Opinion No. 435-A

SFPP, L.P.
Order on Rehearing Requests and Compliance Filings
91 FERC ¶ 61,135 (2000)

Opinion No. 435-A denies rehearing of some portions of Opinion No. 435, grants rehearing of some portions, and clarifies other portions. The following only outlines those portions that were clarified or for which rehearing was granted.

Rate Base Issues

- With respect to the period before December 19, 1988, for purposes of determining the debt and equity portions of the SRB as of December 31, 1983, the Commission held that SFPP should use its own debt ratio as of December 19, 1988, the date it became a publicly traded entity, concluding that this more accurately reflected the risks of SFPP's underlying operations than the capital structure of its parent. (at 61,505-06).

- The Commission concluded that the record was inadequate to support its decision to require the replacement of accumulated depreciation associated with the write-up of certain elements of SFPP's rate base. SFPP was allowed to reflect its revalued rate base. (at 61,506-07).

- The Commission also clarified certain questions raised on the calculation of the return on the starting rate base and the deferred equity component. (at 61,507-08).

Cost of Service Issues

- The Interest Expense Component of the Tax Allowance. Relying on the general rule that tax and return interest should be the same, the Commission adopted a method of computation that will yield a calculated interest expense identical to the debt return. (at 61,510-11).

Litigation Expenses

- With respect to SFPP's FERC litigation costs, the Commission determined that since the settlement payments were extraordinary expenses unrelated to SFPP's common carrier obligations, the litigation expenses associated with those settlements were likewise unrelated and also should not be recovered in rates. (at 61,513).

- The Commission also granted rehearing regarding the allocation of litigation expenses on the basis of throughput. It determined that there was no necessary connection between historical throughput and the amount of litigation generated by a particular group of shippers. Litigation expenses were allocated 50/50 to the East and West Lines. (Id.).

Reparations

- The Commission determined that only parties that have filed a complaint are eligible for reparations, and only Navajo filed a complaint against the East Line. (at 61,514).

- The Commission granted rehearing to clarify the general presumption that reparations will be awarded in full for a period two years before a complaint, if a complaint succeeds. If settling parties wish to preclude reparations against a settlement rate, that should be clearly stated in the settlement documents. (at 61,515).

- Although the Commission affirmed the application of indexing to the calculation of refunds, it determined to apply the indexing method to the rate, and not SFPP's cost of service as was done in the prior order. (at 61, 516).

- The Commission determined that it was improper for SFPP to offset the over-recovery of its costs in one reparation year with the under-recovery of costs in another reparation year. (at 61,517).

- The Commission determined that allowing SFPP to collect past environmental, reconditioning, and litigation expenses as offsets to reparations violated the filed rate doctrine. SFPP was required to deduct these expenses from the total revenue it received in excess of the new East Line rates, then charge the remainder as a prospective surcharge from all shippers. (at 61,517-19).

COMM-OPINION-ORDER, 91 FERC ¶61,135, SFPP, L.P., Docket Nos. OR92-8-000, OR92-8-009, OR93-5-000, OR93-5-006, OR94-3-000, OR94-4-000 and OR94-4-006, Mobil Oil Corporation v. SFPP, L.P., Docket Nos. OR95-5-000 and OR95-5-004, Tosco Corporation v. SFPP, L.P.,. . ., (May 17, 2000)

SFPP, L.P., Docket Nos. OR92-8-000, OR92-8-009, OR93-5-000, OR93-5-006, OR94-3-000, OR94-4-000 and OR94-4-006, Mobil Oil Corporation v. SFPP, L.P., Docket Nos. OR95-5-000 and OR95-5-004, Tosco Corporation v. SFPP, L.P., Docket No. OR95-34-000, SFPP, L.P., Docket Nos. IS99-144-000 and IS99-144-001

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SFPP, L.P., Docket Nos. OR92-8-000, OR92-8-009, OR93-5-000, OR93-5-006, OR94-3-000, OR94-4-000 and OR94-4-006

Mobil Oil Corporation v. SFPP, L.P., Docket Nos. OR95-5-000 and OR95-5-004

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

SFPP, L.P., Docket Nos. IS99-144-000 and IS99-144-001

Opinion No. 435-A; Order on Rehearing Requests and Compliance Filings

[61,498]

(Issued May 17, 2000)

Before Commissioners: James J. Hoecker, Chairman; William L. Massey, Linda Breathitt, and Curt Hébert, Jr.

Appearances

Stephen H. Brose, Timothy H. Walsh, Amy W. Lustig, R. Gregory Cunningham, J. Patrick Kennedy, Steven G. T. Reed and *Kelly C. Maynard* for SFPP, L.P.

Thomas B. Magee, Michael Lobue and *John B. Merritt* for Arco Products Company

R. Gordon Gooch, Mark R. Haskell, Glenn S. Benson and *Jonya Walker* for Arco Products Company, Texaco Refining and Marketing, Inc., Mobil Oil Corporation and Tosco Corporation

J. Wade Linsday and *Joel L. Greene* for Arizona Public Service Company, Salt River Project and Phelps Dodge Corporation

D. Jane Drennan, *Andrew S. Katz*, *David L. Hunt* and *Ruth A. Bosek* for Chevron USA Products Company

Patrick J. Keeley and *Franklin R. Bay* for El Paso Refinery, L.P.

Thomas J. Eastman and *Joshua B. Frank* for Navajo Refining Company

Jeron L. Stevens, *Charles M. Butler, III*, *Michael Hamric* and *David Stevens* for Refinery Holding Company

Robert L. Woods, *Arnold H. Meltz*, *Warren C. Wood*, *Dennis H. Melvin* and *John P. Roddy* for the Staff of the Federal Energy Regulatory Commission

[Opinion No. 435-A Text]

On January 13, 1999, the Commission issued an order addressing the reasonableness of SFPP, L.P.'s (SFPP) rates on its east and west lines serving Arizona and New Mexico. [1] SFPP filed two compliance filings on March 15, 1999, one in the main docket [2] and one in Docket No. IS99-144-000 . SFPP filed a request for rehearing in both dockets and two other parties filed requests for rehearing in the main docket. The Commission grants rehearing in part and denies it in part. Having previously accepted and suspended the compliance filing in Docket No. IS99-144-000 , the Commission will accept the compliance filing in the main docket subject to certain modifications required by its rulings on the rehearing requests and an opportunity for further comment on certain of the cost figures that will be included in the revised filing.

I. Background

The factual background of this proceeding is discussed in detail in the January 13, 1999 Order and that detail will not be repeated here. As explained there, SFPP owns a pipeline system that transports refined petroleum products in six Western and Southwestern states: Texas, New Mexico, Arizona, California, Nevada, and Oregon. [3] This

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proceeding involves SFPP's interstate rates, practices, and terms and conditions of service on its "South System," which consists of pipe and other facilities used to transport refined petroleum products into Arizona from El Paso, Texas (the "East Line") and from the Los Angeles, California area (the "West Line"). [4]

The rates for the East and West Lines have been in litigation since 1992. Pursuant to the provisions of the Energy Policy Act of 1992 (EPAct), [5] the Commission found that the West Line rates were, with one exception, grandfathered rates. [6] The Commission therefore examined the concept of substantially changed circumstances under the EPAct as the basis for challenging the grandfathering of the West Line rates, [7] and concluded that the parties complaining against the West Line rates had not established that there were substantially changed circumstances to the economic basis of those rates. [8] The Commission therefore dismissed the complaints pending against the West Line rates for the period November 1992 through August 7, 1995. The Commission did permit certain complaints, which were filed against the West Line rates after that date, to be amended in light of the conclusions in Opinion No. 435. [9] Several amended complaints against the East and West Lines, as well as new complaints against the rest of SFPP's system, were filed on January 10, 2000, and are addressed in a contemporaneous order.

The East Line rates had been determined not to be grandfathered. [10] Therefore the Commission addressed the reasonableness of the East Line rates on the merits. The Commission clarified several issues related to the Opinion No. 154-B methodology for establishing oil pipeline maximum rates. [11] These included the starting rate base, its capital structure, its amortization, the calculation of the deferred equity component, the accumulated deferred income taxes, allowance for funds used during construction, and the accumulated depreciation. The Commission also made findings on such conventional cost of service issues as projected volumes, SFPP's cost of capital, income tax allowances, litigation expenses, power costs, reconditioning expenses, environmental costs, and post-retirement benefits other than pensions (PBOPs). The third major topic was the method for calculating the reparations to be paid to any eligible East Line shippers. The Commission also concluded that SFPP did not have to publish the detailed provisions of its pro-rationing policies in its tariff as long as those details were readily available from the carrier. The Commission required SFPP to make compliance filings consistent with its findings. The specifics of each finding relevant to the filings are reviewed below.

