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October 20, 2004

BY HAND DELIVERY

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board - Case Control Unit
1925 K Street, N.W.
Washington, D. C. 20423

Re: Docket No. 42084, CF Industries, Inc. v. Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P.

Dear Secretary Williams:

Enclosed for filing in the above-referenced proceeding are an original and ten (10) copies of the Opposition of Dyno Nobel, Inc. to Defendants' Request for Vacation of May 9, 2000 Rate Prescription Order.

We have enclosed an additional hard-copy of this Opposition to be date-stamped and returned to the bearer of this letter. Thank you for your attention to this matter.

Sincerely,

Donald G. Avery

Enclosures
cc: Parties of Record

BEFORE THE
SURFACE TRANSPORTATION BOARD

212886

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

OPPOSITION OF DYNO NOBEL, INC. TO DEFENDANTS' REQUEST FOR VACATION OF MAY 9, 2000 RATE PRESCRIPTION ORDER

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Dated: October 20, 2004

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

**OPPOSITION OF DYNO NOBEL, INC.
TO DEFENDANTS' REQUEST FOR VACATION
OF MAY 9, 2000 RATE PRESCRIPTION ORDER**

Pursuant to the order of the Surface Transportation Board ("STB" or "Board") in this docket served October 13, 2004, Intervenor Dyno Nobel, Inc. ("DNI") respectfully submits this, its reply to the opening and rebuttal submissions of Defendants Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P. (collectively, "Kaneb").

For the reasons set forth below, as well as those articulated by Complainant CF Industries, Inc. ("CFI") in its Response dated October 7, the Board should find that Kaneb has failed to demonstrate the "materially changed circumstances" that would be required to support altering or lifting the maximum rate prescription entered by the STB on May 9, 2000 against Kaneb's predecessor, Koch Pipeline Company ("Koch").[1] In particular, the Board should find that Kaneb has not justified any "write-up" of the pipeline investment base to reflect the "acquisition premium" included in the price Kaneb paid Koch for the pipeline. Accordingly, the Board should deny Kaneb's request to vacate that prescription, and instead should allow the prescription to remain in full force and effect against Kaneb.

SUMMARY OF OPPOSITION

Although Kaneb recites a litany of circumstances that, it contends, have changed since the Koch prescription was issued, it utterly fails to demonstrate that any of those changes, singly or in combination, are material changes – that is, Kaneb does not prove that had such changed circumstances been present or known in 2000 they would have dictated a different outcome in Koch. In particular, since the rate prescription in Koch was based on the "revenue adequacy" prong of the Board's "Constrained Market Pricing" ("CMP") standards[2] – that is, it was predicated upon the Board's finding that the pipeline would enjoy more-than-adequate revenues under its pre-existing rates.[3] In order for a subsequent change of circumstances to be material the change would necessarily have to result in a finding that the pipeline can no longer earn adequate revenues under

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[1]Docket No. 41685, CF Industries Inc. v. Koch Pipeline Company, L.P. (served May 9, 2000), *aff'd sub nom.* CF Industries, Inc. v. STB, 255 F.3d 816 (D.C. Cir. 2001).

[2]*See* Coal Rate Guidelines – Nationwide, 1 I.C.C. 2d 520, 534-37 (1985).

[3]Specifically, the Board found that under the prescribed rates the pipeline would earn a return on its net investment over time that was far in excess of its assumed cost of capital.

the rates prescribed in Koch.[4] Otherwise, the changed circumstances, however dramatic they might appear in the abstract, would necessarily be immaterial to the continued legitimacy of the original rate prescription.[5]

In the instant proceeding, an examination of the evidence submitted by both Kaneb and CFI confirms that with one notable exception (Kaneb's "write-up" of the pipeline's investment base to reflect the entire $140 million that Kaneb reportedly paid for the carrier), ***none of the changed circumstances recited by Kaneb, even if accepted at full face value, would suffice to make Kaneb revenue-inadequate***. In other words, as

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[4]In light of this manifest requirement, Kaneb's repeated insistence that a revenue adequacy determination is unnecessary and irrelevant to the issues before the Board in this proceeding, seems bizarrely self-defeating.

Equally misguided is Kaneb's apparent assumption that if changed circumstances were to result in a finding that the existing prescription no longer affords the pipeline the opportunity to enjoy adequate revenues, the Board's only recourse would be to vacate the prescription altogether, rather than to modify the prescription to reflect the changed circumstances, as was done recently in, *e.g.*, Docket No. 41191, West Texas Utilities Company v. the Burlington Northern and Santa Fe Railway Company (unprinted decision served May 29, 2003). In fact, however, the Board's August 11 decision specifically defined the open issue as being whether to "*alter* or lift" the Koch prescription prospectively (unprinted decision at 4, emphasis added). Moreover, agency precedents indicate that complete vacation of a rate prescription at the behest of the carrier – and over the objections of the shipper beneficiaries – is appropriate only when the carrier demonstrates that circumstances have changed so drastically that there is no longer any basis for maintaining any prescriptive control whatsoever over the carrier's rates. *See* I&S Docket No. 9205, Trainload Rates on Radioactive Materials, Eastern Railroads (unprinted ICC decision dated January 6, 1991), 1991 WL 108082 at sheets 4-5. Kaneb has clearly not made such a showing in this case.

