UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Inquiry Regarding	)	**Docket No.**
Income Tax Allowances	)	**PL05-5-000**

COMMENTS OF THE COALITION OF PUBLICLY TRADED PARTNERSHIPS

The Coalition of Publicly Traded Partnerships ("the Coalition") offers these comments in response to the Commission's Request For Comments ("Request") on the Income Tax Allowance, issued December 2, 2004, in Docket No. PL05-5-000. The Coalition is a national, non-profit trade association representing publicly traded partnerships ("PTPs") and those who work with them. PTPs, as the Commission is undoubtedly aware, are limited partnerships (often known as "master" limited partnerships"), as well as limited liability companies (LLCs) choosing partnership tax treatment, the interests in which (known as "units") are traded on public exchanges or over the counter. Section 7704 of the tax code explicitly limits partnership tax status to PTPs earning certain types of income, including income and gain from natural resources activities. Such activities are defined in 26 U.S.C. §7704(d1E).to include transportation of natural resources through pipelines

To the Coalition's knowledge, there are currently 20 PTPs trading on major exchanges which own and operate oil and gas pipelines. Of these, 15 have operations subject to rate regulation by the Commission, and another two are regulated by the Commission in other aspects of their operations. We estimate that PTPs collectively own and operate roughly 135,000 miles of energy pipelines, including approximately 30,000 miles of crude oil pipelines, 36,000 miles of

refined product pipelines, 53,000 miles of natural gas pipelines, and 16,000 miles of natural gas liquids pipelines.[1]

The Coalition has long supported the principle that PTPs should be accorded a tax allowance regardless of the extent of corporate ownership, and advocated that position at the time of the original *Lakehead* decision.[2] It is the Coalition's opinion that while the D.C. Circuit was correct in its conclusion in *BP West Coast Products, LLC v. FERC* ("*BP West Coast Products*") [3] that the logic of that decision is not sustainable, the answer is not to deny all PTPs a tax allowance but rather to reject the notion that a tax allowance depends upon the payment of income tax at an entity level. To do otherwise would be to ignore the reality that income taxes are in fact paid on revenue generated by PTP-owned pipelines, and would be contrary to the purposes of the PTP structure and Congressional policy as manifested in the tax law governing PTPs.

I. Background

On June 15, 1995, when this question first came before it, the Commission established its policy of providing an oil pipeline limited partnership with an income tax allowance equal to the proportion of its limited partnership interests owned by corporate partners ("*Lakehead* Doctrine. On July 20, 2004, the Court of Appeals for the District of Columbia Circuit ("D.C Circuit") issued an opinion in *BP West Coast Producers v. FERC* in which it held, *inter alia*, that the

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[1] Estimate based on mileage reported in SEC filings and company websites.

[2] *Lakehead Pipe Line Company, L*.P., 71 FERC ¶ 61,388 (1995), *reh'g denied,* 75 FERC ¶ 61,181 (1998).

[3] 374 F.3d 1263 (D.C. Cir. 2004), *reh'g denied*, 2004 U.S. App. LEXIS 20976-98 (2004).

Commission had not adequately justified the *Lakehead* Doctrine and remanded the case to the Commission.[4]

In response, on December 2, 2004, the Commission issued the Income Tax Allowances Inquiry in Docket No. PL05-5. The Commission requested comments on whether the D.C. Circuit's ruling (i) applies only to the specific facts of the SFPP, L.P. proceeding on which it was based or whether it extends to other capital structures involving partnership and other forms of ownership, (ii) will result in insufficient incentives for investment in energy infrastructure, and (iii) will result in generally the same amount of investment through other ownership arrangements. Further, the Commission inquired whether there were other methods of earning an adequate return that are not dependent on the tax implications of a particular capital structure.

The Coalition's response to these questions, at least in the case of pipelines currently owned and operated by publicly traded partnerships, is that (i) there is nothing in the D.C. Circuit decision that requires the Commission to deny a tax allowance to partnerships, while there are compelling reasons for allowing one; (ii) denial of a tax allowance will result in reduced and potentially insufficient incentive for investment in energy infrastructure, and (iii) there is not likely to be the same amount of investment through other ownership arrangements. Because the Coalition advocates the interest of publicly traded partnerships, its comments will be limited to the application of the ruling to such partnerships.

