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Uncertainty Ahead For FERC Income Tax Allowance Policy

Law360, New York (July 11, 2016, 5:22 PM ET) -- United Airlines Inc. v. FERC, a decision issued by the D.C. Circuit on July 1, 2016, could have sweeping rate implications across the entire interstate oil and gas pipeline industries. The decision calls into question a decade of Federal Energy Regulatory Commission policy and precedent permitting regulated companies organized as partnerships, and other pass-through entities for income tax purposes to include an allowance for income taxes in their rates.

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The policy and precedent stems from FERC's 2005 policy statement on income tax allowances. The policy statement permits a pass-through regulated utility to include an allowance for income taxes in its rates if it can demonstrate that its eventual owner or owners have an actual or potential income tax liability payable on the income earned from the utility. Many interstate oil and gas pipelines are organized as pass-through entities, including limited partnerships.

United Airlines found that FERC had acted arbitrarily and capriciously when it permitted SFPP LP, an interstate petroleum products pipeline organized as a limited partnership, to include an income tax allowance in its rates. The court agreed with SFPP's shippers that FERC failed to demonstrate that the income tax allowance would not result in the pipeline's partnership owners double-recovering their income taxes in SFPP's rates.

United Airlines seemingly reverses ExxonMobil Oil Corp. v. FERC, a 2007 D.C. Circuit decision that also concerned a tax allowance granted to SFPP pursuant to the policy statement. ExxonMobil, decided by the same three-judge panel as United Airlines, upheld the policy statement. In United Airlines the panel stated it was deciding a question not presented in ExxonMobil. This latest decision could fundamentally change FERC's income tax allowance policy, now over 10 years old, and undermine the existing rates of numerous interstate oil and gas pipelines.

History of Partnership Pipeline Tax Allowance at FERC and Before the D.C. Circuit

United Airlines marks the third time that the D.C. Circuit has reviewed FERC's income tax allowance policy. In fact, the policy statement was a direct response to the first of these decisions, BP West Coast Products LLC v. FERC, decided in 2004. The commission's application of the policy statement was upheld in ExxonMobil. Given FERC's apparent responsiveness to the court's cues in BP West Coast and the affirmance of the commission in ExxonMobil, United Airlines' admonishment of FERC's application of the policy statement to partnership pipelines is somewhat surprising.

FERC allows a regulated entity to recover an allowance for income tax in its rates as a typical cost of doing business. Historically, FERC regulated partnerships as though they were tax paying corporations. This was purposeful in order to provide an incentive for infrastructure development, a public policy that was reinforced by the Internal Revenue Code. In 1995, in Lakehead Pipe Line

Company LP, FERC was confronted for the first time with a pipeline owned by a partnership in which some of the partnership interests were held by individuals, and not corporations. Lakehead changed the then-existing policy. FERC continued to allow a tax allowance for a pass-through entity, but limited the allowance to the proportion of interests in the entity held by corporations. No tax allowance was permitted for noncorporation owners. FERC applied the Lakehead policy to SFPP in the late 1990s, which lead to the BP West Coast decision.

BP West Coast objected to the disparate treatment of corporate and noncorporate unitholders in a pass-through entity. It found that FERC failed to articulate a reasoned basis for this treatment, beyond the conclusory statement that one type of owner incurs corporate tax liability and the other does not. FERC adopted the policy statement in response to BP West Coast. It attempted to address the disparate treatment by providing that a pass-through entity will be allowed to include an income tax allowance in its rates to reflect the actual or potential tax liability that will be owed by each of the entity's owners on income flowed through to those owners. In later decisions, also involving SFPP, FERC provided a refinement of how to perform the analysis to account for the numerous types of partnership owners.

The issue before the court in ExxonMobil was whether it was just and reasonable for FERC to permit an income tax allowance for pass-through entities at all, considering that they do not incur any tax. ExxonMobil upheld the policy statement. It found reasonable FERC's determination that taxes could be "attributable" to the regulated entity given that partners must pay tax on their partnership income regardless of whether they actually receive a cash distribution.

The court also held that FERC had reasonably relied on evidence that a full income tax allowance was necessary to ensure that corporations and partnerships of like risk will earn comparable after-tax returns. Finally, ExxonMobil found it was reasonable for FERC to reject alternative policy proposals, which included modifying the Lakehead policy, eliminating all income tax allowances, and setting rates based on pretax returns, categorically prohibiting limited partnerships from taking income tax allowances, or limiting income tax allowances only to partnerships owned wholly by corporations filing a consolidated return.

