

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Inquiry Regarding the Commission's	§	Docket No. PL19-4-000
Policy for Determining Return on Equity	§	

COMMENTS OF SFPP, L.P. AND CALNEV PIPE LINE LLC

On March 21, 2019, the Federal Energy Regulatory Commission (“FERC” or “Commission”) issued its Notice of Inquiry Regarding the Commission’s Policy for Determining Return on Equity (“NOI”) in the above-captioned docket,¹ seeking comments from stakeholders on the Commission’s policies for determining the return on equity (“ROE”) for public utilities, including “whether any changes to its policies concerning public utility ROEs should be applied to interstate natural gas and oil pipelines.” In response to the Commission’s inquiry, SFPP, L.P. and Calnev Pipe Line LLC (“SFPP-Calnev”) have reviewed the NOI and, as members of the Association of Oil Pipe Lines (“AOPL”), have participated in that organization’s process of preparing comments on behalf of the wider liquids pipeline industry. SFPP-Calnev support AOPL’s comments and file these comments in order to emphasize and amplify certain points for the Commission’s consideration. SFPP-Calnev appreciate the Commission’s initiation of this process and the opportunity to provide comments on this crucial topic.

Correspondence and Communications. Pursuant to Rule 2010 of the Commission’s Rules of Practice and Procedure, the names and mailing addresses of the persons designated to

¹ *Inquiry Regarding the Commission’s Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 (2019).

receive service and to whom correspondence and communications concerning this proceeding should be addressed are as follows:

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Background. SFPP transports refined petroleum products through (a) the 864-mile North Line from Richmond and Concord, California to Brisbane, Sacramento, Chico, Fresno, Stockton and San Jose, California and Reno, Nevada, (b) the 114-mile Oregon Line from marine terminals in Portland, Oregon to Eugene, Oregon, (c) the 515-mile West Line from the Los Angeles Basin to Colton and Imperial, California, and Phoenix, Arizona, (d) the 400-mile East Line from El Paso, Texas to Tucson and Phoenix, Arizona.

Calnev is a 566-mile pipeline that transports refined petroleum products from refineries and marine terminals in the Los Angeles Basin through parallel 14- and 8-inch diameter pipelines that originate in Colton, California, and extend to terminals in Barstow, California, and Las Vegas, Nevada.

SFPP and Calnev are indirect subsidiaries of Kinder Morgan, Inc. (“Kinder Morgan”), which provides energy transportation and storage services in a safe, efficient, and environmentally responsible manner for the benefit of people, communities, and businesses. In addition to SFPP and Calnev, Kinder Morgan transports natural gas through approximately 68,000 miles of pipelines from every important natural gas resource play, including the Bakken, Denver-Julesburg, Eagle Ford, Marcellus, Permian, Utica, Uinta, Haynesville, Fayetteville, Barnett, Mississippi Lime, and Woodford, to markets where it can be put to work. Kinder

Morgan is therefore well equipped to respond to the Commission's inquiry as to whether any changes to Commission policies concerning public utility ROEs should be applied to interstate natural gas and oil pipelines.

Kinder Morgan's natural gas entities are filing separate comments in this docket, and participated in the development of the comments submitted by INGAA, while, as noted, SFPP and Calnev participated in the development of AOPL's comments, because a one-size-fits-all approach to ROE does not work across the industries that the Commission regulates. Public utilities, interstate natural gas pipelines, and interstate liquids pipelines face distinct, industry-specific risks. Just as the Commission has tailored its regulatory scheme for each of the three industries, it should also tailor any ROE policy initiatives to each industry.

