

PUBLIC VERSION

**FEDERAL ENERGY REGULATORY COMMISSION
OFFICE OF ADMINISTRATIVE LITIGATION**

**SFPP, L.P.
Docket No. IS05-230-000**

**PREPARED DIRECT & ANSWERING TESTIMONY OF
COMMISSION TRIAL STAFF WITNESS
PATRICK R. CROWLEY**



**December 6, 2005
Washington, DC**

**Prepared Direct & Answering Testimony of
Patrick R. Crowley**

Summary

Mr. Crowley presents the FERC Trial Staff Cost of Service for SFPP, Inc. proposed FERC Tariff No. 111. Mr. Crowley addresses several issues as they relate to the cost of service: 1) the level of federal income tax allowance to be incorporated into the cost of service, 2) several adjustments to the trended original cost rate base, 3) the removal of Purchase Accounting Adjustments from the allocation of corporate overheads (Massachusetts Formula), the allocation of indirect administrative & general costs (Kansas Nebraska Formula) used in calculating the cost of service, and 4) the estimation of selected elements of the operating expenses incorporated into the cost of service, specifically, environmental remediation costs and litigation costs.

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Exhibit	Descriptive Title	Protected?
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S-7K	Bullock Deposition, Page 62-63	
S-7L	CFR §1/707-1(c) Guaranteed Payments	
S-7M	KMEP – 2004 IRS Form 1065	X
S-7N	KMEP – 2004 IRS Form K-1 for KMGP, GP	X
S-7O	SFPP – 2004 IRS Form 1065	X
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S-7T	OLP-D – 2004 IRS Form K-1 for KMGP	X
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S-7X	IRS Instructions for Schedule K-1	
S-7Y	Bullock Deposition, Page 155	X
S-7Z	Bullock Deposition, Page 149	X
S-7AA	KMEP K-1 Data Base Special Depreciation	X
S-7BB	Bullock Deposition, page 152	X
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**United States of America
before the
Federal Energy Regulatory Commission**

SFPP, L.P.

)

Docket No. IS05-230-000

**Prepared Direct & Answering Testimony of
Patrick R. Crowley
Witness for the Trial Staff of the
Federal Energy Regulatory Commission**

1 **Q. Please state your name and business address.**

2 A. My name is Patrick R. Crowley.

3 My business address is 888 First Street, Northeast, Washington, D.C. 20426.

4 **Q. By whom are you employed and in what capacity?**

5 A. I am employed by the Federal Energy Regulatory Commission (FERC or

6 Commission) as an economist in the Office of Administrative Litigation.

7 **Q. Please state your educational background.**

8 A. I graduated from DePaul University in Chicago, Illinois, in 1976 with a Bachelor

9 of Arts degree in Economics. In 1978, I received a Master of Arts degree in

10 Economics from DePaul University.

11

1 ***Qualifications***

2 **Q. Please summarize your duties from the time you entered your employment**
3 **with the Federal Energy Regulatory Commission.**

4 A. I began work at the Commission in 1979 as an Industry Economist in the Pipeline
5 Rates Division of the Office of Pipeline Rates. As an expert witness with the Staff
6 gas and oil litigation team from 1979 to 1992, I prepared pipeline depreciation
7 studies, long-term forecasts of natural gas reserves and production, mortality
8 studies of plant retirements, cost behavior studies for pipeline facilities, and
9 Mcf/mile studies. From 1992 through 1994, I worked on the operational aspects of
10 the restructuring of Texas Eastern Gas Pipeline Companies and was the team
11 leader for the restructuring of the Tennessee Gas Pipeline Company. From 1994
12 through 1998, I worked on the advisory side of the Commission where I prepared
13 reports for Commission orders regarding proposals for revised tariff terms; new
14 services, rate designs, and tariff rates; and a wide variety of utility reports and cost
15 studies. In 1998, I returned to the litigation side of the Commission where I now
16 work on electric utility, and natural gas and oil pipeline rate cases and complaint
17 cases.

18 In regard to oil pipelines, in recent years I have acted as a subject matter
19 expert in cost of service analysis in the following dockets:

20 Big West Oil v Frontier Pipeline & Express Pipeline Partnership (OR01-02),

1 Big West Oil v Anschutz Ranch East Pipeline Co. (OR01-01),
2 Chevron Products v Frontier Pipeline & Express Pipeline Partnership (OR01-04),
3 EOTT Energy Operating Ltd. v Conoco Pipe Line Corp (OR00-11),
4 Conoco Pipe Line Co. (IS01-444 & IS01-445),
5 Chevron Products, Inc. v Anschutz Ranch East Pipeline Co. (OR02-03),
6 Olympic Pipe Line Company (IS01-441),
7 Express Pipeline (IS02-81),
8 Platte Pipeline (IS02-384),
9 Sinclair Oil Co. v Rocky Mountain & BP Pipelines (NA) (OR02-6-000),
10 Olympic Pipe Line Company (IS03-218),
11 Sinclair Oil Co. v Chevron Pipeline Co. (OR04-6), and
12 Mid-America Pipeline Company (IS05-216)

13 **Q. Have you filed testimony before the FERC?**

14 A. Yes, I filed testimony before the Commission in the following cases:

15 Black Marlin Pipeline Company, Docket No. RP81-67-000;
16 Tarpon Transmission Company, Docket No. RP84-82-000;
17 National Fuel Gas Supply Corporation, Docket No. RP86-136-000;
18 Pacific Gas Transmission Company, Docket No. RP87-62-000;
19 Sea Robin Pipeline Company, Docket No. RP88-181-000;
20 Natural Gas Pipeline Company of America, Docket No. RP88-209-000;
21 Paiute Pipeline Company, Docket No. RP88-227-000;
22 Southwest Gas Storage Company, Docket No. RP89-60-000;
23 Montana Power Company, Docket No. ER98-2382-000;
24 Big West Oil Co. & Chevron Products Co. v Anschutz Ranch East Pipeline Co.
25 & Express Pipeline Partnership, Docket No. OR02-1-000 & OR02-3-000;

1 Big West Oil Co. & Chevron Products Co. v Frontier Pipeline Inc.
2 & Express Pipeline Partnership, Docket No. OR02-2-000 & OR02-4-000;
3 Boston Edison Company, Docket No. ER01-890-000;
4 Avista Corporation & Avista Energy, Docket No. EL02-115-000;
5 Ameren Services Company, Docket No. ER02-929-000;
6 Sinclair Oil Corporation v Rocky Mountain Pipeline system, LLC
7 & BP Pipelines (North America), Inc., Docket No. OR02-6-000;
8 Enron Power Marketing Inc., Docket No. EL03-180-000, et al.

9 **Q. What is the purpose of your testimony?**

10 A. The purpose of my testimony is to present the FERC Trial Staff cost of service for
11 SFPP, L.P.'s (SFPP) proposed North Line Tariff No. 111.

12 **Q. In addition to your written testimony in this case, are you sponsoring any**
13 **supporting exhibits?**

14 A. Yes, the following exhibits are presented in support of this filed testimony:
15 Exhibit No. S-5, FERC Trial Staff Cost of Service Model comprising the cost of
16 service model; Exhibit No. S-6, Supporting Schedules comprising the backup
17 schedules supporting the cost of service model; and Exhibit Nos. S-7A through S-
18 7X, Documents & Workpapers supporting the cost of service model and prepared
19 testimony. A number of exhibits and references in the text of my testimony
20 contain protected material. The text references are highlighted in bold and
21 brackets: **Start protected material [-----] End protected**

1 **material.** Protected documents are stamped **Confidential Protected Material.**

2 Protected data within a spreadsheet is highlighted by a shaded cell.

3 The intervenors in this docket represent groups of shippers with long
4 names. I will use the following abbreviations: “CCV” for Chevron Products
5 Company, ConocoPhillips Company and Valero Marketing and Supply Company,
6 “TES” for Tesoro Refining and Marketing Company, and “BPX” for BP West
7 Coast Products LLC and ExxonMobil oil Corporation.

8 **Q. What issues did the Commission set for hearing in this case?**

9 A. The Commission’s Order, 111 FERC ¶ 61,299, established hearing procedures to
10 “examine all the issues raised by the filing.” These issues include the following:
11 1) whether SFPP’s inclusion of a full income tax allowance in the cost of service
12 comports with the Commission’s Policy Statement on income tax allowance, 2)
13 whether SFPP’s incorporation of a capital structure in the cost of service reflecting
14 its goal of a 40/60 debt/equity capital structure is appropriate in light of its actual
15 capital structure, 3) whether SFPP’s incorporation of a nominal return on equity of
16 13.04% in the cost of service is appropriate, 4) whether SFPP’s categorization of
17 certain forms of debt is appropriate, 5) whether SFPP’s volumes forecast for the
18 test period are accurate, 6) whether SFPP’s four operating expense adjustments are
19 properly estimated, 7) whether there is a substantial enough divergence between

1 SFPP's North Line costs and revenues to warrant a rate increase in SFPP's North
2 Line rates, 8) whether certain of SFPP's tariff rates are grandfathered, and 9)
3 whether SFPP's inclusion of replacement costs for the North Line in both a FERC
4 and a California rate case, constitutes double recovery.

5 **Q. Which of these issues will you address in your direct testimony?**

6 A. I will address the following issues: 1) whether a federal income tax allowance
7 should be incorporated into the cost of service and, if so, at what level, 2) several
8 adjustments to rate base elements of the cost of service, 3) the appropriate
9 allocators for corporate overheads in the Massachusetts Formula and indirect costs
10 in the Kansas-Nebraska Formula, and 4) the appropriate level of operating expense
11 adjustments for Account Nos. 320 and 520.

12 **Q. What other Trial Staff witnesses are testifying in this proceeding and what**
13 **are their responsibilities?**

14 A. Trial Staff witness Sam Wang is presenting evidence regarding the weighted cost
15 of capital in Exhibit Nos. S-1, S-2, and S-3; Trial Staff witness Bonnie Pride is
16 presenting evidence regarding interstate volumes and rate design in Exhibit Nos.
17 S-8, S-9, and S-10.

18

Part I - Federal Income Tax Allowance

1
2 **Q. Please describe the basic issue in regard to income tax allowances.**

3 A. Statement D of the generic oil pipeline cost of service model calculates an
4 interstate income tax allowance as if the pipeline entity were a corporation that
5 paid corporate income tax. Since the regulated entity must be made whole for all
6 costs incurred in providing service, revenue must be sufficient to cover all costs,
7 including income taxes. However, since SFPP is a partnership, as are its parent
8 organizations, it pays no federal income tax, so the tax allowance is, in reality,
9 more in the nature of a return on equity to the investors. Furthermore, in
10 compliance with the Commission's directive in the Policy Statement on Income
11 Tax Allowances (111 FERC ¶ 61,139), I have sought to ascertain the actual or
12 potential tax liability of SFPP's partners and I have concluded that there is, in fact,
13 little or no actual or potential income tax liability on the part of SFPP's partners.

14 **Q. How is your income tax allowance testimony organized?**

15 A. My testimony regarding federal income tax allowance in the cost of service is
16 organized around five basic questions: I) Should master limited partnerships
17 receive an income tax allowance in the cost of service? II) Has SFPP met its
18 burden to establish the tax status of the ultimate holders of SFPP? III) Even if
19 SFPP has not met its burden, is there, nonetheless, a potential tax liability on the

1 part of SFPP's ultimate owners? IV) Despite the lack of evidence to support an
2 income tax allowance, what does the available evidence indicate regarding actual
3 tax liability for SFPP's ultimate owners? V) What does Staff propose in regard to a
4 federal income tax allowance in the cost of service for SFPP's North Line rates?

5 **Q. What are your basic findings as a result of your investigation into the**
6 **question of income tax allowance for the SFPP North Line cost of service?**

7 A. My basic finding from my investigation into the question of income tax allowance
8 for the SFPP North Line cost of service are that 1) a full corporate income tax
9 allowance is inappropriate for SFPP because SFPP cannot trace 100% of its
10 allocated net income in 2004 to taxable entities; 2) the taxable entities to which
11 SFPP could conceivably trace allocated taxable income in 2004 would pay at the
12 highest only 1.23% of actual income tax (on an SFPP aggregate basis) on the
13 allocated net income; 3) the partnership agreements by which net income is
14 allocated, and thereby traceable, are designed to minimize allocated taxable
15 income to the limited partners; 4) the Kinder Morgan Energy Partners, L.P., master
16 limited partnership, by its own partnership agreement, allocated a substantial
17 amount of gross income to its general partner, Kinder Morgan G.P., Inc., to
18 compensate it for its management services and, as such, the allocated gross income
19 is an expense and not an allocation of taxable income.

1 **I Should Master Limited Partnerships Receive an Income Tax**
2 **Allowance in the Cost of Service?**

3 **Q. What is a master limited partnership?**

4 A. A master limited partnership is a limited partnership that engages in certain natural
5 resource commodities and services for 90% or more of its income, and is permitted
6 to trade its ownership units in the partnership on public exchanges as though they
7 were corporate stock shares. Master limited partnerships exist pursuant to Internal
8 Revenue Service (IRS) regulations added to the tax code in 1987 and amended in
9 1997 that created provisions permitting the public trading of partnership interests.
10 SFPP's parent organization, Kinder Morgan Energy Partners, L.P. (KMEP) is a
11 limited partnership that operates within the IRS regulations for master limited
12 partnerships. Master limited partnerships, unlike corporations, are not separate
13 entities legal entities per se so much as they are a way of doing business.

14 Partnerships are pass-through entities for tax purposes, so no income tax is
15 paid at the partnership level. Partnership net income,¹ or loss, is generally passed
16 through to the partners in proportion to their interest in the partnership and each
17 partner pays a tax on its share of the partnership net income at its own individual
18 tax rate. Losses passed through to the partners cannot be used to offset income

¹ The terms gross income, net income, and taxable income will be discussed in Part

1 from other sources but must be carried forward and used to offset income from the
2 same limited partnership in future tax periods.² However, the allocation of
3 partnership net income can be greatly affected by incentive distributions and gross
4 income allocations embedded within the partnership agreement. As discussed
5 more fully below in Part III, a partnership agreement may require a
6 disproportionate gross income allocation to the general partner such that the
7 partnership must allocate negative taxable income to most of the other partners.
8 Such is the case with SFPP's parent organization, KMEP. The general partner's
9 allocation of net income should be included in with the limited partners in
10 assessing the weighted average income tax liability, but special guaranteed
11 payments to the general partner are another matter.

12 **Q. How does a traditional oil pipeline corporate cost-of-service calculation**
13 **incorporate federal income taxes?**

14 A. Traditionally, oil pipeline *corporations* develop a cost of service for rate making
15 purposes that includes a corporate income tax allowance at the highest marginal
16 tax rate for corporations equal to 35% of the net income.³ This allowance is in
17 place to ensure that investors receive the full intended after-tax return on equity
18 embedded within the cost of service. Because corporations must pay corporate

III of my testimony.

² Federal Tax Course 2004, CCH Incorporated, Chicago, Il p. 2219.

1 income tax as a cost of doing business, the tax allowance is built in to cover that
2 cost just as it would be for other elements of the cost of service.

3 **Q. Why is the income tax allowance an issue in this docket?**

4 A. Here, SFPP and its parent organizations are not corporations and do not,
5 themselves, pay any corporate income tax. As a result, any income tax allowance
6 embedded within the cost-of-service derived tariff rate will flow through to the
7 partners of SFPP's parent pass-through entities. The impact, as will be discussed
8 later in my testimony, is two-fold; one, a cost that is not actually incurred by the
9 pipeline entity is being assessed upon the ratepayers, and two, the dollars so
10 collected inure to the partnership owners such that the realized return on equity for
11 the partners in SFPP will be substantially in excess of the actual cost of attracting
12 capital.⁴ If an income tax allowance is incorporated into the cost-of-service
13 derived tariff rates for the North Line, I believe the resulting rates will be unjust
14 and unreasonable.

15 **Q. Do you believe a pipeline entity organized as a partnership should be awarded**
16 **a federal income tax allowance embedded within the cost of service deriving**
17 **the tariff rates paid by shippers?**

18 A. Only to the extent the weighted average tax rate of the partners can be determined.
19 The Commission's Policy Statement instructs those seeking an income tax

³ See Table 3 below for the table of corporate tax rates.

1 allowance to establish the tax status of those ultimately holding the income tax
2 liability on the income derived from utility operations. Entities operating oil
3 pipelines, or any other regulated utility, in the public interest should, in the first
4 instance, only be awarded only those costs actually incurred in the operation of the
5 business at hand. Costs incurred by affiliates of those entities have no bearing on
6 the cost of building and managing the regulated public utility. This is more
7 emphatically the case for entities such as KMEP whose partnership agreements are
8 structured so that the limited partners receive little or no net income. Secondly, as
9 indicated in the Commission's Policy Statement on Income Tax Allowances,
10 regulated utilities should only be awarded the actual average weighted tax liability
11 incurred by its affiliates as determined on a case-by-case basis rather than taxes
12 calculated on a blanket maximum rate to which virtually none of the partnership's
13 partners actually are subject.

14 **A) History of Tax Allowance Issue**

15 **Q. In a nutshell, what is your understanding of the pertinent history of the issue**
16 **regarding an allowance for federal income taxes for partnerships?**

17 **A.** The derivation of just and reasonable rates for public utilities requires that the cost
18 of service underlying those rates must be designed to recover enough revenue to
19 cover all proper costs of the utility's operations, including taxes, plus a fair return

⁴ See Table 4 Real Return on Equity & Taxes.

1 to the investor. If a utility is part of group of entities, some elements of the cost of
2 operations flow down from the parent organization (e.g., corporate overheads)
3 while some elements flow upward (e.g., the tax on net income). The umbrella
4 organization may be able to take advantage of various tax provisions to offset the
5 income from some entities with the losses from others.