II. The *BP West Coast Producers* Decision Does Not Mandate a General Denial of Tax Allowance

The D.C. Circuit's opinion does not hold that the Commission does not have the power to provide a tax allowance to partnerships, either as provided by the *Lakehead* policy or a full

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[4] *BP West Coast Producers, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) ("*BP West Coast Products"*).

allowance irrespective of corporate ownership. The opinion simply reversed the Commission's decision to rely on the *Lakehead* policy in the SFPP case and remanded the case for the Commission's determination regarding the proper tax allowance for the pipeline in that case. The D.C. Circuit stated that it could not uphold the decision to give SFPP a tax allowance "on the record before us", but added that "we could sustain the Commission's decision if the opinions we review had added the reasoned decision-making lacking in *Lakehead*." [5] Thus, the D.C. Circuit has given the Commission latitude to adopt on remand a well-reasoned policy providing partnerships with a tax allowance if the Commission believes that to be the proper course of action.

At the very least, then, the Commission could and should reaffirm the *Lakehead* policy. It is worth noting, however, that in criticizing the logic used by the Commission to arrive at its *Lakehead* decision, the D.C. Circuit focused in particular on the Commission's attempts to distinguish between corporate and individual taxpayers. Discussing the Commission's decision in the *Lakehead II* case, the D.C. Circuit notes that the Commission has a "quite defensible" argument when discussing the case of a corporate subsidiary that does not itself incur tax liability but might appear on a consolidated return of a corporate groups, then states, "The difficulty arose when the Commission attempted to take the next step and explain why this reasoning applied to an entity that is a non-taxable limited partnership and *to justify discriminating between allowances for the tax liability of corporate unitholders and the tax liability of those unit holders who are individuals or otherwise not subchapter C corporations."*[6] After walking through the Commission's reasoning in denying the tax allowance to the extent of noncorporate ownership,

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[5] *BP West Coast Producers* at 1290.

[6] *Id,* at 1289. Emphasis added.

the D.C. Circuit asserts, "This does not supply reasoning for differentiating between individual and corporate tax liability. It is merely restating the proposition that the Commission is so differentiating….. In short, the Commission's opinions in *Lakehead* do not evidence reasoned decision making for their inclusion in cost of service of corporate tax allowances for corporate unitholders, but denial of individual tax allowances reflecting the liability of individual unit holders."[7]

The Coalition agrees with D.C. Circuit that there are serious flaws in the Commission's reasoning. However, despite the D.C. Circuit's evident distaste for an allowance for what it erroneously considers to be "phantom" taxes, the Coalition believes that the way to correct these flaws and arrive at a consistent and defensible policy is not to deny partnerships a tax allowance across-the-board, but rather provide a full tax allowance to publicly traded partnerships, regardless of corporate or individual ownership. While the Coalition believes that this can be justified on the basis that income taxes paid by the partners of a PTP are in fact a cost of service, a full tax allowance is also appropriate as a means of furthering the policies regarding energy infrastructure that have been clearly articulated by the current Administration, by the Commission, and by Congress.

III. A Tax Allowance Should Not be Denied Because Tax on Earnings is Paid by a Collective Entity Rather Than a Separate "Person"

In explaining its opposition to a tax allowance for partnerships, the D.C. Circuit states the principle that a tax allowance should be based only on income tax paid by the regulated entity as an entity, citing approvingly the original ALJ opinion in *Lakehead*, which it characterizes as stating that, "when there is no tax generated by the regulated entity, either standing alone or as

[7] *BP West Coast Producers* at 1290.

part of a consolidated corporate group, the regulator cannot create a phantom tax in order to create an allowance to pass through to the rate payer."[8] The D.C. Circuit criticizes the Commission's view that the allowance should be provided only when earnings are "double-taxed" because the corporate tax is an extra layer of taxation and the tax allowance will insure that the regulated entity has the opportunity to earn its allowed return on equity.

