UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Inquiry Regarding Income Tax Allowances) Docket No. PL05-5-000

COMMENTS OF THE ASSOCIATION OF OIL PIPE LINES

The Association of Oil Pipe Lines ("AOPL") hereby files these comments pursuant to the Federal Energy Regulatory Commission's ("FERC" or "Commission") Inquiry Regarding Income Tax Allowances in Docket No. PL05-5-000. AOPL is an unincorporated trade association representing 50 interstate common carrier oil pipeline companies. Its members carry nearly 85% of the crude oil and refined petroleum products moved by pipeline in the United States. AOPL members reflect the range of ownership interests in pipelines – from subchapter C corporations to limited liability companies to limited partnerships to joint ventures. The policy that the Commission adopts for income tax allowances in oil pipeline rates will have important consequences for AOPL members and for the development of infrastructure in this industry.

AOPL believes that these comments will assist the Commission as it considers the implications of the D.C. Circuit's decision in *BP West Coast Products, LLC v. FERC*[1] and the significant issues raised by the Commission's December 2, 2004, Request for Comments in this docket.

[1] 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) (*BP West Coast*). Petitions for certiorari seeking Supreme Court review of certain rulings in that decision have been filed by BP West Coast Products, LLC and ExxonMobil Oil Corporation (No. 04-900) and by SFPP, L.P. (No. 04-903), but neither petition involves the tax allowance issue.

I. <u>Introduction and Executive Summary</u>

Since the passage of the Energy Policy Act of 1992 ("EPAct")[2] and the rulemakings that followed, the crude oil and petroleum products pipeline industry ("oil pipeline industry") has operated under a combination of indexed rates, settlement/negotiated rates, market-based rates and cost of service rates[3]. This system of regulation has enabled the industry to attract the investment necessary to meet growing consumer demand with relatively little need for Commission intervention. With few exceptions, one of those being the nearly two-decades-old *SFPP* dispute that precipitated the D.C. Circuit decision on which this inquiry is based,[4] shippers are satisfied with the services they receive and the rates they pay. As the Federal Trade Commission recently reconfirmed, this industry is competitive.[5]

Although only a small portion of the oil pipeline industry's rates currently are calculated on a cost of service basis, a greater portion of the industry's rates could become subject to cost of service ratemaking as industry pursues new routes and new services[6], or is forced to cost justify EPAct-approved just and reasonable rates and the indexing of these existing rates[7]. As discussed later in these comments, the ability to use cost of service ratemaking has been very important to gaining support for the

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[2] Energy Policy Act of 1992, Pub. L. No. 102-486 (106 Stat. 2776).
[3] *See* 18 C.F.R. §§ 342.3 and 342.4 (2004).
[4] *SFPP, L.P.*, 86 FERC ¶ 61,022 (1999) (Opinion No. 435); *SFPP, L.P.*, 91 FERC ¶ 61,135 (2000) (Opinion No. 435-A); SFPP, L.P., 96 FERC ¶ 61,281 (2000) (Opinion No. 435-B); *SFPP, L.P.*, 97 FERC ¶ 61,138 (2001) (Clarification and Rehearing Order).
[5] *See Generally,* Report of the Federal Trade Commission Bureau of Economics, "The Petroleum Industry: Mergers, Structural Change and Antitrust Enforcement," August 2004 available at http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf.
[6] The Commission's regulations currently require rates for new routes or services to be justified either with the concurrence of one unaffiliated shipper or using cost of service ratemaking. 18 C.F.R. § 342.2 (2004)
[7] In 1992, Congress deemed all previously unchallenged rates of a certain vintage "just and reasonable" but allowed those just and reasonable rates to be reexamined if "changed circumstances" can be demonstrated. See EPAct § 1803.

construction of significant new pipeline expansions. Because new investment in infrastructure is needed, and because the oil pipeline industry has seen a major restructuring away from corporate ownership and to master limited partnerships ("MLPs"), the units of which are increasingly held by non-corporate entities, this industry must be able to recover in rates the income tax liability incurred by reason of the operation of these pipelines, regardless of the form of the ownership of these pipelines, or face a major disincentive to investment.

