150 FERC ¶ 61,097
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Cheryl A. LaFleur, Chairman;
Philip D. Moeller, Tony Clark,
Norman C. Bay, and Colette D. Honorable.

SFPP, L.P. Docket Nos. IS09-437-007
IS09-437-006
IS10-572-003
IS10-572-004

OPINION NO. 522-A

ORDER ON REHEARING AND COMPLIANCE FILING

(Issued February 19, 2015)

1. On October 22, 2012, SFPP, L.P. (SFPP) and NHW Shippers[1] filed rehearing of Opinion No. 522,[2] which addressed briefs on exceptions to an Initial Decision (2011 ID)[3] involving SFPP's proposed East Line cost-of-service rate increase. Also, on November 13, 2012, SFPP submitted its compliance filing pursuant to Opinion No. 522. As discussed below, the Commission grants rehearing in part and denies rehearing in part. The Commission also finds that SFPP's compliance filing requires modifications. The Commission therefore directs SFPP to make a revised compliance filing within 45 days consistent with this order and, as appropriate, to recalculate the refunds due its shippers.

[1] Navajo Refining Company, L.L.C., HollyFrontier Refining & Marketing LLC, and Western Refining Company, L.P. (NHW Shippers).

[2] *SFPP, L.P.*, Opinion No. 522, 140 FERC ¶ 61,220 (2012).

[3] *SFPP, L.P.*, 134 FERC ¶ 63,013 (2011) (2011 ID).

## I. **Background**

2. On July 31, 2009, SFPP filed a cost-of-service rate increase pursuant to section 342.4(a) of the Commission's regulations to increase the rates for its East Line.[4] The Commission accepted and suspended SFPP's proposed rate increase until January 1, 2010, subject to refund, and established hearing procedures before an administrative law judge.[5] Following a hearing, on February 10, 2011, the presiding administrative law judge issued the 2011 ID.[6] Briefs on exception to the 2011 ID were filed by SFPP, CCSV Shippers,[7] NHW Shippers, and Commission Trial Staff. The same four parties also filed briefs opposing exceptions. On September 20, 2012, the Commission issued Opinion No. 522.

## II. **Rehearing**

3. On October 22, 2012, NHW Shippers and SFPP filed for rehearing of Opinion No. 522. The rehearing requests raise issues related to (A) the calculation of SFPP's income tax allowance, (B) Accumulated Deferred Income Taxes (ADIT), (C) litigation costs related to the costs of using Union Pacific Railroad right-of-way, and (D) the cost of debt. The Commission addresses each issue as discussed below.

### A. **Income Tax Allowance Issues**

#### 1. **Calculating the Weighted Average Marginal Tax Rate**

##### a. **Background**

4. SFPP is a limited partnership in which much of SFPP's taxable income is passed through Kinder Morgan Energy Partners L.P. (KMEP), a master limited partnership (MLP) and then passed on to KMEP's share-owning limited partners (also referred to as

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[4] SFPP's East Line transports refined petroleum products from El Paso, Texas, or Diamond Junction, Texas, to Lordsburg, New Mexico; Tucson, Arizona; Phoenix, Arizona; and various military destinations.

[5] *SFPP, L.P.*, 128 FERC ¶ 61,214 (2009) (Hearing Order).

[6] 2011 ID, 134 FERC ¶ 63,013.

[7] ConocoPhillips Company (ConocoPhillips), Chevron Products Company (Chevron), Southwest Airlines Co. (Southwest), and Valero Marketing and Supply Company (Valero) filed a joint brief on exceptions.

unitholders).[8] Under Commission policy, a partnership-entity may include an income tax allowance in its cost-of-service in order to recover the "actual or potential income tax liability" attributable to the partners.[9] Because different partners are subject to different tax rates, the Commission determines the income tax allowance using a weighted average marginal income tax rate based upon (a) tax rates applicable to each type of partner (e.g., individuals, corporations)[10] which are (b) weighted by the aggregate actual or potential income tax liability attributed to the partners of each type (e.g., individuals, corporations).[11] The weighted average marginal income tax rate is then applied to the pipeline's taxable allowed return in order to calculate the pipeline's income tax allowance.[12]

5. Opinion No. 522 reversed the 2011 ID's holding that the income tax rates should be weighted by the relative share of quarterly "cash distributions"[13] provided to each class of partner.[14] For purposes of calculating the income tax allowance, Opinion No. 522 held that the income tax rates for the six different classes of partner should be

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[8] *E.g.*, Ex. SPE-254 at 2; Ex. SPE-35; Opinion No. 522, 140 FERC ¶ 61,220 at P 293. A partnership does not pay any taxes itself, and the tax liability from the partnership income is passed through to the partners.

[9] *E.g.*, *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139, at PP 33-34 (2005).

[10] The six types of KMEP partner identified in this proceeding are (1) Subchapter C corporations, (2) individuals, (3) mutual funds, (4) other unitholders such as pension funds, IRAs, and Keogh Plans (5) entities that receive Unrelated Business Taxable Income (UBTI) and (6) tax exempt entities.

[11] Thus, in a simple example, consider a hypothetical partnership in which 30 percent of income tax liability is allocated to a corporate partner and 70 percent is allocated to individuals. In this hypothetical, the weighted average marginal income tax rate would equal 30 percent multiplied by the corporate income tax rate plus 70 percent multiplied by the individual income tax rate.

[12] Opinion No. 511-A contains a more comprehensive description of how the income tax allowance is calculated. *SFPP, L.P.*, Opinion No. 511-A, 137 FERC ¶ 61,220, at Appendix C (2011).

[13] 2011 ID, 134 FERC ¶ 63,013 at P 192.

[14] Opinion No. 522, 140 FERC ¶ 61,220 at P 308.

weighted based upon the proportion of "distributed income" attributed to partners in each of the six classes.[15]

### b. NHW Shippers' Rehearing Request

6. NHW Shippers seek rehearing regarding Opinion No. 522's decision to weigh the partners' marginal income tax rates based upon distributed income. NHW Shippers contend that "distributed income" is not a term with a generally accepted definition. NHW Shippers further assert that it is uncertain how, if at all, distributed income differs from taxable income. NHW Shippers contend that taxable income does not reflect the potential future tax liability created by income tax deferrals, and thus taxable income fails to capture the potential income tax liability meant to be embodied in the income tax allowance. NHW Shippers explain that due to 743(b) depreciation expenses,[16] KMEP's public unitholders rarely pay any income taxes in the year KMEP's assets generate income and that the unitholder's tax liability is deferred until the unitholder sells its shares. NHW Shippers emphasize that the Commission's income tax allowance policy is meant to enable the pipeline to recover its actual and potential income tax liability. Thus, NHW Shippers state that using taxable income to determine the weighted average marginal tax rate ignores the potential income taxes (i.e. the deferred taxes) which will be recovered when unitholders sell their shares. NHW Shippers add that failing to account for the deferred taxes increases the weight assigned to the corporate tax rate, thereby increasing the weighted average marginal income tax rate used to determine SFPP's income tax allowance.

7. NHW Shippers assert that the marginal income tax rates should be weighted by the cash distributions as held by the 2011 ID. NHW Shippers acknowledge that cash distributions are treated as a return of capital that reduces the capital accounts of the unitholder. As a result, NHW Shippers concede that unitholders do not ordinarily pay income taxes on the quarterly cash distributions.[17] However, NHW Shippers state that unitholders rarely pay taxes in the year that income is incurred because the taxes are

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[15] *Id.* P 306.

[16] As explained by NHW Shippers, each time a unit is sold, the unitholder's share of the pipeline assets is written-up to the purchase price pursuant to section 743(b) of the Internal Revenue Code, and the unitholder depreciates this written-up purchase price over the remaining useful life of the asset. NHW Shippers Rehearing at 19.

[17] The unitholder only pays income taxes on a cash distribution in the year it is received if the unitholder's capital account has been reduced to zero. NHW Shippers Rehearing at 16-17.

deferred. Ultimately, however, the income tax a unitholder incurs at the time of sale "corresponds directly to the cash distributions received by unitholders."[18] Thus, NHW Shippers state that these cash distributions reflect the "actual or potential" income tax liability that the Commission's income tax policy is designed to permit pipelines to recover.

8. NHW Shippers also object to language in Opinion No. 522 stating that "cash distributions" should not be used to calculate the weighted average marginal income tax rate because cash distributions could include revenue from non-jurisdictional activities.[19] NHW Shippers state it is not clear why the Commission believes "distributed income" includes less non-jurisdictional income than "cash distributions." Thus, NHW Shippers claim the possible presence of non-jurisdictional income provides no basis for calculating the weighted average marginal income tax rate based upon distributed income as opposed to cash distributions.

**c. <u>Discussion</u>**

9. The Commission reaffirms Opinion No. 522's holding that the income tax allowance should be based upon the marginal income tax rates of the six different partner types (e.g., corporations, individuals) weighted by the proportion of distributed income attributed to partners of each type.

10. Although the NHW shippers contend that the term "distributed income" is unclear, the Commission has used this term in prior proceedings.[20] Distributed income is closely related to the taxable income attributed to each partner. However, whereas taxable income only reflects each partner's actual tax liability in a given year, distributed income encompasses both the partner's actual *and* potential income tax liability. Because the income tax allowance is designed to recover both the actual and potential income tax

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[18] NHW Shippers Rehearing at 20; NHW Shippers Rehearing at 21 (citing Ex. NAV-1C at 68; Ex. NAV-23).

