ORAL ARGUMENT NOT YET SCHEDULED

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 05-1382

CANADIAN ASSOCIATION OF PETROLEUM PRODUCERS,
PETITIONER,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

ON PETITION FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION

BRIEF OF RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

JOHN S. MOOT
GENERAL COUNSEL

ROBERT H. SOLOMON
SOLICITOR

LONA T. PERRY
SENIOR ATTORNEY

MONIQUE WATSON
ATTORNEY

FOR RESPONDENT
FEDERAL ENERGY
REGULATORY COMMISSION
WASHINGTON, D.C. 20426

SEPTEMBER 11, 2006

CIRCUIT RULE 28(a)(1) CERTIFICATE

A. Parties and Amici

The parties before this Court are identified in the briefs of Petitioner.

B. Rulings Under Review

1. *Inquiry Regarding Income Tax Allowances, "Policy Statement on Income Tax Allowances"*, 111 FERC ¶ 61,139 (2005) (*"Policy Statement"*).

2. *Inquiry Regarding Income Tax Allowances,* 112 FERC ¶ 61,203 (2005) ("Rehearing Order").

C. Related Cases

The merits of the Commission's *Policy Statement* are directly contested and at issue in *ExxonMobil Oil Corp. v. FERC*, Nos. 04-1102, *et al*. (D.C. Cir.).

Lona T. Perry
Senior Attorney

September 11, 2006

TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

PAGE

TABLE OF AUTHORITIES

*** Cases chiefly relied upon are marked with an asterisk**.

TABLE OF AUTHORITIES
(continued)

COURT CASES **PAGE**

TABLE OF AUTHORITIES
(continued)

TABLE OF AUTHORITIES
(continued)

TABLE OF AUTHORITIES
(continued)

STATUTES: **PAGE**

GLOSSARY

BP West Coast	*BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004)
EPAct 1992	Energy Policy Act of 1992
FERC or Commission	Federal Energy Regulatory Commission
FPA	Federal Power Act
ICA	Interstate Commerce Act
Lakehead	*Lakehead Pipe Line Co., L.P.*, Opinion No. 397, 71 FERC ¶ 61,338, *on reh'g*, Opinion No. 397-A, 75 FERC ¶ 61,181 (1996)
NGA	Natural Gas Act
Petitioner	Canadian Association of Petroleum Producers
Policy Statement	*Inquiry Regarding Income Tax Allowances*, *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005)
Rehearing Order	*Inquiry Regarding Income Tax Allowances*, 112 FERC ¶ 61,203 (2005)

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BRIEF OF RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

STATEMENT OF THE ISSUES

1. Whether this Court has jurisdiction to review the Federal Energy Regulatory Commission's ("FERC" or "Commission") adoption of its *Policy Statement on Income Tax Allowances*, when Petitioner Canadian Association of Petroleum Producers ("Canadian Association") has failed to demonstrate that it has sustained any definitive injury flowing from the Commission's adoption of the *Policy Statement*, and the issues complained of are not ripe for review in this proceeding.

2. Assuming jurisdiction, whether the Commission's decision to make partnerships eligible for an income tax allowance, provided the partnership establishes in a rate proceeding actual or potential income tax liability on the part of its owners arising from income from public utility assets, was reasonable and based on substantial evidence.

STATUTES AND REGULATIONS

The pertinent statutes and regulations are contained in the Addendum to this brief.

COUNTERSTATEMENT OF JURISDICTION

As demonstrated in Section I of the Argument below, Petitioner does not have standing to bring its claim before this Court, in that it has not suffered, and is not in imminent peril of suffering, any justiciable injury caused by the Commission's adoption of the challenged *Policy Statement*. *See infra* Argument, Section I. Likewise, this Court should decline review of the challenged orders because they are not ripe for consideration.

STATEMENT OF THE CASE

I. Nature of the Case, Course of Proceedings and Disposition Below

This appeal concerns the Canadian Association's procedural and substantive challenges to the Commission's *Inquiry Regarding Income Tax Allowances*, "*Policy Statement on Income Tax Allowances*," 111 FERC ¶ 61,139 ("*Policy*

Statement"), *reh'g dismissed*, 112 FERC ¶ 61,203 (2005) ("Rehearing Order"), JA 786. The *Policy Statement* was issued in response to *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) ("*BP West Coast*"), where the Court held, *inter alia*, that the Commission had not adequately justified providing a regulated oil pipeline partnership with an income tax allowance equal to the proportion of its partnership interests owned by corporate partners.

After receiving comments from essentially every segment involved in the regulation of FERC-jurisdictional entities, the Commission adopted the *Policy Statement*, applicable to all energy industries. The *Policy Statement* expanded the pool of entities eligible for an income tax allowance to partnerships and similar entities, provided that the entity can demonstrate that its partners have actual or potential income tax liability arising from income from public utility assets. Contrary to Petitioner's contentions, the *Policy Statement* did not entitle any regulated partnership to receive an income tax allowance, but simply expanded the scope of entities eligible to receive an income tax allowance to include partnerships. The *Policy Statement* accordingly did not ascribe any legal right or grant a tax allowance to any entity; rather, it outlined the requirements that a regulated partnership entity must later meet to receive an income tax allowance. The *Policy Statement* repeatedly emphasizes that these requirements will be met in subsequent, pipeline- or public utility-specific rate proceedings.

