CONFIDENTIAL MATERIALS REMOVED **ORIGINAL**

MAR 31 2006

UNITED STATES OF AMERICA
BEFORE THE
SURFACE TRANSPORTATION BOARD

CF Industries Inc., Complainant	)	
v.	)	
Kaneb Pipe Line Partners, L.P.	)	STB Docket No. 42084
and	)	
Kaneb Pipe Line Operating Partnership, L.P., Respondents	)	216146

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Second Supplemental Brief of Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P. on Impact of Merger

Pursuant to the November 3 Order of the Surface Transportation Board (the "Board"),[1] Kaneb Pipe Line Partners, L.P. ("KPP") and Kaneb Pipe Line Operating Partnership, L.P. ("KPOP") (collectively, "Kaneb") submit this second supplemental brief regarding the impact of Valero LP's acquisition of Kaneb on the issues in this proceeding.

I. BACKGROUND

The issues now before the Board in this proceeding are whether circumstances have substantially changed since 1988, the year establishing the level of the prescribed rates for the transportation of anhydrous ammonia by Koch Pipe Line Partners in STB Docket No. 41685, and whether Kaneb, Koch's successor, is thus entitled to have the prescription vacated.[2] Although

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[1] CF Indus. Inc. v. Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating P'ship, L.P., STB Docket No. 42084, slip op. (Nov. 3, 2005) ("November 3 Order").

[2] On March 20, 2006, Dyno Nobel Inc. ("DNI") and Kaneb executed a settlement resolving all claims pending in front of the Board. On March 24, 2006, DNI filed with the Board a letter, inter alia, setting forth when and how the complaint was satisfied, in accordance with 49 C.F.R. § 1111.6, requesting that the specified claims be

Kaneb believes it has shown substantially changed circumstances justifying a vacation, the Board has not acted. The Board perceived the possibility of an additional complication when on July 1, 2005, Kaneb Services LLC ("KSL") and KPP merged with Valero L.P. bringing KPP, KPOP, and the anhydrous ammonia pipeline system ("Ammonia System") that is the subject of the instant proceeding into the Valero family. Valero L.P. is organized, existing, and doing business under the laws of the State of Delaware, with its office and principal place of business located at One Valero Way, San Antonio, Texas 78249.

In the November 3 Order, the Board directed Kaneb to submit a supplemental pleading detailing (i) the terms and conditions of Valero L.P.'s acquisition of Kaneb, including the relevant transaction documents; and (ii) the impact, if any, of that transaction on the issues and arguments currently before the Board in this docket. On November 22, 2005, Kaneb filed the Supplemental Brief of Kaneb Pipe Line Partners, L.P. And Kaneb Pipe Line Operating Partnership, L.P. on Terms And Conditions of Merger ("Supplemental Brief"), to which it attached (i) an executed copy of the Agreement and Plan of Merger between Valero L.P. and KSL and (ii) an executed copy of the Agreement and Plan of Merger between, inter alia, Valero L.P. and KPP. At that time the Board granted Kaneb an extension until January 31, 2006 to report on the impact of the acquisition on the issues in this proceeding. The extension was based on Kaneb's anticipation that the final purchase price accounting and allocations associated with the merger would be completed by then. On January 26, 2006, the Board granted Kaneb a further extension until March 31, 2006, to allow Kaneb and Deloitte & Touche USA LLP ("Deloitte") more time to confirm the purchase price accounting calculations required to determine the July 1, 2005 acquisition date value, i.e. the purchase price, of the Ammonia

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dismissed with prejudice and notifying the Board that the letter agreement that was in dispute in STB Docket No. 42081 has been cancelled and rescinded. The Board dismissed DNI's complaint on March 29, 2006. Dyno Nobel, Inc. v. Kaneb Pip Line Partners, L.P., slip op., Docket No. 42081 (Mar. 29, 2006).