[19] *Id.* at 23 n.6.

[20] *E.g. SFPP, L.P.*, Opinion No. 511, 134 FERC ¶ 61,121, at PP 225, 227, 236, 269-271, 275-276, 288, 291 (2011); Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 279, 282, 322, 341, 358. The D.C. Circuit affirmed the Commission's income tax policy on the basis that the income tax allowance reflects the pipeline's tax liability is based upon unitholder's "distributive share" of the partnership pipeline's income. *E.g., ExxonMobil Oil Corp. v. FERC,* 487 F.3d 945, at 952, 954 (2007).

liability of the partners,[21] the tax rate used to determine the income tax allowance must be based upon the tax rates of those partners paying taxes in the current year as well as those partners who, by using tax deferrals, have incurred a potential income tax liability for the future.

11. Contrary to NHW Shippers' claims, Opinion No. 522 recognized the distinction between taxable income and distributed income. Opinion No. 522 held that SFPP's use of taxable income ignored the potential income tax liability deferred by certain depreciation expenses and likely to be recaptured at the time each partner sold its ownership share.[22] On compliance, SFPP was directed to calculate an income tax allowance consistent with this holding.[23]

12. Opinion No. 522 properly rejected NHW Shippers' attempt to associate cash distributions with a partner's income tax liability. Cash distributions consist of the quarterly payments received by the partner from the MLP pursuant to the partnership agreement. The unitholder does not typically pay any income tax on these cash distributions, and the tax code equates "cash distributions" to a return of capital that reduces the unitholder's basis.[24] Furthermore, the unitholder's income tax liability is not necessarily the same as the unitholder's cash distribution, and a unitholder incurs an income tax liability whether or not it receives a cash distribution.[25] Given that the unitholder's cash distributions are not taxed as income and are not the same as taxable

[21] The Commission's income tax allowance policy permits the recovery of the partner's actual or potential income tax liability. *E.g., Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 at PP 33-34.

[22] Opinion No. 522, 140 FERC ¶ 61,220 at P 307 (citing 2011 ID, 134 FERC ¶ 63,013 at P 190).

[23] *Id.* P 308.

[24] *E.g.*, Ex. NAV-28 at 11.

[25] *E.g., ExxonMobil*, 487 F.3d. at 954 (noting that "investors in a limited partnership are required to pay tax on their distributive shares of the partnership income, even if they do not receive a cash distribution."). *See also* Ex. NAV-28 at 8-10 ("The amount of cash distributed by a partnership to its partners annually is not necessarily the same as the amount of taxable income allocated to the partner"), 14 ("It is common in any given year for a partner to receive allocations of net income [i.e. distributive share] less than cash distributions. It is also not uncommon for a partner's share of taxable income to exceed the cash distributions he receives….").

income, Opinion No. 522 properly concluded that the weighted average marginal income tax rate should be weighted based upon the distributed income, not cash distributions.[26] Accordingly, the Commission denies rehearing.[27]

### 2. **Whether the Income Tax Allowance Should Reflect The Effects of Tax Deferral**

#### a. **Background**

13. Pursuant to section 743(b) of the Internal Revenue Code, each time a unit in a partnership (such as an MLP) is sold, the transferee unitholder's basis is written-up to the purchase price.[28] This write-up allows the unit-holding partner to claim an increased depreciation expense based upon the written-up basis.[29]

14. The 2011 ID held that SFPP's weighted average marginal income tax rates should be reduced to reflect the deferral of state and federal income taxes caused by 743(b) deprecation. Opinion No. 522 reversed the 2011 ID and rejected the application of such an adjustment.[30]

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[26] NHW Shippers argue that cash distributions ultimately are reflected in the level of income tax liability incurred when the unit is sold. NHW Shippers Rehearing at 18 (citing Tr. 2170:17-19) & 21 (citing Tr. 2148-2149). However, what *may*, as a matter of economic or financial theory, be true for over the long term life of the business enterprise is not necessarily true either for the time period applicable to this litigation or the time period between any particular unitholder's purchase and sale of a share.

[27] Opinion No. 522 also stated that a weighted average marginal income tax rate derived from cash distributions could reflect non-jurisdictional revenues. 140 FERC ¶ 61,220 at P 308. Opinion No. 522 neither cited evidence supporting this proposition nor demonstrated that cash distributions reflect more non-jurisdictional revenues than distributed income. Accordingly, the potential presence of non-jurisdictional revenues in cash distributions is not the basis for the Commission's determination here.

[28] 26 C.F.R. § 1.743(b). *See also* Opinion No. 511, 134 FERC ¶ 61,121 at P 310. The asset write-up only occurs if the partnership has elected to provide this write-up pursuant to section 754(b). *Id.* KMEP has made such an election.

[29] Opinion No. 511, 134 FERC ¶ 61,121 at P 310.

[30] Opinion No. 522, 140 FERC ¶ 61,220 at PP 340-341.

### b. NHW Shippers' Rehearing Request

15. NHW Shippers advocate reducing the income tax allowance to reflect the unitholder's deferral of taxes based upon 743(b) depreciation. NHW Shippers explain that section 743(b) depreciation expenses frequently offset the taxable income allocated to each unitholder in any given year. As a result, the unitholders avoid paying income taxes until the units are sold, and, by deferring tax liability, unitholders enjoy a time-value of money savings.

16. Thus, NHW Shippers assert that the tax rate of KMEP's public unitholders should be adjusted downward by multiplying the tax rate by 80.4 percent. NHW Shippers state that the effect of the deferral can be calculated based upon public unitholders' average holding period of KMEP shares, which NHW Shippers claim is approximately 5.3 years.[31] NHW Shippers then argue that its witness Dr. Horst quantified the resulting time-value savings by discounting the average tax rates, leading to the 80.4 percent multiplier.[32]

17. NHW Shippers state that Opinion No. 522's rationale for rejecting the proposed discount to income tax rate rates is contradictory. The NHW Shippers state that the Commission's income tax allowance policy allows for recovery of the taxes paid by the partners, not the jurisdictional partnership.[33] NHW Shippers state that the Commission acted inconsistently by denying an adjustment to the income tax allowance for the 743(b) write-ups because "tax deferrals apply to individual partners, not the jurisdictional partnership."[34] NHW Shippers state that if specific costs (tax liability) are included in the income tax allowance, then reductions in those costs (tax deferrals) must also be considered.

18. Similarly, NHW Shippers state that the Commission erred by disregarding the tax deferrals because "these deferrals are already accounted for in the MLP unit price and do not necessarily affect the ITA or rates paid by jurisdictional ratepayers."[35] NHW Shippers state that if MLP investors' expected tax liability is already factored into the

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[31] NHW Shippers Rehearing at 25 (citing Ex. NAV-41 at 7; Ex. NAV-44).

[32] *Id*. (citing Ex. NAV-1 at 71-72; Ex. NAV-29 at 1).

[33] *Id*. 27 (citing Opinion No. 511, 134 FERC ¶ 61,121 at P 250).

[34] *Id*. (citing Opinion No. 522, 140 FERC ¶ 61,220 at PP 340-341).

[35] NHW Shippers Rehearing at 30 (citing Opinion No. 522, 140 FERC ¶ 61,220 at P 341).

stock price, then those expectations are also present in the discount cash flow (DCF) analysis used to calculate a pipeline's return on equity (ROE) – meaning that a tax allowance is unnecessary. The NHW Shippers state that it is inconsistent for the Commission to hold that the tax costs themselves are not reflected in the ROE, but that the tax savings are reflected in the ROE.

### c. Discussion

19. The Commission denies rehearing and affirms that SFPP's income tax allowance should not be reduced to account for the section 743(b) tax deferrals.[36]

20. Contrary to NHW Shippers' arguments, there is no inconsistency between Opinion No. 522's holdings (a) providing an income tax allowance based upon the unitholders' imputed tax liability while (b) rejecting NHW Shippers' proposal to reduce the income tax allowance for tax deferrals resulting from the 743(b) write-up to the unitholder's share. The unit-holding partners incur an income tax cost as a direct result of the pipeline's cost-of-service return on equity. It is appropriate to include this income tax cost in the cost-of-service.[37] In contrast, as Opinion No. 522 explained,[38] the section 743(b) write-up is unrelated to the original cost of the pipeline's assets and the costs associated with providing pipeline service. Rather, the section 743(b) write-ups and ensuing deferrals result from the purchase price paid by each KMEP unitholder for the unitholder's ownership share. Thus, whereas the income tax cost recovered by the tax allowance results from jurisdictional pipeline service, the 743(b) write-up (and the ensuing depreciation and tax deferrals) is a separate expense incurred by the unit-holding partner that is not applicable to the jurisdictional service provided by the pipeline.

21. An examination of SFPP's cost-of-service reinforces this point. As Opinion No. 522 explained, "when an expense is not included in the cost of service (because the company did not incur that expense in providing service), the deduction created by that

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[36] Addressing a similar issue, Opinion Nos. 511 and 511-A rejected adjustments to SFPP's ROE for the tax deferrals caused by 743(b) depreciation. Opinion No. 511, 134 FERC ¶ 61,121 at PP 302-313. Following Opinion Nos. 511 and 511-A, Opinion No. 522 applied similar reasoning to hold that no reduction should be applied to the pipeline's income tax allowance to account for 743(b) depreciation.

