UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Inquiry Regarding Recovery For Income Tax Costs	))	**Docket No. PL17-1-000**

COMMENTS OF THE MASTER LIMITED PARTNERSHIP ASSOCIATION

The Master Limited Partnership Association ("MLPA") offers these comments in response to the Notice of Inquiry issued by the Federal Energy Regulatory Commission ("the Commission") on December 15, 2016, in the referenced docket, requesting comments on how to "resolve any double recovery" and allow a sufficient return consistent with *Hope*.[1] MLPA is a national trade association representing master limited partnerships ("MLPs") and those who work with them. For over two decades MLPA has both advocated for and supported the principle that MLPs must be afforded a tax allowance in their costs of service regardless of the extent of corporate ownership. [2] MLPA advocated that position in 1995 under its prior name, Coalition of Publicly Traded Partnerships, in connection with the original *Lakehead* decision,[3] and again in 2005 as part of the proceedings that led to the Commission's current policy.

Among the over ninety MLPs that MLPA currently represents, there are 46 MLPs whose business operations include gathering or transportation of natural gas, natural gas liquids

[1] *F.P.C. v. Hope Natural Gas*, 320 U.S. 591, 603 (1943).

[2] An allowance for income taxes is required if the return on equity is derived from an after-tax view, to the extent that the regulated entity generates income tax liability for its owners. For MLPs, the first tier of tax liability is at the unit-holder level. If a return on equity is determined at a pre-tax level, then a tax allowance is implicit in such return. Under any approach, an MLP must be granted the ability to obtain sufficient revenues to provide its investors an after-tax return that fairly compensates for the risks.

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

(“NGLs”), crude oil, and refined products. As it is not a pipeline association, MLPA does not have expertise in ratemaking and will not attempt a technical analysis of the double recovery issue; rather we endorse the analyses provided by the Interstate Natural Gas Association of America (“INGAA”) and the Association of Oil Pipe Lines (“AOPL”). MLPA’s comments instead seek to inform the Commission on the history and characteristics of MLPs, why they are such an important part of the pipeline industry, and why the income tax allowance is an important factor in MLPs’ contribution to energy infrastructure and should not be altered.

A. Background on MLPs

“MLP” is the common term for publicly traded partnerships (PTPs), limited partnerships and occasionally limited liability companies (LLCs) choosing partnership tax treatment whose interests (known as “units”) are traded on public exchanges or over the counter. Section 7704 of the Internal Revenue Code, enacted in 1987 as part of the Omnibus Reconciliation Act, explicitly limits partnership tax status to PTPs earning certain types of income, including most notably “income and gain derived from the exploration, development, mining or production, processing, refining, transportation *(including pipelines transporting gas, oil, or products thereof)* [emphasis added], or the marketing of minerals or natural resources.”[4]

Prior to the creation of MLPs in the early 1980s, nontraded partnerships, particularly in the oil and gas and real estate industries, were inaccessible to small investors, as the partnerships required a large initial investment and tied up an investor’s money for years. Under the MLP structure, these industries, which had traditionally raised capital in partnership form, were able to reach a broader base of investors. By dividing partnership interests into affordable, liquid units,

[4] 26 U.S.C. §7704(d)(1)(E).

MLPs allowed small investors to participate in these industries and provided the industries with a new source of equity capital.

In 1987, concerned that corporate tax revenue would be lost if MLPs were allowed to spread to other industries that had not previously raised capital through partnerships, and at the urging of then-Assistant Treasury Secretary for Tax Policy Roger Mentz, Congress enacted section 7704 as part of that year's tax bill. From the beginning of discussions about the new provisions, policymakers, including Assistant Secretary Mentz, recognized the need of natural resource industries, and the oil and gas industry in particular, to continue using MLPs due to the industries' importance to the nation and their traditional use of partnerships to raise capital.[5] The provisions that became section 7704 retained partnership taxation for both the energy and the real estate industries based on these considerations.