II. The Requests for Rehearing

Requests for rehearing were filed by SFPP, Chevron Products Company (Chevron), and Navajo Refining Company (Navajo). ARCO Products Company and its related parties who challenged SFPP's West Line rates did not file requests for rehearing, but filed appeals in the U.S. Court of Appeals for the D.C. Circuit. [12]

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A. *Changed Circumstances*

The prior order contains an extensive discussion of rates that are grandfathered under the EPAct and the burden placed on complainants whose rates are grandfathered to demonstrate that such circumstances have occurred. Section 1803(b) of the EPAct requires such a complainant to demonstrate a substantial change in the economic circumstances that were the basis for the rate. The change must have occurred after the enactment of the Act, October 24, 1992, and before the date that the complainant filed its complaint. Applying this test, the prior order held that the parties challenging SFPP's West Line rates had not demonstrated changed circumstances. First, the Commission held that the parties could not rely on facts accumulated or events occurring before the passage of the Act. [13] Second, the prior order ruled that changed circumstances in the instant case must be measured against the economic assumptions underlying the challenged rates when they were adopted. [14] In the instant case, the appropriate date for evaluating those circumstances was the settlement date establishing the rates, November, 1988, rather that the 12 month test period advanced by the complainants. [15] Third, the Commission held that charges currently collected by SFPP for operation of the drain dry facilities at Watson Station were subject to the requirements of Section 1803(b) if those charges were the subject of a valid contract at the time that the complaint was filed. Chevron requests rehearing of these determinations.

1. *The West Line Rates*

In addressing changed circumstances for the West Line rates, Chevron presented evidence purporting to show that there was as much as a 30 to 40 percent increase in volumes on the West line between the end of October 1992 and November 1993. This evidence was designed to demonstrate change measured against a twelve-month test period ending October 1992. The change in volumes occurred after the enactment of the EPAct, and in this regard complied with the statute. On rehearing, Chevron argues that increases of this extent greatly exceed the less than 10 percent annual increases rejected by the Commission in another proceeding, *Santee Distributing Company Co. v. Dixie Pipeline Company*, [16] and therefore the changed circumstances test was satisfied. Chevron further argues that 1988 cannot be used as a base year for measuring changed circumstances because it is based on a "black box" settlement for which there are no details, and that while an otherwise legal rate, it was not a just and reasonable lawful rate under the NGA. As such, Chevron claims that the 1988 Settlement is not binding on Chevron, who was not a party to it. In addition, Chevron states that it advanced changes in SFPP's tax status and additional volumes generated by a new commodity as evidence of changed circumstances.

The Commission denies rehearing. As was discussed in detail in the prior order, the basic failing in Chevron's proof was the base period against which the changes were measured. The change must be measured against the economic circumstances that were the basis for the rate. This cannot be a test period because the purported economic basis for the rate would shift depending on what test period was selected. Test periods do not measure the basis for the rate, which consists of the underlying factors that were used to construct the rate at the time it was established. Test periods only measure how

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the rate is actually performing based on the revenue generated during the test year in relationship to the costs incurred in the test period. As such, a test period demonstrates whether the rate is likely to be just and reasonable under conventional rate making standards in that year. It does not measure how the rate has performed against the circumstances that surrounded its creation or the expectations of the parties that were involved in constructing it. This is true whether the rate is constructed using the traditional components of volume, cost recovery, and return, or is a negotiated amount.

The fact that Chevron was not a party to the 1988 settlement is irrelevant. Section 1803 addresses rates that were on file at the time that the EPAct of 1992 was enacted. Any number of the oil rates then on file with the Commission were either the product of settlements or rate determinations, or had been filed and were uncontested. No oil rate filed before those established by this proceeding is a lawful (as opposed to legal) rate [17] because the Commission has never heretofore made a determination of the just and reasonableness of an oil rate. [18] All oil pipeline rates on file were either uncontested rates at the time they were filed or were the product of settlements. The sole test as to whether those rates would be grandfathered is whether any of those legal rates were unchallenged before the enactment of the EPAct. As has been discussed in the earlier orders, neither Chevron nor any other party filed a complaint before the passage of the EPAct. As a result, the legal settlement rates became just and reasonable lawful rates upon enactment of the EPA, binding on Chevron and all other shippers.

2. *The Watson Enhancement Facilities*

The Commission also held in the prior order that charges for the enhancement facilities at Watson Station are subject to the changed circumstances doctrine. [19] The Commission also held that these facilities are subject to the Commission's jurisdiction. These facilities were completed in April 1992, and enhance the pressure at which products are injected into SFPP's line at Watson Station. The increased pressures were required by a tariff SFPP filed on November 1, 1989. SFPP gave its shippers the choice of building their own facilities to increase the pressure or contracting with SFPP to provide the necessary facilities. [20] According to Chevron, some 31 shippers entered into a uniform contract with SFPP by late 1991 to fund the enhancement facilities rather than constructing their own. [21] The Commission held that shippers have the option of litigation or negotiation to obtain a legal rate, and that a lawful contract rate in effect on October 22, 1992, is deemed to be rate on file with the Commission on that date.

Chevron first asserts that Section 1803 of the EPAct only addresses rates actually on file with the Commission. It argues that since the Watson Station enhancement charges were not on file with the Commission on October 22, 1992, those charges are

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not subject to the grandfathering provisions of the statute. Chevron also asserts on rehearing that Chevron's managers were not sophisticated shippers who were familiar with the Interstate Commerce Act (ICA) and that the Watson Station contracts were contracts of adhesion that most shippers had little choice but to execute. Chevron also argues that SFPP had consistently asserted that the facilities were non-jurisdictional and that this was a deterrent to a legal challenge of that issue.

The Commission denies rehearing. It is true that Section 1803 only addresses rates that were on file with the Commission as of October 22, 1992. As such, the statute does not address the matter of contract charges that were in effect on that date and were not on file with the Commission. This does not mean that the prior ruling is incorrect. The overall purpose of the EPAct of 1992 is to move toward lighter, less complex regulation of oil pipeline markets. To this end, Congress presumed as just and reasonable all rates on file with the Commission unless those rates were challenged in the 12 months proceeding the enactment of the statute. As has been discussed, these were legal rates regardless of how they came to be filed with the Commission. Oil pipeline negotiated or contract rates are also legal rates, and may or may not be filed with the Commission.

In this case, the charges were not filed because of a disagreement about their jurisdictional status; however, if they had been filed as either tariff or contract rates, it is clear that they would have been grandfathered because there was no challenge to them during the 12 months proceeding the enactment of the Act. The instant ruling involves a close analogy to the general obligations to file tariffs with the Commission for any jurisdictional service before the revenues are collected. If this is not done, then the revenues cannot be collected. One exception is if the charges are contained in a valid contract. Then notice is deemed to have been provided as between the parties and the notice period thus waived for purposes of the filed rate doctrine and the revenue, if obtained from a just and reasonable level, may be retained. By analogy, the charges for use of the Watson Station facility would be legal as between the parties whether or not they are filed with the Commission. [22]

The Commission concludes that it would be anomalous, that having successfully argued that the charges at issue here should have been filed when the contracts were executed, that Chevron and Navajo now argue that those charges binding as between them and SFPP, should not be subject to the provisions of the EPAct even though they clearly would have been if they had been on file with the Commission. Whether SFPP elected to file the charges at the time they were created, or is now directed by the Commission to do so, the underlying economic basis for the charges would be the same. In light of the clear purpose of the Act to insulate legal rates in effect at the time the EPAct became effective, the most consistent way to achieve this purpose is to include unchallenged contract charges within the scope of Section 1803(b).

The ruling here thus accomplishes what the complainants have in fact urged the Commission to do: place them in the position they would have been in if SFPP had met its regulatory obligations. The charges for the enhancement facilities at Watson Station are negotiated charges. While SFPP may have had the advantage because it could provide the service at a lower unit cost due to higher volumes (or at least at lower

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threshold cost than the shippers), the shippers had several choices at the time the charges were proposed: contract with SFPP and be satisfied with the terms proffered, build their own facilities, or protest the enhanced pressures SFPP required, or the contracts they were required to sign, at the Commission. The required pipeline pressure was part of SFPP's tariff and was filed with the Commission at the time the requirement was imposed, and was not contested. Whatever claims Chevron may make here that oil producers are not experts in the intricacies of ICA law and procedure, it is reasonable for this Commission to assume that shippers make informed choices, that expert advise is available, and that prudent business persons will seek it when making multi-million dollars investment and operating decisions. Contracts ultimately represent choice, and a delayed appeal to a regulatory agency in the context of a much broader range of issues is the opposite of the more flexible, market-reliant regulation contemplated by the EPAct.

Two clarifications are required to eliminate a minor inconsistency in the prior order. The prior order stated that the changed circumstances requirement would stand as long as a shipper's contract was in effect and the charges were being collected before October 22, 1992. The assumption of the prior order was that the contracts in effect before the effective date of the EPAct would remain in effect until such time as all the costs of the enhancement facilities were recovered or the shipper elected to provide its own. Upon reflection, it is possible that the initial contracts might expire and be periodically renewed, or that new shippers might elect to use SFPP's facilities and be required to sign a contract at that time. If the analogy to the statute is to be correctly pursued, the changed circumstances apply to contract charges, which were established and unchallenged as of October 22, 1992, until such time as the charge was modified. If the same charge and service terms are applied to all shippers after October 22, 1992, then the changed circumstances doctrine applies to new shippers as well, just as if a tariff were on file with the Commission. Since a legal charge existed on October 22, 1992, then the changed circumstances requirement applies to all challenges until such time as SFPP changes the nature and the conditions of the charges.