Summary. As set forth in detail in AOPL's comments, the Commission's proposed four-part ROE is a methodology that should be available to interstate liquids pipelines for use in calculating an ROE on a case-by-case basis, subject to the modifications identified and addressed by AOPL. Given the unique, multi-faceted role ROE calculations play in the Commission's regulation of interstate liquids pipelines, SFPP-Calnev respectfully submit that the Commission should accept a flexible, industry-specific, and regulated-entity-specific application of the proposed methodologies to ROE calculations, which would include the availability of the proposed four-part ROE approach, with AOPL's modifications, as one of the acceptable methodologies available for use by interstate liquids pipelines. SFPP-Calnev also encourage the Commission to recognize that the ROE issue is not just about setting an appropriate return percentage. Equally important is addressing what such a rate is applied to and what return should mean for a fully or near fully-depreciated asset.

1. SFPP-Calnev support making FERC's four-part ROE method, with AOPL's recommended modifications, available for use by interstate liquids pipelines.

On a case-by-case basis, the Commission's proposed four-part ROE approach can be a reasonable and appropriate method for calculating the ROE for interstate liquids pipelines, provided that the methodology is applied with flexibility and a recognition of the particular needs of the liquids pipeline industry and the regulated entity. AOPL has identified certain modifications to the Commission's proposed four-part ROE approach to account for the needs of the liquids pipeline industry: (1) removal of the 50-percent downward adjustment to the long-term growth rate; (2) modifications to the Risk Premium approach to fit the liquids pipeline setting; (3) modifications to proxy group selection; and (4) permitting use of Value Line for short-term growth rates. SFPP-Calnev generally support AOPL's comments and recommendations regarding the methodologies that should be available to interstate liquids pipelines for calculating ROE on a case-by-case basis.

2. It is essential that FERC's ROE methodology be applied with recognition of the unique context of the interstate liquids pipeline industry and its risks.

Context of liquids pipeline rate regulation. Under Section 1(5) of the Interstate Commerce Act ("ICA"), common carrier interstate oil pipelines are to charge just and reasonable rates.¹ The courts and this Commission have acknowledged, however, that there is no single rate that satisfies the "just and reasonable" standard, but that there is a "zone of reasonableness," and any rates falling within the zone are just and reasonable.² In determining whether rates fall

¹ 49 U.S.C. app. § 1(5) (1988).

² See, e.g., *Farmers Union Cent. Exchange, Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir. 1984) ("*Farmers Union II*"); *Seaway Crude Pipeline Co. LLC*, 146 FERC ¶ 61,151, at P 27 (2014) ("*Seaway*").

within the “zone of reasonableness,” the Commission has recognized that there are multiple methodologies and formulae that can be employed in the ratemaking context that—while producing different individual rates—result in rates that are within the zone of reasonableness and therefore are just and reasonable.³ The importance of this principle was discussed by the United States Court of Appeals for the District of Columbia Circuit (“D.C. Circuit”) in *Farmers Union II*, wherein the D.C. Circuit found that assessing rates under the “zone of reasonableness” standard was necessary in order to strike “a fair balance between the financial interests of the regulated company and ‘the relevant public interests, both existing and foreseeable.’”⁴ Another principle announced by the D.C. Circuit in *Farmers Union II* is that, for rates to be just and reasonable, they must be “neither ‘less than compensatory’ nor excessive.”⁵ In *Seaway*, this Commission acknowledged this principle, stating that the “Commission’s statutory directive to determine whether rates are just and reasonable requires that the rates fall within the oft-cited ‘zone of reasonableness,’ where rates that are ‘neither less than compensatory nor excessive.’”⁶ In other words, rates must afford the pipeline the ability to recover its costs, plus earn a reasonable return on and of its investment. Arguably, compensatory also means that a pipeline that is heavily depreciated can and should receive sufficient revenue from its rates to justify the continued incurrence of the risks associated with the on-going operation of a liquids pipeline.

³ See *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) (“*Hope*”) (recognizing that “the Commission was not bound to the use of any single formula or combination of formula in determining rates”).

⁴ *Farmers Union II* at 1502. See also, *Permian Basin Area Rate Cases*, 390 U.S. 747, 767, 92 (1968).

