SFPP, L.P., et al.
80 FERC ¶ 63,014 (1997)

In this complaint case, the rates, practices, and terms and conditions of service for SFPP's common carrier operations on the interstate portion of its South System were at issue. The South System consists of facilities used to transport refined petroleum products into Arizona from El Paso, Texas (the East Line) and from Los Angeles, California (the West Line).

The lengthy Initial Decision addresses almost all aspects of cost of service ratemaking, including issues relating to base year, test year and updated data, rate base, rate of return, cost allocation and revenue crediting, test year throughput expenses, other operating expenses, income taxes, volumes, and rate design. In addition, it also speaks to matters such as the changed circumstances test applicable to grandfathered rates, tariff issues such as prorationing, and reparations.

Some of the more important conclusions reached by the Judge are as follows:

1) SFPP's capital structure as of the date it first became a publicly traded entity was used to develop the starting rate base. SFPP's updated capital structure as of the end of 1994, with one adjustment, was used to develop an overall rate of return.

2) SFPP's allowed rate of return on equity was 12.87%.

3) The Watson facilities were determined to be integral to SFPP's interstate pipeline operations, thus subject to Commission jurisdiction. Tariffs were ordered to be filed, but no reparations were allowed.

4) SFPP was allowed to recover its actual 1994 litigation expenses, reconditioning (replacement) costs, and environmental expenses, but no projected expenses. Actual 1994 volumes were adopted.

5) SFPP was not allowed taxes on income attributable to SFPP Inc.'s limited partnership interest or for income attributable to the non-corporate limited partners of SFPP Partners.

6) Each of SFPP's rates must be evaluated based on fully allocated costs, reflecting mileage and non mileage-based costs.

7) The changed circumstances test requires consideration of all factors affecting a pipeline's economics. West Line shippers failed to do this. Moreover, some of their "changed circumstances" were deemed irrelevant.

8) SFPP's prorationing policy must be published in its tariff.

SFPP, L.P., et al.
Initial Decision Concerning Rates,
Term and Conditions of Service,
and Other Matters
80 FERC ¶ 63,014 (1997)

[¶ 63,014]

SFPP, L.P., Docket Nos. OR92-8-000, OR93-5-000, OR94-3-000, and OR94-4-000

Mobil Oil Corporation v. SFPP, L.P., Docket No. OR95-5-000

Tosco Corporation v. SFPP, L.P., Docket No. OR95-34-000

Initial Decision Concerning Rates, Terms and Conditions of Service, and Other Matters

(Issued September 25, 1997)

Ernst Liebman, Presiding Administrative Law Judge.

APPEARANCES

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II. STATEMENT OF THE CASE

A. Background

SFPP, L.P. (hereafter "SFPP") owns and operates pipelines that transport refined petroleum products in six Western and Southwestern states: Arizona, California, Nevada, New Mexico, Oregon and Texas.[1] This proceeding involves SFPP's rates, practices, and terms and conditions of service for its common carrier operations on the interstate portion of its so-

[1] Ex. 142 at p. 9; *see also* Tr. 8125-27.

called "South System," which consists of pipe and other facilities used to transport refined petroleum products into Arizona from El Paso, Texas (the "East Line") and from the Los Angeles, California area (the "West Line").[2] Exhibit 145 is a map of the South System. A copy of the map is attached to this initial decision as an Appendix.

The West Line consists of a 24-inch pipeline from Watson Station to Norwalk, California, a combination 20-inch and 24-inch pipeline and a 16-inch pipeline from Norwalk to Colton, California, a 20-inch pipeline and a 12-inch pipeline from Colton to Phoenix, and a 6-inch pipeline from Phoenix to Tucson. The East Line consists of parallel 8-inch and 12-inch pipelines between El Paso and Tucson and one pipeline (at various points 8or 12-inches) between Tucson and Phoenix. As of April 1995 the various South system pipeline segments had the following capacities in barrels per day (bbl/d):[3]

West Line

Watson to Colton	340,000 bbl/d
Colton to Phoenix	173,000 bbl/d
Phoenix to Tucson	17,400 bbl/d

East Line

El Paso to Tucson	95,000 bbl/d
Tucson to Phoenix	55,000 bbl/d

As with most oil pipelines, there are two kinds of tanks on SFPP's system: breakout tanks and terminal tanks. Breakout tanks are operated as part of the transportation system along with the pipeline, and SFPP therefore treats them as carrier property. Breakout tanks are used to promote operational efficiency and help to minimize the scheduling interferences inherent in shipment cycles. Breakout tanks usually are located at input points with multiple incoming lines, such as Watson Station, and at locations along the pipeline where there is a higher incoming pumping rate requirement relative to the outgoing pumping rate requirement, such as Colton, Phoenix and Tucson. At input locations breakout tanks are needed to provide temporary storage for product until the product can be routed to one or more outgoing pipelines. In the case of dissimilar flow rates between incoming and outgoing lines, the breakout tanks provide temporary storage for the outgoing lines with slower rates. This allows a larger incoming line to operate at its fully rated capability without having to slow down to deliver directly into a smaller outgoing line. At the same time breakout tanks provide sufficient short-term storage to allow the outgoing line to operate while the incoming line makes deliveries to terminal tanks or other pipelines.[4]

Terminal tanks are used for storage at the delivery points on the pipeline, where they are used to supply the local market. Product in the terminal tanks at destination points is delivered over loading racks into tank trucks and taken to retail service stations, wholesale distributors or other locations. Some shippers own and operate their own terminal tanks at SFPP delivery points. SFPP treats all of its terminal tanks as non-carrier property.[5]

SFPP's pipelines operate on four shipment cycles per month. A cycle represents a complete delivery of all product types during a defined time period. The cycle time period is normally a function of available storage at both ends of the pipeline. A typical cycle would consist of various grades of gasoline—such as premiums and regulars, both of which can be either oxygenated or non-oxygenated and reformulated or conventional—followed by diesel fuels, turbine fuel and military jet fuels. SFPP operates its system on 7½ day cycles.[6]

SFPP also operates an enhancement facility at its Watson Station, in California.[7] The Watson enhancement system consists of vapor collection piping connected to tanks and related vapor collection facilities that allow SFPP to operate its tanks so that they can empty and then refill without emitting vapors into the atmosphere.[8] SFPP installed these facilities so its shippers could meet SFPP's requirement for higher incoming pumping rates.[9]

SFPP, whose rates are at issue in this proceeding, is a limited partnership organized under Delaware law.[10] SFPP is owned one percent by its general partner, Santa Fe Pacific Pipelines, Inc. ("SFPP Inc.") and 99 percent by Santa Fe Pacific Pipellnes Partners, L.P. ("SFPP Partners").[11] SFPP Partners is in turn organized as a master limited partnership, with approximately 56 percent of its ownership consisting of common units publicly traded on the New York Stock Exchange.[12] Santa Fe Pacific Pipelines, Inc. ("SFPP Inc.") is the general partner, holding a one percent general

[2] Ex. 144 at p. 3.

[3] Ex. 144 at pp. 3-4.

[4] Ex. 144 at pp. 4-5.

[5] *Id.* at p. 5.

[6] *Id.* at pp. 5-6.

[7] *Id.* at pp. 12, 14.

[8] *Id.* at p. 14.

[9] *Id.* at p. 16.

[10] Ex. 142 at p. 5; *see also* Tr. 8122, 8127-28.

[11] Ex. 142 at p. 5.

[12] *Id.* at pp. 5-6. A schedule setting forth in percentage terms and type of entity the owners of SFPP

partnership interest in SFPP Partners and owning the remaining common partnership units.[13]

SFPP's predecessor company, Southern Pacific Pipe Lines, Inc. ("SPPL"), was the original owner and operator of the South System.[14] The tariff rates for movements over the East and West Lines into Phoenix were equal from the pipeline's inception in 1956 until 1985.[15] In 1985 SFPP's predecessor filed equalized tariff increases to reflect capital expenditures undertaken on the West Line to increase capacity into Phoenix.[16] The pipeline's 1985 rate filing was protested by certain East Line shippers, including Navajo Refining Company ("Navajo"), which objected to paying any rate increase attributable to capital improvements on the West Line.[17]

The Commission terminated the 1985 rate proceeding upon Commission approval of two settlement agreements reached by the pipeline and the protesting shippers.[18] The settlements rolled back the South System rate increases from those filed in 1985, provided for refunds based on those lower rates, and for the first time established a rate differential for movements into Phoenix on the East and West Lines.[19] Upon completion of certain additional expansion projects, the settlement agreements also permitted SFPP to increase its tariff rates to $1.262 from Los Angeles to Phoenix; $1.543 from Los Angeles to Tucson; $1.012 from El Paso to Phoenix; and $.731 from El Paso to Tucson.[20]

SFPP completed several expansion projects on both its East and West Lines during the late 1980s and early 1990s and increased its rates as permitted under the settlement agreements.[21] The rates challenged in this proceeding are those established in the settlement agreements.[22]

Two West Line expansion projects increased capacity to 173,000 barrels per day into Phoenix from Los Angeles, at a cost of about $140 million.[23] As part of those expansion projects SFPP reinstituted West Line service from Phoenix to Tucson over its 6-inch line.[24] The West Line expansion project was completed in January 1989.[25]

The East Line expansion project was undertaken in two phases. In Phase I, completed in February 1992, SFPP made various facility modifications at Tucson, and it increased pumping capacity and installed drag reducing agent ("DRA") facilities between El Paso and Tucson, at a cost of approximately $4 million.[26] In Phase II SFPP replaced forty miles of 8-inch pipe between Tucson and Phoenix with 12-inch pipe and constructed additional breakout tanks at Tucson at a cost of approximately $20 million.[27] The East Line expansion project increased capacity between El Paso and Tucson to 95,000 barrels per day, and capacity between Tucson and Phoenix from 26,500 barrels per day to 55,000 barrels per day.[28]

During Phase II of the East Line expansion project SFPP reversed and then re-reversed its 6-inch line between Tucson and Phoenix. The 6-inch line had been in West Line service from Phoenix to Tucson since completion of the West Line expansion in 1989, but was under-used during 1990 and early 1991.[29] At the same time SFPP was rationing capacity on its East Line between Tucson and Phoenix.[30] To serve its customers during Phase II of the East Line expansion project, SFPP reversed the 6-inch line in August 1991 to operate in East Line service from Tucson to Phoenix.[31] SFPP returned the 6-inch pipeline to West Line service upon completion of Phase II of the East Line expansion at the end of August 1992.[32]

In August 1992 when SFPP returned the 6-inch line to West Line service, SFPP was carrying out the terms of an agreement it had made with ARCO Products Company

(Footnote Continued)

Partners' units for year end 1990 through 1994 is included in the record as Exhibit 477. *See* Ex. 476 at pp. 9-11.

[13] Ex. 142 at p. 5; *See* Exhibit 143 for a diagram of the SFPP, L.P. organization structure.

[14] Ex. 142 at p. 8; Tr. 8125.

[15] Ex. 142 at p. 11; *see also* Tr. 8128-29.

[16] Ex. 142 at p. 12; Tr. 8129.

[17] *Id.*

[18] Ex. 142 at pp. 12-13; Tr. 8129-30; *see also* *Southern Pacific Pipe Lines, Inc.*, 45 FERC ¶ 61,242 (1988); *Southern Pacific Pipe Lines Partnership, L.P.*, 49 FERC ¶ 61,081 (1989).

[19] Ex. 142 at pp. 13-14; Tr. 8130-31.

[20] Ex. 142 at p. 13; Tr. 8131.

[21] Ex. 142 at pp. 13-14; Tr. 8131; *see* Ex. 147 at pp. 6-14.

[22] Ex. 142 at pp. 13-14.

[23] Ex. 147 at pp. 7-9.

[24] *Id.* at p. 9.

[25] *Id.*

[26] Ex. 147 at p. 10.

[27] *Id.*

[28] *Id.* at pp. 10-11.

[29] Ex. 147 at pp. 9-10.

[30] *Id.* at p. 10.

[31] *Id.*

[32] *Id.* at p. 11.

("ARCO") in early 1992.[33] SFPP entered the ARCO Reversal Agreement in response to ARCO's desire for assurance that ARCO would have continuing direct West Line access into Tucson to supply its branded retail outlets in that market.[34] The ARCO Reversal Agreement obligates SFPP to dedicate the 6-inch line to West Line service for a period of five years, with provisions for extending the agreement for three additional five-year periods.[35] In exchange ARCO agreed to ship an annual volume of 1.825 million barrels of product from Phoenix to Tucson (based on a 5,000 barrels per day commitment) or to pay SFPP damages in the form of equivalent revenues to the extent actual movements fell below the agreed-upon volumes that were the basis for SFPP's agreement to maintain the line in West Line service.[36]

B. Procedural History

This proceeding was initiated on September 4, 1992 when El Paso Refinery, L.P. ("EPR") filed a pleading styled "Protest or, Alternatively, Complaint" with the Federal Energy Regulatory Commission (hereafter "FERC" or "the Commission").[37] EPR alleged, among other things, that SFPP's proration policy[38] and the re-reversal of the direction of flow of the 6-inch line between Phoenix and Tucson adversely affected its business, and that SFPP's existing East Line rates should be reduced.[39] On September 29, 1992, the Commission's Oil Pipeline Board ("Board") suspended SFPP's tariffs for one day and subjected them to investigation[40] under Section 15(7) of the Interstate Commerce Act ("ICA").[41]

On December 31, 1992, SFPP filed FERC Tariff No. 18 to provide its West Line shippers with the service of transporting turbine (or jet) fuel to Tucson. EPR and Chevron USA Products Co. ("Chevron"), which had intervened in the earlier case in September 1992, lodged protests contending that Tariff No. 18 raised the same issues that were pending in the existing proceeding. On January 29, 1993, the Board suspended Tariff No. 18 for one day, instituted an investigation under Section 15(7) of the ICA, and consolidated the two cases.[42]

SFPP filed exceptions to both of the Board's orders. On April 2, 1993, the Commission vacated the original suspension orders and the imposition of refund obligations.[43] The Commission held that the Board had erred in subjecting SFPP's tariffs to investigation under Section 15(7) of the ICA, but ruled that the case should go forward as an ICA Section 13(1)[44] complaint proceeding limited to the issues properly raised by EPR and the intervenors.[45]

Chevron and Navajo Refining Company ("Navajo"), having intervened, thereafter filed petitions for rehearing. Those parties alleged that SFPP should not be entitled to pursue a *Buckeye*-type market power defense[46] and sought clarification as to whether SFPP's preexisting rates must be deemed just and reasonable under the "grandfathering" provisions of the Energy Policy Act of 1992 ("EPAct").[47] The Commission issued two Orders on Rehearing.

In its first Order on Rehearing, issued June 18, 1993, the Commission reaffirmed its ruling vacating the Board's suspension order and imposition of refund obligations but "clarified" that although SFPP could present *Buckeye*-type market-based evidence in its defense, it

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[33] *Id.* at pp. 15-17; *see also* Ex. 119 (ARCO Reversal Agreement).

[34] Ex. 147 at p. 15.

[35] *Id.* at p. 17.

[36] *Id.*

[37] Neither EPR nor any other shipper had protested SFPP's FERC Tariff Nos. 15, 16 and 17, filed on July 31, 1992, which added a new West Line origin point at East Hynes, California.

[38] The term "proration" refers to the allocation of pipeline capacity among shippers during periods when the aggregate volumes of petroleum products which shippers nominate for transportation exceed the capacity of the pipeline.

[39] The Commission granted Refinery Holding Company, L.P. ("RHC") party status as the successor in interest to EPR following EPR's bankruptcy. *SFPP, L.P.*, 65 FERC ¶ 61,028 (1993), *reh'g denied*, 66 FERC ¶ 61,210 (1994).

[40] *SFPP, L.P.*, 60 FERC ¶ 62,252 (1992).

[41] 49 U.S.C. app. § 15(7) (1988).

[42] *SFPP, L.P.*, 62 FERC ¶ 62,060 (1993).

[43] *SFPP, L.P.*, 63 FERC ¶ 61,014 (1993).

[44] 49 U.S.C. app. § 13(1)(1988).

[45] *Id.* On June 14, 1993, EPR sought to amend its complaint by adding claims for reparations. Over SFPP's objection, on September 10, 1993, the presiding administrative law judge ruled that EPR's complaint would be amended back to September 4, 1992, and that EPR could seek reparations for the period beginning two years prior to that date. *SFPP, L.P.*, Order Regarding Damage Claims and Discovery, and Changing Date of Prehearing Conference, Docket Nos. OR92-8-000, *et al.* (Sept. 10, 1993).

[46] Under the Commission's so-called *Buckeye* alternative, an oil pipeline may elect to demonstrate that its rates are constrained by market forces and that it therefore should be entitled to light-handed regulation. *Buckeye Pipe Line Co.*, 44 FERC ¶ 61,066 (1988); *see also Buckeye Pipe Line Co., L.P.*, 45 FERC ¶ 61,046 (1988).

[47] 42 U.S.C. § 7172 note (1994)(Section 1803).

was not entitled to pursue the two-phased *Buckeye*-type procedure.[48] The Commission terminated the suspension dockets and stated that the proceedings would go forward in the complaint docket, OR92-8-000. Thereafter, on August 3, 1993, Chevron filed its complaint challenging SFPP's West Line rates.

On October 5, 1993, the Commission issued a further rehearing order in response to requests filed by EPR, Chevron, Navajo and SFPP.[49] With respect to grandfathering of SFPP's rates, the Commission held that rates in effect for the one year period ending on the date of enactment of the EPAct (October 24, 1992), and rates in effect on the date one year preceding that date, and which were not subject to protest, complaint or investigation during that period, were just and reasonable absent a showing of substantial changed circumstances.[50] The Commission agreed with SFPP that nothing in the initial protests filed by EPR and Chevron challenged SFPP's West Line rates, and therefore found those rates to be just and reasonable under Section 1803(a) of the EPAct. The October 5 Order affirmed SFPP's right to present market-based evidence, reiterated the dismissal of Chevron's protest of Tariff No. 18, and held that Chevron must show substantial changed circumstances under Section 1803(b) of the EPAct as a predicate to any showing that SFPP's West Line rates are unlawful.[51]

Additional complaints were filed on December 22, 1993, by Navajo (challenging SFPP's East and West Line rates) and on January 14, 1994, jointly by ARCO Products Co. and Texaco Refining and Marketing Inc., both of whom challenged SFPP's West Line rates. In its answers SFPP acknowledged that under a special statutory exemption, Section 1803(b)(2) of the EPAct, Navajo need not meet the requirement of showing a "substantial change" in the economic circumstances that form the basis of SFPP's West Line rates. However, SFPP denied that other parties could "piggy-back" on Navajo's complaint and similarly challenge the West Line rates without making the requisite showing of changed circumstances.

On April 20, 1994, the Commission held that the filing of Navajo's complaint removed grandfathering protection from SFPP's West Line rates and that ARCO, Texaco and Chevron therefore need not show changed circumstances.[52] However, in response to SFPP's request for rehearing of that ruling, the Commission reversed its April 20 Order stating, "Upon further consideration, the Commission concludes that the plain meaning of the language of section 1803 requires Chevron and ARCO/Texaco to meet the changed circumstances standard in pursuing their complaints."[53]

Chevron, ARCO and Texaco filed petitions for rehearing of that order, which were denied on September 16, 1994.[54] ARCO and Texaco subsequently filed petitions for review of the Commission's piggy-back ruling in the U.S. Court of Appeals for the District of Columbia Circuit. The Commission and SFPP filed motions to dismiss on the ground that the Commission's orders were not final. The court subsequently dismissed those petitions for review.[55]

Beginning in 1993 extensive discovery was conducted by the participants. Complainants also asked the presiding administrative law judge to order SFPP to present a Cost and Revenue Study. That request was granted in November 1993, and pursuant to the presiding judge's order, SFPP filed a Cost and Revenue Study in February 1994, setting forth unadjusted results for 1993. A technical conference was then held to answer any questions complainants, Staff and their experts had about the study and the data on which it was based.

In June 1994, the complainants filed written direct testimony and exhibits, raising a number of challenges to SFPP's rates and practices. The Commission Staff filed its direct testimony and exhibits in August 1994. SFPP's responsive testimony was filed in April 1995, and the Staff and all complainants filed rebuttal testimony and exhibits in August 1995.[56]

SFPP then successfully moved to strike a portion of the rebuttal cases filed by ARCO

[48] *SFPP, L.P.*, 63 FERC ¶ 61,275 (1993).

[49] *SFPP, L.P.*, 65 FERC ¶ 61,028 (1993).

[50] *Id.*

[51] *Id.* On November 4, 1993, Chevron filed a third petition for rehearing, this time challenging the Commission's October 5 Order. The Commission denied that request on February 17, 1994. *SFPP, L.P.*, 66 FERC ¶ 61,210 (1994).

[52] *SFPP, L.P.*, 67 FERC ¶ 61,089, at p. 61,255 (1994). The Commission further held that any reparations with respect to SFPP's West Line rates could be prospective only, starting from the date of the filing of each complaint. *Id.*

[53] *SFPP, L.P.*, 68 FERC ¶ 61,105, at p. 61,581 (1994).

[54] *SFPP, L.P.*, 68 FERC ¶ 61,306 (1994).

[55] *Texaco Ref. & Mktg. v. FERC* No. 94-1703, 1995 U.S. App. LEXIS 12,179 (D.C. Cir. Apr. 20, 1995).

[56] Additional complaints were filed by Mobil Oil Company ("Mobil") and Tosco Corporation ("Tosco") after SFPP filed its responsive testimony. The Commission eventually consolidated those complaints into the existing proceeding. *Mobil Oil Corp. v. SFPP, L.P.*, 73 FERC ¶ 61,032 (1995); *Tosco Corp. v. SFPP, L.P.*, 74 FERC ¶ 61,056 (1996). Mobil and Tosco were

and Texaco relating to product movements upstream of the West Line origin point stated in the tariffs at issue.[57] SFPP also moved to strike those portions of the Staff's and complainants' testimony that included updated test year information, or alternatively, for leave to file surrebuttal testimony responding to the parties' testimony. The presiding judge granted SFPP's alternative motion and permitted SFPP to file surrebuttal testimony; he also allowed Staff and the complainants to respond with sur-surrebuttal testimony.[58]

The hearing in this matter ran from April 9, 1996 to July 19, 1996, requiring 55 hearing days; there are more than 11,000 pages of transcript and over 950 exhibits.[59]

At the commencement of the hearing, SFPP and the other participants[60] reached agreement on a Summary Issues List that established the issues to be litigated in the proceeding.[61]

While the hearing was underway, SFPP and EPR reached an agreement to settle all issues raised in EPR's complaint, pleadings and testimony filed in this proceeding. On September 6, 1996, the presiding judge granted EPR's motion to withdraw its complaint, as amended, and its sponsorship of all filings, exhibits and testimony, whether sponsored individually or jointly with other parties.[62] After the conclusion of the hearing, Navajo withdrew its complaint against SFPP's West Line rates.[63]

III. BURDEN OF PROOF

Because this case is a complaint proceeding under section 13 of the ICA and section 1803(b) of EPAct, the complainants bear the burden of proof to support their claims against SFPP's rates and practices.[64]

IV. BASE YEAR, TEST YEAR AND UPDATED DATA

There are several issues concerning what base period and test period data to use in developing SFPP's rates and what adjustments to that data are appropriate.

When this proceeding began in 1992, there were no Commission regulations or policies regarding base and test periods for oil pipelines. Commission regulations setting forth the base and test periods for oil pipelines went into effect on November 16, 1994, 18 C.F.R. § 346.2, after the complainants in this case had filed their direct cases. The new oil pipeline regulations concerning base and test periods apply only to filings for initial rates or changes in rates and do not by their terms explicitly apply to complaint proceedings. As noted earlier, the instant case is a complaint proceeding. Thus, when this case began in 1992 there was an initial question as to what base period to use.

As noted, the presiding administrative law judge had ordered SFPP to present a Cost and Revenue Study by an order issued on November 24, 1993. Pursuant to that order SFPP, in February 1994, filed its Cost and Revenue Study which set forth unadjusted results for 1993.

On December 15, 1993, at a prehearing conference, the presiding judge ruled that the twelve month period ending on December 31, 1993, would be the base year.[65]

In June 1994 the complainants filed their written direct testimony and exhibits, and in August 1994 Staff filed its written direct testimony and exhibits; their direct cases used 1993 data. SFPP's answering case also was based on 1993 data.

However, when complainants and Staff filed their rebuttal cases in August of 1995, their

(Footnote Continued)

permitted to participate in the proceeding on the condition that they accept the record as it existed on the dates of consolidation and not add any new issues. *See id.*

[57] *SFPP, L.P.*, Order Granting Motion to Strike, Docket Nos. OR92-8-000, *et al.* (Sept. 26, 1995).

[58] *SFPP, L.P.*, Order Establishing Procedural Schedule, Docket Nos. OR92-8-000, *et al.* (Oct. 12, 1995).

[59] There are 96 volumes of transcript which include hearings on motions and conferences as well as the hearing days devoted to cross-examination of witnesses.

[60] SFPP, complainants, and intervenors are parties and participants. Staff is a participant but not a party. 18 C.F.R. § 385.102(b) and (c).

[61] See Tr. 3675. The Summary Issues List is found in the transcript, Volume 42 at pp. ii, iii, iv, and v, preceding transcript page 3593. A 145-page Consolidated Issues List and Position Statement was filed with the Commission on April 5, 1996 by SFPP on behalf of all participants in the proceeding pursuant to an order of the presiding judge issued on January 16, 1996.

[62] *SFPP, L.P.*, 76 FERC ¶ 63,018 (1996).

[63] *See SFPP, L.P.*, 80 FERC ¶ 63,014 (1997); *SFPP, L.P.*, 80 FERC ¶ 61,088 (1997).

[64] *SFPP, L.P.*, 66 FERC ¶ 61,210, at p. 61,479 n.10 (1994); *SFPP, L.P.*, 65 FERC ¶ 61,028, at p. 61,379 n.17 (1993); *SFPP, L.P.*, 63 FERC ¶ 61,014, at p. 61,125 (1993).

[65] Tr. 1670, 1675, 1676. That ruling was later reaffirmed. Tr. 3252, 3254-55, 3268.

approaches to the data varied, ranging from the use of unadjusted 1993 data (West Line Shippers)[66] to adjusted 1993 data (RHC) to 1993 data adjusted for 1994 events (Navajo and Chevron) to unadjusted 1994 data (Staff).

SFPP moved to strike those portions of the Staff's and complainants' cases that included updated test year information; alternatively SFPP asked leave to file surrebuttal testimony responding to complainants' and Staff's updated cases. The presiding judge granted SFPP's alternative motion to file surrebuttal testimony and exhibits, and he also allowed Staff and complainants to file sur-surrebuttal testimony and exhibits.[67] SFPP's surrebuttal case effectively abandoned the 1993 base year and moved to an adjusted 1994 test year. Thus, all participants had the opportunity to file surrebuttal and sur-surrebuttal evidence and were able to file updated data and respond to the use of updated data by others.

The record now contains data updated from 1993 concerning, *inter alia*, such matters as capitalization and rate of return, volumes, and expenses for power and fuel, drag reducing agents, reconditioning of pipe, litigation expenses, and environmental matters.

The Commission has indicated that oil pipeline regulation has not been subject to the same strict rules about test periods that apply to the other industries the Commission regulates. In Opinion No. 154, for example, the Commission concluded that in oil pipeline proceedings "[r]igid rules about test periods and about the way in which divergences between expectations and actualities should be treated seem out of place . . . ."[68] Although Opinion No. 154 itself was vacated by the United States Court of Appeals, this flexible attitude toward the test period issue was expressly reaffirmed in Opinion No. 154-B.[69]

In *Lakehead Pipe Line Co., L.P.*, Opinion No. 397, 71 FERC ¶ 61,338 (1995), the Commission rejected the protestants' arguments that rigid test year rules apply in oil pipeline cases, particularly in proceedings commenced before the new oil pipeline cost of service regulations became effective. There, in a case involving both a locked-in and a forward-looking period, the Commission endorsed a test year approach specific to that proceeding. In so doing, it noted that for periods prior to January 1, 1995, when the new test year regulations for cost of service filings became effective, "the Commission had no policy with respect to oil pipeline test years," and that on this issue "the Commission's gas and public utility precedents were not controlling."[70]

While the gas and electric utility precedents are not controlling, they provide useful guidance. Thus in *Northwest Pipeline Corp.*, Opinion No. 396-A, 76 FERC ¶ 61,068, at p. 61,424 (1996), the Commission held that it had discretion to use test period data to update rate base when the test period data provided more representative numbers. In *Williston Basin Pipeline Co.*, 67 FERC ¶ 61,137, at p. 61,370 (1994), *aff'd in relevant part*, 71 FERC ¶ 61,019 (1995), the Commission concluded that filed-for rate data can be "updated to reflect post-filing data if the updated data are shown to be reasonable."

The kinds of data the Commission has allowed to be updated in natural gas, electric, and oil pipeline cases are illustrated by the following cases: *Towns of Concord, Norwood, and Wellesley, Mass. v. Federal Energy Regulatory Comm'n*, 955 F.2d 67, 68 (D.C. Cir. 1992) (citing *Anaheim et al. v. Federal Energy Comm'n*, 669 F.2d 799, 806 (D.C. Cir. 1981) (a utility may pass on the increasing *cost of fuel* to its customers without filing a new rate schedule through a fuel adjustment clause; *Kuparuk Transp. Co.* 55 FERC ¶ 61,122, at p. 61,383 (1991) (using post-test period *volumes*); *ARCO Pipe Line Co.*, Opinion No. 351, 52 FERC ¶ 61,055, at p. 61,245 (1990) (using six-year average of *oil shortage expense*); *Southern California Edison Co.*, 8 FERC ¶ 61,099, at p. 61,383 (1979) ("Commission has permitted updating of a company's *capital structure* when the data is presented at the hearing and there is no need to reopen the record."); *Commonwealth Edison Co.*, 3 FERC ¶ 63,026, at p. 65,142 (1978) (updating of *interest expense* for income tax computation is accepted).

I therefore take a flexible approach in this case to the use of data beyond the base period so that forward-looking rates may be established as accurately and fairly as possible. The use of updated data will become apparent as the issues are discussed in the following pages of this initial decision.

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[66] The "West Line Shippers" are ARCO Products Company, Mobil Oil Corporation, Texaco Refining and Marketing Inc., and Tosco Refining Company.

[67] See discussion at Tr. 2840-58 and order issued October 12, 1995.

[68] *Williams Pipe Line Co.*, 21 FERC ¶ 61,260, at p. 61,658 (1982).

[69] *See Williams Pipe Line Co.*, 31 FERC ¶ 61,377, at p. 61,838 (1985); *see also Kuparuk Transp. Co.*, 55 FERC ¶ 61,122, at p. 61,383 n.93 (1991)(Commission may rely on evidence outside the test period if necessary to achieve a rational result).

[70] 71 FERC ¶ 61,338, at p. 62,313 (citations omitted).

V. RATE BASE

A. Introduction

There are several issues involving the rate base for SFPP.

Section 1(5) of the Interstate Commerce Act requires that rates for oil pipeline transportation be just and reasonable.[71] Before 1977 oil pipeline rates were subject to the jurisdiction of the Interstate Commerce Commission ("ICC"). The ICC, in setting oil pipeline rates, used a traditional cost of service approach.[72] However, the ICC's methodology allowed a return on a Valuation Rate Base ("VRB"), which represented a mixture of both original cost and reproduction cost.[73]

In 1977 jurisdiction over oil pipeline regulation was transferred from the ICC to the FERC pursuant to the Department of Energy Organization Act.[74] *Williams Pipe Line Co.* ("Opinion No. 154")[75] represented FERC's first attempt to articulate the regulatory ratemaking standards to be applied to oil pipelines. In Opinion No. 154 FERC adopted the VRB methodology previously used by the ICC.[76] In 1983 FERC denied rehearing of Opinion No. 154.[77]

In 1984 the Court of Appeals for the District of Columbia Circuit held that the Commission's Order in Opinion No. 154 contravened the Commission's statutory responsibility to ensure that oil pipeline rates are just and reasonable.[78] The court set forth five "basic guideposts" for the Commission to use in formulating a regulatory ratemaking policy: (1) oil pipeline rates must fall within a zone of reasonableness as required by the ICA; (2) presumed market forces may not constitute the principal regulatory constraint; (3) any departure from cost-based rates may be made only when the non-cost factors are clearly identified, and the alternate ratemaking methods ensure that the resultant rate levels are justified by those factors; (4) the rate of return methodology employed should take account of the risks associated with the regulated entity; and (5) both rate base and rate of return methodologies must be carefully scrutinized to see that they will operate together to produce a just and reasonable rate.[79] The Court of Appeals then remanded the case to the Commission.[80]

The Commission responded to the Court of Appeals in *Williams Pipe Line Co.*[81] ("Opinion No. 154-B"). In Opinion No. 154-B, the Commission adopted net depreciated trended original cost ("TOC") as the model for calculating an oil pipeline's rate base and capital-related components of revenue requirements, rather than its traditional net depreciated original cost ("DOC").[82]

The Commission described TOC in Opinion No. 154-B:

> TOC works as follows. First, TOC, just like net depreciated original cost, requires the determination of a nominal (inflation-included) rate of return on equity that reflects the pipeline's risks and its corresponding cost of capital. Next, the inflation component of that rate of return is extracted. This leaves what economists call a "real" rate of return. The real rate of return times the equity share of the rate base yields the yearly allowed equity return in dollars. The inflation factor times the equity rate base yields the equity rate base write-up. That writeup, like depreciation, is written-off or amortized over the life of the property.[83]

The Commission gave the following example of how TOC would be determined:

> Assume a new pipeline with an original equity investment of $1,000. Also assume that a just and reasonable overall rate of return on equity would be 16 percent and that 7 percent of that represents inflation. This leaves 9 percent as the so-called "real" rate of return. In its first year of service, the pipeline would be entitled to earn $90 (9 percent times $1,000) and $70 (7 percent times $1,000) would be capitalized into its equity rate base to be amortized over the life of the property starting in the first year, along with the depreciation on the $1,000. If that life were twenty years, in addition to the return of $90, the pipeline would be entitled to recover, in the first year, $3.50 as

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[71] Section 1(5) of the ICA states in part:

> All charges made for any service rendered or to be rendered in the transportation of...property...or in connection therewith, shall be just and reasonable, and every unjust and unreasonable charge for such service or any part thereof is prohibited and declared to be unlawful. 49 U.S.C. app. § 1(5).

[72] Ex. 1 at p. 5.

[73] *Id.*

[74] 42 U.S.C. § 7101, *et seq.* (1994).

[75] 21 FERC ¶ 61,260 (1982).

[76] 21 FERC ¶ 61,260, at p. 61,632.

[77] 22 FERC ¶ 61,086 (1983).

[78] *Farmers Union Cent. Exchange, Inc. v. FERC*, 734 F.2d 1486, 1490 (D.C. Cir.), *cert. denied sub nom. Williams Pipe Line Co. v. Farmers Union Cent. Exchange, Inc.*, 469 U.S. 1034 (1984) ("*Farmers Union II*").

[79] 734 F.2d at 1530.

[80] *Id.*

[81] 31 FERC ¶ 61,377 (1985).

[82] 31 FERC ¶ 61,377, at p. 61,833.

[83] 31 FERC ¶ 61,377, at p. 61,834 (citations omitted).

amortization ($70 divided by 20), $50 as depreciation ($1,000 divided by 20), its embedded debt cost, and depreciation associated with debt investment. This process would continue over the life of the property until the rate base (assuming no salvage value) hit zero. Unless changed in a rate case, the real rate, which should be relatively stable, would be 9 percent each year. The inflation rate would vary as the chosen inflation index varies.[84]

The Commission then went on to say:

> It is important to emphasize that TOC and net depreciated original cost are ... essentially the same except for their treatment of inflation. TOC reflects inflation through an automatic adjustment to rate base. Net depreciated original cost reflects estimated inflation in the nominal rate of return. This difference between them results in a different timing of the recovery of the cost of equity capital, when inflation exists, over the life of the property. But, ... "[t]heoretically, TOC results in the same discounted value of the earning stream for the investor as does 'untrended' original cost."
>
> * * *
>
> The Commission adopts TOC over net depreciated original cost because it is a theoretically acceptable alternative that after the switch from valuation will help newer pipelines with higher rate bases to compete with older pipelines with lower rate bases and will help them compete with other modes of oil transport and so will tend to foster competition generally. This is so because TOC mitigates the front-end load problem for new pipelines.[85]

While TOC and DOC differ in certain important respects, both are designed to achieve a common purpose: a pipeline's cost of service is the sum of all prudently incurred costs of operation, including a reasonable return on the appropriate rate base, and amounts sufficient to recover prudently-invested capital.[86]

In moving from the ICC's VRB methodology to the TOC methodology, the Commission had to create a one-time adjustment to rate base to "bridge" the gap between DOC and the ICC's VRB for oil pipelines' existing assets as of December 31, 1983. This new rate base under TOC, beginning in 1984, is referred to as a pipeline's Starting Rate Base ("SRB"), and the one time adjustment to a level in excess of a DOC base is referred to as the SRB Write-up.[87]

B. Determining Rate Base Under Opinion No. 154-B

The starting point for the rate analysis in this case is the rate base calculation under the Opinion No. 154-B methodology. Unlike the traditional depreciated original cost ("DOC") methodology used in natural gas and electric rate cases, the 154-B rate base is a dynamic structure that requires both a build-up and separate amortization over time because of the combined impacts of the SRB write-up and the calculation of the deferred return each year on the rate base.

Because of the dynamic nature of the rate base calculation, it is important that each element of the calculation be computed properly. Any distortion not only ripples through each year's calculation, but also has a multiplier effect on the calculation in subsequent years. Any overstatement of an element of the 154-B calculation gets magnified and over time results in rates higher than those that would result from a proper application of the 154-B methodology.

SFPP witness Jessen specifically recognized this ripple effect. On cross-examination he acknowledged, for example, that any overstatement in the computation of deferred return would result in an overstatement in the return calculation that would ripple through the cost-of-service calculation.[88] In particular, such an overstatement would result in an excess of accrual of deferred earnings that, in subsequent years, would result in an overstatement of amortization of deferred earnings—a cost of service item; an overstatement of the real return on equity allowance; an overstatement of any tax allowance; and a further overstatement of deferred return on the overstated deferred earnings.

Under the Commission's Opinion No. 154-B methodology, the starting point for developing a pipeline's SRB is the pipeline's rate base as it existed on December 31, 1983.[89] This calculation is mechanical, the formula being defined by the Commission in Opinion No. 154-B as:

> the sum of a pipeline's debt ratio times book net depreciated original cost and the equity ratio times the reproduction cost portion of the valuation rate base depreciated by the

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[84] *Id.* (citations omitted).

[85] *Id.* (citations omitted).

[86] Ex. 1 at p. 7.

[87] Opinion No. 154-B, 31 FERC ¶ 61,377, at pp. 61,833-34. The Commission also referred to SRB as being a "transition rate base." 31 FERC ¶ 61,377, at p. 61,835.

[88] Tr. 11076-78.

[89] 31 FERC ¶ 61,377, at p. 61,839 n.40.

same percentage as the book original cost rate base has been depreciated.[90]

The amount derived from that calculation, added to the carrier's original cost of land, rights of way less book depreciation, working capital and plant not included in the 1983 valuation at cost less book depreciation, yields the total SRB used for ratemaking.[91]

The Commission believed this formula would be a "middle ground" between valuation and net depreciated original cost, but noted that the factual situations of the ninety pipelines it regulates could be expected to differ, and therefore in a particular rate case a participant could raise the issue of the appropriateness of a starting rate base achieved by application of the aforementioned formula.[92]

In the instant case, there is no dispute that this formula must be used to calculate SRB. However, the SRB calculated by SFPP differs from the SRB calculated by the other participants because of several factors, such as the facilities allocated to the East Line versus the West Line, the fact that some participants included investment attributable to the military laterals while SFPP excluded such investment, and the fact that the participants and SFPP argue for different capital structures to be applied in computing SRB. Those issues are analyzed and resolved separately, *infra*; resolution of those issues should allow the SRB to be computed without any further disagreement among the participants.

C. Appropriate Capital Structure for the SRB Computation

A critical element in calculating SRB is determining the proper capital structure, *i.e.*, the debt/equity ratio. Although, as just noted, the dollar amount of the undepreciated portion of SFPP's valuation rate base and of the undepreciated original cost of carrier property in service to be used in computing the SRB as of December 31, 1983, is not generally in dispute, except for a few items which will be resolved in this initial decision, the capital structure to be used in computing the SRB is in dispute.

The dispute over the capital structure is significant because, in the first instance, it determines the amount of the SRB, and correlatively, the amount of the SRB write-up. The SRB write-up is affected because it is the portion of the SRB, computed pursuant to the Commission's formula, which exceeds the DOC rate base. That excess is totally driven by the percentage of equity in the capital structure. In simple terms, the greater the equity percentage of the capital structure, the more the SRB will exceed the DOC rate base and, consequently, the greater will be the SRB write-up included in the rate base for rate calculations.

The Commission established a general rule in Opinion No. 154-B that where the pipeline itself issues no long-term debt, the capital structure of the parent should be used,[93] and the capital structure used should be the one in effect as of the date of Opinion No. 154-B, *i.e.*, June 28, 1985.[94] However, the Commission in Opinion No. 154-B specifically permitted participants "to urge the use of some other capital structure."[95] Subsequently in Opinion No. 351, the Commission made clear that it was concerned that, as applied in individual cases, the resulting capital structure not be "abnormal."[96] The Commission also made clear that the Commission's central focus in determining the capital structure to be applied to derive the SRB —and, thereby, the SRB write-up—was "whether the capital structure is representative of the pipeline's risks."[97]

1. *Positions of the Participants*

The participants have different approaches to the determination of the appropriate capitalization for the SRB and for the years after December 31, 1983.

As of the date Opinion No. 154-B was issued (June 28, 1985), SFPP's predecessor, Southern Pacific Pipe Lines, Inc., was a wholly owned subsidiary of Santa Fe Southern Pacific Corporation ("SFSP") and the pipeline had no outstanding long-term debt.[98] SFPP's presentation used a 21.71 percent debt/78.29 percent equity SRB capital structure which was SFSP's capital structure as of June 30, 1985. In other words, SFPP used the capital structure of the parent of SFPP's predecessor.[99]

Staff, RHC, and Chevron urge that the SRB should have the capital structure of SFPP when it first became a publicly traded entity on December 19, 1988, when its capital struc-

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[90] *Id.* at p. 61,833.

[91] *See Id.* at p. 61,839 n.40.

[92] *Id.* at p. 61,836 (citations omitted).

[93] 31 FERC ¶ 61,377, at p. 61,836.

[94] *Id.* at n.43.

[95] *Id.* at p. 61,833.

[96] *ARCO Pipeline Company*, 52 FERC ¶ 61,055, at p. 61,233 (1990).

[97] *Id.*

[98] Ex. 142 at p. 7.

[99] SFPP Initial Brief at p. 28; Ex. 311 at p. 6; *see also* Ex. 950 (Second Revised) at Sch. 4.

ture was 60.74 percent debt/39.26 percent equity.[100]

Navajo advocates two alternative methods for determining the capital structure of SRB. Navajo's first method, like Staff's, RHC's and Chevron's, uses a capital structure of 60.74 percent debt/39.26 percent equity. Navajo's alternative method derives an SRB capital structure by averaging SFPP's debt/equity ratio over a seven year period when SFPP was a publicly-traded stand-alone company. The average debt/equity ratio of SFPP for that period is 56.48 percent debt/43.52 percent equity.[101]

The West Line Shippers take the position that SFPP should not be allowed an SRB because "there is no satisfactory basis on which to conclude that SFPP has correctly established the rate base from the beginning at the starting rate base . . . stage."[102] Alternatively, the West Line Shippers "support the position of Commission Staff and the other complainants" if an SRB is allowed.[103]

2. Discussion

Having reviewed the evidence, the arguments of the participants, and the law, I hold that the capital structure of SFPP on December 19, 1988 (*i.e.*, 60.74 percent debt and 39.26 percent equity) should be used in determining SFPP's starting rate base. I reject SFPP's position that the capital structure should be that of SFPP's predecessor's parent, SFSP, on June 28, 1985, the date of Opinion No. 154-B. As noted that capital structure consisted of 21.71 percent debt and 78.29 percent equity.

There are several reasons for this ruling. Among other things, the evidence shows that the capital structure of SFPP's predecessor's parent, SFSP, does not reflect the business risks of SFPP. Also, the use of SFSP's capital structure in this proceeding fails the Commission's "middle ground" test because it results either in a starting rate base above the valuation rate base, or one below the valuation rate base but very close to it if one accepts the calculations of SFPP witness Jessen.[104] There are also other reasons for my ruling which will be discussed hereafter.

The question of what capital structure to use in determining the SRB is one of the more important issues in this proceeding because of its dollar impact. One can see from the SRB formula,[105] *supra*, that the debt and equity ratios serve as the weights that are applied to the original cost and reproduction cost amounts. Since reproduction cost can be expected to be higher than original cost, the greater the weight that is applied to reproduction cost, the higher the SRB will be. The impact on SFPP's tariffs, however, goes beyond the initial size of the SRB. Capital structure is also a factor in post-SRB adjustments to the rate base and in the determination of deferred earnings in the TOC methodology.

In determining an appropriate capital structure, the Commission has stated:

> In setting the return on capital, we must first determine the capital structure. The cost of capital borne by the ratepayers is determined both by the allowed rate of return on capital and the composition of the capital structure to which the rate of return is applied. Because of differences among the costs of debt, equity, and preferred and because only interest costs are deductible for income taxes, the capital structure directly affects the cost of capital, as well as the income tax allowed in the cost of service. Consequently in setting just and reasonable rates, it is necessary to ensure that the rates are based on, *inter alia*, a reasonably balanced capital structure that reflects the risk of the regulated utility.[106]

The concern of the Commission in the natural gas cases, that capital structures be appropriately chosen because of the impact on rates, has even greater significance when setting the SRB for an oil pipeline. As noted above, the SRB capital structure has an even greater impact on rates than the rate of return capital structure determined in the usual natural gas rate case, simply because of the reverberating and cumulative effect the SRB capital structure has over the years.

In 1978 the Commission, in a gas pipeline rate case, issued its most comprehensive statement of how the capital structure issue should be evaluated when there is a parent-subsidiary relationship:[107]

> The capital structure of subsidiary operations should not be accepted for use in rate

[100] *See* Ex. 101 at p. 9; Ex. 104 at p. 2 of 2.

[101] *See* Ex. 529 at Sch. 8, p. 1 of 4, lines 1 and 2 (1988 Column) and Sch. 8, p. 3 of 4, lines 1 and 2 (1989-94).

[102] Reply Brief at p. 2.

[103] Reply Brief at p. 5.

[104] *See* Ex. 238 at pp. 44-45.

[105] 31 FERC ¶ 61,377, at p. 61,839 n.40.

[106] *Consolidated Gas Supply Corporation*, 24 FERC ¶ 61,046, at p. 61,133 (1983); *see also Transwestern Pipeline Company*, 59 FPC 797, 800 (1977) ("In general, the capital structure used to arrive at the overall rate of return should represent the prospective capital structure of the utility consistent with the risk profile of its operations.")

[107] *Kentucky West Virginia Gas Company*, 2 FERC ¶ 61,139, *reh'g denied*, 3 FERC ¶ 61,255, *reconsideration denied*, 4 FERC ¶ 61,171 (1978).

determinations without some showing that it is reasonably reflective of the risks of those operations and independent of the parent company's actions relating to its other operations.[108]

* * *

In summary, where the subsidiary is wholly financed by the parent or where the subsidiary's capital structure is atypical, we must impute a capital structure to the subsidiary. We will, in that instance, look first to determine whether the risks facing the parent and subsidiary are substantially similar and, if so, impute the consolidated capital structure to the subsidiary together with the parent's overall cost of capital and the parent's cost of debt and preferred so long as this does not result in rates that are not just and reasonable. Where the risk is not essentially the same, we will look to the average capital structure of comparable independent firms.[109]

As noted, in Opinion No. 154-B the Commission adopted for oil pipelines the capital structure policy it had developed for gas pipelines.[110] The Commission made two statements in Opinion No. 154-B which have significance here. First, it expressed a policy of using actual capital structures rather than hypothetical ones.[111] Second, the Commission said it would "... allow participants on a case-specific basis to urge the use of some ... capital structure" other than that of the pipeline or its parent.[112]

The capital structure of SFPP's predecessor in 1985 was 100 percent equity, and it remained so until SFPP was created and began to be publicly traded in December of 1988. No participant argues for the use of a 100 percent equity capital structure for SFPP.

We therefore look at the capital structure of SFPP's predecessor's parent in accordance with the *Kentucky West* guidelines.[113] Before using such a capital structure, however, it is necessary to establish that the parent's business risks were comparable to SFPP's business risks.[114] The capital structure of the parent is not appropriate to use for developing the SRB of SFPP because that capital structure reflects the parent's higher risk and generally unregulated businesses, particularly trucking and railroads, both of which are subject to significant intermodal and intramodal competition.[115] On the other hand, as a monopoly transporter of oil with effectively no competition, SFPP has a very low business risk, particularly when compared to its parent.