[37] *E.g.*, *ExxonMobil*, 487 F.3d at 952.

[38] Opinion No. 522, 140 FERC ¶ 61,220 at P 340 (stating that section 743(b) "deferrals apply to the partner (through its purchase of the partnership unit), rather than the jurisdictional partnership.")

expense is not allocated to the ratepayers."[39] Because the Commission's cost-of-service policies only permit recovery of the trended original cost of the pipeline's assets, the section 743(b) write-ups are neither reflected in SFPP's cost-of-service rate base nor included in the cost-of-service depreciation expenses.[40] Thus, as the unit-holding partner incurs the 743(b) write-up costs without any opportunity for cost-of-service recovery of those costs, the tax deferrals created by the section 743(b) write-ups must similarly be excluded from SFPP's East Line's cost-of-service. In sum, a pipeline's income tax allowance should not be reduced by a tax deferral resulting from a depreciation expense that is not included in the pipeline's cost-of-service. This alone is sufficient basis to reject NHW Shippers' proposal to adjust the income tax allowance for the 743(b) write-up and the ensuing tax deferrals.

22. In addition to the discussion in Opinion No. 522, Opinion 511-A also explained that reducing pipeline recoveries for the 743(b) deferrals would undermine the Congressional intent behind MLPs. Opinion No. 511-A stated that Congress created MLP's to encourage investment.[41] Downwardly adjusting the pipeline's recoveries for 743(b) deferrals would reduce the benefits of the congressionally established tax deferral and lower investor incentives to invest in MLP pipelines.[42] As the Commission explained, "[t]here is no credible evidence here that Congress intended to deprive jurisdictional MLPs or their limited partners of any benefits derived from income tax deferrals resulting of an MLP."[43]

23. The Commission also rejects NHW Shippers' claim that because an MLP unit price incorporates the effects of tax deferrals, it necessarily follows that "the ROE fluctuates with an investor's perception of the tax burden."[44] On the contrary, if an MLP's cash flows available for distribution change (i.e., via tax deferrals), the MLP unit

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[39] *Id*. P 340 (quoting *Columbia Gulf Transmission Co.*, Opinion No. 173, 23 FERC ¶ 61,396, at 61,851 (1983), *aff'd sub nom*. *City of Charlottesville v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985)).

[40] Opinion No. 511, 134 FERC ¶ 61,121 at P 311.

[41] Opinion No. 511-A, 137 FERC ¶ 61,220 at P 370.

[42] *Id*. PP 370-371.

[43] *Id*. P 371. *See also* Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 272, 314; Opinion No. 511, 134 FERC ¶ 61,121 at PP 253-258.

[44] NHW Shippers Rehearing at 31.

prices will also increase so that the ratio of the MLP unit price to the MLP cash distributions once again provides the market required rate of return.[45] Given that the Commission has previously explained that the application of the DCF model does not lead to a double-recovery of an MLP pipeline's income tax costs, we need not revisit the issue here.[46]

## B. Accumulated Deferred Income Taxes

### 1. Background

24. ADIT records the cumulative deferred taxes resulting from the difference between (a) the use of accelerated depreciation for determining annual federal and state income tax liability and (b) the application of straight-line depreciation in a Commission-regulatory context. The 2011 ID found that SFPP's ADIT calculation was inconsistent with Commission policy because it did not reflect state income taxes, and therefore directed SFPP to adjust its ADIT calculation to reflect the deferral of federal and state income tax costs associated with accelerated depreciation.[47] On exceptions, SFPP did not object to the 2011 ID's holding that it must adjust its ADIT calculations to reflect state income taxes; however, SFPP objected to certain aspects of the 2011 ID's holdings regarding the implementation of this requirement.

25. In Opinion No. 522, the Commission required SFPP to make a compliance filing "setting forth the ADIT calculation so as to reflect state taxes, and in a way that is consistent with the Commission's determinations in Opinion No. 511 and Opinion No. 511-A."[48]

### 2. SFPP's Rehearing Request

26. SFPP seeks rehearing only to the extent that Opinion No. 522 could be read to require SFPP, as was done in Opinion No. 511-A, to calculate ADIT using the 1996 calendar year weighted average marginal income tax rate for the deferred taxes for

[45] In their rehearing request, NHW Shippers provide no analysis supporting a contrary result.

[46] *See, e.g.*, Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 269 (citing Opinion No. 511, 134 FERC ¶ 61,121 at PP 241-250) 280, 283-284, 289-296, 369.

[47] 2011 ID, 134 FERC ¶ 63,013 at P 180.

[48] Opinion No. 522, 140 FERC ¶ 61,220 at PP 349-350.

each year from 1997 to the test period. SFPP emphasizes that Opinion No. 511-A's findings regarding ADIT are pending rehearing. SFPP states that the approach in 511-A was flawed because it improperly analogized ADIT to "rate design" factors, and states that ADIT is calculated based upon cost factors, including income tax rates, which may change over time. SFPP also states that Opinion No. 511-A incorrectly treats ADIT as measuring the difference between (a) income taxes actually paid and (b) the dollar amount of the income tax allowance in the pipeline's most recent fully litigated cost of service rate case.

### 3. Discussion

27. The Commission grants rehearing so that its holding in this proceeding is consistent with the Commission's decision in contemporaneously issued Opinion No. 511-B. Opinion No. 511-B has reversed Opinion No. 511-A in this regard, and the Commission has determined that, for calculating ADIT, each year's deferred taxes must be calculated based upon the pipeline's weighted average marginal income tax rate for the applicable year. SFPP should therefore calculate ADIT consistent with Opinion No. 511-B's resolution of this issue.

## C. Litigation Costs

### 1. Background

28. The 2011 ID ordered SFPP to allocate 4.87 percent of its legal expenses associated with the Union Pacific Railroad right-of-way litigation to the East Line.[49] The 2011 ID explained that 4.87 percent represents the East Line's share of the rental value of the right-of-way at issue in the litigation.[50] On exceptions, SFPP contended that a mileage-based allocation is a more accurate measure of the proportion of the right-of-way litigation costs attributable to the East Line.[51] Opinion No. 522 affirmed the 2011 ID's holding that right-of-way litigation costs should be allocated based upon the East Line's share of the total right-of-way rental value.[52] The Commission explained that the relatively low value of the East Line right-of-way affected the East Line's relative

[49] 2011 ID, 134 FERC ¶ 63,013 at P 291.

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

[51] SFPP Brief on Exceptions at 96.

[52] Opinion No. 522, 140 FERC ¶ 61,220 at P 175.

monetary significance in the litigation, and thus, provided a more appropriate estimate for apportioning the litigation costs than SFPP's proposed mileage approach.[53]

### 2. SFPP's Rehearing Request

29. On rehearing, SFPP advances new procedural challenges to Opinion No. 522's holding that right-of-way litigation costs should be allocated on the basis of rental value.[54] SFPP asserts that no party presented evidence or testimony objecting to SFPP's use of mileage to allocate the right-of-way litigation costs until NHW Shippers presented the issue in post-hearing briefs. SFPP states that because the issue was only presented in the post-hearing briefs, SFPP was precluded from submitting testimony supporting its position and challenging the new rental cost based methodology. Thus, SFPP contends that the 2011 ID's and Opinion No. 522's reliance upon arguments made for the first time in NHW Shippers' post-hearing brief was prejudicial, and thus, the Commission should grant rehearing and adopt SFPP's proposed mileage methodology.[55]

### 3. Discussion

30. The Commission denies rehearing and upholds the allocation of the right-of-way litigation costs based upon the East Line's proportion of the right-of-way rental value. SFPP's arguments are rejected as untimely. The 2011 ID adopted the rental value allocation methodology, and in its brief on exceptions, SFPP did not raise any of the procedural issues it now raises on rehearing. The Commission looks with disfavor on parties raising new arguments on rehearing that should have been raised previously.[56] Furthermore, Rule 711(d)(2) of the Commission's regulations states that "if a participant does not object to a part of an initial decision in a brief on exceptions, any objections by \

[53] *Id.* PP 69, 175.

[54] SFPP Rehearing at 16-17.

[55] SFPP Rehearing at 16-17 (citing *Arizona Public Service Co.*, Opinion No. 193, 25 FERC ¶ 61,092 (1983)).

[56] *See Tennessee Gas Pipeline Co., L.L.C.*, 142 FERC ¶ 61,025, at P 38 (2013) (citations omitted); *Tenaska Power Servs. Co.*, 102 FERC ¶ 61,140, at P 14 (2003) (noting that "[s]uch behavior is disruptive to the administrative process because it has the effect of moving the target for parties seeking a final administrative decision.").

the participant to that part of the initial decision are waived."[57] SFPP's procedural arguments were waived when it failed to raise them in the brief on exceptions and SFPP's procedural arguments cannot now be raised on rehearing.[58] Accordingly, SFPP's rehearing request regarding the treatment of the right-of-way litigation costs is denied.

### D. Cost of Debt and Capital Structure

#### 1. Short Term Debt

##### a. Background

31. All parties agree that the debt costs of KMEP, SFPP's parent company, should be used to determine SFPP's cost of debt and capital structure. Opinion No. 522 required SFPP to include in its capital structure three forms of debt: (a) $950 million of senior notes due to expire within one year of March 31, 2010; (b) $65 million in commercial paper; (c) $675 million of borrowings under KMEP's revolving credit facility.