Only if the Commission provides a full allowance in rates for income tax liability incurred as a consequence of the regulated operations of pipelines, will investors in those pipelines earn a fair and reasonable return on their investment. That return on investment should not be dependent upon the form of ownership that pipeline investors choose. Income taxes associated with pipeline profits, whether they are allocable to interests held by individuals or corporations, should be allowed recovery in pipeline rates as a legitimate component of the cost of providing the service at issue. Simply put, while rates must be just and reasonable, all pipeline owners whether corporate or individual, provide the capital to finance the pipeline assets and must be permitted to recover legitimate costs of service and earn an adequate return on their investment.

The Commission's policy prior to the *Lakehead* case[8] allowed for the recovery of income taxes in rates regardless of the form of ownership of a pipeline.[9] This should be the Commission's policy today and for the future, particularly in light of the current

[8] Lakehead Pipe Line Co., L.P., 71 FERC ¶ 61,338 (1995) (*Lakehead*); *reh'g denied,* 75 FERC ¶ 61,181 (1996) (*Lakehead II*).

[9] *See e.g.,* Riverside Pipeline Co., L.P., 48 FERC ¶61,309 at p. 62,017 (1989). Kuparuk Transp. Co., 45 FERC ¶63,006 , 65,083 (1988), *aff'd,* 55 FERC ¶61,122 (1991). *See also* Pelican Interstate Gas Sys., 29 FERC ¶61,062, at p. 61,135 (1984); Sea Robin Pipeline Co., 28 FERC ¶61,092 (1984); Alaskan Northwest Natural Gas Transp. Co., 19 FERC ¶ 61,218 (1982); Trailblazer Pipeline Co., 15 FERC ¶63,046 (1981), *aff'd* 18 FERC ¶61,244 (1982); Ocean State Power, 38 FERC P 61,140 (1987).

business environment and this nation's growing appetite for an increasingly complicated array of liquid fuels, transported in a secure and reliable manner.[10]

In its Request for Comments, the Commission asked whether the decision of the court in *BP West Coast Products, LLC* applies only to the specific facts of that case or has a broader application. AOPL respectfully suggests that the court's rejection of the *Lakehead* income tax allowance policy applies broadly to all the industries regulated by the Commission. Investments in oil pipelines, natural gas pipelines and electric transmission lines are increasingly being made by investors holding ownership interests in these assets in forms other than traditional corporate shares. These investors need to be assured that they will have an opportunity to recover the costs incurred by these assets, including income tax liability, through rates. Thus, the overriding issue that should be addressed in this inquiry is what the Commission's policy should be with respect to recovery in rates of income tax liability generated by the operation of all Commission regulated entities, regardless of the ownership structure of those entities.

It is important to note that the Commission has considerable discretion in how it chooses to address the D.C. Circuit's *BP West Coast* decision. That decision does <u>not</u> require that the Commission follow a particular policy concerning tax allowances. With proper justification, the Commission may return to its historic policy of permitting full

[10] The oil pipeline industry has made major investments in infrastructure just to stay in business. Important new pipeline safety requirements, and sensitive new clean fuels such as ultra low sulfur diesel fuel, demand significant budget allocations and also strain pipeline capacity as the number of fuels carried constantly increases. An even greater capital influx must occur if these systems are to grow to meet increasing demand. *See e.g.* 49 CFR 195.452, Pipeline Safety: Pipeline Integrity Management in High Consequence Areas (Hazardous Liquid Operators with 500 or more miles of pipeline), 65 FR 75377 (December 1, 2000); Final Rule effective May 29, 2001, 66 FR 9532 (February 8, 2001); Pipeline Integrity Management in High Consequence Areas (Hazardous Liquid Operators with less than 500 miles of Pipeline); Final Rule effective February 15, 2002, 67 FR 2136 (January 16, 2002); Control of Air Pollution from New Motor Vehicles: Heavy Duty Engine and Vehicle Standards and Highway Diesel Fuel Sulfur Control Requirements, 66 FR 5001 (January 18, 2001); and Control of Emissions of Air Pollution from Nonroad Diesel Engines and Fuel, 69 FR 38957 (June 29, 2004).

recovery in rates of income tax liability incurred by a pipeline, regardless of its ownership structure. For the reasons set forth below, AOPL submits that this is precisely what the Commission should do.

