166 FERC ¶ 61,141
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Neil Chatterjee, Chairman;
Cheryl A. LaFleur, Richard Glick,
and Bernard L. McNamee.

Trailblazer Pipeline Company LLC Docket No. RP18-922-000

ORDER ON PAPER HEARING AND ORDERING FURTHER ADMINISTRATIVE LAW JUDGE PROCEEDINGS

(Issued February 21, 2019)

1. On July 31, 2018, the Commission established a paper hearing to address whether a double recovery of income tax costs results from permitting Trailblazer Pipeline Company LLC (Trailblazer) to recover in its cost of service both an income tax allowance for its owners' tax costs and a return on equity (ROE) determined by the discounted cash flow (DCF) methodology.[1] In setting the matter for paper hearing, the Commission explained that Trailblazer's filing raised an issue of first impression regarding whether a pass-through pipeline that is not wholly owned by a master limited partnership (MLP) may recover an income tax allowance in light of the double-recovery concerns raised by the United States Court of Appeals for the District of Columbia Circuit's (D.C. Circuit) decision in *United Airlines, Inc. v. FERC*.[2]

2. As discussed below and on the basis of the paper hearing record, we preliminarily find that because the DCF ROE incorporates investor-level income tax costs, a double recovery appears to result from permitting an income tax allowance for the income tax liability attributable to certain Private Owners' ownership share[3] in Trailblazer in addition to a DCF ROE. However, we also preliminarily find that no such double recovery appears to result from permitting an income tax allowance for the corporate

[1] *Trailblazer Pipeline Co. LLC*, 164 FERC ¶ 61,074 (2018) (Hearing Order). All other aspects of Trailblazer's general Natural Gas Act (NGA) section 4 rate case were set for administrative law judge hearing procedures. *Id.*

[2] 827 F.3d 122 (D.C. Cir 2016) (*United Airlines*).

[3] Trailblazer describes the Private Owners as 11 private equity funds. Ex. TPC-107 at 8.

income tax liability attributable to Tallgrass Energy, L.P.'s (Tallgrass Energy) ownership share in Trailblazer in addition to a DCF ROE.

3. Furthermore, on November 1, 2018, Trailblazer filed supplemental reply comments asserting that the Commission should consider alternatives to the DCF when setting Trailblazer's ROE following the Commission's October 16, 2018 order in *Coakley v. Bangor Hydro-Elec.,* which proposed departing from the Commission's historical reliance upon the DCF methodology as the sole means for determining ROE for electric utilities subject to regulation under the Federal Power Act (FPA).[4] Trailblazer further asserts that no double recovery would result from permitting Trailblazer to recover both an income tax allowance and an ROE based upon the alternative ROE methodologies contemplated by *Coakley*. As discussed below, we confirm that the ongoing administrative law judge hearing procedures may consider whether Trailblazer's ROE should be set using the DCF or some other alternative ROE methodology. However, our initial analysis indicates that any replacement of the DCF with an alternative ROE methodology is unlikely to alter our preliminary finding that a double recovery would result from permitting an income tax allowance for the Private Owners' tax costs while no such double recovery arises from permitting an income tax allowance for Tallgrass Energy's tax costs.

4. We emphasize that the findings in this order are preliminary, and our determinations may change based upon subsequent evidence and argument. We recognize that Trailblazer's ROE and income tax allowance issues present complex factual and policy matters. Accordingly, the ongoing administrative law judge hearing addressing Trailblazer's general NGA section 4 rate case should fully litigate all income tax allowance issues. The parties are free to present evidence supporting the preliminary findings above or to submit evidence supporting different conclusions.

I. Background

A. Income Tax Policy

5. A just and reasonable cost-of-service rate "is designed to yield sufficient revenue to cover all proper costs, including federal income taxes, plus a specified return on

[4] *Coakley v. Bangor Hydro-Elec.,* 165 FERC ¶ 61,030 (2018). *See also Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator. Inc*, 165 FERC ¶ 61,118, at P 1 (2018) (MISO Order); *Arkansas Pub. Serv. Comm'n v. System Energy Resources, Inc.,* 165 FERC ¶ 61,119, at P 9 n.18 (2018); *Constellation Mystic Power, LLC*, 165 FERC ¶ 61,267, at PP 31-34 (2018).

invested capital."[5] When a federal income tax liability arises from providing jurisdictional service, an income tax allowance is recoverable in cost-of-service rates.[6] Thus, for a regulated entity organized as a corporation or as a wholly owned subsidiary of a corporation, longstanding policy permits the recovery of corporate income tax costs arising from the regulated entity's income.[7]

6. However, the Commission's income tax policy for partnership entities (pass-through entities that do not pay income taxes themselves and have multiple owners) has a more complicated history. The D.C. Circuit has addressed the Commission's income tax policies for partnership entities in several decisions addressing Commission orders involving SFPP, L.P. (SFPP), which is an MLP Pipeline.[8] Of particular relevance here, the D.C. Circuit held that a partnership pass-through entity may claim an income tax allowance for its partner-owners' tax costs by showing that: (a) as required by the 2007 *ExxonMobil* decision, its partners incur an "an actual or potential income tax liability" from the partnership's income;[9] and (b) as required by the 2016 *United Airlines* decision, the partners' income tax costs are not already reflected in the DCF ROE such that

[5] *City of Charlottesville v. FERC,* 774 F.2d 1205, 1207 (D.C. Cir.1985).

[6] *E.g., BP West Coast Products, LLC v. FERC*, 374 F.3d 1263, 1288 (D.C. Cir. 2004).

[7] In a cost-of-service rate case involving a pipeline with only corporate ownership, the Commission grosses-up the pipeline's DCF ROE to account for the corporate income tax rate, which is currently 21 percent. This method of calculating an income tax allowance is referred to as the "stand-alone" method. *City of Charlottesville,* 774 F.2d at 1207.

[8] An MLP Pipeline is either a pipeline organized as an MLP or the wholly owned subsidiary of an MLP. An MLP is a special kind of partnership available to oil and gas pipelines in which limited partner units trade on public exchanges. For further discussion of the MLP Pipeline business form, see *SFPP, L.P.*, Opinion No. 511-C, 162 FERC ¶ 61,228, at P 9 (2018); *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, Notice of Inquiry, 157 FERC ¶ 61,210, at PP 4-7 (2016). By contrast the pass-through partnership forms addressed in this order are not publicly traded.

[9] *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945, 948 (D.C. Cir. 2007) (*ExxonMobile*).

permitting both the DCF ROE and an income tax allowance leads to a double recovery of the partners' tax costs.[10]

7. Following the 2016 *United Airlines* decision, the Commission sought to determine the circumstances in which such a double recovery occurred when a pass-through partnership entity recovers both a DCF ROE and an income tax allowance for its partners' tax costs. The Commission issued a Notice of Inquiry (NOI) in December 2016 providing interested entities an opportunity to comment regarding the appropriate response to the *United Airlines* decision.[11]

8. In March 2018, the Commission issued the Revised Policy Statement addressing comments filed in response to the NOI,[12] and the Commission also issued Opinion No. 511-C, the remand order pursuant to *United Airlines* in SFPP's 2008 West Line rate case.[13]

9. These decisions explained that *United Airlines*' double-recovery concern precludes an MLP Pipeline such as SFPP from claiming an income tax allowance. These orders relied upon two findings:

- First, the orders explained that MLP Pipelines do not incur income taxes at the entity level.[14] Instead, the MLP unitholders are individually responsible for paying taxes on their allocated share of the MLP partnership's taxable income.[15]

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[10] *United Airlines,* 827 F.3d 122.

[11] *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, Notice of Inquiry, 157 FERC ¶ 61,210 (2016) (NOI).

[12] *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, Revised Policy Statement on Treatment of Income Taxes, 162 FERC ¶ 61,227 (Revised Policy Statement), *order on reh'g*, 164 FERC ¶ 61,030 (2018) (Revised Policy Statement Rehearing).

[13] Opinion No. 511-C, 162 FERC ¶ 61,228.

[14] *Id.* P 22 (citing *United Airlines*, 827 F.3d at 136).

[15] *Id.* (citing *Policy Statement Income Tax Allowances*, 111 FERC ¶ 61,139, at P 33 (2005); *ExxonMobil*, 487 F.3d at 954)).

- Second, the ROE determined using the DCF methodology incorporates the MLP unitholder's investor-level taxes. This is because the DCF methodology estimates the returns a regulated entity must provide to investors in order to attract capital.[16] To attract capital, entities must provide investors a pre-investor tax return, i.e., a return that covers investor-level taxes and leaves sufficient remaining income to earn investors' required after-tax return.[17] Accordingly, the returns produced by the DCF methodology are pre-investor tax returns, meaning that they incorporate the MLP unitholders' income taxes.