The Coalition agrees that the Commission's argument regarding double taxation is wrong, but disagrees with the D.C. Circuit's view as well. The D.C. Circuit is mistaken in its repeated assertions that the tax on which an allowance for partnerships with noncorporate partners would be based is a "phantom" one. The tax is real, despite the fact that it is paid not by a single entity but by a number of individual or corporate persons who collectively constitute the entity known as a partnership. When a regulated entity is a PTP or other partnership, any discussion of the entity's rate of return must be concerned with the return on equity of the individual partners who collectively constitute the partnership. An examination of how PTPs and their investors are taxed may help in understanding these points.

While partnerships, and particularly large partnerships such as PTPs, may be treated as discrete entities for some purposes of the tax law, the essence of a partnership, and of the income tax principles at issue here, is that the partnership is *not* a separate entity. The business entity is, for all intents and purposes, the partners collectively, whether there are two of them or tens of thousands.

All income earned by the partnership, as well as all capital gains it realizes in a given tax year, is divided up among all the partners in proportion to their ownership interests. Similarly, deductions and losses that an entity would use to offset its income and the credits it would use to

[8] *BP West Coast Products* at 1291.

offset its tax are divided up among the partners. Each partner then nets is share of income and deductions, gain and loss, applies them to its own income, and pays tax on the result.

An important fact to note is that unlike corporate shareholders, which pay tax only on income that they actually receive in cash, a PTP unitholder, as part of the collective entity, must pay tax on his pro rata share of taxable partnership income whether or not it is ever distributed to him in cash. While most PTPs do in fact provide their investors with regular quarterly cash distributions, the possibility of owing tax with no accompanying cash distribution is always a potential downside that a partnership investor must take into consideration. Moreover, if a unitholder receives a cash distribution, it is treated not as a taxable dividend, but as a return on his investment in the business. Thus, a unitholder in a PTP is situated very differently from a corporate shareholder when it comes to taxation.

Is the total amount of income tax paid on the partnership's revenues from a pipeline less than it would be if the partnership paid an entity-level tax? Possibly – although it is important to remember the many means by which corporations reduce or defer taxation of their income at either the corporate or the shareholder level (for instance, by engaging in debt financing and deducting the interest, or, as the D.C. Circuit notes, by retaining earnings rather than paying them out as dividends, so that the second layer of tax never is paid[9]). Are the earnings from the pipeline taxed? Absolutely. The fact that the tax is the collective responsibility of the partners of whom the business entity is constituted, rather than the responsibility of a sole corporate "person," does not make it any less real.

Other areas of the tax code reinforce the fact that the partners of a PTP or other partnership collectively constitute the business "entity" and must pay tax as such. A telling

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[9] *BP West Coast Products.* at 1289.

example can be found in a section of the tax code that has bedeviled PTPs for years: the unrelated business income tax (UBIT) rules.[10] In essence, these rules require an otherwise tax-exempt organization or pension trust to pay income tax on income it earns by regularly engaging in a trade or business that is unrelated to its exempt purpose. The only exception is for businesses generating "passive" investment income, such as interest and dividends.

Very few tax-exempt organizations or pension funds invest in PTPs, and individuals hesitate before putting them in their IRAs and 401(k)s. Why? Because their share of the PTP's income will be subject to tax as unrelated business income. The tax-exempt investor is considered by the tax code to be engaging in the PTP's business and earning its share of the PTP's business income. It is part of the collective "entity" that is engaging in an ongoing business, and is taxed as such. In short, taxation of the earnings of a PTP is anything but "phantom," and is very different from the tax corporate investors pay on their dividends.

IV. Denial of a Tax Allowance Could Affect Investment in Critically Needed Energy Infrastructure

A. There is a Critical Need for Additional Investment in Energy Infrastructure

It is widely recognized that there is a critical need for additional energy infrastructure in this country The 2001 report of the President's National Energy Policy Group makes clear that repairing and expanding the nation's energy infrastructure must be a top priority, stating,

> "Our current, outdated network of electric generators, transmission lines, pipelines, and refineries that convert raw materials into useable fuels has been allowed to deteriorate. Oil pipelines and refining capacity are in need of repair and expansion. ….Natural gas distribution…is hindered by an aging and inadequate network of pipelines. To match supply and demand will require some 38,000 miles of new gas pipelines, along with 255,000 miles of distribution lines. " [11]

[10] 26 U.S.C. §§511-515.

[11] National Energy Policy: Report of the National Energy Policy Development Group (2001) ("Energy Policy Report"), at ix.