One possible example of changed circumstances could be that SFPP has fully recovered the capital costs of the Watson Station enhancement facilities. Since the prior order involved a matter of statutory interpretation regarding the Watson Station enhancement facilities, the Commission further clarifies that parties filing amended complaints may include in those amendments complaints against the Watson Station charges filed after August 7, 1995. [23]

B. *Rate Base Issues*

Rate base issues are among the most complicated elements of oil pipeline ratemaking. This is because of adjustments to the starting rate base required by the Opinion No. 154-B methodology, the deferral of the inflation component of the equity return, and the compounding and amortization schedules that result. [24] All three factors are included in the parties' rehearing requests of the rate base finding in the prior order.

1. *The Capital Structure*

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The prior order adopted two different capital structures to be used in addressing rate base issues, one for the period June 25, 1985 through December 19, 1988, the period before SFPP's predecessor company was converted to a publically held partnership, and one for the period thereafter. The rulings determined the size of SFPP's starting rate base as of December 31, 1983, and the calculation of the deferred equity component thereafter.

a. *Before December 19, 1988*

In the prior order the Commission concluded that SFPP should use its parent company's capital structure as June 25, 1985, as its own for the period December 31, 1983, through December 19, 1988. [25] The Commission concluded that the Opinion No. 154-B methodology includes a strong presumption in favor of using the parent company's capital structure in situations where the pipeline does not have a capital structure determined by its independent participation in the capital markets. SFPP's predecessor company had no record of participating in capital markets before it was created as an independent partnership in December, 1988. Therefore, the Commission adopted the parent company's (Santa Fe Pacific) capital structure of 78.29 percent equity and 21.71 percent debt for the period before December 19, 1988. The Commission also concluded that a settlement entered into between Southern Pacific Pipelines, Inc. (SPPL) (SFPP's predecessor company prior to December 19, 1988) and several of its large shippers in 1988 incorporated the capital structure of SFPP's parent company, that this resulted in rates and rate components that were just and reasonable, and that therefore the Commission would not be change retrospectively in a complaint proceeding. [26]

On rehearing, Chevron and Navajo assert that the Commission erred in two ways in its prior determination regarding the capital structure to be used for the period before December 1998. They assert that the 1988 Settlement should not be construed as precluding a review of the capital structure to be used to develop SFPP's starting rate base. They state that the Commission order approving the 1988 settlement provides:

The Commission's approval of this Settlement does not constitute approval of, or precedent regarding, any principle or issue in this proceeding. [27]

They argue that all the 1988 Settlement provided for was a reduction of rates that had been filed by SPPL in 1984, and that it only bound the Airline Parties who were signatory to the settlement not to file additional complaints for 5 years. They further assert that the Section 5.3 of the 1988 Settlement itself limits its scope:

SPPL and Airline Intervenors further expressly understand and agree that the provisions of this Stipulation and Agreement relate only to the matters specifically referred to in this Stipulation and Agreement, and that no party waives any claim or right which it otherwise may have with respect to any matters not expressly provided for in this Stipulation and Agreement. [28]

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They therefore conclude that the cited paragraphs belie any conclusion that the 1988 Settlement incorporated SPPL's pre-existing capital structure and argue that the issue of the capital structure should be revisited.

On rehearing, the Commission concludes that the cited language clearly establishes that SPPL's capital structure of 1988 should not be deemed to determine that capital structure to be applied in an Opinion No. 154-B rate proceeding once the 1988 settlement expired. The parties expressly provided that any issue not specifically addressed by the 1988 Settlement would not be binding in the context of future litigation. Since the parties did not expressly address the issue of SPPL's capital structure in the black box 1988 Settlement, and the Commission also did not address the issue in approving the Settlement, the Commission will address that issue on the merits here.

Chevron and Navajo argue that the Commission should not adopt the capital structure of SFPP's parent company as of June 25, 1985 to establish SFPP's starting rate base as of December 31, 1983. [29] They recognize that Opinion No. 154-B expresses a preference for the use of the parent capital structure when the pipeline has issued no long term debt of its own, but argue that the preference is not an absolute one, and that the contesting parties are free to urge alternative structures: [30]

Of course the Commission is concerned about whether a capital structure is abnormal. But the correct yardstick is not whether the pipeline's capital structure is in tune with historical capital structures. Rather, it is whether the capital structure is representative of the pipeline's risks. [31]

Chevron and Navajo therefore urge the Commission to affirm the finding of the Administrative Law Judge. The ALJ concluded that SFPP was a monopoly with moderate risk, and on June 8, 1995, provided only 3 percent of its parent company's total revenues. He also concluded that the parent company was involved primarily in the trucking and rail industries, which were substantially deregulated and operating in competitive markets, and as such had considerably higher risk than its oil pipeline subsidiary. He therefore concluded that the market structure adopted by SFPP when it became a publically traded limited partnership on December 19, 1988 reflected a market evaluation of the pipeline's risks, and as such its appropriate capital structure. [32] He agreed with a similar conclusion reached in an initial decision in SPPL's pending rate case in 1987. [33]

On rehearing, the Commission concludes that the ALJ's analysis more accurately reflects the risks of SFPP's underlying operations. While the ALJ's decision and the result here impute SFPP's capital structure to its predecessor entity, this is appropriate in light of the significant difference in the nature of the pipeline's operations and those of its parent company on June 28, 1985. There is no reason to believe that SPPL's operations or risk were in anyway materially different from its successor entity when SFPP was created on December 19, 1988. This conclusion is consistent with the

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determination in the prior order that SFPP faces moderate business risk, primarily related to the business cycle and the underlying demand for petroleum products in its various geographic markets. [34] Therefore the capital structure to be used by SFPP in calculating the starting rate base as of December 31, 1983, will be that adopted as a result of its initial public offering on December 19, 1988, or 60.74 percent debt and 39.26 percent equity. As pointed out by the ALJ, the 60.74 debt ratio is more consistent with that generally adopted by the oil pipeline industry (45 to 55 percent debt), [35] a debt ratio that SFPP has gradually approached over time. [36] In contrast, the 21.7 percent debt ratio of SPPL's parent company in 1988 was less than one half that of the lower bound of the same oil pipeline industry range. Given the Commission's earlier reservations about this ratio, rehearing is therefore granted. [37]

b. *After December 19, 1988*

The prior order concluded that SFPP in effect wrote-up certain elements of its rate base when SFPP was created as a publically held limited partnership on December 19, 1988. [38] Concluding that this violated Commission policy, the prior order required SFPP to place back in its rate base the base accrued depreciation of some $124.77 million that SFPP removed from its predecessor company's rate base when it was created. SFPP did so in its compliance filing, subject to its request for rehearing. Since adding back the accrued depreciation reduced the dollar value of the equity portion of SFPP's balance sheet, complying with the Commission's order had the practical effect of changing SFPP's capital structure to a 31.49 percent equity and 68.51 debt ratio.

On rehearing, SFPP argues that the record in this proceeding is inadequate to support the Commission's decision. It notes that the issue of the adjustments to its rate base was raised by complainants only in a brief cross-examination of the company's president, and that no detailed evidence was presented despite the fact that complainants had the relevant work papers for many months before their prepared testimony was due to be filed. It asserts that since this is a complaint case, the complainants have the burden of proof on the issue, and they failed to produce any probative evidence on the matter. SFPP concludes that the ALJ was correct in ruling that complainants had failed to prove that SFPP's capital structure should be modified from the one generally accepted by the parties in the earlier phases of the hearing.

SFPP further asserts that the process of establishing its initial balance sheet on December 19, 1988, involved the merger of former subsidiaries and adjustments to numerous accounts, some of which related to non-jurisdictional assets. It argues that these are far too complex to be modified without the use of expert testimony, and the danger in using a high level approach is reflected in the fact that the Commission itself had a range of some $115 to $222.5 million in estimating the size of the potential adjustment. It also argues that the adjustment required by the prior order results in a capital structure that does not conform to the general profile of the oil pipeline industry. SFPP asserts that, absent the adjustment, SFPP would have at this time a capital structure that was approximately 31.49 percent equity and 69.61 percent debt. It claims this is 12 equity percentage points below the lowest pipeline equity in the comparable pipeline group, and that if it had been in place at the time the pipeline was formed, would have reduced the rating on its bonds to junk bond status. It points out

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the proposed capital structure of 1994 of 55.21 percent debt and 44.79 equity in 1994 was not protested by any party.

The Commission will grant rehearing. Any complainant has the burden of: (1) establishing on the record an alleged write-up of rate base assets during an acquisition in violation of Commission policy; and (2) the correct amount that should be adopted in light of the alleged write-up. While the record in this proceeding could be read to imply that SFPP may have adjusted its capital structure to write up the assets of its predecessor company when SFPP was created, the Commission now concludes that the record is too thin in this proceeding to require a rate base adjustment here. In fact, most of the Commission's analysis in its prior order was based on SFPP's Form 6 for the year 1988, and SFPP was not given an opportunity to evaluate on the record the basis for the

Commission's prior conclusions. Given the complexity of the adjustments involved, the Commission concludes that SFPP has the better argument in this regard. Thus, for the period December 19, 1988, through the date of rates established by this proceeding, SFPP shall use its December 19, 1988 capital structure, as adjusted under the Opinion No. 154-B methodology. Nothing here precludes complainants from pursuing the same issue in the litigation of complaints amended or filed after August 7, 1995, provided that rate impact of any change to the rate base that may result will not apply prior to the date of the new East Line rates established here.