10. Consequently, the Commission explained that a double recovery results from permitting an MLP Pipeline to recover both: (a) an income tax allowance for the MLP unitholders' investor-level taxes; and (b) a DCF ROE that incorporates those same MLP unitholders' investor-level taxes.

11. The Commission contrasted an MLP Pipeline with a pipeline that is itself a corporation. The Commission explained that no double recovery results when a corporate pipeline's cost of service includes an income tax allowance because the corporate income tax is paid directly by the corporation, rather than by shareholders.[18]

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[16] *Id.* P 11. To determine the ROE for a regulated entity, the DCF methodology uses a proxy group of publicly-traded entities (MLPs or corporations) with similar risk profiles to the regulated entity. The DCF methodology determines for each member of the proxy group a required investor return using the formula k = D/P + g, where D is the dividend (or distribution for an MLP) and P is the stock price (or unit price for an MLP) and g is the growth rate. The DCF ROE is typically set at the median return in the proxy group. *Id.*

[17] *Id.* P 22. If an investment is not providing such a return, then the stock price will drop until the investment does provide a sufficient pre-investor tax percentage return. *Kern River Transmission Co.*, Opinion No. 486-B, 126 FERC ¶ 61,034, at P 114 (2009) (stating "investors invest on the basis of after-tax returns and price an instrument accordingly"). For example, if investors require a projected 6 percent after-tax return and have a 25 percent marginal tax rate, then the security must provide a projected return of 8 percent to achieve a projected after-tax yield of 6 percent. If the security does not project to provide this 8 percent return, then the investors will not buy the security and the security's price will drop until the percentage return is sufficient to attract investment, i.e., a projected 8 percent return in this simplified example.

[18] *See* Opinion No. 511-C, 162 FERC ¶ 61,228 at PP 16, 25, n.53.

12. Regarding pass-through partnerships that were not MLP Pipelines, the Revised Policy Statement explained:

> [T]his record does not provide a basis for addressing the *United Airlines* double-recovery issue for the innumerable partnership and other pass-through business forms that are not MLPs like SFPP. While all partnerships seeking to recover an income tax allowance will need to address the double-recovery concern, the Commission will address the application of *United Airlines* to non-MLP partnership or other pass-through business forms as those issues arise in subsequent proceedings.[19]

13. In July 2018, the Commission issued two additional orders that further addressed its income tax policies for pass-through entities. Order No. 849 reaffirmed longstanding precedent that "a natural gas company organized as a pass-through entity all of whose income or losses are consolidated on the federal income tax return of its corporate parent is considered to be subject to the federal corporate income tax, and is thus eligible for a tax allowance."[20] Also in July 2018, the *Enable MRT* decision affirmed that *United Airlines*' double-recovery concern precludes an income tax allowance for the income tax costs of corporate MLP unitholders as well as other MLP unitholders.[21] The *Enable MRT* decision explained the distinction between: (a) a pipeline organized as a pass-through entity that is owned by an MLP that has corporate unitholders; and (b) a pipeline organized as a pass-through entity that is a wholly owned subsidiary of a corporation, stating:

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[19] Revised Policy Statement, 162 FERC ¶ 61,227 at P 3.

[20] *Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate*, Order No. 849, 164 FERC ¶ 61,031, at PP 3, 32, 56 (2018). The Commission's income tax policies have long permitted a wholly owned pipeline subsidiary to recover the income tax costs of its corporate parent. *See, e.g., City of Charlottesville,* 774 F.2d at 1207-1208 (discussing the Commission's standalone tax policy); *BP West Coast Prods.*, 374 F.3d at 1289 (explaining that an income tax allowance is appropriate in the cost of service of a pass-through subsidiary of a corporation "when such a subsidiary does not itself incur a tax liability but generates one that might appear on a consolidated return of the corporate group").

[21] *Enable Mississippi River Transmission, LLC*, 164 FERC ¶ 61,075 (2018) (*Enable MRT*). Enable MRT was a wholly owned subsidiary of an MLP. Because 86 percent of the MLPs unitholders were corporations, Enable MRT claimed that it should receive an income tax allowance based upon the corporate income tax rate as applied to this 86 percent corporate ownership share.

> An MLP incurs no tax liability prior to making the distribution to its unitholders that is reflected in the DCF model's determination of the MLP's ROE. Thus, the MLP's distribution includes funds that the corporate and individual unitholders may use to pay taxes on their share of the MLP's income. In contrast, a corporation that wholly owns a pass-through pipeline pays the corporate income tax prior to the investor-level dividend reflected in the DCF model's calculation of the pipeline's ROE. Thus, as Opinion No. 511-C explained, although a double-recovery results from granting a pipeline an income tax allowance to reflect the tax liability of corporate or other MLP unitholders, no double-recovery results from granting an income tax allowance to the *wholly owned subsidiary* of a corporation.[22]

14. In sum, following *United Airlines,* the Commission held that it will not permit an income tax allowance for MLP Pipelines, regardless of whether the unitholders are individuals or corporations. The Commission also reaffirmed its longstanding policy permitting an income tax allowance for pass-through entities whose income is reported solely on the consolidated return of a single corporate parent.[23] Prior to Trailblazer's filing, the Commission had not addressed how *United Airlines'* double-recovery concern applies to pass-through partnership entities that are not MLPs.

B. Trailblazer's Filing

15. On June 29, 2018, Trailblazer submitted a filing to revise its rates under NGA section 4. Explaining its proposed tax allowance, Trailblazer represented that it is a non-MLP pass-through business form, owned 55 percent by Tallgrass Energy (a publicly traded partnership which has elected to be taxed as a corporation and pays dividends) and 45 percent by Private Owners (which Trailblazer characterizes as 11 private equity funds).[24] Trailblazer, the regulated entity, does not incur an income tax liability itself. As a pass-through entity, Trailblazer represented that it allocates its income to correspond with these ownership percentages.[25] Accordingly, for purposes of calculating its income tax allowance, Trailblazer attributed the current 21 percent corporate income tax to Tallgrass Energy's 55 percent ownership interest and an income tax liability of 28

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[22] *Id.* P 35 (emphasis in the original).

[23] *Id.* P 36. *See also* Order No. 849, 164 FERC ¶ 61,031 at PP 3, 32, 56.

[24] Ex. TPC-73 at 19:3-15; Ex. TPC-75; Ex. TPC-91 at 38-39; Ex. TPC-108 at 24.

[25] Ex. TPC-91 at 39.

percent to the 45 percent private equity ownership interest.[26] This produces a weighted average federal income tax rate of 24.16 percent.[27] Once state income taxes are also included, Trailblazer claimed that it should receive an income tax allowance of 29.17 percent.[28] Several shippers protested this aspect of Trailblazer's filing.

16. On July 31, 2018, the Commission set Trailblazer's June 29, 2018 filing for administrative law judge hearing procedures.[29] However, recognizing that Trailblazer's filing presented issues of first impression involving the *United Airlines* double-recovery issue, the Commission set the income tax allowance issue for paper hearing with shipper briefs due August 30 and Trailblazer's reply brief due September 15, 2018. Trailblazer Shipper Group (TB Shipper Group),[30] Indicated Shippers,[31] East Cheyenne Storage LLC (East Cheyenne), and the City of Hastings, Nebraska (Hastings) filed briefs arguing that Trailblazer failed to justify its proposed income tax allowance, and that the income tax allowance should either be denied altogether or set for hearing.

II. Discussion of the Paper Hearing Issues

17. We establish the following framework for addressing income tax allowance for partnership entities and whether such an income tax allowance would cause a double recovery with the DCF ROE. As discussed above and established by prior Commission

[26] Trailblazer stated that the tax rate for this private equity is 28 percent because the federal individual tax rate of 35 percent must be discounted by 20 percent due to the Tax Cuts and Jobs Act providing for such investors to pay income taxes on only 80 percent of the taxable distributions from this passive activity. Ex. TPC-91 at 39 (citing Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017)). Trailblazer asserted that the 35 percent tax rate is justified because "[t]ypical investors in [private] equity funds include institutional investors such as pension funds, insurance companies, and wealthy individuals." *Id.* at 35.

[27] Trailblazer represented that the income tax liability is allocated between Tallgrass Energy and the private equity holders in the same percentage as ownership. Ex. TPC-91 at 39.

[28] Ex. TPC-91 at 30.

[29] Hearing Order, 164 FERC ¶ 61,074.

[30] Concord Energy LLC, Mieco Inc., and Tenaska Marketing Ventures.