6 The question of whether and how ratepayers should share in the tax burden
7 or benefits of a utility's parent organization tax status harkens back to the claim
8 made by the City of Charlottesville in 1981 that the Commission must require
9 pipelines to share with their ratepayers a pipeline's tax benefits that arises from
10 the operations of other affiliated entities. There were at the time two methods of
11 incorporating a parent organization's tax status in rate design: flow-through and
12 stand-alone. The Commission eventually opted for the stand-alone method to
13 avoid regulating one company on the basis of the activities of another. (See 249
14 US APP DC 236)

15 Recently, the issue has arisen due to the emergence of partnerships in the
16 gas and oil industries. Under a partnership umbrella organization, the regulated
17 entity standing alone pays no income tax but rather passes through its net income
18 to the partners. Where the corporate form of ownership presents a Cycloptic
19 taxable entity, the partnership presents a Hydra of owners and tax status', making

1 the assessment of what is an appropriate income tax allowance in the cost of
2 service a Herculean task.

3 **Q. What is your understanding of the Commission’s rationale for permitting a**
4 **tax allowance for partnerships only so far as owning interests in the**
5 **partnership were corporations, prior to the *Policy Statement*?**

6 A. The Commission’s two rationales for the *Lakehead* policy permitting income tax
7 allowance only for corporate interests in the partnership were that 1) equity owners
8 of corporations experienced a double taxation in that the corporation was taxed as
9 a cost of operating a business in addition to the taxes paid by its stockholders on
10 dividends, and 2) the divergence between the return on equity permitted to
11 corporations and partnerships is unequal, despite identical financial risks related to
12 the utility operation, due to the non-double taxation of partnership interests.

13 **B) Cost Incurrence and Responsibility**

14 **Q. What is your understanding of the principle of “cost responsibility and cost**
15 **incurrence”?**

16 A. In Opinion No. 173 (23 FERC ¶ 61,850), the Commission held that the inclusion
17 of costs in a company’s cost of service must pass a benefits/burdens test where the
18 cost to be included must bear some causal link to benefits derived by the ratepayer.
19 Similarly, deductions from income in the derivation of taxable income, due to the
20 costs of providing service, that result in reduced taxation on the utility should be
21 passed on to the ratepayer as well. The other side of the coin is that where costs

1 did not occur in support of services to the ratepayer, those deductions should not
2 inure to the benefit of the ratepayer through the cost of service. Under a
3 partnership, the pipeline entity incurs no income tax as a cost of providing direct
4 service to the ratepayers. Hence, where there is no cost incurrence, there is no cost
5 responsibility.

6 **C) Stand Alone Analysis**

7 **Q. Since the partners who own the utility partnership will most likely pay**
8 **income tax on the net income derived from the utility operations, is that not a**
9 **cost incurrence?**

10 A. The tax liability of the partner is a function of each partner's income from all
11 sources. The fact that the exact source of the tax liability cannot be examined is a
12 tell tale sign that there is no causal link between the actual tax paid and the
13 benefits to the ratepayer. With virtually all other costs we can determine with
14 reasonable accuracy what the expected costs to the ratepayer will be. Given the
15 multiple tax brackets for corporate, individual, and other tax paying bodies, there is
16 no way of knowing whether the income from utility operations is the first dollar or
17 last dollar in the stack leading to marginal tax rates. Here, as will be seen when I
18 examine the actual tax returns and K-1s for Kinder Morgan Energy Partners, LP,
19 the actual net income allocated to the limited partners is, more often than not, so
20 small or negative that the recipient may have no tax liability at all. Further, the

1 owners of the partnership are not regulated entities themselves; their liabilities, as
2 unregulated entities, are outside the purview of our cost analysis.

3 **Q. How does the tax status of a partnership’s owners play into the concept of**
4 **stand alone ratemaking?**

5 A. The Commission’s “stand alone” policy generally suggests that a regulated entity
6 must pay its own way and not stand under the shelter of a parent organization’s
7 benefits drawn from other operations. Indeed, the whole question of “stand
8 alone” arose when ratepayers sought to garner the benefits of the utility’s tax
9 benefits from affiliated operations. The Commission’s directive required that the
10 tax status of the parent organization and affiliates was not relevant to the utility’s
11 derivation of costs and that the utility must be examined if as if it were a stand
12 alone entity. The partnership situation stands that policy on its head and requires
13 us to rely on the tax status of the parent organization and its owners.

14 **D) Commission Policy Statement on Income Tax Allowance**

15 **Q. What did the Commission Policy Statement on Income Tax Allowances**
16 **conclude in regard to permitting income tax allowances embedded within cost**
17 **of service derived tariff rates?**

18 A. The Commission’s Policy Statement concludes
19 that it should return to its pre-*Lakehead* policy and permit an income
20 tax allowance for all entities or individuals owning public utility
21 assets, provided that an entity or individual has an actual or potential
22 income tax liability to be paid on that income from those assets.

1 Thus a taxpaying corporation, a partnership, a limited liability
2 corporation, or other pass-through entity would be permitted an
3 income tax allowance on the income imputed to the corporation, or
4 to the partners or members of pass-through entities, provided that the
5 corporation or the partners or the members, have an actual or
6 potential income tax liability on that public utility income. *Given this*
7 *important qualification, any pass-through entity seeking an income*
8 *tax allowance in a specific rate proceeding must establish that its*
9 *partners or members have an actual or potential income tax*
10 *obligation on the entity's utility income.* [111 FERC ¶ 61,139 at P
11 32] (*emphasis added*)
12

13 **II Has SFPP, LP Met Its Burden to Establish the Tax Status of**
14 **the Ultimate Holders of SFPP?**

15 **Q. Has SFPP met the burden of establishing the tax status of the owners of the**
16 **pass-through entity?**

17 **A.** No, SFPP has not met its burden to establish the tax status of those who ultimately
18 receive income taxes derived from SFPP revenues. The Commission's Policy
19 Statement makes clear that a pipeline seeking a tax allowance in the cost of service
20 has the burden of establishing the tax status of the owners of the pass-through
21 entity. The filed testimony of SFPP's witnesses presents no specific or objective
22 evidence to support the notion that the direct or indirect owners of SFPP have an
23 actual or potential tax liability.

24 **A) Burden of Proof**

25 **Q. What did the Commission Policy Statement on Income Tax Allowances direct**
26 **in regard to the burden of establishing the tax status of the owners of the**
27 **pass-through entity?**

1 A. The Commission Policy Statement on Income Tax Allowances states

2 This is a fact specific issue for which the relative data is uniquely
3 within the control of the regulated industry. Thus any pass-through
4 entity desiring an income tax allowance on utility operating income
5 must be prepared to establish the tax status of its owners or, if there
6 is more than one level of pass-through entities, where the ultimate
7 liability lies and the character of the tax incurred. [111 FERC ¶
8 61,139 at P 42]

9 Indeed, in both its written testimony and in oral depositions, SFPP's witnesses
10 failed to show in any way that there is, in fact, any evidence to support the
11 proposition that the owners of partnership interests in SFPP and its parental pass-
12 through organizations have any actual or potential tax liability on income derived
13 from SFPP or any other entity within the KMEP⁵ umbrella. Although the burden
14 to establish the tax status of the ultimate holders of KMEP tax liability does not lie
15 with FERC Staff, I have, nonetheless, endeavored to ascertain whether there is in
16 fact any evidence of either actual tax liability or potential tax liability. As more
17 fully explained below, I have come to the conclusion that there is evidence
18 available to answer that question and that the answer is there is little or no actual or
19 potential income tax liability.

20 **Q. Do any of SFPP's witnesses discuss the actual flow-through of net income**
21 **from SFPP to its parent organizations?**

⁵ KMEP is the second tier owner of SFPP, Kinder Morgan Energy Partners L.P.

1 A. Yes. In Exhibit No. SFN-3, at page 24, line 10, SFPP witness Mr. Bullock states
2 that SFPP's taxable income is allocated to OLP-D⁶ and Santa Fe in accordance
3 with SFPP's partnership agreement. OLP-D's taxable income, which includes its
4 share of SFPP taxable income, is allocated to its general partner (KMGP) and its
5 limited partner (KMEP) in accordance with the OLP-D partnership agreement.
6 KMEP's taxable income, which includes its share of OLP-D taxable income, is
7 allocated among its partners including Kinder Morgan, Inc. (KMI), Kinder Morgan
8 G. P. (KMGP), KN Gas, KNTCI, and Kinder Morgan TransColorado, Inc
9 (KMTCI) in accordance with the KMEP partnership agreement. The taxable
10 income allocated to each of these entities is included in KMI's Consolidated return
11 to determine the actual or potential tax liability of all KMNI entities. Mr. Bullock
12 includes an organizational chart of these entities in Exhibit No. SFN-4.

13 **B) SFPP Witness Testimony**

14 **1) Mr. Hrdlicka's Theories**

15 **Q. What did SFPP witness George Hrdlicka present as evidence to support**
16 **SFPP's burden of establishing the tax status of the owners of the pass-through**
17 **entity?**

⁶ OLP-D is the first tier owner of SFPP, Kinder Morgan Operating L. P. "D"

1 A. In Exhibit No. SFN-15, SFPP partnership tax allowance witness Mr. Hrdlicka
2 offers a wholly theoretical assessment of what various types of owners might pay
3 in taxes under normal circumstances. Mr. Hrdlicka argues that the limited partners
4 of SFPP, OLP-D, and KMEP are not enjoying a tax-free ride. He avers that over
5 the life of each partner's ownership of the interests, each partner is subject to
6 federal income tax on his/her share of KMEP's taxable income. Unfortunately,
7 Mr. Hrdlicka's theoretical presentation is irrelevant because he completely ignores
8 the structural allocations of cash distributions and gross income dictated by the
9 actual partnership agreements in this case as well as the actual K-1 forms filed by
10 the owners of SFPP.⁷

11 Mr. Hrdlicka further argues that cash distributions not taxed in the current
12 year will be taxed upon sale of the interests by the limited partner, if the cash
13 distributed by KMEP is in excess of what the partner paid for its interest in KMEP.
14 While his statement is correct as far as it goes, Mr. Hrdlicka ignores some key
15 factors in that determination. First, the price of partnership shares at the time of
16 sale may not be sufficient to award the owner a gain above his/her capital account
17 basis. Second, a partnership agreement provision, §5.1(d)(v), found in Exhibit
18 No. SFN-5 and discussed more fully below, ensures that partners' capital accounts

⁷ K-1 schedules for OLP-D, KMEP, and KMGP are included in Exhibit Nos. S-7S,

1 are unlikely to fall below zero. Third, we have no way of knowing what any
2 partner's capital account will be if and when that partner sells its interest in the
3 partnership. This is important because Mr. Hrdlicka obfuscates the difference
4 between ordinary income and capital gains when he claims that the ultimate sale of
5 a partner's interest in SFPP is a taxable event – leading us to assume that the tax
6 on the as yet unknown capital gains on the future sale of an interest should be
7 included in the annual cost of service derived tariff rates. This is wrong.

8 If the partner's capital account is zero or negative, it means the partner has
9 recovered all of its capital contribution and any further cash distributions are
10 taxable income. If the partner sold its interest at that point, the entire proceeds of
11 the sale would be capital gains since it had recovered its investment in the
12 partnership. In that case the partner would be subject to the capital gains tax,
13 which is not eligible for inclusion in the cost of service for regulated pipelines.

14 Mr. Hrdlicka's testimony presents an interesting discussion of tax theory.
15 However, he does not discuss in any detail how KMEP goes about calculating the
16 partnership's net income, each partner's capital account, or the partnership's
17 "available cash." These are critical components of determining whether, indeed,
18 cash distributions exceed the partner's contribution so that an actual or potential

1 tax liability may be created. In fact, the K-1 evidence discussed later in my
2 testimony demonstrates that of KMEP's partners, the vast majority has no taxable
3 income and pays no tax.

4 Where the Commission directed that the actual or potential tax liability
5 must be determined on a case by case basis, Mr. Hrdlicka's theoretical testimony
6 sheds no light on whether the partners of KMEP have an actual or potential tax
7 liability. The burden is to establish actual or potential, not theoretical, income tax
8 liability.

9 **Q. Do you agree with Mr. Hrdlicka's proposition that to the extent a partnership**
10 **generates taxable income, the partners, as a group, are subject to tax on that**
11 **income?**

12 A. Only to the extent the partners are actually allocated taxable income from the
13 regulated entity. As I will demonstrate below, all classes of KMEP's limited
14 partners are allocated negative net income, which is not taxable, even though
15 KMEP reported positive taxable income to the IRS. The mere fact that a
16 partnership issues a K-1 to its partners is not sufficient to ascertain whether those
17 partners actually have a tax liability – the content of the K-1 is important, it may
18 show that no taxable income was allocated.

19 Furthermore, the question of how taxable income is calculated is
20 paramount. Here, SFPP's parent organization (KMEP) partnership agreement

1 dictates that gross income flows to the general partner, as a guaranteed payment in
2 compensation for its management services, so that little or no net taxable income is
3 left to allocate out to the limited partners. Hence, they might never become liable
4 for what are up to this point, only potential taxes because they may never receive
5 net income. As a result, I do not recommend building a permanent 35% tax
6 allowance into the cost of service for partners who may never receive taxable net
7 income and, more importantly, whose partnership agreements are designed to
8 avoid them ever receiving taxable income. The stark reality of these structures is
9 revealed in the K-1 forms issued by KMEP to its partners. My analysis of the K-1
10 schedules, discussed more thoroughly below, breaks the data down by class of
11 partner and income brackets to determine whether any net income was in fact
12 allocated to the owners. As seen in my Exhibit No. S-7A, the vast majority of
13 KMEP's owners are allocated no net income.

14 **2) Professor Williamson's Theories**

15 **Q. What did SFPP witness J. Peter Williamson present as evidence to support**
16 **SFPP's burden of establishing the tax status of the owners of the pass-through**
17 **entity?**

18 **A.** In Exhibit No. SFN-17, SFPP cost of capital witness Professor J. Peter Williamson
19 presents an argument that cash distributions from a partnership are not the return
20 of capital but rather taxable income (and, by inference, require a current tax

1 allowance). However, his argument is true only to the extent that cumulative
2 distributions exceed the partner's cumulative capital account. As more fully
3 explained below, the partnership agreement contains special provisions that strive
4 to specifically ensure that the partners' capital accounts are not exceeded by the
5 distributions.

6 **Q. Did any of SFPP's other witnesses disagree with Prof. Williamson's assertion**
7 **that cash distributions are firstly a return on capital?**

8 A. Yes. Mr. Bullock stated in his deposition that cash distributions are considered a
9 return of capital first. (Bullock deposition, page 66, Exhibit No. S-7B)

10 **Q. Prof. Williamson asserts that all cash distributions in excess of a partner's**
11 **contributions are subject to tax; if not in the current tax period then it will be**
12 **when the partner sells its interest in the partnership. Do you agree?**

13 A. It is not clear whether the partner will be liable for tax on its cumulative cash
14 distributions until the facts of each circumstance are examined. It depends on
15 whether the partner's cash distributions have exceeded the partner's capital
16 account. When the capital account is positive, it is difficult to tell whether the
17 partner has recovered all its investment since the capital account includes more
18 than just paid-in capital amounts. It also includes the cumulative net income
19 (gains and losses) allocated to that partner as well as past cash distributions that
20 reduce the account.

1 On the other hand, if the capital account is negative it means the partner has
2 received cash distributions in excess of its investment and cumulative allocated net
3 income. In that event, gains on the sale of the partner's interest in the partnership
4 would constitute neither a return of capital nor a return on capital due to the
5 entity's profitable operations, but rather would constitute a capital gain on the sale
6 of an asset. While one might argue that ratepayers should contribute toward
7 income taxes incurred by an ongoing entity such as a corporation that are a part of
8 doing business, ratepayers should not be held responsible for the capital gains tax
9 generated by the sale of a partner's investment. There is certainly no benefit that
10 inures to the ratepayers as a result of the sale and, as such, ratepayers should not
11 pay for any capital gains tax.

12 More important however, is that the KMEP partnership agreement is
13 structured so that the limited partners are allocated little or no net income,
14 regardless of whatever cash distributions they may be allocated.

15 **3) Mr. Bullock's "Evidence"**

16 **Q. What did SFPP witness Richard Bullock present as evidence to support**
17 **SFPP's burden of establishing the tax status of the owners of the pass-through**
18 **entity?**

19 **A.** In Exhibit No. SFN-3, SFPP tax allowance witness Mr. Bullock makes note of the
20 estimated federal taxable income generated by SFPP, OLP-D, and KMEP. Mr.

1 Bullock also notes the estimated amount of taxable income allocated to the
2 partners of SFPP, OLP-D, and KMEP, and also notes the percentages of ownership
3 by class of owner for KMEP. However, Mr. Bullock stops short of actually
4 recommending that an income tax allowance be included in the cost of service.

5 More importantly, Mr. Bullock's testimony references the details of the
6 partnership agreements relating to cash distributions and taxable income
7 allocations, but then ignores the impact of these provisions on his recommendation
8 regarding the allowance for corporate income taxes. As with Mr. Hrdlicka's
9 testimony, how KMEP goes about calculating net income is a critical component
10 of determining whether, indeed, there is any taxable income upon which KMEP's
11 partners ultimately incur an income tax liability.

12 Further, the amount of estimated taxable income Mr. Bullock claims was
13 allocated to the partners of KMEP does not appear to square with the figures
14 reflected in KMEP's IRS Form 1065 and the summary tables of the K-1 schedules,
15 which report allocated net income to each partner of KMEP. This discrepancy will
16 be discussed in section 4) Actual Tax Liability Evidence.

17

1 **C) SFPP Witness Depositions**

2 **Q. Did the FERC Trial Staff conduct depositions of SFPP’s witnesses in this**
3 **case?**

4 A. Yes, the FERC Trial Staff conducted depositions of SFPP cost of service witnesses
5 Mr. Thomas Turner on Monday, November 28, 2005, SFPP rate of return witness
6 Professor J. Peter Williamson on Tuesday, November 29, 2005, and SFPP tax
7 allowance witness Mr. Richard Bullock on Wednesday, November 30, 2005.

