

**FEDERAL ENERGY REGULATORY COMMISSION
OFFICE OF ADMINISTRATIVE LITIGATION**

**Northern Border Pipeline Company
Docket No. RP06-72-000**

**PREPARED DIRECT & ANSWERING TESTIMONY OF
COMMISSION TRIAL STAFF WITNESS
PATRICK R. CROWLEY**



**May 31, 2006
Washington, DC**

**Prepared Direct & Answering Testimony of
Patrick R. Crowley**

Summary

Mr. Crowley presents the FERC Trial Staff cost of service recommendation regarding the FERC federal income tax allowance, FERC state income tax allowance, and an adjustment to the federal income tax allowance to adjust for the over-funding of the accumulated deferred income tax balance.

Protected material in the following discussion is highlighted by the designation [**begin protected text end protected**].

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Exhibit	Descriptive Title	Protected?
S-10	NB Organizational Charts	
S-11	NBP Annual Report 2004 Excerpts	
S-12	Instructions for IRS Form 1065	
S-13	NB 2004 IRS Form 1065 & Associated GP Schedule K-1	X
S-14	NBILP 2004 IRS Form 1065 & Associated GP Schedule K-1	X
S-15	TCILP 2004 IRS Form 1065 & Associated GP Schedule K-1	X
S-16	NBP 2004 IRS Form 1065 & Associated GP Schedule K-1	X
S-17	TCP 2004 IRS Form 1065 & Associated GP Schedule K-1	X
S-18	NB Taxation Schematic Chart	
S-19	NB Partnership Agreement	
S-20	NBILP Partnership Agreement	
S-21	TCILP Partnership Agreement	
S-22	NBP Partnership Agreement	
S-23	TCP Partnership Agreement	
S-24	NBP Web Site Notes on Cash Distributions	
S-25	NBP and TCP Cash Distribution History	
S-26	Weighted Average Federal Marginal Income Tax Rate	X
S-27	Exhibit number not used	
S-28	IRS Tax Rates & Shares Study 1999	
S-29	NB State Corporate Income Tax Calculation – Statement H3(1)	
S-30	Weighted Average State Marginal Income Tax Rate	X
S-31	ADIT Schematic Diagram	
S-32	NB ADIT Balance Update	
S-33	NBP 2004 Annual Report	
S-34	A. G. Edwards & Sons “MLP Primer”	
S-35	Coalition of Publicly Traded Partnerships “MLP Primer”	
S-36	Wachovia Capital Assets “MLP: Primer 2 nd Edition”	

**United States of America
before the
Federal Energy Regulatory Commission**

Northern Border Pipeline Company)

Docket No. RP06-72-000

**Prepared Direct & Answering Testimony of
Patrick R. Crowley
Witness for the Trial Staff of the
Federal Energy Regulatory Commission**

1 **I Introduction & Qualifications**

2 **Q. Please state your name and business address.**

3 A. My name is Patrick R. Crowley.

4 My business address is 888 First Street, Northeast, Washington, D.C. 20426.

5 **Q. By whom are you employed and in what capacity?**

6 A. I am employed by the Federal Energy Regulatory Commission (FERC or
7 Commission) as an economist in the Office of Administrative Litigation.

8 **Q. Please state your educational background.**

9 A. I graduated from DePaul University in Chicago, Illinois, in 1976 with a Bachelor
10 of Arts degree in Economics. In 1978, I received a Master of Arts degree in
11 Economics from DePaul University.

1 **Q. Please summarize your duties from the time you entered your employment**
2 **with the Federal Energy Regulatory Commission.**

3 A. I began work at the Commission in 1979 as an Industry Economist in the Pipeline
4 Rates Division of the Office of Pipeline Rates. As an expert witness with the Trial
5 Staff gas and oil litigation team from 1979 to 1992, I prepared pipeline
6 depreciation studies, long-term forecasts of natural gas reserves and production,
7 mortality studies of plant retirements, cost behavior studies for pipeline facilities,
8 and Mcf/mile studies. From 1992 through 1994, I worked on the operational
9 aspects of the restructuring of Texas Eastern Gas Pipeline Companies and was the
10 team leader for the restructuring of the Tennessee Gas Pipeline Company. From
11 1994 through 1998, I worked on the advisory side of the Commission where I
12 prepared reports for Commission orders regarding proposals for revised tariff
13 terms; new services, rate designs, and tariff rates; and a wide variety of utility
14 reports and cost studies. In 1998, I returned to the litigation side of the
15 Commission where I now work on electric utility, and natural gas and oil pipeline
16 rate cases and complaint cases.

17 **Q. Have you filed testimony before the FERC?**

18 A. Yes, I filed testimony before the Commission in the following cases:

19 Black Marlin Pipeline Company, Docket No. RP81-67-000;

20 Tarpon Transmission Company, Docket No. RP84-82-000;

1 National Fuel Gas Supply Corporation, Docket No. RP86-136-000;
2 Pacific Gas Transmission Company, Docket No. RP87-62-000;
3 Sea Robin Pipeline Company, Docket No. RP88-181-000;
4 Natural Gas Pipeline Company of America, Docket No. RP88-209-000;
5 Paiute Pipeline Company, Docket No. RP88-227-000;
6 Southwest Gas Storage Company, Docket No. RP89-60-000;
7 Montana Power Company, Docket No. ER98-2382-000;
8 Big West Oil Co. & Chevron Products Co. v Anschutz Ranch East Pipeline Co.
9 & Express Pipeline Partnership, Docket No. OR02-1-000 & OR02-3-000;
10 Big West Oil Co. & Chevron Products Co. v Frontier Pipeline Inc.
11 & Express Pipeline Partnership, Docket No. OR02-2-000 & OR02-4-000;
12 Boston Edison Company, Docket No. ER01-890-000;
13 Avista Corporation & Avista Energy, Docket No. EL02-115-000;
14 Ameren Services Company, Docket No. ER02-929-000;
15 Sinclair Oil Corporation v Rocky Mountain Pipeline system, LLC
16 & BP Pipelines (North America), Inc., Docket No. OR02-6-000;
17 Enron Power Marketing Inc., Docket No. EL03-180-000, et al.;
18 SFPP, L.P., Docket No. IS05-230-000.

19 **Q. What is the purpose of your testimony?**

20 A. The Commission's Order, 113 FERC ¶ 61,230, established hearing procedures to
21 explore the issues raised by the protestors, including whether Northern Border
22 Pipeline Company's (NB) income tax allowance in the cost of service comports
23 with the Commission's Policy Statement on Income Tax Allowance (111 FERC ¶

1 61,139) (*Policy Statement*). The purpose of my testimony is to present the FERC
2 Trial Staff recommendation on the cost of service federal and state income tax
3 allowance and an accumulated deferred income tax adjustment for NB.

4 **Q. In addition to your written testimony in this case, are you sponsoring any**
5 **supporting exhibits?**

6 A. Yes, the exhibits supporting my recommendations regarding federal and state
7 income tax rates and the adjustment to the ADIT balance are listed in the Exhibit
8 List on page 5 of this exhibit.

9 **Q. What Trial Trial Staff witnesses are testifying in this proceeding and what are**
10 **their responsibilities?**

11 A. The following FERC Trial Staff witness are presenting testimony in this docket:
12 Veronica Vansco – Exhibit Nos. S-1, S-2, S-3, and S-4: cost of service
13 Harriet Burt – Exhibit Nos. S-5, S-6, S-7, and S-8: cost of service
14 Patrick Crowley - Exhibit Nos. S-9 through S-36: income tax allowance
15 William Rappolt – Exhibit Nos. S-3 through S-41: rate of return
16 Ulunma Nwokefor – Exhibit Nos. S-42, S-43, and S-44: depreciation
17 Meagan McComb – Exhibit Nos. S-45 through S-48: rate design

18 **Q. What are the names of the entities you will be discussing and what is their**
19 **relationship to Northern Border Pipeline Company?**

20 A. The ownership structure and income allocation structure for Northern Border
21 involves several tiers of entities as illustrated by the ownership schematic provided

1 by Northern Border witness Mr. Peters in Exhibit No. NB-16, Schedule 3, which I
2 have included in my supporting documents as Exhibit No. S-10.

3 Northern Border Pipeline Company (NB) is the first tier pipeline operating entity
4 regulated by FERC.

5 Northern Border Intermediate Limited Partnership (NBILP) is a second tier pass-
6 through entity with a 70% general partner interest in NB as of 2004. NBILP is not
7 regulated by FERC.

8 TC Pipelines Intermediate Limited Partnership (TCILP) is a second tier pass-
9 through entity with a 30% general partner interest in NB as of 2004. TCILP is not
10 regulated by FERC.

11 Northern Border Partners, L.P. (NBP) is a third tier pass-through entity with a
12 99% limited partner interest in NBILP as of 2004. NBP is not regulated by FERC.
13 Ninety-nine percent of NBP interests are in turn held by publicly traded limited
14 partner interests.

15 TC Pipelines, L.P. (TCP) is a third tier pass-through entity with a 99% limited
16 partner interest in TCILP as of 2004. TCP is not regulated by FERC. Ninety-nine
17 percent of TCP interests are in turn held by publicly traded limited partner
18 interests.

1 Northwest Border Pipeline Company (NBPC) is both a third tier and fourth tier
2 entity with a 0.18% general partner interest in NBILP and 0.18% general partner
3 interest in NBP as of 2004. NBPC is not regulated by FERC.

4 Pan Border Gas Company, LLC (PBGC) is both a third tier and fourth tier pass-
5 through entity with a 0.18% general partner interest in NBILP and 0.18% general
6 partner interest in NBP as of 2004. PBGC is not regulated by FERC.

7 Northern Plains Natural Gas Company, LLC (NPNGC) is both a third tier and
8 fourth-tier pass-through entity with a 0.50% general partner interest in NBILP and
9 0.50% general partner interest in NBP as of 2004. NPNGC is not regulated by
10 FERC.

11 TC Pipelines GP, Inc. (TCPGP) is a both a third tier and fourth tier entity with a
12 1.01% general partner interest in TCILP and 1.00% general partner interest in TCP
13 as of 2004. TCGP is not regulated by FERC.

14 **Q. What materials did you examine in preparation for your testimony?**

15 A. I examined the following materials in preparation for this testimony: the
16 organizational ownership chart for NB and its affiliates; the taxation schematic
17 diagram for NB and its affiliates; the IRS Form 1065 and associated schedules for
18 NB, NBILP, NBP, TCILP, and TCP; the NBP and TCP IRS schedule K-1 data

1 base of reports to partners; the IRS tax code sections dealing with partnership
2 income taxes; the partnership agreements for NB, NBILP, TCILP, NBP, and TCP;
3 the testimony of NB witnesses Peter Faber and Jerry Peters; the testimony of NB
4 witness Robert Palmquist from Docket RP96-322; the IRS tax study “1999 IRS
5 Tax Rates & Shares,” and the master state tax guide.

6 **Q. How is your testimony organized?**

7 A. My remaining testimony is divided into three components: 1) Part II below is my
8 recommendation regarding the appropriate federal income tax allowance for the
9 NB cost of service, 2) Part III below is my recommendation regarding the
10 appropriate state income tax allowance for the NB cost of service, and 3) Part IV
11 below is my discussion of the consequences of the *Policy Statement* on NB’s
12 accumulated deferred income tax balance, and a recommendation for a flow back
13 adjustment to the ratepayers. Part V is the summary of my recommendations.

14 **II Federal Income Tax Allowance**

15 **Q. Please describe the basic issue in regard to income tax allowances.**

16 A. Statement H-3 of the generic natural gas pipeline cost of service model calculates
17 an interstate federal income tax allowance as if the pipeline entity were a
18 corporation that paid corporate income tax. Generally accepted ratemaking

1 practice requires that the regulated entity must be made whole for all costs incurred
2 in providing service. Revenue must be sufficient to cover all costs, including
3 corporate income taxes. However, since NB is a partnership, as are its parent
4 organizations, it pays no federal income tax. Consequently, dollars embedded in
5 the cost of service that are intended to reimburse the pipeline for a corporate
6 income tax – a tax it does not pay – instead become more in the nature a return on
7 equity to the investors who then pay an income tax on their earned income.

8 In order to fully address this issue, and in compliance with the
9 Commission’s directive in the *Policy Statement*, I have sought to ascertain the
10 actual or potential tax liability of NB’s partners. I conclude that there is, in fact,
11 little or no actual or potential income tax liability on the part of the great majority
12 of NB’s partners. Therefore, the 35% income tax allowance embedded in the NB
13 cost of service is unjust and unreasonable and should be adjusted.

14 **Q. What did the Commission *Policy Statement* conclude in regard to permitting**
15 **income tax allowances embedded within pipeline cost of service derived tariff**
16 **rates?**

17 A. The Commission’s *Policy Statement* concluded:

18 that it should return to its pre-*Lakehead* policy and permit an income
19 tax allowance for all entities or individuals owning public utility
20 assets, provided that an entity or individual has an actual or potential
21 income tax liability to be paid on that income from those assets.
22 Thus a taxpaying corporation, a partnership, a limited liability

1 corporation, or other pass-through entity would be permitted an
2 income tax allowance on the income imputed to the corporation, or
3 to the partners or members of pass-through entities, provided that the
4 corporation or the partners or the members, have an actual or
5 potential income tax liability on that public utility income. [111
6 FERC ¶ 61,139 at P 32]

7 **Q. What did the Commission surmise might be the outcome of an investigation**
8 **into the actual income tax status of the holders of partnership interests?**

9 A. In its *Policy Statement* the Commission surmised:

10 Thus, the policy the Commission is adopting should not result in
11 increased costs to public utility ratepayers, and may actually reduce
12 them if a partnership or LLC has a lower weighted marginal tax rate
13 and fewer administrative expenses than the normal corporate form of
14 ownership. [111 FERC ¶ 61,139 at P37]

15 That forecast is, indeed, the outcome in this case. Upon close examination if the
16 facts of actual tax liability, rather than NB's vague weighting of maximum
17 marginal income taxes rates by category of partner rather than by individual
18 partner tax status, it was possible to determine that the vast majority of the ultimate
19 holders of actual or potential income tax liability for NB and its parents NBP and
20 TCP have little or no income tax liability. The consequence of this determination
21 is that the ratepayers will, in fact, benefit from a lower cost of service due to the
22 lower weighted marginal tax rate enjoyed by the owners of the partnership interests
23 in NBP and TCP, if NB's proposed inclusion of a full income tax allowance is
24 rejected.

1 **Q. How is your federal income tax allowance testimony organized?**

2 A. The federal income tax section is organized around five basic points: 1) A brief
3 history and background to the income tax allowance issue, 2) whether master
4 limited partnerships should receive an income tax allowance in the cost of service,
5 3) whether NB met its burden to establish the tax status of the ultimate holders of
6 NB, 4) whether, even if NB has not met its burden at the outset, there is,
7 nonetheless, a potential tax liability on the part of NB's ultimate owners, and 5)
8 whether the available evidence indicates an actual tax liability for NB's ultimate
9 owners.

