

Lakehead Pipe Line Company, Limited Partnership

Opinion No. 397-A

75 FERC ¶ 61,181 (1996)

In Opinion No. 397-A, the Commission affirmed its conclusions in Opinion No. 397 regarding trended original cost, starting rate base, tax expenses, Lakehead's rate floor, and the treatment of natural gas liquid facilities and requirements.

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Opinion and Order Denying Rehearing  
and Clarifying Opinion No. 397

75 FERC ¶ 61,181 (1996)

## [¶ 61,181]

Lakehead Pipe Line Company, Limited Partnership, Docket Nos. IS92-27-001, IS93-4-001, and IS93-33-002

Opinion No. 397-A; Opinion and Order Denying Rehearing and Clarifying Opinion No. 397

(Issued May 17, 1996)

Before Commissioners: Elizabeth Anne Moler, Chair; Vicky A. Bailey, James J. Hoecker, William L. Massey, and Donald F. Santa, Jr.

[Opinion No. 397-A Text]

On June 15, 1995, the Commission issued Opinion No. 397<sup>1</sup> in which the Commission addressed Lakehead Pipe Line Company, Limited Partnership's (Lakehead) rates for the shipment of crude oil and natural gas liquids (NGL) through its system and issues concerning Lakehead's conduct of its NGL business. On July 17, 1995, Lakehead, the Association of Oil Pipe Lines (AOPL), and the Canadian Association of Petroleum Producers and the Alberta Department of Energy (the Canadian Association) filed requests for rehearing.<sup>2</sup> In addition, the Coalition of Publicly Traded Partnerships (Coalition) and SFPP, Inc. (SFPP) each filed a motion for leave to file an *amicus curiae* brief in support of Lakehead's request for rehearing. The Commission grants those motions.<sup>3</sup> As discussed below, the Commission denies rehearing of and clarifies Opinion No. 397.

### I. Rate Base Issues

#### A. Trended Original Cost

In Opinion No. 397, the Commission concluded that trended original cost (TOC), rather than depreciated original cost (DOC), is the appropriate form of rate base to use in determining Lakehead's rates. In doing that, the Commission rejected several arguments presented by the Canadian Association in support of DOC as opposed to TOC. The Canadian Association seeks rehearing.

The Commission will not repeat its discussion of why it adopted TOC in Opinion No. 154-B<sup>4</sup> as the appropriate form of rate base to replace the valuation rate base.<sup>5</sup>

The Canadian Association first maintains that the Commission erred in applying TOC to Lakehead without engaging in a case-specific analysis and determining that the resulting rates are just and reasonable. It accepts the Commission's conclusion that TOC and DOC are essentially the same over time. However, it submits that the Commission's conclusion "is correct only if TOC and DOC are both applied (1) beginning in 'year zero' and (2) to the same rate base."<sup>6</sup> It asserts that, in this case, Lakehead calculated its rates under TOC even though it had not charged TOC-based lower rates since 1983. It describes this "phantom" trending as insupportable because it is the same as if shippers proposed switching from TOC to DOC in midstream. It

<sup>1</sup> *Lakehead Pipe Line Company, Limited Partnership*, 71 FERC ¶ 61,338 (1995).

<sup>2</sup> Lakehead and the Canadian Association also seek clarification of some matters.

<sup>3</sup> The Commission also grants Navajo Refining Company's (Navajo) request to file a "suggestion" in response to SFPP's brief. See discussion *infra*.

<sup>4</sup> *Williams Pipe Line Co.*, 31 FERC ¶ 61,377 (1985), *order on reh'g*, Opinion No. 154-C, 33 FERC ¶ 61,327 (1985).

<sup>5</sup> See *id.* and the discussion in *Lakehead Pipe Line Company, Limited Partnership*, 71 FERC ¶ 61,338, at p. 62,306 (1995).

<sup>6</sup> Request for Rehearing and clarification at p. 7.

relates that Lakehead's rate base in 1992 is \$98.8 million higher under TOC than under DOC. It concludes that the Commission should determine that TOC does not produce just and reasonable rates or should require Lakehead to start trending in 1992 based on the net depreciated original cost of its rate base in 1992.

The issue is the appropriate starting point for the institution of TOC. The Canadian Association maintains that 1992 (the test year) is the appropriate period rather than when TOC was adopted. It bases this argument on the fact that Lakehead did not charge TOC-based rates prior to the instant rate filing. The Commission rejects the Canadian Association's argument. In Opinion No. 154-B, the Commission adopted TOC as part of the methodology to "test the reasonableness of oil pipeline rates on a case-by-case basis", at which time, "the Commission will determine whether the 'end result' of this methodology produces just and reasonable rates."<sup>7</sup> The appropriate starting point for trending an oil pipeline's rate base under TOC was when the new methodology became effective for oil pipelines. At that time, the valuation method was inoperative and the new methodology was operative. Lakehead did not have to file for new rates under TOC to activate the new methodology. If a shipper had filed a complaint from that point on, Lakehead's rates would have been analyzed under TOC and not under the previous valuation methodology. DOC was and is irrelevant to this issue because it was never used as the rate base. There is no phantom trending of the starting rate base because trending began at the appropriate starting point. To conclude, TOC produces just and reasonable rates.