[5]To illustrate the point with a simple hypothetical, a drop of 40% in pipeline volumes moving north from Louisiana origins might appear significant, but if it were offset by a comparable increase in imported volumes flowing through the pipeline, the net effect on revenues and profits would likely be *de minimus* and could actually be positive. Under such circumstances the change clearly would not be "material" to the continued legitimacy of the prescription.

CFI witness Thomas W. Carlton demonstrates,[6] if Kaneb had simply assumed Koch's net investment in the pipeline, and then experienced precisely the same volume reductions, revenue reductions, expenditure increases, and increased capital investment requirements that it now claims it experienced, Kaneb would have continued to enjoy a return on investment substantially in excess of its assumed 9.4% cost of capital figure. It is only by "writing up" the pipeline's net investment base to include the $140 million purchase price that Kaneb paid for it as a going concern, that Kaneb can claim that its return on investment is below the Board's 9.4% cost of capital for the railroad industry.

The threshold issue presented by Kaneb's request for vacation of the Koch prescription, then, is whether the STB should – or indeed, whether under Hope[7] and its progeny the STB lawfully could – authorize a pipeline to increase its rates above a previously-prescribed level, based solely upon the fact that the new owner of the pipeline paid substantially more for the pipeline than its assets were deemed to be worth when

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[6]Verified Statement of Thomas W. Carlton, filed October 7, 2004. Significantly, Mr. Carlton utilized Kaneb's own figures, as sponsored by its witnesses Graham and McElroy, for Kaneb's calendar year 2003 volumes, net revenues from pipeline operations, cash expenditures, and capital additions, as well as Kaneb's 9.4% cost of capital figure. Kaneb's rebuttal challenged Mr. Carlton's calculations primarily on the basis of allegedly unsupported estimates he made for the years 1997-2002, when Koch owned the pipeline, but (a) Kaneb did not proffer actual data for those years despite its claimed custody of Koch's pipeline records, and in any event (b) such estimates and projections only affected Mr. Carlton's year 2003 figure for accumulated depreciation and amortization, for which Kaneb had provided no figures.

Kaneb's rebuttal also criticized Mr. Carlton's use of a projected depreciation/ amortization expense for 2003, but of course he could not use Kaneb's claimed D&A expenses inasmuch as they were predicated on Kaneb's written-up investment base.

[7]FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

they were operated by the prior owner.[8] It is important to recognize that ***this is an issue of first impression*** with respect to STB-regulated pipelines, notwithstanding the Board's acceptance of written-up investment bases, based on acquisition premiums, in recent railroad rate and merger cases.

Because the Board's ultimate resolution of this rate base valuation issue for pipelines is likely in and of itself to determine the continued vitality of the Koch maximum rate prescription, and because more broadly the Board's decision regarding recognition of "acquisition premiums" in pipeline rate cases could well affect its ability to defend its acceptance of such investment base adjustments in future railroad rate cases, DNI will focus on this issue in the balance of its Opposition.

DISCUSSION

As CFI has succinctly explained, it is a fundamental principle of public utilities regulation that when maximum rate determinations are predicated upon allowing a reasonable return on the value of an entity's investment base, that value cannot be made to depend upon what a buyer pays for the entity lest a "fatal circularity" between rate increases and asset write-ups be created. As the Federal Energy Regulatory Commission ("FERC") put it:

> The rationale [for rejecting rate base write-ups based on acquisition costs] is a simple one. Without the net book value standard, all that pipelines would have to do to raise rates and obtain greater income would be to buy utility

[8]Kaneb asserts that it is not actually proposing to increase its rates "in this proceeding" – a curious claim, given that both CFI's complaint in this docket and DNI's complaint in Docket No. 42081 were prompted by Kaneb's publication of substantial rate increases in the spring of 2003, and given that Kaneb is requesting vacation of the existing rate prescription precisely so that it will be free to increase its rates without prior STB review or approval.

> properties from each other at a price higher than original cost and in this very simple way increase the cost of service to customers.

Southern Natural Gas Co., 100 FERC ¶ 61,284 at P 16 (2002) ("Southern"). Indeed, the Supreme Court itself has cautioned in this context that

> rates cannot be made to depend upon "fair value" when the value of the going enterprise depends on earnings under whatever rates may be anticipated.