10 **Q. What are your basic findings as a result of your investigation into the**
11 **question of federal income tax allowance for the NB cost of service?**

12 A. The Commission's *Policy Statement* found:

13 [W]hile the pass-through entity does not itself pay income taxes,
14 the owners of a pass-through entity pay income taxes on the utility
15 income generated by the assets they own via the device of the pass
16 through entity. Therefore, the taxes paid by the owners of the
17 pass-through entity are just as much a cost of acquiring and
18 operating the assets of that entity as if the utility were owned by a
19 corporation. [111 FERC ¶ 61,139 at P35]

20 In other words the Commission has deemed that a partner's personal income tax is
21 a cost of doing business for the regulated pipeline entity, even if the entity is three
22 or four tiers removed from the partner. Given that proposition, I found that the full

1 35% corporate federal income tax allowance proposed by NB is inappropriate for
2 NB for several reasons:

3 1) Under NB's approach, NB's regulated income is co-mingled with income from
4 other sources as it moves up the chains of ownership and, consequently, an isolated
5 calculation of the income tax associated with the regulated income becomes
6 impossible. Further, the co-mingled, unregulated income streams augment the
7 taxable, regulated income that would otherwise be allocated to the fourth or fifth
8 tier partner and push that partner into higher tax brackets, thereby increasing the
9 low tax burden for which the ratepayer would otherwise be held responsible on a
10 stand alone basis. Thus, the ratepayer effectively ends up paying the partner's
11 income tax on income generated from non-regulated sources.

12 2) NB fails to account for the fact that the partnership agreements, by which NB's
13 net income is ultimately allocated, are designed to minimize allocated net income
14 to the partners and to avoid taxation. The partnerships were designed from the
15 beginning to shelter income from taxation and, in fact, take pride in doing so. For
16 example, the 2004 Annual Report for NBP notes on page F-21 that the effective
17 tax rate for NBP in 2004 was 3.5%. (See: Exhibit No. S-11, page 7)

1 3) NB fails to account for the fact that the mechanisms for distributing partnership
2 cash and allocating partnership net income create a divergence between
3 ratemaking accounting and tax accounting whereby ordinary income is converted
4 to capital gains income, and thereby the partner is taxed at the lower capital gains
5 rate.

6 4) Even the presumption of a 28% income tax rate for individuals, as suggested in
7 the Commission's December 16, 2005 Order in the SFPP case (113 FERC ¶
8 61,277), appears to be based on an inaccurate reading of an IRS income tax study
9 and is substantially out of line with the average income tax rate paid by Americans
10 and way out of line with the actual stand alone tax burden on the net income
11 allocated by NB or NBP to the vast majority of its partners.

12 5) NB fails to account for the fact that Northern Border Partners, L.P. and TC
13 Pipelines, L.P., which are master limited partnerships, allocate a substantial
14 amount of gross income to their general partners, NPNGC and TCPGP
15 respectively, to compensate them for management services and, as such, from a
16 ratemaking perspective these gross income allocations constitute an expense to the
17 partnership and not an allocation of taxable net income from the partnership.

1 6) As a result of the factors noted above, the weighted average marginal federal
2 income tax rate applicable to the taxable entities to which NB could conceivably
3 trace allocated net income is no more than 1.76%.

4 **A) Background on Federal Income Tax Allowance**

5 **1) History of Income Tax Allowance Issue**

6 **Q. In a nutshell, what is your understanding of the pertinent history of the issue**
7 **regarding an allowance for federal income taxes for partnerships?**

8 **A.** The derivation of just and reasonable rates for public utilities requires that the cost
9 of service underlying those rates must be designed to recover enough revenue to
10 cover all proper costs of the utility's operations, including corporate income taxes,
11 plus a fair return to the investor. If a utility is part of group of entities, some
12 elements of the cost of operations flow down from the parent organization (e.g.,
13 corporate overheads) while some elements flow upward (e.g., the tax on net
14 income). The umbrella organization may be able to take advantage of various tax
15 code provisions to offset the income from some entities with the losses from
16 others.

17 The question of whether and how ratepayers should share in the tax burden
18 or benefits of a utility's parent organization tax status, harkens back to the claim
19 made by the City of Charlottesville in 1981 that the Commission should require the

1 Columbia Gulf Transmission Company to share with its ratepayers the pipeline's
2 tax benefits that arose from the operations of other affiliated entities. There were
3 at the time two methods of incorporating a parent organization's tax status in rate
4 design: flow-through and stand-alone. Under the flow-through method, the
5 regulated entity's tax status was assumed to be the same as the parent organization
6 and all tax benefits and burdens of the parent flowed through to the subsidiary
7 entities, including those that were regulated. Under the stand alone method, each
8 entity was treated as if it were a sole corporation, allowing the parental entity alone
9 to garner the benefits and burdens of a consolidated tax statement. The
10 Commission eventually opted for the stand-alone method to avoid regulating one
11 company on the basis of the activities of another. (See: 23 FERC ¶ 61,396) The
12 Commission's Opinion No. 173 was upheld by the U. S. Court of Appeals. (See:
13 *City of Charlottesville, Virginia v FERC* 661 F 2nd 945, 950 DC Circuit 1981)

14 **Q. What is your understanding of the Commission's rationale for permitting a**
15 **tax allowance for partnerships only so far as the owning interests in the**
16 **partnership were corporations, prior to the Policy Statement?**

17 A. As expressed in *Lakehead Pipeline Company, L.P.*, (71 FERC ¶ 61,338 (1995)), the
18 Commission's rationale for permitting an income tax allowance only for corporate
19 interests in the partnership was: 1) Equity owners of corporations experience a double
20 taxation because, in addition to the personal income tax its stockholders pay on corporate

1 dividends, the revenues of the corporation are also taxed before they are distributed; thus
2 it is appropriate to provide a corporate income tax allowance on income attributable to
3 corporate owners. 2) However, inasmuch as the income attributable to interests held by
4 individuals is not subject to a corporate income tax, giving them a corporate tax
5 allowance would simply increase their earned return on equity vis-à-vis the corporate
6 owners, despite having identical financial risks related to the utility operation. (See:
7 *Lakehead Pipeline Company, L.P.*, 71 FERC ¶ 61,338 (1995), on rehearing, 75
8 FERC ¶ 61,181 (1996))

9 **Q. Do you believe that the *Policy Statement* has resolved the problem of unequal**
10 **pre-tax return on equity vis-à-vis corporate stockholders and partnership**
11 **unit holders?**

12 A. No, I do not believe the *Policy Statement* has resolved the problem of unequal pre-
13 tax return on equity vis-à-vis corporate stockholders and partnership unit holders.

14 Under *Lakehead*, the corporation form received a gross up in the revenue
15 requirement to compensate for the double income tax burden (at the corporation
16 level and at the stockholder level), and the partnership form received a gross up in
17 the revenue requirements only for the portion represented by corporate investors.
18 Consequently, under *Lakehead*, the revenue requirements of the two entities differ
19 despite identical risks and operating costs. If you then divide the net income by
20 the equity rate base for each entity, the pipeline corporation earns a higher pre-tax

1 return than a pipeline partnership despite their both having similar risk profiles.

2 The after-tax returns, however, should be equal. The *Policy Statement*, as
3 interpreted by NB, does not resolve that problem but rather reverses it. Under the
4 *Policy Statement*, as interpreted by NB, a partnership pipeline would receive a pre-
5 tax return high enough to garner sufficient revenues to pay an implied 35% income
6 tax for all partners. However, because the partnership pipeline does not in fact pay
7 any income tax (the actual corporate income tax is in essence zero, as noted
8 earlier), the actual “after-tax” return to equity using the built in 35% allowance
9 would result in a substantially higher actual return to equity. The difference would
10 now flow the other direction: the partner would earn a substantially higher return
11 than the corporate stockholder for similarly situated pipeline investments.

12 **Q. Do you believe that your interpretation of the *Policy Statement* resolves the**
13 **problem of unequal pre-tax return on equity vis-à-vis corporate stockholders**
14 **and partnership unit holders?**

15 A. No, I do not. The difference, however, is that my interpretation is premised on an
16 analysis of the actual circumstances of the owners in question. Under my
17 interpretation of the *Policy Statement*, each pipeline entity is compensated for the
18 actual estimated tax burden shouldered by its investors: the corporate pipeline
19 receives a 35% income tax allowance to compensate it for the cost of the corporate
20 income tax, and the partnership pipeline receives an income tax allowance equal to

1 the estimated actual tax burden shouldered by the partners on the net income
2 allocated by the partnership. Because of the nature and intent of the organizational
3 structure of partnerships as tax shelters, the actual tax burden will be substantially
4 lower for a pipeline partnership than for a corporate pipeline. While each will be
5 compensated for actual costs incurred, the corporation would earn a higher gross
6 return than the partnership, even though both would earn the same net rate of
7 return on equity. I do not think the divergence of the pre-tax return issue can be
8 resolved because the nature of the governance structures dictates substantially
9 different results vis-à-vis the federal income tax allowance. Nor do I think it is the
10 responsibility of the cost of service revenue requirement model to resolve that
11 problem. The choice of ownership form is an election, made by the regulated
12 entity, from which certain consequences flow, including income tax liability and
13 the realized return on equity.

14

1 **2) Cost Responsibility and Cost Incurrence**

2 **Q. What is your understanding of the principle of “cost responsibility and cost**
3 **incurrence”?**

4 A. In Opinion No. 173, the Commission held that in order for a cost to be included in
5 a company’s cost of service, it must pass a benefits/burdens test where the cost to
6 be included must bear some causal link to benefits derived by the ratepayer:

7 Despite the profusion of allocation methods we employ, there is
8 a common thread that ties them together. That thread is the
9 concept of cost responsibility or cost incurrence. Each of the
10 methods attempts to allocate costs to the group of ratepayers in
11 question on the basis of a causal link between the services the
12 company provides them and the expenses the company reports.
13 That this is a fair method of allocation is self-evident. And it
14 limits the allowance for expenses to the costs associated with the
15 goods and services provided in the period. (footnote omitted) (23
16 FERC ¶ 61,396 at 61,850)

17 In other words, if a cost arises out of the provision of services to the ratepayer, the
18 ratepayer ought to be held responsible for those costs; if a cost arises out of the
19 provision of services unrelated to the service to ratepayers, the ratepayers should
20 not be held responsible for those costs. Here the question arises as to whether the
21 income tax cost proposed by NB in its cost of service arises solely from the
22 provision of regulated services or whether some portion of the income tax cost
23 arises out of the tax burden on income earned from services unrelated to the
24 provision of regulated services.

1 **3) Stand Alone Analysis**

2 **Q. What is your understanding of the stand-alone principle?**

3 A. The stand-alone principle seeks to measure the costs of providing regulated
4 services as nearly as possible in a manner reflecting the actual cost of operating the
5 regulated entity by itself, as an entirely separate entity. Toward that end, the stand-
6 alone principle seeks to avoid shifting the benefits of consolidated corporate tax
7 benefits from those who paid for the assets that generated the benefits to those who
8 did not pay for the assets that generated the tax benefits. Similarly, the stand-alone
9 principle suggests the opposite is its goal as well, that is, to avoid shifting the costs
10 of consolidated corporate tax burdens from those who generated the tax costs to
11 those who did not generate the tax costs. This is grounded in Opinion No. 173,
12 which set the standard for the “stand alone” policy.

13 “...a utility [is] considered as nearly as possible on its own
14 merits and not on those of its affiliates.” This method is called
15 the stand-alone method, for “a stand alone income tax allowance
16 is one that takes into account the revenues and costs entering
17 into the regulated cost of service *without increase or decrease*
18 for tax gains or losses related to the other activities...”
19 (footnotes omitted) (emphasis added) (23 FERC ¶ 61,396 at
20 61,852)

21 The paragraph quoted above ends with the note that the stand-alone method
22 results in a tax allowance equal to the tax on the allowed return on equity. This
23 method of calculating the tax allowance works well if the regulated entity is a

1 single corporate entity that earns the return and pays the corporate income tax. In
2 this docket, however, we do not have a single entity that earns the return and pays
3 that income tax. Rather, we have some 93,700 owners that earn some portion of
4 the return and pay some unknown amount of income tax. Further, we have an
5 entity structured so as to minimize net income reported to the limited partners and
6 shelter income from income taxes. Under this new paradigm, the stand-alone
7 philosophy remains as attractive as ever but implementing it appropriately requires
8 putting generalized assumptions aside and analyzing the particular circumstances
9 of the owners involved. Any other approach may result in the creation of an unjust
10 tax burden where virtually none actually exists.

11 **Q. How does the partnership governance structure create the possibility of an**
12 **unjust tax burden?**

13 A. The tax liability of an individual partner is a function of that individual partner's
14 income from all sources. Any one source may provide the taxpayer with modest
15 income taxed at a modest tax rate. However, multiple sources of income may push
16 the taxpayer into higher tax brackets. For instance, suppose your milkman, a
17 modest man with a modest income, delivered milk to your home every week for
18 \$3.00 per gallon for an annual commodity charge to you of \$156. Suppose too that
19 he tacks on the personal income tax rate that applies to his milk run earnings, *i.e.*,
20 10%, and thereby increases the weekly cost to \$3.30/gallon (annual cost \$171.60).

1 Later, he takes a second job in the afternoon that is much more lucrative than the
2 milk run. Now he earns enough that he is taxed at 28% of his total income. He
3 then comes to you to say that although your service has not changed, he is now
4 subject to a higher tax burden because of his side job and you now must pay \$3.84
5 for your gallon of milk (\$199.68/year); a 16% increase in your costs due to his
6 outside income. You might well introduce him to the concept of stand alone and
7 inform him you are willing to pay for his milk run services on stand-alone basis,
8 with the tax based solely on his milk run operation.

9 Here, as will be seen when I examine the actual tax returns and K-1s for
10 NBP and TCP the actual net income allocated to the limited partners is, more often
11 than not, so small or negative that the recipient may have no tax liability at all. On
12 a stand-alone basis, the net income earned by the partners of NBP and TCP from
13 regulated services will, more often than not, place them in a zero income tax
14 status. It is other income, if any, from other unregulated sources that throws them
15 into higher tax brackets. To require ratepayers to subsidize the tax burden for
16 partners' unrelated, unregulated income activities would be unjust and
17 unreasonable.

18

1 **Q. Do you find any income tax liability?**

2 A. Given the finding in the *Policy Statement* that the partner's tax burden on the net
3 regulated income allocated by the partnership to the partner is a cost of doing
4 business for the pipeline partnership, it follows that the partner's tax burden is a
5 cost incurrence for the pipeline. However, the amount of that cost burden must be
6 measured in such a way as to avoid shifting any additional tax cost due to the
7 partner's unregulated income sources to the ratepayers.