II. STATEMENT OF FACTS

A. Statutory and Regulatory Framework

The Natural Gas Act and Federal Power Act require the Commission to insure that rates of FERC-jurisdictional interstate natural gas pipelines, interstate natural gas storage companies, and public utilities it regulates are "just and reasonable." 15 U.S.C. § 717c(a); 16 U.S.C. § 824d(a).

The Commission's regulation of oil pipeline rates is dictated by the Interstate Commerce Act ("ICA") as it stood on October 1, 1977, 49 U.S.C. §§ 1-15 (1976), *reprinted in* 49 U.S.C. app. §§ 1-15 (1988),[1] and by Title 18 of the Energy Policy Act of 1992 ("EPAct 1992").[2] The ICA requires oil pipeline rates to be just and reasonable, *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1500, 1502 (D.C. Cir. 1984), subject to the provisions of the EPAct

[1] Jurisdiction over oil pipelines was transferred to FERC from the Interstate Commerce Commission on October 1, 1977. *See Department of Energy Organization Act*, Pub. L. No. 95-91, § 402(b), 91 Stat. 565, 584 (1977), *codified at* 42 U.S.C. § 7172(b) (1988)(repealed 1994), *recodified as amended at* 49 U.S.C. § 60502 (West 1996). In the *Revised Interstate Commerce Act*, Pub. L. No. 95-473, 92 Stat. 1337 (1978), Congress recodified the ICA, *see* 49 U.S.C. §§ 10101-11917 (1988), but provided that oil pipeline regulation remained governed by the ICA as it existed on October 1, 1977. *See* Pub. L. 95-473, § 4(c), 92 Stat. at 1470.

[2] Energy Policy Act of 1992, Pub. L. No. 102-486, §§ 1801-1804, Oct. 24, 1992, 106 Stat. 2776, 3010-12 (1992), *reprinted in* 42 U.S.C. § 7172 note (1994).

1992, which established a baseline of historically-effective rates that were deemed just and reasonable under the ICA.[3]

Under cost-of-service ratemaking principles, just and reasonable rates "yield sufficient revenue to cover all proper costs, including federal income taxes, plus a specified return on invested capital." *See City of Charlottesville v. FERC*, 774 F.2d 1205, 1207 (D.C. Cir. 1985). Where the regulated entity is organized as a corporation, a tax allowance is included in the pipeline's rates to assure that the regulated entity has the opportunity to earn its allowed return on equity. *Id.*

B. Events Leading to the Orders on Review

In *Lakehead Pipe Line Co., L.P.*, Opinion No. 397, 71 FERC ¶ 61,338 at 62,314-15 (1995), *on reh'g*, Opinion No. 397-A, 75 FERC ¶ 61,181 at 61,593-99 (1996), the Commission confronted the issue of whether a regulated entity organized as a partnership should, like a regulated corporation, receive an income tax allowance in its regulated rates even though the regulated partnership itself incurs no income tax liability. The Commission concluded that regulated partnerships would be eligible to receive an income tax allowance in proportion to the partnership interests owned by a corporation or other taxable entity, but denied any income tax allowance with respect to income attributable to partnership

[3] Order No. 561, Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992, FERC Stats. & Regs. Preambles ¶ 30,985 (1993), *on reh'g*, Order No. 561-A, ¶ 31,000 (1994).

interests held by individuals. 71 FERC at 62,315. In *BP West Coast*, 374 F.3d at 1285, this Court vacated Commission orders applying the *Lakehead* income tax policy, finding that the policy was not adequately justified.

Following the *BP West Coast* remand, the Commission issued a Request for Comments seeking comments on the income tax allowance issue. *Inquiry Regarding Income Tax Allowances*, "Request for Comments," FERC Docket No. PL05-5 at P 2 (Dec. 2, 2004). R 1 at 1, JA 19. The Commission received forty-two sets of comments from all sectors of the energy industry, including trade associations, individual public utilities, interstate natural gas pipelines, interstate natural gas storage companies, producers, municipalities, and the like. *Policy Statement*, 111 FERC at P 7, JA 788.

C. The Orders Under Review

After evaluating the comments received, the Commission issued the *Policy Statement*, the first challenged order, on May 4, 2004. *Policy Statement*, 111 FERC ¶ 61,139, JA 786. The comments advocated four general positions: (1) provide an income tax allowance only to corporations, but not partnerships; (2) give an income tax allowance to both corporations and partnerships; (3) permit an allowance for partnerships owned only by corporations; or (4) eliminate all income tax allowances and set rates based on a pretax rate of return. *Id.* at PP 7-30 (detailing the various positions), JA 788-97. Petitioner argued the first position.

No party, including Petitioner, argued for the Commission to continue the *Lakehead* doctrine in its then-current form. *Id.* at P 7, JA 788.

Upon consideration of these options, the Commission reversed its *Lakehead* policy and returned to its pre-*Lakehead* policy of permitting "an income tax allowance for all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets." *Id.* at P 32, JA 797. The Commission emphasized that "any pass-through entity seeking an income tax allowance in a specific rate proceeding *must establish* that its partners or members have an actual or potential income tax obligation on the entity's public utility income." *Id.* (emphasis added). To the extent that any of the partners or members of a pass-through interest did "not have such an actual or potential income tax obligation, the amount of any income tax allowance will be reduced accordingly to reflect the weighted income tax liability of the entity's partners or members." *Id.*

The *Policy Statement* also identified several technical or fact-specific issues that were to be addressed in individual rate proceedings where an income tax allowance is requested, including: (1) the amount of any income tax allowance reduction necessary to reflect the weighted income tax liability of the entity's partners or members, *id.* at P 32 n.27, JA 798; (2) allocation and timing issues related to the partners of master limited partnerships that have actual tax liability

for any income recognized by the partnership where distributions may substantially exceed partnership book income, *id.* at P 37 n.35, JA 801; and (3) whether a particular partner or limited liability corporation member has an actual or potential income tax liability, and what assumptions, if any, should determine the amount of the related tax rate, *id.* at P 42, JA 803. Similarly, the Commission reasoned "problems of over- and under-recovering alluded to in the court's order can be addressed through the distribution provisions of the partnership agreement." *Id.* at P 41, JA 803.

