UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

	)	
Inquiry Regarding the Commission's	)	
Policy for Recovery of Income Tax Costs	)	**Docket No. PL17-1-000**
	)	

COMMENTS OF THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

The Interstate Natural Gas Association of America (INGAA) submits its comments on the Federal Energy Regulatory Commission's (Commission) Notice of Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs (NOI), issued on December 15, 2016.[1] INGAA is a trade association representing approximately two-thirds of the nation's natural gas transmission pipeline systems. INGAA's 26 members operate approximately 200,000 miles of interstate gas transmission pipelines. Ten of the INGAA member companies operate pipelines which are organized as publicly-traded master limited partnerships (MLP) that will be affected directly by the outcome of the Commission's NOI.

INGAA commends the Commission for establishing this NOI proceeding and inviting comments on the income tax allowance and related rate of return policies in a context that will allow full examination of all relevant information and careful consideration of the issues affecting natural gas pipelines and other regulated entities. INGAA's comments demonstrate that MLP unitholders have actual tax liability and that the Commission's current policy correctly recognizes that the income tax liability incurred by MLP unitholders is a cost attributable to providing the regulated pipeline service. This cost must be included as a tax allowance in a natural gas pipeline's cost of service in order for MLP pipelines to operate on a

[1] *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, 81 Fed. Reg. 94,366 (Dec. 23, 2016).

level playing field with pipelines organized as corporations. INGAA also demonstrates that applying the Discounted Cash Flow (DCF) methodology for determining a pipeline's return on equity (ROE) does not permit MLP pipelines to over recover or double recover income tax costs.

The Commission's "zone of reasonableness" approach to ratemaking recognizes that ratemaking is an art, not a science.[2] Under this approach, bright-line rules are not always preferable compared to an individualized case-by-case approach. The Commission should retain its existing policy of requiring that MLP pipelines demonstrate in their individual rate cases the existence of an actual or potential income tax liability as part of their burden of proving that their proposed rates are just and reasonable under the Natural Gas Act (NGA). No factual or policy basis exists for the Commission to adopt a generic, industry-wide policy that forecloses MLPs from including an income tax allowance in their costs of service. Such an approach would prevent MLP partners from recovering a real and significant cost of owning and operating a jurisdictional pipeline and would not be supported by basic, time-tested methodologies for determining just and reasonable pipeline rates. A modification of the existing policy would threaten the financial integrity of natural gas pipelines organized as MLPs and erode their ability to maintain credit and attract the capital that is necessary for the development of new pipeline infrastructure. Such a result also would be contrary to the intent of the 1987 amendments to the Internal Revenue Code (IRC) and would undermine MLPs viability as a vehicle for investment in natural gas and oil infrastructure.

[2] *See Cities of Bethany, et al., v. FERC*, 727 F.2d 1131, 1138 (D.C. Cir. 1994); *Alabama Elec. Cooperative, Inc. v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982).

I. EXECUTIVE SUMMARY

INGAA's comments respond to the Commission's NOI that was initiated as a result of the court's holding in *United Airlines, Inc. v. FERC* that, "if FERC elects to impute partner taxes to the partnership pipeline entity, it must still ensure parity between equity owners in partnership and corporate pipelines."[3] The court was concerned that (1) a partnership pipeline incurs no taxes at the entity level apart from those taxes imputed from its partners;[4] (2) a DCF ROE "determines the pre-tax investor return required to attract investment," irrespective of the pipeline's corporate form;[5] and (3) "with a tax allowance, a partner in a partnership pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline, at least in the short term before adjustments can occur in the investment market."[6] INGAA's comments and testimony demonstrate that, despite the lack of entity level income taxation of MLPs, there is parity in the returns to investors in both MLP-owned and corporate-owned pipelines. This provides a sound basis for the Commission to buttress the existing record and conclude that the MLP tax allowance is necessary to permit MLP-owned pipelines to recover the actual tax liability associated with their taxable income.

INGAA witness Barry Sullivan explains that the Commission allows a tax allowance only for those income taxes paid or potentially owed by MLP unitholders (the MLP's owners) which are attributable to the MLP's taxable income, and that the MLP tax allowance is

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[3] 827 F.3d 122, 137 (D.C. Cir. 2016).

[4] *Id.* (citing 26 U.S.C. § 7704(d)(1)(E)). As acknowledged by INGAA witness Erickson, pursuant to an exemption provided in the IRC, an MLP's income "passes through" to its unitholders, and unitholders are assessed an income tax liability on this income and treated as if they directly earned a share of the MLP's income. *See* Prepared Direct Testimony of Dr. Merle Erickson, on Behalf of INGAA, at 5, FERC Docket No. PL17-1-000 (Mar. 8, 2017) (attached hereto).

[5] 827 F.3d at 137 (citing *SFPP, L.P.*, Opinion 511, 134 FERC ¶ 61,121, ¶¶ 243-44 (2011) and shipper legal arguments made in that case).

[6] *Id.* (citing the record in Opinion 511).

comparable to the tax allowance that allows corporate-owned pipelines to recover the tax liability associated with the corporate pipeline's taxable income. The analysis in Mr. Sullivan's testimony also demonstrates that the DCF ROE does not include an income tax allowance, and that an MLP pipeline must be allowed an income tax allowance in order to have the opportunity to recover its full cost of service, consistent with the policy set forth in the Supreme Court's decision in *FPC v. Hope Natural Gas Co*.[7]

INGAA witness Dr. Merle Erickson performs a life-cycle analysis of the overall tax liability associated with investments in both MLP-owned and corporate-owned pipelines. Dr. Erickson concludes that the tax liability for both MLP-owned and corporate-owned pipelines is very similar over the life of the investments. Dr. Erickson's analysis allows the Commission to conclude that its current income tax allowance provides the parity between corporate and MLP pipeline investors required by the court in *United Airlines*.

INGAA's comments, with the testimony of Dr. Erickson and Mr. Sullivan, address the court's holding in *United Airlines* that the Commission, based on the record before the court in that proceeding, had "not provided sufficient justification for its conclusion that there is no double recovery of taxes for partnership pipelines receiving a tax allowance in addition to the discounted cash flow return on equity."[8] Dr. Erickson's testimony demonstrates that the differences in tax recovery between investors in MLP-owned and corporate-owned pipelines are statistically insignificant over the life of the investment.

Mr. Sullivan's testimony provides additional evidence to demonstrate that there is no double recovery associated with the MLP receiving both an income tax allowance and DCF-

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[7] 320 U.S. 591, 603 (1944).

[8] 827 F.3d at 136.

generated ROE. Mr. Sullivan explains that the Commission uses the DCF method to determine the just and reasonable ROE that a regulated pipeline may recover in its rates, and that the ROE generated by the DCF method does *not* include an income tax allowance for either MLP-owned or corporate-owned pipelines. The income tax allowance is instead treated as a separate line item in the pipeline's cost of service. Mr. Sullivan further explains that the tax allowance is necessary for both MLP and corporate-owned pipelines to recover their cost of service and earn the ROE derived from applying the DCF method, and that granting an MLP tax allowance does not result in a double recovery.

Mr. Sullivan further provides an empirical analysis demonstrating that there is no double recovery of income taxes resulting from an MLP receiving both a tax allowance and DCF-derived ROE. Mr. Sullivan addresses witness testimony in the *United Airlines* evidentiary record that claimed that higher DCF ROEs for MLP pipelines were indicative of a double recovery of income tax costs. Mr. Sullivan updates an analysis submitted by certain shippers in that proceeding (SFPP Shippers) that was based on 2008 data. Based on current data, Mr. Sullivan concludes that the corporations included in that study currently have higher DCF ROEs than certain of the MLP pipelines included in the study. Mr. Sullivan also compares the DCF ROEs of existing interstate natural gas pipeline MLPs with their corporate affiliates that own a significant percentage of the units of the MLPs. He concludes that when these ROEs are analyzed over an extended period of time, the DCF ROEs for MLPs have not systematically exceeded the DCF ROEs for corporations, but have been generally comparable. Mr. Sullivan's analysis demonstrates that there has been relative parity between the DCF returns on equity of MLPs and corporations. Mr. Sullivan's analysis provides empirical support that, over time, inclusion of an income tax allowance for MLP pipelines does not result

in systematically higher DCF ROEs for MLP-owned pipelines as compared to corporate-owned pipelines. Mr. Sullivan's and Dr. Erickson's testimony strongly supports the conclusion that the MLP income tax allowance, coupled with the DCF return, does not result in a double recovery of income taxes.

