

*Texaco Refining and Marketing, Inc.*

v.

*SFPP, L.P.*

**ORDER ON INITIAL DECISION**

**117 FERC ¶ 61,285 (2006)**

In this order, the Commission reviewed, among other things, the determination in the Initial Decision of the just and reasonable income tax allowance to include in rates for interstate shipments over SFPP, L.P.'s Sepulveda Line. The Commission clarified that under its *Policy Statement on Income Tax Allowances*, the appropriate federal income tax rate to use for the various categories of partner-taxpayers to determine a weighted income tax allowance was the marginal tax rate rather than the effective tax rate. Further, notwithstanding the Commission's stand-alone doctrine, in ascertaining the applicable marginal tax rate at the partner-taxpayer level, as opposed to the partnership level, the Commission must look at a partner's total taxable income and not simply the amount of that partner's regulated income. Finally, the Commission presumes that for each of the categories of partner-taxpayers the maximum marginal tax bracket rate applies so that, in the case of a Subchapter C corporation which is a partner-taxpayer the marginal tax rate is presumed to be 35% and for an individual partner-taxpayer it is presumed to be 28%.

117 FERC ¶ 61, 285  
UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;  
Sudeen G. Kelly, Marc Spitzer,  
Philip D. Moeller, and Jon Wellinghoff.

Texaco Refining and Marketing, Inc.

Docket No. OR96-2-012

v.

SFPP, L.P.

ARCO Products Company  
Mobil Oil Corporation

Docket No. OR96-10-008

v.

SFPP, L.P.

Ultramar Inc.

Docket No. OR96-17-005

v.

SFPP, L.P.

SFPP, L.P.

Docket No. IS98-1-000

ORDER ON INITIAL DECISION

(Issued December 8, 2006)

1. This order reviews an initial decision (ID) dated August 24, 2005 concluding that SFPP, L.P.'s (SFPP) charges and rates for interstate shipments over its Sepulveda Line are not just and reasonable and have not been so since the filing of a complaint in December 1995.<sup>1</sup> The Commission affirms this conclusion, but disagrees with the Administrative Law Judge's (ALJ) rulings on some aspects of the equity cost-of-capital,

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<sup>1</sup> *Texaco Refining and Marketing Inc. v. SFPP, L.P.*, 112 FERC ¶ 63,020 (2005) (ID).

income tax allowances, and the recovery of SFPP's litigation costs. The ALJ's other rulings are affirmed, as clarified by this order. This order directs SFPP to submit a compliance filing and to file revised Sepulveda rates for 1995 and 1996. The compliance filing shall include estimated reparations and refunds consistent with the tariff filing.

## **I. Background**

2. SFPP's Sepulveda Line is a 3.8 mile line between Sepulveda Junction and Watson Station, an origin point on SFPP's West Line located in Los Angeles, California. The line was constructed in 1982 pursuant to contracts with two of SFPP's shippers, with a third shipper also contracting for the use of the line in 1983. The first two contracts provided for a minimum annual revenue guarantee of \$860,000 for a term of 10 years. These two contracts provided that within that term SFPP would recover all the costs of the line plus a discounted return of fifteen percent on those costs. The contracts included a rate of fifteen cents per barrel. However, once the guaranteed revenue was achieved, any additional revenue obtained during a given calendar year would be credited back to the shippers on a pro rata basis. Since volumes were consistently high during the ten year term of these initial contracts, the annual credits had the effect of reducing the per barrel cost in any given year, and as events proved, over the 10 year life of the contracts. The third contract had similar terms except that it did not include the minimum revenue level. All the initial contracts had expired by June 1993.

3. As the initial contracts expired, SFPP and its shippers negotiated new contract terms for transportation service over the Sepulveda Line. These terms provided for an annual term and five cents per barrel contract rate. There was no minimum annual revenue guarantee, no refund at the end of each calendar year and the contracts were renewable at the end of each year. As noted, since the terms of the initial contracts expired in mid-1993, by the end of that year all of the initial contract terms had expired and the three shippers using the Sepulveda Line were operating under the annual contractual arrangement.<sup>2</sup> On December 1, 1995 Texaco Refining and Marketing, Inc. (TRMI), and on January 25, 1996, ARCO Products Company (ARCO), filed complaints against SFPP asserting that it was providing jurisdictional services over the Sepulveda Line without filing a tariff with the Commission, thus violating a common carrier oil pipeline's obligation to have tariff on file for all shipments in interstate commerce. The

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<sup>2</sup> *Id.* The shippers under the initial contracts were Texaco Refining and Marketing, Inc. (TRMI), Champlain Petroleum Co., predecessor to Ultramar Inc., and GATX Tank Storage Terminals Corp (GATX). *See* Sepulveda ID at P 8.

complaints also alleged that the five cents per barrel contract charge was unjust and unreasonable. Ultramar filed a third complaint in August 1996.<sup>3</sup>

4. The Commission accepted the complaints and referred the jurisdictional matter to hearing. In March 1997, the presiding ALJ concluded that the shipments were not jurisdictional and dismissed the complaints.<sup>4</sup> The Commission reversed this conclusion in May 1997 and required SFPP to file a common carrier rate for transporting interstate shipments over the Sepulveda Line.<sup>5</sup> In October 1997, SFPP filed five cents per barrel rate, the same level as included in the second series of contracts. The Commission accepted and suspended the rate and set it for hearing.<sup>6</sup> In response to SFPP's request to use market-based rates for shipments over the Sepulveda Line, in September 1998 the Commission concluded that SFPP had no market power for deliveries to the destination point (Watson Station), but set the issue of market power at the origin point (Sepulveda Junction) for hearing.<sup>7</sup> The presiding ALJ concluded that SFPP had market power at the origin point,<sup>8</sup> which the Commission affirmed.<sup>9</sup>

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<sup>3</sup> *Texaco Refining and Marketing, Inc. v. SFPP, L.P., et al.*, 80 FERC ¶ 61,200 (1997) at 61,803, *reh'g denied*, 81 FERC ¶ 61,388 (1997); *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 78 FERC ¶ 63,017 (1997) at 65,187-88. Tosco Corporation (Tosco) and Chevron U.S.A Products Company (Chevron) intervened but did not file complaints. *See* 75 FERC ¶ 61,292 (1996) at 61,939. The third complainant was Ultramar Inc. *See* 78 FERC at 65,187. Of the complainants, only TRMI and Ultramar shipped under the one year 5 cent per barrel contracts. GATX shipped under such contracts, but was not a complainant. ARCO complained but was not a shipper.

<sup>4</sup> *SFPP, L.P.*, 78 FERC 63,017 (1997).

<sup>5</sup> *Texaco Refining and Marketing, Inc. et al. v. SFPP, L.P.*, 80 FERC ¶ 61,200 at 61,804-08 (the Jurisdictional order).

<sup>6</sup> *SFPP, L.P.*, 81 FERC ¶ 61,177 (1997). The intervening and protesting parties were ARCO, TRMI, Tosco, Ultramar, and Chevron. *Id.* at 61,767.

<sup>7</sup> *SFPP, L.P.*, 84 FERC ¶ 61,338 (1998).

<sup>8</sup> *SFPP, L.P.*, 93 FERC ¶ 63,023 (2000).

<sup>9</sup> *SFPP, L.P.*, 102 FERC ¶ 61,240 (2003) (the Market Power order).

5. The issue of reasonableness proceeded to hearing upon completion of two initial decisions in Phases I and II of Docket No. OR96-2-000 regarding SFPP's West Line rates, among others. The ALJ issued his decision in Phase I in June, 2003,<sup>10</sup> and held that SFPP's West, North, and Oregon Line rates were no longer grandfathered under section 1803 of the EP Act of 1992. The ALJ issued his decision in Phase II in September 2004, holding that SFPP's East and West Line rates were unjust and unreasonable.<sup>11</sup> These dates are a matter of some importance because much of the cost-of-service evidence the ALJ relied on in Phase II of Docket No. OR96-2-000, *et al.* was also used as a foundation for the instant proceeding addressing the reasonableness of the Sepulveda Line rates. The two cases are therefore closely linked and are derived from the same series of complaints. In July 2004, the Court of Appeals for the D.C. Circuit remanded the Commission's traditional basis for determining the amount of an income tax allowance to be afforded a jurisdiction partnership such as SFPP.<sup>12</sup> In January 2005, in *HIOS* the Commission excluded the use of the master limited partnerships (MLPs) as part of the proxy group used to determine a jurisdictional partnership's equity cost of capital unless distributions by the MLP has the same characteristics as a corporate dividend.<sup>13</sup>

6. Thus, when the reasonableness of the Sepulveda Line rate proceeding went to hearing in late 2004 and early 2005, there was some uncertainty regarding the calculation of an income tax allowance for a jurisdictional MLP, if any, and the proper method for determining its equity cost of capital. Moreover, the August 2005 initial decision regarding the Sepulveda Line was issued after the Commission adopted its *Policy*

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<sup>10</sup> *Texaco Refining and Marketing, Inc. and Equilon Enterprises, LLC v. SFPP, L.P.*, 103 FERC ¶ 63,055 (2003) (Phase I ID). This conclusion was reversed as to the North and Oregon Line rates in March 2004. See *ARCO Products Co. a Division of Atlantic Richfield Company, Texaco Refining and Marketing Inc., and Mobil Oil Corporation v. SFPP*, 106 FERC ¶ 61,300 (2004) (March 2004 order).

<sup>11</sup> *Texaco Refining and Marketing, Inc. and Equilon Enterprises, LLC v. SFPP, L.P.*, 108 FERC ¶ 63,036 (2004) (Phase II ID). These determinations were reviewed in the Commission's December 16, 2005 order. See *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005) (December 2005 order).

<sup>12</sup> *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) (*BP West Coast*).

<sup>13</sup> *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61, 043 (2005), *orders on reh'g*, 112 FERC ¶ 61,050 (2005) and 113 FERC ¶ 61,280 (2005) (*HIOS*).

*Statement On Income Tax Allowances* on May 4, 2005<sup>14</sup> and the June 1, 2005 order addressing portions of the September 2004 Phase II initial decision.<sup>15</sup> The latter addressed in the income tax allowance in the same terms as the Policy Statement, but the Commission provided no specific guidance on how any income tax allowance determinations should be made until its December 16, 2005 order.<sup>16</sup> The Commission's principal order on rehearing in *HIOS* issued July 7, 2005,<sup>17</sup> or shortly before the August 2005 ID at issue here and materially influenced the ALJ's deliberations.

7. Thus, when briefs on and opposing exceptions were filed in October and November 2005, the status of the law had materially changed since the instant case first went to hearing in late 2004 but was unsettled in several regards. This changing framework accounts in part of the evolution in the parties' arguments that occurred in this proceeding and some of the limitations in the record of the Sepulveda Line proceeding. Moreover, the Commission's December 2005 order provided the first detailed instructions on the implementation of the Commission's *Policy Statement*, as well as rulings on a number of cost-of-service issues involving the carrier's East and West Line rates. The December 2005 order also instructed SFPP to file a compliance filing that conformed to those rulings by March 7, 2006. SFPP submitted the compliance filing and comments were filed on April 21, 2006 and reply comments on May 1, 2006 by SFPP. The shipper party comments filed on April 21 incorporated and expanded on many of the themes developed by the ALJ in the Sepulveda ID issued in August 2005.

8. Given this, it is clear that the instant Sepulveda Line proceeding has been overtaken by the more extensive and more recent litigation involving the East and West Line rates in Docket Nos. OR92-8-000 *et al.* and Docket No. OR96-2-000, *et al.* As noted, in this order the Commission requires SFPP to file new rates for its Sepulveda

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<sup>14</sup> 111 FERC ¶ 61,139 (2005) (*Policy Statement*).

<sup>15</sup> *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) (June 2005 order).

<sup>16</sup> *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005), *order on reh'g*, 114 FERC ¶ 61,136 (2006). The December 2005 order required SFPP to make a compliance filing regarding a number of issues no later than March 7, 2006, and to establish new interim rates for its East and West Lines, effective May 1, 2006 (after certain extensions of time by the Commission regarding the compliance filing.) SFPP made the required compliance filing on March 7 and parties filed comments. Thus, the compliance filing became another vehicle for arguments on the income tax allowance and *HIOS* issues.

<sup>17</sup> *HIOS*, 112 FERC ¶ 61,050.

Line and to make a compliance filing supporting those rates. As is normally the case, the Commission applies current law and policy in making its determination based on the factual information in the record of the proceeding before it. Fortunately, the current record permits SFPP to make the required compliance filing. Moreover, the analysis is informed by some of the arguments made here and by the parties in their comments on SFPP's March 7, 2006 compliance filing involving SFPP's East and West Line rates. It makes no sense for SFPP to submit a compliance filing that does not reflect the Commission's most recent thinking on the income tax allowance and *HIOS* issues the ALJ specifically addressed in August 2005. This order therefore addresses the most recent arguments known to the Commission from public sources.

## II. Discussion

### A. Procedural Framework.

9. The ID addressed two separate proceedings that have a number of common issues. One is the complaint proceedings stemming from the complaints filed in December 1995 and January 1996 (the Complaint proceeding).<sup>18</sup> The second proceeding involves SFPP's October 1997 rate filing at the direction of the Commission (the Rate Filing proceeding).<sup>19</sup> Because there are two different types of proceedings, the parties and the ID adopted two separate test years. The test year for the Complaint proceeding is 1995 and the test year for the Rate Filing proceeding is 1996. The ID contains separate analyses for both years. This order reviews each of those common issues in a single discussion since the fundamental conclusions are the same with regard to both years, although the specific cost factors are, of course, different. The issues on exceptions fall into six general categories: (1) rate base; (2) cost of equity and allowed return; (3) income tax allowance; (4) other cost-of-service issues; (5) reparations and refunds, and (6) conclusions.