⁵ *Farmers Union II* at 1502.

⁶ *Seaway* at P 27.

Farmers Union II and the Commission's *Seaway* decision are built upon the bedrock principles set forth by the Supreme Court in *Hope* and *Bluefield*. In these orders, the Supreme Court made clear that, for a rate to be compensatory, the carrier must be afforded a return on equity that is commensurate with returns on investment in other enterprises having corresponding risks.⁷ The Supreme Court also noted in *Hope* that such return "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."⁸ Accordingly, in conformance with the principles described above, as established in *Hope* and *Bluefield*, the Commission has included the return on equity as a cost component of a pipeline's cost of service. The general cost-of-service methodology that applies to liquids pipelines is set forth in Opinion No. 154-B,⁹ which was issued on the heels of *Farmers Union II*. The Opinion No. 154-B methodology includes a trended original cost rate base and a rate of return based upon actual embedded debt cost and equity costs reflecting the pipeline's risk.¹⁰ With respect to the return on equity, Opinion No. 154-B did not dictate a specific methodology for calculating the return on equity, but noted that the "equity rate of return should be determined on a case-specific basis with reference to the risks and corresponding cost of capital associated with the liquids pipeline whose rates are in issue. Of course, one factor which

⁷ *Hope* at 603; *Bluefield Water Works & Improvements Co. v. Public Serv. Comm'n*, 262 U.S. 679, 689 (1923) ("*Bluefield*") ("Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility of its property in violation of the *Fourteenth Amendment*.").

⁸ *Hope* at 603.

⁹ *Williams Pipe Line Co.*, 31 FERC ¶61,377 (1985) ("Opinion No. 154-B").

¹⁰ *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Order No. 561, 58 F.R. 58753, at 30,943 (Nov. 4, 1993) ("Order No. 561").

may be included in any risk analysis is the competition faced by the pipeline.”¹¹ As the Commission recognizes, liquids pipelines have calculated the return on equity using a two-step discounted cash flow (DCF) method for the past twenty years, and the Commission has approved the use of that methodology to calculate a reasonable return on equity.

While the cost-of-service methodology set forth in Opinion No. 154-B remains the methodology used today for developing cost-based rates and defending rates against cost-based challenges, in Order No. 561 the Commission adopted a simplified indexing methodology that permitted pipelines to adjust their rates annually to capture inflation-driven cost changes without the need to provide any cost justification.¹² The indexing methodology is based on the change in the Producer Price Index for Finished Goods, plus an “index adder” that is adjusted every five years based on the Commission’s assessment of industry-wide cost changes during the prior five-year period. As noted in Order No. 561, the purpose of the indexing regime is to “preserve[] the value of just and reasonable rates in real economic terms. This is because it takes into account inflation, thus allowing the nominal level of rates to rise in order to preserve their real value in real terms.”¹³

Though indexing is the default mechanism used by liquids pipelines to adjust their rates, the principles set forth in *Hope* and *Bluefield* continue to be relevant. As noted above, the return on equity is a cost component included in a pipeline’s cost of service, and pipelines subject to the Commission’s annual reporting requirements are required to report their costs of service on Page 700 of their annual FERC Form 6 submissions. Those costs of service—which include a return

¹¹ Opinion No. 154-B at 61,836.

¹² Order No. 561 at 30,948.

¹³ *Id.* at 30,950.

on equity—can be and are used by shippers to form the basis of any challenge to a pipeline’s base rates or indexed rates; indeed, while a pipeline is permitted to adjust its rates by the index, shippers are likewise entitled to challenge a pipeline’s indexing adjustments on the grounds that the pipeline’s proposed indexing adjustments are substantially in excess of the actual cost changes incurred by the pipeline during the prior two-year period.¹⁴ In addition, the costs of service reported on the Page 700s were used by the Commission in its most-recent five-year review of the indexing methodology and formed the basis of the “index adder” of 1.23 percent that would apply during the next five-year period.¹⁵

As such, it is critical that the methodology that a pipeline is required to apply to develop the return on equity component included in its cost of service—whether it be for purposes of the FERC Form 6, developing a cost of service as part of a litigated rate proceeding, or otherwise—is sufficient to ensure that the pipeline will earn a reasonable return on its investment that is commensurate with returns on investments in other companies that have similar risks, as well as be compensated for assuming the risks inherent to its particular business, as required by *Hope* and *Bluefield*.

