

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Inquiry Regarding Income Tax Allowances)

Docket No. PL05-5-000

**COMMENTS OF
THE NATURAL GAS SUPPLY ASSOCIATION**

Pursuant to the Commission's "Request for Comments" issued on December 2, 2004, and subsequent notice of extension of time, the Natural Gas Supply Association ("NGSA") hereby submits comments on behalf of its members regarding the Commission's inquiry in the above-captioned proceeding regarding its policy on income tax allowances.

I.

INTRODUCTION AND BACKGROUND

NGSA represents integrated and independent companies that produce and market natural gas in the United States. Established in 1965, NGSA encourages the expanded use of natural gas and supports regulatory and legislative actions that foster competitive markets.

On December 2, 2004, the Commission issued a Request for Comments in this proceeding to address questions regarding its income tax allowance policy in light of the U.S. Court of Appeals for the D.C. Circuit's decision in *BP West Coast Products v. FERC*, 374 F.3d 1264 (2004). There, the Court of Appeals rejected an income tax allowance for SFPP, L.P., a limited partnership oil pipeline owned by a publically traded partnership or master limited partnership, rejecting the Commission's "*Lakehead*" rationale and denying SFPP's claim for a full corporate income tax allowance. *See Lakehead Pipe Line Company*,

Opinion No. 497, 71 FERC ¶ 61,338 (1995), *aff'd*, Opinion No. 497-A, 75 FERC ¶ 61,181 (1996).

The Commission now seeks comments in this Inquiry on the impact of the Court of Appeals decision on its policy on income tax allowances in general for partnerships and partnership structures of organization.

II.

COMMUNICATIONS AND CORRESPONDENCE

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III.

EXECUTIVE SUMMARY

The Commission's Inquiry spans more than just public utilities in the oil pipeline arena. This is understandable as more and more natural gas pipelines and oil pipelines are being acquired by or converted into a master limited partnership ("MLP") or publicly traded partnership ("PTP"). For example, Kinder Morgan, the present ultimate MLP owner of SFPP, L.P., the oil pipeline that is the subject of the Court of Appeals decision, and whose claim for an income tax allowance was rejected as both "phantom" and "fictitious," *BP West Coast Products v. FERC*, 374 F.3d at 1288, 1291-1293, also owns a number of gas pipelines which presumably for income tax allowance purposes would fall into the same category as SFPP.

Shippers such as the members of NGSAs that move natural gas on pipelines owned by these MLPs naturally are concerned about having to pay unjust and unreasonable rates caused by the inclusion of a phantom and fictitious income tax allowance. Including an allowance for such phantom income taxes is the equivalent of an “under the table” increase in the return on equity of 60% or more.

The question of whether an income tax allowance is appropriate for a particular type of public utility is not a “one size fits all” situation. The Commission should look at the facts of individual cases, whether they are electric, oil or gas cases, whatever the organizational structure of the entity, to determine whether an income tax is appropriate under the Commission’s cost of service regulatory paradigm, the principles of which were affirmed by the Court of Appeals in *BP West Coast Products*.

NGSA believes that incentives for investment in the energy infrastructure should not be done through the “back door” of a “phantom” or “fictitious” income tax allowance.

Finally, NGSAs encourage the Commission to revise the FERC Form 2 annual report of gas pipelines to provide more useful information on the costs and revenues as well as a more detailed description of the ownership and capital structure of interstate pipelines.

IV.

COMMENTS

A. The Commission Should Make Determinations Regarding The Appropriate Income Tax Allowance For Interstate Natural Gas Pipelines on a Case-By-Case Basis.

NGSA believes that the Commission should not adopt a generic policy regarding income tax allowances in this proceeding. Whether an income tax allowance is appropriate for a public utility, whether that utility be a corporation or partnership or joint venture or some

other entity, is a question of fact that should be considered and decided in an on-the-record proceeding based upon substantial evidence.

