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PRATT'S

# ENERGY LAW REPORT

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# FERC Reaffirms Its Final Rule on Rate Changes Relating to Federal Income Tax Rates for Natural Gas Pipelines

***By Mark R. Haskell, Brett A. Snyder, George D. Billinson, Lamiya N. Rahman, and Jane Thomas****

*The Federal Energy Regulatory Commission's recent order upholds the Form No. 501-G filing requirement, which was designed to determine whether pipelines are over-recovering on their cost of service in light of recent federal income tax rate and policy changes. Thus far, the Commission has initiated investigations into the rates of six pipelines pursuant to its authority under Section 5 of the Natural Gas Act. The authors of this article analyze the issue.*

The Federal Energy Regulatory Commission ("FERC" or "the Commission") issued an order ("Order No. 849-A")[1] denying requests for rehearing of its final rule on federal income tax rates for jurisdictional natural gas pipelines ("Order No. 849").[2] Order No. 849 adopted procedures for determining whether pipelines may be collecting unjust and unreasonable rates in light of income tax reductions established by the Tax Cuts and Jobs Act and the Commission's revised tax allowance policy following the *United Airlines, Inc. v. FERC* decision.[3] These procedures included a requirement that certain interstate

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[1] *Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate, Order Denying Rehearing*, 167 FERC ¶ 61,051 (2019).

[2] *Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate*, Final Rule, 164 FERC ¶ 61,031 (2018).

[3] In *United Airlines, Inc. v. FERC*, 827 F.3d 122 (D.C. Cir. 2016), the D.C. Circuit found that the Commission failed to show that allowing SFPP, L.P., an MLP pipeline, to recover both an income tax allowance and the discounted cash flow ("DCF") methodology rate of return did

natural gas pipelines file a FERC Form No. 501-G to estimate cost of service reductions and changes in returns on equity ("ROE") resulting from the income tax changes.

Parties requested rehearing of several aspects of Order No. 849, including the ROE and capital structure used in the FERC Form No. 501-G, the rate moratorium for pipelines electing to make a voluntary limited rate reduction, the treatment of Accumulated Deferred Income Taxes ("ADIT"), and the tax allowance for pass-through entities.[4] The Commission's determinations on rehearing are analyzed below.

## BACKGROUND

Order No. 849 implemented a reporting requirement directing all interstate natural gas companies with cost-based stated rates that filed a 2017 FERC Form No. 2 or 2-A to file a Form No. 501-G informational filing. The Form No. 501-G is intended to provide information, in light of the recent tax rate and policy changes: (1) as to whether the Commission should initiate an investigation pursuant to Section 5 of the Natural Gas Act ("NGA") into a pipeline's rates; and (2) to support any limited NGA Section 4 filing a pipeline may make to voluntarily reduce its maximum tariff rates.

The Form No. 501-G uses data from each pipeline's 2017 Form Nos. 2/2-A to approximate the percentage reduction in the pipeline's cost of service and the pipeline's current ROE before and after the reduction in corporate income taxes and the elimination of income tax allowances for master limited partnership ("MLP") pipelines. Order No. 849 additionally permitted each pipeline to file an addendum to make adjustments to the Form No. 501-G to the extent the pipeline believed the 2017 Form No. 2/2-A data was not fully representative of its current situation.

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not result in double-recovery of investor tax costs. On remand, the Commission determined that allowing SFPP an income tax allowance in addition to an ROE based on the DCF methodology resulted in double-recovery, and accordingly ordered removal of the additional income tax allowance from SFPP's cost of service. *See SFPP, L.P.*, Opinion No. 511-C, 162 FERC ¶ 61,228 (2018). The Commission also issued a policy statement, consistent with the *United Airlines* decision, announcing that it will no longer allow MLP pipelines to recover income tax allowances in their cost of service. *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs, Revised Policy Statement*, 83 Fed. Reg. 12362 (Mar. 21, 2018), FERC Stats & Regs. ¶ 35,060 (2018), order on reh'g, 164 FERC ¶ 61,030 (2018).

