

**PREPARED DIRECT TESTIMONY OF  
DWIGHT E. JETER  
ON BEHALF OF  
SALTVILLE GAS STORAGE COMPANY L.L.C.**

A. I received a Bachelor of Science degree in Accounting from the University of Missouri in Columbia, Missouri, in 1973. After obtaining my degree, I worked for a predecessor of Price Waterhouse Coopers (“PWC”) for two years as part of their audit team and for 10 years as part of their tax consulting group. I held positions at PWC with increasing responsibilities over time and was a Senior Manager when I left the firm in 1985 to join Panhandle Eastern Corporation (“Panhandle”), a predecessor of Spectra Corp. At Panhandle and its successor PanEnergy Corp (“PanEnergy”), I held the position of Tax Director, Research & Planning from 1985 through 1997, and I also served as Panhandle’s tax

1 representative to the Tax Committee of the Interstate Natural Gas Association of  
2 America, the trade organization that advocates regulatory and legislative positions  
3 of importance to the natural gas pipeline industry, for five of those years. From  
4 1997 through 2006, I held various positions within the corporate tax department  
5 of Duke Energy Corporation (“Duke”) following PanEnergy’s merger with Duke.  
6 My responsibilities at Duke included tax research and planning for Duke’s  
7 domestic activities and businesses, as well as various international tax matters.  
8 Since Duke’s spin-off of Spectra Corp at the beginning of 2007, I have served in  
9 my current position as General Manager Tax, Research & Planning for Spectra  
10 Corp.

11 As part of my current responsibilities, I researched and advised Spectra  
12 Corp regarding the tax consequences to Spectra Corp related to the income tax  
13 liability generated by Saltville following the contribution of the ownership of  
14 Saltville to a subsidiary of Spectra Energy Partners, LP (“SEP”), a publicly-  
15 owned master limited partnership (“MLP”) formed last year by Spectra Corp.

16 **Q. 3 On whose behalf are you testifying in this proceeding?**

17 A. I am testifying on behalf of Saltville.

18 **Q. 4 Have you previously testified before the Federal Energy Regulatory**  
19 **Commission?**

20 A. No.

21 **Q. 5 What is the purpose of your testimony in this proceeding?**

22 A. The purpose of my testimony is to support Saltville’s proposed federal and state  
23 income tax allowance and to explain why the expected contribution of the

1 ownership of Saltville to a subsidiary of SEP will have no effect on the actual or  
2 potential income tax liability generated by Saltville.

3 **Q. 6 What statements, schedules, or exhibits are you sponsoring in conjunction**  
4 **with your testimony?**

5 A. I am sponsoring Part 2 of Statement H-3 and Schedules H-3.1 and H-3.2. I am  
6 also sponsoring the following exhibits: (i) SGS-26, which sets forth Spectra  
7 Corp's federal taxable income for calendar year 2007; (ii) SGS-27, which  
8 includes portions of Spectra Corp's 10-K for calendar year 2007; (iii) SGS-28,  
9 which includes the U.S. Master Tax Guide's corporate income tax rates for 2007;  
10 (iv) SGS-29, which is a schedule that shows the remedial allocations for calendar  
11 year 2007 to the Spectra Corp unitholders of SEP; (v) SGS-30, which includes the  
12 Schedule K-1s for each such Spectra Corp unitholder for calendar year 2007; and  
13 (vi) SGS-31, which includes a draft Form 1065 for calendar year 2007 for SEP.

14 **Q. 7 Were these statements and exhibits prepared by you or under your direction**  
15 **or supervision?**

16 A. Yes. Part 2 of Statement H-3, Schedules H-3.1 and H-3.2, and all of these  
17 exhibits were prepared under my direction and supervision.

18 **FEDERAL INCOME TAX LIABILITY**

19 **Q. 8 Why is it necessary to explain that contributing the ownership of Saltville to**  
20 **a subsidiary of SEP will have no effect on the actual or potential income tax**  
21 **liability generated by Saltville?**

22 A. As of the date of this Section 4 rate case filing ("Rate Filing"), Saltville is a  
23 wholly-owned subsidiary of Spectra Energy Transmission, LLC ("Spectra")  
24 which, in turn, is a wholly-owned indirect subsidiary of Spectra Corp. This  
25 organizational structure remained unchanged for the entirety of calendar year  
26 2007. For federal income tax purposes, the income currently generated by

1 Saltville is consolidated at the Spectra Corp level. Therefore, presently, it is clear  
2 that the marginal federal income tax rate for each dollar of taxable income  
3 generated by Saltville is the marginal federal income tax of Spectra Corp. In turn,  
4 prior to the contribution of Saltville to a subsidiary of SEP, the appropriate  
5 marginal federal income tax rate to use in determining an appropriate federal  
6 income tax allowance for Saltville is clearly the marginal federal income tax rate  
7 of Spectra Corp.