Petitioner sought rehearing of the *Policy Statement*. R 64, JA 828. Petitioner complained that: (1) the Commission did not adequately address the court's holding in *BP West Coast*; (2) the policy would result in different income and revenue streams for different business structures, resulting in windfalls for certain of them; (3) the Commission failed to identify any public benefits flowing from the *Policy Statement*; (4) the *Policy Statement* confuses the concepts of jurisdictional revenue and public utility revenue; and (5) the Commission should clarify whether it intends to apply the *Policy Statement* in all rate proceedings, and if so, it should issue the *Policy Statement* as a rule. *Id.*

In the second challenged order, the Commission denied Petitioner's rehearing request. *Inquiry Regarding Income Tax Allowances*, 112 FERC ¶ 61,203, JA 841. In doing so, the Commission explained that the "first three issues

were fully addressed in the *Policy Statement*. The fourth is a narrow point that the Commission can clarify in later proceedings where the issue may arise. As regards the fifth point, parties may always challenge the assumptions and conclusions of a *Policy Statement* in individual proceedings." *Id.* at P 2, JA 841. Last, in response to another rehearing request, the Commission emphasized that questions concerning the calculation of an income tax allowance, the calculation of blended tax rates, and the treatment of accumulated deferred income taxes were "fact specific type issues that the Commission expressly reserved for individual rate proceedings by the *Policy Statement*." *Id.* at P 3, JA 841.

This petition for review followed.

SUMMARY OF ARGUMENT

Petitioner does not have standing to bring its claims before this Court. It has failed to demonstrate that it has suffered, or is in imminent peril of suffering, any injury because of the *Policy Statement*, which merely broadened the regulated entities potentially eligible for an income tax allowance to include partnerships and similar pass-through entities. The *Policy Statement* did not grant any entity an income tax allowance. In fact, the Commission concluded that partnerships seeking an income tax allowance must make fact-specific showings in later proceedings evidencing that its owners have "actual or potential income tax

liability to be paid on that income from those assets." *Policy Statement* at PP 32 and 42, JA 797, 803.

Alternatively, for similar reasons, this Court should find the challenged *Policy Statement* unripe for review because the approval of an income tax allowance has only occurred, and will only occur, in individual cases not at issue in the challenged orders. Moreover, the Commission permits challenges to its policy in the context of such individual cases.

Assuming jurisdiction, the Commission reasonably exercised its broad discretion in adopting the *Policy Statement*, after requesting, receiving and evaluating comments from virtually every FERC-regulated entity. In the *Policy Statement*, the Commission decided it would allow cost-of-service rates to reflect actual or potential income tax liability for all public utility assets, regardless of the ownership structure. The Commission required, however, that entities or individuals owning public utility assets that seek an income tax allowance prove in a later proceeding that they have an actual or potential income tax liability to be paid on income from those public utility assets.

Petitioner contends that the *Policy Statement* permits an income tax allowance based upon "phantom" taxes, as partnerships have no income tax liability, and fails to distinguish between costs of the regulated entity and costs of investors in the entity. The Commission rejected these arguments because the

income of the partnership is attributed directly to its owners, which have actual or potential income tax liability on that income, just as a corporation has actual or potential income tax liability on income from the public utility assets it controls. Thus, the income taxes on revenues generated from the regulated operations of a partnership are comparable to the taxes generated from the regulated operations of a utility corporation, rather than, as Petitioner contends, comparable to the taxes generated by the payment of dividends to shareholders.

The Commission also rejected arguments that *BP West Coast* precluded granting a partnership income tax allowance. Nothing in the Court's mandate required the Commission to reach a particular result on the income tax allowance issue. Rather, the Court remanded this issue because there was no supportable rationale for the income tax allowance policy applied in *BP West Coast*.

ARGUMENT

I. THE PETITION FOR REVIEW SHOULD BE DISMISSED FOR LACK OF JURISDICTION BECAUSE PETITIONER LACKS STANDING AND THE ISSUES COMPLAINED OF ARE NOT RIPE FOR JUDICIAL REVIEW.

It is undisputed that the *Policy Statement* did not grant a tax allowance to any pipeline or public utility. Rather, the *Policy Statement* merely expanded the pool of entities eligible to request an income tax allowance in their individual rate proceedings. Indeed, Petitioner acknowledges, Br. at 10, that the *Policy Statement* expressly provided that the grant of an income tax allowance was not automatic,

but was contingent on the "pass-through entity" establishing in a subsequent rate proceeding "the tax status of its owners, or if there is more than one level of pass-through entities, where the ultimate tax liability lies and the character of the tax incurred." *Policy Statement* at P 42, JA 803.

