

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

**Inquiry Regarding the Commission’s Policy)
For Recovery of Income Tax Costs)**

Docket No. PL17-1-000

**INITIAL COMMENTS OF THE
NATURAL GAS SUPPLY ASSOCIATION
IN RESPONSE TO NOTICE OF INQUIRY**

On December 15, 2016, the Commission issued a Notice of Inquiry (NOI) seeking comments regarding how to address any double recovery resulting from the Commission’s current tax allowance and rate of return policies. The Natural Gas Supply Association (“NGSA”) appreciates the opportunity to respond to this important NOI. For the reasons set out more fully below and consistent with both the holding of the Court in *United Airlines*¹ as well as NGSA’s support for a level regulatory playing field,² NGSA urges the Commission to adjust its current ratemaking policies to eliminate the income tax allowance for interstate natural gas pipelines owned by a Master Limited Partnership (“MLP”).³

STATEMENT OF INTEREST

NGSA was established in 1965 and represents major integrated and large independent domestic producers of natural gas. The companies that comprise its membership produce and market roughly 40 percent of the U.S. natural gas supply and rely on numerous interstate natural gas pipelines to transport their product to market. NGSA seeks to maintain competitive markets,

¹ *United Airlines, Inc., et al. v. FERC*, 827 F.3d 122, 134, 136 (D.C. Cir. 2016).

² NGSA recognizes that the policies adopted in response to this NOI will apply to all FERC-jurisdictional entities involved in cost-of-service ratemaking. In these comments, however, we focus our remarks on the impact of any change in FERC ratemaking policies on interstate natural gas pipelines and leave for others to comment on the impact on other FERC regulated entities.

³ A MLP is a type of business organization that exists in the form of a publicly traded limited partnership. MLPs allow for pass-through income, meaning that they generally are not subject to corporate income taxes. Instead, owners of an MLP are personally responsible for paying taxes on their individual portions of the MLP's income, gains, losses, and deductions. MLPs are discussed more fully *infra*.

improve downstream efficiencies and to foster increased supply to U.S. markets. NGSA also supports a balanced energy future, one which ensures a level playing field for all market participants and eliminates inappropriate regulatory barriers to supply.

SUMMARY OF ARGUMENT

1. An MLP-owned pipeline does not incur income taxes at the entity level and the income taxes of the pipeline's investors are recovered through the return on equity ("ROE") as discussed in *United Airlines*. Permitting an MLP-owned pipeline to recover, in rates, the investor-level income taxes that it is already recovering through its ROE is fundamentally inappropriate and contrary to basic cost-of-service ratemaking principles.

2. Permitting an MLP-owned pipeline to double-recover investor income taxes results in rates that are not just and reasonable and is contrary to the Natural Gas Act.⁴ Allowing double recovery through a distinct tax allowance recovery line item in absence of a specific entity tax liability has contributed to many pipelines recovering excessive returns for years. Pipeline returns in the range approved by the Commission are more than adequate for a healthy pipeline industry.

3. Other methods to address the holding of the Court in *United Airlines*, such as adjusting the Discounted Cash Flow ("DCF") method, would be difficult, would not address the fundamental flaw of the tax allowance for MLP-owned pipelines, and would require far more lengthy adjustments than simply eliminating the income tax allowance for MLP-owned pipelines. It would only accomplish introducing a level of opaqueness that will unnecessarily frustrate the DCF method. NGSA asserts that the DCF methodology sets adequate pre-tax returns to attract investment and notes that the Commission has long relied on this methodology

⁴ 15 U.S.C. § 717, *et seq.*

to reliably set returns sufficient to provide investors with the ROE needed to cover their taxes under all pipeline tax structures.

4. Any change to the Commission's current income tax policy for MLP-owned pipelines will have impacts that extend beyond oil pipelines to interstate natural gas pipelines and perhaps to the electricity industry as well. Given the number of FERC-jurisdictional pipelines that will need to comply with any new policy issued by the Commission on MLP tax treatment, NGSA supports a staggered approach in which the pipelines with the most egregious over-earnings are directed to comply first.