8 **1) Mr. Turner’s Instructions**

9 **Q. Did Mr. Turner comment in his deposition on whether it mattered to his cost**
10 **of service derivation if SFPP actual paid any income tax in 2004?**

11 A. Yes, Mr. Turner was asked if he was concerned during the preparation of his cost
12 of service model about whether SFPP actually paid income taxes in 2004. His
13 response was that as a cost analyst he was not concerned with whether or not SFPP
14 actually had any allocable income in the base period 2004. (Turner Deposition,
15 page 52, Exhibit No. S-7C)

16 Mr. Bennett: {at line 9}

17 Q. Were you at all concerned, as you were preparing your testimony for
18 an income tax allowance in this case for test period 2004 whether SFPP, LP
19 actually had in 2004 any allocable taxable income?

20 Mr. Turner: {at line 25}

21 A. As a cost analyst, no, I would not have been concerned with that.

1 Q. Why not?

2 A. I rely on others to provide me with that information.

3 **Q. Did Mr. Turner comment on whether the Policy Statement affected his**
4 **instructions to use a full income tax allowance in his cost of service model?**

5 A. Yes, Mr. Turner was asked whether his instruction to use a full income tax
6 allowance was affected by the Policy Statement. His reply was that he was not
7 responsible for the decision to use a full income tax allowance in his cost of
8 service. (Turner Deposition, page 54, Exhibit No. S-7D)

9 Mr. Bennett:

10 Q. Did you ever discuss with anyone the instructions you had been
11 given in how the tax policy statement that the Commission issued in or about May
12 of 2005 might have affected those instructions?

13 Mr. Turner:

14 A. I have had conversations with counsel regarding the impact of the
15 policy statement. Although, again, it's not part of my testimony to determine what
16 impact that would be. I would simply, if there were a change necessary that
17 information would have to be provided to me, since I am not the one who is
18 determining the ultimate tax allowance amount.

19 **Q. Did Mr. Turner comment on whether he had conducted any independent**
20 **assessment of whether a full income tax allowance was appropriate for SFPP?**

21 A. Yes, was asked whether there were corporate tax rates other than 35% and why he
22 chose that one. He responded that income levels that would be taxed at the lower
23 tax rates would be very small. (Turner Deposition, page 61, Exhibit No. S-7E)

24 Mr. Bennett:

1 Q. Are there other corporate tax rates than the 35 percent rate?

2 Mr. Turner:

3 A. Well, there would be, depending on the level of income, taxable
4 income of a corporation.

5 Q. So why did you pick 35 percent then? As opposed to some other tax
6 rate for corporations?

7 A. Well, it's – I mean, the levels of income applicable to lower tax
8 rates, very small. 35 percent is or has been a standard application in FERC
9 proceedings for a full income tax allowance.

10 Mr. Turner's response indicates that he is unaware that the vast majority of
11 KMEP's partners, upon whom the determination of SFPP tax allowance depends,
12 receive little or no taxable income⁸, and consequently are subject to no actual
13 income tax, corporate or otherwise. The fact that other tax rates only apply to very
14 small income levels is actually quite on point in determining what average income
15 tax allowance to incorporate into the SFPP cost of service – KMEP's partners
16 receive very small levels of income from KMEP.

17 **2) Mr. Bullock's Admissions**

18 **Q. Did Mr. Bullock confirm that he included in his evidentiary presentation**
19 **actual 2004 federal income tax returns for SFPP, OLP-D, and KMEP, as**
20 **evidence of actual tax liability in this proceeding?**

21 A. No, to the contrary, Mr. Bullock confirmed that his direct testimony, Exhibit No.
22 SFN-3, and supporting documents, Exhibit Nos. SFN-4 through 14, did not include

⁸ More often than not, they receive negative net income.

1 actual 2004 federal income tax returns. (Bullock Deposition, page 40, Exhibit No.
2 S-7F)

3 **Q. What do you conclude at this point?**

4 A. SFPP cannot argue that it has met its burden to establish the actual or potential tax
5 liability of the partners – it didn't provide any evidence one way or another. The
6 Commission's Policy Statement was issued on May 4, 2005, in response to the
7 Remand from the Court of Appeals of Commission Opinion issued in an earlier
8 SFPP proceeding, and SFPP filed a Brief on Compliance with the Policy Statement
9 on June 16, 2005. I assume SFPP was aware of the requirements of the Policy
10 Statement when it filed its direct testimony on August 26, 2005 and yet it offered
11 no evidence to support its case seeking a full income tax allowance in the cost of
12 service.

13 **Q. Did Mr. Bullock address the question of whether tax liability follows whether**
14 **or not actual taxes are paid?**

15 A. Yes, SFPP witness Mr. Bullock, the Chief Tax Officer for KMEP, noted in his
16 deposition that if actual taxes are not paid, there is no tax liability. (Bullock
17 Deposition, page 37, Exhibit No. S-7G)

18 Mr. Bennett:

19 Q. I understand. I'm trying to figure out with respect to tax liability and
20 when it triggers. If a taxpayer files a return and the return shows no taxes due, has
21 tax liability been triggered?

22 Mr. Bullock:

1 A. Well, I'm having a little difficulty differentiating between liability
2 and actual tax paid because what I'm hearing the question to be is if there's no tax,
3 then there is a liability.

4 There can be - - there may be no liability because you have
5 aggregated many components of items that are required to be reported. If the
6 question is do you have liability and there is no tax paid, I would say that the
7 answer is no.

8 Q. Is it also no to the question after you've aggregated all of these tax
9 items, there is no tax owed, then tax liability has not triggered?

10 A. For that particular tax payer, right.

11 **Q. Since the question of how taxable net income is calculated and then allocated**
12 **depends in this proceeding almost entirely on the provisions of the KMEP**
13 **partnership agreement, was Mr. Bullock able to answer Staff's questions**
14 **about the details of the agreement?**

15 A. No. While Mr. Bullock showed some familiarity with the cash distribution sections
16 of the KMEP partnership agreement, Mr. Bullock did not appear at all familiar
17 with the provisions in the KMEP partnership agreement that dictate the allocation
18 of taxable income. Mr. Bullock's statement that no one else within the KMEP
19 organization would have a better understanding than he raises a question of how
20 we can have any certainty in assigning cost responsibility for potential income tax
21 liability if the chief tax officer is uncertain of how that taxable income is derived
22 and allocated. (Bullock Deposition, page 43, Exhibit No. S-7H)

23 Mr. Bennett: {at page 43}

24 Q. I want to ask you some questions now about the KMEP partnership
25 agreement, which attached to your testimony as Exhibit No. SFN-5. If you'll turn

1 to your Exhibit No. SFN-5, starting at line 31. Let me ask you generally, Mr.
2 Bullock, are you familiar with Exhibit No. SFN-5?

3 Mr. Bullock:

4 A. Yes I'm familiar with the document.

5 Q. If you will look on page 31 at article 5 called "allocations and
6 distributions," do you see that?

7 A. Yes.

8 *** {on page 46}

9 Q. Can you just tell me generally what the purpose is of the special
10 allocations of section 5.1(d) is just as an expert to a layman? Could you tell me
11 generally what the purpose of those special allocations is?

12 A. Actually, I would need to do some reading and some studying and
13 some research to be able to explain that.

14 Q. Also with respect to 5.1(d)(iii), priority allocations, can you tell me
15 generally what priority allocations are as an expert to a layperson in this SFN-5?

16 A. That's going to take some study to do that.

17 Q. With respect to page 36, if you look at the section called "curative
18 allocations," it is 5.1(d)(x). "Curative allocation," do you see that?

19 A. Yes.

20 Could you explain to me, as an expert to a layperson, what curative allocations are
21 about in Exhibit No. SFN-5?

22 A. Again, I think that would take quite a bit of reading and work.

23 *** {on page 51}

24 Q. Is there anybody that you know of, other than counsel, who is at
25 KMI now who might have a more in depth understanding of SFN-5 than me or
26 you?

27 A. I would say probably not.

28 **Q. Did Mr. Bullock address the question of whether gross income allocations to**
29 **the general partner could result in negative taxable income to limited**
30 **partners?**

1 A. Yes, Mr. Bullock was asked about the KMEP partnership agreement incentive
2 allocations and the associated gross income allocations (these details from the
3 partnership agreement are discussed more fully in my testimony in Part III). He
4 agreed that if the general partner is allocated gross income, there will be less
5 taxable net income to allocate among the limited partners and that limited partners
6 could be allocated negative income because of those provisions. (Bullock
7 Deposition, page 53, Exhibit No. S-7H)

8 Mr. Bennett:

9 Q. Is it possible, then, that because of that shifting of allocable taxable
10 income from gross income to the general partner and away from the other partners
11 in the partnership, that a situation could arise in which the limited partners for
12 some tax year, say 2004, are allocated a negative taxable income?

13 Mr. Bullock:

14 A. Yes, that's possible.

15 The fact that gross income is allocated to the general partner, KMGP, regardless of
16 the effect on the net income to be allocated to the partners, and, which in fact, can
17 shift the partnership from a positive net income status to a negative net income
18 status vis-à-vis the partnership allocations to limited partners, indicates that
19 §5.1(d)(iii) is a guaranteed payment mechanism to the general partner as a
20 manager rather than a return on capital to the general partner as an owner.

21

1 **Q. Did Mr. Bullock address the question of why KMEP would make gross**
2 **income allocations to limited partners?**

3 A. Yes. Mr. Bullock was asked why the KMEP partnership agreement provides in
4 §5.1(d)(v) that gross income allocations will be made to limited partners in the
5 event a limited partner has a deficit balance in its adjusted capital account. He did
6 not know. (Bullock Deposition, page 50, Exhibit No. S-7H)

7 Mr. Bennett: {after having §5.1(d)(v) read into the record}

8 Q. Can you tell me the purpose of this provision?

9 Mr. Bullock:

10 A. Not without some research.

11 Q. You mean from the language itself, you can't tell me?

12 A. Right.

13 Q. From what you now about Kinder Morgan operation, you can't tell
14 me?

15 A. No.

16 Q. What you understand about the Kinder Morgan operations as chief
17 tax officer, you can't tell me?

18 A. Right.

19 Inasmuch as allocations from gross income will have a direct effect on net taxable
20 income, §5.1(d)(v) could have important consequences. The assertion by Mr.

21 Hrdlicka and Prof. Williamson that net income is allocated on a pro rata basis in

22 accordance with` the partner's interests is questionable at best if some partners are

23 being allocated gross income prior to the calculation of net taxable income. If the

24 chief tax officer does not know how taxable income is calculated, the

1 establishment of any income tax liability by SFPP would appear to be speculative
2 at best.

3 **Q. Did Mr. Bullock address the question of whether KMEP would make gross**
4 **income allocations to limited partners pursuant to §5.19d(v)?**

5 A. Mr. Bullock was asked whether KMEP would act quickly pursuant to §5.1(d)(v)
6 to raise a limited partner's capital account to ensure it would not fall below zero
7 due to the gross income allocations to the general partner. He did not know.
8 (Bullock Deposition, page 57, Exhibit No. S-7J)

9 **Q. Did Mr. Bullock address the question of how the KMEP board of directors**
10 **makes income allocation decisions?**

11 A. Yes, Mr. Bullock was asked about how the board of directors makes decisions on
12 quarterly cash distributions and about how they make quarterly income allocations
13 decisions. (Bullock Deposition, page 62, Exhibit No. S-7K)

14 Mr. Bennett:

15 Q. Do you know upon what basis the board of directors makes its
16 determination quarterly {of cash distribution}?

17 Mr. Bullock:

18 A. Well, it's going to be based on the results of that have been achieved
19 in that quarter. The partnership agreement defines cash from operations and
20 provides for the distribution of cash from operations.

21 Q. Do you know whether the board of directors similarly makes
22 quarterly decisions about the allocation of taxable income?

23 A. No. The board doesn't make any decisions regarding the allocation
24 of taxable income. That's done pursuant to the partnership agreement.

1 It would appear that the income allocation provisions, about which Mr. Bullock
2 would need to do “some reading and some studying and some research,” (Bullock
3 Deposition at page 46) are an automatic mechanism in which the KMEP board of
4 directors has very little say. Here again, it is apparent that the gross income
5 allocation to KMGP as a management incentive, which takes place prior to any
6 assessment of its effect on the taxable net income to be allocated to the limited
7 partners, is a guaranteed payment that takes place without regard to the general
8 income of the organization.

9 **Q. Did Mr. Bullock comment on the question of whether cash distributions are a**
10 **return of capital or a return on capital??**

11 A. Yes, Mr. Bullock was asked in his deposition about the effect of cash distributions
12 on a partner’s capital account. He confirmed that cash distributions are a reduction
13 in the partner’s capital account and are considered to be a return of capital,
14 contrary to Prof. Williamson’s assertion. (Bullock deposition, page 66, Exhibit No.
15 S-7B)

16 Mr. Bennett:

17 Q, What is the effect of a cash distribution on the capital account of
18 limited partners?

19 Mr. Bullock:

20 A. Cash distribution will reduce the capital account of a partner.

21 Q. Is that a way of giving back to the limited partner the capital they
22 contributed into the partnership?

1 A. Well, distributions are first considered to be a return of capital.

2 Q. Sorry. I didn't hear that?

3 A. The distributions are considered first to be a return of capital.

4 As a return of capital first, the partner's capital account becomes depleted of the
5 partner's capital contribution before any cash distributions would be considered
6 ordinary income, contrary to what Prof. Williamson and Mr. Hrdlicka argued.

7 **III Even If SFPP Has Not Met Its Burden, Is There a *Potential Income***
8 **Tax Liability on the Part of SFPP's Ultimate Owners Nonetheless?**

9 **A) Trial Staff Investigation into Potential Tax Liability**

10 **1) Definition of Terms**

11 **Q. What are cash distributions?**

12 A. Cash distributions are disbursements of cash to the partners of a partnership. The
13 term cash distribution is not synonymous with the terms gross income allocation,
14 net income allocation, gross income, taxable income, or net income. Cash from
15 entity operations comes from revenues received for goods or services rendered,
16 debt acquired, or capital contributed. Cash is an asset on the entity's balance sheet
17 but does not play a role in determining income, net income, or taxable income as
18 calculated on the entity's income statement. Cash may be used to pay operating

1 expenses, retire debt, acquire plant and equipment, return of capital to investors, or
2 simply to distribute to investors.

3 In relation to the discussion below, cash distributions may be thought of as
4 a payment to the partner representing some combination of return of capital and
5 return on capital. In other words, a partner's capital account represents, in a sense,
6 the partnership's IOU to the partner for the partner's investment in the entity and
7 for the partner's allocated net income. Cash distributions are the payment of that
8 IOU, which may be distributed to the partner in a manner wholly unrelated to the
9 timing of net income allocations.

10 **Q. What are incentive distributions?**

11 A. Incentive distributions are quarterly cash distributions made to the general partner
12 in excess of 1% of the total amount distributed pursuant to the target distributions
13 for that quarter. SFPP witness Mr. Bullock explains in Exhibit No. SFN-3, page
14 23, line 8, that incentive distributions "reward the general partner for effectively
15 managing the partnership operations and producing greater amounts of cash from
16 operations for distributions to all partners excluding partners owning i-units."

17 **Q. What is gross income?**

18 A. Gross income, as defined by the Code of Federal Regulations 26 CFR §1.61, is the
19 total income from all sources including income realized in any form whether in

1 money, property, stocks, or services. It should be noted that gross income does not
2 include the return of capital ⁹

3 **Q. What is net income?**

4 A. Net income is a defined term in the KMEP partnership agreement, Exhibit No.
5 SFN-5, page 18. In pertinent part it reads:

6 “Net Income” means for any taxable period, the excess, if any, of the
7 Partnership’s items of income and gain...for such taxable period
8 over the Partnership’s items of loss and deduction...for such taxable
9 period. The items included in the calculation of Net Income shall be
10 determined in accordance with Section 4.3(b) and shall not include
11 any items specially allocated under Section 5.1(d).¹⁰

12 In relation to the discussion below, net income may be thought of as an IOU to the
13 partner representing the partner’s share of return on capital. The partner’s capital
14 account will include the net income IOU and an IOU to the partner for the
15 partner’s investment in the entity. Cash distributions are the payment of that IOU,
16 which may be distributed to the partner in a manner wholly unrelated to the timing
17 of net income allocations.

18

19

⁹ Federal Tax Course 2004, CCH Incorporated, Chicago, IL at ¶ 401

¹⁰ §4.3(b) lists several categories of income, gain, loss or deduction that may be deducted from a partner’s capital account.

1 **Q. What is taxable income?**

2 A. Taxable income is the amount of net income subject to income tax. The
3 Code of Federal Regulations 26 CFR §1.703-1 provides that partnership
4 taxable income shall be computed in the same manner as the taxable income
5 for an individual. Taxable income may differ from net income by the
6 amount of expenses that are not deductible for federal income tax purposes.

7 **Q. What is a guaranteed payment?**

8 A. The Code of Federal regulations 26 CFR §1.707-1(c), reproduced in Exhibit
9 No. S-7L, defines guaranteed payments as fixed amounts paid to partners
10 for services or for the use of capital without regard to the income of the
11 partnership. They are treated the same as payments to an outsider for
12 purposes of computing gross income and business expense deductions.¹¹
13 As it relates to a regulated entity, a guaranteed payment should have some
14 causal relationship to the cost of providing services to ratepayers for that
15 guaranteed payment to be incorporated into the cost of service directly or
16 indirectly.

17

¹¹ Federal Tax Course 2004, CCH Incorporated, Chicago, IL, at ¶ 1923.

