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Tax Cuts & MLPs: FERC Announces Changes Designed to Reduce Cost-Based Rates Charged by Regulated Pipelines

FERC eliminates tax allowance in MLP pipelines' cost-based rates and establishes procedures to address income tax changes.

Key Points:

- FERC will no longer permit MLPs to recover an income tax allowance in cost-based rates.
- Gas pipelines will be required to submit information reports showing the impact of lower corporate tax rates and the disallowance of taxes for MLPs, and then are encouraged to voluntarily reduce rates; oil pipelines rates will be reduced in 2020 on a generic basis through indexing.
- Generally, only cost-based maximum rates will be affected: market-based rates, negotiated rates, discounted rates that remain below any reduced maximum rate, committed rates, and some settlement rates will not be altered.

In a series of orders issued on March 15, 2018, the Federal Energy Regulatory Commission (FERC or Commission) took actions to address the allowance for income taxes in cost-of-service rates for natural gas and oil (including hydrocarbon liquids) pipeline companies that it regulates. Most dramatically, FERC revised its previous policy and held that gas and liquids pipelines organized as master limited partnerships (MLPs) will no longer be permitted to recover an income tax allowance in cost-of-service rates. Of wider impact, FERC also took actions intended to reduce all jurisdictional pipelines' maximum cost-based rates to reflect the reduction (from 35% to 21% effective January 1, 2018) in the corporate tax rate in the Tax Cuts and Jobs Act of 2017 (the Tax Act). The means FERC proposed to adjust rates differ between gas and oil pipelines to reflect differences in FERC's methodology for regulating their rates. FERC also requested comments from industry stakeholders regarding other actions it should take associated with the Tax Act, including in particular with regard to Accumulated Deferred Income Taxes (ADIT).

Importantly, the rates changes that could result from FERC's orders affect only a pipeline's maximum, cost-based rates. Other pipeline rates — including market-based rates, negotiated rates, discounted rates that remain below any reduced maximum rate for gas pipeline transportation, and settled or committed rates for oil pipelines — generally would not be affected. Therefore, the impact of FERC's approach on particular pipelines will vary depending on the extent to which customers are paying the maximum cost-of-service rates.

Elimination of Income Tax Allowance for MLPs

In the “Revised Policy Statement on Treatment of Income Taxes” issued in Docket No. RM18-11 (the Revised Policy Statement), the Commission concluded that an impermissible double recovery results from granting an MLP both an income tax allowance and a return on equity (ROE) derived from the Commission’s discounted-cash-flow (DCF) methodology (which is used to determine the pre-tax return required by investors). Accordingly, the Commission will no longer permit an MLP pipeline to recover an income tax allowance in its cost-of-service rates.[1]

The issue of whether the combination of an income tax allowance in those pipelines’ transportation rates results in double recovery of taxes for gas and liquids pipelines organized as MLPs had been pending before FERC for almost two years. This issue had been remanded to FERC by the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit) in *United Airlines v. FERC*, 827 F.3d 122 (D.C. Cir. 2016),[2] and FERC solicited comments on the issue in December 2016.

In the Revised Policy Statement, FERC rejected numerous arguments that no double recovery results, including claims that:

- Changes to the stock price eliminate the double recovery.
- MLP partners’ taxes are “first tier” taxes that should be recoverable in an income tax allowance.
- The return produced by the DCF analysis is never grossed-up to include MLP partners’ tax costs.
- The presence of an income tax allowance causes MLP investors to demand a lower return in the market place.
- A life-cycle hypothetical shows that corporate and MLP tax costs and after-tax returns are similar when an income tax allowance is present.
- The calculation of the growth rate in the DCF Formula for MLP pipelines addresses the double-recovery issue.
- Empirical studies refute the double-recovery concerns in *United Airlines*.
- Providing MLP pipelines an income tax allowance furthers Congressional intent to facilitate infrastructure investment.
- Preserving the income tax allowance for MLP pipelines is necessary to maintain parity with corporate pipelines.
- Preserving MLP pipelines’ income tax allowance is necessary to attract capital.

