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February 4, 2005

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The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, DC 20423-0001

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

Dear Secretary Williams:

Enclosed for filing please find (i) an original and ten (10) copies of the Public Version of CF Industries, Inc.'s Supplemental Brief and (ii) an original and ten (10) copies of the Confidential Version of CF Industries, Inc.'s Supplemental Brief. In addition, copies of the briefs are included on the accompanying CD-ROMs (also marked as either Public or Confidential).

Please date stamp the extra copies of this cover letter and the filing and return them to our messenger. Thank you for your assistance in this matter.

Sincerely,

Mitchell F. Hertz

cc: Service List

**Exhibit Nos. TC-2 and TC-3, attached to the Supplemental
Statement of Thomas W. Carlton, are in color.**

**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. NOR 42084

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CF INDUSTRIES, INC.'S SUPPLEMENTAL BRIEF

CF Industries, Inc.
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Dated: February 4, 2005

**EXHIBIT NOS. TC-2 AND TC-3, ATTACHED TO THE SUPPLEMENTAL VERIFIED
STATEMENT OF THOMAS W. CARLTON, ARE IN COLOR**

CF INDUSTRIES, INC.,
Complainant,

v.

KANEB PIPE LINE PARTNERS, L.P.

and

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Defendants.

CF INDUSTRIES, INC.'S SUPPLEMENTAL BRIEF

Kaneb's¹ own documents confirmed CF Industries, Inc.'s ("CFI") expectations – that Kaneb paid too much for its ammonia pipeline because it relied upon careless, uninformed, and speculative increases in revenues. Kaneb now asks the Surface Transportation Board ("Board") to backstop its carelessness by lifting the rate prescription and allowing Kaneb to increase rates to captive customers such as CFI.

Kaneb's after-the-fact attempt to mask its carelessness is equally disturbing. After incorrectly projecting future revenues, Kaneb now claims that several allegedly "changed circumstances" justify the Board lifting the existing rate prescription. But Kaneb's internal documents demonstrate that Kaneb knew about those "changes" before it purchased the pipeline. Kaneb either ignored the "changes" in its valuation or is now attempting to shift the risk of these "changes" to captive customers through a rate increase. The Board should reject Kaneb's plan.

¹ Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P. (collectively, “Kaneb”).

When deciding whether to lift a rate prescription, the Board must consider whether the reasons for the original rate prescription (*i.e.*, the presence of market power and revenue adequacy) are still valid. They are. And when evaluating revenue adequacy for a market dominant pipeline such as Kaneb, the Board should use an investment base that mimics market mechanisms while protecting captive customers. This will force investors to assume the risks and rewards of their investment. In cases where the regulated asset was purchased for less than book costs,² the Board should use the purchase price to set the investment base. In cases where the purchase price substantially exceeds the book costs (and the regulated asset has been found to be market dominant), the Board should use the book costs to set the investment base. This rule will ensure that the investor achieves its expected return only if it properly valued the asset. Kaneb did not. It paid almost two to three times the book costs based upon careless and uniformed speculation that volumes would increase. Kaneb, not CFI, should assume the risks associated with its valuation.

If the Board uses book costs to set the investment base, then the pipeline remains revenue adequate. Therefore, the Board should leave the rate prescription in effect.

I. The Board Must Consider Whether The Reasons Underlying The Original Rate Prescription Are Still Valid.

In recent pleadings, Kaneb has argued that the only issue in this proceeding is whether *any* circumstances have changed since the Board imposed the rate prescription.³ Kaneb argues

² In its CF Industries, Inc.'s Response to Kaneb's Opening Evidence and Argument, CFI used the term "Predecessor Investment Cost." In this Supplemental Brief, CFI will use the shorter term "book costs." They are intended to be interchangeable.

³ See Motion for Protective Order at 6.

too much. Variables such as volumes or capital expenditures will change every year, and Kaneb's argument would prohibit rate prescriptions from remaining in effect for any length of time. This position could also produce unintended results. For example, under Kaneb's argument, if costs increase but revenues correspondingly increase, such a change would be sufficient to lift the rate prescription. Certainly the Board would not remove a rate prescription if the pipeline's revenues and returns were actually increasing.