System to be recorded on Valero L.P.'s books in accordance with the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 141 ("SFAS No. 141"), "Business Combinations."[3]

II.
VALERO L.P.'S PURCHASE PRICE CONFIRMS KANEB'S CLAIM OF CHANGED CIRCUMSTANCES

SFAS No. 141 requires that Valero L.P.'s purchase price for the Ammonia System recorded on Valero L.P.'s books be shown as the fair value on the acquisition date. As defined in SFAS No. 141, the fair value is the amount at which an asset – in this case the Ammonia System – could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Although Valero L.P. has not yet received Deloitte's final report, with the information received to date, which Valero L.P. believes is complete, Valero L.P. has determined that, to comply with SFAS No. 141, its books must show $175 million as the value of the Ammonia System on July 1, 2005, the acquisition date.[4]

In the Shoaf VS, Valero L.P. has broken its purchase price down into categories. Valero L.P.'s purchase price of the anhydrous ammonia that is the Ammonia System's line fill was $ million,[5] compared to Kaneb's $10 million[6] purchase price of the anhydrous ammonia from Koch. Valero L.P.'s purchase price for the remaining Ammonia System assets was $

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[3] SFAS No. 141, para. 35 states: "[f]ollowing the process described in paragraphs 36-46 (commonly referred to as the purchase price allocation), an acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition. . . . Prior to that allocation, the acquiring entity shall (a) review the purchase consideration if other than cash to ensure that it has been valued in accordance with the requirements in paragraphs 20-23 and (b) identify all of the assets acquired and liabilities assumed, including intangible assets that meet the recognition criteria in paragraph 39, regardless of whether they had been recorded in the financial statements of the acquired entity."

[4] Verified Statement of Thomas R. Shoaf ("Shoaf VS"), at p. 2.

[5] Shoaf VS, at p. 3.

[6] Confidential Version of Kaneb Pipe Line Partners, LP's and Kaneb Pipe Line Operating Partnership, LP's Opening Evidence and Argument ("Evidence"), Exhibit F (Sept. 13, 2004).

million,[7] compared to Kaneb's $130 million[8] purchase price for the remaining Ammonia System assets from Koch.

The position of CFI Industries Inc. ("CFI") in this proceeding is that there has been no change in circumstances justifying vacation of the rate prescription. In pursuit of its position, CFI has repeatedly charged that "Kaneb paid too much" for the pipeline at issue.[9] CFI has claimed that Kaneb made a mistake and paid above the market price and that the shippers should not have to pay for Kaneb's bad decision.[10] Kaneb responded to CFI's unsupported charges with facts. Kaneb paid within bounds of what its management thought the market justified.[11] Management's judgment was supported by an independent appraisal from Corporate Valuation Advisors, Inc., valuing the pipeline assets, excluding line file, at $150 million.[12] Valero L.P.'s recent acquisition for $ million (excluding line fill), compared to Kaneb's purchase price plus capital investment of $136 million (excluding line fill), confirms that Kaneb's purchase price was reasonable. The market has spoken loudly and clearly. The managements of Kaneb and Valero L.P. believed the purchase price was reasonable. Two independent appraisers believed the purchase price was reasonable. Only CFI disagreed. Kaneb was right. CFI was wrong. Kaneb did not pay too much.

III.
VALERO L.P.'S ACQUISITION HAS NO IMPACT ON THIS PROCEEDING

Valero L.P.'s recent acquisition of Kaneb has had no impact on the captioned proceeding and only reinforces Kaneb's argument that the prescription should be vacated. Valero L.P.'s

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7 Sheaf VS, at p. 3.

8 As Mr. Graham's Exhibit No. JG-2 shows, Kaneb paid approximately $130 million for the assets, made $6 million in additional investments for a total investment of $136 million in assets. In addition, Kaneb paid approximately $10 million for line fill (or working capital).

9 See, e.g., CF Industries, Inc.'s Post-Oral Argument Brief ("CFI Brief"), Docket No. No.R-42084, at 1 (Jun. 3, 2005).

10 Id., at 8, 13.

11 Evidence, Exhibit B at 3.

12 Bates Nos. KNB-00367-KNB-00411.

acquisition price for the assets, exclusive of line fill, is not significantly different from the price Kaneb paid for the assets three years prior, plus Kaneb's capital investment in the assets after Kaneb acquired them. Thus, the Board's concerns regarding an "upward spiral" have not been borne out by the facts. Further, Valero L.P.'s acquisition price confirms that the price paid by Kaneb in 2002 was reasonable and that Kaneb did not overpay for the assets. Most importantly, regardless of the acquisition price, shippers are protected by constrained market pricing ("CMP"). Given the strong evidence of substantial change of circumstances and to avoid further injury to Kaneb, the Board should vacate the rate prescription.

The Board has expressed concern that using acquisition price will result in a rate spiral, a concern expressed in Hope,[13] which was decided many years before the Board and its predecessor, the Interstate Commerce Commission ("ICC"), embraced CMP. CMP ensures that Hope's and the Board's concerns are allayed. The purpose of CMP is to protect captive shippers by emulating market constraints found in contestable markets.

