.* in 1999 were $157,064 and $2,171,916 in 2000, a total of $2,328,980. The costs attributed to Docket No. OR98-11-000 (the Sepulveda case) were $1,627,531 in 1999 and $836,202 in 2000. The total costs for the two years were $2,248,631 in 1999 and $3,197,433 in 2000.[119] This demonstrates the volatility of SFPP's regulatory costs and the difficulty in finding a representative number. For this reason the Commission will follow the approach used in the Opinion No. 435 Orders for the period 1999 through May 30, 2005, with one modification. In addition to costs allocated to the three major dockets just discussed, SFPP's 1999 test year included $153,857 for regulatory cost items other than the those three enumerated proceedings, a sum that is based on a five year average through 1999.[120] SFPP may include the $153,857 for regulatory costs other than the three large enumerated proceedings in the new East and West Line rates in proportion to its 1999 East, West, North, and Oregon Line volumes.[121]

94. As has been discussed, the revised East Line rates established in Docket No. OR92-8-000, *et al.* were made effective on August 1, 2000. Thus, after that date all East Line shippers paid the same rate on a prospective basis and there were no reparations required in that docket for the period thereafter. While SFPP's regulatory costs, as allocated to the East Line shippers, continued in 1999 and 2000, the Commission did not apply its gross reparations offset methodology to those years in the Opinion No. 435 Orders. At this point, since the actual regulatory expenses for those years are available, it

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[119] *See* Ex. SFPP-111 at 13.

[120] *See* Ex.SFPP-111 at 4, Line 31. The number is conservative considering that the same category of Commission regulatory costs increased to $296,211 in 2000.

[121] The sum allowed here will provide some funds to cover SFPP's more routine tariff filings and matters such as Docket No. PL05-5-000, all of which have been contested and are outside the scope and regulatory costs of the three major regulatory proceedings analyzed at Ex. SFPP-111, page 13.

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will do so through the end of the reparations period in Docket No. OR92-8-000, *et al,* which ends July 31, 2000. Thus, to recover regulatory costs incurred in that docket through that date, SFPP may offset the East Line's share of its regulatory costs against any East Line reparations paid up to August 1, 2000, based on the 1994 cost-of-service. Thereafter, the East Line proportion of any regulatory costs incurred in Docket No. OR92-8-000, *et al.* may be recovered through a five year surcharge added to the new East Line rates beginning March 1, 2006, the projected effective date of any new rates established under this order. Finally, for the period beginning August 1, 2000, the Commission will allocate regulatory costs in that docket between the East and West Lines based on their relative volumes in 1999, as established here. Given a situation where a surcharge is being allocated on a going forward basis it is more equitable to allocate costs among all of SFPP shippers on the basis of the more recent volumes so that all West and East Line shippers will benefit from the rater reductions required here.

95. In Docket No. OR96-2-000, *et al.* the Commission will allocate the regulatory costs based on the relative volumes of four lines, the East, West, North and Oregon lines rather than on the percentages adopted by the ID, which are based primarily on the ALJ's perceptions of relative effort.[122] Recovery of regulatory costs attributable to the West Lines will utilize the methodology contained in the Commission's Opinion No. 435 Orders. In the instant case any revised West Line rates will be based on the rate established from the 1999 cost-of-service established by this order. Those rates will be indexed back to the date of the relevant complaints and forward to the proposed March 1, 2006 effective date. Reparations will be due accordingly and SFPP will calculate the gross reparations that would have been due if all West Line shippers had filed

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[122] Because the interstate portion of Watson Station volumes flow over the West and North Lines, regulatory costs involving the Watson Station facilities should be allocated proportionately to the rates for those Lines in the absence of a discrete proceeding such as that established in Docket No. OR92-8-025 for the Watson Station charges. This will avoid overstating the importance of the volumes of this subsidiary asset in allocating costs. The ID recognized that an allocation of regulatory costs based on relative volumes of the East Lines, West Line, and Watson Station facilities would distort the allocations and therefore attributed only .5 percent to the Watson Station facilities. Contrary to the statement in its text, the ID did not establish charges for the Watson Station facilities in Phase II. It only found that certain costs had been fully recovered and that the existing charges were unjust and unreasonable. *See* ID at P 571-73, 586-88. The conclusion here about the allocation of certain overhead costs does not change the fact that historically the Watson Station facilities have been a separate cost center on the SFPP system and as such has had its own rate structure.

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complaints. The difference between that gross figure and the refunds due shippers that actually filed complaints will be offset against West Line regulatory costs for the date of the complaints through May 31, 2005. Any remaining costs will be amortized over 5 years through a surcharge effective May 1, 2006.[123]

96. The situation for the regulatory costs involved in two other assets, the Sepulveda Line and Watson Station facilities, is relatively simple. SFPP has been in litigation over the Sepulveda Line rates since early 1995. That proceeding is separate and unique and any regulatory costs incurred in that proceeding should be allocated to it alone. Similarly, for the period June 1, 2005 forward, all litigation concerning the Watson Station charges has been consolidated in a single proceeding and all costs related to that proceeding should be separated. The means for recovering SFPP's prudent regulatory costs in the Sepulveda Line and Watson Station proceedings will be addressed in the respective orders on the merits of those proceedings.

6. Arizona Real Estate Tax Issues.

97. The ID addressed the level of the Arizona real estate taxes SFPP pays on its right-of-way in that state, how those taxes should be allocated between carrier and non-carrier property, and technical accounting issues related to tax refunds received during 1999. The ID held that SFPP should not be permitted to recover increased real estate taxes paid in 1999 since that increase stemmed from the inclusion of the 1998 PPA in SFPP's rate base. In doing so, the ID suggested that the Commission should pre-empt the level of taxes involved because the increase in those taxes was based on a cost-of-service element that the Commission should reject, namely the PPA. The ID also held that SFPP incorrectly used the so-called central versus local method for allocating real estate taxes between jurisdictional and non-jurisdictional elements. Finally, the ID held that certain refunds received in 1999 for the tax years 1995-98 should be included in SFPP's cost of service. SFPP excepts to all three conclusions for the reasons discussed below. The Commission staff asserted that if the Commission retains its existing policy of accepting state taxes, the Commission should require SFPP to establish that the assessment increase has not been offset by increased depreciation. Refinery Holding asserts that SFPP should

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[123] SFPP did not except to the ID's conclusion that it could not recover as regulatory or litigation costs sums paid certain shippers to settle some of the complaints filed against its East Line rates. The Commission notes that the ID's ruling is consistent with the holding in Opinion No. 435 that settlement costs are non-recurring costs. In any event, such costs are similar to refunds or reparations which a pipeline cannot recover from the shippers who paid an unjust or unreasonable rate.

