# FERC Seeking Comment on Recovery of Income Tax Costs by Jurisdictional Natural Gas and Oil Pipelines and Electric Utilities

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## FERC's Current Ratemaking and Tax Allowance Policies

Natural gas and oil pipelines and electric utilities typically charge "cost-based" rates for interstate transportation service under rates approved by FERC. Under governing law, those rates must provide for the recovery of all of the costs incurred by the regulated entity to provide service and allow the regulated entity to earn a reasonable return on the entity's investment (a "return on equity" or an ROE) to maintain its financial health and attract additional investment. To determine a lawful "just and reasonable" ROE, FERC uses a "discounted cash flow" (DCF) methodology to estimate the return on capital that investors require in order to invest in the regulated entity. The DCF methodology utilizes a proxy group of publicly traded entities with similar risk, and compares the returns achieved by those entities on an after-tax basis (since investors generally choose to invest capital based on the return on equity they will receive after paying any incurred taxes) to develop a range of returns provided by the market. FERC then chooses an ROE within that range of after-tax returns, taking into account a number of factors.

Since 2005, the Commission has allowed all regulated entities – including MLPs and corporations – to include an "income tax allowance" in their cost-based rates to recover actual or potential tax liability that they incur based on income from regulated assets (e.g., pipeline and electric transmission facilities). FERC allowed both kinds of regulated entities to collect this allowance, even though MLPs, under federal law, do not themselves pay taxes on income from their operations, unlike a corporation. Instead, an MLP's taxable income is distributed to the partners, who are personally responsible for paying any resulting income taxes. FERC concluded that, because the partners in an MLP incur a tax liability based on income from the MLP's assets – just as a corporation incurs tax liability based on income from its assets – such tax costs are properly included in an MLP's cost-based rates.

### The United Airlines ***Decision***

In *United Airlines*, the court reversed a series of Commission orders applying these policies and allowing SFPP, L.P., an MLP-owned oil pipeline, to recover an income tax allowance cost in its rates for interstate transportation service. The court held that FERC had not adequately demonstrated that allowing an MLP like SFPP to recover an income tax allowance would not result in "double recovery" of income tax costs, given that the MLP receives both the allowance and an after-tax ROE (determined through an application of the DCF methodology).[2] Specifically, the court expressed concern that, under FERC's income tax and ROE policies, an MLP could be compensated twice for the same incurred tax liability – once through the income tax allowance (which essentially adds the tax, dollar for dollar, to rates) and once through the ROE (which takes into account the tax liability that investors will face and provides the pipeline with extra revenues in its rates to cover that liability). In addition, the court held that FERC had failed to demonstrate that its policies ensure "commensurate" returns (or "parity") between equity owners in MLPs and corporations, since the additional compensation for tax liability received by an MLP partner would allow it to receive a higher return than a corporate shareholder.[3]

### FERC's December 2016 Notice of Inquiry

The court remanded the proceeding to FERC with instructions to "consider . . . mechanisms for which the Commission can demonstrate that there is no double recovery" of income taxes by MLPs. In response to that remand – and recognizing that the issues raised in the *United Airlines* decision extend well beyond that specific case – FERC's Notice of Inquiry broadly seeks comment on "methods to allow regulated entities to earn an adequate return . . . that do not result in a double recovery of investor-level taxes for partnerships or similar pass-through entities."[4] In particular, FERC asks for detailed proposals (with supporting data, theoretical analysis, empirical studies or other relevant evidence) to adjust its income tax allowance or ROE policies to resolve the potential for double recovery of investor-level taxes.[5] Such proposals should consider the "fundamental concerns presented by *United Airlines*" and account for any practical impacts that adjusting one set of policies may have on the other.[6]

Initial comments in response to the Notice of Inquiry are due March 8, 2017; reply comments are due April 7, 2017.

[1] *Inquiry Regarding the Comm'n's Policy for Recovery of Income Tax Costs*, 157 FERC ¶ 61,210 (2016) (NOI).

[2] 827 F.3d at 134, 136.

[3] *Id.* at 136.

[4] NOI at P 17.

[5] *Id.* P 19.

[6] *Id.*PP 18, 20.

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