

The D.C. Circuit Court of Appeals Affirms FERC's Income Tax Allowance Policy for Limited Partnerships

On May 29, 2007, in *ExxonMobil Oil Corp. v. Federal Energy Regulatory Commission*, No. 04-1102, the United States Court of Appeals for the District of Columbia Circuit resolved a long-contested issue regarding the Federal Energy Regulatory Commission's (FERC) income tax allowance (ITA) policy for pipelines operating as limited partnerships. In particular, the Court determined that FERC's decision to allow SFPP, L.P. an ITA on all of its partnership interests, to the extent the owners of such interests incurred actual or potential tax liability, was neither arbitrary nor capricious.

The Court's opinion details the "tortuous history" of FERC's ITA policy, beginning with the "Lakehead Policy," which allowed ITAs for income taxes attributable to a pipeline's corporate partners, but disallowed ITAs for the income attributable to individual partnership interests. *Lakehead Pipe Line Co.*, 71 FERC ¶ 61,338, 62,313-15 (1995). The Lakehead Policy, as applied to SFPP, L.P.'s rates in FERC's Opinion No. 435 proceedings (*SFPP, L.P.*, 86 FERC ¶ 61,022 (1999)), was vacated by the D.C. Circuit in *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004), because FERC failed to provide a reasonable explanation for allowing ITAs for corporate, but not individual, partners.

In response to the D.C. Circuit's decision in *BP West Coast*, FERC sought comments from interested parties regarding its ITA policy, and subsequently issued a Policy Statement (111 FERC ¶ 61,139 (2005) (Policy Statement)) indicating that it would "permit an income tax allowance for all entities or individuals owning public utility assets, provided that [such] entity or individual has an actual or potential income tax liability to be paid on that income from those assets." 111 FERC at ¶ 61,741. FERC applied the new ITA policy in *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) (Remand Order), and petroleum shippers appealed the Remand Order to the D.C. Circuit in *ExxonMobil*. This time, however, the D.C. Circuit affirmed, concluding that FERC reasonably explained the basis for its new ITA policy in both the Policy Statement and Remand Order.

As a result of *ExxonMobil*, an entity seeking an ITA for a pipeline operating as a limited partnership must demonstrate, in the context of the pipeline's rate proceeding and for the relevant test year, that the "partners or members have an actual or potential income tax obligation on the entity's public utility income. To the extent that any of the partners or members do 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." Policy Statement, 111 FERC at ¶ 61,741-42. Whether a particular partner

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or member has an actual or potential income tax liability “is a fact-specific issue” and “any pass-through entity desiring an income tax allowance on utility operating income must be prepared to establish 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.” *Id.* at ¶ 61,744.

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