Both in 2005 and today, MLPA has consistently argued that denying MLPs an income tax allowance undermines the intent of Congress in creating section 7704. As we did in our 2005 submission to the Commission, we offer as evidence the words of Senator Max Baucus, a member of the Senate Finance Committee when section 7704 was enacted and subsequently its Chairman. In response to the Commission's 1995 *Lakehead* decision providing a tax allowance only to the extent there are corporate partners, Senator Baucus wrote:

> [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

[5] Master Limited Partnerships: Hearings Before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, 100th Cong. 1st Sess. Statement of J. Roger Mentz.

> [publicly traded partnerships] to be singled out for negative treatment relative to other pipelines solely because of their partnership status.[6]

Ongoing Congressional support for the use of MLPs to raise capital in the energy sector has been demonstrated several times since then. In 2004, Congress enacted legislation that made it easier for regulated investment companies ("RICs") to invest in MLPs,[7] and in 2008 Congress expanded the definition of "qualifying natural resources" to include industrial source carbon dioxide and expanded "qualifying activities" to include the transportation and storage of certain renewable fuels.[8] In 2014, when the then-Ways and Means Chairman, Dave Camp, introduced a comprehensive tax reform bill, the proposed legislation specifically retained partnership tax treatment for midstream and most other natural resource MLPs. This was one of the few provisions benefiting the oil and gas industry that was retained in the proposal.[9]

B. MLPs and Midstream Assets

Over the years following the enactment of section 7704, the MLP universe changed dramatically. One factor was the departure of most of the MLPs whose businesses no longer qualified for partnership tax treatment; another was the failure of traditional oil and gas and real estate MLPs whose industries experienced severe downturns. Another significant change was an increased movement of midstream energy assets (*e.g.,* pipelines and other energy infrastructure) out of large corporations and into MLPs.

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[6] 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).

[7] American Jobs Creation Act, P.L. 108-357 § 331.

[8] Emergency Economic Stabilization Act of 2008, P.L. 110-343, §§ 116 and 208.

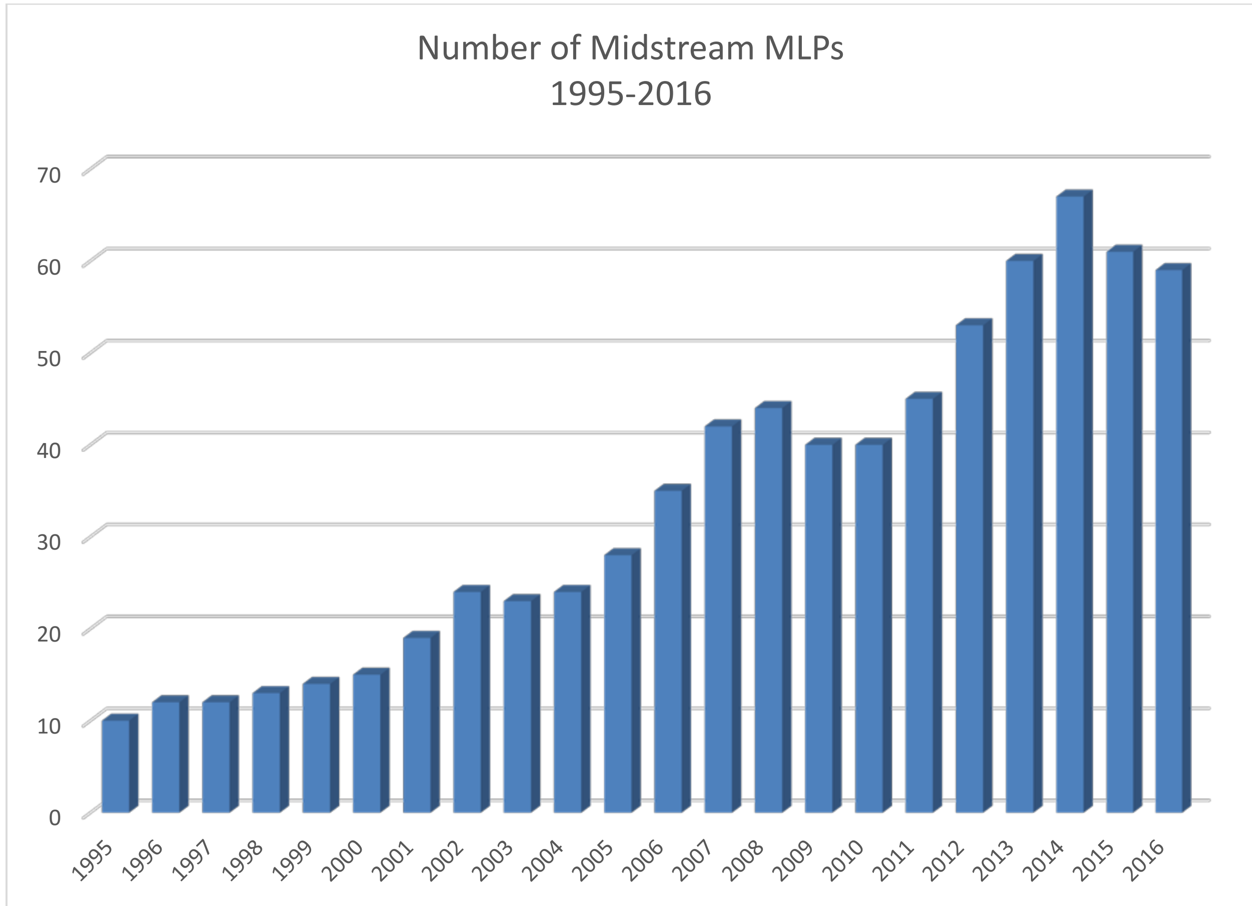
[9] Tax Reform Act of 2014, H.R. 1, 113th Cong. § 3620.

