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FERC TAKES AIM AT INCOME TAX OVER RECOVERY IN PIPELINES' REGULATED RATES

To Our Clients and Friends:

Last week, on March 15, 2018, the Federal Energy Regulatory Commission (FERC) issued a number of orders aimed at addressing potential over-recovery of income tax in pipelines' regulated rates. First, in the wake of a loss in the D.C. Circuit, FERC reversed course on its long-standing policy of allowing master limited partnerships (MLPs) to include an income-tax allowance in their cost-of-service rates. Second, FERC announced various initiatives to address potential over-recovery of taxes through cost-of-service rates that may result from the reduction in the corporate tax rate from 35% to 21%. Although the markets initially reacted quite negatively, the actual impact will not be immediate and will vary considerably from company to company. Indeed, many companies have already announced that the FERC orders will not have a material impact on their revenue.

Reversal of Income Tax Policy for MLPs[1]

In the wake of the unfavorable *United Airlines v. FERC*[2] decision, the FERC reversed its long-standing policy of allowing MLPs to include an income-tax allowance in their cost-of-service rates. FERC issued a policy statement that found such an allowance results in an impermissible double-recovery of costs in combination with the discounted cash flow (DCF) methodology for calculating return on equity. FERC concluded that because the DCF methodology used to calculate the return necessary to attract capital is done on a pre-tax basis, investors' tax liability is already reflected in calculated return on equity. Thus, FERC concluded that any allowance for income tax with respect to an MLP would result in double-recovery of those costs.

A few important points to keep in mind regarding the impact of this policy change:

- This only impacts FERC cost-of-service rates:
    - Oil Pipelines: For oil pipelines, market-based rates and settlement rates will be unaffected. With respect to indexed rates, there is no automatic immediate impact. FERC will, however, address this issue in the next reassessment of the index in 2020.
    - Gas Pipelines: For interstate gas pipelines negotiated rates, market-based rates, and settlement rates are not affected. Discount rates could be impacted, but only to the extent recourse rates are reduced below the discount-rate level as a result of the implementation of this policy.

- The policy statement does not actually change any pipeline's rates.

    - Oil Pipelines: For oil pipelines, it announces a new policy that the pipelines may no longer include an income tax allowance in their cost of service on the annual Form 6 reporting. Once this cost-of-service data is made publically available, it certainly could lead to FERC or shippers filing a complaint pursuant to Section 13(1) of the Interstate Commerce Act to reduce rates. In addition, FERC intends to address the impact of the tax reduction in the five year review of the oil pipeline index in 2020. Thus, in theory, FERC could require a reduction in rates for any pipelines whose rates are set at the ceiling by setting a negative index at that time.

    - Gas Pipelines: For gas pipelines, FERC is proposing a one-time reporting requirement to obtain data about the impact of this policy and the reduction in the corporate tax rate on each pipeline's cost of service as discussed in more detail below. Again, once this cost-of-service data is made public, FERC or shippers could initiate a proceeding to reduce rates pursuant to Section 5 of the Natural Gas Act. This result is not automatic, however.

- The policy statement did not decide whether other non-pass through entities (*e.g.*, limited partnerships, LLCs, etc.) would also no longer be permitted to recover a tax allowance in their rates. Instead, FERC deferred those issues to consideration in future rate proceedings, but made clear that the issue of double-recovery would need to be addressed in those instances. FERC's Order on Remand in the *United Airlines* case[3] seems to leave little room for FERC to reach a contrary finding or other pass-through entities, as FERC reasoned that "MLPs and similar pass-through entities do not incur income tax at the entity level" and therefore the ROE offered under the DCF methodology must be sufficient to cover the investor's tax liability.