BACKGROUND

MLPs or Publicly Traded Partnerships ("PTPs") are sophisticated and creative means of shifting the incidence of tax liability from the entity level to the partner level. When Apache Oil formed the first MLP in 1981, the starting gun fired on what would become a decades-long dispute in this industry. The maximum entity level corporate tax rate, which hovered around 46 percent in the 1980's, provided the motivation for companies such as Apache Oil to form as a PTP, thereby becoming a non-taxable entity.

The attractiveness of reforming corporations as partnerships (albeit complex partnerships) spread quickly to many industries, so much so that Congressional concern grew that significant potential tax revenue was at risk of being lost. Accordingly, Congress in the mid-1980's acted to codify these MLPs and their treatment for tax purposes. Section 10211 of the Omnibus Reconciliation Act of 1987⁵ created Section 7704 of the Internal Revenue Code of 1986. This was the first time MLPs were ever addressed in the tax code. Section 7704 stated (in an effort to anticipate the tax revenue depletion issue) that MLPs would be taxed as corporations.

⁵ P.L. 100-203 (Revenue Act of 1987).

The exception to that rule would be that PTPs that sourced 90 percent or more of their gross income from certain qualifying industries would not be taxed at the corporate rate. One of those qualifying industries would be pipelines transporting gas, oil or products thereof. Clearly, Congress has always understood that MLPs are formed and function as a means to shift income tax liability away from the MLP entity so that the MLP entity itself pays zero federal income taxes. Fear of the impact of that tax structure is what drove Congress to address MLPs in the Internal Revenue Code. As discussed *infra*, it appears that the Commission prioritized other motivations – such as creating a supportive capital investment environment – over tax allowance concerns.

The proper ratemaking treatment, by the Commission, of income tax allowances for non-corporate regulated entities has been a controversial issue since 1995, when the Commission first addressed the issue in *Lakehead Pipeline Company*⁶. In *Lakehead*, the Commission held that a pipeline organized as a limited partnership was entitled to an allowance for taxes that were attributable to its corporate partners or unit holders, but not to its individual partners or unit holders.

The Commission's *Lakehead* decision remained in force until 2004, when the U.S. Court of Appeals for the D.C. Circuit reviewed an appeal by a number of shippers of a Commission ratemaking proceeding where the *Lakehead* policy was applied.⁷ In *BP West Coast*, the shippers argued that the Santa Fe Pacific Pipeline, L.P. (SFPP) rates should not include any allowance for income taxes because SFPP was a limited partnership and did not pay any entity level income tax. SFPP countered that there should be no distinction between corporate and non-corporate entities. The Court rejected the Commission's *Lakehead* policy. The Court found that where a

⁶ 71 F.E.R.C. ¶ 61, 338 (1995).

⁷ See *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004).

regulated entity did not have a taxable income, the Commission could not create a “phantom tax” with a corresponding tax allowance borne by ratepayers.

The Commission responded to the Court’s decision by issuing a policy statement providing guidance on income tax allowances for pass-through entities.⁸ In the Commission’s *Policy Statement*, the Commission acknowledged that a pass-through entity does not pay income taxes, but nevertheless found that a partnership or similar legal entity should be granted an income tax allowance if the owner of such interest has an “actual or potential” income tax liability on the public utility income earned through interest. The Commission also expressly abandoned its *Lakehead* policy.⁹

In 2007, the *Policy Statement*’s principle was affirmed in *ExxonMobil Oil Corporation v. FERC*.¹⁰ In *ExxonMobil*, the Court stated that in the Commission’s *Policy Statement* the Commission had cured the “principal defect” of the Commission’s *Lakehead* income tax allowance policy because the Commission had removed the differentiation between individual and corporate partners and extended the allowance to all partners that incur an actual or potential liability for income taxes.¹¹ The Court relied on the Commission’s determination that income taxes paid on the partners’ distributive share of the pipeline’s income were properly “attributable” to the regulated entity because the taxes must be paid whether or not partners receive cash distributions.¹²

It is worth noting that the shipper petitioners in *ExxonMobil* argued that the taxes are not paid by the pipeline, but by the investors and that an income tax allowance for the pipeline would

⁸ See *Policy Statement on Income Tax Allowances*, 111 F.E.R.C. ¶ 61,139 (2005). That *Policy Statement* was the result of the Commission’s December 2, 2004, *Inquiry Regarding Income Tax Allowances; Request for Comments*, Docket No. PL05-5-000; NGSa filed a comment in that proceeding.

