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KIRKLAND & ELLIS LLP
AND AFFILIATED PARTNERSHIPS

655 Fifteenth Street, N.W.
Washington, D.C. 20005

202 879-5000

www.kirkland.com

Mitchell F. Hertz
To Call Writer Directly:
202 879-5270
mhertz@kirkland.com

June 10, 2005

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



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

Dear Secretary Williams:

Enclosed for filing please find an original and ten (10) copies of CF Industries, Inc.'s Post-Oral Argument Reply Brief. 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

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**CF INDUSTRIES, INC.,
Complainant,**

V.

KANEB PIPE LINE PARTNERS, L.P.

and

**KANEB PIPE LINE OPERATING
PARTNERSHIP, L.P.,
Defendants.**

Docket No. NOR 42084

CF INDUSTRIES, INC.'S POST-ORAL ARGUMENT REPLY BRIEF

Kaneb Pipe Line Partners, L.P. (“Kaneb”) misunderstands the Surface Transportation Board’s (“Board”) Constrained Market Pricing (“CMP”) rules, the appropriate rates for a pipeline that has recovered 100% of its costs, and the scope of this proceeding.

- CMP constrains revenues at a revenue adequate level. In creating the standards for assessing revenue adequacy, the Interstate Commerce Commission (“ICC”) reserved the flexibility to use either book costs or acquisition costs, depending upon the circumstances. Kaneb now argues that if the Board uses its retained flexibility, it is undermining CMP. Kaneb is wrong.
- When shippers have paid for a pipeline’s entire capital investment, and then some, the pipeline should not complain about the windfall of years of stable rates.
- This case is about Kaneb’s ill-founded request to lift a rate prescription, not prudence. While the evidence demonstrates that Kaneb overpaid for the pipeline, the Board need not reach the prudence issue to apply the proper standard – book costs – in assessing revenue adequacy on Kaneb’s market dominant pipeline.

The Board should retain the prescription that governs rates for the shipments of CF Industries, Inc. (“CFI”) on Kaneb’s pipeline.

A. Kaneb Misunderstands CMP.

Kaneb is wrong in claiming that the Board's use of book costs to evaluate Kaneb's revenue adequacy would be inconsistent with CMP.¹ Indeed, no party in this proceeding is disputing the Board's use of CMP. CFI is simply urging the Board to use the flexibility inherent in CMP to prevent Kaneb from price-gouging its captive customers to compensate for a bad investment decision. Because Kaneb presents its CMP argument for the first time in its post-oral argument brief – and gets it wrong – CFI will demonstrate that the use of book costs to assess revenue adequacy on a market-dominant pipeline is consistent with the Board's CMP precedent.

The ICC first developed its constrained market pricing methodology in *Coal Rate Guidelines*, 1 I.C.C.2d 520, 1985 WL 56819 (1985). In that case, the ICC used CMP to address rate reasonableness in rail cases by subjecting railroad rates to a series of upward constraints (or caps). First, railroad revenues were constrained at those necessary to earn adequate revenues. *See id.* at 534. Second, even if the railroad was not earning adequate revenues, rates could be lowered to eliminate any management inefficiencies. *See id.* at 537. Third, to ensure that the railroad was not cross-subsidizing non-captive with captive traffic, rates could be adjusted further downward if the hypothetical cost of a stand alone railroad to serve a given route ("SAC") was lower than the railroad's fully allocated cost, adjusted for management inefficiency. *See id.* at 542. Fourth, any rate increase would be phased to prevent rate shock. *See id.* at 546.

The first test – and the one underlying CFI's rate prescription – is whether the carrier is revenue adequate. If it is, there is no reason to consider the other constraints. CFI has presented

¹ See Initial Brief of Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P. Supplementing Oral Argument at 2 ("Kaneb's Initial Post-Oral Argument Brief").

unrebutted evidence that the pipeline is revenue adequate when the investment base is set using predecessor book costs. In its Initial Post-Oral Argument Brief, Kaneb attempts to divert attention from this fact by proclaiming that CMP requires the Board to review revenue adequacy using acquisition costs.²

Kaneb ignores CMP precedent. In the 1990 revenue adequacy decision establishing a presumption for use of acquisition costs, the ICC explicitly retained for itself the flexibility to use predecessor book costs when it deemed appropriate: “Nonetheless, we do not mean to suggest that we will accept the sale price of rail assets as a substitute for old book value in every case.”³ The D.C. Circuit Court relied upon this flexibility when it upheld the ICC’s decision.⁴ For Kaneb to now argue that using the flexibility that the ICC specifically reserved for itself (and that the D.C. Circuit relied upon) somehow contravenes the principles of CMP is absurd. CMP does not dictate the use of acquisition costs, it dictates a review of revenue adequacy. And the Board has the flexibility to review revenue adequacy by using either book costs or acquisition costs to set the investment base. Therefore, Kaneb’s argument is without merit.