8 **Q. How does the tax status of a partnership's owners play into the concept of**
9 **stand-alone ratemaking?**

10 A. The Commission's stand-alone policy generally suggests that a regulated entity
11 must pay its own way and not stand under the shelter of a parent organization's
12 benefits drawn from other operations. Indeed, the whole question of stand-alone
13 arose when ratepayers sought to garner the benefits of the utility's tax benefits
14 from affiliated operations. The Commission's directive in Opinion No. 173 was
15 that the tax status of the parent organization and affiliates was not relevant to the
16 utility's derivation of income tax related costs, and that the utility must be
17 examined if as if it were a stand-alone entity. The *Policy Statement*, as interpreted
18 by NB, stands that principle on its head and requires us to look past the stand-alone
19 tax status of the partners to the presumed tax status of the owners of the parent
20 organizations including all income from all sources.

1 **Q. Returning to your milkman analogy, if the milkman’s various income sources**
2 **are all low net income sources where none individually give rise to more than**
3 **the 10% income tax rate but his total income leads to a higher tax rate,**
4 **doesn’t your approach essentially shift tax costs to some other set of**
5 **customers?**

6 A. It does if the milkman can and does raise his rates to the other customers. The
7 milkman dilemma takes us back to the *City of Charlottesville* problem, but in
8 mirror image. The milkman is attempting to raise the rates to his milk run
9 customers to pay for incremental costs that arise due to other businesses.
10 *Charlottesville* tells us that tax benefits may not be shared with ratepayers who did
11 not contribute to building the other businesses; by extension, nor should the tax
12 costs of that arise due to other businesses be foisted upon the ratepayers.

13 We should keep in mind that the inclusion of a corporate income tax in the
14 cost of service is not intended to produce tax-free investments for investors. The
15 inclusion of a corporate income tax allowance was intended to account for the
16 double taxation experienced by corporate stockholders, not eliminate all income
17 taxes for investors. Similarly, partners of a regulated entity ought not be
18 guaranteed a tax-free ride either; if their additional sources of income should push
19 them into a higher tax bracket, they should pay the incremental taxes, not the
20 ratepayers.

1 **4) How is the Federal Income Tax Allowance Calculated?**

2 **Q. How does a traditional pipeline corporate cost-of-service calculate federal**
3 **income taxes?**

4 A. Traditionally, pipeline *corporations* develop a cost of service for rate making
5 purposes that includes a corporate income tax allowance at the highest marginal
6 tax rate for corporations, equal to 35% of the recommended return on equity. The
7 cost of service revenue requirement is then grossed up to generate sufficient
8 revenue to cover the cost of the federal and state income taxes. However, because
9 the additional revenue is itself taxable revenue, even more revenue must be
10 generated to pay the income tax on that income, and so on. The iterative process
11 results in a 53% tax factor for grossing up the after-tax return built into the revenue
12 requirements to cover the total federal income tax allowance. Adding in, for NB, a
13 state income tax estimate of 5.4% generates an income tax factor equal to 61% of
14 the return on equity.

15 The federal income tax allowance is in the cost of service calculation to
16 ensure that investors in a pipeline corporation receive the full intended after-tax
17 return on equity, *i.e.*, after the corporate tax, not after their personal taxes. The
18 allowance works to mitigate the impact of a double taxation on corporate profits.

1 **Q. Does the assumed corporate income tax rate used in the cost of service get**
2 **adjusted to account for different brackets of corporate income?**

3 A. I am not aware of any instances where the federal income tax rate used in a cost of
4 service was adjusted to reflect that a small corporation paid a small income tax
5 rate, probably because there are no small enough pipeline entities for us to
6 encounter such an event. But for illustrative purposes, let's assume there is one.
7 Let's assume a small pipeline corporation that is assumed to have a federal income
8 tax liability of 35% that in fact has an actual income tax liability of 25%. The
9 presumption of a higher income tax rate results in a revenue requirement that
10 awards higher returns for its owners than intended.

	<u>@35%</u>	<u>@25%</u>	<u>Presumed vs Actual</u>
11 Rate Base	\$740,000	\$740,000	
12 Return on Equity 10%	\$ 74,000	\$74,000	
13 Gross-up for tax collection:			
14 35% tax (53% tax factor)	\$113,220		\$113,220
15 25% tax (33% tax factor)		\$ 98,420	
16 Actual Tax Paid	\$ 39,627	\$ 24,605	\$ 24,605
17 Realized Return	\$ 73,593	\$ 73,815	\$ 88,615
18 Realized Return on Equity	9.95%	9.98%	11.98%

19
20
21
22
23 In my example above, I used a small corporation that earned \$74,000, which
24 subjects it to a 25% federal income tax rate. I assumed however, a 34% federal
25 income tax bracket for derivation of its cost of service. Given a 10% return on
26 equity, the tax factor gross-ups that provide sufficient revenue to cover the income

1 tax due on the respective returns generate \$113,220 on which it is assumed to pay
2 a 35% tax – \$39,627. In reality, it will pay a 25% tax – \$24,605, which will
3 provide it with a realized return of \$88,615 an 11.98% realized return on equity.
4 Had we factored in the true tax liability rate, it would have generated \$98,420 on
5 which it would have paid \$24,605, leaving a realized return of \$73,815 – the
6 intended return on equity of 10%. To the extent the cost of service model assumes
7 an income tax rate that is not actually paid, the model is flawed.

8 A similar phenomenon takes place when we examine partnerships; the
9 assumption of a 35% federal income tax rate, where there is in fact almost none,
10 leads to an enormous leap in the realized return to equity, creating an unjust burden
11 on ratepayers.

12 **Q. How does a partnership organizational structure affect the calculation of the**
13 **pipeline cost-of-service federal income tax allowance?**

14 A. Under a partnership ownership structure where there is no income tax liability at
15 the operating entity level, the grossing up of the revenue requirement to ensure an
16 after-tax return on equity for a presumed 35% income tax that does not exist only
17 compounds the problem, and simply results in a significantly higher return on
18 equity to the partners. Here, NB and its parent organizations are not corporations
19 and do not, themselves, pay any corporate income tax. Nor, as I demonstrate in

1 this testimony, do the partnership owners incur much of any tax liability associated
2 with the regulated income. As a result, any income tax allowance embedded
3 within the cost-of-service derived tariff rate will simply flow through to the
4 partners of NB's parent pass-through entities. The impact is two-fold; one, a cost
5 that is not actually incurred by the pipeline entity or anyone else is being assessed
6 upon the ratepayers, and two, the dollars so collected inure to the partnership
7 owners such that the realized return on equity for the partners in NB will be
8 substantially in excess of the allowed cost required to attract capital at reasonable
9 rates. Therefore, if a 35% presumed income tax allowance is incorporated into the
10 cost-of-service derived tariff rates, I believe the resulting rates will be unjust and
11 unreasonable.

12 **Q. What is the impact of including a federal income tax allowance in the cost-of-**
13 **service?**

14 A. The example below provides a simplified corporate cost of service to show how
15 the federal income tax component affects the overall revenue requirement and
16 return to investors. The figures are approximate to NB's filed cost of service and
17 represent a "book" analysis versus a "tax" analysis.

18

1	Assumptions:		
2	Rate Base	\$1,150,000,000	Debt/Equity @ 50% / 50%
3	Equity Return	\$80,500,000	Return on equity @ 14%
4	Debt Return	<u>\$40,250,000</u>	Debt costs @ 7%
5	Overall Return	\$120,750,000	
6			
7	Corporate Cost of Service:		
8	Operating Expenses	\$31,000,000	
9	Debt Costs	\$40,250,000	
10	Taxes Other than Income	\$31,400,000	
11	Depreciation	\$86,000,000	
12	Return on Equity	\$80,500,000	
13	<u>Income Taxes</u>	<u>\$49,105,000</u>	(61% * \$80,500,000)
14	Total Revenue Requirement	\$318,255,000	
15			

16 In general, the cost of service is made up of six basic elements: operating costs,
17 debt costs, taxes other than income (TOTIT), depreciation, return on equity, and
18 income taxes. Of these six elements, operating expenses, debt costs, and TOTIT
19 may be considered as “cash expenses,” in that they are costs of doing business and
20 go out the door to the providers of the services or capital. Depreciation and return
21 may be considered as “non-cash expense” in that they accrue to the corporation
22 and may, in general, be held for future use, reinvested, or paid out as dividends.
23 Income taxes depend on the ability of the enterprise to meet its goals and turn a
24 profit, and for a corporation will head out the door to the federal government. As
25 noted above, the presumed 35% federal income tax rate and 5.4% state income tax
26 rate generate a tax factor of 61% of the return on equity. The depreciation and

1 return on equity components make up the cash available for the payment of
2 dividends to the stockholders. The return component of 14% reflects the “after-
3 tax” return (meaning after the corporate tax) that the investor will earn on his or
4 her investment and take home.

5 The next example provides a simplified partnership cost of service to show
6 how the inclusion of a 35% federal income tax component, regardless of the actual
7 tax liability, affects the overall revenue requirement and return to investors. It uses
8 the same underlying cost of service assumptions. But here we see that because the
9 partnership does not pay a federal income tax, the portion of the revenue
10 requirement generated by the inclusion of a 35% income tax allowance does not go
11 “out the door” to the federal government as a cost to the partnership, but rather
12 goes directly to the investors as return, symbolized hereafter as “Income ~~Taxes~~”.

13 Partnership Cost of Service:

14	Operating Expenses	\$31,000,000	
15	Debt Costs	\$40,250,000	
16	Taxes Other than Income	\$31,400,000	
17	Book Depreciation	\$86,000,000	Total Realized
18	Return on Equity	\$80,500,000	Return on Equity
19	<u>Income Taxes</u>	<u>\$49,105,000</u>	\$129,605,000
20	Total Revenue Requirement	\$318,255,000	
21			

1 Because the actual corporate income tax at the pipeline operating level is in
2 essence zero, the “after-tax” return to investors in this partnership is 22.5% rather
3 than the targeted 14%. [(return + income taxes)/(rate base * 50% equity ratio)]

4	Return on Equity	\$80,500,000
5	Income Taxes	<u>\$49,105,000</u>
6	Total Return on Equity	\$129,605,000
7	Equity Rate Base*50% Equity Ratio	\$575,000,000
8	\$129,605,000/\$575,000,000 = 22.5% Realized Return on Equity	

9 The realized return is substantially in excess of the recommendations of any return
10 witnesses in this case. Indeed, Trial Staff witness William Rappolt is
11 recommending a 10% return on equity.

12 5) Actual Income Tax Liability Evidence

13 **Q. What is taxable income?**

14 **A.** Taxable income is the amount of net income that is subject to federal income tax.
15 From a ratemaking perspective, a regulated entity has “gross revenue,” which is
16 the total revenue generated by the operation; “gross income,” which is essentially
17 gross revenue less depreciation; “net income,” which is gross income less
18 operating costs, book depreciation, debt costs, and TOTIT; and “taxable income,”
19 which is net income adjusted to include deductions allowable under tax law that
20 are not allowed for ratemaking purposes, such as accelerated depreciation. The
21 IRS tax forms use the term “ordinary business income” where the partnership

1 agreements use the term net income. The instructions for IRS Form 1065 are
2 included in Exhibit No. S-12.

3 **Q. Assuming there is taxable income to a person or entity, what are the**
4 **associated income brackets and federal tax percentages that determine actual**
5 **tax payments?**

6 A. The Internal Revenue Service taxes income through a progressive tax schedule.

7 As an individual's income increases, taxes are paid for brackets of income such
8 that the first \$10,200 is taxed at just 10% (assuming a single tax payer not filing a
9 joint return). Additional income above \$10,200 up to \$38,900 is taxed at 15%.

10 Additional income between \$38,900 and \$100,500 is taxed at 25% and so on, as
11 shown on the table below.

Individuals (Head of Household)

less than \$0	0.00%
\$0 - \$10,200	10.00%
\$10,200 - \$38,900	15.00%
\$38,900 - \$100,500	25.00%
\$100,500 - \$162,700	28.00%
\$162,700 - \$319,100	33.00%
Over \$319,100	35.00%

12
13 The whole of one's income is not taxed at the maximum rate, but rather taxes are
14 assessed in increments such that the highest tax level is only assessed on marginal
15 income. Similarly, corporate income taxes are also levied on a tiered bracket basis,

1 although the cost of service assumes a 35% income tax on all the corporate equity
2 return.

3

<u>Corporate Partners</u>	
less than \$0	0.00%
\$0 - \$50,000	15.00%
\$50,000 - \$75,000	25.00%
\$75,000 - \$100,000	34.00%
\$100,000 - \$335,000	39.00%
\$335,000 - \$10,000,000	34.00%
\$10,000,000 - \$15,000,000	35.00%
\$15,000,000 - \$18,333,333	38.00%
Over \$18,333,333	35.00%

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8

9 This tiered structure will play an important part in the derivation of the potential
10 weighted average tax rate to be applied to NB's cost of service. Mr. Faber lists the
11 income tax treatment for several classes of owners among the partners of NBP and
12 TCP. (See: Exhibit No. NB-18, page 4 to end) Each class of owner falls within a
13 tiered tax structure similar to those listed above. As I will demonstrate, the taxable
14 net income allocated to the vast majority of these owners falls well below the
15 income level necessary to be taxed at the maximum marginal tax rate in any set of
16 tables. Most, in fact, have a zero tax liability with respect to their regulated
17 income. The income brackets and associated income tax rates will be discussed
18 later.

1 **Q. Did NB have taxable income in 2004 and did it pay any income tax on that**
2 **income?**

3 A. Because NB is a partnership, it does not have income tax liability and therefore
4 cannot have “taxable income,” nor did it pay any income tax. However, NB did
5 report ordinary business income in 2004, as seen on NB’s 2004 IRS Form 1065.
6 (See: Exhibit No. S-13, page 1 of 21.) NB reported this ordinary business income
7 on IRS tax schedule K-1, for its general partners NBILP and TCILP respectively.
8 (See: Exhibit No. S-13, Page 14 and 17 of 21.)

9 **Q. Did NBILP have taxable income in 2004 and did it pay any income tax on that**
10 **income?**

11 A. Because NBILP is also a partnership, it does not have income tax liability and
12 therefore cannot have “taxable income,” nor did it pay any income tax. However,
13 NBILP did report ordinary business income in 2004, as seen on NBILP’s 2004 IRS
14 Form 1065. (See: Exhibit No. S-14, page 1 of 47.) NBILP reported this ordinary
15 business income on IRS tax schedule K-1, for its general partners NPNGC, PBGC,
16 and NBPC. (See: Exhibit No. S-14, NBP at page 36; NPNGC at pages 38 and 44;
17 PBGC at pages 40 and 46; and NBPC at page 42, respectively. Two schedules K-1
18 were reported for some entities because the capital accounts were zeroed out and
19 the partner’s interest was re-capitalized during the year.)

1 **Q. Did TCILP have taxable income in 2004 and did it pay any income tax on that**
2 **income?**

3 A. Because TCILP is also a partnership, it does not have income tax liability and
4 therefore cannot have “taxable income,” nor did it pay any income tax. However,
5 TCILP did report ordinary business income in 2004, as seen on TCILP’s 2004 IRS
6 Form 1065. (See: Exhibit No. S-15, page 1 of 47.) TCILP reported this ordinary
7 business income, on IRS tax schedule K-1, for its general and limited partner TCP.
8 (See: Exhibit No. S-15, pages 6 and 7 of 11.)