Mr. Sullivan further compares MLP distribution yields with corporate dividend yields for 23 entities that own significant jurisdictional pipeline assets for the period August 2007 to January 2017.[9] Mr. Sullivan explains that these yields "have been in nearly constant flux since 2008," and that "MLPs' distribution yields have not been consistently higher than the corporations' dividend yields."[10] The fact that the relative yields of MLPs and corporations have changed substantially since 2008 despite no change in the Commission's tax allowance policy demonstrates that the tax allowance is not a significant factor affecting either MLP distribution yields or corporate dividend yields. Mr. Sullivan then compares the IBES growth rates for MLPs and corporations and finds that their respective growth rates have been comparable throughout the period January 2008 to January 2017. Mr. Sullivan shows that, during this period, IBES growth rates remained within a relatively narrow band for most of the companies and that IBES growth rates for MLPs were not consistently higher than for corporations. Mr. Sullivan concludes that nothing in the IBES growth rate indicates that MLPs receive an over-recovery as a result of an income tax allowance.[11]

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[9] Prepared Direct Testimony of Barry E. Sullivan, on Behalf of INGAA, at 64-68, FERC Docket No. PL17-1-000 (Mar. 8, 2017). The DCF analysis, at any point in time, utilizes the preceding six months distribution/dividend yield data. In order to illustrate DCF outcomes from January 2008 to January 2017, INGAA Witness Sullivan utilized yield data back to August 2007 to derive the appropriate DCF result. This explains the difference in dates between the Yield Chart and both the DCF and IBES charts in Mr. Sullivan's testimony.

[10] Sullivan Testimony at 66.

[11] *Id.* at 67.

The Supreme Court in *Hope* emphasized that the Commission must balance the interests of the investor and the consumer, including providing returns to the investor that "assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[12] In *United Gas Pipe Line Co. v. Memphis Light, Gas and Water Division*, the Court recognized that the NGA was concerned with the financial stability of natural gas companies.[13] Eliminating the MLP tax allowance would shake the market's confidence in MLPs and place them at a disadvantage as compared to corporate-owned pipelines.

Eliminating the tax allowance would also contravene Congress's intent in providing for pass-through taxation for partnership pipelines. By authorizing pass-through taxation for MLPs, Congress created an incentive for investment in necessary infrastructure to provide oil and natural gas transportation. Eliminating the pass-through taxation would transfer the benefits that Congress intended to confer upon MLP investors to shippers, which would effectively remove the incentive Congress intended to encourage investment in energy infrastructure.[14]

II. BACKGROUND

An MLP is a publicly-traded limited partnership, comprised of a general partner that manages the partnership and limited partners who are investors (*i.e.*, unitholders) and who provide capital and receive an allocation of the partnership's income and, in most cases, cash

[12] 320 U.S. at 603.

[13] 358 U.S. 103, 113-14 (1958).

[14] *See, e.g., SFPP, L.P.*, Opinion No. 511, 134 FERC ¶ 61,121 at P 265, *order on reh'g and compliance filing*, Opinion No. 511-A, 137 FERC ¶ 61,220 at P 314 (2011), *reversed and remanded*, *United Airlines, Inc. v. FERC*, 827 F.3d 122 (D.C. Cir. 2016).

distributions without having a role in management decisions.[15] An MLP is a pass-through entity that does not itself pay any federal income taxes. As explained by Dr. Erickson, under an exemption provided in the IRC,[16] an MLP's income "passes through" to its unitholders, and they are treated as if they directly earn a share of the MLP's income. A unitholder, which may be an individual or a corporation, reflects its allocated share of the MLP's income on its individual or corporate tax return and pays tax on the net income at their applicable federal tax rate, regardless of whether the unitholder has received a cash distribution.[17]

Between 2010 and 2014, partnerships in the interstate and intrastate gas and oil pipeline industry sectors reported, in aggregate, net annual incomes ranging from $6.5 billion to $14 billion.[18] The magnitude of aggregate investments in MLPs is significant and the cash distributions received by unitholders are an essential feature that makes investment in an MLP attractive. The capital provided by investors has facilitated the ability of MLP pipelines to invest in needed pipeline infrastructure.

The cash flow available for MLPs to distribute to general and limited partners and how that cash is allocated among them is determined by the individual MLP's partnership agreement. "Available cash" is typically defined in the partnership agreement as: (1) net income (gross revenues less operating expenses) plus (2) depreciation and amortization, less (3) capital investments the partnership must make to maintain its current asset base and cash flow stream. The portion of MLP cash distributions to unitholders that do not reflect the MLP's income is not taxed when received. Rather, under the IRC, distributions that exceed earnings

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[15] Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity, Policy Statement, 123 FERC ¶ 61,048, PP 10-15 (2008). *See also* MLPA, "Basic Tax Principles," https://www.mlpassociation.org/mlp-101/basic-tax-principles/.

[16] 26 U.S.C. § 7704(c) (2012).

[17] Erickson Testimony at 5-6.

[18] *Id.* at 14-15.

reflect a return of capital and have the effect of reducing the unitholder's tax basis in the investment, and the tax liability associated with that portion of the distribution is deferred until the unit is sold. When the MLP investor sells the partnership unit, the unitholder is taxed on the difference between the sales proceeds and adjusted basis. The portion of the gain related to prior depreciation deductions is "recaptured" and taxed at ordinary income tax rates.[19]

III. COMMENTS

A. The Commission's Existing Income Tax Allowance Policy Is Consistent with Just and Reasonable Ratemaking Principles and Congressional Intent.

1. The Current Income Tax Allowance Policy Is Consistent With Settled Ratemaking Principles Under the Natural Gas Act.

Under the NGA, the rates an interstate natural gas pipeline may charge for natural gas transportation services must be just and reasonable.[20] In *Hope,* the United States Supreme Court articulated important guiding principles that must inform the development of a pipeline's just and reasonable rates.[21] The Court emphasized that, while the NGA must protect consumers from unjust and unreasonable rates, the Commission also must balance the interests of the investor and the consumer. The Court stated:

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. 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 . . . 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.*[22]

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[19] *Id.* at 6. Taxable gains associated with any unit price appreciation above the original purchase price are taxed at the applicable capital gains tax rate similar to the capital gains taxes paid by corporate shareholders.

[20] 15 U.S.C. § 717c(a) (2012).

[21] 320 U.S. at 603.

[22] *Id.* (emphasis added) (citations omitted).

The Supreme Court reaffirmed the importance of ensuring the natural gas company's financial integrity in *United Gas*:

> Congress, in so drafting the [NGA], was not only expressing its conviction that the public interest requires the protection of consumers from excessive prices for natural gas, but was also manifesting its concern for the legitimate interests of natural gas companies in whose financial stability the gas-consuming public has a vital stake.[23]

These principles continue to guide the Commission's cost of service ratemaking policies.[24] The Court's decisions in *Hope* and *United Gas* mean that a pipeline must be given the opportunity to recover the cost of providing jurisdictional service, including applicable income tax liability resulting from the pipeline's income, plus a rate of return on capital invested.[25]

The Commission's current Policy Statement on Income Tax Allowances (Income Tax Allowance Policy Statement) provides that a pass-through entity may include in its cost of service an income tax recovery component to reflect the actual or potential tax liability that will be owed by each of the entity's owners on income flowed through to those owners, irrespective of whether the owners are organized as corporations, are individuals, or another type of taxpayer.[26] This policy appropriately balances the interests of the investor and the consumer and is consistent with the principles of *Hope* and *United Gas*. The policy places an MLP pipeline on equal footing with a corporate-owned pipeline with respect to the opportunity

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[23] 358 U.S. at 113-14 (holding that sections 4(d) and 4(e) of the NGA give a pipeline the right to propose increased rates for services that were subject to the "going rate," and not subject to a fixed rate contract).

[24] *E.g.*, *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 791-92 (1968) (relying on *Hope* in approving maximum rates for interstate gas sales in the Permian Basin); *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 700 (D.C. Cir. 2007) (vacating Commission order because the selected proxy group did not sufficiently reflect pipeline's risk and was inconsistent with *Hope*'s requirements); *Mo. Pub. Serv. Comm'n v. FERC*, 337 F.3d 1066, 1071-72 (D.C. Cir. 2003) (vacating Commission order approving pipeline's proposed rates and finding failure to demonstrate that rates were necessary for pipeline's financial integrity).

[25] *City of Charlottesville, v. FERC*, 774 F.2d 1205, 1207 (D.C. Cir. 1985).