10. A threshold issue involves the burden of proof in the Complaint proceedings. SFPP asserts on exceptions that the ALJ improperly assigned the burden proof in the Complaint proceedings. It argues that complainants have the ultimate burden of proof in complaint proceedings and the ALJ effectively allocated the burden of proof to SFPP. What the ALJ held is that the complainants advanced sufficient information regarding the 1995 test year to sustain their burden on a number of issues, including the rate base to be used, income tax allowances, volumes, and certain of the lesser cost-of-service issues.

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<sup>18</sup> Docket Nos. OR96-2-012, OR96-10-008, and OR96-17-005.

<sup>19</sup> Docket No. IS98-1-000.

The ALJ then held that SFPP failed to provide any information that effectively addressed, much less rebutted, the case advanced by the complainants. Thus, the complainants met their burden of proving that the rates against which they had complained were unjust and unreasonable. On exceptions, the Shipper parties (the complainants) and Commission staff support the ALJ.

11. The Commission affirms the ALJ on two grounds. First, the record fully supports the conclusion that SFPP did not effectively respond to the arguments and data presented by the complainants regarding the 1995 test year. The ALJ correctly held that the initial case presented by the complainants, and their response to SFPP's attempted rebuttal, was more than adequate to sustain their case and provide the substantial evidence required to sustain a ruling in their favor. Second, this case is a fairly unique posture. Well before this case went to hearing the Commission held that SFPP had not complied with its statutory obligation to file at tariff for the interstate portion of its Sepulveda Line service. Through its failure to file an obligatory tariff, SFPP deprived its shippers of the opportunity to protest the statutory filing and to require SFPP to establish the reasonableness of the rate. While SFPP asserts that the Sepulveda Line shippers agreed to the 1993 five cents per barrel contract rate, this argument is irrelevant given its obligation to file a rate for all jurisdictional service. It says nothing about whether the shippers were aware that a jurisdictional service was involved, and as such, whether they believed they had no remedy even though they viewed the rate as unreasonable. Given that the five cents per barrel contract charge SFPP adopted in 1993 should have been filed with the Commission, the Commission concludes as part of the remedy for its failure to file the tariff SFPP must bear the burden on the issue of reasonableness in the Complaint proceedings as well. The ID is affirmed on both grounds.

### **B. Rate Base**

12. The central issue in this proceeding is the whether the investment made by SFPP in 1983 was fully amortized over the term of the contracts that expired in 1993. This issue applies to both the 1995 Complaint Proceeding and the 1997 Rate Filing proceeding. The presiding ALJ concluded that those ten year contracts expressly contemplated the recovery of all the costs to construct and operate the Sepulveda Line plus a discounted rate of return of fifteen percent. The return was stated in the relevant contracts as "15% Discounted Rate of Return." The ALJ concluded that this phrase meant that cash flows would (1) recover all operating expenses during the term of contract, (2) equal or exceed all of the original 1983 capital investment, and (3) require calculation on a present value basis to 1983 at a fifteen percent discount. The ALJ also noted that the 1983-1993 contracts contained a clause permitting SFPP to increase the per barrel charge if necessary to achieve its expectations under the contract. After reviewing analyses of estimated cash flows prepared by Mr. O'Loughlin on behalf of several complainants, the ALJ concluded that SFPP had in fact recovered the cash flows due under the contract, that SFPP had entered no evidence that would suggest the contrary,



and that SFPP had never exercised its rights to increase the charges under 1983-1993 contracts to assure that it did so.<sup>20</sup> The ALJ also concluded that SFPP should not include a deferred equity component in the Sepulveda Line rate base as that investment and its recovery were not based on the Commission's Opinion No. 154-B methodology and that SFPP must remove its 1988 purchase accounting adjustment (PAA) from its rate base.<sup>21</sup>

13. On exceptions, SFPP argues the ALJ's interpretation of the 1983-1993 contracts did not properly apply the concept of a discounted rate of return when concluding that SFPP had recouped its initial investment in the Sepulveda Line, arguing that the contracts did not contemplate the recovery of the initial investment costs as part of the cash flow to be included in the discount calculation. Its second argument asserts that Mr. O'Loughlin used arbitrary and inaccurate estimates of expenses to determine whether the cash flows generated during the 10 year term of the 1983-1993 contracts were sufficient to cover all the operating expenses of the Sepulveda Line during that term, amortize the capital investment, and provide the contemplated return. SFPP's third assertion is that the recovery of the Sepulveda Line investment should be governed by the Commission's accounting regulations for oil pipelines, specifically the Commission's Opinion No. 14-B methodology. It argues that failure to use that methodology is inconsistent with the filed rate doctrine and constitutes retroactive rate making. Finally, it asserts that the ALJ erred in excluding a deferred equity component from the Sepulveda Line rate base and that its 1988 purchase accounting adjustment (PAA) should remain in the rate base. The Shipper parties and the Staff support the ALJ's conclusions.

14. The Commission concludes that SFPP's arguments are without merit. Its first argument that the 1983-1993 contracts did not contemplate the recovery of all of its initial Sepulveda Line investment the term of those contracts flies in the face of the plain language of the contracts and commercial common sense. The basic concept of a discounted cash flow return was correctly stated by both the ALJ and the Shipper parties' witness Matthew P. O'Loughlin.<sup>22</sup> That concept is that all cash flows committed to a

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<sup>20</sup> ID at PP 24-26.

<sup>21</sup> A purchase accounting adjustment is made when the purchase price of the assets includes a premium over the book value of the purchased assets. This practice is consistent with generally accepted accounting practices but is limited for regulatory purposes to situations where the premium reflects benefits to the ratepayers.

<sup>22</sup> Prepared Rebuttal Testimony of Mathew P. O'Loughlin (O'Loughlin Rebuttal), Ex. No. 32 at 3-14. The Commission finds the discussion at these pages particularly credible on the interpretation of the language and purpose of 1983-1993 contracts, and thus on the issue of whether the original 1983 Sepulveda rate base has been amortized.

project or investment over a stated investment time frame, including both capital and operating costs, will be recovered plus sufficient additional cash flow to recover a discounted fifteen percent rate of return. This is done by discounting all the net cash flows generated by the project or investment back to the date of the project start at fifteen percent and determining if the resulting number exceeds zero. If so, the fifteen percent discounted return has been obtained. The only reason to adopt this approach is if the parties contemplated that SFPP would recover its investment in a time frame that was less than the useful life of the assets of approximately 38 to 40 years, and that the return would be tied to the shorter 10 year term of the initial contracts. Otherwise the contracts would have been based on a charge that embedded a much lower annual depreciation rate and an annual return more consistent with the historical approach contained in the Commission's accounting procedures. The fact that in 1983 the contracts were based on an investment approach using discounted cash flows rather than the traditional historical cost accounting approach suggests one reason why the charges at issue were not filed with the Commission.

15. The clear purpose of these contracts was to mitigate SFPP's risk in constructing the Sepulveda Line. The Commission's orders addressing market power issues disclosed that there is a fairly extensive network of oil company (shipper) pipelines in the area. In fact, after the 1983-1993 contracts expired, over time shippers began to develop competitive alternatives, and volume tendered to SFPP from the initial parties, TRMI and Ultramar, began to decline in 1996.<sup>23</sup> Given this environment, SFPP did what any rational business would do, namely, before making a large investment on behalf of two specific customers, it entered into a long term contracts to recover that investment over the term of the contracts. By doing so, it assured that the customers would not shift their volumes to another facility and leave SFPP's Sepulveda Line with unused or under-utilized capacity. In essence, the original 1983 to 1993 contracts were cost-plus contracts that provided a discreet service and insulated SFPP from the risk of under-recovery of its investment, operating, and equity costs. While SFPP argues that no company would enter into a contract at an equity rate that was only 1 percent more than prevailing returns at the time, this return reflected the fact that there was virtually no risk because the cash flows, and the investment return, had been guaranteed through the minimum revenue requirements of the contracts.

16. The Commission therefore affirms the ALJ's conclusion that the initial 1983-1993 contracts contemplated recovery of the initial Sepulveda Line investment based on the

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<sup>23</sup> See 93 FERC at 65,127. As SFPP itself note, the interstate volumes dropped below 9.2 million barrels by 1999. SFPP Reply Brief on Exceptions at 5-6.

plain language of those contracts. It also affirms his second conclusion that SFPP failed to make the required showing that the cash flow estimates developed by the Shipper parties are inadequate. While SFPP attacks the cash flow analyses as speculative, it provided no numbers of its own and Witness O'Loughlin's analysis is the best of record. In any event, the construction cost of the line was approximately \$2.3 million and cash flows over 10 years were at least \$8.6 million. The shippers paid all the pumping costs, which meant that SFPP's costs for the first ten years were essentially maintenance, local taxes, and administrative overhead. As Witness O'Loughlin demonstrates, it is most unlikely that these costs could have equaled anywhere near \$8.6 million.<sup>24</sup> Thus, a spread between the investment cost of \$2.3 million and \$8.6 million could have had no other logical purpose than to recover the investment and to provide the contractual discounted return. SFPP had contractual power to assure that the cash flows did so and did not exercise that power. The Commission therefore concludes that SFPP was satisfied that it had recovered all the costs of constructing the Sepulveda Line and the stated fifteen percent discounted cash flow return. Thus, the only rate base relevant to this proceeding consists of capital additions made after the 1983-1993 contracts expired plus a small amount for a 1995 and 1996 working capital allowance.

17. SFPP's third line of argument asserts that the ALJ's conclusions are inconsistent with the Commission's regulatory accounting procedures and, as such, with the filed rate doctrine and the prohibition against retroactive rate making. It asserts that since the 1983-1993 contract charge appears to have been a jurisdictional charge at all times, that the depreciation, operating, and capital costs should be calculated using the Commission's Opinion No. 154-B methodology. Thus, depreciation would be calculated over some 40 years and a deferred equity return should be included in the rate base. It also asserts that the ALJ's ruling violates the Commission's holding in Opinion No. 435 that an unfiled contract can be enforced according to its terms under the filed rate doctrine and that the ALJ ignored this ruling. The Shipper parties and the Commission staff support the ALJ's conclusion that neither the Opinion No. 154-B methodology nor the filed rate doctrine is relevant here.

18. As the ALJ concluded, this third line of argument is without merit. SFPP never filed a rate for the initial 1983-1993 contracts, never submitted it for review under the Commission's cost-of-service procedures, and never justified the return and depreciation periods embedded in the rate under those procedures. Thus, even though the 1983-1993 contracts involved what the Commission ultimately determined was a jurisdictional service, that does not mean that those contracts were designed or administered based on jurisdictional regulatory procedures. The record establishes that the contracts intended

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<sup>24</sup> See footnote 22, *supra*.

SFPP to recover all of the costs involved with those contracts (including the equity return) and that the initial terms of the contracts expired well before the instant litigation began. To allow SFPP to carry the 1983 construction cost forward under the Opinion No. 154-B methodology would result in an over-recovery of that investment and would be inconsistent with the depreciation method SFPP actually used in the 1983-1993 contracts.<sup>25</sup>

19. The Commission further affirms the conclusion of the ALJ that the filed rate doctrine is not relevant here because SFPP never filed the initial Sepulveda Line charges with the Commission and because the court held that Commission's prior arguments that the filed rate doctrine would apply to charges or rates for unfiled contracts were not persuasive.<sup>26</sup> In any event, the Supreme Court unequivocally held that all rates or charges subject to the ICA must be filed with the appropriate regulatory agency to be valid even if the charges were included in a contract.<sup>27</sup> This clear mandate overrides any contrary reasoning in the Opinion No. 435 orders regarding the filed rate doctrine. Moreover, as in Opinion No. 435-B, here the Commission designs rates based on the reality that resulted from past activity and conditions, not making a ruling that modifies a rate retrospectively in an attempt to deprive the carrier of an opportunity to recover its costs.<sup>28</sup> As such, the ruling here does not violate the ban against retroactive rate making. Finally, given the prior ruling that the Opinion 154-B methodology is not relevant there is also no merit in SFPP's position that the Commission should include a deferred equity component in the Sepulveda Line rate base. The deferred equity component is relevant only to rates or charges designed under that methodology. Similarly, the 1988 PAA is not relevant to the instant rate base issues because increase in the initial 1983-1993 Sepulveda Line rate base that may have resulted from the 1988 PAA was completely amortized by 1993 based on the rulings here. Its relevance, if any, is to the capital structure is discussed below. The ruling here applies to the rate base for both the Complaint Proceeding 1995 test year and Rate Proceeding 1996 test year.

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<sup>25</sup> *Cf. BP West Coast* at 1284-85.

<sup>26</sup> *Id.* at 1274.

<sup>27</sup> See *Maislin Industries, U.S., Inc. et al. v. Primary Steel, Inc.*, 497 U.S.116 (1990) (*Maislin*).

<sup>28</sup> *Cf. BP West Coast* at 1274.

### **C. Cost of Equity and Allowed Return.**

20. On exceptions there are three issues involving SFPP's equity cost-of-capital and its allowed return that apply to both the test years 1995 and 1996. Two of these are based on the fact that SFPP was a master limited partnership in 1995 and 1996.<sup>29</sup> The first is the use of master limited partnerships (MLPs) in the equity proxy group. The second is the role of the 1988 PAA, if any, in determining the equity component of the capital structure, which establishes the base to which the equity rate of return applies. The third is whether a MLP should be accorded an equity return that is to be set at the median return of the proxy group or at the lower end of the reasonable range of equity returns at issue.