8 Following the contribution of Saltville to a subsidiary of SEP, Saltville  
9 will no longer be a wholly-owned, indirect subsidiary of Spectra Corp because, as  
10 Mr. Gregg E. McBride explains in his Prepared Direct Testimony in this  
11 proceeding, at the time of the contribution, approximately 16 percent of SEP will  
12 be owned by non-Spectra Corp unitholders. Under some MLP structures such a  
13 change could affect a determination of the actual or potential income tax liability  
14 generated by a contributed jurisdictional entity. That is not the case for Saltville.  
15 Accordingly, I am testifying to explain why the actual or potential income tax  
16 liability generated by Saltville after the contribution will continue to be the same  
17 as it was prior to the contribution, at least for the next several years and possibly  
18 longer.

19 **Q. 9 What is the marginal federal income tax rate for Spectra Corp?**

20 A. It is 35 percent.

21 **Q. 10 Please explain.**

22 A. Spectra Corp is a sub-chapter C corporation, with federal taxable income for  
23 calendar year 2007 well in excess of \$18 million. I have attached an exhibit,  
24 designated as SGS-26, that sets forth Spectra Corp's estimated federal taxable

1 income for 2007. As this exhibit shows, Spectra Corp's estimated federal taxable  
2 income for calendar year 2007 was \$749,467,245. The Spectra Corp 2007 federal  
3 tax return is being prepared and will not be final until the summer. The estimate  
4 was prepared as part of the 2007 closing of the books for financial reporting  
5 purposes. I have also attached relevant portions of Spectra Corp's 10-K for 2007,  
6 designated as SGS-27, which further defines Spectra Corp's earnings and taxable  
7 income for 2007.

8 Because \$18 million is the threshold at which the marginal federal income  
9 tax rate switches from 34 percent to 35 percent, Spectra Corp's marginal federal  
10 income tax rate is 35 percent. I have included the relevant portion of the U.S.  
11 Master Tax Guide, designated as SGS-28, that sets forth the corporate federal  
12 income tax rates for 2007. This exhibit shows that the marginal federal income  
13 tax rate for corporate taxable income in excess of \$18,333,333 is 35 percent.

14 **Q. 11 You mentioned earlier that the contribution of Saltville would not result in a**  
15 **change to the actual or potential income tax liability generated by Saltville.**  
16 **Please explain.**

17 A. It is important to understand the upstream ownership structure of Saltville  
18 following the expected contribution of the ownership of Saltville to a subsidiary  
19 of SEP. Mr. Gregg E. McBride, in his Prepared Direct Testimony, provides a  
20 detailed description of the upstream ownership structure of Saltville both before  
21 and after the contribution. As Mr. McBride explains, following the expected  
22 contribution, approximately 84 percent of SEP will be owned indirectly by  
23 Spectra Corp through Spectra, Spectra Energy Southeast Pipeline Corporation  
24 ("SEPL") and Spectra Energy Partners (DE) GP, LP ("SEP GP") (collectively, the  
25 Spectra Unitholders"), with public unit-holders owning the remaining 16 percent.

1 For federal income tax purposes, the income recognized by the Spectra  
2 Unitholders, including income from Saltville that is allocated to these unitholders  
3 following the expected contribution of Saltville to SEP, is consolidated at the  
4 Spectra Corp level. Exhibit No. SGS-6, which is attached to Mr. McBride's  
5 testimony, provides an organizational chart that illustrates Saltville's upstream  
6 ownership following the contribution of its ownership to SEP.

7 As the Spectra Corp organizational structure and income tax reporting  
8 procedure demonstrate, following the contribution of Saltville to SEP, 84 percent  
9 of the ownership of Saltville will be attributed to Spectra Corp, a sub-chapter C  
10 corporate taxpayer. Thus, the question with respect to a determination of the  
11 actual or potential income tax liability generated by Saltville's income following  
12 the contribution resides with the 16 percent of SEP that is owned by public  
13 unitholders. However, at this point, the public unitholders will have no effect on  
14 a determination of the actual or potential income tax liability associated with the  
15 income generated by Saltville, and it still will be appropriate following the  
16 contribution to assume Spectra Corp's marginal federal income tax rate of 35  
17 percent for the entirety of Saltville.

