UNITED STATES OF AMERICA
BEFORE THE
SURFACE TRANSPORTATION BOARD

CF INDUSTRIES, INC., **Complainant,** **v.** **KANEB PIPE LINE PARTNERS, L.P.,** **and** **KANEB PIPE LINE OPERATING PARTNERSHIP, L.P.,** **Defendants.**	))))))))))))	**Docket No. 42084**

REBUTTAL OF KANEB PIPE LINE PARTNERS, L.P. AND KANEB PIPE LINE OPERATING PARTNERSHIP, L.P. TO CF INDUSTRIES, INC.'S RESPONSE TO KANEB'S OPENING EVIDENCE AND ARGUMENT

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CF INDUSTRIES, INC.,	)	
Complainant,	)	
	)	
v.	)	
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KANEB PIPE LINE PARTNERS, L.P.,	)	**Docket No. 42084**
	)	
and	)	
	)	
KANEB PIPE LINE OPERATING	)	
PARTNERSHIP, L.P.,	)	
Defendants.	)	

REBUTTAL OF KANEB PIPE LINE PARTNERS, L.P.
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TO CF INDUSTRIES, INC.'S RESPONSE
TO KANEB'S OPENING EVIDENCE AND ARGUMENT

Pursuant to the Board's August 11, 2004 Decision[1] requesting additional information regarding materially changed circumstances on the anhydrous ammonia pipeline at issue in this proceeding in order to determine whether to vacate the rate prescription it imposed in CF Industries, Inc. v. Koch Pipeline Company, L.P.,[2] Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P. (collectively,

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1 CF Industries, Inc. v. Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P., STB Docket No. 42084 (STB served August 12, 2004) ("August 11 Decision").

2 CF Industries, Inc. v. Koch Pipeline Company, L.P., 4 S.T.B. 637 (2000) ("Koch"), aff'd sub nom. CF Industries, Inc. v. STB, 255 F.3d 816 (D.C. Cir. 2001).

"Kaneb")[3] hereby submit their Rebuttal to CF Industries, Inc.'s Response to Kaneb's Opening Evidence and Argument.

In its Response to Kaneb's Opening Evidence and Argument ("Response"), CF Industries, Inc. ("CFI") does not dispute Kaneb's evidence of materially changed circumstances. Instead, CFI raises various arguments that are irrelevant to the issue of whether there has been a material change in circumstances and to what extent those changes affect the factual underpinnings of the Koch prescription.

In the Koch decision, the Board stated that it stood "ready to promptly lift the rollback and prescription if and when such action should be shown to be necessary."[4] The Board acknowledged that commitment in its August 11 Decision in this proceeding.[5] Kaneb has demonstrated that it is now necessary for the Board to take such action. Kaneb's evidence of materially changed circumstances since the Board's decision in Koch is undisputed. The Board should not continue indefinitely the 16-year freeze on rates that CFI advocates, but instead should restore ratemaking initiative to Kaneb in order to allow the pipeline to earn a reasonable return on investment, consistent with the Board's ratemaking principles.

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3 Kaneb Pipe Line Partners, L.P. is a publicly-traded company which owns Kaneb Pipe Line Operating Partnership, L.P., the owner and operator of the pipeline at issue. Kaneb Pipe Line Company, LLC, which is not a named party to this proceeding, is the general partner of Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P.

4 Koch, 4 S.T.B. at 662.

5 August 11 Decision at 3.

I. BACKGROUND

In its August 11, 2004 Decision in this proceeding, the Board directed Kaneb to submit further information regarding materially changed circumstances in order to determine whether to vacate the existing rate prescription the Board imposed in Koch. Specifically, the Board noted that Kaneb had not indicated "what assets were encompassed in [the] purchase price and how much of the purchase price is attributable to the pipeline itself."[6]

Kaneb submitted its Opening Evidence and Argument in compliance with the Board's order on September 13, 2004. Kaneb's evidentiary submission consisted of the Koch/Kaneb Asset Purchase and Sale Agreement ("Purchase Agreement"); a verified statement regarding the arm's length nature of the Purchase Agreement transaction with Koch; a comparison of the pipeline assets; and other evidence related to its claim of materially changed circumstances. Specifically, Kaneb submitted evidence in verified statements, including: (1) Kaneb's acquisition costs in an arm's length transaction for the pipeline assets, which substantially exceed the pipeline valuation underlying the Koch prescription; (2) Kaneb's average operating costs and capital expenditures, which exceed the average operating costs and capital expenditures the Board examined in Koch; (3) volumes on the pipeline, which have decreased since the Board examined them in Koch; and (4) revenues generated from the pipeline, which have decreased since the Board imposed the Koch rate prescription.

Kaneb also submitted evidence for illustrative purposes which shows that, based on the material change in circumstances, Kaneb's return on investment, when compared

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6 August 11 Decision at 4.

to a conservative cost of capital benchmark, would have substantially different results from the similar comparison which underlies the Board's determination in Koch. Kaneb argued that the factual underpinnings of the Koch decision no longer have validity, and that the Board should lift the rate prescription, based on these materially changed circumstances, and restore ratemaking authority to Kaneb. CFI responded to Kaneb's Opening Evidence and Argument on October 7, 2004.

II. CFI HAS NOT SUBMITTED ANY EVIDENCE DISPUTING KANEB'S CLAIM OF MATERIALLY CHANGED CIRCUMSTANCES.

As Kaneb argued in its Opening Evidence and Argument, in determining whether to vacate a rate prescription, and thus restore ratemaking initiative to a carrier, the Board must assess whether the factual and legal bases of the prescription remain valid.[7] The Board will vacate a rate prescription and restore ratemaking initiative to the carrier where it finds that circumstances have changed significantly since its imposition of the rate prescription.[8]

Circumstances have changed materially on the anhydrous ammonia pipeline at issue since the Board imposed the prescription in Koch. In its Opening Evidence and Argument, Kaneb submitted evidence regarding its acquisition cost, average operating costs and capital expenditures, volumes and revenues, all of which have changed materially since the Board imposed the Koch rate prescription. As discussed in more detail below, CFI has not refuted Kaneb's evidence. Because it is now undisputed that

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7 San Antonio, Texas v. Burlington Northern, Inc., 364 I.C.C. 887 (1981), 1981 ICC LEXIS 78, at *21; Arizona Public Service Co. v. Burlington N. & Santa Fe Ry. Co., STB Docket No. 41185, slip op. at 6 (STB served May 12, 2003).

8 See, e.g., San Antonio, TX, 1981 ICC LEXIS 78, at *14-15 (lifting a 5-year old rate prescription because it was no longer supported by current cost data or current legal standards).

the factual and legal bases of the prescription are no longer valid, the Board should lift the prescription and restore ratemaking initiative to Kaneb.

A. CFI Does Not Dispute that Kaneb's Acquisition Costs Substantially Exceed The Pipeline Asset Valuation Underlying The Koch Prescription.

1. CFI Does Not Dispute that the Assets Kaneb Acquired from Koch Are Substantially the Same Assets that the Board Examined in Koch.