CMP is sound economics and sound policy. It best achieves the Board's goal of protecting captive shippers by emulating the constraints found in competitive markets. The main principles of CMP work together to protect captive shippers and allow a carrier, for the sake of its investors, an opportunity to recover a fair return on its investment: (i) the Revenue Adequacy Constraint is based on acquisition price (as a proxy for replacement cost) and ensures that the current investors are not earning excessive returns; (ii) the Stand Alone Cost ("SAC") Constraint ensures that captive shippers are not paying more than they would incur to provide the service themselves; and (iii) the Management Efficiency Constraint protects captive shippers from paying for avoidable inefficiencies. Moreover, the SAC Constraint and the Management Efficiency Constraint protect CFI against any purchase price imprudence. As the Court of

[13] F.P.C. v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944) ("Hope").

Appeals ruled in Burlington Northern v. STB,[14] CMP meets the Board's "dual objectives" of providing the carrier the prospect of attaining revenue adequacy while protecting captive shippers from excessive rates. CMP and economic theory in general provide that if Kaneb's purchase price exceeds its SAC, then – in CFI's words – "Kaneb paid too much" and its rates should be limited to SAC. If CFI really believes its rhetoric, it should seek a CMP remedy.

In Ex Parte 483,[15] the ICC adopted the same standard as SFAS No. 141, using the acquisition cost in valuing a common carrier's investment base, and stating that acquisition cost represents the fair market value of an asset as established by the purchase price. The ICC found that the use of acquisition cost is consistent with the underlying objectives of a revenue adequacy analysis. The ICC further stated that because the acquisition cost reflects a new valuation base for the acquired asset, "it can be either higher or lower than the previously recorded value."[16] Finally, the ICC noted that in cases where assets are sold for more than book value, the use of predecessor cost "would potentially shortchange investors who paid a premium above the old book value with a return below the cost of capital for their investment."[17] The use of acquisition cost valuation by the ICC and the Board has been judicially approved, and it has been uniformly applied in both agencies. Further, as the Koch Decision recognized, "acquisition cost valuation – the amount paid in an arms-length transaction – is consistent with 'what other business enterprises use for measuring their investments.'"[18] There is no reason to depart from these past decisions adopting acquisition cost.

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[14] Burlington Northern and Santa Fe Railway Co. v. STB, 403 F.3d 771 (D.C. Cir. 2005).

[15] See Railroad Revenue Adequacy – 1988 Determination, STB Ex Parte No. 483, 6 I.C.C. 2d 933 (1990), 1990 ICC LEXIS 247 ("Ex Parte No. 483"); aff'd, 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).

[16] Id., at *17.

[17] Id., at n.3.

[18] CFI Indus., Inc. v. Koch Pipeline Co., 4 S.T.B. 637, 656 (May 9, 2000) ("Koch Decision"), aff'd CFI Industries, Inc. v. S.T.B., 255 F.3d 816 (D.C. Cir. 2001).

If the Board were to decide to move away from purchase price and CMP to set cost-based rates, it would be forced to go back to the original cost. The prescribed rate is not based on original cost. It is not based on Kaneb's acquisition price. It is based on Koch's 1988 acquisition price. No matter what the Board eventually decides – acquisition price or original cost – Koch's 1988 acquisition price cannot properly be the rate's basis. The use of Koch's purchase price is arbitrary and unreasonable. The market price agreed upon between a willing buyer and a willing seller in 1988 cannot be superior to the market price agreed upon between a willing buyer and a willing seller in 2002 for use in setting a 2002 investment base. The Koch Decision has made clear that in calculating a revenue adequacy analysis, a party may only rely on the costs and revenues of the current owner and may not reach back to those of a previous owner. Further, the Board has made clear that parties must use future projections in CMP analyses. To do otherwise would constitute retroactive ratemaking.

The record already has ample evidence of substantially changed circumstances to warrant vacation of the rate prescription. The purchase price paid by Kaneb is the most significant and undeniable change. When the prescription was imposed on Koch in 1988, Koch had paid approximately $77 million for the Ammonia System. In 2002, Kaneb paid $140 million, $130 million for the Ammonia System and $10 million for the line fill, for substantially the same assets in an arm's-length bargain. The purchase price was supported by an independent valuation of $ million. As the record shows, over the following two years, Kaneb invested approximately $6 million in capital expenditures.[19] The Valero L.P. transaction presents additional evidence that circumstances have changed substantially. Valero L.P. bought the Ammonia System in July 2005 for $ million with an independent valuation performed by Deloitte. Valero L.P. paid an additional $ million for line fill. As recognized by Vice

[19] Exhibit No. JG-2.