##### b. SFPP's Rehearing Request

32. On rehearing, SFPP claims that Opinion No. 522 erred by including short-term debt in both the capital structure and the cost of debt. SFPP emphasizes that, as Opinion No. 522 acknowledged, "[t]he Commission generally does not use short-term debt to determine capital structure because short term debt typically does not support the pipeline's rate base."[59] SFPP states that the Commission has not justified making an exception in this case.

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[57] 18 C.F.R. § 385.711(d)(2) (2014). As the Commission has explained, Rule 712(d) prevents "parties from holding back positions and arguments until the rehearing stage." *Revision of Rules of Practice and Procedure to Expedite Trial-Type Hearings*, FERC Stats. & Regs. ¶ 30,358 at, 30,180 (1982). The Commission further emphasized, "it is unfair to other participants and wasteful of the Commission's time and resources for anyone to keep the Commission uninformed of facts and arguments which should otherwise have been presented to the Commission at the hearing and exceptions stages." *Id.* In this particular case, SFPP's decision to wait until rehearing to raise its procedural objections meant that other parties could not respond to these procedural arguments in their briefs opposing exceptions. Permitting SFPP to raise its new arguments at the rehearing stage would contravene the purpose of Rule 711.

[58] 18 C.F.R. § 385.711(d)(3) (2014).

[59] SFPP Rehearing at 8 (citing Opinion No. 522, 140 FERC ¶ 61,220 at P 222).

33. SFPP asserts that Opinion No. 522 erred in finding that this short-term debt represents an ongoing financing source for the pipeline's parent company. In support, SFPP cites Statement of Financial Accounting Standards No. 6 (SFAS No. 6). SFPP states that under SFAS No. 6, the short-term obligations must be classified as long-term debt if the company both intends and has the ability to refinance on a long-term basis as of the measurement date.[60] SFPP states that because it does not have such intentions and ability, the debt was classified as a current liability and should not be included in the cost of capital calculations. SFPP claims that this debt is to be paid off with liquid assets rather than long-term financing.

34. SFPP also challenges the Commission's reliance upon the fungible character of capital and the infeasibility of tracing particular forms of capital to particular expenditures. SFPP states that such a statement would apply to all forms of debt, both long-term and short-term, of any regulated entity seeking to establish the appropriate capital structure and cost of debt to support its rates. Moreover, SFPP argues that whether or not debt is fungible is irrelevant, stating that the relevant factor is how long the debt will be used to fund long-term assets.

35. Addressing the $675 million of borrowings under its revolving credit facility, SFPP states that its revolving credit facility does not represent an ongoing financing source. SFPP states that over the past 11 years, KMEP has rarely had debt outstanding under its revolving credit facility at year end.[61] Yet, SFPP states that the Commission justified including the $675 million credit facility in the capital structure and cost of debt because "there were significant sums outstanding as of March 31, 2010, the date used to derive the capital structure in this proceeding."[62] SFPP argues that if all short-term debt outstanding at the end of the measurement period is included in the capital structure, then the Commission's distinction between long-term debt and short-term debt is meaningless.

36. Furthermore, SFPP argues that if the Commission does not reverse its rulings on short-term debt, the Commission should adopt a hypothetical capital

[60] *Id*. at 10 (citing Ex. SPE-216 at 2).

[61] *Id*. at 12 n.19 (citing Ex. SPE-5 at 48; Ex. SPE-6 at 60; Ex. SPE-7 at 72; Ex. SPE-8 at 81; Ex. SPE-9 at 122; Ex. SPE-10 94; Ex. SPE-11 at 113). SFPP also claims at that at year-end 2010, there was no outstanding credit facility borrowings as reported in KMEP's Form 10-K for the period ending December 31, 2010; however, this filing was not in the record. Moreover, SFPP did not provide a specific cite to support its assertion.

[62] *Id*. at 13 (Opinion No. 522, 140 FERC ¶ 61,220 at P 223).

structure. SFPP states that including the short-term debt reduces KMEP's capital structure to 38.44 percent equity and 61.56 percent debt. SFPP states that the Commission policy allows the use of a hypothetical structure if the use of the pipeline's actual capital structure would be anomalous.[63] SFPP states the Commission has held that a "45 percent to 55 percent" equity-to-debt ratio is considered normal for oil pipelines.[64] SFPP states that this is lower than the average capital structure of the proxy group, which SFPP claims was 46.69 percent as of March 31, 2010.[65]

### c. <u>Discussion</u>

37. The Commission denies rehearing. The Commission is not persuaded by SFPP's arguments based upon its compliance with The General Accepted Accounting Principles (GAAP) standards. The Commission acknowledges SFPP's assertions that the GAAP definition of long-term debt does not include (a) $950 million expiring long term debt, (b) $65 million commercial paper, and (c) $675 million of borrowings under the revolving credit facility. However, accounting rules do not govern ratemaking,[66] and other evidence in this proceeding supports the inclusion of this debt in the capital structure and the cost of debt calculations.

38. Regarding SFPP's expiring long-term debt, Opinion No. 522 explained that "[a]s the record in this proceeding demonstrates, every year when KMEP reported expiring long-term debt at the end of the years 2000 through 2009, KMEP reported an increase of long-term debt in the following year."[67] Thus, Opinion No. 522 concluded that, under KMEP's financing practices, "expiration of long-term debt does not necessarily represent

[63] *Id*. (citing *BP Pipelines (Alaska) Inc.*, Opinion No. 502, 125 FERC ¶ 61,367, at PP 147, 178-79 (2008)).

[64] *Id*. at 14 (citing Opinion No. 522, 140 FERC ¶ 61,220 at P 203).

[65] *Id*.

[66] Opinion No. 511, 134 FERC ¶ 61,121 at P 96 (finding accounting practices are not controlling for ratemaking purposes); *Consolidated Gas Supply Corp.*, 14 FERC ¶ 61,029, *reh'g denied*, 14 FERC ¶ 61,246 (1981). Notwithstanding SFPP's claims that under the accounting rules KMEP did not "both intend[] and [have] the ability to refinance on a long-term basis" this debt, Commission may consider other factors. SFPP Rehearing at 9-10 (citing Ex. SPE-216 at 2).

[67] Opinion No. 522, 140 FERC ¶ 61,220 at P 221 (citations omitted).

an actual change in the ratio of debt to equity in KMEP's capital structure."[68] In its rehearing request, SFPP does not contest these findings from Opinion No. 522 and simply relies upon the GAAP definitions. However, SFPP makes no attempt to reconcile the GAAP rules and definition with the uncontested fact that its long-term debt increased even in years that its debt was expiring. Accordingly the Commission affirms Opinion No. 522's holding that for a company with KMEP's financing practices, the most reasonable estimate of KMEP's long-term debt levels and debt costs includes the expiring long term debt.

39. Opinion No. 522 also correctly included commercial paper in capital structure and the cost of debt. Opinion No. 522 held that KMEP historically sustained significant levels of outstanding commercial paper. Although a credit downgrade rendered KMEP unable to access commercial paper for a period between 2008 and early 2010, KMEP's commercial paper borrowings resumed once KMEP's short-term credit rating was raised on February 25, 2010.[69] Opinion No. 522 explained that KMEP's commercial paper historically provides ongoing support for KMEP's business activities.[70] On rehearing, SFPP does not dispute this finding. The Commission affirms Opinion No. 522's inclusion of the $68 million of outstanding commercial paper in SFPP's cost of debt.

40. The Commission also affirms Opinion No. 522's inclusion in capital structure and cost of debt $675 million of borrowings under KMEP's revolving credit facility. KMEP's credit facility borrowings must be placed in the context of its overall financing program. KMEP characterizes its credit facility as "a back-up for [its] commercial paper program."[71] During the period that KMEP was unable to issue commercial paper (from 2008 through early 2010) and for the immediate period thereafter, KMEP represented that the financing needs ordinarily addressed by commercial paper could be met through its credit facility program.[72] Thus, the outstanding $675 million credit facility borrowings on March 31, 2010, must be considered as the functional continuation of the high levels of commercial paper sustained by KMEP prior to its credit downgrade

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[68] *Id*.

[69] *Id*. P 223 & n.340 (citing Ex. NAV-48 at 12).

[70] *Id*. P 222 & n.340 (showing large quantities of outstanding commercial paper for the period 2001-2008).

[71] Ex. SPE-13 at 116.

[72] *Id.*; Ex. NAV-48 at 12.

in 2008.[73] Opinion No. 522 properly included outstanding borrowings under the credit facility to SFPP's cost of debt.

41. Although the Commission does not typically include short-term debt in capital structure and cost of debt, the facts of this case support a departure from this historic practice. As Opinion No. 522 explained, debt is interchangeable and fungible. The sustained level of short-term debt that KMEP maintained on its books demonstrated that this short-term debt was an ongoing, material part of KMEP's overall financing, and thus a factor in KMEP's overall debt financing and capital structure. SFPP cites no precedent in which the Commission, faced with a similar fact pattern showing similar levels of sustained short-term debt, excluded short-term debt from the cost of debt or capital structure.

42. The Commission also rejects the hypothetical capital structure proposed by SFPP as untimely. SFPP waived its argument for a hypothetical capital structure when it only proposed this matter on rehearing.[74] SFPP's decision to wait until rehearing to propose the hypothetical capital structure precluded the development of a record which could fully evaluate the proposal and deprived other parties the opportunity to litigate this issue.