⁹ See *Policy Statement*, 111 F.E.R.C. ¶ 61,139 at p. 13.

¹⁰ 487 F.3d 945 (D.C. Cir. 2007).

¹¹ *Id.* at 951.

¹² *Id.* at 952.

simply result in excess profits. The Commission, however, raised an infrastructure policy argument to the Court by claiming that as a matter of policy “termination of the allowance would clearly act as a disincentive for the use of the partnership format” and impinges on investment in energy infrastructure.¹³ The Court stated that it would not “second-guess” the Commission’s policy choice and that the Commission’s conclusion was not unreasonable.¹⁴ The Commission went on to apply its income tax allowance policy in a number of subsequent cases.¹⁵ However, on July 1, 2016, the issue was resurrected as a result of a remand by the Court of Appeals for the D.C. Circuit in *United Airlines* in which the Court directed the Commission to develop a mechanism “for which the Commission can demonstrate that there is no double recovery” of partnership income tax costs.¹⁶ It is telling that the very same Court of Appeals panel in *ExxonMobil* – Judges Griffith, Kavanaugh and Sentelle (now Senior Circuit Judge) – is the same judicial panel that has remanded *United Airlines* back to the Commission.

COMMENTS IN SUPPORT OF ELIMINATION OF A FEDERAL INCOME TAX

ALLOWANCE FOR MLP-OWNED PIPELINES

NGSA agrees with the Commission’s assessment that the income tax policy for MLP-owned entities extends well beyond the particular interests of the parties involved in the *United Airlines* proceeding and that the effect of the Court’s holding on oil pipelines, natural gas pipelines and electric utilities subject to the Commission’s regulations is potentially significant and widespread. The directive to the Commission from the Court to eliminate the double recovery of taxes by MLP-owned pipelines is, however, narrow in scope and leaves the

¹³ *Id.* at 952-53.

¹⁴ *Id.* at 948, 953.

¹⁵ See, e.g., *Trans-Elect NTD Path 15, LLC*, 115 F.E.R.C. ¶ 61,047 (2006); *Michigan Elec. Transmission Co.*, 113 F.E.R.C. ¶ 61,343 (2005); Opinion No. 486, *Kern River Gas Transmission Co.*, 117 F.E.R.C. ¶ 61,077 (2006); *Missouri Interstate Gas, LLC*, 119 F.E.R.C. ¶ 61,074 (2007).

¹⁶ See *United Airlines, Inc., et al. v. FERC*, 827 F.3d 122, 134, 136 (D.C. Cir. 2016).

Commission with few options. Moreover, the Court’s decision is specific and binding: to find “the appropriate remedy” to eliminate double recovery. With few options available to the Commission to meet its Court directive, removing the income tax allowance for MLP-owned pipelines is the most straightforward and simplest method for resolving the issue of double recovery of taxes. Simply put, MLP-owned pipelines have no ability to demonstrate that they directly pay or incur income tax liability, while their investors’ income tax liability is recovered through the ROE. Because there are no income taxes on the pipeline’s income that are not already recovered in the cost of service, there should be no tax allowances afforded to MLP-owned pipelines in determining just and reasonable rates.