1 **2) SFPP Organizational Structure**

2 **Q. What is the organizational structure of SFPP and its parent organizations?**

3 A. SFPP is a limited partnership (LP) that is part of a conglomerate of companies and
4 partnerships that operate under the umbrella of Kinder Morgan Energy Partners,
5 L.P., which is also a limited partnership operating under IRS provisions as a
6 master limited partnership. SFPP is owned by Santa Fe Pacific Pipeline, Inc.
7 (Santa Fe) (0.5% interest) and general partner Kinder Morgan Operating L.P. “D”
8 (99.5% interest). Santa Fe Pacific Pipeline, Inc. is a corporation wholly owned by
9 Burlington Northern Industries.

10 Kinder Morgan Operating L.P. “D” (OLP-D) is one of six entities that
11 appear to be, in effect, operating umbrellas for numerous limited liability
12 corporations, limited partnerships, companies, and corporations engaged in various
13 aspects of the energy industry. OLP-D is owned by Kinder Morgan Energy
14 Partners, LP (98.98% interest) and general partner Kinder Morgan GP, Inc. (1.01%
15 interest).

16 Kinder Morgan Energy Partners, LP (KMEP) is a limited partnership owned
17 by numerous persons and entities (99%) and general partner Kinder Morgan G.P.,
18 Inc. (1%). Ownership of KMEP is conferred in the form of “common units,”

1 “Class B” units, and “i-units.” In addition to its 1% interest as the general partner,
2 Kinder Morgan G.P also owns common unit interests and two i-unit interests in
3 KMEP. KMEP is managed by Kinder Morgan Management, LLC, (KMR) which
4 owns approximately 25% of KMEP in the form of i-units. KMR is wholly owned
5 by Kinder Morgan G.P., Inc.

6 *Kinder Morgan G.P., Inc.* (KMGP), a subchapter C corporation, is the
7 general partner in KMEP and is wholly owned by Kinder Morgan (Delaware), Inc.,
8 a subchapter C corporation, which, in turn, is wholly owned by Kinder Morgan,
9 Inc. (KMI), also a subchapter C corporation. KMGP is also the general partner in
10 OLP-D.

11 The full chart of affiliated organizations can be found in Mr. Matthew
12 O’Loughlin’s Exhibit No. CCV-28, and a simplified organization chart can be
13 found in Mr. Bullock’s Exhibit No SFN-4.

14 **Q. What are i-units?**

15 A. I-units are a form of ownership interest in limited partnerships that confer payment
16 of cash distributions in the form of more i-units rather than cash. I-units receive no
17 allocation of taxable income or cash distributions. Taxable income is allocated
18 only to the general partner and limited partners owning common units or Class B

1 units. I-units do have voting rights equal to those of common units, which appears
2 to be the sole purpose of i-units.

3 **Q. What types of organizations make up the limited partners of KMEP?**

4 A. SFPP witness Mr. Richard Bullock provided a list of the types of entities that have
5 an ownership interest in KMEP in Exhibit No. SFN-14. He included individuals,
6 corporations, partnerships, estates, trusts, foreign citizens, “others”, exempt
7 organizations, IRA/SEP/Keogh, pension plans, and a clearing entity. I will discuss
8 these later in my recommendation regarding the level of actual tax liability for
9 SFPP’s partners.

10 **3) Partnership Agreements**

11 **Q. How should we go about determining the potential tax status of the owners of**
12 **the pass-through entities?**

13 A. The potential tax liability of the ultimate owners of SFPP is determined by the
14 taxable net income allocated to those individual partners. The determination of
15 how net income is allocated rests within the partnership agreements that spell out
16 the partnership calculation of net income, net income allocations, and cash
17 distributions.

18

1 **ii) Cash Distributions v Income Allocations**

2 **Q. What is the difference between cash distributions and income allocations?**

3 A. Cash distributions are the flow through of available cash from operations from the
4 enterprise to the partners, irrespective of the profitability of the enterprise. In
5 general, the costs of operating the enterprise will draw down cash as debts are
6 paid, labor is paid, vendors are paid, and taxes are paid. Non-monetary costs, such
7 as depreciation, return on equity, and, for partnerships, income taxes will leave the
8 cash balance untouched. Net income allocations are the assignments of
9 profitability to the partners after the costs of operating the enterprise are
10 subtracted, akin to an IOU, promised and registered in the partner’s capital account
11 but not necessarily paid right away. Net income can only be allocated if there is
12 some measure of net income left after costs are extracted. Allocations of gross
13 income are more like payment of operating costs than measures of profitability.

14 **iii) SFPP & OLP-D Partnership Agreements**

15 **Q. The partnership agreement between OLP-D and Santa Fe creating the SFPP**
16 **partnership contains Article V - Allocations and Distributions. Please**
17 **summarize Sections 5.1(a) and 5.1(b).**

18 A. Article V of the partnership agreement (Exhibit No. SFN-11) between OLP-D and
19 Santa Fe specifies how net income shall be allocated among the partners. Section
20 5.1(a) specifies that net income goes first to the general partner to make up for any

1 current or past losses allocated to the general partner, and then the remainder is
2 allocated to the general and limited partners according to their respective interest
3 percentages. Section 5.1(b) specifies that net losses are allocated to the individual
4 partners in accordance with their respective interest percentages, with the
5 exception that any allocation that would otherwise place a particular partner's
6 capital account into a deficit is instead allocated to the general partner. This means
7 that net income allocations that would cause an individual limited partner's capital
8 account to become negative and thus make its cash distributions taxable income,
9 are unlikely to occur.

10 **Q. Are there any incentive distribution or other special considerations for the**
11 **general partner in the SFPP partnership agreement?**

12 A. I am not aware of any special considerations for the general partner in the SFPP
13 partnership agreement other than the ability to be made whole for previous losses
14 allocated to the general partner.

15 **Q. Are there any cash distribution provisions in the SFPP partnership**
16 **agreement?**

17 A. Yes, §5.3, referring to cash distributions rather than net income allocations,
18 specifies that within 45 days of the end of each calendar quarter, 100% of the
19 available cash will be distributed in accordance with the relative interest
20 percentages of each partner.

1 **Q. The partnership agreement between Kinder Morgan G. P., Inc. and Kinder**
2 **Morgan Energy Partners, L.P. creating the OLP-D partnership contains**
3 **Article V - Allocations and Distributions. Please summarize Sections 5.1(a)**
4 **and 5.1(b).**

5 A. Similar to Article V of the SFPP partnership agreement, Article V of the OLP-D
6 Partnership agreement (Exhibit No. SFN-12) between KMEP and KMGP specifies
7 how net income shall be allocated among the partners. Section 5.1(a) specifies
8 that net income goes first to the general partner to make up for any current or past
9 losses allocated to the general partner, and then the remainder is allocated to the
10 partners according to their respective interest percentages. Section 5.1(b) specifies
11 that net losses are allocated to the partners in accordance with their respective
12 interest percentage, with the exception that any allocation that would otherwise
13 take a partner's capital account into a deficit is instead allocated to the general
14 partner. This means that net income allocations that would cause an individual
15 partner's capital account to become negative and thus make its cash distributions
16 taxable income, are not likely to occur.

17 **Q. Are there any incentive distribution or other special considerations for the**
18 **general partner in the OLP-D partnership agreement?**

19 A. I am not aware of any special considerations for the general partner in the OLP-D
20 partnership agreement other than the ability to be made whole for previous losses
21 allocated to the general partner.

1 **Q. Are there any cash distribution provisions in the OLP-D partnership**
2 **agreement?**

3 A. Yes, §5.3, referring to cash distributions rather than net income allocations,
4 specifies that within 45 days of the end of each calendar quarter, 100% of the
5 available cash will be distributed in accordance with the relative interest
6 percentages of each partner.

7 **Q. What do the net income allocation provisions contained in the SFPP and**
8 **OLP-D partnership agreements indicate in regard to net income derived from**
9 **SFPP operations?**

10 A. The SFPP and OLP-D partnership agreements indicate that all available cash and
11 net income flow through these entities to the parent organizations. This is
12 confirmed in Mr. Bullock’s testimony in Exhibit No. SFN-3, at page 24.

13 **iv) KMEP Income Allocation Provisions**

14 **Q. The partnership agreement between Kinder Morgan G. P., Inc. and the**
15 **limited partners creating the KMEP partnership also contains an Article V -**
16 **Allocations and Distributions. Please summarize the income allocation**
17 **portions in §5.1(a) and (b) of this section.**

18 A. Article V of the partnership agreement (Exhibit No. SFN-5) between KMGP and
19 “persons who become partners” specifies how net income shall be allocated among
20 the partners. This Article V departs substantially from the net income allocations
21 provisions discussed earlier in the other partnership agreements. Where the earlier
22 agreements provided for a straightforward flow through of net income to the

1 partners on a pro rata basis, the KMEP partnership agreement requires that, first,
2 the general partner be made whole for any past net income losses before the
3 limited partners are allocated any net income, second, the limited partner will be
4 made whole for any net income losses allocated to them, then the remaining
5 income will be allocated on a pro-rata basis.

6 Section 5.1(a)(i) specifies that until the general partner is made whole for
7 past losses, net income shall be allocated 100% to the general partner to make up
8 for any current or past losses allocated to the general partner. Section 5.1(a)(ii)
9 specifies that until the limited partners are made whole for past losses, further net
10 income shall be allocated 99% to the limited partners holding common units and
11 Class B Units and 1% to the general partner. Section 5.1(a)(iii) specifies that with
12 respect to any further income after losses are recovered, income will be allocated
13 99% to the limited partners and 1% to the general partner.

14 Section 5.1(b)(i) specifies that 99% of net losses are allocated to the limited
15 partners holding common units and Class B Units on a pro rata basis, and 1% to
16 the general partner until the aggregate net losses for the current and previous years
17 are equal to the aggregate net income from the current and previous years. Section
18 5.1(b)(ii) specifies that net losses will not be allocated to partners who would then
19 fall into a deficit in their capital account. Section 5.1(b)(iii) specifies that any

1 further losses be allocated to the general partner, i.e., the amount that would
2 otherwise be allocated to limited partners.

3 **Q. Doesn't Section 5.1(a) of the KMEP partnership agreement support SFPP's**
4 **contention that income is allocated to all partners in proportion to their**
5 **ownership interest?**

6 A. No, just the opposite. Section 5.1(a) stipulates that net income will be allocated
7 disproportionately until, first, the general partner and then, second, various limited
8 partners are made whole for past losses. Furthermore, the first sentence in §5.1 of
9 the KMEP partnership agreement states that it takes effect only *after* the special
10 allocations of §5.1(d). Section 5.1(d) is labeled "Special Allocations" and contains
11 §5.1(d)(iii) labeled "Priority Allocations." The second paragraph of §5.1(d)(iii)
12 provides that gross income shall be allocated 100% to the general partner until the
13 aggregate amount is equal to the aggregate amount of all incentive distributions
14 made to the general partner. I will discuss incentive distributions below.

15 **Q. What is the importance of §5.1(d)(iii) as it relates to income tax liability?**

16 A. The importance of §5.1(d)(iii) is that it references gross income rather than net
17 income. In other words, KMGP is allocated a major share of income off the top,
18 leaving the others to share the net income, of which KMGP also takes 1% pursuant
19 to §5.1(a). Section 5.1(a) and (b) specify how the net income will be allocated
20 among partners on a pro rata basis. This is an important distinction because net

1 income is the amount upon which tax liability is determined. KMGP's priority
2 allocation of a portion of gross income is, in effect, the means of recovering its
3 cost of managing the partnership, and therefore is a deduction from KMEP's gross
4 income in arriving at KMEP's net income for tax purposes. In fact, the KMEP
5 partnership agreement makes just that point, as noted earlier. Net income shall be
6 determined in accordance with Section 4.3(b) and shall not include any items
7 specially allocated under Section 5.1(d), such as the allocation to KMGP

8 The important point here is that the broad generalization that income is
9 allocated in proportion to the partner's interests should not lead us to believe that
10 all allocated income is taxable income and that therefore SFPP, via KMEP, should
11 be allowed a 35% tax allowance on all income. A very large proportion of
12 KMEP's income is drawn off in advance to compensate its general partner for
13 management services and, as such, is not taxable income but rather is considered a
14 cost of doing business, which should be deducted before tax liabilities are
15 calculated.

16 **Q. In your opinion, does the gross income allocation to KMGP from KMEP**
17 **pursuant to §5.1(d)(iii) qualify as a “guaranteed payment” as defined by the**
18 **IRS Code 1.707-1(c)?**

19 **A.** Yes. According to the definition of a guaranteed payment, as noted earlier, it is for
20 fixed amounts paid to partners for services or for the use of capital *without regard*

1 *to the income of the partnership.* The KMEP partnership agreement clearly states
2 that the gross income allocation to KMGP happens prior to any net income
3 allocation to the limited partners. The agreement also specifies that net income
4 does not include any items allocated under §5.1(d). Net income is the amount of
5 money earned from the provision of goods or services by an enterprise in excess of
6 the capital it took to acquire the means of producing those goods or services, and
7 the cost of operations to render the goods or services to the customers. Gross
8 income is the amount of money available prior to the subtraction of the costs of
9 operations. Since the return of capital is not an “earning” it is excluded from
10 income calculations.

11 In regard to the KMEP derivation of net income, net income is what
12 remains after four basic categories of cost are removed from gross income: debt
13 costs, operating costs, the guaranteed payment to KMGP, and the gross income
14 allocation in §5.1(d)(v) to limited partners who may otherwise experience negative
15 capital accounts. The fact that KMEP’s limited partners are allocated negative net
16 income on their K-1 forms (see part IV, section iii of my testimony) indicates that
17 the gross income allocation to KMGP happens without regard to the income of the
18 partnership and is not the proceeds of profitability of the partnership but a cost to
19 the partnership. The allocation should, therefore, be treated the same as payments

1 to an outsider for purposes of computing gross income and business expense
2 deductions.

3 **Q. Assuming for the moment that the gross income allocation to KMGP were an**
4 **allocation of KMEP's taxable income, rather than gross income, why should it**
5 **not be incorporated into the assessment of income tax liability imputed to**
6 **SFPP ratepayers?**

7 A. The incorporation of KMEP's gross income allocations to its general partner,
8 KMGP, into the assessment of whether SFPP's ratepayers are responsible for an
9 income tax allowance to cover a potential income tax liability on the part of KMEP
10 partners ignores an important principle: that of cost causation/cost responsibility.
11 The principle of cost causation/cost responsibility cautions us to ascertain whether
12 the cost was incurred for something of value to the ratepayers and whether that
13 payment was within some band of reasonable compensation for the good or service
14 rendered. Here, KMGP's gross income allocation takes place regardless of the
15 ability of KMEP to meet its obligations. In fact, the 2004 KMEP Form 1065
16 indicates that the payment to KMGP caused all other partners of KMEP to suffer a
17 negative net income. (see Exhibit No. S-7M)

18 **Q. Mr. Hrdlicka postulates (Exhibit No. SFN-15, Page 4, line 14) that "a**
19 **partnership's taxable income or taxable loss is allocated to the partners on an**
20 **annual basis in accordance with their 'distributive shares' as determined by**
21 **the partnership agreement." Does the KMEP Partnership Agreement**
22 **allocate taxable income to its partners on a distributive shares basis?**

1 A. The partnership agreement does not refer to the term “taxable income,” so it is
2 difficult to determine if taxable income is distributed in accordance with
3 distributive shares or any other basis. Nevertheless, “distributive shares” is not
4 defined in the partnership agreement so it is not clear what Mr. Hrdlicka is
5 referring to when he uses that term. However, it is clear from the language of the
6 partnership, as discussed above, that net income will be allocated
7 disproportionately until the general partner and various limited partners are made
8 whole for past losses.

9 Leaving that aside, §5.1(a) and (b) provide for the allocation of net income,
10 §5.1(d)(iii) provides for the allocation of gross income. I could find no discussion
11 in the agreement that indicates out how these gross income allocations affect
12 KMEP’s net income, let alone what KMEP reports for tax purposes regarding the
13 gross income allocation to KMGP. Further, cash distributions, as spelled out in
14 §5.4, are clearly not distributed in proportion to the ownership interests in the
15 partnership, and those distributions determine the allocation of gross income to the
16 general partner. As noted earlier, §5.1(a) and 5.1(b) specifically allocate net
17 income disproportionately, first, to the general partner and then, secondly, to
18 various limited partners until they are made whole for past losses, and, thirdly, to
19 all limited partners in accordance with their partnership interests. So clearly, the

1 answer is that taxable income is not distributed in a proportionate basis according
2 to partnership interests.

3 **Q. Is the gross income that KMGP receives from KMEP pursuant to §5.1(d)(iii)**
4 **an amount upon which KMEP should collect taxes through SFPP ratepayers?**

5 A. No. Income tax expenses should only be collected to cover taxes payable on
6 taxable income, which is only calculated after gross income is allocated to KMGP,
7 just as operating costs are deducted from gross income before taxes are levied.

8 The gross income allocation of §5.1(d)(iii) from KMEP to KMGP is a guaranteed
9 payment tied to the incentive cash distribution of §5.4(c), (d), and (e). It is a cost
10 of doing business for KMEP, not a profit to KMEP; nor is it part of KMEP's net
11 income.

12 KMGP's earnings from its ownership in KMEP (as opposed to its incentive
13 distribution and gross income allocation compensation for management services),
14 upon which taxes might properly be collected in the cost of service, should
15 represent no more than its net income allocation pursuant to §5.1(a) of the
16 partnership agreement. That is to say, KMGP's allocated taxable income from
17 KMEP should be no more than the 1% of KMEP's net income as specified in
18 §5.1(a).

1 **Q. Are SFPP's ratepayers are now contributing to the gross income that KMGP**
2 **receives from KMEP pursuant to §5.1(d)(iii) through SFPP's income tax**
3 **allowance?**

4 A. It appears to be. SFPP's tariff rates incorporate a 35% tax allowance, 95% of
5 which also flows through to KMEP and, one must assume, is part of the gross
6 income allocation to KMGP pursuant to §5.1(d)(iii).