In the Koch decision, the Board described Koch's pipeline assets as follows:

> Koch's 1,943-mile pipeline . . . runs from Louisiana north to Hermann, MO, where it splits into two legs. The main stem serves one storage destination point in Arkansas, the eastern leg serves eight destination points in Illinois and Indiana and the western leg serves 15 destinations in Missouri, Iowa and Nebraska.[9]

Kaneb purchased those same pipeline facilities from Koch, effective November 2002, for approximately $140 million. Kaneb demonstrated in its Opening Evidence and Argument that the assets it purchased from Koch are substantially the same assets that the Board examined when it set the rate prescription in Koch.

CFI does not dispute that the assets Kaneb purchased from Koch are same assets that the Board analyzed in Koch. Moreover, although CFI questions Kaneb's business judgment in paying $140 million for the pipeline assets throughout its Response, CFI does not dispute that Kaneb paid $140 million for the pipeline assets it acquired from Koch. In fact, CFI quotes Kaneb's Opening Evidence and Argument for those propositions. Specifically, CFI states, "As described in Kaneb's September 13th Filing,

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9 Koch, 4 S.T.B. at 638.

Kaneb purchased the ammonia pipeline from Koch in the Fall of 2002 for approximately $140 million. The assets are essentially the same as those involved in the *Koch Order*."[10]

As Kaneb first argued in its motion to dismiss CFI's complaint, the asset valuation used by the Board in Koch no longer has validity. Because CFI does not dispute that: (1) the pipeline assets that Kaneb purchased from Koch are the same assets the Board valued in Koch at $77.2 million; and (2) Kaneb paid $140 million for those assets, the Board should lift the rate prescription it imposed in Koch based on this undisputed material change in circumstances.

2. CFI Does Not Dispute that the Koch/Kaneb Asset Purchase and Sale Was an Arm's Length Transaction.

As the Board requested in its August 11 Decision, Kaneb submitted a verified statement regarding the arm's length nature of the Purchase Agreement. Specifically, Edward Doherty, Chairman of the Board and Chief Executive Officer of Kaneb Pipe Line Company, LLC, verified that Kaneb does not have and has never had an affiliate relationship with Koch; Kaneb conducted due diligence on the valuation of Koch's assets prior to making its final bid; Koch and Kaneb were of equal bargaining power throughout negotiations; Kaneb believed the purchase price of $140 million was a fair representation of the market value of the assets; and Koch does not receive a percentage of earnings from the pipeline assets and has not retained an interest in the pipeline assets.

Although CFI makes clear its opinion that Kaneb paid too much for the pipeline—an opinion with which Kaneb disagrees—nowhere in its Response does CFI dispute that Kaneb's purchase of the pipeline was conducted at arm's length, or suggest

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[10] CFI Response at 6.

that Kaneb's purchase of the pipeline involved any impropriety.[11] Because Kaneb's purchase of the pipeline was conducted at arm's length and Kaneb's acquisition cost is a substantial increase over the valuation Koch reported in 1988 for the same pipeline assets, the factual underpinnings of the Koch decision no longer have validity. CFI does not dispute these facts. Therefore, the Board should lift the prescription it imposed in Koch.

B. CFI Does Not Dispute that Kaneb's Average Operating Costs and Capital Expenditures Exceed the Average Operating Costs and Capital Expenditures the Board Examined in Koch.

In its Opening Evidence and Argument, Kaneb submitted the verified statement of Joseph Graham, the Controller of Kaneb Pipe Line Company, LLC. The verified statement demonstrated that Kaneb's average cash operating expenses and capital expenditures exceed the average operating costs and capital expenditures that the Board examined in Koch. These cash operating expenses include the costs of Kaneb's implementation of a Department of Transportation-mandated pipeline integrity program to conduct corrosion testing on the pipeline, and increased property taxes. In addition, Kaneb's capital expenditures include costs relating to de-bottlenecking and modernization of the pipeline.

CFI's Response does not dispute that Kaneb's average cash operating costs and capital expenditures exceed the average operating costs and capital expenditures examined by the Board in Koch. Indeed, CFI's Response contains no reference to

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[11] See, e.g., Waterloo Railway Company, STB Docket No. AB-124 (Sub-No. 2), slip op. at 22 (STB served May 3, 2004) (noting that an arm's length transaction is one without any improprieties).

Kaneb's pipeline integrity program or the other costs and expenditures for which Kaneb presented evidence. Instead, CFI merely complains that Kaneb's evidence provides information about costs "without any projections for whether these facts will change."[12] Therefore, the facts are undisputed that the average operating costs and capital expenditures that Kaneb has incurred differ materially from the average operating costs and capital expenditures that the Board examined in Koch. Thus, the Board should lift the prescription it imposed in Koch, because, among other facts, the factual underpinnings of the decision relating to operating costs and capital expenditures are no longer valid.

C. CFI Does Not Dispute that Volumes on the Pipeline Have Decreased Since the Board Examined Them in Koch.

Kaneb submitted the verified statement of Robert A. McElroy, Jr., Vice-President of Kaneb Pipe Line Company, LLC, demonstrating that volumes on the pipeline have decreased from the volumes analyzed by the Board in Koch. Kaneb's evidence noted that volumes for 2004 are projected to be nearly as low as in 1988, the lowest year for which the Board examined data in Koch. Again, CFI does not dispute that volumes of anhydrous ammonia shipped on the pipeline have decreased, and in fact, CFI concedes

12 CFI Response at 7 (citing Verified Statement of Joseph Graham). CFI cites no support for how such projections are relevant to the issue of materially changed circumstances. As the Board noted in Koch, future costs "not yet made and assets that are not in place" are too remote to be considered in the context of a revenue adequacy determination. Koch, 4 S.T.B. at 662. In addition, they are not relevant here, in a proceeding in which the Board is only evaluating whether circumstances have changed materially since it implemented the rate prescription in Koch.

that volumes on the pipeline have decreased. In its Response, CFI acknowledges this decrease and states, "As Kaneb's filing indicates, volumes have decreased."[13]

The decrease in volumes shipped on the pipeline is a material change in circumstance since the Board examined the flow of ammonia on the pipeline in Koch. CFI does not dispute this change from the factual underpinnings of the Board's decision in Koch. Based on this material change in circumstances relating to volumes of anhydrous ammonia shipped on the pipeline, the Board should now lift the rate prescription it imposed in Koch.

D. CFI Does Not Dispute that Revenues Generated from the Pipeline Have Decreased Since the Board Imposed the Koch Rate Prescription.

Finally, Kaneb submitted evidence demonstrating that revenues generated from the pipeline have decreased significantly since the Board examined revenues in Koch. Specifically, Kaneb submitted evidence showing that Kaneb's revenue is projected to be approximately $20.5 million in 2004, nearly equal to the lowest revenue that the Board examined in Koch, for 1988.

Again, CFI submitted no evidence disputing that Kaneb's revenues have decreased. Because this material change in circumstance is now undisputed, the Board should lift the prescription it imposed in Koch.