[31] Anadarko Energy Services Company, ConocoPhillips Company, Shell Energy North America (US), L.P., and XTO Energy Inc.

precedent, if the income tax liability arises from ownership of an MLP unit, then the double-recovery concern precludes granting the pipeline an income tax allowance for the owners' income tax costs.[32] Second, if the partnership's owners' tax liability does not arise from ownership of an MLP unit (as is the case with Trailblazer), then we propose to analyze whether there is a double recovery concern as follows:

- For owners taxed as individuals, *United Airlines'* double-recovery concern generally precludes an income tax allowance because: (i) DCF returns already include investor-level taxes; and (ii) these individuals incur only one level of taxation.

- For owners that are taxed as corporations, *United Airlines'* double-recovery concern generally does not preclude an income tax allowance because: (i) the DCF returns only include investor-level taxes; and (ii) the corporate owner incurs a corporate income tax liability *prior to* the investor-level tax on the corporation's dividends reflected in the DCF return.

18. We further discuss this proposed framework below and apply it to the facts presented by the paper hearing record. Based upon this record, we preliminarily conclude that a double recovery results from granting an income tax allowance for the Private Owners' individual income tax costs. This is because the Private Owners are taxed as individuals and incur only one level of taxation, which is reflected in the DCF ROE. However, in contrast, no double recovery results from granting Trailblazer a DCF ROE and an income tax allowance for the corporate income tax liability attributable to Tallgrass Energy's 55 percent ownership share. Tallgrass Energy reports that it is taxed as a corporation,[33] and no double recovery results from permitting recovery of Tallgrass Energy's income tax costs because Tallgrass Energy incurs a corporate income tax prior to the investor-level tax on its dividends reflected in the DCF ROE.

A. A Double Recovery Results from Permitting Trailblazer to Recover a DCF ROE and an Income Tax Allowance for Its Private Owners' Tax Costs

19. Permitting an income tax allowance for the Private Owners' income tax costs appears to lead to a double recovery. Two separate reasons support this conclusion. First, the Private Owners incur only one level of taxation, specifically a personal income

[32] *E.g., Enable MRT,* 164 FERC ¶ 61,075 at P 35.

[33] Ex. TPC-75, *Tallgrass Income Tax Election*, which consists of an Internal Revenue Service (IRS) letter approving Tallgrass Energy's IRS Form 8832, Entity Classification Election.

tax liability on their income from Trailblazer.[34] Moreover, as *United Airlines* and subsequent Commission orders conclude, the DCF ROE incorporates investor-level taxes[35] which Trailblazer concedes.[36] Thus, because the Private Owners incur only one level of taxes on Trailblazer's income and the DCF ROE already includes a level of taxation, providing the Private Owners an income tax allowance would compensate the Private Owners twice for their single level of taxation.

20. Second, in more general terms, Trailblazer's Private Owners' tax costs appear to be investor-level tax costs just like the investor-level tax costs recovered in the DCF ROE. Trailblazer's own witnesses assert that the tax liability attributable to the Private Owners arises from the taxes of individual "investors" in private equity funds.[37] If the Private Owners are "investors," then the taxes arising from the Private Owners' interests are necessarily "investor-level taxes." As explained above, the DCF ROE is an investor-

[34] Ex. TPC-91 at 35. In contrast, corporations incur double taxation. A corporation pays a corporate income tax and then, after the returns are distributed to investors, the corporate shareholders pay a dividend tax. Opinion No. 511-C, 162 FERC ¶ 61,228 at n.53.

[35] *Enable MRT,* 164 FERC ¶ 61,075 at PP 33-34; Opinion No. 511-C, 162 FERC ¶ 61,228 at P 22. As explained above, *United Airlines* and the Commission's subsequent precedent concluded that the DCF ROE incorporates the MLP unitholder's investor-level taxes and corporate shareholder's investor-level dividend taxes. This is because the DCF methodology estimates the returns a regulated entity must provide to investors in order to attract capital to the publicly traded MLP units and corporate shares. To attract capital, regulated entities must provide investors a pre-investor tax return, i.e., a return that covers investor-level taxes and leaves sufficient remaining income to earn investors' required after-tax return. Accordingly, the DCF ROE includes investor-level taxes. Opinion No. 511-C, 162 FERC ¶ 61,228 at P 22.

[36] Trailblazer Reply Brief at 19 (stating that under *United Airlines*, the MLP distribution "is presumed to include the funds necessary to pay the taxes the investor incurs on its share of the pipeline's taxable income."); 20 (concluding that a DCF proxy group of corporations will include "investor's dividend tax liability.").

[37] Ex. TPC-91 at 3 (defining the Private Owners as "consist[ing] of individual investors that primarily acquired their ownership in Trailblazer through being partners in various private equity funds that were original investors in Tallgrass); Ex. TPC-91 at 37 (explaining that the tax rate of the individual investors in the private equity funds applies to the income from Trailblazer).

level return that, as *United Airlines* held, includes "investor" tax costs.[38] Thus, because the Private Owners' tax liability is attributable to investors and the DCF ROE already includes investor-level taxes, providing the Private Owners an income tax allowance for those same investor-level taxes leads to a double recovery.

21. Trailblazer's arguments for a contrary result are unavailing. These arguments include the following: (a) the DCF returns do not reflect the Private Owners' taxes because the Private Owners' interest in Trailblazer is not publicly traded; (b) the DCF return does not include Private Owners' income tax costs because the Private Owners could not demand a pre-investor tax return; (c) because the Private Owners are more concerned with "growth," the DCF ROE based upon cash distributions does not compensate them for their tax costs; (d) using a proxy group entirely composed of corporations eliminates any "theoretical" double recovery for the tax costs attributable to the Private Owners; and (e) alternatives to the DCF for calculating the ROE could eliminate this double-recovery concern.

22. There is little merit to Trailblazer's first argument that the DCF returns do not reflect the Private Owners' taxes because the Private Owners' shares in Trailblazer are not publicly traded. The fact that the Private Owners' interest is not publicly traded does not alleviate the double-recovery concern.[39] As the *United Airlines* decision concluded and as explained above, the DCF ROE (based upon Trailblazer's proxy group) includes investor-level taxes. Trailblazer's Private Owners' interests are only taxed once at the individual income tax rate. As explained above, given that the DCF already reflects investor-level taxes, granting an income tax allowance for the Private Owners' tax costs leads to a double recovery.

23. Similarly unpersuasive are Trailblazer's related claims that because the Private Owners did not acquire their interest via publicly traded shares, the Private Owners could not make the same demand for a pre-tax return as the investors in the corporations and MLPs included in the proxy group.[40] Notwithstanding Trailblazer's argument,

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[38] Opinion No. 511-C, 162 FERC ¶ 61,228 at PP 22, 24, 25.

[39] It is true that if an ownership interest is in publicly traded stock or MLP shares, then the ownership's tax costs are reflected in the DCF ROE. *Enable MRT,* 164 FERC ¶ 61,075 at P 35. This does not mean, however, that the inverse is true, i.e., if the ownership interest is *not* publicly traded, then the ownership's interests' tax costs *cannot* be reflected in the DCF ROE.

[40] Ex. TPC-73 at 34-35; Ex. TPC-91 at 24-25, 32-34.

Trailblazer's proposed DCF proxy group is composed of corporations and MLPs[41] and Trailblazer concedes that the returns from these entities reflect pre-investor-level tax returns.[42] Thus, to the extent that Trailblazer is correct and its Private Owners could not demand a return that incorporates investor-level tax costs, Trailblazer continues to nonetheless propose a DCF-based ROE that includes investor-level tax costs.[43] Furthermore, the DCF proxy group is used for the express purpose of estimating investor-level returns when the asset itself is not publicly traded (like the Private Owners' interest in Trailblazer),[44] and when such a DCF proxy group is used, the Commission has explained that the investor-level DCF return provides both recovery for investors' tax costs and investors' after-tax return.[45] Accordingly, providing an income tax allowance and resulting DCF ROE leads to a double recovery of the Private Owners' investor-level tax costs.

24. Moreover, if, as Trailblazer claims, its Private Owners do not demand a return that compensates them for their investor-level tax costs, it is not clear that Trailblazer should recover any income tax allowance in cost of service for the Private Owners' tax costs. However, Trailblazer confuses the issue when it argues that Private Owners, unlike other

[41] Of the seven entities included in Trailblazer's DCF study, six appear to have been MLPs at the time of filing. Ex. TPC-86 at 8. (Boardwalk Pipeline Partners, LP; Dominion Midstream Partners LP; Enable Midstream Partners, LP; EQT Midstream Partners, LP; Spectra Energy Partners; TC PipeLines, LP). Only one (Kinder Morgan Inc.) was a corporation. *Id.* Although Boardwalk subsequently converted its business form, the remaining MLPs had not done so as of September 15, 2018. Trailblazer Reply Brief at 28. The proper composition of Trailblazer's proxy group can be litigated at hearing.

