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FERC Income Tax Changes Could Impact Entire Energy Sector

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In its last open meeting of calendar year 2016, the Federal Energy Regulatory Commission took several steps signaling its intention to continue robust oversight over the energy industry. Among those steps, perhaps none has more potential to impact all sectors of the energy industry than FERC's notice of inquiry (NOI) concerning the treatment of income taxes for ratemaking and cost recovery purposes by pass-through entities.[1]

Levi McAllister

This past summer, the Court of Appeals for the D.C. Circuit found that FERC's existing income tax allowance policy and rate of return policy, when applied to pass-through entities such as master limited partnerships (MLPs), creates a possibility of double recovery for income taxes.

The variety of responses to the remand proposed in the NOI suggests that FERC has no solution in mind. Instead, FERC seeks comments from participants in every segment of the energy industry and appears open to considering any proposal that resolves the possibility of double recovery. Given how prevalent pass-through entities have become in FERC-regulated industries, the potential changes could have direct effects on entities in the oil, gas and electric sectors.

Daniel Skees

FERC's NOI is the next step in a process that threatens to upset FERC's existing income tax policy on which pass-through entities across the energy industry have relied for nearly a decade.

D.C. Circuit Court Remand in United Airlines v. FERC

In United Airlines Inc. v. FERC, the D.C. Circuit directed FERC to clarify its basis for allowing a blanket income tax allowance to be included in the cost-of-service of a pass-through entity whose applicable return on equity (ROE) was computed on a discounted cash flow (DCF) basis.[2] The case involved the rates paid for transportation on common-carrier oil pipeline facilities owned by SFPP LP.

Kirstin Gibbs

Shippers on SFPP's pipeline argued that under FERC's 2005 Policy Statement on Income Tax Allowances (Policy Statement)[3] and SFPP's cost-of-service methodology, SFPP's customers would be overcharged because FERC was allowing SFPP, as a pass-

through entity, to “double recover” their taxes from customers: once in the assumptions used in the DCF calculation and once under the income tax allowance.

The shippers argued that FERC currently allows all entities providing jurisdictional services to recover an income tax allowance from customers as an element of the cost of providing service to those customers. This, however, is limited to the extent those entities’ ownership members have an actual or potential income tax obligation.[4]

At the same time, the shippers claimed that FERC’s ratemaking methodology, particularly the ROE calculation, provides for a rate of return that is already sufficient to attract investors, including a return that covers investor-level taxes and leaves sufficient remaining income to earn their required after-tax return.

The shippers argued that, taken together, this results in an overcharge (or “double recovery”) for SFPP because it was formed as a pass-through entity and therefore does not actually have its own income tax liability. Whereas corporation shareholders are taxed once at the entity level and again on individual income taxes, pass-through entities do not incur income tax liability at the entity level.

Instead they “pass through” any profits or losses to their partners. Each partner includes his or her share of the partnership’s income or loss solely on his or her tax return.[5] Therefore, shippers argued that partnership members of SFPP could gain a potential windfall under FERC’s current policy in comparison to corporate stockholders.

The D.C. Circuit Court of Appeals agreed. According to the court, FERC had not provided a reasoned basis justifying the income tax allowance for pass-through entities.

In support of its conclusion, the court relied on three undisputed facts: First, a partnership-owned pipeline incurs no taxes at the entity level, unlike a corporate pipeline. Second, a DCF return on equity determines the pre-tax investor return required to attract investment. And third, a partner in a partnership-owned pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline if permitted to receive a tax allowance recovery.

In doing so, the court suggested that FERC had not justified a blanket income tax allowance for all entities. In the past, FERC has taken the position that, although not taxed at the entity level, both pass-through and non-pass-through entities’ owners are taxed on the income generated from “first tier” income — pass-through entities’ partners on their individual tax returns, and corporate entities’ shareholders at the entity level.[6]

FERC distinguished “first tier” income from “second tier” income. An example of “second tier” income is dividends paid to the common stock investor in corporation (or a corporate investor in a pass-through entity).[7] Second tier income tax is paid by an investor in addition to the corporate tax due on first tier income.

FERC had claimed that determining whether a tax allowance should apply to pass-through entity owners would be unworkable because it could necessitate a review of several layers of pass-through ownership to determine where the ultimate actual or potential liability lies.

The D.C. Circuit concluded that FERC’s policy of granting a tax allowance to partnership pipelines results in inequitable returns for partners in those pipelines, as compared to shareholders in corporate

pipelines. The resultant “windfall,” in the court’s eyes, violated the Supreme Court’s finding in Federal Power Commission v. Hope Natural Gas Co. that “the return to equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.”

