UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

REPLY COMMENTS OF
THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

The Interstate Natural Gas Association of America (INGAA) submits reply comments on the Federal Energy Regulatory Commission's (Commission) Notice of Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs (NOI), issued on December 15, 2016, pursuant to the schedule established by the Commission.[1] INGAA submitted initial comments in this proceeding presenting empirical evidence demonstrating that the Commission should retain its existing income tax allowance for pipelines that are organized as publicly-traded master limited partnerships (MLP).[2] This issue is of primary importance to INGAA, a trade association representing approximately two-thirds of the nation's natural gas transmission pipeline systems. Ten of INGAA's 26 members are organized as MLPs.

I. EXECUTIVE SUMMARY

The Commission issued the NOI in response to the D.C. Circuit's opinion in *United Airlines, Inc. v. FERC*, which held that, "if FERC elects to impute partner taxes to the partnership pipeline entity, it must still ensure parity between equity owners in partnership and corporate pipelines."[3] The court in *United Airlines* was concerned that the Commission, in

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

[2] Comments of the Interstate Natural Gas Association of America (Mar. 8, 2017) (INGAA Comments).

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

addressing an income tax allowance for an oil pipeline organized as an MLP, 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 [(DCF)] return on equity [(ROE)]."[4]

INGAA's initial comments presented testimony of Mr. Barry Sullivan and Dr. Merle Erickson demonstrating that the Commission's current income tax allowance provides the parity between corporate and MLP pipeline investors required by the court in *United Airlines*.[5] INGAA presented empirical evidence demonstrating that there is no double recovery of income taxes resulting from an MLP receiving both a tax allowance and a DCF-derived ROE. INGAA further demonstrated that an MLP pipeline must be allowed an income tax allowance in order to have the opportunity to recover its full cost of service, consistent with the policy set forth in the Supreme Court's decision in *FPC v. Hope Natural Gas Co.*[6] INGAA explained that removal of the income tax allowance would shake the market's confidence in MLPs and place them at a disadvantage as compared to corporate-owned pipelines. INGAA also showed that eliminating the tax allowance would contravene Congress's intent in authorizing pass-through taxation for partnership pipelines and would remove the economic incentives Congress developed to encourage investment in energy infrastructure.

INGAA's reply comments respond to the initial comments of parties that seek to eliminate or modify the Commission's existing income tax allowance policy.[7] The

[4] *Id.* at 136.

[5] Prepared Direct Testimony of Barry E. Sullivan, on Behalf of INGAA (Mar. 8, 2017) (Sullivan Testimony); Prepared Direct Testimony of Dr. Merle Erickson, on Behalf of INGAA (Mar. 8, 2017) (Erickson Testimony).

[6] 320 U.S. 591, 603 (1944) (*Hope*).

[7] INGAA is not responding to certain comments submitted by individuals that were not submitted on behalf of an interested party to the proceeding. INGAA's lack of response to such comments does not imply or reflect agreement with any points raised in those individual comments.

Commission should reject such commenters' assertions that *United Airlines* held that the income tax allowance for MLP pipelines in addition to the DCF ROE results in a double recovery of income taxes. The court did not make that finding, but instead found only that the Commission did not provide "*sufficient justification* for its conclusion that there is no double recovery of taxes."[8] The Commission also should reject commenters' contentions that the Commission's only option on remand is to find a replacement for the Commission's current tax allowance policy. The plain language of *United Airlines* and long-standing judicial precedent make it clear that the Commission can provide additional justification for its current tax allowance policy on remand.[9]

Commenters' assertions that the Commission's current tax allowance policy does not ensure commensurate returns for investors in MLP pipelines and investors in corporate-owned pipelines are also contrary to the facts presented by Dr. Erickson and Mr. Sullivan. The Commission has broad discretion to approve rates that are within a "zone of reasonableness." INGAA has provided substantial empirical evidence demonstrating that, with the tax allowance, the long-term returns of MLP pipelines and corporate pipelines have been commensurate and that no double recovery of income tax results from this policy. INGAA's empirical evidence provides sufficient justification for the Commission to continue its current tax allowance policy.

No commenter has provided any credible evidence demonstrating that the Commission's current tax allowance either results in a double recovery or that the returns for MLP and corporate pipeline investors have not been commensurate under current policy.

[8] *United Airlines*, 827 F.3d at 136 (emphasis added).

[9] *Id.* at 137 (directing the Commission to consider "mechanisms for which the Commission can demonstrate that there is no double recovery" associated with the tax allowance provided to an MLP, and remanding the Commission's decisions "for further proceedings consistent with this opinion.").

Process Gas Consumers Group (PGC) and American Forest & Paper Association (AFPA), filing jointly, attempt to demonstrate using a "theoretical" model that "the Commission's DCF model calculates a return that fully incorporates personal income taxes and need not be 'adjusted' to accommodate such taxes."[10] PGC and AFPA's theoretical model is based on flawed assumptions, contradicted by the empirical evidence offered by INGAA and others, and provides no basis for the Commission to change its existing policy. The comments of Natural Gas Indicated Shippers and Dr. Thomas Horst, which attempt to demonstrate that the Commission's tax allowance policy leads to non-commensurate returns for investors in MLP pipelines and corporate pipelines, are similarly flawed and should be rejected. The Commission should disregard the comments of other parties that simply assert that the Commission's tax allowance policy results in a double recovery of income taxes but provide no supporting evidence whatsoever.

The Commission should conclude, based on the substantial evidence offered by INGAA and others, that the current income tax allowance ensures commensurate returns for investors in both MLP and corporate pipelines and does not result in a double recovery of income taxes by MLP pipelines. The Commission should retain its existing tax allowance policy, disregard the baseless proposals to modify the Commission's DCF formula, and reject the unsupported requests that the Commission implement proceedings under NGA Section 5 to adjust the rates of MLP natural gas pipelines.

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[10] Comments of the Process Gas Consumers Group and American Forest & Paper Ass'n at 4 (Mar. 8, 2017) (PGC and AFPA Comments).

II. REPLY COMMENTS

A. The Court's Remand Does Not Preclude the Commission from Reaffirming Its Existing Policy.

Several commenters assert that (1) *United Airlines* held that permitting partnership pipelines to include an income tax allowance in their costs of service results in a double recovery of income taxes, and (2) that the Commission's only option on remand is to change existing Commission policy by either eliminating the tax allowance for MLP pipelines or removing taxes from the Commission's DCF methodology for determining ROE.[11] These commenters' assertions do not accurately describe the court's holding, nor do they accurately reflect the options available to the Commission on remand. The court did not find that the income tax allowance results in a double recovery of income tax costs by MLP partners and did not hold that allowing an income tax allowance for partnerships is unjust and unreasonable or contrary to law. In remanding the case to the Commission, the court did not constrain the options available to the Commission in responding to that remand.