[26] *Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139, P 32 (2005). The Commission issued a Notice of Inquiry in Docket No. PL05-5-000 on December 2, 2004 and received over 40 sets of comments from interested entities.

to earn a fair return and avoids creating an unfair regulatory impediment to the MLP's ability to recover its costs and maintain its financial integrity. The Commission correctly observed in the Income Tax Allowance Policy Statement that the "taxes paid by the owners of the pass-through entity are just as much a cost of acquiring and operating the assets of that entity as if the utility assets were owned by a corporation," and "the return to the owners of pass-through entities will be reduced below that of a corporation investing in the same asset if such entities are not afforded an income tax allowance on their public utility income."[27]

Relying on the longstanding principles of *Hope* that the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks, the D.C. Circuit in *ExxonMobil Oil Corp. v. FERC* upheld the Income Tax Allowance Policy Statement.[28] The court affirmed as reasonable the Commission's conclusion that if the pass-through entity is not afforded an income tax allowance on its public utility income, owners of the pass-through entity will receive a return that is lower than that of a corporation investing in the same entity.[29] The court also upheld the Commission's determination to allow the regulated pass-through entity an income tax allowance to the extent that "its partners incur 'actual or potential' income tax liability on their respective shares of the partnership income."[30]

Prohibiting natural gas pipeline MLPs from including an income tax allowance in their costs of service would prevent unitholders (the MLPs' owners) from recovering a real and significant cost associated with their pipeline investment, a cost that is routinely recovered by pipelines organized as corporations. Market confidence in the financial integrity of MLPs

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[27] 111 FERC ¶ 61,139 at P 33.

[28] 487 F.3d 945, 953-54 (D.C. Cir. 2007).

[29] *Id.* at 952-53.

[30] *Id.* at 954 (citing *SFPP, L.P.*, 111 FERC ¶ 61,334 at p. 62,456 (2005)).

would be shaken and their ability to maintain credit and attract capital would be undermined. MLPs also would be placed at a significant competitive disadvantage vis-à-vis corporations. Such an outcome would result in unjust and unreasonable rates being established under the NGA and squarely contravenes *Hope* and *United Gas.*

2. The Current Income Tax Allowance Policy Statement Is Consistent With Congressional Intent.

The Commission's Income Tax Allowance Policy Statement also is consistent with congressional intent as reflected in the IRC. Prior to 1987, most publicly-traded partnerships and similar entities were exempt from a requirement to pay income taxes directly at the partnership level.[31] Partnerships and other so-called "pass-through" entities passed the tax obligations of the business to the entities' partners who paid the businesses' taxes on their individual tax returns. In 1987, Congress changed this long-standing policy as part of major revisions to the IRC. Congress required every type of major publicly-traded pass-through entity, in nearly every industry, to start paying taxes directly as if it were a corporation.[32] One of the few exceptions to this general rule was for pass-through entities owning "pipelines transporting gas, oil, or products."[33] This exception reflects Congress's express decision that such pass-through entities should continue to be exempt from corporate-level tax liabilities because of the importance of encouraging investment in natural gas and oil transportation

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[31] H.R. Rep. No. 100-391(II), at 1063 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-378, 2313-678.

[32] *See* 26 U.S.C. § 7704(a) (stating that, except as provided in 26 U.S.C. § 7704(c), "a publicly traded partnership shall be treated as a corporation") (added by Pub. L. 100-203, § 10211(a), 101 Stat. 1330-403) (1987)). This legislation was adopted in response to the proliferation of publicly-traded partnerships following the Tax Reform Act of 1986 which gave tax advantages to pass-through entities and made them a more attractive business form than a C corporation. Subjecting publicly-traded partnerships to taxation was intended to preserve corporate level taxes. H.R. Rep. No. 100-391(II), at 1066 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-681.

[33] 26 U.S.C. § 7704(c) states that an exception from the general rule stated in § 7704(a) where, in any taxable year, 90 percent or more of the publicly traded partnership's gross income consists of "qualifying income." Section 7704(d)(1)(E) defines qualifying income to include "income and gains derived from the . . . transportation (including pipelines transporting gas, oil or products thereof) . . . of any mineral or natural resource."

infrastructure.[34] The effect of this decision was to preserve the then-existing status quo for publicly-traded, pipeline-owning pass-through entities.

Congress's decision to retain this status quo was significant, because at the time of the 1987 amendments to the IRC, the Commission's policy was to "regulate partnerships as though they were tax-paying corporations."[35] This policy permitted pass-through entities to include in their revenue requirements a component equal to what their tax liability would have been had they been corporations under Subchapter C of the IRC. The purpose of the Commission's policy was to provide an incentive for infrastructure development by producing "after-tax returns on common equity invested by the partners, as though [the partnership] were a corporation."[36]

Congress understood the Commission's ratemaking treatment for pass-through entities and intended to continue that rate treatment in the 1987 IRC amendments by exempting pipeline-owning partnerships from the tax liability and allowing pass-through to its partners. In 1996, the Commission issued its decisions in *Lakehead Pipe Line Company* that changed the rate treatment for pass-through entities by precluding an income tax allowance for limited

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[34] *See, e.g.,* Opinion No. 511, 134 FERC ¶ 61,121 at PP 257, 265 (explaining that the legislative history "emphasizes that the tax incentives Congress provided MLPs have important practical financial consequences," including "certain tax advantages particularly due to the avoidance of the double taxation of corporate earnings and the tax deferrals derived from allocation of income and losses among the partners," and stating that "[t]he Commission again concludes that Congress intended to encourage pipeline investment by authorizing tax incentives for MLPs. To achieve this, it is appropriate to grant regulated MLPs an income tax allowance and equalize the return of the MLP and the corporation at the entity level."); Opinion No. 511-A, 137 FERC ¶ 61,220 at P 314 ("[T]here is no doubt that Section 7704 of the IRC was to provide that incentive for certain types of business formats to encourage investment.").

[35] *Riverside Pipeline Co.*, 48 FERC ¶ 61,309, at p. 62,017 (1989). *See also Kuparuk Transp. Co.*, 45 FERC ¶ 63,006, at p. 65,083 (1988), *aff'd*, 55 FERC ¶ 61,122 (1991); *Pelican Interstate Gas Sys.*, 29 FERC ¶ 61,062, at p. 61,135 (1984); *Sea Robin Pipeline Co.*, 28 FERC ¶ 61,092, at p. 61,173 (1984); *Alaskan Nw. Natural Gas Transp. Co.*, 19 FERC ¶ 61,218, at p. 61,426 (1982); *Trailblazer Pipeline Co.*, 15 FERC ¶ 63,046, at p. 65,175 (1981), *aff'd*, 18 FERC ¶ 61,244 (1982).

[36] *Sea Robin*, 28 FERC ¶ 61,092 at p. 61,173.

partners that were not corporations.[37] Senator Max Baucus submitted a letter to the Commission sharply rebuking the Commission's decisions, stating:

> as a member of the Senate Finance Committee who participated in the writing of the Omnibus Reconciliation Act of 1987, I feel that **placing this obstacle in the path of pipeline companies wishing to operate as [publicly traded partnerships] directly contravenes the policy we adopted in that legislation of making the [publicly traded partnership] structure freely available to the pipeline industry.** Language specifically covering pipelines was placed in the legislation so that there would be no doubt that they qualified for partnership taxation as [publicly traded partnerships]. **It was certainly not our intention for pipelines operating as [publicly traded partnerships] to be singled out for negative treatment relative to other pipelines solely because of their partnership status.**[38]

The Commission's *Lakehead* policy was later rejected by the D.C. Circuit because the court found that the Commission failed to adequately explain why it permitted an income tax allowance to partnership interests owned by corporations, but not those owned by individuals.[39] Following that decision, the Commission comprehensively reexamined its income tax allowance policy, and in 2005, issued its current Income Tax Allowance Policy Statement, which is consistent with the congressional intent of the 1987 IRC amendments, and has guided ratemaking decisions for over a decade.

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[37] *Lakehead Pipe Line Co.*, Opinion No. 397, 71 FERC ¶ 61,388 (1995), *reh'g denied*, Opinion No. 397, 75 FERC ¶ 61,181 (1996).

[38] Letter from The Honorable Max Baucus, U.S. Senator, to The Honorable Elizabeth Anne Moler, Chair, Federal Energy Regulatory Commission at 1, FERC Docket No. IS92-27-000 (Jan. 9, 1996) (emphasis added).

[39] *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263, 1289-90 (D.C. Cir. 2004).

3. The Commission Should Implement Congress's Intent to Encourage Investment in Infrastructure in the Same Manner as the Investment Tax Credit.

By allowing MLP pipelines to be taxed as partnerships, Congress sought to encourage investment in needed infrastructure by creating a business structure that was not subject to the same immediate taxation requirements imposed on corporations and their shareholders.[40] Congress achieved that purpose by allowing qualifying partnerships to pass through the income tax obligation of the partnership to its partners, and deferring certain tax obligations until the time the units are sold. The carefully-balanced legislation worked to spur investment by *deferring* taxes, not *avoiding* taxes. The need to encourage investment in pipeline infrastructure is as important today as it was in 1987. If MLPs are not provided a tax allowance, the tax benefit intended by Congress will be effectively transferred to ratepayers instead of investors and the incentive for investment in infrastructure will be eliminated. MLP investors would be worse off than corporate investors if the tax allowance were eliminated, and the continued viability of this important investment vehicle would be threatened.