[73] SFPP adds that borrowings under the credit facility were zero by December 31, 2010. SFPP Rehearing at 12 n.19. SFPP cites to no exhibit in the record to support this proposition, and thus we do not consider SFPP's claim. Moreover – to the extent SFPP was urging the Commission to consider such extra-record evidence – we note that by December 31, 2010, KMEP's commercial paper program had fully resumed and contained an outstanding balance of $522 million. Kinder Morgan Energy Partners L.P. Annual Report, 2010 Form No. 10-K at 89 (*available at* http://www.kindermorgan.com/content/docs/2010_KMI_10K.pdf). Thus, the alleged decline in KMEP's credit facility borrowings by December 31, 2010, coincides with the resumption of KMEP's commercial paper program. The Commissions will not permit SFPP to cherry-pick extra-record evidence.

[74] 18 C.F.R. § 385.711(d)(2) & d(3) (2014); *Tennessee Gas Pipeline Co., L.L.C.*, 142 FERC ¶ 61,025, at P 38 (2013) (citations omitted) (holding that the Commission looks with disfavor on parties raising new arguments on rehearing that should have been raised previously).

### 2. <u>Interest Rate Swaps</u>

#### a. <u>Background</u>

43. In Opinion No. 522, the Commission held that costs associated with certain interest rate swaps executed by SFPP's parent KMEP must be excluded from the cost of debt applied to SFPP's cost-of-service.[75] NHW Shippers seek rehearing of this decision.

44. KMEP's long-term debt primarily consists of fixed interest rate bonds.[76] As a result, if interest rates decline, KMEP may be required to pay above-market rates. To hedge against interest rate declines, KMEP uses interest rate swap agreements. In an interest rate swap, KMEP agrees to pay a variable interest rate[77] on a stipulated principle to another party in exchange for receiving a fixed interest rate on the same stipulated principle.[78] KMEP states that based upon the interest rate swaps it has achieved a mixture of roughly 50 percent fixed-rate debt and 50 percent variable-rate debt.[79] Although KMEP remains responsible for paying its original creditor for the fixed rate debt, the cash flows associated with fixed rate borrowings for the sum of the notional principle are effectively converted into variable rate cash flows. By effectively shifting some of its debt costs to variable cash flows using the interest swaps, KMEP attempts to protect itself from falling interest rates which would cause KMEP to pay above-market rates.[80] The 2011 ID held that SFPP must account for the interest rate swaps when calculating the cost of debt. The 2011 ID held that including the debt swaps reduces SFPP's cost of debt to 4.32 percent from a cost of debt exceeding 6.00 percent. On

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[75] All parties agree that the debt costs of KMEP, SFPP's parent company, should be used to determine cost of debt.

[76] Ex. NAV-7 at 90, 107.

[77] The variable interest rate is based upon the London Interbank Offered Rate (LIBOR) plus a spread. Ex. NAV-7 at 309.

[78] Ex. SPE-107 at 52.

[79] *E.g.*, Ex. NAV-7 at 109, 200; Ex. NAV-48 at 19.

[80] Ex. NAV-7 at 90 ("We use interest rate swap agreements to transform a portion of the underlying cash flows related to our long-term fixed rate debt securities (senior notes) into variable rate debt in order to achieve our desired mix of fixed and variable rate debt, and *in periods of falling interest rates, these swaps result in period-to-period decreases in our interest expense*.") (emphasis added).

exceptions, Trial Staff and SFPP urged the Commission to reverse the 2011 ID and remove the effects of the interest swaps from the cost of debt. Opposing exceptions, NHW Shippers urged the Commission to affirm the 2011 ID on this issue.

45. Opinion No. 522 determined that the 2011 ID erred by requiring SFPP to incorporate KMEP's interest rate swaps into the cost of debt to be used in SFPP's cost of service.[81] Opinion No. 522 found that KMEP's interest rate swap activity is separate from the type of financing necessary for the operation of SFPP's East Line. Opinion No. 522 stated that the fixed interest rate financing for KMEP's assets has provided the necessary principal. Opinion No. 522 explained that KMEP's interest rate swaps served the different purpose of hedging against changing interest rates similar to KMEP's other hedging and derivative activity related to fluctuations in the market price of natural gas, natural gas liquids, and crude oil. Thus, Opinion No. 522 held that it was the parent, KMEP, whose viability was affected by gains or losses[82] from the swaps, not SFPP's East Line service. Accordingly, Opinion No. 522 held that interest rate swaps by the parent KMEP should not be included in SFPP's East Line's cost of service, and the parent KMEP, not SFPP's East Line ratepayers, should be the party that assumes the risks and receives the benefits associated with this hedging activity.

46. Opinion No. 522 also distinguished Opinion No. 486, *et al.*, which the 2011 ID and NHW Shippers cited to support the inclusion of the interest swaps in the cost of debt. Opinion No. 522 explained that in the Opinion No. 486 proceeding, no party disputed that there should be a cost of debt adjustment for the pipeline's claimed debt financing costs, among which the pipeline included interest swap cancellation costs.[83] Accordingly, because the issue was uncontested before the Commission, Opinion No. 486, *et al.*, did not establish precedent as to whether interest swaps should be factored into the cost of debt.

### b. <u>NHW Shippers' Rehearing Requests</u>

47. On rehearing, NHW Shippers argue that the Commission erred by excluding interest swaps from the calculation of KMEP's cost of debt. NHW Shippers state that KMEP's rate swaps are an integral part of KMEP's debt financing. NHW Shippers assert

[81] Opinion No. 522, 140 FERC ¶ 61,220 at PP 244-250.

[82] As a consequence of these swaps, in its 2009 10-K, KMEP warned that the variable interest rates make it vulnerable to interest rate increases. Ex. NAV-7 at 48.

[83] Opinion No. 522, 140 FERC ¶ 61,220 at P 249.

that although KMEP initially obtains most of its long-term financing on a fixed rate basis, KMEP uses the interest swaps to achieve a mix of 50 percent fixed interest debt and 50 percent variable interest debt.[84] NHW Shippers claim that KMEP's fixed-rate obligations and variable-rate obligations both factor into KMEP's borrowing costs. NHW Shippers emphasize statements from KMEP's SEC Form 10-K's that "it is [KMEP's] policy to borrow funds using a mix of fixed rate debt and variable rate debt."[85] NHW Shippers assert that differences between the instruments used to obtain fixed debt (i.e., bonds) and variable debt (i.e., swaps) are irrelevant for the purposes of determining KMEP's cost of debt.

48. NHW Shippers contend that Opinion No. 522 conveyed a mistaken concern with protecting rate payers from the risks of interest rate swaps. NHW Shippers state the variable rate swaps have lowered KMEP's borrowing costs compared to the borrowing costs using the fixed-rate debt instruments alone. NHW Shippers state that the swaps also lower KMEP's risk.[86] NHW Shippers explain that if a company only issues fixed-rate debt, it runs the risk that interest rates may fall and that the company will be forced to pay above-market rates for all of its debts.[87] NHW Shippers assert that KMEP's variable interest swaps serve as a hedge that reduces the pipeline's risk.[88]

49. NHW Shippers also claim that Opinion No. 522 treats interest swaps as though they are "an exotic, speculative derivative" from which shippers must be protected. However, NHW Shippers state that several entities included within the return on equity proxy group in this case use interest rate swaps to manage their returns.[89] Quoting KMEP's 10-K, NWH Shippers state that KMEP "use[s] interest rate swap agreements to manage the interest rate risk associated with the fair value of our fixed rate

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[84] NHW Shippers Rehearing at 7-8 (citing Ex. NAV-1 at 93, Ex. NAV-7 at 90, 109; Ex. NAV-39; Ex. NAV-48 at 19).

[85] *Id*. at 7 (citing Ex. NAV-7 at 200).

[86] *Id*. at 11 (citing Opinion No. 522, 140 FERC ¶ 61,220 at P 226; Tr. 194).

[87] *Id*. (citing Tr. 194-195; 221).

[88] *Id*. (citing Opinion No. 522, 140 FERC ¶ 61,220 at P 226; Tr. 194-195; 221).

[89] NHW Shippers Rehearing at 10. Based upon publically available SEC filings, the NHW Shippers ask the Commission to take notice that Buckeye Partners, L.P.; Enbridge Energy Partners, L.P.; Holly Energy Partners; Magellan Midstream Partners, L.P.; NuStar Energy L.P.; and Plains All American Pipeline, L.P.

borrowings…."[90] NHW Shippers state that under Opinion No. 522, ratepayers bear the entire risk of KMEP's holding fixed-rate debt and KMEP alone will benefit from hedging that risk.

50. NHW Shippers further object to the differentiation made in Opinion No. 522 between KMEP's risk management activities. NHW Shippers state KMEP's cost of debt is being used in this proceeding, so it states there is no reason to ignore activities that affect KMEP's debt cost. NHW Shippers state that by definition, KMEP's debt costs are imputed to SFPP.