Risks faced by liquids pipelines. The liquids pipeline industry faces tremendous risk and uncertainty. As noted above, under the principles established in *Hope* and *Bluefield*, regulated entities must be able to achieve through rates a level of earnings comparable to that earned by other enterprises of similar risk and uncertainty, maintain financial integrity, and attract capital on reasonable terms. While the Commission uses the return on equity as the vehicle for

¹⁴ *Id.* at 30,951.

¹⁵ *Five-Year Review of the Oil Pipeline Index*, 153 FERC ¶ 61,312 (2015).

regulated entities to achieve these goals, the utility and success of the return on equity must be assessed against the backdrop of the particular risks faced by liquids pipelines in general and, indeed, against the particular risks faced by the individual pipeline at issue, when determining that pipeline's cost of service. Liquids pipelines, even those with cost-of-service based rates, unlike electric utilities, are not guaranteed the ability to actually recover all of their costs nor realize the granted return. The ability of liquids pipelines to actually recover their costs and maintain a sufficient return remains uncertain due to factors outside the pipeline's control, including market risk, competition risk, and supply risk (all of which can impact the assumed throughput underlying rates), as well as regulatory risk (namely rules as to the types of costs that can be recovered and the timing of when pipelines can file to recover increased costs).

With respect to market risk, shipments on liquids pipelines are sensitive to price changes in the markets for the commodities liquids pipelines transport, both on a local scale and a global scale. Price differentials between market centers, as well as the global supply and demand of liquids products, can have immediate and profound impacts on a pipeline's throughput. A pipeline's ability to recover its costs, plus a reasonable return on its investment, is directly linked to the volumes transported on the pipeline, and market price fluctuations can impact levels of throughput on particular pipelines or pipeline segments, thereby affecting a pipeline's ability to recover a sufficient return on equity.

Liquids pipelines are also subject to significant competition risk; they do not have an exclusive franchise territory. The existence of a liquids pipeline in one geographic area does not foreclose the entry of a new pipeline competitor into the market to serve the existing pipeline's

customers. Indeed, multiple liquids pipelines can and have been constructed by competing entities to serve the same origin and destination markets.¹⁶ Pipelines also face competition from other modes of transportation, such as truck, rail, and marine vessels. The entry of other pipelines into a pipeline's market, as well as the availability (and easy expandability) of other modes of transportation, such as trucking, rail, and barges, can offer alternatives to shippers and create a highly price-sensitive market.¹⁷ Shippers on liquids pipelines are not captive customers and have the ability to make alternative arrangements for transporting their product, whether by pipeline, truck, marine vessel, or rail. To the extent that there is limited competition in a particular geographic area, liquids pipelines cannot use the lack of competition to their advantage. As common carrier pipelines regulated under the ICA, they have prescribed methods for setting rates (*e.g.*, cost based rates), and regardless of the rates that are on file, they remain subject to the ongoing risk of shipper complaints or protests.

With respect to supply risk, as noted above, a pipeline's ability to recover its costs, including its invested capital, plus earn a reasonable return on its investment, hinges on its throughput level, and liquids pipelines are susceptible to declining or changing production volumes related to their supply regions, as well as refinery output and the availability (and attractiveness) of transportation alternatives. Declines in throughput could be due to changes in refinery output or economics, actual physical declines in specific production basins, or the proliferation of production in other or new basins utilizing newer, more cost-effective production

¹⁶ *See, e.g.*, "U.S. oil pipeline rivals look to consolidate West Texas projects," Reuters, Rod Nickel & Bryan Sims (Oct. 13, 2017).