As the *Policy Statement* determines no entity's *entitlement* to an income tax allowance, Petitioner is not injured by the *Policy Statement* nor does it face the threat of imminent injury. Similarly, the *Policy Statement* is not ripe for review as it merely announced the course the Commission intends to follow in adjudications involving requests for an income tax allowance.

A. Petitioner Lacks Standing To Challenge The *Policy Statement*.

Under FPA § 313(b), 16 U.S.C. § 825*l*(b), and NGA § 19(b), 15 U.S.C. § 717r(b), only a party that is "aggrieved" by a Commission order may obtain judicial review. *See, e.g., Public Util. Dist. No. 1 of Snohomish County v. FERC*, 272 F.3d 607, 613 (D.C. Cir. 2001) (party is not "aggrieved" within the meaning of FPA § 313(b), unless it can establish constitutional and prudential standing); *Interstate Natural Gas Ass'n v. FERC*, 285 F.3d 18, 45 (D.C. Cir. 2002) (a petitioner is "aggrieved" within the meaning of NGA § 19(b) if as a result of a Commission order, the petitioner "has sustained 'injury in fact' to an interest arguably within the zone of interests to be protected or regulated by the [Commission] under the Act"). An "aggrieved" petitioner must meet the

constitutional standing requirements. *See, e.g., Louisiana Energy & Power Auth. v. FERC*, 141 F.3d 364, 366 (D.C. Cir. 1998). These requirements are that: (1) a petitioner must have suffered an "injury in fact" – an "invasion of a legally protected interest which is (a) concrete and particularized . . . and (b) actual or imminent, not conjectural or hypothetical," (2) there must be a "causal connection between the injury and the conduct complained of," and (3) "it must be likely, as opposed to be merely speculative, that the injury will be redressed by a favorable decision." *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-561 (1992) (citations and internal quotation marks omitted); *see also, e.g., Bennett v. Spear*, 520 U.S. 154, 162 (1997).

Petitioner maintains that it is aggrieved by the *Policy Statement* and the Rehearing Order because "the new rule applies to pipelines that transport commodities supplied by [Canadian Association's] members and will operate to increase transportation costs borne by some or all of those suppliers." Br. at 8. Petitioner's alleged injury thus rests solely on the possibility that some pipeline or pipelines on which its members transport may in the future seek an income tax allowance, which in turn may result in "increase[d] transportation costs" to Petitioner's members. Br. at 7.

However, as the *Policy Statement* did not grant an income tax allowance to any entity, Petitioner's members' rates have not changed as a result of the

Commission's adoption of the *Policy Statement*, and therefore the claimed harm arising from future rate proceedings is speculative.[4] Under these circumstances, Petitioner has not suffered an injury, concrete or otherwise, that is in any way actual or imminent. *See Village of Bensenville v. FAA*, 376 F.3d 1114, 1118 (D.C. Cir. 2004) (quoting both *Rainbow/PUSH Coal. v. FCC*, 330 F.3d 539, 542 (D.C. Cir. 2003), and *Sierra Club v. EPA*, 292 F.3d 895, 899 (D.C. Cir. 2002)).

B. The Issues Presented By The Petitioner Are Not Ripe For Judicial Review.

Even if Petitioner satisfies the Court's requirements for standing, the issues presented are not ripe for judicial review. The ripeness doctrine's "basic rationale is to prevent the courts, through avoidance of premature adjudication, from entangling themselves in abstract disagreements over administrative policies, and also to protect the agencies from judicial interference until an administrative decision has been formalized and its effects felt in a concrete way by the challenging parties." *Abbott Labs. v. Gardner*, 387 U.S. 136, 148-49 (1967). Accordingly, typically, a challenge to the substance of a policy statement is not

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[4] On November 14, 2005, the Commission filed a motion to dismiss the instant appeal because the challenge is unripe for review. Petitioner filed its response opposing the motion to dismiss on November 25, 2005. This Court issued an order on March 9, 2006, referring the motion to dismiss to the merits panel to which the petition for review is assigned and directing parties "to address in their briefs the issues presented in the motion to dismiss rather than incorporate those arguments by reference." Consequently, the Commission will detail its jurisdictional arguments herein.

ripe until the policy statement is "reflected in subsequent agency actions." *Hudson v. FAA*, 192 F.3d 1031, 1035 (D.C. Cir. 1999) (citing *Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33, 45, 48-49 (D.C. Cir. 1974) ("*Pacific Gas*")).

1. The *Policy Statement* was not a rulemaking.

Petitioner attempts to evade the lack of ripeness here by contending that the Commission's *Policy Statement* is actually "a binding *de facto* rule." Br. at 7. According to Petitioner, the *Policy Statement* "clearly constitutes a final and definitive determination that non-taxable entities will be entitled to a tax allowance in their rates, based on the actual or potential taxes payable by their investors." Br. at 10.

However, a statement of policy differs from a substantive rule in that the policy statement is not finally determinative of the issues or rights to which it is addressed, and when the agency applies the policy in a particular situation, it must be prepared to support the policy just as if the policy statement had never been issued. *Pacific Gas*, 506 F.2d at 38. *See, e.g., New York State Elec. & Gas Corp. v. FERC*, 177 F.3d 1037, 1041 (D.C. Cir. 1999) (where orders indicated Commission intended to apply in pipeline's next rate case presumption in favor of rolled-in rates from Pricing Policy Statement, petitioner's challenge to those orders was not ripe because petitioner could challenge Pricing Policy Statement

presumption as well as the pipeline's rates in the subsequent rate proceeding if rolled-in rates were actually approved).