Chairman Buttrey in the oral argument, rising natural gas prices account for the increased price of inventory.[20] The market for the assets at issue, and thus the market price, is very different in the 21st century than it was in 1988 when Koch bought the assets from Gulf Central. This change in market circumstances warrants vacation of the prescription. And while Kaneb believes that prudence of purchase price should not factor into this determination, it has shown that the purchase price was prudent as well.[21] A showing of substantially changed circumstances is all that is necessary to vacate a rate prescription, and Kaneb has made that showing.

Vacating the prescription will level the playing field and create an environment for fair negotiations between equals. Vacating the prescription will restore ratemaking initiative to Kaneb, while allowing the CMP principles to continue to protect the rights of captive shippers. Once the prescription is vacated and the playing field leveled, the issue for the Board, if Valero chooses to increase its rates, will be how to ensure that these rates are just and reasonable under its economically sound CMP methodology.

The Board should vacate the prescription now. Kaneb is suffering injury.[22] The fair market values reported in the Shoaf VS are comparable to those reported when Kaneb purchased the Ammonia System.[23] The Graham VS demonstrates the capital investment in the Ammonia System while Kaneb owned it. Given the additional investment since Kaneb acquired the assets from Koch, the fair market value of the assets has not changed significantly between Kaneb's

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20 Transcript page 21, lines 4-6 ("VICE CHAIRMAN BUTTREY: 'Yes. Mr. Tabor, isn't this all about natural gas prices, basic natural gas prices?'"); pages 21, line 19 - page 22, line 1 ("VICE CHAIRMAN BUTTREY: 'Even given that, you would agree that natural gas prices, basic natural gas prices, and the fact that they've escalated so much, really bears heavily on what's going on here, underlying?'").

21 CMP provides additional protection to the shippers, such as CFI, against inflated purchase prices. The SAC constraint ensures that CFI will pay no more than a rate that an optimally sized stand-alone hypothetical competitor would charge. If the purchase artificially inflated the assets above this level, the CMP would prevent the pipeline from charging rates based on such a purchase price.

22 SFAS No. 141 states that "the fair values of other assets distributed as consideration, such as marketable securities or properties, and the fair values of liabilities incurred by an acquiring entity shall be used to measure the cost of an acquired entity." Paragraph 20.

23 Evidence, Exhibit B at 3.

acquisition and Valero L.P.'s acquisition (with exception of the price of line fill due to increased natural gas prices). However, the fair market value has changed substantially since Koch acquired the pipeline for $77 million. Using the information provided in the Graham VS, the Verified Statement of Robert G. Van Hoecke shows substantially changed circumstances since the acquisition from Koch and the extent of the injury Kaneb is suffering under the prescription. In fact, the return on investment ("ROI") for 2004 was 4.01%, well under the 9.4% benchmark. The ROI for the first six months of 2005, when Kaneb still owned the assets, was 2.98%, as compared to a cost-of-capital benchmark of 4.93% for the same period. The last six months of 2005, when Valero L.P. owned the assets, had an ROI of 2.24%, again significantly below the benchmark. The annual ROI for 2005 was 4.5% as compared to the 9.4% annual benchmark. The Ammonia System continues to be revenue inadequate. Further, the analysis proves that the economic circumstances have changed substantially since the Koch Decision. By keeping the prescription in place, the Board has already denied Kaneb the opportunity to recover in excess of $21 million in costs that are permissible under the revenue adequacy constraint. The only way to remedy this situation and prevent further injury is to vacate the prescription immediately.

IV.
CONCLUSION

WHEREFORE, for the foregoing reasons, Kaneb respectfully requests that the Board vacate immediately the rate prescription imposed by the Koch Decision, based on substantially changed circumstances, restoring ratemaking initiative to Kaneb and preventing further injury.