¹⁷ *See, e.g.*, "Why The Oil Industry Might Prefer Rail To Pipelines In Turbulent Times," Forbes, Thomas Covert (July 19, 2017).

technologies. These fluctuations can directly impact throughput and thus, a pipeline's ability to recover its costs and maintain a sufficient return on equity.

Finally, the ability for liquids pipelines to consistently recover their cost of service and maintain a stable return is subject to the risks associated with changing regulatory policies by virtue of being economically regulated entities. New or changing policy directives and orders can destabilize a pipeline's assumed return under pre-existing policies and are a risk of operating in a regulated industry. This regulatory risk, in combination with the market, competition, and supply risks noted above, are critical to understanding the role the return-on-equity component plays in allowing regulated liquids pipelines a return commensurate with the goals of *Hope* and *Bluefield* – namely a return sufficient to attract capital given all of the associated risks with operating an interstate liquids pipeline.

SFPP-Calnev respectfully submit that the foregoing considerations weigh in favor of the Commission adopting a flexible approach to the calculation of ROEs for interstate liquids pipelines that includes the proposed four-part ROE approach, as modified by AOPL, as an acceptable option available to such pipelines on a case-by-case basis. Such flexibility is necessary to ensure that the calculation of an ROE for an individual interstate liquids pipeline fully accounts for the context and risks faced by that pipeline.

3. *If adopted and applied flexibly, the addition of FERC's four-part ROE approach could help support essential energy infrastructure.*

Interstate liquids pipelines are textbook examples of essential energy infrastructure requiring large initial capital investments to put them in place and long-term capital investments to sustain their safe, efficient operation. Over the years, Kinder Morgan has deployed large amounts of capital to SFPP and Calnev—to maintain hundreds of miles of pipe, pumps, and tankage and, in response to customer needs and market demands, expand those facilities. These

investments have tangible effects in the market. For example, SFPP's expansion of service from west Texas to Arizona markets had an immediate impact, causing fuel prices to drop for consumers. Across the liquids pipeline industry, the need for capital investment remains high, to maintain safe, reliable infrastructure and to meet expanding demand, including burgeoning domestic energy production. In some cases, that need may be met with new or expanded pipelines, which is supported by the Commission's policies permitting liquids pipelines to enter into agreements with shippers at committed rates in exchange for take-or-pay obligations. In other cases, however, the most efficient means of meeting the market need may be reinvestment in an existing, fully or near fully-depreciated pipeline without any expansion of capacity. In those situations, simply applying an ROE, whatever the percentage, to a depreciated rate base may not provide an adequate level of return to justify continued operation of the system.

In this context of a significant national need for energy infrastructure, it is essential that the Commission have in place an ROE policy that is clear, stable, and flexible, affording liquids pipelines a reasonable opportunity to recover their investments and earn a return commensurate with the risk environment in which they operate, as well as incentivizing companies to efficiently use the assets already in the ground.

Conclusion. SFPP-Calnev support a flexible, industry-specific, and regulated-entity-specific application of the proposed methodologies to ROE calculations, which would include the availability of the proposed four-part ROE approach, with AOPL's modifications, as one of the acceptable methodologies available for use by interstate liquids pipelines. SFPP-Calnev urge that the Commission pursue an overall return policy that is reflective of the risks faced by interstate liquids pipelines in undertaking much-needed sustaining and expansion capital projects.

Respectfully submitted,

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June 26, 2019

CERTIFICATE OF SERVICE

Pursuant to Rule 2010 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission, 18 C.F.R. § 385.2010, I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary of the Federal Energy Regulatory Commission in this proceeding.

Dated at Houston, Texas this 26th day of June, 2019.

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Document Content(s)

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