In *United Airlines*, the court vacated and remanded the Commission's decision allowing SFPP to reflect an income tax allowance in its cost of service because the Commission did not provide "*sufficient justification* for its conclusion that there is no double recovery of taxes for partnership pipelines receiving a tax allowance in addition to the discounted cash

[11] Comments of Concerned Cooperatives at 3 (Mar. 8, 2017); Initial Comments of the Liquid Shippers Group at 3, 8-9 (Mar. 8, 2017) (LSG Comments); Initial Comments of the Natural Gas Supply Ass'n in Response to Notice of Inquiry at 6-7 (Mar. 8, 2017) (NGSA Comments), Initial Comments of the United Airlines Petitioners and Aligned Shippers at 1, 5-8 (Mar. 8, 2017) (UAL Petitioners Comments). *Cf.* Initial Comments of the Natural Gas Indicated Shippers at 10-14 (Mar. 8, 2017) (suggesting that the Commission has "acknowledged" that the current income tax allowance policy allows a double recovery of income tax costs for partnerships, purporting to demonstrate that the double recovery exists, and stating the next step is to remedy the "error").

flow return on equity."[12] The court stated further that the Commission *failed to demonstrate* "that the resulting rates under [its] policy [were] 'just and reasonable.'"[13] The court directed the Commission to consider "mechanisms for which the Commission can demonstrate that there is no double recovery" associated with the tax allowance provided to an MLP, and remanded the Commission's decisions "for further proceedings consistent with this opinion."[14]

The plain language of *United Airlines* and long-standing judicial precedent demonstrate that the Commission is authorized to support its existing income tax allowance policy on remand. By finding that the Commission did not provide "sufficient justification" for the tax allowance policy, the court gave the Commission the opportunity to provide sufficient justification for its existing policy on remand. The court's finding that the Commission "failed to demonstrate" that the current tax policy results in just and reasonable rates provides the Commission the opportunity on remand to do just that, *i.e.*, to demonstrate the justness and reasonableness of its existing tax allowance policy. In this NOI proceeding, the Commission should consider the empirical evidence offered by INGAA[15] and others[16] and hold that the Commission's existing tax allowance policy is a "mechanism for which the Commission can demonstrate that there is no double recovery" when the tax allowance is utilized in conjunction with the DCF policy.[17] Such a finding would be fully consistent with *United Airlines'* remand instructions.

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[12] 827 F.3d at 136 (emphasis added). The court also stated its holding as finding that the Commission's decision was arbitrary and capricious "because FERC *failed to demonstrate* that there is no double-recovery of taxes for partnership[s], as opposed to corporate, pipelines." *Id.* at 134 (emphasis added).

[13] 827 F.3d at 136.

[14] *Id.* at 137.

[15] *See* Sullivan Testimony at 41-69.

[16] Comments of the Association of Oil Pipelines and accompanying Declaration of John R. Graham (Mar. 8, 2017).

[17] *United Airlines*, 827 F.3d at 137.

Administrative law principles and judicial precedent establish that the Commission is not foreclosed, either on remand or in this NOI proceeding, from properly supporting its conclusion in *SFPP*, reaffirming its existing income tax allowance policy, and holding that the inclusion of an income tax allowance and use of the DCF methodology does not result in a double recovery of income tax costs. In *SEC v. Chenery Corp.*, the court of appeals held that the agency previously had failed to adequately support an order.[18] On remand, the agency "reexamined the problem, recast its rationale and reached the same result."[19] The Supreme Court affirmed this when it stated that "[t]he fact that the Commission had committed a legal error in its first disposition of the case certainly gave [the petitioner's] management no vested right to receive the benefits of such an order. . . . After the remand was made, therefore, the Commission was bound to deal with the problem afresh, performing the function delegated to it by Congress."[20]

In *Radio Televisión S.A. de C.V. v. FCC*, the D.C. Circuit explained the breadth of an agency's options when an administrative order is vacated and remanded.[21] The court stated that when an agency order is vacated, the agency is not foreclosed from "develop[ing] a convincing rationale for re-adopting the same [order] on remand."[22] The court emphasized that remanding an agency decision for "treatment consistent with this opinion," presents "a

[18] 332 U.S. 194 (1947) (Jackson, dissenting).

[19] *Id.* at 196.

[20] *Id.* at 200-01.

[21] 130 F.3d 1078, 1083 (D.C. Cir. 1997) (upholding agency's order on remand that reverted to a previous interpretation of the relevant statute). *See also Monsanto Co. v. FERC*, 963 F.2d 827, 831 (5th Cir. 1992) (finding that remand order "rehabilitate[d]" the previous decision with further explanation and that the decision was no longer arbitrary and capricious).

[22] *Radio Televisión S.A. de C.V.*, 130 F.3d at 1083 (quoting *Ill. Pub. Telecomm Ass'n v. FCC*, 123 F.3d 693, 694 (D.C. Cir. 1997)).

wide range of actions" for the agency.[23] The court further explained "[t]he Commission could have sought to maintain its changed interpretation if it could provide adequate justification, but it was equally free to acknowledge, as it did, that its change in interpretation was incorrect."[24] In *Petal Gas Storage, L.L.C. v. FERC*, the D.C. Circuit vacated and remanded a Commission order and expressly contemplated that the Commission could reach the same outcome but which is "explained and justified in very different terms."[25]

The court in *United Airlines* vacated and remanded the Commission's decisions in *SFPP* "for further proceedings consistent with this opinion."[26] The court did not limit the agency's options on remand, and the Commission has the discretion in this NOI proceeding to provide a convincing rationale to support its existing income tax allowance policy.

The purpose of the instant proceeding is to establish an industry-wide policy. The Commission stated in the NOI:

> The Commission recognizes the potentially significant and widespread effect of this holding upon the oil pipelines, natural gas pipelines, and electric utilities subject to the Commission's regulation. The importance of the income tax policy for partnership entities extends well-beyond the particular interests of the parties to the *United Airlines* proceeding. . . . Accordingly, this NOI seeks further information as the Commission re-evaluates its policies following the *United Airlines* decision.[27]

The Commission is free to develop a new record in this proceeding and is not bound by the still unsettled and more narrow record of the SFPP proceeding when developing an industry-wide policy. The Commission is authorized to and should determine, based upon the

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[23] *Id.*

[24] *Id.*

[25] 496 F.3d 695, 700 (D.C. Cir. 2007). *See also Okla. Natural Gas Co. v. FERC*, 28 F.3d 1281 (D.C. Cir. 1994) (upholding agency order following two remands by the court for further explanation).

[26] 827 F.3d at 137.

[27] NOI, 81 Fed. Reg. at 94,366 (P 2).

substantial empirical evidence offered by INGAA and others, that there is no double recovery associated with including an income tax allowance as part of a partnership's cost of service. In addressing this important ratemaking policy for both the interstate natural gas and oil pipeline industries, the Commission should consider the broad policy implications of this proceeding.[28] Any modification of the Commission's existing policy that does not provide MLP pipelines with cost recovery of income taxes would have negative financial consequences for MLPs and could threaten the continued use of this organizational structure as a vehicle for investment in energy infrastructure. The Commission should reaffirm its existing tax allowance policy.

B. The Returns of MLP Pipelines and Corporate Pipelines Under the Commission's Existing Income Tax Policy Are Commensurate and Consistent with *Hope*.

The Commission should disregard commenters' contentions that the Commission's current tax allowance policy does not ensure commensurate returns for investors in MLP pipelines and investors in corporate-owned pipelines.[29] Mr. Sullivan's testimony directly refutes these unsupported contentions. Mr. Sullivan demonstrated, using actual, up-to-date market data that (1) the DCF ROEs for MLP pipelines are not consistently higher than the DCF ROEs of corporate pipelines of comparable risk over time;[30] (2) the distribution yields of MLP

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[28] *Action for Children's Television v. FCC,* 564 F.2d 458, 471 (D.C. Cir. 1977) ("agency may draw upon its own expertise in interpreting the facts or upon broad policy considerations not present in the record."). The courts have been "'particularly deferential to the Commission's expertise' with respect to ratemaking issues," holding that "FERC's decisions will be upheld as long as the Commission has examined the relevant data and articulated a rational connection between the facts found and the choice made." *ExxonMobil Corp. v. FERC*, 487 F.3d 945, 951 (D.C. Cir. 2007) (quoting *Ass'n of Oil Pipelines v. FERC*, 83 F.3d 1424, 1431 (D.C. Cir. 1996)) ("[P]olicy choices about ratemaking are the responsibility of the Commission-not this Court."). *See also BP West Coast Products*, *LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004), *reh'g denied*, 2004 U.S. App. LEXIS 20976-98 (2004).