The Canadian Association also maintains that the application of TOC is unreasonable because it will not further the Commission's policy goals for which TOC was adopted. It submits that because Lakehead has been in operation since 1949 it, unlike new pipelines, does not require TOC to allow it to charge more competitive rates. It contends that old pipelines, like Lakehead, were not the intended beneficiaries of TOC and that Lakehead does not face the front-end load problem faced by new pipelines under DOC. It maintains that the protection of intergenerational equity is not, standing alone, a sufficient basis to support TOC in this case.

The Commission rejects the Canadian Association's argument. The Commission adopted TOC for all oil pipelines, not just new pipelines. Because, as admitted by the Canadian Association, TOC and DOC are essentially the same over time, there is no reason to reject TOC for all oil pipelines.

#### *B. Starting Rate Base*

In Opinion No. 397, the Commission concluded that the Canadian Association had not shown that Lakehead was not entitled to a starting rate base as adopted in Opinion No. 154-B. The Commission found that the Canadian Association failed to meet its burden of showing that investors had not relied upon the valuation rate base replaced by TOC. The Commission stated:

Opinion No. 154-C set forth as one avenue for showing no reliance on future earnings under a valuation rate base, the existence of earnings in past years higher than those allowed under valuation. The Commission agrees with Lakehead that the Canadian Association has not met its burden under that avenue. This is because Lakehead's actual earnings on valuation of 9.3 percent in 1983 and 9.8 percent in 1984 are not so much higher than allowed earnings of eight percent so

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<sup>7</sup> 31 FERC ¶ 61,377, at p. 61,838.

as to rebut the presumption of entitlement to a starting rate base. In addition, the Commission does not find relevant the data about Lakehead's earnings on its equity capital. This is because that data is nothing more than the earnings on valuation adjusted to reflect earnings from an accounting standpoint as earnings on equity capital. This data thus provides no additional pertinent information beyond that provided by earnings on valuation.<sup>8</sup>

The Commission will not repeat its discussion of why it adopted a starting rate base in Opinion No. 154-B to bridge the transition from valuation to TOC.<sup>9</sup>

The Canadian Association maintains that the Commission's application of a starting rate base to Lakehead directly violates the D.C. Circuit's decision in *Farmers Union Central Exchange v. FERC*.<sup>10</sup> The Canadian Association first argues that this is so because the starting rate base is a valuation methodology, which is not cost-based, and which will permit the reaping of "creamy returns." The Canadian Association next submits that *Farmers Union* prohibited the adoption of a transition methodology based on the expectation that an unlawful methodology would continue to be applied.

The Canadian Association also maintains that it has established that a starting rate base is not appropriate in this case. It argues that Lakehead's earnings on valuation were 23 percent and 16 percent higher in 1983 and in 1994, respectively, than the allowed 8 percent earnings, and that this is substantial excess earnings. It adds that the Opinion No. 154-B standard, in any event, does not involve a specific degree of higher earnings, but only higher earnings.

Last, the Canadian Association submits that the Commission's analysis approving TOC contradicts its decision about starting rate base, because the former ignores the valuation methodology in analyzing TOC while the latter finds valuation reliance dispositive in the adoption of a starting rate base. It asserts that Lakehead's prior history under valuation should not be a basis for the approval of the starting rate base for Lakehead.

It is true that *Farmers Union II* questioned the need for transitional rate bases.<sup>11</sup> However, the Commission found, in Opinion No. 154-B, that a starting rate base was needed because pipeline investors had long relied on a rate base adjusted for inflation. The essence of this conclusion was that investors had foregone current allowed earnings reflecting that inflation in order to have the opportunity to collect the higher earnings in the future. However, Opinion No. 154-B permits participants in a rate case to attempt to prove that a particular company is not entitled to the starting rate base there adopted.

The Commission adheres to its conclusion that Lakehead's "earnings on valuation of 9.3 percent in 1983 and 9.8 percent in 1984 are not so much higher than allowed earnings of eight percent so as to rebut the presumption of entitlement to a starting rate base."<sup>12</sup> Further, as noted in Opinion No. 397, "Lakehead's earnings on valuation from 1985 through 1990 were actually lower and range from 8.5 percent (1985) to 7.05

<sup>8</sup> 71 FERC ¶ 61,338, at pp. 62,311-12 (Footnote Omitted).

<sup>9</sup> *Williams Pipe Line Co.*, 31 FERC ¶ 61,377 (1985), order on reh'g, Opinion No. 154-C, 33 FERC ¶ 61,327 (1985). See 71 FERC ¶ 61,338, at p. 62,309.

