UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

COMMENTS OF THE ASSOCIATION OF OIL PIPE LINES

The Association of Oil Pipe Lines ("AOPL") hereby submits its initial comments in response to the *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Cost*, 157 FERC ¶ 61,210 (2016) ("NOI"). AOPL is a nonprofit trade association that represents the interests of oil pipelines regulated by the Federal Energy Regulatory Commission ("FERC" or "Commission"). AOPL members transport approximately 96 percent of the crude oil and refined petroleum products shipped through pipelines in the United States. AOPL's comments are supported by Dr. John Graham, the D. Richard Mead professor of finance at the Fuqua School of Business at Duke University. Dr. Graham's expertise includes corporate finance, taxes and cost-of-capital issues.

EXECUTIVE SUMMARY

The NOI was issued in response to the decision of the United States Court of Appeals for the District of Columbia Circuit in *United Airlines v. FERC*, 827 F.3d 122 (D.C. Cir. 2016). The petitioners in *United Airlines* argued that the discounted cash flow ("DCF") rate of return methodology the Commission uses to set cost-of-service rates provides master limited partnership ("MLP") pipeline investors a return on equity sufficient to pay their taxes, and that giving MLP-owned pipelines an income tax allowance in addition to the pre-investor-tax rate of return constitutes "double recovery" of income taxes. The court concluded that the Commission 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" and remanded the issue to the Commission for further explanation. *Id*. at 136-37. The NOI seeks comments regarding the "concerns presented by *United Airlines*" with respect to any potential double-recovery of income tax costs as well as "the practical application" of any proposals made by commenters. NOI at PP 18, 20.

The Current Income Tax and Rate of Return Policies Should be Maintained. The Commission's current income tax allowance and rate of return policies are well-considered and should be maintained. The Commission's income tax allowance policy is consistent with established legal precedent regarding the recovery of income tax costs and has been upheld by the D.C. Circuit. *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945 (D.C. Cir. 2007) ("*ExxonMobil*"). The Commission's income tax allowance policy appropriately recognizes that income taxes are a cost of operating a pipeline that regulated entities are entitled to recover regardless of whether they are structured as a corporation or a partnership. *United Airlines* explicitly did not overturn the income tax allowance policy that was previously upheld by the D.C. Circuit, and there is no valid basis to depart from it here. The provision of regulated services by both MLP pipelines and corporate pipelines generates liability for income taxes and there is no reason to assume that one ownership form ultimately pays more or less tax than the other.

The Commission's rate of return policy is also reasonable both on its own and in conjunction with the income tax allowance policy, and does not result in any impermissible "double-recovery" of income taxes for MLP pipelines. On the contrary, as the comments of the Interstate Natural Gas Association of America ("INGAA") demonstrate, empirical data comparing the market-based returns of comparable natural gas pipelines owned by both MLPs and corporations shows that the market-based returns observed for MLP pipelines are not systematically higher than those for corporate pipelines. Further, the analysis submitted on February 6 in this proceeding by Dr. Thomas Horst is inconsistent with the study he conducted on behalf of shippers in the Commission proceeding under review in *United Airlines*, and produces the opposite results if certain of his hypothetical assumptions are replaced by other reasonable assumptions. There is thus no record evidence to substantiate the alleged double-recovery concerns.

When the Commission's existing rate of return and income tax allowance policies are used, they result in rates that are roughly equivalent for MLP pipelines and corporate pipelines. Theoretical concerns regarding the pre-tax nature of the MLP return, which are not supported by market reality, should not be a basis for departing from the Commission's current policies particularly where there has been no showing of any practical difference in the resulting rates for corporate and MLP pipelines and given the important policy considerations discussed below.

Nor is there any viable alternative to the Commission's current policies. As the NOI seems to recognize, an approach of eliminating the income tax allowance for tax pass-through entities and relying on the ROE to recover investor-level taxes would fail to ensure that the ROE reflects appropriate tax costs, including for both tax pass-through and corporation-owned entities. Further, with respect to an approach that adjusts the Commission's DCF methodology, it is entirely unclear how it would even be possible to reasonably adjust the market-based DCF return to remove all investor-level tax costs, as the degree to which tax considerations affect the price relative to the numerous other considerations that investors take into account is impossible to determine and likely varies as events unfold in the market. Ultimately, any adjustment to the Commission's current approach would be arbitrary and impractical, and would inevitably bog down the rate-setting process with unwieldy issues to resolve.

Equality of Returns Is Not Required by Hope. The Supreme Court has held that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks [and] should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *see also Bluefield Water Works & Improvement Co. v. Public Service Commission*, 262 U.S. 679, 693 (1923). But that does not mean the Commission must ensure that all pipeline companies achieve precisely the same return, let alone that all investors in regulated assets achieve the same return. The Interstate Commerce Act does not require the Commission to equalize achieved returns, since the return that each pipeline and each investor ultimately realizes will depend on its own individual circumstances. The issue is how to establish just and reasonable rates that provide a reasonable opportunity for regulated entities to recover their legitimate costs, including income tax costs and a reasonable rate of return on equity. *See City of Charlottesville v. FERC*, 774 F.2d 1205, 1207 (D.C. Cir. 1985).

Important Policy Considerations Support Maintaining the Current Approach. The Commission has the obligation to consider relevant policy considerations in addition to strict cost-of-service ratemaking concepts. *See, e.g., Permian Basin Area Rate Cases,* 390 U.S. 747, 790-791 (1968). As the Supreme Court has held, the requirements of *Hope* regarding risk-appropriate returns that are sufficient to attract capital are pertinent but "scarcely exhaust the relevant considerations." *Id.* at 791. Ratemaking requires various pragmatic adjustments and the weighing of multiple policy considerations. Thus, the Commission "cannot confine its inquiries … to the computation of costs of service," but is "instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress." *Id.* In this case, there are several policy reasons that support maintaining the current rate of return and income tax allowance policies.

First, it is important to maintain the current policies in order to treat all regulated entities fairly regardless of ownership structure and not discourage the use of the tax pass-through structure that is widely used throughout the energy sector, including by oil and natural gas pipelines and electric transmission utilities, to meet our nation's energy infrastructure needs. Indeed, the Commission has recognized previously the substantial amount of investment affected by the income tax allowance policy. Energy infrastructure projects are generally large, capital-intensive investments. During the past ten years (from 2007-2016), MLPs have invested approximately $177 billion in capital in energy infrastructure and are expected to invest another $60 billion through 2020. Indeed, AOPL members, many of whom are MLPs, invested more than $20 billion in new transmission projects during 2014 and 2015 alone. Such major infrastructure projects involve considerable risks that may be beyond the ability or risk-tolerance of a single corporate entity. As the Commission has explained, MLPs and other types of tax pass-through entities permit the sharing of risk and the raising of necessary capital to fund these much-needed projects. While the oil pipeline industry operates under a combination of indexed rates, settlement rates, market-based rates and cost-of-service rates, *see* 18 C.F.R. §§ 342.2, 342.3 and 342.4 (2016), cost-based rates often form the backdrop against which oil pipeline rates are negotiated for new projects and otherwise, since shippers may require new rates, such as "uncommitted" rates for new projects, to be justified on a cost-of-service basis, and may also challenge existing rates based on costs in appropriate circumstances. 18 C.F.R. §§ 342.2, 342.3, 342.4(a), and 343.2 (2016). It is therefore important that the Commission maintain appropriate policies for the recovery of pipeline costs, including income taxes and a reasonable rate of return, as a change in policy could have material adverse impacts on investment in oil pipeline infrastructure, particularly the substantial infrastructure owned by the numerous MLP oil pipelines.

Second, and relatedly, removing the income tax allowance for MLPs would be contrary to Congress's policy of facilitating investment in oil pipeline infrastructure by establishing MLPs as tax-efficient means to raise capital. The Commission has the discretion to structure its ratemaking policies to align with tax incentives created by Congress, just as the Commission has consistently done for accelerated depreciation and other investment incentives for corporate pipelines. In light of the lack of any showing to support the "double recovery" concerns raised by shippers, and the Commission's longstanding policy of encouraging investment in needed energy infrastructure, the Commission should continue to exercise its ratemaking discretion consistent with Congressional policy.