According to the Initial Decision in *Southern Pacific Pipe Lines, Inc.*,[116] the parent's, *i.e.* SFSP's, 1985 annual report to stockholders showed that rail and truck revenues comprised 72.85 percent of total revenues, while total pipeline revenues comprised only 3.25 percent of total revenues. In that case Judge Howe found that SFSP's investment portfolio was "dominated by nonpipeline operations like railroading and mineral exploration."[117] He therefore concluded that the risks of the parent and its subsidiary were not comparable, and that the use of another capital structure was necessary.[118]

I conclude that neither the capital structure of SFPP's predecessor's parent nor that of its predecessor is appropriate for SFPP. I therefore must determine an appropriate capital structure for SFPP. One possibility is to use gas pipeline capital structures as a surrogate in deriving a stand-alone capital structure for SFPP since the gas pipeline industry possesses the characteristics that most closely approximate the characteristics of the oil pipeline industry.[119] Another possible benchmark would be to use the average capital structure of the six publicly traded oil pipeline partnerships.[120]

However, in the final analysis, I agree with Staff witness Manganello who concluded that

[108] 2 FERC ¶ 61,139, at p. 61,325.

[109] *Id.* at p. 61,327.

[110] 31 FERC ¶ 61,377, at p. 61,836.

[111] *Id.*

[112] *Id.* at p. 61,833.

[113] The capital structure for the parent of SFPP's predecessor in June of 1985 consisted of 21.71 percent debt and 78.29 percent equity. Ex. 101 at p. 7.

[114] *See ARCO Pipe Line Company*, 52 FERC ¶ 61,055, at p. 61,233 (1990); *Transcontinental Gas Pipe Line Corporation, order on remand*, 71 FERC ¶ 61,305, at pp. 62,192-95 (1995).

[115] Ex. 101 at p. 8. *See also Colorado Interstate Co.*, 41 FERC ¶ 61,179, at p. 61,456 (1987); *Arkansas-Louisiana Gas Co.*, 31 FERC ¶ 61,318, at p. 61,730 (1985); *Tennessee Gas Pipeline Co.*, 25 FERC ¶ 61,020, at p. 61,095 (1983) (risk to the regulated business is generally less than the non-regulated business).

[116] 39 FERC ¶ 63,018, at p. 65,081 (1987).

[117] *Id.* at p. 65,086.

[118] *Id.*

[119] The average capital structure for major gas pipelines consisted of 45 percent debt and 55 percent equity in 1986. *ARCO Pipe Line Company*, 52 FERC ¶ 61,055, at p. 61,243 n.56 (1990), *order on reh'g*, 53 FERC ¶ 61,398 (1990).

[120] The average and median capital structures for the oil pipeline partnership group were effectively the same at the end of 1993 and 1994, ranging from about 49 to 52 percent equity. *See* Ex. 104, page 4 of 4 and Ex. 284, page 2 of 2.

in determining SFPP's starting rate base the best option was to use the capital structure of SFPP when it first became publicly traded on December 19, 1988.[121] While one might contend that this is a hypothetical capital structure, it is not; it has the virtue of being SFPP's initial, actual capital structure, and one that was chosen by its own management in the 1988 recapitalization.[122] Under these circumstances, the use of SFPP's own capital structure at December 19, 1988 is the best option for purposes of determining the SRB. This is the first time that one can have some confidence that the subsidiary's actual capital structure reasonably reflected its business risks.

There is another important reason for rejecting SFPP's SRB calculation: the capital structure used by SFPP in calculating SRB results in a SRB that fails the Commission's "middle ground" test. The Commission considered its SRB concept as a "middle ground" between the "flawed" valuation rate base and one based on depreciated original cost (DOC).[123] There is a dispute among the participants as to what the phrase "middle ground" means and how it should be interpreted. SFPP witness Jessen believes that the Commission was referring to a "methodological" middle ground and that it did not intend to restrict the SRB to any particular range.[124] By contrast, the Staff and other participants argue that a more sensible interpretation is that the Commission's intent was to have the SRB fall somewhere near the middle of the range between the valuation rate base and the original cost rate base.[125]

To restate the issue, is the Commission's test met as long as the SRB comes any place between the valuation rate base and a depreciated original cost rate base, or is it preferable to have the SRB come closer to the middle of the range? SFPP's position apparently would tolerate an SRB that was just one dollar below the valuation rate base, while the Staff and other participants argue that the "middle ground" should be interpreted to mean that an SRB falling somewhere near the middle of the range is preferable, particularly if a choice needs to be made among more than one proposed SRB.

Staff witness McCelland computed a South System SRB of $55,703,090,[126] based on SFPP's actual capital structure on December 19, 1988; SFPP witness Jessen's calculation, based on the parent's capital structure, produced a South System SRB of $70,678,000.[127] These SRB results effectively were dictated by the capital structures used, as discussed above, with Mr. Jessen's higher equity ratio producing a higher SRB.

Although the Presiding Judge in *Southern Pacific Pipe Lines* found that use of the parent's capital structure was inappropriate because it resulted in an SRB that was higher than the valuation rate base,[128] Mr. Jessen discounted this finding because the data in *Southern Pacific Pipe Lines* was based on the total SFPP company, rather than just the South System.[129] Therefore he computed a valuation rate base of his own just for the South System in the amount of $75,463,720, and it was above his SRB calculation of $70,678,000.[130] Mr. Jessen thus concluded that even the Commission's middle ground test had been satisfied.[131]

Staff witness McCelland computed a South System valuation rate base of $61,455,000 based on numbers submitted in *Southern Pacific Pipe Lines, Inc.* by a company witness.[132] The Staff's derivation was based on the ratio of the South System's net depreciated original cost rate base to SFPP's total net depreciated original cost rate base, multiplied by SFPP's total valuation rate base.[133]

If Mr. McCelland's valuation rate base of $61.5 million is adopted, SFPP's SRB of $70.7 million should be rejected simply because it exceeds the valuation rate base. However, even if Mr. Jessen's valuation rate base of $75.5 million were adopted, SFPP's SRB of $70.7 million is just too close to SFPP's valuation rate base to pass the Commission's middle ground test.

Aside from the use of an inappropriate capital structure, there is another problem with the SRB as developed by SFPP witness Jessen. He did not do a company-wide cost of service,

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[121] SFPP's capital structure when it first became a stand-alone company consisted of 60.74 percent debt and 39.26 percent equity. *See* Ex. 101 at p. 9; Ex. 104, page 2 of 2.

[122] Tr. 9642.

[123] 31 FERC ¶ 61,377, at p. 61,836.

[124] Ex. 238 at p. 42.

[125] *See, e.g.*, Ex. 101 at p. 7.

[126] Ex. 105 at p. 14; Ex. 106, Schedule 1, n.1 and Ex. 107, Schedule 1, n.1.

[127] Ex. 238 at pp. 44-45; Ex. 241, Schedule 1.

[128] *Southern Pacific Pipe Lines, Inc.*, 39 FERC ¶ 63,018, at p. 65,081.

[129] Ex. 238 at p. 44.

[130] Ex. 238 at p. 45; Ex. 241, Schedule 1.

[131] Ex. 238 at p. 45.

[132] Ex. 105 at p. 14.

[133] *Id.* at p. 15.

including rate base, with allocations to all services, carrier and non-carrier. Instead, he attempted to develop for litigation purposes a "starting rate base" for SFPP's South System, based on the Commission's valuation order in *Southern Pacific Pipe Lines, Inc.*, Valuation Docket No. PV-1393-000 (March 28, 1985).[134] That valuation order reviewed all the property held by SFPP's parent on a state by state basis.[135] No separate calculation was performed for SFPP's South System.[136] No separation of interstate and intrastate facilities in California was conducted.[137] Instead, ten years after the valuation order was issued, Mr. Jessen attempted to create a new SRB for the South System.[138] In doing so, Mr. Jessen appears to have employed 1993 throughput data to separate interstate and intrastate facilities in California, and to have imputed those results back to calendar year 1983.[139] In addition, no effort seems to have been made to reconcile Mr. Jessen's separation of California interstate and intrastate facilities with any data filed by SFPP with the California Public Utilities Commission.[140]

While the SRB capital structure issues should rely generally on the same policy considerations that determine capital structures in the Commission's gas cases, there is a feature in oil pipeline cases that distinguishes the SRB determination from determining a rate base in the usual Commission gas rate case.

In gas rate cases where the Commission has been faced with capital structures with unduly "thick" equity ratios, the Commission has stated that it could accept a thick equity ratio because the Commission could lower the allowed rate of return (rather than use a hypothetical capital structure) to ameliorate the impact on ratepayers.[141] However, in a situation involving the determination of an SRB, there is no comparable compensating option available to the Commission. The ratepayers will have to bear the full brunt of an SRB computed by using too high an equity ratio.

For all of the above reasons I conclude and hold that the capital structure of SFPP on December 19, 1988 (*i.e.*, 60.74 percent debt and 39.26 percent equity) shall be used in determining SFPP's starting rate base.

D. The Appropriate Capital Structure for Post-SRB Rate Base Adjustments

For post-1983 determinations of the deferred return on equity and the appropriate returns on the debt-financed and equity-financed portions of rate base, I hold that the appropriate capital structures for SFPP shall be: (1) 60.74 percent debt and 39.26 percent equity for the years 1984 through December 31, 1988, and (2) SFPP's actual capital structure for each year after December 31, 1988.

The reasons for this ruling are discussed hereafter.

For post-SRB rate base adjustments, *i.e.*, capital additions placed in service on and after January 1, 1984, no special treatment is contemplated by the methodology of Opinion No. 154-B. Rather, the original cost of the investment is added to the rate base and subject to depreciation. The only difference as to this investment between the DOC rate methodology and the TOC methodology engrafted into the Opinion No. 154-B methodology is that some portion of the nominal return on equity is deferred and separately accounted for in a deferred equity return account.

SFPP does not use the approach contemplated by the Commission under Opinion No. 154-B. Instead, SFPP employs a so-called "layering" approach, whereby it freezes the equity component of each year's investment after the SRB period to determine the portion of that year's investment attributable to its equity rate base. For future computational purposes, SFPP maintains the original division of the investment dollars into debt and equity based on the capital structure in place at the time of that original investment despite subsequent changes in SFPP's capital structure. Thus, in computing its equity rate base for a particular year, SFPP uses a "layered equity" component, tying the equity component back to the capital ratio existing in the year of the investment rather than the capital ratio in effect during the year being examined.

This layering effect can be seen on Mr. Jessen's Exhibit 950, Schedule 8, Page 3 of 4 ("Development of South System Composite Capital Structure"). To develop what he called the "Composite Capital Structure," Mr. Jessen totals the Carrier Property In Service with "In

[134] Ex. 238 at p. 44; Ex. 290 at p. 7.

[135] Ex. 241 at pp. 1 of 3 and 2 of 3.

[136] Ex. 238 at p. 44; Ex. 290 at p. 7.

[137] Ex. 290 at p. 7.

[138] Ex. 238 at p. 44.

[139] Tr. 10843-59. Mr. Jessen's testimony on cross-examination appears to be inconsistent with his deposition testimony. Ex. 776 at pp. 50-51.

[140] *See* Ex. 924; Ex. 290 at p. 7; Ex. 776 at p. 47.

[141] *See, e.g., Arkansas-Louisiana Gas Co.*, 31 FERC ¶ 61,318, at p. 61,728. ("... the Commission has held...that the return on equity approved for a pipeline can be developed with consideration given to the particular capital structure of the pipeline.")

Service Dates" for each year. For 1993, the total is $494,805.[142] Then, for each year, he takes the figure for Carrier Property In Service and multiplies it by the debt ratio for that year as indicated in the Source column of Exhibit 950, Schedule 8, page 4 of 4. The resulting number represents the debt portion of the Carrier Property in Service for that year. That number is used in every year thereafter; it does not change.[143] For example, the carrier property that was put in service in 1989, $83,087 (Ex. 950, Schedule 8, p. 3 of 4, line 11), is multiplied by SFPP's debt ratio in 1989, 56.53 percent (Ex. 950, Schedule 8, p. 3 of 4, line 1) to get the resulting debt portion of carrier property, $46,970.[144] That number is used every year thereafter, regardless of what SFPP's capital structure was in each year thereafter.

That process is then repeated and the results are totaled to arrive at the 1993 "Weighted" Carrier Property in Service-Debt, $179,925, which appears on Exhibit No. 950, Schedule 8, Page 4 of 4, line 28, 1993 Column. When that number is divided by the total Carrier Property in Service for 1993, $494,805[145], the Weighted Debt Rate for 1993, 36.36 percent results.[146]

The "Weighted Carrier Property in Service-Debt" is not the Original Cost Rate Base derived by SFPP of $150,159 for 1993, shown in Exhibit 950 on line 17 of Schedule 4, Page 2 of 2. Nor is it the "Debt Rate Base" of $54,602, set out on line 19 of that same schedule. And it is not the "Debt Portion of Subtotal," reflected in Exhibit 950 on line 8 of Schedule 2, used in deriving the "Weighted Cost of Capital" on that schedule.

Similarly, the "Weighted Debt Rate"[147] (36.36 percent) is not the Book Debt Capital Structure (57.18 percent), reflected in Exhibit 950 on Schedule 2 at line 6, nor the "Adjusted Debt Capital Structure," (48.09 percent) shown on line 12 of Schedule 3.

What is happening with SFPP's calculations is that an artificially high, and separate, equity rate base is being created for purposes of computing deferred return and converting non-taxable interest expense into taxable return to increase the claimed tax allowance. This fact is demonstrated by the subsequent use of the "Weighted Debt Rate." The percentage so computed is used solely to determine that, through layering, the "Weighted Debt Rate" constitutes 36.36 percent of Carrier Property in Service-Debt. Once the Carrier in Property in Service-Debt ($179,925) has been used to derive that percentage of 36.36 percent, the "Weighted Carrier Property in Service-Debt" number of $179,925 is discarded. But the percentage derived from it lives on, spreading throughout SFPP's remaining rate base calculation and influencing the results.

The first use by SFPP of the 36.36 percent debt number in the preceding example is to derive an imputed equity factor, which is 63.64 percent, derived on the basis that 1 minus 36.36 percent = 63.64 percent.[148] With that subtraction a phantom "Weighted" debt/equity ratio of 36/64 is now created for 1993, which appears in the 1993 column, on lines 29 and 30 of Page 4 of 4 of Schedule 8. This is in contrast to the actual 1993 book debt/equity ratio of 57/43, which can be found on lines 1 and 2 of the same schedule. This distortion appears in each and every year.[149]

The now restated "Weighted" equity factor then infects the calculation in Exhibit 950, Schedule 6, p. 2 of 2, line 12, and it is used for the following year, 1994, because of the one-year lagging methodology adopted by SFPP. Thus the 63.64 percent appears as the "Composite Capital Structure-Equity" for the year 1994 in Exhibit 529, Schedule 6, p. 2 of 2, line 12.

If we stay with Exhibit 950, we can see that the "Weighted Equity Rate" determined for 1992 of 64.31 percent (Schedule 8, p. 4 of 4, line 30, column 1992) is reflected on Line 12 of Schedule 6, Page 2 of 2 for 1993. That ratio, rather than the book equity ratio, is then multiplied by the Original Cost Rate Base to determine the Equity Portion of Original Cost Rate Base. Because the "Weighted Equity Rate" of 64.31 percent for 1992, used in this calculation by Mr. Jessen on a Beginning of Year basis,

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[142] Ex. 950, Schedule 8, p. 3 of 4, line 16, 1993 column. All numbers in this example, like the numbers in the schedules and exhibits being tracked, have three zeros omitted.

[143] Minor changes in the totals for the early years are present. *See e.g.*, Ex. 950, Schedule 8, p. 4 of 4, line 17. Presumably this is a result of property retirements and the like.

[144] Ex. 950, Schedule 8, p. 4 of 4, line 23, column 1989.

[145] Ex. 950, Schedule 8, p. 3 of 4, line 16, column 1993.

[146] Ex. 950, Schedule 8, p. 4 of 4, line 29, column 1993.

[147] *Id.*

[148] Ex. 950, Schedule 8, p. 4 of 4, line 30 ("Source" column).

[149] *Compare* lines 29 and 30 of p. 4 of 4, Schedule 8, Ex. 950, *with* lines 1 and 2 of p. 3 of 4, Schedule 8, Ex. 950.

exceeds by 46 percent the book equity ratio for 1992 of 44.0 percent,[150] the result of this substitution of equity factors is to increase what should be the Beginning of Year Portion of Original Cost Rate Base from $65,844 to the $96,239 shown on Exhibit 950 of Schedule 6, line 13, for 1993, an increase of $30,395 for purposes of the deferred equity computation. When this calculation is combined with the earlier distortions resulting from the use in prior years of the same approach, the result is a "Weighted Deferred Earnings Equity Capital Structure" of 27.43 percent debt and 72.57 percent equity in 1993,[151] when SFPP itself reflects an actual capital structure of 57.2 percent debt and 42.8 percent equity for that year.[152] Like the Weighted Carrier Property in Service-Debt" this "Weighted Deferred Earnings Equity Capital Structure" and related rate base applications stand apart and different from the numbers used for the calculation of the real return on equity and reflected as the "Equity Portion of Subtotal" on line 9 of Schedule 2 of Exhibit 950 or reflected as either the book equity percentage or the adjusted equity percentage on lines 7 and 13 of Schedule 2 of Exhibit 950.[153]

Thus, this complex methodology ultimately generates significant increases in current earnings, deferred earnings, amortized deferred earnings, and the income tax allowance. How this is reflected is addressed *infra.*

Under the approach set out by Navajo's and Chevron's witness Horst, no such layering occurs. Rather the amount of the carrier property placed in service is added to the rate base, and the actual book debt/equity ratio is applied to determine the return components, whether it be the debt return component, the equity return component or the deferred return component. No multiple rate bases, phantom debt/equity ratios built upon other phantom debt/equity ratios, or disappearing rate bases are required. Mr. Horst simply applies each year's capital structure to the entire rate base.

Mr. Horst illustrated his approach beginning at Transcript page 3595 and by referring to his Exhibit 592.[154] He also contrasted his methodology with that of SFPP witness Jessen. Mr. Horst pointed out that a critical difference between his methodology and that of SFPP witness Jessen occurs at lines 17 and 18 in the 1988 column of Exhibit 592, where Mr. Horst uses the actual equity ratio of 40 percent for SFPP for 1988 whereas SFPP witness Jessen uses a higher equity ratio. Tr. 3599-3600. This difference "ripples down" through the calculations of the inflation write-up, the deferred return, and other things. Tr. 3604. A second point of significant difference between witnesses Horst and Jessen lies in their use of different formulae for calculating interest expense. Tr. 3609.

In dealing with SRB in Opinion No. 154-C, the Commission rejected a "layering" approach such as the one used by SFPP, whereby the capital structure attributes of an investment are permanently frozen. As it there stated:

> Third, Justice argues that the capital structure used to determine the starting rate base should be permanent . . . .
>
> We disagree. The starting rate base freezes only the dollars in that base. As with other regulated companies, capital structure may change from time to time.[155]

In short, there is nothing that is intended to be dramatically different between a rate base calculated under the Opinion No. 154-B methodology and one calculated under other rate base methodologies, such as DOC. There are differences: SRB is calculated as a method of transitioning from the old valuation methodology used by the Interstate Commerce Commission to the new TOC methodology used in the Opinion No. 154-B methodology; and there is a deferred equity return account capturing the deferred return allowance because only the real return on equity is allowed currently, as opposed to the nominal return on equity being allowed currently under the DOC methodology. But the resulting rate base, exclusive of the deferred equity return account, is subject to and follows the changes in a regulated company's capital structure that occur from time to time.

Thus each year's investment becomes part of the rate base and is subject to depreciation. The undepreciated portion of the rate base is

[150] Ex. 1 at p. 20; Ex. 4.

[151] Ex. 950, Schedule 6, p. 2 of 2, line 26, column 1993.

[152] Ex. 4, column 7.

[153] Witness Hass, testifying on behalf of Chevron, EPR and RHC, commented on the methodology of SFPP witness Jessen, and concluded that, as a result of the allocation method Mr. Jessen chose, his layering method, and the treatment of the SRB write-up entirely as equity, the "starting rate base...is implicitly only less than 9 percent debt and more than 91 percent equity." Tr. 4133. SFPP did not refute this statement and seems to recognize the truth of the statement in its Reply Brief at page 25, although SFPP argues that the cause of that result is due solely to treating deferred earnings as equity, which Opinion No. 351-A requires.

[154] The page of Exhibit 592, entitled "Illustration of FERC 154- B Calculations," is a revision of Exhibit 44.

[155] *Williams Pipe Line Co.*, 33 FERC ¶ 61,327, at p. 61,640 (1985).

entitled to earn a return at a weighted cost of capital determined by reference to the capital structure of the regulated company at the time the computation is performed. SFPP's attempt to make the process something more than that is an attempt to increase the return, tax, and amortization components, and thereby its cost of service.

I therefore reject SFPP's layering method, as set forth in the testimony and exhibits of witness Jessen. My ruling is that the methodology used by witness Horst shall be used for post-SRB rate base adjustments.

E. The SRB Write-Up and Deferred Return

Two rate base topics merit further discussion: the calculation of the SRB Write-Up and the calculation of the Deferred Return.

1. *SRB Write-Up*

As noted earlier, SFPP's starting rate base includes a "write-up." In Opinion No. 351, the Commission explained what the "SRB write-up" represents:

> [T]he Commission adopted a starting rate base for oil pipelines which consists of the sum of a pipeline's debt ratio times book net depreciated original cost and the equity ratio times the reproduction cost portion of the valuation rate base depreciated by the same percentage as the book original cost rate base has been depreciated. The resultant rate base is higher in dollars than a pipeline's net depreciated original cost of its assets. *The difference between the starting rate base and net depreciated original cost is known as the write-up in starting rate base.*[156]

No participant contests inclusion of the write-up in the SRB. The issue here involves how to amortize the write-up.

Once the SRB write-up is ascertained, it must be amortized.[157] The length of the amortization period is disputed. The position of Navajo, Chevron, RHC and Staff is that the SRB write-up should be amortized over the fixed remaining life of carrier property in existence on December 31, 1983. SFPP, in contrast, seeks to amortize the write-up over the variable remaining life of carrier property, which would result in the SRB write-up becoming a permanent fixture in SFPP's rate base unless and until the carrier property is fully amortized.

The SRB write-up is intended to be a transition mechanism from the former ICC calculation methodology to the TOC methodology incorporated into the Opinion No.154-B model. In Opinion No. 351-A the Commission stated, "The write-up is a transitional measure which should be decreased over time."[158] Therefore the SRB write-up is amortized, although the amortization amount is not included in a pipeline's cost-of-service[159] because "[t]he starting rate base was adopted for the purpose of determining return *on* and not *of* capital."[160]

So long as the SRB write-up exists, however, the pipeline is earning both real and deferred return on both its traditional rate base *and* on the unamortized portion of the SRB write-up which is attributable to the transition from the old ICC valuation methodology to the FERC TOC methodology. This phenomenon occurs because the unamortized portion of the SRB write-up is included in the rate base. This treatment should be compared to the treatment of any investment made by a pipeline after 1983: that investment is included in rate base only at original cost and depreciated solely on the basis of original cost. The difference between post-1983 investment between DOC and TOC ratemaking is that under DOC ratemaking the current return on equity on the remaining undepreciated original cost is computed at the nominal rate of return on equity while TOC ratemaking calculates the current return on equity on the undepreciated remaining original cost at the real rate of return on equity.[161] For post-1983 investment, no write-up of the original investment occurs either under the DOC methodology or under the TOC methodology incorporated into the Opinion No.154-B methodology.

With this background we turn to the issue of the amortization of the SRB write-up. As noted, the Commission viewed the SRB write-up, a value in excess of undepreciated original cost, as a transition mechanism. A transition mechanism is not transitional if it becomes permanently embedded as a part of the rate base. In Opinion No. 351 the Commission rejected the argument that the SRB write-up

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[156] 52 FERC ¶ 61,055, at p. 61,236 (emphasis added).

[157] Opinion No. 351-A, 53 FERC ¶ 61,398, at p. 62,386.

[158] *Id.*

[159] *Id.* at pp. 62,385-86; 52 FERC ¶ 61,055, at p. 61,237; Ex. 42 at p. 11.

[160] 53 FERC ¶ 61,398, at p. 62,385 (emphasis added).

[161] As explained further, *infra*, under the TOC methodology, the difference between the real rate of return and the nominal rate of return on the remaining undepreciated original cost of the asset is captured as deferred return and put into a separate deferred return account for future ratemaking purposes.

should be a permanent part of rate base and emphasized that the write-up was to be only transitional.[162] Thus the approach of Navajo, Chevron, RHC and Staff examines the remaining life of the pipeline on December 31, 1983 and amortizes the SRB write-up over that remaining life.[163] New investment *i.e.*, investment made on and after January 1, 1984, which would extend the remaining life of the pipeline, does not affect amortization of the SRB write-up. This amortization approach is consistent with the SRB write-up's function as a transition mechanism rather than a mechanism for recovery of capital.

By comparison, SFPP advocates a methodology for amortizing the SRB write-up that renders the SRB write-up a permanent element of the pipeline's rate base, in direct contravention of the Commission's holding in Opinion No. 351. SFPP effects this result by making the amortization period for the SRB write-up coextensive with the remaining depreciable life, *i.e.*, the "variable remaining life," of the pipeline.[164] As Dr. Horst explained, the "variable remaining life" method "allows the remaining life over which the SRB write-up is amortized to be continually extended as additional investments in carrier property are made."[165] For example, under that method the remaining life upon which Mr. Jessen bases his amortization of the SRB write-up in 1984 is 18.86 years.[166] Nine years later, in 1993, he bases his amortization of the SRB write-up on a variable remaining life of 25.87 years.[167] Obviously, under this method, the SRB write-up will never be amortized to zero, but rather will continue as a component of SFPP's rate base until the remaining life of the entire pipeline is zero. SFPP thereby embodies the SRB write-up as a permanent element of its rate base, in direct contravention of the Commission's holding in Opinion No. 351 that the SRB write-up is a transition mechanism.

SFPP's approach is rejected. It is held that the SRB write-up must be amortized using the fixed remaining life of carrier property as of December 31, 1983.

2. Deferred Return

Related issues involve the calculation and amortization of SFPP's deferred return component under Opinion No. 154-B. (The deferred return component is also referred to by the participants as the "deferred earnings component.")

a. *The Amount to Which the Inflation Component is Applied*

Navajo's and Chevron's witness Horst applies the inflation component of the deferred return to the equity portion of the rate base used in computing return. His computation is illustrated in Exhibit 561. The deferred return for 1994 for the East Line, for example, is calculated on Schedule 5 of that exhibit. There Dr. Horst takes the total rate base, without deferred return (line 7), and multiplies it by the equity ratio for 1994, as reported by SFPP's witness Mr. Jessen (line 8). The result is the equity portion of the rate base (line 9). He then adds the 1993 deferred return amount (line 10) to arrive at a total equity rate base. The inflation component of 2.6 percent (line 12) is applied to that total equity rate base, and the result is the 1994 "contribution" to the deferred return account (line 13). When added to 1993's running total of accumulated deferred return (line 14), less the 1994 amortization amount, the 1994 net deferred return results (line 17).

Mr. Jessen does not apply the inflation component to the total equity rate base. Instead, as discussed *supra*, he begins a series of computations through his "layering" approach that derive a series of rate bases, both equity and debt, and equity and debt percentages, that each differ from each other and differ from the debt and equity components of the rate base on which he computes his current rate of return.

The growth of the rate base on which he ultimately computes deferred return is illustrated by tracing through the calculation of deferred return on Mr. Jessen's Exhibit 950. The "Adjusted Equity Portion of Subtotal" on line 11 of Schedule 2, which includes the prior year's net deferred earnings, is $110,492. Under Opinion No. 154-B, the inflation component should be applied to the $110,492 to arrive at the 1993 portion of deferred return. As

[162] Opinion No. 351, 52 FERC ¶ 61,055, at p. 61,237. ("Last, the write-up should not be permanent even though it is not amortized as an expense. This is because the ICC depreciated valuation for return purposes despite computing depreciation solely on original cost."). *See also* Opinion 351-A, 53 FERC ¶ 61,398, at p. 62,385.

[163] Ex. 42 at p. 11.

[164] Ex. 365 at p. 15.

[165] *Id.*

[166] Ex. 950, Schedule 9, p. 1 of 2, line 8, 1984 column. Amortization of SRB write-up is calculated on Schedule 7. There Mr. Jessen uses an amortization rate of 5.303 percent. Ex. 950, Schedule 7, p. 1 of 2, line 8, 1984 column. The source for that is Schedule 6, p. 1 of 2, line 6, 1984 column. Schedule 6, line 6 lists 5.303 percent with Schedule 9, line 9 as its source. Schedule 9, p. 1 of 2, line 9, 1984 column contains the 5.303 percent, which is derived from the 18.86 percent year remaining life on line 8.

[167] Ex. 950, Schedule 9, p. 2 of 2, line 8, 1993 column. *See also* Ex. 365 at p. 15.

shown hereafter, the proper inflation component is 2.67 percent. Multiplying $110,492 by the deferred return rate of 2.67 percent yields a deferred return of $2,950.

Instead, Mr. Jessen applies a 1993 inflation factor of 2.70 percent to a "Trending Base" of $157,224 resulting in a deferred return of $4,245.[168] Thus, SFPP computes its deferred return on a base 42.3 percent larger than that on which it computes its real return, with a resulting difference in deferred return of $1,295 (*i.e.* 4245 − 2950 = 1295). In other words, Mr. Jessen's deferred return is 42.3 percent greater than what should be allowed.

This significant overstatement of deferred return pervades SFPP's calculations, as set out on Schedule 6 of Exhibit 950. The result is an overstatement of the equity rate base, an overstatement of the weighted cost of capital, an overstatement of the real return, an overstatement of the adjusted capital structure, an overstatement of the amortization of the deferred return, and an overstatement of the tax allowance claimed by SFPP. Mr. Jessen's method of calculating deferred return is rejected. Instead, the method developed by witness Horst shall be used in computing the amount to which the inflation component is applied. As shown hereafter, the inflation component to be used in the Horst calculation shall be 2.67 percent rather than the 2.6 percent used by Dr. Horst.

b. *Capital Structure for Deferred Return*

Capital structure is relevant to the computation of deferred return because the inflation component is applied to the equity rate base, which is derived using the capital structure, to arrive at the dollar amount of deferred return.[169] The capital structure to be used for computing deferred return should be the same as the capital structure used in the development of SFPP's rate base. For the period ending December 31, 1988 the appropriate capital structure to be used as the basis of the calculation of deferred return is the book capital structure of SFPP when it became a publicly-held, stand-alone company. For the period after 1988 SFPP's actual book capital structure for each year shall be used.

c. *Amortization of Deferred Return*

Witness Horst amortized deferred return using a Composite Depreciation Rate which is the weighted average of the gross depreciation rate for all categories of property, determined by dividing gross depreciation by gross investment.[170]

SFPP used the "variable remaining life" method of amortization.[171] The issue is which of these two methods should be used to amortize the deferred return. The issue boils down to the length of the amortization period to be used.

The issue presented here is different from amortization of the SRB write-up for two reasons. First, unlike the amortization of the SRB write-up, the amortization of deferred earnings is a cost to be recovered in the cost-of-service, just as depreciation is a cost to be recovered. Second, the amortization of deferred earnings is also different from the amortization of the SRB write-up because the deferred earnings are a permanent feature of the rate base, not a transitional mechanism.

The Composite Depreciation Rate used by Navajo ties amortization of the deferred return to the composite of the actual depreciation rates being used to depreciate those assets.[172] A complete tie thus is maintained between the weighted rate of depreciation for the pipeline and the amortization of deferred return.

SFPP, in contrast, uses its variable remaining life calculation to amortize deferred return. The variable remaining life approach has no direct correlation to the actual depreciation of the pipeline. Rather, it takes the depreciation in any year and divides it into the undepreciated investment as of the end of the year to determine the "remaining life" of the depreciable assets.[173]

This approach disconnects amortization of the deferred return from the actual depreciation of the pipeline assets. Amortization of the deferred return is effectively extended by reducing current year amortization and allowing a greater build-up of the deferred return account. The result is to increase both future costs of service and realized returns.

It is held that the Composite Depreciation Rate Method set forth by witness Horst shall be used in calculating amortization of SFPP's deferred return.

F. Accumulated Deferred Income Taxes

Accumulated deferred income taxes ("ADIT") result from timing differences between regulatory accounting methods and tax accounting methods.[174] With accelerated depreciation, in the early years of a property's

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[168] Ex. 950, Schedule 6, p. 2 of 2, lines 16, 17 and 18, 1993 column.

[169] Opinion No. 154-B, 31 FERC ¶61,377, at p. 61,834.

[170] Ex. 446 at pp. 13-19.

[171] Ex. 238 at pp. 79-80.

[172] Ex. 365 at pp. 17-19.

[173] *Id.*

[174] Ex. 42 at p. 29; Ex. 206 at pp. 31-32.

life there is a higher depreciation expense for tax purposes than there is for accounting purposes. The higher depreciation results in less taxable income than book income; in other words actual taxes paid on the lower income for tax purposes in the early years of the life of a property are less than the taxes that would be payable based on book income.[175] In the later years of a property's life the situation is reversed: the actual taxes paid under an accelerated depreciation method are greater than they would be if depreciation had not been accelerated. Because the income tax allowance typically exceeds income taxes paid in the early life of an investment,[176] the difference between these two amounts, as accumulated from year to year, is captured into the ADIT balance. The balance is later charged for the excess of the actual taxes over book taxes, resulting in a reduction in the ADIT balance as the deferred taxes come due. The ADIT balance serves as a reduction in the rate base for purposes of the return calculation.

Aside from accelerated depreciation, two other circumstances affect the ADIT balance, either positively or negatively. One circumstance is a change in the tax rate. If the tax rate is reduced, then there is a permanent tax savings, resulting in an overfunded ADIT balance as to the increment of the tax reduction. The overfunded ADIT balance must be amortized. The amortized amount is subtracted from the company's cost of service. If the tax rate is increased, there is an underfunded ADIT balance as to the increment of the tax increase; the underfunded balance then must be funded.

The other circumstance which affects the ADIT balance arises when prior tax deferrals have not been funded. In these situations, there is underfunded ADIT that must be funded. The net ADIT balance is used to reduce the rate base for purposes of the return calculation.

The ADIT balance represents an amount of money that the pipeline usually has collected from its shippers (as an income tax allowance) but has not yet had to pay out as income taxes.[177] The pipeline has the use of that excess money, and the Commission recognizes the ADIT balance as cost-free funds to the pipeline. Therefore the amount of the ADIT balance is credited against the pipeline's rate base in calculating the return included in the cost of service.[178]

The initial calculation of the ADIT balance is not in dispute between Navajo and SFPP. Dr. Horst was responsible for Navajo's ADIT calculation; Mr. Ganz was responsible for SFPP's ADIT calculation. To calculate the ADIT balance, each used the same book and tax depreciation rates and federal income tax rates and tax credits.[179] Generally they each developed the ADIT balance by the differences in tax and book depreciation for each category of property by vintage year, applied the statutory tax rates in effect for each year and determined for each category of property by vintage year the amount of the deferral.[180]

The first issue with regard to ADIT relates to the method of amortizing the ADIT balance. When there are changes in the income tax rate during the life of an asset, there is a change in the relationship between the timing of taxes and the tax allowance, and the ADIT balance becomes overfunded or underfunded.[181] This overfunded or underfunded balance must be amortized.[182] If the balance is overfunded, the amortization amount is subtracted from a pipeline's cost-of-service to ensure that the excess is returned to ratepayers.[183] If the balance is underfunded, the amortization amount is added to the pipeline's cost-of-service to permit the pipeline to recover that amount of money necessary to pay deferred taxes.

SFPP and a number of the other participants have disputes over (1) the method of determining the amortization period, and (2) when the amortization of an unfunded balance should begin.

Dr. Horst calculated the ADIT balance for each category of depreciable property by vintage year, and he amortized the specific overfunded or underfunded ADIT balance attributable to that category of property by vintage year over the remaining life of that specific category and year using the "South Georgia" method.[184] Under this approach, as the tax deferral attributable to that category of property as to a particular vintage declines, the build-up of the ADIT balance as to that property also declines. Once the "turn-around" occurs as to that category of vintaged property,

[175] Ex. 42 at p. 29.

[176] Ex. 365 at p. 20.

[177] Ex. 42 at p. 30; Ex. 365 at p. 20.

[178] Ex. 365 at p. 20; Ex. 1 at p. 28.

[179] Ex. 365 (Horst Rebuttal) at p. 20 ("I have generally applied the same ... rates as Mr. Ganz applied."); Tr. 3617 (Horst).

[180] Ex. 206 at p. 33.

[181] Ex. 42 at pp. 30-31; Ex. 365 at pp. 20-21.

[182] Ex. 365 at p. 21.

[183] *Id.*

[184] Ex. 365 at p. 22; Tr. 3618-19. *See Natural Gas Pipeline Company of America*, 13 FERC ¶ 61,266, at pp. 61,587-88 (1980); *see also Natural Gas Pipeline Co. of America*, 26 FERC ¶ 61,047, at p. 61,149 n.3 (1984).

i.e., when tax depreciation is less than book depreciation as to that property, the ADIT balance is charged with the amount of the resulting increase in the actual tax liability over book liability. At the end of the book life of any unit of property, the remaining ADIT balance attributable to that property has been reduced to zero, thereby assuring that an ADIT balance attributable to a particular unit of property does not outlast its book depreciable life.

Essentially this is a "fixed remaining life" approach, and it ensures that the ADIT balance for each category of property by vintage is eliminated at the end of the depreciable life of that category of property by vintage.[185] This approach conforms to the requirements of the "South Georgia" method.

Although SFPP examined additions of each category of depreciable property in each applicable vintage year to calculate the build-up of the ADIT balance, SFPP did not follow this same approach in amortizing that balance. Instead, SFPP aggregated all the ADIT balances for all categories and for all vintage years into a single pool. SFPP then amortized the aggregated ADIT balance using a variable remaining life method. ADIT balances were thus "untied" from the category of assets and vintage year to which the ADIT balance related. By this "pooling" approach ADIT balances are carried forward long after the time when the assets on which the balance accrued have been depreciated and retired from service, ultimately lingering on until SFPP has no remaining carrier plant in service.

SFPP's variable remaining life method is rejected. The fixed remaining life method set out in the testimony of Dr. Horst shall be used to amortize the ADIT balance.

The second ADIT issue relates to the amortization of an unfunded ADIT balance. The dispute here is over the funding of the deferred tax liability that existed before 1974.

Beginning in 1974 SFPP's predecessor, SPPL, changed its method of accounting for income taxes from tax flow through to normalization, *i.e.*, the use of "normalized" taxes with ADIT balances for deferrals. Prior to this change of accounting methodology in 1974, the ICC had required SPPL to use flow through accounting.[186] In SFPP's cost and revenue study for the South System, SFPP includes an unfunded ADIT balance for recovery of the deferred tax liability that existed as of December 31, 1973.[187] There is no dispute that SFPP is entitled to recover that unfunded balance. The question concerns when the amortization of that balance should begin.

Navajo witness Horst begins the amortization of the unfunded ADIT in 1974. Dr. Horst ties the start of the amortization to the date when SFPP's predecessor switched to tax normalization. SFPP, on the other hand, does not begin to amortize the unfunded balance until 1984, the effective date of the Commission's Opinion No. 154-B. SFPP argues that, until Opinion No. 154-B was issued and the Commission adopted normalization as the standard for oil pipeline ratemaking,[188] tax timing differences had no effect on the rate base. The result of SFPP's approach is a smaller net ADIT offset to rate base than would be the case if SFPP had begun in 1974 the amortization of the pre-1974, unfunded ADIT balance. In other words, if SFPP had commenced in 1974 the amortization of the unfunded pre-1974 ADIT balance, the unfunded offset to the funded ADIT account for post-1974 balances would have been smaller, and the resulting balance in the ADIT account to be offset against rate base would have been larger than it would be if amortization of the unfunded ADIT balance began in 1984. SFPP's approach allows SFPP to reflect additional return, both real and deferred, in its cost-of-service calculations, as well as an additional tax allowance, than if SFPP had used Dr. Horst's method.

There is a logical inconsistency in SFPP's approach. SFPP is essentially claiming that, for the purpose of determining when the unfunded ADIT balance went on the pipeline's balance sheet, normalization began in 1974, but for the purpose of amortizing that balance, normalization began in 1984.

The date on which the FERC established that tax normalization should be the standard methodology for all oil pipelines is unimportant when an oil pipeline has already been permitted to switch to that methodology at an earlier date. SFPP's predecessor switched to the normalization methodology in 1974, and that is the date on which amortization of the unfunded balance should begin.

It is held that SFPP's proposed method for amortizing the unfunded ADIT balance for pre-1974 taxes beginning in 1984 is rejected; Dr. Horst's method of amortizing the unfunded deferred tax liability, commencing in 1974, is adopted.

SFPP raises two additional ADIT issues. One is whether and how to adjust ADIT balances to reflect the Commission's decisions in Opinion

[185] Ex. 365 at p. 23.

[186] *See* Ex. 365 at p. 24.

[187] *Id.*; *see also* Ex. 42 at p. 31; Tr. 3620.

[188] *See* 31 FERC ¶ 61,377, at p. 61,833.

Nos. 397[189] and 397-A,[190] concerning income tax allowances for oil pipelines organized as limited partnerships. In *Lakehead* the Commision determined that limited partnerships such as SFPP are not entitled to an income tax allowance for income attributable to individual partners and for income allocations made to other partners pursuant to Section 704(c) of the Internal Revenue Code.[191] For reasons discussed more fully *infra*, SFPP is not permitted to include in its cost of service the full income tax allowance which would be available if it were organized as a corporation. SFPP's rates since it became a limited partnership in 1988 have included such a full tax allowance.[192] SFPP therefore has collected deferred income taxes from its ratepayers in excess of the tax allowance it is permitted as a limited partnership.

All participants who addressed this question agree that SFPP's ADIT balance must be adjusted to reflect SFPP's reduced income tax allowance. The approach advocated by SFPP is first to determine the difference between ADIT assuming a full tax allowance and ADIT under *Lakehead* and then "to amortize that difference over the remaining life of the property and deduct accumulated amortizaton from the rate base."[193] Navajo supports a similar approach, arguing that the excess ADIT balance due to application of the *Lakehead* decisions should be treated like other overfunded ADIT balances and amortized using Dr. Horst's fixed remaining life method.[194]

Commission Staff witness McCelland agrees that this excess ADIT balance should be deducted from the rate base "to give ratepayers the time value benefit of the ADIT collected."[195] Mr. McCelland also states that "SFPP should be required to refund the excess ADIT to ratepayers in the future."[196] Staff does not describe the mechanism for its proposed refund, but such a refund can presumably be accomplished through the reduction in SFPP's cost of service resulting from amortization of the excess ADIT balance.

It is held that the difference between SFPP's collected ADIT balance and the ADIT balance to which SFPP is entitled under *Lakehead* shall be amortized consistent with Dr. Horst's fixed remaining life method. The ADIT balance, including the unamortized excess portion of the ADIT balance, shall be deducted from SFPP's rate base.

The final ADIT issue is whether the Commission's treatment of allocations under Section 704(c) of the Internal Revenue Code in Opinion No. 397-A requires the elimination of SFPP's ADIT balance as of the date the limited partnership was formed. SFPP argues that under Opinion No. 397-A, such allocations are to be treated for regulatory purposes as taxes on the gain realized on the sale (or imputed sale) of property to the partnership by the contributing partner. The necessary result of such treatment, argues SFPP, is to reverse existing accelerated depreciation deductions at the time of the contribution (*i.e.*, as of the partnership's formation). As such, the ADIT associated with those deductions is reversed at that time. Under these circumstances, argues SFPP, ADIT balances existing as of the date the partnership was formed in 1988 should be eliminated as of that date and should have no further effect on the rate base or the cost-of-service.

While it is correct that the underlying rationale used by the Commission in Opinion No. 397-A is that the contribution of assets to a partnership must be viewed as a sale of those assets by the contributing partner, I disagree with the positions advocated by SFPP. As the Commission explained in the *Lakehead* rehearing order, under the Internal Revenue Code the tax value of the contributed property retained the same tax basis as it had when owned by the contributing partner, Lakehead, Inc.[197]

Moreover, said the Commission in *Lakehead*, "[b]ecause the fair value of the contributed property was more than its tax value, Lakehead, Inc. would have paid tax on the difference between the property's fair value and its tax basis had it sold the property and used the cash to buy partnership shares."[198] However, no tax was due immediately because of the "sale" of the contributed property when Lakehead was reorganized from a corporation into a partnership. Instead, the tax was deferred and, under section 704(c), Lakehead, Inc., the contributing partner, was required to effectively pay the tax on any gain through the "curative allocation" process.[199] If the reorganization is considered a tax-deferred sale, and no tax was payable by Lakehead, Inc. at the time it con-

[189] *Lakehead Pipe Line Company, limited Partnership*, 71 FERC ¶ 61,338 (1995).

[190] *Lakehead Pipe Line Company, Limited Partnership*, 75 FERC ¶ 61,181 (1996).

[191] 26 U.S.C. § 704(c)(1994).

[192] Ex. 258 at p. 16.

[193] SFPP Reply Brief at p. 149.

[194] Navajo Initial Brief at p. 106.

[195] Ex. 258 at pp. 16-17.

[196] *Id.* at p. 17.

[197] *Id.* at p. 61,598.

[198] *Id.*

[199] *Id.*

tributed property to the partnership, there is no justification in the instant case for adjusting SFPP's 1988 ADIT balance. There is no claim by SFPP that taxes were paid on any gain when SFPP became a partnership.

The ADIT balance at the time of the formation of SFPP in 1988 was $12.921 million.[200] This amount, as adjusted for changes in ADIT from 1989 through 1994, should be deducted from the rate base in 1994. Since no tax liability was incurred when SFPP was formed, there is no basis for making an adjustment to the 1988 ADIT balance, and I so hold. The ADIT balance is available to pay future income taxes, and ratepayers should get the full benefit of the ADIT deduction from rate base until those taxes are paid.

G. Allowance for Funds Used During Construction

Oil pipelines generally are entitled to an allowance for funds used during construction ("AFUDC").[201] That allowance is a component of the rate base, and depreciation on it is recovered through the cost of service.[202]

The issue here is whether the evidence is sufficient to allow AFUDC to SFPP, and if AFUDC is permitted, what should be the amount of AFUDC.

SFPP computed AFUDC by applying SFPP's overall weighted cost of capital to 50 percent of its "South System" capital additions to carrier property in service. Ex. 206 at p. 45. Chevron, Navajo and Staff challenge SFPP's methodology on the ground that SFPP's calculations do not give effect to the actual cash amounts invested month by month in construction, and therefore, they argue, SFPP's methodology produces arbitrary results. "Specifically," argues Navajo (Initial Brief at p. 34), "SFPP has provided no computations that apply an AFUDC rate to monthly balances in its construction in progress accounts." Navajo and Chevron argue that SFPP should not be permitted any AFUDC in rate base. Alternatively Navajo and Chevron argue that if the Commission determines that SFPP should be allowed AFUDC, then the approach advocated by witness Zaegel should be adopted.

Staff witness McCelland testified that he did not agree with the methodology employed by SFPP.[203] Instead of using "Gross Additions to Carrier Property" as the AFUDC base, as SFPP did, Mr. McCelland testified that the proper approach is to include in the AFUDC base only the cash expenditures for each construction project for the years 1984 through the 1994 test year.[204] According to Mr. McCelland, the use of gross additions to compute AFUDC incorporates items on which AFUDC should not be calculated, such as unpaid accruals, overhead, and abandoned project costs.[205]

Chevron's and Navajo's witness Zaegel also criticized SFPP's methodology on a number of grounds.[206]

While it is true that the Commission has not required oil pipelines to use any particular methodology for calculating AFUDC,[207] there is Commission guidance. With respect to AFUDC, the Commission's intent is to put oil pipelines on the same basis as natural gas pipelines and electric companies.[208]

SFPP claims that witness Ganz performed a reasonableness test on his AFUDC numbers using Interest During Construction ("IDC") capitalized for income tax purposes. Unlike Chevron's and Navajo's witness Zaegel, Mr. Ganz did not use IDC capitalized on SFPP's books for his reasonableness test, although IDC is recorded on SFPP's books.

SFPP's use of tax IDC as part of witness Ganz's test of reasonableness is not consistent with the methodology applied by the Commission in determining the proper balance upon which AFUDC should be computed. Witness Zaegel testified that SFPP capitalized interest on suspended or completed projects for income tax purposes.[209] SFPP provided no contrary evidence. SFPP should not be allowed to use investment in completed or suspended construction projects to justify its AFUDC proposed amounts. SFPP's reasonableness test, which uses tax IDC as its basis, is rejected.

In its brief SFPP states, "AFUDC compensates investors for the costs of capital employed in construction projects before the new prop-

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[200] Ex. 258 at p. 16.