[29] *See, e.g.,* Natural Gas Indicated Shippers Comments at 20-22; NGSA Comments at 11; United Airlines Petitioners and Aligned Shippers Comments at 11.

[30] Sullivan Testimony at 54-63.

pipelines are not consistently greater than the dividend yields of corporate pipelines;[31] and (3) the IBES growth rates of MLP pipelines are not consistently greater than the IBES growth rates of corporate pipelines.[32] Mr. Sullivan explains that the returns of both MLP pipelines and corporate pipelines are subject to significant fluctuations but that, over time, their returns are comparable.[33] This empirical evidence demonstrates that the returns of MLP pipelines and corporate pipelines have been commensurate under the Commission's existing tax allowance policy.

The Supreme Court's decision in *Hope* articulates important guiding principles that inform the development of a pipeline's just and reasonable rates, including the requirement to ensure commensurate returns for MLP pipelines and corporate pipelines.[34] The Court stated:

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business . . . *the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.* That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[35]

In *United Airlines*, the court cited this language from *Hope* and stated that "[e]ven if FERC elects to impute partner taxes to the partnership pipeline entity, it must still ensure parity between equity owners in partnership and corporate pipelines."[36]

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[31] *Id.* at 64-68.
[32] *Id.* at 68-69.
[33] *See, e.g., id.* at 48.
[34] 320 U.S. at 603.
[35] *Id.* (emphasis added) (citations omitted).
[36] 827 F.3d at 137.

The Commission should interpret the "commensurate" and "parity" requirements consistent with the principle that ratemaking is not precise and that the Commission has broad discretion to approve rates that are within a "zone of reasonableness." The Supreme Court in *Hope* explained that just and reasonable rates are not based on any single formula or combination of formulae, but rather rely on "pragmatic adjustments" and the consideration of many factors.[37] The statutory "just and reasonable" standard permits the Commission to approve or establish rates that fall within a "zone of reasonableness."[38] The Court stated in *Permian Basin*:

> [T]his Court has often acknowledged that the *Commission is not required by the Constitution or the Natural Gas Act to adopt as just and reasonable any particular rate level; rather, courts are without authority to set aside any rate selected by the Commission which is within a 'zone of reasonableness.' FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585, 62 S.Ct. 736, 743, 86 L.Ed. 1037. No other rule would be consonant with the broad responsibilities given to the Commission by Congress; it must be free, within the limitations imposed by pertinent constitutional and statutory commands, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests.[39]

The D.C. Circuit has explained, consistent with these principles, that any of the potentially numerous rates which fall along the continuum of just and reasonable rates is permissible under the NGA.[40]

The courts also have recognized that establishing the ROE of a regulated pipeline is an area of ratemaking that lacks mathematical precision and requires flexibility. In *Southern*

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[37] 320 U.S. at 602; *"Complex" Consolidated Edison Co. of N.Y. v. FERC*, 165 F.3d 992, 1002 (D.C. Cir. 1999); *See Cities of Bethany*, *v. FERC*, 727 F.2d 1131, 1138 (D.C. Cir.), *cert. denied*, 469 U.S. 917 (1984); *Farmers Union Cent. Exchange, Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir.), *cert. denied*, 469 U.S. 1034 (1984); *Ala. Elec. Coop., Inc. v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982).

[38] *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968) (relying on *Hope* in approving maximum rates for interstate gas sales in the Permian Basin); *"Complex" Consolidated Edison*, 165 F.3d at 1004; *Farmers Union* 734 F.2d at 1502. *Nev. Power Co v. FPC*, 589 F.2d 1002, 1006 (9th Cir. 1979).

[39] *In re Permian Basin Area Rate Cases*, 390 U.S. at 767 (emphasis added).

[40] *"Complex" Consolidated Edison*, 165 F.3d at 1004.

California Edison Co. v. FERC, the court described the process of setting the rate of return on equity as a "roundabout estimation, including relying on the ROEs of comparable publicly-traded companies, termed a proxy group."[41] The court explained that the process involves "assembl[ing] a zone of reasonable ROEs on which to base a utility's ROE."[42] From there, the Commission selects a rate of return from the range of proxy group return estimates.[43] The ROEs produced by the DCF methodology are different in each proceeding because they are dependent on inputs that change over time and the ultimate makeup of the proxy group. The fact that the Commission requires that the ROE generally be set using the median return among proxy members demonstrates that there is no single ROE that is appropriate for every pipeline. The fluctuations in proxy groups' DCF ROEs that Mr. Sullivan has documented are inherent in the DCF methodology. Such variations reflect the constantly changing, unquantifiable evaluation and weighting by investors of numerous factors, including the market's overall view of the relative risks of the various proxy group companies that are represented in the DCF model.

The court's decision in *United Airlines* does not change the longstanding precedent underlying the Commission's fundamental ratemaking principles. The process of ratemaking and, more specifically, establishing a rate of return, are not the result of mathematically precise calculations. Rather, policy and precedent require that ratemaking provide enough revenue to afford a pipeline an opportunity to recover its costs of providing jurisdictional services, such as income taxes, and to allow a rate of return that is reasonably comparable to the returns on

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[41] 717 F.3d 177, 179 (D.C. Cir. 2013) (citing *Pub. Serv. Comm'n of Ky. v. FERC*, 397 F.3d 1004, 1006-07 (D.C. Cir. 2005)).

[42] *Id.*

[43] *See, e.g., El Paso Natural Gas Co.*, *Opinion No. 528*, 145 FERC ¶ 61,040 at P 686 (2013); *Portland Natural Gas Transmission Sys.*, *Opinion No. 524*, 142 FERC ¶ 61,197 at P 395 (2013).

investments in other enterprises having corresponding risks. The Commission's existing income tax allowance policy is consistent with this policy and precedent because it ensures commensurate returns for the investors in each type of entity taking into account the risks of investment of each entity.[44]

C. No Commenter Has Demonstrated That the Commission's Existing Income Tax Allowance Policy Causes a Double Recovery, and the Commission Should Reject Commenters' Requests to Modify or Eliminate the Tax Allowance.

1. The Natural Gas Indicated Shippers Have Failed to Demonstrate a Double Recovery, and Their Request to Remove the Income Tax Allowance Is Baseless.

The Natural Gas Indicated Shippers request the Commission "to eliminate the income tax allowance for partnerships and other pass-through entities, in order to eliminate the double recovery of the income tax cost through the pipeline cost of service and through the DCF methodology."[45] According to the Natural Gas Indicated Shippers, the affidavit of Elizabeth Crowe, submitted with their comments, shows that "the Commission's current income tax allowance policy is flawed because it allows equity owners of partnerships to receive a return that is considerably higher than the equivalent returns for equity owners in corporations."[46] It does not. Ms. Crowe's affidavit relies upon unrealistic and inaccurate assumptions that invalidate her conclusions. The Commission should reject the Natural Gas Indicated Shippers' request to eliminate the income tax allowance for MLP pipelines.

