

NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS

RATEMAKING FOR FERC-REGULATED PIPELINES

A growing number of publicly traded partnerships own interstate energy pipelines, which are regulated by the Federal Energy Regulatory Commission (FERC). Both the construction of new pipeline systems and the rates charged by pipeline companies to carry oil, gas, and petroleum products on their pipelines are subject to FERC approval.

The growing number of PTPs among the companies owning energy pipelines has raised some issues, particularly with regard to the formula used to determine appropriate rates. To determine whether proposed rates are appropriate and fair, FERC uses "cost of service" ratemaking, under which pipeline rates are supposed to cover the pipeline operator's costs, including taxes, and provide a reasonable return on equity (ROE) to investors.

In determining the appropriate ROE, FERC uses a "discounted cash flow" (DCF) approach, under which the expected ROE for a pipeline company is equal to the dividend yield plus the expected rate of growth in earnings per share. The expected rate of growth is based on both analysts' short-term expectations for growth in the company's stock and economists' long-term expectations for growth in the economy as a whole.

Several issues have arisen with regard to ownership of pipelines by PTPs. These include whether PTPs should be able to include an income tax allowance in determining their cost of service, whether PTPs should be included in the proxy groups used to set rates for pipeline companies which do not have their own publicly traded equity, and the expected rate of growth that should be used for PTPs in the DCF calculation.

Income Tax Allowances in Ratemaking

An issue in which the Association—then the Coalition of Publicly Traded Partnerships--became involved over a decade ago resurfaced in 2004 and was finally resolved in 2007. The issue is whether the ability to include an income tax allowance in pipeline ratemaking is limited to corporations paying an entity level tax, or whether partnerships may do so as well. The income tax allowance is one of the basic components used in determining a pipeline's cost of service under traditional cost-of-service ratemaking.

The first involvement of the Coalition of Publicly Traded Partnerships with this issue was in 1995, when FERC issued what came to be known as the *Lakehead* decision. In a ratemaking case involving a Coalition member, Lakehead Pipe Line Company L.P. (now Enbridge Energy Partners), FERC departed from its prior policy that all pipelines were entitled to an income tax allowance regardless of their form of business organization and ruled that because PTPs and other partnerships do not pay an entity-level tax, they are entitled to a tax

allowance only to the extent they are owned by corporate partners ([Lakehead Pipe Line Company, Limited Partnership, Opinion No. 397, 71 FERC ¶ 61,338 \(1995\)](#)).

Lakehead and several others filed a request for a rehearing, and the Coalition submitted an amicus brief in support of Lakehead. The Coalition also helped implement an effort to persuade Members of Congress to contact FERC in support of Lakehead's position. On May 15, 1996 FERC issued an order ([Opinion No. 397-A75 FERC ¶61,181 \(1996\)](#), commonly referred to as "Lakehead II") in which it denied a rehearing and clarified, but did not change, its earlier decision. From then forward, pipeline ratemaking for PTPs was governed by the *Lakehead* doctrine.

The issue was reopened on July 20, 2004 when the U.S. Court of Appeals for the District of Columbia issued its decision in [BP West Coast Producers, LLC v. FERC, 374 F.3d 1263 \(2004\)](#), which dealt with several issues raised by shippers with regard to the SFPP pipeline. The Court found that "the Commission's opinions in *Lakehead* do not evidence reasoned decision making for their inclusion in cost of service corporate tax allowances for corporate unit holders, but denial of individual tax allowances reflecting the liability of individual unit holders." It rejected the argument that an income tax allowance should apply regardless of the status of unitholders, stating that the tax allowance should apply only to taxes paid by the regulated entity and that any allowance given to partnerships would be for "phantom taxes." The Court also rejected the argument that the 1987 legislation had shown Congressional intent in this matter, saying Congressional policy had long ago been fulfilled by that legislation. The tax allowance question, along with other issues in the case, was remanded to FERC.

On December 2, 2004 [FERC announced that it was seeking comments](#) on whether the Court's ruling in *BP West Coast Producers* "applies only to the specific facts of the SFPP, L.P. proceeding, or also extends to other capital structures involving partnerships and other forms of ownerships." It also asked whether, if the Court's decision precluded a tax allowance, that would result in insufficient incentives for investment in energy infrastructure.

A group of Coalition members worked with Coalition staff to put together comments from the Coalition which were submitted on January 21, 2005. Several members also submitted individual comments. [The Coalition's comments](#) urged FERC to return to the pre-*Lakehead* policy of providing a tax allowance to all partnerships, regardless of the nature of the partners, on the basis that:

- The *BP West Coast Producers* decision did not mandate denial of a tax allowance to partnerships, but only that FERC provide a well-reasoned rationale for applying one.
- The regulated entity does in fact pay tax when the entity is a PTP; the only difference is that the entity is an aggregation of partners rather than a corporate "person."