51. NHW Shippers state that in the Opinion No. 486 proceedings,[91] the Commission accepted a cost of debt for the pipeline that incorporated interest swap costs. NHW Shippers explain that in the Opinion No. 486 proceedings, the pipeline's fixed coupon date rate was 6.676, but the pipeline was allowed a cost of debt of 8.455 percent which reflected amortized debt financing costs and interest swaps. NHW Shippers state that "[n]either the parties nor the Commission questioned that the costs attributed to rate swaps should be recovered once by factoring them into the cost of debt."[92] Rather, NHW Shippers state that the dispute related to the pipeline's attempt to recover an additional return on (as opposed to merely a return of) the swap interest and debt financing costs for a total return of 9.675 percent. NHW Shippers explain that the Commission rejected the pipeline's attempt to recover the contested 9.675 percent cost of debt, but the Commission allowed the pipeline to recover the uncontested sum of 8.455 percent. Consequently, NHW Shippers state that this issue involving the swaps was extensively litigated, and claim that the Opinion No. 486 proceedings established precedent to support allowing a pipeline to recover a return of its swap-related costs.

[90] NWH Shippers Rehearing at 11 (citing Ex. NAV-7 at 200).

[91] *Kern River Gas Transmission Co.*, Opinion No. 486, 117 FERC ¶ 61,077 (2006), *order on reh'g*, Opinion No. 486-A, 123 FERC ¶ 61,056 (2008), *order on reh'g*, Opinion No. 486-B, 126 FERC ¶ 61,034 (2009), *order on reh'g*, Opinion No. 486-C, 129 FERC ¶ 61,240 (2009), Opinion No. 486-D, 133 FERC ¶ 61,162 (2010), *order on initial decision*, Opinion No. 486-E, 136 FERC ¶ 61,045 (2011), *order on reh'g*, Opinion No. 486-F, 142 FERC ¶ 61,132 (2013), Opinion No. 486-G, 145 FERC ¶ 61,042 (2013) (collectively, Opinion No. 486 proceedings).

[92] NHW Shippers Rehearing at 14.

### c. **Discussion**

52. The Commission denies rehearing. As the Commission determined in Opinion No. 522, the principal from traditional debt instruments such as senior notes and commercial paper provide the financial support for KMEP's asset base, including SFPP's East Line. In contrast, the interest swaps serve merely as a hedge and provide no principal to be used as support for KMEP's asset base.[93] Because these swaps provide no underlying principal, the swaps should not be considered as financing for SFPP's East Line.

53. The accounting rules that guide KMEP's statements in the SEC Forms 10-K and 10-Q are not necessarily determinative for ratemaking purposes, including deciding the cost of SFPP's debt.[94] As Opinion No. 522 explained, the swaps are akin to KMEP's other derivative and hedging activity associated with the market price of natural gas, natural gas liquids, and crude oil.[95] Although KMEP's SEC filings indicate that the swaps are linked to specific debt issuances, the swaps do not provide the principal that supports KMEP's asset base. Rather than supporting KMEP's pipeline asset base, the swaps, along with KMEP's other hedging and derivative activity, represent a different aspect KMEP's business activities. The potential benefits and losses related to the swaps should fall on KMEP's investors, not on SFPP's East Line rate payers. NHW Shippers' argument that other business enterprises use interest swaps is also not germane. Because the interest swaps do not provide the principal underlying KMEP's asset base, the swaps should not be incorporated into the ratemaking cost of debt for SFPP's East Line.

54. NHW Shippers draw overly expansive conclusions from the Opinion No. 486 proceedings. In the Opinion No. 486 proceedings, as NHW Shippers acknowledge, no

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[93] The interest rate swaps only involve a "notational" principal that provides the basis for determining the payments under the swap based upon interest rate fluctuations. Ex. NAV-7 at 109.

[94] *See* Opinion No. 511-A, 137 FERC ¶ 61,220 at P 94 ("The SEC and the Commission serve different regulatory purposes and as such, have different accounting and financial reporting requirements for jurisdictional entities."); *Consolidated Gas Supply Corp.*, 14 FERC ¶ 61,029, *order on reh'g*, 14 FERC ¶ 61,246 (1981). Notwithstanding SFPP's claims that under the accounting rules KMEP did not "both intend[] and [have] the ability to refinance on a long-term basis" this debt, Commission may consider other factors. SFPP Rehearing at 9-10 (citing Ex. SPE-216 at 2).

[95] Ex. NAV-7 at 192, 198.

party objected to the incorporation of the interest swaps into the cost of debt.[96] When no party contests the cost that a pipeline seeks to recover in a rate case, the Commission's decision not to reject the pipeline's proposal *sua sponte* does not establish a Commission policy favoring recovery of that particular cost.[97] The heavily litigated Opinion No. 486 proceedings involved multiple Commission orders, some of which consisted of hundreds of pages. The Commission's prudential decision not to create additional controversy where the parties were in agreement about including certain interest swaps in the cost of debt does not establish a broad precedent that all pipelines may in their cost of service recover interest swap costs.

55. Nor does the exception to Commission's typical practice apply to this proceeding. Following Opinion No. 522 and the request for rehearing by NHW Shippers, the Commission's *Portland* decision permitted an adjustment for the cost-of-debt when the pipeline entered into a hedging arrangement for the purposes of facilitating the refinancing of temporary construction financing.[98] As explained in the *Portland* decision, "[i]n order to lock in benefits at a time when interest rates were at an all-time

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[96] NHW Shippers Rehearing at 14. In the Opinion No. 486 proceedings, the parties include the interest swaps in the debt refinancing costs which were to be amortized and recovered in the cost of debt. No party raised any objection to the inclusion of these swaps among the debt financing costs and the pipeline's proposal to earn a return of those costs. Rather, as Opinion No. 522 emphasized and as the NHW Shippers also acknowledge, the only dispute addressed by the Opinion No. 486 proceedings related to the pipeline's attempt to recover an additional return on (as opposed to merely a return of) the debt financing costs (which included the swaps). Opinion No. 522, 140 FERC ¶ 61,220 at P 249 (citing Opinion No. 486, 117 FERC ¶ 61,077 at P 201). *See also* Opinion No. 486-A, 123 FERC ¶ 61,056 at PP 251-256.

[97] *Nevada Power Co.*, 113 FERC ¶ 61,007, at 61,013-14 (2005) (refusing to treat a rate calculation from a prior tariff as precedent because "the issue was not raised, and the Commission did not discuss it or rule on it"); *Transwestern Pipeline Co.*, 36 FERC ¶ 61,175, at 61,438 (1986) (the Commission is not bound by everything in an application that it did not specifically reject); *Northwest Pipeline Co.*, Opinion No. 213-A, 27 FERC ¶ 61,339, at 61,657 (1984) (same). *See also Webster v. Fall,* 266 U.S. 507, 511 (1925) (stating, "Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been so decided as to constitute precedents.").

[98] *Portland Natural Gas Transmission Sys.*, Opinion No. 524, 142 FERC ¶ 61,197, at P 284 (2013).

low, Portland entered into the hedging arrangement, until it was required to refinance the expiring construction loan." The *Portland* decision proceeded to hold:

> Under these circumstances, the debt swap costs are properly counted as part of the cost of Portland's current debt financing, as the costs were incurred in service of the temporary construction financing, and thus were specifically incurred to maintain the financing necessary to construct the pipeline. The construction loan was required to be reacquired and replaced with the longer term permanent financing. That is, the 2003 debt issue was facilitated by reacquiring the construction loan and incurring the debt swap settlement costs. [99]

Unlike the swaps at issue in *Portland,* KMEP's interest swaps do not serve the purpose of refinancing debt (i.e., facilitating the transition between expiring temporary debt and longer-term permanent financing). Rather, KMEP's interest swaps are solely intended to hedge interest rate changes related to *currently outstanding* KMEP debt. KMEP's interest swaps neither provide the principal supporting KMEP's pipeline investments nor support the refinancing of the debt associated with that principal.[100] Thus, as the Commission determined in Opinion No. 522, the KMEP swaps should not be included in the cost of debt.

## III. Compliance

56. On November 13, 2012, SFPP filed its compliance filing to Opinion No. 522. On December 12, 2012, NHW Shippers and CCSV Shippers filed protests. On January 4, 2013, SFPP filed an answer. The Commission rejects subsequent answers filed by NHW Shippers on January 22, 2013, and SFPP on March 18, 2013, as inconsistent with the procedural schedule established in Opinion No. 522.[101]

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[99] *Id*. P 284.

[100] To the extent the Opinion No. 486 proceedings are given any precedential weight, the Commission notes that the pipeline in the Opinion No. 486 proceedings, as in *Portland*, also only sought to recover debt swap costs associated with debt refinancing. Opinion No. 486-A, 123 FERC ¶ 61,056 at P 255 (including swap redemption costs among its debt refinancing cost).

[101] Opinion No. 522, 140 FERC ¶ 61,220 at Ordering Paragraphs (B) & (C).

57. As discussed below, the comments raise issues involving SFPP's compliance with Opinion No. 522 related to (a) the income tax allowance, (b) application of the Commission's indexing rules, and (c) the litigation surcharge.

## A. Income Tax Allowance Issues

### 1. SFPP Compliance Filing

58. In his affidavit attached to the compliance filing, SFPP witness George R. Ganz explained the changes that SFPP made in response to Opinion No. 522. Mr. Ganz states that he updated the exhibits he used to calculate the weighted federal income tax rate for 2008[102] and the combined weighted federal and state income tax rate for 2008.[103]

### 2. NHW Shippers' Comments

59. NHW Shippers contend that SFPP's calculation of the "weighted average marginal income tax" failed to comply with the requirements of Opinion No. 522. NHW Shippers state that Opinion No. 522 affirmed the findings of the 2011 ID that SFPP must modify its calculation of distributed income[104] to include both (a) the partner's actual income tax liability and (b) the potential income tax liability that unitholders deferred to a later period via 743(b) deferrals.[105] Despite the directive of Opinion No. 522, NHW Shippers state that SFPP excluded from distributed income the potential income tax liability deferred by the section 743(b) deferrals.