II. Comments

A. A Full Income Tax Allowance in Pipeline Rates Is Necessary to Ensure That All Investors in Pipeline Assets, Whether Individuals or Corporations, Have an Opportunity to Receive the Fair Returns to Which They Are Entitled.

The course that the Commission takes in this proceeding must comport with the fundamental legal requirement that assures that those committing capital to firms regulated by the Commission are provided an opportunity to earn a fair and reasonable return of and on that invested capital. There is no dispute that the income tax liability incurred by a pipeline is a legitimate cost of service. There is similarly no dispute that legitimate costs of service are recoverable in rates. "The Natural Gas Act [like the Interstate Commerce Act] requires the Commission to insure that the rates of pipelines subject to its jurisdiction are 'just and reasonable.' Under cost-of-service ratemaking principles, this means rates yielding sufficient revenue to cover all proper costs, including federal income taxes plus a specified return on invested capital." *City of Charlottesville, Virginia v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985) (citations omitted) (hereafter *City of Charlottesville*). What AOPL seeks here is the application of these basic principles to recovery in pipeline rates of income tax liability, regardless of the form of pipeline ownership. While the composition of a pipeline's ownership may affect the rate appropriate to use in calculating the recoverable income tax allowance, there is no justification for including an income tax allowance in rates for assets held in corporate form, but providing no income tax allowance whatsoever in rates for assets held by non-corporate owners. Each of these investors is responsible for income taxes that are generated by the regulated entity's activities on behalf of its shippers.

1. The Commission is obligated to set rates that enable all investors in pipeline assets an opportunity to receive after-tax returns that provide adequate incentives for investment and reflect a reasonable return on capital.

It is well established that rates for regulated entities must be just and reasonable and not unduly discriminatory to consumers.[11] In addition, it is the Commission's obligation to set rates that allow the regulated entity to recover the costs of operating the regulated business plus a return comparable to investments in "other enterprises having corresponding risks" to permit the enterprise to attract capital.[12] As the court in *BP West Coast* noted, "[U]sing the principles of cost of service ratemaking, Commission-approved rates must yield 'sufficient revenue to cover all proper costs' and provide an appropriate return on capital."[13] Income taxes long have been recognized as a legitimate cost of doing business and have been recoverable in regulated, cost-of-service rates.[14]

Both the court in *BP West Coast* and FERC agree that pipelines are entitled to recover income taxes from their ratepayers. In *BP West Coast,* the court stated, "there is no question that as a general proposition, a pipeline that pays income taxes is entitled to

[11] *See City of Charlottesville*, 774 F. 2d at 1205; quoting 15 U.S.C. Sec. 7171c(a).
[12] *See* FPC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1943)(*Hope Natural Gas*). The Supreme Court did not dictate a specific method of accounting in utility rate making, so long as "just and reasonable" rates result.
[13] *BP West Coast,* 374 F.3d at 1286 (citing Public Service Co. of New Mexico v. FERC, 653 F.2d 681, 683 (D.C. Cir. 1981).
[14] In addition to *City of Charlottesville, See* Public Service Company of New Mexico v. FERC, 653 F. 2d 681, 683 (D.C. Cir. 1981) ("a regulated utility is allowed to recover from ratepayers all expenses incurred, including income taxes, plus a reasonable return on capital invested in the enterprise and allocated to public use.").

recover the costs of the taxes paid from its ratepayers."[15] In the *Lakehead* case, the Commission agreed that under cost of service ratemaking principles, a regulated company is entitled to rates that yield sufficient revenue to cover its appropriate costs, including state and federal income taxes and a specified return on capital.[16] Where the Commission got turned around was in considering the tax liability recoverable merely because of the alleged "double taxation" of revenues earned by regulated corporations, once at the corporate level and again as a dividend. But that is not the test. A tax allowance is built into the cost-of-service model because the revenues generated by the regulated entity are taxed; and that tax liability is a cost of doing business regardless of the ownership level at which it is paid.

