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Tax Savings & Regulated Rates: Options for FERC Action

January 2018

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The Tax Cuts and Jobs Act of 2017 (the "Tax Act") reduced the nominal federal corporate income tax rate from 35 percent to 21 percent. Almost immediately, various stakeholders, including States' Attorneys General, trade associations, and consumer advocates began to pressure the Federal Energy Regulatory Commission ("FERC") to take action to ensure that cost savings to electric utilities and interstate natural gas pipelines from reduced tax liability flowed through to their customers in FERC-regulated rates. FERC has not yet explained how it will respond to these calls for action as of the time of writing, and its response is likely to be different for electric utilities and interstate pipeline companies due to key differences in FERC's statutory authority. The impact of any FERC response will also be felt differently depending on whether a particular electric company or pipeline is providing services under cost-of-service rates or market-based / negotiated rates. Each regulated entity and customer will need to evaluate its rates carefully to determine exposure to change as a result of any FERC action in response to the Tax Act.

This alert first briefly describes FERC's statutory authority over electric utility rates under the Federal Power Act ("FPA") and over interstate pipeline rates under the Natural Gas Act ("NGA"), and then explores main options FERC may employ to address pass through of tax savings to regulated utilities' customers.[1]

FERC's Regulatory Authority Under the FPA and NGA

While the FPA and NGA are similar in many respects, there are key differences to FERC's rate authority and regulatory oversight that may differentiate how FERC addresses electric utility and interstate pipeline rates.

Regulatory Authority Under the FPA

FERC's regulatory authority over electric utility rates stems from sections 205 and 206 of the FPA. Under section 205 of the FPA, public utility rates for wholesale sales of energy and transmission services in interstate commerce must be filed with FERC and found by FERC to be just and reasonable. With respect to wholesale sales of energy, FERC has granted many sellers market-based rate authority for energy, capacity and some ancillary services, which allows them to charge rates set by market forces, rather than cost-of-service rates. However, some services, such as reactive power and voltage control services, are typically

[1] This alert does not address intrastate or Hinshaw pipeline interstate rates under the NGA or the Natural Gas Policy Act. As these rates are lightly regulated, are often derived from intrastate rates regulated by states, and often are already subject to triennial rate review, FERC is less likely to focus on these rates immediately and the impacts of tax savings from the Tax Act will likely vary by state action on intrastate rates.

provided at cost-based rates and certain markets such as PJM and MISO require the filing with FERC of cost-of-service revenue requirements before sales of reactive power can be made.

With respect to transmission rates, some public utilities have stated cost-of-service rates on file with FERC, while others employ formula rates that periodically update rates to reflect actual costs incurred according to formula rate protocols on file with FERC. Still, other public utilities, primarily merchant transmission developers, have authority to charge market-based rates for their transmission services.

Section 206 of the FPA empowers FERC to initiate an investigation into the justness and reasonableness of public utility rates on file, either at FERC's own direction or in response to a customer complaint. Section 206 of the FPA places the burden of proof on FERC or the complainant to demonstrate that the rates on file are no longer just and reasonable. If rates are found to be no longer just and reasonable, FERC must determine a new just and reasonable rate. In an important distinction from FERC's authority under the NGA, section 206 of the FPA grants FERC authority to order refunds and set a refund effective date that is no earlier than the date a complaint was filed, but no later than five months after the filing date. Typically, FERC will set a refund effective date of the date the complaint was filed, in order to maximize refunds if due. Refunds may be ordered for a 15-month period following the refund effective date set by FERC.

Regulatory Authority Under the NGA

FERC's regulatory authority over interstate gas pipeline rates arises under sections 4, 5 and 7 of the NGA. When a developer applies to FERC under section 7c of the NGA to construct, own and operate an interstate natural gas pipeline, it must file initial rates for approval by FERC. These initial rates for services remain in effect until such time as the pipeline files rates for FERC review under section 4 of the NGA. Often, developers will enter into negotiated rates with anchor shippers necessary to make the project financially viable. These negotiated rates may vary significantly in structure from the pipeline's initial recourse rates.

Section 4 of the NGA empowers natural gas companies to file prospective changes to their existing recourse rates with FERC. The natural gas company must demonstrate that its proposed rates are just and reasonable. Through this process, resulting rates may either be litigated rates resulting from full litigation before an administrative law judge and approval by FERC, or settlement rates resulting from a settlement agreed between the parties to a section 4 proceeding. Settlement agreements can include obligations on the pipeline to file another section 4 rate case within an agreed period of time.

Section 5 of the NGA empowers FERC to initiate an investigation into the justness and reasonableness of existing rates on file with FERC. As with section 206 of the FPA, an investigation may be initiated *sua sponte* by FERC or in response to a complaint by shippers. Notably, if rates are found to be not just and reasonable, the rates can be set at a just and reasonable rate only prospectively from the date of FERC's order finding the existing rates to be not just and reasonable. Unlike under section 206 of the FPA, FERC does not have statutory authority to order the interstate pipeline to refund amounts collected in excess of the newly determined just and reasonable rate from the date the investigation was instituted. Moreover, the pipeline has the option of initiating a section 4 rate case prior to a Commission determination in the section 5 investigation which effectively moots the section 5 filing. This approach effectively extends the timeline for rate relief and generally limits the effectiveness of section 5 investigations as a means of forcing rate reductions.