The Natural Gas Indicated Shippers contend that Exhibit A of Ms. Crowe's affidavit "demonstrates that an investor in a partnership with no tax allowance in the pipeline cost of service would retain the same after-tax return as an investor in a corporation" and that, "[i]n

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[44] Sullivan Testimony at 62.

[45] Natural Gas Indicated Shippers Comments at 10.

[46] *Id.*at 20 (citing Exhibit A, Affidavit of Elizabeth H. Crowe, at 5:6-16).

contrast, if a partnership were permitted to include a tax allowance in the pipeline cost of service, the Commission would not be providing a commensurate return to the equity holder, vis-à-vis the equity holder in a pipeline company owned by a corporation."[47] This conclusion relies on the flawed assumptions that (1) both corporate shareholders and MLP unitholders pay the same 15% tax rate on the dividends or distributions received from their respective corporation or MLP, and (2) that shareholders of corporations are receiving 100% of the pipeline's net income in dividends.

Ms. Crowe's assumptions are inconsistent with current tax laws and are unrealistic with respect to the level of dividends that are typically paid by corporations. There are substantial differences between the tax treatment of distributions received by MLP unitholders and the dividends received by corporate shareholders. INGAA Witness Mr. Sullivan explains that an MLP unitholder receives a distribution from the MLP pipeline that includes the "unitholder's proportion of a partnership's income that is taxable to the unitholder whether or not it is distributed."[48] He further explains that "[f]or an MLP owned pipeline, the corporate and individual partners are liable for taxes on the income generated by the pipeline."[49] INGAA Witness Dr. Erickson explains that the income tax liability attributable to the partner's proportionate share of the MLP's taxable income is paid by the MLP unitholders and is taxed at the applicable ordinary income tax rate.[50] MLP-owned pipelines receive an income tax allowance based on this tax liability. For corporate pipelines, the pipeline's income tax

[47] *Id.* at 20-21.
[48] Sullivan Testimony at 11:2-3.
[49] *Id.* at 11:4-5.
[50] Erickson Testimony at 6.

liability is paid directly by the corporation.[51] Corporate-owned pipelines receive an income tax allowance based on this tax liability.[52] The dividend paid to corporate shareholders, which is taxed at a lower rate than MLP taxable income, does not include a pass-through of the corporate pipeline's income tax liability. The Commission does not provide a tax allowance for the taxes associated with corporate dividends just as the Commission does not provide a tax allowance for an MLP unitholder's tax liability at the end of the investment period identified in Dr. Erickson's "life-cycle" analysis.[53]

Ms. Crowe's analysis is fundamentally flawed because she does not give effect to the fact that corporate dividends are taxed at a lower rate than MLP distributions. The dividend tax rate is no higher than 20%, but MLP distributions are taxed as ordinary income at rates up to 39%. Given the difference in tax treatment between dividends and distributions, the assumption that the two would be taxed at the same rate is unfounded. It is also highly unlikely that a pipeline formed as a corporation would ever pay 100% of its net income in dividends.[54] Ms. Crowe's failure to utilize realistic assumptions about the level of taxes paid by partnership unitholders improperly skews the results of the return percentages derived in Exhibit A in favor of the results she is supporting. Given these material errors, the Commission should reject her conclusions.

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[51] *Id.* at 12

[52] Sullivan Testimony at 18.

[53] *Id.* at 11-14. Dr. Erickson demonstrated in his "life-cycle" analysis that, over time, C-corporations and owners of partnerships are both responsible for income taxes, and the total combined taxes paid by the C-Corporation and its shareholders are comparable to the total taxes paid by MLP unitholders.

[54] *See* Erickson Testimony at 8. Dr. Erickson utilized a 65% C-Corporation dividend payout ratio which is "the payout ratio that was utilized by FERC in an example attached as Appendix B to its 2008 Policy Statement in Docket No. PL07-2-000 concerning the composition of proxy groups."

If Ms. Crowe were to utilize realistic tax rates and Dr. Erickson's reasonable assumptions regarding the percentage of corporate net income paid as dividends, both C-Corporations and partnerships would show "commensurate" returns. This directly contradicts the Natural Gas Indicated Shippers' conclusion that the Commission's current income tax allowance policy allows "equity owners of partnerships to receive a return that is considerably higher than the equivalent returns for equity owners in corporations."[55] The Natural Gas Indicated Shippers' conclusion is further refuted by Mr. Sullivan's testimony, which demonstrates that under the Commission's existing income tax allowance policy, MLP pipelines and corporate pipelines have earned comparable returns.[56]

2. The Commission Should Reject United Airlines Petitioners and Aligned Shippers' and Liquid Shippers Group's Unsupported Assertions of Double Recovery.

United Airlines Petitioners and Aligned Shippers (UAL Petitioners) and Liquid Shippers Group (LSG) claim that in *United Airlines*, the D.C. Circuit concluded that the grant of an income tax allowance to an MLP-owned pipeline causes the pipeline to double recover its income tax liability, once through the income tax allowance and a second time through the allowed ROE.[57] Their claim is refuted by the plain language of the court's opinion. The court held only that "*FERC has not provided sufficient justification* for its conclusion that there is no double recovery of taxes for partnership pipelines receiving a tax allowance in addition to the discounted cash flow return on equity."[58] UAL Petitioners and LSG also fail to provide

[55] Natural Gas Indicated Shippers Comments at 20.

[56] Sullivan Testimony at 27.

[57] UAL Petitioners Comments at 1, 6; LSG Comments at 5.

[58] *United Airlines*, 827 F.3d at 136 (emphasis added). *See supra* Section II.A.

any empirical support for their claim of double recovery. The Commission should reject their unsupported assertion.

LSG focuses on the wrong perspective to support its claim that a partnership-owned pipeline double recovers its income taxes because the partnership does not pay taxes at the entity level and the corporation does pay entity level taxes.[59] INGAA Witness Mr. Sullivan explains that this type of simplistic analysis incorrectly focuses on "'who pays the taxes' (*i.e.*, the entity or investor) rather than on the more fundamental cost allocation principle of 'what costs are attributable to the regulated pipeline service.'"[60] This is the same approach the Commission determined to be the critical flaw of its *Lakehead* policy, and which the Commission expressly designed the current income tax allowance policy to correct in the 2005 Policy Statement. Mr. Sullivan explains that, "[i]n determining whether a regulated rate is just and reasonable, the proper perspective is to consider the costs associated with providing the regulated pipeline service," and that "[i]ncome taxes are a cost attributable to regulated pipeline service."[61] Mr. Sullivan further explains that the Commission and the courts have held that it is reasonable to include an income tax allowance for first-tier income taxes.[62] For MLP-owned pipelines, first-tier income taxes are not paid directly by the MLP pipeline but instead are passed through to the MLP unitholders.[63] The Commission "imputes the income taxes paid by partners in a partnership pipeline to the pipeline itself."[64] Contrary to LSG's

[59] LSG Comments at 5.

[60] Sullivan Testimony at 13:5-7.

[61] Sullivan Testimony at 13:21.

[62] Sullivan Testimony at 13:22-14:16 (citing *Inquiry Regarding Income Tax Allowance*, 111 FERC ¶ 61,139, P 37 (2005) (Policy Statement)).

[63] *See* Sullivan Testimony at 14:8-9.

[64] *United Airlines*, 827 F.3d at 136.

position, both corporation-owned and partnership-owned pipelines have an actual tax liability for first-tier income taxes that is properly recovered through a tax allowance.