[201] *See, e.g.*, Opinion No. 154-B, 31 FERC ¶61,377, at p. 61,839 n.38; *Kuparuk Transp. Co.*, 55 FERC ¶61,122, at p. 61,372; Opinion No. 351, 52 FERC ¶61,055, at p. 61,234; *see also, e.g.*, Tr. 4924-25.

[202] *See e.g.*, Ex. 238 at pp. 79-82; Ex. 206 at pp. 38-40; Ex. 240, Schedule 1, line 16; Ex. 240, Schedule 4, p. 1 of 2, lines 5 and 9; *see also* Tr. 4973-74.

[203] Ex. 105 at p. 13; Tr. 7018.

[204] *Id.*

[205] Ex. 105 at pp. 13-14; Tr. 7018.

[206] Ex. 337 at pp. 25-33.

[207] *Express Pipeline Partnership*, 76 FERC ¶61,245, at p. 62,255 (1966).

[208] *ARCO Pipe Line Company*, 52 FERC ¶61,005, at p. 61,235 n.26 (1990), *order on reh'g*, 53 FERC ¶61,398 (1990).

[209] *See* Ex. 337 at p. 32.

erty becomes part of the carrier's rate base."[210] SFPP cites *Kuparuk Transp. Co.*, 55 FERC ¶ 61,122, at p. 61,371 in support of this position. However, *Kuparuk* states: "[t]he purpose of AFUDC is to compensate the utility for the cost of financing during construction."[211] AFUDC is not intended to compensate a utility for financing costs for the period after completion of construction and before inclusion in rate base; likewise, AFUDC is not intended to compensate a utility for its investment in suspended projects.

SFPP's evidence does not show that SFPP is entitled to AFUDC. The next question therefore is whether there is sufficient other evidence in the record to grant SFPP some AFUDC.

As noted, SFPP's witness Ganz computed an AFUDC allowance equal to the interest cost on 50 percent of the gross additions to carrier property in any year in which there was a "South System" addition. He did not attempt any month-by-month build-up of the AFUDC nor any reconsideration of interest costs incurred during the construction of any East Line or West Line capital project which SFPP capitalizes on its books.

By comparison, Navajo's and Chevron's witness Zaegel examined the books and records of SFPP. Because SFPP did not separately account for East Line capital projects, he reviewed the interest capitalized on SFPP's books in total. The interest costs were not separately identified to a project but were the interest costs generated by all of SFPP's capital projects. Reviewing those capitalized interest costs for a five-year period, and reviewing SFPP's capital projects over that same period, Mr. Zaegel determined that the average AFUDC factor was 29.3 percent of the capital cost of all projects undertaken and placed into service by SFPP during that five-year period. Accordingly, he applied that 29.3 percent factor to compute the AFUDC allowance to be allowed an East Line project placed into service in any year. Ex. 357.

SFPP criticizes Mr. Zaegel's approach on a number of grounds and claims that the base data he used, the limited period analyzed and the weighting employed all unreasonably bias the results downward.[212]

Whatever the shortcomings of Mr. Zaegel's approach, it does have the merit of being based on SFPP's books and records for its derivation and results in some AFUDC for SFPP. If I were to accept SFPP's criticisms and disregard Mr. Zaegel's methodology because Mr. Zaegel did not go far enough, SFPP will get no AFUDC. For SFPP some AFUDC may be better than none. I therefore accept Mr. Zaegel's methodology.

It is held that SFPP shall compute AFUDC using the methodology set forth in Exhibit 357, resulting in AFUDC being calculated on a base equal to 29.3 percent of gross additions to carrier property in a year.

VI. RATE OF RETURN

A. Capital Structure

The capital structure to be used in developing an overall rate of return (weighted average cost of capital) for SFPP shall be SFPP's actual capital structure at the end of 1994, with one adjustment described hereafter. In 1994 that capital structure, without adjustment, consisted of 55.21 percent term debt and 44.79 percent partners' capital.[213] This is the most recent capital structure data in the record and should be used.[214]

The capital structure for 1994 must be adjusted because the deferred equity return, under Opinion No. 351-A, earns only equity return. This adjustment is reflected on Dr. Horst's Exhibit 561, Schedule 7, lines 8-12 and on Mr. Jessen's Exhibit 950, Schedule 2, lines 9-11. See the discussion *supra*, under the heading "Deferred Return."

Navajo argues that two additional adjustments should be made to SFPP's capital structure which would result in a decrease in the equity component and an increase in the debt component of SFPP's capital structure.

First, Navajo argues (Initial Brief at pp. 41-44) that when SFP Pipeline Holdings, Inc. in 1990 issued $219 million in debentures, this transaction in effect was a conversion into debt by SFPP's general partner (SFPP Inc.) of its limited partner interest in SFPP (equal to 41.7 percent of the equity interest in the partnership).[215]

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[210] SFPP Initial Brief at p. 48.

[211] 55 FERC ¶ 61,122, at p. 61,371.

[212] SFPP Initial Brief at pp. 51-53, Reply Brief at pp. 32-37.

[213] Ex. 284 at p. 1. SFPP's 1994 book capital structure of 55.21 percent debt and 44.79 percent equity is derived from SFPP's $355,000,000 of long-term debt and $287,961,000 of partners' capital, *i.e.*, equity.

In 1993 the unadjusted capital structure of SFPP was 57.18 percent long-term debt and 42.82 percent common equity. Ex. 104 at p. 3 of 4.

[214] *Southern California Edison Company*, 8 FERC ¶ 61,099, at p. 61,383 (1979); *Southwestern Electric Power Company*, 4 FERC ¶ 61,330, at p. 61,766 (1978).

[215] See Ex. 143.

I disagree. SFPP Inc., as a holder of a limited partnership interest, should be permitted to issue debt, either by itself or through a corporate affiliate, without having as a consequence a restructured capital structure for SFPP. In any event, the record on this issue is not well developed and the evidence is not sufficient to allow Navajo's recommended adjustment.[216]

Second, Navajo argues that at the time of the formation of SFPP in 1988, $115 million in depreciation was reduced to zero dollars. As a result argues Navajo, "the equity portion of the capital structure was increased. This adjustment to capital structure is nothing less than an acquisition cost adjustment, which Commission precedent does not allow." Navajo then argues that that equity should be reduced by the $115 million.[217]

I disagree with Navajo. The record in this case is insufficiently developed regarding the propriety of the restatement of the $115 million and how the matter should be handled for rate purposes. The cross examination of SFPP witness Toole[218] is not sufficient evidence to justify the equity adjustment Navajo seeks.

B. Cost of Debt

There is no dispute regarding the cost of debt which was 10.51 percent for both 1993 and 1994.[219] Therefore, it is held that SFPP's cost of debt for determining SFPP's overall rate of return will be 10.51 percent.

C. Nominal Cost of Equity

There are three recommendations in the record concerning a nominal cost of equity for SFPP. Staff witness Manganello recommended a nominal cost of equity of 12.87 percent. Navajo adopted Mr. Manganello as its rate of return witness.[220]

Chevron and RHC witness Hass recommended a nominal cost of equity of 12 percent.

SFPP witness Williamson recommended a nominal cost of equity of 14.45 percent.

The witnesses generally agree on the general approach for calculating the nominal cost of equity, including the use of the discounted cash flow ("DCF") methodology. They also generally agree that the proper proxy group for SFPP consists of six specific oil pipeline master limited partnerships,[221] with a group of natural gas pipelines serving as a corroborative test.[222] The differences among the witnesses center on the application of the methodology and the "inputs" to it.[223]

The following table shows a comparison of the end results of the analyses of Dr. Williamson, Mr. Manganello and Dr. Hass:

Comparison of Manganello, Hass and Williamson DCF end results:

	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
				Williamson		
Return on Equity	*Manganello Rebuttal*	*Hass Direct*	*Hass Rebuttal*	*Single Stage*	*Two Stage – 1st Table*	*Two Stage - 2nd Table*
Bottom of range	12.74%	12.4%	11.3%	12.05%	13.51%	12.78%
Top of range	14.85	15.6	13.5	16.08	15.98	15.25
Mean	14.18	13.7	12.6	14.21	15.06	14.33
Median	14.39			14.76	15.27	14.53
Midpoint	13.80			14.07	14.75	14.02
SFPP	14.27	14.1	13.5	14.62	15.04	14.31
Recomm for SFPP	12.87	12.75	12.0	14.45	14.45	14.45

Notes:
(1) From Manganello Ex. 282, p. 3.
(2) From Hass Ex. 7.
(3) From Hass Ex. 314.
(4) From Williamson Exhibit 200 (using IBES median growth forecasts).
(5) From Williamson Ex. 203, p.1 (using Manganello 6.8% long-term growth rate forecast).
(5) From Williamson Ex. 203, p.1 (using Manganello 5.4% long-term growth rate forecast).

Staff witness Manganello employed the DCF method for estimating the range of rates of return on common equity for 1993 and 1994. He used the simple, constant growth DCF

[216] *See* Tr. 8521-8536.

[217] Navajo Initial Brief at p. 44.

[218] Tr. 8495-8500.

[219] Ex. 104, p. 3 of 4; Ex. 284, p. 1 of 2.

[220] Navajo Pretrial Brief at p. 20.

[221] Williamson Direct, Ex. 197 at p. 4; Hass Direct, Ex. 1 at pp. 35-36; Tr. 3939; Manganello Direct, Ex. 101 at pp. 13-14; Manganello Rebuttal, Ex. 281 at p. 5.

[222] Williamson Direct, Ex. 197 at pp. 16-17; Hass Direct, Ex. 1 at p. 36; Manganello Direct, Ex. 101 at pp. 13-14; Manganello Rebuttal, Ex. 281 at p. 5.

[223] In Ex. 908, pp. 5-8, Williamson compared the positions and methodologies of the three rate of return witnesses and criticized the positions of Hass and Manganello at Tr. 9463-73.

model, K=D/P+G, where K is the expected rate of return, D/P is the dividend or distribution divided by the market price (dividend or distribution yield), and G is the expected growth in dividends (or distributions).

Mr. Manganello used a DCF approach approved by the Commission in several opinions.[224] The version he used in his direct testimony for 1993 differed slightly from what he used in his rebuttal testimony for 1994, because of the Commission's then latest pronouncements.[225]

In his direct testimony, Mr. Manganello stated that in both *Young Gas Storage Co., Ltd.*, 67 FERC ¶ 61,375 (1994) and *Ozark Gas Transmission*, 68 FERC ¶ 61,032 (1994), the Commission relied on DCF analyses whose growth rates were derived from two factors: (1) a five year median forecast of earnings per share from the Institutional Brokers Estimate System (IBES), and (2) a longer-term forecast of natural gas throughput and price growth published by DRI/McGraw Hill in its *Energy Review*. Mr. Manganello noted that there was a problem in applying this same methodology to oil products pipelines: there is no precisely comparable DRI forecast to apply to oil products pipelines, since each pipeline has its own particular blend of products throughput; also, the blend of products throughput for each pipeline can change yearly. He testified further that one could use a long-term growth rate of the general economy as a proxy for an industry specific long-term forecast, because, over the long-term, most industries' growth rates will tend toward the growth of the over-all economy. He noted that DRI produces, for the years 2000 and 2010, a forecast of the real growth of the Gross Domestic Product (GDP), currently 2.0 percent, and a forecast of the GDP price deflator, currently 3.4 percent. When added together, this 5.4 percent forecast provides a long-term growth rate for the overall economy that is comparable to the DRI forecast used in natural gas DCF analyses.

Mr. Manganello believed this forecast could be used to provide a long-term growth forecast, in conjunction with the IBES five year forecast, to develop the growth rate required in a DCF analysis. This 5.4 percent DRI growth rate exceeded the average IBES growth rate of 4.83 percent for his DCF group of products pipelines. To comply with the then Commission precedent, he developed a long-term growth rate by averaging the IBES forecasts and DRI's forecast for the general economy to derive his DCF growth or "g" factor.[226]

Mr. Manganello noted that the Commission previously had used natural gas pipelines in oil pipeline DCF analyses because they more closely represented the risks of the products pipelines than did the products pipelines' actual parents. Therefore, Mr. Manganello performed a DCF analysis on seven natural gas pipelines, in addition to his DCF analysis of product pipeline partnerships.

The data on page 1 of Exhibit 103 show the IBES growth rates or "g" factors, the DRI growth rate, and the average of these growth rates for each of the product pipeline companies in his DCF analysis. The data on page 2 of Exhibit 103 show the 6-month average dividend yield and the dividend yield adjusted by the "g" factor for each of the companies in his DCF analysis. The data on page 3 of Exhibit 103 combine the adjusted dividend yields and the "g" factors to produce the total DCF return for each company in his DCF analysis. Page 4 of Exhibit 103 shows the adjusted dividend yields, growth rates, and total DCF returns for a group of seven natural gas pipelines.

Mr. Manganello's DCF results appear on pages 3 and 4 of Exhibit 103. The last column on each page shows the DCF return for each company in his comparison groups. The DCF return for oil pipeline partnerships averaged 13.18 percent, with a median return of 13.10 percent. The DCF returns ranged from 12.07 to 14.76 percent. The DCF return for SFPP was 12.38 percent. The DCF returns for his group of natural gas pipelines averaged 12.07 percent, with a median of 12.30 percent. The DCF returns ranged from 10.78 percent to 13.43 percent.

Mr. Manganello noted that in *Young Gas Storage Co., Ltd.*, 66 FERC ¶ 61,280, at p. 61,797 (1994), the Commission set the bottom

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[224] *Ozark Gas Transmission System*, 68 FERC ¶ 61,032, at p. 61,105 (1994); *Northwest Pipeline Corporation*, 71 FERC ¶ 61,253, at p. 61,992 (1995); *Panhandle Eastern Pipe Line Corporation*, 71 FERC ¶ 61,228, at p. 61,833-35 (1995); *Williston Basin Interstate Pipeline Company*, 72 FERC ¶ 61,074, at p. 61,376 (1995).

[225] *Compare* Ex. 101 at pp. 12-13 *with* Ex. 281 at pp. 1-2.

[226] *Northwest Pipeline Corp.*, 79 FERC ¶ 61,309 (June 11, 1997) and *Williston Basin Interstate Pipeline Company*, 79 FERC ¶ 61,311 (June 11, 1997), two natural gas pipeline cases which used the long term growth of the United States economy to measure the "g" factor in the DCF analysis, had not been decided when Mr. Manganello testified on June 4, 1996. Tr. 7596, *et seq. See also Transcontinental Gas Pipe Line Corporation*, 80 FERC ¶ 61,157 (August 1, 1997).

of the range of equity returns at 100 basis points above the Baa utility bond rate. He noted that as of June 1994, the six month average Baa utility bond yield was 8.21 percent. Adding 100 basis points to this yield sets the bottom of the range of reasonable equity returns at 9.21 percent. In the *Young Gas* case the Commission had set the upper end of the range of returns at the top of the DCF range. As noted, the top of Mr. Manganello's DCF range was 14.76 percent for product pipeline partnerships and 13.43 percent for natural gas pipelines. Thus the returns ranged from 9.21 percent to 14.76 percent for the products pipeline DCF and 9.21 percent to 13.43 percent for natural gas pipelines.

Mr. Manganello then reviewed SFPP's risks and said:

> As a result of my analyses, I have set a range of reasonable returns on equity starting at 9.21%, based on Baa utility bond yields and rising to approximately 14% based on the top of my DCF analysis of both products pipelines and natural gas pipelines. The DCF analysis of products pipelines resulted in an average return of 13.18%, with a median of 13.10%. The DCF return for SFPP was 12.38%. The DCF results for natural gas pipelines averaged 12.07%, with a median of 12.30%. It would appear that the middle or average returns cluster around the 12.5% to 13.00% range. SFPP's slightly higher financial risk appears to be offset by a favorable competitive position and favorable business prospects. I am therefore recommending a return on equity in the middle of the 12.5% to 13.0% range, or 12.75%.[227]

In his rebuttal testimony, Mr. Manganello updated his rate of return testimony to include 1994 data. His recommended return on equity (*i.e.* partners' capital) was 12.87 percent instead of the 12.75 percent he had derived using 1993 data. The small difference in Mr. Manganello's results between 1993 and 1994 is due to the use of updated data for 1994 and to averaging the midpoints of the ranges for the companies in the two groups for 1994, rather than using the mean or median.[228]

SFPP criticizes witness Manganello for changing his methodology by using the midpoint rather than the mean and median in arriving at a result from the range of returns generated by the DCF methodology.[229] However, Mr. Manganello's use of the midpoint is correct.[230]

SFPP also claims, "Mr. Manganello also erred by averaging the midpoint of the oil pipeline range with the midpoint of the gas pipeline range."[231] By emphasizing that "costs of equity for gas pipelines were substantially lower than the bottom of the range for oil pipelines,"[232] SFPP implies that Mr. Manganello's decision, to incorporate both the extensive data from gas pipelines and the relatively limited new data from oil pipeline partnerships, was result-driven.

The contention is not well taken. As Mr. Manganello explained in his rebuttal testimony, the results of a DCF analysis using oil pipelines and a DCF analysis using gas pipelines should be weighted:

> Since the Commission has previously relied on natural gas pipeline DCF analyses to develop returns for oil pipelines, it is not fully clear, now that a calculation for an oil pipeline DCF is possible, how the Commission will weigh a DCF analysis of oil pipeline partnerships. Therefore, I am proposing, in this case, to average the two midpoint results to arrive at a recommended return on partner's capital of 12.87%.[233]

SFPP concedes that Mr. Manganello's result of 12.87 percent was within the range for oil pipelines, although at the low end of the range.[234]

In contrast to Mr. Manganello's DCF results, SFPP witness Williamson concluded that SFPP should be allowed a rate of return on equity of 14.45 percent, based on price data from August 1994 through January 1995, and assuming that SFPP's South System is treated as a single system for ratemaking. If the South System were to be regulated on the basis of separate East and West lines, Dr. Williamson argued that a higher cost of equity would be warranted based on the analyses done by SFPP witness Pifer.[235]

To determine the dividend growth expected by investors for his oil pipeline partnership group, Dr. Williamson initially relied on the five year earnings forecasts published by both IBES and Zacks Investment Research.[236] His

[227] Ex. 101 at p. 17.

[228] Ex. 281 at pp. 1-2; 11-12.

[229] SFPP Initial Brief at p. 58.

[230] *Williston Basin Interstate Pipeline Co.*, 72 FERC ¶ 61,074, at p. 61,376 (1995); *Northwest Pipeline Corp.*, 71 FERC ¶ 61,253, at p. 61,992 (1995), *reh'g granted and remanded on other grounds*, 76 FERC ¶ 61,068 (1996).

[231] SFPP Initial Brief at p. 58.

[232] SFPP Initial Brief at p. 59.

[233] Ex. 281 at p. 11.

[234] SFPP Initial Brief at p. 59.

[235] Ex. 197 at p. 23.

[236] *Id.* at p. 14.

DCF results based on these short term growth rates ranged from 14.2 percent to 14.7 percent.[237] Dr. Williamson's initial methodology, however, violates the Commission's mandate that a longer term growth rate be used in the DCF model.[238]

However, Dr. Williamson engaged in a variety of alternative calculations which used the same DRI data used by Mr. Manganello and which produced similar results[239] (as shown *supra* in the table at the beginning of the discussion on the Nominal Cost of Equity). Dr. Williamson also performed a DCF analysis using the same gas pipeline group used by Mr. Manganello, but obtained a higher range, 16 percent to 16.25 percent.[240]

Because the DCF results obtained by both witness Manganello and witness Williamson for the oil pipeline partnership group were reasonably comparable to one another, it is the use made of the DCF results for the gas pipeline group that essentially defines the difference between Mr. Manganello's recommendation and that of Dr. Williamson. Dr. Williamson derived his 14.45 percent recommended SFPP cost of equity by limiting his analysis to only the six companies in the oil pipeline partnership group.[241] He used the DCF results for the gas pipeline group for illustrative purposes to demonstrate how conservative his recommendation was for SFPP. Mr. Manganello, on the other hand, did a DCF analysis for the gas pipeline group, using both short term and longer term data, and then averaged the lower resulting number with the number for the oil pipeline partnership group to produce a rate of return for SFPP.

Thus the basic issue between Mr. Manganello and Dr. Williamson is whether it is better to give 100 percent weight to the oil pipeline partnership data, as Dr. Williamson recommended, or only 50 percent weight, as Mr. Manganello suggests.

SFPP criticizes Staff's and complainants' methodologies for using equal averaging of long-term and short-term growth rates rather than weighted averaging used by Dr. Williamson and used in *Ozark*. Whatever the merits of weighting, the cases do not make weighting a condition of a proper application of the DCF method. In *Ozark* the Commission noted that the Staff witness "weighted each year of the 18 year period equally, *which is acceptable in this case*" (emphasis added). 68 FERC ¶ 61,032, at p. 61,107 n.46 (1994) However, simple averaging of the short- and long-term data was upheld in the later cases of *Williston Basin Interstate Pipeline Company*, 79 FERC ¶ 61,311 (1997); *Northwest Pipeline Corporation*, 79 FERC ¶ 61,309 (1997); *Panhandle Eastern Pipe Line*, 71 FERC ¶ 61,228, at p. 61,834 (1995); and *Williston Basin Interstate Pipeline Company*, 72 FERC ¶ 61,074, at p. 61,376 (1995).

Dr. Hass in his direct testimony performed a DCF analysis on the same six oil pipeline partnerships used by witness Williamson and Manganello. Dr. Hass combined distribution yields over the six months ending May 1994 with a combination of growth forecasts from IBES, Zacks and Value Line. In his rebuttal he used the same companies and updated numbers, but introduced some new data and altered his methodology to rely on historical calculations instead of forecast growth for his second stage. He also concluded that SFPP's risk was lower than the average natural gas pipeline. As a result he estimated a cost of equity in the range of 11 percent to 13 percent and his final recommendation for a nominal cost of equity for SFPP was 12 percent, down from his original recommendation of 12.75 percent.

Dr. Williamson's recommendation suffers from too exclusive a reliance on the oil pipelines, his conclusion that oil and natural gas pipelines are similar in terms of risks,[242] his conclusion that the risk of oil pipelines is as great as the risk of common stocks, his use of a 7 percent risk premium based upon past risk (1926-1994), his use of realized returns as an indicator of future returns,[243] and his reliance on SFPP witnesses Pifer and Abboud in assessing SFPP's economic and operational risks.[244]

Dr. Hass's recommendation improperly relies on historical calculations based on growth in retained earnings[245] and a Capital Asset Pricing Model ("CAPM") which relied on a calculation of beta coefficients as an index of market risk.

The record fails to provide any foundation for relying on a CAPM analysis of oil pipelines. While the Commission accepted a combination of DCF and risk-premium models for gas pipelines in one case, *KansOk Partnership*, 71

[237] *Id.* at p. 16.

[238] *Williston Basin Interstate Pipeline Company*, 72 FERC ¶ 61,074, at p. 61,376 (1995); *Ozark Gas Transmission System*, 68 FERC ¶ 61,032, at p. 61,105 (1994).

[239] Ex. 203 at pp. 1-2.

[240] Ex. 197 at p. 19.

[241] *Id.* at pp. 19-23.

[242] Ex. 197 at p. 16.

[243] *Id.* at p. 20.

[244] Tr. 9506.

[245] Tr. 9470-71; Ex. 908 at pp. 7-8.

FERC ¶ 61,340 (1995), it has not used such an analysis for oil pipelines.

Indeed, "[f]or many years now, [the Commission] has demonstrated a clear preference for using the Discounted Cash-Flow (DCF) methodology," and "the Commission looks with disfavor upon risk premium methodologies."[246] As the Commission has noted, "a risk-premium analysis can accentuate erratic market conditions and tends to over-emphasize recent market changes . . . ."[247]

The participants argue over whether SFPP is more or less risky than other oil pipelines. SFPP offered testimony to the effect that SFPP's rates are constrained by the threat of entry of new, competing pipelines into SFPP's market; competition between SFPP's own East and West lines; competition from non-pipeline sources; and rate regulation and market forces.[248]

On the other hand, complainants argue that SFPP faces very low risk. A report by Goldman Sachs entitled "a Holiday Package of Goodies for Yield-Oriented Investors,"[249] characterizes SFPP as "one [of] the most attractive MLPs in our universe" and stated that it has "significant investor appeal."[250] SFPP's Toole testified that "SFPP has a sustainable competitive advantage with respect to long-haul deliveries"[251], that it has "continuing growth opportunities," and it has enjoyed "a consistent and growing cash flow."[252]

Despite SFPP's claims, *Lakehead* [253] has not significantly affected its stock price, as that price has rebounded to pre-*Lakehead* levels, a point made by SFPP witness Toole.[254] Thus this basis for Dr. Williamson's conclusion that *Lakehead* increased SFPP's risk is unsound. In addition, regulating SFPP's South System on the basis of a separate East Line and a separate West Line will not increase its risks. SFPP is currently regulated on a separate East Line and West Line basis and has been so regulated since 1988. Both the East Line and West Line are owned by SFPP. Although there is a differential between the rates on the two lines, SFPP has stated in its Form 10-K filed with the Securities and Exchange Commission that volume swings between the two lines will not have a significant effect on its revenues.[255]

Furthermore, SFPP has a monopoly on the transportation by pipeline of petroleum products into Phoenix and Tucson, and transportation of such products via SFPP is the only economic alternative.[256]

A proposed refinery project in Phoenix[257] has been pending for over a decade; the Williams Companies, Inc. found buying an almost bankrupt gas pipeline a less risky endeavor than building a refinery[258] and accordingly abandoned the project.[259] With respect to earthquakes and floods,[260] even though SFPP has experienced such events in the past, no witness claimed the impact was material, nor did SFPP's 10-K. With respect to the argument that another East Line pipeline is possible,[261] SFPP's own evidence of this proposal establishes that the cost is prohibitive because the capital costs of such a project would be at least three times SFPP's rate base, even when existing assets are utilized.[262] With respect to trucks and rail competition, SFPP's president, Mr. Toole, stated, "I would say the trucks and rail are not a good alternative to the pipeline."[263]

The risk claimed by SFPP does not accord with what SFPP is telling its investors: there is no risk from East Line/West Line competi-

[246] *System Energy Resources, Inc.*, 76 FERC ¶ 63,001, at pp. 65,002, 65,006 (1996).

[247] *Montaup Elec. Co.*, 38 FERC ¶ 61,252, at p. 61,869 n.101 (1987); *see also Pennsylvania Power Co.*, 26 FERC ¶ 61,354, at p. 61,779 (1984)("[I]t has become apparent that [the risk premium] approach can produce distortions during certain time periods....").

[248] *See* Exs. 154, 169-72, 513-PO, 179-82; Tr. 7710-11, 9955-56, 9960-62.

[249] Ex. 826.

[250] *Id.* at p. 29.

[251] Tr. 8250.

[252] Tr. 8253-54.

[253] *Lakehead Pipe Line Company, L.P.*, 71 FERC ¶ 61,338 (1995); *reh'g denied* 75 FERC ¶ 61,181 (1996).

[254] *See* Ex. 871 and Ex. 872 (graphs of SFPP's closing stock price). As Mr. Toole testified, as soon as SFPP issued a press release stating that the decision would not affect its distribution, "the price went back up." Tr. 8513, 8515-16.

[255] Ex. 866 at p. 42 (Santa Fe Pacific Pipeline Partners, L.P., Form 10-K for 1995).

[256] *See, e.g.*, Ex. 866 at p. 44.

[257] SFPP Initial Brief at p. 66.

[258] *See* Tr. 10141.

[259] Ex. 866 at p. 44.

[260] SFPP Initial Brief at p. 63.

[261] SFPP Initial Brief at pp. 64-65.

[262] *Compare* Ex. 170 ($66,498,000 for new pipeline utilizing existing pipeline already in the ground) *with* Ex. 392, Schedule 1 ($23,251,265 for SFPP).

[263] Tr. 8176-77.

tion;[264] there is no reasonable prospect of a competing pipeline being built into the Phoenix and Tucson markets;[265] and there is no real prospect of a refinery.[266]

Considering the evidence, the arguments of the participants and the law, I conclude that Staff witness Manganello's recommended fair rate of return on equity for SFPP of 12.87 percent shall be adopted for SFPP. All things considered, I find his recommendation is best supported by the evidence.[267]

D. Real Cost of Equity—Inflation Adjustment

Once we have established SFPP's *nominal* rate of return on equity, we must determine a *real* rate of return on equity for purposes of trending the rate base under the TOC methodology. The computation is not controversial: to determine the real rate of return subtract the inflation rate from the nominal rate of return on equity. There is a dispute, however, as to the particular inflation rate to use in deflating the nominal rate of return on equity. The Commission has not required that any particular inflation rate be used in computing the real rate of return on equity.

All of the parties agree that the Consumer Price Index is the appropriate index.[268] They diverge, however, on whether to use actual rates or forecasts. Professor Williamson used the actual 1994 inflation rate of 2.67 percent.[269] The Staff advocates an inflation rate of 2.6 percent to arrive at a real rate of return on equity.[270] However, Staff witness McCelland uses 3.0 percent for trending the rate base.

Chevron, RHC and West Line Shippers favor a ten-year inflation forecast of 3.3 percent based on the March 1, 1995, ten-year CPI forecast compiled by *Blue Chip Financial Forecasts*.[271] It is not clear why such forecasts are superior to the actual data presented by SFPP and the Staff.[272] It appears that such forecasts routinely overstate inflation: in seven of ten years, actual rates of inflation were lower than the forecasted rates.[273]

In Opinion No. 154-B the Commission concluded, "What is important is that the [inflation] index used to decrease the nominal equity rate of return is also used to increase the equity rate base."[274] The witnesses agree that it is important to maintain consistency between the inflation rate used for rate of return and for trending the rate base.[275] Dr. Hass conceded that if one uses the actual rate of inflation to trend the equity portion of the rate base and a higher forecasted rate for cost of equity, the calculations provide less compensation to investors than that intended under Opinion No. 154-B.[276] Chevron, RHC and West Line Shippers nevertheless want to use the actual CPI rate for trending rate base, but a ten-year forecast for adjusting the cost of equity.[277] This approach cannot be reconciled with Opinion No. 154-B.

It is held that the same actual inflation rate, 2.67 percent, shall be used to adjust the cost of equity and to trend the rate base.

VII. COST ALLOCATION AND REVENUE CREDITING

"Allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts."[278]

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[264] Ex. 866 at p. 42.

[265] *Id.* at p. 44.

[266] *Id.*

[267] After the record was closed in this case and after briefs were filed, the Commission issued orders in two natural gas pipeline cases. *Williston Basin Interstate Pipeline Company*, 79 FERC ¶ 61,311 (1997) and *Northwest Pipeline Corporation*, 79 FERC ¶ 61,309 (1997). In those cases the Commission adopted, for those cases and "future cases" as its "preferred approach," the long-term growth of the United States economy as a whole, as measured by the growth in gross domestic product (GDP), to be applied in the Commission's Discounted Cash Flow (DCF) model. Whether the Commission intends to apply the *Williston* and *Northwest* precedents to oil pipeline rate cases is not now known. If the Commission were to do so in the instant case, the record would probably have to be opened to take additional evidence on the issues raised by the *Williston* and *Northwest* methodologies. *See TransCanada Pipelines Ltd. v. FERC*, 24 F.3d 305 (D.C. Cir. 1994). In any event Staff's approach in the instant case, which uses in part GDP, is clearly the best approach in the evidentiary record for making an estimate of the long-term growth rate of the oil pipeline industry.

[268] Tr. 9473; Ex. 281 at p. 12; Ex. 1 at p. 41.

[269] Ex. 197 at p. 23.

[270] Staff Pretrial Brief at p. 17; Ex. 281 at p. 12. The Staff switched its methodology between its direct and rebuttal cases, moving from the year-end to year-end rate for CPI to the change in the average of the 12 month-end indices for each year. Year-end to year-end is less cumbersome and more widely accepted, and was in fact used by Dr. Hass. Tr. 9475-76.

[271] Ex. 311 at p. 41.

[272] Ex. 197 at p. 31; Tr. 9474-75.

[273] Tr. 3988; Ex. 204 at p. 5; Ex. 317.

[274] 31 FERC ¶ 61,377, at p. 61,835.

[275] Tr. 9473; *cf.* Tr. 3963 (recognizing a "clear virtue in having consistency").

[276] Tr. 3999-4000; *see also* Tr. 9474.

[277] Tr. 9473.

[278] *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 589 (1945).

There are several issues involving how operating and capital costs are to be allocated between FERC jurisdictional services and non-jurisdictional intrastate services, between carrier and non-carrier, between jurisdictional interstate services and non-jurisdictional military service, and between the East Line and the West Line.

There are also several issues involving whether revenue crediting is appropriate. The revenue crediting issues sometimes overlap the cost allocation issues.

A. Carrier and Non-Carrier Allocation of Overhead Costs

The first allocation issue involves the method for removing from the pool of SFPP's corporate-level overhead costs the portion attributable to non-carrier operations.[279] The removal of these costs is necessary to assure that only carrier costs are charged to jurisdictional ratepayers.[280]

SFPP's witness Jessen, in making SFPP's allocation, used the carrier and non-carrier general and administrative ("G&A") allocations that appear on SFPP's general ledger, the basic element of SFPP's corporate financial books.[281] Mr. Jessen concluded that 83.5 percent of the total corporate unallocated expense as set forth on the general ledger should be allocated to carrier operations. Chevron and Navajo would ascribe approximately 77 percent of the corporate G&A costs to carrier operations.[282] The West Line Shippers would allocate approximately 76 percent of corporate unallocated G&A expenses to carrier operations.[283]

SFPP's book allocation has been the basis for its split between carrier and non-carrier expenses since April 1991.[284] For the instant case SFPP hired an outside consultant, Ernst & Young LLP, to study and test the reasonableness of SFPP's book allocation.[285] The conclusion of the study was that between 82 and 87 percent of SFPP's total corporate unallocated G&A expense is properly allocated to carrier operations.[286] Because witness Jessen's allocation of 83.5 percent is within that range, witness Jessen recommended that the book allocation be used for purposes of this case.[287] Both RHC and the Commission Staff accepted SFPP's book allocation of carrier and non-carrier costs for purposes of their own cost of service analyses.[288]

Chevron and Navajo reject the book allocation and rely instead on the "*KN*" method to allocate "corporate unallocated" overhead costs.[289] The KN method "... is used to allocate A&G costs of the pipeline among its jurisdictional divisions and functions ... as well as the pipeline's nonjurisdictional divisions and subsidiaries."[290] Based on Mr. Battese's recommendation, Chevron and Navajo reduced SFPP's total carrier corporate G&A cost pool to reflect the results of the *KN* formula.[291]

SFPP's position is that the *KN* formula should not be used in preference to the more detailed specific information which was available to SFPP.

Navajo and Chevron note that even though "SFPP agrees that in gas pipeline cases the *KN* method has been used in 'functionalizing' overhead costs,"[292] SFPP nevertheless insists that this precedent can be ignored. Navajo, Chevron and West Line Shippers criticize SFPP because it advocates use of an internal allocation procedure, and, they claim, SFPP has refused to provide its business records to justify the procedure. Instead, what SFPP introduced into the record to support its procedure, they argue, is a report, performed by Ernst & Young, regulatory consultants, and SFPP's own personnel that purports to confirm the pipeline's internal allocation even though Ernst & Young never were provided the business records on which the allocations were based. Because this allocation is contrary to Commission precedent and remains unsubstantiated, they argue, it should be rejected.

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[279] This issue relates to what are known as "corporate unallocated" costs, which are also referred to as general and administrative costs. The issue is limited to costs at the corporate level and does not involve overhead expense that can be directly attributable to particular locations or operations. *See* Ex. 238 at pp. 54-55.

[280] SFPP's principal non-carrier costs involve its terminal operations. *See* Ex. 144 at p. 11.

[281] Ex. 238 at p. 86; Tr. 10686.

[282] Ex. 91 at p. 1.

[283] Ex. 290 at p. 13.

[284] Tr. 4566.

[285] *See, e.g.*, Exs. 704, 705.

[286] Ex. 238 at p. 87.

[287] There are two exceptions. SFPP allocated its Arizona property taxes between carrier and non-carrier operations on the basis of Arizona tax invoices, and its California property taxes based on the relationship of carrier to total company California gross property. Ex. 238 at pp. 65-67; Ex. 524 at pp. 3-4; Ex. 526 at p. 15.

[288] Tr. 5686; Tr. 7103; Ex. 803.

[289] *See Kansas-Nebraska Natural Gas Co.*, 53 FPC 1691 (1975), *aff'd*, 534 F.2d 227 (10th Cir. 1976).

[290] *Questar Pipeline Co.*, 74 FERC ¶ 61,126, at p. 61,455 (1996).

[291] Tr. 4687.

[292] SFPP Initial Brief at p. 79.

Navajo and Chevron note that SFPP generally allocates on its general ledger 85 percent of its G&A costs to carrier operations and 15 percent of its G&A costs to non-carrier operations. The apportionment factors were developed in early 1991 and have been in effect since April 1991 pursuant to an allocation study undertaken by SFPP in 1990.[293] However, the actual business record allocations on which SFPP relies are not in the evidentiary record. Ernst & Young did not have the underlying study used by SFPP to arrive at the allocations used by SFPP. Thus, Navajo and Chevron argue that Ernst & Young did not audit the basis for SFPP's allocation.

Moreover, the Ernst & Young report is not credible, argue Navajo, Chevron, and West Line Shippers. The report found that groups of field personnel reflected precisely the same time splits between carrier and non-carrier, and that virtually all personnel, no matter what they did, spent 75 percent or more of their time on jurisdictional endeavors. Yet that consistency of time allocations raised absolutely no question in the consultants' minds, even when it came to the personnel located at the large, non-jurisdictional tank and loading facilities owned by SFPP, *e.g.*, in Phoenix.

Navajo and Chevron also argue that because the report was produced solely for the purposes of litigation, it is entitled to no credibility.[294] Such a make-weight, litigation-driven "report," they argue, cannot serve to overcome the Commission's requirements for the use of the *KN* method.[295]

Chevron also notes that while SFPP allocates about 15 percent of overhead costs to non-carrier activities, those activities account for 25 percent of SFPP's investment and 30 percent of its direct labor costs.[296]

I find that the methodology supported by SFPP is flawed; the *KN* method in this case appears more likely to produce a just and reasonable allocation of carrier and non-carrier G&A costs. Considering the evidence, the law, and the arguments of the participants, I hold that the *KN* formula advocated by Chevron and Navajo shall be used to allocate SFPP's General and Administrative Costs, alternatively referred to as Overhead or Corporate Unallocated, between SFPP's carrier and non-carrier operations.

B. Allocation of General and Administrative Costs to the South System and to the East and West Lines

After allocating G&A costs between carrier and non-carrier, the next step is to allocate a portion of those costs to the South System and then to the East and West Lines. In making this allocation, SFPP used a modified Massachusetts formula.

The unmodified Massachusetts formula is derived from *Midwestern Gas Transmission Co.*, 32 FPC 993 (1964), *modified*, 44 FPC 721 (1970). The Massachusetts formula "allocat[es] parent overhead costs to a subsidiary on the basis of the average of the ratios that the subsidiary's labor costs, gross plant, and gross revenues have to the parent's."[297] SFPP averaged the South System portion of each of these factors and then applied that average number to the G&A costs previously assigned to carrier operations.[298]

Chevron and Navajo object to SFPP's use of a modified Massachusetts formula; they argue that Commission precedent requires use of the *KN* formula for allocating G&A costs to the South System and the East and West Lines.

In support of its approach, SFPP alleges that "proper use of the *KN* method is limited to true 'functionalizations'—that is, cost assignments based on different operational functions to which corporate overhead costs would relate."[299] SFPP criticizes Navajo witness Andrew W. Battese's "overuse" of the *KN* method

[293] Ex. 359 at p. 28; Tr. 4566.

[294] *See, e.g., AMPAT/Midwest, Inc. v. Illinois Tool Works Inc.*, 896 F.2d 1035, 1045 (7th Cir. 1990)("Litigation is not a 'regularly conducted business activity,' and this for the practical reason that documents prepared specifically for use in litigation are...'dripping with motivations to misrepresent.'")(citations omitted). Indeed, argue Navajo and Chevron, even if the report were a summary, rather than one created solely for the purpose of litigation, it would not be deemed credible enough to be admissible due to SFPP's failure to provide the underlying business records. Fed. R. Evid. 1006; *United States v. Kim*, 595 F.2d 755, 764 (D.C. Cir. 1979).

[295] Navajo and Chevron cite *Questar Pipeline Co.*, 72 FERC ¶ 61,195 (1995), compliance filing accepted and rejected, 74 FERC ¶ 61,126 (1996); and *Panhandle Eastern Pipe Line Co.*, 74 FERC ¶ 61,109 (1996).

[296] Ex. 34 at p. 7.

[297] *Distrigas of Massachusetts Corporation*, 41 FERC ¶ 61,205, at p. 61,554 (1987).

[298] SFPP notes in its Initial Brief (pp. 80-81 n.67):

> For the purposes of two subsidiary allocations to the South System and its component segments, SFPP used other methods specifically tailored to the tasks at hand: it used actual or normalized throughput data to assign oil losses and shortages; and it used a modified Massachusetts formula (substituting a barrel-mile factor for the revenue component of the formula) to allocate its district offices expenses. *See* Jessen Direct, Ex. 238 at p. 55.

[299] SFPP Initial Brief at p. 81.

because "Mr. Battese was unable to define any meaningful point at which the 'functionalization' process should end and other forms of allocation or separation should begin."[300]

However, Commission precedent makes it clear that the *KN* method applies not only to functionalization, but also to allocating G&A costs among a company's divisions.[301] In *Questar Pipeline Co.* [302] the Commission stated:

> The Commission did not adopt the *Distrigas* [Massachusetts] formula as a method for allocating A&G expenses between company functions or divisions. Rather, the Commission adopted the *Distrigas* formula for allocating overhead from parent companies to subsidiaries where the revenue factor is more material and supported by financial statements. Moreover, availability of data does not necessarily make the data appropriate to use for allocation purposes.[303]

Subsequently, in its February 7, 1996, order in *Questar*, the Commission reaffirmed its preference for the *KN* method whether for functionalization or allocation. Noting that the Massachusetts formula factors in revenue, while the *KN* method does not, the Commission stated that the basis for preferring the *KN* method in such instances is that revenues are not factored into the allocation process in applying the *KN* method. The Commission said:

> Revenues are not factored in because the pipeline has its own sources of revenues. Indeed, since the ... rates are the source of a pipeline's revenue and those rates, in turn, depend on the amount of costs allocated to each ... function, it would be circular for the Commission to use revenue to allocate any costs among the ... functions of the pipeline.[304]

SFPP relies on *Tennessee Gas Pipeline Co.* to justify its use of the Massachusetts formula.[305] *Tennessee* involved allocating the overhead of a parent holding company; it did not involve allocating among functions, among jurisdictional assets, and between jurisdictional and non-jurisdictional assets—the allocation issues involved here.[306] In allocating G&A expenses from a parent among its subsidiaries, use of the Massachusetts formula is appropriate because revenue constitutes part of the Massachusetts formula, which has some relationship to the amount of time a parent allocates among its various operating entities.[307] But use of the Massachusetts formula is not appropriate for allocating G&A costs to the South System and to the East and West Lines.

Having considered the evidence, the arguments of the participants, and the law, I hold that the *KN* formula, as applied by Navajo witness Battese, shall be used by SFPP in allocating G&A costs to the South System and to the East and West Lines.[308]

C. Allocation of Operating and Capital Costs Between Jurisdictional Interstate Service and Non-Jurisdictional Intrastate Service

The third allocation issue involves isolating the costs attributable to interstate service from the total costs assigned to the South system and to carrier operations. This issue arises with respect to the California portion of SFPP's South System, which serves both interstate and intrastate pipeline movements.

The basic mechanism for SFPP's approach is a route directory, sponsored by SFPP witness Ganz, which identified all of the applicable operating locations in California as providing either interstate, intrastate or dual interstate/intrastate service. The dual service locations were further assigned to one of eight categories (CA-1 through CA-8) for purposes of developing appropriate interstate and intrastate factors based on actual usage.[309]

The route directory allowed SFPP to identify each California facility and apportion the operating expense and capital costs associated with that facility based on interstate and intrastate use.[310] For example, for a facility such as the line segment between the Niland Terminal and the Imperial Terminal, which was used in in-

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[300] SFPP Initial Brief at p. 82.

[301] *Questar Pipeline Co.*, 74 FERC ¶ 61,126, at p. 61,455.

[302] 72 FERC ¶ 61,195 (1995).

[303] *Id.* at p. 61,927.

[304] 74 FERC ¶ 61,126, at p. 61,455.

[305] SFPP Initial Brief at pp. 81-82.

[306] *Tennessee Gas Pipeline Co.*, 32 FERC ¶ 61,086, *reh'g denied*, 33 FERC ¶ 61,005 (1985), *modified*, 813 F.2d 448 (D.C. Cir. 1987).

[307] Even in this situation, the Massachusetts formula may not be appropriate. The Commission in *Tennessee* stated:

> Therefore, although the Commission adopts that formula for use in this proceeding, this adoption does not mean that the Commission would reject another method that had sufficient record support in a different proceeding.

nnessee Gas Pipeline Company, 32 FERC ¶ 61,086, at p. 61,233.

[308] As discussed *infra*, separate rates will be developed for the East and West Lines.

[309] Ex. 206 at pp. 10-11, 15-18; *see* Ex. 211.

[310] Tr. 10687-89; Tr. 10422.

trastate service only, all of its costs were removed from the interstate cost of service.[311] For a facility such as the line segment from the Niland Terminal to the California-Arizona border, which was used only in interstate service, all of its costs were included in the interstate cost of service.[312] For a facility such as the line segment between the Ontario Terminal and the Colton Terminal[313] (designated as CA-7), which was used in both interstate and intrastate service, the costs were assigned on the basis of the number of barrels moving through that facility in interstate and intrastate service during the year.[314]

As a result of that analysis SFPP, in its cost of service presentations for the South System and alternatively in its cost of service presentations for the East and West Lines, only included the costs associated with interstate service.

The Staff similarly used SFPP's California route directory in making its allocations.[315] RHC witness Eberst testified that he had no problem with a volume allocation methodology of this type.[316]

Chevron and Navajo witness Battese, however, objected to SFPP's approach to isolating California interstate costs.[317] Instead, he argued for a "totality of costs" approach, in which intrastate costs would be lumped together with interstate costs for a subsequent assignment.[318] He also complained that he was not able to use SFPP's route directory approach because he did not have adequate data showing SFPP's "totality of costs" that would allow him to verify SFPP's results.[319]

Mr. Battese's criticism of the route directory approach is not consistent with some of his other testimony. Mr. Battese used an approach similar to a route directory approach in assigning Arizona common costs to the East and West Lines, a task which is substantively indistinguishable from the California interstate-intrastate separation.[320] Moreover, Mr. Battese himself used SFPP's California route directory for four of the eight California sections.[321]

SFPP's approach specifically eliminates costs attributable to intrastate service, and thus it satisfies the basic ratemaking goal of having interstate ratepayers bear only the costs associated with interstate service.

The West Line Shippers' approach to the isolation of interstate costs is somewhat different from the approach of Mr. Battese. For purposes of their basic presentation, the West Line Shippers used the results of SFPP's California route directory analysis, and to that extent they appear not to take issue with SFPP's approach.[322] However, they go on to support an adjustment by which the interstate cost of service is credited with an amount that purports to represent "excess revenues" allegedly earned by SFPP on its intrastate movements.[323]

The West Line Shippers' proposal regarding an "excess intrastate revenue credit" is not acceptable. The Commission has no jurisdiction over the revenues earned by an oil pipeline from its intrastate operations, which in this case are regulated by a state agency.[324] Also, the proposed credit is based on a mismatch of cost and revenue data from different years (specifically, 1991 test year data based on a 1990 base year, compared with 1993 Form 6 data).[325]

Finally, the West Line Shippers' proposal lacks the precedential support claimed by them. The case on which they rely, *Panhandle Eastern Pipe Line Co. v. FPC*, 324 U.S. 635 (1945), involved a gas pipeline that had both regulated interstate wholesale sales and unregulated direct industrial sales. The FPC made no separation or allocation of the properties, costs or revenues between the two classes of service, for reasons that the Supreme Court described as "exceptional" (including the "incidental" and "byproduct" nature of the direct

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[311] Ex. 211-PO, Schedule 1, p. 4 of 4.

[312] *Id. See* Ex. 145, which is a map of the South System.

[313] Ex. 211-PO, Schedule 1, p. 4 of 4.

[314] *Id.*; Ex. 206 at pp. 10-11.

[315] Tr. 7114.

[316] Tr. 5695.

[317] Tr. 4589.

[318] Tr. 4360.

[319] Tr. 4350-51.; Ex. 359 at p. 6.

[320] *See* Tr. 4372-79.

[321] Tr. 4350. His refusal to do so for the other four California sections was based on an allegation that he somehow lacked data necessary to allow its use in those geographic areas. Battese Rebuttal, Ex. 359 at p. 6; Tr. 4351. However, Chevron and Navajo witness Zaegel testified that he had available to him all necessary data relating to all eight of the California sections, Tr. 4755-57, and no other party suggested any data deficiency.