When the income generated by the regulated entity is taxed, this diminishes the return to the entity responsible for paying the taxes. Failure to allow recovery of taxes associated with an owner's allocable share of a pipeline's income as a legitimate cost of doing business effectively reduces an owner's return on invested equity, whether that investor is an individual or a corporation. Accordingly, income taxes associated with pipeline profits, whether they are allocable to interests held by individuals or corporations, should be allowed recovery in pipeline rates as a legitimate component of the cost of providing the service at issue.

The Commission appeared to understand this in a pre-*Lakehead* case, *Sea Robin Pipeline Co*., 28 FERC ¶61,092 (1984), in which the Commission explained that, "in developing the cost-of-service levels used in setting Sea Robin's rates, income tax allowances are provided so as to produce after-tax returns on common equity invested by

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[15] *BP West Coast*, 374 F.3d at 1286.
[16] *See Lakehead,* 71 FERC at 61,314.

the partners, as though Sea Robin were a corporation." The Commission did so because even though "Sea Robin, a partnership, is not subject to income taxes . . . its partner corporations must include the revenues and deductions generated by Sea Robin's activities in their income tax returns." The Administrative Law Judge ("ALJ") in *Lakehead* relied on this case to find that the characteristics of various partners should not be a basis for disallowing an income tax allowance in rates and that unless an income tax allowance is provided, after tax returns on common equity will not be provided 'as if Lakehead were a corporation.'[17] The Commission overturned the ALJ's decision in this regard, resulting in the *Lakehead* policy that was rejected by the court in *BP West Coast.*

The distinction that was adopted in *Lakehead,* where corporate partners were permitted an income tax allowance in rates--while individual investors were not--simply does not make sense and is not justified.[18] It is the return to the investor, not the form of investment, that should be the focus. Based on the principle that a regulated entity is entitled to recover taxes incurred as a consequence of its regulated activities from its ratepayers, the granting of an income tax allowance in rates is appropriate regardless of whether a pipeline is organized as a partnership or a corporation. Currently, the cost-of-service tax allowance on assets held in corporate form is 35%, the maximum corporate tax rate. As the D.C. Circuit determined in *City of Charlottesville,* the applicable tax allowance is determined by applying "[t]he statutory tax rate (which in the case of regulated utilities, will almost always be the maximum rate)" to the tax base.[19] It might be appropriate to consider an alternative tax allowance for partnerships if the

[17] Lakehead Pipe Line Company, LP, 65 FERC ¶ 63,021 at 65,138 (1993).
[18] At the oral argument in the BP West Coast proceeding, Judge Sentelle opined that "it would make more sense" to give a corporate tax allowance even to the income attributable to an individual's ownership "than what the Commission did [in Lakehead]." *See* November 12, 2003 *BP West Coast* Transcript at p. 94.
[19] *City of Charlottesville* at 1207.

characteristics of various partners affected the maximum tax rate used to set the allowance for tax liability in rates. Under the current tax code, however, there is no basis for making a distinction.

For example, if 50% of a partnership's interests are owned by corporations incurring tax at a 35 % federal tax rate and 50% are individuals, for whom the highest marginal rate is also 35% in 2005, the blended tax rate is 35%. Even tax-exempt and pension trust partners must pay taxes on income generated by the regulated pipeline under the unrelated business income tax (UBIT) rules.[20] As with corporate owners, under the Stand-Alone test approved in *City of Charlottesville*, the rate to be used would be derived from treating the regulated entity as a stand-alone entity. No other items of income, gain, loss, deduction or credit of the individual owners would be considered.