7 **Q. Is there an actual or potential tax liability associated with this income?**

8 A. To the extent that these amounts are not net income for KMEP, there is no tax
9 liability potential for KMEP and no tax allowance should be incorporated into
10 SFPP's tariff rates to provide for tax purposes on that gross income.

11 **v) KMEP Cash Distribution Provisions**

12 **Q. Why is cash distribution an important issue in this case?**

13 A. Cash distributions are important in that they are the basis upon which gross income
14 is allocated to the general partner, and they thereby directly affect the level of
15 taxable net income allocated to the limited partners. The gross income allocation
16 to the general partner is tied to the incentive cash distribution to the general
17 partner, discussed below. The partnership agreement does not provide for any
18 discretion in determining the amount of the cash distribution or the gross income
19 allocation, which, in effect, renders them guaranteed payments to the general
20 partner.

1 We should keep in mind that net income allocations to the limited partners
2 are not like getting a check in the mail, it is more like an IOU upon which you may
3 or may not have to pay taxes. The cash distribution is, in a sense, the payment of
4 that IOU, the timing of which is unrelated to the timing of the net income
5 allocation itself.

6 **Q. What does the KMEP partnership agreement provide in regard to how cash**
7 **distributions will be made among partners?**

8 A. Section 5.4 of the KMEP partnership agreement (Exhibit No. SFN-5) specifies
9 how cash distributions will be made. Distributions are made on a quarterly basis
10 based on Minimum Quarterly Distributions and targeted distributions as illustrated
11 in Table 1 below.

1

Table 1 – Incentive Distributions			
§		Target Distribution	Cash Distribution Mechanism under §5.4
§5.4(a)	Minimum Quarterly Distribution	\$0.2750/ Limited Partner Unit	99% to Limited Partners & 1% to General Partner up to the Minimum Quarterly Distribution
§5.4(b)	First Target Distribution	\$0.3025/ Limited Partner Unit	99% to Limited Partners & 1% to General Partners for any excess cash over the Minimum up to the First Target
§5.5(c)	Second Target Distribution	\$0.3575/ Limited Partner Unit	85.87% to Limited Partners & 14.13% to General Partner for any excess cash over the First Target up to the Second Target
§5.4(d)	Third Target Distribution	\$0.4675/ Limited Partner Unit	75.76% to Limited Partners & 24.23% to General Partner for any excess cash over the Second Target up to the Third Target
§5.4(e)			50.51% to Limited Partners & 49.49% to General Partner for any excess cash over the Third Target

2 The distribution mechanism requires that all “available cash” from operations will
3 be distributed to the partners on a pro rata basis until the available cash equals
4 \$0.3025 per unit of interest. Thereafter the cash distribution to the general partner,
5 KMGP, increases dramatically from 1% to 14.13%, then to 24.23%, and finally to
6 49.49%. To the extent these escalating distributions to the general partner exceed
7 1% of the aggregate cash being distributed pursuant to these sections, they are
8 called Incentive Distributions and are used as the base upon which Priority

1 Allocations are made under §5.1(d)(iii), i.e., gross income is allocated to the
2 general partner in an amount equal to the incentive distributions.

3 **Q. What are capital accounts and how do they figure into this discussion?**

4 A. Capital accounts are the measure of each partner's tax basis in the partnership, the
5 net amount by which they are "vested" in the entity. Section 4.3 of the partnership
6 agreement provides that each partner's capital account will be increased by its
7 capital contributions and allocated net income, and decreased by its cash
8 distributions and partnership deductions. The balance in the capital accounts is
9 used to determine whether cash distributions are taxable income in any given tax
10 period. According to the Coalition of Publicly Traded Partnerships
11 (www.ptpcoalition.org), cash distributions are only taxable to the extent the
12 distribution exceeds the capital account. Cash distributions in excess of a partner's
13 capital account signify that it has recovered its capital contribution and the
14 partner's cash distributions have caught up with its allocated net income, which
15 makes the cash distribution more taxable income to the partner.

16 **Q. Are KMEP's partners likely to find their capital accounts negative?**

17 A. No. KMEP's partnership agreement contains a provision that strives to ensure that
18 partners' capital accounts remain positive so that distributions remain non-taxable
19 in the current tax period. Section 5.1(d)(v) provides that any partner's capital
20 account that would otherwise have a deficit balance at the end of the taxable

1 period (and thus have its cash distribution become taxable income) will receive a
2 gross income allocation as quickly as possible to make up the deficit.

3 **Q. How are i-units treated in regard to the cash distributions?**

4 A. As I noted earlier in my testimony, i-units are not eligible for cash distributions or
5 net income allocations. Distributions that would otherwise be made to an i-unit
6 holder are instead made in the form of more i-units pursuant to §5.7 of the KMGP
7 partnership agreement. The purpose of i-units appears to be that they hold voting
8 rights for KMR, the managing entity that operates KMGP for KMGP, the general
9 partner.

10 **IV) Actual Tax Liability Evidence**

11 **Q. Assuming there is taxable income to a person or entity, what are the**
12 **associated income brackets and federal tax percentages that determine actual**
13 **tax payments?**

14 A. The Internal Revenue Service taxes income through a progressive tax schedule.
15 As an individual's income increases, taxes are paid for brackets of income such
16 that the first \$7,300 is taxed at just 10% (assuming a single tax payer not filing a
17 joint return). Additional income above \$7,300 up to \$29,700 is taxed at 15%.
18 Additional income between \$29,700 and \$71,950 is taxed at 25% and so on, as
19 shown on the tax table below.

20

1

Table 2 - Individual Income Tax Brackets	
Income Bracket	Tax Rate
\$0 - \$7,300	10%
\$7,301 - \$29,700	15%
\$29,701 - \$71,950	25%
\$71,951 - \$150,150	28%
\$150,151 - \$326,450	33%
\$326,451 - over	35%

2

The whole of one's income is not taxed at the maximum rate but rather taxes are

3

assessed in increments such that the highest tax level is only assessed on marginal

4

income. Similarly, corporate income taxes are also levied on a tiered bracket basis

5

as illustrated in the table below.

Table 3 - Corporate Income Tax Brackets	
Income Bracket	Tax Rate
\$0 - \$50,000	15%
\$50,000 - \$75,000	25%
\$75,000 - \$100,000	34%
\$100,000 - \$335,000	39%
\$335,000 - \$10,000,000	34%
\$10,000,000 - \$15,000,000	35%
\$15,000,000 - \$18,000,000	38%
\$18,000,000 - over	35%

6

1 This tiered structure will play an important part in the derivation of the potential
2 weighted average tax rate to be applied to SFPP's cost of service. Professor
3 Williamson and Mr. Bullock note in their filed testimony that there are several
4 classes of owners among the partners of SFPP's parent organization, KMEP. Each
5 class of owner falls within a tiered tax structure similar to those listed above. As I
6 will demonstrate, the taxable net income allocated to the vast majority of these
7 owners falls well below the income level necessary to be taxed at the maximum
8 marginal tax rate in any set of tables. Most, in fact, have a zero tax liability.

9 **Q. How do the cash distribution targets and income allocations translate into**
10 **dollars distributed to partners?**

11 A. KMEP's cash distributions to KMGP were **Start protected material** [\$-----
12 -----] **End protected material** for 2004, as shown on KMEP's K-1 for KMGP
13 (as the general partner) (Exhibit No. S-7N, line 19). Line 1 of that same K-1
14 shows ordinary business income allocated from KMEP to KMGP of **Start**
15 **protected material** [\$-----] **End protected material**. This reflects the
16 partnership agreement §5.1(d)(iii) discussed above.

17 **Q. If SFPP is permitted a federal income tax allowance in its rates, what happens**
18 **to that money if there is no actual federal tax paid at the pipeline entity level?**

19 A. If the pipeline entity is a pass-through organization that generates no federal
20 income tax liability for the pipeline, the revenues associated with a tax allowance

1 built into the cost-of-service tariff rates are flowed through to the partners of the
 2 partnership providing them a substantially higher rate of return than the one
 3 allowed by the Commission in the cost of service. As illustrated in the table
 4 below, for example, let’s assume an SFPP rate base of \$55,500,000 with a 50%
 5 equity ratio, and then apply rate of return on equity (ROE) of 10%. Applying the
 6 10% ROE to the equity portion rate base yields an intended return on equity of
 7 about \$2,775,000. Now apply the 35% corporate tax rate and thus add about
 8 \$971,250 to the cost of service revenue requirement. But tax must be paid on that
 9 additional revenue as well, so the actual tax factor is 53.85%. Now the total equity
 10 return and tax revenue requirement is \$4,269,231. Since SFPP does not pay any
 11 corporate income tax, the \$4,269,231 of return and taxes simply flows into the
 12 partner’s pockets for a 15.38% real return on equity for the partners.

Table 4 – Real Return on Equity & Taxes	
Rate base	\$55,500,000
Equity 50%	\$27,750,000
Allowed Return on equity	10.0%
Taxable return	\$2,775,000
Income tax rate	53.85%
Income taxes	\$1,494,231
Return & tax rev. req.	\$4,269,231
Earned Return to Partners	15.38%

1 **Q. Did KMEP pay a corporate income tax in the base period 2004?**

2 A. No, since KMEP is a pass through entity, KMEP reported ordinary business
3 income to its owners on IRS tax form K-1 for KMGP as a limited partner Exhibit
4 No. S-7U, for KMGP as a general partner Exhibit No. 7.V, and for KMI as a
5 limited partner, Exhibit No 7.W. The data base of KMEP K-1s for 2004 is
6 contained in a CD filed as part of Mr. Sintetos' Exhibit No. BPX-8 (CPS)-6).

7 **Q. What portion of SFPP's taxable income was used to provide for KMGP's**
8 **incentive distribution and gross income allocation in 2004?**

9 A. The portion of SFPP's taxable income used to provide for KMGP's incentive
10 distribution and gross income allocation in 2004 cannot be determined from the
11 data available.

12 **Q. What portion of OLP-D's taxable income was used to provide for KMGP's**
13 **incentive distribution and gross income allocation in 2004?**

14 A. The portion of OLP-D's taxable income used to provide for KMGP's incentive
15 distribution and gross income allocation in 2004 cannot be determined from the
16 data available.

17 **2) IRS Schedule K-1**

18 **Q. What is IRS Schedule K-1?**

19 A. IRS Schedule K-1 is a report filed by partnerships with both the IRS and the
20 partners reporting the partner's share of partnership income, gain, loss, deductions,
21 and credits. The partner may then use that information to calculate its taxable

1 partnership income. The partner is liable for tax on the net income, if any,
2 reported on the K-1 not on the cash received through distributions, if any. The IRS
3 instruction manual for the K-1 is in Exhibit No. S-7X.

4 **Q. How does the IRS Schedule K-1 report ordinary income?**

5 A. The IRS Schedule K-1 reports ordinary income allocable to the partner in Part II,
6 box 1 on the first page. The sum of all partners' K-1, box 1, ordinary income
7 amounts should equal the ordinary income reported by the partnership on its IRS
8 income form 1065. For example, box 1 amounts for SFPP's two K-1 forms for
9 Santa Fe and OLP-D, Exhibit Nos. S-7P and 7Q, add up to the amount shown as
10 ordinary income on its Form 1065 in Exhibit No. S-7O. Similarly, the box 1
11 amounts for OLP-D's two K-1s for KMEP and KMGP, Exhibit Nos. S-7S and 7T
12 add up to the amount for ordinary income reported on OLP-D's Form 1065,
13 Exhibit No. S-7R.

14 **Q. Are the K-1 numbers also reflected in the Form 1065?**

15 A. Yes, the IRS Form 1065, page 4, contains a series of boxes at the top of the page
16 that report cumulative net income allocations by class of partner. SFPP's Form
17 1065 shows its two partners' allocated net income on lines 2a and 2b. Line 2a is
18 for general partners, line 2b is for limited partners. Since SFPP has only two
19 partners, it's simple to check them against the partner's K-1s to see that they add
20 up properly.

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Q. Do OLP-S's ordinary income and net income allocations add up?

A. Yes, the amounts shown on OLP-D's Form 1065 for ordinary income and net income allocated to the partners add up correctly. (Exhibit No. S-7R)

Q. Do KMEP's ordinary income and net income allocations add up?

A. KMEP's additions and deductions on page 23 on Form 1065 add up to the figure shown in Box 1 on page 4. However, the allocations of net income to the partners shown on lines 2a and 2b of page 4 contain some disturbing inconsistencies.

(Exhibit No. S-7M) The first anomaly is that the general partner's income allocations are a positive **Start protected material** [\$-----] **End protected material** while each class of limited partner was allocated negative income: **Start protected material** [-----]

-----] **End protected material** These figures again point to the fact that

1 the gross income allocation to the general partner is a guaranteed payment rather
2 than a return on capital as an owner.

3 **Q. Do the net income allocations on KMEP’s Form 1065 add up to the net**
4 **income reported by KMEP on Page of its 1065?**

5 A. No, the amounts shown on KMEP’s Form 1065 (Exhibit No. S-7M) for ordinary
6 income and net income are the same but the net income allocations to the partners
7 do not add up to the reported net income. The sum of the allocations to all partners
8 equals **Start protected material [\$-----] End protected material**, while
9 the reported net income of the partnership is **Start protected material [\$-----**
10 **-----] End protected material**. That leaves a discrepancy of **Start**
11 **protected material [\$-----] End protected material** of “missing” net
12 income.

13 **Q. Do SFPP witnesses have any explanation for the discrepancy?**

14 A. When asked at his deposition about this discrepancy, Mr. Bullock asserted that
15 there were two reasons why the numbers do not add up. He claimed there was a
16 problem with incorrect nominations among the identified partners to whom the
17 allocations are made, and allocations of special depreciation amounts to particular
18 partners. (Bullock Deposition, page 149, Exhibit No. S-7Z)

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- 22 **Q. What are these special depreciation provisions about?**
- 23 A. Investors in a partnership have the option of depreciating their personal investment
- 24 in the pipeline entity for their personal tax purposes wholly apart from whatever
- 25 depreciation allowances the Commission may permit to be included in the cost of
- 26 service. A new investor could purchase someone else's interest in a pipeline
- 27 partnership, and begin depreciating it all over again on his own income tax
- 28 reporting as if it were brand new plant, regardless of whether the previous owner

1 had fully recovered its investment through depreciation. So it is entirely possibly
2 and, given Mr. Bullock’s discussion about partner depreciation distortions in the
3 net income allocation calculation, quite likely, that investors who are provided
4 with a federal income tax allowance by the Commission, could be avoiding tax
5 liability by using these tax depreciation provisions. In that case they are not only
6 not getting taxed at the pipeline partnership level, they are not getting taxed at the
7 personal level either. And, given Mr. Bullock’s statement that cash distributions
8 are return of capital first, the pipeline partnership investor may well have fully
9 recovered its investment while taking the tax write-off and upon the sale of its
10 interest reap only capital gains, so that the pipeline income tax allowance
11 embedded in the cost of service serves no tax-related matter at all, but rather inures
12 straight to the investor’s pockets – with no perceivable benefit to the SFPP
13 ratepayers.

14 **Q. Have you looked for some evidence that the depreciation allocations by**
15 **KMEP to its limited partners add up to *Start protected material* [\$-----]**
16 ***End protected material*?**

17 A. I examined the KMEP data base of K-1s for all 152,000 plus unit holders in an
18 attempt to verify that the special depreciation allocations add up to the net income
19 discrepancy of **Start protected material** [\$-----] **End protected material.**

20 Exhibit No. S-7AA presents a summation of the depreciation allocations by

1 KMEP to its partners by class of partner in 2004 as found in the KMEP K-1 data
2 base that was filed with Mr. Sintetos' exhibits as Exhibit No. BPX-8. The sum of
3 the special depreciation allocations is **Start protected material** [\$-----]
4 **End protected material.** I could find nothing in the K-1 data base relating to the
5 nominee problem mentioned by Mr. Bullock. Assuming the depreciation amounts
6 are a component of the net income discrepancy, that still leaves something on the
7 order of **Start protected material** [\$-----] **End protected material** in
8 unaccounted for taxable net income for KMEP.

9 **Q. What does this discrepancy tell you about divining a potential income tax**
10 **liability from the K-1s?**

11 A. What this tells us is that the figures in the K-1 and Form 1065 are insufficient to
12 determine whether there is an actual or potential income tax liability on the part of
13 KMEP's partners. Yet the series of negative income allocations to all KMEP
14 limited partners would certainly suggest that at best only one partner has a
15 potential income tax liability. Plus, the enormous amount of unaccounted for
16 taxable net income, almost **Start protected material** [--%] **End protected**
17 **material** of the full reported net income, cannot be attributed to any class of
18 limited partner, nor can it be attributed to a set of income tax brackets into which
19 partners may fall, nor whether those that received the unaccounted for allocations
20 in fact had any tax liability at all.

1 **Q. Did Mr. Bullock address the question of whether the data in the IRS schedule**
2 **K-1 is sufficient to determine whether a particular partner has actual or**
3 **potential income tax liability?**

4 A. Yes, Mr. Bullock was asked whether the K-1 data would be helpful in determining
5 the income tax liability for SFPP. Mr. Bullock's response indicates that the K-1
6 data has significant problems and cannot be relied upon, on its face, to accurately
7 reveal the actual or potential income tax liability of the partners. (Bullock
8 Deposition, page 152, Exhibit No. S-7-BB)

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28 **]End protected material**

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1 **IV What Does the Available Evidence Indicate Regarding Actual Tax**
2 **Liability for SFPP's Ultimate Owners?**
3

4 **Q. Have you examined the KMEP's 2004 K-1 reports to the IRS and to its**
5 **partners?**

6 A. Yes, I have examined the data base of K-1 schedules filed by KMEP with the IRS
7 and each partner. This data base was provided by SFPP in Bates No. SFPPNL
8 24195 and included in a CD filed by Mr. Sintetos in his Exhibit No. BPX-8.