<sup>10</sup> 734 F.2d 1486 (D.C. Cir. 1984) (*Farmers Union II*).

<sup>11</sup> *Id.* at pp. 1517-18.

<sup>12</sup> 71 FERC ¶ 61,338, at p. 62,312.

percent (1990)."<sup>13</sup> Thus, while it is true that the Opinion No. 154-B standard specifies "earnings in past years higher than those allowed under valuation,"<sup>14</sup> that does not mean that earnings could not be above valuation in some years.

Last, the Commission sees no error in its analysis of starting rate base compared to its analysis of TOC. The Commission ignores the past (i.e., valuation method) in analyzing TOC versus DOC because that analysis must begin at the time the new rate base is adopted. The Commission did not ignore the inflation factor in valuation in adopting a starting rate base because earnings may have been foregone.<sup>15</sup> In short, the two analyses are not inconsistent because they are different in purpose and nature.

## II. Tax Expense

In Order No. 397, the Commission concluded that Lakehead is not entitled to an income tax allowance for income attributable to limited partnership interests held by individuals. The Commission stated:

This is because those individuals do not pay a corporate income tax. Since there is no corporate income tax paid, there should be no corporate income tax allowance built into Lakehead's rates with respect to income attributable to individual limited partners. This comports with the principle that there should not be an element in the cost-of-service to cover costs that are not incurred.

The individual limited partners are entitled to an after tax return "commensurate with returns on investments in other enterprises having corresponding risks." If Lakehead were to receive a corporate tax allowance with respect to individual limited partners, Lakehead and those investors would be earning an after tax return on equity in excess of that to which they are entitled for Lakehead's risks.

This would overcompensate Lakehead for its risk. It is true that Lakehead's individual limited partners will pay income taxes on their share of partnership income. However, with respect to those partners, the corporate level of income tax has been avoided and no tax allowance is needed to ensure that the partnership has the opportunity to earn its allowed return on equity.<sup>16</sup>

Lakehead seeks rehearing of that conclusion.<sup>17</sup> The Coalition and SFPP in their *amicus curiae* briefs also ask the Commission to overturn its conclusion.<sup>18</sup> The Canadian Association seeks clarification that Lakehead is not entitled to an income tax allowance for income that is received by individuals, but is allocated to its corporate partners for tax purposes.

Lakehead maintains that the Commission arbitrarily failed to consider the adverse impact of Opinion No. 397's decision on the market value of the Lakehead partnership units held by the public.<sup>19</sup> It adds that the market did not predict that decision because the Commission provided, in the past, a full tax allowance to partnerships,

<sup>13</sup> *Id.* n.39.

<sup>14</sup> Opinion No. 154-C, 33 FERC ¶ 61,327, at p. 61,641.

<sup>15</sup> However, unlike TOC, there was no capitalization of inflation for future recovery via amortization. See *ARCO Pipeline Corp.*, 52 FERC ¶ 61,055, at p. 61,237 (1990).

<sup>16</sup> 71 FERC ¶ 61,338, at p. 62,315.

<sup>17</sup> Lakehead's request for oral argument is denied.

<sup>18</sup> SFPP endorses and adopts Lakehead's arguments on the merits in Lakehead's rehearing petition.

<sup>19</sup> Lakehead's units are traded on the New York stock exchange.

including limited partnerships.<sup>20</sup> It also refers to *Ocean States Power*,<sup>21</sup> where the Commission provided a tax allowance for "a partnership in which some partners will not be corporations."<sup>22</sup> Last, it maintains that Opinion No. 397 will discourage the limited partnership vehicle as a means for raising capital for the pipeline industry at a lower cost through increased sources of supply of capital.<sup>23</sup>

While the Commission must consider the financial integrity of its regulated companies, there is no argument here that Lakehead's financial integrity is even remotely in jeopardy owing to Opinion No. 397. In *Ocean States Power*, the issue of the appropriate income tax rate was considered. No participant raised the issue of whether an income tax allowance should be denied with respect to individual partners. In any event, to the extent inconsistent, *Ocean States Power* was in error. The Commission is not required to perpetuate past errors and permit the recovery of a phantom cost. Similarly, it is not unreasonable to deny the recovery of a phantom cost even if it will have an impact on the raising of capital.

Lakehead next submits that the Commission's "actual taxes paid" rationale does not justify the ruling in this case because, in other contexts, the Commission permits, under the "stand alone" tax policy, a regulated entity to collect a full tax allowance even where no actual tax liability is incurred.<sup>24</sup> It compares partnerships to corporate subsidiaries—"rate payers should be responsible for the tax liability otherwise associated with the revenue generated from jurisdictional activities, without regard to any actual amount paid to the IRS."<sup>25</sup> Similarly, the Coalition claims that the fact that the entity paying the tax is an aggregate of partners rather than a corporation does not make it any less true that tax has been paid. It maintains that because the partner pays tax on his allocated share of income, the tax is analogous to the tax paid by a corporation and not a corporate shareholder. Further, it submits that a cash distribution is not the same as a corporate dividend, but is a non-taxable return on the partner's capital.