- Denial of a tax allowance to PTPs could affect investment in critically needed infrastructure. The need has been noted by many, including FERC itself, and PTPs have increasingly been the entities filling it.
- A full tax allowance for PTPs is in accord with continuing Congressional policy to adopt measures to encourage the flow of capital into energy infrastructure, as shown by the recent enactment of legislation facilitating investment in PTPs by mutual funds.

On May 4, 2005, FERC issued a [Policy Statement on Income Tax Allowances \(111 FERC ¶61,139\)](#) which largely adopted the Coalition's position. FERC concluded that it "should return to its pre-*Lakehead* policy and permit an income tax allowance for all entities or individuals owning public utility assets, *provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets.*" [emphasis added].

The Policy Statement explicitly reversed the *Lakehead* decisions, stating that the *Lakehead* policy (as well as those opposing any tax allowance for partnerships) "mistakenly focused on who pays the taxes rather than on the more fundamental cost allocation principles of what costs, including tax costs, are attributable to regulated service and therefore properly included in a regulated cost of service." The Policy Statement expressed agreement with the Coalition's argument that income tax liability is no less real because it falls on individual partners rather than a corporate entity.

The FERC statement represented an important victory, but one that came with caveats. First, as the emphasized language makes clear, a partnership seeking a tax allowance must establish that its partners have an actual or potential tax liability on its public utility income, and will be permitted a tax allowance only to the extent that this is true. The Policy Statement states that this should be determined at individual rate proceedings.

Second, there was little question that FERC's implementation of this policy would lead to further appeals. On December 16, 2005 FERC issued an order reaffirming its tax allowance policy and directing SFPP to provide evidence necessary for the pipeline to determine its income tax allowance. The new policy and the December 16 order were appealed to the D.C. Circuit Court of Appeals, which held oral arguments on December 12, 2006.

The Court of Appeals issued its decision, [Exxon Mobil Corporation v. Federal Energy Regulatory Commission \(376 U.S. App. D.C. 259; 487 F.3d 945\)](#), on May 29, 2007. The decision upheld FERC's policy, stating that its *BP West Coast* decision was based on FERC's failure to provide a reasoned explanation for its decision to distinguish between corporate and individual partners in permitting an income tax allowance. FERC's May 2005 policy statement, on the other hand, had carefully examined the alternative policies, had reasonably explained its decision, and was not arbitrary and capricious. The Court's role, it said, was not to decide whether FERC had made the best possible policy decision, but only whether it had "operated within the scope of its discretion and reasonably explained its actions."

MLPs and Allowed Returns on Equity

Background

Another key component of “cost of service” in traditional (“Section 4”¹) FERC ratemaking is the return on the rate base. The goal is to set pipeline rates at a level that will allow the pipeline to earn a reasonable rate of return, providing both a reasonable return on equity (ROE) to investors and a return on debt that covers financing costs. The allowed ROE is thus a critical element in determining pipeline rates. Since a higher ROE can translate into higher rates, pipelines naturally want higher allowed ROEs and shippers want the allowed ROE to be held as low as possible.

In times when gas prices are high, there may also be consumer pressure to hold down pipeline rates, and thus ROEs, as a cost over which (unlike the cost of gas) regulators can exercise control. While this may provide some relief to consumers, it comes at the cost of reducing the incentive to invest in new pipeline infrastructure, potentially resulting in lower capacity which can itself lead to higher costs down the road.

In determining the appropriate ROE, the FERC uses a “discounted cash flow” (DCF) approach. Under this approach, the expected return on equity for a pipeline company is equal to the dividend yield plus the expected rate of growth in earnings per share. The expected rate of growth is based on both analysts’ short-term expectations for growth in the company’s stock and economists’ expectations for long-term growth in the economy as a whole. The formula currently used by FERC assigns short-term growth a 2/3 weight and long-term growth a 1/3 weight in the DCF calculation. The result of this calculation theoretically represents the earnings that an investor would expect from that stock and hence the return necessary to attract equity investment to pipeline infrastructure.

When the company in question does not issue its own publicly traded equity, as is the case with all the natural gas pipeline companies (although a parent company may issue stock or partnership units), the FERC uses a proxy group method. Under this method, a proxy group of several publicly traded companies in the same or a similar industry is selected. The dividend yield rate for the proxy companies is added to a projected rate of growth in earnings per share for each company to establish the range of expected returns for those companies. The FERC then typically establishes the ROE at the median of the range of proxy companies, although it may and has used a different value when the calculated value does not appear to match investor expectations.

