

162 FERC ¶ 61,227  
UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Docket No. PL17-1-000

Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs

(Issued March 15, 2018)

AGENCY: Federal Energy Regulatory Commission.

ACTION: Revised Policy Statement on Treatment of Income Taxes

SUMMARY: Following the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *United Airlines, Inc., et al. v. Federal Energy Regulatory Commission*, 827 F.3d 122 (D.C. Cir. 2016), the Commission issued a notice of inquiry (NOI) seeking comment regarding how to address any double recovery resulting from the Commission's current income tax allowance and rate of return policies. The Commission finds that an impermissible double recovery results from granting a Master Limited Partnership (MLP) pipeline both an income tax allowance and a return on equity pursuant to the discounted cash flow methodology. Accordingly, the Commission revises its policy and will no longer permit an MLP to recover an income tax allowance in its cost of service. While all partnerships seeking to recover an income tax allowance will need to address the double-recovery concern, the Commission will address the application of *United Airlines* to non-MLP partnership forms as those issues arise in subsequent proceedings.

EFFECTIVE DATE: This Revised Policy Statement will become effective [date of publication in the *Federal Register*].

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Docket No. PL17-1-000

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SUPPLEMENTARY INFORMATION:

162 FERC ¶ 61,227  
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FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Kevin J. McIntyre, Chairman;  
Cheryl A. LaFleur, Neil Chatterjee,  
Robert F. Powelson, and Richard Glick.

Inquiry Regarding the Commission's Policy for  
Recovery of Income Tax Costs

Docket No. PL17-1-000

REVISED POLICY STATEMENT ON TREATMENT OF INCOME TAXES

(Issued March 15, 2018)

1. On December 15, 2016, the Commission issued a Notice of Inquiry (NOI)<sup>1</sup> following the decision of the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit) in *United Airlines*.<sup>2</sup> In that decision, the D.C. Circuit held that the Commission failed to demonstrate that there was no double recovery of income tax costs when permitting SFPP, L.P. (SFPP), a master limited partnership (MLP),<sup>3</sup> to recover both an income tax allowance and a return on equity (ROE) determined pursuant to the discounted cash flow (DCF) methodology. The NOI sought comments regarding the double-recovery concern.

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<sup>1</sup> *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, 157 FERC ¶ 61,210 (2016) (NOI).

<sup>2</sup> *United Airlines, Inc., v. FERC*, 827 F.3d 122, 134, 136 (D.C. Cir. 2016) (*United Airlines*).

<sup>3</sup> An MLP is a publicly traded partnership under the Internal Revenue Code that receives at least 90 percent of its income from certain qualifying sources, including gas and oil transportation. *See* 26 U.S.C. 7704; NOI, 157 FERC ¶ 61,210 at PP 4-7. At the time of SFPP's rate filing, Kinder Morgan Energy Partners (KMEP), an MLP, indirectly owned a 99 percent general partner interest in SFPP. *SFPP, L.P.*, Opinion No. 511, 134 FERC ¶ 61,121, at P 74 (2011).

2. As explained below, the Commission revises the 2005 Income Tax Policy Statement<sup>4</sup> and will no longer permit MLPs to recover an income tax allowance in their cost of service. To the extent the comments in this proceeding raise arguments that an MLP pipeline should continue to receive an income tax allowance, those comments fail (a) to undermine the conclusion that a double recovery results from granting an MLP both an income tax allowance and a DCF ROE or (b) to justify preserving an income tax allowance notwithstanding such a double recovery. Consistent with this policy, the Commission is concurrently issuing a Remand Order<sup>5</sup> denying SFPP an income tax allowance in response to *United Airlines*.

3. In addition, this record does not provide a basis for addressing the *United Airlines* double-recovery issue for the innumerable partnership and other pass-through business forms that are not MLPs like SFPP. While all partnerships seeking to recover an income tax allowance will need to address the double-recovery concern, the Commission will address the application of *United Airlines* to non-MLP partnership or other pass-through business forms as those issues arise in subsequent proceedings.

#### **I. Background**

4. Prior to *United Airlines*, the Commission's 2005 Income Tax Policy Statement allowed all partnership entities (including MLPs, such as SFPP) to recover an income tax allowance for the partners' tax costs much like a corporation receives an income tax

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<sup>4</sup> *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (2005 Income Tax Policy Statement).

<sup>5</sup> SFPP, L.P., Opinion No. 511-C, 162 FERC ¶ 61,228 (2018) (Remand Order).

allowance for its corporate income tax costs.<sup>6</sup> The Commission explained that while a partnership itself does not pay taxes, the partners pay income taxes based upon the partnership income and these partner-level taxes could be imputed to the pipeline.<sup>7</sup>

5. Alongside this income tax policy, the Commission has used the DCF methodology to determine the rate of return regulated entities need to attract capital.<sup>8</sup> Under the DCF methodology, the required rate of return is estimated to equal a corporate investor's current dividend yield (dividends divided by share price) plus the projected future growth rate of dividends, such that  $k = D/P + g$ .<sup>9</sup> Similarly, for an MLP, the Commission uses the same formula, substituting unitholder distributions for dividends, unit price for share price, and using a lower long-term growth rate.<sup>10</sup>

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<sup>6</sup> 2005 Income Tax Policy Statement, 111 FERC ¶ 61,139. The Commission's policy permits an income tax allowance, provided that the owners can show an actual or potential income tax liability to be paid on income from the regulated assets.

<sup>7</sup> *Id.*

<sup>8</sup> *United Airlines*, 827 F.3d at 136; *Coakley v. Bangor Hydro-Electric Co.*, Opinion No. 531, 147 FERC ¶ 61,234, at P 14 (2014). The Supreme Court has stated that "the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works & Improvement Co. v. Public Service Comm'n*, 262 U.S. 679 (1923).

<sup>9</sup> Where P is the price of the stock at the relevant time, D is the current dividend, k is the investors' required rate of return, and g is the expected growth rate in dividends. When a regulated entity is a wholly owned subsidiary and not publicly-traded, the Commission applies the DCF formula to other publicly-traded entities in a proxy group, and, based typically upon the median of the range of returns in the proxy group, the Commission determines the regulated entity's allowed ROE.

<sup>10</sup> *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on* (continued ...)

6. In addressing SFPP's West Line rate case filed in 2008, the Commission applied its 2005 policy that allows a partnership to recover an income tax allowance.<sup>11</sup> In *United Airlines*, the D.C. Circuit remanded the Commission's application of this policy, holding that the Commission failed to adequately explain why a double recovery did not result from allowing SFPP to recover both an income tax allowance and a ROE determined by the Commission's DCF methodology.<sup>12</sup> Accordingly, the D.C. Circuit remanded the decisions to the Commission to consider "mechanisms for which the Commission can demonstrate that there is no double recovery."<sup>13</sup>

7. In response, the Commission issued the December 2016 NOI, soliciting comments on how to resolve any double recovery resulting from the 2005 Income Tax Policy Statement and rate of return policies. The Commission received 24 comments and 19 reply comments from customer, pipeline, and electric utility interests.

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*Equity*, 123 FERC ¶ 61,048, at P 6 (2008) (Proxy Group Policy Statement).