Kaneb's position fails to recognize that the Board did not impose the rate prescription based on a finding of particular volumes, capital expenditures, or taxes, but instead rested its holding on a finding that (1) the pipeline is market dominant with respect to certain origin/destination points and (2) that the pipeline is revenue adequate.⁴ Indeed, during the years examined by the Board in the original rate prescription proceeding, variables such as volumes and capital expenditures fluctuated significantly. As the Board noted in its *August 11 Order* in this proceeding, before the Board can lift the prescribed rates, it must "assess whether the factual and legal bases of the prescription remain valid."⁵ Therefore, the Board should review the *Koch Order's* rate prescription in light of the two factual findings it made in that order. In this proceeding, no party is challenging the Board's original finding that the pipeline is market dominant. The only issue, then, is whether the pipeline is "revenue adequate" – not the narrow issue presented by Kaneb of whether there has been any change, regardless of the revenue adequacy impact.

⁴ See *CF Industries, Inc. v. Koch Pipeline Company, L.P.*, 4 S.T.B. 637 (2000) ("*Koch Order*").

⁵ See *CF Industries, Inc. v. Kaneb Pipe Line Partners, L.P.*, STB Docket No. 42084 (Aug. 11, 2004) ("*August 11 Order*").

II. In This Proceeding, The Board Should Use Book Costs To Establish The Investment Base.

Kaneb paid too much for its ammonia pipelines. Therefore, this case will turn on what investment base the Board uses to determine whether the pipeline is revenue adequate. Kaneb urges the Board to set the investment base using its excessive purchase price. It argues that (i) this is how the Board evaluated the investment base in the *Koch Order* and (ii) this comports with how the Board sets the investment base in railroad revenue adequacy evaluations.⁶ As CFI has explained in prior pleadings, however, the *Koch Order* never explicitly addressed the issue of whether to set the investment base using book costs or purchase price.⁷ In the original rate prescription proceeding, the two costs were virtually identical (indicating a prudent purchase decision by Koch in contrast to Kaneb), and so the issue of using book costs or the purchase price was not explicitly addressed. Instead, the debate in that proceeding centered on whether the Board should use a Stand Alone Cost test to determine revenue adequacy.⁸ Kaneb's second argument is also not dispositive. As CFI has explained in prior pleadings, the Board has clarified that it will not always use the purchase price to set the investment base, but will review the specific facts of each case before making that determination.⁹ Thus, it is important to review the

⁶ See 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 at 14-21.

⁷ See CF Industries, Inc.'s Response to Kaneb's Opening Evidence and Argument at n.11.

⁸ See *Koch Order* at 20-21 ("There is simply no reason why . . . a SAC presentation should be necessary Accordingly, we will apply the revenue adequacy constraints here."). The Board used the 1988 acquisition costs which it found contained no write-up or write-down of the pipeline: "Koch, however, did not write up the AA pipeline assets or provide any other evidence showing a valuation different from the \$77.2 million that it allocated to those assets in its 1988 regulatory filings." See *id.* at 22. Thus, in that case, the acquisition and book costs were virtually identical and the Board never had to distinguish between the two.

⁹ See CF Industries, Inc.'s Response to Kaneb's Opening Evidence and Argument at 14-15.

specific facts of this case before the Board determines whether to use the purchase price or book costs.

A. THE BOARD SHOULD USE AN INVESTMENT BASE THAT ESTABLISHES THE PROPER INCENTIVES.

The Board has two goals when regulating ammonia pipelines: (1) to minimize regulation so as to mimic market forces as much as possible and (2) to advance traditional regulatory aims such as protecting customers.¹⁰ When conducting a revenue adequacy review, the Board should set the investment base in a manner that promotes both goals.

In the case of ammonia pipelines, the most effective way to do this is to establish a rule that puts the risks and rewards of the investment decision on the investor. This can be done by setting the investment base using the lower of the purchase price or book costs if the pipeline is market dominant. If the purchase price is below the book costs, the Board should establish the investment base using the purchase price. Since the investor has no stake in the prior book costs, the investor would only be entitled to a return on its investment. The customers, who do have a stake in the prior book costs because they were paying such costs, would benefit from the write-down.