This same issue arose in connection with Congress's efforts to encourage investment in infrastructure through an Investment Tax Credit ("ITC"). The ITC was enacted for natural gas companies as part of the Revenue Act of 1962,[41] and gave natural gas companies a credit for investments in certain natural gas properties. The FPC and the Federal Communications Commission, among others, initially responded to this favorable tax treatment by requiring that regulated companies flow through the benefits of the ITC to their ratepayers. In response to these agency-mandated flow-through requirements, Congress clarified that the intent of the

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[40] *See, e.g.,* Opinion No. 511, 134 FERC ¶ 61,121 at PP 257, 265; Opinion No. 511-A, 137 FERC ¶ 61,22 at P 314.

[41] Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960.

ITC was to confer the tax benefit on the regulated company and its investors, and that passing that tax benefit to ratepayers would defeat that purpose.

Congress enacted new legislation inserted into the Revenue Act of 1964 that required ratemaking agencies to ensure that the benefit of the ITC went to the regulated companies, and not their ratepayers.[42] As stated in the committee report accompanying this legislation, the goal of the new provision was to ensure that shareholders, and not ratepayers, received the benefit of the ITC.[43] The FPC subsequently made the appropriate adjustments in its rate treatment of the ITC, allowing natural gas pipeline companies to "*retain the tax savings derived from the investment tax credit and use them in any proper manner decided upon by company management, including reinvestment, payment in dividends to stockholders, or voluntary reduction of rates*."[44]

The ITC is substantially similar to 1987 IRC Amendments allowing pipeline partnerships to continue to use pass-through taxation. Both tax-related statutes were intended to spur investment in energy infrastructure, and the intent of both statutes could be effectuated only if the pipeline's investors were entitled to retain the intended tax benefit, as opposed to the benefit being transferred to ratepayers. Congress does not need to pass additional legislation clarifying the intent of the 1987 IRC Amendments, as it did with respect to the ITC, because congressional intent in allowing qualifying partnerships to retain the tax deferral

[42] Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19. Section 203(e)(2) of that legislation stated that "Congress does not intend that any agency or instrumentality of the United States having jurisdiction with respect to a taxpayer shall, without the consent of the taxpayer use . . . any credit against tax allowed by section 38 of such Code, to reduce such taxpayer's Federal income taxes for the purpose of establishing the cost of service of the taxpayer or to accomplish a similar result by any other method." 78 Stat. at 35.

[43] *See* H. Rep. No. 88-749, *reprinted in* 1964 U.S.C.C.A.N. 1313, 1345.

[44] *Investment Tax Credit Under 1962 and 1964 Amendments to Internal Revenue Code; Accounting Treatment by Natural Gas Pipelines*, Order No. 289, 32 FPC 1255, 1256 (1964) (emphasis added).

benefits of the 1987 IRC Amendments in order to encourage investment in infrastructure is not in question and needs no clarification.

Allowing MLPs to retain the tax deferral benefit as Congress intended is consistent with *Hope* because the allowed returns of corporations and MLPs remain the same even with this tax treatment. The returns of both forms of organization will continue to be determined through the application of the DCF methodology irrespective of the taxes included in the pipeline cost of service. The Commission should continue to give effect to the congressional purpose in allowing pass-through taxation for partnership pipelines by continuing to allow an income tax allowance to be included in an MLP's cost of service. This will ensure that any benefits of the provision are conferred upon MLP investors as Congress intended.

B. *SFPP* and *United Airlines* Addressed a Limited Evidentiary Record.

The Commission orders considered in *United Airlines* were the result of a contested rate case proceeding filed by SFPP, L.P. (SFPP) in 2008. In that proceeding, certain SFPP shippers argued that it was inappropriate for SFPP to recover an income tax allowance in its cost of service because it was organized as an MLP that paid no entity-level taxes. Some of the SFPP shippers asserted that this provided an unfair competitive advantage over corporate-owned pipelines that have an entity-level tax obligation. The shippers contended that the inclusion of an income tax allowance for SFPP enabled the MLP's unitholders to recover a higher ROE than if they were corporate shareholders in a corporate-owned pipeline, at undue cost to ratepayers. The chief contention concerned the Commission's DCF methodology that is used to calculate a pipeline's ROE.[45] Testimony in the record asserted that the DCF ROE already accounts for the investor-level income tax liability for MLPs and that the addition of a

[45] Opinion No. 511, 134 FERC ¶ 61,121 at P 240.

separate income tax allowance in the MLP pipeline's cost of service permits double recovery of investor level income taxes.[46]

Although the shippers' arguments were rejected both by the presiding administrative law judge and the Commission initially and on rehearing,[47] in *United Airlines*, the court vacated and remanded the tax allowance issue to the Commission, holding that the Commission did not provide "sufficient justification for its conclusion that there is no double recovery of taxes for partnership pipelines receiving a tax allowance in addition to the discounted cash flow return on equity."[48] The court further directed the Commission to *consider* "mechanisms for which the Commission can demonstrate that there is no double recovery" associated with the tax allowance provided to an MLP.[49]

The court stated that three "essential facts" from the *SFPP* proceeding "support the conclusion that granting a tax allowance to partnership pipelines results in inequitable returns for partners in those pipelines as compared to shareholders in corporate pipelines."[50] Among these "essential facts" is the statement that "with a tax allowance, a partner in a partnership pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline, at least in the short term before adjustments can occur in the investment market."[51] INGAA witness Dr. Erickson demonstrates, with facts and analysis that go beyond the record in the *SFPP* proceeding, why this "essential fact" is not correct when viewed using a life-cycle analysis.[52]

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[46] *Id.* at P 241.

[47] *SFPP, L.P.*, 129 FERC ¶ 63,020 (2009) (Initial Decision); *order on initial decision,* Opinion No. 511, 134 FERC ¶ 61,121, *order on reh'g and compliance filing*, Opinion No. 511-A, 137 FERC ¶ 61,220 (2011).

[48] 827 F.3d at 136.

[49] *Id.* at 137.

[50] *Id.* at 136.

[51] *Id.*

[52] Erickson Testimony at 7-12.

The court did not conclude that a pipeline's income taxes are reflected in the DCF methodology or that applying the methodology results in a double recovery of income tax liability for partnership pipelines. INGAA Witness Mr. Sullivan demonstrates that income taxes are not reflected in the returns calculated using the DCF methodology. The court in *United Airlines* also focused on short-term differences in tax liability between MLPs and corporations. It did not address long-term tax liability issues, which are addressed by Dr. Erickson.

C. The NOI Provides the Commission with the Opportunity to Demonstrate that the Current Income Tax Allowance and DCF Methodology Policies Do Not Result in Double Recovery of Income Taxes.

The Commission initiated this NOI proceeding to address whether any double recovery results from its income tax allowance and rate of return policies in light of *United Airlines*.[53] The Commission seeks comments regarding "methods to allow regulated entities to earn an adequate return consistent with *Hope* that do not result in a double recovery of investor-level taxes for partnerships or similar pass-through entities."[54] The Commission requests that comments consider the concerns presented by the court in *United Airlines* and raised by the SFPP Shippers. The NOI also invites comments on proposed methods to modify current policies to resolve any double recovery of investor-level tax costs for partnerships or similar pass-through entities.[55]

INGAA supports the Commission's decision to address this industry-wide issue through an NOI proceeding that will enable the Commission to make a determination based on a full and complete record that is not constrained by the limited facts of a specific contested

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[53] *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, 81 Fed. Reg. 94,366 (Dec. 23, 2016).

[54] *Id.* at 94,368 (footnote omitted).

[55] *Id.* at 94,369.

oil pipeline rate proceeding that was focused on the 2008-2009 time period. The court in *United Airlines* did not find that the income tax allowance generally leads to a double recovery of income tax costs by MLP partners. The court found that the Commission had not sufficiently supported its conclusion that there was no double recovery of income taxes. The Commission is not foreclosed from properly supporting its conclusion and holding that its existing income tax allowance policy remains sound and that reliance on the DCF methodology does not result in a double recovery of income tax costs.