<sup>11</sup> Opinion No. 511, 134 FERC ¶ 61,121, *order on reh'g*, Opinion No. 511-A, 137 FERC ¶ 61,220 (2011), *order on reh'g*, Opinion No. 511-B, 150 FERC ¶ 61,096 (2015).

<sup>12</sup> *United Airlines* marks the third time the D.C. Circuit has reviewed the Commission's income tax allowance policy with respect to partnership entities. See *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004); *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945 (D.C. Cir. 2007).

<sup>13</sup> *United Airlines*, 827 F.3d at 137. The D.C. Circuit did not restrict the Commission's policy options, but, among other possibilities, it noted that the Commission could consider removing any duplicative tax recovery for partnerships directly from the DCF ROE, or eliminating all income tax allowances and setting rates based on pre-tax returns. *Id.*

## II. Discussion

8. This Revised Policy Statement explains the Commission's conclusion following *United Airlines* that an impermissible double recovery results from granting an MLP pipeline both an income tax allowance and a DCF ROE. Accordingly, the Commission will no longer permit MLPs to recover an income tax allowance in their cost of service. Therefore, the Commission instructs oil pipelines organized as MLPs to reflect the Commission's elimination of the MLP income tax allowance in their Form No. 6, page 700 reporting. Based upon this page 700 data, the Commission will incorporate the effects of this Revised Policy on industry-wide oil pipeline costs in the 2020 five-year review of the oil pipeline index level. The Commission is also concurrently issuing a Notice of Proposed Rulemaking that addresses the effects of this Revised Policy on the rates of interstate natural gas pipelines organized as MLPs.<sup>14</sup> For those partnerships that are not MLPs, the Commission will address such matters in subsequent proceedings.

### A. An Impermissible Double Recovery Results from Granting an MLP Pipeline Both an Income Tax Allowance and a DCF ROE.

9. While some of the comments in this proceeding argue that no double recovery results from granting an income tax allowance to an MLP, none of these arguments are persuasive. As the Commission explains in the Remand Order, a double recovery results from granting an MLP an income tax allowance and a DCF ROE:

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<sup>14</sup>*Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate*, 162 FERC ¶ 61,226 (2018).

- MLPs and similar pass-through entities do not incur income taxes at the entity level.<sup>15</sup> Instead, the partners are individually responsible for paying taxes on their allocated share of the partnership's taxable income.<sup>16</sup>
- The DCF methodology estimates the returns a regulated entity must provide to investors in order to attract capital.<sup>17</sup>
- To attract capital, entities in the market must provide investors a pre-tax return, i.e., a return that covers investor-level taxes and leaves sufficient remaining income to earn investors' required after-tax return.<sup>18</sup> In other words, because investors must pay taxes from any earnings received from the partnership, the DCF return must be sufficient both to cover the investor's tax costs and to provide the investor a sufficient after-tax ROE.
- The DCF methodology "determines the *pre-tax* investor return required to attract investment."<sup>19</sup>

Given that the DCF return is a "pre-tax return," permitting an MLP to recover both an income tax allowance and a DCF ROE leads to a double recovery of the MLP's income tax costs.<sup>20</sup>

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<sup>15</sup> *United Airlines*, 827 F.3d at 136.

<sup>16</sup> 2005 Income Tax Policy Statement, 111 FERC ¶ 61,139 at P 33; *see also ExxonMobil*, 487 F.3d at 954 (noting that "investors in a limited partnership are required to pay tax on their distributive shares of the partnership income, even if they do not receive a cash distribution"). In contrast, corporations pay entity-level income taxes, and corporate dividends are second tier income to a common stock investor, not analogous to partnership distributions.

<sup>17</sup> *See Coakley v. Bangor Hydro-Electric Co.*, Opinion No. 531, 147 FERC ¶ 61,234 at P 14.

<sup>18</sup> *Kern River Transmission Co.*, Opinion No. 486-B, 126 FERC ¶ 61,034, at P 114 (2009) ("investors invest on the basis of after-tax returns and price an instrument accordingly").

<sup>19</sup> *United Airlines*, 827 F.3d at 136 (emphasis added).

<sup>20</sup> *Id.* at 137.

10. This Revised Policy Statement addresses comments responding to the NOI asserting that (a) granting an MLP an income tax allowance does not cause a double recovery or (b) notwithstanding the existence of a double recovery, MLPs should continue to receive an income tax allowance. As discussed below, these arguments are unavailing.

1. **A double recovery results from granting an MLP both an income tax allowance and a DCF ROE**

11. The Commission rejects arguments from pipelines and pipeline groups that no double recovery results from granting an MLP both an income tax allowance and a DCF ROE. These include claims that (a) changes to the stock price eliminate the double recovery, (b) MLP partners' taxes are "first tier" taxes that should be recoverable in an income tax allowance, (c) the return produced by the DCF analysis is never grossed-up (or adjusted) to include MLP partners' tax costs, (d) the presence of an income tax allowance causes MLP investors to demand a lower return in the market place, (e) a life-cycle hypothetical shows that corporate and MLP tax costs and after-tax returns are similar when an income tax allowance is present, (f) the calculation of the growth rate in the DCF Formula for MLPs addresses the double-recovery issue, and (g) various empirical studies refute the double-recovery finding in *United Airlines*. As discussed below none of these arguments resolves the double-recovery concern, and accordingly, the Commission will no longer permit MLPs to recover an income tax allowance in cost-of-service rates.

a. **Changes to a Pipeline's Unit Price Do Not Resolve the Double-Recovery Issue**

12. Some commenters argue that there is no double recovery caused by an income tax allowance for MLPs because the income tax allowance merely increases the price of the

MLP units.<sup>21</sup> These commenters assert that as a result of the increased unit price, investors will receive the same rate of return whether or not the pipeline receives an income tax allowance, and, thus, there is no double recovery.

13. The Commission rejects such arguments as inapposite. As explained in the Remand Order, the double-recovery issue is separate from the post-rate case effects upon an MLP pipeline's unit price. An MLP pipeline's DCF ROE is typically based upon a proxy group of other MLPs,<sup>22</sup> all of which must provide investors with sufficient pre-investor tax returns to attract capital. Permitting an MLP pipeline to recover both the DCF pre-investor tax return and an income tax allowance for the investor-level tax costs leads to a double recovery. Whether or not the double recovery leads to an increased unit price, the impermissible double recovery in the MLP's cost of service remains.<sup>23</sup>

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<sup>21</sup> *E.g.*, Association of Oil Pipe Lines (AOPL) Initial Comments at 24-27, Graham Declaration at 12-13; SFPP Initial Comments at 21-26, Vander Weide Declaration at PP 8, 19. These commenters argue that if an MLP is able to charge a higher tariff rate, the increased cash flow will lead to increased distributions to investors and MLP prices will rise to reflect the additional cash flow. Hence, the market will immediately react to eliminate any differences such that the after-tax returns of partnership and corporate investors are equalized.

<sup>22</sup> The proxy group may include corporations as well. In that case, the ROE will reflect the dividend tax paid by corporate investors.

