9 NOVEMBER 2018

Height Commentary

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Cost of Service Rates

First Impressions Matter - What's Next for FERC's MLP Income Tax Policy

THE TAKEAWAY

The Federal Energy Regulatory Commission (FERC) process to reduce natural gas pipeline cost of service rates began in earnest this quarter with the first and second waves of filings already before the Commission. We now have enough data to make some predictions about the outcome of the process for cost of service rates broadly, and we can see how companies appear to be managing the impact to rates. Additionally, we are closely monitoring the paper hearing on Tallgrass Energy's (TGE) Trailblazer rate case—an "issue of first impression" for FERC following the United Airlines ruling—for insight on what FERC's ultimate precedent on tax allowance for mixed-ownership pipelines may look like.

501-G Process

As part of FERC's MLP Income Tax Allowance decision, natural gas pipeline companies with cost-of-service rates must file Form 501-G to help FERC evaluate the impact of the Tax Cuts and Jobs Act on pipelines rates and return on equity. The 501-G aggregates financial data from annual Form 2 tax filings to help FERC determine whether rates are just and reasonable in light of tax reform. Companies whose rates are currently being examined in Section 4 or Section 5 rate cases need not submit.

FERC assigned pipeline companies into four groups to schedule 501-G filings, with older pipelines generally in the first tranche. The deadline for this first group to file was on October 11, 2018 and the second group on November 8, 2018. In order to determine whether pipeline company shareholders are over-earning, FERC is analyzing companies' pre-tax and pro forma return on equity (ROE). On the 501-G form, pipeline companies must include their calendar year 2017 ROE, an adjusted ROE for 2018, and a "Rate Moratorium Option" wherein companies can initiate a limited Section 4 rate case using the specified ROE. FERC is currently analyzing these filings to determine whether to initiate a Section 5 investigation and force companies to lower their rates.

When filing the 501-G form, companies have four options:

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1. File a limited Natural Gas Act Section 4 filing to reduce the pipeline's rates;
2. Make a commitment to file a general Natural Gas Act Section 4 rate case in the near future;
3. File a statement explaining why an adjustment to its rates is not needed; or
4. Take no action other than filing the informational filing.

For rates to remain just and reasonable, pipelines need to pass along the savings from tax reform to customers. If pipeline companies choose option 3 and have a significantly higher ROE before and after tax reform, they will need to make an extremely compelling argument for why a rate adjustment is unnecessary. For instance, pipelines like Kinder Morgan's (**KMI**) Horizon Pipeline and Energy Transfer's (**ET**) ETC Tiger Pipeline argue they do not need to adjust their rates because their rates are negotiated with shippers and outside the scope of cost-of-service regulations. Eventually, pipelines seeking to use tax savings to boost ROE or for other business expenses like infrastructure maintenance and investment could face Section 5 rate cases, where FERC seeks to challenge these rates. As many investors will recall, FERC-initiated Section 5 cases typically result in a settlement between the pipeline and its shippers.

Proceedings to Watch

We anticipate two ongoing proceedings related to natural gas pipeline rates—Tallgrass Energy's (**TGE**) Trailblazer Pipeline and ongoing appeals of the Enable Midstream (**ENBL**) Mississippi River Transmission (MRT) rate case—could meaningfully shape the application of FERC's final MLP income tax policy. The Trailblazer case is the first time FERC will address "the extent to which a pass-through pipeline that is not wholly-owned by an MLP…may recover an income tax allowance following *United Airlines*"—a so-called "issue of first impression." We expect the outcome of the Trailblazer case may set a critical precedent for the appropriate ROE calculation mechanism, particularly in the wake of FERC's Emera Maine order on transmission ROEs. Additionally, the MRT case in the US Court of Appeals for the DC Circuit—which will likely be dismissed and potentially re-filed before the end of the year—will test the legal footing of FERC's new policy as it pertains to pipelines with mixed ownership such as the Kinder Morgan (**KMI**) and Brookfield Infrastructure Partners' (**BIP**) Natural Gas Pipeline Company of America and many others.

Trailblazer Case

On June 29, 2018, Trailblazer submitted a general rate case filing proposing to increase its cost of service. Trailblazer, under the newly structured Tallgrass Energy (**TGE**), a C-Corp, included an income tax allowance that reflects the income tax liability of C-Corp and private equity owners in the cost-of-service. On July 31, 2018, FERC issued an order accepting and suspending Trailblazer's rates and established a paper hearing to examine the extent to which Trailblazer is entitled to an income tax allowance. FERC asked parties to address whether Trailblazer may recover an income tax allowance following *United Airlines v. FERC* decision, in which the DC Circuit instructed the Commission to explain why granting an income tax allowance and a ROE determined by the discounted cash flow (DCF) methodology to a pipeline that was wholly owned by an MLP does not result in a double recovery of income taxes.

On August 30, 2018, Trailblazer's shippers filed initial briefs in the paper hearing, arguing Trailblazer either should not be permitted to recoup an income tax allowance or, as an alternative, that the Commission should limit any

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further review to determine whether Trailblazer is entitled to a partial income tax allowance to only account for the portion of Trailblazer's ownership attributable to the Class A Shareholders in TGE. Trailblazer filed a reply brief on September 14, arguing that the pipeline is in fact entitled to an income tax allowance given its 55% C-Corp (TGE) and 45% private ownership structure. Unlike MLP distributions, TGE pays taxes before issuing dividends, and distributions to private owners are not reflected in Trailblazer's DCF model's determination of ROE. We believe this structure is consistent with a corporate structure that would be entitled to claim tax costs, per FERC's July 18, 2018 order on the MLP Income Tax Allowance policy.