Third, in addition to the chilling effect on investment, abandoning the Commission's current policies would likely have serious real-world consequences, including significant market instability, credit downgrades, higher debt costs and an increased risk of bankruptcy for MLP pipelines. The partial removal of the income tax allowance under the Commission's former *Lakehead* policy led to an immediate significant drop in unit prices for MLP pipelines (*e.g.*, a 17% decline in price in one day for Lakehead pipeline), and the complete removal of the income tax allowance would likely cause an even greater drop in MLP prices and significant market instability. Given the requirement "to assure confidence in the financial integrity" of regulated entities, *Hope*, 320 U.S. at 603, and the obligation to consider all relevant policy considerations, *Permian Basin*, 390 U.S. at 790-791, the Commission should not depart from its current policies if the change could impair the ability of pipelines to maintain their credit and attract capital, which would ultimately work to the detriment of shippers and consumers as well as investors. Moreover, these increased risks would present significant challenges to oil pipelines at a time when substantial new investment is needed and when significant additional obligations regarding pipeline integrity[1] and regulatory uncertainties (*e.g.*, regarding indexing and annual reporting requirements) are facing the industry.

Fourth, the Commission's current policies are necessary to ensure that the tariff rates of corporate and MLP pipelines do not diverge significantly for similar services and that MLPs are not put at a competitive disadvantage simply based on their ownership form. The Commission has previously recognized the importance of comparable rate treatment for MLP pipelines and corporate pipelines and the concerns with creating rate incongruity between the two organizational forms. In this regard, removing the income tax allowance for MLPs, either directly or through an adjustment in the ROE, would put MLPs at a permanent competitive disadvantage against corporate pipelines, because the cost-of-service tariff rates that MLP pipelines would be permitted to charge would be capped at levels materially below those of corporate pipelines for the same services. In addition, given that cost-based rates often form the backdrop against which oil pipeline rates are negotiated for new projects and otherwise, a change in the level of cost-of-service rates for pipelines with one type of ownership structure could have far reaching

[1] AOPL members spent more than $4 billion on pipeline integrity during 2014 and 2015. *See* American Petroleum Inst. & Ass'n of Oil Pipe Lines, *Annual Liquids Pipeline Safety Excellence Performance Report and Strategic Plan* at 13 (2016), available at http://www.aopl.org/wp-content/uploads/2016/08/2016-API-AOPL-Annual-Pipeline-Safety-Excellence-Performance-Report-Strategic-Plan.pdf; American Petroleum Inst. & Ass'n of Oil Pipe Lines, *Annual Liquids Pipeline Safety Excellence Performance Report and Strategic Plan* (2017) (forthcoming).

impacts on other pipelines, including pipelines with other ownership structures and pipelines that employ other ratemaking mechanisms that have been relied upon when making infrastructure investments.

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DISCUSSION

I. The Commission Has the Legal Authority to Maintain its Current Policy on Remand.

In *United Airlines*, the D.C. Circuit held that the Commission 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," and remanded the issue to the Commission. 827 F.3d at 136, 137. It is a basic principle of administrative law that when an agency action is found to be arbitrary and capricious because of a failure to provide adequate reasons for its decision, the agency on remand may adopt a new policy or retain the current policy provided the agency supplies a reasoned explanation for its actions. *See SEC v. Chenery Corp.*, 332 U.S. 194, 200-201 (1947); *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 700 (D.C. Cir. 2007) (on remand, the Commission may "return to this court with just the same arrangements it has chosen, albeit explained and justified [differently]"); *see also FPC v. Idaho Power Co.*, 344 U.S. 17, 20 (1952) ("the function of [a] reviewing court ends when the law is laid bare. At that point the matter once more goes to the [agency] for reconsideration").

For example, in *Chenery* the Supreme Court upheld a decision of the U.S. Securities and Exchange Commission ("SEC") that the Court had previously held could not be sustained based on the agency's original rationale. On remand, the SEC "reexamined the problem, recast its rationale and reached the same result." *Id.* at 196. The Court made clear that it was permissible for the agency to retain its prior policy, because when an agency policy is set aside as "unsupportable for the reasons supplied by that agency," the agency has the authority and indeed *the duty* to "deal with the problem afresh" on remand. *Id.* at 200-01. If a fresh look at the problem results in an adequately-justified decision to maintain the original policy, the Court will uphold the agency action. As the Court explained, where an agency decision is the "product of administrative experience, appreciation of the complexities of the problem, realization of the statutory policies, and responsible treatment of the uncontested facts," it is "an allowable judgment which we cannot disturb" even if it is the same policy that was previously rejected for lack of reasoned decision making. *Id.* at 209.

II. The Commission's Income Tax Allowance Policy Has Been Upheld by the D.C. Circuit and Should Not Be Disturbed.

The Commission's established income tax allowance policy is the result of careful consideration of the applicable legal and policy issues. The Commission's policy is consistent with established legal precedent regarding the recovery of income tax costs and was upheld by the D.C. Circuit in *ExxonMobil*. The Commission's established income tax allowance approach also furthers important Commission goals such as ensuring comparability in ratemaking between MLP pipelines and corporate pipelines, and encouraging investment in pipeline infrastructure through the use of the MLP organizational form. In short, the Commission's income tax allowance policy is reasonable and there is no valid basis to depart from it.

A. The Commission's Income Tax Allowance Policy Is Well-Reasoned and the D.C. Circuit Has Upheld It.

Historically, the Commission provided all regulated entities with an income tax allowance, regardless of whether the entity was owned by a corporation or a partnership. *See Inquiry Regarding Income Tax Allowances*, 111 FERC ¶ 61,139, at P 2 (2005) ("ITA Policy Statement"). In 1995, the Commission established its "Lakehead" policy, under which oil pipelines structured as corporations continued to receive a full income tax allowance, but pipelines structured as partnerships received an income tax allowance only to the extent they were owned by corporations. *Lakehead Pipe Line Co.*, 71 FERC ¶ 61,338 (1995), *reh'g denied*, 75 FERC ¶ 61,181 (1996). In *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004), the D.C. Circuit held that the Commission had not justified its disparate treatment of individual and corporate partners under the *Lakehead* policy and remanded to the Commission for further consideration.

In response to the remand, the Commission determined that it should return to its pre-*Lakehead* policy of permitting a full income tax allowance for all regulated oil and gas pipelines, including partnership pipelines, provided the entity has an "actual or potential income tax liability to be paid on [income from the regulated assets]." ITA Policy Statement, 111 FERC ¶ 61,139, at P 32. The Commission explained that its *Lakehead* policy "mistakenly focused on who pays the taxes rather than on the more fundamental cost allocation principle of what costs, including tax costs, are attributable to regulated service, and therefore properly includable in a regulated cost of service." *Id.* at P 33. The Commission further explained that "[w]hile the pass-through entity does not itself pay income taxes, the owners of a pass-through entity pay income taxes on the utility income *generated* by the assets they own." *Id.* (emphasis added). The Commission made clear that "the taxes paid by 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." *Id.*

The Commission further explained that permitting a full income tax allowance for both corporations and partnerships was supported by important policy concerns, including that it "allows rate recovery of the income tax liability attributable to regulated utility income, facilitates investment in public utility assets, and assures just and reasonable rates." *Id.* at P 1. The Commission cited the importance of maintaining comparable treatment of MLP pipelines and corporate pipelines with respect to ratemaking and observed the incongruity in denying an income tax allowance to a partnership pipeline when the same assets held by a corporation would be entitled to an income tax allowance. *Id.* at PP 33-36, 38 & n.33.