9 **Q. Did the limited partners of KMEP, as a group, have taxable income in 2004?**

10 A. No. KMEP allocated its negative taxable net income to its partners in 2004.
11 KMEP's IRS Form 1065, page 4, Exhibit No. S-7M, reports negative income for
12 all classes of partners, as noted above. The sum of the reported ordinary income
13 allocated to KMEP's limited partners on KMEP's Form 1065 was **Start protected**
14 **material [(\$-----)] End protected material.** The sum of the reported
15 ordinary income allocated to KMEP's limited partners on the KMEP K-1 data base
16 was **Start protected material [\$(-----)] End protected material.**

17 **Q. Did some of the limited partners of KMEP have taxable income in 2004?**

18 A. Yes, but very few. Approximately **Start protected material [-----**
19 **-----] End protected material** were allocated a
20 positive net taxable income for 2004. (Exhibit No. S-7A) The rest were allocated
21 negative taxable net income. The data summaries in Exhibit No. S-7A demonstrate

1 that even for those partners who did receive allocations of positive income, the
2 great majority of these fell in the lowest tax bracket. Only **Start protected**
3 **material [-----] End protected material** unit holders, estates, were in the 33 to
4 35% tax bracket. **Start protected material [---] End protected material**
5 individuals or corporations earned enough income from KMEP to be taxed at a
6 35% rate.

7 **Q. Have you calculated a weighted average tax rate for possible use in the cost of**
8 **service income tax allowance?**

9 A. Yes, I have. Using the K-1 schedules, I grouped the partners of KMEP by
10 ownership class and income tax bracket. I then weighted the percentage of total
11 partnership interest represented by each class of owner/tax bracket by the tax rate
12 for that tax bracket. The cumulative weighted federal income tax for KMEP's
13 partners is 1.23%. This figure excludes KMGP. The worksheet for this
14 calculation is in Exhibit No. S-7A.

15 **V Summary & Recommendation Regarding an Income Tax**
16 **Allowance in the Cost of Service**

17 **Q. What did the Commission surmise might be the outcome of an investigation**
18 **into the actual status of the holders of partnership interests?**

19 A. In its Policy Statement on Income Tax Allowance, the Commission surmised that

20 Thus, the policy the Commission is adopting should not result in
21 increased costs to public utility ratepayers, and may actually reduce

1 them if a partnership or LLC has a lower weighted marginal tax rate
2 and fewer administrative expenses than the normal corporate form of
3 ownership. [111 FERC ¶ 61,139 at P37]

4 That forecast is, indeed, the outcome in this case. Upon close examination if the
5 facts of actual tax liability, rather than the theories of tax liability, it was possible
6 to determine that the ultimate holders of income tax liability and potential income
7 tax liability for SFPP and its parent KMEP have little or no income tax liability.
8 The consequence of this determination is that the ratepayers will, in fact, benefit
9 from a lower cost of service due to the lower weighted marginal tax rate enjoyed
10 by the owners of the partnership interests in KMEP if SFPP's proposed inclusion
11 of a full income tax allowance is rejected.

12 **Q. What is your recommendation regarding whether an income tax allowance**
13 **should be included in the SFPP cost of service?**

14 **A. I recommend that there be no income tax allowance incorporated into SFPP's cost**
15 **of service for the North Line rates for the following reasons:**

16 1) Neither SFPP's filing nor its testimony include any supporting evidence the
17 SFPP's partners had any actual or potential income tax liability for 2004. Mr.
18 Bullock's testimony contained, at best, speculative estimates of what the
19 partnerships as a whole might have reported as net taxable income for 2004, he
20 provided no evidence regarding what the individual partners may have paid in
21 actual or potential income taxes.

1 2) KMEP's limited partners, as a class, have been allocated no taxable income for
2 the base period 2004 and consequently can have no actual tax liability, as a group,
3 for 2004. KMEP's federal income tax Form 1065 and its Schedule K-1 summaries
4 reflect that actual net taxable income for KMEP's limited partners was negative
5 for all classes of partners.

6 3) KMEP's partnership agreement, through which KMEP's taxable income is
7 derived, is structured so that its limited partners are unlikely to have taxable
8 income or cash distributions that exceed their capital accounts and consequently
9 become taxable income.

10 4) KMEP cash distributions to its partners are only taxable to the extent a
11 particular partner has a capital account that has been exceeded by its cash
12 distributions. However, §5.1(d)(v) of the partnership agreement provides that if
13 such an event were about to take place, a special infusion of gross income will be
14 allocated to that partner to fend off what would otherwise be a taxable distribution.

15 5) Given that cash distributions from KMEP to its partners are considered a return
16 of capital first, according to SFPP witness Bullock, and given that §5.1(d)(v) of the
17 partnership wards off taxable cash distributions that harm the capital account, the
18 sale of a partner's interests on a public exchange is likely to be wholly a gain on

1 the sale of the assets, subject to capital gains tax rather than a income tax on
2 ordinary income.

3 6) KMEP's IRS Form 1065 contains substantial unaccounted, for unallocated net
4 taxable income equal to **Start protected material [---%] End protected material**
5 of its reported net income, which makes relying on these documents to determine a
6 cost responsibility for income tax liability for SFPP ratepayers questionable at best.

7 7) KMEP's K-1 data base, upon which an actual or potential tax liability should be
8 relied, is rife with errors, as noted by SFPP witness Mr. Bullock, which makes its
9 use for determining a cost responsibility for income tax liability for SFPP
10 ratepayers questionable at best.

11 8) KMEP's gross income allocation to KMGP, is a guaranteed payment condition
12 with its partnership agreement for services rendered rather than a reward to KMGP
13 as an owner, and as such should not be included in the amount of income upon
14 which an income tax is calculated.

15 9) Even if the gross income allocation to KMGP by KMEP as a condition of the
16 partnership agreement were to be considered a return on capital to KMGP, it is a
17 contractual obligation of KMEP that works only in the interests of KMGP and
18 provides no benefits to the ratepayers of SFPP tariff and, as such, should be

1 excluded from calculation of the income tax liability on KMEP's net taxable
2 income for ratemaking purposes.

3 10) SFPP's cost of service incorporates a 35% income tax rate in total disregard to
4 any actual or potential tax liability on the part of its partners. As noted by SFPP
5 witness Mr. Turner, he made no attempt to determine the actual average income
6 tax paid by any KMEP partners, or the actual average income tax bracket into
7 which any KMEP partner might fall. SFPP's use of a 35% income tax allowance
8 in its filing was without thought or analysis as to whether 35% reflected the actual
9 experience of KMEP's partners.

10 In summary, SFPP has neither met the burden set out by the Commission's
11 Policy Statement on Income Tax Allowances to establish the income tax status of
12 its partners nor has it established actual or potential income tax liability of its
13 partners. Furthermore, my analysis of the actual or potential income tax liability
14 for SFPP's partners and ultimate holders of income tax liability indicates that these
15 ultimate holders of the income tax liability have little or no actual income allocated
16 to them, and consequently can have to actual income taxes to pay or potential
17 income tax liability. If an income tax allowance is incorporated into the cost of
18 service derived tariff rates for the North Line, I believe the resulting rates will be
19 unjust and unreasonable.

Part II - RATE BASE ADJUSTMENTS

1
2 **A) *Starting Rate Base***

3 **Q. What is the starting rate base?**

4 A. The starting rate base is an adjustment to the rate base that provides an oil pipeline
5 entity with an enhanced return on equity to compensate the pipeline investors for
6 the change in rate making methodology from the reproduction cost valuation
7 method used prior to 1985 to the original cost methodology used by FERC. The
8 starting rate base was derived as the sum of a pipeline's debt ratio times its net
9 depreciated original cost plus the pipeline's equity ratio times its reproduction
10 portion of the valuation rate base (depreciated by the same percentage as the
11 original cost rate base). The starting rate base figure is added to the cost of service
12 rate base upon which the return on equity is calculated. The starting rate base was
13 not intended to be a permanent feature of the rate base and is therefore amortized
14 over what was the then-estimated remaining life of the pipeline (derived by
15 dividing the net depreciable plant by the composite depreciation expense). The
16 annual amortized amount is not itself recovered in the cost of service, rather it is
17 the return on the net starting rate base that is included in the cost of service.

1 **Q. How does the composite amortization rate derived from the assorted**
2 **depreciation rates and used for various purposes in the cost of service differ**
3 **from the amortization rate applied to the starting rate base?**

4 A. The rates used for depreciation purposes are derived from the average remaining
5 useful life of the assets. These rates can change from time to time based on plant
6 additions and retirements and current expectations regarding the life of the assets.
7 A composite amortization rate based on the sum of the depreciation expenses is
8 used to calculate the value of various other amortized assets and expenses in the
9 cost of service. The starting rate base, however, has its own amortization rate that
10 does not change over time.

11 **Q. Why are you addressing the starting rate base in this proceeding?**

12 A. SFPP has miscalculated the starting rate base amortization rate, which causes
13 SFPP's proposed trended original cost rate base to be higher than it ought to be.
14 Opinion No. 435-B directs that the amortization of the starting rate base write up
15 should be amortized over the "composite useful life of the pipeline's assets as of
16 December 31, 1983." (96 FERC ¶ 61,281 at 62,076) However, embedded in the
17 calculations of the starting rate base remaining useful life, in SFPP Exhibit No.
18 SFN-28, page 17, Workpaper 1, line 7, SFPP has calculated the useful life by
19 adding back the 1983 depreciation expense to the 1983 end-of-year net depreciable
20 plant, which, in effect, makes it the December 31, 1982, end-of-year balance rather
21 than the December 31, 1983, end-of-year balance. The corrected useful life of

1 24.9 years versus 25.9 years results in an amortization of the starting rate base of
2 \$202,000 per year rather than \$194,000.

3 **Q. How does the amortization of the starting rate base affect the cost of service?**

4 A. The amortized starting rate base is not itself recovered from ratepayers; it is a rate
5 base write-up used only to calculate an additional return component in the cost of
6 service. The somewhat higher corrected amortization rate described above results
7 in a faster draw-down of the starting rate base component of the trended original
8 cost rate base. Hence, there is a lower overall net trended original cost rate base
9 for the test period in Statement E1 of Exhibit No. S-5, page 9, line 16, compared to
10 Mr. Turner's trended original cost rate base in Exhibit No. SFN-28, page 8, line
11 16. The net trended original cost rate base on Statement E1 is used in the
12 determination of the return on equity in Statement C.

13 **Q. What happens when the starting rate base becomes fully amortized?**

14 A. When the starting rate base becomes fully amortized it should cease to be part of
15 the trended original cost rate base. However, because rates are derived and set on
16 an infrequent basis, the impact of the starting rate base write-up can remain
17 embedded within the rates set by the Commission long beyond its intended life. In
18 deriving rates, we should be mindful that non-recurring costs ought not to be
19 permanently incorporated into those rates. In this case, the accumulated

1 amortization of the starting rate base is close to fully accruing the starting rate base
2 write up, as shown on Workpaper 3 of Exhibit No. S-5, page25, line 20/column
3 2004. Indeed, the starting rate base will be fully accrued by late 2008 and should
4 cease to be a recurring element in the cost of service thereafter. I have therefore
5 dropped the amortization of the starting rate base (via Workpaper 3, Line 18 and
6 20) from the derivation of the trended original cost rate base (Statement E1, Line
7 15) so as not to incorporate a short term cost in the derivation in Statement C.

8 **Q. How do you recommend the short term impact of the soon-to-be-obsolete**
9 **starting rate base should be recovered by SFPP?**

10 A. In Opinion No. 435-B the Commission ordered that a soon-to-be-obsolete starting
11 rate base should be charged off to customers as a one time charge for the months it
12 would have been in effect. (96 FERC ¶ 61,281 at 62,076) However, since the
13 starting rate base is itself not recovered from ratepayers, this solution literally is
14 not appropriate. It is the return on the disappearing rate base that should be
15 recovered. Rather than build into the cost of service, and hence the tariff rates, an
16 annual return on equity of approximately \$70,300 (see Table 5 below) for a rate
17 base item soon to be obsolete, I recommend that the starting rate base be deemed
18 fully amortized and removed from the trended original cost rate base. However, I
19 do recommend that the return on the net remaining starting rate base that would

1 have been incorporated into the cost of service be instead recovered in one-time
2 surcharges to the customer's invoices on a volumetric basis.

Table 5 – Amortization of Starting Rate Base Return				
Year	Net Starting Rate Base	Annual Rate Base Amortization	Return on Rate Base	
2005	\$781,000	\$202,000	\$70,300	
2006	\$579,000	\$202,000	\$52,200	
2007	\$377,000	\$202,000	\$33,900	
2008	\$175,000	\$175,000	\$15,700	

3

4 **B) *Amortization Rates***

5 **Q. Why did you adjust the amortization rate embedded within the cost of service**
6 **model?**

7 A. Workpaper 1 of the cost of service model reflects the derivation of an amortization
8 rate that is used in the amortization of the deferred income in Workpaper 2 and the
9 amortization of AFUDC in Statement F2. SFPP derived the composite
10 amortization rate incorporating an average of depreciable property from 2003 and
11 the test year. (Exhibit No. SFN-28, page 17, line 9) SFPP did not explain why
12 they skipped over the base period in calculating the rate. However, skipping over

1 the base period, 2004, incorporates a higher depreciation expense in the numerator
2 with lower net plant in the denominator. The depreciation expense part is
3 developed using the higher 2004 net depreciable plant augmented by the
4 replacement cost of a segment of the North Line in 2004. The net plant part is
5 developed using the lower 2003 net depreciable plant excluding the added cost of
6 the North Line replacement costs. The result is a significantly reduced implied
7 remaining life of the assets (30.2 years instead of 37.5) and a resulting increased
8 annual amortization amount. I have corrected the amortization rate to 2.67% using
9 the proper 2004 base period and 2005 test period figures. (Exhibit No. S-5, page
10 21, line 9)

11 **Q. Have you adjusted the underlying account-by-account depreciation rates?**

12 A. No. Staff reviewed the SFPP North Line depreciation rates and determined that
13 they are within the zone of reasonableness and not in need of adjustment at this
14 time.

15 **C) *Deferred Return Inflation Adjustment***

16 **Q. The trended original cost cost-of-service methodology incorporates an**
17 **inflation-adjusted deferred return. What changes did you make to the**
18 **deferred return?**

19 A. Footnote 35 of Opinion No. 154-B states “The inflation rate for the past year
20 would be used as the estimated rate for the next year. Hence, the rate base would

1 be written up at the start of the year and not the end of the year.” However, the
2 mechanics of Statement E2 in Mr. Turner’s Exhibit No. SFN-28, page 10, which
3 calculates the deferred return, multiplies the prior year trended base on Line 11 by
4 the current year inflation rate on Line 12 to derive the deferred return on Line 13.
5 The correct application, as is done in my Exhibit No. S-5, page 11, Statement E2,
6 is to multiply the prior year trended base on Line 11 by the prior year inflation
7 factor on Line 12 for the deferred return on line 13. The impact is a slightly lower
8 accumulated deferred return in the test year.

9 **D) *Weighted Cost of Capital***

10 **1) *Capital Structure***

11 **Q. What capital structure have you used for the cost of service model?**

12 A. I have used SFPP’s actual capital structure for the test period of 34.53% debt to
13 65.47% equity, as recommended by Staff Witness Wang in Exhibit No. S-1.

14 **Q. What cost of debt did you incorporate into the cost of service model?**

15 A. I used a weighted cost of debt for the test period of 5.96% as supported by Staff
16 Witness Wang in Exhibit No. S-1.

17 **Q. What is the weighted cost of capital you used for the cost of service model?**

18 A. The generic cost of service model calculates a weighted cost of capital based on
19 the actual cost of debt times the debt ratio plus the estimated cost of capital

1 recommended by Mr. Wang, times the equity ratio. The trended original cost cost-
2 of-service model adjusts the debt/equity ratio to accommodate the deferred return
3 impact on income taxes, as I will explain below, prior to calculating the weighted
4 cost of capital. In this case I have removed the adjustment to the debt/equity ratio
5 and calculated the weighted cost of capital at 7.01%.

6 **Q. How is the capital structure incorporated into the cost of service model?**

7 A. The capital structure is incorporated into the cost of service model in a number of
8 ways. The primary impact of capital structure is felt through the calculation of the
9 allowed return on equity and weighted average cost of capital. This is discussed in
10 Mr. Wang's testimony, Exhibit No. S-1. However, capital structure shows up in a
11 number of other ways as well. These include the calculation of deferred return in
12 Statement E2, the calculation of AFUDC in Statement F1, the calculation of the
13 starting rate base in Workpaper 3, and the average cost of debt in Workpaper 6,
14 and the calculation of income taxes in Statement D.

15 **2) *Adjusted Equity & Debt Ratios***

16 **Q. Why does Statement C of Exhibit No. SFN-28, showing SFPP's cost-of-service**
17 **model, include an adjusted debt and equity ratios on lines 10 and 11?**

18 A. The adjusted debt and equity ratios on Statement C of Exhibit No. SFN-28, page 5,
19 lines 10 and 11, come about due to the Commission's desire to ensure that the

1 interest expense, shown on Statement C, line 19 and on Statement D, line 2, does
2 not distort the calculation of federal income tax due to the presence of deferred
3 return shown on Statement C, line 2. The Commission held that, as a general rule,
4 the interest expense for tax purposes should be the same as for ratemaking
5 purposes.

6 The Commission is now persuaded that the better solution is to use
7 the same actual capital structure for both the interest expense
8 deduction and the allowed interest return. ... We see no reason why
9 this should not also be the case for oil pipelines, if the equity write-
10 up can be eliminated. At this time, therefore, *subject to re-*
11 *examination on a case-by-case basis*, it appears appropriate for an oil
12 pipeline to determine its interest expense by multiplying its weighted
13 cost of debt times its net depreciated original cost rate base....