9 **Q. Did NBP have taxable income in 2004 and did it pay any income tax on that**
10 **income?**

11 A. Because NBP is also a partnership, it does not have income tax liability and
12 therefore cannot have “taxable income,” nor did it pay any income tax. However,
13 NBP did report ordinary business income in 2004, as seen on NBILP’s 2004 IRS
14 Form 1065. (See: Exhibit No. S-16, page 1 of 31.) NBP reported this ordinary
15 business income on IRS tax schedule K-1, for its general and limited partners
16 NPNGC, PBGC, and NBPC. (See: Exhibit No. S-16, NPNGC at pages 18, 20, 26,
17 and 28; PBGC at pages 22 and 30; and NBPC at page 24, respectively. Two forms
18 K-1 were reported for some entities because the capital accounts were zeroed out
19 and the partner’s interest was re-capitalized during the year.) The K-1 reports for

1 NBP's limited partners were provided in response to Trial Staff data request TAX-
2 2.19 in a data base format and will be discussed later.

3 **Q. Did TCP have taxable income in 2004 and did it pay any income tax on that**
4 **income?**

5 A. Because TCP is also a partnership, it does not have income tax liability and
6 therefore cannot have "taxable income," nor did it pay any income tax. However,
7 TCP did report ordinary business income in 2004, as seen on the TCP's 2004 IRS
8 tax Form 1065. (See: Exhibit No. S-17, page 1 of 13) The K-1 reports for TCP's
9 general partner were not included in the IRS tax return. The K-1 reports for TCP's
10 limited partners were provided in response to Trial Staff data request TAX-2.19 in
11 a data base format and will be discussed later.

12 **B) Should Partnerships Receive a Federal Income Tax**
13 **Allowance in the Cost of Service?**

14 **Q. What are the different forms of partnerships?**

15 A. A general partnership is a form of business created when two or more persons
16 form an entity as co-owners. No documentation need be filed with the state or
17 federal government to establish a partnership, and it is in fact the default business
18 form when people begin a business. Partners in a partnership have equal rights to
19 manage the business, unless they come to some other specific arrangement; the

1 partners are personally liable for the debts of the entity; each partner is liable for its
2 share of income tax generated by the income of the enterprise; partners can
3 generally exit the business whenever they want.

4 A limited liability partnership (LLP) is a form of business created generally
5 to shelter partners from some or all of the debts of the business. Under an LLP,
6 all the partners are general partners. Establishing an LLP requires a filing with the
7 state government. Some states provide shelter from all debts, similar to a
8 corporate stockholder, while other states restrict the LLP to certain businesses, and
9 other states provide debt shelter only from some types of activities.

10 A limited partnership (LP) is a form of business established with at least
11 one general partner and one limited partner. The general partner shoulders
12 personal responsibility and liability for the debts of the enterprise; limited partners
13 are not liable for the debts of the enterprise and do not have management rights in
14 the organization. Some states also have limited liability limited partnerships
15 (LLLP), which extends limited liability to the general partner as well as the limited
16 partners.

17 A limited liability company (LLC) is a form of business similar to a
18 partnership wherein the owners (referred to as “members”) enjoy limited liability

1 for the debts of the enterprise, taxation as if they were in a partnership, and equal
2 management in the enterprise unless they elect to create a managing member.

3 A master limited partnership (MLP) is a limited partnership that engages in
4 certain natural resource commodities and services for 90% or more of its income,
5 and is permitted to trade its ownership units in the partnership on public exchanges
6 as though they were corporate stock shares. Master limited partnerships exist
7 pursuant to IRS regulations, added to the federal income tax code in 1987 and
8 amended in 1997, that created provisions permitting the public trading of
9 partnership interests. NB's parent organizations, Northern Border Partners, L.P.
10 (NBP) and TC Pipelines, L.P. (TCP) are limited partnerships that operate within
11 the IRS regulations for master limited partnerships. (An excellent primer on MLPs
12 is included in Exhibit No. S-34)

13 Partnerships are pass-through entities for tax purposes, so no income tax is
14 paid at the partnership level. Partnership net income, or loss, is generally passed
15 through to the partners in proportion to their interest in the partnership and each
16 partner pays a tax on his or her share of the partnership net income at his or her
17 own individual tax rate. Losses passed through to the partners cannot be used to
18 offset income from other sources but must be carried forward and used to offset
19 income from the same limited partnership in future tax periods.

1 **Q. Do you believe a pipeline entity organized as a limited partnership should**
2 **have a federal income tax allowance permanently embedded within its cost of**
3 **service and in the tariff rates paid by its shippers?**

4 A. I believe that such an allowance should be permitted only to the extent that an
5 actual or potential income tax liability for the partners can be established, and the
6 weighted average tax rate of the partners can be determined. I do not believe that
7 partners in a regulated partnership experience anything close to a 35% income tax
8 burden on their regulated income. Entities operating pipelines, or any other
9 regulated utility, in the public interest should, in the first instance, be awarded only
10 those costs actually incurred in the operation of the business at hand. Costs
11 incurred by unregulated affiliates of those entities have no bearing on the cost of
12 operating and managing the regulated public utility.

13 Moreover, the Commission's *Policy Statement* instructs those seeking an
14 income tax allowance to establish the tax status of those ultimately holding the
15 income tax liability on the income derived from utility operations. However, the
16 co-mingling of revenues and costs for the consolidated enterprises makes it
17 difficult, if not impossible, to assess the direct tax burden placed on the partner due
18 solely to the net income generated by the regulated entity.

19 This is more emphatically the case for entities such as NBP and TCP whose
20 partnership agreements are structured so that the limited partners receive little or

1 no net income. The closest we can get to determining actual or potential income
2 tax liability of the individual partners is to look at the net income allocations made
3 by the holding partnership to each partner. As the evidence will show, the
4 resulting actual or potential income tax burden placed on the partners is virtually
5 zero. When one considers that the Commission's *Policy Statement* directs that
6 regulated utilities should only be awarded the actual average weighted tax liability
7 incurred, rather than taxes calculated on a blanket maximum rate to which virtually
8 none of the partnership's partners actually are subject, the bottom line is that NB is
9 entitled to little or no tax allowance.

10 **C) Has NB Met Its Burden to Establish the Tax Status of the Ultimate**
11 **Holders of NB Income Tax Liability?**

12 **1) Burden of Proof**

13 **Q. What did the Commission *Policy Statement* direct in regard to the burden of**
14 **establishing the tax status of the owners of the pass-through entity?**

15 A. The Commission *Policy Statement* places the burden of demonstrating an income
16 tax liability on the part of the owners of the pass-through entity squarely on the
17 shoulders of the entity claiming an income tax burden:

18 ... Given this important qualification, any pass-through entity
19 seeking an income tax allowance in a specific rate proceeding must
20 establish that its partners or members have an actual or potential
21 income tax obligation on the entity's utility income. [111 FERC ¶
22 61,139 at P 32]

1 This is a fact specific issue for which the relative data is uniquely
2 within the control of the regulated industry. Thus any pass-through
3 entity desiring an income tax allowance on utility operating income
4 must be prepared to establish the tax status of its owners or, if there
5 is more than one level of pass-through entities, where the ultimate
6 liability lies and the character of the tax incurred. [111 FERC ¶
7 61,139 at P 42]

8 NB's witnesses did not meet that burden. NB failed to support the proposition
9 that the individual owners of partnership interests in NBP and TCP have an actual
10 or potential income tax liability on income derived from NB at any level
11 approaching the 35% income tax allowance proposed in the filing. Thus, its
12 claimed income tax allowance should be denied. However, although the burden to
13 establish the tax status of the ultimate holders of NBP and TCP tax liability does
14 not lie with FERC Trial Staff, I have, nonetheless, endeavored to ascertain whether
15 there is in fact any evidence of either actual tax liability or potential tax liability.
16 As more fully explained below, I have come to the conclusion that there is
17 evidence available to answer that question. The answer is there is little or no
18 actual or potential income tax liability.

19 **Q. Has NB met the burden of establishing the tax status of the owners of the**
20 **pass-through entity?**

21 A. No, NB has not met its burden to establish the tax status of the individuals who
22 ultimately bear the burden of income taxes derived from NB revenues. The filed
23 testimony of NB's witnesses presents calculations summarizing the weighted

1 maximum tax rate for each category of partner for NBP and TCP interests as if the
2 IRS levied income taxes on groups of taxpayers rather than on individuals and that
3 all individual partners were taxed at that maximum rate. However, both the
4 partnership agreements and the IRS tax code treat each partner as a separate
5 taxpaying individual with unique elements of income and deductions, and an
6 actual tax payment burden based on a progressive tax rate structure irrespective of
7 their neighbor's or partner's income.

8 **2) NB Witness Testimony**

9 **Q. Do any of NB's witnesses discuss the actual flow-through of net income from**
10 **NB to its parent organizations?**

11 A. Yes. In Exhibit Nos. NB-15 and NB-17, NB witnesses Jerry L. Peters and Peter L.
12 Faber present NB's income tax proposal for the cost of service. However, as I
13 demonstrate herein, neither Mr. Peters nor Mr. Faber make the appropriate effort
14 to comply with the Commission's *Policy Statement*.

15 **a) Jerry L. Peters' Testimony**

16 **Q. What does Mr. Peters' testimony propose?**

17 A. NB Exhibit Nos. NB-15 and NB-16 contain witness Peters' presentation of NB's
18 derivation of its proposed 35% federal income tax rate. Beginning at page 12, Mr.
19 Peters notes that NB is a general partnership and as such is not directly subject to
20 income taxes at the entity level. He also notes that, pursuant to its tariff, NB

1 calculates an income tax allowance for rate purposes as if it were a corporation
2 without limit as to the negative or positive amounts of current or deferred income
3 taxes it can accumulate. The tariff also requires the provision of deferred income
4 taxes for temporary timing differences between when expenses are recognized for
5 book and tax purposes.

6 Mr. Peters touts the existing income tax approach as one that offers a
7 straightforward tax allowance derivation uncomplicated by multi-level ownership
8 structures. He then claims the existing approach “consistently and directly
9 correlates the income tax allowance to the actual operation of the pipeline.”

10 (Exhibit No. NB-15, page 12 of 22, at line 19) Mr. Peters also claims that NB’s
11 rates “are lower under its existing tariff provision than the rates that may result
12 under the Policy Statement approach.” (Exhibit No. NB-15, page, at line 1)

13 **Q. Do you agree with Mr. Peters’ claims that are intended to support the NB’s**
14 **tax allowance claim?**

15 A. No, I do not. While it is true that NB’s existing income tax approach offers a
16 straightforward tax allowance derivation uncomplicated by multi-level ownership
17 structures, it sacrifices all fairness and accuracy in the name of simplicity. The
18 fact is, that in order to determine the ultimate income tax liability for NB’s net
19 income, one simply cannot avoid acknowledging a complicated ownership

1 structure (See: Exhibit No. S-10), as well as complex cash distribution structures,
2 complex income allocation structures, and complex tax avoidance structures.
3 Indeed, the very reason the organizational structure is set up as it is, is to avoid
4 paying that straightforward income tax rate. As to the notion that NB's 35% tax
5 allowance approach somehow correlates to actual operations, a brief glance at the
6 NB 2004 IRS Form 1065 tax returns reveals that NB pays no actual income tax.
7 (See: Exhibit No. S-13) Consequently, the existing tax approach for rate purposes
8 does not match actual the income tax status of NB, or any of the individual
9 partner's income tax status for that matter. The claim that the existing tax
10 approach results in a lower tax burden than would a rate derived under the *Policy*
11 *Statement* guidelines, is totally unsubstantiated and, in fact, is disproven by my
12 calculation of an appropriate weighted average federal marginal income tax rate in
13 Exhibit No. S-26.

14 **Q. Mr. Peters argues that the NB's tax allowance approach reflects the intent**
15 **from the initial certificate proceedings that taxes would be calculated without**
16 **regard to the individual circumstances of the partners. (Exhibit No. NB-15,**
17 **page 14 of 22, line 13). Can you comment on this assertion?**

18 A. I was not involved with the derivation of the NB income tax allowance calculation
19 methodology in the certificate proceedings so I cannot comment on the intent of
20 those proceedings. However, it should be noted here that the certificate

1 proceedings for which NB were conducted under the auspices of *Lakehead* and in
2 the *Policy Statement* the Commission expressly reversed its *Lakehead* orders
3 (*Policy Statement* at P 33), and expressly instructed that the amount of the income
4 tax allowance should reflect the weighted average income tax liability of the
5 entity's partners or members. The *Policy Statement* says nothing about waiving
6 this requirement if it conflicts with earlier certificate proceedings. This instruction
7 would suggest that we must now expressly look to the individual circumstances of
8 the partners in developing the income tax allowance.

9 **Q. Do you agree with Mr. Peters' claim that the existing tax allowance approach**
10 **has provided substantial benefits to shippers for 24 years (Exhibit No. NB-15,**
11 **page 13 at line 10)?**

12 A. No, I do not. Mr. Peters points to the effect of rate base reductions stemming from
13 the accumulated deferred income tax balances. I would not characterize the
14 absence of a return on capital cost associated with the cost-free funds represented
15 by the ADIT as a benefit offered by the pipeline to the ratepayers. The rate base
16 reduction effect simply reflects the fact that the pipeline has the use of those funds
17 at no cost, and therefore no cost is passed on to the ratepayers. That is entirely
18 separate from the question of whether NB should be collecting an income tax
19 allowance in the first place.

1 **Q. Do you agree with Mr. Peters' claim that the existing tax allowance approach**
2 **offers a relief from the administrative burden of calculating the income tax**
3 **(Exhibit No NB-15, page 13 at line 20)?**

4 A. While the NB income tax proposal does offer administrative ease, it does not
5 produce reasonable or accurate results. The substantial difference between
6 assuming a 35% income tax burden and calculating the true weighted average
7 income tax liability outweighs the relevance of the administrative burden argument
8 many times over.

9 **Q. Mr. Peters argues that the Commission's order in Docket No. RP96-45**
10 **precludes the raising of the income tax allowance issue for seven years after**
11 **the Settlement Adjustment mechanism became effective. (Exhibit No NB-15,**
12 **page 14 at line 17) Will you comment on that assertion?**

13 A. The Commission's Order (at 80 FERC ¶61,150) was issued on August 1, 1997,
14 nine years ago. The Settlement Adjustment Mechanism (SAM Adjustment)
15 became effective in 1999. Therefore, the seven year moratorium on raising the
16 income tax issue lapsed in December 2005.

17 **Q. Mr. Peters argues that implementation of the *Policy Statement* could result in**
18 **a higher income tax allowance for the ratepayers. (Exhibit No NB-15, page 15**
19 **at line 20 & following) Do you agree?**

20 A. No, I do not. Mr. Peters argues that the mix of owners of NB's parent
21 organizations could result in a higher tax burden because the highest marginal tax
22 rate applicable to some partners exceeds 35%. The highest marginal tax rate is
23 35% for those earning over \$326,450 (head of household, 2005), but a great deal

1 of that income will be taxed at substantially lower rates. The *average* tax rate for a
2 head of household earning \$336,451 would be 28%.