At the heart of the movement of midstream energy assets into MLPs was the desire of corporate energy companies to direct their capital to the investments providing the greatest returns. Pipelines and other midstream asset projects require a significant deployment of capital up front, to construct facilities that do not provide cash flow until the new facilities commence service. Once these projects are placed in service, capital continues to be employed to operate and maintain the facilities on an annual basis. These assets' costs are also increasing due to expenses related to real or perceived environmental risks. Yet, at the same time, they provide a return on investment that is highly reliable but limited when compared with other potential investments, because of both regulation and competition. These facts led a number of corporate energy companies to divest themselves of their midstream assets to pursue more lucrative ventures, or to place midstream assets they owned or acquired into MLPs over which they retained control.[10]

In the 2000s, the investment community became more familiar with MLPs, and income-oriented investors realized that investing in the growing number of midstream MLPs provided steady cash flow with a higher yield than many bonds – particularly after the financial crisis of 2008 – and, unlike bonds, with significant growth potential. As a result, capital began to flow into MLPs not only from individual investors, but also, beginning in 2004, from MLP-oriented funds. The result was a steady growth in MLPs until 2015 when the universe of energy-oriented MLPs (even those without commodity exposure) was impacted by the precipitous drop in oil and natural gas prices, as shown in the chart below. Even with the downturn, at the end of 2016,

[10] For example, in 2001 Sunoco, Inc. formed an MLP, Sunoco Logistics Partners, to own and operate a substantial portion of its logistics business (crude oil and refined product pipelines and terminal facilities). In another example, Anadarko Petroleum, a corporation engaged in oil and gas exploration and production, acquired midstream assets to service its natural gas production through its purchase of Western Gas Resources Inc., then formed a subsidiary MLP, Western Gas Partners, which purchased the assets.

market capital for all natural resource MLPs was close to $400 billion, with the midstream sector accounting for over 88 percent of that capital.