[322] Tr. 6563.

[323] Ex. 290 at pp. 17-19.

[324] Section 1(1) of the Interstate Commerce Act expressly limits the reach of the Act to carriers engaged in transportation in interstate or foreign commerce. 49 U.S.C. app. § 1(1)(1988). Section 1(2) expressly states that the provisions of the Act do not apply to "the transportation of...property...wholly within one State...." *Id.* § 1(2)(a).

[325] Tr. 6570-71.

sales).[326] The parties in the Commission proceeding had also "[a]ll agreed that an allocation on the basis of investment or costs would be impractical."[327]

The Court concluded that under the "exceptional circumstances" presented in that case the FPC had not erred in simply attributing to the regulated sales the overall company profits in excess of 6½ percent. At the same time, however, the Court emphasized that "the Commission must make a separation of the regulated and unregulated business when it fixes the interstate wholesale rates of a company whose activities embrace both. Otherwise, the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act."[328]

Contrary to the West Line Shippers' argument, then, *Panhandle Eastern* stands for the proposition that, except in the most extraordinary of cases, unregulated results should not be ascribed to the regulated business and that to do so would exceed the Commission's statutory grant of jurisdiction.

For all of these reasons, the suggestion that "excess California profits" should be credited against the interstate cost of service is rejected.

It is also held that SFPP's route directory methodology shall be used to allocate operating and capital costs between jurisdictional interstate service and non-jurisdictional intrastate service.

D. Military Facilities

Another issue involves how to remove from SFPP's jurisdictional South System costs the costs associated with providing service to U.S. military installations. SFPP's South System serves a number of those facilities through a combination of common carrier lines that connect to lateral lines serving only the military destinations.[329]

The issue regarding the removal of the military facilities costs arises because of the way rates applicable to movements by the military are determined. SFPP and the government negotiate for the charges to be paid for the transportation and other services provided to the military by SFPP.[330] The result of the negotiation is an all-inclusive, fully-loaded rate for service to the military installation; the starting point for the negotiation is SFPP's published rate for the portion of the movement that uses SFPP's common carrier lines.[331] SFPP witness Pearl testified that the military pays the same rate as any other shipper to the extent it uses common carrier lines; the negotiated aspect of the overall charge to the military is for the transportation and other services that do not involve the specific use of SFPP's common carrier lines.[332]

An example is the rate charged to the military for service from El Paso to Davis-Monthan Air Force Base, which is near Tucson. The rate for that movement, effective January 1, 1994, was $1.359 per barrel of turbine fuel.[333] That charge consisted of two components—the commercial rate for movements from El Paso to Tucson,[334] and a negotiated component for transportation over the lateral line to Davis-Monthan and for additional services provided to the military.[335] While the composite rate for this total service is renegotiated with the military from time to time, the commercial portion of the rate is never subject to negotiation.[336]

SFPP included in its cost of service presentations all of the costs and revenues associated with the commercial portion of the military movements—that is, the portion associated with transportation through the South System common carrier lines—and excluded all of the

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[326] *Panhandle Eastern Pipe Line Co. v. FPC*, 324 U.S. at 642, 647 (1945).

[327] *Id.* at 645.

[328] *Id.* at 641-42.

[329] Ex. 147 at p. 6; *see also* Exs. 208, 242. The specific military-exclusive lateral lines are identified in Exhibit 208 (*e.g.*, p. 4, Location Code 7052) and are shown on the location diagram in Exhibit 209. *See also* Ex. 145 (South System map)(blue lines).

[330] *See generally* Tr. 9399-9401. Section 22 of the Interstate Commerce Act, 49 U.S.C. app. § 22 (1988), provides that it is not unlawful for a carrier regulated by the Act to provide the United States government with transportation at reduced rates. However, nothing in the Act requires that reduced rates be offered to the government. None of SFPP's South System military rates are discounted. Tr. 9387-88.

[331] There are two military movements—to Yuma and Williams Air Force Bases—that involve connections to military-exclusive use lateral lines at points that are not published as common carrier destinations. In those instances, SFPP calculates the common carrier component of the charge to the military based on the distance to the next nearest published destination point. *See* Tr. 10973-74.

[332] Tr. 9400.

[333] Ex. 822 at p. 3.

[334] *See* SFPP FERC Tariff No. 15, Item A by Reference.

[335] Tr. 9399-9400.

[336] *Id.*

costs and revenues associated with the remainder of the composite charge to the military.[337]

Several parties, including the Staff, nevertheless contend that SFPP's allocation methodology fails to exclude all indirect costs associated with military deliveries, and thus inflates the cost of service attributed to commercial ratepayers. Their recommended solution is to credit to SFPP's cost of service with 100 percent of the revenues associated with military movements.[338]

From the discussion, *supra*, requiring the use of the KN method to allocate that portion of SFPP's corporate G&A expense attributable to non-carrier, non-South System and intrastate operations, the G&A expense will be excluded from the cost pool applicable to the military movements before the military exclusion is made. What is left is the portion of G&A expense properly attributable to South System interstate pipeline operations, including both military and commercial movements. As a result, when the costs associated with the military-exclusive use portion of SFPP's South System are excluded, they require no additional allocation of overheads—by definition, the excluded costs carry with them their appropriate share of the previously allocated G&A cost pool. Furthermore, to the extent the commercial portion of the military movements are included in SFPP's South System allocation, the evidence shows that portion carries with it an appropriate share of allocated expenses.[339]

Staff seems to concede that Mr. Jessen's approach on behalf of SFPP "may in this instance achieve the intended objective . . . ." of excluding the costs and revenues associated with the exclusive service to military facilities. However, Staff's concern with SFPP's approach appears to be the potential for SFPP to charge the military reduced rates under section 22 of the Interstate Commerce Act.[340] Staff perceives a risk of discriminatory treatment in that potential, particularly if SFPP's approach is adopted.

Staff's alternative approach—based on a credit to SFPP's cost of service of all of the revenues SFPP received from the military—is not necessary and is less precise than SFPP's allocation method. As RHC noted, revenue crediting mechanisms are inherently less desired than direct attributions or allocations of costs.[341]

Navajo and Chevron also endorse a revenue crediting approach for military-related costs. Navajo recognizes, however, that SFPP's approach "excludes all revenues collected from the military for the use of those [exclusive-use] facilities, as well as investment and expenses associated with those facilities."[342] Chevron's endorsement of a revenue crediting approach proceeds from an incorrect perception of the facts. Chevron states that "SFPP includes the investment costs and operating expenses of these exclusive military facilities in its rate base and cost of service."[343]

Considering the evidence and the arguments of the participants, I hold that the method advocated by SFPP for removing military facilities costs from the South System is approved; the revenue crediting mechanism advocated by some of the other participants is not approved.

E. Assignment of Arizona Common Costs

Because separate rates are being established for the East and West Lines (see discussion *infra*), an assignment needs to be made to the East and West Lines of certain Arizona facilities (principally certain tanks and other facilities at Tucson and Phoenix) that are used in common by both the East and West Lines.

SFPP's approach is to assign the costs associated with these facilities on the basis of volumes, as was done for the California facilities used in both interstate and intrastate service.[344] In other words, SFPP analyzed the extent to which each Arizona common facility was used in East and West Line service in each relevant period, and assigned the capital and operating costs of that facility accordingly.

There is no issue with respect to this method of allocating the costs of the Arizona common use facilities. All of the parties who made this assignment use the same method as SFPP—including Mr. Battese, who objected to its use in the case of the California facilities used in common for interstate and interstate transportation.[345]

A related issue, upon which some participants disagree, involves the proposed assignment to the West Line of certain costs associated with the 1992 East Line expansion.

[337] Ex. 238 at pp. 100-01; Tr. 10746-47.

[338] However, RHC witness Eberst adopted in full SFPP's approach to the costs associated with service to military installations. Tr. 5691.

[339] *See* Ex. 238 at pp. 100-01.

[340] 49 U.S.C. app. § 22 (1988).

[341] RHC Initial Brief at pp. 16-17.

[342] Navajo Initial Brief at p. 74.

[343] Chevron Initial Brief at p. 65.

[344] Ex. 238 at pp. 57-58; Tr. 10688.

[345] *See* Ex. 34 at p. 37; Tr. 4372-75, 5692, 7131-32.

At all times relevant to this discussion, the 8-inch line flowed in East Line service, *i.e.*, from Tucson to Phoenix.[346] The 6-inch line, however, has flowed both in East Line service from Tucson to Phoenix and in West Line service from Phoenix to Tucson.[347] At the time of SFPP's 1985 rate case, the 6-inch line was in East Line service. In the subsequent settlement of that case the parties agreed that SFPP would be entitled to publish a tariff on the West Line for service into Tucson without objection from the settling parties; as a result SFPP reversed the 6-inch line and placed it in West Line service in 1989.[348] A corollary provision in the settlement with Navajo was that SFPP was required to undertake, on a best efforts basis, to maintain adequate capacity into Phoenix on the East Line.[349]

In the ensuing two years, the expected use of the 6-inch line by West Line shippers did not materialize,[350] averaging only 1,000 to 1,500 barrels per day[351] on a line that in East Line service had a capacity of 9,500 barrels per day[352] and that later had a capacity in West Line service of 17,000 barrels per day.[353] During this same period, SFPP's East Line began in late 1990 to experience prorationing, and both Navajo and EPR began refinery expansions.[354] As a result, both Navajo and EPR pressured SFPP to expand its East Line system.

SFPP agreed to undertake some pipeline capacity expansions to eliminate certain bottlenecks on the El Paso to Tucson portion of the pipeline and to expand capacity between Tucson and Phoenix.[355] SFPP reversed the 6-inch line and put it back in East Line service to provide the needed additional capacity from Tucson to Phoenix to relieve the prorationing on the East Line segment. The reversal of the 6-inch line increased East Line capacity from 27,000 to 36,000 barrels per day.[356] Because that capacity was still insufficient in light of the growing East Line volumes, SFPP installed additional facilities on the 8-inch line so that by early 1992, East Line capacity between Tucson and Phoenix had increased to 42,000 barrels per day.[357]

However, West Line shippers were requesting the restoration of West Line service to Tucson. ARCO, for example, was willing to execute a transportation and deficiency agreement guaranteeing throughput of not less than 5,000 barrels per day for 5 years to obtain the reversal into West Line service of the 6-inch line.[358]

In these circumstances, SFPP determined that the most economical manner by which to provide the capacity from Tucson to Phoenix required by the East Line shippers and to provide the expanded capacity from Phoenix to Tucson being requested by the West Line shippers was to expand the 8-inch line and further upgrade the 6-inch line.[359] With this approach East Line capacity could be expanded to 55,000 barrels per day with just the expanded 8-inch line[360] in East Line service,[361] and the 6inch line could be taken out of East Line service and placed in West Line service, providing West Line shippers, after installation of additional facilities, with up to 17,000 barrels per day of capacity.[362]

Navajo asserts that the needs of both East Line and West Line shippers were met with the minimum capital expenditure necessary to achieve the needed additional capacity. Accordingly, argues Navajo, the appropriate allocation of those capital costs is to allocate the undepreciated original cost of the 6-inch line between the East Line and West Line based on historical usage,[363] and to allocate the upgrade costs between the two lines based upon the increased capacity realized by each of the two sets of shippers as a result of the upgrade.

In its alternative presentation, which assumes that rates will be established separately for the East Line and West Line, SFPP assigned the costs of that expansion to the East Line, just as it assigned to the West Line the costs associated with its expansion. Consistent with that approach and its route directory approach, SFPP assigned the costs of the 6-inch line to the East or West Line, depending on the

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[346] Ex. 142 at pp. 14-15.

[347] Ex. 147 at p. 14.

[348] Ex. 859 (Navajo/SFPP settlement) at p. 2; Ex. 892 (Airline Intervenor/SFPP Settlement) at p. 6.

[349] Ex. 859 at p. 5.

[350] Ex. 147 at p. 16.

[351] Ex. 147 at p. 10.

[352] *Id.* at pp. 10-11.

[353] Tr. 5242.

[354] Ex. 147 at p. 14; Ex. 867 at p. 2.

[355] Ex. 147 at p. 10.

[356] *Id.* at p. 11.

[357] *Id.* at p. 11.

[358] *Id.* at p. 17.

[359] Tr. 8482.

[360] The expansion of the 8-inch line involved installation of 40 miles of 12-inch line.

[361] Ex. 147 at p. 11.

[362] Tr. 5242.

[363] This allocation appears in Ex. 343 at the bottom of each page.

direction that line was flowing in any particular period.[364]

Chevron argues that during 1991 and 1992, the costs of the 6-inch line should be assigned to the East Line or West Line ". . . on the basis of the number of months that the Six Inch Line was dedicated to East Line or West Line Service."[365]

Having considered that arguments of SFPP, Navajo, and Chevron, I hold that SFPP's methodology shall be used to allocate to the East Line and the West Line the costs of SFPP's lines between Phoenix and Tucson.

F. Watson Enhancement Facilities

Watson is the primary origin point for interstate shipments on SFPP's West Line to Phoenix and Tucson, Arizona, and to the Calnev Pipeline.[366] Chevron, ARCO, Texaco, Mobil and other shippers cannot ship product on SFPP's West Line without going through SFPP's Watson Station.

At Watson SFPP provides for its shippers facilities which it characterizes as a "gathering enhancement system."[367] Shippers who use this facility pay a fee of $0.032 per barrel[368] pursuant to contracts they have signed with SFPP. However, shippers whose pumping rates are sufficiently high are not required to pay the fee,[369] even though their product necessarily goes through the Watson enhancement facilities.[370] In other words, every shipper's product entering SFPP's system at Watson goes through the enhancement system, whether or not the shipper pays the fee.[371] No tariff is filed with the Federal Energy Regulatory Commission for this charge and for the terms and conditions of the service provided.

Chevron asks that the Watson facilities be held to be subject to FERC jurisdiction under Sections 1(3)(a) and 1(4) of the Interstate Commerce Act, that SFPP be directed to file a tariff with FERC setting forth its proposed tariff rate and the terms and conditions of its service as required by Section 6(1),[372] and that SFPP also be directed to file a cost of service that includes its investment, operating costs, and fees collected since the inception of the Watson operations.

Staff's position is similar to Chevron's; in addition Staff asks that SFPP's West Line cost of service be credited with the interstate revenues derived from the shippers' use of the Watson enhancement facilities.[373] Chevron does not object to revenue crediting.[374]

West Line Shippers ask that the Watson Service be held to be jurisdictional and that all Watson revenues ". . . should be credited to the interstate movement."[375]

SFPP's position is that the enhancement facilities are not subject to regulation under the ICA.[376] However, SFPP asserts that if the enhancement facilities are held to be subject to ICA regulation, SFPP must be permitted to file a rate for them and to justify it as market-based.[377] In any event, SFPP argues that no credit to SFPP's cost of service should be made relating to Watson[378] nor should any reparations be awarded with respect to charges paid for use of the Watson enhancement facilities under shippers' contracts with SFPP.

The Watson enhancement service came into existence in the following way.

In March 1989 SFPP notified shippers on the West Line that it was increasing the minimum pumping rate at its Watson Station from 10,000 to 15,000 barrels per hour ("BPH") for gasolines, and 9,000 to 13,500 BPH for distillates, effective April 1, 1992.[379] SFPP stated that volumes transported through Watson had grown and "have exhausted the capabilities of the existing supply infrastructure."[380] SFPP informed shippers that if they did not use the Watson gathering service or in some other way meet the new pumping rate, they would not be allowed to ship product on SFPP's interstate pipeline from Watson.[381]

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[364] Ex. 213; Ex. 238 at pp. 93-94.

[365] Chevron Reply Brief at p. 58.

[366] *See* Ex. 126; Tr. 8663-65; *see also* Ex. 145.

[367] Ex. 144 at p. 14.

[368] Ex. 113 at p. 17.

[369] Tr. 8672.

[370] Tr. 8883.

[371] Ex. 404 at p. 62.

[372] Section 6(1) of the ICA states, in part:

> Every common carrier subject to the provisions of this chapter shall file with the Commission...schedules showing all the rates, fares, and charges for transportation between different points on its own route . . . by pipe line . . . .
>
> 9 U.S.C. app. § 6(1) (1988).

[373] Staff Initial Brief at p. 68.

[374] Chevron Initial Brief at p. 198.

[375] West Line Shippers Initial Brief at p. 45.

[376] SFPP Initial Brief at p. 220.

[377] *Id.* at p. 227.

[378] *Id.* at p. 228.

[379] Ex. 113 at p. 16; Ex. 122 (March 7, 1989 letter from SFPP to ARCO ("March Letter")).

[380] Ex. 122 at p. 2.

[381] Ex. 404 at p. 62.

The suppliers were asked to complete the necessary modifications to reach the higher pumping rates in two phases having completion dates of October 1, 1990 and April 1, 1991.[382]

Shortly after that notification to Watson Station suppliers of the increased pumping rate requirement, SFPP was contacted by ARCO, which indicated that the modifications required for it to reach the higher rate would involve a substantial investment. ARCO asked if there were possible alternatives to the higher pumping rates. As a result of that request, SFPP determined that if the incoming tankage could be operated on a drain-dry basis (described below), the efficiency of the shippers' gathering facilities would be improved and therefore the incoming pumping rate increase could be deferred until a later date.[383]

SFPP then advised ARCO of the cost to convert to a drain-dry operation, including the estimated charge to amortize the investment and cover operating costs. ARCO indicated that it preferred this alternative, and as a result the service was offered as an option to all suppliers at Watson Station.[384]

The enhancement facilities include vapor collection piping (20-inch diameter) connected to 10 of the 14 tanks, flame arresters, vapor blowers and flow regulators on each of the collection lines, a vapor saturation system and a thermal oxidizer.[385]

The system collects all of the displaced vapors under the internal floating roofs of the storage tanks and allows each tank to go completely empty and be refilled without emitting vapors to the atmosphere. Thus, the system allows each tank to handle multiple grades of product. Prior to installation of the drain-dry system, each tank was dedicated to a specific product family, which greatly reduced the station's throughput capacity.[386] The system actually does not increase the pumping rate; it simply improves the efficiency of the shippers' own gathering systems.[387]

The ICA applies to "common carriers engaged in ... [t]he transportation of oil ... by pipe line ... from one State ... of the United States ... to any other State ... of the United States ...."[388] Thus, the Act clearly applies to transportation of oil by pipeline from California to other states.

Under Section 1(4) of the ICA, SFPP, as a common carrier, must transport product "upon reasonable request therefor."[389] Transportation is broadly defined under the ICA to include "all instrumentalities and facilities of shipment or carriage ... and all services in connection with the receipt, delivery ... transfer in transit ... storage, and handling of property transported."[390]

The Commission recently affirmed the duty of common carrier pipelines to transport product and "furnish services in connection therewith, on its system upon reasonable request."[391] In *Lakehead*, the issue was whether Lakehead Pipe Line Company ("Lakehead") had to provide breakout tankage at Superior, Wisconsin if shippers without access to such facilities requested transportation.[392] The Commission held that these breakout tank facilities were "part and parcel of Lakehead's transportation of NGLs on its system," and were an "integral part" of Lakehead's overall transmission function.[393] It reasoned that the NGLs shipped on Lakehead's system to Superior, Michigan always go into breakout tank facilities and, as such, the facilities were an essential part of Lakehead's transportation service, and were integrated into Lakehead's system of common carriage.[394] The Commission held that if shippers delivering product to Lakehead's system had no access to breakout tank facilities, then Lakehead "must provide

[382] Ex. 144 at p. 13.

[383] *Id.* at pp. 13-14.

[384] *Id.* at p. 14.

[385] *Id.*

[386] *Id. See also* Exhibit 832 which is a schematic drawing of the breakout tank recovery system at Watson.

[387] Ex. 144 at p. 16.

[388] 49 U.S.C. app. § 1(1)(b)(1988).

[389] 49 U.S.C. app. § 1(4) (1988).

[390] 49 U.S.C. app. § 1(3)(a) (1988).

[391] *Lakehead Pipe Line Company, L.P.*, Opinion No. 397, 71 FERC ¶ 61,338, at p. 62,324 (1995), *reh'g denied*, Opinion No. 397-A, 75 FERC ¶ 61,181 (1996).

[392] In *Lakehead*, Interprovincial Pipe Line, Inc. ("IPL") transported natural gas liquids ("NGLs") from Western Canada to Lakehead at the international border at Neche, North Dakota. Lakehead then transported the NGLs to Superior, Wisconsin and eastward to Marysville, Michigan. To transport NGLs eastward to Marysville, the NGLs had to be broken out from Lakehead's pipeline and stored at Superior. Lakehead required that its shippers provide their own NGL receipt, intermediate breakout, and delivery facilities at Superior to the extent not provided by Lakehead. At that time, the NGLs were broken out using breakout storage tank facilities owned by Lakehead's single NGL shipper, Amoco Canada Petroleum Company, Ltd. 71 FERC ¶ 61,338, at pp. 62,319-22.

[393] 71 FERC ¶ 61,338, at p. 62,325.

[394] *Id.*

or arrange for the provision of [breakout tank] facilities."[395]

The Commission rejected Lakehead's claim that it could require shippers to provide their own breakout tank facilities. It stated that:

> [t]he common carrier can make reasonable and appropriate rules respecting the acceptance and transportation of traffic. However, those rules cannot be such that they vitiate the common carrier's obligation to hold out service upon reasonable request . . . . [That] would be unreasonable because it would render its common carrier obligation a nullity and convert Lakehead into a private carrier . . . . This would violate its common carrier obligation under the ICA to provide transportation upon reasonable request.[396]

Similarly at Watson, there are only two ways by which a shipper can access SFPP's interstate pipeline: either (1) by installing its own pumping facilities to meet SFPP's prescribed higher pumping rate, or (2) by using SFPP's gathering services at Watson.[397] None of SFPP's West Line shippers who currently ship from Watson meet the pumping rate and, therefore, all use SFPP's gathering facilities at Watson and pay SFPP's required fee.[398]

The Watson enhancement facilities are shown in various schematic diagrams in evidence.[399] The West Line shippers's product enters SFPP's Watson facilities at an entry point, referred to as "Incoming Lines From Suppliers,"[400] before it enters the breakout tanks that perform the enhancement service.[401] The product flows through SFPP's pipe facilities to SFPP's breakout tanks. After leaving these tanks, the product flows through SFPP's mainline pumps and meters into SFPP's trunkline facilities.

As described by Staff witness Pride, the SFPP-designated "nonjurisdictional" facilities at Watson are connected to the jurisdictional facilities, and are related to the receipt of product into SFPP's system and to the transportation of product through that system.[402] Product cannot enter SFPP's system unless it either meets the requisite pumping rate or uses "all of [SFPP's] facilities."[403]

Although SFPP currently provides this service for its shippers, it does so under private contract and charges shippers an additional fee above its currently published tariff rate.[404] This has been SFPP's approach since initiating the service on November 1, 1991.[405]

The agreement SFPP provided to Chevron for use of the Watson enhancement facilities[406] demonstrates SFPP's recognition that the facilities are part of its interstate pipeline transportation system.[407] Paragraph 2 of that agreement states that Chevron "agrees to pay to SFPP a Gathering Charge of $.032 per BBL of product transported through the 'system.'"[408] Additionally, the agreement implies that the product has passed into SFPP's custody when it enters the facility.[409] Further, SFPP considers that uniform pumping rates are "necessary" to ensure that no shipper's introduction of product will slow the rate of flow through the system. As in *Lakehead*, SFPP's Watson gathering facilities are integral to SFPP's interstate pipeline operations and are a "necessary feature of the flow of oil on SFPP in interstate commerce."[410]

SFPP's response is that the Watson gathering facilities are not a necessary part of SFPP's interstate service.[411] That position flies in the face of the Commission's decision in *Lakehead*.[412] As stated above, SFPP's own schematic diagram shows product entering SFPP-owned carrier property at a point before the facilities that provide the gathering service for SFPP.[413] It is at that point that Chevron and other shippers on the West Line tender their product to SFPP for shipment in interstate commerce. SFPP's witness has testified that the breakout tanks used for the gathering service are "operated as part of the transportation

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[395] *Id.*

[396] *Id.*

[397] Ex. 34 at pp. 48-49; Ex. 404 at p. 62.

[398] Ex. 404 at p. 62.

[399] Exs. 40, 125, and 832.

[400] Ex. 34 at p. 49; Ex. 40; Ex. 125.

[401] Ex. 34 at p. 49; Ex. 40; Ex. 113 at p. 18; Ex. 125.

[402] Tr. 7759; *see also* Ex. 34 at pp. 49-50; Ex. 404 at pp. 5862.

[403] Tr. 7759; *see also* Ex. 404 at p. 62.

[404] Ex. 113 at pp. 17-18.

[405] Ex. 41 ("Watson Agreement").

[406] *Id.*

[407] Ex. 34 at p. 50.

[408] Ex. 41.

[409] *Id.*

[410] Tr. 7759; *see also* Ex. 404 at pp. 61-63.

[411] Ex. 144 at p. 15.

[412] See discussion of *Lakehead*, *supra*. Despite the fact that SFPP filed its Direct testimony prior to the issuance of the *Lakehead* decision, SFPP reiterated its position in the Consolidated

Issues List and Position Statement, filed April 5, 1996, at pp. 131-32.

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[413] Ex. 34 at p. 49; Ex. 40; Ex. 113 at p. 18; Ex. 125.

system along with the pipeline, and SFPP therefore treats it as carrier property."[414] Since SFPP has acknowledged that the breakout tanks which provide the Watson gathering services are part of its jurisdictional system, its argument that the service itself is not jurisdictional is not persuasive.

SFPP witness Abboud testified that even if a shipper meets the required pumping rate, the gathering facilities will be used for the transportation of product. The equipment is in place and there is no means of bypassing it. Therefore, a shipper that installs its own pumping equipment still moves its product through the Watson facilities. SFPP would continue to incur operating costs associated with the shipper's transportation, but the shipper would not be required to pay a fee.[415]

Courts and agencies have addressed the circumstances under which a facility's services can properly be characterized as an integral part of a larger, interstate transportation scheme. If the services can be so characterized, the facility may be subject to ICA jurisdiction. The Federal Energy Regulatory Commission has stated,

> the fact that the movement in question begins and ends in one state is not dispositive of the issue of jurisdiction. If the shipment is in fact a link in an interstate chain of movements, then it may still be subject to Federal jurisdiction.[416]

In making this jurisdictional determination, courts and agencies have looked at several factors. In *Southern Pacific Terminal Co. v. ICC*,[417] the Supreme Court held that a wharf that connected an interstate railway-steamship transportation system was subject to ICA jurisdiction. The Court based its holding in large part on a finding that the wharf was "necessary in the transportation or delivery of the interstate and foreign freight transported by" Southern Pacific rail carriers.[418]

The Court affirmed the ICC's order, finding that the wharf was "united . . . into a system of which all are necessary parts, the [wharf] as well as the railroad companies."[419] The Court then quoted approvingly from the ICC's order:

> The [wharf] is part and parcel of the system engaged in the transportation of commerce, and to the extent that such commerce is interstate the Commission has jurisdiction to supervise and control it within statutory limits. To hold otherwise would in effect permit carriers generally, through the organization of separate corporations, to exempt all of their terminals from our regulating authority.[420]

The Court dispatched the argument that manufacturing activities at the wharf vitiated the conduct of interstate transportation there. It concluded that the shipments "were all destined for export and by their delivery to [a railway] they must be considered as having been delivered to a carrier for transportation to their foreign destination, the [wharf] being a part of the railway for such purpose."[421]

Similarly, in *Atlantic Pipe Line Company*,[422] Division 1 of the ICC held that tank storage facilities were needed for the practical operation of the pipeline system and therefore subject to ICC jurisdiction. These facilities were used in part to accumulate quantities of oil "for movement through the line in large batches" and "for equalizing irregular receipts and intermittent deliveries."[423] The tribunal found that "[s]torage, up to a point, is a necessary incident of transportation,"[424] and concluded that tanks with an aggregate capacity of 1,120,000 barrels at two separate tank farms were "adequate to meet all transportation requirements" and could be classified as used for common-carrier purposes.[425]

Like Southern Pacific Terminal's Galveston wharf and Atlantic Pipeline's tank storage facilities, the Watson facilities are a necessary link in the transportation of oil from the Los Angeles carrier facilities to the SFPP system. SFPP witness Abboud testified that shippers tendered a variety of petroleum products to SFPP at the Watson Station for transportation through the system to Calnev (which straddles the state line), Phoenix, and Tucson, and that

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[414] Ex. 404 at p. 60; Ex. 144 at p. 4.

[415] Tr. 8765-66. Mr. Abboud testified (Tr. 8883-84):

> [T]hat's the way the facilities were originally established as an option to the suppliers coming into Watson. That's what provided the revenue source to put the facilities in initially.

[416] *Hydrocarbon Trading and Transport Company, Inc. v. Texas Eastern Transmission Corp.*, 26 FERC ¶ 61,201, at p. 61,470 (1984).

[417] 219 U.S. 498 (1911).

[418] *Id.* at 523 (internal quotation omitted).

[419] *Id.* at 521.

[420] *Id.* at 522.

[421] *Id.* at 527.

[422] 47 I.C.C. Val. Rep. 541 (1937).

[423] *Id.* at p. 545.

[424] *Id.* at p. 546.

[425] *Id.* at p. 548.

SFPP redelivers the product to the shippers without interruption.[426]

In determining whether the facilities' services should be characterized as an integral part of the transportation originating outside of the state, both the ICC and FERC have given substantial weight to the intent of the shipper using the interstate transportation.

In *Determination of Jurisdiction over Transportation of Petroleum and Petroleum Products by Motor Carriers Within a Single State*, the ICC adopted the following approach:

> In determining the "essential character of the commerce" the factor most often relied on is the fixed and persisting transportation intent of the shipper at the time of shipment.[427]

The ICC stated that the following factors manifested an intent by the shipper *not* to ship the goods beyond the storage facility:

> (1) At the time of shipment there is no specific order being filled for a specific quantity of a given product to be moved through to a specific destination beyond the terminal storage, (2) the terminal storage is a distribution point or local marketing facility from which specific amounts of the product are sold or allocated, and (3) transportation in the furtherance of this distribution within the single state is specifically arranged only after sale or allocation from storage.[428]

The Federal Energy Commission has applied the ICC criteria for determining the intent of the shipper on two occasions.[429]

The principal function of the Watson facility is to facilitate transportation of a portion of the oil from points in California to Calnev, Phoenix, and Tucson by raising the efficiency of the system through its vaunted drain-dry system.[430] As Mr. Abboud testified, the portion of the product tendered by the shippers at Watson is redelivered to the same shippers at Calnev, Phoenix, and Tucson without interruption.[431] Thus, the Watson facilities do not act as a distribution point from which quantities of oil are sold or allocated.

Nor do SFPP's Watson services meet the first and third ICC criteria for intrastate services—the absence of orders and transportation arrangements to move a specific quantity of oil beyond storage prior to shipment of that oil to storage. These criteria acknowledge that the flow of interstate transportation may cease at the storage facility if no arrangements for further transportation of the oil have been made by the time the oil arrives. In that situation, shippers are using the facility to "maintain inventory," *i.e.*, keep supplies on hand, pending further demand.

An entirely different situation occurs at the Watson facility. When the shippers deliver oil to the Watson pumping facilities, they have purchasers that are contractually committed to buy the oil far downstream from the tailgate of that plant. The shipping arrangements have already been made on SFPP continuously to Calnev and points beyond. The oil does not remain in storage at the Watson facilities.

A recent case, *Advantage Tank Lines, Inc.*,[432] provides further support for the conclusion that the Watson pumping facilities perform services that are an integral part of the continuous transportation of oil in interstate commerce from California to other parts of the United States. In that case, the ICC determined that a motor carrier's transportation of gasoline from a Michigan distribution center to points within Michigan was an integral part of a larger, interstate transportation scheme. An oil refiner shipped gasoline by pipeline from refineries in Illinois to its distribution center in Michigan. From the distribution center, the refiner arranged for transportation of the gasoline by motor carrier to the following destinations in Michigan: to the refiner's service stations; to competitors, as part of an exchange program; and to other non-affiliated retailers.

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[426] Ex. 144 at pp. 12-16; Tr. 8663-66, 8725-26. *See also Lakehead*, 71 FERC ¶ 61,338, at pp. 62,324-26 (1995), *reh'g denied*, 75 FERC ¶ 61,181, at p. 61,601 (1996)(facilities which are necessary to complete the jurisdictional transportation process are an integral part of that process).

[427] 71 M.C.C. 17, 29 (1957).

[428] *Id.*

[429] *Interstate Energy Company*, 32 FERC ¶ 61,294 (1985); *Northville Dock Pipe Line Corp.*, 14 FERC ¶ 61,111 (1981). Both cases are factually distinguishable from the instant case. Each case involved the shipment of oil, first, from outside a state to storage facilities by intrastate pipeline to another destination within the state. In both cases, the Commission determined that the transportation by the intrastate pipeline (from the storage facility to the oil's ultimate destination) was intrastate. However, the principal factors upon which the Commission relied in making those determinations are not present in the instant case. In both cases, the shippers used the storage facilities to "maintain inventory," *i.e.*, to maintain a certain level of supply; the shippers use the Watson facilities solely as a mechanism to transport product to Calnev and beyond. In *Interstate Energy Company*, the shippers did not request shipments of oil from storage until after the oil arrived at the storage facilities; in the instant case, after the shippers deliver their product to the Watson facilities, SFPP promptly redelivers the product to the shippers downstream.

[430] Ex. 144 at pp. 13-14; Tr. 8663-66, 8725-26.

[431] *Id.*

[432] 10 I.C.C. 2d 64 (1994).

These last two groups took title to the gasoline prior to its delivery to the motor carrier.

In ruling that the motor carrier's transportation was an integral part of the transportation originating at the Illinois refineries, the ICC relied on three factors. First, the ICC observed that the notation on each bill of lading, stating "CONTINUOUS INTERSTATE SHIPMENT," manifested the refiner's intent that the gasoline move continuously in interstate commerce, and the refiner could implement this intent because it controlled the movement of the gasoline from Illinois to its final destination. Second, from the time the gasoline left Illinois, the refiner knew that a substantial majority of the volumes would reach specific destinations, *i.e.*, his service stations, his competitors' stations and the facilities of non-affiliated retailers. Third, the gasoline only rested at the facility for a relatively short time.

The flow of the oil through the Watson facilities has the same indicia of continuous interstate movement as the movement of the gasoline in *Advantage Tank Lines*. In both cases, the shippers at the point of origin set in motion a series of events that make the continuous movement of the product to its final destination an inevitability. When they deliver their oil to the Watson facilities, the interstate shippers must immediately ship the oil on the SFPP system to a destination at Calnev or beyond. Thus, both the refiner in *Advantage Tank Lines* and the SFPP shippers ensured the continuous interstate movement of product by arranging all of the transportation.

The other indicia of continuous transportation in *Advantage Tank Lines* are also present in the instant case. Just as the refiner in *Advantage Tank Lines* knew in a general way the ultimate destination of most of its gasoline, the shipper-producers of SFPP know the destinations precisely. Whereas the refiner's gasoline in *Advantage Tank Lines* stayed in his distribution center for an average of 10 days, there is no evidence that SFPP detains the flow of product at Watson at all.

The foregoing decisions compel the conclusion that the Watson pumping facilities are an integral part of interstate oil pipeline transportation.[433]

SFPP claims that the Watson gathering enhancement facilities "do not provide any form of regulated transportation."[434] As shown above, the integral nature of these facilities, and the essential part they play in SFPP's transportation service contradict this. SFPP also asserts that these facilities were provided as an alternative to shippers. According to SFPP, the obligation to satisfy the increased pumping rate lies with the shippers, not SFPP.[435] However, as required by *Lakehead*, SFPP must provide or arrange for the provision of these facilities to meet their common carrier obligation.[436] Having done so, SFPP must charge a just and reasonable rate for the service.

SFPP also attempts to support its position that Watson is not subject to the ICA by arguing that the West Line shippers have alternatives to Watson whereby they can gain access to SFPP's West Line, or that the West Line shippers can use the facilities of other companies. Whatever alternatives may exist, and they are not documented very well in the evidentiary record, the evidence shows that all shippers from the Los Angeles area inject oil product at Watson in order to access SFPP's interstate system. Whether or not there are viable other alternatives to the shippers is not relevant to the jurisdiction question.

What has been shown is that at a point beyond where a shipper tenders its product to SFPP, product moves through Watson.[437] It has also been shown that once product is tendered to SFPP at its Watson Station, that product cannot avoid going through the gathering facilities, even if it meets SFPP's increased pumping rate.[438]

Moreover, SFPP has acknowledged the fact that the gathering facilities are operated as part of its pipeline transportation system, and are treated as carrier property.[439] SFPP has

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[433] The Commission's recent Order Reversing Initial Decision in *Texaco Refining and Marketing, Inc. v. SFPP, L.P., et al.*, 80 FERC ¶ 61,200 (August 5, 1997) supports this conclusion. There the Commission found it had jurisdiction over movements of oil product over two pipelines connecting refineries at Sepulveda to Watson Station.

[434] SFPP Initial Brief at p. 220.

[435] *Id.* at pp. 220-21.

[436] *See* discussion *supra*; *Lakehead*, 71 FERC ¶ 61,338, at p. 62,324. As stated by the Commission in *Lakehead*:

> [t]he common carrier can make reasonable and appropriate rules respecting the acceptance and transportation of traffic. However, those rules cannot be such that they vitiate the common carrier's obligation to hold out the service upon reasonable request.... [That] would be unreasonable because it would render its common carrier obligation a nullity and convert Lakehead into a private carrier.... This would violate its common carrier obligation under the ICA to provide transportation upon reasonable request.

1 FERC ¶ 61,338, at p. 62,325.

[437] Ex. 34 at p. 49; Ex. 40; Ex. 113; Ex. 125.

[438] Tr. 8883.

[439] Ex. 404 at p. 60; Ex. 144 at p. 4.

also admitted that its shippers have paid for Watson several times over.[440] SFPP cannot now argue that it was unfairly "induced" to build these facilities, particularly since its investment has been fully recovered and the facilities now are profitable to SFPP.

SFPP characterizes Watson as a service provided solely for the convenience of shippers, and cites cases wherein the Commission found the services in question to have been provided for convenience.[441] These cases are distinguishable. The services at issue in SFPP's cited cases were found not to be connected with, or play a direct part in, the carrier's transportation services.[442] Furthermore, the Watson enhancement facilities also benefit SFPP. As noted earlier, SFPP witness Abboud testified that the enhancement facility allows each tank to go completely empty and be refilled without emitting vapors. This allows each tank to handle multiple grades of product, rather than, as before, be dedicated to a specific product family, which greatly reduced Watson's throughput capacity.[443]

SFPP also claims that *Northwestern Steel & Wire Co. v. Inland Waterways Corp., et al.*,[444] where the ICA was held not to apply, is similar to this case.[445] Contrary to SFPP's characterization, *Northwestern Steel* was a complaint case wherein a shipper sought reparations at the ICC from the transportation of scrap iron under joint barge-rail rates. The complainant did not challenge the ICC's jurisdiction, but rather claimed the resulting charges from the shipments were excessive. The ICC dismissed the complaint finding that the charges for the jurisdictional services were not unreasonable.

Like the barge and rail facilities, Watson is integral to the interstate transportation of product from California to Arizona and other destinations. Unlike the situation in *Northwestern Steel*, the interstate movement of the product at Watson does not require the ancillary, nonjurisdictional services that the scrap iron in *Northwestern Steel* required.

Finally, SFPP asserts that the shippers signed contracts for the use of Watson, and that alone is dispositive.[446] The ICA does not support SFPP's position. Section 1(3)(a) of the ICA states in pertinent part that:

> The term "transportation" as used in this chapter shall include . . . all instrumentalities and facilities of shipment or carriage, *irrespective of ownership or of any contract, express or implied, for the use thereof*, and all services in connection with the receipt, delivery, elevation, and transfer in transit . . . storage, and handling of property transported.[447]

The fact that a contract exists in no way resolves the issue as SFPP suggests.

Having considered the evidence and the arguments of the participants, I hold that SFPP, within 60 days after the order in the case becomes final, shall file with the Federal Energy Regulatory Commission a tariff rate for the Watson enhancement facilities, the terms and conditions of service for the Watson enhancement facilities, and a supporting cost of service.

I further hold that no revenue crediting will be required nor will SFPP have to make refunds or reparations of monies it has collected from use of the Watson facilities prior to the time the above-mentioned Watson tariff filing is made.

G. Upstream Lines (Sepulveda)

West Line Shippers argue that the revenues received by SFPP from its line that runs from Sepulveda Junction to Watson Station should be credited to SFPP's cost of service.[448] SFPP opposes the proposal.

When West Line Shippers attempted to raise issues regarding the charges for service upstream of Watson Station, I granted a motion to strike testimony related to those issues, because West Line Shippers were attempting to inject new issues in the proceeding at too late a stage.[449] West Line Shippers then filed complaints against SFPP regarding charges by SFPP relating to Watson Station and lines upstream of Watson. The Commission dismissed the complaints relating to Watson, because those issues were being tried in the instant case. The Commission upheld the undersigned judge's ruling that issues relating to lines upstream of Watson would not be heard in the instant case. Instead, the Commission set for

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[440] Tr. 8311, 8764.

[441] SFPP Initial Brief at p. 225.

[442] *Id.* (citing *Great N. Ry. Co. v. Minnesota ex rel. State R.R. & Warehouse Comm'n*, 238 U.S. 340, 345 (1915); *Coastal States Trading, Inc. v. Shell Pipeline Corp.*, 573 F. Supp. 1415, 1421 (S.D. Tex. 1983); *In re Bills of Lading*, 52 I.C.C. 671, 722 (1919)).

[443] Ex. 144 at p. 14.

[444] 291 I.C.C. 268 (1953).

[445] SFPP Initial Brief at pp. 226-27.

[446] *Id.* at pp. 222-23.

[447] 49 U.S.C. app. § 1(3)(a) (emphasis added).

[448] West Line Shippers Initial Brief at pp. 45-46.

[449] Tr. 2834, 2836 (September 22, 1995); Order Granting Motion to Strike (September 26, 1995).

separate hearing, before another administrative law judge, the issues regarding lines upstream of Watson and did not consolidate those issues with the instant case.[450] After hearing, the administrative law judge in that case issued an initial decision holding that transportation over certain lines upstream of Watson were not subject to Commission jurisdiction.[451] As noted earlier, that ruling was reversed by the Commission, and the Commission required SFPP to make an appropriate rate filing. Reparations issues were delayed until after the Commission determined an appropriate rate.[452]

In light of the foregoing discussion, it is clear that issues regarding lines upstream of Watson Station, including the lines from Sepulveda to Watson Station, are not before me. Revenue crediting to SFPP's cost of service in the instant case is not appropriate.

It is therefore held that no revenues will be credited to SFPP's cost of service from lines upstream of Watson Station, including the line from Sepulveda to Watson Station.

H. Arco Reversal Agreement

1. *Background*

There are several issues regarding the ARCO Reversal Agreement. The controversies arise out of the following events which have been discussed in some detail, *supra*, under the heading "Assignment of Arizona Common Costs." The salient facts are repeated here.

The 6-inch line between Phoenix and Tucson, Arizona, from 1989 until July of 1991, flowed from Phoenix to Tucson, although at times the flow was interrupted.[453] Thus it provided West Line service. However, in mid-1991, to accommodate the needs of East Line shippers pending completion of the East Line capacity expansion, SFPP reversed the 6-inch line so that it would flow from Tucson to Phoenix. The 8-inch line also flowed from Tucson to Phoenix at all times material to this discussion. Because this situation left West Line shippers without direct pipeline access to Tucson, SFPP notified its shippers that SFPP intended to reverse the 6-inch line again (to flow again from Phoenix to Tucson) upon completion of the East Line expansion.

ARCO was interested in assuring that such a re-reversal would occur; in early 1992 ARCO entered into an agreement with SFPP in which SFPP committed that, upon completion of the East Line expansion, it would return the 6-inch line to West Line service and maintain it in that service for five years. In return, ARCO agreed to ship a specified minimum volume, 5,000 barrels per day, from Los Angeles to Tucson or, if it did not, to pay SFPP the equivalent of the revenue shortfall. The Agreement runs for five years with options to ARCO to renew for three additional five year periods.[454]

2. *Issues*

ARCO claims that under the ARCO Reversal Agreement SFPP charges a rate in excess of the tariff because on a per barrel basis ARCO pays more than the tariff rate to get barrels to Tucson. ARCO also claims that it made payments under the Reversal Agreement to SFPP in excess of the tariff rate, that such payments are illegal, and that SFPP should be required to refund the excess payments to ARCO or the excess revenues should be reflected as carrier revenues.[455]

In addition, ARCO raises the question whether the Reversal Agreement has to be filed with the Commission. ARCO does not argue that the Agreement must be filed. ARCO states only that it "... has no objection to the filing of the contract or any part thereof as part of SFPP's tariff."[456]

ARCO finally claims that the contract should be construed to bar any payment by ARCO if 5,000 barrels per day are flowing on the West Line even if ARCO is not shipping 5,000 barrels per day.[457]

Staff takes the position that the significant terms of the ARCO Reversal Agreement should be published in SFPP's tariff.[458] However, Staff states that SFPP does not have to obtain Commission approval to reverse the direction of flow in its 6-inch line.

Chevron claims first that SFPP is required to publish the Reversal Agreement in its tariff, or at a minimum publish the primary terms of the Agreement in its tariff: to wit, the fact that the line is being reversed, the debiting/crediting arrangements, the guaranteed minimum

[450] *Texaco Refining and Marketing, Inc. v. SFPP, et al.*, 75 FERC ¶ 61,292, at pp. 61,938-40 (1996).

[451] *Texaco Refining and Marketing, Inc. v. SFPP, et al.*, 78 FERC ¶ 63,017 (1997).

[452] *Texaco Refining and Marketing, Inc. v. SFPP, et al.*, 80 FERC ¶ 61,200, (*mimeo.* at p. 13)(August 5, 1997).

[453] Ex. 147 at p. 14; Tr. 4997. For the history of the expansions of the East and West Lines and the reversals of flows in the lines, *see generally* Ex. 147 at pp. 7-16.

[454] Ex. 147 at pp. 16-17; Ex. 119 (ARCO Reversal Agreement).

[455] West Line Shippers Initial Brief at p. 47.

[456] *Id.* at p. 74.

[457] *Id.* at p. 75.

[458] Staff Initial Brief at p. 121.

volumes, and the length of the agreement.[459] Chevron claims that failure to publish these terms of the Agreement violates Section 6(1) of the Interstate Commerce Act (ICA) and 18 C.F.R. § 341.8 of the regulations of the Federal Energy Regulatory Commission.[460]

Second, Chevron claims that the Reversal Agreement violates the ICA because SFPP has collected from ARCO a transportation rate greater than its tariff rate and the rate charged to other similarly situated shippers. Chevron sees "potential" violations of Sections 2, 3(1) and 6 of the ICA, 49 U.S.C. app. § § 2, 3(1) and 6, because ARCO under the Agreement may receive preferential and discriminatory rights to capacity during prorationing and because ARCO receives "special crediting arrangements."[461]

Chevron also claims that SFPP effectively gave ARCO guaranteed access to the 6-inch Line, ". . . which may be interpreted as a violation of Section 1(4) of the ICA."[462] That section of the ICA establishes the common carrier's duty to provide service to its shippers "upon reasonable request."[463] Chevron argues that in *Texaco Pipeline Inc.*,[464] the Commission addressed the issue of "whether preferences in access to service may be permitted on a contract basis."[465] In that case the Commission found that the terms of Texaco's FERC Tariff No. 264, a local proportional contract pipeline tariff, granted an unreasonable preference by designating a portion of the pipeline's capacity for the exclusive use of a special class of shippers.[466] The Commission stated:

> This preference takes the form of a guarantee of service, which, in effect, denies access to other shippers. Thus, the tariff violates the [ICA] common carrier obligation to provide service upon reasonable request.[467]

SFPP witness Toole testified, however, that ARCO did not have guaranteed capacity on the 6-inch line, and that in the event of prorationing, ARCO would be prorated. SFPP witness Pearl also testified that the Reversal Agreement is a throughput and deficiency ("T & D") agreement; he claimed that it is similar to other such agreements which are common in the industry.[468]

Chevron also contests ARCO's position that the guaranteed payment provisions of the Reversal Agreement should be found unlawful and that at the same time ARCO should retain its ability under the other contractual provisions of the Agreement to control the direction of flow in the 6-inch line.

3. *Discussion*

Chevron argues in its Reply Brief (at p. 140) that the Commission has jurisdiction over SFPP's decision to take the 6-inch line out of East Line service and place it in West Line service. However, the Commission has found repeatedly that it has no jurisdiction over oil pipeline abandonments.[469] Indeed, the Commission has held it has no jurisdiction to review the abandonment of oil pipeline service in one direction while the same facilities continue to be used to provide service in the opposite direction.[470] In recognition of those principles, Staff

[459] Chevron Initial Brief at p. 200 n.660.

[460] Chevron Initial Brief at p. 200.