The Commission found that the MLP form was important for encouraging investment in energy infrastructure and held that "termination of the allowance would clearly act as a disincentive for the use of the partnership format." *Id.* at PP 26, 30, 36. The Commission noted the "substantial amount of existing investment" affected by the income tax allowance policy. *Id.* at P 33 n.30. For example, the record in that proceeding indicated that "75 percent of $14.4 billion in energy infrastructure invested for the years 2001 through 2003 [was] in pass-through entities," and that the market capitalization of MLP pipelines was approximately $38.5 billion at the time of the policy statement. *Id.* Since then, those numbers have only increased. As the Master Limited Partnership Association notes in its comments, during the past ten years (from 2007-2016), MLPs have invested approximately $177 billion in capital in energy infrastructure and are expected to invest another $60 billion through 2020. AOPL members, many of whom are MLPs, invested more than $20 billion in new transmission projects during 2014 and 2015 alone. Moreover, the market capitalization of MLPs involved in oil and gas pipeline operations has risen to approximately $350 billion as of the end of 2016. The Commission noted that the use of the MLP form helped to facilitate large infrastructure projects in part because it permits risk sharing among various parties, including municipalities and public power entities that may be prohibited from owning corporate stock, and permits "greater flexibility in making contributions in-kind" and distributing earnings. *Id.* at PP 29, 36.[2] The Commission also cited Congress's intent to encourage investment through the use of the MLP form. *Id.*

On judicial review, the D.C. Circuit upheld the Commission's income tax allowance policy in *ExxonMobil*.[3] The court held that the Commission had "resolved the principal defect of the *Lakehead* policy, which was the inadequately explained differential treatment of the tax liability of individual and corporate partners." *Id.* at 951. The court concluded that the Commission's "explanation in support of this policy choice is reasonable" and was not inconsistent with *BP West Coast*. *Id.*

As the court explained, "regulated entities are entitled to recover all 'proper' costs from their ratepayers." *ExxonMobil*, 487 F.3d at 953 (citing *City of Charlottesville*, 774 F.2d at 1207). The court observed that "[o]bviously, 'proper' is not a self-defining term, and the Commission thus has broad discretion to determine which costs may be recovered through a pipeline's rates." *Id.* The court concluded that "FERC has reasonably explained why income taxes paid on partnership income are properly

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[2] The Commission noted that investment by municipalities and other tax exempt entities in MLP pipelines would tend to reduce the costs for ratepayers by lowering the weighted marginal tax rates used to calculate the income tax allowance. ITA Policy Statement at P 37. The comments of American Transmission Company LLC ("ATC") in this proceeding further discuss how the partnership-type model permits investment by tax exempt entities and other benefits of this organizational form. ATC Comments at 11, 13-17.

[3] The policy came before the court on review of *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005), which applied that policy in the context of a litigated proceeding

allocated to the regulated entity for ratemaking purposes, and the shipper petitioners have offered no compelling reason to second-guess the agency's policy choices." *Id.*

In holding that the Commission had "weigh[ed] the relevant policy concerns," the court specifically relied on the Commission's findings that termination of the income tax allowance would create a disincentive for regulated entities to use the partnership form and that pipelines "operating as limited partnerships should receive a full income tax allowance in order to maintain parity with pipelines that operate as corporations." *Id.* at 950, 953. Ultimately, the court stated it would "defer to FERC's expert judgment about the best way to equalize after-tax returns for partnerships and corporations," explaining that "policy choices about ratemaking *are the responsibility of the Commission – not this Court.*" *Id*. at 953 (emphasis added).

In *United Airlines*, the D.C. Circuit again reviewed the income tax allowance issue (once more in the context of a challenge to SFPP's rates, *see SFPP, L.P.*, 134 FERC ¶ 61,121 (2011) ("Opinion No. 511"), *order on reh'g*, 137 FERC ¶ 61,220 (2011) ("Opinion No. 511-A")), and remanded the case to the Commission for further consideration. 827 F.3d at 136-37. The *United Airlines* court made clear, however, that it was not overturning *ExxonMobil*, and was "unable to do [so] in any case absent an en banc decision from the Court." *United Airlines*, 827 F.3d at 137. Instead, the court reaffirmed its holding in *ExxonMobil* that the Commission "has a justifiable basis for its attribution of partner taxes to the partnership pipeline," and that the Commission has "adequately explained why partner taxes could be considered a pipeline cost." *Id.* at 135-137. The court concluded that *ExxonMobil* continues to stand for the proposition that "to the extent FERC has a reasoned basis for granting a tax allowance to partnership pipelines, it may do so." *Id.* at 135.

Given the reasoned basis for the policy as affirmed on judicial review, there is no valid justification for changing the Commission's existing income tax allowance policy. Under longstanding precedent, income taxes are a legitimate cost item that regulated entities are permitted to recover in their cost of service. *See City of Charlottesville,* 774 F.2d at 1207 ("cost-of-service ratemaking principles" require "rates yielding sufficient revenue to cover all proper costs, including federal income taxes, plus a specified return on invested capital").

B. The Federal Income Tax Regime Applicable to Corporations and MLPs Supports Continuation of the Commission's Current Income Tax Allowance Policy.

All oil pipelines, whether structured as corporations or partnerships, generate tax liability on the income earned from providing regulated services. As the Commission has explained, "[w]hile the pass-through entity does not itself pay income taxes, the owners of a pass-through entity pay income taxes on the utility income *generated* by the assets they own." ITA Policy Statement, 111 FERC ¶ 61,139, at P 33 (emphasis added). Thus, as the Commission properly observed, "the taxes paid by 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." *Id*. In other words, for purposes of the income tax allowance, the "jurisdictional partnership together with its partners … are jointly treated as the public utility entity." Opinion No. 511, 134 FERC ¶ 61,121, at P 228.

Dr. Graham discusses the key tax characteristics of corporate pipelines and MLP pipelines in his declaration. As Dr. Graham explains, pipelines "structured as C corporations and MLPs both generate substantial income," and "federal income tax is automatically imposed on such income, regardless of C corporation or MLP form." Graham Decl. at 7.[4]

"For a C corporation pipeline, federal income tax is automatically imposed on its income … in the year in which it is earned." *Id.* at 3 (citing Internal Revenue Code ("IRC") Section 11). To the extent the C corporation pays a cash distribution to its shareholders (*e.g.*, a dividend), the shareholders are then generally subject to federal income tax on the distribution. *Id.* at 4 (citing IRC Sections 1(h)(11), 301, 316). Currently, the top federal income tax rate for corporate pipelines is 35 percent. *Id.* at 5 (citing IRC Section 11). The top federal income tax rate for individual investors is generally 23.8 percent on dividend distributions and long-term capital gains from the sale of corporate shares (3.8 percent of this tax reflects the so-called Medicare surtax enacted

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[4] As Dr. Graham notes, "[a]ny discussion of the income tax consequences to pipelines and their investors would not be complete without mentioning that significant changes to the [Internal Revenue Code] are currently under consideration by Congress and the President." Graham Decl. at 8. The uncertainty regarding the applicable statutory tax regimes suggests the Commission should be cautious about making any changes to existing policy that may need to be undone if the current tax law changes.

in conjunction with the 2010 Affordable Care Act). *Id.* at 5 (citing IRC Sections 1(h), 1411).[5]

For MLP pipelines, federal income tax is also "automatically imposed on the income from an MLP pipeline … in the year in which it is earned." Graham Decl. at 5. However, "unlike C corporation pipelines, such tax is imposed directly on the investors … and the top federal income tax rate imposed on such income is significantly higher than the corporate income tax rate." *Id.* (citing IRC Sections 1, 701, 702). "Currently, the top federal income tax rate on ordinary income for individual MLP investors is 43.4% (the top federal income tax rate of 39.6% plus the 3.8% so-called Medicare surtax)." *Id.* at 5-6 (citing IRC Sections 1, 1411).