The problem exists in all areas of the energy industry. The Energy Policy Group reported, "Insufficient domestic pipeline capacity has caused peak load problems in moving oil and petroleum products such as gasoline from one region of the country to another... Much of the pipeline is old, requiring regular safety and environmental reviews to ensure its reliability. The potential risk of pipeline accidents to human health and safety is of grave concern." [12]

With regard to natural gas, the report noted that virtually all natural gas in the United States is moved via pipeline, and that "the current domestic and natural gas transmission capacity of approximately 23 trillion cubic feet (tcf) will be insufficient to meet the projected 50 percent increase in U.S. consumption projected for 2020." [13] According to the report, some parts of the U.S., such as California and New England, already face capacity shortages, and natural gas connections from Canada are near capacity. In addition, the report notes that natural gas resources have been shifting from the Southwest to the Deepwater Gulf of Mexico, the Rockies, Western Canada, and the Canadian Atlantic, while at the same time, the country's population has been shifting from the Midwest to growing population centers in South and West. The additional 263,000 miles of new distribution pipelines and 38,000 miles of new transmission pipelines will be needed "to meet increased consumption and the geographic realities of supply and demand."[14]

A study by Energy and Environmental Analysis, Inc. for the Interstate Natural Gas Association estimates that approximately $61 billion (in constant 2003 dollars) will need to be invested in natural gas pipeline and storage infrastructure by 2020 if demand for natural gas is to

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[12] *Energy Policy Report* at 7-9 – 7-10.

[13] *Id*. at 7-11.

[14] *Id*. at 7-12.

be met in an efficient manner. $19 billion will be required to replace existing pipeline just to maintain current capacity, and $42 billion will be needed for new pipeline and storage projects. The report estimates that a two-year delay in construction of such infrastructure will cost U.S. consumers some $200 billion by 2020. [15]

As an example of Congressional interest in this issue, the Senate Energy & Natural Resources Committee staff has invited 32 groups to present and discuss their proposed solutions to the predicted U.S. shortage of natural gas at a half-day bipartisan conference scheduled for Monday, January 24. Among the scheduled topics for discussion: "What legislative or regulatory policies should be implemented to encourage needed additional safe and adequate infrastructure for natural gas transmission and distribution lines and storage?"

And the Commission itself has recognized this need in its Strategic Plan for 2003-2008 by setting as its first goal, "Promote a Secure, High-Quality, Environmentally Responsible Infrastructure through Consistent Policies." Among the objectives for achieving that goal is to "Provide for Timely Cost Recovery to Infrastructure Investors" by "Giv[ing] transportation infrastructure investors confidence that they have the opportunity to cover their costs and make a fair return on their investment." The Plan also advocates adopting innovative rate of return proposals to further this goal.[16]

The threat of terrorism and instability abroad has only increased the urgency of maximizing the potential of every domestic energy resource, and of building, maintaining, and protecting the infrastructure to efficiently distribute these resources to points around the country.

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[15] Environment and Energy Analysis, Inc., *An Updated Assessment of Pipeline and Storage Infrastructure for the North American Gas Market: Adverse Consequences of Delays in the Construction of Natural Gas Infrastructure.* (The INGAA Foundation 2004) at 7-9.

[16] Federal Energy Regulatory Commission, *Strategic Plan for Fiscal Years 2003-2008* (Sept. 2003) at 3, 8.

As the sources cited above make clear, pipelines carrying crude oil, natural gas, and petroleum products are an essential part of that distribution system.

B. PTPs Have Increasingly Been a Means of Attracting Capital to Pipeline Infrastructure

Even if the Commission does not believe that the income tax paid by partners in a PTP is a cost of service for which a tax allowance should be granted, there are compelling policy reasons for providing such an allowance. Over the past several years, a substantial portion of the nation's energy pipeline network has been moved into PTP ownership. The reason for this is the exact subject which is at the heart of the rate-setting discussion: a rate of return that makes it worthwhile to invest in these assets.