21. By way of background, the Commission's historical method for determining the equity cost of capital for oil pipelines is similar to that used to determine the equity cost of capital for natural gas pipelines with one important distinction. To determine the equity cost of capital for an oil pipeline, the Commission has used its traditional DCF constant dividend growth model. This involves selecting a proxy group of companies with similar risks to determine the dividend required by investors, plus a short and long term growth factor. Based on the proxy group, the Commission determines the discount rate that will provide a competitive return to an equity investor. The analysis yields a range of reasonable equity returns for the proxy group and the Commission selects the median of that range as the equity return to be afforded the regulated entity.<sup>30</sup>

22. In gas pipelines this results in a nominal return on equity that includes three factors: an inflation factor, a risk factor, and the true cost of money, which is established by the demand for funds without regard to risk or inflation. For example in *Kern River*, after including the inflation factor and adjustments for risk, the nominal return on equity was 11.2 percent.<sup>31</sup> However in oil pipeline cases the Commission uses the real equity cost of capital, which does not include the inflation factor. Thus, once the Commission

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<sup>29</sup> This is in contrast to *Kern River Transmission Company*, which, while a partnership, the Commission held should be treated as a corporation because it is taxed as a corporation under Internal Revenue Regulations. See *Kern River Gas Transmission company*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486) at P 143.

<sup>30</sup> See *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486) (*Kern River*) at PP 121-23 and 148 for a more extensive analysis of these principles.

<sup>31</sup> *Id.* P. 122.

develops a nominal cost of equity capital based on the median of the range of reasonable returns, the inflation factor is subtracted from the nominal return to get the real return. In the instant case the inflation factor for the 1996 test year is 3.32 percent. For the reasons discussed below, in this case the Commission reverses that ALJ and adopts a preliminary real cost of capital for SFPP of 9.37 percent. Adding the 1996 inflation factor of 3.32 percent would result in a nominal return of 12.69 percent when compared to the Commission's method for determining the equity return for a natural gas pipeline.

**1. Inclusion of the MLPs in the proxy group.**

23. As has been discussed, after the *HIOS* decision issued in January 2005, both SFPP and the shipper parties supplemented the record in February and March 2005<sup>32</sup> and addressed and briefed the issue to the ALJ. Following the Commission's analysis in *HIOS*, the ALJ concluded that if a return of capital were included in a MLP distribution, this would lead to an overstatement of the equity cost of capital. After noting that the most important thing was the source of distributions and not their characterization, the ALJ further concluded earnings growth cannot be used as a proxy for income to determine if MLP distributions are the equivalent of dividends. This is because earnings can be erratic and corporate dividends tend to be more constant and predictable based on the corporation's history and the presence of retained earnings. He further concluded that the unit holders of an MLP would never pay any income taxes on the cash distributions they received, which would also overstate an MLP's equity cost of capital. After reviewing the record, the ALJ held that SFPP failed to establish that the distributions by the MLP's included in the proxy group were derived from income and were not a distribution of capital. As such, the proxy group did not meet the *HIOS* concern and as a result SFPP's rate of return on equity was too high.<sup>33</sup> To correct these perceived limitations, the ALJ set SFPP's cost-of-equity at the lower end of the range of reasonableness used to develop an equity cost of capital, in this case a real equity cost of capital of 8.77 percent for 1996. The ALJ adopted a real return of 10.29 percent, the median of the range for 1995. While stating that the lower end of the range should control, he did not state what the actual number should be used for 1995.<sup>34</sup>

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<sup>32</sup> *Cf.* Ex. Nos. SEP SFPP-49 and 50 (JPW-6 and 7); SEP SFPP 56 and 58 (JPW-13 and 15) SEP AROC – 28 (CPS-5); and SEP SFPP 116 (JPW-20).

<sup>33</sup> ID at PP 55-56, 79-82.

<sup>34</sup> ID at P 142.

24. SFPP opposes the conclusions of the ALJ, asserting that a survey of Value Line reports establishes that the financial community and investors view MLP distributions and dividends as having the same financial results. It asserts that both view distributions as a yield on the market price of the instrument and not as a return of capital. SFPP also asserts that the phrase “return of capital” is rather a shorthand way of addressing the particular tax aspects of partnership accounting under which cash distributions are not taxed, but reduce the basis of the partner’s investment. It further argues that the Value Line reports<sup>35</sup> it used to supplement the record establish that all members of the proxy group show an increase in earnings which are the source of increases in both dividends and distributions. Thus, the Commission’s constant dividend growth DCF model can be reasonably applied here. SFPP further asserts that the DCF model works equally well regardless of the payout ratio because a higher payout ratio means lower reinvestment, and hence lower growth. The Shippers and the Staff support the ALJ with a series of arguments related to the capital structure and theory of MLP financing, including extensive references to Kinder Morgan Energy Partners (KMEP) and its financing practices.

25. The Commission concludes that much of the debate on this issue in this proceeding focuses on nomenclature or on the accounting practices of MLPs rather than the substance of the distributions at issue here. The Commission’s analysis of the relevant period follows. First, the Commission issued its first decision in the *HIOS* proceedings while the record was drawing to a close.<sup>36</sup> At bottom, *HIOS* held that if MLPs are to be included in the proxy group used to determine the cost-of-capital, the distributions made by those MLPs must have characteristics similar to those of corporate dividends. In *HIOS* the Commission noted that several of the MLPs that were included in the proxy group had pay-out ratios that exceeded partnership income in any given year.<sup>37</sup> As such, the Commission questioned whether such pay-outs, or distributions, were suitable for use in the discounted cash flow model (DCF model) that the Commission uses to establish a regulated entity’s equity cost of capital. The Commission’s concern was that a pay-out or distribution in excess of regularly reported income would represent a return of capital. As such, the distributions could overstate the current and projected dividend stream included in the IBES forecasts utilized in the constant growth increase DCF model. In a narrowly based ruling involving a gas pipeline, the Commission held that a regulated entity must prove that a MLP’s distributions are sufficiently similar to

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<sup>35</sup> Ex. No. SEP SFPP-58 (JPW-15).

<sup>36</sup> 110 FERC ¶ 61, 043 (2005).

<sup>37</sup> 112 FERC ¶ 61,050 at PP 64-65.

corporate dividends if a MLP is to be included in the proxy group used in the application of the Commission's DCF model.<sup>38</sup>

26. On review of the record the Commission concludes that for the 1995 and 1996 test years there is no *HIOS* issue present for five of the six oil pipeline MLPs in the proxy group. As discussed, the *HIOS* issue centers on a concern that the cost of equity capital may be skewed if distributions exceed earnings. SFPP submitted supplemental testimony including a substantial number of Value Line analyses to address the issue of whether distributions were viewed as dividends and whether they were considered to be a return of capital.<sup>39</sup> The same Value Line reports also contain analyses of the income, the earnings per unit, and the distributions per unit. Moreover, consistent with standard financial analysis and corporate practice, the Value Line reports normalize earnings per share to eliminate non-recurring or extraordinary items. Since the issue is the consistency of the dividend or distribution stream, and the likelihood it will increase over time, this normalization assures that the issue of distributions in excess of income (earnings) will not be skewed by non-recurring items that overstate or understate the long term pattern of income (earnings) of the firm.

27. As noted, 1995 and 1996 are the test years for this proceeding. As the ALJ noted, analyzing what actually happened in those years is more important than the emphasis on nomenclature that SFPP made the central point of its review of the supplemental materials. Thus, to address the issue it is necessary to look at the pattern of MLP distributions in those years and determine whether the *HIOS* issue actually arises in each proceeding for the test year in that proceeding. In 1995 and 1996 the proxy group consisted of Buckeye Partners, L.P. (Buckeye), Enron Liquids Pipeline, L.P. (Enron), Kanab Pipe Line Partners, L.P. (Kanab), Lakehead Pipe Line Partners, L.P. (Lakehead), Santa Fe Pacific Pipeline Partners, L.P. SFPPP), and TEPPCO Partners, L.P. (TEPPCO).<sup>40</sup> On review, the Commission examined these Value Line reports and looked at the patterns of earnings and distributions for each firm for the years 1993 through

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<sup>38</sup> *Id.* at P 63; 110 FERC ¶ 61,043 at PP 126-127.

<sup>39</sup> Footnote 29, *supra*.

<sup>40</sup> See the April 4, 1995 Prepared Direct Testimony of J. Peter Williamson on Behalf of SFPP, Ex. 197, and the August 28, 1995 Rebuttal Testimony of Rodney C. Manganello, Commission Staff, Ex. No. 281 in Docket No. OR92-8-000, *et al.*, included in Phase I of the related proceedings. See Prepared Answering Testimony of J. Peter Williamson on behalf of SFPP dated December 10, 2004, Ex. No. SEP SFPP-26, in Docket No. IS98-1-000, *et al.*



1997. While the DCF model adopts a cost of capital for one year based on projections developed during that year, and as such does not normally utilize projected returns from more than one year, the Commission will examine several years of data to ensure that any conclusions made here are conservative and fully addresses the *HIOS* issue.

28. Turning to the proxy group, in the case of Buckeye, earnings (income) per unit exceeded distributions for each of the five years 1993 through 1997, often by a considerable margin, and the distributions slowly increased over time. Consistent with the theory of the DCF model, Buckeye's unit price gradually increased over the same period, as did its partnership equity.<sup>41</sup> Lakehead's distributions were somewhat less consistent, with earnings exceeding distributions in all years but 1996, a year in which earnings dropped and were slightly less than the distribution. The distribution remained constant and the negative difference between income (earnings) and the distribution was less the retained earnings that had accumulated in the earlier four years. Payment of a stable dividend (distribution) from retained earnings is, as the ALJ noted,<sup>42</sup> consistent with standard corporate practice. Thus, for this five year period Lakehead does not present a *HIOS* concern since the test under *HIOS* is whether the distribution has the characteristics of a corporate dividend. Kaneb had an income and distribution pattern similar to Buckeye. For the five years 1993 through 1997, earnings per unit exceeded distributions per unit. Kaneb had a relatively high payout to earnings ratio, and consistent with the DCF theory, its units showed little increase in that period.<sup>43</sup> After adjustment for extraordinary items, earnings per unit also exceed distributions in the case of SFPP for the five year period 1993-1997. The modest earnings and distribution growth was reflected in a modest increase over the five year period in the SFPPP unit price.<sup>44</sup> TEPPCO's history demonstrates the same characteristics as Buckeye, Kaneb, and SFPP. For the period 1993 through 1997, earnings per unit exceed distributions per unit in each year. The steady increase in earnings and distributions was reflected in the gradual increase in the unit price.<sup>45</sup> Based on this information, the Commission concludes that none of these five MLPs raises a *HIOS* concern for the test years 1995 and 1996 and it is appropriate to include them in the proxy group.

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<sup>41</sup> Ex. SEP SFPP-58 at 1 of 127.

<sup>42</sup> *Id.* at 25 of 127

<sup>43</sup> *Id.* at 58 of 127.

<sup>44</sup> *Id.* at 110 of 127.

<sup>45</sup> *Id.* at 111 of 127.

29. The sixth member of the 1995 and 1996 proxy groups is Enron Liquids, the predecessor firm to KMEP for the period before 1997. The Value Line reports analyzing these two firms are on pages 75 to 91 of Ex. No. SEP SFPP-58. Page 77 of those reports shows that there was no distribution in 1991 and that income of 51 cents per share (unit) exceeded the distribution of 17 cents in 1992. Thereafter the distributions per unit exceeded per unit income from 1993 through 1999 by the following amounts: 1993, 35 cents; 1994, 37 cents; 1995, 40 cents; 1996, 36 cents; and in 1997, 60 cents. The Commission notes that the increase in earnings and distributions over this period was stable and the differential between the earning and income was constant except for the year 1997, where it increased. While this pattern suggests that an investor might have reasonably relied on anticipated growth from the portions of Enron's Liquids' cash flow that were reinvested, in this case the Commission will not include Enron Liquid's in the proxy group. A five member proxy group is adequate for the purposes of the DCF model, and as noted, the other five members of the proxy group do not raise a *HIOS* issue here.

30. Exclusion of Enron Liquids from the proxy group will reduce SFPP's equity rate-of-return somewhat, but will not materially affect the dollar amount of that return in this case because of the small amount of equity involved. Moreover, the simpler approach adopted here will help close this long standing case. To avoid any confusion, the Commission will state here the nominal and real returns that are to be the basis for any adjustments to the equity return required by this order, including the removal of Enron Liquids from the proxy group and any further adjustments required in subsequent sections of this order. For 1995, the Commission selects 14.18 percent nominal and 11.65 percent real returns<sup>46</sup> For 1996, the Commission uses a nominal return on equity of 13.63 percent and a real return of 10.31 percent before the exclusion of Enron Liquids from the proxy group.<sup>47</sup> As indicted in the footnotes, both sets of numbers are drawn from the Dr. Williamson's analyses for SFPP in Docket No. OR96-8-000, *et al.* In making its compliance filing SFPP must work from the cited sources, remove Enron Liquids, and include a worksheet in the compliance filing showing the corrected calculations. The ruling here does not preclude inclusion of Enron Liquids or KMEP in the proxy group in any of the pending related proceedings based on further analysis of the *HIOS* issue in those proceedings.

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<sup>46</sup> O'Loughlin Direct Testimony, Ex. No. SEP U/CT-1 at 15.

<sup>47</sup> O'Loughlin Rebuttal Testimony, Ex. No. SEP U/TR/T-32 at 32. As discussed below, the Commission is requiring one additional adjustment to reflect the additional return that flows to the public limited partners from the tax savings they achieve due to the allocation of income among the partners.