### 3. SFPP's Reply Comments

60. In its reply comments, SFPP asserts that it adequately supported its income tax calculations based upon Mr. Ganz's Affidavit and supporting exhibits in its compliance

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[102] Affidavit, George R. Ganz at 6 citing Ex. SPE-36C and Ex. SPE-254C. The revised calculation was included in the Compliance filing in the Excel file labeled "Revised SPE-254C SFPP 2008 Taxable Income Allocation-Op 522.xls."

[103] *Id*. at 6 citing (Exhibit SPE-38 and Exhibit SPE-255).

[104] As explained previously, the proportion of distributed income assigned to each type of partner (i.e., corporations, individuals, etc.) provides the mechanism for weighting the different marginal tax rates in order to calculate the weighted average marginal income tax rate.

[105] NHW Shippers Comments at 15 (citing Opinion No. 522, 140 FERC ¶ 61,220 at PP 307-308).

filing. SFPP further states that the terms "distributive income" and "distributed income" have been used by the Commission in the past as the taxable income distributed to the partners.[106] SFPP states that in compliance with Opinion Nos. 511 and 511-A it used the same methodology to calculated distributed income and no party claimed in that proceeding that SFPP misapplied the Commission's directives.

### 4. **Discussion**

61. The Commission finds SFPP has not complied with Opinion No. 522, and directs SFPP to re-calculate the distributed income used to weight the marginal tax rates of the six classes of unitholders. Opinion No. 522 affirmed the 2011 ID's holding that by reducing the weight assigned to the tax rates of common unitholders by the section 743(b) deferrals:

> SFPP severs the connection between the allocation method and the SFPP income on which the ITA is calculated. SFPP in effect ignores the taxable income recognized by public unitholders at the time of the sale of their units ….[107]

SFPP did not seek rehearing or clarification of these holdings in Opinion No. 522.

62. Yet in its compliance filing, SFPP disregards these findings for the purposes of determining the distributed income awarded to each class of unitholder. SFPP continues to exclude from distributed income the potential income tax liability deferred by the section 743(b) deferrals.[108] This is contrary to the findings of Opinion No. 522, and

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[106] SFPP Reply comments at 4 (citing *SFPP, L.P.*, 121 FERC ¶ 61,240 at PP 7, 9, 22, 44 & 47 (2007) (December 2007 Order)); Opinion No. 511, 134 FERC ¶ 61,121 at PP 223, 273, 307 & 308; Opinion No. 511-A, 137 FERC ¶ 61,220 at PP 340, 356, 363 & n.604; *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945, at 951-52, 954 (D.C. Cir. 2007).

[107] Opinion No. 522, 140 FERC ¶ 61,220 at P 307 (citing 2011 ID, 134 FERC ¶ 63,013 at P 190). Opinion No. 522 also held that "the weighted tax calculation is based on the *income distributed* to the six partnership categories used to develop the jurisdictional entity's weighted marginal tax rate, not the taxable income of a partner that results after all costs and credits that may offset distributed income when a partner prepares an IRS return." *Id*. (citation omitted).

[108] SFPP reduces the "ordinary business income (loss)" reported on Line 1 of Schedule K by the "other deductions" appearing on line 13(d) of Schedule K. *Compare* Exhibit No. SPE-254 (revised per Opinion No. 522) at 3 *with* SPE-25C at 5.

SFPP must revise its compliance filing accordingly.

## B. Application of Indexing

63. In its compliance filing, SFPP calculated rates and refunds for the January 1, 2010, through November 30, 2012 period. To be effective July 1, 2010, SFPP calculated cost-of-service rates based upon the holdings of Opinion No. 522.[109] Effective July 1, 2011, SFPP applied an index increase of 5.1614 percent to calculate rates and refunds (July 2011 index increase).[110] Effective July 1, 2012, SFPP applied a second index increase of 8.6011 percent (July 2012 index increase).

### 1. Shippers Comments

64. CCSV Shippers and NHW Shippers object to SFPP's proposed index increases. As a result CCSV Shippers state SFPP miscalculated both its going forward rates and the refunds owed to its shippers. Compared to the July 2011 index increase of 5.1614 percent proposed in SFPP's compliance filing, the CCSV Shippers and NHW Shippers emphasize that SFPP previously withdrew its proposal implementing a July 2011 index rate for its East Line.[111] Similarly, compared to the July 2012 index increase of 8.6011 percent proposed by SFPP in its compliance filing, CCSV Shippers and NHW Shippers explain that SFPP only sought a 5.4 percent index-based rate increase to be effective July 2012.[112]

65. Citing the December 2007 Order, CCSV Shippers and NHW Shippers object that SFPP's compliance filing erred when it departed from the index increases that it filed to take in 2011 and 2012.[113] CCSV Shippers explain that applying a 0.00 percent increase

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[109] Specifically, SFPP calculated a rate of $1.4736 per barrel for deliveries to Phoenix, $1.0787 per barrel for delivery to Tucson, and $0.6265 for delivery to Lordsburg. SFPP Compliance Filing, Tab A, Schedule 23.

[110] SFPP explains that because the adjustment period in this case extended until March 31, 2010, it based the 5.1614 percent increase upon 75 percent of the 6.8819 percent of the Commission's indexing increase for July 1, 2011.

[111] CCSV Shippers Comments at 4 (citing *SFPP, L.P.*, 135 FERC ¶ 61,274 (2011)).

[112] *Id*. at 4 (citing *SFPP, L.P*, 139 FERC ¶ 61,267 (2012)).

[113] *Id.* at 7 (citing *SFPP, L.P.*, 121 FERC ¶ 61,240, at P 102 (2007) (December 2007 Order)); NHW Shippers Comments at 16-18 (same).

(as opposed to the 5.1614 percent) for the July 2011 index increase and a 5.4 percent increase (as opposed to a 8.6011 percent increase) for the July 2012 Increase lead to cumulative refunds and interest of $30.3 million as compared to SFPP's estimate of $23.6 million and lowered SFPP's prospective rates by approximately $0.13 to $0.06 cents per barrel.

### 2. <u>SFPP Reply Comments</u>

66. In its reply comments, SFPP claims it correctly applied the Commission's indexing polices when calculating its refunds and prospective rates. SFPP states that once a cost-of-service rate is established in a fully litigated rate case, Commission policy permits the pipeline to apply an index increase for each year whether or not the pipeline filed an index increase in those years. SFPP claims that, following complaints in Docket Nos. OR92-8, *et al.*, SFPP was directed to apply annual index factors to its 1994 cost-of-service in order to calculate rates and reparations for subsequent years – notwithstanding that SFPP had not previously filed for an index increase in some of the years at issue (including 1996, 1997, and 1998).[114] SFPP states that the Joint Shippers' reliance upon the December 2007 Order is misplaced, as that order merely directed SFPP to calculate its 2001 and 2002 index increases based upon the then-effective indexing level (i.e., PP1-1)[115] as opposed to the altered indexing level which applied in later years.[116]

67. SFPP further argues that it qualifies for the index increase under the Commission's percentage comparison test. The percentage comparison test compares (a) the company-wide change reported on Page 700, Line 9, Total Cost of Service, with (b) the pipeline's proposed change to any given rate. However, in this instance, SFPP asserts that the Commission should account for the fact that SFPP has not applied index increases to all of its rates (specifically, SFPP explains that it only sought a 2012 index increase for its West and East Lines, but not its North and Oregon Lines). Thus, in performing the percentage comparison test, SFPP urges that its proposed index increases (for example its proposed July 2012 index increase of 8.6011) should be factored as a percentage of SFPP's total revenues which relate to the East and West Line (i.e., 78.3 percent). SFPP

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[114] SFPP Reply Comments at 14 (citing *SFPP, L.P.*, Opinion No. 435-A, 91 FERC ¶ 61,135, at 61,516 (2000)).

[115] The term "PPI" refers to the Producer Price Index for Finished Goods. The Commission has long calculated the index level based upon the PPI plus or minus some differential.

[116] SFPP Reply Comments at 18 (citing December 2007 Order, *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 102).

also argues that because its litigation charges are being recovered via a separate surcharge, the litigation costs should be removed from the cost comparison. Applying these modifications, SFPP proposes to compare a rate change of 6.7 (i.e., 78.3 percent multiplied by the 8.6011 percent change proposed by SFPP) with a 2.2 percent change in costs for a difference of 8.9 percent. SFPP states that this difference is below the threshold that the Commission typically permits in indexing cases.

68. SFPP states that if the Commission does not apply SFPP's modified version of the percentage comparison test, and instead applies the traditional percentage comparison test, SFPP should be permitted to apply a 5.9 percent increase for the July 2011 index and a 5.4 percent increase for the 2012 index.

### 3. Discussion

69. The Commission will permit SFPP to apply an increase of 5.1614 percent for the July 2011 index increase. The Commission rejects SFPP's proposed July 2012 index increase of 8.6011 percent, but will permit SFPP to propose an index increase that is consistent with the Commission's percentage comparison test.