A number of corporations have concluded that in the current economic and regulatory environment investment in pipeline construction and maintenance is not the best use of their limited capital. Rate regulation is part of the equation, but not the only part. Pipeline construction and acquisition requires large amounts of capital which many energy companies, faced with decisions on how to best allocate limited resources, feel they could put to more profitable use. In addition, pipelines carry with them a number of environmental risks – mishaps can lead to expensive fines and litigation – which tip the risk-reward balance towards other investments. Therefore, a number of corporate energy companies—both major oil companies and smaller oil and gas producers-- have divested themselves of their pipeline assets in order to focus their capital investment on assets that they feel will be more rewarding.

To whom are these assets being sold? PTPs. There are a number of reasons why PTPs have proven to be an ideal vehicle for attracting investors to pipeline assets. Tax benefits are part of the equation, of course: the lack of double taxation increases the after-tax return on investment, making the return more attractive than it would be if the pipeline were held in

corporate form. Most PTPs pay substantial quarterly cash distributions, providing investors, particularly those looking for an income stream, with a higher return than they would receive from many corporate stocks. This is the case not only because taxation occurs after the distribution of income to the investor rather than before, but also, as discussed above, because the fact that the investor is responsible for tax on the PTPs earnings regardless of whether they are paid to him in cash generates pressure on PTPs to pay out as much as possible.

There are other factors pointing to PTPs as a good location for pipeline assets. PTPs, unlike corporate energy companies, are limited by the tax code in the type of income-producing assets that they can hold. While corporations can diversify into a number of other, more lucrative investments if they wish, pipeline revenues are one of the very few types that a PTP can receive if it wishes to be taxed as a partnership.

In addition, the PTP structure creates discipline; as one investment analyst has put it, PTPs are "good stewards of capital."[17] Because PTPs must pass through their earnings to their unitholders (most of their partnership agreements require that they also distribute available cash), they do not have the option, as corporations do, of retaining earnings for future capital investment. Rather, they must go to the equity or debt markets for each major acquisition, providing added assurance that such transactions have been thoroughly scrutinized and make economic sense.

For all these reasons, there has been a substantial movement of capital into PTPs operating in midstream energy industries, pipelines chief among them, over the past few years. On January 1, 2000, there were 20 energy PTPs on the market (including one coal company), of

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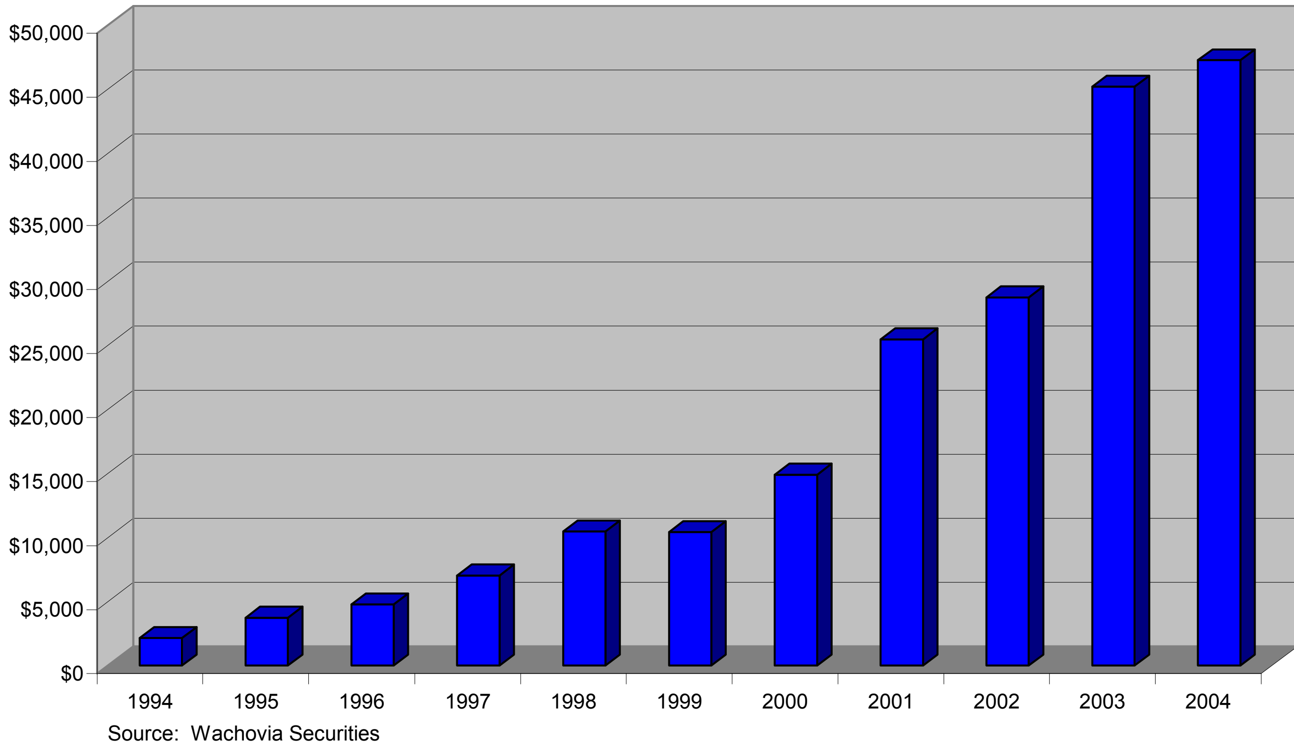
[17] Wachovia Securities, *"Show Me The Money: A Return on Capital Analysis,"* November 29, 2004 ("Wachovia Return on Capital Analysis").