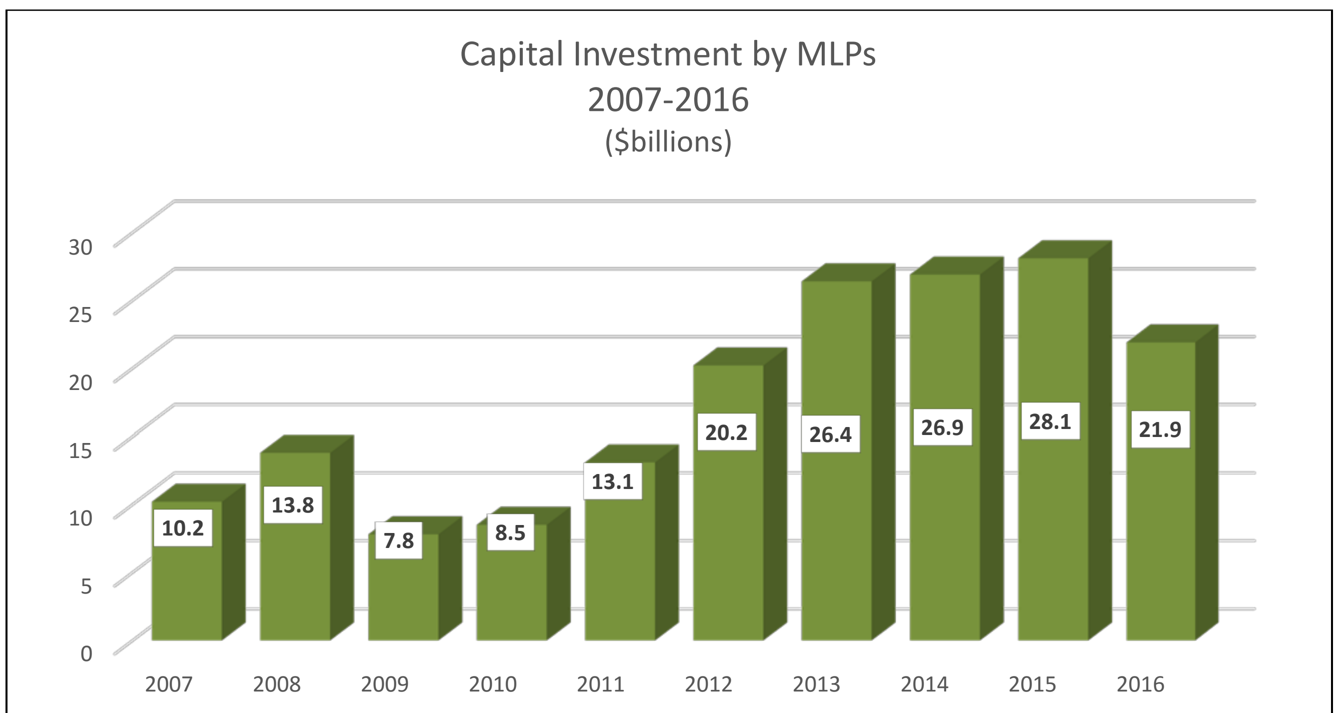
C. MLPs and Their Investors Today

Today there are some 48 MLPs whose activities include gathering or transportation of natural gas, NGLs, crude oil, and refined products (MLPA's 46 members plus two others) versus 20 when the association last submitted comments in 2005. Together these MLPs own close to 400,000 miles of gathering and transportation pipelines (versus 135,000 in 2005), including over

270,000 miles of natural gas pipelines; over 40,000 miles of natural gas liquids pipelines; over 50,000 miles of crude oil pipelines; and 22,000 miles of refined product pipelines.[11]

Thirty-five of these MLPs own assets that are subject to regulation by the Commission. A large portion of the pipelines regulated by the Commission are wholly or partially owned, or operated, by MLPs.

The provisions of section 7704 have had the intended effect of directing capital to important energy industries. MLPs have invested some $177 billion of capital in energy infrastructure over the past ten years and are on track to invest another $60 billion through 2020.[12]



Source: Wells Fargo Securities

[11] Estimates based on mileage reported in SEC filings and on company websites.

[12] Wells Fargo Securities, MLP Monthly January 2017, Exhibit 18. Based on company reports and analyst estimates of MLPs covered by Wells Fargo, which includes most midstream MLPs.