The Commission has frequently taken the opportunity on remand to provide further explanation to justify a correct policy and outcomes that are just and reasonable.[56] The Commission provided a more thorough explanation in a policy statement issued in response to a prior D.C. Circuit remand in connection with this very issue. In *BP West Coast,* the D.C. Circuit rejected the Commission's reliance on its prior *Lakehead* policy, finding that FERC could not create a phantom tax in order to create a tax allowance to pass through to ratepayers.[57] The court reversed and remanded the tax-allowance portion of FERC's opinion that allowed recovery for "income taxes not incurred and not paid."[58] Subsequent to the court's remand in *BP West Coast,* the Commission issued its industry-wide 2005 Policy Statement on Income Tax Allowances. In this 2005 Policy Statement, the Commission explained, that because the owners of a pass-through entity, such as an MLP, pay a tax on the income generated by the

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[56] *See, e.g., Consolidated Edison Co. of N.Y. v. FERC*, 510 F.3d 333, 341-42 (D.C. Cir. 2007) (finding that, on remand, the Commission adequately explained certain actions with respect to the New York Independent System Operator); *City of New Orleans v. FERC*, 875 F.2d 903, 905-06 (D.C. Cir. 1989) (upholding FERC's decision on remand providing further explanation of a decision allocating costs of generating electricity among operating companies of a nuclear power plant).

[57] *BP West Coast Products, LLC v. FERC,* 374 F.3d 1263, 1291 (D.C. Cir. 2004).

[58] *Id.*at 1312.

MLP, it was incorrect to conclude that allowing an MLP an income tax allowance would allow it to recover a "phantom tax."[59]

On review of a subsequent SFPP rate case, the court in *ExxonMobil* agreed with the Commission's finding in the 2005 Income Tax Allowance Policy Statement that the taxes attributable to MLP income are real, not phantom. In rejecting the petitioner's argument that the Commission had disregarded the court's admonition against creating a phantom tax, the court relied on the Commission's more comprehensive explanation in the Policy Statement. The court stated:

> In *BP West Coast,* we vacated the *Lakehead* policy because the Commission had offered *no* reasoning to support its distinction between corporate partners and individual partners. . . . However, in the instant case FERC has gone to great lengths to explain why the taxes in question are not "phantom" and are properly attributed to the regulated entity.[60]

Following the remand in *United Airlines*, the Commission should provide a more thorough explanation of why the DCF method does not include a tax allowance from both a theoretical and factual perspective and does not result in a double recovery of taxes. As discussed in the testimony of Dr. Erickson and Mr. Sullivan, the 2008 data utilized by the SFPP Shippers that purportedly shows that MLPs earn higher returns than corporations due to a double recovery of taxes, and was included in the record in *United Airlines,* has not withstood the test of time. The *United Airlines* court's factual finding that "with a tax allowance, a partner in a partnership pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline"[61] must be limited to the evidentiary record of the *SFPP* case and not form the basis of a generic industry-wide change in policy.

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[59] *Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139 at P 33.

[60] *ExxonMobil,* 487 F.3d at 954.

[61] 827 F.3d at 136.

To determine whether MLP partners receive a systematically higher after-tax return than corporate shareholders sufficient to justify a change in existing policy, the Commission should examine the more comprehensive and current data submitted by Mr. Sullivan and Dr. Erickson. The Commission should retain its existing policy of allowing an MLP pipeline in individual rate proceedings to include an income tax allowance for the pipeline's actual or potential income tax liability in its cost of service. The pipeline would retain its overall burden of proof of demonstrating that its rates are just and reasonable. This approach satisfies the requirements of *Hope* and *United Gas* that a pipeline be permitted the opportunity to earn a return on equity that "assures[s] confidence in the financial integrity of the enterprise, so as to maintain [the pipeline's] credit and to attract capital."[62] A generic policy precluding an income tax allowance for MLP pipelines would have far-reaching adverse impacts. Such a change in policy would shake the market's confidence in MLPs as a viable investment structure, undermining their ability to access the capital markets and construct needed pipeline infrastructure.

The Commission also should refrain from applying any policy established in this proceeding in a manner that disrupts existing pipeline rate settlements. Many recent settlements of natural gas pipeline rate cases are "black box" settlements that do not specify the individual components of the pipelines' costs of service, including an income tax allowance and the rate of return on equity.[63] There is no basis to conclude that these settlements, which

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[62] *Hope*, 320 U.S. at 603, *United Gas*, 358 U.S. at 113-14. *See also In re Permian Basin Area Rate Cases*, 390 U.S. at 791-92; *Petal Gas Storage*, 496 F.3d at 700; *Mo. Pub. Serv. Comm'n*, 337 F.3d at 1071-72.

[63] *See, e.g., Tallgrass Interstate Gas Transmission, LLC*, 157 FERC ¶ 61,082 (2016); *Empire Pipeline, Inc.*, 157 FERC ¶ 61,034 (2016); *Iroquois Gas Transmission System, L.P.*, 157 FERC ¶ 61,035 (2016); *Tuscarora Gas Transmission Co.*, 156 FERC ¶ 61,188 (2016); *Columbia Gulf Transmission, LLC*, 156 FERC ¶ 61,189 (2016); *Gulf South Pipeline Co.*, 153 FERC ¶ 61,326 (2015) (partial settlement), *settlement of reserved issues*, 156 FERC ¶ 61,172 (2016); *Colorado Interstate Gas Co.*, 156 FERC ¶ 61,085 (2016); *ANR Storage Co.*, 156 FERC ¶ 61,074 (2016); *Sabine Pipe Line LLC*, 155 FERC ¶ 61,142 (2016); and *Maritimes & Northeast Pipeline, L.L.C.*, 154 FERC ¶ 61,182 (2016).

involve a basket of compromises, reflect an inappropriate tax allowance for MLPs. The Commission should protect the parties' expectations and interests in maintaining rate and service stability established in these settlements.

D. Natural Gas Pipeline MLP Unitholders Incur Actual Income Tax Liabilities.

MLP pipelines are pass-through entities. The income generated by the pipeline asset(s) is passed through to the MLP's unitholders, who incur a tax liability on that income.[64] Recognizing that the tax paid by the MLP unitholder is a tax on the pipeline's income, the Commission's Income Tax Allowance Policy Statement has long permitted recovery of this cost in the pipeline's cost of service:

> the taxes paid by the owners of the pass-through entity are just as much a cost of acquiring and operating the assets of that entity as if the utility assets were owned by a corporation. . . . just as a corporation has an actual or potential income tax liability on income from the first tier public utility assets it controls, so do the owners of a partnership or LLC on the first tier assets and income that they control.[65]

The court of appeals in *ExxonMobil* agreed.[66] Nothing since the issuance of the Income Tax Policy Statement or the *ExxonMobil* decision, including the *United Airlines* decision, has changed this basic fact.

The Commission's tax allowance policy applies only to a limited portion of the income taxes paid by MLP unitholders. Dr. Erickson explains that MLP unitholders are taxed on their

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[64] As noted above in Section E.2, a large percentage of MLPs' publicly-traded units are owned by corporate general partners. Often, corporate general partners own large percentages of the outstanding units of their affiliated MLPs. Sullivan Testimony at 50. For corporate general partners, the income they earn from their interest in an MLP is taxed at the corporate tax rate. *See* Erickson Testimony at 7 (describing blended tax rate assuming ownership of MLP by corporate and individual unitholders). Treating them differently from individual unit holders results in disparate treatment. *See BP West Coast Products*, 374 F.3d at 1289-90 (finding the Commission failed to adequately explain why it permitted an income tax allowance to partnership interests owned by corporations, but not those owned by individuals).

[65] *Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139 at PP 33-34.

[66] 487 F.3d at 954.

allocated share of the MLP's taxable income in the year in which the income is earned.[67] The Commission allows a tax allowance only for those income taxes paid by MLP unitholders which are attributable to the MLP's taxable income, which Dr. Erickson explains, are akin to the tax paid by corporations on the taxable income of corporate-owned pipelines.[68] The Commission's tax allowance policy does not apply to other income taxes paid by MLP unitholders, such as income taxes paid on the return of capital.

When measured over time, the total aggregate taxes paid by the unitholders of MLP-owned pipelines are comparable to the total taxes paid by corporations and their investors. Dr. Erickson illustrates this by performing a "life-cycle analysis" that compares the total taxes paid by MLP unitholders with the total taxes paid by corporations and their shareholders over a five-year investment horizon. He assumes for this analysis a top corporate tax rate of 35%, a 20% dividend tax rate on corporate shareholders, a 20% capital gains tax and a tax rate of 37.3% for MLP ordinary income, which assumes equal 50% ownership of the MLP's units by corporate and individual unitholders. Other assumptions include a 65% dividend payout. This life-cycle analysis shows that, over a five-year investment horizon, after-tax cash flows to MLP investors and corporation investors are very similar. Based on a $1,000 investment, the after-tax cash to investors in the corporation was $1,574, while the total after-tax cash to investors in the MLP is $1,564. The total taxes paid by the corporation and its investors is $326, while total taxes paid by the MLP investors are $336.[69]

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[67] Erickson Testimony at 5, 14.