3 NB's own K-1 data base demonstrates that there are no individuals with
4 ownership interests in NBP or TCP that receive an allocation of net income from
5 NBP or TCP, which, on a stand alone basis, would place those unit holders in the
6 over-35% tax bracket. Even if there were a few owners whose net income
7 allocation placed them in a high tax bracket, the vast majority of the unit holders
8 are allocated less than zero income and therefore are liable for no income taxes
9 whatsoever. As demonstrated below, the weighted average marginal income tax
10 rate applicable to the individual unit holders of NBP and TCP comes nowhere near
11 35%.

12 **Q. Mr. Peters presents a taxation schematic diagram in Exhibit No. NB-16,**
13 **Schedule 3, to illustrate the NB tax burden. Will you comment on that**
14 **schematic?**

15 A. Mr. Peters' taxation scheme diagram offers an excellent illustration of my
16 objections to NB's interpretation of the *Policy Statement*. I've included his
17 exhibit in my own set of exhibits as Exhibit No. S-18. For example, the taxation
18 schematic diagram has a dark-lined box on the left that represents the income
19 stream for NB alone. This would be the ideal point at which to determine the
20 actual or potential income tax liability for each partner because it represents the

1 income from regulated services free of the noise of non-regulated income sources
2 and deductions. Indeed, I note that in paragraph 32 of the *Policy Statement* the
3 Commission makes three separate references to the source of income for which a
4 tax liability is sought: “actual or potential income tax liability to be paid on *that*
5 *income from those assets*”...“actual or potential income tax liability on *that public*
6 *utility income*”... “an actual or potential income tax obligation *on the entity’s*
7 *public utility income*” (emphasis added). Clearly, the Commission’s interest is on
8 the income tax liability that stems solely from regulated utility income. If we
9 could determine the amount of net income that each ultimate tax liability holder
10 received from NB alone, the tax schematic diagram would end there. However,
11 NB’s parent entities are both pass-through entities themselves and pay no income
12 tax, so we must look further up the chain of ownership.

13 At the next level up, the difficulty of following the regulated income
14 increases, although it is not impossible. Income streams from other un-regulated
15 operations begin to come into play, as well as tax code provisions related to each
16 partner’s interest in the partnership. In the center of the taxation schematic
17 diagram both above and below the dark-lined box are smaller boxes that represent
18 income from affiliates’ operations for NBP and TCP (which Mr. Peters labels as
19 TCLP), and boxes that represent each partner’s individual partner-specific income

1 and deductions related to that partner's interest in the partnerships. The seven
2 other energy operations are shown on a separate diagram labeled Organizational
3 Structure, which was provided in response to Trial Staff data request COS-1.05
4 and presented here in Exhibit No. S-10, page 2. The IRS Form 1065 incorporates
5 several more entities in the various schedules and statements under the NBILP and
6 NBP umbrellas for the consolidated tax returns. (See: Exhibit No. S-14, page 28
7 or Exhibit No. S-16, page 10 and 11)

8 **Q. How does the inclusion of income streams from other operations square with**
9 **the stand-alone principle?**

10 A. It does not. As I noted earlier, Opinion No. 173 lays out a clear directive that the
11 income tax benefits derived through consolidated tax filings should not inure to the
12 benefit of ratepayers who have not contributed to the assets that generated the
13 income tax benefits. Similarly, and to be consistent, income tax costs due to
14 revenues from unregulated affiliated operations ought not augment the income tax
15 burden on ratepayers since the ratepayers have not benefited from the assets that
16 gave rise to the added income stream.

17 **Q. What is the impact of the income streams from other operations?**

18 A. Income streams from other operations would, other things being equal, tend to
19 build up the net income allocation to each partner. As a result, one would expect
20 the added unregulated income to push the various partners into higher income

1 brackets and higher income tax rates. However, the complexities of the NBP and
2 TCP consolidated tax returns make the task of isolating the NB net income
3 allocations to the ultimate holders of income tax liability impractical, if not
4 impossible. The result is that we must be cognizant that, in theory, the net income
5 allocations reported in the K-1s to each partner are greater than the net income
6 derived solely through NB's operations. Nonetheless, as will be evident in the
7 examination of the actual net income allocations, most partners of NBP and TCP
8 still are allocated net income of less than zero, and thus have no income tax
9 liability.

10 **Q. What if the income stream from other sources represents losses that**
11 **overwhelm positive income from NB?**

12 A. While the possibility exists that affiliated operations may report losses up through
13 the chain of ownership such that on the consolidated reports these losses might
14 offset positive net income from NB on the books of NBP and TCP, there is no
15 indication in the IRS 1065 tax returns of NB, NBILP, TCILP, NBP, or TCP to
16 suggest that there are substantial losses from other operations to offset NB's net
17 income allocation, so this remains merely a theoretical possibility. However, the
18 manner of allocating income among partners does appear to have played a role in
19 how the individual limited partners of NBP and TCP shared in the success of the

1 two entities. Despite running profitable enterprises (See; Exhibit No. S-11, pages
2 1 and 2), the limited partners appear to have widespread tax losses – as is intended
3 by the partnership agreements and structures.

4 **Q. What reason might lead to negative taxable income allocations to limited**
5 **partners despite an otherwise profitable enterprise?**

6 A. The allocation of partnership income can be greatly affected by incentive
7 distribution and gross income allocation requirements embedded within the
8 partnership agreement. A partnership agreement may require a disproportionate
9 gross income allocation to the general partner such that the partnership must
10 allocate negative net income to most of the limited partners. Such is the case with
11 NB’s parent organizations, NBP and TCP. The Forms 1065 for NBP and TCP
12 reveal large negative income allocations to the limited partners. Given the positive
13 income allocations from NB, it is evident that some partners must be allocated
14 large gross income allocations, which are causing the negative net income
15 allocations to so many limited partners. In addition, the use of accelerated
16 depreciation to offset the partners’ net income further reduces the partner’s taxable
17 income.

18

1 **Q. What is the impact of the tax code provisions related to each partner's**
2 **interest in the partnership?**

3 A. The boxes in Mr. Peters' schematic diagram labeled "Partner-Specific Income &
4 Deductions," refer, I believe, to the write-up and subsequent amortization of each
5 partner's §743(b) interest in the partnerships. This element has to do with the tax
6 code provisions that allow an investor to recognize the premium paid for
7 partnership interests in the open market and to amortize that premium over time as
8 an offset to the income derived from the partnership. The impact of these
9 provisions, as reflected in the boxes on the diagram, is that they reduce taxable
10 income for the partner. This topic will be discussed more fully below.

11 **Q. What does the next set of boxes in the taxation schematic diagram represent?**

12 A. The next column of boxes in Exhibit No. S-18 represents the taxable income from
13 all other sources to each partner and the K-1 net income allocation from all NBP
14 and TCP income sources. As noted in the discussion above, income streams from
15 other sources would, other things being equal, tend to build up the taxable income
16 of each ultimate holder of NB. The added income would push the partners into
17 higher income brackets with resulting higher income tax rates. As noted, the
18 higher income tax brackets into which partners might fall due to the income from
19 other sources ought not augment the income tax burden on ratepayers, since the
20 ratepayers have not benefited from the assets that gave rise to the added income

1 stream. The K-1 regulated net income allocation from NBP and TCP should be
2 the only income stream used in the derivation of the income tax rate for the cost of
3 service income tax allowance.

4 **Q. Have you examined Mr. Peters workpapers supporting his income tax**
5 **recommendation?**

6 A. Yes, I have. Mr. Peters' Exhibit No. NB-16, Schedule 2, page 1, summarizes his
7 route to a 35.05% federal income tax rate (despite the fact that no entity is assessed
8 more than 35%). I have two criticisms of Mr. Peter's workpaper: 1) he assumes a
9 35% income tax rate for some categories of entities that in fact pay no income tax,
10 and 2) he calculates an income tax rate without any regard to the income received
11 by the categories of partners, let alone the partners themselves.

12 **Q. Please explain your first criticism.**

13 A. The list of categories of partners shown on Mr. Peters' Exhibit No. NB-16,
14 Schedule 2, page 1, includes some entities that do not pay income tax. Some
15 (partnerships, other, clearing entity, and unknown entity) are noted as such with
16 "0.0000%" shown as the "Entity %" and no corresponding income tax rate shown
17 in the "Fed Tax Rate" column. Three other groups (IRA/Sep/Keogh, exempt
18 organizations, and pension plans) however are shown as taxpaying categories that
19 are not taxpaying entities. These categories represent groups that invest in mutual

1 funds and similar investments. The income that mutual funds earn from MLPs
2 have been exempt (to the mutual fund) from income tax liability on income earned
3 through master limited partnerships since the passage of the American Jobs
4 Creation Act of 2004. (See: Public Law 108-357-Oct.22, 2004, Section 331)
5 Further, IRAs/Keoghs and Pension Plans must attain a gross income allocation of
6 over \$1,000 to become subject to income tax liability. Similarly, exempt
7 organizations must also be allocated a gross income of over \$1,000 to become
8 subject to the unrelated business income tax (UBIT). Of the **[begin protected**
9 **xxxxxx end protected]** partner entities in the IRA/Keogh category, only **[begin**
10 **protected xx end protected]** earned more than \$1,000 from NBP. For exempt
11 organizations, only **[begin protection xxxxxxxxxxxxxx end protection]** partners
12 received net income allocations over \$1,000. (Data drawn from income tax data
13 provided in response to Trial Staff data request TAX-2.19) Even under the
14 categories trusts and estates, \$1,000 income would be taxed at most at 15%, not
15 35%. (See tax rates by category: Exhibit No. S-26)

16 I also note the irony that Mr. Peters categorizes the Partnership category of
17 owners as having a zero weight because of the tax exempt characteristic of these
18 pass-through entities. He awards them a zero weight in deriving an income tax
19 allowance, yet of the five key partnerships in this case, NB partnership, the NBILP

1 partnership, the TCILP partnership, the NBP partnership, and TCP partnerships,
2 Mr. Peters ignores the tax exempt characteristic of these pass-through entities and
3 assigns a 35% income tax burden to them.

4 **Q. Please explain your second criticism.**

5 A. Mr. Peters' Exhibit No. NB-16, Schedule 2, page 1, conveniently avoids showing
6 the actual net income allocated to any of the partner categories. He demonstrates
7 the relative weight each category has relative to the percentage ownership in NBP
8 and TCP but does not provide any weighting related to actual income received
9 from these partnerships. In fact, as demonstrated by the NBP Form 1065, the
10 limited partners of NBP were allocated a net loss of **[begin protected**
11 **xxxxxxxxxxxxx end protected]**. (See: Exhibit No. S-16, page 4, line 2b.) TCP
12 allocated a net income of **[begin protected xxxxxxxxxxxx end protected]** to its
13 limited partners. (See: Exhibit No. S-17, page 4, line 2b) There is no tax liability
14 associated with zero income, let alone a **[begin protected xxxxxxxxxxxxxxxx end**
15 **protected]**.

16 **b) Peter L. Faber's Testimony**

17 **Q. What does Mr. Faber's testimony propose?**

18 A. Mr. Faber proposes a full 35% income tax allowance in the NB cost of service.

1 **Q. Mr. Faber claims that the effective income tax rate for individuals could be**
2 **higher than the 35% rate he proposes. Will you comment on his assertion?**

3 A. Yes. Mr. Faber states that because deductions and exemptions of individuals can
4 be phased out under the IRS code and because of the alternative minimum tax, a
5 partner's effective income tax rate may be higher than the 35% rate he proposes
6 (Exhibit No. NB-19, pages 2 and 3 of 18). Mr. Faber provides one example on
7 page 6 whereby the use of itemized deductions is phased out for taxpayers with
8 income above \$145,950. He suggests that the loss of deductions means the
9 effective tax rate may be higher than 35%. However, Mr. Faber provides
10 absolutely no evidence to suggest that this is the case for any partner of NBP or
11 TCP. He also argues on page 6 of his testimony that partners subject to the
12 alternative minimum tax may pay a rate higher than 35%. However, given the
13 negative net income allocations from NBP and TCP to the great majority of its
14 partners, it seems more likely that few if any partners will be exposed to the
15 alternative minimum tax.

16 Further, Mr. Faber's claim that the effective income tax rate for individuals
17 could be higher than 35% glosses over a fine point in mathematics. In essence, he
18 argues that at higher income levels, some deductions are no longer applicable or
19 fully applicable. It is true that as deductions fall off, taxable income rises,
20 subjecting the taxpayer to possibly higher income tax rates. If that happens, the

1 incremental increase in taxable income is what pushes the taxpayer into the higher
2 tax bracket – assuming the taxpayer is not already in the 35% tax bracket.
3 However, in support of his argument, Mr. Faber appears to divide the difference in
4 total tax payment by just the incremental income to arrive at an “effective” tax
5 rate. That is one way to look at it; however one should not obscure the fact that his
6 “effective” tax rate applies only to that increment, not the whole of the taxpayer’s
7 income. The rest of the taxpayer’s income is taxed at lower effective rates.
8 Despite Mr. Faber’s implication, the taxpayer will not pay more than 35% on the
9 whole of its income; in fact, given our progressive tax structure, the taxpayer will
10 only pay 35% on the amount of income greater than \$ 319,100 (in 2004). In fact,
11 because of the progressive tax structure, a person who earned income in that range
12 would be taxed at an average rate of 28%, even though his or her marginal rate is
13 35%.

14 **D) Even If NB Has Not Met Its Burden of Proof, Is There a *Potential***
15 **Income Tax Liability on the Part of NB’s Ultimate Owners**
16 **Nonetheless?**

17 **Q. How should we go about determining the potential tax status of the owners of**
18 **the pass-through entities?**

19 A. The Commission directed pipelines desiring an income tax allowance to establish
20 the tax status of the ultimate holders of the actual income tax liability or potential

1 income tax liability on a case by case basis. In this case the chain of pass-through
2 organizations leads to the NBP and TCP partnerships. From there, the majority of
3 partners are taxable entities. Income derived by the partners from the partnership
4 is the critical component in determining income tax liability. How the partnership
5 gross and net income allocations are made rests within the partnership agreements
6 that spell out how cash is distributed, how incentive cash distributions are
7 calculated, how gross income is allocated, and how net income is allocated.

8 The provisions of the NBP and TCP partnership agreements work to ensure
9 that the partners' net income is as close to zero as possible and that the limited
10 partners have in fact almost no potential net income and therefore no potential tax
11 liability. I would note again that because partnerships do not pay income tax,
12 partnerships cannot have "taxable income," but simply net income, which,
13 nonetheless, is often referred to as taxable income. The partnership agreements do
14 not refer to taxable income, rather, they deal only with gross income and net
15 income allocations. The partners assemble their personal income information,
16 including the net income allocated to them by the partnership, and calculate the
17 deductions and exemptions applicable to them as individuals to arrive at their own
18 individual taxable income.