The *Policy Statement* did not grant an income tax allowance to any entity. To obtain a tax allowance, any entity must make a showing, in a subsequent pipeline-specific rate case, that its owners "have an actual or potential income tax obligation on the entity's public utility income." *Policy Statement* at PP 32 and 42, JA 797, 803. As the *Policy Statement* involved no application of the stated policy to any pipeline, it has no immediate and significant impact on Petitioner, nor are the issues and record suitable for judicial review. *Pacific Gas*, 506 F.2d at 48 (citing *Abbott Labs.*, 387 U.S. 136; *Toilet Goods Ass'n, Inc. v. Gardner*, 387 U.S. 158 (1967)).

Moreover, "[w]hen the agency states that in subsequent proceedings it will thoroughly consider not only the policy's applicability to the facts of a given case but also the underlying validity of the policy itself, then the agency intends to treat the order as a general statement of policy." *Pacific Gas*, 506 F.3d at 39. Here, in the Order Dismissing Rehearing Requests, the Commission specifically recognized that parties "may always challenge the assumptions and conclusions of a policy statement" in subsequent proceedings in which the policy statement is applied. Rehearing Order, 112 FERC at ¶ 2, JA 841.

2. The Commission has permitted challenges to the *Policy Statement* in individual rate proceedings.

Petitioner contends that the Commission has refused to permit parties to challenge the *Policy Statement* in individual rate proceedings. Br. at 10-15. However, none of the cited cases supports that contention. In fact, the very case scheduled to be argued with this appeal belies Petitioner's concerns.

As Petitioner points out, Br. at 11, this Court has directed that oral argument be heard in the instant appeal (if necessary) on the same day as the appeal of the Commission's orders on remand from *BP West Coast. ExxonMobil Oil Corp. v. FERC*, No. 04-1102 (D.C. Cir.). *See Canadian Ass'n of Petroleum Producers v. FERC*, No. 05-1382 (D.C. Cir. 2006). In the orders challenged in *ExxonMobil*, the Commission expressly adopted the *Policy Statement* and responded to challenges of its rationale, including the same challenges raised by Petitioner here. *See SFPP, L.P.*, 111 FERC ¶ 61,334 at PP 21-27 (2005). The parties in *ExxonMobil* are now briefing, *inter alia*, the issues of whether, pursuant to the *Policy Statement*, SFPP, L.P., as a limited partnership, can be eligible for an income tax allowance, and whether the Commission's *Policy Statement* is consistent with the Court's remand in *BP West Coast*.

Indeed, the discussion of the merits of the Commission's income tax allowance policy herein, *see* Section III *infra*, is a reprise of the points made in the Commission's *ExxonMobil* brief, filed on July 31, 2006. Thus, the merits of the

Policy Statement are directly contested and at issue in *ExxonMobil*. Further, like the *Policy Statement*, the orders challenged in *ExxonMobil* were issued in direct response to the remand in *BP West Coast.* Therefore, the Commission respectfully submits that the *ExxonMobil* appeal is the appropriate forum to address the merits of the Commission's *Policy Statement*.

Petitioner's citation to *Trans-Elect NTD Path 15*, 112 FERC ¶ 61,200 (2005), fares no better. In the passage quoted by Petitioner, the Commission did reject challenges to the *Policy Statement* raised in the *Trans-Elect* proceeding on the ground that those arguments had been disposed of in the *Policy Statement*. Br. at 14 (quoting *Trans-Elect*, 112 FERC at 62,042 PP 6 & 8). Nevertheless, this Court dismissed a petition for review of that order, finding that petitioners had suffered no injury in fact because the challenged order did not actually grant an income tax allowance to Trans-Elect. *Transmission Agency of N. Calif. v. FERC*, No. 05-1382, 2006 U.S. App. LEXIS 6177 (D.C. Cir. Mar. 9, 2006). On rehearing of that order, moreover, the Commission addressed *on the merits* challenges to the *Policy Statement*. *Trans-Elect NTD Path 15, LLC*, 115 FERC ¶ 61,047 at PP 21-30 (2006). Challenges to this order are pending on appeal before this Court in *Transmission Agency of Northern California, et al. v. FERC*, No. 06-1189 (D.C. Cir.) (the Commission has filed a motion to dismiss or to hold in abeyance pending completion of agency proceedings on the income tax allowance issue).

The third order cited by Petitioner, *Columbia Gas Transmission Corp.*, 113 FERC ¶ 61,118 (2005), *see* Br. at 12-13, was followed by two requests for rehearing, filed December 1, 2005, challenging the *Policy Statement*. However, before the Commission acted on rehearing, those requests for rehearing were withdrawn. *See Columbia Gas Transmission Corp*., 144 FERC ¶ 61,209 at P 1 (2006). Accordingly, the Commission never had the opportunity on rehearing to address the challenges to the *Policy Statement*.

Thus, none of the individual proceedings on which Petitioner relies in fact supports its contention that the Commission has refused to consider the merits of the *Policy Statement* in individual rate proceedings.

Petitioner also contends that the *Policy Statement* has "direct, concrete effects" and therefore should be addressed by the Court in the instant proceeding, notwithstanding the fact that the *Policy Statement* makes no final determinations regarding any entity's income tax allowance. Br. at 16-17. The Commission agrees that the *Policy Statement* has far-reaching implications for regulated entities, and consequently in *ExxonMobil* asked that the issue be decided notwithstanding the fact that there has been no final determination as to the income tax allowance to be afforded SFPP. However, as discussed above, the *ExxonMobil* proceeding, not this appeal, is the more appropriate vehicle for consideration of this issue as the Commission is applying the *Policy Statement* there.