<sup>23</sup> While an inflated cost of service will likely increase distributions to investors and cause a pipeline's unit price to rise, such benefits to a pipeline's unitholders do not render the double recovery permissible. Under this theory, the Commission could increase a pipeline's cost of service by allowing the pipeline to incorporate duplicative costs, yet these commenters appear to claim that because its unit price would subsequently rise, the inclusion of duplicative costs in the pipeline's cost of service is not unjust or unreasonable. This argument is without merit.

14. Moreover, while permitting such a double recovery may increase the unit price, these changes in the unit price do not resolve the double-recovery problem or change the DCF return from a pre-investor tax return to an after-investor tax return. Rather, if an MLP pipeline obtains a new revenue source that increases distributions to investors (such as an income tax allowance), the unit price will rise until, once again, the investor receives the cash flow necessary to cover the investor's income tax liabilities and to earn an after-tax return that is comparable to other investments of similar risk.<sup>24</sup> Likewise, if the MLP's cash flows are reduced (such as via the removal of the income tax allowance) and consequently distributions decline, the MLP unit price will drop until the returns once again both cover an investor's tax costs and provide the sufficient after-tax returns. Whether or not a pipeline

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<sup>24</sup> *United Airlines*, 827 F.3d at 136. In finding that “the [DCF ROE] determines the pre-tax investor return required to attract investment, irrespective of whether the regulated entity is a partnership or a corporate pipeline,” the Court relied on Opinion No. 511, 134 FERC ¶ 61,121 at PP 243, 244, which included the following example:

The investor desires a 6 percent after-tax return and has a 25 percent marginal tax rate. Thus, the security must have an ROE of 8 percent to achieve an after-tax yield of 6 percent. Assume that the distribution or dividend is \$8. The investor will price the security at \$100. Conversely, if the security price is \$100 and the yield is \$8, the Commission determines that the required return is 8 percent. If the dollar distribution increases to \$10, the investor will price the security at \$125 because \$10 is 8 percent of \$125. The Commission would note that the security price is \$125 and that the yield is \$10, or a return of 8 percent. If the distribution is \$6, the security price will drop to \$75, a return of 8 percent. The Commission would observe a \$75 dollar security price, a \$6 yield, and a return of 8 percent. In all cases the ROE is 8 percent and the after-tax return is 6 percent based on the market-established return.

receives an income tax allowance, the MLP's DCF return will always be a pre-investor tax return.<sup>25</sup>

**b. The Argument that MLPs Are Entitled to Recover “First Tier” Taxes Is Irrelevant**

15. Some commenters contend that removing the income tax allowance is contrary to Commission and court findings that MLP pipelines may recover so-called “first tier” taxes for income generated by the regulated pipeline.<sup>26</sup> The pipelines claim that because a partnership does not itself pay taxes, the taxes paid by the partners are the “first tier” tax, much like the corporate income tax is the “first tier” tax for the corporation. The pipelines contrast these “first tier” taxes with so-called “second tier” taxes (such as the dividend tax paid by corporate stockholders) which are not typically recovered by the income tax allowance.

16. The Commission is not persuaded by such arguments, which were already presented to the D.C. Circuit.<sup>27</sup> The pipelines' arguments do not address the D.C. Circuit's finding that the DCF ROE itself enables the recovery of an MLP's “first tier” tax costs, rendering an income tax allowance unnecessary. Whether or not a tax can be labeled a “first tier” tax is irrelevant to the double-recovery issue. No double recovery results when a corporate

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<sup>25</sup> This is true both for the entity whose rates are at issue in a cost-of-service rate case (such as SFPP in the Remand Order) and for the entities in the proxy group.

<sup>26</sup> Interstate Natural Gas Association of America (INGAA) Initial Comments, Sullivan Affidavit at 12-14, 24-25, 27.

<sup>27</sup> Federal Energy Regulatory Commission and United States of America, Brief for Respondents, Case No. 11-1479, at 26 (D.C. Cir., filed Feb. 5, 2016).

pipeline's cost of service includes an income tax allowance because this so-called "first tier" corporate income tax is paid directly by the corporation, rather than by unitholders from the dividends used in the DCF methodology.<sup>28</sup> In contrast, the MLP itself pays no taxes.<sup>29</sup> Because the "first tier" MLP income taxes are paid directly by the unitholders,<sup>30</sup> the D.C. Circuit explained that the pre-investor tax DCF return must be sufficient to recover an MLP investor's tax costs in order to attract capital. While the D.C. Circuit reaffirmed that an MLP pipeline may recover such "first tier" investor income tax costs, the D.C. Circuit also held that an MLP pipeline may not double recover those costs via both an income tax allowance and the DCF return.<sup>31</sup>

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<sup>28</sup> Corporations first pay the corporate income tax from their earnings prior to any dividends to investors. Then, subsequently, investors pay taxes on dividends. While the pre-investor tax DCF return would reflect the dividend tax paid by investors, it does not reflect the corporate income tax.

<sup>29</sup> *United Airlines*, 827 F.3d at 136 (explaining "unlike a corporate pipeline, a partnership pipeline incurs no taxes, except those imputed from its partners, at the entity level").

<sup>30</sup> In the past, the Commission has stated that its income tax allowance policy "imputes" those investor-level taxes to the partnership entity. In using such phrasing, the Commission never denied that investors nonetheless pay the investor-level taxes.

<sup>31</sup> In *United Airlines*, the D.C. Circuit acknowledged that in *ExxonMobil* it held that the Commission provided a reasoned basis for allowing an MLP pipeline to recover the "first tier" income tax costs paid by the MLP partners. However, the D.C. Circuit explained that in *ExxonMobil*, it had "reserved the issue of whether the combination of the [DCF ROE] and the tax allowance results in a double recovery of taxes for partnership pipelines." *United Airlines*, 827 F.3d at 134; *see also ExxonMobil*, 487 F.3d 945.

c. **The Argument that the Tax Allowance Reduces Investors' Required Return Lacks Merit**

17. SFPP argues that investors recognize that the income tax costs are recovered by the pipeline through the income tax allowance and therefore, elect not to demand a DCF return on their investment that would cover those income tax costs.<sup>32</sup> Because under this theory the DCF return would not include investor tax costs, SFPP argues that there is no double recovery. In essence, SFPP contends that the pre-tax return produced by a DCF analysis of an MLP with a tax allowance is the equivalent of an after-tax return, since investors do not demand a pre-tax return. Similarly, SFPP argues that if MLPs lose the income tax allowance, then the MLP investors will demand a higher pre-tax return than under present policy.

18. The Commission rejects SFPP's assertions. These arguments distort how the income tax allowance affects investor tax liability. MLP investors owe a tax on any increased income, whether or not that income results from an income tax allowance or another source.<sup>33</sup> Accordingly, while as discussed above an MLP income tax allowance may increase the unit price, investors will continue to demand a pre-tax return even when a portion of a pipeline's rate is attributable to an "income tax allowance."<sup>34</sup> Notwithstanding

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<sup>32</sup> SFPP Initial Comments at 17, Vander Weide Declaration at PP 12, 14, 18. SFPP claims that investors will not "gross-up" the required after-tax return to include tax costs. SFPP Initial Comments at 16; Vander Weide Declaration at PP 6, 18.

<sup>33</sup> The Internal Revenue Code does not exempt from taxation income that results from the increases to rates resulting from the cost-of-service income tax allowance.