III. CFI'S ARGUMENTS ARE INAPPOSITE TO THE ISSUE OF WHETHER THE RATE PRESCRIPTION SHOULD BE LIFTED.

CFI offers many arguments to distract the Board from the one issue remaining in this proceeding: whether the Board should alter or lift the rate prescription it imposed in

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[13] CFI Response at 22.

Koch, based on material changed circumstances that affect the factual underpinnings of the prescription.[14] CFI had the opportunity to present evidence to show that there has been no material change in circumstances on the pipeline since the Board imposed the rate prescription in the Koch case, and did not do so. Rather than submitting evidence to dispute Kaneb's evidence regarding materially changed circumstances, CFI has raised arguments that conceivably might be more appropriate, albeit legally and factually inaccurate, in the context of a rate challenge proceeding. However, Kaneb is not seeking to raise its rates in this proceeding.

Despite the fact that CFI concedes all of the material changed circumstances for which Kaneb presented evidence, CFI persists in asserting that the 16-year freeze on rates imposed by the Board must remain in place, presumably for as long as the pipeline transports anhydrous ammonia. Although CFI's arguments are not appropriate for consideration in the context of this proceeding to lift the rate prescription, the arguments warrant response to the extent that they misconstrue both the law and the facts.

A. A Revenue Adequacy Determination Is Inappropriate in this Proceeding.

CFI argues that Kaneb "fails to present the same type of evidence that underlies the rate prescription" and that the Board must conduct a revenue adequacy analysis "similar to the one that it used to set the rate prescription in the *Koch Order*" in order to determine whether to lift the rate prescription.[15] CFI misconstrues the law entirely on this point. While the Board is required to conduct a "full hearing" prior to prescribing a

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[14] August 11 Order at 4.

[15] CFI Response at 11.

rate,[16] the Board has no such requirement for lifting a prescription and returning ratemaking initiative to the carrier. See San Antonio, Texas v. Burlington Northern, Inc., 364 I.C.C. 887 (1981), 1981 ICC LEXIS 78, at *20-21. Rather, in order for the Board to lift a rate prescription, it must find that circumstances have materially changed since it imposed the rate prescription.[17] It is neither necessary nor appropriate for the Board to perform a revenue adequacy determination in this proceeding.

Because CFI has misconstrued the law on the type of evidence necessary for the Board to lift a rate prescription, all of its arguments relating to this issue are without merit. For example, CFI argues that Kaneb's evidence is insufficient because "[r]ather than follow Board precedent by providing a multi-period discounted cash flow analysis to evaluate its rates, Kaneb presented a mere short term snapshot."[18] CFI mischaracterizes the evidence Kaneb submitted regarding materially changed circumstances and attempts incorrectly to apply the Board's precedent on revenue adequacy determinations in rate challenge proceedings. Kaneb submitted evidence for illustrative purposes demonstrating that as a result of the material change in circumstances, Kaneb's return on investment would be significantly lower than the return on investment upon which the Koch rate prescription is based, and to give the Board an idea of revenues on the pipeline for the period in which Kaneb has owned the pipeline. Kaneb did not submit a discounted cash flow analysis to justify new rates because, as noted previously, Kaneb is not seeking to raise its rates in this proceeding. An evaluation of rates is not necessary or appropriate in

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16 49 U.S.C. § 15503.

17 San Antonio, TX, 1981 ICC LEXIS 78, at *21; Arizona Public Service Co., STB Docket No. 41185, slip op. at 6.

18 CFI Response at 2.

a proceeding in which the only issue before the Board is whether it should alter or lift an existing rate prescription.[19]

CFI further states: that "Kaneb urges the Board to review the pipeline's revenue adequacy by using its $140 million acquisition cost to set the new investment base for the pipeline assets;"[20] that "Kaneb concedes that the Board should examine the revenue adequacy of the pipeline in determining whether to lift the rate prescription,"[21] and that "Kaneb and CFI agree that the Board must examine whether the key factor underlying the rate prescription – whether the pipeline is revenue adequate – is still valid prior to lifting the rate prescription."[22] These statements are factually incorrect and wholly without merit. Kaneb has not argued that a revenue adequacy determination is necessary or even appropriate in this proceeding; Kaneb has made no "concession" that the Board should examine the revenue adequacy of the pipeline in determining whether to lift the rate prescription; and Kaneb does not agree, as CFI suggests, that the Board must make a revenue adequacy determination in this proceeding. As noted above, in determining whether to lift a rate prescription, a full-blown hearing involving a revenue adequacy determination is not required by Board precedent, and is not necessary or even relevant to the Board's inquiry regarding materially changed circumstances.

By the same account, CFI's evidence regarding Kaneb's revenue adequacy is flawed. As discussed in more detail in the attached verified statement of Robert Van Hoecke, CFI's evidence fails to comply with Board precedent regarding revenue

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[19] San Antonio, TX, 1981 ICC LEXIS 78, at *21; Arizona Public Service Co., STB Docket No. 41185, slip op. at 6.

[20] CFI Response at 11.

[21] CFI Response at 9.

[22] CFI Response at 10.

adequacy, misrepresents the Board's decision in Koch, and contains illogical and inconsistent assumptions relating to the actual costs of operating the pipeline assets. The fundamental premise of CFI's evidence, i.e., that predecessor investment cost should be used to calculate revenue adequacy, is incorrect, as discussed below. Moreover, the evidence contained in the verified statement of Mr. Tom Carlton[23] includes a return on investment calculation that makes several assumptions in order to develop an estimated net income and net investment, most of which are illogical and consequently lead to erroneous results. For example, Mr. Carlton's evidence estimates expenses based on revenues instead of throughput, calculates income taxes based on book depreciation instead of tax depreciation, arbitrarily inflates depreciation expense instead of calculating it based on gross or net investment, and ignores evidence of actual cost incurred by Kaneb in favor of unsupported estimates. As described in further detail in the attached verified statement of Robert Van Hoecke, Mr. Carlton's verified statement and his revenue adequacy calculations should be disregarded by the Board.

B. Even Assuming, Arguendo, that a Revenue Adequacy Determination Were Appropriate Here, CFI Misconstrues the Law on Acquisition Cost Valuation.

CFI makes several arguments concerning acquisition cost valuation. Even assuming, arguendo, that a revenue adequacy determination were appropriate in this proceeding—although no revenue adequacy determination is necessary or even relevant to the issue of whether to lift the existing rate prescription—CFI's misguided arguments regarding the Board's use of acquisition cost valuation warrant response.

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23 CFI Response, Attach. B.