1 **1) Partnership Agreements**

2 **Q. What partnership agreements will you be referring to in the following**
3 **discussion?**

4 A. To assess the potential income tax liability for which NB's ratepayers will be held
5 responsible in the cost of service, I have examined partnership agreements for the
6 following entities: NB (Exhibit No. S-19), NBILP (Exhibit No. S-20), TCILP
7 (Exhibit No. S-21), NBP (Exhibit No. S-22), and TCP (Exhibit No. S-23).

8 **a) Capital Accounts**

9 **Q. What are capital accounts and how do they figure into this discussion?**

10 A. Capital accounts are the measure of each partner's equity interest in the
11 partnership, the net amount by which they are vested in the entity. Each partner's
12 capital account is increased by the partner's capital contributions to the partnership
13 and allocated net income from the partnership, and decreased by cash distributions
14 from the partnership to the partner, and partnership deductions. The balance in the
15 capital accounts may be used to determine whether cash distributions are taxable
16 income in any given tax period. Prior to its conversion from NBP to ONEOK on
17 May 17, 2006, the NBP web site contained a brief explanation of cash distributions
18 and income allocations. (See: Exhibit No. S-24)

1 **Q. What are distributive shares and how do they figure into this discussion?**

2 A. A distributive share is the individual partner's portion of one of several measures
3 of a partnership's financial condition. Distributions and allocations of partnership
4 items of income, loss, deductions, and capital are based on each partner's
5 distributive share of the partnership. Although one is tempted to conceive of a
6 distributive share as a simple percentage of ownership interest, the concept is
7 much more complex. For example, a partner's distributive share of the profits of
8 the enterprise may differ from that partner's distributive share of losses, depending
9 on the structure of the partnership agreement. Further, the distributive share of the
10 capital of the enterprise may differ from the shares of profit or loss. Each
11 partner's share of these elements is listed on the K-1 reported to the partner. The
12 partner's distributive share may also vary depending on when it is measured, what
13 the profitability of the enterprise is, how non-monetary contributions will be
14 valued, or on some preset conditions such as the level of gross or net income.
15 Because the partnership agreement is a contract between or among the partners, it
16 may specify any number of ways of calculating distributive shares.

17 **Q. Can a limited partner's capital account show a deficit balance?**

18 A. It is possible but unlikely. Since the capital account is a balance, the quarterly
19 recording of cash distributions and income allocation could temporarily push a

1 limited partner's capital account into a deficit if no further actions were taken. It
2 would seem that a zero balance for each partner is the ultimate goal of a
3 partnership, *i.e.*, each partner's capital contribution would eventually be balanced
4 by the depreciation component of the quarterly available cash, and the income
5 allocations would be balanced by the return and taxes component of the quarterly
6 available cash. Since the cash distributions are a return of capital, as noted in the
7 NBP web site extract in Exhibit No. S-24, from a ratemaking perspective, the
8 capital accounts should move toward zero as the capital contributions of each
9 partner are offset by the cash distributions to him or her.

10 **Q. Are NB's limited partners likely to find their capital accounts negative?**

11 A. No. Although the NB partnership is a simple pass through entity that passes cash
12 distributions and income allocations directly to the parent entities on a percentage
13 of ownership basis (See: Articles 5 and 6 of NB partnership agreement, Exhibit
14 No. S-19, page 25 of 77), its parent entities are more sophisticated and include
15 provisions that would tend to counteract the possibility of a deficit capital account
16 for their limited partners. The NBILP and TCILP partnership agreements contain a
17 complex income allocation procedure with provisions for addressing deficit capital
18 accounts for limited partners. For example, the NBILP partnership agreement
19 contains Article V, Section 5.1(d)(iv) *Gross Income Allocations*, that specifies that

1 if any partner has a deficit balance in its adjusted capital account at the end of any
2 taxable period, the partnership shall allocate gross income and gain in the amount
3 of the excess deficit to the partner as quickly as possible. (See: Exhibit No. S-20,
4 page 25 of 59) The effect of increasing that partner's income allocation is to make
5 sure the cash distribution would not become taxable income to the partner. The
6 'adjusted capital account' reference is intended to mean that cash distributions and
7 other allocations are made temporarily prior to the determination of whether the
8 capital account is in a deficit condition. The TCILP partnership agreement has
9 essentially the same language in Article 6.1(d)(iv). (See: Exhibit No. S-21, page
10 32 of 68)

11 The NBP and TCP partnership agreements contain even more complex
12 income allocation procedures. The NBP partnership agreement contains Article V,
13 Section 5.1(d)(iii) in addition to 5.1(d)(v) relating to gross income allocations.
14 Section 5.1(d)(iii)(A) specifies that if a limited partner receives a cash distribution
15 in excess of its pro rata share of cash distributions, the partnership shall allocate
16 gross income equal to the amount of that distribution. In other words, the income
17 allocated to the partner's capital account will equal the deficit created by the cash
18 distributions that drew down the capital account. Section 5.1(d)(v) specifies, like
19 its NBILP and TCILP counterparts, that if any partner has a deficit balance in its

1 adjusted capital account at the end of any taxable period, the partnership shall
2 allocate gross income and gain in the amount of the excess deficit as quickly to the
3 partner as possible. (See: Exhibit No. S-22, page 38 of 96) The TCP partnership
4 agreement has essentially the same provision under Article VI, Sections
5 6.1(d)(iii)(A) and 6.1(d)(v). (See: Exhibit No. S-23, page 47 of 104)

6 The effect of these provisions is that if a limited partner's capital account
7 would otherwise fall into a deficit for any reason, the partnership will allocate
8 gross income to that partner to balance any potential capital account deficit,
9 rendering the cash distribution as a non-taxable event.

10 **Q. Why are these provisions important to this discussion?**

11 A. The *Policy Statement* directs us to examine the tax status of the ultimate holder of
12 income tax liability for the partnership income, as well as the character of the tax
13 paid by the partner. Income allocations to the partners are included in each
14 partner's derivation of its current taxable income. Cash distributions are only
15 taxable as current taxable income to the extent the cash distributions exceed the
16 balance of the capital account for any particular partner. So the balance in each
17 partner's capital account will determine whether a cash distribution would result in
18 an income tax liability. Furthermore, the capital account balance will play a role
19 in establishing the character of future tax liabilities.

1 **Q. How does the balance in the capital account affect the character of the taxes**
2 **paid in the event the partner sells its interest?**

3 A. When a partner sells its interest in the partnership, the partner measures the gain or
4 loss on the sale by comparison to its capital account; the lower the capital account,
5 the greater the gain on the sale of the partner's interest. Section 741 of the IRS tax
6 code states that the sale or exchange of an interest in a partnership shall be treated
7 as the sale or exchange of a capital asset resulting capital gain or loss, unless
8 section 751 applies, whereby the gain or loss represents unrealized receivables or
9 appreciated inventory. (Unrealized receivables and appreciated inventory would
10 be ordinary income items had the partner held its interests until those items were
11 realized.) This is important here because there is a long standing principle of
12 ratemaking that the capital gains tax on an investor due to the sale of a regulated
13 asset is not an appropriate item for reimbursement by the ratepayers. Inasmuch as
14 the ratepayers garner no gain or benefits from the sale, they should not be held
15 liable for any costs arising from the investor's gain on the sale. As noted in
16 Opinion No. 441, gain or loss on the sale of property is income that does not arise
17 from utility operations, thus, for ratemaking purposes, is to be considered to be
18 "below the line." Similarly, a partner's gain on the sale of its interest is not
19 income that arose from utility operations but from the investor's risk in making the
20 investment.

1 **b) Cash Distributions v. Income Allocations**

2 **Q. What are cash distributions?**

3 A. Cash distributions are the flow-through of available cash from operations of the
4 enterprise to the partners, irrespective of the profitability of the enterprise. In
5 general, the costs of operating the enterprise will draw down cash as debts are
6 paid, labor is paid, vendors are paid, and taxes are paid. Non-monetary costs, such
7 as depreciation, return on equity, and, for partnerships, income taxes will leave the
8 cash balance untouched. The term cash distribution is not synonymous with the
9 terms gross income allocation, net income allocation, gross income, taxable
10 income, or net income. Nor are cash distributions necessarily dependent upon or
11 related to any of these amounts. Cash from entity operations comes from revenues
12 received for goods or services rendered, debt acquired, or capital contributed.
13 Cash is an asset on the entity's balance sheet but does not play a role in
14 determining income, net income, or taxable income as calculated on the entity's
15 income statement. Cash may be used to pay operating expenses, retire debt,
16 acquire plant and equipment, return of capital to investors, or simply to distribute
17 to investors.

18 Cash distributions are drawn from available cash. From a ratemaking
19 perspective, available cash (and therefore cash distributions) may be thought of as

1 representing some combination of return of capital, return on capital, and income
2 tax allowance. Looking again at the simplified cost of service example, the only
3 sources of available cash are depreciation, return on equity, and income tax
4 allowance.

5 Partnership Cost of Service – Available Cash:

6	Operating Expenses	\$31,000,000	
7	Debt Costs	\$40,250,000	
8	Taxes Other than Income	\$31,400,000	
9	Book Depreciation	\$86,000,000	} Available Cash
10	Return on Equity	\$80,500,000	
11	Income Taxes	\$49,105,000	
12	Total Revenue Requirement	\$318,255,000	\$215,605,000

13 **Q. Are cash distributions treated as taxable income?**

14 A. Not generally. Cash distributions are only taxable to the extent the distribution
15 exceeds the capital account. Cash distributions in excess of a partner's capital
16 account signify that it has recovered its capital contribution and the partner's cash
17 distributions have caught up with its allocated net income, which makes the cash
18 distribution taxable income to the partner.

19 **Q. What are income allocations?**

20 A. Net income allocations are the assignments of profitability to the partners after the
21 costs of operating the enterprise are subtracted. Akin to an IOU, the net income
22 allocation is registered in the partner's capital account but not necessarily paid

1 right away even though it must be reported to the IRS and may result in income tax
2 liability.

3 **Q. What are gross income and net income?**

4 A. Gross income, as defined by the Code of Federal Regulations 26 CFR §1.61, is the
5 total income from all sources including income realized in any form whether in
6 money, property, stocks, or services. It should be noted that gross income does not
7 include the return of capital, *i.e.*, depreciation.¹ While the depreciation
8 component of a cost of service revenue requirement is included in gross revenue, it
9 is not included in gross income.

10 Net income is a defined term in the NBP and TCP partnership agreements.
11 (See: Exhibit No. S-22, page 21 of 96 or Exhibit No. S-23, page 15 of 104)). In
12 pertinent part they read:

13 “Net Income” means for any taxable period, the excess, if any, of the
14 Partnership’s items of income and gain...for such taxable period
15 over the Partnership’s items of loss and deduction...for such taxable
16 period. The items included in the calculation of Net Income shall be
17 determined in accordance with Section 4.4(b) and shall not include
18 any items specially allocated under Section 5.1(d).²

¹ Federal Tax Course 2004, CCH Incorporated, Chicago, IL at ¶ 401

² §4.4(b) of the NBP agreement lists several categories of income, gain, loss or deduction that may be deducted from a partner’s capital account. The relevant sections of the TCP agreement are 5.5(b) and 6.1(d).

1 Generally, net income can only be allocated if there is some measure of net income
2 left after costs are extracted. However, partnership contract provisions may
3 require a greater allocation of *gross* income to the general partner than there is *net*
4 income available, thereby leaving the limited partners to carry a negative net
5 income allocation.

6 In the figures below, the depreciation component is moved to the top to
7 emphasize that depreciation is not a component of gross income.

8 Partnership Cost of Service – Gross Income:

9	Book Depreciation	\$86,000,000	}	Gross Income: \$232,255,000
10	Operating Expenses	\$31,000,000		
11	Debt Costs	\$40,250,000		
12	Taxes Other than Income	\$31,400,000		
13	Return on Equity	\$80,500,000		
14	Income Taxes	\$49,105,000		
15	Total Revenue Requirement	\$318,255,000		

16 Partnership Cost of Service – Net Income:

17	Book Depreciation	\$86,000,000	}	Net Income: \$129,605,000
18	Operating Expenses	\$31,000,000		
19	Debt Costs	\$40,250,000		
20	Taxes Other than Income	\$31,400,000		
21	Return on Equity	\$80,500,000		
22	Income Taxes	\$49,105,000		
23	Total Revenue Requirement	\$318,255,000		

24

25

1 **c) Cash Distributions Provisions**

2 **Q. Why is cash distribution an important issue in this case?**

3 A. For some limited partnerships like NBP and TCP, the partnership agreement
4 provides for special incentive cash distributions to the general partner. They act as
5 an inducement to the general partner to manage the operations so as to generate
6 higher levels of Available Cash. The incentive distributions are important here in
7 that they are the basis upon which gross income is allocated to the general partner,
8 and thereby directly affect the level of net income available for, and allocated to,
9 the limited partners, upon which they calculate their taxable income. The gross
10 income allocation to the general partner is tied to the incentive cash distribution to
11 the general partner, discussed below for NBP and TCP. Importantly, the NBP and
12 TCP partnership agreements do not provide for any discretion in determining the
13 amount of the cash distribution or the gross income allocation. This, from a rate
14 making perspective, renders them guaranteed payments to the general partner, as
15 will be discussed in more detail below.

16 **Q. What are incentive distributions?**

17 A. The NBP partnership agreement defines incentive distributions as quarterly cash
18 distributions made to the general partner in excess of 1% of the total amount
19 distributed pursuant to the target distributions for that quarter. Incentive

1 distributions reward the general partner for effectively managing the partnership
2 operations and producing greater amounts of cash from operations for distributions
3 to all partners. The TCP partnership agreement defines incentive distributions as
4 any cash distribution made to holders of incentive distribution rights. The TCP
5 incentive distribution rights holders are essentially the general partners. As will be
6 seen below, the cash distribution matrices demonstrate that the incentive
7 distributions made to NBP's general partners and to TCP's incentive distribution
8 rights holders, have a great impact on the ultimate profitability of the enterprise as
9 well as the calculation of, and allocation of, net income to the limited partners.

10 **Q. How does the NB partnership agreement specify the manner of cash**
11 **distributions?**

12 A. Article 5 of the NB partnership agreement specifies that cash distributions shall be
13 made from time to time as determined by the Management Committee to each
14 partner simultaneously in proportion to each partner's undistributed cumulative net
15 profits vis-à-vis the aggregate of all partners' undistributed cumulative net profits.
16 Thereafter, distributions shall be made in the ratio of the Partner's Percentage of
17 ownership. (See: Exhibit No. S-19, page 25 of 77) For NB, the Partnership
18 Percentage is the ratio of each partner's capital account to the aggregate of all
19 capital accounts.