## 2. The 1988 PAA

31. The second issue is the role, if any, of the 1988 PAA in determining the capital structure. By way of background, in 1988 SFPP, L.P.'s predecessor pipeline sold its assets to SFPP, L.P. at a price that resulted in a write up of the previous rate base of between \$122.7 million and \$139.2 million, depending on the source for the calculation. This write up is called a purchase accounting adjustment and is permitted for accounting purposes, but is generally not permitted for rate making purposes.<sup>48</sup> Holding that this write up was inconsistent with Commission policy,<sup>49</sup> the ALJ directed that SFPP's 1995 and 1996 capital structures be reduced by the amount of the 1988 PAA and that the entire dollar amount be deducted from the equity portion of the capital structure. This changed the recommended capital structure to 67.97 percent debt and 32.03 percent equity in both years. Staff and the Shipper Parties support the ALJ's decision in the ID while SFPP opposes it. SFPP asserts that in this case the debt-equity ratio was established by a market offering of debt and equity and that this ratio would be unchanged even if the 1988 purchase price was reduced by the amount of the PAA.

32. The Commission will reverse the ALJ. The ALJ was correct that the Commission normally requires the removal of a PAA unless the pipeline demonstrates that the increase in the carrier's rate base resulting from a PAA benefits the rate payers. However, in the case of the 1988 PAA this standard is not relevant here for two reasons. First, the 1988 PAA can have no impact on the Sepulveda rate base for depreciation purposes because the rate base of the Sepulveda Line was fully amortized well before the instant case was filed. Thus, there is no rate base to inflate. Moreover, the Commission concludes here that the 1998 PAA will not have a distorting impact of SFPP's capital structure for purposes of determining the debt equity ratio. In contrast to the instant case, the Commission's December 16, 2005 order directed the removal of the 1999 PAA from SFPP's rate making capital structure in part because the entire dollar amount of the PAA was added to the equity component of the balance sheet and there was no demonstrated benefits to the rate payers.<sup>50</sup> Unlike the situation involving the 1999 PAA, in the instant case there are no grounds for concluding that entire PAA was added to the equity

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<sup>48</sup> June 2005 order at PP 66-67.

<sup>49</sup> ID at ¶P 42-43. In the instant case SFPP's test year capital structure without the addition of deferred equity component consisted of 56.68 percent debt and 42.32 percent equity in 2005, and 57.45 percent debt and 42.55 percent equity in 1996.

<sup>50</sup> *SFPP, L.P.*, 113 FERC ¶ 61,227 (2006) at PP 64-65 and 70-71 (December 2005 Order).

component of SFPP's capital structure or that the revised capital structure would cause any harm to the ratepayers. As SFPP points out, the 1988 PAA increased the size of the asset base when the assets were transferred to a new owner, SFPP, L.P. This new owner then raised financing that resulted in a roughly 60 percent debt and 40 percent equity structure after the size of the asset base was determined.<sup>51</sup> There is no reason now, nor was there then, to believe that this market established debt-equity ratio would have changed if the 1988 asset base resulting from the 1988 sale was the same, smaller, or larger. This is because SFPP's risk profile was quite stable at the time.<sup>52</sup> Thus the Commission will use the debt-equity ratios previously stated: 56.68 percent debt and 42.32 percent equity for 1995, and 57.45 percent debt and 42.55 percent equity for 1996, which are based on SFPP's book values in each year without a deferred equity component.

### **3. The ALJ's use of the lower end of the allowed range of equity return**

33. The third equity cost-of-capital issue is whether SFPP's equity return should be set at the median or the lower end of the range of reasonable returns established by the Commission's constant growth DCF model. In the instant case the ALJ reduced the equity return in this proceeding to the lower end of the allowable range based on these arguments. As has been discussed, the ALJ's reasons included that MLP distributions often exceed income in the year of the distribution, that there is unusually rapid growth on the part of some MLPs, and the fact that many MLP distributions have a tax deferred component that may increase the equity return beyond what would be derived from the Commission's traditional constant dividend increase DCF model.

34. Addressing each point in turn, the first argument that the payout ratio may lead to unrepresentative returns was discussed earlier in this order and determined to be of limited relevance here. This is because all but one of the members of the proxy group met the *HIOS* test during the test years at issue. Moreover, to the extent the ALJ focused on KMEP's financial and accounting practices to support his conclusion that the SFPP's distributions are not characteristic of corporate dividends KMEP did not own SFPP in 1996. At that time SFPP was an integrated single firm entity consisting of a limited partnership operating entity, a limited partnership that controlled that entity, and a corporate partner that controlled 49.71 percent of the limited partnership units. The

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<sup>51</sup> *BP West Coast* at 1284-85; Opinion No. 435-A at 61,504-06 and Opinion No. 435- B at 62,064-66.

<sup>52</sup> *Id.*

balance of the limited partnership interests was held by the general public. As such, the corporate structure or practices of KMEP discussed by the ALJ are irrelevant to this case.

35. Second, despite the argument that there is a material difference in growth patterns between the corporate and the MLP models, which may be true in a generic sense, the prior analysis in this order of the *HIOS* issue demonstrates that in this case there is not a material difference through 1997, with the possible exception of Enron Liquids, and after 1996 KMEP,<sup>53</sup> both of which are excluded here, suggest that the growth of the proxy group MLPs is similar to what would be predicted by the Commission's constant growth DCF model. This is that the higher payout ratio of MLPs results in a lower growth rate because there are fewer funds for reinvestment.<sup>54</sup>

36. There may be more merit to the concern that MLPs distributions are often tax sheltered and that this may result in an overstated return on equity if MLP distributions are treated as dividends for purposes of the Commission's traditional DCF model. As has been discussed, the Commission's DCF model determines that cost of equity capital by use of a proxy group to calculate the current yield of the dividends paid and the estimated growth of the dividend in future years, the latter being a function of reinvestment and the growth in income that results.<sup>55</sup> From this information the Commission develops an equity rate of return based on the proxy sample, which is then expressed as an allowed

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<sup>53</sup> Enron Liquids changed its name to KMEP in late 1996.

<sup>54</sup> The Commission notes that this conclusion might not hold for a similar 5 year period after 1996. Some of the more general financial materials in this record state that MLPs often use external debt and equity sources to finance growth, either through acquisitions or for capital expenditures designed to enhance their existing operations. Under these circumstances, it is possible to pay out cash in excess of nominal earnings per unit and for the MLP to continue to grow as long as the return on the external funds exceeds their cost. See: Ex. Nos. SEP SFPP-61 (JPW-18) at 3; SEP SFPP-62 (JPW-19) at 3; SEP ARCP-53; Comments of BP West Coast, *et al.* dated January 11, 2005 in Docket No. PL05-0-000, Attachment A at 5; Docket No. OR92-8-025, SWST-18 at 36-39. Thus, it is possible that a MLP would have a high payout ratio of available cash (as defined in the partnership agreement) and have a rapid growth pattern based on external financing.

<sup>55</sup> The projection for the first five years constitute 2/3s of the value and is derived from return and growth estimates from a proxy group using the IBES data; thereafter projected dividend growth is based on long term estimates of the overall economic growth.

dollar return by applying the equity rate of return to the equity portion of the rate base. As discussed in *City of Charlottesville*, under the Commission's stand-alone method the resulting dollar return is deemed taxed at the marginal tax rate of the regulated entity generating the income.<sup>56</sup> In the case of a corporation, this is generally at the highest statutory, or marginal, tax rate. Then the allowed return for the corporation is grossed up to reflect the stand alone tax burden at the applicable statutory (*i.e.* the marginal) tax rate.

37. As is also discussed in the *City of Charlottesville* and the *Policy Statement*, this permits the corporation to earn an after-tax return equal to the allowed return.<sup>57</sup> This return becomes the source of funds for dividends and the reinvestment that drives further growth in income and dividends. As such, the Commission's DCF model assumes that the full tax burden is applicable in the test year to ordinary income after the deduction from operating income of cash operating expenses and such non-cash costs as depreciation. If the tax payments are deferred on regulatory income because the depreciation and amortization used by the regulated entity varies from straight line depreciation, the regulated entity is required to normalize its taxes. The normalization protects the ratepayers by reducing the rate base by the amount of any tax payments that are so deferred. Thus, to the extent that the taxes are not actually paid due to differences in taxable income and reported regulatory income, the company's equity overall return is reduced by the amount of the additional return that would result from reinvesting the cash flow from the deferred payment of the federal and state income taxes.<sup>58</sup>

38. The situation of a partnership is more complicated. As with any investment instrument, the investor looks at the risk of the partnership instrument and its after-tax return in determining the price to be paid. As discussed in the *Policy Statement*, partnerships file an information return, and items of income, loss, and deductions are reflected on the partner's Form K-1. If income, loss, and distributions are in exact proportion to ownership interests, the result is no different than a corporation except that the income tax obligation falls on the partner rather than the partnership operating entity.

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<sup>56</sup> See *City of Charlottesville, Va. v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985) (*City of Charlottesville*) at 1207. In the instant case SFPP's test year capital structure without the addition of deferred equity component consisted of 56.68 percent debt and 43.32 percent equity in 1995, and 57.45 percent debt and 42.55 percent equity in 1996.

<sup>57</sup> *Id.*; *Policy Statement* at PP 4-5, 21, 24-25.

<sup>58</sup> See *Kern River*, 117 FERC ¶ 61,077 at PP 224-31 for a more extensive analysis of these principles.

But as the ALJ properly noted,<sup>59</sup> MLPs often distribute more cash than current earnings, and items of income and loss may be allocated in a manner that shelters that income.<sup>60</sup> When distributions exceed income, the partner's basis (its capital account) is reduced by the difference. There is no immediate income tax liability on the portion of the distributions that exceeds income until the partner's basis has been reduced to zero. Thereafter, distributions in excess of income are taxed at capital gains rates. This situation usually results because certain items of loss or deduction, usually depreciation and amortization, "shelter" a portion of the distribution from an immediate income tax liability. However, when the instrument is sold, if the partner's basis was reduced by distributions in excess of income that flow from items of loss and deduction, the resulting reduction in basis, as far down as zero, will be taxed at ordinary income rates. Thus, such a reduction in basis due to cash distributions in excess of income results an ordinary income tax deferral, not tax avoidance.<sup>61</sup> This ordinary income tax deferral may be amplified if items of income or expense are reallocated among the partners.

39. It appears, therefore, that the tax deferral features of many MLPs may result in the Commission's DCF model understating a limited partner's return in the initial ownership years. Under the DCF model, the tax obligation of the operating entity that controls the first tier assets<sup>62</sup> is assumed to be incurred in the in year which the income is incurred. To avoid confusion about the source of the deferral, it is important to recognize, as does *City of Charlottesville*, that if the regulated entity has items of loss and deduction for operations other than those of the entity in question, this may reduce the income taxes that are actually paid or incurred. This is because the items of loss from other operations may reduce taxable income and can result in further tax deferrals beyond those generated by jurisdictional operations of the regulated entity whose rates are under review. Those deferrals that result from non-jurisdictional activities, or from those of affiliated companies, are not deemed to be a cost to the rate payers under the stand-alone method.

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<sup>59</sup> ID at PP 68-69.

<sup>60</sup> See Ex. Nos. SEP SFPP-21 at 1-2; SEP ARCO-22 at 4-5; Ex. No. SWST-18 at 43-44; BP West Coast Comments, Attachment A at 10.

<sup>61</sup> *Id.*

<sup>62</sup> The first tier assets are those used in the operations of the regulated entity, in this case those controlled by SFPP as the operating partnership. The corporate equivalent is the corporation that owns assets, not its shareholders, who are second tier owners. See *Policy Statement* at PP 22, 34-36, 38.

40. Thus, under the stand-alone method normalization is normally required only for the tax deferrals that are caused by accelerated depreciation or amortization by the first tier regulated entity whose rates are under review. The impact of any such deferrals declines as the accelerated depreciation or amortization expires and jurisdictional income is no longer sheltered. At this point income taxes increase and the allowance for deferred income taxes (ADIT) reflected on the entity's books is amortized as the deferred taxes are paid. The reduction in the rate base declines and it is gradually restored to its straight line book value amount. As was previously discussed, any "surplus" cash flow from an income tax allowance does not result in an over-recovery of the projected income tax expense because there has been a corresponding reduction in the rate base and the dollar amount of the allowed return.

41. The difficulty for the Commission's constant dividend growth model occurs when the sheltered income is generated by the reallocation of items of income or of deduction and loss among the partners at the partner level in a manner that does not reflect their respective ownership percentages. If items of credit and loss are allocated among the partners in proportion to their ownership interests, then the result is no different than that of the Subchapter C Corporation. If there are tax deferrals at the level of the operating entity, *i.e.* at the partnership level, then normalization is required and the mechanics of the deferral are as described in the previous paragraphs. However, if items of income, loss or deduction resulting from the regulated entity's operations are reallocated among the partners other than on the basis of their ownership shares, an additional tax deferral may occur at the partner rather than the partnership level.

42. Such a result cannot be corrected through the normalization required by the Commission's regulatory procedures. This is because the partner level deferral is not reflected on the books of the regulated entity whose rates are under review, but only in the income and loss that is reported on the partner's K-1 and the partner's tax return. Since such an allocation of the items of income and deduction of loss will result in a lesser tax liability or obligation for some partners and a greater tax obligation for others, the partners with the reduced actual or potential income tax liability have greater tax sheltered cash flow that would otherwise be the case. This gives them an opportunity to earn a further return by investing the cash generated by the income tax allowance. Unlike the corporate model, there is no credit to the ratepayers for the additional equity return resulting from the tax deferrals derived from the operations of the regulated first tier owner.