14 To correct this oversight, the full 154-B rate base (depreciated
15 original cost plus the deferred equity account plus the starting rate
16 base write-up) should be multiplied by the adjusted, weighted cost of
17 debt (adjusted for the deferred equity treated as 100% equity in the
18 rate base). (Opinion No. 435-A at ¶ 61,510) (*emphasis added*)

19 The sole reason for creating the adjusted debt and equity ratios was to
20 accommodate the impact of the trended original cost methodology on interest
21 expense in the income tax calculation. In light of my earlier recommendation to
22 eliminate the allowance for income taxes, the time has come to re-examine the
23 adjusted debt/equity ratio methodology. The rationale for incorporating the
24 methodology in the cost of service is not applicable in this case.

1 **Q. How does the isolation of the deferred return from the otherwise overall**
2 **capital structure impact the rate of return?**

3 A. The deferred return is a rate making concept that is not mirrored in any actual asset
4 accounts and therefore not included in the capital structure. However, its inclusion
5 in the derivation of the weighted cost of capital creates a higher-than-actual
6 interest expense and understates the actual return on equity, resulting in an under-
7 calculation of income tax allowance. For illustrative purposes, assume a capital
8 structure of 60% equity/40% debt on an asset base of \$100. Then add \$10 to the
9 asset base as a deferred return for a trended original cost rate base of \$110. The
10 true capital structure applied to the new asset base suggests \$66 in equity and \$44
11 in debt, even though we know the debt is only \$40 and the trended original cost
12 equity is \$70. The overstated debt cost that arises through the actual capital
13 structure applied to the trended original cost rate base results in a tax calculation
14 where the interest expense is higher, \$2.64, than the actual interest expense, \$2.40,
15 resulting in an under-calculation of income tax allowance.

16 **Q. What was the Commission's solution to this problem?**

17 A. The Commission directed that the deferred return be subtracted from the trended
18 original cost rate base and added in to the equity-only portion of the rate base,
19 creating a new ~ higher ~ equity ratio and new ~ lower ~ debt ratio. In my
20 illustration above, the adjusted capital structure of the trended original cost rate

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1 base is 63.64% equity (\$70/\$110) and 36.36% debt (\$40/\$110). This phenomenon
2 is immaterial to the true cost of debt but has significant repercussions on the return
3 on equity as illustrated in Table 6 - Deferred Return Impact of Debt/Equity Ratios
4 below.

Table 6 - Deferred Return Impact on Debt/Equity Ratio						
				TCS	ACS	ACS/NT
1	Original Cost Rate Base	given		\$100	\$100	\$100
2	<u>+ Deferred Return</u>	given		<u>\$10</u>	<u>\$10</u>	<u>\$10</u>
3	TOC Rate Base	line 1 + line 2		\$110	\$110	\$110
4	Debt Ratio	given		40.00%	40.00%	40.00%
5	Equity Ratio	given		60.00%	60.00%	60.00%
6	Actual Debt Portion of Original Cost Rate Base	line 1 * Line 4		\$40	\$40	\$40
7	Actual Equity Portion of Original Cost Rate Base	line 1 * line 5		\$60	\$60	\$60
8	<u>+ Net Deferred Return</u>	line 2		<u>\$10</u>	<u>\$10</u>	<u>\$10</u>
9	Adjusted Equity Portion of TOC Rate Base	line 7 + line 8		\$70	\$70	\$70
10	Adjusted Debt Ratio	line 6 / line 3			36.36%	
11	Adjusted Equity Ratio	line 9 / line 3			63.64%	
12	Cost of Debt	given		6.00%	6.00%	6.00%
13	Cost of Equity	given		10.00%	10.00%	10.00%
14	Weighted Cost of Capital	lines 4*12 + lines 5*13		8.40%		8.40%
14a	Adj Wghd Cost of Cap	lines 10*12 + lines 11*13			8.55%	
15	Actual Interest Expense	Line 1* line 4* line 12		\$2.40	\$2.40	\$2.40
16	Implied Interest Expense	Line 3* line 4* line 12		\$2.64		
16a		Line 3* Line 10* Line 12 or Line 1* Line 4* line 12			\$2.40	\$2.40
17	Return on TOC Rate Bae	Line 3 * line 14		\$9.24	\$9.40	\$9.24
18	Return on Implied Equity	Line 17 – line 16		\$6.60	\$7.00	\$6.84
19	Return on Real Equity	Line 17 – line 15		\$6.84	\$7.00	\$6.84
20	Tax on Implied ROE	Line 18 * tax factor		\$3.55	\$3.77	\$0.00
21	Tax on Real ROE	Line 19 * tax factor		\$3.68	\$3.77	\$0.00

1 **Q. Why do the adjusted equity and debt ratios cause a problem?**

2 A. I created Table 6 - Deferred Return Impact of Debt/Equity Ratios above to
3 illustrate the effect of the adjusted debt and equity ratios. Columns TCS, ACS,
4 and TCS/NT represent the effect using the True Capital Structure, the Adjusted
5 Weighted Capital Structure, and the True Capital Structure with No Taxes. Under
6 the true capital structure, the implied interest expense is \$2.64 (line 16: TOC rate
7 base * debt ratio * debt cost), while the actual interest expense is \$2.40 (line 15:
8 OC rate base * debt ratio * debt cost). (TOC = trended original cost, OC = original
9 cost) Also under the true capital structure, the weighted cost of capital is 8.40%
10 (line 14) and the overall return on capital is \$9.24 (line 17). However, when these
11 figures move over into the income tax allowance calculation, the implied interest
12 expense causes the calculated return on equity to be lower than it should, \$6.60 v
13 \$6.84 (line 18 v line 19), causing an under-calculation of the income tax allowance
14 by 13¢, \$3.55 v \$3.68 (line 20 v line 21).

15 To correct the tax problem, the Commission required the calculation of the
16 adjusted debt and equity ratios described above with the deferred return moved
17 wholly to the equity portion of the trended original cost rate base. The adjusted
18 debt/equity ratios result in a higher weighted cost of capital 8.55% (line 14a) and a
19 consequent higher overall return on capital, \$9.40 v \$9.24 (line 17). The adjusted

1 ratios result in the interest expense being the same for return and tax purposes, but
2 now the greater weighted return on capital results in a greater return on equity and
3 a greater tax amount on that return. So the tax-conscious adjustment results in a
4 cost to the ratepayers of an additional 16¢ in return and 22¢ in tax allowance to
5 protect the investor against a 13¢ shortfall in income tax allowance.

6 **Q. Have you made an adjustment to the adjusted equity and debt ratios on**
7 **Statement C?**

8 A. Yes. In the discussion in the first part of my testimony I reported that there is no
9 evidence to support that SFPP's partners have any potential tax liability and that
10 there should be no federal income tax allowance in the cost of service. As noted
11 above, the reason for creating the adjusted equity and debt ratios was to ensure that
12 federal income tax allowances were sufficient to cover the tax liability on the
13 return on equity augmented by the deferred return rate base component. If there is
14 no income tax allowance, there is no reason to make an adjustment to the equity
15 and debt ratios to ensure an adequate tax is collected from the ratepayers.

16 Therefore, in Statement C of my Exhibit No. S-5, page 6, I have ignored the
17 adjusted ratios in the derivation of the weighted cost of capital, resulting in a
18 reduction in the weighted cost of capital from 7.25% to 7.01% for the test period.
19 Furthermore, since SFPP has no debt and we are relying on the capital structure of
20 the parent organization, as Mr. Wang recommends, it is entirely appropriate to use

1 the KMEP capital structure in the development of the weighted cost of capital
2 without the distortion caused by the tax-conscious debt and equity ratio
3 adjustments.

4 **3) Past Period Capital Structures**

5 **Q. Mr. Wang recommended revised capital structures for several past periods**
6 **for SFPP’s North Line cost of service. How were these incorporated into your**
7 **model?**

8 A. The revised capital structures are incorporated in Workpaper 5 of Exhibit No. S-5,
9 page 29.

10 **Part III - COST OF SERVICE ADJUSTMENTS**

11 **A) Purchase Accounting Adjustment**

12 **Q. What is a purchase accounting adjustment?**

13 A. A purchase accounting adjustment (PAA), as it relates to this case, is a write up in
14 the value of an asset to reflect the purchase cost above the original cost of the
15 asset. Here, KMEP acquired SFPP in 1998, paying considerably more for the
16 pipeline assets than their net book value at the time (original cost less accumulated
17 book depreciation).¹² KMEP acquired SFPP for **Start protected material [-----**
18 **-----**

¹² This is a different write up in the value of the assets than the “starting rate base,”

1 -----] **End protected material**, as
2 reflected on SFPP’s response to CCV Data Request No. 13(c), Bates No. 22192,
3 see Exhibit No. S-7CC .

4 **Q. What is the Commission’s policy regarding PAAs?**

5 A. The Commission’s policy regarding PAAs is that to protect the public interest
6 from repeated transfers of property that inflate the rate base without any
7 commensurate increase in the value of services rendered to the public, tariff rates
8 should be derived using only the original cost less the accumulated depreciation.
9 (Opinion No. 435, 86 FERC ¶ 61,022 at 61,097)

10 **Q. Has SFPP removed the impact of PAAs from its cost of service?**

11 A. Not quite. While SFPP has removed PAAs from the derivation of its capital
12 structure for the purposes of calculating the deferred return and rate of return
13 components of the cost of service, there remains an implicit PAA problem in two
14 cost allocation formulas that rely on gross plant balances: 1) the Massachusetts
15 Formula (Mass Formula) for calculating corporate overhead allocations and 2) the
16 calculation of the Kansas-Nebraska Formula (KN Formula) for allocating indirect
17 operating expense costs.

18 **Q. Are there other KMEP PAAs that affect the SFPP cost of service?**

which is discussed earlier in my testimony.

1 A. Yes. KMEP made other acquisitions wherein the “market value” of the assets was
2 greater than the depreciated original cost, which resulted in a write-up so that the
3 “book” value equaled the “market value.” Six of these acquisitions are regulated
4 entities from which the PAAs should be stripped before inclusion in the Mass
5 Formula calculations.¹³

6 **Q. Why are the PAAs of affiliated entities an issue in an SFPP cost of service?**

7 A. SFPP’s incorporation of PAAs of affiliated entities tends to shift costs from
8 unregulated entities to regulated entities. Regulated entities should only be
9 included in the cost of service using the depreciated original cost plant valuation.
10 The property value write-up shifts costs in any allocation formula that uses gross
11 plant balances to allocate costs. These PAAs impact the allocation of corporate
12 overheads (within the Massachusetts Formula) and the allocation of carrier and
13 non-carrier expenses (within the Kansas-Nebraska Formula).

14 **B) *Massachusetts Formula***

15 **Q. What is the Mass Formula and how is it derived?**

16 A. The Mass Formula is a cost of service cost allocation methodology used to
17 distribute corporate overheads among a number of subsidiary entities. An entity

¹³ These six entities are Kinder Morgan Interstate Gas Transmission Co., Trailblazer Pipeline Co., TransColorado Gas Transmission Co., Kaston Pipeline Co. L.P., and

1 such as SFPP that is part of a much larger organization should bear a fair share of
2 the overhead costs of operating the umbrella organization. Overhead costs are
3 those expenses that are being charged from affiliates (parent companies or
4 subsidiaries) and service companies, and are considered either a direct expense or
5 an indirect expense. Direct expenses or costs are those costs that can be
6 specifically identified and directly charged to the entity for which they were
7 incurred. Indirect expenses or costs are those costs that cannot be directly
8 identified or assigned to the entity for which they were incurred.

9 The Mass Formula is based on three factors: gross property, gross revenue,
10 and direct labor. Each factor is made up of the subsidiaries' share of the umbrella
11 entity. The Mass Formula takes the average of each subsidiary's percentages of
12 the gross factors to arrive at the allocator for corporate overheads among the
13 subsidiaries.

14 **Q. How did SFPP derive its Mass Formula allocator?**

15 A. SFPP witness Mr. Bullock describes the allocation of KMEP overhead costs
16 through the Mass Formula in Exhibit No. SFN-3, beginning at page 8. Mr.
17 Bullock used a four-tier approach to the 3-factor Mass Formula based on his
18 assessment of the degree to which each affiliate should bear KMEP overhead

1 costs. Mr. Bullock deemed Tier 1 costs to be applicable to all KMEP entities and,
2 thus, allocated Tier 1 costs to all KMEP entities via the three factor formula. Tier
3 2 costs included costs that related to certain offices within KMEP that perform
4 services only for some entities, and, thus, were allocated to only those related
5 entities. Tier 3 costs related only to non-bulk terminals. Tier 4 related only to bulk
6 terminals so none of these costs were allocated to SFPP. These allocators
7 developed a 20% overhead cost sharing for SFPP of \$35,939,883 as seen on
8 Exhibit No. SFN-30, Schedule 1, Page 5 of 5, line 46. Mr. Turner, in his cost of
9 service, then took the \$35.9 million and allocated 81.60% to SFPP carrier
10 operations based on a KN Formula methodology (incorrectly, as discussed below)
11 in Account Nos. 520 and 580 on Schedule 18 of Exhibit No. SFN-29. Mr. Turner
12 also added in capitalized overheads allocated from KMEP to SFPP.

13 **Q. What criticisms do you have of the SFPP allocation of corporate overheads?**

14 A. SFPP's derivation of the corporate overhead allocator has four major flaws: 1) it
15 uses a 4-tier approach that is not justified by SFPP's witness, 2) it incorporates
16 purchase accounting adjustments (PAA) that write-up the gross plant value of
17 some affiliates that should be stripped out before deriving the Mass Formula, 3) it
18 omits several affiliates from the calculations so that they do not bear any of the

1 costs of the corporate overheads, and 4) it includes capitalized overheads that I
2 believe are also incorporated into the rate base.

3 **Q. Why do you oppose the 4-tier approach proposed by SFPP?**

4 A. While the 4-tier approach may have some theoretical merit, SFPP witness Mr.
5 Bullock provides us with no verifiable allocation method independent of his
6 opinion. In other words, there is no way to verify the reasonableness or the
7 accuracy of his assessment as to which KMEP corporate overhead costs should be
8 spread out among all the affiliates, and which costs should be spread out among
9 only some of them. Furthermore, in his deposition Mr. Bullock was asked if he
10 knew who was ultimately responsible for including a particular cost in a tier. He
11 responded that he did not know who was responsible for making the tiered
12 allocations of cost. (Bullock Deposition, page 104, Exhibit No. SD-7DD)
13 Therefore, we not only do not know how the decision was made to include some
14 affiliates in the allocation process, we don't even know who made the decision.

15 **Q. Did you use the 4-tier approach?**

16 A. No. Since it cannot be verified why any particular corporate overhead cost should
17 be applied via the various tiers to some entities rather than all entities, I corrected
18 the 4-tier approach by using only one tier, as shown on Exhibit No. S-6, page 19 -
19 20.

1 **Q. How did you remove the impact of the purchase accounting adjustments?**

2 A. As noted above, the plant balances of regulated companies should be stripped of
3 the purchase accounting adjustments before being included in the Mass Formula
4 calculations. The PAAs associated with the six regulated entities were provided
5 by SFPP in response to ConocoPhillips, data request #13c Bates No. SFPPNL
6 22192, shown in Exhibit No. S-7CC. The PAA associated with Calnev Pipeline is
7 included in CococoPhillips's witness Mr. Matthew O'Loughlin's Exhibit No. CCV-
8 6. The removal of these write-ups is shown in Exhibit No. S-6, Page 25-26 . The
9 resulting corrected plant balances are shown in the Mass Formula workpaper in
10 Exhibit No. S-6, page 19-21 as lightly shaded figures in column (a).

11 **Q. Why do you oppose SFPP's proposed exclusion of 19 entities from the Mass**
12 **Formula?**

13 A. SFPP's exclusion of 19 affiliated entities from the Mass Formula, as proposed by
14 SFPP's witness Mr. Bullock, is not supported by any compelling rationales or
15 evidence for the method of exclusion. Mr. Bullock states on page 10 of his direct
16 testimony, Exhibit No. SFN-3, that the 19 entities were excluded because they
17 would distort the allocation formula, but he does not say how or in what manner
18 they would distort the formula. He simply states that these subsidiaries do not
19 require any KMEP management. However, upon cross examination during his
20 deposition, Mr. Bullock was asked a series of questions in regard to how these

1 entities are in fact managed. (Bullock deposition page 102-109, Exhibit No. S-
2 7EE) His answers revealed that he really knows very little about the management
3 of these companies. In fact, Mr. Bullock offered that his role in the development
4 of the SFPP Mass Formula was only to determine if there were any tax problems
5 associated with the allocations. (Bullock Deposition, page 103) Thus, there is no
6 credible evidence to suggest that these companies operate entirely free of
7 management activities. The Commission has determined that corporate overheads
8 should be allocated among all entities if the subsidiary benefits in any way from
9 the parent's management of the entity. (Williams Natural Gas Co., 85 FERC ¶
10 61,285)

11 **Q. How did you account for the omitted 19 affiliated entities?**

12 A. As discussed earlier, although Mr. Bullock states on page 9 of his Exhibit No.
13 SFN-3 that the SFPP Mass Formula model includes all the entities operated by
14 KMEP, it does not in fact include all the entities operated by KMEP because it
15 excludes the 19 entities. The gross plant balances, gross labor costs, and gross
16 revenues associated with the 19 omitted affiliates were provided by SFPP in
17 response to ConocoPhillips data request no. 7, (no Bates stamp) (Exhibit No. S-
18 7FF). I added these balances into the Mass Formula worksheet as shown on
19 Exhibit No. S-6, page 20, starting at line 56.