[68] *Id.* at 14.

[69] *Id.* at 12 and Table 1.

When timing is taken into account, Dr. Erickson demonstrates that, "in the aggregate, total taxes paid under either MLP or C-Corporation structure over a five-year investment horizon are similar."[70] For both corporations and MLPs, income taxes represent a significant and actual cost of doing business that must be included as a component of the pipeline's cost-of-service in ratemaking proceedings. The life-cycle analysis is particularly important because pipelines are long-lived assets and it is appropriate for the Commission to consider this fact during the ratemaking process.[71]

The court in *United Airlines* held that, "if FERC elects to impute partner taxes to the partnership pipeline entity, it must still ensure parity between equity owners in partnership and corporate pipelines."[72] The Commission's existing tax allowance policy ensures this parity by applying the tax allowance only to the portion of MLP unitholders' tax liability attributable to the MLP pipeline's taxable income, which is comparable to the tax allowance allowed for corporate-owned pipelines. Dr. Erickson's life-cycle analysis confirms that the overall tax liability associated with investments in both MLP-owned and corporate-owned pipelines are very similar over the life of the investments. The Commission should conclude that its current income tax allowance provides the parity the court required.

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[70] *Id.* at 12, 15.

[71] The Commission's depreciation rates, which return investors' capital over time, reflect the long lives of pipelines.

[72] 827 F.3d at 137.

E. Removing the Existing Tax Allowance for MLP Unitholders' Actual Income Liability Would Have Adverse Financial Consequences on MLPs and Would Increase the Cost of Capital Paid by Ratepayers in Their Rates.

The Commission's existing policy, affirmed in *ExxonMobil*, regarding the income tax allowance requires an MLP to demonstrate the existence of a unitholder's potential or actual tax burden, ensuring that a tax allowance is permitted only where a tax burden exists.[73] MLP unitholders have an actual income tax liability based on the taxable income of the MLP pipeline. Eliminating the income tax allowance for MLPs would frustrate investors' expectations, create market uncertainty, and adversely affect the market for MLP units, which would impede a pipeline's ability to access the capital markets. Such a result would be in direct contravention of the requirements of *Hope* and *United Gas* that the financial integrity of the enterprise be maintained.

Prohibiting MLPs from including an income tax allowance in their costs of service commensurate with the actual tax liability stemming from the MLP pipeline's taxable income would cause a reduction in the MLPs' Earnings Before Interest, Tax, Depreciation, and Amortization (EBITDA). This would reduce the amount of income available to distribute to investors and could force a reduction in cash distributions, creating an incentive for investors to sell their units, which could lead to a fall in unit prices and increase an MLP's cost of capital. While MLPs could turn to debt markets rather than equity markets for funding, the MLPs' ratio

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[73] 111 FERC ¶ 61,139 at P 32.

of debt-to-EBITDA is a key factor that ratings agencies consider when determining credit ratings.[74] MLPs tend to be held to a higher standard (*i.e.*, a lower overall debt-to-EBITDA ratio) with respect to this factor when compared to corporations.[75] The reduction in EBITDA would likely result in an increase in MLPs' debt-to-EBITDA ratio, which could trigger an adverse action by the credit rating agencies. If an MLP's credit rating is lowered, the MLP will be required to pay more for any new debt. A reduction in EBITDA could increase the cost of both debt and equity for MLPs, which would be reflected in future rate cases and make it more difficult for an MLP to attract capital. The result of a change in policy would be a two-fold hit to MLPs: a reduction in revenues and a potential reduced ability to access both equity and debt markets at the same cost as they can today under the certainty of the Commission's existing ratemaking policies.

Precluding an income tax allowance for MLP unitholders could have a destabilizing effect on the financial integrity of pipeline-owning entities that are specifically structured to take advantage of the tax treatment that Congress authorized for MLPs. Such disallowance would further impact the ability of MLPs to maintain their existing credit ratings and their ability to access the capital markets. This result is inconsistent with the Supreme Court's

[74] Aimee Duffy *3 Charts That Explain This MLP's Debt*, Motley Fool (Nov 18, 2013) https://www.fool.com/investing/general/2013/11/18/3-charts-that-explain-this-mlps-debt.aspx "This [debt-to-EBITDA] metric is important, not just because it indicates a partnership's ability to pay its debts, but because credit agencies rely on it when they issue ratings. Typically, Standard & Poor's likes to see the ratio no higher than 4.0 to 4.5 times debt-to-EBITDA for investment grade master limited partnerships. That rating will tie in directly to the interest rates on a partnership's debt, increasing the importance of the ratio.")

[75] *See* Maria Halmo, *Research Spotlight: MLPs Making the Grade, Part 1*, Alerian (June 25, 2015) https://www.alerian.com/research-spotlight-mlps-making-the-grade-part-1/ ("Ratings agencies evaluate the elements of an MLP that are the most important to debt investors, which may not be the same metrics that are important to equity investors."); Aimee Duffy, *Which MLPs Have An Investment Grade Rating?*, *Inquiry Regarding Income Tax Allowances*, Motley Fool (Oct 15, 2013) https://www.fool.com/investing/general/2013/10/15/which-mlps-have-an-investment-grade-rating.aspx ("The business structure of an MLP is inherently more risky than a corporation.")

admonition that the Commission's ratemaking methodology must "assure confidence in the financial integrity of the enterprise so as to maintain credit and attract capital."[76]

F. The MLP Tax Allowance Does Not Result in a Double Recovery of Income Taxes.

The court in *United Airlines* held that "FERC has not provided sufficient justification for its conclusion that there is no double recovery of taxes for partnership pipelines receiving a tax allowance in addition to the discounted cash flow return on equity."[77] INGAA provides empirical support for the Commission's conclusion that the tax allowance, in conjunction with the Commission's DCF model, does not result in a double recovery of income taxes for partnership pipelines.

1. Overview of the Commission's DCF Model

The Commission's DCF model estimates the rate of return required to encourage investment in the regulated entity (by a shareholder for a corporation or a unitholder for an MLP), *i.e.*, the return investors require as compensation for the risk associated with the investment. Under the Commission's cost of service ratemaking approach, the DCF model is used to determine the just and reasonable rate of return on equity that a pipeline may recover in its rates.[78]

The Commission set forth its policy on the DCF model in its 2008 Policy Statement on the Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity (Proxy Group Policy Statement).[79] The Commission explained that it began using the DCF model in the 1980s to comply with *Hope*'s requirement that "the return to the equity owner

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[76] *Hope*, 320 U.S. at 603.
[77] 827 F.3d at 136.
[78] Sullivan Testimony at 15-16.
[79] 123 FERC ¶ 61,048 (2008).

should be commensurate with the return on investments in other enterprises having corresponding risks."[80]

Under the Commission's DCF methodology, the return (r) is calculated by dividing the current dividend (D) by the current stock price (P), and then adding the expected constant growth in dividend to be reflected in capital appreciation (g):

(r = D/P +g)[81]

As explained more fully by Mr. Sullivan, there are several key components to calculating the DCF model for a company under the Commission's formula, including yield (either through dividend or distribution), short-term growth rate (derived from the five-year growth projections of Institutional Broker's Estimate System (IBES) or other comparable sources), and long-term growth (derived from estimated long-term growth in gross domestic product (GDP)). The Commission gives the short-term growth projection two-thirds weight and the long-term growth projection one-third weight.[82] The long-term growth rate for MLPs is reduced by 50% in the Commission's DCF analysis. The DCF formula solves for the rate of return on equity (the "r"), which is then added as a line item in the pipeline's cost of service so that the pipeline can recover its cost of equity in its rates. Income taxes are not a component in the DCF formula. The income tax allowance is a separate line item in the pipeline's cost of service calculated after the return on equity has been calculated.[83]

Because most interstate gas pipelines are wholly-owned subsidiaries that are not individually publicly traded, the Commission uses "a proxy group of publicly traded firms with

[80] *Id.* at P 3 (*citing Hope*, 320 U.S. at 603).
[81] *Id.* at P 5.
[82] Sullivan Testimony at 15-16.
[83] *Id.* at 18-21. Mr. Sullivan also explains how the income tax allowance is calculated.

corresponding risks to set a range of reasonable returns for . . . natural gas pipelines."[84] Determining the representative group of companies is a critical step in applying the DCF model. Developing the appropriate representative group of proxy companies can be challenging given the limited number of companies that satisfy the Commission's eligibility requirements. The Commission requires that each company included in the proxy group satisfy the following three standards: (i) "the company's stock must be publicly traded;" (ii) "the company must be recognized as a natural gas or oil pipeline company and its stock must be recognized and tracked by an investment information service such as Value Line;" and (iii) a preference for pipeline operations constituting a high proportion (*e.g.,* 50 percent or more) of the company's business.[85]

Under the Proxy Group Policy Statement, the Commission permits the inclusion of both MLPs and corporations in proxy groups. The Commission also requires the use of the same DCF analysis for both MLPs and corporations, except that it requires the long-term growth projection for MLPs to be 50 percent of projected growth in GDP because the Commission concluded that MLPs would experience slower long-term growth rates than corporations.[86]

The DCF methodology has been used by the Commission to set pipeline rates since the 1980s. There is no evidence that the methodology results in a double recovery of income taxes for MLPs.