43. For example, in the instant case SFPP reported income to its owning limited partner, Santa Fe Pacific Pipeline Partners, L.P. (SFPPP, L.P.), of \$59,560,816 (after all items of income, loss and deduction reported on its K-1) and Santa Fe Pacific Pipeline



Partners, L.P. made distributions to its own limited partners of \$60,786,236 in 1996.<sup>63</sup> On the face of this distribution the difference between reported income and distributions was minimal, a difference of less than 2 percent.<sup>64</sup> Moreover, the cash distributions were in exact proportion to the limited partners' nominal responsibility for items of income and loss. For example, the corporate general partner of SFPPP, L.P., Santa Fe Pacific Pipelines, Inc. (Santa Fe) had a responsibility for 45.711 percent of items of income and loss for the limited partnership interests it held, and received the same proportion of the distribution.<sup>65</sup> This would suggest that there is no income tax issue in the 1996 test year that would affect the outcome of the DCF model since the distributions and income are very close at the partnership level. This is consistent with the earlier holding here that including SFPP, L.P. in the 1996 proxy group does not present a *HIOS* concern.

44. However, in the instant case some income was allocated away from the other limited partners to Santa Fe. Of the \$60,003,450 in total 1996 partnership income, \$37,536,795 was allocated to Santa Fe and \$22,274,323 was allocated to all the other limited partners.<sup>66</sup> These other limited partners received distributions of \$33,000,000. Thus, the gap between the income that would have been reported by these limited partners on their income tax returns and the cash they actually received was \$10,725,677. Since this cash would have not been included in the adjusted gross income of the relevant limited partners, this reduces the potential taxes to be paid on their income. Assuming a

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<sup>63</sup> Ex. No. SEP SFPP-53 at 1. The income is derived from the partner's (SFPPP, L.P.'s) share of the items reported by SFPP, L.P. on Schedule M-2. The distributions are reflected at two different places on the SFPPP, L.P.'s K-1.

<sup>64</sup> In fact, a sample of 1996 SFPP limited partner K-1s disclosed that every member of the sample had taxable income reported on their K-1 after depreciation and other annual expenses. The limited partners other than Santa Fe Pacific Pipelines, Inc did have their basis reduced because distributions slightly exceeded income. However, in 1996 SFPP's limited partners had an actual or potential tax liability on the income allocated to them that was not offset by allocation of items of loss or deduction among the partners.

<sup>65</sup> Ex. Nos. SEP SFPP-52 at 1.

<sup>66</sup> *Id.*; See also March 7 Compliance Filing of SFPP in Docket No. OR92-8-024, Confidential Tab F, 1996 Income Allocation Statistics for SFPP at 3.

marginal tax rate of 28 percent,<sup>67</sup> the tax avoidance in the distribution year would be \$3,003,189.56, and the limited partners so benefited could invest this tax saving for an additional return.<sup>68</sup>

45. Because the limited partnership units receiving the tax deferral benefit from the allocation of income, deduction, and loss among the partners can earn a higher return, SFPP is correct that the tax savings would usually be reflected in a higher unit price that results in a lower cost of capital to the entity.<sup>69</sup> But while the price of the publicly held limited partnership interests may be higher and thus better for the entity, the situation is worse for the ratepayer compared to the corporate model because the additional cash flows that are generated from the tax savings, and thus increased the after-tax return, benefit only the public limited partners, and the tax savings are not normalized as would be the case in the corporate model. This means that the higher stock price comes at the expense of the ratepayers that have provided the additional cash flow through the income tax allowance. Moreover, as the ALJ suggests, it is impossible to predict the date of sale of the limited partnership interests, and thus the end of the tax deferral period and the total value of the tax savings that will accrue from the reallocation of items of income, deductions, and loss among the partners. Since normalization ends when the accumulated difference between regulatory and income tax income is eliminated, the fact that the sale date of the instrument is unknown precludes a reduction of the partner's basis as a normalization device to correct the return on equity. This is in contrast to the adjustment of regulated entity's rate base that would otherwise be made.

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<sup>67</sup> The basis for the use of the 28 marginal tax rates is discussed further. The Shippers might argue here for a higher marginal tax rate since this would increase the tax savings used in this portion of the analysis. However, this would undercut their ongoing position that a lower marginal rate, or the effective rate, should be used in calculating an income tax allowance, assuming a partnership is legally allowed one.

<sup>68</sup> The general partner holding 45.711 percent of the limited partnership interests would pay a higher tax burden on income than the distributions received. Assuming a 35 percent tax bracket given the total income there, the additional burden would be about \$3,500,000. This would not affect the cost of capital calculations since the general partner's units are generally not the ones traded and used to establish the return. This allocation does have an impact on the weighted marginal tax rate to be used in establishing the tax allowance to be applied to the dollar amount of the allowed return.

<sup>69</sup> This is because a higher unit price permits the entity to raise the same amount of capital while issuing fewer shares.

46. Thus, if the traditional DCF model does not effectively credit ratepayers with the tax benefits that flow from some aspects of the partnership structure, some adjustment should be made to the equity return to reflect this fact, as the ALJ attempted to do by reducing the return to the lower end of the range established by the DCF model.<sup>70</sup> A more precise method is to reduce the allowed equity rate-of-return to provide a result similar to the reduction in rate base that flows from normalization. Specifically, in the instant case the additional cash flow in the first year from the tax savings was some 9.10 percent greater than the taxable income assumed by the DCF model. Assuming the same rate of return on equity as that allowed SFPP, the real rate of return earned on that additional cash is 10.31 percent.<sup>71</sup> Applying this return to the additional cash from the tax savings increases the limited partner's equity rate of return by .94 percent.<sup>72</sup> If the regulatory return on equity generated by the DCF methodology is reduced by this .94 percent to compensate the ratepayers for the additional return on the tax deferred cash, this reduces SFPP's allowed real equity rate of return for the test year 1996 from 10.31 percent to 9.37 percent before any adjustment for the exclusion of Enron Liquids from the proxy group. For the test year 1996 this proposed reduction in the real rate of return on equity 10.31 percent to 9.37 percent is materially less than the ALJ's proposed reduction from 10.31 percent to 8.77 percent. The difference in the amount of reduction is .60 percentage points, or 60 basis points.<sup>73</sup>

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<sup>70</sup> If the object is to reduce the results of the DCF model to reflect the tax savings to limited partners that were allocated less income or more losses than their proportionate interests, in theory one should adjust the return on equity of each member of the proxy group to reflect the additional return from any tax savings flowing to the owners of the shares. This appears impractical unless the distribution and partnership income records are available for each member of the proxy group during the test year. Thus, it is more realistic to adjust only the return of the regulated entity involved in the proceeding.

<sup>71</sup> The real allowed equity return for 1996 before any adjustment for the tax savings is 10.31 percent. The Commission assumes that investors in the proxy group deem that group to be a suitable investment and are willing to reinvest at the same rate.

<sup>72</sup> The tax sheltered cash for the test year 1996 equals \$10,725,677. This times the marginal tax rate of 28 percent = \$3,003,189.56 in additional after-tax return. \$3,003,189.56 is 9.10 percent of the total distribution. The 1996 test year real rate of return is 10.31 percent before any adjustments to the proxy group. Thus, the 10.31 rate of return over-recovers the after tax real rate of equity return by 10.31 percent times 9.10 percent or .0094, or .94 percent, or in financial terms, 94 basis points.

<sup>73</sup> Commission: 10.31 percent – 9.37 percent = .94 percent. ID: 10.31 percent – 8.77 percent = 1.54 percent. 1.54 percent - .94 percent = .60 percent.

47. On exceptions, SFPP asserts that the ALJ's conclusion to set its return at the lower end of the ranges lead to illogical conclusion that it and other MLPs are entities of less than average risk because the method adopted by the ALJ assumes a risk oriented approach. This criticism is appropriate. As discussed, the ALJ correctly discerned that there was a potential for an over-recovery of the equity cost of capital due to the tax shelter aspects of a MLP. However, the ALJ made a methodological error by using an approach that reflected a risk adjustment, rather than an adjustment to the equity return that is closer to the normalization approach the Commission uses for other types of tax deferrals, such as for the allowance for deferred income taxes (ADIT). The Commission's conclusion here issue moots this particular argument by SFPP, but for consistency's sake the Commission reiterates its prior conclusion in the Opinion No. 435 orders and the December 2005 order that SFPP has average risk.<sup>74</sup>

48. For the reasons stated the ALJ is reversed and the real return on equity is increased to 9.37 percent from the lower real return adopted by the ALJ. This is before the removal on Enron Liquids from the proxy group.<sup>75</sup> SFPP is directed to perform the same calculation for 1995 using the distribution and income figures in its 1995 partnership and K-1 reports and adjust the equity component of its weighted capital cost for both years accordingly. Since all of the numbers are not readily available to the Commission, SPFF must provide a separate work paper displaying the calculation and identifying the source. If the source is not now part of the record, it must be provided.<sup>76</sup>

#### **D. Income Tax Allowance Issues**

49. This section of the order addresses the eligibility of SFPP for an income tax allowance in this proceeding. As explained in the *Policy Statement*, whether a regulated pass-through entity is eligible for a tax allowance is determined in each proceeding. In

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<sup>74</sup> Opinion No. 435 at 61,100-02; December 16 order at P 78.

<sup>75</sup> As discussed above, unlike the case with natural gas pipelines, the Commission does not include an inflation factor in the equity cost of capital of an oil pipeline. Thus, in the instant case the nominal return would be higher for the test year 1996 because the 1996 inflation rate of 3.32 percent would be added back to the real return. This would result in a nominal return of equity of 12.69 percent for SFPP before the removal of Enron Liquids (KMEP) from the proxy group.

<sup>76</sup> In fact, the record has become so massive that the Commission directs SFPP including copies of the sources as an attachment to the compliance filing.

each proceeding the Commission requires the regulated entity to establish that its partners have an actual or potential income tax liability on the income generated by the regulated entity. On December 15, 2005, the Commission issued an order establishing certain specific procedures to be followed in the proceedings involving certain of SFPP's East and West Line rates.<sup>77</sup> Since this proceeding involves a related docket and the time frames are similar, the Commission requires SFPP to follow the procedures adopted in the December 2005 order subject to certain clarifications discussed below.

50. The Commission recognizes that the Shipper parties have appealed the Commission's determination that a pass-through entity such as a limited partnership may be afforded an income tax allowance if it conforms to the standards contained in the *Policy Statement* and in the Commission's more detailed implementing orders.<sup>78</sup> The core of those arguments is that affording a pass-through entity such as a partnership any income tax allowance is inconsistent with the court's remand in *BP West Coast*. In the *Policy Statement* and in its June 2005 order the Commission explained in detail why it believes that its conclusion to the contrary is appropriate and is consistent with the Court's remand. There is no need to reprise all of those arguments here and the rationale of those prior orders is incorporated herein. The fact that the Commission's prior rulings on the threshold legal issue are again before the court does not preclude an examination here of whether SFPP has met the required standard. However, whether it has cannot be determined with finality until SFPP makes a compliance filing consistent with the terms of this order and the parties have an opportunity to comment on the specifics of the filing.

51. However, given the pending appeal of the Commission's March 2004 and June 2005 orders, any revised rates approved in this proceeding will be subject to the outcome of the pending appeal of the June 2005 order. Thus, if the Commission's position that pass-through entities may be afforded an income tax allowance is reversed, the rates required here will be revised as of their effective date to reflect that fact. In addition, the Commission will clarify five matters that have been raised in comments on SFPP's March 7, 2006 compliance filing in the related SFPP proceedings. These are: (1) the use of the marginal rather than the effective tax rate; (2) the application of the stand-alone doctrine; (3) the use of presumptions to establish the marginal tax rate; (4) the allocation of income and expenses other than in proportion to ownership; and (5) subsequent filings. This will provide more specific guidance for the compliance filing required by this order

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<sup>77</sup> December 2005 order at PP 47-48, 133.

<sup>78</sup> See *ExxonMobil Oil Corporation, et al. v. Federal Energy Regulatory Commission*, U.S.C.A. D.C. No. 04-1102 *et al.*, Initial Brief Filed May 30, 2006.

and clarify a number of points in the Commission's prior orders addressing the specifics for determining whether any income tax allowance is available in a specific case.

### **1. The use of the marginal tax rate**

52. Comments submitted in response to SFPP's March 7, 2006 compliance filing argue that the *Policy Statement* contemplates that the effective, not the marginal, tax rate should be used in determining any income tax allowance.<sup>79</sup> This interpretation is incorrect. While some language in the *Policy Statement* might be construed in this manner, the bulk of the discussion in the *Policy Statement* is to the contrary, as is past Commission practice and court precedent. An interpretation that the effective rather than the marginal tax rate should control is also inconsistent with standard tax nomenclature and with basic financial and tax theory.