2. *Calculation of the Return on the Starting Rate Base*

Navajo raises a narrow issue bearing on how SFPP's rate of return is to be calculated on the starting rate base once the starting rate base has been determined. The prior order determined that once the amount of the starting rate base is determined, the amount of the starting rate base is not modified to reflect changes in the pipeline's capital structure that occur thereafter. [39] The prior order therefore rejected SFPP's argument that the amount of the starting rate base should be modified to reflect any changes in the capital structure over time. SFPP's position would have had the effect of increasing the original amount of the starting rate base to reflect any increase in the equity component of the pipeline's capital structure, and slowing its amortization rate.

Navajo asserts that the prior order should not be read as preventing a change in the rate of return on the amount of the starting rate base in a manner that tracks any changes in the pipeline's capital structure. It argues that all rate of return on all rate base items changes over time, and that return reflects the pipeline's capital structure at the time the rate of return is determined. It claims that this implies that, under the Opinion No. 154-B methodology, once the separate cost of the debt and equity components is determined, the weighted cost that is applied to the rate base each year under the Opinion No. 154-B methodology will vary depending on what the capital structure is for that year.

As Navajo argues, this variation in return applies to the net amount of the starting rate base write up in a given year. Thus, while the amount of the starting rate base should not be increased after the year it is created, the return imputed to the rate base varies depending on the capital structure of the pipeline in any given year. Clarification is granted.

3. *Calculation of the Deferred Equity Component*

[61,508]

Navajo also requests clarification of the Commission's prior ruling on the calculation of the deferred equity component. Consistent with the prior subject, the prior order held that once the deferred equity component is determined for a given year, the amount of the deferred equity remains fixed thereafter and is then amortized over the remaining useful life of the pipeline's assets. [40] Navajo requests clarification that this is the intent of the Commission's prior order. The requested clarification is granted. The amount the deferred equity return is determined by the capital structure applicable to the year in which the deferred equity component is initially calculated. Navajo also requests clarification that, as with starting rate base, the return on the amount of the deferred equity component varies with the capital structure in effect for each year in which the pipeline's cost of service is actually calculated, even though the amount itself does not increase once it has been established. The requested clarification is granted.

C. *Cost of Service Issues*

The cost of service issues raised on rehearing include income tax allowance issues, two of which turn on the interpretation of the so-called *Lakehead* doctrine and one on the proper method for calculating the interest expense to be included in the income tax allowance. The other cost of service issues concern the recovery of litigation expenses.

1. *Income Tax Allowance Issues*

a. *The Income Tax Allowance Under a Consolidated Return*

Opinion No. 435 concluded that SFPP was entitled to an income tax allowance attributed to the limited partnership interest of Santa Fe Pacific Pipelines Inc. (SFPP Inc.) in the publically traded company controlling the pipeline. SFPP Inc. owns a 1 percent general partnership interest in SFPP, the operating company. The balance of the operating company equity consists of 99 percent limited partnership interests, which are owned by a publically traded partnership, Santa Fe Pacific Pipeline Partners, L.P., of which SFPP Inc owns 41.7 percent, as well as the 1 percent general partnership interest in the publically traded company. Thus, overall, 42.7 percent of the publically traded company limited partnership interest is owned by SFPP Inc.

SFPP Inc. is in turn owned by SFP Pipeline Holdings, Inc., which functions as an intermediate owner between SFPP Inc. and the Santa Fe Pacific Corporation (SFPC). SFP Pipeline Holdings Inc. has issued $219 million in *debentures that bear an interest rate with a minimum rate of 8 percent and a maximum rate of 16 percent. The* minimum is an absolute liability and any sums earned in excess of the maximum may be retained by the partnership. Thus, the interest rate actually paid may vary but is generally equal to the actual limited partnership income received from SFPP, Inc. Since the interest on the debentures is taken as a tax deduction within the consolidated return of the entire corporate family, the tax on the income generated by the limited partnership interests held by SFPP Inc. is offset by the interest paid on the debentures.

On rehearing, Chevron and Navajo again assert that since SFPP Inc. serves to wash out the taxes on partnership interest, no income tax liability is ever incurred on those interests by SFPP, and therefore no income tax allowance should be permitted. They cite *Lakehead Pipe Line Co.* [41] for the proposition that a regulated entity cannot

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collect taxes for an amount greater than its actual income tax liability, [42] and argue the Commission's longstanding policy is to adjust tax allowances to representative levels of taxes actually incurred. They then argue that there is no rational basis for distinguishing between a situation where taxes are not paid because of the nature of the ownership, in which case the allowance may be denied under *Lakehead*, and the impact of a corporate structure which also has the practical result of eliminating a parent company's income tax liability.

The Commission will deny rehearing. The prior order concluded that the Commission's stand-alone policy applies to the instant case, and therefore including an income tax allowance in SFPP's cost of service is appropriate. This is necessary to provide SFPP's investors with the opportunity to earn the Commission-approved after-tax return on their investment. Because SFPP's regulated earnings generate corporate income tax liabilities, SFPP is entitled to recover such corporate income tax liabilities from its shippers. SFPP's parent company's ability to avoid paying tax by offsetting SFPP's income with interest deductions generated by its non-utility operations is not relevant in determining SFPP's regulated cost of providing utility service, since, as was previously held, it is not appropriate to subsidize regulated operations with tax reductions generated by non-regulated operations.

Also, contrary to the assertions here, this result is entirely consistent with the results of application of the *Lakehead* policy. As with stand-alone, under *Lakehead* the Commission provides an income tax allowance only if the operations of the regulated company generate a corporate income tax liability on the part of a corporation owning an equity interest in the regulated company. The *Lakehead* doctrine looks to whether the regulated company's income is subject to a corporate income tax; if it is, a tax allowance is provided to allow corporate shareholders the opportunity to earn the same specified, after-tax return as non-corporate investors in SFPP.

b. Tax Status of the Owning Interests

While Opinion No. 435 did not apply the *Lakehead* doctrine to the debentures owned by SFP, Opinion No. 435 did apply that doctrine to the tax status of parties owning the Santa Fe Pacific Pipelines Inc. partnership interests. The Commission permitted the tax allowance on the interests that were owned by corporate entities, but concluded that SFPP had not adequately demonstrated on this record what other interests were, or were not, subject to a potential double taxation. The Commission also applied the *Lakehead* doctrine retroactively to the date of the complaints against the East Line rates and required that any adjustment of those rates reflect the Commission's rulings. [43]

On rehearing, SFPP asserts that it adequately explained which partnership interests were subject to taxation. It asserts that it provided ample expert testimony on the type of interests in its ownership structure that have a potential multi-tier tax liability in addition to Subchapter C corporations. The list provided by SFPP's witness Miller included pension plans, profit sharing plans, business and certain other trusts, certain partnerships, limited liability companies, and tax exempt organizations. [44] The rehearing request asserts that even organizations that are normally considered to be tax exempt are subject to taxation depending on the nature of the activity and the source of the income. One example given is of a tax exempt organization that receives

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income from SFPP that does not have the same income character as SFPP (*i.e.*,the organization is not involved in the oil pipeline industry), then the income is not related to organization's mission and becomes taxable as unrelated business income. SFPP also asserts that most mutual funds are subject to double taxation unless they distribute at least 90 percent of annual income. Finally, it asserts that simply because some owning interests might have their taxes deferred is not grounds for denying the tax allowance since multi-tier tax liability can be avoided by holding income in retained earnings rather than distributing it.

The Commission will deny rehearing. On the record here SFPP has failed to substantiate its claim that the income earned by its non-corporate equity owners actually results in double taxation. Although certain non-corporate owners may face a potential double tax on income generated by SFPP under certain conditions, SFPP has not shown, on this record, that such conditions existed during the test period. Therefore, SFPP must modify the cost of service contained in any revised compliance filing to eliminate any tax allowance related to non-corporate owners.