CFI is mistaken that the use of acquisition cost valuation does not comport with Board precedent.[24] Specifically, CFI states that "In the *Railroad Revenue Adequacy Order*, the ICC instituted the policy of using acquisition costs to examine revenue adequacy in cases where railroads were sold for less than their book costs."[25] This entirely misstates the Board's policy regarding acquisition cost valuation. In the Board's predecessor agency's decision in the 1988 Railroad Revenue Adequacy Determination, the ICC stated that it would, from that point forward, use acquisition cost valuation in its annual railroad adequacy determination.[26] Specifically, the ICC stated that:

> [A]cquisition cost represents the fair market value of an asset as established by the purchase price on the date acquired. Since it reflects a new valuation basis for an acquired asset, it can be either higher or lower than the previously recorded value. Once recorded on the books of the acquiring [carrier], this becomes its 'book value' and its new basis for depreciation.[27]

In explicitly rejecting future use of predecessor cost/value or original cost/value, the ICC stated that the use of acquisition cost in valuing a railroad's investment bases comports with generally accepted accounting principles and is consistent with the underlying objectives of the ICC's revenue adequacy analysis.[28] On appeal, the D.C. Circuit upheld

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24 CFI Response at 11.

25 CFI Response at 15.

26 Railroad Revenue Adequacy – 1988 Determination, STB Ex Parte No. 483, 6 I.C.C. 2d 933 (1990), 1990 ICC LEXIS 247, at *15 ("1988 Revenue Adequacy Determination").

27 Id. at *5 n.3 (emphasis added).

28 Id. at *15.

the ICC's decision to adopt acquisition cost valuation in computing revenue adequacy, rather than continuing to use original or predecessor cost valuation.[29]

Although the ICC indicated, as CFI points out, that it would not necessarily accept the sale price of rail assets as a substitute for old book values in every case,[30] there are no instances—and indeed, CFI points to no cases—since the 1988 change in policy in which the Board or its predecessor agency rejected acquisition cost valuation in favor of the old book value.[31] Instead, CFI points to other agency decisions for the proposition that "predecessor investment cost" is appropriate for use in this proceeding.[32] Specifically, CFI cites to the decisions of the Federal Energy Regulatory Commission[33]

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29 Assoc. of Am. Railroads v. ICC, 978 F.2d 737, 741 (D.C. Cir. 1992) (finding that the ICC made a rational choice between conflicting policy alternatives).

30 1988 Revenue Adequacy Determination, 1990 ICC LEXIS 247, at *19.

31 CFI's citation to Ashley Creek Phosphate Co. v. SF Phosphates Ltd. Co., 1992 MCC LEXIS 191 (ICC served Dec. 29, 1992), CFI Response at 14 n.15, which it incorrectly cites as a Board decision, is inapposite. In Ashley Creek, the ICC found that the acquisition in that case, because it occurred in the midst of a pending rate challenge proceeding against the predecessor, warranted the application of the same ratemaking methodology that the ICC had begun to employ in the pending proceeding, which it also consolidated with the new proceeding against the successor. Id. In selecting a hybrid of original cost ratemaking and stand alone cost, the ICC discussed at length the "unique nature of the case" which dictated neither straight stand-alone cost ratemaking nor original cost ratemaking as the proper methodology. Id. Specifically, the complaint had been filed shortly after the pipeline went into service and there were antitrust claims involved due to the interdependency of demand. Id. Because the facts are so radically different and the ICC did not use the revenue adequacy constraint, Ashley Creek is irrelevant to this proceeding.

32 Regardless of whether CFI calls it "predecessor investment cost" or "predecessor cost," as discussed above, since the 1988 Revenue Adequacy Determination, the Board has advocated the use of acquisition cost valuation in its revenue adequacy determinations. In addition, as discussed below, the Board used acquisition cost valuation in Koch.

33 CFI Response at 13, 16.

("FERC"), the Federal Communications Commission,[34] and the California Public Utilities Commission,[35] although none of these agencies' decisions are remotely relevant. Even assuming, arguendo, that CFI has correctly interpreted those other agency decisions, the Board's predecessor stated that it did not believe that it was "bound in any respect by FERC's methodological approach" and that "the decisions of that agency, although they may be helpful, are not binding upon this Commission."[36] CFI's claim that "using predecessor investment cost would be in line with the way other regulatory agencies set rates"[37] is irrelevant to the way the Board sets rates under an entirely different statutory and regulatory scheme, and is not relevant to the Board's review in this proceeding.

The Board has been using acquisition cost valuation in its revenue adequacy determinations for fourteen years, and its use has been judicially upheld.[38] In fact, the Board has determined, even where complainants have argued that purchase price is "excessive," that the use of acquisition cost valuation is appropriate because "the actual purchase price of a rail asset, negotiated at arm's length, best reflects that asset's actual value."[39] If and when the Board makes a revenue adequacy determination relating to the

34 CFI Response at 21.

35 CFI Response at 21.

36 Ashley Creek Phosphate Co. v. Chevron Pipe Line Co., et al., 1992 ICC LEXIS 58, at *16-17 (ICC served March 30, 1992).

37 CFI Response at 20.

38 Assoc. of Am. Railroads, 978 F.2d at 741.

39 Erie-Niagara Rail Steering Committee, et al. v. STB, 247 F.3d 437, 442 (2d Cir. 2001).

pipeline Kaneb now owns, it should continue its policy of using acquisition cost valuation, as it did in Koch, notwithstanding CFI's suggestions to the contrary.[40]

Despite the fact that CFI was the complainant in the Koch proceeding and is obviously knowledgeable about the case, its suggestion that the Board applied predecessor cost in Koch is, at best, inaccurate. The Board in Koch found that "Koch's 1988 acquisition provided a new investment base" and "in testing defendant's rates under the revenue adequacy constraint, we may properly use Koch's own $77.2 million valuation as a reliable estimate of its cost of acquiring—and the value of its initial investment in—the pipeline."[41] Furthermore, the D.C. Circuit opinion affirming the Board's decision in Koch makes clear that the Board used acquisition cost valuation: "[Rather than rely on original cost], [t]he Board relied, instead, on 'acquisition-cost valuation—the amount [Koch] paid in an arm's length transaction' to acquire the pipeline."[42] CFI's claim that the Board used predecessor valuation in Koch is simply an attempt to rewrite the Koch case for CFI's own purposes and should be rejected here.

Several other points regarding CFI's unsubstantiated arguments regarding the use of acquisition cost valuation warrant response. First, Kaneb disagrees entirely with CFI's argument that using predecessor costs in this proceeding will allow Kaneb a return on

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40 CFI Response at 11-12 n.11.

41 Koch, 4 S.T.B. at 658-59.

42 CF Industries, Inc. v. STB, 255 F.3d 816, 828 (D.C. Cir. 2001). In citing its approval of the Board's 1988 Revenue Adequacy Determination, the D.C. Circuit also stated that the Board, in Koch, "reasonably interpreted its own guidelines as using acquisition rather than replacement cost as the investment base upon which to determine revenue adequacy." Id. at 830 (citing 1988 Revenue Adequacy Determination, 6 I.C.C. 2d at 940).

prudent investments.[43] CFI acknowledges that the Board is "not required to conduct a prudency review."[44] Despite this acknowledgement, CFI argues that Kaneb "misjudged the pipeline's future costs and volumes"[45] and asserts that there were signs in the anhydrous ammonia industry prior to Kaneb's purchase of the pipeline that volumes shipped on the pipeline were declining.[46] Even assuming this information were relevant—although it is not—CFI's evidence does not show that at the time Kaneb purchased the pipeline demand for anhydrous ammonia was decreasing, or that any decrease in volumes would be long-lasting.[47] Indeed, CFI's evidence shows there were expectations of increased demand and increased imports to compensate for domestic plant closures.[48]

Second, the Board should reject CFI's argument that using acquisition costs to measure revenue adequacy in this proceeding would harm "captive customers" like itself.[49] Again, although CFI may seek to argue this point in a rate challenge proceeding,

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43 CFI Response at 18.