Lakehead has misconstrued the Commission's policy as to actual taxes paid. As with other projected cost-of-service items, the Commission does not true up the difference between projected test period income taxes used to establish a tax allowance in a rate case, and the actual amounts incurred during the period the rates are in effect. Nevertheless, the Commission as part of its ongoing audit activities does review taxes incurred by pipelines. If the Commission finds that the amount of corporate income taxes reflected in a pipeline's rates is not representative of the amount of taxes actually being incurred by the pipeline, the Commission will adjust the tax allowance in future rate cases to a representative level of taxes actually incurred.<sup>26</sup>

<sup>20</sup> E.g., *Riverside Pipeline Company, L.P.*, 44 FERC ¶ 61,309 (1989).

<sup>21</sup> 38 FERC ¶ 61,140 (1987).

<sup>22</sup> *Id.* at p. 61,379.

<sup>23</sup> In a letter to Chair Moler, dated June 22, 1995, PaineWebber Incorporated makes arguments similar to those of Lakehead and AOPL. Because PaineWebber is not a party, the Commission will not expressly address PaineWebber's arguments, which are similar to those made by parties.

<sup>24</sup> Citing *Northern Border Pipeline Co.*, 67 FERC ¶ 61,194, at pp. 61,110-11 (1994).

<sup>25</sup> Request for Rehearing at pp. 22, 23.

<sup>26</sup> The Commission computes an income tax allowance based on the pipeline's allowed return on equity (as adjusted) as a surrogate for full review of the pipeline's corporate tax liability. The Commission has found over time that this is a reliable method of determining a pipeline's projected actual tax liability. Unless information from an audit or other source indicates that this method is not appropriate in the circumstances, the Commission will use it to establish the basic tax allowance in rate case proceedings.

As to its arguments regarding actual taxes paid versus the stand alone tax policy, Lakehead again is incorrect. The Commission's stand alone policy fully comports with the actual taxes paid principle. In this regard, Lakehead misunderstands the *Northern Border* case. In that case, the Commission explained that there may be situations in which no consolidated income taxes are paid to the IRS because the tax liability generated by some members of the consolidated group is offset by tax deductions generated by other members of the group. The Commission provides a tax allowance in that situation for a jurisdictional pipeline member of the group (based on the pipeline's allowed return on equity) because the allowed equity return generates an actual tax liability for the pipeline that must be paid to the IRS, either in cash or through the use of another member's deductions. As stated in *Northern Border*, either way, the tax liability of the jurisdictional company is a real cost of providing service. In contrast, there is no corporate tax liability associated with individual partners' equity return and therefore it is not appropriate to allow Lakehead to collect for such amounts in its cost of service.

The Coalition argues otherwise, that the tax paid by individual partners is analogous to that paid by a corporation, but the Commission disagrees. Rather, the tax paid by partners who are individuals is similar to the tax paid on dividends by individuals who are corporate shareholders. If the Commission were to permit a tax allowance for the taxes paid by individual limited partners, it would be analogous to the Commission permitting a tax allowance for the taxes paid by the shareholders of a corporation on the dividends they receive. Conversely, permitting a tax allowance only for the corporate partners allows both the individual stockholders of the corporate limited partners and the individual limited partners to earn a return on equity in the partnership commensurate with Lakehead's risk.

The existence of owners that are not corporations is akin to finding in an audit that a pipeline has incurred taxes that are less than the amount of corporate income taxes reflected in its rates. If taxes paid are consistently less than the corporate tax allowance, the Commission will adjust the tax allowance downward, since otherwise the pipeline would overrecover the cost of its taxes. The Commission must do the same here, where the pipeline is a partnership whose owners are not all corporations and thus have a corporate tax liability that is less than if all the partners were corporations. As Lakehead's tax allowance reflects a corporate tax on all the partnership earnings, it too must be adjusted downward.

Lakehead maintains that the Commission's comparison of tax liability imposed at the corporate level was simplistic because the Commission should have looked at the alternatives from the investor's point of view. It refers to several circumstances where shareholders pay no taxes and to the fact that individual stockholders are taxed only if dividends are distributed. It states that a partnership interest owner is taxed on the owner's allocable share of the partnership's net income, regardless of the amount actually distributed in cash. It concludes that therefore "it simply cannot be assumed that the ultimate tax bill paid on a partnership's net income will be smaller than the ultimate tax bill paid on a corporation's net income."<sup>27</sup> The Coalition also maintains that, under the corporate model, not all corporate earnings are subject to double taxation. It refers to earnings retained rather than distributed to shareholders and stock that is owned by tax exempt entities. It further states that the highest corporate tax rate is 35 percent and the highest tax rate for individuals is 39.6 percent. It

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<sup>27</sup> Request for rehearing at p. 26.

concludes that all this shows is that it is not fixed or predictable to compute the difference between the overall tax rate paid by a publicly-held limited partnership and a corporation.