1 **Q. Does the NB partnership agreement include any incentive cash distributions**
2 **for the general partners (NPNGC, PBGC, and NBPC)?**

3 A. No.

4 **Q. How does the NBILP partnership agreement specify the manner of cash**
5 **distributions?**

6 A. Section 5.3 of the NBILP partnership agreement specifies that within 45 days of
7 the end of each calendar quarter, 100% of the available cash will be distributed in
8 accordance with the relative interest percentages of each partner. (See: Exhibit
9 No. S-20, Page 29 of 59)

10 **Q. Does the NBILP partnership agreement include any incentive cash**
11 **distributions for the general partners (NPNGC, PBGC, and NBPC)?**

12 A. No.

13 **Q. How does the TCILP partnership agreement specify the manner of cash**
14 **distributions?**

15 A. Section 6.3 of the TCILP partnership agreement specifies that within 45 days of
16 the end of each calendar quarter, 100% of the available cash will be distributed in
17 accordance with the relative interest percentages of each partner. (See: Exhibit
18 No. S-21, Page 37 of 68)

19 **Q. Does the TCILP partnership agreement include any incentive cash**
20 **distributions for the general partner (TCPGP)?**

21 A. No.

1 **Q. How does the NBP partnership agreement specify the manner of cash**
2 **distributions?**

3 A. Section 5.4 of the NBP partnership agreement specifies that within 45 days of the
4 end of each calendar quarter, 100% of the available cash will be distributed in
5 accordance with the specified targets listed in the agreement. (See: Exhibit No. S-
6 22, Page 42 of 96) Distributions are made on a quarterly basis based on Minimum
7 Quarterly Distributions and targeted distributions as illustrated in Table 1 below.

8 **Q. Does the NBP partnership agreement include any incentive cash distributions**
9 **for the general partners (NPNGC, PBGC, and NBPC)?**

10 A. Yes. As Table 1 illustrates, the NBP agreement specifies that the general partners
11 (currently NPNGC, PBGC, and NBPC) shall receive cash distributions in
12 progressively larger shares of the total distribution of Available Cash increases.

13

1

Table 1 – NBP Incentive Distributions			
§		Target Distribution	Cash Distribution Mechanism under §5.4
§5.4(a)	Minimum Quarterly Distribution	\$0.55/ Unit	99% to Limited Partners & 1% to General Partner up to the Minimum Quarterly Distribution
§5.4(b)			99% to Limited Partners & 1% to General Partner until any Common Unit arrearages are erased
§5.4(c)	Minimum Quarterly Distribution		99% to Limited Partners & 1% to General Partner until subordinated units equal the Minimum Quarterly Distribution
§5.4(d)	First Target Distribution	\$0.605/ Unit	99% to Limited Partners & 1% to General Partners for any excess cash over the Minimum up to the First Target
§5.5(e)	Second Target Distribution	\$0.715/ Unit	85.87% to Limited Partners & 14.13% to General Partner for any excess cash over the First Target up to the Second Target
§5.4(f)	Third Target Distribution	\$0.935/ Unit	75.76% to Limited Partners & 24.23% to General Partner for any excess cash over the Second Target up to the Third Target
§5.4(g)			50.51% to Limited Partners & 49.49% to General Partner for any excess cash over the Third Target

2 Starting from a modest 1% share, the general partners’ share grows to 49.5% as the
3 target cash distribution goals are met. Importantly, to the extent these escalating
4 distributions to the general partner exceed 1% of the aggregate cash being
5 distributed pursuant to these sections (1% being the general partners’ ownership

1 percentage), they are called Incentive Distributions and are used as the base upon
2 which Priority Allocations are made under §5.1(d)(iii), *i.e.*, gross income is
3 allocated to the general partner in an amount equal to the incentive distributions.

4 **Q. What is NBP's history in regard to meeting its target distribution goals?**

5 A. Exhibit No. S-25 is an excerpt from the NBP web site showing the history of NBP
6 cash distributions starting in 1997. The text notes that the minimum quarterly
7 distribution target of \$0.55/unit was paid every quarter from February 1994
8 through December 1997. The first target of \$0.605/unit was met on February 1999
9 and every quarter thereafter until May 2001 when the second target of \$0.715/unit
10 was met. Since then the second tier cash distribution target has been met every
11 quarter. Thus, the general partners have received incentive distributions
12 continuously for at least the last five years.

13 **Q. How does the TCP partnership agreement specify the manner of cash**
14 **distributions?**

15 A. Section 6.4 of the TCP partnership agreement specifies that within 45 days of the
16 end of each calendar quarter, 100% of the available cash will be distributed in
17 accordance with the specified targets listed in the agreement. (See: Exhibit No. S-
18 23, Page 51 and 53 of 104) Distributions are made on a quarterly basis based on
19 Minimum Quarterly Distributions and targeted distributions as illustrated below.

1 **Q. Does the TCP partnership agreement include any incentive cash distributions**
2 **for the general partner (TCPGP)?**

3 A. Yes. As Table 2 illustrates, the TCP agreement specifies that the general partners

Table 2 – TCP Incentive Distributions			
§		Target Distribution	Cash Distribution Mechanism under §5.4
§6.4(b)(i)	Minimum Quarterly Distribution	\$0.45/ Unit	99% to All Unit Holders & 1% to the General Partner up to the Minimum Quarterly Distribution
§6.4(b)(ii)	First Target Distribution	\$0.5275/ Unit	85.87% to All Unit Holders, 13.13% to Incentive Rights Holders & 1% to General Partner for any excess cash over the Minimum up to the First Target
§6.4(b)(iii)	Second Target Distribution	\$0.6900/ Unit	75.77% to all Unit Holders, 23.23% to Incentive Rights Holders & 1% to General Partner for any excess cash over the First Target up to the Second Target
§6.4(b)(iv)			50.51% to All Unit Holders, 48.49% to Incentive Rights Holders & 1% to General Partner for any excess cash over the Second Target

4 shall receive cash distributions in progressively larger shares of the total
5 distribution as the partnership’s Available Cash increases. Starting from a modest
6 1% share, the general partner’s share grows to 49.5% as the target cash distribution
7 goals are met. Again, any distributions in excess of the general partner’s 1%
8 ownership share is an incentive distribution. These Incentive Distributions are
9 used as the base upon which Priority Allocations are made under §6.1(d)(iii), *i.e.*,

1 gross income is allocated to the general partner in an amount equal to the incentive
2 distributions.

3 **Q. What is TCP's history in regard to meeting its target distribution goals?**

4 A. Exhibit No. S-25, page 3 of 3, also has the TCP cash distribution history from its
5 web site. TCP met its minimum quarterly distribution target of \$0.45/unit every
6 quarter from August 1999 through August 2003 when it reached \$0.55/unit,
7 surpassing the first target goal of \$0.5275. It has attained and surpassed its first
8 target goal, resulting in incentive distributions, every quarter since then.

9 **d) Income Allocation Provisions**

10 **Q. Why is net income allocation important in this case?**

11 A. Net income is the amount of income passed through to the partners, which they use
12 to calculate their individual taxable income. As such, net income determines the
13 income tax bracket into which the individual partner falls, and the associated
14 income tax rate that will be factored into the weighted average marginal income
15 tax rate.

16 **Q. What is taxable income?**

17 A. Taxable income is the amount of net income subject to income tax. Taxable
18 income may differ from net income by the amount of expenses that are
19 deductible for federal income tax purposes but not for book purposes, or

1 expenses deductible for book purposes but not for tax purposes. The
2 primary difference between taxable income and net income is the difference
3 between book depreciation and accelerated depreciation.

4 **Q. Are there “incentive allocations” for the general partner?**

5 A. In a sense, yes. For NBP and TCP, the general partners’ income allocation is
6 based not on the profitability of the enterprise but on the amount of cash
7 distributions awarded to the general partner. The partnership agreements call for
8 the general partners to receive gross income allocations in amounts equal to the
9 incentive cash distribution. Therefore, the more cash the general partner can
10 generate, the more gross income will be allocated to the general partner; the more
11 gross income allocated to the general partner, the less net income there is available
12 for allocation to the limited partners.

13 There are subtle differences among the partnership agreements regarding
14 income allocations. The general gist of the provisions is that there is a priority for
15 income allocation: first, general partners are made whole for past losses; next,
16 limited partners are made whole for any past losses; then deficit balances in the
17 capital account are alleviated; then general partners are allocated gross income to
18 match their incentive cash distributions (NBP and TCP); last, the limited partners
19 are allocated any remaining net income.

1 **Q. How does the NB partnership agreement allocate income?**

2 A. Section 5 of the NB partnership agreement provides for the allocation of income
3 (using the term “profits and losses”) in proportion to each partner’s respective
4 partnership percentage. (See: Exhibit No. S-19, page 25 of 77)

5 **Q. How does the NBILP partnership agreement allocate income?**

6 A. NBILP is an intermediate partnership between NB and NBP. Article V of the
7 NBILP partnership agreement spells out the gross and net income allocations
8 provisions. (See: Exhibit No. S-20, pages 23 through 26 of 59) Section 5.1(a)(i)
9 specifies that after the special allocations of §5.1(d) are made and, until the general
10 partners are made whole for past losses, net income shall be allocated 100% to the
11 general partners (NPNGC, PBGC, and NBPC) to make up for any current or past
12 losses allocated to the general partners. Section 5.1(a)(ii) specifies that any
13 remaining income will be allocated 99% to the limited partner (NBP) and 1% to
14 the general partners.

15 Section 5.1(b)(i) specifies that *after* the special allocations of §5.1(d) are
16 made, net losses will be allocated to the general partners and limited partner, NBP,
17 in proportion to their respective adjusted capital accounts; thereafter 100% among
18 the general partners.

1 Section 5.1(d) specifies the special allocations that are made prior to the
2 allocations of net income or net losses. Section 5.1(d)(iv) specifies that if any
3 partner has a deficit in its capital account in excess of amounts that the partner
4 would be otherwise required to restore, the partnership shall allocate gross income
5 in an amount equal to that excess as quickly as possible. (Note that there are no
6 gross income allocations matching the cash distribution to the general partner here,
7 as we will see in NBP and TCP, below.)

8 **Q. How does the TCILP partnership agreement allocate income?**

9 A. TCILP is an intermediate partnership between NB and TCP. Similar to the
10 NBILP partnership allocations, Article VI of the TCILP partnership agreement
11 spells out the income allocations provisions. (See: Exhibit No. S-21, pages 29
12 through 33) Section 6.1(a)(i) specifies that after the special allocations of §6.1(d)
13 are made and until the general partner is made whole for past losses, net income
14 shall be allocated 100% to the general partner (TCPGP) to make up for any current
15 or past losses allocated to the general partner. Section 6.1(a)(ii) specifies that any
16 remaining income will be allocated 99% to the limited partner (TCP) and 1% to
17 the general partner.

18 Section 6.1(b)(i) specifies for the years 1999 through 2002, 100% of the net
19 losses of TCILP will be allocated to the general partner TCPGP. Thereafter, 1%

1 of the net losses will be allocated to the general partner and 99% allocated to the
2 limited partner TCP unless such allocations would cause a limited partner's capital
3 account to have a deficit balance. (A deficit balance in its capital account would
4 make the cash distributions taxable income.) Any further losses are to be
5 allocated to the general partner, *i.e.*, the amount that would otherwise be allocated
6 to limited partners.

7 Section 6.1(d) specifies the special allocations that are made prior to the
8 allocations of net income or net losses. Section 6.1(d)(iv) specifies that if any
9 partner has a deficit in its capital account in excess of amounts that the partner
10 would be otherwise required to restore, the partnership shall allocate gross income
11 in an amount equal to that excess as quickly as possible. (Again, there are no gross
12 income allocations matching the cash distribution to the general partner here, as
13 we will see in NBP and TCP, below.)

14 **Q. How does the NBP partnership agreement allocate income?**

15 A. Article V of the NBP partnership agreement spells out the gross and net income
16 allocation provisions. (See: Exhibit No. S-22, pages 34 through 38 of 96) Section
17 5.1(a)(i) specifies that *after* the special allocations of §5.1(d) are made and until
18 the general partners are made whole for past losses, net income shall be allocated
19 100% to the general partners (NPNGC, PBGC, and NBPC) to make up for any

1 current or past losses allocated to the general partners. Section 5.1(a)(ii) specifies
2 that *after* the special allocations of §5.1(d) are made, net losses will be allocated
3 100% to the general partners and limited partners until the aggregate net losses are
4 made up. Thereafter, net income is allocated based on the partner's respective
5 percentage interests.

6 Section 5.1(d) specifies the special allocations that are made prior to the
7 allocations of net income or net losses. Section 5.1(d)(iii)(A) specifies that if any
8 partner has a deficit in its capital account in excess of amounts that the partner
9 would be otherwise required to restore, the partnership shall allocate gross income
10 in an amount equal to that excess as quickly as possible. Section 5.1(d)(iii)(B)
11 specifies that all or a portion of remaining gross income of the partnership (after
12 capital account deficits are made whole) shall be allocated 100% to the general
13 partners until the aggregate amount is equal to the cumulative cash distributions
14 made to the general partner through the incentive cash distribution provisions.
15 Section 5.1(d)(v) specifies that if any partner has a deficit in its capital account in
16 excess of amounts that the partner would be otherwise required to restore, the
17 partnership shall allocate gross income in an amount equal to that excess as
18 quickly as possible.

1 **Q. How does the TCP partnership agreement allocate income?**

2 A. Article VI of the TCILP partnership agreement spells out the income allocation
3 provisions. (See: Exhibit No. S-21, pages 29 through 33) Section 6.1(a)(i)
4 specifies that *after* the special allocations of §6.1(d) are made and, until the general
5 partner is made whole for past losses, net income shall be allocated 100% to the
6 general partner (TCPGP) to make up for any current or past losses allocated to the
7 general partner. Section 6.1(a)(ii) specifies that any remaining income will be
8 allocated 99% to the limited partner (TCP) and 1% to the general partner.

9 Section 6.1(b)(i) specifies for the years 1999 through 2002, 100% of the net
10 losses of TCILP will be allocated to the general partner TCGP. Thereafter, 1%
11 of the net losses will be allocated to the general partner and 99% allocated to the
12 limited partner TCP unless such allocations would cause the limited partner's
13 capital account to have a deficit balance. (A deficit balance in its capital account
14 would make the cash distributions taxable income.) Any further losses will be
15 allocated to the general partner, *i.e.*, the amount that would otherwise be allocated
16 to limited partners.

17 Section 6.1(d) specifies the special allocations that are made prior to the
18 allocations of net income or net losses. Section 6.1(d)(iii)(B) specifies that all or a
19 portion of remaining gross income of the partnership (after capital account deficits

1 are made whole) shall be allocated 100% to the holders of incentive distribution
2 rights until the aggregate amount is equal to the cumulative incentive right cash
3 distributions. Section 6.1(d)(iv) specifies that if any partner has a deficit in its
4 capital account in excess of amounts that the partner would be otherwise required
5 to restore, the partnership shall allocate gross income in an amount equal to that
6 excess as quickly as possible.