With regards to these passthrough entities, SFPP is in essence arguing that they should not be subject to the *Lakehead* doctrine because on occasion they may not conform to the basic legal and investment purpose for which they are created. This turns the *Lakehead* doctrine, and the purpose for which the entities are created, on their heads. Savings devices such as IRA or Keogh accounts are expressly designed to permit income and capital gains to accrue until withdrawn from the account once the beneficiary reaches an age that the withdrawals are possible without penalty. To argue that this is likely to occur otherwise in the normal course of events is contrary to common experience and undercuts the rest of SFPP's assertions regarding this issue.

c. *The Interest Expense Component of the Tax Allowance*

On rehearing, Navajo asserts that the Commission's treatment of the computation of interest expense for tax allowance purposes does not follow its previous indications that the allowance for interest expense for tax purposes be the same as that for debt return. In Opinion No. 154-C the Commission stated:

> Both ARCO and Justice argue that the interest expense deduction for determining the tax allowance should be the same as the interest produced by the capital structure adopted for rate of return purposes. The Commission agrees that, as a general rule, tax and return interest should be the same. The problem here, as

stated in Opinion No. 154-B as recognized by ARCO, is that the TOC methodology adopted in Opinion No. 154-B includes an equity write-up. Hence, the usual method of multiplying the company's weighted cost of debt times its rate base will not produce a proper interest expense deduction. The Commission's solution to this problem was to require the use of a pipeline's actual interest expense. The Commission is now persuaded that the better solution is to use the same actual capital structure for both the interest expense deduction and the allowed interest return. . . . We see no reason why this should not also be the case for oil pipelines, if the equity write-up can be eliminated. At this time, therefore, subject to re-examination on a case-by-case basis, it appears appropriate for an oil pipeline to determine its interest expense deduction by multiplying its weighted cost of debt times its net depreciated original cost rate base. [45]

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The Commission concludes that the result of the prior order was an unintended difference between the interest expense for tax purposes and that used for debt return. Thus, as Navajo asserts, as a general rule, tax and return interest should be the same. Matching of the interest expense for tax purposes and for debt return should be the result here. To correct this oversight, the full 154-B rate base (depreciated original cost plus the deferred equity account plus the starting rate base write-up) should be multiplied by the adjusted, weighted cost of debt (adjusted for the deferred equity treated as 100 percent equity in the rate base). Using this method of computation will yield a calculated interest expense which should be identical to the debt return while maintaining the desired use of the same capital structure for both the calculations of interest expense and debt return. Rehearing is therefore granted on this issue and the conclusions reflected in SFPP's revised cost of service.

2. *Litigation Expenses*

The prior order permitted SFPP to recover the litigation expenses it incurred in the 1994 test year. Those expenses included all expenses incurred in conducting litigation in that year, but did not include settlement payments to Navajo and the El Paso Refining Company that terminated certain commercial litigation between SFPP and those parties. The Commission concluded that such settlement payments were extraordinary costs that could not be recovered. The expenses that were permitted were to be amortized over five years, exclusive of any settlement payments. Those costs were to be allocated between the East and West Lines based on their relative throughput in the 1994 test year. [46]

The Commission also held that litigation expenses beyond 1994 were not known and measurable within the test period, and as such could not be included within the SFPP's 1994 test period cost of service. The Commission therefore rejected SFPP's efforts to create a litigation expense reserve to cover the costs that might be incurred in later years. The Commission did not preclude SFPP from making a separate filing to recover costs in the calender years 1995-98, and stated that SFPP would be permitted to offset litigation expenses incurred in those years against reparations that might be due. [47]

On rehearing the parties raise several issues related to litigation expenses. These include whether SFPP should be permitted to recover its litigation expenses, the allocation of litigation expenses between the East and the West Lines, and the methods that would allow SFPP recover litigation expenses incurred after the 1994 test period. To the extent these relate to the calculation of reparations, they are discussed below.

a. *The Recovery of Litigation Expenses*

On rehearing, Navajo asserts that SFPP should not be permitted to recover any litigation expenses incurred in connection with this proceeding, nor should it be permitted to recover any litigation expenses related to the commercial litigation between SFPP on the one hand, and Navajo and El Paso Refining on the other. Navajo asserts that expenditures for litigation in the instant rate proceeding do not benefit the rate payers and represented a futile attempt to maintain rates that were unjust and unreasonable. It asserts that rate payers should not be required to underwrite SFPP's unsuccessful defense of these rates, and by SFPP's including litigation expenses in rates

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or as an offset to reparations. It asserts that this eliminates any incentives for settlement and is unfair when SFPP's rates are unreasonable by a substantial margin.

Navajo also asserts that the Commission erred in permitting SFPP to recover the litigation expenses incurred in defending certain civil litigation involving Navajo and El Paso Refinery Company regarding alleged breaches of agreements to make capacity available to those shippers on its East Line between El Paso and points in Arizona and New Mexico. It asserts, that contrary to the Commission's finding in Order No. 435 , these were not part of normal, and ongoing, disputes between SFPP regarding the costs and capacity allocation of its South Lines. [48] It again asserts that there was no benefit to the shippers, and argues that if the settlement payments are to be considered extraordinary, then the litigation expenses should have the same character. [49] Navajo reiterates its prior position that none of the settlement costs related to the civil litigation should be included in SFPP's 1994 cost *of service or as an offset to reparations.*

The Commission will deny rehearing in part and grant rehearing in part. The instant litigation examines whether SFPP's rate levels are just and reasonable, and whether charges for certain services and the pipeline's prorationing policies must be filed with the Commission. Litigation related to the pipeline's cost of service and the structure of its tariff are part of its normal, ongoing operations, and such costs are recoverable as part of the pipeline's cost of service. [50] The instant case is a complaint proceeding under the ICA with the burden on the shippers to prove SFPP's rates are unjust and unreasonable, or that certain additional charges and conditions should be included in its tariff. SFPP is entitled to mount a defense of its tariff, and recent court decisions have tended to reject efforts to preclude the recovery of litigation costs that arise from Commission actions involving the *pipeline's service obligations under its tariff and costs that may incurred in fulfilling that obligation.* [51] *The* Commission therefore affirms its prior conclusion that SFPP may include in its cost of service the litigation costs incurred in the instant proceeding in its 1994 cost of service, to be amortized over five years. The reason for the five year amortization is to mitigate the impact of the substantial costs that were incurred. The fact that the costs were substantial does not necessarily preclude SFPP from recovering them given the custom that the litigation expenses related to economic regulation are regularly included in the pipeline's cost of service.

The prior order required SFPP to amortize its 1994 test year regulatory litigation expenses over a five year period. Since the five year period expired on December 31, 1998, those costs should not be included in the rates that SFPP is collecting prospectively from the effective date of its compliance filing. Rather, the costs to be amortized are additional factors to be included in determining the appropriate rate level for the years 1994-98, and thereafter determining the amount of any reparations that may be due. This should be done by showing the relevant costs as a surcharge in the relevant years, which is eliminated from the overall cost of service at the end of the five year period.

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The Commission will grant rehearing regarding the recovery of the civil litigation expenses. This litigation involved assertions of anti-competitive behavior and breach of contract to make capacity available, including agreements regarding under what circumstances the capacity would be made available. Civil litigation of this type does not address what obligations SFPP may have under its common carrier tariff, not does it address legal costs and remedies that SFPP would normally incur in the conduct of its common carrier operations, such as tort liability for injuries or damage to property while conducting its pipeline operations, environmental obligations related to its jurisdictional operations, tax issues, and the like.

Having concluded that the settlement costs for the civil litigation between El Paso on the one hand, and Navajo and El Paso Refining on the other, are extraordinary expenses, the Commission concludes that the expenses and the litigation costs should be treated the same. This is consistent with the determination involving pipeline litigation and settlement costs involving the Exxon Valdez oil spill, which the Commission concluded were extraordinary in nature. [52] Therefore the civil litigation expenses between SFPP and Navajo and El Paso Refining may not be included in SFPP's 1994 test year cost of service.

b. *Allocation of Litigation Costs Between the East and West Lines*

El Paso requests rehearing of the Commission's determination that litigation costs should be allocated among the East and West Lines based on relative throughput. [53] It asserts that West Line throughput is disproportionately high in relationship to overall cost of the litigation, and that many of these issues raised in the regulatory proceedings to date were engendered by the East Line shippers. It asserts that the only rational way to allocate the costs is to accept the 50-50 ratio adopted by the ALJ's initial decision.

The Commission will grant rehearing in this regard. Upon reflection, there appears to be no necessary connection between relative historical throughput and the relative volume of litigation generated by a particular group of shippers. It is quite possible that one group would have substantially less throughput, yet generate the greater portion of a given litigation based on the complexity of the issues and how aggressively the issues are pursued. As the ALJ was in a position to observe the complexity and the flow of the instant litigation, his 50-50 allocation is adopted on rehearing. The issue of whether SFPP should be permitted to offset its litigation expenses for the years 1995-1998 against any reparation obligation is discussed in the next section of this order.

D. *Reparations*

The prior order did not make any final determinations regarding reparations, leaving such determinations to be made once the compliance filing was made and the scope of any reparations was clearer. However the Commission did provide certain guidelines. First, it held that Navajo's settlement barred any reparations for the period the settlement was in effect. The Commission also held that no reparations would be paid for the period before the complaints were filed. [54] The Commission further concluded that SFPP could net out reparations over the years for which they might be due and established a procedure for determining what amounts might be due. Finally,

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the Commission stated it would allow SFPP to propose an offset of any reparations due by unrecovered litigation, environmental, and pipeline recoating costs that might be due in the same period. Each of these determinations is challenged on rehearing.