[42] Trailblazer Reply Brief at 20 (stating "a DCF proxy group of all corporations will generate a return that includes the investors' dividend tax liability."), 27 (stating a proxy group of corporations will produce a return that includes investors' dividend tax liability), 29 (reaffirming that a proxy group of corporations would produce a return that includes dividend-level taxes).

[43] Ex. TPC-85 at 10. As noted above, Trailblazer makes no claim that the Private Owners are subject to double-taxation.

[44] *Petal Gas Storage, LLC v. FERC*, 496 F.3d 695 (D.C. Cir. 2007) (explaining that when "the cost of equity capital for a private natural gas company cannot be read from the market, the Commission estimates this figure based on a proxy group of publicly traded, but otherwise comparable, natural gas companies").

[45] Opinion No. 511-C, 162 FERC ¶ 61,228 at P 22.

investors, do not require a pre-tax return. Although the Private Owner's equity interests are not traded on an exchange, the Private Owners (like investors in an MLP unit or corporate stock) will still demand a return that is sufficient to cover their tax costs while leaving remaining profits to compensate them for the time value of money and the risk of the investment.[46] Such investors perform the same analysis whether they are purchasing an asset on the publicly traded exchanges or elsewhere.[47] The Private Owners require a pre-investor tax return, but no income tax allowance is necessary because that pre-investor tax return is already reflected in the DCF ROE.

25. Similarly unconvincing is Trailblazer's suggestion that because the Private Owners are concerned with growth as opposed to cash flows in the DCF, the DCF ROE does not compensate those investors for their tax costs.[48] Trailblazer fails to substantiate this inference. Whether or not a particular investor is concerned with growth, the DCF ROE (based upon Trailblazer's proxy group) is a pre-investor tax return and thus includes investor-level taxes. Furthermore, Trailblazer itself proposed to use the DCF ROE as its equity return (including for the Private Owners' share), and thus Trailblazer itself is representing that the DCF ROE is a reasonable measure of Private Owners' required investor returns (which include investor level taxes), irrespective of the Private Owners' focus on cash flow or growth.

26. Likewise, Trailblazer fails to support its claim that a proxy group composed of corporations would alleviate the double-recovery concern as applied to the Private

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[46] Opinion No. 511-C, 162 FERC ¶ 61,228 at P 22 (citing Opinion No. 486-B, 126 FERC ¶ 61,034 at P 114 ("investors invest on the basis of after-tax returns and price an instrument accordingly")). This is particularly true for the sophisticated "accredited investors" that Trailblazer claims invested as private owners. Ex. TPC-91 at 36 (stating that an individual investing as an accredited investor must have at least $1 million of net worth, excluding the value of the person's home).

[47] There is even less merit to Trailblazer's broader argument, made in its June 29, 2018 filing, that "the DCF analysis applies only to publicly traded investments and cannot be utilized to analyze an investment made through a private equity fund." Ex. TPC-91 at 33. Trailblazer undermines this position when Trailblazer uses the DCF to calculate its cost-of-service ROE and Trailblazer claims this return is just and reasonable. Ex. TPC-85 at 10. By using the DCF to calculate its ROE, Trailblazer is representing that the DCF provides a mechanism to establish an ROE necessary to attract capital that is equally applicable to both investors in corporations and private investors.

[48] Ex. TPC-108 at 35.

Owners in this cost-of-service rate case.[49] This argument is not supported by Trailblazer's filing because Trailblazer's proposed June 29, 2018 cost-of-service DCF ROE was not based upon a proxy group composed solely of corporations. Rather, Trailblazer's DCF study in its June 29, 2018 filing consists of a proxy group composed of six MLPs, whose investors incur an income tax liability, and one corporation.[50] However, even if Trailblazer had proposed to determine the DCF ROE in its cost of service using a proxy group composed solely of corporations, this would not resolve the double-recovery concern.[51] A proxy group composed entirely of corporations still produces a DCF ROE that includes investor-level taxes because, as Trailblazer concedes, the corporations' DCF returns include the investor-level dividend tax.[52] Thus, in a hypothetical scenario in which Trailblazer's proxy group consisted entirely of corporations, a double recovery of investor-level taxes still results from permitting Trailblazer to recover both an income tax allowance for investor-level taxes and a DCF ROE that also includes investor-level taxes.

27. Trailblazer similarly fails to support its argument that an income tax allowance is needed to ensure parity because corporations and private equity are taxed at approximately the same level. Trailblazer's own pleadings show that corporations are actually taxed at a higher level (the corporate income tax at 21 percent plus the dividend tax at 15-20 percent) than the private income tax liability (28 percent) attributable to private equity holders.[53] Even if Trailblazer were correct that the overall tax levels were

[49] Trailblazer Reply Brief at 6.

[50] *See* Ex. TPC-86 at 8

[51] After its initial filing, Trailblazer's September 2018 reply comments present a hypothetical proxy group of corporations. Trailblazer Reply Brief at 27. This proxy group is not used in Trailblazer's cost of service, but the composition of Trailblazer's proxy group can be further litigated at hearing.

[52] *Id.* at 20 (stating "a DCF proxy group of all corporations will generate a return that includes the investors' dividend tax liability."), 27 (stating a proxy group of corporations will produce a return that that includes investors' dividend tax liability), 29 (reaffirming that a proxy group of corporations would produce a return that includes dividend-level taxes).

[53] Trailblazer emphasizes that its private equity owners "can be taxed" at up to 37 percent. Ex. TPC-91 at 28. However, Trailblazer's own calculation of its income tax liability assumes a 35 percent tax rate which must be reduced to 28 percent because the Tax Cuts and Jobs Act only requires private equity investors to pay taxes on 80 percent of the taxable distributions from passive investment activity. *Id.* at 39.

similar, Trailblazer's argument does not address *United Airlines*' central concern. From the perspective of *United Airlines*, the relevant question is which taxes are included in the DCF return (investor-level taxes) and which ones are not (the pre-investor level corporate income tax).[54] As Opinion No. 511-C explained, the Commission establishes parity by ensuring that no entity double-recovers its income tax costs.[55]

B. No Double Recovery Results from Permitting Trailblazer to Recover a DCF ROE and an Income Tax Allowance for Tallgrass Energy's Tax Costs

28. We preliminarily find that inclusion of an income tax allowance for Tallgrass Energy's corporate income tax liability does not appear to result in a double recovery because Tallgrass Energy's corporate income tax costs are not reflected in the DCF ROE. The DCF ROE reflects investor-level returns (e.g. MLP unitholder distributions and corporate shareholder dividends) and investor-level taxes (MLP unitholder income taxes and corporate shareholder dividend taxes).[56] However, as *United Airlines* recognized, the DCF ROE does not include corporate income tax costs that are incurred prior to the distribution of investor-level returns.[57] This is because the corporation "pays the corporate income tax prior to the investor-level dividend reflected in the DCF model's

[54] Trailblazer concedes that "the corporation itself is responsible for paying" corporate income tax. *Id.* at 26.

[55] Opinion No. 511-C, 162 FERC ¶ 61,228 at P 25. Although investor level taxes differ, this does not change the fact that *some* investor-level taxes are embedded within the DCF returns.

[56] The DCF model is based upon a range of returns that the market provides investors in a proxy group of publicly-traded entities with similar risk profiles. For each member of the proxy group, the required rate of return is estimated to equal investors' current dividend yield – dividends (or in the case of MLPs, distributions) divided by stock (or unit) price – plus the projected future growth rate of dividends (or distributions), such that $k = D/P + g$. In the DCF formula, P is the six-month average price of the stock (or units) over the relevant test period, D is the current dividend (or distribution), k is the investors' required rate of return, and g is the expected growth rate in dividends (or distributions). The Commission typically determines the regulated entity's allowed ROE using the median of these proxy group returns.

[57] *United Airlines,* 827 F.3d at 136.

calculation of the pipeline's ROE,"[58] and investors will not demand a percentage return that compensates for a corporate income tax that the investors do not pay.[59] Accordingly, as the Commission has recently reaffirmed, pass-through entities that are wholly owned by corporations can recover an income tax allowance without raising double-recovery concerns.[60]

29. Similarly, a double-recovery concern does not appear to apply to Tallgrass Energy's 55 percent ownership share in Trailblazer. Just like the corporate owner of a wholly owned subsidiary, Tallgrass Energy "pays the corporate income tax prior to the investor-level dividend reflected in the DCF model's calculation of the pipeline's ROE."[61] Although Tallgrass Energy's shareholders' dividends and dividend taxes are reflected in the DCF ROE, Tallgrass Energy's corporate income taxes are not. As a result, permitting the income tax allowance for Tallgrass Energy's corporate income tax liability does not lead to a double recovery.