70. SFPP is not foreclosed from seeking to apply index increases to the compliance filing rates resulting from Opinion No. 522. The Commission recognizes that SFPP did not take a July 2011 East Line indexing increase.[117] At SFPP's then-effective rate levels, there may have been reasons not to seek an index rate increase. However, SFPP's then-effective East Line rates have been substantially reduced by the holdings in Opinion No. 522 to establish a lower just and reasonable rate. Allowing the index increases to that lower rate places the parties in the same position had the lower rates established by Opinion No. 522 been in place on January 1, 2010, and SFPP had sought the index increases it was permitted to pursue. Such an approach is consistent with the Commission's prior decisions, which have permitted, where appropriate, an annual index adjustment to a rate established following cost-of-service litigation.[118] Thus,

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[117] SFPP withdrew its July 2011 East Line index increase. *See SFPP, L.P.*, 135 FERC ¶ 61,274 (2011); *SFPP, L.P.*, 137 FERC ¶ 61,078 (2011). However, the Commission has accepted a pipeline's index increases after the party withdrew the initial request. *Compare NuStar Logistics, L.P.*, 139 FERC ¶ 61,278 (2012) *with NuStar Logistics, L.P.*, 140 FERC ¶ 61,107 (2013).

[118] *SFPP, L.P.*, Opinion No. 435-A, 91 FERC ¶ 61,135, at 61,516 (2000). The NHW Shippers and CCSV Shippers' reliance upon the December 2007 Order for the contrary proposition is misplaced. No part of the December 2007 Order discussed or reversed the Commission's prior decision to permit SFPP to index forward its rates for years in which SFPP had not previously sought an index increase. Moreover, to the

(continued…)

notwithstanding SFPP's prior decisions not to seek the July 2011 index increase for its East Line rates, we will not foreclose SFPP from applying the July 2011 index increase on compliance.[119]

71. The Commission evaluates SFPP's 2011 and 2012 index increases applying the same methodology that the Commission applies to evaluate any rate change pursuant to the Commission's indexing regulations. Consistent with the EPAct 1992, the Commission's indexing mechanism was designed as a simplified ratemaking methodology conducted with streamlined procedures.[120] In order to preserve the simplicity of the indexing methodology, the Commission applies the percentage comparison test to determines whether a protest meets the "so substantially in excess" standard articulated by the indexing regulations.[121] The percentage comparison test is a narrow test that compares (a) a proposed indexing rate increase in a given index year to (b) the cost changes recorded in the Page 700 corresponding to that index year.[122]

72. In the past, when SFPP has sought index increases for parts of its system while forgoing increases on other parts of their system, the Commission has applied the percentage comparison test so as to compare (a) the company-wide cost change on Page 700 to (b) individual rate increases.[123] Such an application of the percentage comparison test is consistent with the simplified methodology embodied in Commission regulations and the EPAct 1992.

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extent any statements in the December 2007 Order could be construed as in tension with such a result, the Commission has explained and justified its policy in this order.

[119] Due the decreases in SFPP's rates due to Opinion No. 522, at no time will the rates as increased by the July 2011 index increase or the July 2012 index increase exceed the rates which were then on file with the Commission.

[120] *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act* of *1992*, Order 561, FERC Stats. & Regs. ¶ 30,985 (1993) (cross-referenced at 65 FERC ¶ 61,109 (1993)), *order on reh'g*, Order No. 561-A, FERC Stats. & Regs. ¶ 31,000 (1994) (cross-referenced at 68 FERC ¶ 61,138 (1994)), *aff'd, Ass'n of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996).

[121] *E.g.*, *Calnev Pipe Line L.L.C.*, 130 FERC ¶ 61,082, at P 10 (2010).

[122] *E.g.*, *SFPP, L.P.*, 147 FERC ¶ 61,012 (2014).

[123] *SFPP, L.P.*, 143 FERC ¶ 61,140 (2013) (index increase for SFPP's East Line rates); *SFPP, L.P.*, 143 FERC ¶ 61,141 (2013) (index increase for West Line rates).

73. The Commission rejects SFPP's proposed weighting of index increases based upon the pipeline's revenues for each segment that receives an index increase. Among other potential issues, such segmented revenue information is not available on Page 700 and would require the pipeline to submit additional information with each annual index filing – raising further questions about transparency and the right of shippers to challenge the segmented data as presented by the pipeline. Further, such weighting may cause different issues on different pipeline systems, and SFPP has conceded that there are multiple ways in which such weighting could be done. Accordingly, the Commission rejects SFPP's novel modification to the percentage comparison test because it would unduly complicate the Commission's indexing policies contrary to the simplified regulation mandated the by EPAct 1992.

74. The Commission also rejects SFPP's proposal to remove litigation costs when applying the percentage comparison test. In Docket No. IS11-444-000, the Commission held that litigation costs should be included in the costs of service for purposes of calculating the year-to-year percentage change in costs.[124] There is no reason to apply a different standard in this proceeding.

75. Applying the percentage comparison test as it has been applied in prior Commission decisions, the July 2011 index increase proposed by SFPP is consistent with index increases the Commission has accepted in the past. SFPP's FERC Form No. 6, Page 700 for 2011 shows a total cost of service decrease between 2009 and 2010 of approximately 4.0232 percent. SFPP's 4.0232 percent decrease in costs combined with the proposed East Line index-based rate increase of 5.1614 percent[125] results in divergence of approximately 9.1845 percent. This is consistent with levels that the

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[124] *SFPP, L.P.*, Opinion No. 527, 143 FERC ¶ 61,213, at PP 98, 100 (2013).

[125] SFPP explains that because the test period extended through March 30, 2010, it would apply only 75 percent of the Commission's July 2011 index increase (6.8819 percent) for cost changes during 2010. SFPP acknowledges this consistent with the holdings of Opinion No. 511-A. We reject SFPP's suggestion that it is entitled to a higher increase of 5.9 percent given the Commission's rejection of SFPP's alternative methodology. SFPP has provided no justification for distinguishing between the facts of this proceeding and the facts present in Opinion No. 511-A, which required a reduction to a proposed index increase where the cost-of-service rates already included costs for a portion of the period that provided the basis of the index increase. 137 FERC ¶ 61,220, at PP 405-411.

Commission has permitted in the past, and the Commission accepts this portion of SFPP's compliance filing.[126]

77. However, the July 2012 index increase proposed in SFPP's compliance filing appears to substantially exceed the changes in SFPP's costs. FERC Form No. 6, Page 700 for 2012 shows a total cost of service decrease between 2010 and 2011 of approximately 8.6011 percent. SFPP's FERC Form No. 6, Page 700 for 2011 shows a total cost of service decrease between 2010 and 2011 of approximately 4.4812 percent. SFPP's 4.4812 percent decrease in costs combined with the proposed East Line index-based rate increase of 8.6011 percent results in divergence of approximately 13.0823 percent. Such a level is consistent with those the Commission has found to contravene the "substantially in excess" standard,[127] and the Commission directs SFPP in its compliance filing to this order to propose a 2012 index increase consistent with the percentage comparison test as it has been applied by the Commission.

### C. Calculation of the Litigation Surcharge

78. In SFPP's compliance filing, its rates for the January 1, 2010 through December 31, 2012 period include a litigation surcharge of $0.0373 per barrel as permitted by Opinion No. 522. SFPP calculated this surcharge on schedule 25 by dividing its total litigation expenses by the total East Line volumes for the January 1, 2010, through December 31, 2012 period. Due to the timing of the compliance filing, SFPP was required to estimate volumes for the last three months of 2012.

79. In their comments, NHW Shippers state that SFPP should be required to use the actual volumes for October, November, and December 2012. In its reply comments, SFPP states that it does not object to updating its litigation surcharge calculations to reflect actual, rather than estimated, East Line volumes for October through

[126] *SFPP, L.P.*, 140 FERC ¶ 61,106, at P 8 (2012) (accepting increase with a percentage comparison divergence of 9.88 percent), *order on reh'g*, 143 FERC ¶ 61,141 (2013); *NuStar Logistics, L.P.*, 140 FERC ¶ 61,107, at P 8 (2012) (accepting filing with a percentage comparison difference of 9.85 percent), *reh'g denied*, 143 FERC ¶ 61142 (2013).

[127] *E.g.*, *NuStar Logistics, L.P.*, 139 FERC ¶ 61,278, at PP 11-13 (2012); *SFPP, L.P.*, 139 FERC ¶ 61,266, at PP 6-9 (2012).

December 2012. SFPP also states that it will update its litigation expenses consistent with the holdings of Opinion No. 522.[128]

80. The Commission finds that SFPP should update its litigation surcharge to use actual volume levels for the entire January 1, 2010, through December 31, 2012 period, and the litigation expenses may also be adjusted consistent with the holdings of Opinion No. 522.[129]

The Commission orders:

(A) The requests for rehearing are granted in part and denied in part for the reasons stated in the body of this order.

(B) SFPP shall file revised East Line rates consistent with this order within 45 days after this order issues, including a supporting cost of service, workpapers, explanatory statements, and any other necessary documentation.

(C) Comments on the compliance filing directed in Ordering Paragraph (B) are due 60 days after this order issues and reply comments are due 75 days after this order issues.

By the Commission.

( S E A L )

Nathaniel J. Davis, Sr.,
Deputy Secretary.

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[128] SFPP Reply Comments at 26 (citing Opinion No. 522, 140 FERC ¶ 61,220, at P 80).

[129] Opinion No. 522, 140 FERC ¶ 61,220, at P 80.