MLP pipeline income "is generally allocated proportionately among all investors, and such 'distributive share' of MLP pipeline income is automatically subject to federal income tax in the hands of the investors." *Id*. at 5 (citing IRC Sections 701, 702, 704). The "distributive share of income is generally characterized at the level of the MLP pipeline as ordinary business income (rather than capital gain), and such character carries over into the hands of the investor." *Id.* (citing IRC Section 702). Crucially, as Dr. Graham explains, the MLP pipeline investors are required to pay tax on their distributive

[5] The Commission's income tax allowance is intended to recover the costs associated only with the "first tier" income tax (*i.e.*, the tax imposed on the income of the corporation in the year in which it is earned rather than the taxes that shareholders pay on dividends or capital gains). ITA Policy Statement at PP 35-40. As the Commission has observed, and as discussed below, MLP unitholders are also liable for these "first tier" income taxes. *See also id.* at PP 38-40.

shares of partnership income "regardless of whether any [cash] distributions are made to such investors." *Id.* (citing IRC Sections 1, 701, 702); *see also* NOI at P 6 n.8. Thus, as the court explained in *ExxonMobil*, the argument that the income taxes generated by MLP pipelines are "phantom taxes … cannot ultimately prevail," since the income taxes are "real" and the partners are required to pay them "even if they do not receive a cash distribution." 487 F.3d at 954.[6]

As Dr. Graham explains, "[i]n some cases, the C corporation pipeline form results in a higher federal income tax burden than the MLP pipeline form." Graham Decl. at 7. "In other cases, the MLP pipeline form results in a higher federal income tax burden that the C corporation pipeline form." *Id.* "The relative federal income tax burdens depends on various conditions (some in the control of the pipeline entity and some not), including (i) the frequency and magnitude of distributions, (ii) an investor's holding period for its relevant equity interest, (iii) an investor's broader tax landscape (such as loss carryovers, non-US person status, and non-individual status), (iv) a pipeline entity's broader tax landscape, and (v) statutory tax regimes (not just tax rates) for individuals, C corporations

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[6] Although MLP investors undoubtedly hope to receive cash distributions that exceed the level of their income tax liability, there is no guarantee that this will be the case. For example, generation of non-cash taxable income in a partnership may result in a tax liability to the partners without a sufficient distribution of cash to pay the tax liability. One such circumstance relates to cancellation of debt income, which generally occurs when debt is restructured in bankruptcy, but can also result from a significant modification of partnership debt (*e.g.*, a large extension of the maturity or change in the interest rate). The recent challenges faced by the oil industry as a result of the dramatic decline in the price of oil have only increased the likelihood of this type of event occurring.

and MLPs." *Id.* at 7. For example, while deductions such as depreciation may substantially offset or eliminate taxable income for an MLP investor in a given year, when the units are sold the portion of the gain attributable to prior depreciation reductions is "recaptured" and, instead of being taxed as a capital gain, is taxed at the higher ordinary income tax rates. *See* Graham Decl. at 6; *see also* NOI at PP 6-7. Whether an investor sells the corporate shares or MLP units or holds them until death will also likely affect the overall tax liability, since at death the tax basis of the investment is reset to fair market value (*i.e.*, is "stepped up"), thus eliminating any un-taxed gain. *See* Graham Decl. at 4-5, and 7. Thus, as Dr. Graham explains, "[g]iven the multiple variables that drive the manner in which these factors are taken into account and apply to a given pipeline, there is no reasonable basis to assume that one organizational form will necessarily incur higher taxes than the other." *Id.* at 7-8.

In short, the Commission's existing policy recognizes that income taxes are a cost that regulated entities are entitled to recover and that both MLP pipelines and corporate pipelines generate liability for income taxes. Since there is no basis to assume that one form will necessarily result in the payment of more income taxes than the other, the Commission's policy of providing an income tax allowance for all regulated entities with an actual or potential income tax liability is reasonable.

III. The Commission's ROE Policy is Reasonable and Does Not Result in Any Impermissible "Double Recovery" in Conjunction With its Existing Income Tax Allowance Policy.

The Commission's ROE policy reasonably relies on a proxy group of publicly-traded MLP pipelines to establish ROEs for the broad range of oil pipelines. While the

Court in *United Airlines* observed that the DCF return derived from the MLP proxy group is a pre-investor tax return, that does not result in any impermissible "double recovery" of income tax costs.

A. The Commission has reasonably concluded that it is appropriate to base the returns for all oil pipelines on a proxy group consisting of MLPs.

The Supreme Court has held that "the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks [and] should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *see also Bluefield Water Works & Improvement Co. v. Public Service Commission*, 262 U.S. 679, 693 (1923). The D.C. Circuit has also held that the members of the proxy group used to establish the appropriate rate of return must be "comparable" in risk to the regulated entity whose rates are being set. *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 700 (D.C. Cir. 2007).

Consistent with those standards, the Commission calculates the ROEs for oil and gas pipelines and electric utilities using the DCF method that determines the appropriate rate of return investors expect based on a proxy group of comparable publicly-traded companies. *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, at P 2 (2008) ("ROE Policy Statement"); *Coakley v. Bangor Hydro-Electric Company*, 147 FERC ¶ 61,234 (2014) (determining that electric utilities should use the same DCF methodology as oil and gas pipelines). With respect to the proxy group for oil pipelines, the ROE Policy Statement concluded that it is appropriate to base the returns for all oil pipelines on a proxy group consisting of publicly-traded MLP oil pipelines. ROE Policy Statement at PP 2, 47-53. The Commission explained that "MLPs are the only publicly traded ownership form for oil pipelines and are the most representative group for determining the equity cost of capital for oil pipelines." *Id*. at P 49. The Commission concluded that a proxy group of MLP pipelines generated ROEs that were reasonable for all oil pipelines and were unlikely to be significantly different from the returns that corporate pipelines would generate. *Id*. at PP 57-66 and Appendix B.

In reaching that conclusion, the Commission rejected various claims that the ROEs of MLP pipelines were likely to be higher than the ROEs of corporate pipelines. *Id*. at P 52. The Commission recognized that "there are significant differences in the cash flows to investors and growth rates of corporations and MLPs," but nevertheless concluded that it was appropriate to use the MLP proxy group for all oil pipelines. *Id*.

The use of the MLP proxy group for all oil pipelines is entirely appropriate. *Hope* requires returns to be "*commensurate* with the return on investments in other enterprises having *corresponding* risks." 320 U.S. at 603 (emphasis added). *Petal* requires that the risks be "comparable." 496 F.3d at 699-700. Neither requires absolute equality of risks or returns.

As the Commission has observed in accepting the use of MLP pipelines in a natural gas rate case, while the proxy group must contain firms with risks that are "comparable" to that of the regulated entity, it is "unlikely there will be complete congruence among the characteristics of all proxy group members" and the regulated entity whose rates are at issue. *Kern River Gas Transmission Company*, 126 FERC ¶ 61,034, at P 51 (2009). Thus, while the risks of MLPs and corporations may "vary somewhat," that does "not preclude developing a proxy group with a reasonable range of returns if the firms' business fundamentals and risk are comparable." *Id.* at P 118. The Commission explained that the "business fundamentals" that were relevant to a risk assessment included the firm's "debt to equity ratio …, its interest cost and exposure, the stability of its markets and the related stability of its revenue stream, its cost structure, and its operating and managerial efficiency." *Id.* at P 117. The Commission therefore concluded it was unlikely that the fundamental risks of an enterprise would be "determined primarily by [the] ownership format." *Id.*

The Commission's decision to use the MLP proxy group for all oil pipelines is consistent with its longstanding presumption that all oil pipelines "fall within a broad range of average risk." ROE Policy Statement at P 7; *see also Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 700 (D.C. Cir. 2007) (accepting the Commission's assumption as "decisive"). A party must "show highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines to overcome the presumption." *Id.* (*citing Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279, at 61,936 (2000)). In other words, the ROE derived from the oil pipeline proxy group covers all oil pipelines, including the Trans-Alaska Pipeline System, short-distance pipelines in California and Texas, pipelines with significant competition, pipelines with less competition, pipelines that are full and pipelines that struggle to fill their capacity. *See, e.g., BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287, at PP 195-196 (2008); *SFPP, L.P.*, 113 FERC

¶ 61,277, at P 78 (2005). Since the same ROE is appropriately used for pipelines that operate in various different physical and commercial environments, there is no reason to single out a pipeline's governance structure as the sole basis on which to distinguish it for purposes of calculating the ROE.

B. The Commission's ROE Policy Does Not Result in "Double Recovery" of Income Tax Costs for MLP Pipelines.

The Court in *United Airlines* observed that because MLP unitholders must pay taxes on the income distributed to them by the partnership, the return that investors require as measured by the DCF formula is a pre-investor-tax return. 827 F.3d at 136. But that does not mean using the ROE derived from the MLP proxy group results in an impermissible "double-recovery" of income tax costs. As an initial matter, investors in MLP pipelines do not receive a higher after-tax return as a result of the inclusion of an income tax allowance in rates, because the price of the MLP units adjusts to reflect the expected cash flow. More fundamentally, the Commission's current policies do not lead to a higher cost of service for MLP pipelines than corporate pipelines. In fact, as INGAA's comments demonstrate, the data show no systematic difference between MLP pipelines and corporate pipelines in the equity returns generated by the DCF method over time. Further, the comments of Dr. Horst show that it would be inappropriate for the Commission to make any change in policy based on any "snapshot" of DCF return information. The Commission's existing ROE policy when used in conjunction with the existing income tax allowance policy therefore treats corporate and MLP pipelines generally equally and results in comparable rates for similar service – not an excessive or "double" recovery for MLP pipelines.