1. *What Parties Are Eligible for Reparations?*

The most fundamental issue here is what parties are eligible for reparations. The basic rule is that only parties that have filed a complaint are eligible for reparations if an existing rate is found to be unjust or unreasonable, and the burden is on the shipper to establish that the rates are unjust and unreasonable. This is in contrast to a suspension proceeding in which the rate is challenged at the time it is filed. If a suspended rate is reduced to be less than the rate originally filed, refunds are due to all shippers who paid the rate during the suspension period. While one of the West Line rates, that relating to turbine fuel, was suspended, the prior order concluded that there were no grounds for determining that rate was unjust and unreasonable. Since the complaints regarding the West Line rates were dismissed, neither refunds nor reparations lie against the West Line rates. Since none of the East Line rates were subjected to suspension, only reparations are due. Moreover, only Navajo filed a complaint against the East Line rates; all other complaints were against the West Line rates only. As such, only Navajo is eligible for reparations against the East Line rates. [55]

2. *Does Navajo's Prior Settlement With SFPP Bars Reparations?*

The proceeding against the East Line rates began when Navajo filed a complaint against the East Line rates on December 23, 1993. Until that date Navajo was barred by a Stipulation and Agreement dated January 30, 1989 from bringing an action, for a five year period after November 23, 1989. Both the ALJ and the prior order concluded that Navajo was barred from obtaining reparations by the terms of the January 30, 1989 Settlement. [56] On rehearing, Navajo renews its argument that while that Settlement bars reparations against the West Line rates "during any part of the five year period," it asserts that the absence of this language in the portion of the settlement dealing with the East Line rates permits reparations against the East Line Rates. It argues that reparations should be permitted against the East Line rates after the five year bar against filing a complaint has expired.

The Commission will deny rehearing. Section 2.3 of the 1989 Settlement states in part that "Navajo shall not challenge . . . the East Line rates . . . nor shall they seek reparations or other damages with respect to such rates." Yet reparations are just what Navajo seeks here in express violation of the limitation. To grant reparations is to permit a challenge to the reasonableness of the East Line rates for two years before the expiration of the 1989 Settlement because SFPP might be required to return some of the revenues it had collected during the settlement term. The purpose of such a provision is to preserve rate stability during the term of the settlement, which can be obtained only by prohibiting the granting of reparations during the Settlement term. While the drafting of the 1989 Settlement lacks precision, it is difficult to see why SFPP would agree to a settlement with a five year term that in fact would provide rate certainty only for three, as would be the case if Navajo's construction were adopted. While Navajo is not without grounds to assert that the reparations bar was waived with

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respect to the last two years of the East Line rates settlement, the Commission concludes that this is not the most reasonable interpretation of the 1989 Settlement.

3. *Are Reparations Available Prior to the Date of the Complaint?*

The prior order also held that because a settlement has been entered into, reparations would not be available for two years prior to the filing of a complaint. Navajo requests rehearing of this ruling, asserting that the ICA specifically contemplates that reparations are available two years prior to a complaint. Navajo asserts that while the Commission has some discretion in determining whether to award reparations, the presumption is that full reparations will be awarded unless there is a good reason for not doing so. In the instant case the Commission concluded that the settlement rates established by SFPP were based on the expectation that it would expand its lines, and that SFPP relied on the rates in doing so.

Navajo asserts that all carriers rely on settlement rates when they enter into a settlement and that this would effectively eliminate reparations in all cases involving settlement rates for the two year period prior to the filing of a complaint. It then argues that SFPP should have known that its rates were unjust and unreasonable well before the filing of the complaints in these proceedings and that this undercuts any argument SFPP may have that reparations are not equitable in this case. Finally, Navajo asserts that allowing reparations for two years prior to the filing of the complaint will provide the complainant shippers with some opportunity to recover their litigation costs.

The point at issue is a narrow one as regards Navajo since its complaint was filed on December 23, 1993, and it was barred from filing a complaint or seeking reparations through November 23, 1993. However, as Navajo asserts, the statements in the prior order are relatively broad and would have the effect, if applied in all cases, of barring reparations for a period two years before a complaint in all cases involving settlement rates. This would be the case regardless of how much the economic basis for the rates had changed, and the attendant unreasonableness of the rates in the two years proceeding the complaint. Upon rehearing, the Commission concludes that the prior ruling was overly broad given the general presumption that reparations will be awarded in full if a complaint succeeds. Therefore, while granting rehearing will have little practical effect in the instant proceeding, the Commission will do so. If settling parties wish to preclude reparations against a settlement rate, the appropriate method is to preclude the pursuit of reparations during the settlement term, as was done in the 1989 Settlement.

4. *The Reparations Methodology*

The prior order adopted a reparation methodology based on the comparison of the indexed cost of service and the related revenues authorized to cover that cost of service with the revenues actually generated in each year. To the extent the actual revenues generated exceeded the revenue permitted in each year, refunds were due. In addition, if the permitted revenues were exceeded in some years, but not achieved in other years, then SFPP was permitted to net out the difference. The Commission also indicated that if SFPP had additional legal, environmental, or rehabilitation costs, these could be used to offset its reparation obligation. All three components are challenged on rehearing.

a. *How the Reparation Levels Are Determined*

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On rehearing Navajo questions the use of the Commission's indexing methodology to increase the level of costs that can be recovered in each year. It claims that this permits the pipeline to both recover costs under the indexing methodology and to recover cost increases without having to file for a rate increase under the Commission's regulations. It asserts that this method permits the pipeline to recover cost increases that occurred between 1994 and the date of SFPP's compliance filing on a retroactive basis, and as such violates the filed rate doctrine.

The first step in determining reparations or refunds is to determine the proper rate level. This is done by developing the cost of service for the test year, in this case 1994, and dividing the costs by the relevant test period volumes for each class of service. This results in a just and reasonable unit rate that replaces the previous unit rate that the Commission has determined to be unjust and unreasonable. The projected revenues for that year should equal the cost of service when the unit rate is multiplied times the test period volumes. Over time the underlying costs may increase or decrease while revenues remain the same, or the revenues may increase or decrease depending on the throughput that actually occurs. In any event, if the ratio of total expenses diverges, the pipeline can file for rate increase, or as in the instant case, the shippers can file a complaint for a decrease.

Under this regime, the proper method for determining reparations or refunds is to measure the new lawful unit rate against the older rate now determined to be unlawful, and pursuant to which the pipeline has already collected the revenues. The purpose is to place the shipper in the same situation the shipper would have been in if the proper rate per unit of throughput had been in effect during the period to which reparations apply. Gross revenues and costs are not relevant to this calculation. The pipeline may make more or less money depending on the mix of costs and throughput that actually results, but it is the relative, not the absolute level, of the revenue stream that is the basis for calculating reparations. Thus, if the former rate was 10 cents a barrel, and the new rate is 7 cents a barrel, the reparation obligation is 3 cents a barrel for every barrel shipped. Thus, the gross reparation level due for each year is the difference between the revenues generated in that year under the old rates and the revenue level that would have been generated under the new rates. The reparation liability applies only to that portion of the difference that is attributable to Navajo's throughput during each year.

Under these circumstances the application of the Commission's indexing methodology to the rates established by the prior order is appropriate. All rates may be indexed under the Commission's indexing methodology. Thus, whether the indexing is applied to the rate that the Commission had determined to be unjust and unreasonable, or the legal rate established by this order, the parties are placed in the same position as they would have been by the application of either rate. Since on rehearing the Commission is applying the indexing method to the rate, and not SFPP's cost of service as was done in the prior order, the Commission is not permitting SFPP to restate its cost of service retrospectively between the effective date of the compliance filing and the December 31, 1994 *date for determining SFPP's cost of service.*

In addition, Navajo requests that the Commission clarify that interest is due on any reparations at the rate required for refunds under the Commission's regulations. The requested clarification is granted since this is the normal practice.

b. *The Leveling of the Reparation Obligation*

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The prior order stated that, in determining its refund obligations, SFPP would be permitted to offset under-recovery of its cost of service in some years with over-recovery of its cost of service in other years. [57] On rehearing Navajo argues that this ruling also violates the filed rate doctrine because it permits SFPP to recover costs that were not recovered in some years with excess revenues that were earned in later years. It asserts that if SFPP is facing a shortfall in any year, the proper solution is to file for a rate increase under the Commission's oil pipeline regulations. It also argues that the offset methodology adopted by the prior order reflects Surface Transportation Board (STB) practice in the regulation of railroads that is not applicable to the oil pipeline industry.

The Commission will grant rehearing. The previous discussion of the proper methodology recognized that reparations are measured by the difference between the unit value of the old and the new rate, not the difference in gross and net revenues for the operations of the pipeline as a whole. The differences in gross and net revenues between any two years are caused primarily by differences in the volumes and the unit costs incurred after the test year. As has been discussed, neither determine the level of reparations due after the level of the new unit rate is determined based on the costs and throughput of the new year.

The revised method adopted here is therefore materially different from the STB method which determines the total revenue stream required to recover the costs of particular service over its economic life. [58] In the instant case there is no material result because the volumes on SFPP's East Line have been increasing since 1994 and have been above the levels used to design the new East Line rates. It is therefore unlikely that SFPP has failed to recover the cost of service applicable to its new East Line rates in the intervening period. Moreover, since SFPP need only pay Navajo its *pro rata* portion of the gross reparation obligation, the balance, while in excess of the restated cost of service for each year since 1994 and the resulting rate, is retained by SFPP. Thus no injury should result to SFPP from the ruling here.

c. *Should the Offset of Certain Costs Be Permitted?*

The prior order concluded that SFPP should not be permitted to create reserves for certain costs that it projected it would incur after the 1994 test year because those costs were not know and measurable during the test year. The order did not conclude that these were costs for which no recovery would be permitted, but held that in applying the test period concept SFPP could not build into its rates cost factors that reflected anticipated expenditures. Those costs included litigation expenses, environmental remediation costs, and recoating repairs to the pipeline. The Commission also concluded that as matter of equity these allowable costs could be offset against the reparations due the East Line shippers under the prior order. [59]

Navajo argues on rehearing that these findings violated the filed rate doctrine because they permit recovery of costs that were not included in the pipeline's rates in a subsequent period. It asserts that the proper method for recovering any costs that were not foreseen and were not included in the pipeline's cost of service is for the pipeline to file for a rate increase to recover those costs. Navajo argues that since only Navajo is eligible for reparations, the rulings in the prior order place the whole burden of any

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offset of the costs on Navajo. It further argues that since the costs are being offset against a refund obligation, this severely limits the opportunity for shippers to challenge the appropriateness and the accuracy of the costs involved.