Respectfully submitted,

Albert S. Tabor, Jr. by AMH

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March 31, 2006

ATTACHMENT A

VERIFIED STATEMENT OF THOMAS R. SHOAF

CONFIDENTIAL MATERIALS REMOVED

UNITED STATES OF AMERICA
BEFORE THE
SURFACE TRANSPORTATION BOARD

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

VERIFIED STATEMENT OF THOMAS R. SHOAF

My name is Thomas R. Shoaf. I am Vice President and Controller of Valero LP. In that position I am responsible for financial accounting and reporting of Valero LP. The purpose of my verified statement is to provide to the Surface Transportation Board (the "Board") the value to be recorded on the books of Valero LP ("Valero") as of July 1, 2005, for the Ammonia System that is the subject of this proceeding. July 1, 2005 is the date of the acquisition (the "Acquisition") by Valero, of Kaneb Services LLC ("KSL") pursuant to the Agreement and Plan of Merger that was attached as Exhibit A to the Supplemental Brief Kaneb Pipeline Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P. (collectively, "Kaneb") filed with the Board on November 22, 2005.

Valero's acquisition was a merger with KSL, and the assets of KSL, the merged entity, consisted of other assets in addition to the Ammonia System. The parties to the merger agreed only to the value of the shares of KSL. They did not agree upon the values of the various components of KSL. Under such circumstances, the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 141 ("SFAS No. 141"), "Business Combinations" addresses financial accounting and reporting for business combinations. SFAS No. 141 requires that the total compensation in a business combination be allocated among the components of the merged company in accordance with generally accepted accounting principles to determine the fair value at the date of the Acquisition to be assigned to each component of the merged entity. SFAS No. 141 defines fair value as the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Compliance with SFAS No. 141 necessitated the purchase price adjustments, allocations and acquisition accounting that Kaneb previously advised the Board were required before Kaneb could fully comply with the Board's direction contained in its November 2, 2005 order in this proceeding.

Although Valero has not yet received the final report of Deloitte & Touche USA LLP to assist us in assigning a July 1, 2005 value to the Ammonia System (which, in January, we anticipated we would have received by now), with the information we have received to date, which we believe is complete, I can state that the July 1, 2005, value of the Ammonia System that, in accordance with SFAS No. 141, will appear on the books and records of Valero after the purchase price adjustments, allocations and acquisition accounting resulting from the Acquisition will be $ million.

That value will be broken down into categories as follows:

Asset[1]	Valero Purchase Price[2]
Pipeline Facilities and Equipment	$
Line Fill	$
Rights of Way	$
Building/Facilities	$
Machinery and Equipment	$
Vehicles	$
Office Furniture/Equipment	$
Land	$
Total	$

[1] These categories correspond to the categories in Mr. Joseph Graham's verified statement filed September 14, 2004, and concurrently with this verified statement, respectively.

[2] After purchase price adjustments, allocations and acquisition accounting.

VERIFICATION

I, Thomas R. Shoaf, 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.

Thomas R. Shoaf

Executed on: March 29th, 2006

Subscribed and sworn to before me this 29th day of March, 2006.

____

A Notary in and for the County of Bexar, _____

ESTHER SALINAS
Notary Public
State of Texas
My Comm. Exp. 06-22-2008

ATTACHMENT B

VERIFIED STATEMENT OF JOSEPH GRAHAM

CONFIDENTIAL MATERIALS REMOVED

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 STATEMENT
OF
JOSEPH GRAHAM

My name is Joseph Graham. I am currently Tariffs & Regulatory Planning Director for Valero GP, the general partner of Valero LP. Prior to joining, Valero upon Valero's acquisition of Kaneb Pipe Line Company LLC ("Kaneb"), I was the Controller of Kaneb. In that capacity I was responsible for all of Kaneb's internal and external financial reporting. I have previously provided verified statements to this Board containing data regarding the assets Kaneb acquired from Koch Pipeline Company, L.P. and Koch Fertilizer Storage and Terminal Company ("Koch"). My current verified statement will provide current data which Robert G. Van Hoecke will use in his verified statement.

In my previous verified statement I provided the Board with a list and itemized valuation of the assets that Kaneb purchased from Koch. On July 1, 2005 Valero consummated a merger with Kaneb. As a result all Kaneb assets listed and described in my previous affidavit, plus an additional capital put in service by Kaneb on the anhydrous ammonia system became Valero assets.

In Exhibit No. JG-2, I provide updated revenues and operating expenses for the time period from September 2004 through December 2005. Subtracting operating expenses from revenue generated Net Operating Income. The expenses cover the same type of activities I discussed in my previous verified statement. The revenues were generated by the same type of activities discussed in my previous verified statement. Exhibit No. JG-2 simply updates the numbers I provided previously to include actual experience as of December 2005. The updated figures from September 2004 through June 2005 relate to Kaneb's operation of the Ammonia System that is the subject of this proceeding. Beginning in July 2005, the financial data reflects Valero's operation of the Ammonia System.