1. The Commission's current policies do not cause MLP investors to earn a higher after-tax return.

In *United Airlines*, the court stated it was undisputed by the parties to that case 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." 827 F.3d at 136. But, whatever concessions may or may not have been made in that proceeding, the Commission's current policies *do not and cannot* give MLP unitholders either (1) a higher after-tax return than MLP investors would have without a tax allowance or (2) a higher after-tax return than shareholders in a corporate pipeline.

As the NOI observed, "[i]f an MLP obtains a new revenue source that increases its distributions to its investors (such as an income tax allowance that increases its rates), the share price will rise until, once again, the investor receives the cash flow necessary to cover investors' income tax liabilities and earn a sufficient after-tax return." NOI at P 18. In other words, as Dr. Graham explains, if the Commission were to permit MLP pipelines to charge higher tariff rates (for whatever reason), "that would likely increase the cash distributions to investors and, if so, MLP prices would immediately rise in order to reflect the anticipated level of cash flow. The overall return that investors require, however, would remain the same as long as the underlying risk characteristics of the pipeline have not changed." Graham Decl. at 12-13.

Moreover, regardless of any alleged differences that may or may not exist with respect to the *pre-investor-tax returns* that corporate shareholders and MLP unitholders may require, there is no basis for the assumption that the *after-tax return* demanded by investors from MLP pipelines will be any different than that for corporate pipelines. Indeed, the Commission has correctly observed that a company's risks depend primarily on its "business fundamentals," not its ownership structure. *Kern River*, 126 FERC at PP 117-118. Assuming that, all else being equal, oil pipelines have basically the same underlying risk regardless of how they are structured for tax purposes, the after-tax rate of return would be the same because the market would immediately react to eliminate any differences.

Contrary to the assumption in *United Airlines* that there may be a short-term lag before the price adjusts, established economic theory is clear that the adjustment will be immediate. The Efficient Market Hypothesis, which the D.C. Circuit has explained is "the cornerstone of modern investment theory" and a bedrock principle on which the DCF methodology is based, "says that stock prices will react promptly to new public releases of information and thus fully reflect all public information." *See Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1210 (D.C. Cir. 1991) (citations omitted). In fact, the market will assimilate such information "with lightning speed," and the response of stock prices even to "unexpected announcements" will not "persist beyond the day of announcement." *Id.* at 1211 (citing Douglas K. Pierce and V. Vance Roley, "Stock Prices and Economic News," 59 Journal of Business 49 (January 1985)); *see also* Principles of Corporate Finance, Richard A. Brealey, Stewart C. Myers, at 360 (6th ed.

2000) ("when a firm publishes its latest earnings or announces a dividend change, the major part of the adjustment in price occurs within 5 to 10 minutes of the announcement") (citing J.M. Patell and M.A. Wolfson, The Intraday Speed of Adjustment of Stock Prices to Earning and Dividend Announcements, *Journal of Financial Economics*, 13 at 223-252 (June 1984)). For example, when the Commission adopted its *Lakehead* policy, the drop in MLP unit prices "occurred immediately" after the announcement of that policy. Opinion No. 511, at P 249; *see also* Graham Decl. at 12 (discussing 17 percent drop in the price of Lakehead units).

Since the Commission's current policies have been in place for several years, the after-tax returns of corporate and MLP pipelines have plainly been equalized for some time. There is simply no basis for the assumption that MLP investors enjoy a higher after-tax return than corporate shareholders under the Commission's current policies. Thus, to the extent the court's reference to ensuring "parity between equity owners in partnership and corporate pipelines," *United Airlines*, 827 F.3d at 137, concerned the equalization of *after-tax returns*, such parity is achieved under the Commission's existing policies.

It is true that a change in policies might help or hurt the individual investors that owned the securities at the time of the change, but even that is uncertain, since the returns achieved by individual investors depend on numerous factors including how long the security is held, the price at purchase and sale, and whether the investor dies before sale of the asset (and passes the security to his estate at a stepped up basis). *See* Graham Decl. at 6-7. In any event, it is not possible to equalize the returns of individual investors, and the ICA does not require it. *Hope* simply requires that tariff rates be set at a level sufficient to permit the regulated entity to earn a return that is "commensurate" with that of "other enterprises having corresponding risks." *Hope*, 320 U.S. at 603. In short, the Commission's ratemaking methodology is concerned with "the relative risk of *enterprises*," *Kern River*, 126 FERC at P 117 (emphasis in original), not the equalization of achieved returns to each individual investor.

2. The Commission's existing policies do not result in any impermissible "double-recovery" of income tax costs in cost-of-service rates for MLP pipelines.

Ultimately, the relevant question is not whether individual investors or groups of investors achieve the same returns through their investments, but whether the Commission's ROE and income tax allowance policies produce just and reasonable rates or an impermissible "double-recovery" of income tax costs in the pipeline's cost of service. The "double-recovery" theory is based on the assumption that the DCF returns for MLP pipelines are higher than the DCF returns that would be observed for corporations and that when this higher return is combined with the income tax allowance, the MLP pipeline will "double-recover" its income tax costs in its cost-of-service rates. The underlying assumption that the DCF methodology produces higher returns for MLP pipelines than corporate pipelines, however, is not supported by empirical data.

a. There is no systemic difference in the DCF returns for natural gas pipelines structured as MLPs and corporations.

As noted, there are no publicly-traded stand-alone corporate oil pipelines. However, as INGAA's comments in this proceeding demonstrate, a review of historical

DCF returns for various corporate and MLP natural gas pipelines does not show MLP returns to be systematically higher than the returns investors demand from corporations over time. INGAA's comments are supported by the testimony of Barry Sullivan, who analyzed whether the Commission's DCF methodology produces a higher ROE for MLP pipelines than for corporate pipelines. Mr. Sullivan performed three different analyses of DCF returns, each of which showed that the Commission's established income tax and ROE policies do not produce systematically higher ROEs for MLP pipelines than corporate pipelines.

As Mr. Sullivan discusses in his testimony, he first reviewed the study of Dr. Horst that was submitted on behalf of shippers in the SFPP case under review in *United Airlines*. Dr. Horst claimed that the DCF ROE for MLP pipelines was 367 basis points higher than the ROE for corporate pipelines based on his review of data from 2008. But when Mr. Sullivan updated Dr. Horst's study to the current period and adjusted it to remove companies that would not qualify as proxy companies under Commission precedent, Dr. Horst's conclusion did not hold up. In fact, the DCF return for corporate natural gas pipelines was higher than those of MLP pipelines. Mr. Sullivan's analysis is consistent with the Commission's prior conclusion that Dr. Horst's study was unreliable for several reasons, including errors in the analysis and the use of a group of corporations that included companies with significant exposure to non-pipeline activities and companies that lacked investment grade credit ratings. Opinion No. 511-A at PP 300-305.

Mr. Sullivan then analyzed the historical DCF returns for a group of 23 companies with significant natural gas pipeline operations going back approximately ten years. Mr. Sullivan's analysis showed no systematic difference in the DCF returns for MLPs and corporations.

