Federal Energy Regulatory Commission
October 19, 2006
Open Commission Meeting
Statement of
Commissioner Marc Spitzer

Item G-1: Kern River Gas Transmission Company (RP04-274-000)

"I support this Order. I believe the Return on Equity balances ratepayer and investor interests and results in just and reasonable rates. The Kern River line provides benefits not only to California shippers, but eases supply constraints throughout the west.

I must address application of the discounted cash flow ("DCF") model *in futuro* in light of the increasing importance of the master limited partnership entity ("MLP") in the energy sector. A key issue in this case is the paucity of reliable proxies for natural gas pipelines. The Order recognizes that in recent years fewer and fewer companies have met the Commission's historical standard for inclusion in natural gas pipeline proxy groups, particularly in which pipeline operations constitute a high proportion of their business. The determination of the types of entities to be included in natural gas pipeline proxy groups now squarely confronts the DCF model and the Commission.

The pleadings reflect a general observation that natural gas pipelines are not organized as C corporations. I pose the question "why?"

I recognize that pipelines are now rarely stand alone enterprises under any form of business organization. However, the risk profile of the pipeline business increasingly favors organization in partnership form, be it a general partnership, limited partnership or MLP. Several aspects of tax and corporate law suggest this trend will continue.

Partnerships are "tax efficient" because passthrough entities under subchapter K are subject to one level of income taxation. Partnership income is generally taxable to the partners based on their distributive share of income regardless of whether cash distributions are made. Thus, the tax paid by the partner is a first-tier tax on the income of the partnership rather than a second-tier tax on cash distributed to the partner. C corporations, on the other hand, pay in the first instance the income tax on the income from corporate operations (a first-tier tax), then if the corporation distributes cash by paying a dividend, a shareholder in the corporation generally is taxed on the amount of the dividend received (a second-tier tax). Further, upon liquidation a C corporation is subject to entity level income tax and its shareholders recognize a gain on the ensuing corporate distribution, unlike a partnership. There is one incidence of tax upon realization of gains by passthrough entities.

Corporate governance matters also favor the MLP form for equity capital formation. Sarbanes-Oxley established important disclosures for investors in publicly traded corporations. Corporate audit and compliance fees have increased dramatically. Private investment has become, therefore, comparatively less costly. Further, the increasing frequency of shareholder derivative lawsuits and recent events regarding corporate boards may accelerate the trend towards private equity. Partnerships avoid some of these issues, and the MLP entity facilitates public equity capital formation in a partnership form.

In summary, the MLP form of business is likely to increase, particularly in the entrepreneurial energy sector. This argues for inclusion of MLPs in the DCF proxy

group. I understand that a potentially duplicative return of capital from MLPs is a major concern of Staff. I also recognize the record in this proceeding did not adequately address the extent to which MLP distributions of capital can be "backed out" from aggregate partnership distributions. I would point out, however, that there has been frequent litigation in the context of corporate taxation as to whether distributions to corporate shareholders are capital redemptions or dividends. Thus, absolute clarity in the demarcation between a capital and dividend distribution is elusive.

In cost-of-service ratemaking the objective is to allow a fair profit, after taxes, ascertained after taking into account a variety of factors, such as the risks of the business and the necessity of attracting capital. The return necessary to attract investors is measured by the return an investor could obtain from investments bearing having commensurate risks. Further, the basic regulatory premise that a utility must earn a comparable return refers to the after tax return to the investor, regardless of the form of ownership. Therefore, I look forward to a more fulsome factual record on MLP proxies in forthcoming cases."