1 **Q. Why do you oppose the inclusion of capitalized overheads in the Mass**
2 **Formula proposed by SFPP?**

3 A. Capitalized overheads are corporate overhead costs associated with particular
4 capital projects. For FERC reporting purposes, the capitalized overhead is
5 reversed and entered as an expense. The problem is that we cannot verify that the
6 overheads were in fact reversed from the plant balances amounts. In his deposition
7 of Monday November 26, 2006, Mr. Turner was asked if he had examined the “‘04
8 MDB database” to determine if the capitalized overheads had been treated as
9 expenses or as capital; Mr. Turner reported he did not know. I assume that the
10 capitalized overheads are still in the plant balance figures and that, therefore, they
11 should be removed from the operating expense schedules.

12 **Q. How did you adjust for the capitalized overheads?**

13 A. The spreadsheet in Exhibit No. S-6, page 20, shows the Mass Formula total
14 overhead cost on line 75 of column H. I subtracted the \$37,114,000 of capitalized
15 overheads, which had been added in Mr. Bullock’s table on page 13 of Exhibit No.
16 SFN-3.

17 **Q. What was the practical result of these four adjustments?**

18 A. The impact of these changes is to simplify the approach, correctly spread the
19 overhead costs among more entities, shift some of the cost share from regulated to
20 unregulated utilities, and reduce the overall amount to be allocated. As a result,

1 the corporate overheads allocated to SFPP drop from some \$28.7 million to \$13.5
2 million; the North Line's share of the SFPP corporate overheads falls to \$1.1
3 million.

4 **C) *Kansas-Nebraska Formula***

5 **Q. What is the KN Formula and how is it derived?**

6 A. For an entity such as SFPP that has both carrier and non-carrier operations, it is
7 important that ratepayers be allocated no more than a fair portion of the indirect
8 costs of the whole entity. SFPP uses about 25 different allocators to separate
9 carrier-related costs from non-carrier related costs. These are shown on Exhibit
10 No. CCV-22, page 2 of 6. Among these allocators is a KN Formula allocator for
11 corporate unallocated costs of 81.60%, listed under Location Code 0050. The KN
12 Formula is a cost of service cost allocation methodology that is generally used to
13 allocate indirect operating and maintenance expenses between carrier and non-
14 carrier activities. The formula is a simple average of: 1) the ratio of direct carrier
15 gross plant to total gross plant in service and 2) the ratio of the direct carrier labor
16 costs to total company labor costs. The average is then multiplied by the total
17 indirect costs to arrive at the amount of indirect costs to be allocated to carrier
18 operations. The important point here is that the KN Formula is an allocator that
19 incorporates gross plant balances.

1 SFPP's cost of service model shows operating expenses as a component of
2 the total cost of service on Line 3 of Statement B of Exhibit No. SFN-28. Line 3
3 comes from Statement C, which reflects the operation and maintenance (O&M)
4 and general costs. These costs summaries are, in turn, drawn from Exhibit No.
5 SFN-29, Schedule 18. The figures shown in the column labeled "Carrier Amount"
6 were allocated from the total SFPP operations cost using the KN Formula
7 allocator. The allocator is derived in Schedule 14 of Exhibit SFN-28. Schedule 14
8 shows SFPP's allocation of direct carrier investment between the North Line and
9 all other carrier operations.¹⁴ Schedule 14 also shows SFPP's allocation of direct
10 carrier labor costs between the North Line and all other carrier operations. The
11 average of the two ratios is the North Line KN Formula allocator, 8.19%, shown
12 on line 17.

13 **Q. Are there two KN Formula allocators in use in the cost of service model?**

14 A. Yes. There is a KN Formula allocator used to allocate corporate unallocated
15 expenses between carrier and non-carrier operations, and another KN Formula
16 allocator to separate North Line costs from all other carrier costs. The second KN

¹⁴ The allocation between North Line and all other carrier operations was done on the basis of volumes drawn from the Route Directory in Schedule 11 of Exhibit SFN-29.

1 figure, 8.19%, shows up in Schedule 14, while the first, 81.60%, is embedded
2 within a data base that allocated corporate unallocated costs.

3 **Q. Why are you concerned about the KN Formula in this cost of service?**

4 A. SFPP's calculation of the corporate unallocated KN Formula allocator for indirect
5 costs (embedded in the expenses data base) incorporates purchase accounting
6 adjustments (PAA) in the gross plant balances used to derive the 81.60% corporate
7 unallocated KN Formula allocator. Upon close examination, it can be seen that
8 SFPP incorporates PAAs that should have been stripped out before deriving the
9 corporate unallocated allocator. SFPP's incorporation of PAAs in its KN Formula
10 shifts costs from non-carrier activities to carrier activities. Although Mr. Turner
11 believes that the "fair market appraisal" should be included in the plant balances
12 used to calculate the KN Formula,¹⁵ these inflated bookkeeping values have
13 nothing to do with the indirect costs we are allocating. Moreover, the Commission
14 has directed us to remove the impact of PAAs from the cost of service. (Opinion
15 No. 435, 86 FERC ¶ 61,022 at 61,097) Mr. Turner does not explain why he
16 ignored the direction set forth in Opinion No. 435.

17 **Q. What is the effect of improperly incorporating the PAAs into the overheads**
18 **KN Formula allocator?**

¹⁵ See, Mr. Turner's testimony in OR96-2 (provided in O'Loughlin's Exhibit No. CCV-23 at page 5).

1 A. The plant balances used to derive SFPP's corporate unallocated allocator are seen
2 in a workpaper, Bates No. SFPPNL 00217, provided in response to the
3 intervenors' Initial Data Request No. 1. That workpaper uses a total gross property
4 figure of \$1,747,174,000 in the plant ratio calculation that results in an allocator of
5 81.60%. However, as seen in Mr. Turner's testimony in OR96-2, the PAA write-
6 ups incorporated in the plant balances are \$646,793,000 for carrier property and
7 \$91,584,000 for non-carrier property. These write-ups disproportionately weight
8 the plant balances toward carrier operations, which results in the 81.60% allocator.
9 When these PAAs are stripped out of the plant balances, the KN Formula
10 allocator drops to 78.87%, as shown in my Exhibit No. S-6, page 4.

11 **Q. How have you incorporated the revised KN Formula allocator?**

12 A. I used the corporate unallocated KN Formula allocator to revise the indirect costs
13 shown in Schedule 18 of Exhibit No. SFN-29. As shown in my Exhibit No. S-6,
14 page 6, I grossed up the indirect costs by 81.60% to estimate the total indirect
15 costs, then applied the revised 78.87% to allocate indirect costs to carrier
16 operations before the North Line percentages are applied. The line items I revised
17 are the shaded indirect costs. These revised base period operating expenses are
18 reflected in my cost of service model Exhibit No. S-5, Statement B.

19

1 **D) *Account 320 – Environmental Remediation Expense***

2 **Q. What does SFPP propose in regard to Account 320 – Environmental**
3 **Remediation Expense for the North Line in this proceeding?**

4 A. SFPP proposes a test period Environmental Remediation Expense of \$2,070,000 as
5 seen on Exhibit No. SFN-28, Statement B, line 3. This amount adjusts the base
6 period figure of \$1,666,000 by adding \$404,000 for the test year estimate.

7 **Q. How did SFPP arrive at the base year Environmental Remediation Expense?**

8 A. SFPP provided base period Environmental Remediation Expense amounts in
9 Exhibit No. SFN-29, Schedule 18, Page 1 of 3, above the heading “320 Total.”
10 These entries appear to be subdivided into several North Line projects. The
11 segmented environmental costs are then adjusted to reflect just the portion of such
12 costs to be borne by interstate shippers. My adjustment is done by applying the
13 interstate volume route directory percentages developed in Staff Witness Bonnie
14 Pride, reproduced in Exhibit No. S-6, page 18, as adjusted from SFPP Exhibit No.
15 SFN-29, Schedule 11.

16 **Q. How did SFPP arrive at the test year Environmental Remediation Expense**
17 **adjustment?**

18 A. SFPP developed its test year Environmental Remediation Expense adjustment by
19 averaging the expenses incurred over the last five years, as shown in Exhibit No.
20 SFN-28, Workpaper 9. This workpaper shows expenses associated with 14

1 environmental remediation projects. The expenses are adjusted to reflect just the
2 portion of such costs to be borne by interstate shippers. SFPP then calculated a
3 five year average of these expenses and subtracted the 2004 base year amount from
4 the five year average to arrive at the test year adjustment. In other words, SFPP is
5 using the Commission's average five year expense as a proxy for the test year
6 "known and measurable" expenses standard.

7 **Q. Do you agree with SFPP's methodology?**

8 A. No. The 8 months of actual 2005 environmental remediation costs, when
9 annualized, suggest a significantly smaller remediation cost than the five year
10 average used by Mr. Turner. Even more striking, SFPP's own estimates of
11 environmental remediation costs for 2006 and 2007, as reflected in Mr. Matthew
12 O'Loughlin's Prepared Answering Testimony, Exhibit No. CCV-1, page 56, Table
13 14, (which incorporates SFPP's response to ConocoPhillips/Valero Data Request
14 No. 38, Bates No. SFPPNL 22537) show a range of \$663,000 to \$1,027,000 – as
15 adjusted for North Line allocations. Mr. Turner's method results in a remediation
16 cost of 2,070,000, which is over \$1,043,000 higher than SFPP's own highest
17 internal estimate.

18 The Commission's test year regulations for cost of service derivation do not
19 suggest using a five-year average for operating expenses; rather, the regulations

1 call for an adjustment based on known and measurable changes from the base
2 period to the test period. While there is some discretion within the term
3 “measurable,” any test period adjustment should be drawn from data within the
4 time frame of the base and test periods. A five-year average reaches well beyond
5 the time frame of the base and test periods and includes costs way outside the test
6 period.

7 **Q. How do you recommend the Environmental Remediation Expense for the test**
8 **year be derived?**

9 A. I recommend using an average of the 2004 actual costs for the base period and an
10 annualized estimate of the 8-months actual costs for 2005. This estimate is shown
11 on Workpaper 9 of my Exhibit No. S-5, page 34. The 2005 8-months actual costs
12 are drawn from SFPP’s response to Staff Data Request No. 1.13, Bates No.
13 SFPPNL 22189, shown in Exhibit No. S-7GG, page 1. This method results in an
14 adjustment to the test year Environmental Remediation Expense for the North Line
15 of (\$54,000), for a total Environmental Remediation Expense for the North Line of
16 \$1,612,000 as shown on Statement B, Line 3 of Exhibit No. S-5, page 5.

17

1 **E) Account No. 550 – Outside Expenses - Litigation Costs**

2 **Q. What does SFPP propose in regard to Account No. 520 – Outside Services –**
3 **FERC Litigation Expense for the North Line in this proceeding?**

4 A. SFPP proposes a test period FERC Litigation Expense of \$2,916,000 as seen on
5 Exhibit No. SFN-28, Statement B, line 11. This amount adjusts the base period
6 stated expense of \$2,786,000 by adding \$129,000 for the test year estimate.

7 **Q. How did SFPP arrive at its FERC Litigation Expense?**

8 A. SFPP provided base period FERC Litigation Expense amounts in Exhibit No.
9 SFN-29, Schedule 18, Page 2 of 3, above the heading “520 Total.” The entry
10 appears to be subdivided into several rate case sub-sets. The subsets are then
11 adjusted to reflect just the portion of such costs to be borne by North Line
12 interstate shippers. That adjustment is done using percentages presented in Exhibit
13 No. SFN-29, Workpaper 12.

14 **Q. How did SFPP develop the percentages used to allocate Litigation Costs to**
15 **North Line shippers?**

16 A. SFPP witness Mr. Thomas A. Turner developed the percentages used to allocate
17 FERC Litigation Costs, as described in his Prepared Direct testimony, Exhibit No.
18 SFN-26, Page 9 through 14. Mr. Turner evaluated five on-going rate cases and
19 allocated portions of the litigation cost to North Line shippers (Docket Nos. OR92-
20 8, OR96-2, IS98-1/OR98-11, OR03-5, and OR04-3). His general allocation
21 methodology is to derive an annual average litigation cost per rate case and divide

1 the costs equally among four pipeline systems, East Line, West Line, North Line,
2 and Oregon Line, regardless of throughput.

3 For Docket No. OR92-8, which relates generally to SFPP's East and West
4 Lines, Mr. Turner allocated no costs to the North Line shippers.

5 For Docket No. OR96-2, which relates generally to all SFPP lines, Mr.
6 Turner divided the costs equally among the four lines, allocating a 25% share to
7 the North Line shippers.

8 For Docket Nos. IS98-1/OR98-11, which are directed toward the Sepulveda
9 Line but appear to raise issues relevant to all the SFPP systems, Mr. Turner
10 allocated half of the IS98-1/OR98-11 cost to Sepulveda and half to all other lines;
11 he then further allocated the other-line's half equally among four line segments for
12 a 12.5% share to the North Line shippers.

13 For Docket Nos. OR03-5 and OR04-3, which are routine cost of service
14 complaint cases that have not yet been set for hearing, Mr. Turner allocated the
15 costs for these cases equally to all lines with a 25% share for each line. Mr. Turner
16 acknowledged that it is too early to tell if these costs should be allocated to less
17 than all of SFPP's pipeline systems.

18 **Q. Do you agree with the 25% share used by Mr. Turner to allocate OR96-2**
19 **litigation costs to North Line customers?**

Public Version

SFPP, L.P.
Docket No. IS05-230-000

Exhibit No. S-4
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1 A. No. The Commission, as affirmed by the Court of Appeals, has directed that a
2 volumetric approach is best. Consequently, I concur with Mr. Peter Ashton's
3 calculation of the relative shares of litigation expense to be borne by North Line
4 shippers based on the percentage share of volumes in 2004, i.e., 8.89% as shown in
5 Mr. Ashton's Exhibit No. TES-15.

6 **Q. Do you agree with the 12.5% share used by Mr. Turner to allocate OR98-11**
7 **and IS98-1 litigation costs to North Line customers?**

8 A. No. These dockets relate strictly to costs incurred on the Sepulveda Line and
9 should be borne by Sepulveda Line customers. Mr. Turner argues that the issues
10 raised in Docket Nos. OR98-11 and IS98-1 apply to all the SFPP lines and that the
11 intervenors specifically noted in a post hearing brief that the issues were a test case
12 that could shape public utility issues for decades to come. However, Mr. Turner
13 provided no discussion or list of issues that might cross over to support the
14 allocation of Sepulveda case costs to other operating lines. But even if he had
15 done so, cost of service issues arise in almost every litigated case, and they almost
16 always have the potential to have consequences well beyond the case at hand. If
17 we were to tie every cost of service to the costs of previous rate cases that gave
18 rise to the regulations governing the decisions affecting that cost of service, we
19 would be overwhelmed with trying to devise allocation mechanisms. Furthermore,
20 it is unfair to burden North Line customers with paying for costs arising from other

1 customers complaints filed by on other lines. I propose that no litigation costs
2 from Docket Nos. OR98-11or IS98-1 be included in the North Line cost of service.

3 **Q. Do you agree with the 25% share used by Mr. Turner to allocate OR03-5 and**
4 **OR04-3 litigation costs to North Line customers?**

5 A. No. The allocation of litigation costs arising from Docket No. OR03-5, which
6 relates to all of SFPP's rates, should be done in the same manner as that in Docket
7 No. OR96-2: an 8.89% allocation to North Line customers. Docket No. OR04-3
8 relates only to the West Line and the Watson facilities rate. Consequently, as in
9 the case of Docket Nos. OR98-1 and IS98-1, no costs from that rate case should be
10 allocated to North Line customers.

11 **Q. How should the litigation expenses be normalized?**

12 A. SFPP normalized its litigation expenses by taking an average of each rate case's
13 costs over the life of the case and then subtracting the base period allocations from
14 the average so that the test year is equal to the average. Commission regulations
15 require test year estimates to be based on known and measurable costs occurring
16 within the base and test periods, not an average of costs going back 13 years.
17 Therefore I have used only base year and test year costs in deriving the test year
18 adjustment. Further, so as not to permanently burden the cost of service with the
19 entirety of these litigation costs for every year henceforth, I have amortized the

1 cost of test year litigation over a five year period consistent with Opinion No. 435-
2 A at 61,519.

3 **Q. What is your proposed level of litigation costs that should be borne by North**
4 **Line customers?**

5 A. As noted, SFPP's base period litigation costs, as shown on Exhibit No. SFN-29,
6 Schedule 18, Page 2 of 3, Account 520, incorporate allocation percentages that are
7 not appropriate, which skew the test period adjustment and hence the cost of
8 service. Mr. Turner's use of 25% for OR96-2 and "Other Dockets" and 12.5% for
9 IS98-1 and result in an inappropriate base period litigation expense of \$2,786,000 -
10 Exhibit No. SFN-28, Statement B, Line 11. The base period amounts should be
11 adjusted to reflect the percentage allocations outlined above. The result is a base
12 period litigation expense of \$2,499,000 as shown on Statement B, line 11 of my
13 Exhibit No. S-5, page 5.

14 SFPP's test period litigation costs should also reflect allocation percentages
15 as outlined above as well as an amortization of the costs over 5 years, as directed
16 in the Commission's Phase Two Opinion, 108 FERC ¶ 61,036 at P 423. The test
17 period litigation expense allocations are shown on Workpaper 12 of my Exhibit
18 No. S-5, page 37. The result is a test period adjustment to the adjusted base period
19 of \$84,000 for a total litigation expense of \$2,572,000.

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2 **Q. Does this complete your prepared direct testimony?**

3 A. Yes, it does.

United States of America
before the
Federal Energy Regulatory Commission

SFPP, Inc.

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Docket No. IS05-230-000

AFFIDAVIT OF Patrick R. Crowley

I, Patrick R. Crowley, do hereby declare that under penalty of perjury that I am the author of the foregoing affidavit, that the facts set forth herein are true and correct to the best of my knowledge.

_____ December 6, 2005