53. As was stated over 20 years ago in *City of Charlottesville*, the income tax allowance designed to compensate the regulated entity for its "tax cost" is "[the] statutory tax rate (which, in the case of regulated utilities, will almost always be the maximum rate)...."<sup>80</sup> This discussion makes it quite clear that the regulated entity's "tax cost" is determined by applying the statutory or marginal rate to the allowed return. Nothing in the *Policy Statement* compels the contrary and the weight of the *Policy Statement* text favors the use of the marginal tax rate. For example, at paragraph 37 the Commission refers to the "lower weighted marginal tax rate" of the regulated entity and at paragraph 40 that "all this would do [is] incorporate a presumed marginal income tax rate into the rate structure."<sup>81</sup> In paragraph 41 the Commission does refer to the "income tax status" of the "owning interest" and states that its approach will assure that the rate payers do not pay more than the "actual tax cost" of that interest.<sup>82</sup> However, as the citation from *City of Charlottesville* makes clear, for over 20 years the concept of "tax cost" has been defined by the statutory (*i.e.* the marginal rate). Thus, the "income tax status" of the entity is defined by the marginal rate because it is the marginal rate that determines

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<sup>79</sup> See Protest and Comments of Chevron Products Company, ConnocoPhillips Company, Tosco Corporation, Ultramar Inc., and Valero Marketing and Supply Company (the CVV Group) dated April 21, 2006 in Docket No. OOR92-8-024, *et al.*, at 13, and Testimony of O'Loughlin at 17-18.

<sup>80</sup> *City of Charlottesville* at 1207.

<sup>81</sup> *Policy Statement* at PP 37, 40.

<sup>82</sup> *Id.* at P. 41.

entity's tax liability, or burden, under a graduated income tax. The *Policy Statement* embodies these income tax nomenclatures and principles. Moreover, in its later orders the Commission made clear that the marginal tax rate was to be used.<sup>83</sup> Arguments to the contrary in comments on SFPP's March 7 compliance filing ignore this consistent interpretation of the *Policy Statement*.

54. Moreover, given other comments filed in response to SFPP's March 7 compliance filing in the related proceedings, the marginal tax concept warrants some further exploration.<sup>84</sup> The assertion is that it is impossible to determine when a particular dollar of marginal income is received and that only the income received from the MLP should be used in determining the marginal bracket. This is incorrect. Income tax liability increases with taxable income under the graduated income tax structure through a series of brackets that range in the case of individuals from 15 to 35 percent. Income accrues over time during the taxable year and the taxpayer may not know what the actual marginal tax bracket will be until the close of the year. In the case of an individual, the taxpayer first calculates adjusted gross income (which includes all items of income and offsetting items of business and investment costs or loss) and then determines taxable income after, exemptions, deductions and credits that are subtracted for adjusted gross income on page 2 of the Form 1040. The point is that every dollar of income received during the year contributes to adjusted gross income and taxable income and each such dollar is therefore taxed at the marginal rate. As such, the timing of its receipt is irrelevant and it cannot be segregated from all other income received by the taxpayer in a given tax year. For this reason, an informed taxpayer will often project total income to be derived from all sources and the tax. In practice, all taxpayers are required to do so through withholding, or to make estimated quarterly income tax payments if the projected taxable liability is not withheld at the source.

55. As such, every dollar included in adjusted gross income serves to increase taxable income and the possibility of a higher bracket. Dollars of income that are excluded by law, or sheltered through various devices, reduce the possibility of a higher marginal rate. Whether dollars received during the year are included, or are included and offset, in determining adjusted gross income, all have an increment impact and the marginal tax

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<sup>83</sup> December 2005 order at PP 29-32. *See also Trans-Elect NTD Path 15, LLC*, 111 FERC ¶ 61,140 (2005), *order on reh'g*, 112 FERC ¶ 61,202; *Trans-Elect NTD Path 15* (113 FERC ¶ 61,162 (2005) at PP 6, 9, *order on reh'g*, 115 FERC ¶ 61,047 (2006) at P 4.

<sup>84</sup> April 21, 2006 comments of the CCV Group at 14 and O'Loughlin at 7-8, 17-18 filed in Docket Nos. OR 92-8-000 *et al.* and OR96-2-000, *et al.*

rate applies to each one. Thus, when the *Policy Statement* says the regulated entity must establish that its partners have an actual or potential income tax on “that” regulated income, it follows that the marginal tax rate for “that” dollar is also the marginal tax rate on all of the partner’s income since “that” dollar of income contributes to the marginal rate. To hold otherwise is inconsistent with the financial underpinnings of the tax burden caused by a graduated income tax. Thus, the Commission must look at the partner’s total taxable income to determine the marginal tax rate, not just marginal tax rate of the regulated income that is included on the partner’s return.<sup>85</sup> For these reasons, the use of a rate other than the partner’s marginal rate to determine the income tax allowance of regulated pass-through entity will be rejected.

## **2. The stand-alone methodology.**

56. The December 2005 order discussed the Commission’s stand-alone method for determining regulated income and the related income tax allowance and concluded that the stand-alone method and the methodology used in that order are consistent.<sup>86</sup> This conclusion is challenged by the comments on SFPP’s March 7 compliance.<sup>87</sup> At bottom, the stand-alone method provides that the tax allowance for a regulated entity will be determined by looking at the net income of the regulated entity, but excludes non-jurisdictional income or losses generated by the regulated entity and all the losses and income of any affiliate or the corporate parent. The fact that a jurisdictional operating entity may have losses from other activities that offset its jurisdictional income or that the operating entity’s income may be offset by losses on the part of a parent company or an affiliate will not affect the amount of an income tax allowance. Thus, that amount is

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<sup>85</sup> The income from partnerships is first recorded on Schedule D (income from real estate, farms, partnerships and trusts) and reflects the items of income, loss, and deduction that were included in the partner’s Form K-1. This is included on a single line on the first page of the Form 1040 or 1120. It then flows with other items of income (or loss) to adjusted gross income. Taxable income may be further reduced by deductions and exemptions to arrive at taxable income. The marginal tax bracket is applied at this point in the case of individuals. See page 2 of Form 1040.

<sup>86</sup> December 2005 order at PP 27-28.

<sup>87</sup> April 21, 2006 comments of the CCV Group, O’Loughlin at 11-12 filed in Docket Nos. OR 92-8-000 *et al.* and OR96-2-000, *et al.*



calculated by determining the marginal tax rate that applies to the regulated income of the entity.<sup>88</sup> *City of Charlottesville* discussed this method in detail and approved it.<sup>89</sup>

57. Again, some further analysis and clarification is required given the comments on SFPP's March 7 compliance filing. First, as discussed, the Commission's approach under the *Policy Statement* uses all the taxable income of the owning partners to determine the marginal tax rate to be applied to the regulated entity's jurisdictional income. As the *Policy Statement* discusses, a partnership is a pass-through entity that acts as the collective entity for its individual partner's interest because it has no income tax liability of its own. A partnership's net income is determined at the partnership level, but the actual or potential tax liability of the individual partner is determined by the marginal tax rate burden on the partner's taxable income, which is then imputed and applied to the income of the partnership.

58. This framework does not defeat the intent of the stand-alone doctrine at the partnership level. All partnerships that are treated as partnerships for tax purposes are required to file a Form 1065 that summarizes income and deductions and discloses the net income of the partnership. A regulated partnership owning and operating jurisdictional assets must apply the stand-alone method and eliminate all non-jurisdictional income and losses from the income reported to the Commission and thus reflect only the net income resulting from jurisdictional items. As was previously discussed, if the partnership does not use straight line depreciation, it must normalize its depreciation accounts just like a corporation. A partner's taxable net income in each year is determined by the net of the income and losses (and credits and deductions) that appear on the partner's return. In the absence of tax deferrals generated by sources other than those of the partnership, the marginal tax rate reflects the partner's "actual" tax "cost" for the year because actual taxes are paid or incurred on the taxable income for that year. The weighted marginal tax rate of all the partners then determines the marginal rate used to determine the partnership's income tax allowance, which is then applied to partnership income to determine the dollar amount of the income tax allowance included in its rates. This reflects partnership tax principles and the stand-alone method is not relevant to that determination.

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<sup>88</sup> *Id.* at 1207-08.

<sup>89</sup> *City of Charlottesville, passim.*

### 3. The use of presumptions to establish the marginal tax rate.

59. The December 2005 order recognized that in some cases it may be difficult to establish the marginal tax rate of the owning partners because the regulated entity does not have access to its partners' tax returns. This is not a problem when the partnership is owned in wholly by readily identifiable corporate partners, as in *Trans-Elect*. In that case the Commission was able to obtain affidavits with supporting information that established that the projected income of the Subchapter C corporate partners would fall within the 35 percent marginal tax bracket.<sup>90</sup> Similarly, the earlier discussion in this order indicated that the Santa Fe, the corporate partner owning 45.711 percent of the limited partner units, had been allocated some \$37,536,795. In this case the marginal tax bracket for Santa Fe, the corporate general partner as well as a holder of limited partnership interests, could be readily determined by including its IRS Form 1060 in the record or from disclosures that may be required under the Security and Exchange Commission's annual reporting requirements. Moreover, since its affiliate is the regulated entity in this proceeding, this disclosure could be required. The marginal tax rate of other Subchapter C owners might also be determined from relatively public sources, such as annual reports or SEC materials that disclose the net taxable income and the total income taxes paid during the test year. However, the relevant information is not reasonably available for individual partners filing a Form 1040 or for corporate partners not affiliated with the regulated entity or whose stock is not publicly issued. Based on this experience, it is not always true, as stated in the *Policy Statement*, that the necessary information is in the exclusive control of the regulated entity.<sup>91</sup>

60. The December 2005 order recognized that it is unreasonable to require a partnership to provide information that it has no means of obtaining and then deny it an income tax allowance on that basis.<sup>92</sup> In the December 2005 order the Commission adopted a presumption that Subchapter C corporate partners would have a marginal tax rate of 35 percent. Upon reflection, this may be too high in the absence of more proof. In 1995 and 1996, the 35 percent corporate bracket was reached at \$335,000, with

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<sup>90</sup> *Trans-Elect*, 113 FERC at PP 6, 9, 15.

<sup>91</sup> See *Policy Statement* at P 42.

<sup>92</sup> Assuming that a jurisdictional partnership is eligible for a partnership, denying an income allowance in this manner would be arbitrary and almost certainly confiscatory given a regulated entity is entitled to a reasonable opportunity to recover its costs.

adjustments to reflect specific surcharges as taxable income increases further.<sup>93</sup> In contrast, the 34 percent corporate bracket was reached at \$75,000. While the dollar differences that separate the two brackets can be relatively narrow, if it is not possible to establish that a Subchapter C corporate partner fell in the 35 percent marginal bracket, the 34 percent marginal tax rate will be used. In instant case, if necessary, SFPP will be permitted to submit supporting testimony with its compliance filing since it has the burden in both Complaint and the Rate Filing Proceedings.

61. The December 2005 order also adopted a presumption of a 28 percent marginal tax bracket for individual investors or for fiduciary accounts (such as mutual funds, pensions, and trusts) where the beneficiaries could not be identified because a regulated entity would not have access to their confidential IRS returns. This assured that a tax allowance attributed to unidentified unit holders would be restricted to the 28 percent rather than one derived from the higher brackets. In developing the 28 percent presumption, the Commission concluded, based on the general financial materials in the record, that many pipeline MLPs are registered tax shelters or are intended to function as such,<sup>94</sup> a point that Shippers have vigorously urged. Given this, the Commission concluded that individuals that invest in MLP units most likely have income; otherwise they would have no need for the tax shelter feature of the investment.

62. Given the argument by Shippers that investors in these units have higher levels of income to be sheltered, such higher income will be reflected in adjusted gross income and the taxable income of those partners. Thus, the Commission sought a marginal bracket that would most likely capture income from a partnership because (1) that income will likely be included in adjusted gross income, or (2) the investor would likely have adjusted gross income and taxable income that would reflect at least that marginal tax bracket. For each test year the Commission has reviewed official published Internal Revenue Statistics on the distribution of adjusted gross income and taxable income.<sup>95</sup>

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<sup>93</sup> See IRS 1995 Instructions for Forms 1120 and 1120-A at 15; IRS 1996 Instructions for Forms 1120 and 1120-A at 13.

<sup>94</sup> Ex. Nos. SEP SFPP-21 at 1-2; SEP ARCO-22 at 4-5; Ex. No. SWST-18 at 43-44; BP West Coast Comments, Attachment A at 10.

<sup>95</sup> Regulatory agencies routinely rely on each others official data in making policy and adjudicatory decisions. For example, the Commission relies on the PPI index produced by the Department of Labor in implementing its annual oil pipeline index adjustments. See 18 C.F.R. § 342.3(d)(2) (2006). The Commission does not calculate the index using its own resources. The reliance on IRS statistics here is no different.

These reveal that in 1996,<sup>96</sup> the 28 percent marginal tax bracket covered income between \$24,000 and \$58,150 for an individual tax payer, and that 85.6 percent of all federal adjusted gross income was reported by taxpayers with adjusted gross income of more than \$25,000.<sup>97</sup> Such taxpayers had 61.6 percent of all taxable income, which is the amount taxed after all deductions and credits. As a further check, the Commission reviewed the 1995 and 1996 IRS statistics on the sources of income. Of the income derived from partnerships and Subchapter S corporations reported on all returns, in 1996 97.10 percent was from returns that had more than \$25,000 in adjusted gross income, and 97.02 percent in 1995.<sup>98</sup> For adjusted gross incomes in excess of \$40,000 the percent was 96.46 percent in 1996 and 94.58 percent in 1995. Since the income from an MLP must be reported as income derived from partnerships, these figures strongly suggest that partnership income is reported and taxes are actually paid or incurred by partners with at least a 28 percent marginal tax bracket. The Shipper parties also argue that investors in MLP receive much of their return from the payment of capital gains taxes, thus avoiding ordinary income taxes. The same IRS statistics for 1996 reveal that of taxable returns reporting capital gains, 93 percent had adjusted gross income of \$25,000 or more in 1996 and 90.28 percent in 1995.<sup>99</sup> For adjusted gross incomes in excess of \$40,000 the

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<sup>96</sup> See IRS 1996 Tax Rate Schedules. For married taxpayers filing jointly the 1996 figures were \$40,100 to \$96,900. *Id.* In 1995 the comparable range for single taxpayers was \$ 23,350 to 56,550 and for married filing jointly was \$39,000 to \$94,250. See IRS 1995 Tax Rate Schedules. The Commission notes that taxpayers do not get any credit for the social security contributions deducted from wages and salaries, which further reduces the cash available for investment after federal, state, and local taxes.