Exhibit No. JG-2 also shows changes to investment. Three events have changed the value of the investment since September 2004. First, Kaneb (and after July 1, 2005 Valero) invested additional capital in order to continue to operate the Ammonia System. In total this investment increased the Plant Property and Equipment ("PPE") by approximately $0.633 million since September 2004. Second, I updated Exhibit No. JG-2 to reflect the amount Valero paid for the asset on July 1, 2005. Finally, the market value of the anhydrous ammonia line fill inventory at the Valero acquisition date was significantly higher than when Kaneb acquired the anhydrous ammonia line fill from Koch. My exhibit reflects a working capital balance that includes the anhydrous ammonia inventory valued at the average Mid Cornbelt market price for anhydrous ammonia as of the date of the Valero transaction, July 1, 2005, which is $352.50 per ton. It is my understanding that the current market price for anhydrous ammonia is higher than the price that existed on July 1, 2005. For example, the 3/27/2006 average Mid Cornbelt market price was $425 per ton, or 20.5% higher than the July 1, 2005 price. This subsequent increase is not reflected in my exhibit.

CONFIDENTIAL MATERIAL REMOVED

VERIFICATION

I, Joseph Graham, 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.

Joseph Graham

Executed on: March 29, 2006

Subscribed and sworn to before me this 29th day of March, 2006.

A Notary in and for the County of Bexar, ____

ESTHER SALINAS
Notary Public
State of Texas
My Comm. Exp. 06-22-2008

ATTACHMENT C

VERIFIED STATEMENT OF ROBERT G. VAN HOECKE

CONFIDENTIAL MATERIALS REMOVED

UNITED STATES OF AMERICA
BEFORE THE
SURFACE TRANSPORTATION BOARD

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

VERIFIED STATEMENT
OF
ROBERT G. VAN HOECKE

My name is Robert G. Van Hoecke. I am a Principal with Regulatory Economics Group, LLC ("REG"), a firm specializing in economic, financial and regulatory consulting for the pipeline industry. My business address is 12010 Sunset Hills Road, Suite No. 730, Reston, VA 20190. I have over 20 years of experience working directly in the pipeline industry and as a consultant. I have presented testimony on several occasions regarding the economic regulation of pipelines and pipeline ratemaking. I have attached a more detailed statement of my qualifications as Exhibit No. RGV-3. On

September 13, 2004 I presented an affidavit supporting of Kaneb's request for the Board to vacate the rate prescription it ordered in Koch.[1]

In July of 2005, Valero LP ("Valero") acquired Kaneb Pipe Line Partners, L.P. ("Kaneb"), which included acquisition of its Ammonia System examined in this proceeding. Prior to the acquisition, the Surface Transportation Board ("Board") issued an order requesting Kaneb to submit further evidence to support its claim of changed circumstances which would validate the lifting of the Koch rate prescription.[2] At that time, the Board recognized "that there could be changed circumstances associated with Kaneb's purchase of the pipeline from Koch [Koch Pipeline Company, L.P.] that might warrant vacating the prescription..."[3] Upon learning of Valero's acquisition of Kaneb, the Board issued a decision on November 3, 2005 requesting Valero to submit information regarding its acquisition.[4] This verified statement supports Valero's claim of changed circumstances that justify the Board vacating its previous rate prescription and restoring ratemaking initiatives to Valero. Specifically, Valero has requested that I update the analyses contained in my prior affidavit to reflect the actual financial results up to the current period.

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

2 August 11, 2004 Decision at 4. 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). According to the August 11 Decision, Kaneb acquired the anhydrous ammonia pipeline system from Koch Pipeline Company, L.P. in the fall of 2002, thus stepping into Koch's shoes as the carrier providing the transportation at issue subject to the same regulatory requirements that applied to Koch, including the outstanding rate prescription for providing transportation to CF Industries, Inc.

3 December 2, 2005 Decision at 1.

4 November 3, 2005 Decision at 2.

In Koch, the Board found Koch to be revenue adequate, indicating that "[w]ith the exception of its first year of ownership in 1988, Koch's rate of return on net investment (ROI) has exceeded its cost of capital in all years and by increasingly larger margins so that by 1996 its ROI (21.52%) was almost twice the Board's benchmark cost of capital (11.80%)." Order at 25. This verified statement will illustrate how the economic circumstances have materially changed since the Koch decision, including the purchase price paid by Kaneb and Valero for the pipeline assets and the decrease in transportation volumes, affect the factual underpinnings of the Koch prescription. Specifically, the analysis contained herein, which is based on the most recent data available, demonstrates that, as a result of the changed circumstances, Kaneb's return was and Valero's return on investment continues to be significantly below the benchmark relied on by the Board when making its determination in Koch.