Figure 1
Energy PTP Market Capital 1994-2004
(millions)



which 13 were primarily pipeline companies.[18] On January 1, 2005, there were 34 energy PTPs on the market, 21 of which are pipeline companies.[19]

PTP market capital has grown accordingly. As illustrated in Figure 1, a recent analysis by Wachovia Securities estimates that market capitalization of energy PTPs has grown from $2.15 billion at the end of 1994, to $14.9 billion at the end of 1999, to $47.3 billion at the end of 2004. It has thus increased more than 20-fold in a decade, and more than tripled in five years.

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[18] Five were propane companies; one owned working interests in and support facilities for gas wells.

[19] Of the rest, five are propane companies, three provide marine transportation of petroleum products, three own coal mines and reserves, and one owns natural gas and oil fields. Two PTPs, Kaneb Pipe Line Partners and Kaneb Services, are associated with one pipeline company.

PUBLICLY TRADED PARTNERSHIPS OWNING AND OPERATING ENERGY PIPELINES
(dollars in millions)

	Market Capital	Cash Invested in Expansion and Acquisition FY 1999-2003	Equity Raised 2004	Natural Gas Pipelines	Oil Pipelines	Refined Products Pipelines
Atlas Pipeline Partners, L.P	$145		$101.1	✓		
Buckeye Partners, L.P.	$1,450	$276				✓
Copano Energy, L.L.C.*	$201		$107.0	✓		
Crosstex Energy Partners, L.P.	$289	$137		✓		
Enbridge Energy Partners	$2,810	$1,346	$176.3	✓	✓	✓
Energy Transfer Partners, L.P.	$2,210	$190	$558.8	✓		
Enterprise Products Partners, L.P.	$9,631	$3,384	$610.8	✓	✓	
Genesis Energy, L.P.	$117				✓	
Holly Energy Partners, L.P.*	$241		$135.7			✓
Kaneb Pipe Line Partners, L.P.	$1,724	$755				✓
Kinder Morgan Energy Partners, L.P.	$8,322	--	$285.2	✓		✓
Magellan Midstream Partners, L.P.	$1,697	$872	$374.1			✓
Mark West Energy Partners	$371	$114	$153.6		✓	
Northern Border Partners, L.P.	2,235	$1,042		✓		
Pacific Energy Partners, L.P.	$856				✓	
Plains All American Pipeline, L.P.	2,368	$1,033	$172.1		✓	
Rio Vista Energy Partners*	$21					✓
Sunoco Logistics Partners, L.P.	$543	$121			✓	✓
TEPPCO Partners, L.P.	2,482	$1,933		✓	✓	✓
Valero, L.P.	$799	$524			✓	✓
All Pipeline PTPs	$38,512	$11,727	$2,674.7			

*Entered market 2004. Rio Vista was a spin-off; all common units were distributed to shareholders of Penn Octane.