44 CFI Response at 20.

45 CFI Response at 22.

46 CFI Response, Attach. A, Verified Statement of Fred A. Mugica.

47 Several of the articles attached to Mr. Mugica's verified statement suggest that demand decreases are due to plants being down for temporary repairs. See Green Markets at 2 (Mar. 4, 2002) (noting that FertiNitro had taken down an ammonia unit for mechanical reasons and suggesting that it may be out of service for "as long as 45 days"); Green Markets at 2 (Mar. 11, 2002) (stating that Koch took down a Sterlington plan for a few weeks for repairs and maintenance).

48 See Green Markets at 1 (Jan. 21, 2002) ("Despite its recent quarter, Farmland remains optimistic about fertilizer market conditions and looks for improvements industrywide."); Green Markets at 9 (Apr. 1, 2002) (stating that although Koch has opted to keep one of its anhydrous ammonia units down for the remainder of the year, it has bought Caribbean tons for the near term and "inked a contract to buy 300,000 – 350,000 tons of the product" to compensate for the outage).

49 CFI Response at 17.

it is an inadequate justification for keeping the Koch prescription in place and is irrelevant to whether there has been a material change in circumstances. There has been no competitive inquiry undertaken in this proceeding and there is no need for one. The fact is that the Board used acquisition cost to determine whether to impose a rate prescription in Koch and in determining whether there has been a material change in circumstances such that the Koch prescription is no longer valid, the Board should consider Kaneb's acquisition cost.

Finally, CFI incorrectly asserts that use of predecessor investment costs in this proceeding is appropriate because Kaneb's pipeline is rate regulated.[50] CFI's statement that Kaneb is unlike railroads and more like gas pipelines or electric transmission systems is both contrary to the purpose and provisions of the Interstate Commerce Commission Termination Act ("ICCTA") and an unsuccessful attempt to suggest that other agencies' policies are more relevant here than the Board's own policy. The fact that a rate prescription is currently in effect for the pipeline does not mean that it has more in common with gas pipelines or electric transmission systems from a rate regulation standpoint. CFI ignores the fact that many rail carriers also have rate prescriptions. The ICCTA retained the requirement in the Interstate Commerce Act that pipeline carriers, like rail carriers, must fulfill the entire range of common carrier obligations.[51] However, the ICCTA made significant changes in the way common carriers, including pipelines, were regulated. For example, unlike the ICC, the STB may not begin investigations of a pipeline's rates on its own initiative. Instead, the STB may begin investigations only in

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50 CFI Response at 20.

51 ICCTA, 49 U.S.C. § 15501 et seq. (2000); see also General Accounting Office, Issues Associated with Pipeline Regulation by the Surface Transportation Board, GAO/RCED-98-99 at 7 (April 1998) ("GAO Report).

response to complaints by shippers or other affected parties.[52] In addition, the ICCTA eliminated the requirement for pipeline carriers to file their rates and does not provide the STB with any authority to regulate a pipeline carrier's decision to enter or abandon markets.[53] Last, the STB does not routinely collect information from pipeline carriers.[54]

In contrast, natural gas pipelines and electric transmission systems are still required to file their rates with FERC, the federal regulatory authority, and are subject to extensive information filing requirements.[55] Their rates are closely regulated, except in rare circumstances. FERC has statutory authority to initiate rate investigations.[56] Moreover, transmission providers must obtain approval from FERC before entering or abandoning markets, as well as before embarking on major construction or extension projects.[57] The regulatory schemes of the Federal Power Act and the Natural Gas Act are much more restrictive than the ICCTA. Therefore, it is simply absurd for CFI to assert that Kaneb's pipeline has more in common with these regulated industries.

C. Discovery Is Not Necessary or Appropriate in this Proceeding.

CFI argues in its Response that the abbreviated hearing process set by the Board in this proceeding does not allow the parties (presumably, CFI) to develop an adequate record on the rate prescription, and that Kaneb's discovery "stonewalling" has

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52 ICCTA, 49 U.S.C. § 15503(c) (2000).

53 GAO Report at 7.

54 Id.

55 See generally Federal Power Act, 16 U.S.C. § 824d (2000) ("FPA"); Natural Gas Act, 15 U.S.C. § 717c (2000) ("NGA").

56 See FPA, 16 U.S.C. § 824e (2000); NGA, 16 U.S.C. § 717d (2000).

57 See FPA, 16 U.S.C. § 824b (2000) (governing disposition of property and consolidation); NGA, 15 U.S.C. § 717f (2000).

exacerbated the problem.[58] CFI served Kaneb with a discovery request on September 16, 2004, and, as agreed between the parties, Kaneb answered its request with objections on October 1, 2004. CFI filed a motion to compel discovery five days later, on October 6, 2004—a mere 24 hours before its Response to Kaneb's Opening Argument and Evidence was due. Given the abbreviated hearing process set by the Board, it is obvious that the Board did not believe discovery was necessary to resolve the one item at issue here: whether circumstances had changed materially and warrant lifting the existing rate prescription. This may explain why CFI did not seek a change in the procedural schedule in order to accommodate discovery, or file its motion to compel discovery more than 24 hours before its Response was due.

Nonetheless, Kaneb submitted a reply to CFI's motion to compel—and also sought a motion for protective order from discovery—on October 8, 2004, just two days after CFI filed its motion to compel. As discussed in greater detail in Kaneb's Reply to CFI's Motion to Compel, CFI's discovery requests are not designed to produce any evidence remotely relevant to whether there has been a material change in circumstances since the Board imposed the rate prescription in Koch. Although CFI cites a case stating that "It is well-established that '[a] party is entitled . . . to know the issues on which a decision will turn and to be apprised of the factual material on which the agency relies for decision,"[59] CFI has not sought discovery on whether there has been a material change in

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58 CFI Response at 7.

59 CFI Response at 9 (citing Williston Basin Interstate Pipeline Co. v. FERC, 165 F.3d 54, 63 (D.C. Cir. 1999)).

circumstances—the very issue on which this decision will turn.[60] Indeed, CFI concedes all of the changed circumstances alleged by Kaneb.

CFI's discovery requests attempt to elicit information regarding the level of any future rates Kaneb may charge should the Board lift the prescription, which is not an issue in this case. The Board should not permit CFI to conduct discovery for use in any future rate case in advance of a rate increase. CFI does not intend to use any of the information it seeks in this proceeding because it has already submitted its Response to Kaneb's Opening Evidence and Argument. CFI does not indicate that it will seek to supplement its Response if and when it receives such discovery.