<sup>34</sup> Suppose an income tax allowance increases a pipeline's rates, raising investor income from \$10 to \$12. Two things have occurred; first the investor's pre-tax income (*continued ...*)

the presence of an income tax allowance, the pre-investor tax ROE produced by the DCF analysis does not equal the investor's after-tax return. Likewise, if an MLP pipeline's loss of its income tax allowance reduces rates and investor income, the unit price will decline until the investor once again earns an adequate pre-tax return.

19. SFPP's comments rely almost exclusively upon the incorrect assumption that for an MLP with an income tax allowance, an MLP investor's pre-tax return equals its after-tax return.<sup>35</sup> However, while SFPP relies heavily upon this assumption in this proceeding, SFPP elsewhere takes the opposite position – presenting hypotheticals showing that an investor will demand a pre-tax return whether or not the pipeline receives an income tax allowance.<sup>36</sup>

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increased from \$10 to \$12 and second the investor now owes taxes on \$12 of income just as she owed taxes on the initial \$10. The unit price will increase until the investor receives the same pre-tax return at \$12 of income that it received at \$10 of income. In other words, Commission policy does not shift the actual liability to pay income taxes from the MLP partners to the MLP itself.

<sup>35</sup> *E.g.*, SFPP Initial Comments, Vander Weide Affidavit at 8 (Table 1, Lines 11-15, showing the before-tax DCF ROE equaling the investor's after-tax return), 12 (Table 2, Lines 11-15, showing the before-tax DCF ROE and investor's pre-tax return equaling the investor's after-tax return), 16 (Table 3, lines 11-15 showing for a pipeline with an income tax allowance, the before-tax DCF ROE and investor's pre-tax return equaling the investor's after-tax return).

<sup>36</sup> In its West Line rate case, SFPP filed post-remand comments and supplemental comments following *United Airlines*. In those comments, SFPP presented a hypothetical showing that an MLP recovering both an income tax allowance (Table 1, Column C) and a DCF ROE earns the same 6.5 percent investor after-tax return as an MLP without an income tax allowance (Table 1, Column D). SFPP, L.P., Supplemental Reply Comments, Docket No. IS08-390, at 10 (November 30, 2016). While the table does not show the investors' pre-tax returns, since both pipelines were subject to a 35 percent investor level tax, both must have recovered a 10 percent pre-tax investor return. Thus, in SFPP's own example, the cost-of-service double-recovery of income tax costs of the pipeline in Column C inflated (*continued ...*)

d. **The Cost-Of-Service Gross-Up Theory Was Rejected by the D.C. Circuit**

20. Some pipeline commenters also attempt to reframe the cost-of-service “gross-up” theory rejected by the D.C. Circuit. This argument, which the Commission also made on appeal in the *United Airlines* proceeding, asserts that the DCF return does not include investor tax costs because the Commission never adjusts, or “grosses-up,” the return produced by the DCF analysis to recover such tax costs.<sup>37</sup> In response to the NOI, pipeline commenters assert that the DCF ROE cannot include an MLP investor’s income tax costs because the income tax costs are not a separate line item in the DCF methodology.<sup>38</sup>

21. The Commission rejects this position. The Commission’s DCF methodology need not include a mathematical step to add income taxes. For the reasons described above, “the [DCF ROE] determines the *pre-tax* investor return”<sup>39</sup> that already reflects cash flow for both the (a) investor’s tax costs and (b) the investor’s post-tax return.

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the unit price until it earned the same pre-tax return as the pipeline without an income tax allowance in Column D.

<sup>37</sup> Federal Energy Regulatory Commission and United States of America, Brief for Respondents, Case No. 11-1479, at 28-29 (D.C. Cir., filed Feb. 5, 2016) (citations omitted) (“In contrast to the way in which income taxes are grossed up outside the context of Commission regulation, the Commission does not gross up [i.e., increase] a jurisdictional entity’s operating revenues or return to cover the income taxes that must be paid to obtain its after-tax return.”).

<sup>38</sup> INGAA Initial Comments at 24, Sullivan Affidavit at 6, 17-18, 22, 25-27, 30.

<sup>39</sup> *United Airlines*, 827 F.3d at 136 (citing Opinion No. 511, 134 FERC ¶ 61,121 at PP 243-44).

e. **The Life-Cycle Hypothetical Does Not Refute the D.C. Circuit's Holding**

22. INGAA witness Merle Erickson presents a life-cycle model that compares the total tax expenses of a hypothetical MLP to a hypothetical corporation. Under the assumptions of the model, Erickson finds that MLPs' and corporations' aggregate tax burdens are comparable and that both earn similar returns if MLPs are permitted an income tax allowance.<sup>40</sup> Pipeline commenters claim that the model globally demonstrates that the Commission's current income tax policy provides parity in the returns to partnerships and corporations.<sup>41</sup>

23. We do not find this argument to be persuasive. Erickson's life-cycle model does not undermine the fundamental premise of *United Airlines* that an income tax allowance for MLP pipelines leads to a double recovery. Whether or not the overall MLP and corporate tax burdens are equivalent or different, if the investor tax costs are incorporated into the DCF returns, then the income tax allowance for MLP pipelines leads to a double recovery.<sup>42</sup>

24. In addition, Erickson's model does not necessarily establish that overall MLP tax levels are actually comparable to corporate tax levels or that an income tax allowance equalizes returns. Like similar hypothetical models, the results of Erickson's proposal rely

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<sup>40</sup> INGAA Initial Comments, Erickson Affidavit at 12.

<sup>41</sup> INGAA Initial Comments at 4, 25.

<sup>42</sup> Erickson himself concedes that MLP unitholders must pay the entirety of the tax burden whereas corporate unitholders must only pay the dividend tax (not the corporate income tax). INGAA Initial Comments, Erickson Affidavit at 13. Accordingly, it follows that whereas the DCF return for an MLP pipeline must include the entire income tax costs, a corporate pipeline's DCF return would not include the corporate income tax.

upon subjective assumptions.<sup>43</sup> For example, as Thomas Horst explains, Erickson's hypothetical would show that MLPs (with an income tax allowance) receive higher returns if Erickson had accounted for (a) the time value of money<sup>44</sup> and (b) certain tax issues related

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<sup>43</sup> When attacking models proposed by shippers, AOPL witness John Graham states that for such hypotheticals, "There are too many variables to draw broad-based conclusions." AOPL Initial Comments, Graham Affidavit at 8. This comment applies with equal force to Erickson's model. Erickson's assumptions include (1) a five-year investment horizon; (2) that the MLP distributes all available cash and the corporation has a 65 percent dividend pay-out ratio; (3) certain tax rates for corporate income, corporate dividends and capital gains, and ordinary MLP income; and (4) that the corporate investors are able to sell their stock for the value of their original investment plus accumulated retained earnings, while the MLP investors sell their units for the value of their original investment. The life-cycle model also assumes constant earnings before interest, taxes, depreciation and amortization and application of a fifteen-year Modified Accelerated Cost Recovery System. The life-cycle analysis does not take into account the time value of money in reporting the total after-tax cash flow to the MLP and corporate investors.