Mr. Sullivan further explains that the income taxes paid on dividends by the shareholders of a corporate pipeline are not a cost of providing the regulated pipeline service.[65] Taxes on basis recapture paid by MLP unitholders upon the sale of their partnership units are also not included in development of the cost of service for a regulated pipeline.[66] INGAA Witness Dr. Erickson's analysis demonstrates that the combined total taxes paid by the entity and the investors in each organizational form are commensurate.[67] The corporate shareholders' income tax liability on dividend income and the MLP unitholders' tax liability on basis recapture are both irrelevant in determining what costs can reasonably be included in the pipeline's cost of service. The Commission should reject LSG's overly-simplistic and unsupported analysis.

Both the UAL Petitioners and LSG recommend the removal of the income tax allowance as the solution to the over-recovery issue. But no such over-recovery exists. INGAA Witness Mr. Sullivan explains that MLP unitholders' income tax liability attributable to an MLP pipeline's taxable income is "a cost of operating and owning the pipeline asset and they are entitled to the recovery of those costs in the pipeline's cost of service."[68] The Commission has explained that a pipeline will not recover its required after-tax ROE if denied an income tax allowance because the income tax allowance is not factored into the DCF ROE.[69]

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[65] Sullivan Testimony at 14.

[66] *Id.* at 15.

[67] Erickson Testimony at 14.

[68] Sullivan Testimony at 25:11-13 (citing *Policy Statement*, 111 FERC at PP 33, 34, 37; *ExxonMobil*, 487 F.3d 945, 952, 954-55 (D.C. Cir. 2007)).

[69] *SFPP, L.P., Opinion No. 511-A*, 137 FERC ¶ 61,220, at PP 286-88 (2012).

The Commission should not require the removal of the income tax allowance, which would cause MLP-owned pipelines to under-recover their allowed ROEs.

UAL Petitioners' and LSG's assertions of double recovery appear to be based on the misunderstanding of the way that investors account for an MLP's tax liability and the Commission's income tax allowance policy.[70] Because of the income tax allowance, investors know that the MLP pipeline's distributions will be sufficient to fund the investors' income tax liability associated with their allocated shares of the pipeline's net income. The DCF formula is a theoretical model that produces an estimate of investors' required return. The model does not purport to identify or quantify the factors that underlay the current stock/unit price (which determines the current yield) and the estimated earnings growth rate that are both used in the formula. The DCF theory holds that investors (in the aggregate, i.e., "the markets") are aware of and consider all publicly-available information about every available investment (for purposes of FERC's DCF application, the stocks or units of the proxy companies). For MLPs, that available information includes the fact that MLP pipelines' rates are designed to recover income taxes through an income tax allowance included in the cost-of-service, not through the DCF model. This income tax recovery is a component of the available cash flows that the pipelines will distribute to unitholders. There is no reason to anticipate that any other income taxes have any bearing on DCF-derived estimates of ROE.

UAL Petitioners' and LSG's assertion that the DCF ROE results in an over-recovery of income taxes suggests that MLP investors either disregard the income tax allowance in an MLP pipeline's cost of service, or seek a return that will compensate them for taxes additional

[70] LSG Comments at 3.

to those the pipeline recovers through its rates. That proposition is directly contrary to the DCF theory that the Commission and the courts have endorsed.[71] It also is contrary to the evidence presented by INGAA's witness Mr. Sullivan, which establishes that DCF-derived ROEs of MLP-owned pipelines are not systematically higher than, but instead are essentially commensurate with, those of corporation-owned pipelines.

UAL Petitioners and LSG both cite to *Opinion No. 511*,[72] which provides an example that uses the after-tax percentage ROE to determine the before-tax percentage ROE necessary to recover the income tax allowance.[73] LSG jumps to the conclusion that *applying* the tax adjustment factor [= 1/(1-tax rate)] to the after-tax ROE results in an ROE that *includes* the income tax allowance. For instance, for a corporate tax rate of 35%, a DCF ROE of 10 percent results in a 15.385 percent [=10%/(1-35%)] pre-tax ROE. UAL Petitioners and LSG fail to recognize that because the DCF ROE is one of the determinants of the income tax allowance, it does not logically follow that the DCF ROE formula would also include an income tax allowance. INGAA Witness Mr. Sullivan explains that the income tax allowance is determined using the after-tax percentage ROE reported as a separate line item in the cost of service.[74] Mr. Sullivan explains that, "[i]n order to ensure that it will have an opportunity to earn its after-tax equity return as determined based on the DCF analysis, the company's rates must also recover an amount to pay the taxes its owners will owe on the return allowance included in its rates."[75] The tax allowance in the cost of service simply recovers this tax liability and nothing more.[76]

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[71] *See, e.g., Tenn. Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1210 (D.C. Cir. 1991).

[72] *SFPP, L.P.*, Opinion No. 511, 134 FERC ¶ 61,121, at PP 243-44 (2011).

[73] *United Airlines*, 827 F.3d at 136.

[74] Sullivan Testimony at 21.

[75] *Id.* at 19:8-11.

[76] Mr. Sullivan description of tax allowance calculation at page 19 of his testimony is consistent with the description of the income tax allowance in Commission Staff's Cost of Service Manual. FERC, Cost-of-Service

UAL Petitioners argue that if the FERC allows an income tax allowance for MLPs, "it must construct an offsetting adjustment to the DCF ROE to ensure that 'there is no double recovery.'"[77] UAL Petitioners fail to demonstrate that the inclusion of an income tax allowance results in an over-recovery or double recovery of taxes. By contrast, INGAA Witness Mr. Sullivan provides substantial empirical evidence demonstrating that the Commission's DCF model does not include an income tax component and that the Commission's income tax policy does not result in a double recovery of income taxes by MLP pipelines.[78] The Commission should reject commenters' unsupported assertions of double recovery and affirm its current income tax allowance policy.

3. PGC and AFPA's Complex Theoretical Presentation Is Based on a Flawed Assumption and Does Not Show a Double Recovery.

PGC and AFPA request that the Commission remove the income tax allowance for MLP pipelines. Their request is based upon a "theoretical" model that purportedly demonstrates that "the Commission's DCF model calculates a return that fully incorporates personal income taxes and need not be 'adjusted' to accommodate such taxes."[79] PGC and AFPA attempt to demonstrate that a double recovery of income taxes results from the Commission's DCF model by undertaking a complex theoretical exercise consisting of approximately twenty pages of mathematical equations. Buried within the PGC and AFPA model is the incorrect assumption that income taxes are included in the Commission's DCF

Rates Manual at 21, Appendix A-12 (June 1999) (see the calculation reflected in Appendix A-12), http://www.ferc.gov/industries/gas/gen-info/cost-of-service-manual.doc.

[77] UAL Petitioner Comments at 7 (quoting *United Airlines*, 827 F.3d at 137).

[78] Sullivan Testimony at 18, 41-69.

[79] PGC and AFPA Comments at 4.

formula. PGC and AFPA then proceed to perform a series of complex equations intended to demonstrate what it had already assumed to be the result.

PGC and AFPA concede that the Commission's "DCF model itself is sound in principle" and that "no additional changes to the DCF model are required,"[80] a position with which INGAA agrees. As explained by Mr. Sullivan, the Commission's "DCF model is used to determine the ROE that a regulated entity may recover in its rates in addition to the cost of providing service."[81] Within the DCF model, the ROE for each proxy group member "equals (1) the current dividend yield (dividends divided by share price for corporations) or (distributions divided by unit price for MLPs) plus (2) the projected future growth rate of dividends/distributions."[82]

PGC and AFPA's theoretical model relies on a formula (Formula 5), which PGC and AFPA state reflects "the price of stock taking into account expected cash flow after personal taxes (or net cash flow) and reflecting dividend growth at a constant rate and reflecting investor's discount rate."[83] Formula 5 assumes that personal, *i.e.*, investor, income taxes are included in this formula, which are reflected as *p*. Formula 5 is stated as:

$$P_0 = \frac{D_1 \cdot (1 - p)}{\delta - g}$$

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[80] *Id.* at 4, 14.