In contrast, if the purchase price is above the book costs and there are captive customers, the Board should establish the investment base using the book costs.¹¹ This rule requires the investor to evaluate whether any factors justify paying more than book costs for the asset. If the

¹⁰ See H.R. CONF. REP. 104-422 (1995), reprinted in 1995 U.S.C.C.A.N. 850, 1995 WL 767862 (Leg.Hist.) (“The Conference is committed to the elimination of unnecessary regulation but does not wish to interfere with regulation that is based on sound principles and aids in regulatory aims, e.g., consumer protection.”).

¹¹ As explained in CFI’s opening brief, if there is no market power, this rule may not be necessary to protect customers because the customers could choose other transportation options (in fact, the Board would not have prescribed rates in such circumstances). See CF Industries, Inc.’s Response to Kaneb’s Opening Evidence and Argument at n.17.

investor identifies factors indicating that the true value of the pipeline is greater than the book costs, then it is free pay more than book, but it must assume the risks associated with that decision.¹² The investor cannot, however, subsequently seek a higher investment base if it miscalculated the value of the asset. This rule ensures that captive customers are not punished due to poor decisions by investors. Importantly, it also avoids the need for the Board to review why the investor choose a particular purchase price.

B. DISCOVERY IN THIS PROCEEDING ILLUSTRATES WHY CAPTIVE CUSTOMERS SHOULD NOT BE LIABLE FOR INVESTORS' ASSUMPTIONS.

This proceeding illustrates why the Board should require an investor to assume the risks of its investment decisions. Kaneb's internal documents reveal that Kaneb assumed that the pipeline would transport significantly greater volumes than were being shipped at the time of the acquisition and significantly more than actually materialized. Koch's prospectus predicted volumes of [] million tons in 2002, [] million tons in 2003, and [] million tons for the years 2004-06,¹³ despite the fact that the volumes on the pipeline had decreased from [] million tons in 1997 to [] million tons in 1999 to [] million tons in 2001.¹⁴ Koch cited

¹² This proceeding addresses a revenue adequacy evaluation, not setting rates. An investor may recognize that using book costs to set the investment base will result in a finding of revenue adequacy, but still be willing to pay more than book costs because its revenues are not capped by such a finding. The Koch pipeline is an example. The pipeline was found to be revenue adequate, but the rates of return were substantially in excess of the returns used to determine revenue adequacy. Thus, a buyer could reasonably have purchased the pipeline at a cost above book value knowing that it would still meet an anticipated return if its projections of revenues, costs, *etc.* were accurate.

¹³ See KNB-00014. Copies of all discovery materials cited in this brief are attached as Exhibit B.

¹⁴ See KNB-00013.

several reasons for its optimistic projections – []¹⁵ – most of which turned out to be wrong.

As part of its due diligence when purchasing the pipeline, Kaneb ran analyses to determine the potential return on investment using several variables – notably variations in purchase price and volumes. Using Koch’s forecasted volumes, Kaneb determined the “value” of the pipeline to be \$[] million if seeking a discounted cash flow present value return of []% over [] years; \$[] million for a []% return; and \$[] million for a []% return.¹⁶ Kaneb ran another analysis using the average volume for the years [] ([] million tons). Under this scenario, the value of the pipeline was \$[] million for a return of []%; \$[] million for a return of []%; and \$[] million for a return of []%.¹⁷ Kaneb ran a third analysis using Koch’s [] (which assumed volumes of [] million tons).¹⁸ On the sheet calculating its final offer, Kaneb used future volume projections of [].¹⁹ [].²⁰

These volume figures turned out to be overly optimistic. As reported in Kaneb’s Opening Evidence, volumes for 2002, 2003, and 2004 (estimated) were, respectively, 1.3, 1.2, and 1.2 million tons. These figures are more in line with the actual 2001 volumes (*i.e.*, 1.4 million tons) than the estimates in Kaneb’s internal documents. Kaneb had access to the 2001

¹⁵ See KNB-00021 through 00023.

¹⁶ See KNB-00305. For more analysis using Koch’s numbers see KNB-00318 through 320.