<sup>44</sup> Thomas Horst Reply Comments at 2. An investor in a corporation usually must pay his dividend taxes immediately. In contrast, an MLP investor can use depreciation and other deductions to offset taxable income. As a result, an MLP investor may have no net taxable income in a given year. NOI, 157 FERC ¶ 61,210 at P 6. Even though the investor may ultimately be required to pay such taxes when the units are sold, the MLP investor benefits from the time value of money during the deferral period.

to the sale of MLP units.<sup>45</sup> The Brattle report presented by shipper commenters similarly demonstrates how reasonable changes to Erickson's assumptions change the model's output.<sup>46</sup> Thus, Erickson's hypothetical does not undermine the fundamental conclusion of *United Airlines* that allowing MLP pipelines to include both an income tax allowance and a full DCF ROE in their cost of service leads to a double recovery.

**f. The Treatment of the Growth Rate in the DCF Does Not Resolve the Double Recovery Concern**

25. Pipelines emphasize that in the DCF formula, the Commission projects that the long-term growth of MLP pipelines will be only half that of corporations.<sup>47</sup> Therefore, they argue "to the extent the Commission concludes that there is a potential for double recovery of income tax costs through the MLP ROE, the Commission has already addressed that concern."<sup>48</sup>

26. The Commission concludes that the treatment in the DCF analysis of the long-term MLP growth projection does not resolve the double-recovery concern in *United Airlines*.

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<sup>45</sup> *Id.* Dr. Horst argues that when an MLP unit is sold, its basis increases – much like in the sale of any property or asset. This only further increases the depreciation deferrals that are available to the subsequent investor.

<sup>46</sup> United Airlines Petitioners Reply Comments, Brattle Report at PP 73-74.

<sup>47</sup> AOPL Initial Comments at 46. As noted above, the DCF relies upon the general formula  $k=D/P+g$ . The growth rate in this formula incorporates two components: a short term growth rate (calculated using security analysts' five-year forecasts for each company in the proxy group as published by IBES) and a long-term growth rate (based upon forecasts for gross domestic product (GDP) growth). The short-term forecast receives a two-thirds weighting and the long-term forecast receives a one-third weighting in calculating the growth rate in the DCF model. Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 6.

<sup>48</sup> AOPL Initial Comments at 46.

When conducting a DCF analysis to determine investors' required rate of return, the Commission halves the long-term growth rate for MLPs in the proxy group because MLPs are likely to have a lower long-term growth rate than corporations.<sup>49</sup> The treatment of investor-level taxes presents an entirely separate issue. As discussed above, regardless of the projected growth rate used in the DCF analysis to determine the investors' required rate of return, that required return must provide investors cash flows to both (a) recover investor level tax costs and (b) provide the investor with a sufficient after tax return.

**g. Pipelines' Empirical Studies Do Not Resolve the D.C. Circuit's Double-Recovery Concern**

27. Pipeline commenters advance two empirical criticisms of the holdings in *United Airlines*. First, they criticize studies presented by shippers in the underlying SFPP proceeding showing that MLP pipeline DCF returns exceed corporate pipeline DCF returns, while shipper commenters argue that a modified version of these studies supports the opposite result. Second, the pipelines argue the relationship between MLP and corporate pipeline DCF returns does not show a systemic disparity consistent with the different tax levels, and, thus, they argue that this refutes the holding that there is no double recovery. As discussed below, these arguments lack merit.

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<sup>49</sup> The Commission explained corporations "(1) have greater opportunities for diversification because their investment opportunities are not limited to those that meet the tax qualifying standards for an MLP and (2) are able to assume greater risk at the margin because of less pressure to maintain a high payout ratio." Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 93. Accordingly, the Commission concluded that the "long term growth rate for MLPs will be less than that of schedule C corporations...." *Id.* P 94. *See also El Paso Natural Gas Co.*, Opinion No. 528-A, 154 FERC ¶ 61,120, at PP 271-275, 278-283 (2016).

i. **The Reasoning in *United Airlines* Holds, Whether or Not MLP DCF Returns Exceed Corporate DCF Returns**

28. In order to counter the D.C. Circuit's double-recovery finding, pipeline commenters attack studies presented by shippers in the underlying SFPP 2008 West Line rate case addressed on appeal in *United Airlines*.<sup>50</sup> These studies purported to show that MLP pipeline DCF returns exceeded corporate pipeline DCF returns, which the shippers argued showed that the DCF returns reflected tax differences. Now, pipeline commenters argue that due to alleged flaws in these studies, the court in *United Airlines* erred by finding that the MLP pipeline DCF returns include investor-level tax costs. They assert that if their preferred sample of six pipelines (two corporations and four MLPs) is considered, corporate DCF returns may actually exceed MLP DCF returns.<sup>51</sup>

29. The criticisms of the underlying studies in SFPP's 2008 West Line Rate case are irrelevant. In *United Airlines*, the D.C. Circuit did not rely upon these studies to find that the DCF returns include MLP investors' income tax costs, and the shipper-petitioners did not cite these studies in their appeal.<sup>52</sup> Any such reliance would have been unnecessary. As described above, the inclusion of MLP investor-level taxes in the DCF return necessarily follows from the basic application of DCF theory and the understanding that investors consider the tax consequences of their investments.

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<sup>50</sup> INGAA Initial Comments, Sullivan Affidavit at 41-48.

<sup>51</sup> *Id.* at 47-48.

<sup>52</sup> Before the Administrative Law Judge and the Commission, shippers argued that this disparity demonstrated the inclusion in the DCF ROE of the MLP investors' income tax costs, which they argued generally exceeded the dividend taxes paid by corporate investors.

30. Furthermore, the studies are also inapposite. The holding in *United Airlines* would not change if the pipeline commenters were to conclusively establish that when controlling for all factors but investor-level taxes, corporate pipeline DCF returns exceeded MLP pipeline DCF returns. This would merely demonstrate that the MLP investors' tax burden was less than the corporate investors' dividend tax burden.<sup>53</sup> In order to attract capital, the investor-required MLP pipeline DCF return would still include the investor-level tax costs, and thus, a double recovery results from the additional recovery of an income tax allowance for MLPs.<sup>54</sup>

**ii. The Pipeline Commenters' Empirical Evidence Fails to Disprove the Double Recovery**

31. Pipelines make two broad arguments. First, pipeline commenters argue that if the DCF methodology includes investor-tax costs as determined by the D.C. Circuit in *United*

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<sup>53</sup> While historically a corporate investor's dividend tax rate has typically been less than the weighted average income tax rate for MLP investors (AOPL Initial Comments, Graham Affidavit at 5-6), MLPs have various tax deferrals and other characteristics that may further narrow or eliminate this difference. Nonetheless, any such conclusion based

upon the pipeline commenters' data is dubious, as it is based upon a small sample size of only two corporations and four MLPs. INGAA Initial Comments, Sullivan Affidavit at 47-48.

<sup>54</sup> Likewise, the December 22, 2017 Tax Cuts and Jobs Act does not alter the Commission's analysis. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017). While the tax rates for both corporations and individuals have been reduced, the DCF ROE will continue to provide a pre-investor tax return. As discussed above, investors will continue to demand a return that both covers the investor level tax costs and leaves the investor a sufficient after tax return compared to other investments of comparable risk.