[4] Specifically, requests for rehearing were filed by Process Gas Consumers Group and American Forest and Paper Association ("Process Gas"); Enable Mississippi River Transmission, LLC and Enable Gas Transmission, LLC ("Enable"); and the Kinder Morgan Entities, Spectra Energy Partners, LP, and Enable (the "Pipeline Group").

The Commission noted that of the 129 interstate natural gas pipelines identified as required to fulfil the reporting requirement, 120 pipelines filed the Form No. 501-G, one pipeline continues to have an extension of time, and eight have been granted a waiver from the filing requirement. Of the 120 pipelines that have made the filing, nine have made limited Section 4 rate reduction filings; 22 have filed general rate cases or prepackaged settlements to revise their rates; 84 provided explanations as to why no changes in rates were necessary, and five pipelines decided to take no action. The Form No. 501-G reports resulted in six NGA Section 5 investigations.[5]

## LEGAL AUTHORITY

As a preliminary matter, the Commission dismissed challenges alleging that it exceeded its statutory authority under the NGA in requiring pipelines to file the Form No. 501-G. The Commission noted that the Form No. 501-G itself does not require a pipeline to modify its rates, reiterating the voluntary nature of any limited Section 4 rate reduction filing a pipeline may choose to make, and the Commission's own use of the form to determine whether to exercise its discretion to open an NGA Section 5 investigation.

## RETURNS ON EQUITY AND CAPITAL STRUCTURE USED IN FERC FORM NO. 501-G

Order No. 849 required each pipeline to use in its Form No. 501-G filing an indicative ROE of 10.55 percent—the last litigated ROE as established in *El Paso Natural Gas Co.*[6] Additionally, pursuant to the Commission's capital structure policy, the Form No. 501-G automatically populates the filing with either the pipeline's reported capital structure, its parent's capital structure, or a hypothetical capital structure of 57 percent equity and 43 percent debt, as appropriate.[7]

[5] The Commission has instituted NGA Section 5 proceedings against the following pipelines: Stagecoach Pipeline & Storage Company LLC (Docket No. RP19-439); Southwest Gas Storage Company (Docket No. RP19-257); Panhandle Eastern Pipe Line Company, LP (Docket No. RP19-78); East Tennessee Natural Gas, LLC (Docket No. RP19-63); Northern Natural Gas Company (Docket No. RP19-59); and Bear Creek Storage Company, LLC (Docket No. RP19-51).

[6] *El Paso Natural Gas Co.*, Opinion No. 528, 145 FERC ¶ 61,040 at P 686 (2013), *reh'g denied*, Opinion No. 528-A, 154 FERC ¶ 61,120 (2016) ("El Paso").

[7] As the Commission explained, "a pipeline may use its own capital structure, if its debt is issued in its own name and publicly traded, the debt is rated by a rating agency, and the equity portion of the capital structure is not excessive. If the pipeline's own debt does not satisfy these standards, it can use its parent's capital structure, if the parent satisfies the same standards. Otherwise, the pipeline must use a hypothetical capital structure." Order No. 849-A at P 25.

The Pipeline Group argued that the Commission failed to show that the proxy group and 10.55 percent ROE used in El Paso (which was litigated six years ago and involved a different pipeline serving different markets) are appropriate. In Order No. 849-A, the Commission upheld its determination to use the last-litigated indicative ROE of 10.55 percent. Although it recognized that this indicative ROE was based on 2011 financial data, the Commission noted that no pipelines provided updated ROE analyses using current financial data that the Commission could use in the Form No. 501-G. The Commission also rejected the suggestion that pipelines use their own ROEs or ROEs derived in their last rate cases, because many of these existing rates are based on proceedings that occurred at the same time or prior to *El Paso*. Since many pipeline rates are developed in "black box" settlements, the Commission preferred to use the indicative 10.55 percent rather than a variety of generally unlitigated ROEs.

The Commission also disagreed with the Pipeline Group's contention that Form No. 501-G required pipelines to propose a capital structure and to make a legal determination as to whether that capital structure satisfied Commission policy. To the contrary, the Commission noted that the form simply requires the pipeline to answer questions regarding relevant facts, and then auto-populates the form with the appropriate capital structure without requiring the pipeline to make a legal determination.