18 **Q. 12 Why will it continue to be appropriate to assume Spectra Corp's marginal**  
19 **federal income tax rate of 35 percent in determining the actual or potential**  
20 **income tax liability generated by Saltville following the contribution?**

21 A. I have included a schedule, designated as Exhibit SGS-29, that illustrates why this  
22 is the case, but it is important first to understand the Commission's current policy  
23 in this regard. The Commission's current policy, as I understand it, dictates that a  
24 jurisdictional entity owned through a tax-pass-through partnership structure, like  
25 Saltville following the contribution, continues to be entitled to an income tax

1 allowance in its rates if the entity can establish that its partners had an actual or  
2 potential income tax liability on the distributive income that was attributed to  
3 them.<sup>1</sup>

4 In a proceeding involving SFPP, L.P. (“SFPP”), a limited partnership that  
5 owns petroleum products pipeline assets, the Commission concluded that, for  
6 purposes of determining the actual or potential income tax liability generated by  
7 SFPP, the pipeline should calculate a weighted marginal tax rate on the basis of  
8 how partnership income is allocated, not on the basis of nominal partnership  
9 interests and not on the basis of actual distributions.<sup>2</sup> The Commission  
10 determined in the SFPP proceeding that once the weighted marginal tax rate is  
11 calculated, that tax rate should be applied to SFPP’s jurisdictional income because  
12 that is the income being regulated and where the tax cost of the partner must be  
13 compensated.<sup>3</sup> The Commission clarified that when determining the actual or  
14 potential tax liability generated by a pipeline, the issue is the imposition of the tax  
15 cost to the partners for the relevant period. If income is allocated to a partner for  
16 the period in excess of its nominal partnership interest, that income becomes the  
17 partner’s distributive income for the purposes of this determination.

18 **Q. 13 How would this policy apply to Saltville after the contribution to SEP?**

19 A. In determining the actual or potential income tax liability generated by Saltville  
20 after the contribution, the Commission’s policy directs Saltville to determine the  
21 income allocated by SEP to its unitholders for a particular period that serves as a

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<sup>1</sup> *Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139 (2005).

<sup>2</sup> *SFPP, L.P.*, 113 FERC ¶ 61,217 (2005), *order on reh’g, remand, compliance and tariff filings*, 121 FERC ¶ 61,240 (2007).

<sup>3</sup> *Id.*

1 proxy for calculating the appropriate weighted marginal income tax rate. Because  
2 Saltville's direct parent company is a wholly-owned, tax pass-through subsidiary  
3 of SEP, the appropriate entity to use for this calculation is SEP. SEP was created  
4 in July 2007, and therefore, the only period available to use as a proxy for this  
5 calculation is calendar year 2007. The schedule provided in Exhibit No. SGS-29  
6 shows the allocation of federal taxable income for calendar year 2007 among the  
7 Spectra Unitholders and the public unitholders of SEP. It is important to  
8 remember that this is an allocation of taxable income, not distributions among the  
9 unitholders. As the schedule shows, the taxable income generated by SEP during  
10 2007 was \$18.9 million. Line No. 1 of the schedule shows the ownership  
11 percentage breakdown between the Spectra Unitholders and the public unitholders  
12 of SEP during 2007 – 83 percent and 17 percent, respectively. As Line No. 2 of  
13 the schedule shows, an allocation of the \$18.9 million in taxable income based  
14 upon nominal partnership units would be \$15.6 million, or 83 percent, to the  
15 Spectra Unitholders, and \$3.3 million, or 17 percent, to the public unitholders.  
16 However, for income tax purposes, income was allocated in a different manner.