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not recover the higher taxes since they resulted from the inclusion of the 1998 PPA in SFPP's property accounts.

98. The difficult issue here is the level of the assessment, which increased by some $4 million due to the increase in the book value of SFPP's assets in Arizona when SFPP included the 1998 PPA in its accounts. While state and local governments use many factors in determining the assessed value of real estate, there are no grounds here for disputing the connection between the increased assessment and the inclusion of the 1998 PPA in SFPP's property accounts. This fact pattern places two Commission policies in potential conflict. One is the Commission tradition that it will not review or contradict decisions regarding the level of state and local taxes, which are simply accepted as one of the pipeline's cost-of-service elements. The other is that a purchase price that involves a premium over book value should not result in an increase in costs to the rate-payers except under well defined, limited circumstances. The ID suggests that the Commission abandon its current policy of deferring to state and local government assessment decisions and preempt the state assessment decision. SFPP argues that none of this theory applies here.

99. The issue here is not the assessment, or challenging the State of Arizona's standards or conclusions in making the assessment, but whether the extra $4 million should be included in SFPP's cost-of-service in light of the Commission's prior conclusion that the 1998 PPA should not be used in designing the pipeline's rates. In this case the Commission will permit SFPP to include the additional $4 million in additional real estate taxes in its cost-of-service because it is an out-of-pocket cash expenditure with one condition. The condition is that if SFPP prevails in its appeal of the assessment in the state proceedings, the $4 million must be removed from its cost of service (or adjusted to such lower amount as might result), and any tax refund distributed to its shippers.

100. On the two secondary tax points, the Commission agrees that SFPP did not err in using the traditional allocation method under Arizona state law for allocating real estate taxes between jurisdictional and non-jurisdictional facilities. It is also clear the Arizona state real estate tax refund received in 1999 was a non-recurring event related to the prior four calendar years. As such, SFPP is not required to include in its 1999 cost-of-service a sum that is not related to that year.

7. Modification of SFPP's Depreciation Methodology

101. At hearing Staff testified that SFPP's depreciation rates needed to be modified to reflect the different composite depreciation rates for SFPP's East, West, North, and Oregon Lines. Staff concluded that because investment in certain of those lines had grown more rapidly than in others, their depreciation rates should be adjusted. The ID

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stated that SFPP did not object to the establishment of new depreciation rates as long as they went into effect on a prospective basis and recognized the merit of adjusting depreciation rates to reflect the expansions that have occurred on each line. However, the ID concluded that Staff's proposed depreciation methodology was defective in two ways. First, Staff failed to explain how its concern with use of a system-wide depreciation rate squared with the fact that the method had been in effect since 1991, especially since there have been a number of plant expansions on SFPP's various lines both before and after 1991. Second, the ID held that Staff had relied on system-wide data, rather than line-by-line data, for two elements of its recent depreciation study – survivor curves and net salvage- Staff excepts to the ID's conclusions and reiterates its position that line-by-line depreciation rates for most elements will result in rates that are just and reasonable by more accurately assigning costs. It asserts that system-wide survivor and salvage curves are reliable because the data on individual lines would result in small samples and could yield inconclusive curves. SFPP supports the ID's conclusion that consistency is required. It asserts that the Commission's general instructions regarding depreciation rates provide that depreciation shall be described by account, and not individual system components, absent a specific request of the carrier.[124] It states that SFPP did not request component rates and in fact opposes them, preferring to retain its current composite rates. SFPP further asserts that while the Commission has approved component depreciation rates for gathering and other facilities that have shorter economic lives than the remainder of a pipeline system, it has not approved component rates for segments of a system when each segment has the same supply and the same projected rates. SFPP asserts that Staff's 1991 depreciation study underlying SFPP's current depreciation rates recommended use of account-by-account rates even though expansion occurred on only some of SFPP's lines.

102. The Commission will affirm the continued use of system-wide depreciation accounts for SFPP. As regards SFPP's argument that component costs should not control, the Commission has concluded that SFPP's East, West, North, and Oregon Lines should be treated as separate assets for rate purposes. As such, it is by no means clear that treating them as separate components for depreciation purposes would be improper. Moreover, as Staff points out, a specific type of asset within an account may age at the same rate regardless of the location of the asset on the system, but the distribution of that aging (and therefore the composite rate) may vary depending on when the investments were made and the total amount. However, in the instant proceeding the Commission is examining under its rate jurisdiction only the rates for the East and West Lines, and is taking no action on the costs or rates for the North and Oregon Lines. Thus, reallocating

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[124] *Citing* 18 C.F.R. Pt. 32, General Instruction 1-8(b).

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the depreciation costs for the entire system in this proceeding would require the Commission to address assets and costs that are not before the Commission in this proceeding.