¹⁷ See KNB-00306. This scenario, which has lower volumes/revenues, has a higher value because Kaneb also ran its analysis using the average operating expenses for the years 1997-2001, instead of the higher operating expenses Koch projected. For more analysis using five-year average numbers, see KNB-00321 through 323.

¹⁸ See KNB-00315 through 317.

¹⁹ See KNB-00361.

²⁰ See KNB-00367.

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volume figures, a portion of the 2002 volume figures, and it knew [],²¹ but it still valued the pipeline assuming substantially higher throughput estimates than in recent years. CFI should not be held responsible for Kaneb's unreasonably optimistic projections.

This is particularly true when Kaneb's due diligence revealed problems with Koch's volume projections. One of Kaneb's due diligence memoranda highlighted concerns over Koch's explanation for its projections:

[

] ²²

Thus, Kaneb's memorandum questions the support for the purported justifications for Koch's projections. Later in the same memorandum,[]²³ Thus, during the course of due diligence, Kaneb noted that the volumes were off by nearly [], but it never ran a "low volume" analysis.

It also appears from discovery that Kaneb was unfamiliar with the ammonia industry. Part of the discovery materials contained basic information about ammonia, as though Kaneb was just learning the market.²⁴ Indeed, in the memorandum cited above, Kaneb revealed [].²⁵ As part of its effort to get up to speed, Kaneb apparently commissioned a report [

²¹ See Response to CFI/Kaneb 2-4 ([]) and CFI/Kaneb 2-5 ([]).

²² KNB-00271.

²³ KNB-00272.

²⁴ For example, [].

²⁵ See KNB-00271. ("[]").

].”²⁶ With regard to industrial users: [].²⁷ The report gives an overall summary of the U.S. market [].²⁸

Still other discovery responses indicate that Kaneb was aware of the “changed circumstances” that it now claims justify lifting the rate prescription. []²⁹ But in a discovery response, [].³⁰ Likewise, [].³¹ But in a discovery response, [].³² If Kaneb truly believed that such circumstances would materially affect its returns, then it should have taken such circumstances into consideration when it valued the pipeline, not simply pass those costs onto captive customers.

After reviewing the due diligence, it is clear that Kaneb did not fully understand the law³³ or the issues surrounding the industry before it purchased its first ammonia pipeline. While Kaneb’s due diligence memoranda illustrate that Kaneb was asking the right questions (*i.e.*, questioning the reasons behind Koch’s volume projections), they also illustrate that Kaneb failed to follow-up on these questions. Instead, Kaneb’s financial modeling of projected returns either assumed that Koch’s volume projections would be correct or, at least, no worse than the average for the years []. Kaneb made these projections despite a declining trend that led to 2001 volumes significantly below these projections, despite 2002 volumes coming in significantly below Kaneb’s projections, despite knowledge of [], and despite reports from experts in the

²⁶ KNB-00331 (emphasis added).

²⁷ KNB-00334 (emphasis added).

²⁸ See KNB-00338.

²⁹ See Kaneb’s Opening Evidence and Argument at 17 and 19.

³⁰ See Kaneb’s Response to CFI/Kaneb 2-6.

³¹ See Kaneb’s Opening Evidence and Argument at 17.

³² See Kaneb’s Response to CFI/Kaneb 2-7.

³³ []. See KNB-00276. [].

industry predicting []. The Board should not allow Kaneb to increase rates to captive customers based upon uninformed expectations of a nearly []% increase in volumes.

However, if the Board sets the proper rule, it does not matter what CFI or the Board thinks of Kaneb's evaluations because Kaneb will assume the risks and the rewards of its investment decisions. Just as in a market unimpaired by market power, Kaneb would make money if it correctly projected the asset's revenue stream; alternatively, it would be required to accept the risks for failing to make the correct projections. Establishing the right rule protects consumers and captive customers such as CFI while at the same time mimicking market forces. This promotes both of the Board's goals.

Therefore, considering the specific facts of this case and the need to provide the proper incentives to the industry, the Board should evaluate Kaneb's revenue adequacy.