<sup>97</sup> See IRS Official Web Site, Tax Stats Page, and SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income - Table 1.1--1996 Individual Income Tax Returns, Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income. The same statistics are not available on the IRS public website, but close relationship between 1995 and 1996 income source statistics cited in the next footnote suggest that the relationship of income to adjusted gross income and taxable income would be close.

<sup>98</sup> See IRS Official Web Site, Tax Stats Page, SOI Tax Stats - All Returns: Sources of Income, Adjustments, and Tax Items: Table 1.4--1996, All Individual Income Tax Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income; Table 1.4--1995, Individual Income Tax Returns, All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income.

<sup>99</sup> *Id.*

percentage was 87.98 percent in 1996 and 87.32 percent in 1995, again strongly suggesting that taxpayers owning partnership interests are in the 28 percent bracket or higher even allowing for the lower tax rate paid on capital gains.

63. Thus, even if individuals with less than an adjusted gross income of \$25,000, or a couple with less than \$40,000 in adjusted gross income, had money to invest in MLP units, the IRS statistics support the Commission's conclusion that the 28 percent bracket is a conservative estimate of the marginal tax bracket that would apply to non-corporate investors in SFPP's limited partnership units. While the discussion here speaks in terms of individual tax payers, the Commission (and SFPP) extended the 28 percent marginal tax rate to entities having fiduciary obligations to individuals that cannot be identified. Such entities include mutual funds, various types of trusts, Individual Retirement Accounts and similar devices available individual taxpayers, and pension funds.

#### **4. The use of allocated income percentages**

64. The *Policy Statement* contains a relatively generic discussion of partnership law and taxation that assumed items of income, loss, and deduction incurred at the partnership level are allocated to the partners on the basis of their respective partnership interest. Thus, if a partner owns twenty percent of the partnership, that partner would be allocated 20 percent of net income, or if the partnership has a fiscal year loss, 20 percent of that loss.<sup>100</sup> In subsequent filings in the various complaint dockets involving SFPP it became clear that partnerships may allocate items of income, loss, and deduction among the partners in ways that do not reflect their respective partnership interests. Thus, in an extreme example, it is possible to allocate all items of loss and deduction to one category or group of partners, and all income to another. Recognizing this fact, the December 2005 order permitted SFPP to use the percentage of income allocated to each of the partners to determine the weighted marginal tax bracket to be used in calculating any income tax allowance. Some of the comments on the March 7 compliance filing assert that the ownership percentage of units should be used, not the percent of allocated income.<sup>101</sup> This basis for this position is that an allocation of income to the corporate partner, which has a 34 or 35 percent marginal tax rate, increases the weighted income tax allowance if the individual partners are have a collective lower marginal tax rate than the corporate partners.

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<sup>100</sup> See *Policy Statement* at P 42; cf. Footnote 35.

<sup>101</sup> Comments of the CCV Group at 13-14, O'Loughlin at 4-7.

65. The Commission again concludes that the allocated income percentages should be used. While the *Policy Statement* speaks in terms of an income tax allowance being based on ownership interests,<sup>102</sup> this should not prevent use of the most rational approach to accomplish the *Policy Statement's* goals. Income is the basis upon which an actual or potential income tax liability is based. As such, income establishes the financial cost imposed on the income and capital of the partnership by the partner's actual or potential income tax liability at such time as it is recognized. The purpose of the income tax allowance is to assure the regulated entity has an opportunity to earn its allowed return.<sup>103</sup> This would be defeated if the income tax allowance did not reflect the rate at which the actual or potential income tax liability is or will be incurred. The clear intention of the *Policy Statement* is to follow the weighted marginal income tax rate of the owning partners, and the decision here reflects a practical interpretation of the *Policy Statement* to reflect the realities of some partnership structures.<sup>104</sup> Some implications of this conclusion for the equity cost of capital were discussed earlier in this order.<sup>105</sup>

##### **5. Conclusions and instructions on income tax allowance issues.**

66. The December 2005 order resulted in a number of additional issues regarding the income tax allowance that might be afforded a regulated pass-through entity. The Commission has addressed several of these in the preceding paragraphs. In making its compliance filing and in preparing an estimated income tax allowance for the test years 1995 and 1996, SFPP must conform to classifications required by the December 2005 order and to the clarifications made in this proceeding. SFPP has already included much of the relevant data for the years 1995 and 1996 in its March 7, 2006 compliance filing in Docket Nos. OR92-8-000 *et al.* and OR96-2-000, *et al.* Subject to the possible

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<sup>102</sup> *Policy Statement* at PP 1, 13, 26-27, 41-42.

<sup>103</sup> *City of Charlottesville* at 1207; *See also City of Chicago v. FPC*, 385 F.2d 629,623 (D.C. Cir. 1967).

<sup>104</sup> For example, if the corporate and non-corporate partners each own 50 percent of the units, the weighted marginal cost is 31.5 percent (50 percent of 28 = 14 and 50 percent of 35 = 17.5, which when added is a weighted calculation of 31.5 percent).

<sup>105</sup> It is possible for the income allocated to partners to be offset by the reallocation of items of loss and deduction to achieve that purpose, which would result in a deferral of income recognition, and therefore actual taxes, until the deferrals created by the allocation are exhausted. This would present a partnership level deferral issue similar to that discussed earlier in this order. However, this particular allocation issue is not present here because only income was reallocated among the partners.

modification of the marginal tax rate attributed to corporations, it may utilize the information included in that filing. However, it must show its calculations and identify the source of any data used in the compliance filings and included in any supporting documents. All statements and the filing itself must be supported by affidavits.

#### **E. Other Cost of Service Issues.**

67. The cost of service issues on exceptions included the volumes to design the rates, the recovery of regulatory litigation costs, the amount for California real estate taxes, and the volumes to be used in the 1996 Rate Filing proceeding.

##### **1. Throughput**

68. The proposed throughput for the Complaint proceeding is based on the actual 1995 volumes, or 23,315,000 interstate barrels. This is uncontested and is adopted here, as it was by the ALJ. The ALJ adopted SFPP's proposed throughput of 18,519,652 barrels for the 1996 test year, agreeing with SFPP that the actual 1996 volumes of 20,933,300 barrels were unrepresentative given the sharp decline in Ultramar volumes that occurred after mid-1996. On exceptions, Chevron, Tosco, and Ultramar oppose the ALJ's conclusion. SFPP and the Staff support it.

69. The Commission will affirm the ALJ while recognizing that there is no wholly satisfactory method for resolving the matter of the 1996 test year throughput. However, the result adopted by SFPP and the ALJ is the one that most closely conforms to the Commission's costing procedure of starting with a base year, and the adjusting the base year to reflect changes that were known or measurable within 9 months of the end of the test period. As Staff points out on brief, the modification to the test period volumes should only reflect a change that is a significant lasting change, not a cyclical change.<sup>106</sup> SFPP met this burden with regard to the decline in Ultramar's volumes, which fell off sharply beginning in June 1996. Ultramar asserts that the record demonstrates that GATX's volumes were increasing at the same time that Ultramar's were decreasing during the period July 1996 through August 1997. It argues that those volumes should also be included, as should TRMI's, and to exclude them was arbitrary and capricious.

70. The Commission concludes that Staff and the ALJ are correct that the Shippers have not met their burden establish that the increase in GATX's volumes in 1997 meets

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<sup>106</sup> See Staff Brief Opposing Exceptions at 45-46. Citing *Northwest Pipeline Corporation*, 87 FERC ¶ 61,266 (1999) and *Williston Basin Interstate Pipeline Company*, 52 FERC ¶ 61,170 at 61,147-148 (1990).

the known and measurable standard. The overall record in this proceeding does not support Ultramar's position. The ID in the market-based rate case shows that GATX's total throughput on the Sepulveda Line (including intrastate volumes) was 14.84 million barrels in 1993, 14.80 million barrels in 1994, 15.03 million barrels in 1995, 14.29 million barrels in 1996, 14.27 million barrels in 1997, 12.76 million barrels in 1998, and 8.04 million barrels in 1999.<sup>107</sup> Thus, GATX's throughput was at best stable through 1998, and in fact followed the declining trend for the Sepulveda Line as a whole thereafter. The Commission did explore several other methods, including a test year from July 1, 1996 to June 30, 1997, to coincide with the first 12 month period in which Ultramar sharply reduced its volumes. This resulted in jurisdictional throughput of 20,015,133 barrels, more than the actual throughput of 19,614,000 barrels in 1997 or the throughput of 19,358,000 barrels in 1998. An average of these two numbers would be well outside the test period and would still not reflect the long term downward trend of throughput, which dropped to 9,167,000 barrels in 1999 and did not exceed that number in the next five years. The adopted throughput is 94.42 percent of the actual 1997 throughput, 95.67 percent of 1998 throughput, and 95.04 percent of the two years average. Given that rate making is not an exact science and SFPP is unlikely to recover all its Sepulveda Line costs after 1998 under these rulings, the ALJ's result is reasonable.

## **2. Regulatory Litigation Costs**

71. Using the test year methodology, the ALJ awarded SFPP a small amount for its regulatory litigation costs, with those costs to be recovered by means of a surcharge over five years. The ALJ denied SFPP any recovery of regulatory costs that were incurred in litigation regarding the jurisdictional status of Sepulveda Line services and the determination of whether SFPP should be permitted to use market-based rates for those services. SFPP opposes this result, arguing that this grossly under-recovers the regulatory costs of litigation related to the Sepulveda Line, and that both the jurisdictional and market-based rate proceedings were legitimate. Staff and the Shippers support the ALJ, asserting that SFPP's alternative proposal would result in a large component of any prospective rate being driven by the recovery of SFPP's past litigation expenses.

72. The Commission will reverse the ALJ. This litigation has proceeded over many years and includes three distinct phases. The first was to determine the jurisdictional status of the Sepulveda line, the second to determine whether SFPP could use market-based rates, and the third the reasonableness of the current five cents per barrel common carrier and previous five cents per barrel contract rates. While the Commission has notable reservations about certain of SFPP's arguments during the instant rate design

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<sup>107</sup> *SFPP, L.P.*, 93 FERC ¶ 63,023 at 65,127 (2000).



phase, the arguments advanced in the first two phases of these proceedings involved difficult issues of first impression and resulted in two close decisions.<sup>108</sup> The Commission therefore concludes that those proceedings were appropriate, as was the overall prosecution of the third phase of the case involving reasonableness and rate design. While spread over many years, the litigation costs at issue here involve one continuing proceeding, and like most rate case proceedings, and particularly those involving SFPP, should not be embedded in the prospective rate.

73. However, the costs are large and these raise inter-generational issues in this instance. As has been discussed, when the litigation started there were three parties using the Sepulveda Line under contracts: Ultramar, TRMI, and GATX. Beginning in 1996 Ultramar had shifted much of its volume to another line, a process it had largely completed by 1998. In 1998, TRMI also developed an alternative that permitted it to also move its volumes away from the Sepulveda Line. Thus, as demonstrated in the ID in the market-rate decision, by 1999 both shippers have shifted the bulk of their throughput to other alternative lines leaving GATX as the principal shipper on the Sepulveda Line.<sup>109</sup> Thus, this litigation directly benefits the 1995-1996 complainants although there are likely to be few litigation expenses attributed to the 1995 test year. It is unreasonable that the complainants in the 1995 Complaint proceeding should receive large reparations but would have no litigation costs included in the revised rates established for that year.

74. In light of these facts the Commission will add a litigation regulatory cost factor in the 1995 and 1996 Sepulveda Line rates it establishes here. This factor will be surcharge on all barrels transported in any year to which either rate the new 1995 or 1996 rate applies, including the reparation years, until SFPP's Sepulveda Line regulatory litigation costs are recovered. At that point the surcharge will cease and will be removed from the 1996 rates established here. SFPP's Sepulveda Line regulatory costs are stated as \$109,580 in 1996 and \$645,399 in 1997, or an average for the two years of \$377,489.50. This amount will be added to the cost-of-service in the two test years as the representative annual litigation costs for both the Complaint and the Rate Case Proceedings, both of which have continued since their filing to the current time. The test year volumes for 1995 are 23,315,000 barrels, which results in litigation cost per barrel of \$.0162 (1.62 cents). The test year volumes for 1996 are 18,519,652 barrels, which results in a per barrel cost of \$.0204 (2.04 cents). SFPP must provide an annual accounting

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<sup>108</sup> Both the ALJ's decision in the jurisdictional phase (78 FERC ¶ 63,017 (1997)) and the dissent in the market-based rate determination phase (102 FERC ¶ 61,240 at 61,724 (2003)) advanced reasonable arguments for their conclusions. This belies the argument that SFPP's positions had no merit.

<sup>109</sup> See *SFPP, L.P.*, 93 FERC ¶ 63,023 at 65,105 (2000).

within 30 days after the end of each year in which the new rates, or any subsequent rates apply, stating the amount of Sepulveda Line regulatory costs outstanding at the beginning and end of each year and the amount of those costs recovered during each year.