As the Board explained, "[a]dequate revenues are those which cover all costs and provide a rate of return on investment equal to the current cost of capital (i.e., the level of return available on alternative investments), so that the carrier can compete equally with other firms for available financing in order to maintain, replace and, if necessary, expand its facilities and services."[5]

Under the Board's procedures, a carrier is considered revenue adequate if it achieves a ROI equal to at least the current cost of capital for its industry. In Ex Parte No. 393, the Board concluded "that revenue adequacy should be determined on the basis of data for the most recent single calendar year."[6] Historically, the Board has determined

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[5] August 12 Decision at 2.

[6] Standards for Railroad Revenue Adequacy, Ex Parte No. 393 (Sub-No. 1), 3 I.C.C. 2d 261; (1986).

the revenue adequacy of rail carriers on an annual calendar year basis. (See, STB Ex Parte No. 552 (Sub-No. 8) issued August 11, 2004).

My analysis, set forth in Exhibit No. RGV-4, relies on actual financial information from Kaneb and Valero relating to carrier revenues, operating expenses, working capital, acquisition cost, depreciation, retirements and capital additions. This financial information is being sponsored in a verified statement being submitted by Mr. Joseph Graham. See, Exhibit No. JG-2.

The first step in performing the revenue adequacy calculations is to determine Valero's Net Operating Income ("NOI") associated with the Ammonia System. The operating expenses I used reflect Kaneb's and Valero's actual historical operating costs, associated with the Ammonia System, which include general and administrative costs.[7] These operating expenses do not include income tax expenses because Valero is organized as a limited partnership, which is not subject to income taxation.[8] Valero's NOI is determined by subtracting its operating expenses from its revenues, as described above. The result appears on line 5 of Exhibit No. RGV-4.

The attached analyses do not reflect cash or cash equivalents in the working capital allowance used to determine net investment base ("NIB").[9] Therefore, there is no

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7 As Mr. Graham discusses all revenues, operating expenses and capital costs reflect the cost of the entity that owned the Ammonia System at that time. In other words for the period from November 1, 2002 to July 1, 2005 all data reflect Kaneb's revenue and cost. Beginning July 1, 2005 all data reflect Valero's revenue and cost.

8 This represents a conservative cost estimate since other regulatory agencies recognize the economic cost associated with taxes for pass through organizations, such as limited partnerships.

9 The exclusion of cash equivalents in the working capital will most likely understate the actual cost of operating the Ammonia System thereby making the attached analyses conservative.

need to make any adjustments to the NOI on line 2 of Exhibit No. RGV-4 for interest income related to cash working capital.[10]

Mr. Graham has informed me that the revenues, expenses and investment which he has provided are directly related to the jurisdictional Ammonia pipeline service. Therefore, it is unnecessary to perform any sort of separation to adjust for non-pipeline income and deductions on line 4 of Exhibit No. RGV-4.

In calculating the NIB for the ROI determination, an average of the beginning and end of period investment is used, as reflected on lines 6, 7 and 8 of Exhibit No. RGV-4. In Koch, the Board confirmed that an owner's acquisition cost establishes a new investment base for purposes of determining revenue adequacy. Order at 23. For the period since Valero acquired the assets the calculations in Exhibit No. RGV-4 reflects Valero's acquisition cost in determining the NIB of the Ammonia System.[11] This figure was allocated to various property accounts based on the verified statement being submitted by Mr. Thomas R. Shoaf. Mr. Graham has provided the gross investment, its associated deprecation, retirements and additions, as appropriate, to determine the net investment on a monthly basis.

Valero's NIB also includes a working capital allowance for its line fill and materials and supplies inventory, as reflected on lines 18, 19 and 20 of Exhibit No. RGV-4.[12] Typically, the Board's revenue adequacy calculations reflect adjustments in the

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10 Valero's working capital allowance consists of line fill and materials and supplies inventory.

11 To the extent the Board still considers the period when Kaneb owned the assets relevant, I have provided calculations of Kaneb's return on investment based on Kaneb's NIB.