Upon review, the Commission will grant rehearing in part and clarify its prior order for several reasons. First, as Navajo points out, the full cost of any offset will be borne solely by Navajo since no other shipper will receive reparations for the East Line rates. The reason for allowing SFPP to recover certain costs incurred between 1995 and 1998 is that benefits that flowed to the system when the costs were incurred. In the case of litigation expenses, the rationale was to permit recovery of expenses that would otherwise have no cost component in the cost of service for the years after 1994. Upon review, it appears that the resolution adopted by the prior order was in the nature of a direct bill against Navajo's reparations for the projected costs that were excluded from SFPP's 1994 cost of service, a result which can conflict with the filed rate doctrine.

The situation here is not completely analogous to a direct bill as the revenues had already been collected and the costs at issue would be charged against excess revenues that were collected in the same period, the calender years 1995-1998. Here, because the Commission has restated the rates to be applied to the same period, the costs at issue are outside the cost of service for the period after 1994. To offset these costs against the reparations would in essence charge Navajo for costs incurred during a period in which those costs were not included in the pipeline's rates (as restated) for that period, a violation of the filed rate doctrine. [60] Moreover, the offsets proposed in the prior order do not appear to meet the traditional standards for offsets in the Commission's prior cases. [61]

Navajo correctly argues that any costs that were not included in SFPP's 1994 test year cost of service (such the additional litigation, environmental, or reconditioning costs) should be collected prospectively from the date of a compliance filing and be borne by all shippers. The Commission will therefore modify its prior order as follows. SFPP will calculate the gross reparations that would be due if all shippers that had used the East Line had filed complaints for the applicable reparations period. This will establish the total revenue that was received in excess of the new East Line rates established by the prior order. Navajo will be paid its *pro rata* share of the reparations for the relevant time frame. Since Navajo is the only shipper entitled to reparations for the East Line shipments, this should leave a surplus of revenues in excess of the East Line restated cost of service for the period between the beginning of the reparations period and the actual date on which the restated rates began to be collected by SFPP. SFPP will first deduct from that surplus its recorded environmental costs for the years 1995-1998, then the portions of its recoating maintenance program that were not required to be capitalized in the same period, and then any litigation costs properly

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charged to the East Line rates, also for the calender years 1995-1998. If any of these costs are not so offset, SFPP may include those costs in a surcharge to be established as part of its revised compliance filing and amortized prospectively over five years. To the extent that the environmental, repair, and litigation costs are or could have been recovered as permitted here, SFPP may not recover those costs as part of any further litigation involving the East Line rates.

Moreover, since the surcharges will be collected prospectively from all East Line shippers, the surcharge will reflect the benefits to those shippers of environmental mitigation and system repairs as well as the lower rates resulting from the litigation. As the surcharge will be prospective, shippers will be permitted to challenge the costs at the time the revised compliance filing is made.

E. *Prorationing Policies*

The prior order generally accepted SFPP's prorationing policies subject to SFPP providing better notice provisions in its tariff to more clearly state where its detailed prorationing policies are located. [62] SFPP's prorationing method provides that customers must provide a justification of their need for capacity in situations involving a shortfall and that any shortage of capacity will be allocated accordingly. The purpose of the method is to prevent the excessive nominations that are likely to occur under a good faith method in periods of severe capacity constraint. The Commission also required SFPP to shorten the period for replies to requests for nominations and required that SFPP refrain from requesting certain types of confidential information. [63]

Chevron requests rehearing, asserting that the Commission overruled the arguments of the complaining parties, the Commission's trial staff, and the ALJ. It asserts that the only assured method of preventing discrimination is to adopt a good faith nomination test and require that the test be placed in SFPP's tariff.

The Commission denies rehearing. Any request to change the provisions of SFPP's prorationing procedures is in the nature of a complaint proceeding since SFPP did not propose to change its tariff. The Commission did require SFPP to make some clarifications and limitations to its procedures, but otherwise concluded that the complainants had not established that SFPP's procedures were unjust and unreasonable. The Commission also noted that even under a good faith nomination test, a pipeline can demand justification for the nomination and require a modification if the request is not grounded in a reasonable need for the capacity. The rehearing arguments present nothing that was not addressed in the prior order, which is affirmed for the reasons stated in greater detail in that order. [64]

F. *Rehearing of the Compliance Filing in Docket No. IS99-144-000*

On March 15, 1999, in response to Opinion No. 435, [65] SFPP filed FERC Tariff Nos. 43 and 44 in Docket No. IS99-144-000 with a proposed effective date of April 1, 1999. The Commission accepted and suspended the proposed tariffs, effective April 1, 1999, subject to refund, to the outcome of the ongoing proceeding in SFPP, L.P., *et al.* Docket No. OR92-8-001 , *et al.*, and to SFPP's correcting the statement of its proration policy. On rehearing, SFPP argues that the suspension of the revised tariffs was improper because both were rates that were prescribed by the Commission. It argues that when a rate has been prescribed by the Commission, it is the lawful rate and

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thereafter no refunds or reparations lie against the rate. It therefore requests that the Commission remove the refund obligation now attached to Docket No. IS99-144-000 .

The Commission will deny rehearing in part and grant rehearing in part. Tariff No. 43 reflects the new East Line rates and pro-rationing policy required by Order No. 435 . While Opinion No. 435 contained instructions on how to design those rates, the calculations were complex and several were challenged when the rates were filed. At the time Tariff No. 43 was filed there was a significant chance that the rate levels in the tariff would change depending on how the protests and related requests for rehearing were resolved. Therefore the suspension obligation will not be lifted as to Tariff No. 43.

Tariff No. 44 was filed to comply with the requirement that SFPP file a tariff equal to the charge it has made for the use of the enhancement facilities. Opinion No. 435 concluded that charge was grandfathered through August 7, 1995, the effective date of the findings required by Opinion No. 435. Because the charges for the use of the enhanced facilities were grandfathered through that date by the provisions of the EPAct, the charge is presumed to be just and reasonable. Therefore no refunds or reparations are due provided that the charge was accurately filed. While the various complainants are opposed to the charge and its level, they have not represented that the rates for use of the Watson Station enhancement facilities do not accurately reflect the charges that were collected prior to the enactment of the EPAct. Since no refund obligation can attached to a just and reasonable rate, the refund obligation is lifted with respect to Tariff No. 44.

G. *Miscellaneous Issues*

SFPP requests a number of miscellaneous clarifications. First, it states that last sentence of the first paragraph at 80 FERC ¶61,076 should be corrected to read: "The Commission also finds that *complaints against* the charges for the use of SFPP's Watson enhancement facilities are barred in the absence of substantially changed circumstances and that issue will not be pursued here." Second, its believes that the inflation rate shown at page 61,090, line 7 should read 2.67 (not 2.97) percent. Third, it believes that portions of the ordering language in Paragraphs C and D were omitted during publication. The first and second clarifications are granted. The ordering paragraphs have since been corrected by the publisher of the FERC Reports.

III. The Compliance Filings

As has been previously noted, SFPP filed two compliance filings on March 15, 1999, one in the main docket [66] and one in Docket No. IS99-144-000 . Chevron and Navajo both filed protests to these compliance filings. The protests to the filing in the main docket centered on SFPP's treatment of its litigation costs, including both the inclusion of the costs and how the costs were allocated between the East and West Lines. In addition, the protesting parties raised many of the arguments included in their rehearing requests, including how the interest component should be applied to the rate base and how certain aspects of the rate base should be calculated.

The Commission concludes that the rulings on the request for rehearing address all the issues raised by the parties in their comments on the compliance filing. The rulings in this order will require substantial changes to the compliance filing, including the size of and amortization of the starting rate base, the calculation of the tax allowance, and

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the calculation and amortization of litigation costs, including the exclusion from the revised compliance filing of any costs attributable to SFPP's settlement of civil litigation with Navajo and El Paso Refinery. In light of these changes, the most efficient disposition of the objections to the pending compliance filing is to require a revised compliance filing with 60 days after this order issues, including a revised estimate of any reparations due in a manner consistent with this filing. That portion of the filing shall also include a statement of the costs SFPP is charging against that portion of the funds collected in excess of the revised East Line rates that is not being distributed to Navajo.

