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D.C. Circuit Overrules FERC on Partnership Pipeline's Tax Recovery

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In a July 1 decision with major rate implications for FERC-regulated oil and gas pipelines, the United States Court of Appeals for the District of Columbia Circuit ("D.C. Circuit" or the "Court") sided with shippers in an appeal of a Federal Energy Regulatory Commission ("FERC") decision regarding the tax allowances that FERC has allowed oil pipelines to include as a component of their cost of service transportation rates.***[1]*** The Court's decision in *United Airlines, et al. v. FERC, et al.* strikes at the ability of interstate oil pipelines structured as partnerships to account for income taxes in their cost-based rates, and given the prevalence of the master limited partnership structure among oil and gas pipeline companies, this decision could have a wide impact on cost-based rates.

The decision resulted from several appeals of a FERC decision on the cost-of-service rates of oil pipeline SFPP, L.P. ("SFPP"). Most notably for FERC-regulated pipelines that are structured as partnerships or otherwise exempt from entity-level income taxes under the Internal Revenue Code, the Court held that FERC failed to adequately justify its policy of granting partnership pipelines an income tax allowance in their cost of service rates in addition to the return on equity built into those same rates. Under the challenged policy, FERC allows an income tax allowance for pipelines as a cost component of their rates, provided they have "an actual or potential income tax liability to be paid on that income from those assets."***[2]*** However, the Court found that the Commission's policy of permitting a discounted cash flow return on equity component in rates already compensates a partnership pipeline for the tax liabilities of its investors (since a partnership pipeline is not assessed taxes on an entity level like a corporation pipeline). Accordingly, the Court agreed with SFPP shippers that FERC acted arbitrarily and capriciously by failing to demonstrate that partnership pipelines - compared to corporate pipelines - do not "double recover" tax expenses in their rates under this policy.***[3]***

The case is remanded to FERC to either demonstrate that the income tax allowance does not permit partnership pipelines to "double recover" taxes, remove any duplicative tax recovery for partnership pipelines by adjusting the discounted cash flow return on equity, or eliminate income tax allowances and set rates based on pre-tax returns alone. While the Court's order on income tax allowance for a partnership is significant, we note that setting rates on pre-tax returns alone would constitute a significant and dramatic change in FERC ratemaking, affecting

all pipeline cost of service ratemaking, whether the entity has a partnership or corporate structure.

The Court Held that FERC Must Justify its Tax Allowance Policy and Demonstrate there is No Double Recovery of Taxes for Partnership Pipelines

Shippers of SFPP, a Delaware limited-partnership oil pipeline, alleged that FERC's income tax allowance policy resulted in double recovery of taxes because 1) partnership pipelines are not taxed at the pipeline level; and 2) FERC's discounted cash flow return on equity already ensures an after-tax return to attract investment in the pipeline.[4] This "double recovery" argument had been raised before the same Court previously in *ExxonMobil v. FERC*.[5] In *ExxonMobil*, the D.C. Circuit rejected arguments against FERC's tax allowance policy that permitted income tax allowance to both partnership pipelines and corporate pipelines on grounds that,

investors in a limited partnership are required to pay tax on their distributive shares of the partnership income, even if they do not receive a cash distribution[,] . . . the income received from a limited partnership should be allocated to the pipeline and included in the regulated entity's cost-of-service.[6]

While noting this justification, the Court in *United Airlines, Inc.* stated that the *ExxonMobil* opinion implicitly reserved the question of double recovery that came before it in this case, since it had previously held only that granting partnership pipelines an income tax allowance in addition to its return on equity may be reasonable, but FERC failed to demonstrate that it was reasonable here.

The Court went on to find that since unlike a corporate pipeline, a partnership pipeline incurs no taxes at the entity level other than those imputed from its partners, the discounted cash flow return on equity component on a partnership pipeline rates, when combined with a separate tax allowance, results in a higher after-tax return for a partner in the pipeline compared to a shareholder in a corporate pipeline. The Court also found that FERC conceded this fact at oral argument in the case.

The Court concluded that without further explanation by FERC, the tax allowance therefore results in "inequitable returns" for partnership pipelines, and noted that under *Hope Nat. Gas Co.*, "the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks".[7] The Court found that because FERC did not provide adequate explanation for the seemingly inequitable result, the SFPP rates under the tax allowance policy were not just and reasonable.[8]

The Court's decision vacated and remanded the tax allowance issue to FERC. The Court noted that the *ExxonMobil* decision need not be overturned if FERC can provide a reasoned basis to demonstrate that its policy does not result in double recovery.[9] FERC's counsel stated at oral argument that the discounted cash flow return on equity methodology could be modified to remove duplicative tax recovery.[10] Furthermore, prior to *ExxonMobil*, FERC had considered "eliminating all income tax allowances and setting rates based on pre-tax terms".[11] Thus, the

Court suggested there may be multiple ways for the Commission to demonstrate that partnership pipelines do not double recover taxes, although each of the specific means the Court suggested appear to involve FERC modifying the components of its cost-of-service rates for pipelines to either remove the income tax allowance or adjust the return on equity for such pipelines to remove the "duplicative" tax recovery from that component.*[12]*

The Court Also Ruled On Two Separate Issues and Found for SFPP On One Of Those

Regarding a separate issue raised on appeal by SFPP, the Court sided with SFPP and held that FERC had failed to justify its decision to calculate SFPP's rate of return on equity using data from September 2008 rather than April 2009, as SFPP had proposed. While finding that FERC was justified in setting aside the April 2009 data due to the market anomalies of the time resulting from the financial crisis, the Court found for SFPP that FERC failed to justify its choice of using September 2008 data instead. The Court also rejected SFPP's challenge to FERC's decision not to apply the full amount of the 2009 rate index adjustment in calculating SFPP's rates for the year beginning July 1, 2009, finding that FERC did not act arbitrarily or capriciously in given credence to protests claiming that SFPP should not be permitted to realize the full 2009 index increase because that increase was beyond the actual cost of service increase incurred by SFPP during the relevant period.

Conclusion

It is the tax allowance issue, though, that has the most important and potentially sweeping cost of service rate implications for partnership pipelines in the first instance, and potentially for all pipelines if FERC seeks to move to a pre-tax return component in ratemaking. Ultimately, however, the D.C. Circuit did not dictate how FERC should proceed and it is too early to tell how this decision will actually affect pipeline cost of service ratemaking. Going forward, FERC will respond to the decision in the coming months to either demonstrate how its existing policy does not result in a double recovery for SFPP, or seek to modify its tax allowance policy to account for the D.C. Circuit's finding that the existing policy impermissibly favors partnership pipelines over others. The proceeding deserves close watching not only by partnership oil pipelines like SFPP, but by all FERC-regulated pipelines with cost of service rates.

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[1] *United Airlines, Inc. v. FERC*, No. 11-1479, 2016 U.S. App. LEXIS 12122 (D.C. Cir. July 1, 2016).

[2] Policy Statement on Income Tax Allowances, 111 FERC ¶ 61,139, at p. 32 (2005).

[3] *United Airlines, Inc.,* No. 11-1479 at 19.

[4] *Id.*at 18.

[5] *487 F.3d 945,* (D.C. Cir. 2007).

[6] *Id.* at 954.

[7] *United Airline, Inc.* at 18 (citing *Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944)).

[8] *Id.* at 22-23.

[9] *Id.* at 24-25.

[10] *Id.*

[11] *Id.*

[12] *Id.*