The Commission adheres to the simple example of Opinion No. 397, because it shows the impact of this issue on the return to investors without regard to matters that simply put are beside the point. That is, the appropriate comparison is in the context of the allowed return on equity to Lakehead's investors from Lakehead and not with the individual investors' own tax situations or whether earnings are or are not distributed.

Lakehead also claims that the Commission's decision contravenes Congressional intent by discouraging the master limited partnership structure that Congress permitted in adding section 7704 to the Internal Revenue Code.<sup>28</sup> The Coalition also maintains that the Commission has contravened the policy underlying section 7704 of the I.R.C. by denying Lakehead a tax allowance, which is allowed other pipelines, solely on the basis of its partnership structure.

The Commission is denying Lakehead this particular tax allowance because that tax expense does not exist. Congress did not endorse phantom taxes in enacting section 7704 of the I.R.C. It simply endorsed this particular form (partnership) in connection with taxing an enterprise. That form should be advantageous on its own merits without the addition of phantom taxes in a cost-of-service just as it is advantageous for companies without a cost of service that are covered by section 7704's exception.

Lakehead asserts that the Commission has penalized it for tax purposes, but has disregarded its change in status to a partnership from a corporation. It refers to its failure to seek a step-up in basis for its rate base to reflect what the partnership investors paid for their partnership interests. It also states that its rates with the tax allowance are no higher than they would be if it were a corporation (and possibly lower owing to greater leverage in its capital structure). It argues that fairness requires an acquisition adjustment since the acquisition made possible the reduced tax allowance. Further, it maintains that the issue of its appropriate rate of return on equity must be revisited.

Lakehead's choosing not to seek a step-up in basis when the partnership was formed was its own, as was its choosing during litigation to stipulate to the appropriate rate of return on equity. It would be inappropriate to consider or revisit those issues.

Next, the Coalition claims that the Commission's decision will be hard to administer because it is difficult to know on an ongoing basis who the public individual partners are. It refers to units held in street name by brokers, which information a pipeline receives yearly.

The Commission sees no reason that a yearly listing of partners would not be frequent enough to determine whether a change in the mix of corporate and individual partners were sizeable enough to merit a change in rates under the cost-of-service method.

SFPP argues that, if the Commission is not at present inclined to revise Opinion No. 397's income tax ruling, it should hold it in abeyance while it initiates a broader inquiry into what, if any, policy changes it should adopt with respect to publicly traded partnership pipelines. It maintains this will make available a broad range of perspec-

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<sup>28</sup> I.R.C. § 7704.

tives, facts about the practical implications of the decision, and its impact on form of organization and investments.<sup>29</sup> Lakehead also maintains that the Commission should have proceeded by notice-and-comment rulemaking rather than acting in an isolated adjudicatory context. It states that this would have allowed for more and fairer input and for transition mechanisms to account for reliance.

The Commission sees no reason to institute a rulemaking or to hold this decision in abeyance. There is simply no need for a broad inquiry for this cost-of-service issue. The Commission also sees no need for transition techniques. This precise issue was never formally adjudicated between the regulated entity and its ratepayers. Thus, it is difficult to see how Lakehead could rely on Commission precedent to support the allowance of phantom costs.

Last, the Canadian Association seeks clarification that Lakehead is prevented from receiving a tax allowance for income that is earned by and received by individual partners, but that is allocated for tax purposes to a corporate partner under a curative allocation or other private agreement. The Canadian Association is concerned that Lakehead will argue that its tax allowance should be based on which partner *pays* income tax rather than which partner receives income. Since Lakehead Pipe Line Company, Inc. (Lakehead, Inc.), is a corporate partner, Opinion No. 397 could be read to permit Lakehead to recover all income taxes paid by Lakehead, Inc. The Canadian Association argues that taxes paid through a curative allocation are in effect taxes paid by shareholders on profits from the sale of interest in a utility.<sup>30</sup> The Canadian Association argues that the tax allowance inquiry must focus on the income actually received by the corporate and individual investors and not on the fact that income is distributed to the corporate partner for tax purposes under the curative allocation procedure.<sup>31</sup> According to the Canadian Association, since the gain from the sale of ownership interests was retained by shareholders, the related taxes should not be recoverable from ratepayers.<sup>32</sup> The Commission agrees and will clarify its holding in Opinion No. 397 to exclude income taxes paid by a corporate partner under the curative allocation procedure.