8. Other Cost-of-Service Issues.

103. On exceptions SFPP opposes six other rulings on cost-of-service issues. The first involves the write-off in test year 1999 of the central control software program that SFPP was developing before its acquisition by KMEP. The ID held that the rate-payers received no benefit from past costs incurred prior to the write-off and denied the costs. SFPP asserts that this ruling is incorrect because it is not supported by evidence that the undertaking was imprudent and the ruling would discourage innovation. It concludes it should be permitted to amortize the write-off over 5 years. Staff and Western Refinery support the ID. Since the record does not support a conclusion that SFPP's efforts to adopt a more efficient way of dispatching its system were imprudent, the Commission will permit SFPP to write of 50 percent of the development costs over a five-year write off beginning in 1999. This is consistent with a long standing policy in Commission electric regulation that permits 50 percent of the prudent costs of cancelled investment to be recovered by the regulated entity.[125] This policy creates incentives for prudence and efficiency in pursuing investment in plant, equipment, and software without placing all risk of failure on the regulated entity. The Commission further notes that since the write-off will be completed in the locked-in period and the cost will not be included in SFPP's prospective rates beginning May 1, 2006.

104. The ID rejected SFPP's proposed adjustment to its 1999 cost-of-service by excluding the reversal of a $1.5 million maintenance cost accrued in 1998. As SFPP explains it, it accrued $1.5 million in 1998 for expenses that it had not yet incurred, and excluded the same sum in 1999 because the related work was not needed and would not be performed. In other words, SFPP concludes that because it did not actually need to make the accrual in the first instance in 1998, elimination of the expense in both years leaves the actual cost-of-service in the same position as if the accrual had not been made. Staff and Western Refinery support the ALJ. The Commission accepts SFPP's reasoning on this point because the elimination of the costs in both years is offsetting.

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[125] *Public Service Company of New Mexico*, 75 FERC ¶ 61,266 at 61,859 (1996), *but see Southern California Edison Co.*, 112 FERC ¶ 61,014 at P 58-61, *reh'g denied*, 113 FERC ¶ 61,143 at 9-15 (2005), where 100 percent recovery was permitted when the regulated entity had no control over the decision make the investment and the company's shareholders would not share in the benefit.

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105. The ID rejected SFPP's efforts to include a 3 percent salary increase in its cost of service that resulted from its calendar year 2000 merit increase program. Because the Commission is relying only on a 1999 calendar test year, this point is moot. The ALJ also rejected SFPP's proposal to average its 1999 and 2000 oil losses and shortages. SFPP asserts that the 1999 figures are not representative, a position Staff and Western Refinery say is not supported by SFPP's actual experience. Given the Commission's use of the 1999 cost-of-service year, the ID is affirmed. The ID also rejected SFPP's proposed adjustment to reflect increased power costs that became effective on January 4, 2001 as a result of increased electric rates in California. SFPP presents four pages of argument why this adjustment was appropriate and is long term in nature. As Staff replied, the short answer is that this increase is far outside the test period and is the type of operating cost that would be subsumed within the Commission's annual indexing methodology. The indexing procedure provides a simplified method of recovering the net increases based on changes to the PPI.[126] As was discussed in the June 1 Order, the Commission's regulatory structure requires the carrier to demonstrate that there was a substantial divergence between the cost increases that it actually incurred and the relief provided by the index. The increase in power costs is a classic example of the type of cost that is governed by the indexing procedure and the rationale contained in the June 1 Order controls here. The ID is affirmed on this point.

D. The West Line Turbine Fuel Rates

106. The Remand Opinion held that the Commission erred in Docket No. OR92-8-000, *et al.* when it declined to determine whether SFPP's West Line turbine fuel rates were just and reasonable. Therefore, on remand the Commission must address the complaints filed against those rates on the merits and determine a just and reasonable rate for the transportation of turbine fuel. The technical difficulty presented on remand is that only the turbine fuel component of SFPP's West Line rates is before the Commission in Docket No. OR92-8-000, *et al.* The projected volumes for that service were 365,000 barrels per year in comparison to total 1993 volumes on the West Line of 32,850,000, or approximately 1 percent. The challenge here is to determine a just and reasonable rate for this relatively small portion of West Line volumes without undue administrative

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[126] Compare the costs for the years 2000 and 2001 as reflected on Page 700 of SFPP's 2001 FERC Form No. 6 Report. The total cost of service for 1999 was $88,870,968 and for 2001 was $89,487,649, a difference of .7 percent (0.007). The percentage increase permitted by the indexing methodology in 1991 was .9565 percent (0.009565). *See Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, 99 FERC ¶ 61,219 (2002).

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expenses, including the additional regulatory costs that will apply to the service if litigation proceeds beyond the compliance phase.

107. The Commission's June 1 Order deferred action on the turbine fuel rates until the Commission had an opportunity to review litigated West Line rate issues to determine if there are any issues unique to those rates that might materially influence the calculation of the turbine fuel rate. Based on the analysis in the preceeding cost-of-service section of this order, and a review of the Opinion No. 435 Orders, the Commission concludes that it is not necessary to send this matter to hearing and the matter should be resolved on the instant record. The Opinion No. 435 Orders made formal rulings on all issues that affect the cost of service for both the West and East Line rates and established standards for allocating the costs between them. One highly technical issue, the separation of volumes and costs between jurisdictional and non-jurisdictional services for the West Line rates, was not ruled on in Docket No. OR92-8-000, *et al.*, but neither was it contested.

108. Therefore, SFPP should make a compliance filing using the 1994 cost-of-service included in its last compliance filing in Docket No. OR92-8-000, *et al.* and use the allocations between the East and West Lines contained therein to complete a West Line cost-of-service, including the application of the income tax allowance methodology adopted here. Once the West Line costs are derived from the system-wide 1994 test year, these would then be allocated proportionately by volume to the actual turbine fuel volumes transported in 1994. SFPP must then prepare a related rate filing that establishes an interim just and reasonable rate as of January 1, 1994 and then index this interim West Line turbine fuel rate forward to December 31, 1998. Thereafter, if a lower rate results from the use of the 1999 cost of service, the West Line rate after January 1, 1999 will be based on that cost-of-service. Otherwise the existing 1994 rate will be indexed forward to March 1, 2006.