This significant investment has been fueled by millions of investors with diverse investing objectives, who have provided capital in exchange for a reliable stream of cash, unit price appreciation, and the opportunity to participate in the creation of the energy infrastructure needed to take advantage of new sources of supply and expanding energy markets. According to PricewaterhouseCoopers ("PwC"), which does the tax processing for most MLPs, the number of investors has grown with the increase in MLPs. For example, in 2005, PwC processed returns for 2.3 million accounts representing unitholders who had owned MLP units for all or part of the year. At the end of 2015, the last figures available, the number had grown to over 10 million with over three-quarters of these accounts representing individuals owning units either directly or in their retirement accounts.

D. MLP Investment in Pipelines is Still Needed

There is little doubt that MLP investment in pipelines and other energy infrastructure is still needed. The INGAA Foundation periodically releases studies by ICF International of the amount of capital investment in midstream infrastructure required in order for consumers to fully benefit from the abundance of oil, natural gas, and NGLs awaiting development in the United States and Canada. Midstream infrastructure is defined as:

- Natural gas gathering and lease equipment, processing, pipeline transportation and storage, and LNG export facilities.
- NGL pipeline transportation, fractionation, and export facilities.
- Crude oil gathering and lease equipment, pipeline transportation, and storage facilities.

The latest study, released in April 2016, factored in the effects of the downturn in the energy markets and analyzed both a "high case" and a "low case" with different assumptions regarding economic activity and demand. It found that there continues to be a very significant

need – between $421 billion and $621 billion over twenty years – for midstream infrastructure investment in all scenarios, including $123 to $208 billion for transportation pipelines and $104 to $128 billion for gathering systems.[13] Much of this capital will need to come from MLPs. Thus, not only is the Congressional intent behind section 7704 still in force, the necessity for the incentive it creates still exists.[14]

E. MLP Investors Are Uniquely Situated Relative to Corporate Shareholders

An implicit assumption behind the Shippers' "double recovery" argument in *United Airlines*[15] is that corporate pipeline investors and partnership pipeline investors are similarly situated because they face equal risks, and therefore differences between corporations and partnerships with respect to the ROE generated in the Commission's Discounted Cash Flow ("DCF") reflect the tax expectations for both types of investors associated with the distributions/dividends they receive. The Shippers argue that investor-level taxes are "included" in the DCF analysis. MLPA defers to INGAA's expert witnesses in demonstrating empirically that income taxes are not included in the Commission's DCF methodology. MLPA also notes the INGAA analysis showing that over time there is no demonstrated consistent difference in the DCF returns between MLPs and C-Corporations. MLPA offers comments on risk factors the Commission must consider in applying the DCF method to MLPs and C-Corporations, as

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[13] ICF International, North American Midstream Infrastructure Through 2035: Leaning Into the Headwinds. The INGAA Foundation Inc. 2016.

[14] While our comments focus on MLPs, other, strategic partnerships between companies in the energy sector (including but not limited to interstate natural gas pipelines) are utilized as a way to pool resources and spread risk for complicated and expensive infrastructure projects. The strategic partners in some of these infrastructure expansion projects may be corporations. Because the activities conducted in these partnerships would qualify under section7704, these interests ultimately could be transferred to an MLP.

[15] *United Airlines, Inc. v. FERC*, 827 F.3d 122 (D.C. Cir. 2016).

investors in partnership pipelines face quite different risks than investors in corporate-owned pipelines, and MLP investors expect a return commensurate with those risks.

To be a limited partner in a partnership is different from being a shareholder in a corporation. Limited partners have fewer rights than corporate shareholders, and those rights are determined under the MLP's limited partnership agreement. The MLP typically is governed by a general partner, which has the authority to make most decisions as to the conduct of the MLP's business. Its limited partners do not have a vote in selecting the board of directors of the general partner and they do not attend an annual meeting such as those at which issues may be raised and voted upon by shareholders. The MLP's limited partnership agreement may expand, restrict, or eliminate the fiduciary duties otherwise owed by the general partner to the limited partners and to the partnership. Most MLP limited partnership agreements eliminate all duties of the general partner to the limited partners, and replace them with a standard to act in, or not opposed to, the best interests of the MLP. Most MLP limited partnership agreements may grant limited partners approval rights on major decisions such as a sale of most assets of the MLP's assets, or a merger, but in general their rights as investors are more circumscribed than those of corporate shareholders.