The court therefore remanded the issue to FERC to consider various mechanisms the commission could utilize to demonstrate that there is no double recovery. The Court of Appeals suggested as possibilities removing any duplicative tax recovery for partnership pipelines directly from the DCF return on equity calculation or eliminating income tax allowance recovery for any entity and setting rates based on pre-tax returns.

NOI

Apparently recognizing the magnitude of the issue created by the court’s order, FERC declined to address the D.C. Circuit’s ruling in the limited context of the SFPP docket. Rather, on Dec. 15, 2016, FERC issued the Notice of Inquiry requesting all industry participants to weigh in on the issues, asking for any proposed methods to adjust FERC's income tax allowance or rate of return policies to resolve any double recovery of tax costs. Comments are due 45 days from the date of publication in the Federal Register.

The NOI requests that commenters consider the concepts presented by the D.C. Circuit’s ruling in United Airlines, and sets forth several specific concerns mirroring the concerns of the court. FERC also asks commenters to provide a detailed explanation of their proposals, including “evidentiary support and how any adjustment to the Commission’s tax allowance and/or ROE policies should be specifically implemented.”

Industry Implications

The D.C. Circuit’s opinion together with FERC’s NOI make two points clear: (i) FERC’s current income tax allowance policy cannot continue in its current form; and (ii) the far-reaching implications of the court’s ruling concerning FERC’s policy renders FERC open to any and all suggestions for a feasible path forward. At this point the alternatives are wide open — FERC does not appear to have a preferred alternative. Everything from eliminating the income tax allowance for pass-through entities to removing all investor-level tax costs from the DCF-calculated return is on the table.

While the D.C. Circuit’s opinion was issued in the context of an oil pipeline proceeding, the issue is likely to impact ratemaking and cost-of-service computations far beyond the transportation service provided by SFPP on its crude oil pipeline system.

Indeed, the presence of such a large number of FERC-jurisdictional entities organized as pass-through entities necessarily suggests that any FERC action taken in response to the NOI will create industry-wide impacts. This includes not only MLPs, but other pass-through structures without entity-level income taxation, such as real estate investment trusts, joint ventures and closely-held partnerships in every industry subject to FERC rate regulation.

In the oil and gas sectors, interstate pipelines subject to regulation under the Natural Gas Act and the Interstate Commerce Act will unquestionably feel the effects of any resulting FERC action. Pipeline entities are often organized as pass-through entities such as LPs. Existing pipelines organized as pass-through entities may well have rates on file to which its customers are subject that were computed under the very policy that the D.C. Circuit has now determined to potentially result in a double recovery.

As a result, any change by FERC to its existing policy raises material questions concerning the justness and reasonableness of existing rates for those pass-through entities that receive an income tax allowance and compute return on equity based on a DCF methodology. Likewise, potential changes to FERC's existing policy raise questions concerning the manner in which pass-through entities compute future rates that might be proposed in accordance to the terms of the Natural Gas Act or the Interstate Commerce Act.

In the electric power sector, electric transmission entities organized as pass-through entities could face similar challenges to the justness and reasonableness of their rates under the Federal Power Act if they use cost-based rates. FERC has in the past allowed transmission developers organized as pass-through entities to receive an income tax allowance, even though the parent companies or partners in the development entity have the tax liability, not the development entity.

Although not a concern for the small number of transmission companies charging negotiated rates for transmission service, most electric transmission projects, including those developed under FERC's Order No. 1000, use cost-based rates. To the extent pass-through entities own or are building those transmission projects, the outcome of the NOI could affect any income tax allowance they receive because their rates reflect the same "double recovery" issues highlighted by the D.C. Circuit.

For all three sectors, FERC's response to the NOI is also likely to impact investment decisions. Potential investors in oil, natural gas or electric transmission infrastructure seek certainty in knowing that they will receive an adequate return on capital investments.

That certainty is achieved, in part, on the existence of stability in FERC's policies and an ability to predict how a reasonable ROE and customer rates might be computed. The uncertainty introduced by the D.C. Circuit's decision and FERC's issuance of an NOI that could introduce significant changes to its existing income tax policy introduces the potential for a chilling effect among potential investors in pass-through entities developing energy infrastructure.

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[1] Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs, 157 FERC ¶ 61,210 (2016).

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

[3] Policy Statement on Income Tax Allowances, 111 FERC ¶ 61,139 (2005) (Policy Statement).

[4] Id. at P 32.

[5] See https://www.irs.gov/businesses/small-businesses-self-employed/partnerships.

[6] See BP West Coast Prods. LLC v. FERC, 374 F.3d 1263 at P 35 (DC Cir. 2004)

[7] Policy Statement at P 38.

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