<sup>29</sup> Navajo suggests that the Commission disregard the exhibits proffered by SFPP and the arguments based thereon in SFPP's amicus brief because they are related to the proceeding in SFPP, L.P., Docket No. OR92-8-000, *et al.* Refinery Holding Company and El Paso Refinery, L.P., SFPP Shippers, filed a motion to hold in abeyance this proceeding pending receipt of the record in Docket No. OR92-8-000, *et al.*, and to lodge their prepared testimony in Docket No. OR92-8-000, *et al.* Lakehead filed a response in opposition to both aspects of the SFPP Shippers' motion. The Commission concludes that the exhibits in Docket No. OR92-8-000, *et al.*, should be rejected. The Commission considered SFPP's arguments in its *amicus curiae* brief solely in connection with resolving the present proceeding. The Commission has not considered the SFPP Shipper's arguments because they were filed out-of-time for filing a brief in this proceeding. Last, the Commission will not hold this rehearing order in abeyance pending receipt of Docket No. OR92-8-000.

<sup>30</sup> Section 704(c) of the Internal Revenue Code provides in part:

income, gain, loss, and deduction with respect to property contributed to the partnership by a part-

ner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution . . .

<sup>31</sup> It is not clear from the Canadian Association's pleading whether it is concerned with only the technical "curative allocation" or with all allocations pursuant to section 704(c) of the Internal Revenue Code. Technically the term "curative allocation" refers only to the method used to "cure" a ceiling limitation on section 704(c) allocations. However, since all allocations of income, gain, loss, or deduction attributable to section 704(c) property shift tax consequences among Lakehead's partners, our findings with respect to the "curative allocation" are meant to apply to all section 704(c) allocations. For purposes of our discussion we will use the term "curative allocation" to refer to all allocations under section 704(c).

<sup>32</sup> Although the Canadian Association correctly states that the "curative allocation structure" *per se* is optional, the basic requirement to reallocate partnership taxable income to take into account any variation between the tax basis and its fair market value is required by section 704(c) of the Internal Revenue Code and Treas. Reg. Section 1.704-3(a).

When Lakehead was reorganized from a corporation into a partnership, Lakehead, Inc., contributed all of its assets to the partnership in exchange for a 20 percent ownership share of the partnership. The 20 percent interest was based on the fair value of the assets contributed, i.e., Lakehead, Inc., effectively "sold" its assets to the partnership at their fair value. The other 80 percent ownership of the new partnership was effected through the public sale (for cash) of partnership shares.

Under the Internal Revenue Code, the tax value of the assets contributed by Lakehead, Inc., did not change, i.e., the property retained the same "tax basis" as it had when owned by Lakehead, Inc. Because the fair value of the contributed property was more than its tax value, Lakehead, Inc., would have paid tax on the difference between the property's fair value and its tax basis had it sold the property and used the cash to buy partnership shares. In this type of situation, section 704(c) of the Internal Revenue Code requires the partner contributing property (in this case, Lakehead, Inc.) to effectively pay the tax on such gain through the "curative allocation" process.

The curative allocation process re-allocates partnership income, deductions, gains or losses among partners so that more tax liability is assigned to Lakehead, Inc., than would have been absent the curative allocation. Generally, each partner is taxed on the income of the partnership in proportion to the partner's ownership share of the partnership. The curative allocation changes this by shifting the allocation of, e.g., depreciation deductions away from Lakehead, Inc., and to the other partners. Because Lakehead, Inc., is allocated fewer deductions, its share of the partnership's tax liability is greater. Thus, the liability for corporate income taxes is greater than it would have been based on the proportionate ownership share of the corporate partners. Therefore, rather than a corporate tax being incurred on 20 percent of Lakehead's profits, a higher percentage would actually be subject to corporate tax. This is done to ensure that the partner that contributed property, and not the other partners, pays the tax on the increase in the value of such property.<sup>33</sup>

The Commission concludes that Lakehead is not entitled to an income tax allowance in connection with taxes attributed to its corporate partner under the curative allocation. Lakehead's income tax allowance must be determined solely according to how the income is attributed on the books of Lakehead. Only in this way will Lakehead's tax allowance provide it with the full amount of income taxes associated with providing utility service, while not overcompensating Lakehead for income taxes that are unrelated to its operations. The fact that income earned by the partnership is re-allocated to the corporate partner in the reporting of income to the I.R.S. in order to "cure" a situation related solely to the value afforded ownership interests upon the formation of the partnership, simply put, is not relevant to the determination of the tax cost associated with providing service. The Commission agrees with the Canadian Association that since the curative allocation taxes are essentially

<sup>33</sup> To illustrate, assume "A" and "B" form a partnership, each owning a 50 percent share. "A" contributes property with a tax basis of \$8,000 and a fair value of \$10,000. "B" contributes \$10,000 cash. The partnership has taxable income before depreciation of \$1,200. The \$8,000 tax basis of the property is depreciated for income tax purposes at a 10 percent rate (i.e., \$800 per year). Each partner would normally be allocated one-half of the \$800 of depreciation, or \$400. However, had the tax basis of the property equalled its \$10,000 fair value, "B" would have been entitled to \$500 of depreciation ( $\$10,000 \times 10\% \times 50\%$ ).