Hope, *supra*, at 601.

To be sure, the STB has concluded that the Hope problem does not apply to the railroad industry, and accordingly has accepted acquisition-based write-ups of railroad rate bases in its annual revenue adequacy determinations,[9] and also in its merger[10] and maximum rate cases.[11] Now, however, the Board is being asked to reach the same conclusion and adopt the same rule for STB-regulated pipelines. Before the Board acts on that invitation, it should take care to re-examine its reasons for ruling as it did in the railroad context, in order to determine whether those reasons have any relevance to pipelines.

The Board has advanced two basic rationales for accepting acquisition-base asset write-ups in the railroad context:

first, in compliance with the recommendations of the Congressionally-created

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[9]*See*, *e.g.*, Railroad Revenue Adequacy – 1988 Determination, 6 I.C.C. 2d 933 (1990).

[10]*See* CSX Corp. et al.–Control–Conrail Inc. et al., 3 S.T.B. 196, 261-66 (1998) ("Conrail").

[11]*See*, *e.g.*, FMC Wyoming v. Union Pacific Railroad Company, 4 S.T.B. 699, 708-09 (2000); *cf.* Docket No. 42051, Wisconsin Power & Light Co. v. Union Pacific Railroad Company (unprinted decision served September 13, 2001), at sheet 39.

Railroad Accounting Principles Board, the Board's accounting rules require railroads to keep their books in accordance with "Generally Accepted Accounting Principles" ("GAAP"), which in turn call for the inclusion on balance sheets of assets acquired in arms length purchases at the lesser of acquisition cost or fair market value;[12] and

second, prospective purchasers of railroads (including prospective merger partners) will not be tempted to over-pay because most railroad traffic is subject to competition and therefore unregulated, so that a purchaser would be unlikely to recover, in the form of increased rates on the small proportion of traffic that is subject to regulation (and more particularly, the rates on which are held to the 180% jurisdictional threshold), for any overpayments it made in the acquisition.[13]

Significantly, these rationales – and especially the second – have been accepted by reviewing courts as sufficient to justify the Board's departure, in the railroad context, from the predecessor cost standard applied by other regulatory agencies and endorsed in

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[12]*See, e.g.*, FMC, *supra*; *cf.* 49 C.F.R. Part 1201, Instruction 2-15(c).

The "lesser of" aspect of the GAAP standard for acquisition pricing must not be overlooked: if a purchaser pays more for a going concern than the fair market value of its identifiable assets, the excess is properly assigned to "goodwill" (*see* Financial Accounting Standards Board Statement No. 141), and in the case of railroads is NOT part of the carrier's rate base for purposes of determining revenue adequacy, *cf.* Standards for Railroad Revenue Adequacy, 364 I.C.C. 803, 811 n.12 (1981). In past railroad merger cases the carriers are understood to have retained independent appraisers to determine the value of their acquired properties on an asset category by asset category basis, and on the basis of those appraisals have adjusted asset values up or down from predecessor book costs. In this case, by contrast, there is no indication that Kaneb did anything more than conduct its own internal evaluation of the Koch Pipeline as a going concern, and then spread the final purchase price over the acquired assets, assigning nothing to good will. In other words, even if the Board were to conclude that acquisition cost write-ups may be accepted in the pipeline context, contrary to Hope and its progeny, it would not follow that Kaneb had supported its write-up of the pipeline rate base in this case.

[13]*See, e.g.*, Conrail, 3 S.T.B. at 262.

Hope.[14]

What must be recognized at this juncture, however, is that ***neither of the STB's railroad-specific rationales for acquisition cost pricing applies to STB-regulated pipelines generally, or to Kaneb in particular.*** Thus, by their very terms the Board's accounting rules – and the RAPB recommendations underlying them – apply only to railroads, and not to pipelines. And in sharp contrast to the heterogenous traffic mix of modern Class I railroads, with their preponderance of intermodal and other competitive traffic, pipelines subject to STB jurisdiction by their very nature carry only one homogeneous commodity, and at least in Kaneb's case the overwhelming majority of pipeline customers are captive, and the overwhelming preponderance of their volumes are non-competitive.[15] In this pipeline world, which is clearly so very different from the railroad world usually addressed by the STB, the "fatal circularity" problem is definitely alive and kicking. Indeed, Kaneb's own actions – its payment of a purchase price that could not possibly have been squared on a cost-of-capital return basis with the Koch Pipeline's then-existent cash flows, followed in such short order by Kaneb's posting of major rate increases predicated on its allegedly-inadequate revenues -- vividly illustrate the problem that the Supreme Court and FERC, as well as other regulatory agencies, have repeatedly cautioned us against.[16]

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[14]*See* Erie-Niagara Rail Steering Committee *et al.* v. Surface Transportation Board, 247 F.3d 437, 443-44 (2d Cir. 2001).