17 **Q. 14 Please explain.**

18 A. When property contributed to an MLP has a difference between its fair market  
19 value and its tax basis at the time of the contribution (the "Built-In Gain"),  
20 Section 704(c) of the Internal Revenue Code of 1986, as amended (the "Code"),  
21 requires that allocations of items of taxable income, gain, loss and deduction of an  
22 MLP related to the contributed property take into account the Built-In Gain. The  
23 purpose of Code Section 704(c) is generally to allocate to the property contributor  
24 the tax consequences of the Built-In Gain, notwithstanding the property



1 contributor's overall percentage interest in the MLP. As a mechanical matter, this  
2 is accomplished by allocating a disproportionate amount of taxable income  
3 attributable to a sale of the contributed property to the property contributor and  
4 away from the non-contributing public unitholders. If, instead of selling the  
5 contributed property, the MLP owns and operates the property for its entire useful  
6 life (for tax purposes), Code Section 704(c) will generally cause the same overall  
7 tax result to occur by effectively allocating a disproportionate share of net taxable,  
8 operating income to the property contributor. Simplistically, this is done by  
9 allocating depreciation to the non-contributing public unitholders equal to their  
10 percentage interest in the fair market value of the contributed property, regardless  
11 of whether there is enough tax depreciation to accomplish this result. If there is  
12 insufficient tax depreciation to provide the public with depreciation equal to the  
13 fair market value of the contributed property, the shortfall is made up by  
14 allocating "deemed" tax depreciation to the public equal to the shortfall and an  
15 equivalent amount of ordinary income to the contributing partner. This allocation  
16 of "deemed" tax depreciation to the public and the recognition of income by the  
17 contributing partner is referred to as a "remedial" allocation.

18 In the instant case, Spectra Corp, through its ownership of Spectra, will  
19 bear the Built-In Gain relating to Saltville, and Spectra Corp, through its  
20 ownership of the Spectra Unitholders, will continue bearing the Built-In Gain of  
21 property already contributed to SEP, which, to date, has been entirely Spectra  
22 Corp property. Specifically, with respect to Saltville and the other property  
23 previously contributed into SEP, as a result of the remedial allocations associated

1 with these Built-In Gains, Spectra Corp, through the Spectra Unitholders, will  
2 recognize over 100 percent of the taxable income generated by Saltville during  
3 the test period for this rate case. The contribution of Saltville to the MLP by  
4 Spectra Corp is expected to increase the overall allocation of taxable income from  
5 the MLP to the Spectra Unitholders during the test period for this rate case. This  
6 is because Spectra Corp already was recognizing the Built-In Gain associated  
7 with the assets contributed at the time of the creation of SEP. This additional  
8 property contribution results in an increase in the remedial allocation to the  
9 Spectra Unitholders.

10 **Q. 15 Please explain how this remedial allocation to the Spectra Unitholders has**  
11 **been applied since the creation of SEP in July 2007.**

12 A. In the formation of SEP in July 2007, the property contributed by Spectra Corp  
13 through the Spectra Unitholders had a fair market value of approximately  
14 \$1,937.9 million and a tax basis of approximately \$818.3 million for a Built-In  
15 Gain of approximately \$1,119.6 million. Approximately \$647.1 million of this  
16 Built-In Gain is tangible property and approximately \$473 million of this Built-In  
17 Gain is intangible property. Current assets and liabilities had an associated loss of  
18 \$0.5 million. Over time, the public unitholders of SEP will be allocated their 17  
19 percent share of the fair market value through depreciation and amortization  
20 deductions, or other cost recovery. This allocation is performed in a two-step  
21 process. First, the public unitholders will be allocated their 17 percent share of  
22 available tax depreciation/amortization, or \$139 million in the aggregate. The  
23 public unitholders are also entitled to cost recovery associated with their share of  
24 the fair market value in excess of the available tax basis, which is 17 percent of

1 the Built-In Gain of approximately \$1,119.6 million, or approximately \$190  
2 million. In short, the public unitholders are allocated \$190 million of deductions  
3 over time and the Spectra Unitholders recognize income through the shifting of  
4 depreciation and amortization.

5 For the year 2007, the amount of the shifting is approximately \$4.0  
6 million, as reflected on Line No. 3 of the schedule attached hereto as Exhibit  
7 SGS-29. For 2008, the amount shifted is expected to be greater due to the  
8 contribution of Saltville into SEP and due to the fact that 2008 will reflect shifting  
9 over a full 12-month period, while 2007 was only a partial year with respect to the  
10 previous contributions of property.