Furthermore, as discussed in greater detail in Kaneb's Motion for Protective Order, the Board's August 11 Decision did not contemplate discovery. Under the schedule set by the Board in this proceeding, it would be impossible to conduct discovery within the regulatory timeframe. In addition, discovery is not needed for the Board to decide the single issue remaining in this proceeding. Kaneb has submitted evidence in support of its claim of materially changed circumstances, and, as discussed above, CFI has not disputed its evidence. Therefore, discovery is not needed for the Board to lift the rate prescription it imposed in Koch.

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60 Although CFI mistakenly argues that "the primary issue in this proceeding [is] whether to use acquisition costs or predecessor investment costs," CFI Response at 4 n.4, the Board has not mentioned that issue at all in this proceeding. Rather, the Board has made clear that the only issue remaining in this proceeding is whether it can or should alter or lift the Koch prescription. August 11 Decision at 4.

IV. CONCLUSION

WHEREFORE, in consideration of the above and foregoing, Kaneb respectfully requests that the Board lift the rate prescription it imposed in CF Industries, Inc. v. Koch Pipeline Company, L.P based upon materially changed circumstances, and restore ratemaking authority to Kaneb.

Respectfully submitted,

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Dated: October 14, 2004

CERTIFICATE OF SERVICE

Pursuant to Rule 1104.12 of the Surface Transportation Board's Rule on Service of Pleadings and Papers, I hereby certify that I have this day served a copy of the foregoing document by hand delivery upon all parties of record in this proceeding and upon Counsel for Dyno Nobel, Inc.

Dated at Washington, D.C., this 14th day of October 2004.

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UNITED STATES OF AMERICA
BEFORE THE
SURFACE TRANSPORTATION BOARD

CF INDUSTRIES, INC., **Complainant** **v.** **KANEB PIPE LINE PARTNERS, L.P.,** **and** **KANEB PIPE LINE OPERATING PARTNERSHIP, L.P.,** **Defendants.**	))))))))))))	**Docket No. 42084**

VERIFIED REBUTTAL STATEMENT
OF
ROBERT G. VAN HOECKE

My name is Robert G. Van Hoecke. I previously filed a verified statement with the Surface Transportation Board ("Board") in this proceeding on September 13, 2004. A detailed statement of my qualifications was attached to my prior verified statement as Exhibit No. RGV-1.

Kaneb Pipe Line Partners, L.P. ("Kaneb") has asked me to prepare a verified statement to rebut certain statements and allegations contained in the verified statement of Thomas W. Carlton ("Mr. Carlton"), CFI's Manager of Corporate Business Analysis submitted as a part of CF Industries, Inc.'s ("CFI") reply evidence ("Response").

The issue before the Board is whether to vacate the prescription, and thus to restore ratemaking initiative to Kaneb. In making this decision, the Board must assess whether the factual and legal bases of the prescription remain valid. In my prior verified statement, I presented, for illustrative purposes, a revenue adequacy calculation which compared the revenue stream produced by these assets to the capital investment and operating costs Kaneb has incurred in acquiring and operating them. Contrary to CFI's allegations, my calculations are fully consistent with the Board's prior orders relating to revenue adequacy and the methodology used by the Board in Koch.[1] Conversely, CFI's evidence fails to comply with the Board's revenue adequacy precedent, misrepresents the Board's decision in Koch, and contains illogical and inconsistent assumptions relating to the actual costs to operate these pipeline assets. The Board has sufficient evidence of changed circumstances based solely on the changes in Kaneb's revenues, costs and investment to support a decision in favor of lifting the prescription.

Deficiencies in the Verified Statement of Thomas W. Carlton

Mr. Carlton states that the purpose of his verified statement is to demonstrate that Kaneb would be revenue adequate if the Board were to use predecessor investment cost when reviewing Kaneb's revenue adequacy. (Carlton at 1). As described in Kaneb's Rebuttal, the Board does not need to determine whether Kaneb is revenue adequate in deciding whether to vacate the Koch rate prescription. Nevertheless, to ensure that the Board is not misled by the erroneous assumptions and calculations in Mr. Carlton's verified statement, I am providing this critique of those calculations.

Mr. Carlton performs a return on investment calculation by dividing his estimated net income by estimated net investment. Mr. Carlton makes several assumptions in order to develop his estimated net income and net investment, most of which are illogical and consequently lead to erroneous results. For example, Mr. Carlton estimates expenses

[1] CF Industries, Inc. v. Koch Pipeline Company, L.P., 4 S.T.B. 637 (2000) ("Koch"), aff'd sub nom. CF Industries, Inc. v. STB, 255 F.3d 816 (D.C. Cir. 2001).

based on revenues instead of throughput, he calculates income taxes based on book depreciation instead of tax depreciation, he arbitrarily inflates his depreciation expense instead of calculating it based on gross or net investment, and he ignores evidence of actual cost incurred by Kaneb in favor of his unsupported estimates. In addition, contrary to CFI's assertions, Mr. Carlton does not perform a multi-period DCF analysis. In fact, Mr. Carlton's Exhibit TC-1 provides a narrower snapshot of Kaneb's financial performance than that contained in Kaneb's Opening Evidence.

As I will discuss below, not only does Mr. Carlton fail to apply the Board's revenue adequacy methodology correctly, his assumptions are illogical, internally inconsistent, and flawed. Specifically, Mr. Carlton analysis is inaccurate because he:

1) Relies on Koch's acquisition cost rather than Kaneb's acquisition cost, as Board precedent would dictate,

2) Assumes a revenue estimate for which he has no rational basis,

3) Uses a non-existent relationship between revenues and expenses to estimate cash expenditures,

4) Incorrectly estimates income taxes by failing to apply even basic elements of the tax code,

5) Completely ignores generally accepted accounting principals ("GAAP") when calculating depreciation expense; and disregards or misrepresents actual financial information provided by Kaneb, and

6) Uses assumptions for depreciation, capital additions and capital costs which are internally inconsistent and contradictory; and misrepresents the basis for his cost of capital.

Item numbers 2-4 do not directly impact the revenue adequacy calculation in the years when Kaneb owns the asset. However, Mr. Carlton's statement and his calculations undermine statements made in CFI's Response that Mr. Carlton's calculations show the pipeline has been revenue adequate since 1989. (CFI Response at 13). Mr. Carlton does not make such a claim and the numerous errors and illogical assumptions that underlie his calculations render such a claim unsupportable by Mr. Carlton's testimony. Item numbers 1, 5 and 6 have a direct impact on any revenue adequacy calculations performed for the time period when Kaneb owned the asset. Consequently, Mr. Carlton's verified statement and his revenue adequacy calculations should be disregarded by the Board.