Section 6(1) of the ICA, 49 U.S.C. app. § 6(1), states in part that common carriers must file with the Commission and print and keep open to public inspection:

> . . . all privileges or facilities granted or allowed, and any rules or regulations which in any wise change, affect, or determine . . . rates, fares, and charges, or the value of the service rendered to . . . shippers[s] . . . .

Section 341.8 of the regulations of the Federal Energy Regulatory Commission, 18 C.F.R. § 341.8, states in part:

> Carriers must publish in their tariffs rules governing . . . all . . . charges, services, allowances, absorbtions and rules which in any way increase or decrease the amount to be paid on any shipment or which increase or decrease the value of service to the shipper.

18 C.F.R. § 341.2(b) states in part:

> All tariff publications . . . must be filed with the Commission and posted not less that 30 . . . days prior to the proposed effective date.

[461] Chevron Initial Brief at p. 207.

[462] *Id.*

[463] 49 U.S.C. app. § 1(4).

[464] 74 FERC ¶ 61,071 (1996).

[465] 74 FERC ¶ 61,071, at p. 61,201.

[466] By making a tender under the tariff, a shipper would become a "Contract Shipper," guaranteeing a monthly payment to Texaco for the shipment of an average of 20,000 barrels per day for a three-year period. Texaco guaranteed that the 20,000 barrels per day of contract throughput would not be subject to prorationing, as otherwise provided for in Texaco's FERC No. 2. Tenders exceeding 20,000 barrels per day also would not be subject to prorationing, except under certain circumstances. 74 FERC ¶ 61,071, at p. 61,201.

[467] 74 FERC ¶ 61,071, at p. 61,201.

[468] Ex. 147 at pp. 16-17.

[469] *See, e.g., ARCO Pipe Line Co.*, 55 FERC ¶ 61,420 (1991); *Chevron Pipe Line Co.*, 64 FERC ¶ 61,213 (1993).

[470] *ARCO Pipe Line Co.*, 66 FERC ¶ 61,159 (1994).

witness Pride testified on cross-examination that "the Staff doesn't assert that the Commission has jurisdiction over the direction of the flow of an oil pipeline."[471] When asked whether SFPP could abandon service over the 6-inch line without obtaining any approval from the Commission, Ms. Pride responded that it is her "understanding that there is no abandonment authority required for SFPP to not provide service over a particular line."[472]

If SFPP had abandoned all East Line service to Phoenix, or had abandoned the 6-inch line entirely, the East Line shippers would have had no valid complaint. Here, as a result of the 1992 re-reversal, SFPP was not abandoning its East Line service to Phoenix; rather, it was maintaining that service while changing the use to which some of its assets were being put. Since the Commission would have no jurisdictional basis to enjoin a complete abandonment of service, it follows that SFPP's re-reversal of the 6-inch line and placing it in West Line service, while maintaining the East Line service to Phoenix, is not a matter subject to Commission jurisdiction.

I hold that the re-reversal of the 6-inch line and the placement of it in West Line service was an action within SFPP's business discretion and not subject to regulation by the Federal Energy Regulatory Commission.

The next issue is whether the ARCO Reversal Agreement must be filed with the Commission, or alternatively, at a minimum, whether the primary terms of the Agreement should be published in SFPP's tariff.

The reversal of the 6-inch line constituted a major operational change on SFPP's system. The line's reversal from a westerly to easterly direction, the debiting/crediting arrangements, the guaranteed minimum values, and the extended length of the Reversal Agreement significantly affect the value of services to SFPP's East Line and West Line shippers.[473] Yet, SFPP's FERC Tariff No. 16[474] states nothing about the Reversal Agreement or the privileges granted to ARCO. It provided shippers no advance notice of the line reversal, no indication the carrier had entered into the Reversal Agreement with one of its shippers, and no information as to how the line's reversal would affect operations for other shippers. Failure of SFPP to publish in its tariff the basic terms of the Reversal Agreement violates Section 6(1) of the ICA and the notice provisions of the Commission's regulations,[475] and I so hold.

Under the Reversal Agreement, ARCO was guaranteed capacity of 5,000 barrels per day for five years.[476] In return, ARCO agreed to pay for 5,000 barrels per day whether or not it had actually shipped that amount.[477] At the end of five years, if ARCO continued to ship less than 5,000 barrels per day and decided to extend the agreement, in the sixth year SFPP would give ARCO credit for any deficiency payments.[478]

From September 1992 to October 1993, ARCO shipped less than 5,000 barrels per day and made deficiency payments totaling \$357,573.[479] If one compares barrels actually shipped to the monthly guaranteed minimum, ARCO paid a rate equivalent to \$1.76 per barrel, not the \$1.543 per barrel rate published in SFPP's filed tariff.[480] If ARCO does not extend the agreement for an additional five year, SFPP will keep all the deficiency payments. If ARCO does extend the agreement, any deficiency payments will be treated as credits to ARCO for shipments in the sixth year.[481] Thus ARCO paid for volumes it did not actually ship.

Neither these debiting/crediting terms, nor the guaranteed minimum volumes are published in SFPP's filed tariff. This contravenes Section 341.8 of the Commission's regulations requiring a common carrier to publish any rules that affect the price paid for shipments on the pipeline.[482]

SFPP claims that the Commission has no statutory authority under the ICA to require SFPP to publish the terms of the ARCO Reversal Agreement (or a "reversal policy") as part of its tariffs. SFPP cites *ARCO Alaska, Inc. v. FERC*, 89 F.3d 878, 88486 (D.C. Cir. 1996), for the proposition that "Section 6 of the ICA only requires publication of operating schedules or other rules that form an 'integral part' of the rate paid by shippers, thereby affecting the value or cost of the transportation service

[471] Tr. 7865.

[472] Tr. 7996.

[473] Ex. 113 at p. 12.

[474] FERC No. 16, filed July 31, 1992 to become effective September 1, 1992, Ex. 688 and Item B by Reference.

[475] 18 C.F.R. § § 341.2(b), 341.8.

[476] Ex. 113 at p. 12; Ex. 119 at p. 2.

[477] Ex. 113 at p. 13; Ex. 119 at p. 2. The Jet Fuel Agreement provides that the volumes ARCO ships under FERC No. 18 are credited against the 5,000 barrels per day minimum established in the Reversal Agreement.

[478] Ex. 119 at p. 2 of 3; Ex. 113 at p. 13.

[479] Ex. 113 at p. 13.

[480] *Id.* at pp. 13-14.

[481] Ex. 119 at p. 2 of 3.

[482] 18 C.F.R. § 341.8.

provided."[483] Contrary to SFPP's position, that case supports a filing requirement in the instant case because the terms of the Reversal Agreement are an integral part of the rate paid by ARCO and effect the value and cost of the transportation service provided. Significantly, in the *ARCO Alaska* case the pumpability factors and the methods for apportioning capacity had been published in the tariff. The Court held only that the operating rules governing allocation of capacity did not have to be published. That is a different situation from the instant case.

It is held that SFPP must publish in its tariff the primary terms of the Reversal Agreement; to wit, the fact that the line flows in West Line service from Phoenix to Tucson, the debiting/crediting arrangements, the guaranteed minimum volumes, and the length of the Agreement.

Another issue involves whether any of the provisions of the Reversal Agreement are illegal, and if so what remedies are required. I find no preferences here for ARCO nor any discrimination against other shippers who only pay the West Line tariff rate.

The reversal agreement constitutes an exchange of important rights and obligations among two sophisticated parties.[484] To the extent ARCO has incurred a deficiency payment, that is the result of its failure to meet its contractual obligation, not because SFPP is exacting a charge in excess of the filed rate.[485]

The ARCO Reversal Agreement appears to be a form of throughput and deficiency agreement that is common in the oil pipeline industry.[486] Under such agreements the shipper, making the commitment in exchange for a reciprocal undertaking by the pipeline, pays the rate called for in the pipeline's published tariff for every barrel the shipper moves. If the shipper fails to live up to its end of the agreement, as a matter of contract the shipper becomes liable to pay a deficiency charge.[487]

As demonstrated by the testimony of Ms. Pride, the reversal agreement does not bestow a preference on ARCO. Rather, the agreement, which requires ARCO to ship a minimum of 5,000 barrels per day, "doesn't necessarily guarantee ARCO that amount" of line space, because "if it turned out that [the 6-inch] line had to be prorated, . . . SFPP . . . would prorate the line."[488]

Contrary to the position of ARCO, it is not a reasonable reading of the Reversal Agreement to construe it to bar any payment by ARCO if 5,000 barrels per day are flowing on the West Line even if ARCO is not shipping 5,000 barrels per day.

I hold that the Reversal Agreement is not unjust or unreasonable, nor does it grant undue preferences or prejudices. I also hold that ARCO is not entitled to any deficiency payments it paid to SFPP under the Reversal Agreement. I further hold that the deficiency payments paid to SFPP under the Reversal Agreement shall not be credited against SFPP's cost of service.

As noted above, it is also held that SFPP must publish in its tariff the primary terms of the Reversal Agreement.

VIII. TEST YEAR THROUGHPUT EXPENSES—POWER COSTS AND DRA

A. Power Costs

Power costs relate to the power required to transport products through the pipeline. RHC takes issue with SFPP's proposed adjustment of power costs for 1993.

It is SFPP's position, supported by the testimony of Mr. Abboud, that 1993 actual power costs should be increased by $362,000 (to a total of $5,520,000) to account for the adjustment in 1993 throughput sponsored by Mr. Pearl.[489] Mr. Abboud testified that as a general matter pipeline power costs increase with additional throughput by an exponential factor of 2.85.[490] However, that factor decreases somewhat if the additional throughput can be achieved by extending the pipeline's hours of operation.[491] SFPP historically has increased throughput primarily by increasing the rate of flow and not by extending its hours of operation.

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[483] SFPP Initial Brief at p. 236.

[484] Tr. 8560-61, 9337-40.

[485] Tr. 8171-72.

[486] Ex. 147 at pp. 16-17; Tr. 8558.

[487] *See, e.g., Williams Pipe Line Co.*, 21 FERC ¶ 61,260, at p. 61,698 n.323 (1982); *Osage Pipe Line Co.*, 12 FERC ¶ 62,258, at p. 63,463 (1980); *cf.* 18 C.F.R. §§ 2.76, 2.103 (1996); *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 1022 n.26 (D.C. Cir. 1987)(finding argument that take-or-pay contracts violate NGPA ceiling improbable because "Congress must have been aware that producers and pipelines would incorporate these ceilings into long-term contracts, and that the contracts would include remedies for producers"), *cert. denied*, 485 U.S. 1006 (1988).

[488] Tr. 7852; *see also* Tr. 7854-55 (statement of counsel for ARCO). *Cf. Texaco Pipeline Inc.*, 74 FERC ¶ 61,071, at pp. 61,201-02 n.5 (1996).

[489] Ex. 144 at p. 27.

[490] *Id.* at p. 26; Tr. 8673.

[491] Ex. 144 at pp. 26-27.

Mr. Abboud testified that SFPP's power cost adjustment for the 1993 test year should be calculated using an exponential factor.[492] However, to account for some increased throughput by extending SFPP's operating hours, Mr. Abboud decreased the exponential factor to 2.0 from 2.85 for the 1993 power cost adjustment.[493]

RHC witness Eberst instead would increase power costs linearly with throughput.[494] However, his position was refuted at the hearing.[495] Mr. Abboud explained that although maximum efficiency in terms of power usage results when all additional throughput is achieved by extending a pipeline's hours of operation, that is not what happens on SFPP's pipeline.[496] On cross-examination Mr. Eberst conceded that SFPP's methodology of calculating increased power costs using an exponential formula produced a "very close" estimate when checked by looking back at historical periods.[497]

It is held that to the extent actual volumes are to be adjusted upward for test year purposes, the adjustment for SFPP's power costs also should be adjusted using Mr. Abboud's exponential factor of 2.0.

B. DRA Costs

A drag reducing agent ("DRA") is a substance injected into the pipeline to reduce the turbulence and internal friction, thus allowing more product to flow through the pipeline with less pressure.[498] There are two issues relating to DRA. The first issue involves the amount of SFPP's 1992 miscellaneous DRA-related expenses, other than expenses for DRA itself. The second issue involves whether to include in SFPP's 1993 working capital an amount for DRAs not paid for but included in SFPP's inventory.

1. *DRA-Related Expenses for 1992*

Chevron's and Navajo's witness Zaegel challenged SFPP's DRA-related expenses for 1992. For every period other than 1992 Mr. Zaegel included the same DRA expense as SFPP,[499] thus accepting the fact that for periods other than 1992 SFPP incurred annual DRA related costs, other than the cost of DRA itself, in an amount approximately 10 percent of the cost of DRA purchases.[500]

For 1992 SFPP estimated the costs of DRA-related operating costs to be $67,000. For 1992 Navajo and Chevron in their cost of service presentation adjusted SFPP's DRA expense downward by $57,000 because Mr. Zaegel did not feel that SFPP had adequately documented its DRA expenses other than the cost of DRA itself. The basis for Mr. Zaegel's adjustment appears to be Exhibit 883, a document entitled, "SFPP, L.P. Identification of 'other DRArelated operating costs' in 1992." This document was supplied by SFPP to Chevron in response to a Chevron data request. If one adds up the numbers corresponding to the checked items in the column, "Other DRA-related Cost?" the total is less than $10,000. However, SFPP witness Abboud questioned whether the document included all DRA-related costs such as nitrogen supply and rental of equipment.[501]

I conclude that Exhibit 883 is better evidence than Mr. Abboud's approximately 10 percent estimate of $67,000.[502] A participant should be able to rely on an answer furnished in response to an interrogatory or data request.

I hold that SFPP's 1992 estimate of DRA-related expenses must be reduced by $57,000.

2. *DRA Working Capital for 1993*

Chevron's and Navajo's witness Zaegel testified that SFPP's witness Jessen had included $118,000 of DRA inventory in SFPP's working capital.[503] In response to Chevron data request 5-22, SFPP advised that $118,000 of the $266,000 DRA inventory of SFPP on hand at year end was represented by accounts payable.[504] SFPP presented copies of documentation supporting the purchases in 1993, the receipt of DRA shipments on December 22, 1993, and the payment of the related invoices in January 1994. The $118,000 had not been expended by the end of 1993, but had been expended in the subsequent year.[505]

Because SFPP did not make actual payment of $118,000 in 1993, it is held that the $118,000 must be excluded from SFPP's 1993 working capital.[506]

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492 *Id.* at pp. 27-28.

493 *Id.* at p. 27.

494 Tr. 5593, 5598-99.

495 Tr. 8673-74.

496 *Id.*

497 Tr. 5858-60.

498 Tr. 8915.

499 Tr. 4830-31.

500 Ex. 144 at p. 29; Tr. 8919.

501 *See* Tr. 8919-22, 8951-53.

502 The total 1992 DRA expense was over $600,000. Tr. 4831.

503 Ex. 414 at pp. 22-23.

504 *Id.* at p. 23.

505 *Id.*

506 *Williston Basin Interstate Pipeline Company*, 52 FERC ¶ 61,170, at pp. 61,645-46 (1990).

IX. OTHER OPERATING EXPENSES

A. Litigation Expenses

SFPP seeks to recover $15.1 million for litigation expenses and associated costs. SFPP wants to amortize this amount over a period of three and a third years beginning September, 1992 (*i.e.* approximately $4.5 million per year). The $15.1 million includes a $12 million reserve plus $3.1 million which SFPP claims is direct expense associated with the instant case and related civil litigation.[507]

Navajo, Chevron and RHC argue that SFPP should not be allowed any litigation expenses. Their general argument for exclusion of the litigation expenses is that SFPP's defense of its rates, using a 1994 test year, is founded on a purported showing that aggregate costs exceed aggregate revenues by $3.3 million.[508] In other words, without the $4.5 million test year amount for litigation expenses, SFPP would be unable to show under its own theory of the case that its rates are just and reasonable, even if the remainder of its affirmative case were accepted by the Commission.

If any litigation expenses are allowed, RHC supports an amortization period of 20 years,[509] Navajo supports an amortization period of not less than 10 years,[510] and Chevron proposes an amortization period of not less than five years.[511]

In addition, Navajo states,

> . . . any recovery of legal fees should not be included in any recalculated cost of service. Rather, it should be a surcharge not subject to the indexing adjustment afforded SFPP's regular rate under Order No. 561. This follows the Commission's Order in *Lakehead*, where it directed that litigation costs be removed from Lakehead's cost of service "so that Lakehead's indexed rates do not include these costs." Once the legal expense is amortized, the surcharge would disappear and the underlying cost-of-service rate, as indexed, would continue in effect.[512]

In its Reply Brief (at p. 64) Chevron states that if any SFPP litigation expenses are allowed, Chevron supports the Staff approach of devising an estimate of litigation costs ($2.6 million), and further that the $2.6 million should be removed from SFPP's rates after the amortization period. RHC takes a similar approach.[513]

West Line Shippers take the position that "the Commission should not allow legal expenses to become a profit center . . . . Either the rate should be lowered after the end of the amortization period or the amortization period should be extended to ten years."[514]

In any event, most of the participants opposing in whole or in part SFPP's claim of litigation expenses would exclude that portion related to civil litigation as not being sufficiently related to the costs of the instant litigation.

The Commission has stated that ". . . litigation expenses are usually recoverable in rates as part of a pipeline's operating expenses . . . ."[515] A pipeline is not entitled to rate case expenses incurred prior to the test year.[516] In *Houlton Water Co., et al. v. Maine Public Service Co.*, 62 FERC ¶ 63,023, at pp. 65,096-97 (1993), the presiding administrative law judge disallowed from wholesale rates litigation expenses related only to retail customers. He also stated,

> Utilities are entitled to recover legitimate regulatory expenses incurred in proceedings brought to raise rates. *See, e.g., Southwestern Public Service Co.*, 49 FERC ¶ 61,296, at p. 62,135 (1989). They are certainly entitled to recover similar costs expended in defending against a complaint brought by their customers, in which they demonstrate that their rates are inadequate.[517]

From this statement some participants argue that in the instant case, where SFPP cannot demonstrate that its rates are reasonable without using litigation expenses, SFPP should be denied recovery of all of its litigation expenses. To hold otherwise, they argue, only serves to encourage a pipeline defending its rates ". . . to engage in a scorched earth defense with knowledge that every dollar spent will create an

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[507] SFPP Initial Brief at p. 99.

[508] Ex. 529 (Revised), Schedule 1.

[509] RHC Initial Brief at p. 23.

[510] Navajo Initial Brief at p. 82.

[511] Chevron Initial Brief at p. 77.

[512] Navajo Initial Brief at p. 83 (footnotes omitted), quoting *Lakehead Pipe Line Company, L.P.*, 71 FERC ¶ 61,338, at p. 62,317.

[513] ". . . any recognized litigation expenses should be recognized only as a surcharge to be removed at the end of the period...." RHC Initial Brief at p. 23.

[514] West Line Shippers Initial Brief at p. 48.

[515] *El Paso Natural Gas Co.*, 61 FERC ¶ 61,107, at p. 61,423 (1992). *See also, Tennessee Gas Pipeline Co.* 65 FERC ¶ 61,138, at p. 61,701 (1993).

[516] *Lakehead Pipe Line Company, L.P.*, 71 FERC ¶ 61,338, at p. 62,317.

[517] 62 FERC ¶ 63,203, at p. 65,096.

asset that serves to justify otherwise unjust rates."[518]

Considering the arguments of participants and the facts peculiar to this case, I find that SFPP should be entitled to its legitimate and reasonable litigation costs in this complaint case to ensure that the rates it recovers from this Commission are just and reasonable and not driven down by complainants to unjust and unreasonable levels. The question then becomes what are legitimate litigation costs in the context of the instant rate case.

SFPP will be allowed expenses of $2,631,815,[519] related to its FERC litigation, that SFPP actually incurred in 1994, SFPP's test year, but the civil litigation expenses,[520] including settlement costs, will not be allowed in SFPP's cost of service. This is essentially Staff's position.[521]

The civil litigation expenses are not representative of future costs. Furthermore, it would not be appropriate to burden SFPP's shippers with these civil litigation expenses. The payments related to the Navajo settlement provided a benefit only to SFPP's unitholders and Navajo. To have such payments in the cost of service would not only compel other shippers to pay for a benefit that went solely to Navajo, but it would also compel Navajo to partially reimburse SFPP for the payments it had achieved in settlement negotiations.[522]

To develop a representative amount of litigation expenses for inclusion in the test year cost of service, Staff witness McCelland amortized SFPP's actual FERC-related litigation expenses over five years and allocated them equally between the East and West Lines. SFPP's choice of an amortization period of three and a third years was based on an estimate of the period of time over which the litigation expenses would be incurred.[523] However, under established Commission policy, the amortization period should be based instead on the period of time over which the rate to be established is expected to be in effect.[524] Under the current indexing procedures for oil pipelines,[525] the base rates established in this proceeding likely will be in effect for many years, without any need for another major rate case or concomitant rate case expense. A five year amortization period seems reasonable under the circumstances, but one could justify an amortization period that is longer.

It is held that (1) SFPP will be allowed in its cost of service litigation expenses of $2,631,815 to be amortized over five years beginning with the effective date of the rates to be established in the instant case; (2) the litigation expenses will be a surcharge not subject to the indexing adjustment, and (3) the litigation costs must be removed from SFPP's cost of service and rates at the end of the amortization period.

B. Reconditioning Costs

SFPP seeks to recover costs associated with a South System line reconditioning program.[526] SFPP's pipelines are protected from corrosion by both special pipe coatings and by cathodic protection, the application of electric current to the pipe.[527] In Surrebuttal testimony, SFPP witness Abboud described SFPP's decision to undertake a program to recondition the following segments of pipe on its East and West Lines: the 6-inch line between Phoenix and Tucson, the 8-inch line between Tucson and Phoenix, and the 8-inch line between El Paso and Tucson.[528] Mr. Abboud estimated that completion of this program will take approximately 15 years.[529] SFPP proposes that adjusted reconditioning costs of at least $3 million be included in its 1994 test year cost of service;[530] SFPP argues that any cost of service which does not reflect this projected annual cost of the reconditioning program would not be representative of current and future periods.

[518] RHC Initial Brief at p. 22.

[519] Ex. 877. Add the FERC Totals on page SFPP 4-019780 ($1,134,540) and on page SFPP 4-019782 ($1,497,275).

[520] The civil litigation involves suits filed by Navajo in a New Mexico state court and by EPR in a Texas state court, as well as a suit brought by ARCO in an Arizona state court. Ex. 142 at p. 16. The Navajo action has been settled; the agreement calls for, among other things, certain payments to be made to Navajo by SFPP. The settlement was certified to the Commission on May 21, 1997. 79 FERC ¶ 63,015. As of April 4, 1995 the El Paso action was pending. Ex. 142 at p. 17.

[521] Staff Initial Brief at p. 72.

[522] *See Virginia Electric and Power Company*, 11 FERC ¶ 63,028, at p. 65,188 (1980), *aff'd in relevant part*, 15 FERC ¶ 61,052 (1981).

[523] Ex. 142 at p. 19.

[524] *Public Service Co. of New Mexico*, 17 FERC ¶ 61,123, at p. 61,251 (1981).

[525] The index system is set forth at 18 C.F.R. § 342.3.

[526] "Reconditioning" refers to the application of a new or additional protective coating to a pipeline. In some instances, a section of pipe may be so corroded or at risk of corrosion that it is replaced with new pipe. This practice is referred to as "replacement" in the industry and does not fall under the heading of "reconditioning."

[527] Ex. 512 at p. 2.

[528] Ex. 512 at pp. 2-9; *see also* Tr. 8679.

[529] Ex. 512 at pp. 6-7.

[530] Ex. 526 at pp. 18-19.

The complainants and Staff argue that SFPP should not be permitted to recover any reconditioning costs in its cost of service.[531] As an initial matter, they argue that SFPP has incurred no actual reconditioning costs during either the base period or the test period. They contend that the adjusted reconditioning costs proposed by SFPP therefore do not meet the Commission's "known and measurable" standard and are too speculative to represent an appropriate adjustment to the test year. In a separate line of argument many complainants claim that SFPP has not demonstrated that a reconditioning program of the scope and duration proposed is necessary.

I first turn to the question of whether SFPP incurred any actual reconditioning costs during the base year or test period. There is no suggestion in the record that SFPP incurred any reconditioning costs during 1993. SFPP witness Jessen initially testified that SFPP had incurred reconditioning expenses of $320,000 in 1994.[532] During cross-examination, however, Mr. Jessen confirmed that the $320,000 in question should have been treated as a capital item and not as an expense under the Uniform System of Accounts because these costs were associated with the replacement and not the reconditioning of pipe.[533] It is therefore clear that SFPP incurred no costs in association with reconditioning its lines during the 1994 test period. Since SFPP's proposed 1994 reconditioning costs of $320,000 is properly designated as a replacement expense to be treated as a capital item, I hold that SFPP is entitled to place the $320,000 in its rate base.

For a regulated oil pipeline to recover an expense in its cost of service, that expense must be known and measurable at the end of the test period. This concept can be found in the Commission's oil pipeline cost-of-service filing requirements:

> A test period must consist of a base period adjusted for changes in revenues and costs which are known and are measurable with reasonable accuracy at the time of filing and which will become effective within nine months after the last month of available actual experience utilized in the filing.

18 C.F.R. § 346.2(a)(ii) (1996). Although this regulation was promulgated after the initiation of the present case, it codifies a long-standing principle of pipeline ratemaking.[534]

The known and measurable standard allows for adjustment of actual base period costs to reflect quantifiable changes in costs during the test period. As noted above, there were no actual reconditioning costs incurred during either the base period or test period in the present case. Under the known and measurable standard, the Commission will, in some circumstances, allow rates to reflect future costs outside the test period.[535] This is generally the case only when those costs are fixed and certain to occur in the near future.[536] This flexibility is consistent with the approach to updating base and test period data adopted in the present case.

SFPP's proposed reconditioning costs, however, are far too indefinite to fall within even this broad application of the known and measurable standard. There is evidence, for example, that SFPP had not committed to a long-term reconditioning program by as late as early 1995. When asked to explain why SFPP's Form 10-K for 1994 contained no reference to reconditioning costs, SFPP President Toole stated, "At the time this document was prepared [in early 1995], we had not yet committed to that [program]."[537] The full scope of the program was at that time, and continues to be,

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[531] The West Line Shippers object to recovery of "estimates of future liability" in the cost of service, but propose that future reconditioning and environmental costs should be recovered through a surcharge mechanism, subject to shipper audit and challenge,

similar to mechanisms used in connection with natural gas pipeline PCB cleanups. *See* West Line Shippers Initial Brief at p. 50. As no other party addresses this proposal, and the West Line Shippers do not describe the proposed surcharge mechanism in adequate detail, I reject this proposal.

[532] Ex. 526 at pp. 18-19.

[533] Tr. 11016-18. *See also* Ex. 779 at pp. 5-6. The distinction between replacement and reconditioning is an important one. Under the Uniform System of Accounts for Oil Companies, when a unit of property is replaced, the cost of the old unit is retired and the cost of the new unit is capitalized. *See* 18 C.F.R. Part 352, Instructions for Carrier Property Accounts 3-5, 3-6, and 3-14.

[534] *See, e.g., Kuparuk Transp. Co.*, 45 FERC ¶ 63,006, at p. 65,080 (1988)(indefinite expenses should not be allowed in cost of service)(citations omitted); *aff'd in relevant part*, 55 FERC ¶ 61,122 (1991).

[535] d"For good cause shown, the Commission may allow reasonable deviation from the prescribed test period." 18 C.F.R. § 346.2(a)(ii).

[536] *See, e.g., Panhandle Eastern Pipe Line Co.*, 74 FERC ¶ 61,109, at p. 61,365 (1996) (permitting recovery of a PBOP expense incurred outside the test period where the amount was known and measurable and the expense was certain to occur one month after the close of the test period).

[537] Tr. 8153.

subject to change.[538] It is extremely unlikely that the costs of a program could be known and measurable at a time when the details of that program were subject to change and when the regulated entity had not even committed to the program.

SFPP's justifications for the projected dollar costs of the reconditioning program are also insufficient to make those costs "known and measurable." Mr. Abboud bases his projections on the reconditioning of an average of 30 miles of pipe per year, at an average expense of approximately $92,500 per mile, over a fifteen year period.[539] These figures are offered with little supporting documentation and appear to be primarily a "guess-timate." SFPP has entered into no long-term contracts for the reconditioning work. SFPP in fact acknowledges that the costs for this work might vary considerably from year to year.[540] SFPP's projected reconditioning costs also are based on the assumption that all affected miles of pipe would be reconditioned and not replaced. Nonetheless, SFPP has requested and states that it will continue to request that contractors submit bids for both recoating and replacement.[541] Indeed, nearly half the pipe mileage slated for recoating (*i.e.* reconditioning) in 1995 ultimately had to be replaced.[542] Since replacement costs are capitalized and not recovered as a reconditioning expense through the cost of service, this evidence suggests an even greater uncertainty as to SFPP's projected reconditioning costs. In sum, SFPP's proposed reconditioning costs are far too questionable to satisfy the Commission's known and measurable standard.

A related ratemaking principle prohibits the inclusion of expenses which are too speculative or conjectural in the cost of service.

> In determining future costs of maintenance and operations as a basis for utility rates, claimed costs must be bottomed on actual costs adjusted, where necessary, to reflect known changes. Only in this way can future costs, vital to the establishment of just and reasonable rates, be removed from the realm of speculation and conjecture.

Transcontinental Gas Pipe Line Corp., 11 FPC 94, 106 (1952). This principle addresses the concern that speculative costs might not materialize, allowing the regulated entity to enjoy a windfall at the expense of its ratepayers.[543]

Many of the facts which demonstrate that SFPP's proposed reconditioning costs are not known and measurable also go to the speculative nature of those costs. SFPP's projected costs are based on certain assumptions. Changes in contracting conditions and the possibility that pipe currently slated for recoating might instead need to be replaced could render these assumptions invalid, highlighting the level of conjecture in those assumptions. Moreover, the fact that SFPP has made no long term binding commitment to the reconditioning program only adds to the speculative nature of these costs. SFPP's Board of Directors has never formally committed funds for the full fifteen year scope of the proposed program, preferring to approve funding of the program year by year.[544] SFPP is under no legal, regulatory or contractual obligation to complete its proposed reconditioning program. SFPP's stated intent to complete the program at its proposed expansive scope is simply an insufficient guarantee. Conditions on the East and West Lines could easily change such that SFPP decides to abandon the reconditioning program even as its ratepayers continue to reimburse SFPP for the projected costs of the program. This concern is only heightened by the potential for the rates which are established in the current proceeding to remain in effect for some time under the Commission's new oil pipeline rate methodologies and procedures as set forth in 18 C.F.R. Part 342.

In light of all the evidence, I conclude that SFPP's 1994 adjusted reconditioning costs are too uncertain to satisfy the known and measurable standard and are too speculative to include in the cost of service. I need not reach the question of whether the reconditioning program is necessary or prudent. Having already determined that SFPP incurred no actual reconditioning expenses during either the base period or the test period, I hold that SFPP is not entitled to include any reconditioning costs in its cost of service.

C. Environmental Expenses

There are two issues with respect to environmental expenses: the first concerns the level of environmental costs to be included in SFPP's cost of service; the second addresses the possibility that SFPP might be reimbursed for a

[538] Mr. Abboud testified that "[t]he plan has been, and will be, revised and updated annually . . . ." Ex. 512 at p. 6.

[539] Ex. 512 at p. 7.

[540] Mr. Abboud stated that reconditioning costs would depend on "how busy and how hungry contractors are at the time." Tr. 8826-27.

[541] Tr. 8926.

[542] Tr. 8808.

[543] *See, e.g., El Paso Natural Gas*, 46 FPC 454 (1971).

[544] Tr. 8795-97.

portion of those costs through insurance proceeds.

The participants in this case offer two approaches for determining the environmental expense component of SFPP's cost of service. The approach adopted by SFPP is based on reserves which it has established to cover the costs of known environmental contamination sites. In 1992, SFPP established a reserve of $10 million (the "1992 Reserve") for certain environmental assessment and remediation costs associated with three specific sites, including a site in Colton, California on SFPP's South System.[545] SFPP allocates approximately $700,000 of this amount to the South System and proposes amortizing this $700,000 over five years beginning in October 1992, the time frame during which most of these funds are intended to be used.[546] In 1993, SFPP established a second environmental reserve of $15.15 million (the "1993 Reserve") to cover costs associated with more than 40 additional sites.[547] SFPP proposes allocating $2.6 million of the 1993 Reserve to the South System and amortizing that amount over a five year period starting in October 1993.[548] An additional $950,000 was added to the 1993 Reserve in 1994, $418,000 of which SFPP allocates to the South System to be amortized over four years, consistent with the remaining period for amortizing the 1993 funds.[549] Under the SFPP approach, the annual amortized amount for the 1994 test period would therefore be $764,500.[550]

Staff opposes SFPP's reserve accrual approach to calculating the environmental expense component of the cost of service. Staff contends that SFPP's environmental reserves are based on projections which are not sufficiently reliable to serve as the basis for a cost of service item. Instead, Staff argues that the most defensible test year amount for environmental expenses is the amount actually expended by SFPP in the 1994 test year. Staff witness McCelland testified that SFPP incurred actual environmental expenses of $553,942 in 1994.[551]

It is particularly difficult to determine the level of environmental expenses which a pipeline will incur. Such expenses arise when an oil pipeline must address the environmental impact of leaks or spills of petroleum products. When leaks or spills of this kind may occur cannot be predicted, and the magnitude of needed remediation efforts may be difficult to assess. Due to these factors, long-term projections of environmental expenses tend to be uncertain. None of the proposed approaches will account for all potential variability in future environmental remediation costs. The question in this case is which proposal will serve as the best proxy for the most likely future environmental expenses.

SFPP argues that its reserve accruals should not be characterized as "mere projections" because the reserves and amortization periods are based on a rigorous, site-specific, analysis of the tasks and costs which will be involved in undertaking necessary remediation work at known environmental sites.[552] I cannot agree. SFPP has attempted to account for the probable costs of known remediation projects, but that accounting is based on certain assumptions which fall in the realm of informed speculation. There is also considerable uncertainty as to the period over which those projects will be completed. SFPP does not claim that it intends to complete those projects within the planned amortization period. Mr. Abboud merely stated that "most" or "the bulk of" the remediation costs would be incurred within the projected five year periods for each reserve.[553] The environmental costs to be covered by the reserves could in fact be incurred over a six year period, a seven year period, or even longer.

As discussed *supra* in the section on Reconditioning Costs, the Commission has a policy against the inclusion of expenses which are too speculative or contingent in the cost of service. The reserve accrual approach is based on long-term assumptions as to SFPP's environmental costs which raise concerns under this policy. Where, as in the present case, there is a choice between using projected long-term future costs divided over a potentially variable number of years and using actual test year costs, the latter is preferable.

I therefore hold that the 1994 actual environmental costs of $553,942 shall be included as the environmental expense component of SFPP's cost of service.

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545 Ex. 144 at p. 18.

546 Ex. 238 at p. 56.

547 Ex. 144 at p. 19.

548 Ex. 238 at p. 56.

549 Ex. 526 at pp. 17-18.

550 This is the sum of the amortized South System allocation of the 1992 Reserve ($700,000/5 or $140,000) plus the amortized South System allocation of the 1993 Reserve ($2,600,000/5 or $520,000) plus the amortized South System allocation of the 1994 additions to the 1993 Reserve ($418,000/4 or $104,500).

551 Ex. 258 at p. 11.

552 *See* SFPP Initial Brief at pp. 131-33.

553 Ex. 144 at pp. 18-19.

I next turn to the question of insurance proceeds. A number of parties and participants claim that there is a risk of overrecovery if SFPP is permitted to recover environmental expenses in its cost of service and to later collect insurance proceeds related to those same environmental expenses. Chevron, Staff, and the West Line Shippers contend that SFPP should be required to establish procedures or a mechanism by which such future insurance proceeds will be credited to its ratepayers. Raising the same concerns, Navajo proposes crediting likely future insurance proceeds against SFPP's test year environmental expenses "based on its past experience as to those claims remaining outstanding."[554]

Several parties cite the Commission's holding in *Tennessee Gas Pipeline Co.*, 70 FERC ¶ 61,076 (1995), to support these arguments. In that case the Commission directed Tennessee Gas to "propose a mechanism for crediting its customers the insurance proceeds for the [PCB remediation] environmental costs recovered through its rates."[555] The circumstances involved in that decision, however, are significantly different from the facts of the present case. In *Tennessee Gas* the pipeline had already received PCB-related insurance proceeds from settlements with some of its insurance carriers.[556] The pipeline company also had acknowledged a reasonable likelihood that additional insurance recoveries would be forthcoming.[557] Determining that the pipeline may have failed to offset its environmental expenses with those known and probable insurance recoveries, the Commission held that Tennessee Gas must account for insurance proceeds already received and develop a mechanism for crediting its customers for the anticipated future recoveries.[558]

The record shows that SFPP had not received any insurance proceeds related to the South System environmental costs included in its 1994 actual environmental expenses.[559] Nor is there any evidence in the record which demonstrates that SFPP expects to receive insurance proceeds of this kind in the foreseeable future. Those advocating a recovery mechanism point to two facts as evidence of likely future recoveries: SFPP's notification to its insurers about potential claims related to its South System environmental expenses and SFPP's 1996 filing of two separate actions in California to recover certain environmental remediation costs.[560] These facts alone do not give SFPP reason to expect any forthcoming payments from its insurers. Even where claims have been filed, the procedures are far too preliminary to make predictions as to their outcome.[561] Projecting recoveries based on the mere filing of claims and notification of insurers is, at best, an exercise in speculation. As such, the possibility that SFPP will recover such insurance proceeds is simply too remote to mandate a recovery mechanism of the type described in *Tennessee Gas*.

There is a more fundamental reason for rejecting an insurance proceed recovery mechanism in the present case. As noted above, environmental expenses are likely to vary considerably over time. Actual environmental expenses in 1994 are being used as the best available indicator of long-term environmental costs in this case. Permitting SFPP's customers to recover future insurance proceeds would essentially allow a reduction in the environmental expense component of SFPP's cost of service in the post-test year period. No mechanism has been proposed, however, which would allow SFPP to increase the environmental expense component of its cost of service in the event that future environmental costs exceed the test period amount.[562] It would be inequitable to craft a mechanism which compensates for post-test year reductions in SFPP's environmental costs but not for post-test year increases.

I therefore hold that SFPP need not establish a mechanism which credits its ratepayers for future insurance proceeds related to its environmental expenses.

D. Post-Retirement Benefits

SFPP's cost of service includes an amount for post-retirement benefits other than pensions ("PBOPs"). Under SFPP's accrual methodology the amount includes future benefits earned by active employees in the current period.

Chevron and Navajo contend that only SFPP's cash payments during the period at issue (*i.e.* amounts that were actually paid with respect to retired plan participants for benefits earned in prior periods) should be included in SFPP's cost of service.

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[554] Navajo Initial Brief at p. 89.

[555] 70 FERC ¶ 61,076, at p. 61,199.

[556] *Id.*

[557] *Id.*

[558] *Id.*

[559] *See* Tr. 6674-75.

[560] *See* Ex. 260; Ex. 777; and Ex. 778.

[561] The California claims are primarily related to remediation costs at a Nevada terminal facility which is not a part of SFPP's South System. Tr. 8677.

[562] The West Line Shippers do mention the use of a "surcharge, subject to audit and challenge by the shippers", but provide no details as to how such a mechanism might work. West Line Shippers Initial Brief at p. 50.

The PBOP expense issue arose in this proceeding because of a change in accounting standards which became effective in 1992. That change, known as Statement of Financial Accounting Standards No. 106 ("SFAS 106"), requires companies such as SFPP to record a periodic accrual for certain post-retirement benefits that are earned by plan participants in the current period but may not be paid until some years later.[563] Accruing for PBOP expense is mandatory for SFPP under SFAS 106.[564]

SFAS 106 had two major implications for purposes of the issue presented here. First, it required companies such as SFPP to adopt the accrual method of accounting for PBOP expense, where previously this expense generally was accounted for on a pay-as-you-go basis. Second, it resulted in SFPP recording a charge against earnings, referred to as the "transition obligation," to account for the present value of all future obligations of the company earned by plan participants as of that date.

SFPP excluded from its operating expenses the amortization cost of the transition obligation.[565] Thus there is no issue regarding the transition obligation portion of SFPP's PBOP expense. However, SFPP proposes to recover in ratemaking the accretion of the discounted present value of the transition obligation by including the interest component, while excluding recovery of the transition obligation itself.[566]

Because the accrual basis for recognizing expenses for ratemaking purposes can provide regulated companies with collections of ratepayer funds years in advance of the periods when the funds will be expended, FERC established policies to ensure the payment of benefits to employees and to provide that post-retirement benefits are accounted for properly in establishing rates.[567]

To recover accrual basis PBOP costs, the company must comply with the requirements set forth under the Commission's *Policy Statement*. The FERC's *Policy Statement* reads in pertinent part as follows:

> It shall be the policy of the Commission to recognize, as a component of jurisdictional cost-based rates of natural gas pipeline companies and public utilities under its jurisdiction, and *oil pipelines should they elect to comply with this statement*, allowances for prudently incurred costs of PBOPs of company employees when determined on an accrual basis . . . that are consistent with the accounting principles set forth in SFAS 106 provided that the following conditions are met: (1) The company must agree to make cash deposits to an irrevocable external trust fund . . . equal . . . to the annual test period allowance for PBOPs . . . [and] (2) [t]he company must . . . maximize the use of income tax deductions for contributions to [the trust] fund . . . .[568]

According to the *Policy Statement*, the Commission shall recognize post-retirement benefits as a component of jurisdictional cost-based rates for oil pipelines that elect to comply with the *Policy Statement* and that account for the benefits in a manner consistent with the standards in SFAS 106. To obtain recognition, the jurisdictional entity "must agree" to make cash deposits to an irrevocable external trust fund, whose trustee must be independent of the company, and the jurisdictional entity must maximize the use of income tax deductions for contributions to the trust fund.[569]

SFPP has elected not to comply with the FERC's *Policy Statement*.[570] SFPP has not established an irrevocable trust fund for the benefit of its employees, and there is no assurance that the amounts SFPP would collect from its ratepayers for PBOP costs, recorded on an accrual basis, ultimately will be paid to its employees.

Applying the accrual method, SFPP booked an annual expense for PBOPs in an amount of \$2.231 million in 1992, \$1.555 million in 1993 and \$1.5 million in 1994.[571] Having thereby increased its cost of service by those amounts

[563] Tr. 4891.

[564] Tr. 4892. The Financial Accounting Standards Board ("FASB") issued SFAS 106 in December 1990. SFAS 106 requires that, for fiscal years beginning after December 15, 1992, employers reflect in current expense an accrual for post-retirement benefits other than pensions during the working lives of covered employees. SFAS 106 essentially finds that PBOP plans are "deferred compensation arrangements whereby an employer promises to exchange future benefits for employees' current service and that their cost should be recognized over the employees' service periods for financial accounting and reporting services." *Post- Employment Benefits Other Than Pensions, Docket No. PL93-1-000, Statement on Policy* ("*Policy Statement*"), 61 FERC ¶ 61,330, at p. 62,199 (1992), *reh'g denied*, 65 FERC ¶ 61,035 (1993).

[565] *See* Ex. 524 at pp. 5-6; Tr. 10730-31.

[566] Tr. 4906-09.

[567] *Policy Statement*, 61 FERC ¶ 61,330, at p. 62,200.

[568] *Policy Statement*, 61 FERC ¶ 61,330, at p. 62,200 (emphasis added).

[569] *Id.*

[570] Tr. 4705.

[571] *See* Ex. 719.

in each of those years, SFPP then amended its plan in 1994, reducing plan benefits. The result was that SFPP recorded a gain in the amount of $3.1 million on its 1994 financial statements.[572] Moreover, by that plan amendment, SFPP also was able to reduce plan expense to only $770,000 in 1995.[573]

Although SFPP increased its cost of service in 1992, 1993 and 1994 by plan expenses on an accrual basis, it made no correcting or crediting entry to the benefit of the ratepayers when it modified the plan in 1994 and thereby captured a $3.1 million gain.

It was this kind of a situation which concerned the Commission when it required that an irrevocable trust be established if ratepayers are to be charged in their rates with the funding of PBOP amounts on an accrual, rather than a pay-as-you-go, basis. As stated by the Commission:

> FASB statements permit in certain instances gains realized on settlements and curtailments of post-retirement plans to be taken to income. Recognition of income by the regulated company without a concurrent reduction in rates would not be fair to ratepayers, particularly if any shortfalls in fund assets are to be made up through increased future rates. That would be the effect of adopting the accounting principles of SFAS 106 for ratemaking purposes. A mandatory requirement to establish an irrevocable trust will prevent the company from realizing income not intended to be earned when the rates were originally established by the Commission.[574]

SFPP has chosen not to establish an irrevocable trust for the benefit of its employees, and it has within two years of implementation of SFAS 106 in 1992 already amended the plan once and reduced benefits, recognizing a gain for its investors and reducing PBOP expenses. SFPP has provided no assurance that it will not again amend the plan in the future to reduce benefits. On this basis, SFPP should not be allowed to reflect its accrual basis PBOP amounts in cost of service but rather should reflect the PBOP amounts it actually paid.

As SFPP pointed out, the Commission has not applied its policy regarding the irrevocable trust requirement generally to oil pipelines as it has to gas and electric utilities.[575] Rather, the Commission has stated that it will apply its policy to oil pipelines on a case-by-case basis. Here, the facts demonstrate the propriety of applying the irrevocable trust requirement to SFPP. It was actions such as those taken by SFPP which led the Commission to impose the irrevocable trust requirement as a condition to accrual accounting for PBOPs.

In these circumstances, for rate purposes no accrual of PBOPs will be allowed, nor will SFPP be permitted to recover in its cost of service the discounted present value of the transition obligation by including the interest component in its cost of service.

It is held that SFPP will be allowed in its cost of service only those amounts that were actually paid in 1994 with respect to retired plan participants for benefits earned in prior periods.

E. Right-of-Way Expense

Navajo and Chevron dispute SFPP's right-of-way expense. To the extent that events are considered for test year purposes that occurred beyond the end of the 1993 base year, SFPP contends that an adjustment must be made because SFPP anticipates increased right-of-way costs beginning January 1, 1994.[576]

SFPP incurs annual South System expenses associated with rights-of-way held by Southern Pacific Transportation Company ("SPT Co.").[577] This expense is incurred by SFPP because of an agreement entered into between SFPP and SPT Co. in 1983, at the time the pipeline and the railroad ceased their affiliation.[578] Under the agreement, the base rental price is subject to renegotiation every ten years.[579]

At the expiration of the initial ten-year period at the end of 1993, SFPP and SPT Co. were unable to agree on the value of the rights-of-way or a new baseline rental amount.[580] That disagreement resulted in litigation. In April 1994, SFPP and SPT Co. entered into a settlement agreement in which they agreed that a new base year rental for the rights-of-way would be established retroactive to January 1, 1994.[581] Under the agreement, SFPP's rental expense for 1994 can be no lower than what it actually paid in 1993.[582]

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[572] Ex. 337 at pp. 12-13.

[573] Ex. 719.

[574] *Policy Statement*, 61 FERC ¶ 61,330, at p. 62,202.

[575] SFPP Initial Brief at p. 144.

[576] SFPP's proposed adjustment, which is a confidential figure, is set forth in Mr. Abboud's Surrebuttal Testimony. Ex. 512-PO at p. 11.

[577] Tr. 8674-75; *see also* Ex. 512 at pp. 9-10.

[578] Tr. 8674.

[579] *Id.*

[580] Tr. 8675.

[581] Ex. 512 at p. 10.

[582] *Id.*

Subsequent to the settlement, SFPP and SPT Co. were unable to agree on the amount of the annual rental payment for the first 10-year period starting January 1, 1994; SPT Co. initiated a judicial reference proceeding to resolve the rental issue.[583] In that litigation, SPT Co. is seeking an increase in the annual right-of-way rent to be paid by SFPP from $3.7 million to $18.5 million.[584] (These figures are total figures for SFPP; the portion allocated to the South System would be less.) The judicial reference proceeding had not concluded at the time Mr. Abboud testified in this proceeding.[585]

SFPP recorded on its books for 1994 an anticipated right-of-way expense higher than what it paid in 1993, but below the amount that SPT Co. is seeking in the judicial reference proceeding.[586] SFPP seeks to include that booked amount in its 1994 cost of service.

Chevron and Navajo object to the inclusion of the estimated proposed increase in SFPP's right-of-way expenses on the ground that SFPP's adjustment does not meet the "known and measurable" standard for test year adjustments. All that is known is that SFPP's 1994 rental expense will be no lower than its 1993 rental expense. Whether there will be an increase is speculative.