11 **Q. 16 Is the actual allocated income amount in Exhibit SGS-29 reflected in data**  
12 **provided to the Spectra Unitholders?**

13 A. Yes. SEP is required by the Code and Internal Revenue Service ("IRS")  
14 regulations to provide each of its unitholders with a Schedule K-1 (Form 1065)  
15 each year, reflecting the unitholder's distributions from the previous calendar  
16 year, its allocated income for the previous calendar year and other tax and capital  
17 account adjustment information. I have included, in Exhibit SGS-30, the K-1s for  
18 each of the Spectra Unitholders for calendar year 2007. These K-1s have been  
19 provided to us by PWC, the outside service provider for Schedule K-1  
20 preparation, and are based upon information that SEP has provided to PWC, as  
21 well as the audited financials of SEP for calendar year 2007. As the K-1s reflect,  
22 the ordinary business income (loss) for 2007 for Spectra, SEPL and SEP GP is  
23 \$1,897,031, \$5,287,330 and \$6,838,552, respectively, and the allocated interest  
24 income to these entities is and \$1,256,165, \$4,139,583 and \$133,239,

1           respectively, for a total allocated income to the Spectra Unitholders of  
2           \$19,551,900. The amounts for both ordinary business income and allocated  
3           interest income are reflected in my schedule in Exhibit SGS-29 on Line Nos. 16-  
4           17, 19-20 and 22-23, respectively. Finally, I note that I have included, as Exhibit  
5           SGS-31, a draft Form 1065 for SEP for 2007. Page 1, Line No. 22 of the Form  
6           1065 reflects ordinary business income for SEP for 2007 of \$12,231,505, and  
7           Page 2, Line No. 5 reflects interest income for SEP for 2007 of \$6,662,350.  
8           These two amounts together reflect the aggregate taxable income amount for SEP  
9           for 2007 of \$18,893,855, which is reflected at the top of my schedule in SGS-29.

10   **Q. 17 You state that the Form 1065 for SEP is a draft. Why is that?**

11   A.    The Form 1065 is a draft because it has not yet been completed and filed with the  
12           IRS. I note also that while the K-1s are available to the SEP unitholders, they are  
13           not yet final because they also have not been filed with the IRS. However, the  
14           amounts reflected on the draft Form 1065 and the K-1s are accurate and any  
15           change to an amount prior to filing the Form 1065 and the K-1s with the IRS will  
16           be *de minimis*.

17   **Q. 18 Do the K-1s in Exhibit SGS-30 and the SEP Form 1065 in Exhibit SGS-31**  
18           **reflect the final taxable amount for SEP for calendar year 2007?**

19   A.    No.

20   **Q. 19 Why not?**

21   A.    The final amount is still being finalized, but if there is a difference between the  
22           taxable amounts shown in Exhibits SGS-29, SGS-30 and SGS-31 and the final  
23           taxable amounts, the difference would be related to a minor tax adjustment that  
24           was made while preparing the tax return.

1   **Q. 20 Please explain.**

2   A.     In January of this year, SEP calculated its taxable income for calendar year 2007,  
3           and provided that amount to PWC, so that PWC had the information necessary to  
4           allocate the income among the approximately 15,000 unitholders. In March and  
5           April of this year, SEP actually will prepare its tax return. At the time of the  
6           preparation of the tax return, SEP anticipates a small tax adjustment of less than  
7           \$10,000 due to the organizational expenses for forming SEP. At this point, we  
8           know of no other tax adjustments.

9   **Q. 21 Is it possible for this small tax adjustment or any other tax adjustment that**  
10   **may occur in the preparation of SEP's tax return for 2007 to affect the**  
11   **taxable income allocated to the public unitholders?**

12   A.     It is unlikely. First, technically, the adjustment described and any other potential  
13           adjustment would not impact the taxable income to the public unitholders. In any  
14           event, \$10,000 is immaterial in the overall taxable income calculation when one  
15           spreads that amount over 66 million limited partner units. Also, the adjustment  
16           and any other likely adjustment are or would be deductions and would lower  
17           taxable income. The public unitholders are currently in a loss position, from a  
18           taxable income standpoint, and the additional deduction would increase the  
19           amount of the loss.