NGSA believes that the Commission should not attempt here to determine how the Court's decision may apply to partnerships or to any other type of entity. Instead, the Commission should determine whether an income tax allowance is appropriate in individual proceedings. Indeed, the various possible ownership structures listed on page 2 of the Commission's "Request for Comments" confirm NGSA's belief that the Commission cannot decide this issue generically. Whether an income tax allowance is appropriate depends on the facts, and the facts will vary from case to case. Accordingly, NGSA urges the Commission to determine income tax allowances on a case by case basis, applying the time-honored cost of service principles recognized by the Court.

B. The Commission Should Apply Its Time-Honored and Court-Tested Cost of Service Ratemaking Principles in Making Determinations Regarding Income Tax Allowances for Interstate Pipelines.

1. Fundamental Cost of Service Principles Are The Bedrock of Commission Regulation.

The Court of Appeals decision in *BP West Coast Products* disallowing an income tax allowance for SFPP, L.P. applied fundamental principles that are the bedrock of the Commission's cost of service regulation. *BP West Coast Products* at 1291 (discussing *FPC v. Hope Natural Gas*, 320 U.S. 591 (1944)). There are reasons for permitting a public utility to include an income tax allowance in its cost of service. Federal and state income taxes are considered to be a "cost" of doing business for the corporate public utility. Therefore, this cost item is included in the utility's cost of service. This is true even if the "cost" is negated as a result of deductions or other offsets in a consolidated tax return filed by a parent. The

regulated entity is typically looked at in isolation from its affiliates under the Commission's "stand-alone policy." *City of Charlottesville v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985).

NGSA fully endorses this principle and believes that it results in "just and reasonable" rates. Moreover, NGSA believes the *BP West Coast Products* decision does not preclude an income tax allowance for a partnership or flow through entity if the income tax liability is actually incurred. When income taxes are a cost of doing business, they should be included in the cost of service.

2. Application of the Court of Appeals Decision

In *BP West Coast Products*, the Court of Appeals basically found that there is no justification for an income tax allowance for SFPP to cover "phantom" or "fictitious" taxes. *BP West Coast Products*, 374 F.3rd at 1288, 1291, 1293. The Court rejected the Commission's *Lakehead* rationale for the allowance as well as SFPP's claim that the Congress had decreed that PTPs -- and only PTPs -- would get a phantom income tax allowance. *Id.* at 1289-1290, 1293. Holding that the Commission could not create a "phantom" liability, it set the income tax allowance at zero. *Id.* at 1291.

As noted above, SFPP argued for a full corporate income tax allowance, but the Court rejected that claim as well. *Id.* at 1288. In addition to rejecting any income tax allowance, the Court remanded the case for the Commission to address other errors that the Court had found.

While the Court of Appeals opinion specifically addressed the PTP type of organizational structure and rejected any income tax allowance for SFPP, it did so based on basic cost of service principles applied to the facts in the case. NGSA recognizes that there could be other types of partnerships, limited liability structures, or other factual situations that might merit an income tax allowance under the Commission's cost of service principles.

However, NGSAs believe that the determination of an income tax allowance for such entities should be considered based on the facts in each case.

C. It Is Inappropriate to Use Phantom Income Tax Allowances to Encourage Energy Infrastructure.

NGSA is not at all convinced that additional incentives are needed to encourage investment in energy infrastructure. In fact, according to an annual study of pipeline cost recovery performed by NGSAs, pipelines are very profitable businesses. In the annual study, NGSAs assume that all 32 pipelines examined are entitled to a tax allowance in their cost of service. Therefore, for each pipeline for which an income tax allowance is inappropriate, the study would actually reflect even higher levels of cost over-recovery. Consequently, the realized returns of those pipelines are in actuality even higher than those reflected in the current NGSAs study. Thus, the analysis suggests that allowing recovery in the cost of service of phantom income taxes significantly raises a pipeline's actual realized rate of return to far in excess of just and reasonable levels.¹

Additional incentives, if any, that are needed to encourage investment in energy infrastructure should not be given "through the back door" by granting a fictitious income tax allowance that typically could boost the utility's return on equity by upwards of 60%.

