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MLPs Sell Off on Today's FERC Policy Revision – Warranted or Not?

"Beware the Ides of March!" is ringing true today in MLP land, but we don't believe the impact of today's policy revision from the Federal Energy Regulatory Commission (FERC) regarding cost-of-service rates charged by pipelines is as extreme as the initial market reaction indicated.

Background, for context

Cost-of-service rates are a type of rate that an interstate pipeline can charge. The rate is determined by taking the cost it takes to run a pipeline and factoring in a "just and reasonable" rate of return. Even though MLPs do not pay federal taxes, an income tax allowance was previously allowed as a cost. In March 2016, the D.C. Circuit Court issued a decision in United Airlines vs. FERC remanding FERC to demonstrate that there is no double recovery of income taxes by MLPs or adjust the approach to prevent double recovery of taxes. Two years later, the FERC has responded to the court's remand in announcing that MLPs will not be allowed an income tax recovery in their cost-of-service rates, thus removing the "double" tax benefit for MLPs as it relates to setting pipeline rates.

Not all pipelines, not all assets, and not all rate types impacted.

To be clear, this only relates to interstate long-haul pipelines, so it has no bearing on revenues from gathering & processing (fractionation plants, processing plants), storage, or intrastate (within one state) pipelines. Interstate natural gas pipelines can charge cost-of-service rates, market rates, or negotiated rates. Interstate liquids (crude, refined product, natural gas liquids) pipelines adjust their rates annually by FERC's prescribed index methodology (currently: PPI + 1.23%), or elect to charge cost-of-service, market, or negotiated rates. The FERC plans to address tax changes for liquids pipelines in 2020 with its regular five-year review of its index. Since the vast majority of liquids pipelines choose the indexed rate, today's ruling primarily impacts natural gas pipelines in the near-term. We also use near-term lightly, as the backlog of paperwork from every interstate natural gas pipeline will likely delay the impact of any rate adjustments. Importantly, this only impacts natural gas pipelines charging cost-of-service rates. For example, DCP Midstream (DCP) expects a de minimis impact to its earnings from the policy change because its FERC-regulated pipelines are charging rates below the cost of service determined by the FERC.

Income tax allowance only one component of cost-of-service rate.

The income tax allowance isn't the only consideration that goes into the cost-of-service calculation. Other items like maintenance and operating expenses) are also large factors that figure into the ratemaking. It will take time for this change to take effect (years) and of course, other variables can change in the meantime. At the end of the day, the FERC ratemaking process will continue to ensure MLPs earn a reasonable rate of return on their interstate pipelines.

Asset diversification and rate diversification likely mutes impact.

MLPs with diversified asset bases and a variety of pipeline rates (market, negotiated, indexed and cost of service) should be more insulated from any impact of the FERC's policy revision. Enterprise Products Partners (EPD) has already announced that it expects no material impact to its financial results as a result of the policy revision. Andeavor Logistics (ANDX) expects the FERC ruling to have a possible annual negative impact of less than $10 million on earnings and EBITDA (~1% impact, based on FY2017 EBITDA of $977 million). We would expect other MLPs to announce impacts of the policy revision as they have time to assess the change.

Bottom Line

The bottom line for natural gas cost-of-service, liquids cost-of-service, and liquids indexing is that the removal of the income tax allowance from the calculation does not necessarily mean that all rates will go down. There are many other cost variables (maintenance, operating costs, etc.) that will determine the cost-of-service rate and FERC's liquids index adjustment in 2020. MLPs may be able to use the changes to such costs to justify to the FERC that its current rate should be maintained or even increased. Every long-haul pipeline is different, and it will take time for FERC to review the rates for every cost-of-service pipeline.

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