1. Koch's Acquisition Costs

Mr. Carlton's most egregious error is his exclusive reliance on Koch's acquisition cost which CFI misleadingly refers to as predecessor investment cost.[2] As Kaneb explains in its Rebuttal Brief,[3] the Board uses acquisition cost rather than predecessor cost when making a revenue adequacy determination. Mr. Carlton relies on Koch's acquisition costs and ignores the cost of Gulf Central Pipeline Company ("GCPL"), Koch's predecessor: the first party to dedicate the assets to common carrier service. For this reason, I use the more accurate description of these figures as "Koch's Costs," rather than employing Mr. Carlton's misleading description of these as predecessor costs. More importantly, Koch's Costs are completely irrelevant with regard to the economics of Kaneb's investment.

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[2] The ICC stated in the 1988 Railroad Revenue Adequacy Determination that: "'Acquisition cost' represents the fair market value of an asset as established by the purchase price on the date acquired. Since it reflects a new valuation basis for an acquired asset, it can be either higher or lower than the previously recorded value. Once recorded on the books of the acquiring railroad, this becomes its 'book value' and its new basis for depreciation. 'Predecessor cost' (or predecessor value) represents the cost of the asset when it was first dedicated to public service, plus any subsequent improvements, less depreciation and retirements. It is equivalent to the regulatory term 'original cost.'" Railroad Revenue Adequacy – 1988 Determination, STB Ex Parte No. 483, 6 ICC 2d 933 (1990), 1990 ICC LEXIS 247, at *15 (emphasis added).

[3] Kaneb Rebuttal at 15.

CFI claims in its Response that Board precedent dictates the use of Koch's Cost in lieu of acquisition cost in a revenue adequacy determination. Contrary to these assertions, the Board has a long-standing precedent to use acquisition costs in determining revenue adequacy.[4] In Koch, the Board clearly relied on acquisition cost.[5] The illustrative revenue adequacy analysis attached to my initial verified statement relies on Kaneb's acquisition cost, as supported by the arm's length purchase agreement between Koch and Kaneb, and is fully consistent with Board precedent.

2. Revenue Estimates

Beyond the mistake of using Koch's Costs, Mr. Carlton's revenue adequacy calculation is based on a number of illogical and inconsistent assumptions. He asserts that revenues for 1997 and 1998 should be based on an average transportation rate of $18.52 per ton. Mr. Carlton claims to have developed this figure based on the 1999-2003 average revenue per ton; however, he fails to explain if this average is volume weighted or a simple average. In addition, he provides no rationale to support his assumption that Koch's 1997 or 1998 revenues are the same as the 1999-2003 average revenue per ton. Mr. Carlton's assumption is inconsistent with CFI's assertion that volumes (and hence traffic patterns) have changed since Kaneb acquired the assets due to the closure of two production facilities. Changes in traffic patterns will most likely impact the average transportation rate per ton. In fact, Mr. Carlton's exhibit shows that the average rate per ton ranged from $20.51 to $17.46 during the period from 1999-2003.[6] This range

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[4] Id.

[5] Id. at 17-18.

[6] Mr. Carlton ignores the fact that Kaneb's 2003 revenues include a partial year rate increase for all non-CFI movements.

represents a potential revenue variance of $2-4 million. The revenue adequacy analysis attached to my initial verified statement relies on Kaneb's actual revenues collected while it has owned and operated the assets. My approach in determining revenues is fully consistent with Board precedent.

3. Cash Expenditure Estimates

Mr. Carlton compounds his mistakes by using his inaccurate revenue estimates to derive estimated cash expenditures. First, Mr. Carlton picks cash expenditures for two separate and distinct time periods (i.e., 1996 and 2003) and simply assumes that the relationship between the operating expenses and revenues in these two years establishes a trend for the operating expenses incurred during the six intervening years. Specifically, he divides expenses by revenues in 1996 and 2003 and interpolates the intermediate trend in operating expenses between these years based on these two ratios.[7] There is no basis for his assumption that expenses are directly related to revenues. Mr. Carlton's own exhibit shows that there is no trend in the expense/revenue ratio between 1988 and 1996.[8] Expenses are a function of fixed costs and variable costs (i.e., incremental costs as a function of throughput). Mr. Carlton does not explain why he ignored changes in throughput when determining cash expenses, nor does he explain why he believes operating costs are a function of revenues instead of fixed costs and costs that vary with throughput.[9] The monthly cash expenditures presented in the verified statement of Mr.

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[7] Mr. Carlton states "[b]ecause we could calculate this [Expense/Revenue] ratio for 1996 and 2003, I assumed that the [cash expenditure] levels trended up at an even pace each year from 1996 to 2003." (Carlton at 4).

[8] See Exhibit TC-1. The second column on the right is labeled "Exp/Rev."

[9] Mr. Carlton's cash expenses are not evenly trended on a unit basis. In fact, they are not even directly related to the system throughput. Exhibit TC-1 shows a volume increase in 1998 over the prior year; however, Mr. Carlton's cost per ton also increases over the prior

Joseph Graham in Kaneb's Opening Evidence, which are reflected in the analysis in my initial verified statement, are based on cost that Kaneb has actually incurred to operate the assets.

4. Income Tax Estimates

Mr. Carlton's next error involves his estimate of cash income taxes for 1996-2002, a period when Koch owned the assets. First he assumes a combined federal and state tax rate of 40%. His only justification for this is that "40% is the figure that CF Industries typically uses in-house as a proxy for combined state and federal." (Carlton at 5). Mr. Carlton provides no support for the assumption that CFI and Koch have similar tax positions. Mr. Carlton indicates that he eliminated any income taxes once Kaneb acquired the assets since Kaneb is organized as a partnership. Although Kaneb acquired the assets on November 1, 2002, Mr. Carlton failed to include any income taxes for the calendar year 2002 for the ten month period that Koch owned the assets. (See Exhibit TC-1). Moreover, Mr. Carlton calculated income taxes for 1997-2001 by applying his 40% tax rate to the difference between Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") and his estimated book depreciation ("DD&A"). Mr. Carlton fails to discuss the relevance of accelerated tax depreciation, or attempt to estimate it. Since the tax depreciation schedule for pipelines is significantly shorter than the book life (e.g., fifteen years for tax depreciation versus thirty to fifty for book depreciation,

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period. (See Exhibit TC-1, Exp/Ton Column). In reality, one would expect that the normalized cost per unit would decrease if volumes increased. This is due to the fact that the fixed costs are spread over a larger throughput denominator. Similarly, Mr. Carlton's exhibit indicates that the expense/ton ratio decreases in 2001, even though he also reports a decrease in throughput over the prior period. Here one would expect unit costs to increase since fixed costs must now be spread over fewer volumes. There is no indication that Mr. Carlton ever attempted to isolate the fixed or variable cost.

respectively), this error likely has a significant impact on his tax estimate. In addition, as I discuss below, Mr. Carlton's DD&A estimate lacks merit and is internally inconsistent. This effectively adds to the potential discrepancy in his income tax estimate.