30. In this proceeding, shipper objections do not compel rejection of an income tax allowance for Tallgrass Energy's corporate income tax liability on the basis that it leads to a double recovery. As discussed below, these shipper arguments include: (1) no income tax allowance is needed because Trailblazer is a wholly owned subsidiary of a pass-through entity and is only partially owned by a corporation; (2) Tallgrass Energy is "too many levels of pass-through entities" above Trailblazer for Tallgrass Energy's income tax costs to be reflected in Trailblazer's cost of service; (3) the Commission's *Enable MRT* decision justifies denying Trailblazer an income tax allowance for Tallgrass Energy's ownership share; (4) Tallgrass Energy does not incur an actual tax bill; and (5) Trailblazer's restructuring was motivated by the Commission's income tax policy changes involving MLP Pipelines.

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[58] *Enable MRT*, 164 FERC ¶ 61,075 at P 35; Opinion No. 511-C, 162 FERC ¶ 61,228 at n.53.

[59] The corporate income tax affects the cash flows available for a corporation to distribute to its shareholders via dividends. As these cash flows increase or decrease, the stock price will fluctuate. However, the corporation (not investors) pays the corporate income tax. Thus, when investors compare percentage returns from a corporate stock (such as those reflected in the DCF ROE) with other investments, the investors will consider dividend taxes but not the corporate income tax.

[60] *Enable MRT*, 164 FERC ¶ 61,075 at P 36; Order No. 849, 164 FERC ¶ 61,031 at PP 3, 32, 56.

[61] *Enable MRT*, 164 FERC ¶ 61,075 at P 35.

31. Regarding the first argument, shippers do not support their claim that Trailblazer should be denied an income tax allowance for Tallgrass Energy's corporate income taxes merely because Trailblazer is not a wholly-owned subsidiary of Tallgrass Energy.[62] Whether or not Tallgrass Energy wholly owns Trailblazer, the Commission's policy as affirmed in *ExxonMobil* permits Trailblazer an income tax allowance with respect to Tallgrass Energy's ownership share if Tallgrass Energy incurs "an actual or potential" corporate income tax liability based upon Trailblazer's income.[63] Likewise, as explained above, Tallgrass Energy's corporate income tax is incurred prior to the shareholder dividends reflected in the DCF, and thus there is no *United Airlines* double-recovery concern.

32. Similarly, there is little support for the TB Shipper Group's argument that no income tax allowance should be permitted because Tallgrass Energy's income tax liability is "two steps up the distribution ladder beyond Trailblazer's direct ownership level…" and thus the DCF provides sufficient recovery for Tallgrass Energy's tax costs.[64] In fact, Tallgrass Energy is four distribution steps above Trailblazer.[65] However, for purposes of the income tax allowance analysis required by *ExxonMobil* and *United Airlines,* the number of pass-through levels in the organizational structure between Trailblazer and Tallgrass Energy is irrelevant.[66] None of the intermediate entities incur a corporate tax liability nor are the intermediate entities publicly traded partnerships like an

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[62] Indicated Shippers Brief at 13.

[63] *ExxonMobil*, 487 F.3d at 948. The Court in *ExxonMobil* further explained that the tax costs of the partners (such as Tallgrass Energy) can be imputed to the partnership and recovered in cost of service. *Id.* at 955.

[64] TB Shipper Group Brief at 8.

[65] Trailblazer is a wholly owned subsidiary of (1) Tallgrass MLP Operations, LLC, which is a wholly owned subsidiary of (2) Tallgrass Energy Partners, LP, which is a wholly owned subsidiary of (3) Tallgrass Equity, LLC, which is owned by two categories of owner, (4A) Tallgrass Energy (which owns 55 percent and incurs a corporate income tax liability) and (4B) the Private Owners (which own 45 percent of Trailblazer). Ex. TPC-107 at 7.

[66] More broadly, TB Shipper Group's argument is contrary to the Commission's stand-alone policy. Under the stand-alone policy, a regulated entity is permitted an income tax allowance notwithstanding the fact that it is the corporate parent that pays the income tax on behalf of the regulated entity. *City of Charlottesville,* 774 F.2d at 1207. Under the stand-alone policy, it does not matter how many pass-through entities are between the regulated entity and the corporate parent incurring the tax liability.

MLP such that the income (and related tax liability) from Trailblazer would be reflected in the investor-level DCF returns.

33. Likewise, contrary to shippers' claims, the Commission's July 2018 *Enable MRT* decision fully supports providing Trailblazer an income tax allowance for Tallgrass Energy's ownership share.[67] The *Enable MRT* decision denied an income tax allowance to a pipeline organized as a pass-through entity that is wholly owned by an MLP that has corporate unitholders. That order explained: "An MLP incurs no tax liability prior to making the distribution to its unitholders that is reflected in the DCF model's determination of the MLP's ROE. Thus, the MLP's distribution includes funds that the corporate and individual unitholders may use to pay taxes on their share of the MLP's income."[68] In contrast, the *Enable MRT* decision explained that an income tax allowance could be included in the cost of service for "a corporation that wholly owns a pass-through pipeline that pays the corporate income tax prior to the investor-level dividend reflected in the DCF model's calculation of the pipeline's ROE."[69] Tallgrass Energy is no different from such a corporate owner, other than that Tallgrass Energy incurs a tax on 55 percent of Trailblazer's income as opposed to 100 percent.

34. Further, notwithstanding shipper arguments, the fact that Tallgrass Energy does not actually pay taxes in any given year (or for several years)[70] does not necessarily preclude recovery of an income tax allowance for Trailblazer's income that is allocated to Tallgrass Energy.[71] Under the Commission's stand-alone methodology,[72] a regulated entity's income tax allowance is based on the income and deductions specifically attributable to the regulated entity's jurisdictional cost of service and the income tax

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[67] TB Shipper Group Brief at 7.

[68] *Enable MRT*, 164 FERC ¶ 61,075 at P 35. As explained previously, the Commission has long permitted a corporation to recover an income tax allowance for a pass-through pipeline subsidiary.

[69] *Id.*

[70] Indicated Shippers at 11.

[71] *City of Charlottesville,* 774 F.2d at 1215 (explaining that an income tax allowance may be collected even when the parent's tax liability on the regulated entity's income is in actuality deferred to another period or offset by losses of other affiliated subsidiaries).

[72] *See Columbia Gulf Transmission Co.*, 23 FERC ¶ 61,396 (1983); *City of Charlottesville,* 774 F.2d at 1207-1208.

allowance does not incorporate potentially offsetting losses and deductions of the parent owner not reflected in the regulated entity's jurisdictional cost of service.[73] The present record appears to support Trailblazer's representation that Tallgrass Energy is taxed at the federal level as a corporation,[74] and, to the extent Trailblazer's income is allocated to Tallgrass Energy, Tallgrass Energy incurs a corporate income tax liability on Trailblazer's income. Under the stand-alone methodology, it is not relevant that the income from Trailblazer allocated to Tallgrass Energy may be offset by other deductions or losses that are not appropriately included in Trailblazer's cost of service. Shippers may present evidence at hearing to refute any of Trailblazer's representations (including whether Tallgrass Energy is in fact taxed as a corporation), but the shippers must litigate these issues consistent with the stand-alone methodology. The mere fact that Tallgrass Energy does not pay actual taxes in any particular year does not, by itself, preclude Trailblazer's collection of an income tax allowance.

35. Similarly, we need not consider shipper claims regarding the timing of or motivations behind the 2018 reorganization of Trailblazer's parent company away from the MLP structure effective June 29, 2018. We are reluctant to substitute our business judgment for the business judgment of the regulated entity; pipelines are permitted to select their corporate form. This proceeding involves rates based upon Trailblazer's organizational structure during the test period ending December 31, 2018.[75]

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[73] *City of Charlottesville,* 774 F.2d at 1207-1208. Because the regulated entity's costs that serve as deductions (such as depreciation) are already factored into the regulated entity's cost of service, the regulated entity's income tax allowance can simply be calculated by applying the appropriate weighted average marginal tax rate to the ROE.

[74] Ex. TPC-75.

[75] In any case, there is evidence that factors other than the Commission's tax policies prompted the reorganization. *See, e.g.,* Ex. TPC-107 at 10-11 (stating that the reorganization was intended to improve overall cost of capital and optimize capital market access.). East Cheyenne Gas Storage Initial Brief, Exhibit A at 44-45 (Tallgrass Energy GP LP SEC filing recommending the reorganization to lower capital costs, eliminate potential conflicts of interest in the prior business structure, and create savings). Also, Trailblazer presented evidence that the discussions to change business structure began before the Revised Policy Statement and Opinion No. 511-C issued on March 15, 2018, which announced the Commission's policy that a double recovery results from granting an MLP pipeline an income tax allowance. Ex. TPC-73 at 18; TPC-107 at 10.