[15]As CFI notes, the Board already ruled in the Koch case that Kaneb did not face effective competition in 19 of the 21 markets at issue in that case. Moreover, DNI has submitted evidence in Docket No. 42081 that its traffic is likewise captive.

[16]Kaneb's contention on rebuttal (at pages 20-21) that STB regulation of its

(continued...)

For the foregoing reasons, DNI respectfully submits that application of the STB's railroad-centric acquisition-cost investment base standards to the pipeline industry, as Kaneb proposes, would be both logically untenable and legally indefensible. Moreover, such a step could conceivably undermine the legal underpinnings of the STB's reliance on acquisition costing for the railroads themselves. This is so because courts might view with greater skepticism STB claims that Hope and its progeny do not apply to railroads due to the special characteristics of that industry, if the Board had then proceeded to extend that same treatment to an industry that shares none of those special characteristics.

Kaneb contends, however, that the STB has already crossed this bridge – that in the Koch case, in particular, the STB specifically adopted acquisition cost pricing, which in the rail context it had previously recognized could result in write-ups as well as write-downs, and that the STB cannot now upset that settled principle.

Kaneb is mistaken; the write-up issue remains undecided. As CFI pointed

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[16](...continued)
pipeline is more nearly akin to STB regulation of railroads than it is to, *e.g.*, FERC regulation of gas pipelines (*inter alia* because the STB, unlike FERC, does not require tariff filings or investigate pipeline rates absent complaint), and that application of the STB's acquisition cost approach to pipelines like Kaneb would therefore be appropriate, cannot withstand scrutiny. The question, under Hope, is not whether an agency's overall scheme of regulation can be characterized as "heavy" or "light"; rather, the question is whether, for the particular entity being scrutinized, the particular combination of rate base valuation methodology and maximum rate regulation is such as to create a circularity problem. In this case, because Kaneb is subject to a maximum rate cap tied directly to a target return on the calculated value of its pipeline investment base, to allow Kaneb to pay more than book value for the pipeline and then turn around and charge higher rates based on that inflated purchase price, would create precisely the same circularity problem as other regulatory agencies, and the Supreme Court, have condemned – regardless of how "light-handed" the STB's regulatory regimen for pipelines might be in other respects.

out, although the Board in Koch indeed accepted and applied acquisition cost pricing for rate base purposes, there was no issue in that case regarding asset write-ups because Koch had only paid predecessor or book value for the pipeline. In Koch the issue was not book value versus acquisition cost, it was book-value/acquisition-cost versus *replacement* cost, and the STB (correctly) opted for the former. In this case, unlike in Koch, the Board must, for the first time, decide whether to allow otherwise-unreasonable rate increases, based solely on a large acquisition premium paid by a pipeline's purchaser. For all the reasons set forth above, by FERC in Southern, and by the Supreme Court in Hope, the Board's answer to Kaneb should be a resounding "no." The parties should not be forced, as they would be if Kaneb's request were granted, to go through another protracted maximum rate case simply to relitigate the issues addressed and resolved in Koch.[17]

WHEREFORE, DNI respectfully urges the Board to deny Kaneb's request for vacation of the maximum rate prescription prescribed by the Board in Koch, and to

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[17]In Trainload Rates on Radioactive Materials, *supra* note 4, the ICC explained that it would not lightly lift a prescription that had been entered only after a long and difficult rate case, noting that

> There must be finality to litigation. To grant defendant's petition [to vacate a prescription] would be to invite relitigation of an issue which has been thoroughly explored in an already overlong proceeding. Should [the carrier] believe that its costs for hauling [the traffic involved] have significantly changed, it may petition for modification of our [prior] order to allow a filing of increased rates for that traffic. Such a petition should be accompanied by a cost study and state the proposed increased rates.

Id. at sheet 5, *quoting* Potomac Electric Power Co. v. Penn Central, 358 I.C.C. 473, 480 (1978).

reaffirm that said prescription remains in force and binding on Kaneb until such time as Kaneb can make a sufficient showing of materially changed circumstances to justify alteration or revocation of that prescription.

Respectfully Submitted,

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Dated: October 20, 2004

Certificate of Service

I hereby certify that I have this 20th day of October, 2004, caused copies of the foregoing "Opposition of Dyno Nobel, Inc. to Defendants' Request for Vacation of May 9, 2000 Rate Prescription Order" to be served upon counsel for all parties of record, by hand delivery and electronic mail, in accordance with the Board's Rules of Practice.

KA A. S

Kendra A. Ericson