I agree with Chevron and Navajo. It is held that SFPP may include in its cost of service an expense for right-of-way equal to the actual 1993 right-of-way expense allocated to the South System.[587]

F. Property Taxes

There is an issue whether accrual or invoiced amounts shall be used for Arizona property taxes when calculating SFPP's rates. SFPP wants to base its Arizona property tax figures for the years 1990 through 1994 on the accrual amounts on its books. Chevron and Navajo urge the use of the actual invoice amounts for those years, essentially because the accrued estimated amounts are inaccurate. The actual invoiced amounts exceeded accrual amounts by $4,828 in 1990 and by $88,760 in 1994. However, the accrual amounts exceeded actual invoice totals in 1991 by $36,351, in 1992 by $114,111 and in 1993 by $248,415. Tr. 4983-87. Thus SFPP's net accrual amounts exceed actual net invoice amounts for the period 1990 through 1994 by a net amount of $305,389 and by $394,049 over the period 1990 through 1993.

SFPP's property taxes for property in California and Arizona first must be allocated between carrier and noncarrier property. SFPP adopted Chevron's method of allocating California property taxes.[588] Chevron allocated the actual amount of California property taxes paid by SFPP in the calendar year on the basis of the relationship of end-of-year gross investment in carrier versus noncarrier property in California.

Chevron used the same method of allocating Arizona property taxes in its direct case. SFPP Witness Jessen rejected that methodology for Arizona taxes, stating that Arizona tax invoices distinguished between carrier and noncarrier property. After an investigation, Chevron Witness Zaegel concluded that the Arizona tax invoices did not enable SFPP to distinguish its tax bills for carrier from those for non-carrier property.[589] Upon reconsideration, SFPP Witness Jessen agreed and amended his property tax allocation in his supplemental direct testimony filed on November 17, 1995. Mr. Jessen corrected the errors in Arizona property tax allocations. Those errors, before being corrected, overstated Arizona carrier property taxes by nearly $900,000 over four years.[590]

SFPP has incorrectly characterized Chevron's position on this issue as a cash method. The method used by Chevron Witness Zaegel is an accrual method, adjusted to eliminate the errors contained in SFPP's accrual numbers. The level of expense recognized by Witness Zaegel is the total of actual property tax invoices relating to each year, even though approximately one half of each year's total property tax amounts are not paid until the succeeding year.

Considering the evidence and the arguments of the participants, I hold that the use of actual invoice amounts for Arizona property taxes shall be used in calculating SFPP's Arizona property taxes. This ruling also conforms to the method used by SFPP in this proceeding of allocating actual taxes paid (*i.e.*, invoice amounts) between carrier and non-carrier expenses.

[583] *Id.*

[584] Tr. 8675.

[585] *See* Tr. 8675.

[586] Ex. 512-PO at p. 11; Tr. 8675.

[587] The actual figure can be calculated from the figures given by SFPP witness Abboud in Exhibit 512-PO, page 11, lines 7-12. The figures are not mentioned in this Initial Decision because they are confidential and covered by the protective order in this case.

[588] Ex. 612 at p. 24; Ex. 34 at p. 37; Ex. 238 at p. 67.

[589] Ex. 414 at p. 17.

[590] Ex. 612 at pp. 24-25; Ex. 414 at pp. 16-17.

X. INCOME TAXES

The Commission has traditionally permitted the utilities it regulates, most of whom are corporations, to include an allowance for state and federal income taxes in their costs of service. Such allowances are necessary to ensure that the regulated entities have the opportunity to earn their allowed rates of return on equity after taxes.[591] SFPP, the regulated entity in the present case, is organized not as a corporation, but as a publicly traded limited partnership commonly known as a master limited partnership. The ownership structure of SFPP raises issues as to whether and to what extent SFPP should be permitted an income tax allowance.

A. Availability of the Income Tax Allowance

The first issue is whether it is appropriate for SFPP to include an income tax allowance in its cost of service.

Chevron, RHC, and West Line Shippers argue that SFPP is entitled to no federal income tax allowance.[592] These complainants note that SFPP, as a limited partnership, is an entity which neither incurs nor pays federal income taxes.[593] They argue that because a limited partnership does not itself pay federal income taxes, it is both unnecessary and improper for such an entity to recover, through a tax allowance, "costs" which are not actually incurred.

In the *Lakehead* decisions the Commission addressed the permissibility of income tax allowances for limited partnerships. The Commission there concluded that Lakehead was entitled to an income tax allowance for income attributable to its corporate partners but not for income attributable to its individual limited partners.[594] The regulated entity in *Lakehead* was a master limited partnership, similar in many ways to SFPP.[595] Lakehead was permitted a partial tax allowance even though it was a limited partnership which did not itself pay income taxes but which passed income through to its partners. The Commission permitted such an allowance with respect to costs incurred by certain of Lakehead's partners:

> When partnership interests are held by corporations, the partnership is entitled to a tax allowance in its cost-of-service for those corporate interests because the tax cost will be passed on to the corporate owners who must pay corporate income taxes on their allocated share of income directly on their tax returns. The partnership is in essence a division of each of its corporate partners because the partnership functions as a conduit for income tax purposes.

71 FERC ¶ 61,338, at pp. 62,314-15.

The argument that SFPP should be denied an income tax allowance simply because it is a limited partnership which does not itself pay income taxes cannot be reconciled with the Commission's opinions in *Lakehead.* To the extent that certain complainants contend that the Commission's decision in *Lakehead* was contrary to ratemaking principles or otherwise incorrect,[596] those arguments must be addressed to the Commission.

B. Level of the Income Tax Allowance

Having determined that SFPP, as a limited partnership, is not barred from recovering a tax allowance as part of its cost of service, the next issue is what level of income tax allowance should be provided to SFPP.

SFPP argues that it is entitled to a full income tax allowance. SFPP concedes that permitting it a full tax allowance, including an allowance for income attributable to individual limited partners, would be contrary to the Commission's decisions in *Lakehead.*[597] Nevertheless SFPP submits that *Lakehead* draws invalid distinctions between corporate and individual pipeline owners and that the distinctions are contrary to Congressional tax policy favoring the use of the partnership form by oil pipelines.[598] SFPP urges a return to the apparent pre-*Lakehead* practice of treating limited partnerships like corporations and permitting them full income tax allowances. As noted above, and as acknowledged by SFPP in its

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[591] *See, e.g., Lakehead Pipe Line Co., L.P.,* 71 FERC ¶ 61,338, at p. 62,313.

[592] Staff and Navajo take the position that SFPP is entitled to a partial income tax allowance.

[593] *See* Tr. 8201 *in camera.*

[594] *Lakehead,* 71 FERC ¶ 61,338, at pp. 62,314-15; *see also* 75 FERC ¶ 61,181, at p. 61,593.

[595] The stipulated facts set forth in the Initial Decision in *Lakehead* include the following:

> 4. . . . The assets of the pipeline are owned by Lakehead. Lakehead, which is structured as a master limited partnership is 99 percent owned by Lakehead Pipe Line Partners, L.P. and 1 percent by Lakehead Pipe Line Company, Inc. (LPL, Inc.). LPL, Inc. is the general partner of Lakehead. LPL, Inc. owns approximately 20 percent of the units in Lakehead Pipe Line Partners, L.P., with the remaining shares publicly held.

Lakehead Pipe Line Co., L.P., 65 FERC ¶ 63,021, at 65,121 (1993).

[596] *See, e.g.,* RHC Initial Brief at p. 32; Chevron Initial Brief at pp. 114-15.

[597] SFPP Initial Brief at p. 152.

[598] *Id.* at pp. 152-54.

briefs,[599] any action to overturn clearly established precedents in *Lakehead* must be taken by the Commission.

I therefore hold that SFPP shall not be treated like a corporation for tax allowance purposes and, for reasons discussed more fully below, that it is entitled to a partial, but not a full, income tax allowance.

Under *Lakehead*, the determination of a partnership's proper income tax allowance begins with a consideration of the partnership's ownership and income allocation structure by type of entity.

As noted in the beginning of this initial decision, SFPP is owned one percent by its general partner, Santa Fe Pacific Pipelines, Inc. ("SFPP Inc.") and 99 percent by Santa Fe Pacific Pipelines Partners, L.P. ("SFPP Partners").[600] SFPP Partners is in turn organized as a master limited partnership, with approximately 56 percent of its ownership consisting of common units publicly traded on the New York Stock Exchange.[601] SFPP Inc. is the general partner, holding a one percent general partnership interest in SFPP Partners, and owner of the remaining common partnership units.[602]

As an initial matter, we must determine how many levels of ownership should be considered. The West Line Shippers argue that the inquiry should focus only on the proximate ownership of SFPP itself. In other words, they claim that the only ownership shares which are relevant to determine SFPP's proper income tax allowance are SFPP Inc.'s one percent general partner interest in SFPP and SFPP Partners' 99 percent limited partner interest in SFPP.[603] Under this approach, there would be no consideration of the ownership of SFPP Partners, and SFPP would be entitled to a tax allowance only with respect to the one percent interest of SFPP's corporate general partner.

Such an approach is at odds with the analysis dictated in *Lakehead*. As noted above, Lakehead, like SFPP, was one percent owned by a corporate general partner and 99 percent owned by a limited partnership (which consisted of corporate and individual partners).[604] The fact that the Commission reached the question of tax allowances with respect to the individual and corporate partners of the 99 percent owner of Lakehead indicates the need in the instant case to look beyond the immediate proximate ownership of entities structured like SFPP and Lakehead. The goal of the *Lakehead* analysis is to determine the tax costs of the actual owners of a regulated pipeline. It is not necessary in the instant case to decide how many layers of ownership need to be examined in all future cases; but where, as in the instant case, a regulated oil pipeline is 99 percent owned by a limited partnership, the ownership structure of the limited partnership must be considered.

As of December 31, 1994, SFPP was owned by and allocated income to the following entities and types of entities: SFPP Inc. as a general partner of both SFPP and SFPP Partners; SFPP Inc. as a limited partner of SFPP Partners; the individual limited partners holding publicly traded units of SFPP Partners; the corporate limited partners holding publicly traded units of SFPP Partners; and other entities, including trusts, mutual funds, and estates, holding publicly traded limited partner units of SFPP Partners.[605] All participants in the present case submitted some analysis or discussion of the partial income tax allowance to which SFPP is entitled.[606] We hereafter consider the arguments for allowing a tax allowance with respect to each type of entity.

We begin with SFPP's individual limited partners. In many ways, this is the easiest type of entity to address. The *Lakehead* decisions establish that a limited partnership "should not receive an income tax allowance with respect to income attributable to the limited partnership interests held by individuals."[607] Only SFPP contends that it should receive an income tax allowance for income attributable to its individual limited partners, and it only makes that contention insofar as it argues that

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[599] SFPP Initial Brief at p. 155; SFPP Reply Brief at p. 130.

[600] Ex. 142 at p. 5.

[601] *Id.* at pp. 5-6. A schedule setting forth in percentage terms and type of entity the owners of SFPP Partners' units for year end 1990 through 1994 is included in the record as Exhibit 477. *See* Ex. 476 at pp. 9-11.

[602] Ex. 142 at p. 5; *See* Exhibit 143 for a diagram of the SFPP, L.P. organization structure.

[603] West Line Shippers Initial Brief at pp. 53-55.

[604] 65 FERC ¶ 61,021, at p. 65,121.

[605] Ex. 670; Ex. 477; Ex. 478.

[606] Even those participants arguing that *Lakehead* was wrongly decided discuss what tax allowance should be permitted under a *Lakehead* analysis. SFPP, for example, contends that under such an analysis it is entitled to a partial tax allowance of up to 66.09 percent of the full allowance. *See* SFPP Initial Brief at pp. 156-558. RHC, on the other hand, states that "under the express language of *Lakehead*, [SFPP] would get only a 1 percent federal income tax allowance." RHC Reply Brief at p. 11 n.5. This conclusion appears to be based on the single-ownership level analysis which we have rejected.

[607] 71 FERC ¶ 61,338, at p. 62,315.

the Commission should overturn the tax allowance portions of the *Lakehead* decisions. It is appropriate to set forth here the reasons why a tax allowance is inappropriate with respect to individual limited partners and to reiterate the Commission's rationale in *Lakehead*, thereby establishing some principles which will apply to the novel tax allowance issues raised in the present case.

These principles are rooted in the fundamental purpose of the income tax allowance. Investors in a regulated pipeline are entitled to a return "commensurate with returns on investments in other enterprises having corresponding risks."[608] Where a regulated pipeline is a corporation, that corporation must pay corporate income taxes on its revenues. The shareholders of the corporation are then taxed on their dividends. Thus, where a regulated entity is a corporation, the return realized by the investors in that corporation is reduced by two or more layers of taxation. The Commission permits a regulated corporation to include a tax allowance in its cost of service to compensate for this multi-tier tax structure. The allowance is intended to allow an investor an opportunity to recover, after taxes, a return equivalent to the return which would have been realized if the corporation's revenues were not subject to the additional tier of corporate income taxation. If a regulated corporation were unable to recover in its rates the costs of the corporate income taxes which it pays, it would also be unable to offer its investors the "commensurate return" which is the basis of fair ratemaking.

The same rationale is not applicable to individual unitholders in a limited partnership. A limited partnership is a flow-through entity which does not pay federal income taxes. An individual limited partner is taxed on his or her allocated share of the partnership income directly, at the individual income tax rate. In such a structure, the return realized by individual investors is only reduced by the income taxes paid by the individual limited partners. These taxes are generally equivalent to those paid by an individual shareholder on corporate dividends. Because there is no dual taxation, a tax allowance is not necessary to ensure that an individual limited partner obtains a "commensurate return." As the Commission stated in *Lakehead*:

> Since there is no corporate income tax paid, there should be no corporate income tax allowance built into Lakehead's rates with respect to income attributable to individual limited partners. This comports with the principle that there should not be an element in the cost-of-service to cover costs that are not incurred.

71 FERC ¶ 61,338, at p. 62,315. I therefore hold that SFPP is not entitled to an income tax allowance with respect to income attributable to its individual limited partners.

We next must consider the corporate owners of publicly traded limited partner interests in SFPP Partners. Chevron and Navajo argue that SFPP should not be provided with an income tax allowance with respect to corporate owners other than the general partner SFPP Inc. Navajo relies on the comments of its witness Horst, who characterizes the corporate limited partners as "passive" owners of SFPP because they purchase their units on public markets like any public shareholder or unitholder.[609] Since the values of those units are established by the public market, Navajo claims that there is no need to treat corporate public unitholders any differently than individual unitholders.[610] Chevron presents a similar line of argument. Chevron contends that because all unitholders buy their units on the public market, and because each unit receives the same cash distribution, SFPP's costs are not affected by what type of entity owns the publicly traded units.[611] Therefore, the different types of entities owning limited partner units should be treated the same in the tax allowance portion of SFPP's cost of service.[612] Both Chevron and Navajo argue, in effect, that SFPP is not entitled to an income tax allowance with respect to the percentage of its ownership represented by all publicly traded units of SFPP Partners.

It is true that permitting a tax allowance with respect to corporate holders of publicly traded limited partner units will not necessarily allow the shareholders in those corporations to realize the same return on their investment as individual holders of the same units. As Chevron observes, both types of public unitholders may receive the same cash distribution, or more appropriately for our purposes, the same income allocation. Shareholders in corporate public unitholders would then see their return reduced by two or more tiers of taxation while individual public unitholders would only be subject to one tier.

Insofar as tax allowances are intended to reflect actual corporate income tax costs in-

[608] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

[609] Navajo Initial Brief at p. 97; Ex. 365 at p. 30.

[610] *Id.*

[611] Chevron Initial Brief at pp. 121-22.

[612] *Id.*

curred, providing an income tax allowance with respect to corporate public unitholders is more consistent with this goal than the approach proposed by Chevron and Navajo. Consider the example of a regulated pipeline limited partnership which is 95 percent owned by corporations holding publicly traded limited partner units. The pipeline investors who are shareholders in those corporations would see the return on their investment reduced by two or more tiers of taxation. If the pipeline is permitted a tax allowance with respect to the corporate limited partners, the shareholders would be far more likely to recover, after taxes, their allowed return on equity than they would under the Chevron/Navajo approach, which would deny a tax allowance with respect to all publicly traded limited partner units. Conversely, if our hypothetical pipeline were 95 percent owned by individual limited partners, a tax allowance with respect to the individual investors would not be necessary for them to recover their allowed return on equity after taxes.

This is the approach followed by the Commission in the *Lakehead* decisions. There seems little doubt that the Commission intended to provide entities like Lakehead and SFPP with a tax allowance with respect to corporate public limited partners. On rehearing, in response to an argument that the *Lakehead* approach would be hard to administer "because it is difficult to know on an ongoing basis who the *public* individual partners are," the Commission responded that it saw "no reason that a yearly listing of partners would not be frequent enough to determine whether a change in the mix of corporate and individual partners . . . merit[ed] a change in rates under the cost-of-service method."[613] Although the *Lakehead* tax allowance method is not an exact mechanism for ensuring that investors in a regulated pipeline realize their allowed return on equity after taxes, the Commission, by making a distinction between corporate and individual limited partners, arguably permits a partnership to structure its distributions and allocations of income so as to achieve that goal.

I hold that SFPP is entitled to an income tax allowance with respect to its corporate holders of limited partner interests.

The remaining holders of publicly traded limited partner units of SFPP Partners are neither individuals nor corporations.[614] The *Lakehead* decisions only draw a distinction between individual and corporate limited partners for tax allowance purposes. Since *Lakehead*, the Commission has not addressed whether a regulated pipeline should be permitted a tax allowance with respect to other types of entities.

SFPP contends that it should be provided a tax allowance based on the percentage of income allocated to all owners that are not individuals. It claims that, under *Lakehead*, a limited partnership is entitled to a tax allowance with respect to all limited partners subject to multi-tier taxation and argues that, "[t]he evidence demonstrates that virtually all, if not all, of the SFPP owners that are not corporations or individuals are in fact subject to multi-tier taxation on their income."[615]

Complainants generally read the *Lakehead* decisions as restricting a limited partnership's income tax allowance to the ownership interests of corporations alone. Staff accepts the use of multi-tier taxation as a basis for determining whether a limited partnership is entitled to a tax allowance with respect to certain entities, but states that, "contrary to its assertions, SFPP has not presented substantial evidence to demonstrate that there are any owners, other than corporations, that are subject to multi-tier taxation."[616]

I agree with Staff. While a limited partnership may be entitled to a tax allowance with respect to entities that actually pay taxes in a multi-tier taxation structure similar to corporations, there is insufficient evidence in the present case to establish that SFPP's non-corporate and non-individual partners are such entities. SFPP's reliance on the statements of its witness Mr. Miller on this question is misplaced. Mr. Miller merely agrees that "most of SFPP's owners that are neither individuals nor corporations [are] also subject to multi-tier taxation."[617] He provides virtually no discussion or analysis of the taxation structures to which these owners are subject and gives no evidence about the actual taxes paid by these entities. Mr. Miller's bald statement that these owners are subject to multi-tier taxation does not justify a tax allowance with respect to the non-individual and non-corporate partners of SFPP.

I hold that SFPP is not entitled to an income tax allowance with respect to income attributed to the non-corporate and non-individual limited partners of SFPP Partners.

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[613] 75 FERC ¶ 61,181, at p. 61,596 (emphasis added).

[614] As of December 31, 1994, approximately 20.4 percent of SFPP's ownership consisted of estates, foreign citizens, mutual funds, trusts, pension plans, other partnerships, exempt organizations, and other entities holding publicly traded limited partner interests in SFPP Partners. Ex. 477; Ex. 670.

[615] SFPP Initial Brief at p. 158.

[616] Staff Reply Brief at pp. 27-28.

[617] Ex. 479 at pp. 9-11.

SFPP Inc. is the final entity which owns, and is allocated income by, SFPP. As of 1994, SFPP Inc. had a one percent general partner interest in SFPP, a one percent general partner interest in SFPP Partners, and a 41.7 percent limited partner interest in SFPP Partners.[618] SFPP Inc. is a corporation. As a corporation, the *Lakehead* decisions would seem to dictate that SFPP is entitled to an income tax allowance with respect to income attributable to SFPP Inc.

A number of complainants, however, claim that SFPP is not entitled to a tax allowance with respect to at least SFPP Inc.'s limited partner interest. They point out that in 1990 a holding company for SFPP Inc. was created which issued debentures paying interest in an amount equal to the amount of distribution paid to SFPP Inc. on its limited partner interest in SFPP Partners.[619] The complainants contend that this arrangement allows SFPP Inc., in a consolidated return, to render its revenues on its limited partner interest a tax deductible interest expense such that SFPP Inc. never pays income taxes on that portion of its income from SFPP.[620] Chevron, Navajo, and RHC argue that permitting SFPP to include in its cost of service an allowance for "phantom income taxes," with respect to SFPP Inc.'s limited partnership interest, which are never actually paid, would provide SFPP with a windfall in the form of an excessive return on equity.[621] SFPP disagrees with the contention that income taxes are never paid on income attributable to SFPP Inc.'s limited partnership interest and further contends that such arguments are contrary to the Commission's "stand-alone" tax policy.

I agree with the complainants' factual contentions. SFP Pipeline Holdings was formed and began operation in 1990, at which time it acquired 100 percent of the outstanding capital stock of SFPP Inc. and issued debentures in a principal amount of $219 million.[622] The holding company has no employees and is managed by officers of SFPP Inc.[623] SFPP witness Mr. Toole confirmed that the holding company's only business is administering the debentures.[624] The yield on these debentures is tied to cash distributions made with respect to SFPP Inc.'s limited partner interest in SFPP Partners.[625] Mr. Toole confirmed that as a result of this organizational structure and conditions related to the issuance of the debentures, all of SFPP Inc.'s income tax liability attributable to its limited partner interest in SFPP Partners is offset by interest payments in the consolidated return.[626] All evidence shows that the sole purpose of this holding company/debenture arrangement is to wash out any income taxes due on SFPP Inc.'s limited partner interest. As such, the SFPP family never pays corporate income taxes on the income attributable to SFPP Inc.'s limited partnership interest.

It is true that the Commission's stand-alone tax policy generally would dictate that the tax liability of SFPP Inc. be considered without regard to deductions generated by other members of a consolidated group. That policy, as set forth in cases such as *Northern Border Pipeline Co.*, recognizes that a regulated corporation may collect a full tax allowance even where a regulated corporation pays no income taxes to the IRS because the tax liability of the regulated corporation may be offset by tax deductions generated by other members of a consolidated group.[627] The Commission commented on that policy in its rehearing of *Lakehead*, noting that "the tax liability of [a] jurisdictional company is a real cost of providing service" which could be included in the tax allowance component of a regulated entity's cost of service.[628]

The stand-alone policy, however, has never been applied to the situation in the present case, where a holding corporation is created whose sole function is to cancel out a corporation's income tax liability with respect to a specific stream of income. Indeed, SFP Pipeline Holdings seems to have been created in the present case to maintain the appearance that SFPP Inc. continues to have income tax liability on its income attributable to its limited partner interest. As SFPP witness Toole conceded, SFPP Inc. could have issued the debentures and taken the resulting income tax deductions itself.[629] If it had done so, SFPP Inc. would have no "stand-alone" corporate income tax liability for the income attributable to its limited partner interest. Under these circumstances the stand-alone policy must be

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618 Ex. 870.

619 *See, e.g.*, Navajo Initial Brief at pp. 97-100.

620 *Id.*

621 Chevron Initial Brief at pp. 112-119; *see also* Navajo Initial Brief at pp. 97-100; RHC Initial Brief at pp. 29-38.

622 Ex. 866 at p. 3.

623 Tr. 8524.

624 Tr. 8536.

625 Tr. 8380-81; Ex. 142 at p. 6.

626 Tr. 8386, 8635-36.

627 67 FERC ¶ 61,194, at pp. 61,610-11 (1994), *vacated on other grounds*, 75 FERC ¶ 61,194 (1996).

628 75 FERC ¶ 61,181, at p. 61,595.

629 Tr. 8636.

applied in a manner consistent with the broader dictates of cost-based ratemaking.

Section 1(5) of the Interstate Commerce Act mandates that all oil pipeline rates "shall be just and reasonable."[630] The determination of what constitutes a "just and reasonable" rate is of course a complex inquiry based on a potentially broad standard. Courts have generally directed the Commission to turn to a consideration of a regulated entity's actual costs as the foundation for setting "just and reasonable" rates.[631] The District of Columbia Circuit has cautioned against departing from considerations of actual costs in establishing oil pipeline rates:

> Departures from cost-based rates must be made, if at all, only when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods ensure that the resulting rate levels are justified by those factors.

Farmers Union Central Exchange, Inc. v. FERC, 734 F.2d 1486, 1530 (1984); *see also*, *FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 517-19 (1979). The Commission also has made clear that "there should not be an element in the cost-of-service to cover costs that are not incurred."[632]

In the present case, SFPP, or more specifically the SFPP organizational family, pays no corporate income taxes and therefore incurs no costs on the income attributable to SFPP Inc.'s limited partnership share in SFPP Partners. These costs are avoided solely through the creation of a holding corporation designed to cancel out those taxes. SFPP offers no justification for including such phantom costs in its income tax allowance other than its claim that a failure to provide a tax allowance with respect to SFPP Inc.'s limited partnership interest would be contrary to the stand-alone policy.

Under the facts peculiar to this case, the broader principles of cost-based ratemaking require that SFPP Inc.'s tax liability be considered in conjunction with that of the holding company designed to cancel out its tax liability. Since SFPP Inc., in conjunction with SFP Pipeline Holdings, effectively incurs no corporate income taxes on the income attributable to SFPP Inc.'s limited partner interest, a tax allowance with respect to that interest should not be included in SFPP's cost of service. Having reviewed the evidence and the law, I hold that SFPP is not entitled to an income tax allowance with respect to income attributable to SFPP Inc.'s limited partnership interest in SFPP Partners.

SFPP Inc.'s general partnership interest in SFPP and SFPP Partners must be considered separately. The interest paid on the holding company's debentures is not directly tied to SFPP Inc.'s revenues with respect to its general partner interests.[633] The holding company's debentures therefore should not be treated as directly canceling out SFPP Inc.'s corporate income tax liability with respect to its general partnership interests. Absent such treatment, SFPP Inc.'s income attributable to its general partnership interest should be treated like the income attributable to any other corporate partner of a limited partnership.

I therefore hold that SFPP is entitled to an income tax allowance with respect to income attributable to SFPP Inc.'s general partnership interest in SFPP and SFPP Partners.

In summary, SFPP may claim an income tax allowance with respect to income attributable to SFPP Inc.'s general partnership interest and income attributable to corporations holding publicly traded limited partner interests in SFPP Partners. SFPP is not, however, entitled to an income tax allowance for income attributable to SFPP Inc.'s limited partnership interest and for income attributable to the non-corporate limited partners, both individuals and other entities, of SFPP Partners.

C. Calculation of the Tax Allowance

All parties appear to agree on the basic procedure to be followed in calculating the tax allowance. First, an income tax allowance base is computed as follows: amortization of deferred earnings, depreciation of equity AFUDC, and depreciation of investment tax credit (ITC) basis reduction are added to the allowed total return, and interest expense is subtracted.[634] The resulting subtotal is then adjusted by the net-to-tax multiplier (or t/1-t, where "t" is equal to the blended statutory state and federal income tax rate) to arrive at a new subtotal, which is then adjusted by the amortization of the overfunded and un-

[630] 49 U.S.C. app. § 1(5) (1988).

[631] *See, e.g., Mobil Oil Corp. v. FPC*, 417 U.S. 283, 305-10, 316 (1974); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602-03.

[632] *Lakehead Pipe Line Company, L.P.*, 71 FERC ¶ 61,338, at p. 62,315.

[633] "That interest [on the debentures] is keyed to the amount of distributions paid on almost all of the common units held by Santa Fe Pacific Pipelines, Inc., *the limited partner interest* held by Santa Fe Pacific Pipelines, Inc.,...." Tr. 8381 (emphasis added).

[634] Ex. 188 at pp. 3-4.; *see also* Ex. 381, Schedule 8.

derfunded deferred tax amounts, resulting in the income tax allowance.[635] Although this general procedure is not in dispute, the parties have raised a number of questions as to how the procedure should be applied to the facts of the present case.

Having concluded that SFPP may only claim an income tax allowance with respect to SFPP Inc.'s general partnership interest and to the corporate holders of publicly traded limited partner units of SFPP Partners, I must now determine whether the calculation of the partial tax allowance will be based on an ownership percentage or based on an allocation of income. SFPP argues that the tax allowance should be based on the percentage of taxable income allocated to the owners of SFPP, while Staff and most complainants argue for basing the allowance on the percentage of units held by the owners of SFPP.

In Opinion No. 397, the Commission stated that "there should be no corporate income tax allowance built into Lakehead's rates with respect to *income attributable to* individual limited partners."[636] The phrase "income attributed to" seems to favor a calculation of a partial tax allowance based on the income allocated to the corporate limited partners. Such an approach is also more consistent with the way in which partners in a limited partnership are subject to income taxes. Partners are not taxed on their ownership percentage in the limited partnership. Instead, partners are taxed on the income allocated to them by the partnership. This income allocation need not be directly correlated to the partners' ownership shares. Therefore, basing the calculation of the partial tax allowance on income allocation more accurately reflects actual taxes paid than basing the calculation on ownership.

The Commission's decision in Opinion No. 397-A, however, establishes that the calculation of a partial income tax allowance cannot be based purely on an income allocation. In that case the Commission clarified its holding in Opinion No. 397 and held that no income tax allowance would be permitted with respect to income allocated to partners under a "curative allocation" pursuant to section 704(c) of the Internal Revenue Code.[637] Such allocations are designed to reflect differences between a partner's tax basis in property contributed to the partnership and the fair value of that property.[638] The Commission reasoned that "since the curative allocation taxes are essentially taxes on the gain realized by [the general partner] Lakehead, Inc., on its [effective] sale of assets to the partnership, Lakehead, Inc., and not the ratepayers, must bear the tax associated with such gain."[639] The Commission further stated that the phrase "income attributable to" as used in Opinion No. 397 should be read as meaning "income as attributable *on Lakehead's books for earning and distribution purposes.*"[640]

Opinion No. 397-A follows an income allocation approach and not an ownership percentage approach. If the Commission had calculated the partial tax allowance on the basis of an ownership percentage, there would have been no need to consider the effect of section 704(c) allocations on the allowance. The Commission, however, followed a modified income allocation approach. It permitted Lakehead a partial allowance only with respect to income allocated to Lakehead's corporate partners "for earning and distribution purposes." In light of Opinion No. 397-A, I conclude that SFPP's partial income tax allowance should be calculated on the basis of an income allocation to the extent such an allocation reflects actual earnings and distributions.

SFPP concedes that it should not be permitted an income tax allowance with respect to income attributed to its general partner, SFPP Inc., under section 704(c).[641] There is a question, however, as to whether SFPP is entitled to an income tax allowance with respect to other income allocated to SFPP Inc. as general partner. Two income allocations to the general partner are at issue: incentive distributions under the partnership agreement and a special allocation of income that was made for the first three years after the publicly traded partnership was formed. These allocations were made under section 704(b) of the Internal Revenue Code[642] and not under section 704(c).[643] SFPP witness Mr. Miller testified that the incentive allocations are tied to current cash distributions to the general partner which are made to encourage proper management of the pipeline and reward certain levels of performance.[644] He further testified that the special allocations in the first three years of the partnership, which

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[635] Ex. 188 at p. 4; Navajo Initial Brief at p. 100.

[636] *Lakehead*, 71 FERC ¶ 61,338, at p. 62,315 (emphasis added).

[637] *Lakehead*, 75 FERC ¶ 61,181, at pp. 61,597-99; 26 U.S.C. § 704(c)(1994).

[638] 75 FERC ¶ 61,181, at p. 61,598 n.33.

[639] *Id.* at pp. 61,598-99.

[640] *Id.* at p. 61,599 (emphasis added).

[641] SFPP Initial Brief at p. 156.

[642] 26 U.S.C. § 704(b)(1994).

[643] Tr. 9833.

[644] *Id.*

were intended to induce public purchase of shares in SFPP Partners, would result in future cash distributions to the general partner.[645]

Chevron argues that no tax allowance should be permitted for the incentive allocations "to the extent that the ability to make such an 'incentive' distribution is derived from collecting on unjust and unreasonable tariff rates."[646] Chevron also cites prior testimony by Mr. Miller, that cash distributions were not affected by the special allocations, as evidence that these allocations are not tied to cash distributions and should therefore not be reflected in any income tax allowance.[647]

SFPP contends that there is no evidence that the incentive distributions could only be made if rates are set at unjust and unreasonable levels.[648] SFPP also cites Treasury Regulations establishing that section 704(b) allocations can only be made by partnership agreement where the allocations correspond to some substantial economic benefits or burdens and stating that "the partner to whom the allocation is made must receive such economic benefit or bear such economic burden."[649] SFPP argues that, despite the timing difference between the special allocations to SFPP Inc. and the later cash distributions, the fact that the allocations are tied to these distributions means that they are allocations of income "for earnings and distribution purposes."[650]

On this issue I agree with SFPP. The evidence, taken as whole, establishes that the 704(b) allocations are allocations which reflect actual earnings and distributions. In addition, I am unconvinced by Chevron's claims that the incentive allocations/distributions are dependent on unjust and unreasonable rates. I therefore hold that SFPP is entitled to an income tax allowance with respect to all income allocated to the public unitholder corporate limited partners of SFPP Partners and with respect to all income allocated to SFPP Inc. as general partner of SFPP and of SFPP Partners less any income allocated to SFPP Inc. as general partner under a section 704(c) curative allocation.

The next issue is what tax rate should be employed in computing SFPP's tax allowance. All parties agree that a composite rate, which incorporates both the federal corporate income tax rate of 35 percent and the applicable state income tax rates, should be used. This composite rate represents "t" in the formula t/1-t which is used to compute the tax allowance multiplier. For example, if the composite corporate income tax rate was 35 percent, the multiplier would be 0.35/1-0.35 which equals 0.35/0.65 or 0.5385. The allowance is then calculated by multiplying the income tax allowance base by this multiplier and making an adjustment for overfunded and underfunded deferred tax amounts.[651]

The dispute in the present case is over which multiplier to use in calculating SFPP's tax allowance. Navajo and the West Line Shippers support the use of a multiplier of 0.6667, as calculated by Navajo witness Horst based on a 40 percent composite income tax rate.[652] SFPP argues that the 0.6883 composite tax multiplier calculated by its witness Jessen should be used to compute its tax allowance.[653]

Upon further review, there appears to be little disagreement between the parties on this issue. Mr. Jessen's 0.6883 multiplier is based on an analysis of 1993 total South System cost of service,[654] whereas Dr. Horst calculated the 0.6667 multiplier for use in his analysis of a 1993 East Line cost of service.[655] Differences between these analyses are to be expected. SFPP's South System runs through California, Arizona, New Mexico, and Texas. Any composite tax rate multiplier for the entire South System would reflect corporate income tax rates in all four states. The East Line covers only Arizona, New Mexico, and Texas, while the West Line includes only California and Arizona. Composite tax rate multipliers calculated with respect to the separate lines would reflect only these states and would therefore be different from the South System multiplier calculated for the same year. Indeed, Mr. Jessen calculated a 1993 East Line multiplier and a 1993 adjusted East Line multiplier which are identical to Dr. Horst's multiplier of 0.6667 except for rounding conventions.[656] Mr. Jessen also calculated a 1993 West Line multiplier of 0.6962.[657] Since the East Line and West Line

[645] Tr. 9833-34.

[646] Chevron Initial Brief at p. 124.

[647] Ex. 186 at p. 12; Chevron Initial Brief at pp. 124-25.

[648] SFPP Reply Brief at pp. 142-43.

[649] Treas. Reg. § 1.704-1(b)(2)(ii)(1996).

[650] SFPP Reply Brief at p. 143.

[651] Ex. 188 at p. 4.

[652] *See, e.g.,* Navajo Initial Brief at p. 107; West Line Shippers Reply Brief at p. 45.

[653] SFPP Reply Brief at pp. 151-53.

[654] Ex. 240, Schedule 1, line 9.

[655] Ex. 463, Schedule 8, lines 8-9.

[656] *See* Ex. 251, Schedule 1 (Revised), line 9; Ex. 252, Schedule 1 (Revised), line 9.

[657] *See* Ex. 256, Schedule 1 (Revised), line 9; Ex. 257, Schedule 1 (Revised), line 9.

will be treated separately for cost of service purposes for reasons discussed hereafter, I hold that a multiplier of 0.6667 shall be used to determine SFPP's tax allowance for the East Line and that a multiplier of 0.6962 shall be used to determine SFPP's tax allowance for the West Line.

The next tax allowance issue concerns the calculation of the interest expense used in the tax allowance base equation. The Commission established the framework for this calculation in *Williams Pipe Line Co.*, Opinion No. 154-C, where it directed an oil pipeline "to determine its interest expense deduction by multiplying its weighted cost of debt times its net depreciated original cost rate base."[658] The parties disagree about the proper method for computing the weighted cost of debt used in this calculation. SFPP witness Mr. Jessen calculates the weighted cost of debt by multiplying the cost of debt times a debt capital structure adjusted to reflect the treatment of unamortized deferred earnings.[659] Navajo and West Line Shippers rely on Navajo witness Horst's approach of calculating the weighted cost of debt by multiplying the cost of debt times SFPP's book debt capital structure.[660]

In Opinion No. 154-C, the Commission held that the same capital structure should be used to calculate both the interest expense deduction and the allowed interest return.[661] The Commission also has held that the capital structure used to calculate interest return must be adjusted to treat unamortized deferred earnings as equity.[662] Furthermore, the *ARCO Pipe Line* Initial Decision expressly rejected the use of book capital structure for determining either the return on DOC rate base or the interest expense.[663] The Commission ultimately upheld this decision without modification on this point.[664]

Mr. Jessen uses the same adjusted capital structure in his calculation of both the overall allowed return and the interest expense deduction.[665] The approach advocated by Navajo, however, uses an adjusted capital structure only in the calculation of the allowed return and a separate book capital structure in determining the weighted cost of debt for the interest expense calculation.[666] This approach is contrary to the procedures for calculating tax allowance interest expense deductions set forth in the *Williams Pipe Line* and *ARCO Pipe Line* cases. In light of the foregoing, I hold that the same capital structure shall be used to calculate both the interest expense deduction and the allowed interest return, and the interest expense shall be calculated using a weighted cost of debt which reflects a debt capital structure adjusted to treat unamortized deferred earnings as equity.

XI. VOLUMES

A. Positions of the Participants

All the participants in this case have submitted different proposals as to what volumetric throughput should be used in developing SFPP's rates.

SFPP's volume recommendations are based on adjusted 1993 actual throughput. SFPP contends that, if 1993 is the base year, actual 1993 volumes must be the starting point for determining which volumes will be used. SFPP witness Pearl made adjustments to actual 1993 volumes to account for atypical reductions in East Line shipments due to refinery shutdowns in 1993.[667] These adjustments were made on the assumption that overall Arizona demand for South System petroleum product would remain relatively constant, with the refinery shutdowns causing only a shift in volumes between the East and West Lines. SFPP's proposed 1993 annual adjusted volumes are 19,448,406 barrels for the East Line and 34,045,385 barrels for the West Line.[668] These proposed volumes do not reflect either West Line volumes shipped to the connection with Calnev Pipeline for interstate movements to Nevada or the trunkline component of volumes shipped to military facilities.[669]

In the alternative, if a 1994 base year is to be used for test year purposes, SFPP proposes

[658] *Williams Pipe Line Co.*, 33 FERC ¶ 61,327, at p. 61,640 (1985).

[659] Ex. 240, Schedule 3 (Revised); Tr. 10644.

[660] *See, e.g.*, Navajo Initial Brief at pp. 101-05.

[661] 33 FERC ¶ 61,327, at p. 61,640.

[662] *ARCO Pipe Line Co.*, 53 FERC ¶ 61,398, at p. 62,389 (1990).

[663] 43 FERC ¶ 63,033, at p. 65,378 n.4 (1988).

[664] Opinion No. 351, 52 FERC ¶ 61,055; Opinion No. 351-A, 53 FERC ¶ 61,398 (1990).

[665] Tr. 10677-78; Ex. 240.

[666] *See, e.g.*, Ex. 42 at pp. 8-11.

[667] The EPR refinery was shut down for the first ten months of 1993 after EPR filed for bankruptcy in 1992. Ex. 34 at p. 22. East Line volumes in 1993 also were affected by other unrepresentative events, including a two month shutdown of Chevron's refinery and three months of downtime at Navajo facilities due to scheduled maintenance. *Id.*

[668] SFPP proposes the following breakdown of 1993 adjusted volumes: 10,810,415 barrels on the East Line to Phoenix, 8,637,991 barrels on the East Line to Tucson, 30,302,063 barrels on the West Line to Phoenix, and 3,743,322 barrels on the West Line to Tucson. Ex. 511 at p. 2.

[669] *Id.* at pp. 2-3.

the use of volumes based on 1994 actual data. SFPP opposes any adjustments to 1994 data to reflect anticipated or actual post-1994 increases in East or West Line volumes. SFPP's proposed 1994 actual annual volumes are 20,674,520 barrels for the East Line and 37,521,093 barrels for the West Line.[670] As with SFPP's proposed 1993 adjusted volumes, these figures do not reflect either West Line volumes shipped to the connection with Calnev Pipeline for interstate movements to Nevada or the trunkline component of volumes shipped to military facilities.[671]

The West Line Shippers support the use of actual 1993 volumetric throughput.[672] Arguing that the evidence demonstrates a sustained, substantial increase in West Line volumes in every year since 1993,[673] the West Line Shippers oppose the use of any West Line throughput below 1993 actual West Line volumes.

Chevron favors the use of adjusted 1993 volumes in calculating SFPP's prospective rates.[674] Chevron witness Battese looked to actual throughputs for 1990 through 1993, using historical volume data for the years 1990 to 1992 as well as volume data from the end of 1993 to make adjustments to the overall actual throughput for 1993. Chevron's adjusted volumes reflect both corrections for refinery shutdowns on the East Line in 1993 and estimates of post-1993 market growth in Phoenix and Tucson. Mr. Battese projected East Line volumes to Phoenix of 36,000 barrels per day and to Tucson of 27,000 barrels.[675] Chevron's adjusted West Line volumes include projected West Line deliveries to Phoenix of 80,000 barrels per day and projected West Line deliveries to Tucson of 10,000 barrels per day.[676] These projected 1994 daily volumes correspond to annual volumes of 22,995,000 barrels on the East Line and 32,850,000 barrels on the West Line. If 1994 volumes are to be used, Chevron objects to adjusting East Line volumes upward to reflect anticipated increases in East Line throughput due to future events outside the test period.

Navajo contends that the minimum volumetric throughput which should be used for the East Line is the actual 1994 throughput, including military volumes, of 66,720 barrels per day.[677] Moreover, Navajo argues that adjustments to 1994 actual volumes are necessary to fully compensate for the unrepresentative events of the 1993 base year. Navajo relies on the testimony of RHC witness Mammarelli placing pre-shutdown East Line volumes at 72,500 barrels per day.[678] Navajo witness White testified that it took the East Line market three years to fully recover from the refinery shutdowns of 1992 through 1993.[679] Navajo also notes that the construction of the Diamond Shamrock pipeline from its refinery in Amarillo to El Paso has increased significantly petroleum product supply in the El Paso market.[680] Navajo argues that the Diamond Shamrock pipeline has merely restored the El Paso market to its pre-1992 supply availability. Based on this return of the East Line market to its historical status quo, Navajo therefore supports the utilization of a daily East Line throughput of 75,000 to 80,000 barrels.[681]

RHC's arguments on volumes focused on two periods: the period from the base year through the initiation of deliveries on the Diamond Shamrock line and the post-Diamond Shamrock period. For the first period, RHC supports the use of updated 1993 data. RHC's witness Mammarelli reviewed refinery production records and other historical data to determine that, but for events linked to refinery shutdowns, 1993 East Line throughput would have

[670] SFPP proposes the following breakdown of 1994 volumes: 11,471,061 barrels on the East Line to Phoenix, 9,203,459 barrels on the East Line to Tucson, 33,372,065 barrels on the West Line to Phoenix, and 4,149,028 barrels on the West Line to Tucson. *Id.* at p. 2.

[671] *Id.* at pp. 2-3.

[672] In both their Initial and Reply briefs, the West Line Shippers state, without further explanation, that "making a modest adjustment for El Paso Refining does not make a big difference." West Line Shippers Initial Brief at p. 58; West Line Shippers Reply Brief at pp. 46-47.

[673] *See* Ex. 763.

[674] Although Chevron refers to its proposed volumes as "1994 test year volumes" and "actual 1994 volumes", it is clear that these terms are being used to refer to projected 1994 volumes based on adjustments to actual 1993 volumes. *See* Chevron Initial Brief at p. 126.

[675] Ex. 34 at pp. 20-24.

[676] *Id.*

[677] *See* Tr. 9275. This corresponds to an annual throughput of 24,352,800 barrels.

[678] Ex. 12 at p. 3.

[679] Ex. 536 at p. 2.

[680] The Diamond Shamrock pipeline was designed to deliver petroleum products at a rate of 27,000 barrels per day with the potential to be expanded to a capacity of 50,000 barrels per day. This pipeline went into service in November 1995. Ex. 580.

[681] *See* Ex. 536 at p. 2. These proposed daily volumes correspond to an annual East Line throughput of between 27,375,000 barrels and 29,200,000 barrels.

been 69,662 barrels per day or approximately 25,400,000 barrels annually, including military volumes.[682]

RHC contends, however, that rates based solely on adjusted 1993 volumes would be unjust and unreasonable under section 1(5) of the ICA as applied to the post-Diamond Shamrock period. This contention is based on the anticipated impact of the Diamond Shamrock pipeline on the East Line market. RHC claims that the influx of new product into El Paso will substantially increase volumes on the East Line, especially after the planned direct connection of the Diamond Shamrock pipeline to SFPP.[683] RHC argues that allowing SFPP to collect rates based on adjusted base year volumes would therefore permit SFPP a substantial overrecovery of its costs. RHC relies on the Court of Appeals' holding in *Distrigas of Mass. Corp. v. FERC*:

> Case law does not rigidly tie a regulator to the use of test-year figures, when later information reveals that the estimates based on those figures are likely to be seriously in error . . . . Indeed, to fail to adjust past figures may well lead to serious mistakes, creating rates radically different from those that would replicate costs or serve other valid regulatory purposes.

737 F.2d 1208, 1220 (1st Cir. 1984) (citations omitted). RHC does not propose any specific volumes for use in establishing prospective rates, but rather advocates a number of methods by which rates based on post-Diamond Shamrock data can be determined.[684]

The Commission Staff supports the use of volumes based on actual 1994 calendar year data. Staff favors the use of 1994 data over 1993 data because the 1994 data better reflect shipment patterns after the reopening of refinery capacity on the East Line. Staff argues that the use of 1994 actual volumes is, if anything, conservative given recent volume increases on both the East and West Lines and the likelihood of greater increases in the future. The Staff's recommended 1994 annual throughput, not including volumes associated with military shipments, is 21,357,021 barrels for the East Line and 62,883,189 barrels for the West Line.[685]

B. Discussion

I agree with the position held by virtually all participants that 1993 actual data should not be used because the reduced refinery capacity on the East Line for much of 1993 makes it an aberrational year. Participants propose either the adjustment of 1993 base year volumes or the use of 1994 volumes. Some participants argue that the use of adjusted 1993 volumes is preferable to the use of 1994 volumes because data from the base year should be the foundation for establishing rates. As noted above, however, the Commission permits the use of data outside the base period where the use of updated data leads to a more rational result.[686] Given the widespread agreement that 1993 volumes are the result of anomalous conditions, 1994 actual volumes are more representative of typical East Line throughput than even adjusted 1993 volumes would be. I therefore hold that actual 1994 volumes shall be used.[687]

Having determined that 1994 data should be used, the next question is whether actual 1994 throughput should be adjusted to reflect actual or anticipated post-1994 volume changes. Navajo argues that 1994 actual volumes must be adjusted because the East Line market had not fully recovered from the aberrational market conditions by 1994. I reject this argument. The overwhelming consensus in this case is that 1994 actual volumes are representative of pre-shutdown volumes.[688]

I next consider Navajo and RHC's arguments as to the impact of the Diamond Shamrock pipeline on East Line throughput. It is not unreasonable to project increases in East Line volumes due to increases in the El Paso petroleum supply attributable to the Diamond Shamrock pipeline. Indeed, there is some slight evidence that such increases are already occurring.[689] Conversely, the Diamond Shamrock

[682] Ex. 323 at pp. 1-7.

[683] Tr. 5429.

[684] The advocated methods include issuing an order that rates after 1996 must be based on higher volumes, holding the record open with a directive that SFPP file updated testimony on volumes and expenses, or directing SFPP to file an East Line cost and revenue study at some future time. RHC Initial Brief at pp. 44-45.

[685] Tr. 7761.

[686] *See, e.g., Kuparuk Transp. Co.*, 55 FERC ¶ 61,122, at p. 61,383 n.93 (1991) (the Commission may rely on updated volume data outside the test period if necessary to achieve a rational result).

[687] The use of 1994 volumes is consistent with the heretofore discussed approach of using data beyond the base period in this case so that forward-looking rates may be established as accurately and fairly as possible.

[688] Even RHC witness Mammarelli, whose testimony Navajo cites to support its arguments, states that "I know of no major aberrational events in 1994 . . . that would cause me to say 1994 should have been something different . . . ." Tr. 5295.