E. <u>Reparations Issues</u>

109. The ID's discussion of reparation addresses three main issues. After summarizing the filings SFFP made to comply with the Commission's Opinion No. 435 Orders, the ID first stated that none of the East Line rates under review here were grandfathered. The ID then proceeded to analyze *Arizona Grocery Co. v. Atchison, T. and S. F. Ry.* Based on that analysis, the ID concluded that reparations would be available for two years before the East Line complaints at issue in this proceeding. The ID also concluded that *Arizona Grocery* does not preclude awarding reparations for two years before the filing of the complaints against the West Line rates at issue here.

110. On exceptions, SFPP asserts that the ID misapplied *Arizona Grocery,* arguing that the Commission established final East Line rates based on the 1994 cost-of-service developed in Docket No. OR92-8-000, *et al.* and then indexed those rates forward to

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August 1, 2000. It argues that this precludes setting an East Line rate that is lower than the indexed rate for the period between 1994 and August 1, 2000, and that the East Line rates may be modified only prospectively. SFPP also asserts that awarding reparations for the East Line rates would be inconsistent with the standards established by the Commission's indexing procedures. SFPP further argues that the Energy Policy Act of 1992 (EP Act) bars pre-complaint relief of any complaints that were filed against the grandfathered West Line rates. Moreover, on exceptions Chevron argues that it is the successor-in-interest to TRMI [127] and should be able to obtain reparations from the date of the TRMI's complaint. Ultramar asserts that the ID could lead to an erroneous reading of the ICA that would restrict pre-complaint relief. Western Refinery asserts that SFPP's reading of *Arizona Grocery* would eviscerate the two year pre-compliant relief available under the ICA and would be inconsistent with the statements in the Opinion No. 435 Orders that the rulings in those orders would not preclude reparations here. On reply, SFPP argues that the Commission has stated numerous times that Chevron is not entitled to substitute itself for TRMI and thereby obtain complainant and reparations status.

111. The first step is to summarize what *Arizona Grocery* holds and how it has been applied to date in the various dockets at issue here. Simply put, *Arizona Grocery* holds that once the Commission establishes a prescriptive, final rate, that rate may only be changed prospectively. On appeal of the Opinion No. 435 Orders, the issue before the court was whether the Commission had established such a rate. The court upheld the Commission's position that it had established only interim rates as of August 1, 2000, and that therefore those rates could be modified by subsequent Commission orders and the related compliance filings. Thus, the rates established on an interim basis as of August 1, 2000, became final only after the Commission accepted SFPP's last compliance filing to Opinion No. 435 Orders and ruled on related rehearing requests on September 26, 2002.[128] The Remand Opinion also held that a shipper party must actually file a complaint to be eligible for reparations and intervention alone was inadequate to establish standing for reparations.[129] Thus, the Remand Opinion established the time frames to which *Arizona Grocery* applies and the threshold requirement for reparations.

112. What the Commission did in the Opinion No. 435 Orders was to establish SFPP's East Line rates as of January 1, 1994, the beginning of the relevant test year, and

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[127] Texaco Refinery and Marketing, Inc.

[128] Remand Opinion at 1305, *citing SFPP, L.P.*, 98 FERC ¶ 61,177 at 61,657 (2002) (September 26 Order).

[129] *Id.* 1310.

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then index the rates forward to an effective date of August 1, 2000, subject to suspension and refund. At that point the rate applied to all East Line shippers regardless of whether they were complainants in Docket No. OR92-8-000, *et al.* and these shippers could get refunds if the East Line rates were lowered for the period after August 1, 2000. Since the East Line rates were not grandfathered, reparations were due eligible shippers (those filing complaints before August 7, 1995) with certain narrow exceptions that were limited by statute.[130] After several adjustments those rates became final rates for purposes of *Arizona Grocery* when the Commission issued its September 26, 2000 order and there were no further administrative actions by the Commission. Thereafter those East Line rates were remanded on July 24, 2004, and as such are now before the Commission for revision. This has the effect of reopening those East Line rates and requires the Commission to establish new East Line rates based on a revised 1994 cost-of-service. Once the Commission accepts the revised East Line cost-of-service, a new set of East Line rates must be designed based on that cost-of-service and indexed forward to August 1, 2000.

113. Under the Commission's indexing procedures, those revised East Line rates would be further indexed to establish their current level as of December 31, 2005. Thus, if the complaints filed in the consolidated dockets in OR96-2-000, *et al*. result in lower rates for the East Line than those in effect on January 1, 1999, as indexed forward from January 1, 1994, any further reduction could be prospective only from the date established by this order. By way of example only, assume that the new East Line rate established by this order would be $1.00 on January 1, 1994, and the indexed rate would be $1.10 on August 1, 2000 and $1.20 on May 1, 2006 (the target date of new interim rates in this proceeding). These levels ultimately become the January 1, 1994 indexed final rates adopted by the Commission in this decision for Docket No. OR92-8-000, *et al.* The projected final rate developed from the 1999 cost-of-service in Docket No. OR96-2-000, *et al.* are $1.05 as of August 1, 2000 and $1.15 as of May 1, 2006. This latter and lower rate of $1.15 would be effective prospectively on May 1, 2006 because the East Line rates previously established in Docket No. OR92-8-000, *et al.* are subject to the *Arizona Grocery* doctrine.

114. Under these circumstances no reparations are due for most East Line shippers because any new East Line rate based on the 1999 cost-of-service may be prospective only as of May 2006 at the $1.15 level.[131] However, there is one situation where an East

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[130] The Commission's determinations in this regard were also upheld. *Id.*

[131] Conversely, if any newly designed rate based on the 1999 cost-of-service is higher than the East Line rate in effect on August 1, 2000, the issue is moot.

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Line shipper may be eligible for reparations for complaints filed against the East Line rates between August 8, 1995 and August 1, 2000. If such a shipper had not filed a valid complaint against the East Line rates before August 7, 1995, it would not have heretofore received reparations for East Line movements occurring before August 1, 2000.[132] Under such circumstances the complaining East Line shipper may receive reparations for a period two years before its complaint, and forward to August 1, 2000, the date the new East Line rates became applicable to all shippers. However, this will occur only if the rate paid in the reparations period was higher than the *Arizona Grocery* rate for the same period. The Commission did not intend in its prior orders that reparations would be available for all complaints filed against the East Line rates between August 1995 and August 1, 2000.