The Commission pointed out that the indicative ROE and stated capital structure in Form No. 501-G are merely rough estimates that are necessary to aid the Commission's determination of whether to initiate an NGA Section 5 proceeding or a pipeline's determination to make a limited Section 4 rate reduction. The Commission noted that it would not use the Form No. 501-G's ROE and capital structure to establish rates in an NGA Section 5 investigation.

**RATE MORATORIUM**

Order No. 849 granted a three-year moratorium on an NGA Section 5 investigation in the event a pipeline chose the NGA Section 4 rate reduction option. In order for a pipeline to qualify for the moratorium, (1) the Commission must accept the pipeline's limited NGA Section 4 filing; and (2) the pipeline's Total Estimated ROE after the filing must be 12 percent or less. The Pipeline Group supported the availability of a moratorium. However, it argued that the 12 percent ROE test was arbitrary and not supported by the record or past Commission precedent. The Commission disagreed, finding that the 12 percent threshold balances the goals of encouraging limited NGA Section 4 filings and preventing pipelines with "significantly excessive ROEs" from avoiding Commission scrutiny.

## ACCUMULATED DEFERRED INCOME TAXES

Order No. 849 recognized that reductions in tax rates rate meant that previously deferred taxes will be owed to the Internal Revenue Service at the 21 percent income tax rate, as opposed to the 35 percent rate at which ADIT was originally recognized. The Commission noted that ADIT balances must be adjusted to account for any excess or deficiency resulting in this discrepancy. To account for how excess or deficient ADIT may affect rates, the Form No. 501-G required pipelines to use 2017 ADIT balances as reported in their 2017 FERC Form Nos. 2 and 2-A to calculate rate base.[8] FERC Form No. 501-G additionally required pipelines to reduce their income tax allowance by an amount reflecting the first year's amortization of excess ADIT. Finally, when a pass-through entity indicates that it does not pay taxes, the Form No. 501-G eliminates ADIT in addition to eliminating the entity's income tax allowance.

In Order No. 849-A, the Commission upheld its determination to eliminate ADIT in the Form No. 501-G for pass-through entities as consistent with Commission policy and court precedent. The Commission found that, to the extent an income tax allowance is eliminated from the cost of service, allowing continuing deductions or credits of ADIT balances would amount to impermissible retroactive ratemaking. The Commission also stated that the elimination of ADIT does not violate the normalization policies because such policies only apply to the extent an entity has an income tax allowance component in its cost of service rates.

## TAX ALLOWANCE FOR PASS-THROUGH ENTITIES

If a pipeline indicates that it is not a taxpaying entity on the Form No. 501-G, the form automatically populates a federal and state income tax of zero. However, Order No. 849 noted that a pass-through subsidiary of a corporation may qualify for an income tax allowance, even where the subsidiary itself does not incur a tax liability, if it nonetheless generates a tax liability that may appear on the consolidated income tax returns of its corporate parent or corporate group.

The Commission rejected a request for rehearing based on the claim that Order No. 849 incorrectly permitted wholly-owned pass-through subsidiaries of a corporation to claim this income tax allowance on Form No. 501-G without proof that a tax liability was actually generated. The Commission determined that its standalone income tax policies allowed wholly-owned pipeline subsidiaries to recover income tax costs of its corporate parent that

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[8] Pursuant to the Commission's accounting guidance, pipelines were required to reflect recalculated deferred tax liabilities and assets in the Form No. 2/2-A covering the year in which the Tax and Cuts Jobs Act was effective (*i.e.*, 2017).

arose from jurisdictional service, notwithstanding any deductions or losses of the parent or affiliates that offset the subsidiary's income. Order No. 849-A also rejected a request for rehearing alleging the Commission erred by permitting tax allowances to wholly-owned subsidiaries of a corporation, but not permitting tax allowances to MLP pipelines that are owned in part indirectly by corporate unitholders. The Commission distinguished MLPs (which incur no tax liability before making distributions to unitholders) from corporations that wholly own a pass-through pipeline (which pay the corporate income tax prior to issuing dividends). In the former case, a double-recovery would result from granting the pipeline an income tax allowance, whereas no double-recovery would result in the latter case.