Potential Actions to Incentivize Pass Through of Tax Savings

There are many potential actions FERC could take to incentivize electric utilities and interstate pipelines to pass through tax savings from the Tax Act. Several options and considerations are discussed below.

Electric Utility Rates Under the FPA

Sellers selling energy, capacity and ancillary services under market-based rates will be largely immune. As many rates for wholesale sales of energy, capacity and ancillary services are negotiated under market-based rate authority today, these rates will be largely immune to FERC action under the FPA unless specific terms of the parties' agreements dictate otherwise. The *Mobile-Sierra* doctrine applies to wholesale energy sales under the FPA, and the US Supreme Court has over the years clarified a strong presumption that freely negotiated rates are just and reasonable ("FERC 'must presume that the rate set out in a freely negotiated wholesale-energy contract meets the 'just and reasonable' requirement imposed by law. The

presumption may be overcome only if FERC concludes that the contract seriously harms the public interest.'").[2]

FERC may require utilities to reflect tax savings in cost-based rates already pending action before FERC. To the extent electric utilities have pending filings before FERC for proposed cost-based rates, FERC may on a case-by-case basis require such utilities to update their proposed rates to reflect the lowered federal tax rate via deficiency letters or through trial staff positions in ongoing settlement negotiations. The issue may also be raised in investigation proceedings initiated through required informational filings. For example, sellers of reactive supply and voltage control services in PJM and MISO are required to make informational filings with FERC in advance of any direct or upstream sale or transfer of the generating facilities used to produce such reactive supply and voltage control services. FERC may institute FPA section 206 investigations in response to such informational filings in order to compel revisions to the reactive revenue requirement calculation based on the reduced federal tax rate. It is important to note that while the change in federal tax rate would not be the basis under which FERC initiates an update to the calculation, it would likely be a corollary addressed in the review of a change to ownership or upstream control.

FERC may try to incentivize filings under section 205 of the FPA by offering a streamlined, "single-issue" rate filing option. An efficient way for the Commission to address the potential over-collection of costs associated with taxes would be to prompt utilities to voluntarily file rate cases pursuant to section 205 of the FPA. For example, the Commission previously addressed a reduction of the federal corporate income tax rate in 1986 through Order No. 475. The Tax Reform Act of 1986 reduced the nominal corporate tax rate from 46 percent to 34 percent. Order No. 475 adopted a voluntary, abbreviated, *i.e.* single-issue, rate filing procedure that would allow electric public utilities to file for certain rate decreases under section 205 of the FPA. As incentive, Order No. 475 stated that FERC would review rates, and where appropriate, initiate investigations of the rates of utilities that did not voluntarily reduce their rates through either the abbreviated procedure or a general rate case. The single-issue rate filing procedure proposed by the Commission enabled utilities to alter their rates to reflect the tax rate reduction without launching a full general rate case, thus providing an opportunity to avoid significant time and expense. A single-issue filing similar to that proposed in Order No. 475 would enable utilities to avoid the time, uncertainties and expense of a full general rate case, and expeditiously alter their rates to reflect the new corporate income tax rate.

FERC could initiate investigations under section 206 of the FPA into rates it believes may be over-recovering as a result of the Tax Act federal tax rate reduction. FERC could initiate investigations into utility rates under section 206 of the FPA based on complaints filed by customers or based on its own independent review. Notwithstanding its utility as an incentive to encourage public utilities to file under section 205 of the FPA, a 206 investigation would be a less attractive option for FERC and potential complainants given the burden of proof. Cost of service rates can be derived in myriad different ways, and therefore the benefits to customers from the federal tax rate reduction will vary by public utility, the manner in which the utility structures its cost-of-service rates, and the terms of any settlement that the parties are able to achieve in a section 206 proceeding. In addition, in the transmission rate context, many utilities currently use formula rates to generate their transmission rates. For transmission customers taking service under formula rates, the rates would likely be trued-up and prospective formula rate inputs would be altered prior to resolution of the 206 investigation. FERC and transmission customers under formula rates would need to weigh the cost and utility of putting on a case under section 206 of the FPA against the potential refunds that might flow to customers during the period between initiation of the complaint and the next regular update to the formula rates. Transmission customers that take service under stated rates would likely not be similarly affected by regulatory lag given the additional time that it would take for their rates to be changed and refunds paid.

FERC could require modification of formula rate protocols. Although a seemingly less likely option, the Commission could also choose to achieve longer-lasting prospective results through modification of formula rate protocols. The Commission could prompt utilities to voluntarily submit section 205 filings to revise their formula rate protocols to address changes in the tax code in a timely manner. For those that did not file voluntarily, the Commission could initiate an investigation under section 206 of existing formula rate protocols similar to a wide-reaching order that prompted utilities to adopt "best practices" for their formula rate protocols in 2012.[3] In this instance, the Commission could require that formula rate protocols create procedures for ensuring the timely modification of formula rate inputs impacted by tax rates in instances where federal

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2 *Morgan Stanley Capital Group Inc.* v. *Public Util. Dist. No. 1 of Snohomish Cty.*, 554 U.S. 527 (2008).