C. BP West Coast Does Not Preclude Permitting an Income Tax Allowance for Only the Corporate Ownership Share

36. The above arguments support providing an income tax allowance for Tallgrass Energy's 55 percent interest in Trailblazer and no income tax allowance for the Private Owners' 45 percent interest. However, both Trailblazer and City of Hastings assert that the D.C. Circuit's *BP West Coast* decision precludes permitting an income tax allowance for Tallgrass Energy's corporate ownership share while, at the same time, denying an income tax allowance for the Private Owners' share.

37. As these parties explain, in the 2005 *BP West Coast* decision, the D.C. Circuit overturned the Commission's then-existing policy permitting an income tax allowance for income tax costs attributable to corporate MLP limited partner unitholders,[76] but not for income tax costs attributable to individual MLP limited partner unitholders. Among other reasons for rejecting the Commission's policy, *BP West Coast* emphasized that the Commission failed to justify the different treatment for corporate and individual MLP limited partner unitholders.[77] Moreover, in 2007 the D.C. Circuit's *ExxonMobil* decision subsequently affirmed the Commission policy of permitting an income tax allowance for both corporate and individual unitholders, and the D.C. Circuit explained that "the Commission resolved the principal defect [identified in *BP West Coast* regarding the prior] policy, which was the unexplained differential treatment of individual and corporate partners."[78] Thus, Trailblazer and City of Hastings assert that *BP West Coast* could be construed as supporting a proposition that the Commission must provide an income tax allowance for every owner of Trailblazer (i.e., both Tallgrass Energy and the Private Owners) or neither.

38. However, the *BP West Coast* decision does not mandate such a result. First, in the instant proceeding, *ExxonMobil* and *United Airlines* combine to provide the justification for a partial income tax allowance that *BP West Coast* found lacking. Together,

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[76] *BP West Coast*, 374 F.3d at 1286-1293. The MLP pipeline limited partners are frequently referred to as unitholders because they own the publicly traded MLP limited partner units.

[77] *Id*. at 1290 (stating that the Commission did not "supply reasoning for differentiating between individual and corporate tax liability").

[78] *ExxonMobil*, 487 F.3d at 955. The *ExxonMobil* decision went so far as to state, "*BP West Coast* did not pass upon the specific question at issue in the instant case—whether FERC may grant an [income tax allowance] to limited partnerships for the income taxes paid by all partners on the income they receive from the partnership." *Id.* at 954.

ExxonMobil and *United Airlines* hold that a partnership pass-through entity may claim an income tax allowance for its partner-owners' tax costs by showing both that: (a) partners incur an "an actual or potential income tax liability" from the partnership's income;[79] and (b) the partners' income tax costs are not already reflected in the DCF ROE such that permitting an income tax allowance leads to a double recovery of the partners' tax costs.[80] As discussed above, permitting an income tax allowance for tax liability incurred by the Private Owners leads to a double recovery whereas permitting an income tax allowance for the corporate income tax liability incurred by Tallgrass Energy does not lead to a double recovery. Accordingly, the Commission's application of the *United Airlines* precedent provides the explanation for the different income tax allowance treatment that was absent in *BP West Coast*.[81]

39. Second, unlike Trailblazer, the *BP West Coast* decision involved corporate and non-corporate MLP unitholders. Accordingly, in *BP West Coast*, both the corporate and non-corporate partners owned the same MLP units and thus both recovered their tax costs via the same unitholder returns reflected in the DCF ROE. The Commission's recent *Enable MRT* decision provides a distinction between: (a) the corporate unitholders at issue in *BP West Coast;* and (b) the corporate owner such as Tallgrass Energy:

> An MLP incurs no tax liability prior to making the distribution to its unitholders that is reflected in the DCF model's determination of the MLP's ROE. Thus, the MLP's distribution includes funds that the corporate and individual unitholders may use to pay taxes on their share of the MLP's income. In contrast, a corporation that wholly owns a pass-through pipeline pays the corporate income tax prior to the investor-level dividend reflected in the DCF model's calculation of the pipeline's ROE. Thus, as Opinion No. 511-C explained, although a double-

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[79] *Id.* at 948.

[80] *United Airlines,* 827 F.3d 122.

[81] Along similar lines, in support of an income tax allowance for the Private Owners, Trailblazer argues that *BP West Coast* concluded that whether an owner is taxed once or twice is irrelevant, so long as the owner incurs an actual or potential income tax liability. Trailblazer Reply Brief at 24 (citing *BP West Coast*, 374 F.3d at 1288). However, as explained above, the fact that corporations' dividends are taxed twice is relevant for the double-recovery analysis required by *United Airlines.* Because the corporate income tax is incurred prior to the dividend distribution to shareholders, it is not included in the DCF ROE and, thus, can be recoverable as a tax allowance in cost of service without raising double-recovery concerns. In contrast, the DCF ROE incorporates investor-level dividend taxes paid by corporate shareholders and the income taxes paid by MLP unitholders.

> recovery results from granting a pipeline an income tax allowance to reflect the tax liability of corporate or other MLP unitholders, no double-recovery results from granting an income tax allowance to the *wholly owned subsidiary* of a corporation.[82]

As discussed above, the income tax liability Tallgrass Energy incurs in its non-publicly-traded 55 percent ownership share in Trailblazer is akin to the tax liability incurred by a parent corporation for its 100 percent interest in its wholly owned subsidiary.

D. Subsequent Hearing Procedures

40. The ongoing administrative law judge hearing should further address all income tax allowance issues. The preliminary findings in this order may change based on the result of subsequent proceedings in the administrative law judge hearing process.[83] The parties are free to present evidence supporting the preliminary findings above or to submit evidence supporting different conclusions. In addition to the double-recovery issues discussed above, potential issues to be addressed in the administrative law judge hearing could include verifying Trailblazer's representations regarding how much of Trailblazer's income is allocated to Tallgrass Energy[84] and changes to any of the material facts that occur prior to the conclusion of the test period on December 31, 2018 that are not reflected in the paper hearing record.

III. Alternatives to the DCF for Determining ROE

41. On November 1, 2018, Trailblazer filed supplemental reply comments asserting that alternatives to the DCF should be considered for calculating Trailblazer's ROE. As the basis for its motion, Trailblazer cites the Commission's October 16, 2018 *Coakley* decision. Trailblazer further asserts that no double recovery would result from permitting Trailblazer to recover both an income tax allowance and an ROE based upon these alternative methodologies.

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[82] *Enable MRT*, 164 FERC ¶ 61,075 at P 35 (emphasis in original).

[83] Hearing Order, 164 FERC ¶ 61,074.

[84] Trailblazer has represented that approximately 55 percent of its income is allocated to Tallgrass Energy. *See, e.g.,* Ex. TPC-91 at 39. Further procedures at hearing could include discovery and analysis of any additional relevant documents (such as partnership agreements and Internal Revenue Service forms) demonstrating how Trailblazer's taxable income is allocated through affiliated pass-through entities to Tallgrass Energy, where Trailblazer claims a corporate income tax allowance is incurred.

42. As discussed below, we find that the ongoing administrative law judge hearing proceedings may address: (a) alternatives to the DCF methodology for calculating Trailblazer's ROE; and (b) whether the adoption of an alternative ROE methodology would alter the above income tax allowance double-recovery analysis resulting from the paper hearing.

A. The October 16, 2018 *Coakley* Decision

43. After Trailblazer filed its NGA section 4 rate case and after the August 31 and September 15, 2018 filings of the briefs in the paper hearing addressed by this order, the Commission issued its *Coakley* decision on October 16, 2018.[85] In *Coakley*, the Commission proposed to depart from longstanding practice of relying solely upon the DCF methodology for calculating the ROE of electric utilities. Although the Commission emphasized that it was not making any final determinations, the Commission expressed concern that "the DCF methodology alone no longer captures how investors view utility returns because investors do not rely on the DCF alone and the other methods used by investors do not necessarily produce the same results as the DCF."[86] Thus, the Commission preliminarily determined that "relying on the DCF methodology alone will not produce a just and reasonable ROE."[87] Instead, the Commission in *Coakley* proposed to determine electric utilities' ROE based upon the average of four methodologies, including the DCF as well as the Capital-Asset Pricing Model (CAPM), Risk Premium, and Expected Earnings.[88] The Commission emphasized that the proposed ROE methodology was preliminary and not the Commission's final policy.[89] In the *Coakley* proceeding, the Commission sought briefing via a paper hearing regarding the proposal to determine the ROE based upon the four methodologies.[90] The

[85] 165 FERC ¶ 61,030.