115. Moreover, the Commission reverses that ALJ's ruling that the 1988 PPA should be removed for purposes of calculating reparations that are due for the East Line rates before August 1, 2000. Opinion No. 435-A afforded complainants an opportunity to pursue the issue further in the context of complaints filed after August 1995.[133] While the complainants provided extensive evidence on the relevance and import of the 1998 PPA, they did not do so with regard to the 1988 PPA. Therefore, for the same reasons as in Opinion No. 435-A, the Commission will not pursue the further in either of consolidated proceedings at issue here.

116. Two additional issues raised here turn on the technical requirements for filing a complaint. The first is an argument by Ultramar that the ID could lead to an erroneous application of section 1803 (b) of the EPA that would restrict pre-complaint relief. Ultramar notes that it filed complaints against SFPP's West Line rates on October 21, 1996, and against the West, East, North, and Oregon Line rates on November 21, 1997, and amended those complaints on January 10, 2000. It notes that Tosco also filed complaints against all West, East, North, and Oregon rates on April 28, 1998, and that both companies filed further complaints against those rates on August 17, 2000, and August 21, 2000, respectively.[134] Ultramar asserts that since the Commission found that certain of the West Line rates were no longer grandfathered as of 1995 and others as of 1997, that complaints filed against those rates after those dates were not required to show

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[132] *Cf.* Remand Opinion at 1310.

[133] 91 FERC at 61,506-07.

[134] Ultramar also filed a complaint against the Watson Station charges on August 30, 1996. Ultramar's concern does not reach those rates because the Commission has held they are not grandfathered.

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substantially changed circumstances. Thus, pre-complaint reparations would not be barred as to those complaints by section 1803(b) of the EP Act because the rates would no longer be grandfathered at the time those complaints were filed.[135] The Commission agrees with this analysis. However, such complaints may be barred from some portion of pre-complaint reparations by the *Arizona Grocery* doctrine for the same reasons stated in the discussion of the East Line rates. Specifically, a rate established in the first complaint that prevails against specific West Line rates establishes a just and reasonable rate and rate floor that could limit the reparations or refund that could be obtained from subsequent complaints.

117. The remaining reparation issues involve Chevron's continuing quest for complainant status before July 3, 2003. On October 23, 2003, the Commission accepted a complaint Chevron filed against SFPP's North, East, West, and Oregon Line rates, as well as the Watson Station Drain-Dry facilities.[136] The Commission had previously rejected as inadequately filed a complaint Chevron filed on February 11, 2002, [137] and denied rehearing and reconsideration of that decision.[138] However, in the proceedings below Chevron asserts that it succeeded to the complainant interests of TRMI as a result of its merger with Texaco on October 9, 2001. The ALJ in this proceeding rejected this argument on April 12, 2002.[139] On exceptions, Chevron first revisits certain arguments related to its intervention status in Docket No. OR92-8-000, *et al.* It also urges the Commission to reverse the ALJ's April 12 ruling. SFPP opposes Chevron's arguments at length. The Commission rejects Chevron's arguments.

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[135] Section 1803(b) of the Energy Policy Act, Pub. L. 102-486, 106 Stat. 2772 (1992) (EP Act). Section 1803(a)(1) provides that any rate in effect for the 365-day period ending on the date of the enactment of this Act shall be deemed just and reasonable (within the meaning of section 1(5) of the Interstate Commerce Act).

[136] *Chevron Products Company v. SFPP, L.P.*, 105 FERC ¶ 61,142 (2003), Docket No. OR03-4-000, held in abeyance pending this order.

[137] *Chevron Products Company v. SFPP, L.P.*, 99 FERC ¶ 61,196 (2002).

[138] *Chevron Products Company. SFPP, L.P.*, 100 FERC ¶ 61,231 (2002) and 103 FERC ¶ 61,231 (2003).

[139] *Texaco Refining and Marketing Inc. v. SFPP, L.P.*, 99 FERC ¶ 63,009 (2002) (April 12 Order).

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118. Chevron's first assertions reiterate why its initial intervention in Docket No. OR92-8-000, *et al.*, should grant it complainant status based on its protest against SFPP's proposed Tariff Nos. 15 and 16 in September, 1992. The Commission concluded that this protest had nothing to do with the West Line rates.[140] These decisions eliminated any prospect that Chevron would be deemed to have filed a complaint against the West Line rates more than 365 days prior to the enactment of the EP Act. Chevron eventually filed a complaint against all of SFPP's West Line rates in August 1993, but failed in its efforts to relate that complaint back to its prior protests. As such, Chevron was required to prove substantially changed circumstances, and like the other West Line complainants in Docket No. OR92-8-000, *et al.*, it failed to meet its burden. On appeal, the Remand Opinion held that the Commission properly denied Chevron complainant status based on its interventions and protests prior to July 1993 and rejected Chevron's relation back theory in a footnote.[141] Its attempt to relate its July 1993 complaint against SFPP's West Line rates to proceedings involving SFPP's East Line rates is rejected here for the same reasons as stated in the prior orders.

119. The ALJ's April 12 Order contains an exhaustive analysis of why Chevron failed to establish that it is the successor-in-interest to the second round of complaints filed against SFPP's West Line rates (among others) beginning December 1995 by TRMI and others. Chevron intervened in those proceedings in May 1996. The ALJ held that Chevron had not adequately documented that it was a successor in interest, that granting successor status would result in confusion regarding rights to reparations, and that the relation-back doctrine did not apply to Chevron's 1996 intervention. On exceptions, Chevron disputes each of these rulings, and further argues that equitable considerations require granting it complainant status before July 3, 2003, the point at which it finally filed an adequate complaint in Docket No. OR03-4-000. These equitable factors are that SFPP would retain profits that were unjust and unreasonable at Chevron's expense, that Chevron was never given notice that its reparation rights would be terminated in the absence of a complaint in light of the long delays involved in these proceedings, that the ALJ applied FERC's procedural rules too narrowly to Chevron's injury did so in a manner that was too protective of SFPP, and that the ALJ erred by not recognizing that an intervenor has the same reparation rights as a complainant.