Finally, Mr. Sullivan compared the DCF returns for five different pairs of MLPs and corporations from 2008 through the present. The first four pairs compared the DCF returns for MLP natural gas pipelines and their corporate parents (*i.e.*, Spectra Energy Partners LP and Spectra Energy Corporation; TransCanada Pipeline, LP and TransCanada Corporation; Williams Partners, LP and The Williams Companies, Inc.; and Equitrans Midstream Partners, LP and EQT Corporation). The final pair compared the DCF returns of Boardwalk Pipeline Partners and Kinder Morgan Inc. Again, the results showed that the DCF ROEs for MLP pipelines do not systematically exceed the DCF ROEs for corporations. Although the difference in returns for each pair fluctuated over time, the MLPs do not consistently generate a higher DCF return over corporations during the period from 2008 through the present. In short, Mr. Sullivan's thorough and well-reasoned analysis conclusively demonstrates that the Commission's established income tax and ROE policies do not result in systematically higher DCF ROEs for MLP pipelines than corporate pipelines.

b. *The comments of the oil pipeline shipper expert in this proceeding do not support his claim that the pre-tax ROE required by corporate shareholders will generally be less than the pre-tax ROE required by MLP unitholders.*

On February 6, 2017, Dr. Horst filed comments in this proceeding.[7] Dr. Horst continues to maintain that the pre-tax ROE required by shareholders in C corporations will generally be less than the pre-tax ROE required by MLP unitholders, because, in his view, the income tax burden from shareholder-level taxes is less than the income tax burden on MLP partners. In a departure from his previous analyses, Dr. Horst contends that, in order to equalize the ROE for MLP and corporate pipelines, the ROE for MLP pipelines should be reduced by 1.4 percentage points. Dr. Horst's various "snapshot" DCF analyses of MLP and corporate ROE's submitted to the Commission in recent years, however, actually underscore the fact that there is no record support to demonstrate any systemic difference in returns between the two organizational forms.

As an initial matter, Dr. Horst's comments in this proceeding abandon his conclusions in the *SFPP* case discussed above in which he testified that the returns for partnership pipelines were 367 basis points higher than those for corporation-owned pipelines. Dr. Horst's current comments also abandon his testimony in a subsequent SFPP proceeding in which he claimed that partnership pipeline returns were 238 basis

[7] Dr. Horst apparently filed the comments on his own, as he does not indicate that the comments are on behalf of any energy market participant or other entity.

points higher than those of corporate pipelines. *See Prepared Answering Testimony of Thomas Horst*, Docket No. IS09-437-000, at 34 (Mar. 29, 2010).

In addition to proposing an ROE differential that is significantly lower than that claimed in prior proceedings, Dr. Horst's analytical method is now substantially different. Instead, of attempting to support his claims with empirical data involving the returns of actual companies, Dr. Horst's current comments are based on hypothetical assumptions. As Dr. Graham discusses, Dr. Horst's 1.4 percentage point differential is based on hypothetical assumptions regarding several key variables, including cash distribution levels, retention percentages, growth rates and the length of time the investments are held. Graham Decl. at 8-11. As Dr. Graham explains, if other reasonable assumptions are used, the results change and in fact show the opposite of Dr. Horst's conclusion.

For example, Dr. Horst's analysis is dependent upon his assumption that corporate shares and MLP units are held for five years after which the securities are sold. Horst Comments at n.6. But Dr. Horst bases the five-year holding period on his observation of the average holding period for one MLP (SFPP, L.P.) as of December 31, 2007. *Id.* As Dr. Graham explains, there is no reason to assume that this isolated snapshot is necessarily representative of all MLPs, let alone of C corporations. Graham Decl. at 9. In fact, as Dr. Graham explains, in a prior proceeding Dr. Horst used an average holding period of eight years, although he also testified that "most investors [in SFPP] hold their investments indefinitely." *Id.* at 9-10 (citing January 26, 2009 testimony of Dr. Horst in FERC Docket No. IS08-390-002). As Dr. Graham demonstrates, simply changing the assumed five-year holding period makes a significant difference in the results. For example, if an eight-year holding period is used, the differential between the MLP and corporate ROEs in Dr. Horst's analysis declines to 1.0 percentage points. If a 15-year holding period is used, the differential declines further to 0.4 percentage points. Moreover, if the five-year holding period is retained, but the investment is assumed to be held until death instead of sold, the differential reverses and equals -2.3 percentage points. In other words, using Dr. Horst's analysis but assuming the investment is held until death, the MLP return should be increased by 2.3 percentage points, just the opposite of Dr. Horst's main conclusion. Graham Decl. at 9-10. In short, the analysis provided by the expert witness for the shippers that contested the Commission's income tax policies fails to provide record evidence to demonstrate his theoretical double-recovery concern.

c. Theoretical concerns about the use of the pre-investor tax MLP returns do not render the Commission's current policies improper, particularly absent any empirical showing that the DCF returns for MLP pipelines are systematically higher than those for corporate pipelines.

The Supreme Court has made clear that the Commission is "not bound to the use of any single formula or combination of formulae in determining rates." *Hope*, 320 U.S. at 602. "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling." *Id.* (citations omitted). "It is not theory but the impact of the rate order which counts." *Id.* If the end result is reasonable, then the "fact that the method employed to reach that result may contain infirmities is not … important." *Id.* Thus, theoretical concerns regarding the pre-tax nature of the MLP return, which are not supported by market reality, should not be a basis for departing from the Commission’s current policies particularly where there has been no showing of any practical difference in the resulting rates for corporate and MLP pipelines.

Moreover, the DCF ROEs for corporate oil pipelines (if there were any), would also be pre-investor-tax returns, because they would include the return required to cover any income taxes on dividends and capital gains from the sale of shares. The income tax allowance is not intended to reimburse investors for these “second tier” taxes. ITA Policy Statement, at PP 34-35, 38. Nevertheless, to the extent a corporation is more tax efficient (*i.e.*, pays income taxes at an effective rate of less than 35%), that may allow the corporation to pay higher dividends or it may increase the corporation’s share price either through a stock buy-back or because of investor expectations of higher dividends in the future. In other words, by reducing its first-tier income tax obligation, the corporation might cause investors to pay higher second-tier income taxes either now or in the future. That in turn could cause the pre-tax return observed for a corporate pipeline to be higher than it otherwise would be if the corporation paid income taxes at the 35% marginal rate. Corporations that are able to pay lower income taxes (and increase the taxes for their shareholders), however, are not denied an income tax allowance in rates on the theory that there is a “double recovery” of taxes generated by the provision of regulated services. Indeed, D.C. Circuit precedent is clear that corporation-owned pipelines are entitled to a full tax allowance regardless of whether the corporation actually pays taxes. *See City of Charlottesville*, 774 F.2d at 1205.

d. *To the extent an adjustment to the pre-tax MLP returns is necessary, the Commission has already made it.*

The Commission's DCF approach already includes a downward adjustment to the ROE for MLP pipelines. The Commission reduces the long-term growth rate for MLPs by 50 percent to account for the Commission's assumption that MLP distributions will grow more slowly over the long term because of the relative lack of retained earnings. ROE Policy Statement at PP 88-106. Thus, while there is no empirical evidence that the ROE for MLP pipelines is higher than that for corporate pipelines, any concern regarding the potential for higher MLP returns, has been addressed by the Commission's existing policy of reducing long-term growth rates for MLPs.

C. The Commission's Existing Policy Complies with *Hope's* Requirement to Ensure that Regulated Entities Earn Returns Sufficient to Maintain Their Credit and Attract Capital.

The Supreme Court has made clear that the returns for regulated entities must not only be commensurate with the returns expected from other companies with similar risks, but "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." *Hope*, 320 U.S. at 603. The Commission therefore has the authority and the obligation to retain its current policy if it finds that a change could impair the ability of the many MLP pipelines to maintain their credit and attract capital. Here, the evidence shows that abandoning the Commission's current policies could impair the ability of MLP pipelines to maintain their credit and attract capital and lead to credit downgrades, higher debt costs and an increased risk of bankruptcy for MLP pipelines.