- 1. It is antithetical to generally accepted ratemaking principles to allow MLP-owned pipelines to set rates based on a cost of service that includes a federal income tax allowance.**

The Commission’s current approach allowing an income tax allowance for MLP-owned pipelines does not comport with the long-standing tenets of legitimate cost-of-service ratemaking. In sum, cost-of-service ratemaking principles dictate that a pipeline’s rates should be set to provide the pipeline the opportunity to recover reasonable costs incurred in providing its services as well as an allowed profit margin or return on investment. Judged against this very basic core principle, it is fundamentally improper to allow a pipeline to double-recover *any* costs in its rates, including costs associated with income taxes.

The double recovery of costs is never appropriate in calculating just and reasonable rates. For example, a pipeline with a cost of service that already includes a component for compression facilities or services would not be allowed to include a second allowance in its rates for costs associated with compression. Why should federal income taxes be afforded any different treatment? It is clear that an MLP-owned pipeline does not pay federal income tax at the entity

level and the investor taxes “attributable” to the pipeline’s cost of service are already reflected in the ROE. As a result, no income tax allowance should be included in its cost of service for ratemaking purposes. Any other result is incongruous and contrary to decades of fundamental ratemaking principles.

2. Allowing MLP-owned pipelines to claim a tax allowance results in unjust and unreasonable rates.

In addition to the fact that allowing MLP-owned pipelines a tax allowance is fundamentally contrary to core ratemaking principles, it also results in rates that are unjust and unreasonable, in complete contravention of the dictates of the Natural Gas Act. As shippers and customers have compellingly argued in the cases leading up to the issuance of this NOI, including a tax allowance for MLP-owned pipelines that do not pay income taxes at the entity level creates a disproportionate benefit to the pipeline at a confiscatory cost to its shippers and customers. Captive to their pipelines, the shippers and producers have recognized for decades now that the financial arrangement on the MLP-owned pipeline’s side between it and the Internal Revenue Code is one thing, but that it is fundamentally unjust, unfair and indefensible for a pipeline to extract a duplicative recovery of income taxes from the pipeline shippers through inflated rates that are not just and reasonable.

This is not a theoretical issue but is real. As demonstrated by the record in *SFPP, L.P.*¹⁷, granting an income tax allowance to an MLP-owned pipeline enables the pipeline to double recover the income tax liability of its investors from its ratepayers. This same policy approach has also adversely impacted shippers on interstate natural gas pipelines. On principle, it should not matter how much or how little MLP-owned pipelines are over-recovering due to the income tax allowance since any duplicative amount is not justified. However, from a cursory analysis of

¹⁷ F.E.R.C. Docket No. IS08-390-002.

MLP-owned pipelines in NGSAs ROE study for 2017, it appears there are hundreds of millions of dollars every year and ultimately billions of dollars over several years at stake, which are taken directly out of shippers' pockets. Using the DCF methodology, the Commission already approves an adequate return necessary for a healthy interstate pipeline industry because by design, the DCF model demonstrates the pre-tax returns that investors demand from entities of comparable risk.

The Commission now has the opportunity in this inquiry to remove the income tax allowance from the cost-of-service filings of jurisdictional pipelines that are owned by MLPs and to fulfill its statutory responsibilities under the Natural Gas Act to ensure that rates are just and reasonable.¹⁸ Removal of the income tax allowance will restore integrity to the Commission-approved rates and will honor the intention of the U.S. Supreme Court's rationale that supports its decision in *Federal Power Commission v. Hope Natural Gas Company*,¹⁹ where the Court found, "[T]he return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."²⁰

3. The DCF methodology reliably sets returns to attract investment.

PTPs, also called MLPs, were created specifically to avoid entity level income tax liability. A potential tax liability that is never incurred is, as the Court has said, a "phantom tax." Compounding this with the DCF pre-tax ROE component in PTP pipeline rates creates the

¹⁸ The unjust and unreasonable impact of the inclusion of the income tax allowance is further compounded when it is noted that with the removal of the triennial rate filing requirement for interstate natural gas pipelines, and the necessity that Commission review is only triggered by a section 5 complaint, some gas pipelines have not had their rates reviewed by the Commission in over a decade and with no future obligation to do so.

¹⁹ 320 U.S. 591 (1944).