Rulemaking on Tax-Related Rate Changes for Natural Gas Pipelines

Also on March 15, the Commission issued a notice of proposed rulemaking (NOPR) proposing that interstate natural gas pipelines subject to regulation under the Natural Gas Act (NGA) must make a one-time filing to address whether their rates should be reduced to reflect the reduced corporate tax rate implemented by the Tax Act, as well as the Revised Policy Statement for MLPs if applicable. According to the NOPR, “[t]he Commission believes that interstate natural gas pipelines and intrastate natural gas pipelines providing interstate service should flow through the benefits of the corporate income tax reduction and elimination of MLP income tax allowances to consumers to the extent that their rates would otherwise over-recover their costs of service. Therefore, the Commission is initiating this rulemaking proceeding to consider the most efficient and expeditious method of accomplishing this goal…" FERC's proposals are intended, according to the NOPR, to encourage natural gas pipelines to voluntarily reduce their rates to "achieve just and reasonable rates."

As further described below, the proposed, one-time informational report (new FERC Form 501-G) would be an abbreviated cost and revenue study estimating (1) the percentage reduction in the pipeline's cost of service resulting from the Tax Act and revised MLP policies, and (2) the pipeline's current ROEs before and after the reduction in corporate income taxes and the elimination of income tax allowances for MLPs. Recognizing that it cannot simply order pipelines to reduce their rates, FERC proposes to encourage interstate pipelines voluntarily to reduce their rates to reflect only the impact of these changes through a "limited" NGA section 4 rate filing, or risk a more general investigation by FERC into the reasonableness of their rates. Alternatively, an interstate pipeline may commit to file by December 31, 2018, either a "prepackaged" uncontested rate settlement or, if that is not possible, a general NGA section 4 rate case if the pipeline believes that using the limited NGA section 4 option will not result in a just and reasonable rate.[3]

The NOPR proposes that any rate reductions through limited rate filings must align with calculations in the FERC Form No. 501-G, and that these rate proceedings be limited to the tax issue. The NOPR explains: "Interested parties may protest any limited NGA section 4 filing, but the Commission will only consider arguments relating to matters within the scope of the proceeding. …[ ] If shippers or other interested parties believe further adjustments to the rate are warranted, they may file an NGA section 5 complaint with the Commission." The NOPR recognizes that FERC generally does not permit pipelines to change a single component of cost of service outside of a general NGA section 4 rate case, but concludes that an exception to the general policy is justified "to permit interstate pipelines to voluntarily reduce their rates as soon as possible to reflect a reduction in a single cost component … so as to flow through that benefit to consumers."

Pipelines choosing not to initiate rate proceedings, according to the NOPR, may file with their FERC Form No. 501-G either a statement of future intent to file a rate case or a statement indicating why a rate reduction is not warranted. The NOPR also provides pipelines the option to file the informational form without taking any other action. The NOPR recognizes that a rate reduction may not be justified for a variety of reasons, including (1) a pipeline's rates under- recover its cost of service, even with the tax reduction, and (2) pipelines' existing settlements or rate moratoriums preclude rate reductions.

The NOPR states that — for pipelines that do not reduce their rates through a limited rate filing or commit to a general rate case or settlement by the end of the year, FERC will consider on a case-by-case basis initiating an NGA Section 5 investigation of the pipeline's rates if it appears the rates may be unjust and unreasonable. Although the Commission always has this option and, indeed, initiated two Section 5 investigations on March 15, pursuant to the NOPR, the Commission's determinations on whether to initiate a rate investigation into other pipelines' rates will be further informed by the information provided in Form 501-G and "comments by interested parties."