2. All Partnership Unit Owners Incur Tax Liability on the Earnings of the Regulated Entity and Should not be Disadvantaged by the Fact That a Partnership, Itself, Does Not Directly Pay Taxes

The fact that an entity is a pass-through entity that does not, itself, pay taxes at the regulated level does not mean that the activities performed by the pass-through entity are not subject to tax. They are, but they merely are taxed at the ownership level rather than at the Commission regulated entity level. The partnership income is attributed to the partners and is taxed in the hands of the partners as though they had earned it in the first instance. This tax must be paid regardless of whether the income is actually distributed to the partners or not. The fact that a partnership is transparent for tax purposes does not mean that its income is "exempt" from taxation. It is not.

[20] 26 U.S.C. §§ 511-515 (2004).

Although there was much discussion in *BP West Coast* that including an allowance in pipeline rates for income taxes not paid directly by a partnership-owner of a pipeline results in the recovery of "phantom taxes," the tax liability of non-corporate investors who own pipeline assets via a partnership is as real as the tax liability of corporations that own pipelines that are consolidated for tax purposes on the parent's return. In both cases, income tax expenses are incurred on the income generated by the regulated activities of the pipeline and the payment of these tax expenses reduces the returns received by investors, unless a tax allowance is provided. Income generated by a partnership is not only passed through and attributable to its owners but this income also generates a corresponding tax liability on the part of the partnership's owners. This tax liability, whether paid or unpaid because it is offset by other owner/partner credits or deductions, is no different than the tax liability generated by a corporate subsidiary regulated pipeline company that is consolidated for tax purposes within a corporate owner. In each case, income and tax liability associated with this income is attributable to the ultimate pipeline owner who is liable for payment of the tax. The taxes due on revenue generated by the pipeline differ substantially from the analogy to administrative costs, such as bookkeeping and accounting costs, incurred by the owners of the regulated entity by reason of that ownership that was drawn by the court in *BP West Coast Products*.[21] Such administrative costs would not, of course, be chargeable to the rate payers.

As approved by the court in *City of Charlottesville*, 774 F.2d at 1214, the Commission should focus its attention on the fact that the regulated entity generates income that is subject to taxation, not on whether the regulated entity, itself, actually pays

[21] *BP West Coast*, 374 F.3d at 1290-1292.

the taxes. Any other approach elevates form (a partnership or other pass through entity does not pay the taxes itself) over substance (the owners of such entities do) and will not result in a ratemaking policy that fairly compensates the investors in these entities.

The full-tax-cost-recovery-regardless-of-ownership-form policy that AOPL advocates also makes sense from the standpoint of shippers. The tax liability at issue here is a result of income that is generated by a pipeline's jurisdictional activities. A pipeline's shippers should be responsible for this tax liability as they are for any other cost incurred by the pipeline to provide the jurisdictional service. Shippers should not avoid liability for a reasonable and recoverable business expense, based on the form of ownership of a pipeline. Recovery of a pipeline's full tax liability (along with other prudently incurred costs) from shippers in rates will ensure that shippers are paying the full cost of the services provided to them.

In sum, under *Hope Natural Gas, City of Charlottesville* and other longstanding legal precedent, the investors that provide the capital to own and operate regulated pipelines are entitled to a reasonable return of and on invested capital. Requiring these investors, whether they are corporations or non-corporate entities, to forgo recovery in rates of the income tax liability incurred by the operation of the pipeline in which they have invested would deny these investors the opportunity to earn the reasonable return to which they are entitled.

B. In Addition to Permitting A Legally Sufficient Return for Pipeline Investors, the Income Tax Allowance Policy Adopted by the Commission Must Encourage, Not Inhibit, Investment in Pipeline Infrastructure.

A full income tax allowance in oil pipeline rates is a critical element in the regulatory environment needed to ensure that the investment to maintain, upgrade and expand oil pipeline infrastructure continues to flow to the industry. In addition to being legally deficient, any policy that disallows recovery in rates of income tax liability attributed to non-corporate ownership of interests in oil pipelines will inhibit investments in pipeline assets. This is particularly true for the oil pipeline industry, which has seen a substantial movement away from ownership by traditional corporations and to master limited partnerships, with decreasing corporate ownership of partnership interests.