The most important differences, however, lie in the tax structure within which MLP investors operate. As the Commission recognizes in the discussion of MLPs in the Notice of Inquiry, an MLP or other partnership is not a separate taxpaying entity. Under the partnership tax regime, as was explained in our 2005 submission, the partner is in effect both the investor and a part of the regulated business entity. For tax purposes, the business entity is, for all intents and purposes, the MLP's partners (unitholders) collectively.

All income earned by the partnership, along with capital gains it realizes in a given tax year, generally is divided among the partners, as are the deductions and losses that an entity would use to offset its income and the credits it would use to offset its tax. Each partner then nets its allocated share of partnership income and deductions and includes them with its own income to pay tax on the result.

Here is where an important element of risk is factored into the investment equation. While corporate shareholders pay tax only on dividends that they actually receive in cash, MLP unitholders, as part of the collective entity, must pay tax on their share of the partnership's taxable income regardless of whether or not that income is ever distributed to the unitholder in cash. While most MLPs do in fact provide their investors with regular quarterly cash distributions, there have been MLPs that have been forced to reduce or eliminate distributions in recent years. The possibility of owing tax with no accompanying cash distribution is always a potential downside that a partnership investor must take into consideration, and it is a risk that is carried during the entire period of investment.

In addition, MLP unitholders pay a second layer of tax when they sell their units, as explained in detail in the comments filed by INGAA in the instant proceeding. The difference between the unit value and their adjusted basis (unitholders' bases are increased by taxable income and decreased by distributions and tax losses allocated from the partnership; the net adjustment is usually downwards) will be taxed, largely at ordinary income rates due to tax depreciation recapture. A unitholder may have to pay tax upon sale even if the value of the units has declined. Shareholders of C-Corporations do not adjust their bases downwards in this manner and usually pay tax at capital gains rates on any gain realized when they sell their shares.

We understand that this tax obligation at the time of sale of the unit was not discussed or contemplated as part of the SFPP case that gave rise to the Commission's Notice of Inquiry. As INGAA states, the second tier of income taxes associated with C-Corporations has never been an explicit factor or consideration in developing a regulated pipeline's cost of service. However, if the second tier of income taxes is considered by evaluating an investment with an assumed holding period, the Commission must also consider income tax obligations of unitholders at the time of sale which, as pointed out by the INGAA experts, results in a different tax liability than that of a C-Corporation shareholder. The expert witnesses sponsored by INGAA's comments demonstrate that under a holistic tax analysis which includes second-tier shareholder dividend tax and the unitholder's second layer of tax at the time of sale, the taxes paid in both situations are nearly equivalent.

MLP unitholders face two additional risks that are uniquely greater than those faced by corporate shareholders. The first is cancellation of indebtedness income ("CODI"). When debt is forgiven, cancelled, or redeemed at a discount, as in a debt restructuring transaction, the amount of debt forgiven is considered taxable income to the debtor. If the debtor is an MLP, the unitholders will be allocated their share of the CODI and have to pay tax on it. Additionally, in a financially troubled MLP, a unitholder's distributions may well have been reduced or eliminated.

Another risk is an acquisition or merger. Unless carefully structured, the acquisition of an MLP or its merger with another company may be treated as a taxable transfer of the partnership units. The unitholders then must pay tax on the difference between the market value of the units and their adjusted basis, a sizeable amount for longtime unitholders whose basis has been adjusted down to a low level; and that tax obligation is imposed at ordinary income rather than capital gain rates.

MLP unitholders also can face a significantly greater burden than corporate shareholders due to certain tax attributes of MLPs. MLP unitholders face more burdensome recordkeeping and reporting requirements under the tax rules than corporate shareholders. The complexity of partnership taxation generally and the specifics of dealing with tax information reported by the entity weighs more heavily on an MLP investor than do tax considerations for a corporate investor. The information on the 1099 form provided by a corporation to its investors is relatively simple to enter on a tax return, while the K-1 form provided to an MLP investor can be difficult to decipher, and may require MLP investors to pay additional fees for tax preparation.