[81] Sullivan Testimony 16:13-15.

[82] *Id.* at 17:9-12. With respect to the growth rate, Mr. Sullivan explains that:

> The Commission uses a two-step procedure to determine the projected growth in dividends of the Proxy Group companies, averaging short-term and long-term growth estimates. The Commission uses the five-year Institutional Broker's Estimate System (IBES) growth projections for the short-term growth projection, and the growth rate of the Gross Domestic Product (GDP) as its long-term growth rate. The Commission gives two-thirds weight to the short-term growth projection and one-third weight to the long-term growth projection.

Id. at 16:4-9.

[83] PGC and AFPA Comments at 7.

The Commission's DCF formula does not include investor/personal income taxes. As stated by PGC and AFPA, the DCF formula used by the Commission is as follows:

$$P_0 = \frac{D_1}{k - g}$$

The difference between the Commission's DCF formula and PGC and AFPA's Formula 5 is that Formula 5 includes investor/personal taxes and the Commission's DCF formula does not.

The assumptions that PGC and AFPA make to equate Formula 5 and the Commission's DCF model effectively remove the income tax component from Formula 5. PGC and AFPA assume that "[i]f there are no personal taxes, then $p = 0$" which reduces the formula to reflect that "the price of stock equals the expected dividends and reflects the discount rate applied to such dividends by the investor."[84] PGC and AFPA then assume that, "*in a world where investors do not pay personal income taxes*, $k = \delta$, that is, the discount rate applied by the market to the regulated firm's stream of dividends will be equal to the investor's required rate of return."[85]

By removing income taxes from Formula 5 in order to make their formula equal the Commission's DCF formula, PGC and AFPA acknowledge that the Commission's DCF formula does not include an income tax component. This is just the opposite of what PGC and AFPA are attempting to prove and supports INGAA's conclusion that the Commission's DCF model does not include an income tax component.

When they actually apply Formula 5 in their theoretical model, PGC and AFPA drop the assumption of a zero income tax rate ($p = 0$) and add back in the assumption that Formula

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[84] *Id.*

[85] *Id.* at 8 (emphasis added).

5 includes a tax component, *i.e.,* AFPA and PGC assume that "$p > 0$."[86] PGC and AFPA include an income tax in Formula 5 throughout the remainder of their mathematical exercise. The fatal flaw in PGC and AFPA's theoretical model is that Formula 5 assumes the very proposition that the model purports to prove: that income taxes are recovered through the Commission's DCF model.

By inserting an income tax component into Formula 5, PGC and AFPA rely on a formula that is no longer the same as the Commission's DCF formula. To demonstrate the magnitude of PGC and AFPA's analytical flaw, INGAA compares the return of a single C-Corporation using both the Commission's DCF formula and Formula 5. Relying on PGC and AFPA's own conclusion that the Commission's DCF formula is "sound in principle" and "requires no further adjustment," for the same company, one must hold constant the dividend (D_1), the growth rate (g), and the return (k or δ). For Formula 5, INGAA has assumed a dividend tax rate of 20%. The comparison shows that the use of Formula 5 would substantially skew the DCF results of a hypothetical C-Corporation because of the inclusion of the income tax component.

	Commission's DCF Formula	Formula 5
C-Corporation	$P_0 = \frac{D_1}{k - g}$	$P_0 = \frac{D_1 \cdot (1-p)}{\delta - g}$
Formula=	$= \frac{\$2.00}{12\% - 2.5\%}$	$= \frac{\$2.00 * (1 - 20\%)}{12\% - 2.5\%}$
P=	= \$21.05	= \$16.84

[86] *Id.* at 11.

As shown in this simplistic example, with all factors held constant for the same C-Corporation, the results of the price of the stock (P) are not equal. This plainly demonstrates that Formula 5 is not equivalent to the Commission's DCF formula.[87]

In the following table, INGAA utilizes both the Commission's DCF formula and Formula 5 to solve for return in each formula. INGAA has maintained the same Dividend (D_1) assumption and growth rate (g) assumption and held the stock Price (P_0) in each scenario constant at $21.05:

	Commission's DCF Formula	Formula 5
C-Corporation	$k = \frac{D_1}{P_0} + g$	$\delta = \frac{[D_1 \cdot (1-p)]}{P_0} + g$
Formula=	$= \frac{\$2.00}{\$21.05} + 2.5\%$	$= \frac{[\$2.00 \cdot (1-20\%)]}{\$21.05} + 2.5\%$
Return (k or δ) =	= 12.00%	= 10.10%

The lower return generated using Formula 5 in this example further demonstrates that Formula 5 is not the same as the Commission's DCF formula. The return generated by Formula 5 is sensitive to the personal income tax rate, *p*, since higher personal income tax rates result in lower generated returns. The only way to equalize Formula 5 with the Commission's DCF formula would require an upward adjustment to return (δ) to account for the tax impact that is not part of the Commission's DCF methodology.

[87] PGC and AFPA's argument hinges upon the unsupported assertion that the "Commission's DCF model calculates a return k that fully incorporates personal income taxes and need not be 'adjusted' to accommodate such taxes," regardless of whether those taxes are the lower dividend and long-term capital gains rates paid by the C-Corporation investors or the higher ordinary income tax rate paid by MLP investors. PGC and AFPA's Comments at 4, 14. The only way this is possible is to assume a lower return in Formula 5. For the Price (P_0) generated in Formula 5 to match the Price (P_0) generated in the Commission's DCF model, a downward adjustment to the return (δ) in Formula 5 would be necessary.

The inclusion of Formula 5 in PGC and AFPA's mathematical proof and the assumption that the magnitude of the tax does not matter is fatal to the conclusions that flowed from that analysis. The income tax component is not part of the Commission's DCF model. PGC and AFPA's theoretical model shows an income tax component only because Formula 5 artificially includes the income tax component as an "assumption." Without this assumption, there is no basis for PGC and AFPA's conclusion that "the Commission's DCF model calculates a return that fully incorporates personal income taxes."[88]

The testimony of INGAA's witnesses provides additional support that PGC and AFPA's analysis is flawed. Mr. Sullivan provides empirical evidence demonstrating that the Commission's DCF model does not include an income tax component and that the DCF returns of MLPs and C-Corporations over time are generally commensurate.[89] The Commission should reject PGC and AFPA's unsupported conclusions.

4. The Commission Should Reject Natural Gas Indicated Shippers' Request to Return to the Lakehead Policy.

The Natural Gas Indicated Shippers request that that the Commission "revise its income tax allowance policy to permit the income tax allowance only for those pipeline companies whose publicly-traded owners pay income taxes at the entity level, and prohibit the income tax allowance for pipelines owned by partnerships (or similar income pass-through entities) where income taxes are paid at the investor level."[90] The Natural Gas Indicated Shippers are essentially requesting that the Commission return to the *Lakehead* policy, pursuant to which limited partnerships could include an income tax allowance in their rates equal to the

[88] PGC and AFPA Comments at 4.

[89] Sullivan Testimony at 18, 41-69.