120. None of these arguments suffice. The ALJ exhaustively examined the documentation involved and reasonably concluded that Chevron had not proven that it

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[140] *See SFPP, L.P.*, 65 FERC at 61,378 (1992); SFPP*, L.P.*, 63 FERC ¶ 61,104 (1993).

[141] Remand Opinion at 1311-12.

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was the successor in interest to TRMI. This is particularly true since in a complaint filed on January 10, 2000, Equilon Enterprises, LLC (Equilon) claimed that it was the successor in interest to TRMI.[142] Thus, any successor in interest status is at best ambiguous. Moreover, the ALJ correctly concluded that there is another problem. Different shippers ship oil products from different facilities and in different volumes. It is undisputed that in 1995 Chevron and TRMI were different shippers. Thus, both Chevron and TRMI shipped petroleum products from separate facilities in California, as TRMI did from its. As the ALJ points out, granting Chevron successor status would allow it to obtain reparations for flows from its facilities before the merger in 2001, even though during that period complainant status attached only to TRMI's flows and these were clearly different than Chevron's flows.

121. The ALJ was correct in refusing to give these different flows the same legal status because the complaint status for the different flows arose at different times. This was particularly wise given that a dispute about which entity is the proper successor in interest to TRMI is reflected on the face of January 10, 2000 Equilon complaint. Keeping the flows separate for accounting and reparations purposes was the prudent thing to do under these circumstances. In any event, the ALJ's April 26 Order was notably evenhanded in this regard. He denied successor in interest status to the assets and entities in other mergers, or transfers of assets, where the ownership of the assets prior to the transaction involved parties having different legal identities.[143] The only exception was the substitution of Western Refinery for Refinery Holding Company when the latter became Western Refinery through a bankruptcy proceeding. All that entailed was a name change for the entity controlling a given set of assets, and hence the related shipments, without any reallocation or change in the title to the assets among entities that had previously had separate legal status and separate transportation interests. Where the record suggested that there could be confusion about which entity shipped which volumes from what assets, and in what time frame, the ALJ uniformly denied successor in interest status.

122. Regarding Chevron's other claims, as was previously discussed, the Remand Opinion made quite clear that intervention does not support the complainant status necessary to support a claim for reparations.[144] The Remand Opinion also rejected the relation-back argument in support of an effort to relate an eventual complaint back to

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[142] *See* Exhibit A to SFPP's October 19, 2004 filing in Docket No. OR96-2-000, *et. al.*

[143] April 12 Order at 65,034-35.

[144] Remand Opinion at 1310.

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earlier interventions and protests. This was true even though all those filings involved pleadings directed against the East Line rates. The fact that they were made at different times was sufficient to defeat the relation-back plea. The result should be no different here and would undercut the clear distinction between interventions and complaints. The EP Act is clearly intended to discourage complaints against oil pipeline rates[145] and acquiescing in the relation-back theory would have the opposite effect.

123. Moreover, as the ALJ found, consistent with its formerly passive approach to these proceedings, Chevron did nothing to avail itself of an opportunity in 2000 to file amended or additional complaints, and did not file a legally sufficient complaint until July 2003. SFPP correctly notes that it never conceded complainant status to Chevron before 2003, and correctly asserts that the fact that Chevron filed testimony under its 1996 intervenor status is an inadequate basis upon which to grant it complainant status. While there was a long delay between Chevron's filing as an intervenor in May 1996 and the Commission's statements in Order No. 435-A (May 17, 2000) that complainant status is required,[146] that delay does not relieve Chevron of the obligation to have acted aggressively to protect its own interests. The relevant case states that each shipper must filed its own complaint to have any eligibility for reparations status. The ALJ's April 26 order is affirmed on this point.

F. <u>Issues Regarding the Commission's Indexing Procedures</u>

124. On exceptions BP West Coast asserts that any inflation adjustments that may have been built into the rates at issue here are not grandfathered and may be challenged by complaint. It asserts that therefore any issues related to inflation adjustments may be addressed in the compliance phase. BP West Coast also asserts that inflation adjustments can be challenged through complaints, that it has done so here, and that certain adjustments should be rolled back in the compliance phase. SFFP responds to BP West Coast's assertions with three pages of argument asserting that BP West Coast has not challenged any of the index adjustments related to the rates at issue here. While conceding that any index increases to the underlying base rates are reduced in a proportional reduction to reductions in the base rates, SFPP argues that there is no basis in this proceeding for a complete reduction of any index-based increases to the base rates at issue here. In particular, it asserts that BP West Coast has failed to challenge SFPP's North and Oregon Line index adjustments and that there is no basis here for rolling back prior adjustments. In addition to these arguments, SFPP and Indicated Shippers have

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[145] *Id.,* 1311-12.

[146] *Opinion No. 435-A*, 91 FERC at 61,514 (2000).

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pending rehearing requests of the Commission's June 30, 2004 Order accepting SFPP's index filing based on SFPP's calendar year 2003 cost increases.[147]

125. When SFPP made its 2004 filing to recover its 2003 year costs increases, Indicated Shippers challenged the integrity of the index, asserting that it was impossible for them to verify the accuracy of the calculations because SFPP controlled all the relevant information. They further asserted that SFPP overstated its 2003 costs and was substantially over-recovering them. They asserted that an income tax allowance was included in the index filing and objected that such a cost component was illegal based on the ruling in the Remand Opinion.[148] They therefore concluded that they had "alleged reasonable grounds for asserting …that the rate increase was so substantially in excess of the actual cost increases incurred by the carrier that the rate is unjust and unreasonable."[149] At bottom, they argue that because SFPP's rates were already unjust and unreasonable, any increase necessarily results in a rate that is unjust and unreasonable. They assert that the June 30 order did not adequately address these concerns.