20   **Q. 22 How does the SEP income allocation for 2007 translate into a marginal**  
21   **income tax rate to use for calculating the income tax liability for Saltville?**

22   A.     As I stated earlier, the Commission clarified in the SFPP proceeding that the issue  
23           when determining the actual or potential tax liability generated by a pipeline is the  
24           imposition of the tax cost to the partners for the relevant period. Therefore, if  
25           income is allocated to a partner for the period in excess of its nominal partnership

1 interest, that income becomes the partner's distributive income for the purposes of  
2 this determination. With respect to SEP for calendar year 2007, the actual income  
3 allocated among the unitholders following the recognition by the Spectra  
4 Unitholders of a portion of its deferred gain, resulted in an allocation of income to  
5 the Spectra Unitholders that exceeded the income generated by SEP and an  
6 allocation of negative income to the public unitholders. As explained earlier, all  
7 income allocated to the Spectra Unitholders generates a federal income tax  
8 liability subject to Spectra Corp's marginal tax rate of 35 percent. Accordingly,  
9 for purposes of this Rate Filing, because all of SEP's taxable income for the proxy  
10 year 2007 was allocated to the Spectra Unitholders, the weighted marginal federal  
11 income tax rate to use for purposes of calculating the actual or potential income  
12 tax liability generated by Saltville following the contribution to SEP is 35 percent.

13 **Q. 23 Will this shift of depreciation and amortization to the Spectra Unitholders**  
14 **change after Saltville is contributed to SEP?**

15 A. Yes, it will actually increase the amount of the depreciation and amortization  
16 shift.

17 **Q. 24 Please explain.**

18 A. Following Spectra Corp's contribution of Saltville to SEP, the Spectra  
19 Unitholders will be responsible for an additional deferred gain equal to the  
20 difference between the depreciated book value of Saltville on Spectra Corp's  
21 books and the higher market value of Saltville at the time of the contribution. In  
22 addition, because there is a significant amount associated with the existing  
23 deferred gain, which has not yet been recognized by the Spectra Unitholders for  
24 income tax purposes, this amount, along with the deferred gain associated with

1 the Saltville contribution, will result in a significant shift of taxable income to the  
2 Spectra Unitholders and away from the public unitholders of SEP. This is  
3 expected to result in all of the taxable income generated by SEP, including the  
4 income generated by Saltville, being allocated to Spectra Corp for the next several  
5 years and perhaps longer.

6 **Q. 25 How is the weighted average federal income tax rate utilized in the overall**  
7 **calculation of the rates proposed in Saltville's Rate Filing?**

8 A. Once I calculated the appropriate weighted federal income tax rate, I supplied that  
9 rate to Ms. Kimberly Johnston for her Prepared Direct Testimony in this  
10 proceeding. Ms. Johnston uses the rate in calculating the accumulated deferred  
11 income tax and total weighted federal income tax allowance. Ms. Johnston's  
12 calculations are then used in determining the overall cost-of-service underlying  
13 the rates proposed by Saltville in the Rate Filing.

14 **STATE INCOME TAX LIABILITY**

15 **Q. 26 Have you calculated the weighted average state income tax rate to use for**  
16 **state income tax allowance purposes following the contribution of Saltville to**  
17 **SEP?**

18 A. Yes, I have.

19 **Q. 27 Please explain your calculation.**

20 A. First, I want to note that my calculation is determined based on the weighted  
21 marginal state income tax rate of all SEP Unitholders that were allocated income  
22 during 2007, the proxy year for all calculations associated with the relevant  
23 weighted marginal income tax rates used in deriving Saltville's proposed rates.  
24 As I discussed earlier, for calendar year 2007, all taxable income generated by  
25 SEP was allocated to the Spectra Unitholders and, in light of the remedial

1 allocations described above, including those associated with Saltville after the  
2 contribution, all taxable income generated by SEP likely will be allocated entirely  
3 to the Spectra Unitholders for the next several years and perhaps longer.  
4 Accordingly, all state income tax liability generated by SEP and Saltville, like  
5 federal income tax liability generated by SEP and Saltville, also will be allocated  
6 to the Spectra Unitholders. Therefore, my calculation is based on the weighted  
7 marginal state income tax rate of the Spectra Unitholders, as they are the only  
8 SEP unitholders that are required to declare SEP's income in the states in which  
9 SEP operates.