3 *FERC Takes on Formula Rate Protocols*. White & Case. Washington Energy Update: April – May 2013. Located at: https://www.whitecase.com/sites/whitecase/files/files/download/publications/newsletter-washington-energy-update.pdf

corporate income tax rates are altered by some threshold amount. Although this option would suffer from the same regulatory lag issues discussed above, this approach would ensure that the Commission need not take action to alter the rates of customers taking service under formula rates if taxes were to be altered in the future.

Interstate Pipeline Rates Under the NGA

Negotiated rates will likely be largely immune. While FERC retains regulatory authority over negotiated rate agreements under the NGA, it is highly unlikely that FERC would initiate such an investigation or that negotiated rate shippers would file such a complaint due to the very high bar to challenging a freely negotiated contract. Negotiated rate shippers, by definition, could have chosen the pipeline recourse rate when signing up for service, but freely elected to take their negotiated rate instead. The *Mobile-Sierra* doctrine applies to gas transportation contracts under the NGA, and as noted above, the US Supreme Court has clarified a strong presumption that freely negotiated rates are just and reasonable Thus, it is highly unlikely that a challenge under NGA Section 5 regarding pass through of tax benefits, if not a feature of the terms of the negotiated rate agreement itself, would be successful under *Mobile-Sierra*.

FERC could require pipelines that have pending applications for initial rates under NGA Section 7 to pass through tax savings in their initial rates. We have already seen FERC taking this step through data requests to individual pipeline applicants in current proceedings.[4] Further, FERC has issued final orders granting certificates that require revision of the initial rates to reflect the lower corporate tax rate.[5]

FERC could require pipelines that have pending applications for revised rates under NGA section 4 to address the pass through of tax savings in those proceedings. The Commission's authority to compel pipelines to alter their transportation rates to reflect the reduced federal corporate income tax rates is most forceful in pending section 4 proceedings. As such, FERC trial staff will likely advocate for pass through of tax savings as part of any resolution to such pending proceedings. In any event, FERC orders may address this issue as part of the overall review of the proposed rate under the just and reasonable standard.

FERC could invite pipelines to submit an abbreviated, single-issue filing under section 4 of the NGA to pass through the tax savings. Such an opportunity would present a way for pipelines to voluntarily offer to pass through any tax savings without becoming enmeshed in a general rate case. As incentive, this would likely be coupled with notice that FERC intends to evaluate whether to initiate a NGA section 5 investigation into the just and reasonableness of rates of pipelines that do not take advantage of this opportunity, similar to the approach taken with respect to electric utility rates in Order No. 475.[6] However, the incentive is significantly more limited in the NGA context because of FERC's limited refund authority under section 5.

FERC could consider opportunities to package a desirable pipeline benefit with a requirement to come in to FERC for approval of revised rates under NGA section 4 that pass through the tax savings. For example, FERC issued a policy statement in its Modernization Cost Tracker ("MCT") Order,[7] which instructed pipelines on how to develop simplified mechanisms, *i.e.,* trackers, for recovering pipeline modernization costs. The policy statement required pipelines to also ensure that existing rates were not over-recovering cost of service as a result of an MCT. One possible vehicle might be a policy statement in the open proceeding considering FERC's income tax allowance and ROE policies for master limited partnerships and avoidance of a potential double-recovery issue identified by the courts.[8]

FERC could initiate an investigation into pipeline rates under NGA Section 5 (either sua sponte or in response to a complaint from shippers). As noted above, however, FERC's ability to require timely revision

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4 *See, e.g., DTE Midstream Appalachia, LLC*, FERC Letter Order, Docket No. CP17-409-000 (issued January 12, 2018).

5 *See, e.g., Dominion Energy Cove Point LNG, LP*, 162 FERC ¶ 61,056 (2018).

6 At the time, interstate gas pipelines were excluded because most pipeline rates included tax trackers or were subject to periodic rate reviews and so were not included in the scope of Order No. 475.

7 *Cost Recovery Mechanisms for Modernization of Natural Gas Facilities*, 151 FERC ¶ 61,047 (2015).

8 On December 15, 2016, FERC opened a Notice of Inquiry (NOI) into how to address any double recovery resulting from FERC's current income tax allowance and rate of return policies, particularly with respect to FERC-regulated utilities that are master limited partnerships. *See* Docket No. PF17-1-000. FERC has not issued a Notice of Proposed Rulemaking or other substantive order on its NOI to date.

to pipeline rates under section 5 of the NGA is significantly limited compared to its authority under section 206 of the FPA.

FERC is under a lot of political pressure to take action to pass through tax savings from the Tax Act to customers. However, as Chairman McIntyre has said, the role of FERC is to "ensure that the [electricity] markets proceed in accordance with law."[9]

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9 *FERC Nominees Commit To Enforcement, Regulatory Goals*. *Law360* (2017). Located at: https://www.law360.com/articles/961210/ferc-nominees-commit-to-enforcement-regulatory-goals