Interestingly, on November 1, 2018, Trailblazer supplemented its reply brief in light of FERC's October 16 Emera Maine Remand Order, wherein FERC determined that "relying on the DCF methodology alone will not produce a just and reasonable ROE." Going forward, for Transmission ROEs, FERC will supplement the DCF method with capital-asset pricing model analysis, expected earnings analysis, and risk premium analysis. While the Emera Maine case concerned transmission ROEs rather than pipeline ROEs, Trailblazer argues that courts have long considered the Federal Power Act and the Natural Gas Act to be substantially the same; therefore, the Commission could no longer rely solely on the DCF method to set Trailblazer's ROE. Since *United Airlines* only applies to ROEs calculated using DCF, Trailblazer posits that the Commission cannot reasonably find that granting the pipeline an income tax allowance would result in a double-recovery of income taxes. **The outcome of this decision could be enormously significant. FERC has used the two-step DCF methodology to calculate pipeline ROEs for decades, and a broader ROE analysis could allow MLPs to side-step the double recovery problem in future rate cases.**

MRT Case

On June 29, 2018, MRT submitted revised rates that included an income tax allowance in its cost of service for the liability incurred by Enable's corporate unitholders, which hold 86% of its equity. On July 31, 2018, FERC issued an order accepting and suspending MRT's tariff record and determined that MRT should not include an income tax allowance in its cost of service. In the order, FERC differentiated between pass-through entities that can include an income tax allowance per the Commission's July 18, 2018 ruling and subsidiaries of MLPs with corporate unitholders.

On August 30, 2018, MRT requested a rehearing on FERC's July 31 suspension order, but FERC has yet to respond. MRT grew tired of waiting and on September 14 took its case (no. 18-1252) to the US Court of Appeals for the DC Circuit. MRT is challenging two orders that it argues guided FERC's decision on the rate proceeding: (1) the March 15 "Revised Policy State on Treatment of Income Taxes" and (2) the July 18 "Order on Rehearing." However, until FERC denies rehearing on the MRT rate case, the court case cannot proceed. On October 24, FERC filed a motion to dismiss the case as the proceeding won't be ripe until FERC formally denies MRT's rehearing request.

We expect FERC will formally deny MRT's rehearing request after it decides on the Trailblazer case, likely before the end of the year. Depending on the outcome of the Trailblazer case—i.e. if and how mixed-ownership pipelines can include income tax allowances—MRT may re-file its case in the DC Circuit to challenge FERC's March 15 and July 18 income tax orders. If FERC finds that mixed-ownership pipelines like Trailblazer are entitled to any income tax allowance, consistent with its July 18, 2018 order, MRT will likely include this decision in its raft of

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legal complaints against FERC. **The outcome of this case would either solidify FERC's new precedent or remand the policy statement back to FERC, potentially creating major upside for MLP pipelines.**

History of the MLP Tax Policy

The FERC MLP policy does not exist in a vacuum, but rather it has a long and contentious history stretching back to the creation of MLPs in the 1986 federal tax reform law. Figure 1, below, walks through the many cases and iterations of the MLP income tax policy.

Figure 1. FERC Income Tax Allowance Policy

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Income Tax Allowance History			
Date	**Event**	**Impact**	**Actor**
18-Jul-18	FERC Finalizes New ITA Policy	Eliminates ITA policy for most MLPs, but allows wholly owned (or nearly wholly owned) MLP subsidiaries of C-Corps to claim an ITA	FERC
15-Mar-18	FERC eliminates ITA policy, order subject to rehearing	Eliminates ITA policy for all MLP-owned pipelines	FERC
1-Jul-16	*United Airlines v FERC*	Court overturns the FERC MLP ITA Policy	DC Circuit Court of Appeals
29-May-07	*Exxon Mobil Corporation v. FERC*	Court upholds the expanded FERC ITA policy in principle	DC Circuit Court of Appeals
4-May-05	FERC Reinstates whole ITA Allowance for MLPs	FERC allows MLPs to claim full real or estimated income tax costs and later decides to includes them in proxy group for DCF modeling	FERC
20-Jul-04	*BP West Coast Products, LLC, v. FERC*	The court overturns FERC's Lakehead policy on the basis that it is an arbitrary and capricious treatment of tax costs for non C-Corp owners of MLPs	DC Circuit Court of Appeals
1995 (various dates)	FERC establishes the Lakehead Policy	Lakehead, so named after the group of pipelines to which the decision originally applied, allows MLP owned pipelines to claim a tax allowance proportional to their ownership by C-Corp taxpayers	FERC
Pre-1995	Pre-Lakehead policy	Before FERC later changes the policy, FERC allows MLPs to claim tax costs for all their C-Corp and non-C-Corp ownership. This policy will later be overturned by FERC in its Lakehead decision, and the full tax allowance will later be dubbed the "pre-Lakehead" policy.	FERC

Any future legal challenges or applications of the Income Tax Allowance policy are necessarily constrained by past case law and FERC precedent. In summary, we caution investors that any resolution to the ITA policy is likely not near. FERC is already facing significant problems eliminating the ITA as exemplified in the MRT and Trailblazer lawsuits. Going forward, FERC will have to fend off legal challenges that could well lead to the vacatur of the current no-ITA policy as well.

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COMPANIES MENTIONED IN THIS REPORT

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RISKS

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