126. The Commission will deny rehearing of both SFPP's and Indicated Shippers' rehearing requests. SFPP is correct that the Commission had not previously suspended index rate increase or subjected the increase to a refund obligation. However suspension is a matter for the Commission's sole discretion. In June 2004 when the Commission acted it had made no final determination whether the North and Oregon rates were grandfathered because requests for rehearing of the Commission's March 2004 order were pending. While the Commission could lift the suspension and refund obligation attached to those rates, it sees no need to do so until all matters are completed in this proceeding. Given the complexity of the litigation here, the Commission's action was reasonable and the suspension will remain in effect.

127. The Commission also concludes that Indicated Shippers' request for rehearing should be denied. As noted, Indicated Shippers assert that they "alleged reasonable

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[147] *SFPP, L.P.*, 107 FERC ¶ 61,334 (2004) (June 30 Order). The case involves Docket Nos. IS04-323-000 and 001 and reviews SFPP's May 19, 2004 index filing.

[148] Because the Remand Opinion was dated July 24, 2004, and the Commission's order on the index issued on June 30, 2004, this accorded Indicated Shippers an opportunity to include this argument in their rehearing request.

[149] *Citing* the June 30 Order at P 5. The quoted language was derived from 18 C.F.R. § 343.2(c)(1).

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grounds for asserting that the increase is so substantially in excess of the actual cost increases incurred by the carrier that the rate is unjust and unreasonable." The request for rehearing has three specific points: (1) What is the standard for a protest, an allegation or a showing? (2) If the standard is a showing, how can protestors meet that burden since the pipeline controls all the information? (3) Since the underlying rates are being adjudicated in Docket No. OR96-2-000, *et al.*, will SFPP have the burden to prove that its actual costs increases between 2002 and 2003 were sufficient to qualify for the index increase that became effective in 2004? The answer to these questions lies in the Commission's past explanations of the indexing regulations, all of which have been explained in prior orders involving SFPP.[150]

128. Moreover, in Order Nos. 561 and 561-A the Commission specifically addressed what could be protested in the context of a filing.[151] The Commission made clear in those orders that in an index proceeding it is only the amount of the increase in the underlying rate that may challenged, not the level of the resulting rates.[152] The two Orders are equally clear that if a shipper wishes to challenge the level of the rate that results from an index-based increase, the shipper must file a challenge against the base rate that has been indexed.[153] The answer to the first question is that the shipper must allege reasonable grounds that the rate increase is so substantially in excess of the carrier's actual cost increase that the resulting rate would be unjust and unreasonable. This can be done on the basis of the information contained on Page 700 of the carrier's annual FERC Form No. 6.[154] Page 700 of SFPP's 1993 FERC Form No. 6 report discloses total jurisdictional expenses and total jurisdictional revenues for the years 1992 and 1993, thus permitting a

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[150] *See SFPP, L.P.,* 96 FERC ¶ 61,322 (2001) at 62,272, and *SFPP, L.P.* 102 FERC ¶ 344 at P 10, 12.

[151] *Revision to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Order No. 561, FERC Stats. & Regs. ¶ 30,985 and Order No. 561-A, FERC Stats. and Regs. 31,000 (1994).

[152] *Opinion No. 561* at 30,955; *Opinion No. 561-A* at 31,103-104.

[153] *Opinion No. 561* at 30,955 and *Opinion No. 561-A* at 31,104.

[154] *Opinion No. 561-A* at 31,098.

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comparison of one year's expenses with the other.[155] This can be used to determine the percentage increase in the expenses and calculate the percentage increase. In 1993 SFPP's increase in costs exceeded the percentage increase permitted by the Commission's index for rate increases.

129. Under the Commission's regulations the increase can only be unjust and unreasonable if the increase in the rate so substantially exceeds the increase in the carrier's costs that the amount of the increase is unjust and unreasonable. Indicated Shippers argue here that the increase is unreasonable because the profits earned under the base rate are unreasonable, and allowing the index to go into effect will result in profit margins that are even more unreasonable. But as has been previously discussed, the matter of the reasonableness of the base rate, and as such the profit margin that results, can be examined only in a complaint proceeding. Under the Commission's regulations, if the base rate is reduced, the increase in the dollar amount generated by the index is proportionately reduced. Because the index operates on the basis of system-wide costs and revenues, any concerns about the level of the base rate after the index is applied can be addressed only in complaints directed against a specific rate. As such, the fact that the index may include an increase in an underlying tax allowance, which Indicated Shippers consider to be of questionable legality, is irrelevant to the index computation since an income tax allowance is an existing component of the rate design that can be modified only in response to a complaint.

130. At bottom, all that can be challenged during an index rate proceeding is whether the increase in the rate so exceeds the increase in the carrier's costs as to be unjust and unreasonable, or the accuracy with which SFPP reported them in 1993. The first test fails because the percentage increase in SFPP's costs in 1993 exceeded, as those costs were reported, the increase permitted by the index. Thus, for the year 1993, the sole issue is whether SFPP accurately reported the costs. While it is true that only SFPP has control of the underlying cost data, the remedy is to file a complaint stating the costs involved in the filing at issue are incorrect. This would not, contrary to what Indicated Shippers seem to imply, be the equivalent of a complaint against the base rates for the purpose of examining rate design. Thus, to the extent Indicated Shippers attempt to attack the reasonableness of the North or Oregon Line rates, or costs of those lines that are

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[155] The expense accounts are Operating and Maintenance Expense, Depreciation Expense, AFUDC, Amortization of Deferred Earnings, Rate of Return %, Return on Rate Base, Income Tax Allowance, and Total Cost of Service (Lines 1 through 9) The remaining three lines are Total Interstate Revenues, Throughput in Barrels, and Throughput in Barrel-Miles. The underlying accounts are required to conform to the Commission's Opinion No. 154-B costing methodology.