In this case, the Board should use its retained flexibility to evaluate Kaneb’s revenue adequacy based upon book costs. A mere change in ownership should not result in a rate increase, absent some countervailing shipper benefit. Otherwise, shippers previously protected by a rate prescription will face the risk of upward rate spirals simply because a carrier pays a higher price than its predecessor. As the Federal Energy Regulatory Commission, facing a similar situation, has stated:

² See Kaneb’s Initial Post-Oral Argument Brief at 3.

³ *Railroad Revenue Adequacy – 1988 Determination*, 6 I.C.C.2d 933 at 941 (1990).

⁴ See *Ass’n of Am. Railroads v. ICC*, 978 F.2d 737 at 742 (D.C. Cir. 1992).

The rationale for this policy 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 properties from each other at a price higher than original cost and in this very simple way increase the cost of service to consumers.⁵

Allowing rate increases or lifting rate prescriptions simply because of a change in ownership would also run afoul of the Supreme Court's decision in *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 at 601 (1944), which rejected the circularity inherent in evaluating rates based upon value when the value itself was a direct product of the rates. The Board has recognized this concern with regard to carriers such as Kaneb with predominantly captive shippers.⁶

It is also noteworthy that CMP-related issues were fully litigated in the proceeding leading to the rate prescription.⁷ There, Koch Pipeline Company, L.P. ("Koch") attempted to argue that CMP required the use of SAC instead of revenue adequacy. The Board rejected Koch's argument, noting that while SAC is part of CMP, it is a complimentary cap to revenue adequacy, and a cap that is not required in a revenue adequacy case.⁸ The importance of these caps being complimentary is demonstrated by the facts of this case. If the Board adopted Koch's SAC model from the rate prescription case, Kaneb would be able to more than *triple* its 2005 rates. This history shows the Kaneb's hidden suggestion – that the Board should not concern itself with revenue adequacy and instead should use SAC as a backstop limiting the size of any

⁵ *Southern Natural Gas Co.*, 100 FERC ¶ 61,284 at P 16 (2002).

⁶ *See CSX Corp., et al.*, STB Finance Docket No. 33388, 1998 WL 456510 (1998).

⁷ *See, e.g., CF Industries, Inc. v. Koch Pipeline Co., L.P.*, STB Docket No. 41685, 4 S.T.B. 637, 2000 STB Lexis 260 at *13-15 (2000) ("*Koch Order*").

⁸ *See id.* at *15.

potential rate increase – is both contrary to CMP and provides no practical protection to captive shippers.

B. The Pipeline Has Received a Windfall Due To Prolonged Rate Stability.

During the oral argument, and again in its Initial Brief, Kaneb complains that the pipeline's rates have not increased in a number of years.⁹ This is not surprising for a pipeline that has recovered more than 100% of its investment due to its massive over-earning.¹⁰ Indeed, the evidence in the rate prescription case demonstrated that Koch was earning substantially more than its cost of capital and its profitability could justify lower – not higher – rates.¹¹ The pipeline's substantial over-earning is amply demonstrated by the fact that it has experienced a decline in revenues, but is still revenue adequate based upon Koch's book costs. The fact that Kaneb overpaid for the pipeline should not lead the Board to require shippers to pay for the pipeline again.

C. Kaneb Is Wrong In Suggesting That CFI Is Bringing A Prudence Challenge.

Kaneb misconstrues the scope of this case.¹² CFI is not bringing a prudence challenge, but rather is requesting that the Board take advantage of the flexibility inherent in its rules to use book costs to review revenue adequacy for Kaneb's market dominant pipeline. Indeed, if the Board applies the proper rule, there is no need for a prudence challenge and the risk of Kaneb's investment decision will reside where it belongs – with Kaneb.

⁹ Kaneb's Initial Post-Oral Argument Brief at 8.

¹⁰ See *Koch Order* at *52.