75. In applying this ruling, SFPP must itemize its Sepulveda Line regulatory litigation expenses for the years 1996 forward. It must apply the cost factor here to each barrel of throughput to which the new 1995 and 1996 just and reasonable rates apply. The yield will be used to offset the regulatory litigation costs at issue until this proceeding is completed, the total amount of the costs determined, and all such costs have been collected. After the month that this occurs, any differential during that month will be trued up, and the surcharge will be removed from the Sepulveda Line rates in effect at that time, including any successor rate to the new 1995 and 1996 rates established here.

### **3. California Real Estate Taxes.**

76. The ALJ rejected SFPP's proposed cost for California real estate taxes assessed against the Sepulveda Line on the grounds that SFPP had included an annualized accrual for taxes that would occur in 1997. SFPP objects to this conclusion, arguing that the accrual reflects actual experience during the first nine months of 1997. Staff and the Shippers oppose the adjustment. The ALJ and Staff correctly conclude that a normalization for the entire year falls outside the normal use of the known and measurable adjustment to the test period. The ALJ is affirmed.

### **F. Reparations and Refunds.**

77. The Commission is affirming the ALJ's conclusion that SFPP's rates are unjust and unreasonable for the periods covered by both the Complaint and Rate Filing proceedings. Reparations will be due for the Complaint proceeding for two years before the complaints for the shippers that filed those complaints and were billed the contract five cents per barrel rate from late 1993 through the effective date of the Sepulveda common carrier rate in October 1997. The common carrier five cents per barrel rate was accepted and suspended subject to refund, and as such refunds will be due for the difference between the level of that rate and any new rate based on the 1996 cost of service established here in the Rate Filing proceeding.

78. There are three issues raised on exceptions. First, SFPP argues that the new five cents per barrel contract rate in effect between 1993 and October 1997 was a lawful contract rate and should be enforced. It also argues that the 1983-1993 contracts were lawful contracts, and that the rates and charges therein were therefore grandfathered. It further argues that the fifteen cent rate embedded in those contracts therefore creates a rate floor. Second, BP West Coast argues that reparations should extend back to the original 1983-1993 contracts whose original terms expired in 1993. Third, there is a

dispute over what entity should receive the reparations and refund that would be due TRMI if that entity still existed.

79. The first two contentions are without merit. It is true that shippers and oil pipelines can enter into transportation contracts and those contracts will be enforced in accordance with their terms. This does not change the fact under section 6(1) the ICA all rates, fares, and charges must be on file with the Commission to be lawful.<sup>110</sup> As previously noted, the Supreme Court's 1990 *Maislin* decision held that there are no exceptions to this requirement. Thus, the contract rate, fare, or charge embodied in the contract must be a legal or lawful rate on file with the Commission before the rate component of the contract may be enforced. While SFPP cites the Opinion No. 435 orders for the contrary proposition, the court over-ruled that portion of the Commission's reasoning that relied on the filed rate doctrine. Moreover, the filed rate doctrine is premised on the existence of a lawful rate on file with the Commission. Therefore the Commission will not pursue that reasoning further here.<sup>111</sup>

80. The court did leave open the issue of whether a contract that included an unfiled rate in effect before the effective date of the EP Act of 1992 could be grandfathered. The Commission concludes that this is not possible. Section 1803(a) of the EP Act of 1992 explicitly contains the phrase "any rate in effect" in three different clauses of the section.<sup>112</sup> Section 6(3) of the ICA specifically states that no rate, fare, or charge shall go into effect until it has been on file with the Commission for 30 days unless the Commission permits the carrier's filing to become effective within a shorter period.<sup>113</sup> Given that *Maislin* was settled law when the EP Act of 1992 was enacted, the Commission concludes that grandfathering attaches only to those contracts that embody a rate, rate, or charge that was on file with the Commission, and therefore in effect, for the 365 period ending on the date of the enactment of that Act. As Shippers argue, it would be anomalous if the requirement of file under the ICA could be defeated by executing contract premised on a rate or charge that is not filed with the Commission.<sup>114</sup> Thus,

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<sup>110</sup> 49 App. U.S.C. § 6(1) (1988).

<sup>111</sup> *BP West Coast at 1274-75.*

<sup>112</sup> Sections 1803(a)(1) and (2), as well as the final clause of the section.

<sup>113</sup> 49 App. U.S.C. § 6(3) (1988).

<sup>114</sup> *Citing United States v. Baltimore & Ohio Railway Company*, 333 U.S. 169, 175 (1948).

neither the rates nor charges in the 1983-1993 contracts or the subsequent one year amendments are rates or charges eligible for grandfathering under the EP Act of 1992 because the relevant rate or charge was not on file with the Commission and “in effect” during the 365 period ending on the date of the enactment of the EP Act of 1992.

81. In any event, the five cents per barrel Sepulveda contract rate, or charge, at issue in Complaint proceeding was established well after the October 1992 effective date of the EP Act of 1992. As such, that five cents per barrel contract rate was a new charge or rate for a service and as such was not grandfathered. The parties may have amended their earlier 1983 to 1993 contract documents to memorialize the new charge, but the EP Act does not refer to contracts (or amendments) executed within one year prior to the effective date of the EP Act, but to rates and charges that were effective within that time.<sup>115</sup> Thus, even assuming that a contract amendment was involved rather than a new agreement, the matter here is no different than the developing of a new base rate after the effective date of the EP Act for an existing service. The new rate would be based on different economic concerns and assumptions or on new transportation terms and conditions; otherwise there would be no need to risk the loss of the grandfathered status. Any such new or revised rate must be filed with the Commission and would be outside the EP Act’s grandfathering provisions.

82. For similar reasons, there is no merit to BP West Coast’s efforts to relate back to charges collected under the 1983 to 1993 contracts. BP West Coast asserts that its first complaint in 1994 intended to reach all illegal or unlawful rates whether known at the time of the complaint or in the future. This argument falls for the basic reason that the Commission requires that complaints be made against specific rates and charges and plead such. General objections or statements of concern or intention are inadequate.<sup>116</sup> In any event, the 1993 five cents per barrel charge was a different charge based on contract terms and conditions that expired well before the filing of the first complaints in late 1995. As the other Shippers argue regarding that 1983 charge, this included an annual guarantee and a refund provision that were absent from the five cents per barrel contract charge or rate created in 1993. The ICA has a strict two year statute of limitations that places both the 1983-1993 contract terms and the rate or charges therein outside the reparation provisions of the Interstate Commerce Act.<sup>117</sup>

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<sup>115</sup> Section 1803(a) of the EP Act of 1992 provides that there “must be a substantial change to the economic basis of the rate.” (emphasis added).

<sup>116</sup> See *Shell Pipeline Company, LP*, 104 FERC ¶ 61,021 (2003) and cases cited.

<sup>117</sup> Section 16(3)(b), 49 App. U.S.C. §16(3)(b).

83. The Commission also concludes that there is no merit to SFPP's arguments that reparations should be denied because the shippers were sophisticated and had competitive alternatives. This matter was considered in the market-based proceeding and was rejected as a grounds for finding that SFPP lacked market power over a portion of the movements that were transported under the 1993 five cents per barrel contract charge. Similarly, the Commission reverses the ALJ's conclusion that GATX should not obtain reparations because it is now affiliated with KMEP, which also controls SFPP. The fact that GATX had become affiliated with KMEP was known to the Commission when the market-based rate decision issued, but this did not preclude GATX from being treated as a shipper in its own right and receiving the protection afforded by the IC Act.<sup>118</sup> That protection includes the right to receive reparations if the relevant rate is found to be unjust and unreasonable, as is the case here.

84. The third issue is what entity is the proper successor to TRMI and should receive any reparations and refunds that would have been due it if it were still an extant firm. The ALJ held that Chevron, and not Equilon, was the proper successor in interest to any reparation and refund claims that TRMI might have against SFPP. SFPP opposes this result, arguing that Chevron's witness contradicted himself, that the ALJ improperly placed the burden of proof on this issue on SFPP, and that relevant contractual documents do not support the ALJ's conclusion. SFPP also asserts that the ALJ's conclusions SFPP to the risk of double payment of any funds that might be due TRMI's successor and that the layout of the pipeline grid suggests the opposite conclusion. Staff and Shippers support the ALJ.

85. As was discussed, TRMI was one of three shippers that executed annual contracts beginning in 1983 for transportation at the five cents per barrel rate and one of two that filed a complaint. In the late 1990s the oil industry entered a period of consolidation. Two aspects of that consolidation are relevant here. First, on January 1, 1998, Texaco and Shell Oil Company created a joint venture called Equilon in the Los Angeles basin by contributing certain of their respective assets to that venture. TRMI remained a separate subsidiary of Texaco and continued certain of its operations in the Los Angeles area. In 2002 Texaco merged with Chevron and TRMI thus merged with Chevron. The sole issue here deals with the creation of the joint venture in 1998. The issue is whether any transportation claims TRMI may have had against SFPP at that time were retained by TRMI or transferred to Equilon in 1998 as a condition of the second merger. It is undisputed that Chevron is the successor entity if the interests were not transferred to Equilon. Finally, the issue here is not about the ability of Chevron to obtain complainant

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<sup>118</sup> Market Power Order, 102 FERC ¶ 61,240 at P 22, 39-40, 51, 62.

status by its acquisition of TRMI. It is solely about the claims arising from the filing of TRMI's complaint in 1993.<sup>119</sup>

86. The Commission affirms the ALJ. First, Chevron has provided detailed evidentiary materials on this matter and has explained that it was not until those materials were available that it was able to determine that it, not Equilon, was successor to the TRMI complaint. Second, when the Commission created Docket No. OR96-2-012 as a separate proceeding for all Sepulveda Line issues, Equilon was notified and did not respond.<sup>120</sup> It also did not object to Chevron's proposal, as a successor to TRMI, on September 27, 2004 to dismiss the complaint TRMI had filed against the Sepulveda Line charge January 10, 2000. While SFPP opposed the motion and the Commission has not acted on it, Equilon's quiescence is a strong indicator that the ALJ's conclusion is correct. The record also establishes that SFPP never billed Equilon for transportation services after the creation of Equilon and that Texaco (*i.e.* TRMI) continued to be billed for transportation over the Sepulveda Line after 1998 and paid the invoices.

87. Another telling point is that Equilon owned two separate lines of its own after its creation (Equilon lines 25 and 28) and that Texaco began to use Line 28 as competitor to the Sepulveda Line after Equilon was created in 1998. Chevron and its witness quite logically argue that there was little reason to transfer a contract to Equilon when Equilon had no need for it and was in fact a direct competitor of the Sepulveda Line.<sup>121</sup> The Commission also agrees that in creating a joint venture the assets to be transferred would normally be specifically itemized to avoid any confusion and conflicting rights by the parties. Silence would be a weak reed upon which to base a legal right unless that instrument was specifically incorporated into the asset transfer. Finally, the Commission concludes that there is no merit in SFPP's argument that it would be exposed to double liability as the Commission's ruling will be binding on all parties involved and Equilon has not appeared despite the notice provided it.<sup>122</sup> The ALJ is affirmed on this issue.

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<sup>119</sup> *Cf.* ID at P 181

<sup>120</sup> *Id.* PP179, 187.

<sup>121</sup> *See* 98 FERC at 65,105.

<sup>122</sup> The Commission also concludes that it would be inequitable for SFPP to retain the reparations and refunds that would be due TRMI in any event. If those funds are not due Chevron, they should be credited against the high litigation regulatory costs to be recovered here to avoid a regulatory windfall. *See BP West Coast* at 1294.

### **G. Conclusion.**

88. The Commission finds that the five cents per barrel contract rate for transportation over the Sepulveda Line was unjust and unreasonable as of the date of the complaints filed against that rate filed in December 1995 and January 1996 in the Complaint proceeding. The Commission further finds that the five cents per barrel common carrier rate filed by SFPP in October 1997 in the Rate Filing proceeding is not just and reasonable. SFPP must prepare and file with the Commission within 30 days after this order issues revised cost-of-services for the test years 1995 and 1996 consistent with the requirements of this order. The calculation of any income tax allowance must follow the categories and procedures established by the December 2005 order, as further clarified in this order. The rate-of-return on equity shall be recalculated to reflect the two adjustments required in the body of this order.

89. SFPP must develop a revised 1995 cost-of-service and use that cost of service to develop a 1995 rate for the purpose of calculating the reparations due in the Complaint proceeding. SFPP must also develop a 1996 revised cost-of-service common carrier rate for transportation over the Sepulveda Line for the period after the effective date of the rate five cents per barrel rate filed in October 1997. The revised 1996 rate should be indexed forward to an effective date of February 1, 2007, and will apply to all interstate shipments over the Sepulveda Line after that date. SFPP must calculate the reparations and refunds accordingly and include a reparations and refund schedule in its compliance filing.

#### **The Commission orders:**

(A) The findings and conclusions of the ALJ in August 25, 2005 ID are affirmed and reversed as stated in this order.

(B) Within 30 days after this order issues, SFPP must make a compliance filing establishing a revised cost of service for the 1995 and 1996 test years consistent with the requirements of this order.

(C) Within 30 days after this order issues SFPP must file the revised rates for the Complaint and Rate Filing proceedings, including the litigation cost surcharge, as specified in this order, with the revised rate in the Rate Filing proceeding (Docket No. IS98-1-000) and litigation cost surcharge to be effective February 1, 2007, subject to refund.

(D) Within 30 days after this order issues SFPP must prepare and file with the Commission an estimated refund report based on the rates required in the previous paragraph.

(E) The conclusions on the income tax allowance issue contained in this order and the resulting rate element, and hence the revised rates required here, are subject to the outcome of the pending judicial appeal discussed in body of this order.

By the Commission.

( S E A L )

Magalie R. Salas,  
Secretary.