¹ “Section 4” refers to Section 4 of the Natural Gas, Act, 15 U.S.C. §717c., which requires pipelines to show that proposed rates are “just and reasonable.”

Because ownership of crude oil pipelines is heavily oriented towards PTPs, PTPs are included in the proxy groups used for oil pipeline ratemaking. MLPs have not been used in proxy groups for natural gas pipelines, however. In the January 2005 [High Island Offshore System, L.L.C. \(HIOS\) decision \(110 FERC ¶ 61,043\)](#), FERC asserted that because cash distributions from MLPs are considered a return on investment they were not directly comparable to corporate dividends and stated that it would not consider including MLPs in a proxy group unless it was clear that the MLP distribution did not include a return of investments, but was only a payment of earnings.

Kern River Ruling

Most rate cases are ultimately settled and formally adjudicated decisions in rate cases are relatively rare – just 31 over the past thirty years. Until 2006, the allowed ROEs in these cases had all been in the low double digits, averaging 13.3 percent. Approved ROEs in certificate cases, which deal with major new pipeline facilities (there have been 20), have been higher, with 95 percent set at over 13 percent.²

On March 2, 2006, a FERC administrative law judge (ALJ) recommended an allowed ROE of 9.34 percent in a ratemaking case for the [Kern River Gas Transmission Company \(114 FERC ¶ 63,031\)](#). The ruling drew widespread attention and created a good deal of consternation that, if affirmed by the FERC Commissioners, it would force natural gas pipelines to operate under allowed ROEs lower than needed to attract equity capital. The composition of the proxy group, including in particular whether MLPs should have been included as proposed by Kern River, was one of the heavily debated issues both in the proceedings and after the decision. The ALJ cited *HIOS* and concluded, “Inclusion of MLPs unreasonably inflates ROE.” Many industry members and analysts, however, felt that unless MLPs were included, the ROE calculation would not truly reflect the returns expected in the current market.

On October 19, 2006, the Commissioners reversed the ALJ’s determination that the proper ROE was 9.34 percent and adopted an ROE of 11.2 percent ([Order No. 486, 117 FERC ¶ 61,077](#)). They Commissioners modified the proxy group to exclude two companies “whose adverse financial circumstances are not representative of the natural gas pipeline industry,” producing a median ROE of 10.7%; and because the proxy group was small and included companies with a relatively low proportion of pipeline business, they adjusted the ROE another 50 basis points upwards to reach 11.2%. However, they upheld the ALJ’s refusal to include MLPs, “since our concerns about the inclusion of MLPs have not been adequately addressed on this record.”

² Richard Smead, *Allowed Returns on Equity in the Interstate Gas Pipeline Industry Issues and Options Regarding the FERC DCF Approach*, prepared for the Interstate Natural Gas Association of America, August 24, 2006, pp. 9-10.

FERC Request for Comments on Allowing MLPs in Proxy Groups

On July 19, 2007, in remarks at an open meeting of the FERC Commissioners, FERC Chairman Joseph Kelliher announced that FERC was proposing a change in policy to allow PTPs to be included in proxy groups for natural gas as well as oil pipelines. However, because FERC remained concerned about the comparability between corporate dividends and partnership distributions, particularly the fact that PTPs distribute cash in excess of earnings and that a portion of the distribution is considered return of capital, it was proposing to cap the distribution used in the DCF calculation at the level of the PTP's reported earnings. Contemporaneously with Chairman Kelliher's announcement, FERC issued a [Proposed Policy Statement](#) detailing the new policy and FERC's reasoning, and inviting interested parties to submit comments.

NAPTP submitted its [Initial Comments](#) on August 30, 2007. The comments endorsed the proposal to include PTPs in proxy groups, but urged FERC not to cap distributions, arguing that the full amount of the distribution accurately reflects the rate of return expected by the investor and that including would not, as FERC suggested, result in double recovery of depreciation. The comments also urged that FERC consider the effect of incentive distributions to general partners in its calculation of the necessary ROE. NAPTP reiterated this last point in greater detail in its [Reply Comments](#) filed on September 19.

On November 15, 2007, FERC issued a notice requesting additional comments on the specific issue of how an MLP's growth rate should be projected for purposes of the DCF analysis, particularly there were no cap on distributions for this purpose, and scheduling a technical conference on the issue for January 8 (later changed to January 23), 2008. The notice stated that the current record did not contain adequate information for it to determine whether the current methodology adequately reflects what FERC believed to be "the lower growth potential of MLPs over the long term." NAPTP submitted its [Additional Comments](#) on this issue on December 21, 2007.