Sources: Wachovia Securities, company data

From 1999 to 2003, energy PTPs invested $21.7 billion in expansion projects and acquisitions.[20] In 2004 alone existing and new PTPs raised $4.3 billion in equity capital (and another $5 billion through debt offerings).[21] A substantial share of this investment was channeled into pipelines. As a result, as noted earlier, at least 135,000 miles of energy pipelines are owned and operated by PTPs, and this number continues to grow.

While moving pipeline assets into PTPs has made the risk-return equation more attractive to investors, it is still a delicate balance, and for regulated pipelines, the tax allowance is part of that balance. Taking away even the partial tax allowance that has been allowed under the *Lakehead* policy will tip that balance in a negative direction and undermine what heretofore has been a feasible and efficient means of allocating capital to energy pipelines. Raising tax costs is a deterrent to investment and could stem the flow of new capital into pipelines through PTPs. While this would not eliminate investment in pipeline assets altogether, it would certainly, by raising a new obstacle to an importance source of capital for energy infrastructure, reduce the rate at which such capital becomes available, and hence slow the pace of construction of new energy infrastructure as well maintenance and replacement of existing infrastructure. Moreover, creating rate policy differences between partnerships and corporations creates a Commission bias regarding the choice of business form--a factor which should be irrelevant in ratemaking--toward the less tax efficient corporate form.

Adopting a full tax allowance, on the other hand, could tip the balance more positively, not only preserving pipeline companies' current access to capital through the PTP structure but, by offering investors a more attractive return, enhancing it at a time when it is most needed.

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[20] Wachovia, Return on Capital Analysis at 12.

[21] Wachovia Securities, *MLPs: Surveying the Landscape*, January 6, 2005 at 9-10.

Given the recognized need and the Commission's stated commitment to policies that will encourage investment in energy infrastructure, including specifically innovative rate of return proposals, the latter course is clearly the most appropriate.

V. A Full Tax Allowance for PTPs is in Accord With Continuing Congressional Policy

As has been noted by many, including the D.C. Circuit, Congress has recognized and given its blessing to this means of attracting capital to the energy industry and to pipelines in particular. In 1987, when a proposal to tax all publicly traded partnerships as corporations was before Congress, Congress recognized the importance of the PTP structure to the energy industry and preserved it through the provisions of section 7704 – and, lest there be any mistake as to its intentions, specifically mentioned in the statute transportation through pipelines as one of the activities that it wished to benefit. The D.C. Circuit was dismissive of this fact as a reason for continuing to encourage investment through PTPs, stating that "the mandate of Congress in the tax amendment was exhausted when the pipeline limited partnership was exempted from corporate taxation."[22]

The Coalition could not disagree more. The intent of Congress was in 1987 and continues to be now, not merely to provide the energy industry with tax exemptions, but to adopt the most effective measures possible to channel capital into the development of energy resources and to remove all possible obstacles to such development and to the creation of the infrastructure needed to extract, process, and distribute these resources. Section 7704 was one piece of an overall policy, not its conclusion. Providing PTPs with a full and fair tax allowance in setting rates for their pipeline assets so that their owners will find it worthwhile to continue providing capital for these assets should be another piece of that policy.

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[22] *BP West Coast Products* at 1293.

Any doubt on this score should have been laid to rest in 1995, when Senator Max Baucus (D-MT), currently the ranking Democrat on the Senate Finance Committee and a member of that Committee when the 1987 provision was written, wrote to the Commission criticizing the original *Lakehead* decision for distinguishing between corporations and partnerships with regard to the tax allowance and declaring this decision to be directly contrary to Congress' intent in 1987:

> [A]s a member of the Senate Finance Committee who participated in the writing of the Omnibus Reconciliation Act of 1987, I feel that placing this obstacle in the path of pipeline companies wishing to operate as [publicly traded partnerships] directly contravenes the policy we adopted in that legislation of making the [publicly traded partnership] structure freely available to the pipeline industry. Language specifically covering pipelines was placed in the legislation so that there would be no doubt that they qualified for partnership taxation as [publicly traded partnerships]. It was certainly not our intention for pipelines operating as [publicly traded partnerships] to be singled out for negative treatment relative to other pipelines solely because of their partnership status.[23]