United Airlines Insistence of an "Implicit Reservation" in ExxonMobil

In United Airlines, SFPP shippers alleged that the policy statement, as applied to SFPP, permitted SFPP's partners to double recover their taxes in SFPP's rates. Shippers argued that the discounted cash flow (DCF) methodology that FERC uses to determine a regulated pipeline's return on equity already ensures a sufficient after-tax return to attract investment to the pipeline. The court accepted this premise.

In doing so, the D.C. Circuit narrowed its earlier holding in ExxonMobil. According to United Airlines, ExxonMobil did not permit FERC to allow a blanket income tax allowance for all partnership pipelines. Rather, it only permitted a tax allowance when FERC has provided a reasoned basis for the allowance. The court rejected FERC's argument that the shippers were collaterally attacking ExxonMobil. Rather, the court stated that ExxonMobil had implicitly reserved the question of whether the combination of the DCF return on equity and the tax allowance resulted in a double recovery of tax costs for partnership pipelines. It determined that FERC had not adequately answered this question in the decision under review.

The court listed three facts supporting its conclusion that FERC had failed to demonstrate no double recovery by a partnership pipeline: (1) a partnership pipeline, unlike a corporate pipeline, incurs no taxes at the entity level; (2) a discounted cash flow return on equity determines the pretax investor return required to attract investment, irrespective of the pipeline's corporate structure; and (3) a partner in a partnership pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline if permitted to receive a tax allowance, at least in the short term before adjustments can occur in the investment market.

The court also referenced the standard for setting just and reasonable rates set forth in the U.S. Supreme Court's 1944 landmark Federal Power Commission v. Hope Natural Gas Co. decision. This standard provides that a pipeline's equity owners must be permitted the opportunity to earn a return that is "commensurate with returns on investments in other enterprises having corresponding risk." United Airlines accepted the premise that a pipeline organized as a

partnership carries a similar level of risk as one organized as a corporation. It explained that ExxonMobil did not absolve FERC of its obligation to ensure parity between the equity owners of both pipeline types. The court held that FERC’s failure to perform this type of analysis rendered its underlying decision on SFPP’s rates arbitrary and capricious.

While the court claims that it did not reverse itself, parsing United Airlines and ExxonMobil, the decisions appear to be inconsistent. In ExxonMobil, the D.C. Circuit relied on Hope Natural Gas to uphold FERC’s conclusion that it would be inequitable to grant a full income tax allowance to corporations while denying a similar allowance to limited partnerships. In United Airlines, the court found, albeit based on the specific facts before it, that it would be inequitable to grant a tax allowance to partnership pipelines as compared to shareholders in corporate pipelines, again relying on Hope Natural Gas.

Implications

The court remanded the case to FERC to allow it to have an opportunity to provide a reasoned basis for its decision on income tax allowances for partnership pipelines. The court noted that FERC had previously considered the possibility of setting rates based on pretax returns and eliminating the income tax allowance. In light of the large number of jurisdictional entities organized as pass-through entities, this will be a major issue for FERC to address.

FERC appears to have three options moving forward. It could, on remand, bolster its rationale for why the income tax allowance, as applied to partnership pipelines, does not result in a double recovery of income taxes, potentially resulting in another battle before the court if the shippers again seek judicial review. Another outcome would be for FERC to reopen the record in the SFPP rate proceeding, and allow an administrative law judge to hear evidence on SFPP’s income taxes, before making a decision on double recovery. A third option would be for FERC to address the issue in a policy statement, as it did following the BP West Coast decision.

There is no clear path for FERC to take if it chooses the third option. ExxonMobil already examined the policy options considered by FERC prior to adopting the current policy statement, and found that policy adopted in 2005 was reasonable. United Airlines backtracks a bit from that conclusion. It suggests that FERC could eliminate all income tax allowances and set rates based on pretax returns, even though ExxonMobil acknowledged that option, but found FERC reasonably had rejected it. It is difficult to understand how FERC could remove “duplicative tax recovery” from the DCF return on equity. FERC explained on brief that the DCF analysis does not recover pipeline-level taxes, and a tax allowance is necessary to recover real, albeit indirect, partnership costs.

Regardless of which path FERC chooses, it is clear that investment decisions based on pass-through entity corporate structures will need to be reexamined and reassessed in light of the United Airlines decision and that current pipeline rates may be at risk for review by FERC.

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