III. The Kaneb Pipeline Is Revenue Adequate If The Investment Base Is Set Using Book Costs.

If the Board were to use book costs to review whether the pipeline remains revenue adequate, there is no basis for lifting the rate prescription. Using the new information contained in Kaneb's discovery materials, CFI Witness Thomas W. Carlton has calculated the pipeline's return on investment since 1988:

Year	Return on Investment (%) – end of year	Return on Investment (%) – average	Cost of Capital ³⁴	Revenue Adequate
1988			11.7	
1989			11.5	
1990			11.8	
1991			11.6	
1992			11.4	
1993			11.4	

³⁴ Cost of Capital for years 1988-1996 come from Appendix 11, Table 5 of the *Koch Order*. Cost of Capital from the years 1997-2002 come from the Board orders. Cost of Capital for 2003 comes from Kaneb's filing.

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1994			12.2	
1995			11.7	
1996			11.8	
1997			11.8	
1998			10.7	
1999			10.8	
2000			11.0	
2001			10.2	
2002			9.8	
2003			9.4	

The figures in this chart are calculated using the financial data provided by Kaneb through discovery.³⁵ For the years 2001 and 2002, the return on investment dipped below the cost of capital largely because []. After completing that program, however, the return on investment increased and once again exceeded the benchmark cost of capital.

Kaneb has not provided complete data for 2004. However, as part of its discovery, Kaneb did produce its 2005 budget for the upcoming year. That budget projects [].³⁶ If these projections are correct, then Kaneb's return on investment will not only likely exceed the benchmark cost of capital, but will increase significantly over the 2003 figures.

As CFI noted in prior pleadings, the Board examines whether a pipeline is revenue adequate over time.³⁷ For [], the pipeline has been revenue adequate. Therefore, the Board should retain the rate prescription in the *Koch Order*.

³⁵ See Supplemental Verified Statement of Thomas W. Carlton. Mr. Carlton presents two analyses in his statement. The chart in this brief reflects the normalized analysis that Kaneb used to evaluate the value of the pipeline. Mr. Carlton includes a second, more conservative analysis that also shows the pipeline to be revenue adequate for the same years.

³⁶ See KNB-00002.

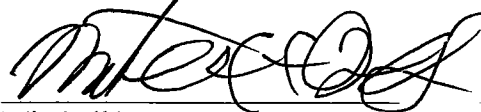
³⁷ See CF Industries, Inc.'s Response to Kaneb's Opening Evidence and Argument at 3-4.

CONCLUSION

Before the Board lifts the rate prescription established in the *Koch Order*, it should determine whether the underlying findings in that order are still applicable. That requires the Board to conduct a revenue adequacy review. When conducting such a review, the Board should not automatically use acquisition costs to establish the investment base as this could shield investors from the risks associated with poor investment decisions and pass on those risks to captive customers. Instead, in cases where the Board has found market dominance and the purchase price exceeds the book price, the Board should use the book price to establish the investment base. This is such a proceeding. If the Board evaluates Kaneb's revenue adequacy using the book price as the investment base, then it should deny Kaneb's request to lift the rate prescription because the pipeline has been, and continues to be, revenue adequate.

Respectfully submitted,

CF Industries, Inc.



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Counsel for **CF Industries, Inc.**

Dated: February 4, 2005

**EXHIBIT A:
SUPPLEMENTAL VERIFIED STATEMENT OF
THOMAS W. CARLTON**

(CONTAINS CONFIDENTIAL MATERIAL – REMOVED FROM PUBLIC VERSION)

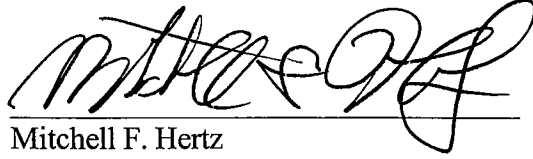
EXHIBIT B:
COPIES OF DISCOVERY RESPONSES

(CONTAINS CONFIDENTIAL MATERIAL – REMOVED FROM PUBLIC VERSION)

CERTIFICATE OF SERVICE

I certify that I have this day served copies of CF Industries, Inc.'s Supplemental Brief on all parties in this proceeding by hand delivery.

Dated at Washington, DC, this 4th day of February, 2005.



Mitchell F. Hertz