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embedded in the index, that effort must fail. To the extent that Indicated Shippers' protest is directed to the resulting level of the East and West Line rates, any adjustment to those rates is addressed in the portions of this order dealing with Docket No. OR98-2-000, *et al*., not here. Rehearing is denied regarding SFPP's 1993 indexing of the West, East, North and Oregon line rates.

G. Residual Jurisdiction Issues

131. The ID addressed certain jurisdictional and threshold issues related to the Watson Station charges and to SFPP's adding an additional origination point at East Hynes, California. The ALJ held that charges for the Watson Station Drain Dry facilities were not grandfathered. The ALJ further held that SFPP's creation of an additional origination point at East Hynes created a new service and therefore was not grandfathered.[156] On exceptions SFPP asserts that those issues were simply not before the ALJ at the time he issued the ID. Ultramar asserts that the ID erroneously concluded that SFPP should continue to publish the Watson Station Drain Dry charge as a separate rate. It asserts that the ID first found that the Watson Station Drain Dry rates were not grandfathered and that all capital investment in those facilities had been recovered. Ultramar therefore concludes that the Watson Station facilities should be folded into the West Line rate structure. SFPP replied that Ultramar had not demonstrated that there were reasonable grounds to eliminate the Watson Station Drain Dry facilities as a separate cost center with its own rates. BP West Coast supports the ID, arguing that none of SFPP's rates was ever grandfathered, including the East Hynes rates.

132. The Commission concludes that Ultramar's arguments regarding the Watson Station Drain Dry facilities are premature, and therefore so is SFPP's reply. By way of background, the ALJ found that the charges for the Watson Station Drain Dry facilities were not grandfathered in Phase I of Docket No. OR98-2-000, *et al.* The Commission's March 26, 2004 order reviewing the ALJ's Phase I determinations deferred decision on the jurisdictional status of those charges until the reviewing court acted on the Commission's earlier determinations in the Opinion No. 435 Orders.[157] The June 1 Order concluded that the Watson Station Drain Dry facility charges were not grandfathered based on the effective dates of those contracts.[158] However, since the Phase I decision did not address all of the costs relevant to the Watson Station Drain Dry facilities, but

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[156] ID at P 581-85.

[157] *SFPP, L.P.*, 106 FERC ¶ 61,300 at P 2-3 (2004) (March 2004 Order).

[158] June 1 Order at P 31-36.

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only their rate base, the Commission set the issue of the just and reasonable rate for hearing in a separate proceeding.[159] Since Ultramar's argument is based solely on the ALJ's prior, and yet to be reviewed, determination regarding the rate base issue, it is premature to determine whether the Watson Station Drain Dry facilities should continue to have a separate rate. Finally, the Remand Opinion resolved the addition of the East Hynes origination point in the Commission's favor[160] and on the grandfathered status of the West Line rates. There is no need to discuss these issues further.

H. Compliance Filings and Related Proceedings.

133. This order requires SFPP to make several compliance filings that have two elements. These comprise a cost-of-service for the relevant service and period that conforms to this order and a related but separate rate filing that conforms to the cost-of-service. These filings include: (1) a revised cost-of-service for the West Line turbine fuel service based on the 1994 and 1999 cost-of-service established here and in the Opinion No. 435 Orders, together with an interim just and reasonable rate determined as of the first day of each year; (2) the indexing of each of those turbine fuel rates forward to April 30, 2006 and inclusion of the lower of the two rates as an interim rate applying to all West Line shippers on May 1, 2006; (3) a revised East Line cost-of-service in Docket No. OR92-8-000, *et al.* based on the 1994 cost of service, together with just and reasonable rates that should be indexed forward to March 31, 2006; (3) a revised East Line cost-of-service based on the 1999 cost of service in Docket No. OR96-2-000 *et al.*, together with interim just and reasonable rates that should be indexed forward to April 30, 2006; (4) the filing of the lower of those two sets of East Line rates as interim rates applying to all shippers on May 1, 2006; (5) developing a West Line cost of service for 1999 and interim just and reasonable rates determined as of the first day of 1999; (6) the indexing of those West Line rates (which include the turbine fuel rate) forward to April 30, 2006, to apply to all shippers on May 1, 2006. SFPP must also prepare reports on estimated reparations that are consistent with the analysis of reparation issues earlier in this order. The reparations, where applicable, are measured by the difference between rates actually paid and the just and reasonable rate established for 1994 and 1999, as indexed forward to the effective date for the revised rates, in this case May 1, 2006.

134. All of the compliance filings required here must be supported by verified statements explaining how the cost-of-of service and proposed rates were designed. As indicated in the body of this order, this requirement extends to certain components of the

[159] June 1 Order at P 36, 74.

[160] Remand Opinion at 1272-73.

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filing, such as the income tax allowance, for which a separate explanation and verification is required. Parties commenting on the compliance filings should include with their comments verified statements supporting their comments and not simply relying on arguments with citations to the record. This is because the Commission is requiring that certain of evidence previously submitted be recast in forms that could facilitate the resolution of the issues raised by this order without further on-the-record proceedings. If such proceedings should prove necessary, the more extensive comment format required here should enable the Commission to further narrow the range of disputes and expedite the completion of these protracted proceedings.

135. The Commission directs SFPP to make its compliance filing not later than February 15, 2006, so that any interim new rates can become effective on May 1, 2006, subject to suspension and refund. Because the filings will be complex, interested parties will have until March 31, 2006 to file comments. Reply comments are be filed on April 15, 2006. Finally, the Commission will address the procedural schedule for complaints filed against SFPP rates in 2003, 2004, and 2005 in a separate order.

The Commission orders:

(A) SFPP shall make the compliance filings required by this order by no later than February 15, 2006, with the proposed interim rates contained therein to be effective May 1, 2006. Comments on that filing are due March 31, 2006 and reply comments due on April 15, 2006.

(B) The requests for rehearing of the Commission's June 30 Order in Docket No. IS04-323-000 are denied.

(C) All compliance filings and comments thereon must conform to the filing requirements established in Part H of this order.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.