The fact that Congress still considers the exemption from corporate taxation provided to energy PTPs in 1987 to be just one element of a comprehensive and ongoing policy is amply demonstrated by its recent decision to further facilitate the use of PTPs as a means of raising capital for energy infrastructure. It did this last year by enacting a provision amending the regulated investment company (RIC) rules of the tax code to make it easier for PTPs to raise capital from mutual funds.[24] Under these rules, mutual funds are required to obtain 90 percent of their income from specified sources in order to maintain their pass-through tax status as RICs. Because income from PTP investment was not one of those sources, few mutual funds chose to

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[23] Letter from The Honorable Max Baucus, U.S. Senator, to The Honorable Elizabeth Anne Moler, Chair, Federal Energy Regulatory Commission (Jan. 9, 1996) (available in FERC Docket No. IS92-27-000).

[24] Section 331 of the American Jobs Creation Act of 2004, P.L. 108-357, amending 26 U.S.C. §851.

risk their RIC status by investing in PTPs. The legislation removed this impediment by adding PTPs to the list of approved income sources for RICs.

The legislative history of this provision makes clear Congress' view that encouraging a greater flow of capital to PTPs would enhance the effort to expand the nation's energy infrastructure. In introducing the bill in the Senate, Senator Jeff Bingaman (D-NM), ranking Democrat on the Senate Committee on Energy and Natural Resources as well as a member of the Senate Finance Committee, stated that he was introducing the legislation

> "so [PTPs] can raise sufficient capital for new investments in pipelines and infrastructure…..The overwhelming majority of these partnerships are energy-related companies that need the ability to raise capital from mutual funds to build pipelines and other facilities. This legislation would be a strong shot in the arm for the economy as it encourages companies to begin new projects that are currently on hold for lack of capital. It also provides us with the ability to expand our pipeline network to meet our current demands for natural gas." [25]

Although ultimately enacted as part of a corporate tax bill, the provision was originally placed in the tax portion of the Congressional energy bill[26] and was added to the other legislation only after the energy bill (for reasons unrelated to this provision) failed to win final Senate approval.

VI. Conclusion

Although the D.C. Circuit in the *B.P. West Coast Products* case clearly disapproved of the Commission's reasoning in granting a tax allowance to PTPs to the extent of corporate ownership under the *Lakehead* doctrine, and expressed the view a tax allowance given for anything other than a corporate income tax imposed on the ratemaking entity is an allowance for a "phantom" tax, it did not tell the Commission that it could not grant PTPs a tax allowance. Rather, it remanded the case to the Commission for a decision based on better reasoning.

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[25] 149 Cong. Rec. S4635 (2003).

[26] Section 1363 of H.R. 6, the Energy Policy Act of 2003, as agreed to by the House and Senate conferees.

The Coalition believes that the D.C. Circuit was correct in its opinion that the Commission's reasoning in granting a tax allowance to PTPs only to the extent of corporate ownership was deeply flawed: however, it believes that the answer is not to discard the tax allowance for PTPs, but rather to adopt a rational and consistent policy of providing a full tax allowance to all PTPs. There are compelling arguments for doing so:

- Due to the flow-through nature of partnership taxation, the entity earning revenue from the pipeline is in fact the aggregation of taxpaying partners. This collective entity is no less entitled to a tax allowance reflecting the effect of income taxation on its earnings than is a single corporate taxpayer.
- Because they offer a business structure that provides a reasonable rate of return on investment in energy pipeline when other structures may not, PTPs are an important source of capital for the construction of new energy infrastructure and the upgrading and replacement of existing infrastructure.
- Because of the widely recognized need for new energy infrastructure, particularly in the natural gas industry which is regulated by the Commission, and the Commission's own policy of doing what is necessary to provide a sufficient return to attract investment in such infrastructure, it is logical for the Commission to assist energy PTPs in attracting investors through reasonable rate regulation.
- Congress has clearly expressed the view that eliminating barriers to investment in energy infrastructure through PTPs is an important component of the nation's overall energy policy.

The Coalition urges the Commission not to place an unnecessary burden on investment in energy infrastructure by denying a tax allowance to PTPs, but rather to help PTPs do an even

better job of bringing needed capital to this sector by adopting, as one of its desired “innovative rate of return proposals,” a full tax allowance for all PTPs.

Respectfully submitted,

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Mary S. Lyman
Executive Director