As part of the revised compliance filing SFPP must also determine how the revised rates required by this order differ from those included in the initial compliance filing dated March 15, 1999. To the extent the revised rate is less than the rate included in revised filing, SFPP must summarize the difference and prepare an initial estimate of refunds that will be due shippers for any changes. To the extent that the rate is higher, SFPP must state the difference and propose a method to recover the difference from shippers who utilized its East Line system between April 1, 1999 effective date of the March 15, 1999 compliance filing and the date it begins billing the rates contained in the revised compliance filing. This will not violate the filed rate doctrine because shippers have been on notice that a new set of rates would be established that conforms to the rulings of the Commission's orders in this proceeding, and revising the rates initially filed on March 15, 1999 reflects the corrections the Commission is making to its prior order. However, any surcharges that SFPP proposes in response to this order designed to recover costs incurred between 1995 and 1998 will be prospective only because this is the first time that notice has been provided that such surcharges may become part of its filed rates.

The protests to the filing in Docket No. IS99-144-000 also argued that the rate filed was unjust and unreasonable. The substance of the filing was a 3.2 cents per barrel rate for the processing of volumes, at a minimum throughput level, at the Watson Station enhancement facilities. SFPP's obligation was to file a rate that conformed to the uniform contract that is signed by all shippers utilizing that facility. None of the protests establish that the tariff rates or its conditions are inconsistent with contracts pursuant to which the service as previously provided. As was stated in the rehearing section of the order, these rates continue to be deemed just and

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reasonable pursuant to the EPAct. Therefore the filing in Docket No. IS99-144-000 is accepted with finality. The suspension obligation attached to that docket was lifted in the rehearing portion of this order. The rates contained in that filing are final until such further action may be taken in response to the complaints against the enhancement charges now before the Commission.

The Commission orders:

(A) Rehearing is granted and denied as stated in the body of this order.

(B) The compliance filing in Docket No. IS99-144-000 is accepted and the refund obligation previously attached to that filing is lifted.

(C) SFPP shall make a revised compliance filing in Docket Nos. OR92-8-000 though OR95-34-000 consistent with this order within 60 days after this order issues, to be effective April 1, 1999.

– Footnotes –

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[1] *SFPP, Inc.*, 86 FERC ¶61,022 (1999) (Opinion No. 435).

[2] In this order the main docket encompasses Docket No. OR92-8-000 and all the other dockets listed in the caption except Docket No. IS99-144-000 .

[3] Exh. 142 at p. 9.

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[4] Exh. 144 at p. 3.

[5] Section 1803(b) of the EPAct, Pub. L. No. 102-486, 106 Stat. 2772 (1992).

[6] 86 FERC at pp. 61,061 -62.

[7] *Id.* at pp. 61,064-67.

[8] Id. at pp. 61,067-78.

[9] *Id.* at p. 61,061.

[10] *Id.* at pp. 61,059-60.

[11] *Williams Pipe Line Company*, Opinion No. 154-B , 31 FERC ¶61,377, at pp. 61,834 -35 (1985).

[12] *ARCO v. FERC*, Nos. 99-1062.

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[13] 86 FERC at p. 61,068 .

[14] Id. at p. 61,067.

[15] *Id.* at p. 61,068.

[16] 71 FERC ¶61,205, at p. 61,755 (1995) (Santee).

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[17] A lawful rate is one for which the Commission has made a determination that the rate is just and reasonable. A legal rate is one that is on file with the Commission but for which the Commission has made no determination that the rate is just and reasonable. *See Arizona Grocery v. Atchison Ry.*, 284 U.S. 370 (1932). As is explained below, contract rates are legally binding as between the parties whether or not such a rate has been filed with the Commission since the contract provides the required notice under the filed rate doctrine. As such, contract rates are legal rates.

[18] The Commission did make a determination that an oil pipeline's rates had not been shown to be just and reasonable in *Williams Oil Pipe Line*, 84 FERC ¶61,022 (1998). However, the case was settled and Williams' currently filed rates are now settlement rates. *See Williams Pipe Line Company*, 89 FERC ¶61,025 (1999).

[19] 86 FERC at pp. 61,075 -76.

[20] *Id.* at pp. 61,073-75.

[21] Chevron's request for rehearing dated March 16, 1999, at 27.

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[22] A retrospective determination that the charges should have been filed with the Commission does not in and of itself mean that the charges were unjust and unreasonable. *See Koch Gateway Pipeline Company, et al.*, 72 FERC ¶61,154, at p. 61,778 . *See also City of Piqua v. FERC*, 610 F.2d 950 (D.C. Cir. 1979), upholding a Commission decision to waive the 30 day notice requirement of the statute to allow a rate increase to take effect prior to the date it was filed with the Commission, on the basis that the contracting parties had contractually agreed to its effective date.

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[23] Ultramar filed its initial complaint against SFPP regarding the Watson Station enhancement facilities on August 30, 1996. Complaints were filed by Texaco Refining and Marketing Company (Texaco) on December 1, 1995, by ARCO Products Company (Arco) on January 16, 1996, by both Arco and Texaco on October 22, 1997, and by ARCO, Texaco, and Mobil Oil Corporation on July 27, 1998.

[24] The mechanics of the rate base calculation under the Opinion No. 154-B methodology are discussed at 86 FERC at pp. 61,085 -86.

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[25] 86 FERC at p. 61,088 .

[26] *Id.* at pp. 61,089-90.

[27] 45 FERC ¶61,242, at p. 61,176 (1988).

[28] 1998 Settlement and Agreement Between SPPL and Airline Intervenors: Article V, Section 5.3.

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[29] This order refers to SFPP's starting rate base as of December 31, 1983, although technically this is the rate based of its predecessor company. The Opinion No. 154-B methodology requires starting that methodology on December 31, 1983 for existing company, and therefore it is necessary to reach back to the earlier entity.

[30] *Citing Arco Pipeline Company*, Opinion No. 351, 52 FERC ¶61,055 (1990).

[31] *Id.* at p. 61,233.

[32] *SFPP, L.P.*, 80 FERC ¶63,014, at p. 65,128 (1997).

[33] *Id.*, *citing* 39 FERC ¶63,018, at p. 65,081 (1987).

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[34] 86 FERC at p. 61,101 .

[35] *Id.*, at p. 65,128.

[36] *See* Exh. No. 529 at Schedule 8, page 3 of 4, lines 1 and 2 (years 1989-94).

[37] 86 FERC at p. 61,089 , n.148.

[38] *Id.* at p. 61,097.

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[39] *Id.* at p. 61,090.

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[40] *Id.* at p. 61,092.

[41] *Lakehead Pipe Line Co.*, Opinion No. 397, 71 FERC ¶61,338 (1995); *Lakehead Pipe Line Co.*, Opinion No. 397-A , 75 FERC ¶61,181 (1996).

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[42] 71 FERC at p. 62,314 , n.53.

[43] 86 FERC at p. 61,103 .

[44] *Id.*

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[45] 33 FERC ¶61,327 (1985), at p. 61,639.

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[46] 86 FERC at p. 61,097 .

[47] *Id.*

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[48] 86 FERC at p. 61,106 .

[49] *Citing* Mountain States Tel. And Telegraph Co. 939 F.2d. at 1043 (treating the cost of settlement and litigation the same).

[50] Extraordinary costs are those that reflect infrequent occurrences are events or transaction are types that are not reasonably expected to recur in the forseeable future. This contrasts to costs that reflect ordinary, frequently, recurring event. *See Amerada Hess Corporation, et al.*, 71 FERC ¶61,040, at pp. 61,169 -71 (Opinion No. 393) (1995).

[51] *Iroquois Gas Transmission System v. FERC*, 145 F.3d 398 (D.C. Cir. 1998).

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[52] Opinion No. 393 at pp. 61,163 and 61,176.

[53] 86 FERC at p. 61,097 .

[54] *Id.* at p. 61,111.

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[55] Chevron complained against the reversal of one of SFPP's lines and its capacity allocation procedures, but did not complain against the East Line rates as such. *See SFPP, L.P.*, 63 FERC ¶61,014, at p. 61,123 (1993).

[56] 86 FERC at p. 61,111 .

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[57] 86 FERC at p. 61,113 .

[58] *Williams Oil Pipe Line*, 84 FERC ¶61,022, at p. 61,104 , n.60.

[59] 86 FERC at p. 61,113 .

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[60] *See Transcontinental Gas Pipe Line*, 71 FERC ¶61,108, at pp. 61,357 -58 (1995) for discussion of how billing customers amounts due based on their prior contract demands violates the filed rate doctrine. This was in contrast to the pipeline's recovery of past take-or-pay costs based on a substantial relationship to the pipeline's performance of current services. *Id.* at p. 61,360.

[61] *See Panhandle Eastern Pipe Line Company*, 83 FERC ¶61,261 (1998) at p. 62,089:

[T]he Commission has refused to allow offsets where refunds to be offset against claims or debts that are not related to the rates, the rate period, and the rate issues that gave rise to the refunds.

Since the costs discussed in the prior order were determined to be outside the scope of the restated rates, the offsets proposed in the prior order would appear to fall within the rubric of the cited language. In essence, the Commission requires that the offsets fall within the scope of rates and charges that conform to the requirements of the filed rate doctrine.

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[62] 86 FERC at p. 61,115 .

[63] *Id.*

[64] *Id.* at pp. 61,115-16.

[65] *SFPP, L.P.*, *et al.*, 86 FERC ¶61,022 (1999).

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[66] In this order the main docket encompasses Docket No. OR92-8-000 and all the other dockets listed in the caption except Docket Nos. IS99-144-000 and IS99-144-001 .