Under the curative allocation requirement, \$500 of depreciation would be assigned to "B" and \$300 to "A". Thus "A" would be liable for \$102 of income tax on \$300 of taxable income ( $\$1,200$  of income  $\times$  50% less \$300 of depreciation) and "B" would only be liable for \$34 of income tax on \$100 ( $\$1,200 \times 50\%$  less \$500 of depreciation). "A" would pay an additional \$34 tax due to the curative allocation. The curative allocation would be made each year until "A" pays tax on the \$2,000 difference between the fair value of the property it contributed and its tax basis.

taxes on the gain realized by Lakehead, Inc., on its sale of assets to the partnership. Lakehead, Inc., and not ratepayers, must bear the tax associated with such gain. Since Lakehead is entitled to recoup from ratepayers only the cost of providing service, it is not appropriate to allow it to recover curative allocation taxes, notwithstanding that they are paid by the corporate partner. Accordingly, the language in Opinion No. 397 that "Lakehead should not receive an income tax allowance with respect to income attributable to the limited partnership interests held by individuals" and "there should be no corporate income tax allowance built into Lakehead's rates with respect to income attributable to limited partners"<sup>34</sup> is clarified to mean income as attributable on Lakehead's books for earning and distribution purposes to its partners according to their partnership interests and not as attributable in the reporting of income for income tax purposes.<sup>35</sup>

### III. Rate Floor

In Opinion No. 397, the Commission concluded that Lakehead's rates in effect on October 24, 1991 were not deemed just and reasonable by the Energy Policy Act of 1992, because those rates were subject to a complaint of October 13, 1992, filed by the Canadian Association. However, the Commission also concluded that the Canadian Association had not sought reparations. Hence, Lakehead's rates were subject to refund down to the level of its effective rates on May 2, 1992.

Lakehead seeks rehearing and argues that its rates in effect on October 24, 1991 (its pre-May 3, 1992 rates) are deemed just and reasonable under the Energy Policy Act because the Canadian Association's October 13, 1992 pleading did not meet either the Commission's or the Interstate Commerce Act's complaint requirements. With respect to the former, it submits that the Canadian Association did not meet the requirements of rule 206 of the Commission's Rules of Practice and Procedure for complaints. With respect to the latter, it maintains that the Canadian Association never asked that the Commission take action against Lakehead's pre-existing rates. The AOPL also argues that the Commission erred in not finding Lakehead's rates to be deemed just and reasonable. The AOPL maintains that the Canadian Association's October 13, 1992 pleading was not a valid complaint because it was captioned as a protest<sup>36</sup> and the Commission did not notice the complaint so that Lakehead could respond or launch an investigation of Lakehead's prior rates.

The Canadian Association also seeks rehearing and argues that it is entitled to reparations for unjust and unreasonable rates in effect prior to May 3, 1992. It maintains that the Commission should apply a common-sense approach to this issue as it did in finding its October 13, 1992 pleading a complaint. It submits that the only rational purpose for filing a complaint against prior rates is to seek reparations. It adds that Lakehead's rates on May 2, 1992, may not be used as a refund floor and it (the Canadian Association) is entitled to refunds down to the level of the rates found to be just and reasonable.

The Commission adheres to its conclusion that the Canadian Association had filed a complaint against Lakehead's rates under section 13 of the ICA. That was the substance of its October 13, 1992 protest filing whether or not it was styled as a

<sup>34</sup> 71 FERC ¶ 61,338, at p. 62,315.

<sup>36</sup> 18 C.F.R. § 385.2002.

<sup>35</sup> In light of this result, there is no need to consider the Canadian Association's "acquisition adjustment" argument.

complaint or noticed. rule 206 of the Commission's Rules of Practice and Procedure does not require more than an allegation of the violation which the Canadian Association did. Section 2002's heading requirement is ministerial and the Canadian Association's protest was not rejected.

The Commission also adheres to its conclusion that the Canadian Association did not seek reparations for unlawful rates prior to May 3, 1992. The Canadian Association is in error that that would be the only rational purpose of a complaint under the ICA. Such a complaint would enable the Commission to lower Lakehead's rates to the lawful level prospectively, if that level were lower than its rates in effect May 2, 1992. Here, however, after the complaint was filed, Lakehead made a new rate filing (June 4, 1993) because of which Lakehead did not have to reduce its rates prospectively.<sup>37</sup>

#### IV. Natural Gas Liquids

In Opinion No. 397, the Commission concluded that Lakehead did not violate the ICA at this time by transporting natural gas liquids (NGLs) only for shippers who provide their own breakout storage tank (BOST) facilities at Superior, Wisconsin, because no potential shipper could make a reasonable request for NGL service, since there is no access for those shippers in Canada to the pipeline connecting with Lakehead. However, the Commission concluded that if shippers obtain access in Canada to Lakehead, it must ensure that their NGLs can move beyond Superior. Lakehead seeks clarification and, in the alternative, rehearing. The AOPL requests rehearing.