¹ The latest NGSAs study using Form 2 data from 1999 through 2003 shows that 20 out of 32 pipelines examined are earning ROE's greater than 13% and 9 of the 32 pipelines are earning in excess of 17% ROE's on average over a five-year period.

D. The Commission Should Revise The FERC Form 2 Annual Report of Interstate Gas Pipelines To Provide Adequate Information That May Be Used by Shippers As Well As the Commission In Evaluating Pipeline Rates.

NGSA once again urges the Commission to revise the FERC Form 2 for interstate pipelines to provide more useful information for purposes of evaluating pipeline costs and the reasonableness of pipeline rates.² This is particularly important as the Commission, in the post-Order No. 636 era, no longer imposes a three-year rate filing requirement on interstate natural gas pipelines. As a result, pipelines in recent years typically have only filed rate cases when their customers require it as a part of a settlement. Consequently, the rates of a number of gas pipelines have not been reviewed for more than a decade. Given the Commission's reluctance to initiate pipeline rate reviews on its own accord, the burden is on the shippers to file complaints in order to keep pipeline rates just and reasonable. It is therefore vital that shippers have access to information adequate to analyze the rates of the pipelines on which they are shippers. Moreover, any Form 2 changes should include a clear roadmap for determining a regulated gas pipeline's organizational structure and income tax situation. Currently, Form 2 does not provide sufficient detail in many cases for interested parties to accurately track or understand the corporate structure of the pipelines both for tax and rate purposes.

In Order No. 646-A, the Commission recognized that changes to the FERC Form 2 may well be needed, and the Commission committed to review the situation at some time in the future following the first annual cycle of quarterly reporting. Order No. 646-A, 107

² NGSA was a participant in the Industry Coalition that filed comments in the Commission's rulemaking on quarterly reports and financial reporting in Docket No. RM03-8-000 urging that changes be made to the FERC Form 2, to include detailed cost-of-service and rate information. *Quarterly Financial Reporting and Revisions to the Annual Reports*, Order No. 646, III FERC Stats. & Regs. ¶ 31,158, *order on reh'g*, 646-A, 107 FERC ¶ 61,231 (2004).

FERC ¶ 61,231, at ¶ 13 (2004). The Commission also stated that it would provide interested parties an opportunity to comment and suggest improvements to the quarterly and annual financial reporting requirements. *Id.* NGSA submits that the time is ripe now to review whether changes to the Form 2 are warranted to ensure that the Commission can adequately review and monitor gas pipeline rates.

Almost a decade ago now, the Commission revised the FERC Form 6 annual report of oil pipelines establishing a new Page 700 to provide complete cost of service information and annual revenues for both the reporting year and the prior year. *Cost of Service Reporting and Filing Requirements for Oil Pipelines*, Order No. 571, [Regs. Preambles 1991-1996] FERC Stats. & Regs. ¶ 31,006, at 31,168 (1994), *aff'd*, *Ass'n of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996). This information has been a useful resource to shippers as the foundation for evaluating oil pipeline rates. *See, e.g., ARCO Products Co., et al. v. SFPP, L.P.*, 91 FERC ¶ 61,142 (2000). Similar detailed information obviously would also be useful to the Commission in determining whether a natural gas pipeline's rates remain just and reasonable. Accordingly, NGSA urges the Commission to implement improved Form 2 reporting similar to that required on Page 700 of Form 6 for oil pipelines.

V.

CONCLUSION

NGSA urges the Commission not to adopt a generic policy regarding income tax allowances, but rather to determine the income tax allowance for interstate gas pipelines on a case by case basis, based on the facts in each particular case, consistent with cost of service ratemaking principles. NGSA further urges the Commission not to provide "incentives" via the "back door" of giving pipelines a phantom income tax allowance. Finally, NGSA requests that the Commission adopt changes to the FERC Form 2 to require interstate gas pipelines to

provide detailed cost of service and revenue information as well as better organizational structure reporting.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'Patricia Jagtiani', with a long horizontal flourish extending to the right.

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