[90] Natural Gas Indicated Shippers Comments at 14-15. This contention is reflected in Figures 1-3 of the Natural Gas Indicated Shippers' comments. *Id.* at 17-19.

proportion of their limited partnership interests owned by corporate partners, but could not include a tax allowance for their partnership interests that were not owned by corporations.[91]

The *Lakehead* policy was already brought before the D.C. Circuit, where the court held that the Commission failed to justify that policy.[92] On remand from the court's decision, the Commission determined that it would cease using the *Lakehead* approach, explaining that "*Lakehead* 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 included in a regulated cost of service."[93]

Under the Commission's current tax allowance policy, MLP pipelines receive a tax allowance only to the extent that they can demonstrate that their unitholders have an actual or potential tax liability.[94] Adopting Natural Gas Indicated Shippers' proposal would prevent MLP pipelines from receiving an income tax allowance despite the fact that MLP unitholders have an actual or potential income tax liability for the income of MLP pipelines. For the same reasons the Commission rejected the *Lakehead* policy in the *Policy Statement*, it should reject the Natural Gas Indicated Shippers' request that it re-adopt that policy here.

5. *The Commission Should Reject Dr. Horst's Unsupported Proposal to Adjust the Returns of MLP Proxy Group Companies.*

Dr. Thomas Horst asserts that MLP returns consistently exceed those of C-Corporations, and he proposes a downward adjustment of 1.4% (140 basis points) to the ROEs

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[91] *See Policy Statement*, 111 FERC ¶ 61,139, P 2 (2005) (citing *Lakehead Pipe Line Co.*, 71 FERC ¶ 61,388 (1995), *reh'g denied*, 75 FERC ¶ 61,181 (1996) (*Lakehead*)).

[92] *BP West Coast Products*, *LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004), *reh'g denied*, 2004 U.S. App. LEXIS 20976-98 (2004).

[93] *Policy Statement*, 111 FERC ¶ 61,139, P 33.

[94] *Id.* at P 34.

of MLPs used in a proxy group of corporate pipelines.[95] The Commission should reject Dr. Horst's analysis, which is based on unsupported conjecture and departs without explanation from his prior testimony.

Dr. Horst's comments are plainly inconsistent with the analyses he presented in the 2008 *SFPP* proceeding. The Association of Oil Pipe Lines correctly pointed out this incongruity in its comments.[96] In the 2008 *SFPP* proceeding, Dr. Horst stated that MLP ROEs should be adjusted downward by 3.67% (367 basis points) based on the differences between the ROEs of MLPs and C-Corporations.[97] Dr. Horst stated in a subsequent *SFPP* proceeding that partnership pipeline returns were 2.38% (238 basis points) higher than those of corporate pipelines.[98]

Dr. Horst moves the target again in this proceeding, now proposing a downward adjustment of 1.4% (140 basis points) to the ROEs of MLPs, based upon a new analysis. Dr. Horst's new analysis represents a 227 basis point, or almost 62%, reduction in the size of the ROE adjustment he proposed, and which the Commission rejected, in the 2008 *SFPP* proceeding. Dr. Horst's new proposal also changes his analytical methods from those used in the 2008 proceeding. Rather than attempting to support his claims with empirical data

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[95] Thomas Horst, Comments Submitted in Response to the FERC Notice of Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs at 6 (Feb. 6, 2017) (Horst Comments). It appears that Dr. Horst filed comments as an individual party since he does not indicate that his comments are being sponsored by any specific entity or trial group.

[96] Comments of the Association of Oil Pipe Lines at 31-32 (Mar. 8, 2017).

[97] *See* Prepared Answering Testimony of Thomas Horst on Behalf of ExxonMobil Corp., FERC Docket No. IS08-390-002 (Jan. 26, 2009); Prepared Cross-Answering Testimony of Thomas Horst on Behalf of ExxonMobil Oil Corp at 7:20-8:2, FERC Docket No. IS08-390-002 (Feb. 20, 2009).

[98] *See* Prepared Answering Testimony of Thomas Horst on Behalf of Navajo Refining Co., L.L.C. at 45:17 to 50:4, 73:15-17, Docket No. IS09-437-000 (Mar. 29, 2010), corrected in Exh. NAV-66, (July 21, 2010).

involving the returns of actual companies, Dr. Horst's current comments are based on yet another unsupported hypothetical analysis of effective tax rates.[99]

Dr. Horst does not attempt to reconcile his new position with his previous testimony. His failure to reconcile his inconsistent analytical approaches, coupled with the empirical analysis presented by INGAA Witness Mr. Sullivan showing that MLP returns are not consistently higher than C-Corporation returns, demonstrates why Mr. Horst's new analysis has no probative value. There is no justification for Dr. Horst's proposed adjustment given Mr. Sullivan's demonstration that, with the Commission's existing income tax allowance, the long-term returns of MLP pipelines and corporate pipelines have been comparable. The Commission should find that there is no over-recovery of income taxes by MLP pipelines and reject Dr. Horst's proposed ROE adjustment.

D. The Commission Should Reject Requests to Institute Section 5 Proceedings.

The Commission should reject the requests of the American Public Gas Association (APGA), the Natural Gas Supply Association (NGSA), and the Natural Gas Indicated Shippers to initiate proceedings under Section 5 of the Natural Gas Act requiring MLP pipelines to eliminate the income tax component of their rates.[100] INGAA has demonstrated through empirical evidence that the Commission's income tax allowance policy does not result in double recovery by MLP pipelines. None of the parties arguing for the Commission to initiate proceedings under Section 5 to eliminate the income tax component of an MLP's rates have provided any factual basis or empirical evidence demonstrating an actual over-collection has occurred on any interstate pipeline that is owned by an MLP.

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[99] Horst Comments at 6.

[100] *See* Comments of the American Public Gas Ass'n at 4-5; NGSA Comments at 12; Natural Gas Indicated Shippers Comments at 22-23.

There is no legal basis for initiating Section 5 proceedings to remove the income tax allowance from the rates of MLP pipelines, even if the Commission elects to modify its policy on the income tax allowance. Commenters' requests are contrary to the Commission's ratemaking policy which "generally does not permit pipelines to change one element of their cost-of-service outside of a general Section 4 rate case where all elements of the pipeline's cost-of-service may be considered and increases in one element may be affected by decreases in another."[101] The Commission has explained that this policy also applies to Section 5 proceedings.[102] The Commission should reject Commenters' unsupported requests that the Commission institute Section 5 proceedings by cherry picking a single item out of MLP pipelines' cost-of-service. Requiring modifications to the income tax allowance outside of a general rate case would lead to unjust and unreasonable results, as it would lower pipelines' rates without reflecting those cost-of-service components that may have increased during the relevant period.

Commenters' request for blanket action that would apply to all MLP pipelines under Section 5 would also unlawfully abrogate pipeline rate settlements. The majority of interstate pipelines currently operate under "black box" rate case settlements that generally do not specifically identify individual components of the pipelines' costs of service such as income tax allowance and rate of return on equity. These settlements are the result of a multitude of compromises on a variety of issues among the various parties in a rate proceeding, including the pipeline, transportation customers, and Commission Staff, and the settlement rates are often

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[101] *ANR Pipeline Co.,* 108 FERC ¶ 61,050, at P 14 (2004), *reh'g denied*, 110 FERC ¶ 61,069 (2005).