*Airlines*, there should be a systematic relationship between MLP pipeline and corporate pipeline DCF returns reflecting these differences in investor-level taxes. Second, they argue that if pipelines are double-recovering their costs, then MLP pipelines should report higher DCF returns, distribution yields, and growth rates than corporate pipelines.

32. In their first argument, pipelines argue that if the DCF returns include investor tax costs, then there should be a consistent differential between MLP pipeline and corporate pipeline DCF returns. For example, if MLP investor-level taxes exceed corporate investor-level taxes, then pipeline commenters state that MLP pipeline DCF returns should always exceed corporate pipeline DCF returns, or vice versa. To refute the holding in *United Airlines*, pipeline commenters present empirical analyses purporting to show that the DCF returns for MLP pipelines do not show a consistent differential.<sup>55</sup> These studies consist of (1) a line graph showing DCF returns for 23 pipelines between August 2007 to January 2017 in which MLP pipelines' DCF returns do not always exceed corporate pipelines'

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<sup>55</sup> See INGAA Initial Comments at 31-35, Sullivan Affidavit at 42-69; AOPL Initial Comments at 3, 24, 28-30; Master Limited Partnership Association (MLPA) Initial Comments at 9.

returns,<sup>56</sup> and (2) DCF returns over the January 2008 to January 2017 period comparing four pairs of MLP and corporate affiliates<sup>57</sup> in which the relationship between the corporate affiliate and the MLP affiliate returns fluctuated significantly.

33. These studies suffer from fundamental methodological flaws that undermine the pipelines' conclusions. It is true that the *United Airlines* double-recovery theory would predict that, assuming all other factors are exactly equal, investor-level tax differences would create a differential between MLP and corporate pipeline DCF returns.<sup>58</sup> However, differences in risk and other factors can subsume any effects of taxation, and because the studies inadequately control for varying risk levels, the studies do not isolate the effect of the MLP and corporate investor-level income taxes on the DCF returns. The first study, which compared 23 MLP and corporate pipelines, completely ignores the entities' differing risk levels<sup>59</sup> and merely shows a line graph of DCF returns for each pipeline without presenting any related numerical analysis.<sup>60</sup> While the pipeline commenters' second study

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<sup>56</sup> INGAA Initial Comments, Sullivan Affidavit at 48-49. INGAA witness Sullivan performed similar analysis for different components of the DCF, including both the dividend yield and the growth rate. *Id.* at 65-69.

<sup>57</sup> *Id.* at 50-51.

<sup>58</sup> In essence, investors would demand higher returns from the business form with the higher investor-level taxes.

<sup>59</sup> INGAA witness Sullivan's arguments involving distribution yields and growth rates are similarly flawed.

<sup>60</sup> For example, on page 49 of his affidavit, INGAA consultant Sullivan submitted a line-chart which purports to show that corporate and MLP DCF returns are not discernibly different. However, (a) the y-axis is drawn so as to compress most of the returns to a narrow band, and (b) meaningful statistical differences could be completely obscured by this (*continued ...*)

attempts to address varying risk levels by comparing four affiliated corporations and MLPs in their first study,<sup>61</sup> the affiliated MLPs were only a fraction of the affiliated corporations' larger business interests, which, as the pipeline commenters concede, contributed to significant fluctuations in the relationship between the two entities' relative DCF returns.<sup>62</sup> Moreover, this analysis based upon a mere four examples does not establish how investor level taxes (as opposed to other factors) affect either corporate or MLP investor returns.

34. Pipelines advance a second argument – that if MLPs are double recovering their costs, they should report higher returns than corporations. For example, INGAA witness Sullivan also argues that “[i]f MLPs double recovered income taxes through both an income tax allowance and a DCF return, I would expect the DCF ROEs and its components, the distribution yields and the IBES growth rates of MLPs to be systematically higher than corporations throughout the period 2008 to the present.”<sup>63</sup> Citing the same studies above,

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poor graphical presentation. Similar criticisms apply to Sullivan's comparison of MLP distributions to corporate dividends on page 65 of his affidavit and growth rates on page 68 of his affidavit. It is possible that a more precise numerical example could actually present facts undermining the pipelines' favored result.

<sup>61</sup> *Id.* at 52-62. Sullivan also adds a comparison between a completely unrelated MLP (Boardwalk Pipeline Partners) and a corporation (Kinder Morgan). Because these are completely different businesses, such a comparison is irrelevant for the purpose of identifying the effect of different tax levels on the DCF.

<sup>62</sup> For each of the four pairs, the DCF return for the corporation at times exceeded the return for the MLP whereas on other occasions the return for the MLP exceeded the corporation. *Id.* Sullivan describes situations in which growth estimates or factors involving unrelated assets would affect the DCF return of the corporation but not the MLP.

<sup>63</sup> *Id.* at 58.

Sullivan argues that because the data does not show systematically higher returns, yields or growth rates for MLPs, there must be no double recovery.

35. The Commission finds this argument unpersuasive because it relies upon the same flawed studies discussed above. As noted above, the line graphs provide a flawed analysis that may obscure actual differences between MLPs and corporations and, more fundamentally, that fails to address the multiple other risk and market factors that could affect any particular MLP and corporate pipeline's DCF returns, distribution yields, and growth levels. Moreover, as discussed previously, to the extent an MLP pipeline double-recovers its costs, the unit price will rise – obscuring the effects of the double recovery in the distribution yields, projected growth rates, and DCF returns.<sup>64</sup> These studies do not undermine the double-recovery findings of *United Airlines* or the Remand Order.

## **2. Other Arguments for Preserving an Income Tax Allowance Lack Merit**

36. Pipeline commenters also argue that even if a double recovery exists, the income tax allowance should nonetheless be preserved. These arguments rely upon (1) Congressional intent, (2) preserving parity between corporate and MLP pipelines, and (3) the effect of removing the income tax allowance upon the ability of pipelines to attract capital. As discussed below, these arguments were either explicitly rejected by the D.C. Circuit in *United Airlines* or are otherwise without merit.

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<sup>64</sup> As explained in section II.A.1.a, whether or not a pipeline receives an income tax allowance, the DCF return will always be a pre-investor tax return. However, to the extent a pipeline is permitted to start double-recovering its costs, the unit price will rise until the DCF once again provides investors with a pre-tax return.

a. **Congressional Intent Does Not Authorize a Double Recovery**

37. Pipeline commenters argue that providing MLP pipelines an income tax allowance implements Congress' intent to facilitate infrastructure investment.<sup>65</sup> In 1987 Congress eliminated pass-through status for most publicly-traded partnerships, but explicitly granted an exception for certain energy-related MLPs in section 7704 of the Internal Revenue Code.<sup>66</sup> Pipeline commenters present two specific arguments to support their Congressional intent claims, both of which are unavailing. First, they argue that because the Commission's policy in 1987 allowed pass-through entities to recover the same income tax allowance as corporations, Congress understood and intended to continue that rate treatment in section 7704.<sup>67</sup> Second, they present a letter that Senator Max Baucus submitted to the Commission in 1996,<sup>68</sup> expressing concern with the Commission's decision to allow MLP pipelines only a partial income tax allowance in *Lakehead*.<sup>69</sup>

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<sup>65</sup> See INGAA Initial Comments at 12-13; MLPA Initial Comments at 3-4; AOPL Initial Comments at 7, 41-42; SFPP Initial Comments at 30; TransCanada Corporation Initial Comments at 2; Enbridge Initial Comments at 4; Meliora Capital, LLC Initial Comments.