10 **Q. 28 How did you calculate the relevant weighted marginal state income tax for**  
11 **the Spectra Unitholders?**

12 A. I want to note that there are two methods by which the relevant marginal state  
13 income tax rate could be calculated for the Spectra Unitholders. One method is to  
14 assume that the Spectra Unitholders sole source of state taxable income is income  
15 generated by Saltville and also to assume that the state in which Saltville's  
16 operations are based, Virginia, is the only state in which the Spectra Unitholders  
17 are required to file a state income tax return attributable to Saltville's income.  
18 This method eliminates the inequities of factoring in the state income taxes and  
19 apportionment percentages of potentially numerous states and thus avoids the  
20 potential for the state income tax allowance calculation to factor in a greater  
21 amount of tax liability than would otherwise be the case under a method based  
22 solely on the source of relevant income. This method is known as the stand-alone  
23 method and it is the Commission's historical method for determining an income



1 tax allowance.<sup>4</sup> This method would result in a marginal state income tax  
2 percentage of 6 percent. I believe this is the most appropriate method for  
3 calculating the state income tax liability generated by Saltville after its  
4 contribution to SEP. However, Saltville has decided to use the second method  
5 described below for this Rate Filing, which results in a lower state income tax  
6 allowance, in order to avoid a controversy regarding the state income tax  
7 allowance in this proceeding.

8 **Q. 29 Please explain this second method.**

9 A. Both methods are based upon the underlying premise that the relevant marginal  
10 state income tax rate is the weighted marginal tax rate of all SEP unitholders that  
11 are required to declare SEP's income in the states where SEP operates. Because  
12 the Spectra Unitholders are the only SEP unitholders required to declare SEP's  
13 income for federal and state income tax purposes for calendar year 2007, my  
14 calculation with respect to the second method assumes that Saltville's state  
15 taxable income was included in SEP's state taxable income for calendar year  
16 2007, and then it determines what state income tax liability that income generated  
17 for each Spectra Unitholder.

18 **Q. 30 Do you have a schedule that explains this calculation?**

19 A. Yes. Schedules H-3.1 and H-3.2 provide my calculation of the appropriate  
20 weighted average state income tax rate for this Rate Filing. Line No. 1 reflects  
21 the taxable income allocated to each of the Spectra Unitholders. The taxable  
22 income amounts tie to each Spectra Unitholder's Schedule K-1, Exhibit SGS-30,

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<sup>4</sup> *City of Charlottesville v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985), writ denied, 475 U.S. 1108 (1986); see also *Kern River Transmission Co.*, 117 FERC ¶ 61,077, at P 221 (2006).

1 and I have layered in the taxable income generated by Saltville during 2007, as  
2 well. Line No. 2 on Schedule H-3.1 provides the blended state income tax rate for  
3 2007 for each Spectra Unitholder. Spectra's blended state income tax rate is the  
4 blended state income tax rate for Spectra Corp because Spectra, as a limited  
5 liability company that is wholly-owned by Spectra Corp, is a disregarded entity  
6 for tax purposes and is therefore consolidated with, and taxed at, Spectra Corp's  
7 separate company blended state income tax rate. Statement H-3, Part 2 and  
8 Schedule H-3.1 provide Spectra Corp's blended tax rate by state for each state in  
9 which Spectra Corp was required to file a state income tax return for 2007. SEPL  
10 is a corporation and it pays state income taxes directly. Therefore, Line No. 2 of  
11 Schedule H-3.1 reflects SEPL's actual blended state income tax rate for 2007.  
12 The blended rate for the state income tax liability allocated to SEP GP is the same  
13 as SEPL's blended rate because SEPL owns 99 percent of SEP GP. SEP GP is a  
14 tax pass-through entity and SEPL reports its 99 percent share of SEP GP's taxable  
15 income. As shown on Schedule H-3.2, the blended state income tax rate for all  
16 three of the Spectra Unitholders is 3.1773 percent.

17 **Q. 31 How did you calculate this blended rate?**

18 A. The blended rate is simply a weighted average of each Spectra Unitholder's  
19 blended state income tax rate based upon each Spectra Unitholder's portion of all  
20 income allocated to the Spectra Unitholders for 2007, with Saltville layered in.

21 **Q. 32 How is this state income tax rate utilized in the overall calculation of the**  
22 **rates proposed in Saltville Rate Filing?**

23 A. Once I calculated the appropriate weighted state income tax rate, I supplied that  
24 rate to Ms. Johnston, who used the rate in calculating the adjusted state income

1           tax allowance. Ms. Johnston's calculation was then used in determining the  
2           overall cost-of-service underlying the rates proposed by Saltville in the Rate  
3           Filing.

4   **Q. 33 Does this conclude your prepared direct testimony?**

5   A.     Yes, it does.