[102] *Kern River Gas Transmission Co.,* 142 FERC ¶ 61,132, at P 174 (2013), "the Commission generally does not permit a pipeline to file a limited section 4 proceeding to change the rates for some services, but not others, *nor would the Commission ordinarily entertain a section 5 proceeding* solely to adjust the rates for some of a pipeline's services without looking at the pipeline's entire cost of service.") (quoting *Kern River Gas Transmission,* Opinion No. 486-D, 133 FERC ¶ 61,162, at P 193 (2010) (emphasis added).

established simply by negotiation. Any attempt to re-open long-approved settlements not only would be poor policy, but also would spawn contentious and potentially lengthy litigation. Many current settlements include rate moratoriums. While not technically binding on the Commission, the Commission has always honored those provisions. A change in that policy could lead parties to question the value of settlements and moratoriums in Commission rate proceedings. The Commission should not modify settlements based upon the outcome of this proceeding.[103]

The Commission should also reject APGA's request that the Commission immediately issue an order pursuant to NGA Section 5 requiring MLP pipelines to issue refunds of the accumulated income tax reserve.[104] The requested relief is plainly unlawful. The Supreme Court, appellate courts, and Commission have long held that "any relief from excessive rates emanating from [proceedings] under Section 5 is prospective only."[105] Even if the Commission were to change its income tax policy, there is no legal basis to require refunds.[106]

E. Eliminating Tax Allowances for Partnerships Would Jeopardize Tax Normalization Benefits.

The Commission should also consider the adverse effects that disallowing an income tax allowance would have on MLP pipelines' ability to use accelerated depreciation and

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[103] Pipeline settlements typically provide for the standard of review that will be applicable to modifications to that settlement. Therefore, any attempt to modify settlements on a generic basis would be required to comply with such provisions in each particular settlement agreement. Whether the just and reasonable standard or the more rigorous *Mobile-Sierra* public interest standard applies, modifying settlements to eliminate one cost component of the settlement rates would not meet either standard.

[104] APGA Comments at 4-5.

[105] *Pub. Serv. Comm'n of N.Y. v. FPC*, 543 F.2d 757, 780 (1974). *See also Atlantic Refining Co. v. Pub. Serv. Comm'n of N.Y.,* 360 U.S. 378, 389, *amendment denied*, 361 U.S. 801 (1959); *Kern River Gas Transmission Co.*, 133 FERC ¶ 61,162, at P 20 (2010) ("When the Commission acts under NGA section 5 to reduce rates below their preexisting level, the rate reduction may only become effective on a prospective basis. NGA . . .").

[106] *See infra* Section II.E below, explaining the adverse effects related to tax normalization that could result from a Commission decision to eliminate the income tax allowance.

investment tax credits. Natural gas pipelines, unlike oil pipelines, are required by the tax laws to use normalization accounting in order to have the right to use accelerated depreciation.[107] If the Commission eliminates the income tax allowance for MLP pipelines, it must assure that decision will not create normalization violations for pipeline partnerships or jeopardize other important tax benefits.[108]

The Internal Revenue Code establishes how two particular tax benefits, accelerated depreciation and investment tax credits, must be reflected in establishing the rates of a regulated utility enterprise. These requirements, referred to as the normalization rules, limit both the timing and, in some situations, the quantity of these tax benefits to customers. The application of the depreciation normalization rules to an MLP pipeline raises some very difficult issues concerning the computation of the tax expense element of the cost of service, as well as the treatment of established accumulated deferred income taxes (ADIT). These are issues on which there is currently no Commission precedent.

The mechanics of the depreciation normalization rules can best be described as effecting a sharing of tax incentives between utilities and their customers. For example, the normalization rules prescribe that the "zero-cost" funds produced by claiming accelerated depreciation tax deductions must be retained by the utility (*i.e.*, they may not be "flowed through" to customers). These rules allow the benefit of the availability of these funds to the utility to be reflected as a reduction in the financing costs the utility charges to its customers

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[107] Transportation of petroleum by pipeline is not one of the activities that, by statute, is subject to tax normalization rules. The transmission of natural gas by pipeline is one of those activities.

[108] *See Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260, at p. 61,957 (2002) (The Commission "is reluctant to take an action which would endanger a pipeline's right to favorable tax treatment through the use of normalization."), *order on reh'g*, 102 FERC ¶ 61,310 (2003); *Koch Gateway Pipeline Co.*, 74 FERC ¶ 61,088, at p. 61,277 ("While the Commission is not bound to follow an IRS ruling for ratemaking purposes, we are reluctant to take action which would endanger a pipeline's right to favorable tax treatment from the IRS."), *reh'g denied*, 75 FERC ¶ 61,364 (1996).

(in the form of a reduction in the regulated entity's rate base). The utility gains access to incremental funds available as a result of accelerated depreciation and customers enjoy rates lower than those they would have paid had that incentive not been available. Failure to comply with these rules makes the utility ineligible to claim accelerated tax depreciation with respect to its assets that are subject to the regulatory ruling that causes the non-compliance.

Elimination of the income tax allowance for MLP pipelines would implicate the portion of the depreciation normalization requirements known as the "consistency" rule.[109] This rule requires consistency in the rate-setting process regarding the procedures and adjustments applicable to rate base, regulatory depreciation, tax expense, and ADIT. As an example of the operation of this rule, the IRS has held that if an asset is not in rate base, then no ADIT attributable to that asset can reduce rate base.

The operation of the consistency rule could have significant implications for an MLP pipeline if the income tax allowance were eliminated. If a regulated MLP pipeline was afforded no income tax allowance in its rates, it would become unclear whether the pipeline could use any ADIT it records to offset its rate base. If not, the benefit of accelerated depreciation would shift from ratepayers to the MLP pipeline's owners–the ones responsible for paying the taxes. Because customers would not fund the tax benefit, they would also not receive the associated tax benefits. To do otherwise would seemingly be contrary to the consistency rules.

Should an existing MLP pipeline which previously was afforded a tax allowance be prospectively denied such an allowance, it also would become unclear whether the consistency rule, upon the effectiveness of the rate-making change, would even permit recognition of pre-

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[109] *See* Internal Revenue Code, 26 U.S.C. §168(i)(9)(B) (2012).

existing ADIT in determining the pipeline's rate base. The notion that taxes are not a cost of the MLP pipeline would arguably be inconsistent with the recognition of any ADIT. These balances are created and reversed through the tax expense element of cost of service. Absent a tax allowance, there arguably would be no vehicle by which to reverse any pre-existing ADIT balance. Removing ADIT from the MLP pipelines' rate bases would increase pipelines' costs of service and rates.

The ripple effect of a change in Commission policy must be carefully considered before the Commission could reasonably justify a decision to eliminate the income tax allowance for MLP pipelines. The parties that advocate removing MLP pipelines' income tax allowance have not even considered these impacts to the rates they are paying or the impact on the pipeline. The Commission should re-affirm its current income tax allowance policy.[110]

[110] INGAA supports the reply comments filed by Dominion Resources, Inc. and adopts the supporting affidavit of James Warren, which explains that APGA's requested relief could result in a violation of the Internal Revenue Service's tax normalization rules.

III. CONCLUSION

The Commission should continue to allow MLP pipelines to recover in their jurisdictional rates an income tax allowance based on the income tax liabilities of MLP unitholders that are attributable to the MLP's taxable income from providing jurisdictional pipeline services. The tax allowance for MLP pipelines is comparable to the tax allowance that the Commission permits on the taxable income of corporate-owned pipelines and is necessary to provide parity between the equity owners of MLP and corporate pipelines. No adjustment to the Commission's DCF formula is warranted.

Respectfully submitted,

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