As Dr. Graham explains, if the income tax allowance were removed, either directly or through an adjustment in the ROE, "the tariff rates that MLP pipelines could charge would fall." Graham Decl. at 11. Since this would leave fewer funds available for MLP pipelines to distribute to investors, the price of MLP units would also fall. *Id.* at 11-12. This is not merely theoretical speculation. On June 15, 1995, the Commission issued its *Lakehead* decision, which held that MLP pipelines would no longer be allowed an income tax allowance on income attributable to the limited partnership interests held by individuals but instead would be permitted an income tax allowance only with respect to income attributable to the partnership interests held by corporations. *Lakehead Pipeline Company*, *L.P.*, 71 FERC ¶ 61,338, at 62,314-15 (1995). As Dr. Graham reports, "[o]n June 15, 1995, the day the decision was issued, the unit closing price for Lakehead Pipeline Company was $30.25, and the next day the price had fallen to $25. Graham Decl. at 12. "In other words, the price of Lakehead's units dropped 17 percent in one day as a result of only a partial removal of the income tax allowance. All else equal, a complete removal of the income tax allowance would likely therefore cause an even greater percentage decline in the price of MLP units." *Id.*

In addition, as Dr. Graham explains, if the tax allowance were removed, either directly or through an adjustment to the ROE, "the financial condition of MLP pipelines could become more tenuous." Graham Decl. at 13. Since the tariff rates that MLP pipelines could charge would be lower, that "would leave fewer funds available to reinvest in and maintain the pipeline as well as fewer funds to pay obligations such as interest on debt." *Id.* Since current MLP pipeline debt is likely tied to cash flows premised on the assumption of an income tax allowance, pipelines may be unable to service their current debt obligations if the income tax allowance is removed. The reduced cash flow resulting from the lack of an income tax allowance could therefore lead to lower credit ratings and an increased risk of default and bankruptcy. *Id.* This, in turn, could cause lenders to demand higher interest rates, further increasing the financial pressure on firms structured as MLPs. *Id.*

Removing the income tax allowance for MLPs would also put them at a permanent competitive disadvantage against corporate pipelines, because the cost-of-service tariff rates that MLP pipelines would be permitted to charge would be capped at levels materially below those of corporate pipelines for the same services. *See* Graham Decl. at 13. Thus, as Dr. Graham explains, that could "make it more difficult for MLP pipelines to compete for capital against corporation-owned pipelines, since lenders might view an MLP pipeline as less creditworthy and equity investors might view the MLP pipeline as a less attractive investment." *Id.*

These financial pressures would only compound the problems for an industry that is already facing considerable challenges due to the drop in the price of crude oil, the need for significant capital to ensure pipeline safety, and other regulatory uncertainties (*e.g.*, the Advance Notice of Proposed Rulemaking in Docket No. RM17-1-000 proposing significant changes to the Commission's indexed rate regulations and annual reporting requirements). *Hope* requires the Commission to permit returns for regulated entities that are sufficient to ensure their financial integrity, maintain capital and attract credit. In discharging that duty, the Commission plainly cannot ignore the practical consequences of a change in policy and the significant additional financial burdens that MLP pipelines would face in a world in which MLP tariff rates are materially constrained below those of corporations as a result of the removal of the income tax allowance or a downward adjustment to the ROE designed to accomplish the same purpose.

IV. The Commission's Existing Income Tax and Rate of Return Approaches are Supported by Important Policy Considerations.

Importantly, the Commission has the authority to consider policy goals in addition to strict cost-of-service ratemaking concepts. Indeed, it has an obligation to do so. As the Supreme Court has explained, the requirements of *Hope* regarding risk-appropriate returns that are sufficient to attract capital are pertinent but "scarcely exhaust the relevant considerations." *Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968). The Commission therefore "cannot confine its inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress." *Id.* at 791; *see also FERC v. Pennzoil Producing Co.,* 439 U.S. 508, 517 (1979) (Commission not required "to adhere 'rigidly to a cost-based determination of rates'") (quoting *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 308 (1974)); *Farmers Union Cent. Exchange, Inc. v. FERC*, 734 F.2d 1486, 1502, 1530 (D.C. Cir. 1984) (departures from cost-based rates permitted where the non-cost factors are clearly identified and justified).

The Commission is entitled to deference in weighing the various policy issues at stake. "The breadth and complexity of the Commission's responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties." *Permian Basin*, 390 U.S. at 790. Indeed, the D.C. Circuit in *ExxonMobil* noted that the decision of whether to permit a full income tax allowance for partnership pipelines or to attempt to use a pre-tax return instead of an income tax allowance was a "policy decision," and "policy decisions are for the Commission and not the court." 487 F.3d at 955. Here, there are important policy reasons for maintaining the Commission's current policy of permitting an income tax allowance for both corporation-owned and MLP-owned pipelines.

First, it is important to treat all regulated entities fairly regardless of ownership structure in order not to discourage the use of MLPs and other tax pass-through entities, which are widely used throughout the energy sector, including by oil and natural gas pipelines and electric transmission utilities, to meet our nation's energy infrastructure needs. Energy infrastructure projects are generally large, capital-intensive investments. Such major infrastructure projects involve considerable risks that may be beyond the ability or risk-tolerance of a single corporate entity. The Commission has recognized that MLPs and other types of tax pass-through entities permit the sharing of risk and the raising of necessary capital to fund these much-needed projects. As discussed above, the partnership form facilitates investment in oil pipeline and other energy infrastructure in various ways, including by permitting investment by entities that are not permitted to hold corporate shares and by allowing "greater flexibility in making contributions in-kind" and distributing earnings. *See* ITA Policy Statement at PP 29, 36.

While the oil pipeline industry operates under a combination of indexed rates, settlement rates, market-based rates and cost-of-service rates, *see* 18 C.F.R. §§ 342.2 and 342.4 (2016), cost-based rates often form the backdrop against which oil pipeline rates are negotiated for new projects and otherwise, since shippers may require new rates, including "uncommitted" rates for new projects, to be justified on a cost-of-service basis and may also challenge existing rates based on costs in appropriate circumstances. 18 C.F.R. §§ 342.2, 342.3, 342.4(a), and 343.2. It is therefore important that the Commission maintain appropriate policies for the recovery of costs, including income taxes and a reasonable rate of return, for all oil pipelines regardless of ownership form, as a change in policy could have material adverse impacts on investment in oil pipeline infrastructure. Not only would a change in policy be unfair to pipeline owners that relied on the current policies to fund important infrastructure investment, it would have a significant chilling effect on future infrastructure expansions and increase the risks to the industry at a time when substantial new investment is needed, and when significant new obligations (pipeline integrity) and uncertainties (indexing ANOPR) are facing the industry.[8]

[8] An additional potential consequence of discouraging the use of the MLP form may ultimately be the lack of sufficient MLP pipelines to form an oil pipeline proxy group. Since corporations do not have the same limitations as MLPs with respect to requirements to engage in certain specific natural resource activities, the resulting corporate pipelines could well be part of larger integrated companies that are not pure-play pipelines. In other words, in attempting to remove any theoretical over-recovery of income tax costs from its current policies, the Commission could find itself with no viable market-based mechanism for measuring oil pipeline ROEs.

Second, and relatedly, the Commission's current policies "facilitate[] investment in public utility assets," consistent with Congressional tax policy. ITA Policy Statement at P 1 & P 33 n.30. In 1987, Congress withdrew incentives for most enterprises to be publicly-traded partnerships by taxing them as corporations. Pub. L. 100-203, 101 Stat. 1330-403 (1987) (codified at IRC § 7704). However, Congress permitted certain specific industries, including "pipelines transporting gas, oil, or products thereof," to use that form and be taxed as partnerships." IRC § 7704(d)(1)(E). In singling out this narrow category of companies, Congress plainly intended to facilitate investment in those sectors by providing a tax-efficient means to raise capital. *See* Opinion No. 511, at PP 253-256 (discussing legislative history). If the Commission were to deny an income tax allowance for MLP pipelines, either directly or through a downward adjustment to the ROE, and thereby reduce rates below those permissible for otherwise identical corporations, that would plainly undercut Congress's goal of facilitating investment in oil pipeline and other energy infrastructure by encouraging the use of the MLP form. Opinion No. 511, at P 262; ITA Policy Statement at P 36.

In *BP West Coast*, the court stated that "[t]he mandate of Congress in the tax amendment was exhausted when the pipeline limited partnership was exempted from corporate taxation." 374 F.3d at 1293. But that holding responded to the argument that the Congressional mandate *required* the Commission to permit a full tax allowance. 374 F.3d at 1292 ("no precedent for the proposition that we should compel the Commission … to adopt a rate structure bringing it into line with the perceived intent of Congress to achieve objectives in general"). While Congress's action did not mandate any specific ratemaking approach, the Commission plainly has the discretion to take Congressional tax policy into account in setting rates and to structure its ratemaking policies to align with tax incentives created by Congress. Indeed, the Commission has historically attempted to accommodate tax benefits conferred by Congress through ratemaking, and the courts have upheld such decisions as a permissible exercise of the Commission's ratemaking expertise. *See, e.g., City of Charlottesville*, 774 F.2d at 12-07-1216 (upholding Commission's calculation of pipeline income tax allowance on a "stand-alone" basis without reducing it to reflect tax savings resulting from use of a consolidated corporate return); *Papago Tribal Utility Authority v. FERC*, 776 F.2d 828, 832 (9th Cir. 1985) (holding in the case of investment tax credits that the Commission's "normalization" approach is permissible because it "serves the public interest" and "accommodates the utility's need for investment capital by permitting the utility to generate more capital internally").

