FERC Tax Allowance Market Update

March 15, 2018

Earlier today, the Federal Energy Regulatory Commission (FERC) issued a news release ruling they were disallowing the Income Tax Allowance Cost Recovery in MLP pipeline rates. This is a reversal from the previous policy.

The vast majority of MLP and energy infrastructure assets will not be impacted by the FERC's new guidance. Only those natural gas and liquids pipelines that cross state lines are regulated by the FERC. These pipelines are typically large and have little direct competition. To avoid these pipelines charging monopolistic prices to their shippers, the FERC sets tariff rates based upon their cost of service. Part of the cost of service is taxes incurred by the pipeline. Starting in 2005, an MLP-owned pipeline was allowed to incorporate a tax allowance into the rate of service it charged based upon the argument that the MLP unitholders paid taxes on the pipeline's earnings, even though the pipeline itself did not. The recent court ruling disallowed this policy and the FERC issued guidance today disallowing the tax recovery portion of the rate making process for MLP-owned pipelines. Fearing the worst, the market sold off all MLPs and many energy infrastructure stocks.

In our view the sell-off is materially overdone. Not all MLPs are impacted, in fact most new pipelines that are still under their original contracts operate under negotiated rates; not FERC set tariffs. Many pipelines face competition and therefore charge market-based rates. Further, only interstate pipelines charging the maximum allowable FERC tariff rate are impacted by the ruling. The majority of the assets owned by the companies we invest in are not impacted. Those assets include interstate pipelines charging negotiated or market rates, intrastate pipelines, gathering and processing, fractionation, compression, storage, import/export facilities, to name a few.

For those pipelines affected by today's policy shift, they will be required to go through a FERC rate case to reassess the allowable tariffs. There are several offsets to potentially lower tariff rates due to the policy change. For liquids pipelines, the rate cases will not occur until post 2020. The tariffs charged are based upon an allowed equity return on the pipeline's rate base. The rate base is the invested capital in the pipeline system. To the extent a pipeline has spent money on maintaining or expanding the system, the rate base will be higher. A potentially lower tariff rate applied to a larger rate base could mitigate any impact of the lower rate. We also believe it is highly likely that pipelines look to appeal the court ruling that predicated the FERC's policy change. It is important to note that this policy change does not impact pipelines owned by corporations, only pass-through entities like MLPs.

While today's -4.6% correction for the Alerian MLP Index is likely a short-term event, there are some potential longer-term impacts to the group. It will take some time to quantify the impact on the MLPs affected, as the outcomes of the rate cases are uncertain. There are several names that could be affected by a negative outcome but only three with material impacts: Enbridge Energy Partners, TC PipeLines, and Williams Partners. It is worth noting that these names operate other businesses not impacted by the FERC's decision. The FERC's announcement has certainly increased the discussion about the merits of being formed as an MLP over a C-corporation. In fact, Williams Partners announced that they will assess their option of converting into a corporation, likely by selling to Williams Companies, their parent. If the FERC rate cases result in lower allowable tariffs for MLP-owned cost of service pipelines, will the lower rates trickle down and impact profitability of other systems? We think this is unlikely as the affected pipelines have little competition, hence their ability to dictate the rates they charge. The vast majority of MLP and energy infrastructure assets charge negotiated or market rates.

Today's trading was painful to anyone invested in the space, our team included, but we think it provides long-term investors a buying opportunity. There will no doubt be some volatility as these issues are debated, but current fundamentals for energy infrastructure overall are far superior to current market valuations.

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