Notice of Proposed Rulemaking on Federal Income Tax Rate Reductions for Gas Pipelines[4]

FERC issued a notice of proposed rulemaking that seeks require natural gas pipelines to do a one-time informational filing of an "abbreviated cost and revenue study" to provide information to allow FERC to determine whether gas pipelines are over-recovering for taxes in light of the reduction in the corporate tax rate. FERC proposed to use the same form that FERC has attached to its orders initiating Section 5 rate investigations in recent years for this informational filing. FERC then proposes several options to address over-recoveries, including some intended to encourage pipelines to voluntarily reduce rates:

1. Limited Section 4 Filings: Although FERC typically does not allow pipelines to file a limited rate case to adjust individual components of rates, FERC proposed to allow pipelines to file a limited Section 4 rate case to reduce their rates by the percentage reduction in the cost of service from the decrease in the federal corporate income tax rate and the elimination of the income tax allowance for MLPs.

2. File a Statement Explaining Why an Adjustment is Not Necessary: If a pipeline's reduction in cost of service from the tax cuts and elimination of income tax allowance are offset by increases in costs elsewhere or if the pipeline is overall not recovering its cost of service despite the tax

decease, a pipeline can file a statement explaining why no decrease in rates is appropriate despite the income tax reduction.

3. Commit to File a General Section 4 Rate Case (or an Uncontested Settlement): In lieu of a limited Section 4 rate case, pipelines can commit to file a general Section 4 rate case and indicate an approximate time-frame for making such a filing. FERC proposes that if a pipeline commits to make such a filing by December 31, 2018, FERC will not initiate a Section 5 investigation of the pipeline's rates prior to that time.

4. File the Information Required and Do Nothing Else: FERC, in a somewhat disingenuous acknowledgement that it cannot legally force pipelines to file a Section 4 rate case, notes that a pipeline may simply file the required information with FERC, take no further action, and wait to see if FERC initiates a Section 5 investigation. FERC proposes, however, to open a rate proceeding docket for each filing and issue a public notice inviting interventions and protests on the filing. FERC will then decide whether to initiate a Section 5 proceeding based on the public comments and protests. In sum, these procedures are strikingly similar to requiring a Section 4 rate filing.

With respect to intrastate Hinshaw and Section 311 pipelines, FERC found that its existing policies are generally sufficient to address potential over-recovery resulting from the Tax Cuts and Jobs Act. However, FERC does propose to require that if a pipeline adjusts its state-jurisdictional rates as a result of the Act, then the pipeline must file a new rate election within 30 days after the reduced intrastate rate becomes effective.

Notice of Inquiry Regarding the Effect of Tax Cuts and Jobs Act[5]

Finally, FERC opened an inquiry to solicit comments on the impacts of other aspects of tax reform on jurisdictional rates, such as the treatment of accumulated deferred income taxes and the new 100% bonus depreciation regime which applies to oil pipelines. In this regard, FERC is particularly interested how to treat accumulated deferred income tax going forward in light of the reduction in future tax liability. FERC is soliciting comments on various topics related to ADIT, including:

- How to ensure rate base continues to be treated in a manner similar to that prior to the Tax Cuts and Jobs Act until excess and deficient ADIT is fully settled.
- Whether and how adjustments should be made so that rate base may be appropriately adjusted by excess and deficient ADIT.
- How tax allowance or expense in cost of service will be implemented to reflect the amortization of excess and deficient plant-based ADIT.

FERC is also soliciting comments on the effect of the bonus depreciation change under the Tax Cuts and Jobs Act, which increases the bonus depreciation allowance from 50% to 100% for qualified property placed into service after September 1, 2017 and before January 1, 2023.

Comments are due 60 days after publication of the notice in Federal Register.

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[1] Revised Policy Statement on Treatment of Income Taxes, 162 FERC ¶ 61,227 (2018).

[2] 827 F.3d 122 (D.C. Cir. 2016).

[3] *SFPP, L.P.*, 162 FERC ¶ 61,228 at P 22 (2018).

[4] Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate, 162 FERC ¶ 61,226 (2018).

[5] Inquiry Regarding the Effect of the Tax Cuts and Jobs Act on Commission Jurisdictional Rates, 162 FERC ¶ 61,223 (2018).

Gibson Dunn's Energy, Regulation and Litigation lawyers are available to assist in addressing any questions you may have regarding the developments discussed above. Please contact the Gibson Dunn lawyer with whom you usually work, or the following:

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