¹¹ See *id.* at *53. In contrast to Kaneb's stable rates, many industries experience declining rates over time. For example, the railroad and airline industries have both experienced declining rates during the past two decades.

¹² See Kaneb's Initial Post-Oral Argument Brief at 12.

There is no dispute that Kaneb paid too much for the pipeline. There is no dispute that Kaneb gambled that volumes would increase nearly 50%. And there is no dispute that Kaneb ignored its due diligence showing that volumes were well-below what Koch was projecting for 2002. There is no reason, however, to resolve whether Kaneb should have realized that the price was too high at the time of the purchase. If the Board uses book cost in this proceeding to assess Kaneb's revenue adequacy, investors will bear the benefits and burdens of their decisions, thereby mimicking a competitive market.

To demonstrate that the Board need not render a prudence decision to determine whether or not to lift a rate prescription, consider a hypothetical situation where revenues had dropped 80% on the pipeline and had no potential to increase. In that case, the pipeline would likely be revenue inadequate even at book costs and a case could be made for lifting the rate prescription. Thus, even though Kaneb's purchase price was excessive and was probably imprudent, Kaneb may still be entitled to some rate relief.

In contrast, the only time the rate prescription would remain in effect under Kaneb's proposal to use acquisition costs to assess revenue adequacy would be when there is not a single negative change to the assumptions underlying the investment decision. Because Kaneb paid the maximum price possible while projecting only a revenue adequate return, any decrease in revenues or increase in costs would result in revenue inadequacy. While Kaneb is entitled to take this risk, the Board should not incorporate Kaneb's risk-taking into the revenue adequacy determination.

Kaneb's acquisition cost proposal would require a prudence review. Use of book costs in this case does not. It so happens that the facts in this case vividly highlight the injustice in letting Kaneb lift the rate prescription based upon its poor investment decisions. But even with a

different set of facts, the Board should use the lower of book costs or acquisition costs to evaluate Kaneb's revenue adequacy when determining whether to lift the rate prescription. This result is consistent with the Board's precedent for a pipeline with predominantly captive shippers, mimics market results (benefits and burdens on the investor) and adheres to the principles in the Board's governing statute (*i.e.*, consumer protection). Kaneb's claim that CFI is somehow applying a prudence-type standard to this proceeding is wrong.

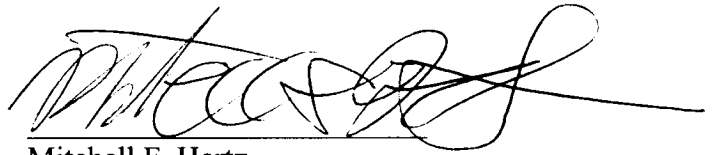
CONCLUSION

The Board should reject Kaneb's request to lift the rate prescription. A carrier seeking to lift a prescription has the burden of presenting updated evidence underlying the prescription to show changed circumstances. Kaneb failed to even offer a multi-period revenue adequacy model updating the one the Board relied upon in setting the original rate prescription. This failure of proof alone should end this case.

Even if the Board examines the evidence of Kaneb's revenue adequacy (substantially provided by CFI), the Board should conclude that there have been no changed circumstances that justify lifting the rate prescription. The only real change that could impact revenue adequacy is that Kaneb paid a higher price for the pipeline than Koch paid. This change of ownership cannot form the basis for lifting the rate prescription under the Supreme Court's and the Board's precedent.

Respectfully submitted,

CF Industries, Inc.

A handwritten signature in black ink, appearing to read "Mitchell F. Hertz", written over a horizontal line.

Mitchell F. Hertz

Jeffrey Williamson

Kirkland & Ellis LLP

655 Fifteenth Street, N.W.

Suite 1200

Washington, D.C. 20005

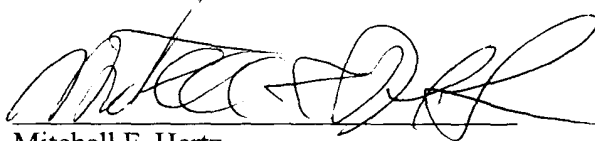
Counsel for CF Industries, Inc.

Dated: June 10, 2005

CERTIFICATE OF SERVICE

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

Dated at Washington, DC, this 10th day of June, 2005.

A handwritten signature in black ink, appearing to read 'Mitchell F. Hertz', written over a horizontal line.

Mitchell F. Hertz