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[84] *Proxy Group Policy Statement*, 126 FERC ¶ 61,048 at P 7.
[85] *Id.* at P 8.
[86] *Id.* at PP 41-42.

2. Empirical data demonstrates that MLPs do not over-recover income taxes or double recover them in the return calculated under the DCF methodology.

Given the broad policy ramifications of this proceeding, the Commission must recognize the limitations of the evidentiary record in *SFPP* that led to the *United Airlines* court's findings. This limited record includes testimony that the DCF methodology already accounts for the amounts attributable to the MLP unitholders' income tax liability and that permitting an additional income tax allowance for that tax liability in the pipeline's cost of service results in a double recovery of the unitholder's income taxes.[87] Testimony submitted in that proceeding also alleged that "DCF rates of return on MLP units *will exceed* the DCF rates of return on corporate shares *because of the higher income tax burden* on MLP units versus corporate shares, *even if both investments have comparable risk for the investor*."[88] Testimony also stated that "pipelines organized as MLPs will be allowed to charge higher tariffs than pipelines organized as corporations even though an MLP's overall income tax burden is less than a corporation's overall income tax burden," and "pipelines will have a very strong tax/regulatory incentive to operate as MLP's [*sic*] rather than as corporations."[89]

INGAA witness Sullivan's testimony puts these arguments into a proper context by providing nearly ten years of data that demonstrates the error of relying on a single snapshot in time to determine whether there are real differences in the DCF returns of MLPs and corporations. Mr. Sullivan reviews the same proxy group considered in the *SFPP* evidentiary

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[87] Opinion No. 511, 134 FERC ¶ 61,121 at P 241 (citing ExxonMobil/BP Brief).

[88] Prepared Cross-Answering Testimony of Thomas Horst on Behalf of ExxonMobil Oil Corp at 7:20-8:2, FERC Docket No. IS08-390-002 (Feb. 20, 2009) (emphasis added) (Horst Cross-Answering Testimony).

[89] Prepared Answering Testimony of Thomas Horst on Behalf of ExxonMobil Corp. at 23:5-11, FERC Docket No. IS08-390-002 (Jan. 26, 2009).

record that relied on data limited to 2008, but updates it to reflect current data and to recognize that certain companies no longer exist as a result of mergers and acquisitions.[90] He also applies a data analysis based on Commission precedent to update the *SFPP* proxy group to exclude companies that would not qualify for inclusion in a proxy group for natural gas pipelines for various reasons, including differences in bond ratings, the companies' lines of businesses, the financial health of their customers, economic conditions in the markets they serve, competition from alternate suppliers, the presence or absence of long-term contracts with shippers, and numerous other factors.[91] These differences were not considered in the 2009 analysis filed in the *SFPP* record, which was based on 2008 data.[92]

Mr. Sullivan's robust analysis using current and historical data disproves the conclusions made in the 2009 analysis using 2008 data. He demonstrates that DCF ROEs for MLP pipelines are not consistently higher than DCF ROEs of corporate pipelines of comparable risk over time.[93] This fact alone undermines the assertion that income taxes are embedded in the DCF model. It also supports the finding that the DCF methodology does not result in the double recovery of income taxes.

Mr. Sullivan's updated proxy group results in a reversal in the differential between MLPs and corporations. His analysis demonstrates that corporations' median ROE is 208 basis

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[90] Sullivan Testimony at 43-45.

[91] *Id.* at 17 and 41-47. Maria Halmo, *Research Spotlight: MLPs Making the Grade, Part 1*, Alerian (June 25, 2015) https://www.alerian.com/research-spotlight-mlps-making-the-grade-part-1/ (stating that "[t]e higher an MLP's credit rating, the cheaper its debt will be. When an MLP has cheaper debt, its cost of capital is lower, so less of the profits from a particular project go toward interest payments to bondholders. If less money is paid to bondholders, more money is available to be paid to equity holders in the form of distribution increases. . . . Rating agencies evaluate the elements of an MLP that are the most important to debt investors, which may not be the same metrics that are important to equity investors.").

[92] Deposition Summary of Thomas Horst at 144:5-147:18, FERC Docket No. IS08-390 (May 14, 2009).

[93] Sullivan Testimony at 48-62.

points (2.08%) higher than the median ROE of MLPs.[94] This comparison undermines any allegations that the DCF ROEs of MLPs are systematically higher than those of corporations and refutes any assertion that the DCF methodology provides MLPs with double recovery of income taxes.[95]

Mr. Sullivan next compares the DCF rates of return on equity of MLPs and corporations to determine whether MLP rates of return on equity generate an over recovery of costs. He compares existing interstate natural gas pipeline MLPs with their corporate affiliates that own a significant percentage of the units of the MLPs and operate the MLP as the general partner. The entities in this analysis are Spectra Energy Corporation and Spectra Energy Partners; TransCanada Corporation and TC Pipelines, LP; EQT Corporation and EQT Midstream Partners; and The Williams Companies, Inc., and Williams Partners L.P. Mr. Sullivan also includes a comparison of Boardwalk Pipeline Partners, LP, (an MLP) with Kinder Morgan Incorporated because both pipeline companies are frequently included in proxy groups in Commission rate proceedings but neither pipeline company has an appropriate affiliate that could be used for comparison purposes.[96] Mr. Sullivan analyzes the DCF rate of return data for each of these ten entities for the period 2008 through January 2017 from the perspective of a potential investor in the interstate natural gas pipeline industry. If there were a double

[94] *Id.* at 46-47. The *SFPP* record included testimony, which used a 2008 proxy group, showing that the median ROE of MLPs exceeded the median ROE of corporations by 3.67 percent. Mr. Sullivan updated the proxy group by removing companies that have been merged or acquired, which reduces the alleged difference by 85 basis points. Removing companies with negative IBES growth rates reduces the difference by an additional 57 basis points. Removing entities ineligible under Commission policy results in a further 433 basis point swing. The overall change from updating the 2008 proxy group is over 575 basis points. Mr. Sullivan's adjustments of that proxy group and use of current data demonstrates that the median ROE of corporations now exceeds the median ROE of MLPs by 2.08 percent. *Id.*

[95] Sullivan Testimony at 53-54.

[96] Kinder Morgan no longer has an affiliated MLP and Boardwalk does not have a corporate affiliate that would meet the Commission's requirements to be included in a proxy group.

recovery or over-recovery of MLP income taxes, the DCF returns of MLP-owned pipelines should be consistently higher than those of corporate-owned pipelines.

Mr. Sullivan demonstrates that the double recovery theory is incorrect. For all time periods examined for these entities, the DCF rates of returns for MLPs have not systematically exceeded the DCF rates of return for corporations.[97] The respective returns of MLPs and corporations were comparable over all time periods. Mr. Sullivan attributes the different results for EQT Midstream Partners and EQT Corporation to the fact that EQT Corporation includes a substantial amount of exploration and production assets and its equity value was affected directly by the decline in commodity prices. Beginning in February 2015, EQT Corporation's IBES growth rate was strongly negative for more than a year. This accounts for its lower rate of return on equity when compared to its MLP affiliate.[98] The difference is not attributed to a perceived inclusion of an income tax allowance in EQT Midstream Partners' regulated rate of return.

Mr. Sullivan explains that other factors, not the MLP income tax allowance, are responsible for variances in the DCF returns of various pipeline entities.[99] Pipelines face an array of business and financial risks associated with competition, natural gas supplies, length of customer contracts, the quality of customer credit, their ability to access capital markets, operational efficiency, pipeline integrity, and regulatory uncertainty. Financial returns are also affected by future throughput, and announced growth projects. Cash flows are affected by unexpected capital costs and operational costs. Competitive market forces and low basis

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[97] Sullivan Testimony at 54-63.

[98] *Id.* at 59.

[99] *Id.* at 62-63.

differentials also affect a pipeline's ability to attract and retain customers. These market forces also dictate that a natural gas pipeline must often discount transportation capacity below the maximum recourse rate.[100] All of these factors affect the value of a pipeline's equity, regardless of how the public entity is structured. Any differences in the historic DCF rates of return between MLPs and corporations are not attributable to the income tax treatment of MLPs, but to a wide array of business risks and opportunities.