[86] *Id.* P 40. *See also Coakley v. Bangor Hydro-Elec.,* 166 FERC ¶ 61,013, at P 11 (2019) (Order on Motion for Disclosure) (explaining that the Commission has not reached any final conclusions or made any final determinations regarding the use of the DCF in determining the ROE or whether the DCF alone has ceased to be sufficient to estimate investors' expectations for a return on equity).

[87] *Coakley,* 165 FERC ¶ 61,030 at P 32.

[88] *Id.* P 36.

[89] *E.g., id.* P 55; Order on Motion for Disclosure, 166 FERC ¶ 61,013 at PP 11-12.

[90] *Coakley,* 165 FERC ¶ 61,030 at PP 55, 61.

Commission subsequently provided similar guidance in proceedings involving other electric utilities subject to regulation pursuant to the FPA.[91]

44. Although *Coakley* and subsequent orders addressed this policy for electric utilities subject to regulation under the FPA, the Commission has not previously addressed whether it will consider alternatives to the DCF for setting the ROE for natural gas pipelines and, if so, whether the alternative ROE methodologies preliminarily proposed in *Coakley* are also appropriate for natural gas pipelines.

B. Trailblazer's Motion and Answers

45. In response to the October 2018 *Coakley* order, Trailblazer filed a motion to file supplemental reply comments on November 1, 2018. On November 14, 2018, Hastings filed an answer to Trailblazer's motion, and on November 16, 2018, Indicated Shippers also filed an answer to Trailblazer's motion. On November 21, 2018, Trailblazer filed an answer responding to Hastings' and Indicated Shippers' answers. On November 30, 2018, Indicated Shippers filed an additional answer. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2018), prohibits an answer to an answer unless otherwise ordered by the decisional authority. We will accept Trailblazer's November 21, 2018 answer and Indicated Shipper's November 30, 2018 answer because they have provided information that assisted us in our decision-making process.

46. In its motion and subsequent answer, Trailblazer argues that the reasoning in *Coakley* that supports adopting alternatives to the DCF for determining electric utilities' ROE also supports adopting alternatives to the DCF for setting natural gas pipelines' ROE.[92] Trailblazer emphasizes that the October 2018 *Coakley* order identified concerns with the DCF methodology itself, not the DCF as applied to particular investments, such as electric utilities as opposed to natural gas pipelines.[93] Furthermore, regarding how the application of these alternative methodologies could affect its recovery of an income tax allowance, Trailblazer states that "[i]t has never been asserted … that the CAPM, Expected Earnings, or Risk Premium give rise to the double-recovery theory posited in *United Airlines*."[94] Accordingly Trailblazer argues that because Trailblazer's ROE need

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[91] *See* MISO Order, 165 FERC ¶ 61,118 at P 1; *Arkansas Pub. Serv. Comm'n,* 165 FERC ¶ 61,119 at P 9 n.18; *Constellation,* 165 FERC ¶ 61,267 at PP 31-34.

[92] Trailblazer Motion to Supplement Reply Brief at 7.

[93] Trailblazer November 21, 2018 Answer.

[94] Trailblazer Motion to Supplement Reply Brief at 8.

not be determined solely based on the use of the DCF method, the double-recovery issues set by the Hearing Order for paper hearing should be addressed in the general evidentiary hearing before the administrative law judge.[95]

47. In contrast, Hastings and Indicated Shippers argue that Trailblazer has failed to justify the consideration of alternative ROE methodologies after the filing of the briefs in the paper hearing. They argue that the Commission's decisions contemplating departure from the DCF have only involved the ROE for electric transmission services, not natural gas pipelines. They note that the Commission has historically adopted somewhat different ROE policies for electric utilities and natural gas pipelines. They also argue that if the Commission considers alternative ROE methodologies for gas pipelines, the alternative ROE methodologies (like the DCF) include investor-level tax costs. Thus, permitting Trailblazer to recover an income tax allowance would lead to a double recovery.

C. Discussion

48. The administrative law judge hearing proceeding may address all issues involving Trailblazer's ROE. The Hearing Order set for administrative law judge hearing procedures Trailblazer's cost-of-service NGA section 4 rate change, which includes the determination of Trailblazer's ROE.[96] We clarify that in considering the ROE, the hearing may also consider alternatives to the DCF. Although *Coakley* involved an electric transmission utility, at least some of the concerns expressed in *Coakley* regarding the Commission's historical reliance upon the DCF also appear applicable to natural gas pipelines. For example, in *Coakley*, the Commission preliminarily determined that investors rely upon multiple methodologies (not just the DCF) to evaluate potential investments,[97] and investor reliance upon multiple methodologies presumably applies to investments in natural gas pipelines. Accordingly, the administrative law judge hearing may address whether it would be appropriate to apply alternatives to the DCF for determining Trailblazer's ROE, and, if so, what alternative methodologies (such as the methodologies contemplated by the *Coakley* decision) should be used. In addressing these issues, relevant considerations at hearing may include, but are not limited to, what methodologies investors use when making investment decisions and whether or not appropriate data are available that would support these alternatives. We emphasize that

[95] *Id. See also* Trailblazer Reply Brief at 29; Ex. TPC-0110 at 10 (Trailblazer witness Spitzer asserting the same); Ex. TPC-0108 at 30 (Trailblazer witness Moul asserting the same).

[96] Hearing Order, 164 FERC ¶ 61,074.

[97] *Coakley*, 165 FERC ¶ 61,030 at PP 34-36 (citing Roger A. Morin, *New Regulatory Finance* 428-429 (Public Utilities Reports, Inc. 2006) (Morin)).

the parties are free to raise any other pertinent issues regarding the application of these alternative ROE methodologies to Trailblazer. Moreover, to the extent that Trailblazer's ROE is determined by methodologies other than the DCF, the hearing should also address whether these alternative ROE methodologies include investors' tax costs such that permitting an income tax allowance would lead to a double recovery.

49. However, although the parties may further address these issues at hearing and we make no final determinations in this order, our preliminary expectation is that the adoption of an alternative ROE methodology would not fundamentally change our analysis regarding the double-recovery issue. Rather, as discussed below, our preliminary analysis supports a finding that replacement of the DCF with an alternative ROE methodology is unlikely to alter our preliminary finding that a double recovery would result from permitting an income tax allowance for the Private Owners' tax costs while no such double recovery arises from permitting an income tax allowance for Tallgrass Energy's tax costs.

50. Regarding the Private Owners' tax costs, we preliminarily find that the alternative ROE methodologies incorporate the Private Owners' tax costs much like the DCF. As the Commission has previously explained, "to attract capital, entities must provide investors a pre-investor tax return, i.e., a return that covers investor-level taxes and leaves sufficient remaining income to earn investors' required after-tax return."[98] While the Commission made these statements when describing the DCF, the same reasoning would apply to any estimate of the returns demanded by investors. If the ROE is based upon a pre-investor tax return, then providing the Private Owners an income tax allowance appears to compensate Trailblazer twice for the Private Owners' single level of taxation.

51. Similarly, adoption of the alternative ROE methodologies appears unlikely to change our preliminary finding that an income tax allowance is permissible for Tallgrass Energy's corporate income tax liability. In general, the alternative ROE methodologies reflect an estimate of investor returns, but they do not include taxes incurred prior to the distribution of returns to investors (such as a corporate income tax liability). Accordingly, as discussed above, double-recovery concerns do not appear to preclude Trailblazer from recovering an ROE using the alternative ROE methodologies as well as an income tax allowance for Tallgrass Energy's tax costs.

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[98] Opinion No. 511-C, 162 FERC ¶ 61,228 at P 22 (citing *Kern River Transmission Co.*, Opinion No. 486-B, 126 FERC ¶ 61,034 at P 114 ("investors invest on the basis of after-tax returns and price an instrument accordingly"). *See also Enable MRT,* 164 FERC ¶ 61,075 at P 33; Morin at 130 (pre-tax risk premiums are measured from capital market data rather than post-tax quantities).

52. In further support of these general propositions, we briefly discuss each of the alternative four methodologies (DCF, Risk Premium, CAPM, and Expected Earnings) that the Commission proposed to average together in the *Coakley* order. We also briefly address specific arguments made by Trailblazer that no double recovery would result from both an income tax allowance and an ROE determined by each of the alternative methodologies considered by *Coakley*. Although we are providing this guidance to assist the parties, we reiterate that this order makes no final determinations and the parties may fully litigate these issues at hearing.[99]

1. DCF

53. In *Coakley,* the Commission proposed to depart from its sole reliance upon the DCF to determine ROE. However, the *Coakley* order includes the DCF in the average of the ROE methodologies. As discussed above in response to the paper hearing, the Commission has provided extensive guidance regarding the DCF ROE and the double-recovery issue. Thus, to the extent the DCF is used to determine Trailblazer's ROE (either alone or in conjunction with other ROE methodologies as contemplated by the *Coakley* order), the hearing must address the preliminary findings of this order regarding any double recovery of Tallgrass Energy's and the Private Owners' tax costs.