The majority of oil pipeline rate changes are filed under the oil pipeline rate index authority, the base rates for which are often the rates deemed just and reasonable by Congress in EPAct and which pre-date *Lakehead*. Another substantial segment of oil pipeline rates are negotiated with and agreed to by the shippers using that individual rate. Many pipelines set rates using market-based rate authority. Finally, a relatively small but important segment of the industry also uses the Commission's approved cost-of-service methodology to set rates.[22] These tend to be pipelines offering new service or looking to make a major expansion in order to meet consumer demand, or pipelines substantially under recovering costs using the indexed rate methodology. Use of these rates to fund system expansions provides the revenues and the regulatory certainty necessary to attract the capital for these expansions. Examples of recent, cost-based rates to fund new

[22] In calendar years 2003 and 2004, there were 1096 oil pipeline tariff filings. Of those, 937 (88%) were index based, and 159 were justified on another basis. Of those others, roughly 49% were market-based, 30% were "settlement rates," 14% resulted from pervious settlements and 7% were cost of service based.

pipelines or expansions that include a full tax allowance include *Express Pipeline Partnership*, 76 FERC ¶ 61,245 (1996), *Colonial Pipeline Company*, 89 FERC ¶ 61,095 (1999)(pro forma rates),[23] *P.M.I. Services North American, Inc*., docket number IS04-16 (2003), and *Koch Pipeline Company, L.P*., docket numbers IS03-250, IS03-310, and IS04-459 (2003 and 2004). Without the ability to rely upon an income tax allowance in rates that fully reflects all income taxes payable as a result of the operations of these regulated entities, the investment necessary to construct these expansions may not be forthcoming.

The Commission's policy with respect to income tax allowances also is especially important to the oil pipeline industry, because it has made substantial use of publicly traded partnerships as a means of accessing capital. As Congress intended, master limited partnerships have proven to be an important and popular form for investors in oil pipelines.[24] Most of these pipelines last set their cost-of-service rate levels prior to adoption of the *Lakehead* policy on tax allowance. If the Commission adopts a policy that requires non-corporate MLP investors to absorb income tax costs that other regulated entity investors do not bear, the capital currently provided by investors in publicly traded partnerships may be more difficult to attract, depriving pipelines of many capable investors. This, in turn, will drive up the cost of capital for oil pipelines in order to counteract the effects of this adverse regulatory treatment. On the other hand, a policy that permits a full income tax allowance in rates, regardless of the form of ownership structure, will properly enable recovery in oil pipeline rates of a legitimate cost of service

[23] Also Order on Rehearing, Colonial Pipeline Company, 95 FERC ¶ 61,355 (2001). Colonial later withdrew its petition for declaratory order after the planned project was cancelled.
[24] In Section 7704 of the Internal Revenue Code, Congress provided favorable tax benefits in connection with oil pipelines owned by publicly-traded partnerships.

and will assist the oil pipeline industry to attract the capital that it needs to serve its shippers and consumers.

III. <u>Conclusion</u>

It is axiomatic that regulated pipelines are entitled to recover prudent costs resulting from the jurisdictional services provided. The Commission must provide a full income tax allowance in pipeline rates for taxes incurred as a result of providing regulated services regardless of the form of ownership that pipeline investors use. Such a policy will accurately reflect the reality that tax liability is derived from income generated by the provision of jurisdictional services, and therefore reflects a cost of service that should be recovered from shippers. This policy will also give all pipeline investors the opportunity earn a fair and adequate return on their investment, which will enable the oil pipeline industry to attract the investment necessary to meet consumers' needs. Any other approach with regard to an income tax allowance in rates will fail to compensate investors adequately, as *Hope Natural Gas* demands, and will inhibit the very investment in pipeline infrastructure that the Commission seeks to foster.

Respectfully Submitted,

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