3. Denying review here will not prejudice Petitioner.

Denial of review in this appeal does not prejudice Petitioner. None of Petitioner's members incurred any injury as a result of the *Policy Statement*. Moreover, Petitioner indicates that it is now a party to a pipeline ratemaking proceeding in which a partnership has requested an income tax allowance. *See* Br. at 16. If a tax allowance is awarded in that proceeding and Petitioner suffers injury, it will then have the opportunity to pursue its arguments on appeal. *See Toca Producers v. FERC*, 411 F.3d 262, 266 (D.C. Cir. 2005); *Friends of Keeseville v. FERC*, 859 F.2d 230, 236-37 (D.C. Cir. 1988).

Further, as the *Policy Statement* proceeding was not a rulemaking, *see* Br. at 17-18, the Commission had no obligation to comply with rulemaking procedures. Petitioner errs, in any event, in suggesting the Commission provided no notice that the income tax allowance issue was under consideration. *Id*. The Commission issued a "Request for Comments," R 1, JA 19, inviting interested parties to comment on when, if ever, it is appropriate to provide an income tax allowance for partnerships or similar pass-through entities that hold interests in a regulated public utility. The Commission received forty-two comments from virtually every entity regulated by or shipping on FERC-regulated entities, including Petitioner. For example, the regulated entities' trade associations submitted comments. *See* (1) Interstate Natural Gas Association of America, R 31, JA 344; (2) the Edison

Electric Institute, R 12, JA 96; and (3) the Association of Oil Pipelines, R 34, JA 406. The Commission also received comments from various shipper interests: (1) the Natural Gas Supply Association, R 8, JA 57; (2) the American Gas Association, R 49, JA 696; (3) the American Public Gas Association, R 7, JA 43; (4) the National Rural Electric Cooperative Association, R 10, JA 76; (5) the Electric Power Supply Association, R 28, JA 310; and (6) Petitioner, R 15, JA 139.

II. STANDARD OF REVIEW.

The Court reviews FERC orders under the arbitrary and capricious standard of 5 U.S.C. § 706(c)(A). *Florida Mun. Power Agency v. FERC*, 315 F.3d 362, 365 (D.C. Cir. 2003). Under that standard, the Commission's decision must be reasoned and based upon substantial evidence in the record. The Commission's factual findings are conclusive if supported by substantial evidence. NGA § 19(b), 15 U.S.C. § 717r(b); FPA § 313(b), 16 U.S.C. § 825*l*(b). The substantial evidence standard "'requires more than a scintilla, but can be satisfied by something less than a preponderance of the evidence.'" *Florida Mun.*, 315 F.3d at 365 (quoting *FPL Energy Maine Hydro LLC v. FERC*, 287 F.3d 1151, 1160 (D.C. Cir. 2002)). Furthermore, the Commission's "determinations regarding rates of return, definition of rate base, and other technical aspects of ratemaking" are entitled to considerable weight. *Public Serv. Comm'n v. FERC*, 813 F.2d 448, 451 (D.C. Cir. 1987). The Commission's adoption of its *Policy Statement* was reasonable,

responsive to the arguments of the various parties, and supported by substantial evidence in the record.

III. THE COMMISSION REASONABLY ADOPTED THE *POLICY STATEMENT* BASED ON SUBSTANTIAL EVIDENCE.

Petitioner argues that the "Policy Statement" is arbitrary and capricious and is not the product of reasoned decisionmaking. Br. at 18-24. Specifically, Petitioner argues that the Policy allows the recovery of "phantom income taxes," *id.* at 18-19, 23-24, and is inconsistent with *BP West Coast*. *Id.* at 19-22. *See also id*. at 15-16 (judicial review will not be facilitated by further proceedings because the Commission has relied on a rationale that was already addressed in *BP West* [*Coast]*)." These contentions are without merit.

A. Development Of The Income Tax Allowance *Policy Statement*

Under cost-of-service ratemaking, Commission-approved rates "must yield 'sufficient revenue to cover all proper costs,' and provide an appropriate return on capital." *BP West Coast*, 374 F.3d at 1286 (quoting *City of Charlottesville v. FERC*, 774 F.2d at 1207). Where the regulated entity is organized as a corporation, a tax allowance is included in the pipeline's rates to assure that the regulated entity has the opportunity to earn its allowed return on equity. *Id.* The issue presented here is the appropriate treatment of a tax allowance where the regulated entity is a partnership that itself incurs no tax liability.

In *Lakehead*, the Commission determined that regulated entities organized as partnerships should receive a tax allowance for income taxes attributable to corporate partners because "the tax cost will be passed on to the corporate owners who must pay corporate income taxes on their allocated share of income directly on their tax returns." *Lakehead*, 71 FERC at 62,314-15. In contrast, no tax allowance was permitted for taxes attributable to individual partners because those partners do not pay a corporate income tax. *Id*. at 62,315. In the *SFPP* proceeding, the Commission applied *Lakehead* and denied SFPP, a limited partnership, any income tax allowance for taxes attributable to partners that were not corporations. *SFPP, L.P.*, Opinion No. 435, 86 FERC ¶ 61,022 at 61,102 (1999).

