INCOME TAX ALLOWANCE IN PIPELINE RATEMAKING

On July 1, 2o16 an issue that had been considered settled for over a decade was suddenly reopened by an unexpected court decision. The issue, in which MLPA was involved in the mid-2000s as well as in the mid-1990s, is whether the ability to include an income tax allowance (ITA) 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 under the Federal Energy Regulatory Commission (FERC). On July 1, in *United Airlines v. Federal Energy Regulatory Commission*, No. 11-1479 (*United Airlines)* the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit Court of Appeals) remanded to FERC a ratemaking case in which FERC had followed its 12-year policy of allowing a partnership to include an ITA in its calculations, asking that FERC provide additional justification for its policy.

BACKGROUND

Lakehead Policy and *BP West Coast Producers*

MLPA, known then as the Coalition of Publicly Traded Partnerships, first became involved with this issue 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 an ITA 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)) 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 D.C. Circuit Court of Appeals 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 ITA should apply regardless of the status of unitholders, stating that the ITA 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 ITA question, along with other issues in the case, was remanded to FERC, much as has been done in *United Airlines*.

FERC Information Gathering and Policy Statement

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 an ITA, 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 an ITA 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 then-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 ITA 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.

As the emphasized language made clear, a partnership seeking an ITA must establish that its partners have an actual or potential tax liability on its public utility income, and will be permitted an ITA only to the extent that this is true. The Policy Statement states that this should be determined at individual rate proceedings. As a result of this requirement many pipeline MLPs have included in their prospectuses and annual reports language warning that unitholders who are not subject to U.S. taxation risk having their units redeemed.

ExxonMobil Decision

The shippers wasted little time in trying to reverse the new policy. On December 16, 2005 FERC issued an order reaffirming its ITA policy and directing SFPP to provide evidence necessary for the pipeline to determine its ITA. 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 ITA. 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."

UNITED AIRLINES V. FERC

In the nine years since *ExxonMobil*, challenges to SFPP's rates have continued on a number of issues. In United Airlines, the petitioners argued that because FERC's discounted cash flow (DCF) return on equity already ensures a sufficient after-tax return to attract investment to the pipeline, ITA results in a "double recovery" of taxes to SFPP's partners.[1] The Court ruled that this was not an impermissible collateral attack on *ExxonMobil* because the issue had not been addressed in that decision. It agreed with the petitioners that FERC had acted arbitrarily and capriciously because it "failed to demonstrate that there is no double-recovery of taxes for partnership, as opposed to corporate, pipelines" and therefore lacked the "reasoned basis" for allowing an ITA that is required under ExxonMobil.

The Court found as an agreed-upon "essential fact" that "with a tax allowance, a partner in a partnership pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline, at least in the short term before adjustments can occur in the investment market." According to the Court, this violated the policy set forth by the Supreme Court in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."

Based on these findings, the Court remanded the case to FERC to consider mechanisms by which it can demonstrate that there is no double recovery if an ITA is allowed. Specific mechanisms mentioned for consideration were to "remove any duplicative tax recovery for partnership pipelines directly from the discounted cash flow return on equity," a possibility mentioned by FERC during oral arguments; and to eliminate all ITAs and set rates based on a pre-tax return.

The case was decided by a three-judge panel—the same panel, in fact, that decided ExxonMobil. The parties had until August 15 to file a petition for a rehearing by the full Court of Appeals. No petition was filed, so the remand to FERC is effective and the ball is in FERC's court. FERC has not, as of the writing of this report, indicated how it will respond. It could reopen the rate case docket and gather more evidence and arguments to support its original decision, or it could, as in 2004, re-open the matter, put out a call for comments, and issue a new Policy Statement. It has no time limit for acting.

MLPA Position

First, it is important to remember that only those MLP pipelines whose rates are determined by cost-of-service ratemaking regulated by FERC will be affected by *United Airlines* and FERC's response. A large number of pipelines owned by MLPs, particularly newer expansion projects, have either negotiated or market rates that don't go through this process. In addition, any pipelines that are underearning their cost of service will not be subjected to lower rates.

[1] The petitioners raised two other arguments unrelated to the ITA; the court found for the petitioners on One and upheld FERC on the other)

That said MLPA believes the Court was wrong and opposes any change in FERC's current Policy Statement. Future action by MLPA will depend on how FERC decides to proceed, but if the policy is reopened, MLPA will, as in 2004-2005, advocate in favor of retaining the current policy. While our arguments will be more fully developed at that time some points that can be made in support of the current policy include:

- The Court incorrectly concluded that a partner in a partnership pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline if the partnership pipeline is allowed both an ITA and a DCF return (pre-investor-tax return) in its rates.

- FERC's ITA policy treats partner owned pipelines and shareholder owned pipelines the same. Under FERC's policy
  - Shippers pay the same rates for the same service whether the pipeline is MLP- or corporate-owned.
  - Pipelines earn equivalent equity returns, whether MLP or corporate; and
  - Investors earn equivalent equity returns, whether MLP or corporate.

- The law does not require FERC to remove from rates an intentional tax treatment provided for by Congress.

- Congress, through IRC Section 7704, intentionally removed the second level of taxation for MLPs to create an incentive for investment in MLP oil and natural gas pipelines and, in turn, afforded them easier access to capital to invest in such infrastructure.
  - The Court misidentified the incentive as "double recovery"; removing it from rates would undermine the purpose of Section 7704.
  - Treating MLP pipelines differently by removing what the Court identified as "double recovery" (which would result in lower rates for shippers) would result in giving to the shippers the tax benefits IRC Section 7704 intended for the MLP pipeline and its investors.

- FERC has the discretion to align its ratemaking policies with the intent of Congress
  - FERC made a policy choice to align its ratemaking policies with the tax code's removal of the second level of tax liability for MLPs. There is no "windfall" here. Instead, FERC has preserved the pipeline investment incentive created by Congress.
  - This incentive has been an enormous success, with MLPs investing tens of billions of dollars in new, much needed pipeline infrastructure over the past several years.