[689] For example, East Line volumes increased to 79,311 barrels per day in December 1995, the month after the Diamond Shamrock pipeline commenced operation. *See* Ex. 577 at pp. 6-7.

pipeline ultimately may have little or no impact on East Line volumes. There is evidence that the bulk of additional product delivered to El Paso via the Diamond Shamrock pipeline will be shipped over Chevron Pipe Line's system to the Albuquerque market and not over SFPP's East Line.[690] The record is simply insufficiently developed on this point. It may be several years until the full impact of the Diamond Shamrock pipeline on East Line volumes can be determined. Resolution of this issue cannot be delayed for so long, and I cannot establish rates based on purely speculative increases in throughput. I hold that 1994 actual volumes should not be adjusted.

There are discrepancies between the 1994 "actual volumes" proposed by the participants. These discrepancies are primarily due to what is included in the proposed figures. Navajo and RHC include the trunkline component of volumes shipped to military facilities in their proposed 1994 actual volumes. The figures proposed by SFPP and Staff exclude military volumes. The relationship of military facilities to interstate petroleum pipelines requires special consideration. The charges paid by military facilities for transportation and related services are not established by Commission ratemaking procedures; they are negotiated between SFPP and the United States government.[691] In recognition of the special status of military facilities, I have already approved of SFPP's method of excluding costs attributable to these military facilities from the South System costs of service.[692] Because military facility costs are excluded from the East and West Line costs of service, it is appropriate to exclude military volumes as well.

Staff's proposed 1994 actual West Line volumes, not including military volumes, are 62,883,189 barrels. SFPP's proposed 1994 actual West Line volumes, not including military volumes, are 37,521,093 barrels. The difference is due to the treatment of volumes shipped over California segments of the West Line to the connection with the Calnev Pipeline for interstate movements to Nevada. Staff includes these volumes in its proposed 1994 West Line volumes, while SFPP does not.[693] The Calnev Pipeline is not a part of SFPP's South System. To the extent that volumes intended for the Calnev Pipeline are shipped over a portion of the West Line in California, costs associated with the transportation of such volumes are excluded from the West Line cost of service through the mechanism of SFPP's route directory.[694] As such, Calnev volumes should not be included in the 1994 West Line actual volumes. I therefore adopt SFPP's proposed 1994 actual West Line volumes.

Staff's proposed 1994 actual East Line volumes, not including military volumes, are 21,357,021 barrels. SFPP's proposed 1994 actual East Line volumes, not including military volumes, are 20,674,520 barrels. The difference here is due to the treatment of volumes shipped over the East Line to Lordsburg, New Mexico. Staff includes such volumes in its proposed 1994 East Line actual volumes, while SFPP does not.[695] Lordsburg, New Mexico is on SFPP's East Line.[696] Shipments from El Paso to Lordsburg are interstate shipments on the East Line. Lordsburg volumes therefore should be included in the 1994 East Line actual throughput. I therefore adopt Staff's proposed 1994 actual East Line volumes.

In light of these findings, I hold that the following 1994 actual East Line volumes shall be used in developing SFPP's rates: an annual volume of 21,357,021 barrels, which includes 682,501 barrels on the East Line to Lordsburg, 9,203,459 barrels on the East Line to Tucson, and 11,471,061 barrels on the East Line to Phoenix. The following 1994 actual West Line volumes shall be used in developing SFPP's rates: an annual volume of 37,521,093 barrels, which includes 33,372,065 barrels on the West Line to Phoenix and 4,149,028 barrels on the West Line to Tucson.

XII. SEPARATE EAST LINE AND WEST LINE COSTS OF SERVICE

Another issue is whether SFPP's rates should be based on separate costs of service for the East Line and West Line or on a single "South System" cost of service. SFPP bases its proposed rates on a single South System cost of service. Chevron, Navajo, RHC, and Staff disagree with SFPP's approach and contend that East and West Line costs should be computed separately.[697]

SFPP argues that rate regulation based on a single combined South System is more consistent with applicable Commission precedent. SFPP relies principally on the Commission's

[690] *See* Ex. 733 at p. 3; Ex. 743 at pp. 5-6.

[691] These charges are subject to the provisions of a special statute, Section 22 of the ICA. 49 U.S.C. app. § 22 (1988).

[692] See the discussion *supra* on Cost Allocation and Revenue Crediting.

[693] *Compare* Ex. 511 at p. 2 *with* Ex. 278.

[694] See the discussion *supra* on Cost Allocation and Revenue Crediting.

[695] *Compare* Ex. 511 at p. 2 *with* Ex. 278.

[696] *See, e.g.*, Ex. 145.

[697] The West Line Shippers took no position on this issue. *See* West Line Shippers Initial Brief at p. 59; West Line Shippers Reply Brief at pp. 47-48.

decision in *Williams Pipe Line Co.*, Opinion No. 154, 21 FERC ¶ 61,260 (1982). In that decision the Commission stated a general preference for system-wide regulation over "point to point regulation" in oil pipeline cases.[698] The Commission said that "this rule avoids the need for refined inquiries into the allocation of costs that would be essential to segment-by-segment regulation," noting that "[s]uch inquiries tend to be metaphysical, inconclusive, and barren."[699] SFPP contends that the Commission established a system-wide regulation policy in *Williams* which requires in the present case the assessment of costs based on a single South System.

Although Opinion No. 154 does support a system-wide regulation policy, it is doubtful that the Commission still follows such a policy. SFPP cites several more recent decisions where the Commission supposedly evaluated rates on a system-wide basis,[700] but nothing in those cases addresses the issue of assessing the costs of an oil pipeline system comprised of multiple lines or segments with distinctive characteristics. A far more relevant precedent is the D.C. Circuit Court's review of Opinion No. 154 in *Farmers Union Cent. Exchange, Inc. v. FERC*, 734 F.2d 1486 (D.C. Cir.) *cert. denied sub nom. Williams Pipe Line Co. v. Farmers Union Cent. Exchange, Inc.*, 469 U.S. 1034 (1984) ("*Farmers Union II*"). There the court suggests that point-to-point regulation would be more consistent with both ICC oil pipeline precedent and the Interstate Commerce Act's requirement that "*every* unjust and unreasonable charge . . . [be] prohibited and declared to be unlawful."[701] The Court went on to state, "Because oil pipeline rates are charged on a point-to-point basis, such cost allocation ensures that the costs of providing service over a given territory will be recovered only from the companies that use that particular service."[702]

It is true that the *Farmers Union II* court did not make a final determination of the "system-wide regulation" issue, determining instead that the issue had been decided prematurely by the Commission.[703] Nonetheless, the Court of Appeals sent a strong signal that the Commission should allocate costs on a point-to-point or "segment" basis where appropriate in future oil pipeline cases.[704]

This signal was heeded by Administrative Law Judge Thomas L. Howe in *Southern Pacific Pipe Lines, Inc.*, 39 FERC ¶ 63,018 (1987). That case resulted from challenges to rate increases on the East and West Lines proposed by SFPP's predecessor, SPPL. In his initial decision Judge Howe relied in part on *Farmers Union II* to reject SPPL's argument for assessing East Line and West Line costs on a combined South System basis.[705] This portion of the initial decision is arguably dictum because the proposed rate increases in that case were rejected primarily due to the failure of SPPL to allocate costs between interstate and intrastate operations.[706]

The *Southern Pacific* initial decision nevertheless establishes a framework for determining whether an oil pipeline's costs should be allocated on a segmented or system-wide basis. *Farmers Union II* dictates that costs should be allocated to appropriate segments of an oil pipeline to ensure fair distribution of costs among the pipeline's customers.[707] In *Southern Pacific*, Judge Howe looked at all available facts concerning the South System, including pipeline design, customer usage, and any costs common to both lines to make this determination. I follow a similar factual inquiry in the present case.

SFPP states that the facts set forth in this case require single system cost allocation. Specifically SFPP claims that the following facts support the use of that approach:

> (1) those [East and West Line] operations have always been treated by SFPP and its predecessors as a single system; (2) the East and West Lines are operated on a completely integrated basis; and (3) in practice shippers use the East and West Lines as a single system.

SFPP Initial Brief at p. 173.

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[698] 21 FERC ¶ 61,260, at pp. 61,650-51.

[699] *Id.* at p. 61,651.

[700] *See* SFPP Initial Brief at pp. 174-75 (citing *ARCO Pipe Line Co.*, Opinion No. 351, 52 FERC ¶ 61,055 (1990), *aff'd and modified in part on reh'g*, Opinion No. 351-A, 53 FERC ¶ 61,398 (1990); *Lakehead Pipe Line Co., L.P.*, Opinion No. 397, 71 FERC ¶ 61,338 (1995), *reh'g denied*, Opinion No. 397-A, 75 FERC ¶ 61,181 (1996)).

[701] 734 F.2d at 1528-29 (quoting 49 U.S.C. § 1(5) (emphasis in Circuit Court opinion)).

[702] 734 F.2d at 1528.

[703] *Id.* at 1529.

[704] "In making a decision on cost allocation principles, FERC should be cognizant of the ICC's past cost allocation practices, and should accord appropriate consideration to the mandate of section 1(5)." 734 F.2d at 1529.

[705] "I find that the East Line and the West Line are not contiguous portions of the same system but are each a separate 'section' or 'segment' . . . [a]ccordingly the costs of the East and West Lines should be separately computed . . . ." 39 FERC ¶ 63,018, at p. 65,079.

[706] *Id.* at pp. 65,077-78.

[707] 734 F.2d at 1529.

In support of its assertion that the East and West Lines have always been treated as a single system, SFPP notes that the two lines were built as part of one construction project.[708] SFPP also states that decisions on capacity expansions are only made after a consideration of overall South System factors.[709]

Other facts, however, do not support the claim that SFPP always treats the East and West Lines as a single system. For example, SFPP currently has unequal rates on the East and West Lines. The separate rates, established by settlement agreement with the parties in the *Southern Pacific* case, were designed to reflect separate developments and expansion projects specific to each line.[710]

SFPP also focuses on the "operational integration" of the South System. SFPP witness Abboud testified that the East and West Lines are managed by a single computer control system and are serviced by many of the same personnel and physical facilities.[711] Mr. Abboud used the Phoenix tankage operations as an example of this operational integration; he testified that "product from the East Line comes into those breakout tanks as well as product from the West Line."[712] SFPP also cites the administration of its proration policy, which permits a shipper to use historical movements on one line to show "demonstrated need" for line space on the other line, as a further illustration of an integration which supports the South System cost allocation approach.[713]

The fact that SFPP maintains computer systems, personnel, and facilities which service both the East and West Lines does not support a conclusion that both lines should be treated as part of a single system. SFPP witness Abboud testified that the central computer control system also controls operations on its Oregon Line and Northern California Line and that SFPP's Watson facilities and personnel service both its West Line and San Diego Line.[714] SFPP is not arguing, however, that the Northern California Line, Oregon Line, and San Diego Line should be considered part of a common system with the East and West Lines. Nor is SFPP's proration policy compelling evidence of a need to treat the East and West Lines as a single system. A history of shipments on one line does not guarantee a shipper any priority shipping rights with respect to the other line. Instead, that history is merely considered evidence that the shipper has met a "demonstrated need" criteria as a *new* shipper on the other line.[715] A West Line shipper is therefore assured of no special status on the East Line and vice versa. Such a policy does not support the single system approach.

SFPP claims that shippers use the East and West Lines as a single system. SFPP witness Pearl testified that "nearly 50 percent of total East Line and more than 40 percent of total West Line movements" consisted of volumes moved by those shippers who ship on both the East and West Lines.[716] SFPP cites this and other facts to support its characterization of the South System as one where shippers routinely shift volumes between the two lines. This characterization is not completely accurate. SFPP uses batch cycling when shipping on the East and West Lines, rotating shipments of different types of petroleum products on a 7½ day cycle.[717] Batch cycling constraints dictate when a shipper can move product from one line to the other, and limits imposed by SFPP's proration policy restrict how much product can be moved.[718] Such limitations prevent shippers from quickly and easily shifting volumes between lines.

Mr. Pearl's testimony confirms that over half of the volumes shipped on both the East and West Lines were from those shippers that do *not* ship on both lines. If rates were established on a combined South System basis, East Line-only shippers would be likely to bear a disproportionate share of the costs associated with the West Line, essentially subsidizing the West Line shippers.[719] This result would be contrary to the Court's direction in *Farmers Union II* that the costs of providing service over a given territory should be recovered only from the companies that use the particular service.

[708] Tr. 8125.

[709] SFPP Initial Brief at p. 177.

[710] *See* Ex. 859: Ex. 892.

[711] Ex. 144 at p. 6-7.

[712] Tr. 8847.

[713] SFPP Initial Brief at pp. 178-79 (citing Tr. 8848-49, 890003, 9069-71).

[714] Tr. 8844-45.

[715] Tr. 8848-52.

[716] Tr. 9068.

[717] *See, e.g.*, Tr. 5242.

[718] *See* Ex. 403 at pp. 10-12.

[719] Although East and West Line costs of service have yet to be calculated in accordance with this decision, all the evidence indicates that West Line costs will substantially exceed East Line costs. *Compare* Ex. 264, Schedule 1, p. 1 (proposed West Line cost of service of $43,001,232) *with* Ex. 263, Schedule 1, p. 1 (proposed East Line cost of service of $13,362,599). The projected expansion costs for each line also vary substantially. *See* Ex. 258 at p. 4 (East Line expansion costs will total approximately $24 million, whereas West Line expansion costs will total approximately $140 million).

The physical design of the South System is another fact strongly supporting a segmented cost allocation approach. Product flows in opposite directions on each line, in a westerly direction from El Paso on the East Line and in an easterly direction from Los Angeles on the West Line. Although the two lines run parallel, albeit in opposite directions, between Phoenix and Tucson, the two lines do not overlap. In other words, petroleum products which originate in Los Angeles on the West Line are never transported to El Paso over the East Line, and petroleum products which originate in El Paso are never transported to Los Angeles on the West Line. The East and West Lines therefore are separate and distinct segments of pipeline and cannot be considered parts of a single uninterrupted system.

I find that the facts set forth in the record support the establishment of rates based on separate costs of service for the East and West Lines.

SFPP makes several arguments as to the potential impact of establishing rates based on separate East and West Line costs of service. Noting that there likely would be a disparity between rates based on separate East and West Line costs of service, SFPP argues that a significant number of shippers would shift product to the line with lower rates.[720] SFPP witness Pifer claims that the resulting variability in throughput would lead to a variability in revenue such that SFPP would be placed at the risk of long-term cost underrecovery.[721] In addition to its own risk of underrecovery, SFPP contends that the shifting volumes would lead to frequent adjustments of and challenges to tariffs, resulting in ongoing volatility of the East and West Line rates.[722]

I do not agree with these arguments. SFPP has not demonstrated a substantial increase in its risk of cost underrecovery. As discussed above, SFPP greatly overstates the ease with which shippers can shift volumes between lines. Moreover, the East and West Lines currently have unequalized rates, a situation which SFPP concedes has resulted only in "a modest variability in its total revenue as throughput shifts from one line to the other."[723] It is true that the rates established under line-specific cost allocation may result in some volume shifts that may ultimately lead to the filing of subsequent rate adjustments or challenges. This possibility is not a reason for abandoning the otherwise appropriate approach of line-specific cost allocation. The filing of subsequent rate adjustments or challenges is instead the natural response of an oil pipeline or its shippers to changes in market conditions.

Having considered all the arguments of the participants, the law, and the relevant evidence, I reject SFPP's "South System" cost of service approach and hold that SFPP's rates should be based on separate costs of service for the East Line and West Line.

XIII. RATE DESIGN

The rate design issue is whether SFPP's present rates should be evaluated in the first instance by comparing company system-wide costs and revenues or whether SFPP's present rates should be evaluated by a fully-allocated cost analysis.

SFPP argues that an adjustment to rates would only be necessary and appropriate if it is first shown that SFPP's revenues for a system exceed its costs for that system. If an adjustment to rates were necessary, then in the case of prospective rates, argues SFPP, the starting point for further analysis for SFPP's South System should be the pipeline's existing rate design resulting from the 1988 and 1989 settlements that produced the current rates; the prospective rates would be adjusted based on those relationships to reflect the newly allowed costs and assumed volumes. Only in the event of a finding of discrimination, argues SFPP, should the application of some more elaborate and detailed analysis, such as fully allocated costs, even be considered.[724]

The participants in this case have referred to this position of SFPP as SFPP's "headroom analysis." Under this approach SFPP only attempts to justify its rates by producing evidence which, SFPP alleges, shows that its South System costs exceed its revenues.

The complainants and Staff take issue with SFPP's position. In essence they argue that SFPP's rates must be evaluated by doing a fully allocated cost analysis, which SFPP did not do, and that SFPP's headroom approach should not be accepted. Furthermore, they argue that, even assuming the validity of SFPP's headroom approach, SFPP's current rates cannot be justified by its headroom analysis.

The Staff and complainants submitted evidence attempting to demonstrate that SFPP's individual rates are unjust and unreasonable. These showings were supported by cost of ser-

[720] *See* Ex. 154 at pp. 45-55.

[721] *Id.*

[722] *Id.* at pp. 53-55.

[723] SFPP Initial Brief at p. 182.

[724] SFPP Initial Brief at p. 188. In the section of its Initial Brief discussing rate evaluation and rate design, SFPP also discusses how reparations, if any, should be determined. Reparations are discussed *infra* in this initial decision.

vice analyses that fully allocated SFPP's costs down to each individual rate at issue.

Under the Interstate Commerce Act ("ICA"), each and every rate charged by a jurisdictional carrier must be just and reasonable.

> All charges made for any service rendered or to be rendered in the transportation of passengers or property . . . or in connection therewith, shall be just and reasonable, and every unjust and unreasonable charge for such service or any part thereof is prohibited and declared to be unlawful.[725]

As justification for its headroom analysis and presentation, SFPP relies on statements in Commission Order No. 561-A,[726] Order No. 571[727] and Opinion No. 391-A.[728] However, these authorities do not support SFPP's position.

The Commission in Order No. 561-A left the door open for oil pipelines to advocate costing methodologies other than fully-allocated costs when electing a cost of service alternative to indexed rates.[729] The instant case, which began in 1992 before Order No. 561-A and Order No. 571 were issued, does not involve electing a cost of service alternative to indexed rates. In any event the election option in Order No. 561-A is available only in an initial rate filing when the oil pipeline is electing a cost of service alternative to indexed rates. Once a filing is protested, however, the burden on the oil pipeline increases. This was made clear three months after Order No. 561-A in the companion rulemaking, Order No. 571, where the Commission reaffirmed what it had said earlier.[730] The Commission stated:

> All a pipeline need show to make a *prima facie* case under the cost-of-service alternative is that the revenues to be produced by the indexed ceiling rates substantially diverge from its costs. *Upon challenge, however, the pipeline must provide data supporting its proposed individual rates, including allocation and rate design. It will not be allowed to charge rates higher than its properly allocated costs would justify for any one service.*[731]

Although the instant case is a complaint case, there is no reason to apply a different standard under the circumstances here, where the complainants have made a *prima facie* case challenging existing rates, and the burden of proof has shifted to the pipeline to respond. There is no basis to SFPP's witness Crichfield's argument that the system approach is appropriate merely because the complainants carry the burden of proof.[732] Once that burden of proof shifted to SFPP, it had an obligation to defend its individual rates, including allocation and rate design, and this it did not do.

SFPP relies in part on a statement of the Commission in Opinion No. 391-A[733] that Williams Pipe Line Co. could present in Phase II of that proceeding any method it chose for arriving at just and reasonable rates. Williams then presented in Phase II of that case a headroom analysis. Judge Nelson, the presiding administrative law judge, decisively rejected that analysis:

> It is undisputed that Williams' system-wide revenues are substantially less than its system-wide Opinion 154-B cost of service. Therefore, says Williams, all of its rates are just and reasonable.
>
> The conclusion does not follow. This total cost of service includes all costs of everything—intrastate, interstate, crude, LPG, as well as the "products" in issue here. There was no effort even to match relevant costs with relevant revenues. In any event, the fact that total revenues produced by all of the rates may be lower than total costs sheds no light on the propriety of any particular rate—and thus proves nothing in assessing the reasonableness of the rates for the twelve noncompetitive markets. Such rates could well be unreasonably high—while company-wide revenues nevertheless remained below company-wide Opinion 154-B costs. There is no authority for the proposition that this cost of service somehow blesses all individual rates . . . .[734]

SFPP's headroom analysis does not prove the reasonableness of its individual rates. A fully allocated cost analysis, on the other hand, does allow shippers and the Commission to determine the reasonableness of individual rates.

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[725] 49 U.S.C. app § 1(5)(a) (1988).

[726] FERC Stats. & Regs. ¶ 31,000, at p. 31,107 (1994).

[727] FERC Stats. & Regs. ¶ 31,006, at pp. 31,166-67 (1994).

[728] *Williams Pipe Line Co.*, Opinion No. 391-A, 71 FERC ¶ 61,291, at p. 62,148 (1995).

[729] FERC Stats. & Regs. ¶ 31,000, at p. 31,107 (1994).

[730] FERC Stats. & Regs. ¶ 31,006, at pp. 31,165-67 (1994).

[731] *Id.* at p. 31,167 (emphasis added).

[732] *See* Ex. 188 at p. 18.

[733] *Williams Pipe Line Co.*, 71 FERC ¶ 61,291, at p. 62,148 (1994).

[734] *Williams Pipe Line Co.*, 75 FERC ¶ 63,016, at p. 65,063 (1996) (citations omitted).

SFPP also seeks support for its headroom approach in Commission Opinion No. 154[735] where the Commission supported a system-wide rate approach for oil pipelines. The case then went to the United States Court of Appeals.[736] That Court, while not ruling on the issue of system-wide versus point-to-point ratemaking, because the Court deemed the issued to be premature, left no doubt where the Court stood on the matter:

> Our review of relevant ICC precedents shows that past oil pipeline proceedings have included attempts to set rates "computed on a detailed allocation of costs to the proper section of the pipe-line system."[737]

The court then stated:

> We also find disturbing the apparent tension between FERC's action and the language of section 1(5). While FERC made assurances in *Williams* that patently discriminatory tactics will not be immunized from searching regulatory scrutiny, the FERC's systemwide approach would apparently tolerate substantial variance in allowable returns among pipeline segments without any justification, cost-based or otherwise.[738]

The Court provided direction to the Commission in the event it considered the cost allocation issue on remand:

> In making a decision on cost allocation principles, FERC should be cognizant of the ICC's past cost allocation practices, and should accord appropriate consideration to the mandate of section 1(5).[739]

SFPP's arguments that the *ARCO* line of decisions supports its position is similarly misplaced.[740] The ARCO cases dealt with separating crude systems from products systems, not separating products systems from one another.

As noted, SFPP argues that an adjustment to rates is only necessary if it is shown that SFPP's revenues exceed costs for the South System. But on this record, even if we were to accept SFPP's argument, its argument fails. Complainants and Staff have shown that SFPP can only justify its headroom analysis by relying on costs which have been disallowed, in whole or in part, by this initial decision, such as SFPP's request for litigation costs and the costs of its reconditioning program. It was seen repeatedly throughout the hearing that the disallowance of even one of these elements would sink SFPP's costs below revenues and thus invalidate SFPP's headroom approach.[741]

In accordance with ICC and FERC precedent, it is held that SFPP's rates shall be evaluated based upon a fully allocated cost of service. Moreover, as Staff witness McCelland testified, the rates shall be designed by allocating the cost of service between mileage and non-mileage costs.[742] The mileage costs include such items as depreciation, return, taxes, and operation and maintenance expenses. Non-mileage costs include items that are not distance sensitive, such as administrative and general expenses.[743]

The non-mileage costs shall be allocated on a per barrel basis to derive their cost per barrel. The mileage costs shall be allocated first between point-to-point movements, using barrel-miles as the allocation factor. The allocated total costs on a barrel-mile basis shall then be divided by the test year barrel-miles for each movement to determine the cost per barrel on a barrel-mile basis. To derive the total cost per barrel, the product of the mileage cost per barrel on a barrel-mile basis and the miles of each movement shall be added to the cost per barrel on a barrel basis.[744]

XIV. CHANGED CIRCUMSTANCES

For Chevron and the West Line Shippers to pursue their complaints against the majority of SFPP's existing West Line rates, they must satisfy the "changed circumstances" test of § 1803(b) of the Energy Policy Act of 1992 ("EPAct"). The Commission has determined that most of SFPP's West Line rates satisfy the conditions for "grandfathering" protection of existing rates under § 1803(a) of the EPAct and are therefore deemed "just and reasonable" as a matter of law.[745] Such "grandfathered" rates can only be challenged

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[735] *Williams Pipe Line Co.*, 21 FERC ¶ 61,260, at p. 61,651 (1982).

[736] *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984).

[737] *Id.* at 1528 (citations omitted).

[738] *Id.* at 1529.

[739] *Id.*

[740] *ARCO Pipe Line Co.*, 41 FERC ¶ 63,015 (1987); *ARCO Pipe Line Co.*, 41 FERC ¶ 61,397 (1987).

[741] *See, e.g.*, Tr. 10786-10787, 10884, 11013, 11027-11028, 11034-11035.

[742] Ex. 105 at pp. 17-18.

[743] *See, e.g.*, *Great Lakes Gas Transmission Limited Partnership*, 74 FERC ¶ 61,257, at pp. 61,857-58 (1996).

[744] *See* Ex. 263, Schedule 5, p. 12; and Ex. 264, Schedule 5, p. 12.

[745] 65 FERC ¶ 61,028, at p. 61,378 (1993). The Commission has held that rates for the transportation of turbine fuel on the West Line under SFPP's FERC Tariff No. 18 are not deemed just and reasonable under § 1803(a) because these rates, which went into effect on January 31, 1993, were not in effect for one

pursuant to the conditions of § 1803(b) of the EPAct, which reads as follows:

(b) CHANGED CIRCUMSTANCES. - No person may file a complaint under section 13 of the Interstate Commerce Act against a rate deemed to be just and reasonable under subsection (a) unless -

(1) evidence is presented to the Commission which establishes that a substantial change has occurred after the date of enactment of this Act -

(A) in the economic circumstances of the oil pipeline which were a basis for the rate; or

(B) in the nature of the services provided which were a basis for the rate; or

(2) the person filing the complaint was under a contractual prohibition against the filing of a complaint which was in effect on the date of enactment of this Act and had been in effect prior to January 1, 1991, provided that a complaint by a party bound by such a prohibition is brought within 30 days after the expiration of such prohibition.

42 U.S.C. § 7172 note § 1803(b)(1994) [hereafter "EPAct § 1803(b)"].

Complainant Navajo satisfied the conditions of § 1803(b)(2) with respect to its West Line rate complaint and therefore did not need to show changed circumstances to pursue its claims that those rates were unjust and unreasonable.[746] However, Navajo was permitted to withdraw its complaint against West Line rates by order of the presiding judge on May 21, 1997. 79 FERC ¶ 63,014. On July 21, 1997, the Commission terminated Navajo's West Line complaint proceeding. 80 FERC ¶ 61,088.

As set out more fully *supra* in the discussion of the Procedural History of this case, Chevron and the West Line Shippers argue that they should be permitted to "piggy-back" on Navajo's valid complaint and that, as a result, they should not be required to satisfy the changed circumstances test to pursue their West Line rate complaints. The Commission has rejected this argument and held that Chevron and the West Line Shippers must "meet the changed circumstances standard in pursuing their complaints."[747] The issue remaining is whether Chevron and the West Line Shippers have presented evidence establishing that a substantial change has occurred in either the economic circumstances or the nature of the services provided which were a basis for a West Line rate.[748]

An initial question concerns the time period to be considered in evaluating whether there has been a change in circumstances. SFPP argues that the two time periods which should be considered begin on October 24, 1992, when the EPAct was enacted, and end respectively on August 3, 1993, when Chevron filed its complaint, and on January 14, 1994, when the ARCO/Texaco complaint was filed for the West Line Shippers.[749] The West Line Shippers agree that the date of the enactment of the EPAct should be the starting point for the relevant period but argue that complainants should be permitted to present evidence of all changes that have occurred or will occur from that date forward, even if such changes have occurred or will occur after the filing of complaints.[750] Navajo contends that SFPP's economic circumstances during two periods should be compared: the period in 1989 when the West Line rates were placed in effect and the period when each complainant filed its complaint.[751]

Other than orders in the present case, the only significant Commission orders to date addressing the changed circumstances provisions of the EPAct are those in *Santee Distrib. Co. v. Dixie Pipeline Co.*[752] In that case, the Commission held that "the relevant period of time for determining whether there had been a substantial change in economic circumstances is the period *after* the enactment of the EPAct, *i.e.*, October 24, 1992."[753] The complaint in *Santee* was filed on November 18, 1994.[754] The Commission held that Santee had failed to demonstrate changed circumstances as to the challenged rates in that case because Santee had provided little 1993 data and no 1994 data and had therefore failed to present evidence of a change in circumstances during the relevant period.[755] In its order denying petitioners' request for rehearing, the Commission reviewed FERC Form No. 6 data for 1994 and 1995 which was not available when the complaint

(Footnote Continued)

year prior to the enactment of the EPAct. 68 FERC ¶ 61,306, at p. 62,263 n.12 (1994).

746 *See, e.g.*, 67 FERC ¶ 61,089, at 61,254 (1994).

747 68 FERC ¶ 61,105, at p. 61,581 (1994).

748 Chevron and the West Line Shippers have stated that they may take the "piggy-back" issue up on appeal, pending the Commission's final order in this case. *See* Chevron Initial Brief at p. 156 n.527; West Line Shippers Initial Brief at p. 63.

749 *See, e.g.*, SFPP Reply Brief at p. 184.

750 West Line Shippers Reply Brief at pp. 57-59.

751 Navajo Initial Brief at pp. 129-30.

752 71 FERC ¶ 61,205 (1995), *reh'g denied*, 75 FERC ¶ 61,254 (1996).

753 75 FERC ¶ 61,254, at p. 61,821 (emphasis in original).

754 71 FERC ¶ 61,205, at p. 61,751.

755 *Id.* at p. 61,754.

was originally filed.[756] The Commission found that even the additional data would not have satisfied the changed circumstances standard.[757] It is not clear from these orders whether the Commission would have allowed Santee to pursue its complaint if data which became available subsequent to the filing of the complaint (*i.e.* post-November 18, 1994 data) did establish a change in economic circumstances. It is also not clear whether data or evidence not available, or, if available, not presented at the time a complaint is filed, may be considered in satisfying the § 1803(b) standard.

Subsection 1803(b) states that "no person may *file* a complaint" unless "evidence *is presented to the Commission* which establishes that a substantial change has occurred after the date of enactment of this Act."[758] The plain reading of this language would seem to limit the data which can be considered in determining whether the statutory standard has been met to that data which both covers the period from October 24, 1992 to the filing of a complaint and which is filed with that complaint. Because this reading would require complainants to demonstrate changed circumstances without the benefit of information obtained through the discovery process, it obviously would make the statutory standard more difficult to meet.[759] For the purposes of the present case, I will follow the Commission's lead in the *Santee* rehearing order. I will consider whether any of the evidence in the record for the period after October 24, 1992 is sufficient to satisfy the changed circumstances standard. Only if that standard is met by any of the data will I reach the question whether that data is within the relevant period to be considered.

Subsection 1803(b)(1) requires complainants to present evidence "which establishes that a *substantial* change has occurred . . . ."[760] SFPP argues that the requirement to demonstrate a "substantial" change imposes an extremely high threshold for challenging grandfathered rates. Chevron and the West Line Shippers contend that the substantial change threshold is far less rigorous. Chevron, for example, relies upon the statements of its witness Johnston defining a "substantial change" as:

> any change in economic circumstances, or the nature of services provided, that formed the basis of the challenged rate, and which a complainant has demonstrated (1) has occurred after October 24, 1992 and (2) may result in changing a challenged rate from a statutory just and reasonable rate, to an unjust and unreasonable rate.

Chevron Initial Brief at p. 160 (citing Ex. 919 at p. 5; Ex. 921 at p. 4). Chevron also analogizes the "substantial change" standard to both the Commission's test for challenges to indexed oil pipeline rates under its revised regulations[761] and to the principle of probable cause in criminal procedure.[762]

Resolution of the issue requires consideration of the relevant statutory language, legislative history, and Commission orders interpreting the statute. The EPAct itself provides no definition of the term "substantial." A review of the history of the EPAct does, however, provide some clues as to the burden which Congress intended to impose on those seeking to demonstrate a "substantial change." An earlier draft of the statute required evidence establishing a "*material* change in economic circumstances."[763] The substitution of the term "substantial" for "material" in the enacted version of the statute suggests a Congressional intent to establish a higher threshold for the "changed circumstances" test than if the phrase "material change" had remained in the statute. The complainants, however, do not agree that the substitution of the term "substantial" creates a more rigorous standard.[764]

In the *Santee* case, the Commission made clear that the EPAct's "substantial change" standard requires complainants to meet a higher burden than is required to challenge a rate as unjust and unreasonable under the ICA. "While the just and reasonable standard of the

[756] 75 FERC ¶ 61,254, at pp. 61,820-21.

[757] *Id.*

[758] EPAct § 1803(b)(1) (emphasis added).

[759] It is worth noting that the Commission apparently did not consider information obtained through any discovery mechanism in *Santee*. Although the Commission, in its rehearing order, did review data other than that submitted with the original complaint, that data consisted of publicly available information from Dixie's FERC Form No. 6. *See* 75 FERC ¶ 61,254, at pp. 61,820-21.

[760] EPAct § 1803(b)(1) (emphasis added).

[761] One standard for challenging a proposed or established indexed rate or cost of service rate is "that the rate increase is so substantially in excess of the actual cost increases incurred by the carrier that the rate is unjust and unreasonable." 18 C.F.R. § 343.2(c) (1996).

[762] Chevron Initial Brief at pp. 160-61; Chevron Reply Brief at p. 101.

[763] *See* Ex. 192 at p. 3 (emphasis added).

[764] ARCO witness D'Alessandro contends that there is no significant difference between the terms "substantial" and "material." Tr. 6269-70. Chevron cites a civil case from Black's Law Dictionary defining "substantial" as synonymous with "material." *Lewandoski v. Finkel*, 129 Conn. 526, 29 A.2d 762 (1942).

ICA remains, the EPAct has established a separate, more rigorous standard for challenging grandfathered rates. A complainant who merely raises a factual issue, without more, does not meet this standard."[765]

Having considered the Commission's statement, the scant legislative history of the EPAct, and the statutory language requiring the presentation of evidence which establishes a "substantial" change, I must reject the complainants' characterization of the changed circumstances standard. The standard clearly requires a greater showing than evidence of "any change" which "may result" in a rate becoming unjust and unreasonable, as advocated by Chevron's witness Johnston. Moreover, I must reject the analogies relied upon by Chevron in describing the standard. The test in 18 C.F.R. § 343.2(c) for challenging indexed oil pipeline rates, for example, is essentially a restatement of the ICA's "just and reasonable" standard, and the Commission has left no doubt that the EPAct's "substantial change" test represents a more rigorous standard. Similarly, the "probable cause" analogy fails because the EPAct requires presentation of evidence which *establishes* that a considerable change in circumstances has occurred and would not be satisfied by the presentation of evidence which only shows the likelihood of such a change having occurred.

The best way of illustrating the threshold for challenging grandfathered oil pipeline rates established by the EPAct's "substantial change in circumstances" test is to apply the standard in the present case. Complainants contend that the following five changes constitute substantial changes in circumstances sufficient to satisfy the statutory standard: (1) increases in West Line volumes; (2) changes in environmental regulations; (3) SFPP's filing of Tariff No. 18 for the delivery of turbine fuel; (4) the Commission's decision in *Lakehead*; and (5) the filing of complaints challenging the West Line rates in the present case. I consider the arguments with respect to each of these changes below.

All of the methods of quantifying volumes proposed by the parties to this case show that there has been an increase in the volumetric throughput on the West Line since 1992. SFPP contends that a consideration of volumes should focus on the entire South System, and not on the West Line separately.[766] However, I have previously held that separate costs of service shall be determined for the East and West Lines; for similar reasons the combined "South System" approach for volume measurements proposed by SFPP should not be used.

The West Line Shippers contend that there was a 16 percent increase in West Line volumes between 1992 and 1995.[767] Chevron computed a cumulative increase in West Line volumes of as much as 43.20 percent over the same period based on SFPP's 1994 and 1995 Form 10-K data.[768] The actual increase in volumes need only be determined if any increase in volume of up to 43.20 percent would satisfy the statutory standard. In the absence of additional information, I find that it does not.

Complainants must show a substantial change in "the economic circumstances ... which were a basis for the rate." Complainants suggest that, since the settlements which form the basis for SFPP's West Line rates are presumably based on lower volumes[769], any significant increase in West Line volumes would cause an increase in SFPP's revenues and therefore result in a change in SFPP's economic circumstances. This argument does not take into account possible increases in SFPP's West Line costs or other factors which could prevent an increase in volumes from leading to an increase in revenues. Chevron concedes that SFPP has "presumably incurred ... increased variable costs, *i.e.*, pumping station fuel" as a result of the increase in West Line volumes, but assumes that these costs do not offset any corresponding increase in revenue related to the increased volumes.[770] Neither Chevron nor the West Line Shippers presented any concrete proof that the increase in West Line volumes was directly tied to increased revenues or other significant changes in SFPP's economic position. Under the EPAct, it is the complainant "that has the burden of showing whether or not there have been changed circumstances."[771] As noted above, that burden is not a slight one. Since the complainants have not presented evidence which establishes a connection between the increased West Line volumes and a substantial change in SFPP's economic circum-

[765] 75 FERC ¶ 61,254, at p. 61,821.

[766] SFPP Initial Brief at pp. 196-201.

[767] West Line Shippers Initial Brief at pp. 64-65; Ex. 763.

[768] Chevron Initial Brief at p. 165; Ex. 845 at p. 4; Ex.866 at p. 42.

[769] Because the West Line rates are based on two settlement agreements and not on a full Commission order, it is difficult for the complainants in this case to characterize what economic circumstances were "a basis for the rate."

[770] Chevron Initial Brief at p. 169.

[771] 71 FERC ¶ 61,205, at p. 61,755.

stances which were a basis for a West Line rate, I hold that the increased volumes do not satisfy the § 1803(b)(1) test.

The West Line Shippers contend that changes in environmental regulations have led to a substantial change in SFPP's economic circumstances since the enactment of the EPAct. According to the testimony of West Line Shippers witness Cormier, the sale of certain types of motor gasoline and diesel fuel was prohibited in California by new California regulations for reformulated gasoline and changes in related federal regulations.[772] Sales of these products are still permitted in Arizona and Nevada.[773] The West Line Shippers argue that, because SFPP's West Line is the only means of transporting these products by pipeline from California to Nevada and Arizona, and because certain refiners would have no option but to move products of this type out of California, a permanent increase in West Line throughput would result which would constitute a substantial change in SFPP's economic circumstances.[774] In support of this argument, the Shippers note that SFPP itself has used these changes in environmental regulations as a basis for rates in the State of California[775] and that SFPP's President has issued a press release which discusses "changes anticipated in market conditions and supply patterns resulting from the reformulated gasoline specifications required by the California Air Resources Board (CARB) . . . by March 1996."[776]

This argument is too conjectural to satisfy the § 1803(b)(1) test. The West Line Shippers presented no evidence which establishes that refiners and shippers have altered their practices in response to the environmental regulations in any manner which affects SFPP's economic circumstances. Even the evidence which arguably shows that SFPP itself believes that these regulatory provisions will have a future impact on its economic circumstances is insufficient. Under the EPAct, a complainant must "establish" that a substantial change in economic circumstances "has occurred," *i.e.* has already taken place. A complainant who only presents evidence of an anticipated future change in economic circumstances or of a speculative present change in circumstances has not met this standard. I therefore find that, on the record of the present case, the changes in environmental regulations do not constitute a substantial change in the economic circumstances which were a basis for a West Line rate.

Chevron and the West Line Shippers argue that SFPP's filing of FERC Tariff No. 18 for jet turbine fuel constitutes a substantial change in both the economic circumstances that were a basis for the West Line rates and in the nature of the services provided that were a basis of the rates.[777] Chevron suggests that Tariff No. 18, by authorizing shipment of an additional product on the West Line, allows SFPP to lower its per barrel costs for all movements on the West Line. They also note that, in December 1992, SFPP entered into an agreement with ARCO under which ARCO guaranteed shipment of a minimum volume under Tariff No. 18.[778] Chevron argues that the lower costs per barrel on the West Line and the guaranteed throughput under the ARCO agreement results in a substantial change in SFPP's economic circumstances. West Line Shippers witness D'Alessandro contends that the filing of Tariff No. 18 also satisfies the § 1803(b)(1)(B) "substantial change in the nature of services" test: "Here there has been a substantial change; a 'new service' has been offered for the transportation of a product heretofore excluded from service. Initiation of a new service is the most obvious change in the nature of services provided . . . ."[779]

I find that the filing of Tariff No. 18 does not constitute a substantial change "in the nature of the services provided which were a basis for the rate." The turbine fuel shipment services are not being provided under the grandfathered tariffs protected under section 1803 of the EPAct. These services are provided under a new, ungrandfathered tariff with a separate rate. Tariff No. 18 therefore does not result in any change, much less a substantial change, in those services which were a basis for any of the challenged West Line rates. I also find that complainants have not met their burden of establishing that either increased throughput on the West Line due to Tariff No. 18 or guaranteed revenue under the ARCO agreement has resulted in a substantial change in SFPP's economic circumstances. Complainants again rely on speculative arguments and inferences instead of making the demonstration of changes in SFPP's economic position which is required by the statute.

In 1995 and 1996, the Commission issued decisions in the *Lakehead* case which clarified

[772] Ex. 306 at pp. 5-9.

[773] *Id.*

[774] West Line Shippers Reply Brief at pp. 62-64.

[775] Ex. 924 at p. 7; Tr. 8402-04, 9802-03.

[776] Ex. 140.

[777] *See, e.g.,* Chevron Reply Brief at pp. 114-16; West Line Shippers Initial Brief at p. 67.

[778] Ex. 767.

[779] Ex. 135 at p. 8.

Commission policy on the rights of oil pipelines organized as limited partnerships to claim income tax allowances in their costs of service.[780] Complainants argue that, since the *Lakehead* decisions affect the ability of pipelines like SFPP to recover income taxes in their costs of service, those decisions result in a substantial change in SFPP's economic circumstances.

I cannot agree with this argument. The key question is whether a substantial change in a pipeline's economic circumstances has occurred since the enactment of the statute. In the present case, SFPP continues to collect the pre-*Lakehead* rates on the West Line. Its economic circumstances have not changed. The fact that SFPP's existing West Line rates may be unjust and unreasonable under *Lakehead* is irrelevant. The issuance of a Commission order which may subject a grandfathered rate to a challenge as unjust and unreasonable is insufficient, by itself, to meet the changed circumstances standard.

Finally, West Line Shippers contend that the filing of West Line rate complaints itself constitutes a substantial change in the economic circumstances that were a basis for the rates. They state that when "the Commission approved the settlements, the Commission specifically provided that anyone could challenge the rates."[781] They argue that, since the Commission's settlement orders left the rates open to challenge, the filing of complaints challenging those rates is a "significant change" altering the circumstances which were a basis for those rates. I am unconvinced by this argument. The fact that the Commission orders which approved the settlements setting SFPP's West Line rates leave the rates open to subsequent challenge is unremarkable. Nothing in those orders, however, can be interpreted as superseding the grandfathering protection offered by the EPAct. The West Line Shippers offer no proof that the mere filing of complaints in this case has resulted in a substantial change to either SFPP's economic circumstance or the nature of the services provided under the West Line rates. Indeed, if the filing of a complaint alone would be sufficient to satisfy the changed circumstances test, then the grandfathering protection offered by the EPAct would be negated.

I reject all of Chevron's and the West Line Shippers' arguments for changed circumstances with respect to SFPP's grandfathered West Line rates. Because these complainants have failed to meet the statutory standard, I hold that they are prohibited under the EPAct from pursuing their claims that the grandfathered West Line rates are unjust and unreasonable.

XV. PRORATIONING

A. Background

The next set of issues involves SFPP's proration policy. The proration policy is the means by which SFPP allocates pipeline capacity among shippers during those periods when the aggregate volume of petroleum products which shippers offer for transportation exceeds the capacity of the pipeline. The only reference to SFPP's proration policy in its East and West Line tariffs is the following sentence in Item 35 of each tariff's Rules and Regulations:

> When more petroleum product is offered by shippers to the carrier under this tariff than can be currently transported within the period covered by such offers, petroleum products offered by each shipper for transportation will be transported in such quantities and at such times to the limit of carrier's capacity in a manner determined by carrier to be equitable to all shippers.

SFPP FERC Tariff No. 15, Item A by Reference; SFPP FERC Tariff No. 16, Item B by Reference; and SFPP FERC Tariff No. 18, Item C by Reference.

SFPP's proration policy is set forth in detail in a separate document. Although this policy document is not on file with SFPP's tariffs, copies of it are provided to SFPP's shippers, and these shippers are notified when the proration policy is changed or modified.[782] SFPP notified shippers of the most recent changes to its policy, which were to go into effect on September 1, 1992, in a letter dated July 31, 1992.[783]

Prior to those changes to the policy, SFPP had reduced Chevron's April 1992 allocation on the prorationed East Line by 40,000 barrels per month as a "penalty" for Chevron's failure to meet conditions for an interim upgrading of

[780] *See Lakehead Pipe Line Co., L.P.*, 71 FERC ¶ 61,338 (1995), *reh'g denied*, 75 FERC ¶ 61,181 (1996); *see also* the discussion *supra* of the application of the *Lakehead* policy in the present case.

[781] West Line Shippers Initial Brief at p. 63 (citing *Southern Pacific Pipe Lines Partnership, L.P.*, 49 FERC ¶ 61,081, at p. 61,319 (1989); *Southern Pacific Pipe Lines, Inc.*, 45 FERC ¶ 61,242, at p. 61,716 (1988)).

[782] Tr. 9361-63.

[783] Ex. 152 at pp. 1-2 of 6. After Chevron notified SFPP that it had not received notification of the new policy until August 3, SFPP delayed implementation of the new policy until October 1992. *See* Tr. 9304-05.

pumping capacity. Chevron notified the FERC's Office of Enforcement of this action. In a letter dated May 5, 1992, the Assistant General Counsel for the Office of Enforcement advised SFPP that it did not have the right to impose such a penalty under SFPP's then-effective tariff and that SFPP could not "impose any condition [concerning rates or terms of service] on shippers that is not part of its tariff as filed with the Commission." Ex. 893 (citing *KK Appliance Co. v. Mid-America Pipeline Co.*, 47 FERC ¶ 61,076 (1989)). In a response letter dated May 15, 1992, SFPP's Senior Vice President Pearl stated that "although we are not entirely in agreement with your assessment of the issue, SFPP intends to comply with your request to modify its tariffs to provide for penalties to those physical suppliers that cannot provide product at maximum mainline pumping rates." Ex. 894. SFPP's new tariffs, filed on July 31, 1992, do not include provisions for such penalties.[784]

SFPP's proration policy, as set forth in the unpublished policy description document, includes a number of elements at issue in the present case. SFPP uses a "demonstrated need" standard in allocating pipeline capacity to "New Shippers" during periods of prorationing.[785] Under this standard, New Shippers must show that they have a "demonstrated need" for space on the prorationed pipeline. There are no definite criteria for the "demonstrated need" standard, but the policy document does offer the following guidance:

> Examples of "demonstrated need" include: (1) actual sales, purchases, or consumption of product in the markets served by the prorated segment; (2) evidence of product transported to those markets by alternative modes of transportation; and (3) substantiation of sales arrangements in those markets that would be consummated if pipeline capacity was available.

Ex. 152 at p. 5 of 6. New Shippers are allocated pipeline capacity equal to the volumes for which they have demonstrated a need divided by a "Proration Factor" which reflects the ratio of total volumes tendered by all shippers to the line capacity. All remaining capacity is allocated among regular shippers based on their shipments during a 12-month base period. Ex. 152 at p. 4 of 6.

Several other aspects of SFPP's proration policy are also pertinent. Under the policy, those shippers seeking New Shipper status must submit nominations to SFPP, and SFPP uses its "best efforts" to complete within 90 days the process of evaluating the New Shippers' "demonstrated need." The policy document explains that the 90 day period is necessary "to allow for orderly processing and proper evaluation of a New Shipper's demonstrated need." Ex. 152 at p. 5 of 6.

In addition, the following language in the unpublished proration policy document gives SFPP the right to obtain a wide range of information from its shippers, both new and historical:

> SFPP reserves the right to review all nominations and forecasts using every means available to ensure reasonableness, including, but not limited to, contacting physical suppliers and recipients of the volumes to be shipped. SFPP reserves the right to adjust any nominations which are determined to be inflated or unreasonable.