<sup>66</sup> 26 U.S.C. 7704.

<sup>67</sup> INGAA Initial Comments at 13-15.

<sup>68</sup> INGAA Initial Comments at 14; MLPA Initial Comments at 3-4.

<sup>69</sup> *Lakehead Pipe Line Co., L.P.*, 75 FERC ¶ 61,181 (1996). Senator Baucus participated in the writing of the 1987 legislation. The letter states 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" and "[i]t 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

(continued ...)

38. As discussed in the Remand Order, the D.C. Circuit has twice rejected the argument that Congress' intent in section 7704 provides an independent basis for upholding a full income tax allowance for partnership pipelines.<sup>70</sup> Consistent with these holdings, the court in *United Airlines* unequivocally instructed the Commission to consider "mechanisms for which the Commission can demonstrate that there is no double recovery."<sup>71</sup> Accordingly, the pipeline commenters' attempt to justify affording MLP pipelines an income tax allowance on the basis that the Commission is implementing Congress' intent in section 7704 is contrary to *United Airlines*.

39. In addition, the pipeline commenters fail to demonstrate that Congress intended the Commission's income tax allowance policy to provide a necessary component of the advantages conferred in section 7704. They provide no support for their argument that because the Commission afforded partnerships a tax allowance in 1987, Congress intended to continue that rate treatment in the 1987 legislation.<sup>72</sup>

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partnership status." Letter from U.S. Senator Max Baucus, FERC Docket No. IS92-27-000 (Jan. 9, 1996).

<sup>70</sup> *BP West Coast*, 374 F.3d at 1293 ("[t]he mandate of Congress in the tax amendment was exhausted when the pipeline limited partnership was exempted from corporate taxation. It did not empower FERC to do anything...."); *United Airlines*, 827 F.3d at 136 (rejecting the Commission's argument that "any disparate treatment

between partners in partnership pipelines and shareholders in corporate pipelines is the result of the Internal Revenue Code, not FERC's tax allowance policy").

<sup>71</sup> *United Airlines*, 827 F.3d at 136.

<sup>72</sup> As the Commission explains in the Remand Order, Congress did not provide explicit instructions to federal agencies regarding how to address section 7704's tax treatment in setting regulated entity rates as, for instance, it did in the Revenue Act of 1964. (*continued ...*)

40. Nor do the pipeline commenters present any legislative history to support their claim. Regarding the letter from Senator Baucus, evidence of legislative intent that occurs subsequent to, and in this case years after, the 1987 enactment of section 7704 is entitled to little, if any weight.<sup>73</sup> The MLPA also points to other legislation by Congress in recent years to demonstrate ongoing support for the use of MLPs to raise capital in the energy

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*See Alabama-Tennessee Natural Gas Co. v. FPC*, 359 F.2d 318, 333 (5th Cir. 1966) (“In the Revenue Acts of 1962 and 1964 Congress demonstrated that when it desires a tax statute to restrict the ratemaking authority of federal regulatory agencies it does so in precise language.”). Courts are hesitant to find that Congress implicitly intended to restrict an agency’s discretion in carrying out its statutory obligations. *See Alabama-Tennessee Natural Gas Co. v. FPC*, 359 F.2d at 335 (“It is unlikely to suppose that Congress amended the Natural Gas Act by a reference in the Internal Revenue Code; it is unreasonable to read Section 167 [of the Code] as a mandate reducing the Commission’s responsibility to fix fair rates according to its usual ratemaking policies in favor of the consumer”); *see also Cheney R. Co. v. ICC*, 902 F.2d 66, 69 (D.C. Cir. 1990) (“in an administrative setting, ... Congress is presumed to have left to reasonable agency discretion questions that it has not directly resolved”).

<sup>73</sup> *See Thomas v. Network Solutions, Inc.*, 176 F. 3d 500, 507 n.10 (D.C. Cir. 1999) (referring to letters from members of Congress written after the legislation in question was passed and noting that “[s]uch isolated post-enactment statements, to the extent that they are legislative history, carry little weight”); *U.S. v. United Mine Workers of America*, 330 U.S. 258, 282 (1947) (remarks of senators in 1943 were not an authoritative source of evidence of Congress’ legislative intent in enacting a 1932 statute); *D.C. v. Heller*, 554 U.S. 570, 605 (2008) (“post-enactment legislative history ... a deprecatory contradiction in terms, refers to statements of those who drafted or voted for the law that are made after its enactment and hence could have no effect on the congressional vote”); *Barber v. Thomas*, 560 U.S. 474, 486 (2010) (“whatever interpretive force one attaches to legislative history, the Court normally gives little weight to statements, such as those of the individual legislators, made *after* the bill in question has become a law”); *Friends of Earth, Inc. v. E.P.A.*, 446 F.3d 140, 147 (D.C. Cir. 2006) (“‘[P]ost-enactment legislative history,’ after all, ‘is not only oxymoronic but inherently entitled to little weight’”) (quoting *Cobell v. Norton*, 428 F.3d 1070, 1075 (D.C. Cir. 2005)).

sector. These statutes do not include any specific provisions related to MLP pipeline rate treatment.<sup>74</sup>

41. In conclusion, removing the income tax allowance will not eviscerate the preferential tax treatment that Congress gave entities engaged in natural resource activities<sup>75</sup> by permitting them to operate as publicly-traded partnerships with pass-through taxation, including the ability to reach a broader base of investors and defer certain tax obligations.<sup>76</sup> Even in the absence of an income tax allowance, the energy sector will benefit from the MLP business form by enabling MLP-owned pipelines to provide lower tariff rates to shippers, including those engaged in production, marketing and refining.

**b. Preserving the Income Tax Allowance for MLP Pipelines Does Not Create Parity**

42. Pipeline commenters claim that removing the income tax allowance would put MLP pipelines at a competitive disadvantage relative to corporate pipelines.<sup>77</sup>

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<sup>74</sup> See MLPA Initial Comments at 4 (citing the American Jobs Creation Act, Emergency Economic Stabilization Act of 2008, and the Tax Reform Act of 2014).

<sup>75</sup> An MLP must receive at least 90 percent of its income from certain qualifying sources including “the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of [certain fuels].” 26 U.S.C. 7704.

<sup>76</sup> Pipeline commenters explain that the MLP structure permits risk sharing by combining pass-through taxation and publicly-traded units which allows MLPs to reach a broader base of investors and facilitates raising capital for infrastructure projects. AOPL Initial Comments at 6, 39, 13; MLPA Initial Comments at 2-3.

<sup>77</sup> AOPL Initial Comments at 43; INGAA Initial Comments at 7, 15; MLPA Initial Comments at 15.