BP West Coast vacated and remanded the determination on SFPP's income tax allowance, finding that the Commission had not established that its *Lakehead* policy was the product of reasoned decision-making. 374 F.3d at 1285. Because SFPP is exempt from taxation, the Court was concerned that any income tax allowance in its cost-of-service would be based upon a "phantom tax." *Id*. at 1288. The Court rejected the justification that *Lakehead* compensates for the double-taxation of profits to corporate partners. *Id*. at 1288-89.

Following the *BP West Coast* remand, the Commission recognized that this issue had implications far beyond the SFPP proceedings, to other proceedings and

other regulated utilities. *Policy Statement* at P 6, JA 788. Investors in the natural gas pipeline and electric utility industries use partnerships and other pass-through entities pervasively. *See Trans-Elect,* 115 FERC ¶ 61,047 at P 21 (citing *Policy Statement* at P 31 & n.30, in which the Commission notes the record evidence in the *Policy Statement* proceeding details that billions of dollars of existing investment could be potentially affected by that proceeding).

Accordingly, the Commission issued a Request for Comments seeking comments on when, if ever, it is appropriate to provide an income tax allowance for partnerships holding interests in a regulated public utility. *Inquiry Regarding Income Tax Allowances*, Request for Comments, FERC Docket No. PL05-5 at P 1, JA 19. FERC received forty-two sets of comments, from all sectors of the energy utilities subject to FERC regulation. Upon consideration of those comments, the Commission concluded that an income tax allowance should be permitted on all partnership interests if the owner of that interest has an actual or potential income tax liability on the public utility income earned through that interest. *Id*. The Commission's policy on partnership income tax allowances is reasonable and fully consistent with *BP West Coast*, as discussed below.

B. The Commission Fully Justified Providing Partnerships With Income Tax Allowances.

In cost-of-service ratemaking, tax obligations attributable to regulated operations are included in the revenue requirement because "[t]he 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." *City of Chicago v. FPC*, 385 F.2d 629, 633 (D.C. Cir. 1967) (citations omitted). Financial investment decisions are based on the real return realized from a business, and income taxes have an important impact on the realized return. Ignoring the tax effect lowers the realized return and discourages investment.

The Commission thus properly allowed recovery of taxes attributable to the operations of a regulated utility, regardless of the corporate form of that utility. The fundamental cost allocation principle concerns what costs, including tax costs, are attributable to regulated service. *Policy Statement* at P 33, JA 798. While a partnership entity does not actually pay taxes itself, the owners of the partnership pay income taxes on the utility income generated by the assets they own via the device of the pass-through entity. *Id*. Thus, the taxes paid by the owners of the partnership are just as much a cost of acquiring and operating the assets of that entity as if the utility assets were owned by a corporation. *Id*. This is a financial cost to the partnership of raising capital, and that tax obligation of those owning the capital of the enterprise must be recognized in ratemaking.

Further, each partner in a partnership incurs tax liability on its distributive share of partnership income, gain, loss, deduction, or credit, whether or not any amount is actually distributed to the partner. *Id.* at P 23 & n.21, JA 794.

Partnership income is reported on, and any actual tax liability paid by means of, the returns of the partners. *Id*.

Thus, while the partnership entity does not itself pay income taxes, the partners of that partnership pay income taxes on the utility income generated by the assets they own via the device of the partnership. *Id*. As such, the taxes paid by the owners of the partnership are just as much a cost of acquiring and operating the assets of the entity as if the utility assets were owned by a corporation.

C. Petitioner's Arguments To The Contrary Are Without Merit.

Petitioner contends that the *Policy Statement* grants a tax allowance for "phantom" taxes on fictitious public utility income. Br. at 18-19. The Commission rejected this argument. *Policy Statement* at P 33, JA 798. Rather, the public utility income of partnerships is attributed directly to the owners of such entities and the owners have an actual or potential income tax liability on that income. *Id*. Just as a corporation has an actual or potential income tax liability on income from the public utility assets it controls, so do the owners of a partnership on the assets and income that they control by means of the partnership. *Id*. Thus, the *Policy Statement* allowed for the recognition in rates of actual or potential income tax liability attributable to regulated utility income, which will facilitate important public utility investments. *Id*. at P 37, JA 800.

In the case of a pipeline partnership, therefore, the partners incur taxes on their allocable portion of regulated activities, regardless of whether or not they have received any distribution from the partnership. The pipeline partnership simply acts as a conduit to the partners of the tax obligations arising from the income of the regulated operations.

Petitioner contends that the *Policy Statement* fails to distinguish between the costs of the regulated entity, which are includable in its costs of service, and the costs of investors. Br. at 20-22. Petitioner likens the income tax expense to partners in a partnership to income tax expenses attributable to dividends received by shareholders in a regulated corporation. *Id*. at 20.

Petitioner fails to make the correct comparison. The income taxes on the revenues generated from the regulated operations of a partnership are comparable to the taxes generated from the regulated operations of a utility corporation, rather than to the taxes generated by the payment of dividends to shareholders. *Policy Statement* at P 34, JA 799. For both corporations and partnerships, income is not necessarily distributed, and cash distributions may be made irrespective of whether there is income or profits to distribute. In the case of a corporation, the corporation pays in the first instance the income tax on the income from corporate operations (a first-tier tax). *Id*. 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). *Id*. at P 38, JA 801.