2. Risk Premium

54. In *Coakley*, the Commission also proposed to consider the Risk Premium methodology. The Risk Premium methodology is a market-oriented methodology based on the premium investors require above the return they expect to earn on a bond investment. This difference reflects the greater risk of a stock investment.[100] Furthermore, investors' required risk premiums expand with low interest rates and shrink at higher interest rates. The link between interest rates and risk premiums provides a helpful indicator of how investors' required rates of return have been affected by the interest rate environment. The Risk Premium return is calculated as follows:

[99] We emphasize that the guidance below is not intended to limit parties from advancing other arguments for why the alternative ROE methodologies lead (or do not lead) to a double recovery.

[100] MISO Order, 165 FERC ¶ 61,118 at P 36; *Coakley,* 165 FERC ¶ 61,030 at Appendix.

$$R = I + RP$$

I= current applicable bond yield

RP= risk premium, which consists of the difference between (a) applicable annual common equity premiums and (b) applicable bond yields.

55. Trailblazer argues that there is no recovery of investor-level taxes in the Risk Premium ROE because "[t]he Risk Premium method uses a spread to reflect the higher risk compensation for common equity versus the lower risk associated with debt. Those spreads have no provision that would specifically account for income taxes." [101]

56. This argument alone appears to insufficiently address the double-recovery issue. Much like the DCF, the Risk Premium model relies upon market-based investor-level returns (see "*RP*" in the above-formula). As explained in Roger Morin's treatise on utility finance, which was cited in both the *Coakley* order and Trailblazer's testimony, Risk Premium's market-based returns are a pre-investor tax return because "it is pre-tax risk premiums that are measured from capital market data rather than post-tax quantities."[102] Thus, just as permitting both the pre-investor tax DCF and an income tax allowance for the Private Owners' tax costs leads to a double recovery, it appears as though permitting an ROE based upon the pre-investor tax Risk Premium analysis and an income tax allowance for the Private Owners' tax costs would lead to a double recovery. To the extent that Trailblazer argues otherwise, Trailblazer will need to address such concerns at hearing.

3. CAPM

57. In *Coakley,* the Commission also proposed to consider CAPM in the determination of the ROE. The CAPM provides a market-based approach determined by beta, a measure of the risk based upon the volatility of a company's stock price over time in comparison to the overall market, and the risk premium between the risk-free rate (generally, long-term U.S. Treasury bonds) and the market's return (generally, the return

[101] Ex. TPC-85 at 15.

[102] Morin at 130. Morin considers and rejects proposals to modify the Risk Premium so that it is after-investor tax. *Id.*

of the S&P 500 or another broad indicator for common stocks).[103] The formula for CAPM is as follows:

$$R = r_f + \beta_a(r_m - r_f)$$

r_f = risk free rate (such as yield on 30-year U.S. Treasury bonds)

r_m= expected market return

β_a= beta, which measures the volatility of the security compared to the rest of the market.

58. Trailblazer claims that the CAPM methodology does not reflect investor-level taxes because "[i]n the CAPM, income taxes are a non-systematic risk factor, which receives no compensation in the model. The CAPM measure of risk, i.e., the beta, measures solely systematic risk."[104]

59. In order to claim that the adoption of CAPM alleviates the double-recovery concern regarding an income tax allowance for the Private Owners' tax costs, Trailblazer would need to more fully justify its position. The CAPM calculation relies upon market-based investor-level returns (the quantity "r_m" in the above formula). Roger Morin's treatise states that such investor-level returns are pre-investor tax returns.[105] This is because, consistent with the *United Airlines* and Opinion No. 511-C findings regarding the DCF, an entity must provide investors a pre-investor tax return in order to attract capital.[106] Furthermore, although Trailblazer seeks to distinguish the CAPM from the DCF, this market return ("r_m" in the formula above) is often determined using the

[103] 165 FERC ¶ 61,118 at P 36; *Coakley,* 165 FERC ¶ 61,030 at Appendix; Morin at 150.

[104] Ex. TPC-85 at 15.

[105] Morin at 127. Although Morin's discussion applies to the Risk Premium model, his reasoning appears to apply also to CAPM. *Id*. Risk Premium, which is discussed in greater detail above, is similar to CAPM in that it relies upon market equity returns and identifies a risk-premium based upon the difference between the market equity returns and lower risk bond yields.

[106] *See, e.g.,* Opinion No. 511-C, 162 FERC ¶ 61,228 at P 22; *Enable MRT,* 164 FERC ¶ 61,075 at P 33.

DCF.[107] To the extent the CAPM incorporates DCF returns, Trailblazer would need to explain why the CAPM does not raise the same double-recovery concerns as the DCF.

4. Expected Earnings

60. *Coakley* also proposed to consider Expected Earnings analysis when determining an entity's ROE. The Expected Earnings methodology provides an accounting-based approach that uses investment analyst estimates of return (net earnings) on book value (the equity portion of a company's overall capital, excluding long-term debt).[108] These Expected Earnings are relevant because those returns help investors determine the opportunity cost of an investment instead of other companies of comparable risk.[109] Algebraically, Expected Earnings can be expressed as follows:

$$R=E/B$$

E = Earnings during Current Year

B = Book Value at the End of the Prior Year

61. As with the other methodologies, Trailblazer argues that the Expected Earnings analysis addresses *United Airlines*' concern that permitting an income tax allowance for investor-level taxes and an ROE leads to a double recovery. Trailblazer asserts that "those returns are based entirely on after-tax results."[110] Accordingly, Trailblazer's witness Moul asserts that Expected Earnings produces an ROE that would permit an income tax allowance for investor-level taxes.[111]

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[107] As applied in *Coakley*, the "r_m" component of the CAPM equation was based upon the "DCF analysis of a large segment of the market." 165 FERC ¶ 61,030, Appendix. Likewise, Trailblazer witness Moul incorporated the DCF into his version of the CAPM. Ex. TPC-85 at 46-47.

[108] MISO Order, 165 FERC ¶ 61,118 at P 36; *Coakley*, 165 FERC ¶ 61,030 at Appendix.

[109] *Coakley*, 165 FERC ¶ 61,030 at Appendix.

[110] Ex. TPC-85 at 15.

[111] Although Trailblazer refers to "Comparable Earnings," this is another name for "Expected Earnings."

62. We preliminarily find that the Expected Earnings return likely reflects a pre-investor tax return and find Trailblazer's argument to the contrary to be misleading. Although, as Trailblazer asserts, the earnings used in the Expected Earnings analysis reflect revenues reduced for taxes paid by the entity itself (such as a corporate income tax), Trailblazer's argument ignores the fact that the model's earnings have not been reduced for any subsequent taxes paid by investors based upon investor-level returns.[112] *United Airlines* was not concerned with a double recovery of an entity's own taxes. Rather, *United Airlines*' concern is that a double recovery results from permitting an income tax allowance for *investor-level* taxes when those same *investor-level* taxes are reflected in the ROE. The ROE resulting from an Expected Earnings analysis is an after-corporate-income-tax figure, and it is not, as Trailblazer's argument implies, an after-investor-income-tax return that would avoid a *United Airlines'* double-recovery argument. Rather, Expected Earnings, much like the DCF, appears to be a pre-investor tax return.

63. Moreover, we also observe that the pre-tax investor-level returns for a particular entity are a subset of that entity's total earnings as used in the Expected Earnings analysis.[113] Accordingly, it seems reasonable to conclude that any determination of the ROE based upon earnings effectively incorporates the pre-investor-tax return. To the extent Trailblazer claims that an Expected Earnings approach alleviates any double-recovery issues associated with an income tax allowance for the Private Owners' tax costs, Trailblazer must address this issue (and any other relevant issues) in the administrative law judge hearing.

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[112] For example, in the case of a corporation, the earnings are determined after revenues have been reduced for payment of corporate income taxes. Thus, if Trailblazer's ROE were calculated using the Expected Earnings methodology, the Commission's analysis would continue to support an income tax allowance for Tallgrass Energy's 55 percent share of Trailblazer's income. However, the *United Airlines* double-recovery concern involves investor level taxes, and the earnings have not been adjusted downward to reflect investors' payment of dividend taxes. Thus, the Private Owners' taxes would continue to be reflected in the Expected Earnings ROE.

[113] Morin at 360 (explaining that D=E(1-b), where D are the dividends (or distributions), E are the earnings, and b are the retained earnings).

The Commission orders:

The Commission directs the presiding administrative law judge to include in the hearing proceedings an examination of Trailblazer's ROE and income tax allowance issues, as discussed in the body of this order.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.