Moreover, Congress's policy of encouraging oil pipeline infrastructure development is also the Commission's policy. *See* ITA Policy Statement at PP 30, 33, 36. The Commission has the authority to advance that policy by not discouraging the use of the MLP form absent Congressional instruction to the contrary.

Third, abandoning the Commission's current policies could have serious real-world consequences. As discussed above, denial of an income tax allowance for MLP pipelines, either directly or through a downward adjustment to the ROE, would cause significant market instability and could lead to credit down-grades, higher debt costs and an increased risk of bankruptcy for MLP pipelines. Given the requirement "to assure confidence in the financial integrity" of regulated entities," *Hope*, 320 U.S. at 603, the Commission plainly has the authority to retain its current policy if it finds that a change could impair the ability of pipelines to maintain their credit and attract capital.

Fourth, it is reasonable for the Commission to set rates for all oil pipelines using the same income tax allowance and ROE policies in order to ensure that the tariff rates for pipelines that provide the same general service do not diverge significantly solely because of how the pipeline is structured for tax purposes. As Dr. Graham explains, removal of the income tax allowance, either directly or through a downward adjustment to the ROE, would put MLP pipelines at a permanent competitive disadvantage to corporate pipelines by capping MLP costs-of-service and tariff rates at levels significantly below those of corporate pipelines. *See* Graham Decl. at 13. As noted, that could "make it more difficult for MLP pipelines to compete for capital against corporation-owned pipelines, since lenders might view an MLP pipeline as less creditworthy and equity investors might view the MLP pipeline as a less attractive investment." *Id.* It would also "clearly act as a disincentive for the use of the partnership format." ITA Policy Statement at P 36. To the extent pipelines continued to be structured as MLPs, the inability of MLPs to charge rates comparable to corporate pipelines for similar services would simply provide a windfall to shippers without any ratemaking justification, since the costs of pipeline operations are basically the same regardless of ownership structure.

Moreover, a change in the level of cost-of-service rates that MLP pipelines are able to charge could have far reaching impacts on pipelines more generally, including pipelines with other ownership structures and pipelines that employ other ratemaking mechanisms.[9] As noted above, the cost-of-service rates that a pipeline would be permitted to charge often form the backdrop for other types of rates. Thus, a reduction in a pipeline's cost-of-service could harm infrastructure development, lead to unwarranted challenges to existing indexed rates, and impact the ability of pipelines to develop reasonable rates for new services.

V. Ultimately, Equalization of Returns is Not Required, and There is No Better, Practical Alternative to the Commission's Existing Policy.

The application of the Commission's existing income tax allowance and ROE policies, just like other ratemaking policies, will necessarily be more advantageous to some pipelines and utilities than others. That does not make it impermissible for the Commission to establish such broad-based policies. It is plainly not possible to ensure precise equality of returns, since each entity has different circumstances. In any event, equalization of individual returns is not required by *Hope*, which simply requires that the ROE used to set cost-of-service rates for regulated entities be "commensurate" with what investors require from enterprises of similar risk. 320 U.S. at 603.

For example, it is not possible for the Commission to determine the "actual taxes paid" by corporate entities, but that does not make it unreasonable for the Commission to

[9] If an MLP pipeline is required to charge lower cost-of-service rates because of the removal of the income tax allowance from its cost of service, in circumstances where a corporation-owned pipeline competes directly with the MLP pipeline, it would be required to lower its rates as well, which would effectively ensure that such a corporation-owned pipeline does not recover its cost of service or allowed return.

include an income tax allowance in those entities' costs of service. The D.C. Circuit has made clear that an income tax allowance will rarely, if ever, equal the "actual taxes paid." *Id*. at 1215. The income tax is based on the regulated entity's jurisdictional activities as if it were a stand-alone entity even if it belongs to a larger corporate group that files a consolidated return and uses losses generated by affiliates to offset some or all of the income tax attributable to the jurisdictional activities. *Id*. at 1207. The income tax allowance also is not reduced to reflect the deferral of taxes that may occur due to accelerated depreciation. *Id*. at 1205. This is true even though entities that are more tax efficient will have the opportunity to earn higher returns than others.

Indeed, the courts have approved the Commission's use of a "nationwide tax allowance" for natural gas producers that "treated the industry as a single enterprise" and did not attempt to reflect the tax liability of any specific regulated entity. *Tenneco Oil Company v. FERC*, 571 F.2d 834 (5th Cir. 1978). The court explained that "issuing rate orders is simply not like the garden variety of administrative action," and that the Commission was entitled to deference in weighing the various policies issues at stake. *Id*. at 839. Ultimately, the court observed, the "'zone of reasonableness' is wide." *Id*. at 840; *see also Permian Basin Area Rate Cases*, 390 U.S. 747, 806-807 (1968) (approving single ROE for all natural gas producers in the Permian Basin).

As discussed, the Commission's current income tax allowance and ROE policies treat corporations and MLPs largely the same. Under the Commission's income tax allowance policy, the use of the weighted marginal tax rates of MLP unitholders is based on presumed marginal tax rates that are lower than the top marginal tax rates for individuals and lower than the corporate marginal tax rate, unless the MLP can rebut the presumed marginal tax rate. *See* ITA Policy Statement at P 41. Thus, unless rebutted by the MLP pipeline, the default income tax allowance for an MLP pipeline will be lower than that of a corporation. *Id.* Moreover, as noted, in applying the Commission's DCF analysis, the long-term growth component is reduced by half for MLP pipelines, which reduces the MLP pipeline's rate of return. Therefore, 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.

In addition, as the NOI appears to acknowledge, there is no better alternative to the Commission's current approach. NOI at P 20. One alternative is to try "eliminating the income tax allowance for partnerships and relying on the ROE awarded the pipeline for the recovery of investor-level tax costs," but in that case there would be no way to ensure that the ROE reflects the "appropriate tax costs for the particular entity whose rates are at issue," including corporation-owned pipelines. *Id*. at P 20 and n.52. Alternatively, one could "propose reducing the DCF return to remove all investor-level tax costs and rely on an income tax allowance to recover the investor-level tax costs." *Id*.

But there is no precise way to make the adjustments to the ROEs that would be required to implement these theoretical alternatives, and attempting to do so would bog down the rate-setting process with unwieldy issues to resolve. For example, it is not clear how the Commission would even begin to tackle the myriad considerations that would be required to attempt to adjust the market-based ROE to remove all investor-level tax costs from the DCF return. The ROEs that investors require undoubtedly include their expectations regarding income taxes, but the degree to which such considerations affect the price relative to the numerous other considerations that investors take into account is impossible to determine and likely varies as events unfold in the market. The Commission has previously held that any "mechanical adjustment" to the DCF return "would most likely be arbitrary." *Kern River*, 126 FERC at P 118. Indeed, as discussed above in connection with Dr. Horst's calculations, adjustments to the DCF return that depend on various assumptions can change dramatically when other reasonable assumptions are used.

Moreover, neither of the above proposed approaches addresses the fundamental inequity that would arise if a change to the Commission's current approach resulted in significantly different tariff rates for MLP pipelines and corporate pipelines. As demonstrated above, both MLP pipelines and corporate pipelines generate substantial amounts of taxable income from the provision of regulated services and the market-based DCF returns for MLP pipelines are comparable to those for corporate pipelines. There is thus no justification for the ownership structure of the pipeline to result in significant differences in the regulated rates. The Commission's current approach properly recognizes this reality and there is no reason to change it.

CONCLUSION

For the reasons stated above, AOPL respectfully submits that the Commission should retain its current income tax allowance and ROE policies.

Respectfully submitted,

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