The Commission proposes to exercise its authority under NGA sections 10(a) and 14(a) to require all interstate natural gas pipelines that file 2017 annual reports (FERC Form Nos. 2 or 2A) to comply with the new Form 501-G requirement, using the data those reports. The proposed one-time filing will also require all partnership pipelines seeking to recover an income tax allowance to address the double-recovery concern addressed in the Revised Policy Statement or submit a statement with supporting documentation to justify why it should continue to receive an income tax allowance. Pipelines not required to file a FERC

Form No. 2 or 2A for 2017 (such as those approved but not yet constructed) would be addressed on a case-by-case basis.

The NOPR has proposed a staggered timeline for requiring pipelines to make these one-time filings. Interstate gas pipelines with cost-based rates are split into four groups, with the first group having a deadline that is 28 days from the effective date of any final rule, and subsequent due dates 28 days from the previous group's due date. Pipelines may file their FERC Form No. 501-G report earlier than the proposed dates.

FERC has proposed to provide separate procedures for intrastate gas pipelines performing interstate service pursuant to section 311 of the Natural Gas Policy Act of 1978 and for "Hinshaw" pipelines performing interstate transportation pursuant to a limited jurisdiction certificate. These pipelines would be required to reduce their interstate rates only if their intrastate rates are reduced to reflect the lower income tax rate.

The NOPR recognizes that the proposed procedures will affect gas pipelines differently depending on their individual contracts, corporate structures, and customer types.. "Changes to a pipeline's recourse rates occurring under NGA sections 4 and 5 do not affect a customer's negotiated rate, because that rate is negotiated as an alternative to the customer taking service under the recourse rate. However, a shipper receiving a discounted rate may experience a reduction as a result of the outcome of a rate proceeding if the recourse rate is reduced below the discounted rate. The prevalence of negotiated and discount rates varies among pipelines, depending upon the competitive situation." Further, pipelines and customers subject to Commission-approved settlement rates may be prevented from filing a rate case, complaint, or rate reductions by the terms of their rate settlement agreements. The Commission notes this possibility, stating that, "the Commission generally does not disturb a settlement during a rate moratorium." Pipelines with market-based rates would not be subject to this proposed rule.

Comments on the NOPR will be due 30 days after publication of the NOPR in the Federal Register.

Impacts of FERC's Orders on Liquids Pipelines

In contrast to its industry-wide action regarding gas pipeline rates (discussed above), FERC stated that it is not taking similar industry-wide action regarding oil pipeline rates, although "these issues will be addressed in due course" through its index-based ratemaking.

When oil pipelines file their 2017 annual reports (Form 6) on April 18, 2018, they must report in their Page 700 data an income tax allowance consistent with the Revised Policy Statement — *i.e.,* no income tax allowance for MLP pipelines. Based on the Page 700 data, the Commission will incorporate the effects of the Revised Policy Statement and the lower corporate income tax rate when it undertakes its five-year review of the oil pipeline rate index level in 2020.[4] "In this way," said the Commission, "[it] will ensure that the industry-wide reduced costs are incorporated on an industry-wide basis as part of the [rate] index review."[5] FERC clarified that, going forward, the Revised Policy Statement and the new corporate income tax rate will be reflected in the Commission's existing ratemaking policies for oil (and gas) pipelines filing initial rates or rate changes based on cost-of-service, as well as in cost-of-service rate proceedings resulting from shipper-initiated complaints.

Notice of Inquiry Regarding ADIT and Other Issues

The Commission also issued, in Docket No. RM18-12, a "Notice of Inquiry" seeking comments on whether it should take any additional actions to address the changes in federal corporate income taxes, emphasizing Accumulated Deferred Income Taxes (ADIT) while also mentioning bonus depreciation.