43. The court in *United Airlines* reached the opposite conclusion. The court determined that granting MLP pipelines an income tax allowance results in inequitable returns for partners as compared to corporate shareholders because this policy allows partnership pipelines, unlike corporate pipelines, to recover their income tax costs twice.<sup>78</sup> Therefore, removal of the income tax allowance for MLP pipelines restores parity between MLPs and corporations by ensuring that a pipeline recovers its income tax costs only once regardless of business form.<sup>79</sup>

c. **Preserving the Income Tax Allowance Is Not Necessary for Pipelines To Attract Capital**

44. Pipelines claim that removal of the income tax allowance for MLPs will deny pipelines adequate recovery under *Hope* and deter investment.<sup>80</sup> This is not the case. Notwithstanding the absence of an income tax allowance, MLP pipelines will continue to recover their costs and a reasonable return for investors. *United Airlines* and the Remand Order merely deny MLP pipelines the double recovery of their income tax costs.

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<sup>78</sup> *United Airlines*, 827 F.3d at 136.

<sup>79</sup> While comments have presented hypotheticals in an attempt to show that MLPs require such a double recovery, they suffer from the same defects as the pipelines' other arguments. For instance, while SFPP attempts to include a hypothetical showing that an income tax allowance is necessary to equalize returns, this hypothetical depends upon the faulty investor gross-up theory discussed above. See SFPP Initial Comments, Vander Weide Affidavit at 12 (Table 2, Lines 11-15, showing the before-tax DCF ROE and investor's pre-tax return equaling the investor's after-tax return).

<sup>80</sup> INGAA Initial Comments at 27-28; AOPL Initial Comments at 7, 35-37.

**B. Conclusion**

45. As discussed above, the Commission finds that granting an MLP an income tax allowance results in an impermissible double recovery. This Revised Policy Statement does not address other, non-MLP partnership or other pass-through business forms.<sup>81</sup> While any such entity claiming an income tax allowance will need to address the concerns raised by the court in *United Airlines*, the Commission will address income tax allowance issues involving non-MLP partnership forms in subsequent proceedings.

46. This Revised Policy Statement will affect both oil and natural gas MLP pipelines on a going-forward basis. Some late-filed comments proposed that the Commission take immediate action to require natural gas and oil pipelines to reduce rates to reflect the Tax Cuts and Jobs Act. As noted above, the Commission is concurrently issuing a Notice of Proposed Rulemaking that addresses the effects upon interstate natural gas pipeline rates of the post-*United Airlines*' policy changes and the Tax Cuts and Jobs Act of 2017.<sup>82</sup> While the Commission is not taking similar industry-wide action regarding oil pipeline rates, these issues will be addressed in due course. When oil pipelines file Form No. 6, page 700 on

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<sup>81</sup> See, e.g., Initial Comments of the United Airlines Petitioners and Allied Shippers at 14 (“A generic proceeding is not well-suited to addressing the wide array of possible organizational forms and their respective tax implications. The better approach would be to examine the appropriate tax allowance treatment on a case-by-case basis in adjudicatory proceedings in which various business structures and their consequences can be examined in detail on an individual, case-specific basis.”); Liquids Shipper Group Initial Comments at 7 (“To the extent there may be individual and complex pipeline ownership structures that include both partnerships and corporations, the application of the FERC’s policy can be determined on a case-by-case basis, addressing those unique circumstances.”).

<sup>82</sup> See Docket No. RM18-11-000.

April 18, 2018, they must report an income tax allowance consistent with *United Airlines* and the Commission's subsequent holdings denying an MLP an income tax allowance.<sup>83</sup>

Based upon page 700 data, the Commission will incorporate the effects of the post-*United Airlines*' policy changes (as well as the Tax Cuts and Jobs Act of 2017)<sup>84</sup> on industry-wide oil pipeline costs in the 2020 five-year review of the oil pipeline index level.<sup>85</sup> In this way the Commission will ensure that the industry-wide reduced costs are incorporated on an industry-wide basis as part of the index review. To the extent the Commission issues subsequent orders affecting the income tax policy for other partnership or pass-through business forms, oil pipelines should similarly reflect those policy changes on Form No. 6, page 700.

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<sup>83</sup> Due to these findings that including an income tax allowance in the cost of service leads to a double-recovery, there is no basis for an MLP pipeline to claim an income tax allowance in the summary Form No. 6, page 700 cost of service for the 2016 or 2017 data listed in the April 18, 2018 filing.

<sup>84</sup> The Tax Cuts and Jobs Act changed oil pipeline tax costs effective January 1, 2018, and the resulting reduction to tax costs should be reflected in the tax allowance (page 700, lines 8 and 8a) in the 2018 data reported in Form No. 6, page 700, to be filed on April 18, 2019.

<sup>85</sup> The overwhelming majority of oil pipelines set their rates using indexing, not cost-of-service ratemaking using an oil pipeline's particular costs. Under indexing, oil pipelines may adjust their rates annually, so long as those rates remain at or below the applicable ceiling levels. The ceiling levels change every July 1 based on an index that tracks industry-wide cost changes. 18 CFR § 342.3. Currently, the index level is based upon the Producer's Price Index for Finished Goods plus 1.23. The index will be re-assessed in 2020 based upon industry-wide oil pipeline cost changes between 2014 and 2019. *E.g. Five-Year Review of the Oil Pipeline Index*, 153 FERC ¶ 61,312 (2015) *aff'd*, *Assoc. of Oil Pipe Lines v. FERC*, 876 F.3d 336 (D.C. Cir. 2017). The industry-wide data filed in the latter years of the 2014-2019 period should reflect the Commission's post-*United Airlines* policy changes as well as the Tax Cuts and Jobs Act.

47. In addition, the Commission emphasizes that the post-*United Airlines*' policy changes (as well as the Tax Cuts and Jobs Act of 2017) will be reflected in initial oil and gas pipeline cost-of-service rates and cost-of-service rate changes on a going-forward basis under the Commission's existing ratemaking policies,<sup>86</sup> including cost-of-service rate proceedings resulting from shipper-initiated complaints.

### **III. Document Availability**

48. In addition to publishing the full text of this document in the Federal Register, the Commission provides all interested persons an opportunity to view and/or print the contents of this document via the Internet through FERC's Home Page (<http://www.ferc.gov>) and in FERC's Public Reference Room during normal business hours (8:30 a.m. to 5:00 p.m. Eastern time) at 888 First Street, NE, Room 2A, Washington, DC 20426.

49. From FERC's Home Page on the Internet, this information is available on eLibrary. The full text of this document is available on eLibrary in PDF and Microsoft Word format for viewing, printing, and/or downloading. To access this document in eLibrary, type the docket number excluding the last three digits of this document in the docket number field.

50. User assistance is available for eLibrary and the FERC's website during normal business hours from FERC Online Support at 202-502-6652 (toll free at 1-866-208-3676) or email at [ferconlinesupport@ferc.gov](mailto:ferconlinesupport@ferc.gov), or the Public Reference Room at (202) 502-8371, TTY (202) 502-8659. E-mail the Public Reference Room at [public.referenceroom@ferc.gov](mailto:public.referenceroom@ferc.gov).

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<sup>86</sup> See, e.g., 18 C.F.R. §§ 154.312(m), 154.313(e)(13), 384.123; 342.2, 342.4(a); 18 C.F.R. pt. 346.

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**IV. Effective Date**

51. This Revised Policy Statement will become effective [date of publication in the *Federal Register*].

By the Commission.

( S E A L )

Nathaniel J. Davis, Sr.,  
Deputy Secretary.

Document Content(s)

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