The complexity adds an element of risk by making taxpayer error, and subsequent adjustments, more likely. In addition, under the rules for partnership audits,[16] a unitholder may unexpectedly owe extra tax as the result of an adjustment for an error in the partnership's calculations in a prior year, even if a unitholder was not a partner when the error occurred. If a corporation goes through an audit and owes additional tax, on the other hand, it is not directly passed through to shareholders.

MLP unitholders are also subject to tax in every state in which the MLP earns income (other than the few that do not have an individual income tax). Some states require nonresidents to file no matter how small the amount involved, and may pursue taxpayers who do not comply, thus adding complexity. Corporate shareholders do not have this concern.[17]

In sum, it is not true that corporate shareholders and MLP unitholders bear commensurate risks, or that MLPs and their investors are overcompensated by the income tax allowance or

[16] Section 1101 of the Bipartisan Budget Act of 2015

[17] In addition, unlike corporate dividends, income from MLP investments held by tax-exempt entities, such as individual retirement accounts (IRAs) and employee benefit plans, will generally will be considered unrelated business taxable income and will be taxable to the entity; and non-U.S.MLP unitholders will be subject to withholding taxes imposed at the highest effective tax rate applicable to them.

return on equity compared to C-Corporations and their shareholders. Corporate shareholders and MLP unitholders bear different risks and need to be compensated accordingly.

F. Effect of Changing the Income Tax Allowance

MLP investors, particularly individual investors, invest in MLPs primarily for their cash flow. MLP unitholders, particularly in the midstream sector, invest capital in MLPs with the expectation of a steady stream of distributions. As the Notice of Inquiry observes, the pricing of MLPs is based on cash flow, and the cash flow resulting from rates that include an income tax allowance has already been factored into MLP valuations and investor expectations since the Commission adopted its current policy almost twelve years ago.

If the income tax allowance is removed from the cost of service formula, the result will be lower rates, which in turn will mean reduced cash flow, and a lower return for the MLP for its investment in the pipeline assets in question. Faced with this reality, MLPs whose rates are determined by cost-of-service ratemaking, will have little choice but to reduce distributions to compensate for the reduced cash flow. As a result unit prices will drop (this has consistently occurred when MLPs have reduced or eliminated distributions), as well as make potential investors less motivated to endure the hassles of partnership taxation. The outcome of either option would be contrary to *Hope,* 320 U.S.at 603, which requires that the *end result* of the cost-of-service ratemaking achieve the following goal:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns 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. (Case citations omitted).

Either way, the benefits of a tax structure intended to promote such investment will be removed from MLPs, putting energy MLPs on an unequal and unfair playing field when compared with energy corporations, to the detriment of necessary capital investment in the nation's energy infrastructure.

G. Conclusion

In sum, MLPA maintains that permitting an income tax allowance for MLPs does not provide an unfair benefit that disadvantages corporate investors. Rather, the allowance fairly and appropriately takes into consideration the following facts:

- Congress fully intended that MLPs and their investors benefit not just from qualification for partnership taxation, but also from all that that implies, including compensation as the regulated taxpaying entity in a ratemaking regime. Congress expressly intended to minimize the burdens on raising capital for this industry, and that intent should be honored in all contexts.
- When pipeline assets are owned by a partnership, it is important to remember that the unitholders are both the "regulated entity" and the investors, and will be taxed in both of these roles.
- MLP unitholders face different risks and challenges than corporate shareholders, which is appropriately reflected in any difference in return on equity.
- Despite the price downturn that slowed down the energy market in 2015-16, the United States still has a critical need for energy infrastructure. Eliminating the tax allowance for MLPs could impair their ability to raise capital and make the types of investments necessary to ensure our energy security.

For all these reasons, MLPA urges the Commission to retain the income tax allowance policy it adopted in 2005 and to support INGAA's comments that a double-recovery of income taxes does not reside within the DCF.