Partnership income is taxable to the partners based on their distributive share of that income regardless of whether cash distributions are made. *Id*. at P 33 & n.29, JA 798. 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. *Id*. at P 38, JA 801. Partners incur second-tier tax liability for cash distributions from the partnership when the partner's basis has been reduced to zero or the partner's interest is sold and ordinary or capital gains income is recognized at the time of sale. *See id*. at P 38 n.35, JA 801. The Commission's failure to distinguish between first- and second-tier taxation of income led to the *Lakehead* double taxation rationale that was rejected in *BP West Coast*. *Id*. at P 38, JA 801.

Further, as Petitioner recognizes, the return necessary to attract investors is measured by the return an investor could obtain from investments having commensurate risks. Br. at 22 (citing *BP West Coast*, 374 F.3d at 1286, 1291). Petitioner references the comparison made in *BP West Coast* between investment in a regulated partnership and investment in an unregulated company, where investors would have no expectation of a tax allowance. Br. at 23-24 (citing *BP West Coast* at 1291).

However, risks come from the nature of the business and its operations and not from whether the enterprise is operated in corporate or partnership form. Commission rate policy must produce comparable outcomes for a regulated partnership engaged in the same business as a corporation. *Policy Statement* at P 37, JA 800. The basic regulatory premise that a utility must earn a comparable return refers to the after-tax, not pre-tax, return to the investor, regardless of the form of ownership. *See Charlottesville*, 774 F.2d at 1207; *Policy Statement* at P 24, JA 795. Thus, if the after-tax return must be 12 percent to attract capital, then all first-tier investors in the utility assets must have a reasonable opportunity to earn a 12 percent after-tax return if the utility is to attract capital. *Id*. If partnerships are not permitted a tax allowance on utility income, then cash will not be generated to pay the taxes due on that utility income, and the partnership form of ownership will not be competitive with the corporate form. *Id*.

D. Whether A Partnership's Income Tax Allowance Will Result In Excessive Returns Is Not At Issue In This Appeal.

Petitioner asserts that the *Policy Statement* will provide non-taxable entities with much higher returns than are called for by the Commission's discounted cash flow methodology. Br. at 22. Petitioner, however, failed to raise this argument before the Commission, and therefore it should not be considered. *See* NGA § 19(b), 15 U.S.C. § 717r(b), and FPA § 313(b), 16 U.S.C. § 825*l*(b) (no objection to a Commission order "shall be considered by the court" on judicial review "unless

such objection shall have been urged before the Commission in the application for rehearing" absent reasonable grounds for a party's failing to do so); *United States v. Tucker Truck Lines, Inc*., 344 U.S. 33 (1952). Further, the relationship between the allowed regulatory return of the partnership, any tax allowance, and the possible increase in the actual return a partner may receive from the income and loss allocation provisions of a specific partnership is a technical issue better resolved in individual rate proceedings.

E. Application Of The *Policy Statement* To A Partnership Is Not Precluded By *BP West Coast.*

Petitioner asserts that *BP West Coast* precludes finding partnership entities eligible for an income tax allowance. In Petitioner's view, the *Policy Statement* adopted a position that was expressly rejected by the Court in *BP West Coast*. Br. at 19-20.

Nothing in the *BP West Coast* mandate required the Commission to reach a particular result on the tax allowance issue. *See Charlottesville*, 774 F.2d at 1212-13. Rather, the Court vacated and remanded the issue of the income tax allowance based upon the absence of a supportable rationale in the Commission's *Lakehead* order or in the orders on review. *See BP West Coast*, 374 F.3d at 1285 ("Because FERC has not established that its 42.7% income tax allowance is the product of reasoned decisionmaking and indeed has provided no rational basis for this part of its order, we find that allowance to have been erroneous and we vacate."); *id*. at

1288 (concluding FERC's rationale "does not support its conclusion"); *id.* (concluding that "on the record before us" SFPP was entitled to no income tax allowance).

Accordingly, on remand, FERC "had the discretion to reconsider the whole of its original decision." *Southeastern Michigan Gas Co. v. FERC*, 133 F.3d 34, 38 (D.C. Cir. 1998). *See also SEC v. Chenery Corp*., 332 U.S. 194, 200-01 (1947) (upon remand "the Commission was bound to deal with the problem afresh, performing the duty delegated to it by Congress"); *FPC v. Idaho Power Co*., 344 U.S. 17, 20 (1952) ("[T]he guiding principle is that the function of the reviewing court ends when an error of law is laid bare. At that point the matter once more goes to the [agency] for reconsideration.")

CONCLUSION

For the reasons stated, the petition for review should be dismissed because Petitioner lacks standing and the *Policy Statement* is not ripe for review, or, in the alternative, denied on its merits.

Respectfully submitted,

John S. Moot
General Counsel

Robert H. Solomon
Solicitor

Lona T. Perry
Senior Attorney

Monique Watson
Attorney

Federal Energy Regulatory
Commission
Washington, D.C. 20426
Phone: (202) 502-8384
Fax: (202) 273-0901

September 11, 2006

Canadian Association of Petroleum Producers v. FERC,
D.C. Cir. 05-1382

CERTIFICATE OF COMPLIANCE

In accordance with Circuit Rule 28(d)(1), I hereby certify that this brief contains 7213 words, not including the tables of contents and authorities, the glossary, the certificate of counsel and this certificate.

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Lona T. Perry
Senior Attorney

Federal Energy Regulatory
Commission
Washington, DC 20426
TEL: (202) 502-6600
FAX: (202) 273-0901

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