Lakehead asks that the Commission clarify that the advisory aspects of its decision are not meant to prevent Lakehead from presenting a full range of defenses in a future proceeding with respect to its obligation to provide NGL service. It states that the Commission need not reverse its current view of the statutory requirements, but that those issues should remain open for further argument if a concrete case is presented. It is concerned about Opinion No. 397's failure to address economic viability, which it maintains should be considered as part of the determination of whether Lakehead's response for service is made "upon reasonable terms and conditions, and without undue discrimination."<sup>38</sup> In particular, it maintains that "[t]he clarification that is necessary is simply to provide an assurance that Lakehead can address requests for NGL transportation service on their merits and, if it determines that such service is not economically justified, can defend its refusal of service on all available grounds, without regard to any advisory language in Opinion No. 397."<sup>39</sup>

The AOPL requests that Opinion No. 397 with respect to Lakehead's future duty to provide BOST facilities be withdrawn because it is an advisory opinion. It claims that it is not sound administrative policy to resolve this issue in the absence of a concrete shipper/carrier dispute.

The Commission will not withdraw Opinion No. 397's discussion of Lakehead's future duty to provide BOST facilities. That issue was hotly contested and it is within the Commission's discretion to provide guidance with respect to its policy on the issue. However, the Commission clarifies that if and when a concrete dispute arises, Lakehead may request reconsideration of that policy on any ground which it elects to proffer.

<sup>37</sup> See 71 FERC ¶ 61,338, at p. 62,319.

<sup>38</sup> Citing 71 FERC ¶ 61,338, at p. 62,326.

<sup>39</sup> Request for Rehearing and Clarification at p. 46.

Lakehead and the AOPL maintain that the Commission erred in concluding that Lakehead must provide or arrange for the provision of BOST facilities if shippers of NGLs without BOST facilities receive service in Canada for delivery to Lakehead. In brief, Lakehead and the AOPL argue that, in Opinion No. 397, the Commission exceeded its authority under that Act and failed to distinguish precedents. The essence of Lakehead's and the AOPL's arguments is that, under the ICA and the precedents, an oil pipeline is obligated only to provide those services that it holds itself out to perform to the public and that, here, it is holding itself out to provide NGL service only to those shippers that provide their own BOST facilities. The Commission adheres to its discussion in Opinion No. 397 and reiterates that a common carrier has a statutory duty to "provide physical facilities essential to a complete system," that "the BOST facilities are essential to completing Lakehead's system by filling a gap in the pipeline system," and that while Lakehead "can make reasonable and appropriate rules respecting the acceptance and transportation of traffic, . . . those rules cannot . . . vitiate . . . [its] obligation to hold out service upon reasonable request [and thereby] . . . render its common carrier obligation a nullity and convert Lakehead into a private carrier for Amoco."<sup>40</sup>

The cases referred to by Lakehead and the AOPL in their rehearing requests do not require a different result.<sup>41</sup> In *Chevron Pipe Line Co.*,<sup>42</sup> the Commission refused to order the pipeline to repair terminal facilities for barges as outside the Commission's jurisdiction. However, the Commission believes that terminal facilities are distinguishable from BOST facilities filling a gap in a system. The BOST facilities are the functional equivalent of missing pipe. In *Chamber of Commerce of Demopolis, Ala. v. Southern Railway Co.*,<sup>43</sup> the ICC found that the failure of the railroad to repair or replace a destroyed bridge and to resume transportation across the river was not a violation of its duty to furnish transportation upon reasonable request. However, there, the railroad continued to provide service, albeit not as satisfactory, for all customers on the discontinued line. There was no issue, as here, about providing service for one customer and not for others. In *Cooper Jarett, Inc. v. U.S.*,<sup>44</sup> the court upheld the provision of flat car service with the shipper supplying the flatcar. The court agreed with the ICC's determination that the "obligations of the railroads to furnish transportation are limited by the extent of what they hold out to the shipping public in their tariffs, and further that the furnishing of services under the tariffs and as required by the Act did not occur until the flatcars or trailers were placed in the possession of the railroad for the purpose of being transported."<sup>45</sup> However, here, Lakehead wants to refrain from providing an instrumentality or facility essential to service after the NGLs are in its possession.<sup>46</sup> This would result in its violation of section 1(4)'s requirement that it provide transportation of NGLs upon reasonable request through its failure to provide "all instrumentalities and facilities of shipment and carriage" as required by section 1(3).<sup>47</sup>

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<sup>40</sup> 71 FERC ¶ 61,338, at p. 62,325.

<sup>41</sup> The Commission will not discuss again those cases discussed in Opinion No. 397.

<sup>42</sup> 64 FERC ¶ 61,213 (1993).

<sup>46</sup> It is noteworthy that, in fact, the railroads also provided a full service where it provided the flat car (the instrumentality) and the trailer (a container).

<sup>47</sup> Similarly, in response to Lakehead, Lakehead

*The Commission orders:*

The requests for rehearing are denied and Lakehead's and the Canadian Association's requests for clarification are granted as discussed in the body of this order.

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