²⁰ *Id.* at 603; see also *Bluefield Waterworks & Improvement Co. v. Public Service Commission*, 262 U.S. 679, 692-93 (1923); *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 (1989).

untenable situation of a pipeline not only having no actual or potential income tax liability, but earning a much higher than justified after-tax return. However, there are several problems with adjusting the DCF approach.

First, the composition of the proxy group is problematic in attempting to adjust the DCF method to somehow offset the inclusion of an income tax allowance for MLP-owned pipelines. An income tax adjustment directly to the ROE for a corporation is simply not possible because corporations' income taxes have **already** been reflected in the DCF calculation. As the Commission determined in its 2008 Policy Statement,²¹ the proxy groups used in the DCF analysis for interstate natural gas pipelines now typically include a mix of partnerships in addition to corporations in order to yield a robust, comparable and large enough proxy group. Since the dividend yields for corporations in the DCF formula already reflect income **excluding** their income taxes, removing the income tax allowance from the selected ROE for any proxy groups containing corporations cannot be done in a fair and reasonable manner. If this was attempted, the resulting ROE would arbitrarily change from case to case depending on the number of corporate entities included, which will not yield fair or commensurate results as directed by the Court in its remand.

In addition, the DCF formula predominantly measures only the return *of* capital that is included in the total cash distributions made to unitholders, which is not taxed.²² While there may be some instances in which unitholders of MLP-owned pipelines receive some taxable income (a return *on* capital), that income is apportioned and accounted for separately in the K-1

²¹ *Policy Statement on Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 F.E.R.C. ¶ 61,048 (April 17, 2008).

²² *Order on Rehearing and Compliance Filing*, 150 F.E.R.C. ¶ 61,097, 6-7 (February 19, 2015) (“Given that the unitholder’s cash distributions are not taxed as income and are not the same as taxable income, Opinion No. 522 properly concluded that the weighted average marginal income tax rate should be weighted based upon the distributed income, not cash distributions.”).

form and will be subject to income tax. Given that the return of capital contained in cash distributions to unitholders is not taxable income, it is simply illogical to apply an income tax “adjustment” to the DCF returns for MLP-owned pipelines.

Furthermore, tinkering with the DCF methodology to provide some level of arbitrary parity will also have much more widespread implications than simply removing the cost of service line item for tax allowances. As the shippers have recently argued,²³ in light of the fact that the same income tax assumptions must be made for either setting the income tax allowance or deciding how to adjust the DCF, the easiest and the most straightforward approach is to eliminate the income tax allowance for MLP-owned pipelines. The DCF methodology relies on market data on the pre-tax ROE required by investors. In turn, there are no separate assumptions being made or that need to be made about the investor tax liability because this information is embedded in the market data. The shippers also argue that in contrast, “the income tax allowance is based on assumptions about the nature of the equity owners and their tax liability, and is therefore a less reliable measure of investor requirements than the market-tested DCF ROE data.” Thus, the Commission’s long-standing reliance on the DCF methodology to determine the appropriate ROE should not be upended.

For all of these reasons, the most reliable and straightforward approach to respond to the Court’s remand in *United Airlines* is to eliminate the income tax allowance in the cost of service of MLP-owned pipelines.

4. The Commission should take prompt action to ensure the integrity of its rate policy.

NGSA recognizes there may be a need for a transition period for the Commission to implement any new policy that eliminates the tax allowance for MLP-owned pipelines. NGSA

²³ *Shippers’ Comments on Remand* at 9, FERC Docket No. IS08-390-000 (Sept. 13, 2016).

supports a reasonably planned phase-in for implementation. For instance, it may be appropriate to stagger compliance with priority given to pipelines with the highest ROE.

However, because of the significant amount that shippers are currently overpaying MLP-owned pipelines, prompt action must be taken by the Commission to remove the income tax allowance using its Section 5 authority to ensure swift compliance with its new policy. It is unacceptable to simply wait for the individual MLP pipelines to initiate a Section 4 rate case, particularly since many pipelines have no future requirement to file a new rate case.

COMMUNICATIONS

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