ADIT balances are accumulated by regulated pipelines to reflect differences between the methods of computing taxable income as reported to the IRS and as used for regulatory and ratemaking purposes. Numerous items may be treated differently for tax and rate-making purposes, but the most prominent example is depreciation: straight-line depreciation is generally used for ratemaking, while accelerated methods of depreciation are typically used for income tax purposes. As a result, income taxes actually paid by both gas and oil pipelines (as well as electric utilities) differ from the income tax allowances included in their jurisdictional rates during the same period. The difference in taxes paid and taxes included in rates is recorded in an ADIT account. An ADIT liability is created when more taxes are included in rates than were actually paid by the pipeline. FERC views that amount (the ADIT liability) as capital that was provided by ratepayers as cost-free to the pipeline; and, in cost-of-service ratemaking, FERC subtracts the ADIT balance from rate base, thus reducing customer rates and essentially passing the tax benefits back to customers over time.

As a result of the corporate tax rate change, pipelines will re-measure their ADIT liabilities and assets and establish regulatory liabilities or assets as appropriate. To the extent ADIT is reduced as result of the tax change, a portion of the ADIT liability that was previously collected from customers will no longer be due to the IRS, and will be considered “excess ADIT” — which the Commission states in the Notice must be returned to customers.

While FERC has not proposed to take any particular action regarding ADIT at this time, the Commission requests comments, with respect to both gas and oil pipelines, regarding:

- How to ensure that rate base continues to be treated in a manner similar to its treatment prior to the change in tax law, until the excess and deficient ADIT have been fully settled
- Whether and, if so how, pipelines should adjust rate base to reflect excess and deficient ADIT, and whether interest on ADIT balances should be accrued from January 1, 2018 until any rate adjustments are implemented
- Recognizing that the Tax Act states that excess ADIT associated with utility plant assets may be flowed back no more rapidly than over the life of the underlying asset, what method should be used (such as the Average Rate Assumption Method or South Georgia method) to adjust the tax allowance or expense included in the cost of service to reflect the amortization of excess and deficient plant-based ADIT
- Whether non-plant-based excess or deficient ADIT should be amortized over a period shorter than the life of the underlying asset (*e.g.*, five years)
- How the income tax allowance in rates should be increased or decreased by the amortization of excess and deficient ADIT and how the amortization should be recorded for accounting purposes
- Given the Commission’s new policy that MLPs are not permitted an income tax allowance, whether existing MLPs’ existing ADIT (and, potentially, ADIT of other pass-through entities) should be eliminated completely from the cost of service, placed in a regulatory liability account and returned to ratepayers, or addressed in another way

In addition to the central focus on ADIT, the Notice of Inquiry also briefly explains the changes in bonus depreciation in the Tax Act and requests comment on whether and, if so how, the Commission should take action to address bonus depreciation-related issues. The Notice also includes a catch-all request for comment on any further action the Commission should take to address the changes in federal tax law.

Comments on the Notice of Inquiry will be due 60 days after its publication in the Federal Register.

We will continue to be involved in ongoing developments and the implementation of these rulemakings and policies.

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Endnotes

1 FERC's order expressly does not address non-MLP pipeline structures or other pass-through business forms. In its Revised Policy Statement, FERC stated that it will address income tax allowance issues for those organizations in "subsequent proceedings," although whether such proceedings will be generic or case-specific remains unclear.

2 The case remanded by the court involved the rates of SFPP, L.P. FERC also issued a March 15 order in that case, in which (among other rulings) it applied the Revised Policy Statement and denied SFPP an income tax allowance.

3 Although the Commission states that all pipelines must file Form 501-G, the NOPR also provides that: "Interstate natural gas pipelines that file general NGA section 4 rate cases or pre-packaged uncontested rate settlements before the deadline … will be exempted from [filing Form 501-G]."

4 FERC's oil pipeline rate index, which reflects industry-wide cost changes, will be reassessed in 2020 based on changes in oil pipeline costs between 2014 and 2019.

5 FERC added that, to the extent it later issues orders affecting the income taxes of oil pipelines not organized as MLPs, those pipelines should reflect such orders in their Form 6, Page 700 data as well.