Ex. 152 at p. 4 of 6. In the past, SFPP has used this authority to request that shippers provide a list of both current contracts and potential or future sales arrangements.[786] On some occasions, SFPP has then initiated communications with a shipper's potential customers at times when multiple shippers were competing for the customers' business and has informed potential customers that the shipper with whom the customers were negotiating would probably not be allocated sufficient pipeline capacity to ship certain volumes.[787]

B. Positions of the Participants

The first question related to prorationing is whether SFPP must publish a detailed description of its proration policy in its tariffs. Chevron, Navajo, RHC, and the Commission Staff all argue that SFPP is required by the Interstate Commerce Act as well as Commission regulations and precedent to publish its detailed proration plan in its tariffs.[788] Specifically they rely on section 6(1) of the ICA, which requires that rates and regulations for all services performed be published in a com-

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[784] SFPP witness Pearl testified that such modifications were not made because SFPP has not needed to impose any further penalties of the kind imposed on Chevron. Tr. 9330.

[785] Under SFPP's proration policy, historical shippers on the East and West Lines are treated by SFPP as "New Shippers" for volumes requested above their historical shipping levels on those lines. *See* Ex. 152.

[786] Tr. 5515-16.

[787] *Id.*

[788] *See* Chevron Initial Brief at pp. 172-83; Navajo Initial Brief at p. 136; RHC Initial Brief at pp. 56-57; and Staff Initial Brief at pp. 99-105.

mon carrier's tariff and that the tariff separately state:

> all terminal charges, storage charges, . . . and all other charges which the Commission may require, all privileges or facilities granted or allowed, and any rules or regulations which in any way change, affect, or determine any part of the aggregate of such aforesaid rates, fares, and charges, or the value of the service rendered to the . . . shipper, or consignee.

49 U.S.C. app. § 6(1)(1988). These participants argue that SFPP's proration policy is a rule or regulation which affects the value of services rendered to shippers and therefore must be set forth in detail in the tariff pursuant to the ICA. In addition, some participants contend that inclusion of the detailed proration policy in the tariff is compelled by Commission regulatory provisions, including the oil pipeline regulations on "Terminal and other services":

> Carriers must publish in their tariffs rules governing such matters as prorationing of capacity, . . . and all other charges, services, allowances, absorptions and rules which . . . increase or decrease . . . the value of service to the shipper.

18 C.F.R. § 341.8 (1996). Proponents of full policy publication also cite a string of Commission decisions, discussed below, which, they claim, support the proposition that significant operating conditions such as prorationing policies must be set forth in detail in a pipeline's tariffs.

SFPP argues that these participants overstate the level of detail which is required by the ICA and Commission regulations.[789] SFPP contends that the summary of the proration policy currently set forth in its tariffs is sufficient to satisfy all statutory and regulatory publication mandates. In support of this position, SFPP points to the Commission's recent decision in *Total Petroleum, Inc. v. Citgo Prods. Pipeline* denying a shipper's request to reinstate a prior prorationing policy where a pipeline had filed a new tariff which briefly described the new proration policy and referred shippers to a separate policy document for details. 76 FERC ¶ 61,164, at p. 61,948 (1996).

The second set of issues concerns the substance of SFPP's proration policy. A number of participants contend that certain elements of SFPP's current proration policy either violate the ICA or are otherwise improper and must therefore be modified or eliminated.

The Commission Staff raises multiple objections to the demonstrated need standard, arguing that it is a purely subjective standard, that it places new shippers seeking capacity on the East and West Lines at a deliberate disadvantage, and that it empowers SFPP to obtain highly confidential and potentially unwarranted information from its shippers.[790] Staff proposes replacing the demonstrated need standard with a "good faith standard," which is far more prevalent in the oil pipeline industry and which Staff claims is equally well suited for protecting SFPP's legitimate prorationing concerns.[791] Staff also proposes reducing the period for processing new shipper transportation requests from 90 days to 30 days.[792] Chevron raises similar concerns about SFPP's demonstrated need standard.[793] Chevron supports the good faith nomination standard and the reduced new shipper evaluation period advocated by Staff.[794]

RHC contends that the demonstrated need standard, as presently applied, gives SFPP unreasonably wide latitude in allocating space on the East and West Lines and permits SFPP to interfere with the business interests of its shippers.[795] RHC does not object to the demonstrated need standard itself, but argues that the standard must be revised to make it more objective and well-defined. The revisions proposed by RHC witness Foster include the use of a "straightforward monthly nomination procedure" and the addition of penalty provisions for shippers that ship less than 90 percent of their nominated values.[796] RHC acknowledges that its proposed revisions result in an approach similar in many respects to the good faith standard advocated by Staff; in the alternative, RHC supports the adoption of the good faith standard.[797] Like Staff and Chevron, RHC argues that a reduction in SFPP's 90 day new shipper evaluation period is also necessary.[798]

Navajo raises objections to those aspects of SFPP's demonstrated need approach which grant SFPP the authority to independently contact a shipper's customers and which allow new shippers to obtain pipeline capacity allocations based on market factors while existing shippers are limited to a portion of their historical shipments.[799] Navajo seeks the elimination

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[789] *See* SFPP Reply Brief at pp. 191-97

[790] Staff Initial Brief at pp. 105-09.

[791] *Id.*

[792] *Id.* at pp. 109-11.

[793] Chevron Initial Brief at pp. 183-88.

[794] *Id.*

[795] RHC Initial Brief at pp. 57-58.

[796] Ex. 23 at pp. 2-4; Ex. 24.

[797] RHC Initial Brief at pp. 59-60.

[798] *Id.*

[799] Navajo Initial Brief at pp. 136-37.

proration request in light of "factors unto itself."[815] The demonstrated need "standard," as defined by SFPP, lacks any quantifiable criteria. Without such criteria, it is almost impossible for shippers or the Commission to determine whether prorationing has been implemented in a fair and reasonable manner, without undue or unreasonable preference for any shipper.

Many shippers have also expressed great concern about SFPP's authority, under its demonstrated need standard, to require that potential shippers submit a wide range of business information. The record suggests that SFPP has used this authority not only to contact a shipper's customers and potential customers but also to communicate information about a shipper's likely capacity allocations to potential customers. Such communications certainly represent an intrusion into a shipper's private business negotiations and may be in violation of section 15(13) of the ICA.[816] SFPP's authority to obtain such information may also place shippers at a competitive disadvantage with the pipeline company itself, should an affiliate of SFPP someday ship on the system. Once again, the potential for discriminatory implementation of prorationing, in violation of the ICA, is great.

A common carrier's duties under section 1(4) of the ICA include a duty to provide transportation services upon reasonable request as expeditiously as possible. Under its demonstrated need standard, SFPP reserves to itself a time period of 90 days or greater to allocate capacity to new shippers. SFPP witness Pearl testified that, although new shipper requests are ideally processed within 30 days, 90 days may be necessary to obtain the voluminous information often considered in the demonstrated need evaluation.[817]

At least 20 pipelines currently employ a "good faith" nomination standard in making capacity allocations.[818] This standard is widely accepted in the industry and requires a new shipper evaluation period of only 30 days.[819] The 90 day period established by SFPP seems unnecessarily excessive.

In sum, I find that numerous aspects of SFPP's demonstrated need standard either violate the ICA or facilitate discriminatory implementation of prorationing in violation of the ICA.

Staff witness Pride recommends that SFPP's proration policy be amended to substitute a good faith standard for the demonstrated need standard.[820] Under the good faith standard, a pipeline allocates capacity based on shipper nominations. The burden is on the shipper to make reasonable nominations in good faith. Shippers must comply with the terms of a pipeline's tariffs such as the requirement to possess unencumbered title of the product to be transported and the requirement to comply with the pipeline's specification. New shippers also may be required to meet certain credit requirements which ensure that they have the ability to pay incurred transportation charges.

The good faith standard does not raise the concerns associated with the demonstrated need standard. Since the pipeline merely accepts the good faith nominations of its shippers, there is no need to seek potentially intrusive information from shippers. The nomination evaluation process would also be considerably simplified. As such, 30 days should be sufficient time to complete the evaluation. Most important, since all nominations are treated the same under the good faith standard, the risk of discriminatory treatment of shippers would be all but non-existent. It is true that this standard creates the possibility of shipper over-nomination, but such practices can be deterred through the use of penalty provisions of the sort already included in SFPP's proration policy.[821] Overall, the good faith standard is a just and reasonable approach to prorationing; under the facts of this case I find that SFPP's current demonstrated need standard is not just and reasonable. I therefore hold that SFPP shall modify it's proration policy in accord with Staff witness Pride's recommendations.

XVI. REPARATIONS

There are two general reparations issues. First, if reparations are to be awarded, how are reparations to be determined? Second, over what period of time may reparations be awarded?

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[815] Tr. 9187-89.

[816] Section 15(13) states that a common carrier may not disclose information concerning a shipper's transportation of product without the shipper's consent, because it may improperly disclose the shipper's business transactions to a competitor. 49 U.S.C. app. § 15(13)(1988).

[817] *See* Tr. 9189-91.

[818] Tr. 7922.

[819] Ex. 113 at pp. 10-11.

[820] *See* Ex. 113 at pp. 8-11.

[821] SFPP's current policy permits a reduction in volumes allocated to a shipper in future proration periods if the shipper fails to deliver products equal to the space allocated to it in the present proration period. Ex. 152 at p. 4 of 6.

A. Determining Reparations

Complaints against West Line rates are covered by the EPAct.[822] Under the EPAct, "Any tariff reduction or refunds that may result as an outcome of any such complaint shall be prospective from the date of filing the complaint."[823]

Because the participants[824] in this case who complained about grandfathered West Line rates have not shown "changed circumstances" within the meaning of the EPAct,[825] there can be no award of reparations with respect to complaints against the grandfathered West Line rates.[826]

East Line rates in this case are not subject to the restrictions of the EPAct, either as to the "changed circumstances" requirements or the EPAct's requirement that reparations run prospectively from the date of the complaint. This is so because the East Line rates were challenged within the one year period ending on the day of enactment of the EPAct and thus were not subject to the provisions of section 1803.[827]

I hold that for all complainants except Navajo, with respect to East Line rates the right to reparations shall begin two years prior to the filing of a complaint.[828] Navajo is treated differently for reasons discussed hereafter.

SFPP argues that reparations are barred by the EPAct, but SFPP recognizes that the Commission has ruled otherwise.[829] SFPP then argues that since the award of reparations is discretionary with the Commission and is an equitable remedy, the Commission can deny or limit reparations.[830] If reparations are to be awarded, SFPP urges the Commission to take a South System multi-year approach and net periods where SFPP overrecovered its costs with periods of underrecovery.[831] (SFPP does not make clear how this approach would work when there are different customers shipping different volumes over different time periods.)

Chevron advocates the calculation of reparations "on an annual, calendar-year basis" and notes that rulings of the Interstate Commerce Commission

> . . . have developed costs of services for each period at issue, and computed reparations based on the difference between the appropriate rate levels established based on the cost evidence presented and the published rates. When the carrier-derived actual revenues were in excess of those established using the appropriate rate levels, reparations were awarded. In addition, any reparations awarded are subject to interest computed from the date of the first unlawful movement.[832]

Under Navajo's approach, for reparations periods prior to 1995, SFPP would owe shippers the difference between the rates paid and what would have been paid under the new rates established in this proceeding on the volumes shipped, plus interest. For years 1995 and thereafter SFPP would pay East Line shippers the difference between what they would have paid under the rates established in this proceeding, as indexed beginning January 1, 1995, and what they paid under SFPP's present rates, multiplied by the volumes shipped, plus interest.[833] In essence Navajo advocates the use of a single test year rate approach in determining reparations for all years in which reparations are due. This approach avoids the need to determine individual yearly costs-of-service for SFPP for the several years that reparations will have to be paid. If, for example, individual yearly costs of service were required by the Commission and the Commission issues a final order in this case in 1998, individual yearly reparations determinations would have to be made from 1990 until 1998. This individual year-by-year process might involve extensive hearings to determine an appropriate cost of

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[822] 68 FERC ¶ 61,105 (1994); 68 FERC ¶ 61,306 (1994).

[823] EPAct § 1803.

[824] As noted earlier, Navajo was permitted to withdraw its complaint as to SFPP's West Line rates. Order Allowing Withdrawal of Complaint Subject to Conditions, 79 FERC ¶ 63,014 (1997).

[825] EPAct § 1803(b).

[826] As noted earlier, West Line rates under SFPP's FERC Tariff No. 18 are not grandfathered; *i.e.*, they are not deemed just and reasonable under section 1803 of the EPAct. *SFPP, L.P.*, 68 FERC ¶ 61,306, at p. 62,263 n.12.

[827] *SFPP, L.P.*, 68 FERC ¶ 61,105, at p. 61,582 (1994).

[828] *SFPP, L.P.*, 68 FERC ¶ 61,306, at p. 62,263 (1994); 68 FERC ¶ 61,105, at p. 61,582 (1994). SFPP has argued in its Initial Brief (p. 239) that despite the Commission's rulings in the orders just cited, under the EPAct, 42 U.S.C. § 7172 note § 1803, reparations for East Line rates can only be prospective from the date of filing a complaint.

[829] SFPP Initial Brief at p. 239 n.184; *see also* *SFPP, L.P.*, 68 FERC ¶ 61,105 (1994).

[830] SFPP Initial Brief at p. 249.

[831] SFPP Initial Brief at p. 251; SFPP Reply Brief at pp. 233234.

[832] Chevron Initial Brief at p. 218 n.729 (citations omitted).

[833] *See* Navajo Initial Brief at p. 141 and Navajo Reply Brief at p. 99.

service for each year. That process should be avoided.

Contrary to the positions of Chevron and SFPP, Navajo argues that the "ICC often used the rate set for prospective application in section 13 complaint cases as the basis upon which to calculate refunds and reparations,"[834] and notes that the Federal Energy Regulatory Commission in its recent decisions in oil pipeline cases has indicated it would do the same.[835]

Navajo also notes that the ICC calculated the amount of reparations in a Rule V proceeding[836] and calculated the reparations by having the parties use a simple Form 5 schedule.[837]

West Line Shippers would accept any of the above-mentioned methods for calculating reparations.[838] Refinery Holding Company, while seeking reparations, does not take a position on how reparations should be calculated.[839] Staff states that it does not take any position on reparations issues.[840]

Considering the arguments of the participants and the law, I conclude that Navajo's approach shall be used in calculating reparations for the periods they are due except for 1993. This approach is fair and avoids costly and protracted litigation over costs of service for each year reparations may be payable. It is in the interest of all parties and in the public interest that litigation in this case, which began in 1992, come to an end.

The test year cost of service in this case is based on a 1993 base year updated with certain 1994 data. If rates produced by this cost of service are just and reasonable for all future years after the Commission issues a final order in this case, those rates, indexed after January 1, 1995, also provide a just and reasonable basis for determining reparations for the period 1994 to the date of the final Commission order and for the period prior to 1994.

Except for 1993, when throughput on the East Line was abnormally low, I hold that in determining the amounts of reparations SFPP shall pay East Line shippers the difference between the rates they paid and what they would have paid under the new rates established in this proceeding on the volumes shipped, plus interest.

Because of the abnormally low throughput on the East Line in 1993,[841] the only change in the calculation of the just and reasonable rates for 1993 when determining 1993 reparations will be that the actual 1993 throughput figures shall be used instead of the 1994 test year throughput figures.

B. Time Periods for Calculating Reparations

If reparations are due, SFPP has a dispute with some of the complainants regarding the dates from which reparations shall be calculated.

1. *Chevron*

Chevron seeks reparations from September 23, 1990.[842] SFPP notes that the complaint filed by Chevron on September 23, 1992 did not seek reparations. SFPP argues that Chevron should not be permitted to seek reparations on the East Line until September 10, 1993, when an order was entered in this case allowing Chevron to seek damages.[843]

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[834] Navajo Reply Brief at pp. 3-4. Navajo cites *Louisville & Nashville R.R. Co. v. Sloss-Sheffield Steel & Iron Co.*, 269 U.S. 217, 222-23 (1925)(citing *Sloss Sheffield & Iron Co. v. Louisville & Nashville R.R. Co.*, 52 I.C.C. 576 (1919)); *Delaware & H.R. Corp. v. Penn Anthracite Mining Co.*, 91 F.2d 634 (3rd Cir.) *cert. denied* 302 U.S. 756 (1937); *Becker, Moore & Co., Inc. v. New York Central R.R. Co.*, 104 I.C.C. 11, 14 (1925), *City of Danville v. Chesapeake & O. Ry. Co.*, 34 F. Supp. 620, 626 (W.D. Va. 1940).

[835] Navajo cites *Union Oil Co. of California v. Cook Inlet Pipe Line Co.*, 71 FERC ¶61,300, at p. 62,184 (1995)("If the Commission ultimately determines that the rate contained in FERC Tariff Sheet Rate No. 21 is not a just and reasonable rate, Unocal could be entitled to receive reparations in an amount equal to the

difference between the just and reasonable rate set by the Commission and the FERC Tariff Sheet No. 21 rate."); *Lakehead Pipe Line Co., L.P.*, 71 FERC ¶61,338, at p. 62,319 (1995)(not awarding reparations since complainant failed to ask for them, yet stating, "It did not seek reparations under the Act in the event Lakehead's effective rates prior to May 3, 1992, were higher than the rates determined here to be just and reasonable."), *reh'g denied*, 75 FERC ¶61,181 (1996).

[836] *See, e.g., Louisville & Nashville R.R. Co.*, 269 U.S. at 222- 23; *Delaware & H.R. Corp.*, 91 F.2d at 634.

[837] Navajo attaches to its Reply Brief (in Appendix A) Rule 5 of the Rules of Practice Before the Interstate Commerce Commission and the ICC Form 5 Worksheet.

[838] West Line Shippers Initial Brief at pp. 76-77.

[839] RHC Initial Brief at p. 61.

[840] Staff Initial Brief at p. 121.

[841] As noted earlier in the discussion on Volumes in this initial decision, the EPR refinery was shut down for the first ten months of 1993 after EPR filed for bankruptcy in 1992. Ex. 34 at p. 22. 1993 East Line volumes were also affected by other unrepresentative events, including a two month shutdown of Chevron's refinery and three months of downtime at Navajo's facilities due to scheduled maintenance. *Id.*

[842] Chevron Initial Brief at p. 217.

[843] SFPP Initial Brief at pp. 241-242.

In a Motion to Intervene and Protest, filed on September 23, 1992, Chevron protested SFPP's FERC Tariff Nos. 15[844] and 16[845] covering shipments of gasoline and petroleum distillate fuel oils on SFPP's East and West Lines. The protest was then converted into a complaint when the Commission changed the case from an investigation into a complaint proceeding under section 13(1) of the Interstate Commerce Act; in its order the Commission expressly reserved to the parties all the remedies available under section 13(1) of the ICA.[846]

In a pleading filed with the Commission on July 9, 1993, Chevron asked for damages pursuant to section 16 of the Interstate Commerce Act for the period beginning two years preceding the filing of its complaint on September 23, 1992.[847] SFPP opposed the position of Chevron and argued then, as it does again in its Initial Brief, that the request of Chevron for relief cannot relate back to Chevron's original complaint. Extensive oral argument was held on the relation-back issue on July 20, 1993[848] and September 8, 1993.[849] On September 10, 1993, I issued an order holding that Chevron could seek damages from September 23, 1990, *i.e.*, two years preceding the filing of its complaint.[850]

SFPP cites a number of old ICC cases for its position that the two-year reparations period cannot relate back to the filing of the original complaint.[851] The ICC rulings were based upon old ICC rules of practice which were not adopted by the Federal Energy Regulatory Commission when oil pipeline regulation was transferred to FERC from the ICC. I do not read these cases as interpreting the Interstate Commerce Act (ICA) to prohibit relating the reparations period back to the filing of the original complaint, nor do I find any language in the ICA to prohibit relating the reparations period back to the filing of the original complaint.

More recent ICC cases indicate that the relation-back doctrine may be used. Since at least 1927, the ICC has used an informal complaint procedure which has acted to toll the running of the statute of limitations set forth in the ICA.[852] An analysis of the operation of the ICC's informal complaint process demonstrates that the ICC provided a means for relating damages claims back to the filing of an earlier pleading. The ICC maintained this procedure for many years and clearly concluded that it had authority to do so under the ICA.

Under the current rules of the ICC's successor, the Surface Transportation Board,[853] and under previous ICC rules,[854] a shipper may file an informal complaint seeking damages from a rail or motor carrier and preserve its rights to damages. If the shipper's informal complaint is not resolved informally, is denied, or withdrawn, the shipper has six months from the date that its informal complaint is terminated to file a formal complaint. The formal complaint is deemed filed as of the date of the informal complaint;[855] *i.e.*, the formal complaint relates back to the date of the filing of the informal complaint. The shipper is entitled to seek damages for the two-year period preceding the filing of the informal complaint regardless of the fact that its formal complaint may not be filed for years after the filing of the informal complaint.

The interaction of the ICC's informal and formal complaint procedures is illustrated by *Thomson Phosphate Co. v. Atlantic Coast Line R. Co.*[856] Thomson filed its initial informal complaint in 1946; that informal complaint

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[844] Item A by Reference.

[845] Item B by Reference.

[846] *SFPP, L.P.*, 63 FERC ¶ 61,275, at p. 62,769 (1993).

[847] Chevron U.S.A. Products Company's Opposition to SFPP, L.P.'s Motion in Opposition to El Paso Refinery, L.P.'s Amendment of Complaint, at pp. 1 and 18-19 (hereafter referred to as "Chevron's Opposition").

[848] Tr. 1060-1115.

[849] Tr. 1149-1219.

[850] The basis for this ruling is persuasively set forth in Chevron's Opposition, cited *supra*. SFPP's written arguments are set forth in a pleading filed June 29, 1993 entitled "Motion of SFPP, L.P. in Opposition to El Paso Refinery, L.P.'s Amendment of Complaint." Although El Paso Refinery (EPR) was also involved in the relation-back reparations argument, EPR has since withdrawn its complaint against SFPP. 76 FERC ¶ 63,018 (1996).

[851] *Hollingshead Co. v. Director General*, 120 I.C.C. 55, 56 (1926); *Becker Moore & Co. v. New York Cent. R.R.*, 104 I.C.C. 11, 15 (1925); *Virginia-Carolina Chem. Co. v. St. Louis, I.M. & S. Ry.*, 18 I.C.C. 1, 2 (1910); *East St. Louis Walnut Co. v. St. Louis Southwestern Ry. Co. of Texas*, 17 I.C.C. 582, 584 (1910); *South-West R.R. Car Parts Co. v. Missouri Pacific R.R.*, No. 40073, 1988 WL 225131 at ** 2-3, 1988 I.C.C. LEXIS 370 at * 4 (I.C.C., Dec. 1, 1988).

[852] Rule III(a)-(g) and Rule 25. *See* Exhibits A and B in Chevron's Opposition.

[853] 49 C.F.R. Part 1130 (1996).

[854] Rule III(a)-(g). *See* Exhibit A in Chevron's Opposition.

[855] 49 C.F.R. § 1130.2(f); *see* Exhibit A in Chevron's Opposition.

[856] 282 F. Supp. 698 (S.D.N.Y. 1968).

proceeding was closed and reopened several times between 1950 and 1956. After the informal complaint was closed for the last time in 1956, Thomson filed a formal complaint seeking damages for shipments made from 1945 through 1950 and the ICC awarded the shipper damages.[857] Thus, pursuant to a complaint filed in 1956, the ICC took official notice of the informal complaint filed 10 years earlier and awarded the shipper damages for shipments that occurred as long as 11 years before the formal complaint was filed. Without relating back to the filing, the shipper would have been barred from obtaining damages under the ICA.

The ICC thus viewed the ICA as not barring relation-back.

The silence of the ICA on the relation-back issue and the absence of FERC rules governing the relation back of claims makes it appropriate to look at the Federal Rules of Civil Procedure for guidance as the Commission has done in other instances.[858] The Commission's Rules of Procedure were modeled on the Federal Rules and they are "appropriate for guidance by this Commission . . . ."[859]

Federal Rule 15(c) provides in pertinent part:

> An amendment of a pleading relates back to the date of the original pleading when . . . the claim or defense asserted in the amended pleading arose out of the conduct, transaction, or occurrence set forth or attempted to be set forth in the original pleading . . . .

Fed. R. Civ. P. 15(c).

In *Union Pacific Railroad Co. v. Nevada Power Co.*, 950 F.2d 1429, 1432-33 (9th Cir. 1991), in an action arising under a portion of the Interstate Commerce Act, 49 U.S.C. § 10761, the United States Court of Appeals for the Ninth Circuit applied Rule 15(c) in holding that Union Pacific's amended complaint related back to the date of its original complaint:

> Rule 15(c) is to be interpreted literally. *Miles v. Department of Army*, 881 F.2d 777, 782 (9th Cir. 1989). We differentiate between pleadings attempting to amend *claims* from those seeking to amend *parties*. *Martell* 872 F.2d at 324. Amendments seeking to add claims are to be granted more freely than amendments adding parties. *See id.* "When a suit is filed in a federal court under the [Federal Rules of Civil Procedure], the defendant knows that the whole transaction described in it will be fully sifted, by amendment if need be, and that the form of the action or the relief prayed or the law relied on will not be confined to their first statement." *Id.* at 326 (quoting *Barthel v. Stamm*, 145 F.2d 487, 491 (9th Cir. 1944), *cert. denied*, 324 U.S. 878, 65 S.Ct. 1026, 89 L.Ed. 1430 (1945)). Thus, we must determine whether Nevada Power had "fair notice of the transaction, occurrence, or conduct called into question." *Id.* at 327.
>
> Under this standard, Union Pacific's reference to only Tariff 6034 in its original complaint does not foreclose its subsequent request for recovery of reparations made under Tariff 6020.

Union Pacific, 950 F.2d at 1432 (emphasis in original).

Similarly, in *Siegel v. Converters Transportation, Inc.*, 714 F.2d 213, 215-16 (2d Cir. 1983), the United States Court of Appeals for the Second Circuit held that an amended complaint could relate back to the date of the original complaint for purposes of setting the time period for which damages could be awarded under the applicable statute of limitations. The Court stated:

> The text of Rule 15 makes explicit Congress's intent that leave to amend a complaint "shall be freely given when justice so requires." Fed. R. Civ. P. 15(a). The purpose of Rule 15 "is to provide maximum opportunity for each claim to be decided on its merits rather than on procedural technicalities." 6 C. Wright & A. Miller, Federal Practice and Procedure, § 1471, at 359 (1971) . . . . We held over forty years ago that Rule 15(c) was to be liberally construed, particularly where an amendment does not "allege a new cause of action but merely . . . make[s] defective allegations more definite and precise." *Glint Factors, Inc. v. Schnapp*, 126 F.2d 207, 209 (2d Cir. 1942). *See also Foman v. Davis*, 371 U.S. 178, 182, 83 S.Ct. 227, 230, 9 L.Ed.2d 222 (1962).

Siegel, 714 F.2d at 216; *see also Tiller v. Atlantic Coast Line R.R. Co.*, 323 U.S. 574, 580-81 (1945) (holding that an amended complaint could relate back to the date of the original complaint because "[t]here is no reason to apply a statute of limitations when, as here, the respondent has had notice from the beginning that petitioner was trying to enforce a claim against it because of the events [alleged in the

[857] *Id.* at 701-703.

[858] *Northern Natural Gas Co.*, 60 FERC ¶ 63,014 (1992)(Federal rule relied upon in resolving attorney-client privilege claim); *Panhandle Eastern Pipe Line Co.*, 49 FERC ¶ 63,019, at p. 65,073 (1989)(Fed. R. Civ. P. 56 relied upon for determining Judge did not have to issue findings of fact in dismissing proceeding under FERC Rule 217); and *Boston Edison Co.*, 1 FERC ¶ 61,300 (1977) (discovery dispute resolved by reference to Fed. R. Civ. P. 33).

[859] *Revere Petroleum Corp.*, 60 FERC ¶ 63,023, at p. 65,192 (1992).

original complaint]"); *Clipper Express v. Rocky Mountain Motor Tariff Bureau, Inc.*, 690 F.2d 1240, 1259-60 n.29 (9th Cir. 1982) (applying Rule 15(c)'s liberal relation-back doctrine to prevent amended complaint from being barred by statute of limitations), *cert. denied*, 459 U.S. 1227 (1983); *American Telephone and Telegraph Co. v. Delta Communications Corp.* 114 F.R.D. 606, 612-13 (S.D. Miss. 1986); *Zagurski v. American Tobacco Co.*, 44 F.R.D. 440, 442-43 (D. Conn. 1967) ("Once a complaint has been served, the policy behind the statute of limitations has been satisfied so long as the different theories introduced by the amendment fuse together within the 'conduct, transaction, or occurrence' set forth in the complaint.")

There is no prejudice here to SFPP. Chevron's complaint clearly protested FERC Tariff Nos. 15 and 16. Its amendment sought an additional remedy, reparations, because Tariff Nos. 15 and 16 are allegedly unjust and unreasonable. SFPP had ample notice of Chevron's reparations claims, which were made long before Chevron filed its direct evidence and SFPP filed its responsive evidence. Indeed, SFPP was even permitted to have sur-rebuttal. SFPP had ample time to prepare its evidence in opposition to all claims for reparations.

SFPP has made no new arguments in its Initial Brief that I had not considered earlier. I reaffirm my prior ruling that Chevron may seek damages from September 23, 1990.

2. *Refinery Holding Company*

Refinery Holding Company (RHC) seeks reparations prospectively from May 4, 1993. SFPP argues that RHC should be allowed to seek reparations only from September 10, 1993, the date of my order allowing RHC to join in EPR's complaint and seek damages. Some background may be helpful in understanding this particular dispute.

EPR filed a protest or complaint on September 4, 1992, concerning the rates and services of SFPP's Tariff Nos. 15 and 16. On June 18, 1993, EPR's protest, like Chevron's protest, was converted by the Commission into a complaint.[860]

On June 14, 1993, EPR filed a motion in which it sought to amend its complaint "so as to clarify that EPR seeks to obtain damages or reparations from SFPP for violations of the ICA, in addition to prospective relief."[861] RHC, a group of EPR's secured creditors who had succeeded to ownership of El Paso's refinery as a result of EPR's bankruptcy,[862] joined in the same September 4, 1992, pleading of EPR and asked for leave to intervene and leave to join in EPR's complaint as originally filed and as amended.[863] EPR sought to recover damages for the two-year period prior to the September 4, 1992, filing of its complaint and running through May 4, 1993, the date of foreclosure by RHC upon EPR's assets, including the El Paso refinery.[864] RHC sought damages from May 4, 1993, forward.[865]

On June 29, 1993, SFPP filed a motion[866] opposing the request of EPR in the RHC Motion of June 14, 1993, for reparations. SFPP did not oppose RHC's intervention but argued that on the pleadings RHC was not entitled to reparations.[867] As noted earlier, I heard extensive oral argument on July 20 and September 8, 1993, on the relation-back reparations issues.[868] On September 10, 1993, I issued an order which read in part:

> 1. The amendment to the complaint of El Paso Refinery, L.P., filed June 14, 1993, is permitted and may include a request for damages for the period beginning two years prior to September 4, 1992 up to and including May 4, 1993.
>
> 2. Refinery Holding Company is permitted to join in the complaint of El Paso Refinery, seek damages for the period after May 4, 1993, and seek prospective and other relief to which it may be entitled under the remedial provisions of the Interstate Commerce Act.

SFPP has not persuaded me that these rulings were not correct, and I hereby reaffirm them.

3. *Mobil*

Mobil Oil Corporation filed a complaint against SFPP on April 3, 1995. It filed an amended complaint on June 12, 1995.[869] SFPP argues that the date for calculating reparations for Mobil is June 12, 1995. Mobil claims that its amended complaint should relate back to the date of filing its original complaint and that Mobil may seek reparations two years

[860] *SFPP, L. P.*, 63 FERC ¶ 61,275, at p. 62,769.

[861] Motion of Refinery Holding Company, L.P. for Leave to Intervene Out of Time and Clarification of El Paso Refinery, L.P.'s Continuing Interest in This Proceeding and Amendment of Complaint at p. 1 (hereafter "RHC Motion").

[862] *Id.* at pp. 3-4.

[863] *Id.* at p. 2.

[864] *Id.* at pp. 6, 12.

[865] *Id.* at pp. 7, 12.

[866] Motion of SFPP, L.P. in Opposition to El Paso Refinery, L.P.'s Amendment of Complaint.

[867] *Id.* at p. 6. RHC was permitted to intervene by the presiding administrative law judge. Tr. 644.

[868] Tr. 1060-1115, 1149-1219.

[869] The Commission consolidated Mobil's complaint proceeding in Docket No. 95-5-000 with the present case on October 5, 1995. 75 FERC ¶ 61,032.

prior to the filing of its complaint, *i.e.* from April 3, 1993.[870]

In Mobil's initial complaint, Mobil explicitly stated:

> ... SFPP has established and continues to charge rates for transportation and related service on its system pursuant to the FERC Tariffs 15, 16, 17, 18 (and any successors or predecessors to these tariffs, or untariffed as the case may prove to be at hearing) which are in excess of just and reasonable rates and therefore violate Section 1(5) of the ICA.

Complaint of Mobil Oil Corporation Against SFPP, L.P., Docket No. OR95-5-000, at pp. 3-4 (April 3, 1995). Mobil's complaint also sought reparations and refunds. Mobil in addition stated that it was adopting the arguments previously propounded by ARCO and Texaco in Docket Nos. OR92-8-000, *et al. Id.* at 4.

In Mobil's amended complaint, Mobil continued to challenge the same SFPP rates it challenged in its original complaint and which were challenged in ARCO and Texaco's direct testimony. First Amended Original Complaint of Mobil Oil Corporation Against SFPP, L.P., or in the Alternative, Second Original Complaint, Docket No. OR95-5-000, at p. 1 (June 12, 1995). Mobil repeated its request for reparations and refunds.

Under these circumstances and for many of the reasons set forth above in the discussion allowing Chevron to have its amended complaint seeking reparations relate back to the time of the filing of its original complaint, I hold that Mobil's amended complaint relates back to the date of its original complaint. In any event, Mobil's original complaint sought reparations.

I therefore hold that Mobil may seek reparations from SFPP for a period commencing two years prior to the filing of its original complaint, *i.e.* from April 3, 1993.

4. *Navajo*

Navajo filed its complaint against SFPP on December 22, 1993. Navajo seeks East Line reparations for the two-year period preceding the filing of its complaint, December 22, 1991 through December 21, 1993. It also seeks refunds for overcharges paid by it on and after December 22, 1993.[871]

In 1989 Navajo entered into a settlement agreement with SFPP's predecessor. Section 2.3 of the settlement agreement states:

> For the five (5) year period following the effective date of FERC Tariff No. 88—*i.e.*, November 23, 1988—Navajo shall not challenge, by complaint or any other means, East Line rates established or increased in conformity with the terms and conditions of this Article, nor shall they seek reparations or other damages with respect to such rates.[872]

The settlement agreement was approved by the Commission in *Southern Pacific Pipe Lines Partnership, L.P.*, 49 FERC ¶ 61,081 (1989). The settlement order in paragraphs (6) and (10) expressly approved the terms of the 5-year moratorium:

> (6) For 5 years starting November 23, 1988, Navajo will not challenge West Line rates established in conformity with the settlement *nor seek reparations.*
>
> (10) For 5 years starting November 23, 1988, Navajo will not challenge East Line Rates established in conformity with this settlement *nor will Navajo seek reparations.*

49 FERC ¶ 61,081, at p. 61,318 (emphasis added).

Navajo argues that although it could not challenge SFPP's rates within the five year period, once that period ended it could seek reparations with respect to East Line rates. It argues that language in section 1.3 of the settlement agreement had different language with respect to West Line rates than the language pertaining to East Line rates.

While the first part of the West Line moratorium is identical to the terms of the East Line moratorium, the West Line moratorium in section 1.3 has added to it the following underlined language.

> ... nor shall they [Navajo] seek reparations or damages with respect to such rates *for any part of that five (5) year period.*[873]

Navajo argues that

> ... the existence of that language in the West Line rate moratorium provision, and the absence of that broader language in the East Line rate moratorium provision, affirmatively demonstrates that Navajo did not waive its right to go back and seek damages or reparations for rates paid during the five-year period once the moratorium expired.[874]

Navajo's argument is not persuasive. A fair reading of the settlement agreement and the

[870] West Line Shippers Reply Brief at pp. 68-72.

[871] As noted earlier, Navajo was permitted by order of May 21, 1997, to withdraw its complaint against West Line rates of SFPP.

[872] Ex. 859 at p. 5.

[873] Ex. 859 at p. 3 (emphasis added).

[874] Navajo Initial Brief at pp. 139-140.

Commission's order approving it precludes claims for reparation by Navajo for rates charged during the period when the settlement was in effect.

SFPP lived up to the terms of its agreement, holding its rates to the levels specified in the agreement, and Navajo must do likewise.[875]

It is held that Navajo may seek reparations on or after December 22, 1993, and not before December 22, 1993.

XVII. MISCELLANEOUS MATTERS

A. Navajo's Motion for Summary Disposition on Market Power Defenses

On September 1, 1994, Navajo filed a motion for summary disposition. The motion sought a ruling that SFPP has the ability to exercise market power in the market for long-distance transportation of refined petroleum products into Phoenix and Tucson, Arizona. At a prehearing conference on October 6, 1994, I declined to rule on the motion because I thought it premature.[876]

On October 9, 1996, after all participants had presented their evidence and cross-examined witnesses and after initial briefs had been filed, Navajo filed a pleading renewing its motion.

Navajo's renewal motion should be denied because the only issue it properly raises—whether SFPP could defend the rates at issue in this proceeding on the basis of a lack of market power—is moot in light of the defenses that SFPP actually raised in its responsive testimony and at hearing. To the extent Navajo's renewal motion seeks a ruling for all time that SFPP has a "monopoly" in serving the Arizona markets, it is beyond the scope of this proceeding and must be denied.

Navajo's renewal motion seeks an unnecessary ruling on an issue that never was joined in this case. That issue is whether SFPP could have shown that it lacked market power in certain of its South System interstate markets and thus qualified for light-handed regulation of its rates in those markets as in *Buckeye Pipe Line Co., L.P.* [877] SFPP never presented a market power defense under *Buckeye* or a request for light-handed regulation of any of the rates at issue.

SFPP included market-related evidence in its responsive case because that evidence was relevant to some issues raised by complainants and Staff, *e.g.*, whether SFPP should be regulated on a South System basis and whether its rate of return should be raised because of business risks.

Granting Navajo's motion at the end of a proceeding that did not involve a *Buckeye* defense could have the pernicious effect of precluding SFPP from pursuing all defenses available to it under the Commission's rules and regulations in the event a protest or complaint against SFPP's rates were to be filed at some future date.[878]

If SFPP were to file rates in the future, those rates were challenged, and SFPP were to defend such rates under *Buckeye*, that defense would have to be evaluated based on market conditions at the time.

For the foregoing reasons, the motion and renewal motion of Navajo Refining Company, for summary disposition on the issue of whether SFPP has the ability to exercise market power for long-distance transportation of refined petroleum products into Phoenix and Tucson Arizona, is denied.

B. Motion of SFPP to Strike Extra-Record Material from Reply Brief of Refinery Holding Company

SFPP, on January 9, 1997, moved to strike Appendix A to the Reply Brief of Refinery Holding Company, L.P. ("RHC"), filed in this proceeding on December 6, 1996, together with one passage from the text of that brief: specifically, the language in the last three lines of text on page 8 of RHC's reply brief, beginning with the words "SFPP has now confirmed" and ending with the parenthetical citation to Ex. 577. The referenced material incorporates and describes certain data that is not part of the record in this proceeding and that therefore may not be relied upon in post-hearing briefs.

The record in this proceeding was closed on July 19, 1996, following 55 days of hearing. The record includes more than 950 exhibits,

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[875] *See Jupiter Corp. & Tennessee Gas Pipeline Co.*, 47 FERC ¶ 61,243, at pp. 61,846-47 (1989); *see also Schneider v. Kelm*, 137 F. Supp. 871, 875-76 (D. Minn. 1956), *aff'd*, 237 F.2d 721 (8th Cir. 1956).

[876] Tr. 2088.

[877] Opinion No. 360, 53 FERC ¶ 61,473 (1990), *reh'g granted in part*, Opinion No. 360-A, 55 FERC ¶ 61,084 (1991).

[878] The market power issue on which Navajo seeks a ruling was not included in the agreed-upon summary issues list for this proceeding. *See* Tr. 3592 (ii-v). Moreover the hearing itself arguably mooted the availability of summary disposition under the Commission's rules and regulations. *See* 18 C.F.R. § 385.217(a)(2)(1996)(summary disposition available in any proceeding or part of a proceeding that is "set for hearing"); *Union Electric Co.*, 50 FERC ¶ 63,010, at p. 65,038 (1990)(hearing itself "rendered moot" a participant's motion for summary disposition).

several of which contain throughput information regarding SFPP's South System for the years 1992 through the first three months of 1996. Exhibit 735, which includes volume information through the month of March 1996, represents the most recent throughput information in the record for SFPP's East and West Lines. The record does not contain any information regarding SFPP's South System throughput on a monthly or average daily basis beyond that date.

By including and referring to throughput information through October 1996, Appendix A and the last three lines on page 8 of RHC's reply brief include data that goes beyond the evidence and thus exceeds the scope of material properly included in post-hearing briefs. Such extra-record material is neither probative nor reliable, because no foundation has been laid for its admission, *see, e.g., J.W. Akin*, 57 FERC ¶ 63,004, at p. 65,028 (1991), and because SFPP has had no opportunity to place the data in its proper context. The Commission's obligation to decide this case solely on the basis of the evidence in the record requires that the documents attached as Exhibit A to RHC's reply brief and the above-mentioned discussion specified in the last three lines on page 8 of that brief be stricken. "[I]t is improper for a participant to discuss in its brief documents that are not in evidence." *Id.*

The prejudice to SFPP if the offending extra-record documents and all references to them are not stricken from the record is clear. SFPP had no opportunity to respond substantively to RHC's reply brief, or to provide other information that may be relevant to the context and significance of the new data. It would therefore be unfair to permit the extra-record material to remain part of the record on which the presiding judge and the Commission will decide this case.

It is therefore ordered that Appendix A to RHC's reply brief and the above-mentioned last three lines on page 8 of that reply brief are stricken.

CONCLUSION

1. SFPP, L.P. should be required to file revised rate schedules and tariffs in accordance with the findings and rulings of this initial decision. Such rates are found to be just and reasonable.

2. The rates of SFPP presently in effect are found to be unjust and unreasonable, except for those West Line rates which are deemed to be just and reasonable under section 1803 of the EPAct, 42 U.S.C. § 7172 note § 1803.

3. SFPP, L.P. should be required to make reparations in accordance with the findings and rulings of this initial decision. As stated in the ordering paragraph below, the Commission will first have to determine just and reasonable rates for SFPP before SFPP will be required to calculate and make reparations.[879]

ORDER

WHEREFORE, IT IS ORDERED, subject to review by the Commission on appeal or on its own motion as provided in the Commission's Rules of Practice and Procedure, that within sixty (60) days after the effective date of this initial decision SFPP, L.P. shall file revised rate schedules and tariffs in accordance with the findings and rulings in this initial decision.

IT IS FURTHER ORDERED that within thirty (30) days after the Commission accepts SFPP's compliance filing, or alternatively determines just and reasonable rates for SFPP, L.P., a reparations report shall be filed by SFPP, L.P. with the Commission showing for each relevant year the amounts of reparations to be paid and to whom such reparations are to be paid.

IT IS FURTHER ORDERED that within thirty (30) days after the Commission accepts SFPP's reparations report, or alternatively determines the amounts of reparations to be paid, SFPP, L.P. shall pay such reparations.

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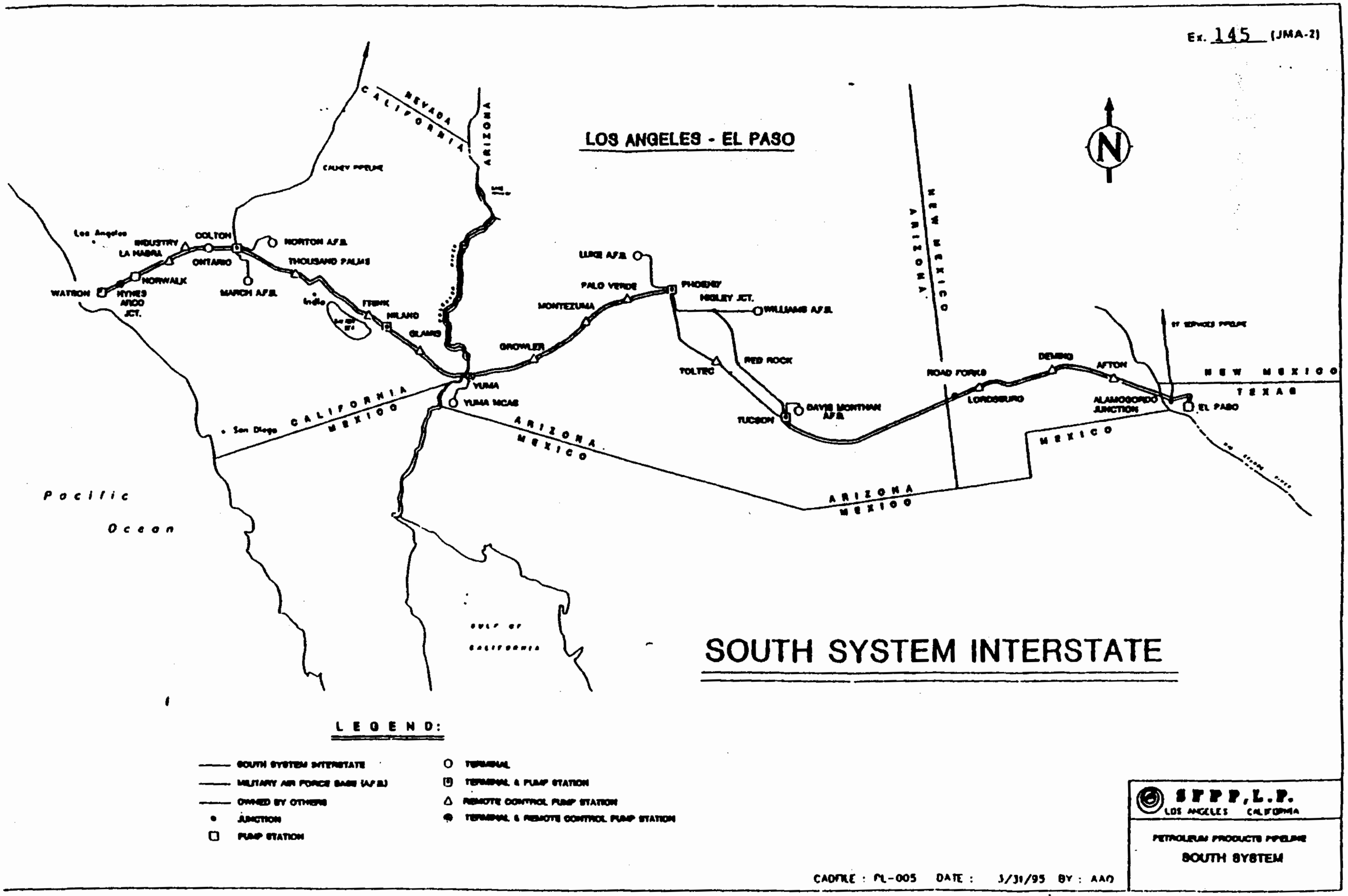
[879] *See Texaco Refining and Marketing, Inc. v. SFPP, et al.*, 80 FERC ¶ 61,200, *mimeo.* at p. 13 (August 5, 1997).


Ex. 145 (JMA-2)
LOS ANGELES - EL PASO
N
NEVADA
CALIFORNIA
ARIZONA
NEW MEXICO
ARIZONA
Los Angeles
INDUSTRY
COLTON
LA HABRA
ONTARIO
NORWALK
WATSON
HYNES
ARCO JCT.
NORTON A.F.B.
THOUSAND PALMS
MARCH A.F.B.
Indio
FRINK
NILAND
GLAMIS
LUKE A.F.B.
PALO VERDE
PHOENIX
HIGLEY JCT.
WILLIAMS A.F.B.
MONTEZUMA
GROWLER
YUMA
YUMA MCAS
TOLTEC
RED ROCK
TUCSON
DAVIS MONTHAN A.F.B.
ROAD FORKS
LORDSBURG
DEMING
AFTON
ALAMOGORDO JUNCTION
EL PASO
NEW MEXICO
TEXAS
MEXICO
San Diego
CALIFORNIA
MEXICO
ARIZONA
MEXICO
ARIZONA
MEXICO
Pacific
Ocean
GULF OF CALIFORNIA
SOUTH SYSTEM INTERSTATE
LEGEND:
SOUTH SYSTEM INTERSTATE
MILITARY AIR FORCE BASE (A.F.B.)
OWNED BY OTHERS
JUNCTION
PUMP STATION
TERMINAL
TERMINAL & PUMP STATION
REMOTE CONTROL PUMP STATION
TERMINAL & REMOTE CONTROL PUMP STATION
SFPP, L.P.
LOS ANGELES CALIFORNIA
PETROLEUM PRODUCTS PIPELINE
SOUTH SYSTEM
CADFILE : PL-005 DATE : 3/31/95 BY : AAO

APPENDIX