5. Depreciation, Depletion and Amortization Estimates

Mr. Carlton fails to explain why he did not attempt to follow GAAP principals and estimate the DD&A based on either gross investment or net book. Instead, Mr. Carlton states, "I averaged 1989-1996 DD&A to calculate 1997's DD&A. I then increased that figure annually by 1.5% for 1998-2003." (Carlton at 5). Mr. Carlton provides no rationale for averaging the historic DD&A to determine a figure for 1997. His own exhibit shows that Koch's DD&A for 1994 and 1995 varied by more than 100%. (See Exhibit TC-1). Mr. Carlton recognizes that "[t]he DD&A figures for 1988-1996 fluctuate more than one would typically expect;" however, he still uses these numbers to derive his DD&A average. Moreover, Mr. Carlton does not even apply his own flawed methodology consistently. First, he calculates the 1997 DD&A by using the 1988-1996 average. Then in subsequent years, he simply takes this number and inflates it by 1.5% per year. He fails to explain why averaging is an appropriate method for determining the DD&A in 1997, or why indexing (based on a 1.5% inflation factor) is more appropriate for each year thereafter. In addition, Mr. Carlton limits his assumed increases in capital additions to $1.097 million per year for 1995 through 2002. This represents 1.19%-1.24% of his gross investment, creating a divergence between his assumed DD&A and investment. Finally, Mr. Carlton's 2003 DD&A figure is $3.622 million. The financial information Kaneb provided in its Opening Evidence demonstrates that its 2003 DD&A was $5.234 million. Moreover, Kaneb's financial information for the first eight months of 2004 reflected a DD&A of $3.538 million. The illustrative analysis in my initial verified statement incorporates Kaneb's actual depreciation expense. Mr. Carlton does not use these figures nor does he explain why his assumptions are more valid than the actual figures.[10]

6. Capital Addition and Capital Cost Estimates

Mr. Carlton's next significant error involves his estimate of capital additions. In his verified statement he states that "[f]or 1995 through 2002, I assumed Capital Additions to be equal to the average for 1989 through 1994." (Carlton at 5). Again, there is no basis for this estimate. Ironically, Mr. Carlton is using a six-year average (1989-1994) to project the capital additions over an eight-year period (1995-2002). Mr. Carlton provides absolutely no factual support for these assumptions. There is no reason to believe that Koch's capital expenditures for these periods were limited to its historical average, $1.097 million per year. In fact, in the prior proceeding Koch indicated that its capital additions during 1998-2001 would include incremental capital additions of $30 million for pipeline integrity (corrosion testing) and $20 million for valve replacement programs which were already "underway." (Koch, 4 S.T.B. at 662 n.69). To put this in context, the Board found that Koch's net investment in 1996 was $55 million, of which $8 million represented anhydrous ammonia inventory (i.e., Koch had investment of $47 million in plant, equipment and land). (Koch, 4 S.T.B. at 658 n.61 and 682, App. 11, table 5). Mr. Carlton assumes that Koch's net investment at the end of 2002 (i.e., two months after Kaneb acquired the assets) is only $45.8 million. In essence, Mr. Carlton assumes that Kaneb's book value for its plant, equipment and land--using Koch's Costs--

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[10] In fact, Mr. Carlton fails to show any financials for 2004 even though Kaneb presented evidence in its September 13th filing through the end of August 2004.

is somewhere between $35.8 and $37.8 million dollars at the end of 2002.[11] In other words, Mr. Carlton assumes that Koch's DD&A exceeded its capital additions by approximately $10 million dollars over this six year period. Conversely, the analysis presented in Exhibit No. RGV-2 of my initial verified statement reflects Kaneb's actual investment (i.e., its acquisition cost plus capital additions less depreciation expense incurred since it acquired the assets). This evidence was sponsored by Mr. Joseph Graham, Kaneb's Controller.

Mr. Carlton indicates that "Cost of Capital for 2002 and 2003 are from Kaneb's filing." (Carlton at 2 n.1) In my initial verified statement, I identified a conservative benchmark cost of capital for 2003 of 9.4% based the Board's 2003 cost of capital for railroads. (Railroad Cost of Capital – 2003, STB Ex Parte No. 558 (Sub-No.7) (STB served June 28, 2004)). This figure only pertains to 2003. I never applied this figure to 2002. The Board previously determined that the railroad cost of capital figure for 2002 was actually 9.8%. (Railroad Cost of Capital – 2002, STB Ex Parte No. 558 (Sub-No.6) (STB served June 19, 2003)).

Mr. Carlton's unfounded and inconsistent assumptions related to DD&A, capital additions and capital costs have a direct impact on his purported analysis of Kaneb's revenue adequacy in 2002 and 2003. Specifically, Mr. Carlton's inconsistent methods of estimating DD&A (i.e., indexing by 1.5%) and capital additions (e.g., ignoring prior estimates and increasing by less than 1.5%) will result in a lower capital charge and consequently increase the return he calculates using Koch's acquisition costs.

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[11] The purchase agreement between Koch and Kaneb valued the anhydrous ammonia inventory at $10 million, as of November 2002.

Conclusion

At several places in his verified statement Mr. Carlton claims that his estimates for the 1997-2002 periods are merely being provided for completeness and do not impact the analysis for the years Kaneb owned the pipeline. (Carlton at 3, 4 and 5). With respect to DD&A and capital additions, Mr. Carlton's estimates have a direct impact on his analysis for the years Kaneb owned the pipeline. Even assuming, arguendo, that the Board were to decide to rewrite the Koch decision to use predecessor cost instead of acquisition cost, Mr. Carlton's analysis is unreliable because it is built upon an unsupported foundation of inaccurate and inconsistent estimates and assumptions. Consequently, the Board should disregard it entirely.

Contrary to CFI's assertion, Mr. Carlton's analysis in no way represents a multi-period DCF analysis. At best it is a series of single year analyses, mostly based on estimated numbers. At no point does Mr. Carlton perform any sort of discounting calculation. Mr. Carlton also fails to break down his estimates for 2002 to distinguish between the periods when Koch and Kaneb owned the assets.[12] Mr. Carlton's analysis only attempts to calculate a return on investment for one single period of Kaneb's ownership (i.e., calendar year 2003). By contrast, Kaneb provided revenues, operating costs, depreciation, capital additions and net investment figures for the twenty-two months it operated the pipeline between November 1, 2002 and September 2004. In addition, the revenue adequacy analysis I provided for illustrative purposes was based on two different twelve-month periods (i.e., the 2003 calendar year and the most recent twelve months ending August 31, 2004). Both calculations showed that Kaneb's return

[12] It appears, based on Mr. Carlton's income tax estimate, that he erroneously assumed that Kaneb owned the asset for the entire 2002 calendar year.

on investment was well below the conservative cost of capital estimate discussed in my initial verified statement.

VERIFICATION

I, Robert G. Van Hoecke, verify under penalty of perjury that I have read the foregoing Verified Statement, that I know the contents thereof, and that they are true and correct. Further, I certify that I am qualified and authorized to file this statement.

Robert G. Van Hoecke

Executed on: October 14, 2004