12 When Valero acquired the plant assets from Kaneb, the inventory was also acquired at the current fair market value. Consequently, post-acquisition, these items are valued at $ million and $ million, respectively.

carrier's NIB for Interest During Construction ("IDC") and Accumulated Deferred Income Taxes ("ADIT"). However, since Valero acquired the assets from Kaneb instead of constructing them, there is no IDC associated with the acquisition cost. In addition, the post-acquisition capital expenditures provided by Mr. Graham in Exhibit No. JG-1 do not include any IDC. Given that Valero has not reflected a tax expense in calculating its NOI, there is no need to adjust the NIB for ADIT.

For purposes of computing achieved ROI, I divided the NOI by the average NIB for the each of the periods being examined in Exhibit No. RGV-4. Because Valero acquired the Ammonia System in July 2005, I have prepared several different revenue adequacy calculations based on actual data from that time period. In each scenario, the ROI is significantly below the 10.1% cost of capital figure the Board recently prescribed for examining whether railroads were revenue adequate.[13]

In my prior affidavit filed on September 13, 2004, I presented annual revenue adequacy calculations for the period beginning with Kaneb's acquisition of the Ammonia System (November 2002) through the most current data then available (i.e., August 2004). The calculations contained in Exhibit No. RGV-4 update my prior affidavit by providing a revenue adequacy calculation for Kaneb for the full 2004 calendar year. The ROI for 2004 is 4.13%, which is shown on Line 30 of Column (e) of Exhibit No. RGV-4. This ROI is well below the cost-of-capital prescribed by the Board as "adequate".

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[13] STB Ex Parte No. 558 (Sub-No. 8), Issued June 21, 2005. Valero believes that the railroad industry cost of capital is a conservative cost of capital benchmark and therefore does not adequately reflect the actual cost of capital required to attract investors in the pipeline industry. For example, Valero's actual cost of debt is well above the figure the STB used to establish the railroad industry benchmark. Valero reserves the right to use a more relevant cost of capital for the pipeline industry in determining or defending challenges to any future rates.

For the 2005, I have prepared three separate sensitivities. The first reflects the revenues and operating expenses that Kaneb had during the first six months of 2005 when it owned the asset. The NOI for this period is compared to Kaneb's NIB to develop Kaneb's ROI for the first six months of 2005. The ROI for this six-month period is 3.04%. The Board's current cost of capital benchmark (i.e., 10.1%) reflects an annual operating period. Therefore, in order to develop a comparable figure for a six month period, I took the square root of the Board's annual cost of capital figure. This resulted in a six month cost of capital benchmark equal to 4.93%. Comparing the six-month ROI to the six month cost-of-capital demonstrates that the pipeline continued to be revenue inadequate during the last six months of Kaneb's ownership. These calculations are shown in Column (f) of Exhibit No. RGV-4

Second, I performed the same calculation for the last six months of 2005 when Valero owned the asset. I used Valero's actual revenues and operating expenses to calculate its NOI and then compared this figure to Valero's NIB, of $174 million, to develop a six month ROI. As shown in Column (g) of RGV-4 this 6 month ROI is 2.24% which is well below the six-month cost-of-capital benchmark of 4.93%.

Finally, I performed an annual 2005 calculation based on the aggregate revenues and operating costs actually incurred by both companies to operate the assets in 2005 as compared to Valero's investment base. I provided this calculation in order to provide the Board with a 2005 revenue adequacy comparison calculated on an annual basis. This calculation, shown in Column (h) of RGV-4 shows that the ROI is 4.54%, well below the annual cost-of-capital of 10.1%.

The first calculation shows that the pipeline continued to be revenue inadequate in the last six months of Kaneb's ownership. The final two calculations show that that pipeline continues to be revenue inadequate even under Valero's ownership. Neither the passage of time nor Valero's acquisition of Kaneb has altered this fundamental fact.

This information demonstrates that the current economic circumstances on the Ammonia System are substantially different from the economic circumstances that the Board relied on when it established its rate prescription in Koch. In fact, as Exhibit No. RGV-4 demonstrates on lines 33 to 35, by keeping the Koch prescription in place, the Board has denied Kaneb and Valero the opportunity to recover in excess of $21 million in costs that should be permissible under the revenue adequacy constraint.

CONFIDENTIAL MATERIALS REMOVED

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

Robert G. Van Hoecke

Executed on: March 29, 2006

Subscribed and sworn to before me this 29th day of March, 2006.

Lori J. Amodio

A Notary in and for the County of Fairfax, VA

CERTIFICATE OF SERVICE

I certify that I have this day served copies of this document upon all parties of record in these proceedings by hand delivery.

Dated in Washington, D.C this 31st day of March 2006.

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