Mr. Sullivan's analysis demonstrates that there has been relative parity between the DCF returns on equity for MLPs and corporations. Mr. Sullivan explains that this analysis provides strong empirical support for the conclusion that the income tax allowance does not result in higher DCF ROEs for MLPs over corporations. Mr. Sullivan's analysis demonstrates that the tax allowance does not result in a double recovery and refutes the argument that positive differences in the DCF returns of MLPs as compared to corporations is the result of the purported double recovery. The Commission should provide a tax allowance to MLPs for the tax paid by MLP unitholders that is attributable to the MLP pipeline's taxable income and which is comparable to the tax allowance provided to corporate pipelines.

[100] *Policy for Selective Discounting by Natural Gas Pipeline*, 111 FERC ¶ 61,309, *order denying reh'g*, 113 FERC ¶ 61,173 (2005); *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No. 436, FERC Stats. & Regs., Regs. Preambles 1982-1985 ¶ 30,665, at pp. 31,543-45, *order on reh'g*, Order No. 436-A, FERC Stats. & Regs., Regs. Preambles 1982-1985 ¶ 30,675, at pp. 31,677-80 (1985), *order on reh'g*, Order No. 436-B, FERC Stats. & Regs., Regs. Preambles ¶ 30,688 (1986), *order on reh'g*, Order No. 436-C, 34 FERC ¶61,404 (1986), *order on reh'g*, Order No. 436-D, 34 FERC ¶61,405 (1986), *order on reh'g*, Order No. 436-E, 34 FERC ¶61,403 (1986), *vacated and remanded*, *Associated Gas Distributors v. FERC)*, 824 F.2d 981, 1010-12 (D. C. Cir. 1987).

G. Neither MLP Distribution Yields nor IBES Growth Rates Show Evidence of a Double Recovery of Income Taxes.

1. The Distribution Yields of MLP Pipelines Are Not Consistently Greater Than the Dividend Yields of Corporate Pipelines.

The *United Airlines* court stated that "a partner in a partnership pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline, at least in the short-term before adjustments can occur in the investment market."[101] The court found that this purported higher after-tax return could potentially be due to a "double recovery" by MLPs of their income tax allowance: "[W]hen one considers the after-tax returns to partners or shareholders, the necessary conclusion is that partners in a partnership pipeline receive a windfall compared to shareholders in a corporate pipeline, a point which FERC concedes."[102]

The record that the Commission and D.C. Circuit reviewed in *SFPP* and *United Airlines* addressed market conditions in 2008. The market data subsequent to 2008 demonstrates that the purported double recovery that the court was concerned about does not exist, and that MLP distributions do not, as a rule, consistently exceed corporate dividends. MLPs have not over the last nine years consistently earned a greater return on equity than corporations. Mr. Sullivan compared MLP distribution yields with corporate dividend yields for twenty-three entities that own significant pipeline assets for the period August 2007 to January 2017.[103] Mr. Sullivan explains that these yields "have been in nearly constant flux since 2008," and that "MLPs' distribution yields have not been consistently higher than the

[101] 827 F.3d at 136.
[102] *Id.* at 137.
[103] Sullivan Testimony at 64.

corporations' dividend yields."[104] Mr. Sullivan demonstrates that the data over a nine-year period does not support a claim that MLPs have a consistently higher yield than corporations.

Mr. Sullivan demonstrates that corporate dividend yields frequently exceed MLP distribution yields and that various MLPs' distribution yields have fallen below corporations' dividend yields at many points over the past nine years.[105] Mr. Sullivan explains that the "lack of consistently higher yields for MLPs demonstrates that MLPs are not receiving the additional income that the Shipper Parties attribute to the difference in tax burden and a purported double-collection of income taxes."[106]

Mr. Sullivan further explains that a number of other market factors, such as relative risk and growth expectations, more likely accounts for differences in yields between various pipeline entities.[107] For example, Mr. Sullivan explains that, in 2008, the relatively higher increased distribution yields of MLPs were likely caused by increased growth expectations of MLP pipelines relative to corporate pipelines. The data from 2008 used in the SFPP proceeding is notable because it reflects a period of historic expansion of the U.S. pipeline system. In 2009, the U.S. Energy Information Administration stated:

> Robust construction of natural gas infrastructure in 2008 resulted in the completion of 84 pipeline projects in the lower 48 States, adding close to 4,000 miles of natural gas pipeline. These completions of new natural gas pipelines and expansions of existing pipelines in the United States represented the greatest amount of pipeline construction activity in more than 10 years.
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> . . . .
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> The number of proposed pipeline projects suggests that construction activity will remain strong over the next several years. For example, the 78 proposed projects scheduled for completion in 2009 indicate that the second

[104] *Id.* at 66.

[105] *Id.* at 65-66.

[106] *Id.* at 67.

[107] *Id.* at 67-68.

highest level of capacity additions in the last decade could be completed during the year.[108]

Mr. Sullivan explains that MLPs were responsible for a relatively large share of this historic expansion, which likely was responsible for the higher earnings growth and increased MLP distributions relative to corporations at that time.[109]

Fast forward to present, and the market view of MLPs has changed, setting MLPs in an entirely different light. Mr. Sullivan explains that, in recent years, low oil and natural gas prices have squeezed MLP profits and put a greater re-contracting risk on those pipelines that were part of the 2008 build out. Pipelines also face risk because lower energy prices have impacted the credit risk of certain pipeline customers involved in oil and gas production. Mr. Sullivan states that these factors, not the purported double recovery of income taxes, are likely the causes of variation in the distribution yields of various MLP pipelines.

Any conclusion that the difference between MLP distribution yields and corporate divided yields is primarily due to tax policy ignores that other factors, apart from an income tax allowance, are likely responsible for changes in MLP distribution yield. Mr. Sullivan concludes that "[t]he fact that the relative yields of MLPs and corporations have changed substantially since 2008 despite no change in the Commission's income tax allowance helps to demonstrate that the income tax allowance is not a significant factor producing variations in MLP distribution yields and corporate dividend yields."[110]

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[108] U.S. Energy Information Administration, Expansion of the U.S. Natural Gas Pipeline Network: Additions in 2008 and Projects through 2011 at 1 (Sept. 2009), available at https://www.eia.gov/pub/oil_gas/natural_gas/feature_articles/2009/pipelinenetwork/pipelinenetwork.pdf.

[109] Sullivan Testimony at 67.

[110] *Id.* at 68.

2. The IBES Growth Rates of MLP Pipelines Are Not Consistently Greater Than the Dividend Yields of Corporate Pipelines.

Mr. Sullivan demonstrates that MLP IBES growth rates, which are factored into the Commission's analysis for projecting dividend growth of companies in the Proxy Group, also do not reflect an income tax. Mr. Sullivan demonstrates that, for the 23 entities that he analyzed, IBES growth rates for MLPs and corporations have been comparable throughout the period January 2008 and January 2017. With few exceptions, his data shows that IBES growth rates remained within a relatively narrow band for most of the companies and that IBES growth rates for MLPs were not consistently higher than for corporations. IBES growth rates for both MLPs and corporations fluctuated constantly, often with MLP IBES growth rates being *lower* than those of corporations.[111]

Like the data showing that DCF rates of returns and dividend and distribution yields are comparable, IBES growth rate data shows that IBES growth rates for MLPs and corporations are comparable and nothing suggests that IBES growth rates for MLPs produce higher returns that cause investor analysts to favor MLPs. Mr. Sullivan concludes that "there is nothing in the IBES growth rate chart that would indicate that MLPs receive an over recovery associated with their income tax allowance."[112] The data provides no support for any contention that IBES growth rates reflect income taxes or that an income tax allowance causes MLPs to over-recover income tax costs.

The fact that distribution yields for MLPs are not consistently higher than dividend yields for corporations and that MLP IBES growth rates are not consistently higher than Corporation IBES growth rates demonstrates that distribution yields and IBES growth rates do

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[111] *Id.* at 68-69.
[112] *Id.* at 68.

not reflect income taxes. Neither results in a double recovery of income taxes for MLPs and neither provides support for modifying the Commission's current income tax allowance policy.

IV. CONCLUSION

The Commission should continue to allow MLP pipelines to recover in their jurisdictional rates an income tax allowance based on the income tax liabilities of MLP unitholders that are attributable to the MLP's taxable income from providing jurisdictional pipeline services. The tax allowance is comparable to the tax allowance that the Commission permits on the taxable income of corporate-owned pipelines and is necessary to provide parity between the equity owners of MLP and corporate pipelines.

Respectfully submitted,

Joan Dreskin
General Counsel
Interstate Natural Gas Association of America
20 F Street, NW Suite 450
Washington, DC 20002
202-216-5928
jdreskin@ingaa.org

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