7 **Q. What is the importance of the sections that match gross income to incentive**
8 **distributions?**

9 A. The gross income allocations to the general partners determine the remaining net
10 income amounts available for allocation to the limited partners. If we revisit my
11 simplified cost of service model, we can see the impact of the incentive
12 distributions and gross income allocations on the net income allocated to the
13 limited partners. I will first assume that NBP's cash distribution and income
14 allocation provisions apply directly to the simplified cost of service model here.
15 Then I will assume that NBP's actual cash distribution attainment level will dictate
16 cash distributions and income allocations.

17 Assuming that NBP's cash distribution and income allocation provisions
18 apply directly to the simplified cost of service model, this partnership's available
19 cash amounts to \$4.68/unit triggering a cash distribution to the general partner of

1 approximately 50%. The remaining cash is distributed to the limited partners
2 giving them about \$2.34 per unit.

3 Partnership Cost of Service – Available Cash:

4	Operating Expenses	\$31,000,000		
5	Debt Costs	\$40,250,000		
6	Taxes Other than Income	\$31,400,000		
7	Book Depreciation	\$86,000,000	}	
8	Return on Equity	\$80,500,000		Available Cash:
9	Income Taxes	<u>\$49,105,000</u>		
10	Total Revenue Requirement	\$318,255,000		

11	Available Cash	\$215,605,000 / 46,000,000 units = \$4.68	
12	General Partner Share	<u> </u> x <u> </u> 50%	
13	General Partner Distribution	\$107,802,500	
14	Limited Partners Share	\$107,802,500 / 46,000,000 units = \$2.34	

15 The income allocation provisions, under the NBP agreement, allocate to the
16 general partner a dollar amount equal to its cash distribution. An allocation out of
17 gross income by necessity reduces net income by the same amount; hence the
18 limited partners share the remaining \$21, 802,500. We can see some of the
19 attraction of the partnership investment as a tax shelter; while the limited partners
20 received a \$2.34/unit cash distribution, their taxable income amounted to only
21 \$0.47/unit.

1	Partnership Cost of Service – Net Income to LPs:		
2	Operating Expenses	\$31,000,000	
3	Debt Costs	\$40,250,000	
4	Taxes Other than Income	\$31,400,000	
5	Book Depreciation	\$86,000,000	
6	Return on Equity	\$80,500,000	} Net Income:
7	Income Taxes	<u>\$49,105,000</u>	
8	Total Revenue Requirement	\$318,255,000	
9	Net Income	\$129,605,000 / 46,000,000 units = \$2.81	
10	General Partner Allocation	- <u>\$107,802,500</u>	
11	Net Income Allocation to LPs	\$ 21,802,500 / 46,000,000 units = \$0.47	

12 Now let's assume that NBP's actual cash distribution attainment level will dictate
13 cash distributions and income allocations. From Exhibit No. S-25, we know that
14 both NBP and TCP have been reaching their second tier target distribution goals
15 for several years, which means that according to the partnership agreements,
16 14.13% of NBP available cash and 13.13% of TCP available cash must be
17 distributed to the general partners. For simplicity, let's call it 13.5%. The
18 partnership agreement incentive cash distributions provisions then would require
19 \$29,106,000 be distributed among the general partners.

20

1 Partnership Cost of Service – Available Cash & GP’s Share:

2	Operating Expenses	\$31,000,000	
3	Debt Costs	\$40,250,000	
4	Taxes Other than Income	\$31,400,000	
5	Book Depreciation	\$86,000,000	} Available Cash:
6	Return on Equity	\$80,500,000	
7	Income Taxes	\$49,105,000	
8	Total Revenue Requirement	\$318,255,000	
9	Available Cash	\$215,605,000 / 46,000,000 units = \$4.68	
10	General Partner Share	<u> </u> x <u> </u> 13.5%	
11	General Partner Distribution	\$ 29,106,000	
12	Limited Partners Share	\$186,499,000 / 46,000,000 units = \$4.05	

13 To continue, because Section 5.1(d)(iii)(B) of NBP and Section 6.1(d)(iii)(B) of
14 TCP require a matching of gross income to the incentive cash distribution, the
15 general partners will also be allocated \$29,106,000 of gross income. Here, our net
16 income now falls from \$129,605,000 to \$100,499,000.

17 Partnership Cost of Service – “Book” Net Income to LPs:

18	Operating Expenses	\$31,000,000	
19	Debt Costs	\$40,250,000	
20	Taxes Other than Income	\$31,400,000	
21	Book Depreciation	\$86,000,000	} Net Income:
22	Return on Equity	\$80,500,000	
23	Income Taxes	\$49,105,000	
24	Total Revenue Requirement	\$318,255,000	
25	Net Income	\$129,605,000 / 46,000,000 units = \$2.81	
26	General Partner Allocation	- <u>\$ 29,106,000</u>	
27	Net Income Allocation to LPs	\$100,499,000 / 46,000,000 units = \$2.18	

1 The above examples illustrate the mechanism of the partnership agreements. As
2 we will see in discussing the actual tax returns, most limited partners receive
3 negative income allocations, suggesting there is another mechanism at play as
4 well. One element is that in deriving the net income to be allocated among the
5 partners, the partnership uses accelerated depreciation, which reduces net income
6 for tax purposes. Another appears to be that some partners appear to be allocated
7 disproportionately large allocations, causing others to bear negative income
8 allocations.

9 **Q. Does this example reflect what actually happened to NB in 2004?**

10 A. Other than the per unit distributions and allocations, yes. The basic cost of service
11 figures correlate with NB's 2004 filed cost of service. While the figures above are
12 only approximations of the Northern Border filing, the net income figure of \$129
13 million is still in the neighborhood of the amount reported on NB's actual IRS
14 1065 tax return as ordinary business income of **[begin protected** xxxxxxxxxxxxxx
15 **end protected]**, while its net income was reported as **[begin protected**
16 xxxxxxxxxxxxxx **end protected]**. (Compare: Exhibit No. S-13, page 1 of 21, line
17 22, and page 4, Schedule M-1 in middle of page, line 1)

1 **Q. What then was the partners' income tax liability on NB for the 2004 net**
2 **income?**

3 A. Zero. (I have to jump ahead for a bit here to discuss the net income allocations as
4 reported on the K-1s that are part of a partnership's IRS Form 1065 filing. I'll
5 return later to an explanation of the K-1s.) Following the income stream through
6 each of NB general partners, NBILP and TCILP, to NBP and TCP, we find that as
7 a whole, the ultimate holders of NB income tax liability received negative income
8 allocations. At least, that's what they reported to the IRS.

9 NB's net income flows through NBILP to NBP, which in turn reported net
10 income of **[begin protected xxxxxxxxxxxx end protected]**. (See: Exhibit No. S-
11 16, page 4, Schedule M-1 in middle of page, line 1) Yet the K-1s show that, as
12 ultimate holders of NB's income tax liability, the general partners of NBP were
13 allocated **[begin protected xxxxxxxxxxxx end protected]** net income while the
14 limited partners were allocated an aggregate loss of **[begin protected**
15 **xxxxxxxxxxxx end protected]**. (Compare: Exhibit No. S-16, page 4, lines 2a and
16 the sum of line 2b)

17 NB's net income also flows through TCILP to TCP, which in turn reported
18 net income of **[begin protected xxxxxxxxxxxx end protected]**. (See: Exhibit No. S-
19 17, page 4, Schedule M-1 in middle of page, line 1) Yet the K-1s show that, as

1 ultimate holders of NB's income tax liability, the general partners of TCP were
2 allocated a gain of **[begin protected xxxxxxxx end protected]** net income while
3 the limited partners were allocated an aggregate gain of **[begin protected**
4 **\$xxxxxxx end protected]**. (Compare: Exhibit No. S-17, page 4, lines 2a and the
5 sum of line 2b) For the approximately **[begin protected xxxxxx end protected]**
6 unit holders of TCP, the almost **[begin protected xxxxxxxxxxxx end protected]** in
7 net income spreads out to about \$1,000 a piece, which on a stand alone basis
8 would generally place them in a zero tax bracket.

9 The *Policy Statement* instructs us to look to the tax status of the ultimate
10 holders of income tax liability for the regulated entity. When we do so, as noted
11 above, we see in these tax returns that the NBP ultimate holders of income tax
12 liability for NB earned not profits, but substantial losses and thus have no income
13 tax liability. Mr. Peters' income tax rate derivation does not address the fact that
14 the actual tax liability, as reflected in the forms they filed with the IRS, show
15 negative income and therefore no actual income tax liability.

16

1 **e) Guaranteed Payments**

2 **Q. What is the importance of the gross income allocations as they relate to**
3 **income tax liability?**

4 A. The importance of the gross income allocations, such as the incentive payments to
5 the general partner, to income tax liability is that the gross income allocations
6 reduce the amount of net income to be allocated among the partners, which is the
7 basis for determining each partner's taxable income. In fact, the NBP and TCP
8 partnership agreements define net income as specifically excluding any items
9 specially allocated under Section 5.1(d) or Section 6.1(d) respectively. (See:
10 Exhibit No. S-22, page 21 of 96) Allocations from gross income are of the nature
11 of an expense to the partnership, not a measure of profitability upon which an
12 income tax would be derived and the burden of which would be placed upon the
13 ratepayers. The partner that receives the gross income allocation will most likely
14 have an income tax liability on that income, but whether that partner pays an
15 income tax on that gross income allocation or not is of no consequence to the
16 ratepayer. The ratepayer is only responsible for the tax burden arising out of net
17 income allocations to the partners, not deductions from gross income for expenses
18 such as the incentive payments.

1 The important point here is that all allocated income is not automatically
2 taxable income for which the ratepayers should be held responsible. That the
3 partnership agreements elected to use the term gross income rather than net income
4 is significant. In other words, the general partners are allocated a major share of
5 revenues off the top, leaving the others to share the net income. The general
6 partner's priority allocation of a portion of gross income is a contractual agreement
7 among the partners rewarding the general partners for managing the partnership in
8 such a way as to generate more cash. Thus, a large proportion of NBP and TCP
9 income is drawn off in advance to compensate its general partners for management
10 services and, as such, is not taxable income but rather is a cost of doing business,
11 which should be deducted before tax liabilities are calculated.

12 Furthermore, the gross income allocations to the general partners of NBP
13 and TCP are not provided for services rendered to NB for the management of the
14 NB pipeline system but rather for the management of the NBP and TCP
15 consolidated operations. As reflected in the organizational charts of Exhibit No.
16 S-10, the general partners of NBP are responsible for gas storage fields, coal slurry
17 pipelines, gas gathering fields operations, processing plants, and other gas
18 pipelines. It is not clear that the ratepayers of NB derive any direct or indirect
19 benefit from the incentive distributions or matching gross income allocations to the

1 general partners or if they do, how much. Therefore, until a more certain causal
2 link can be shown, the ratepayers should not be held responsible for any income
3 taxes arising out of the gross income allocations to the general partners. Any
4 indirect benefits that the ratepayers may derive from the management services of
5 the general partners of NBP and TCP are already incorporated into the corporate
6 overheads included in the operating costs of the NB cost of service.

7 **Q. What is a guaranteed payment?**

8 A. The Code of Federal Regulations, 26 CFR §1.707-1(c), defines guaranteed
9 payments as fixed amounts paid to partners for services or for the use of capital
10 without regard to the income of the partnership. They are treated the same as
11 payments to an outsider for purposes of computing gross income and business
12 expense deductions.³ As it relates to a regulated entity, a guaranteed payment
13 should have some causal relationship to the cost of providing services to ratepayers
14 for that guaranteed payment to be incorporated into the cost of service directly or
15 indirectly.

16

³ Federal Tax Course 2004, CCH Incorporated, Chicago, IL, at ¶ 1923.

1 **Q. In your opinion, does the gross income allocation qualify as a “guaranteed**
2 **payment” as defined by the IRS Code 1.707-1(c)?**

3 A. Yes. A guaranteed payment is for fixed amounts paid to partners for services or
4 for the use of capital *without regard to the income of the partnership*. The
5 partnership agreements clearly state that the gross income allocation to the general
6 partners happens prior to any net income allocation to the limited partners. Net
7 income is the measure of profitability of the enterprise. The incorporation of
8 gross income allocations to the general partners into the assessment of whether
9 NB’s ratepayers are responsible for an income tax allowance to cover a potential
10 income tax liability on the part of the general partners, ignores the important
11 principle of cost causation/cost responsibility. This principle cautions us to
12 ascertain whether the cost was incurred for something of value to the ratepayers
13 and whether that payment was within some band of reasonable compensation for
14 the good or service rendered. The fact that the great majority of limited partners
15 are allocated negative net income on their Schedule K-1 indicates that the gross
16 income allocation to the general partners happens without regard to the income of
17 the partnership. Thus, it is not related at all to the profitability of the partnership,
18 but a straightforward cost to the partnership. The allocation should, for

1 ratemaking purposes, be treated the same as any other payments to an outsider for
2 purposes of computing net income and business expense deductions.

3 **Q. Isn't there an income tax liability regardless of whether the allocation is from**
4 **gross income or net income?**

5 A. There is an income tax liability for the general partner that received the gross
6 income allocation but, for rate purposes, that allocation is not net income to the
7 partnership but a cost to the partnership for which no tax allowance burden should
8 be placed upon the ratepayers.

9 **Q. Do any of the tax returns report guaranteed payments on page 4, Schedule M-**
10 **1, line 3?**

11 A. No.

12 **2) Income Sheltering Aspect of Partnerships**

13 **a) IRS Schedule K-1**

14 **Q. What are IRS Schedules K, M-1, and K-1?**

15 A. IRS Schedule K, which appears as page 3 of the IRS Form 1065, starts with the
16 ordinary business income of the partnership from page 1, line 22 and calculates the
17 partners' (as a whole) distributive share of items of income and deduction.

18 Schedule M-1 reconciles the partnership book net income with the partners'
19 taxable net income. In general, Schedule M-1 starts with net book income on line

1 1, adds back the book depreciation and travel & entertainment expenses on line 4
2 to arrive at a gross income amount. (Compare: my simplified cost of service gross
3 income estimate on page 72 with Exhibit No. S-13, page 4, Schedule M-1 in
4 middle of page, line 5) Schedule M-1 then subtracts the accelerated depreciation
5 and partner's §743(b) depreciation on line 7a and 7b to arrive at the net income on
6 line 9 to be allocated to the partners on page 4, line 1 of Form 1065. The §743(b)
7 depreciation will be discussed below.

8 Schedule K-1 is the associated report filed by partnerships with both the
9 IRS and the partners in conjunction with the Form 1065, reporting each partner's
10 share of partnership income, gain, loss, deductions, and credits. The partner may
11 then use that information to calculate its taxable partnership income. The partner
12 is liable for tax on the net income, if any, reported on the K-1, not on the cash
13 received through distributions, if any.

14 **Q. How does Form 1065 show the allocation of net income among partners?**

15 A. Line 1 of Page 4 of Form 1065 reflects the calculation of the partners' taxable
16 income as derived in Schedule M-1 on page 4 of Form 1065. Lines 2a and 2b
17 show how that net income was allocated among the partners. The instructions for
18 Form 1065 require line 1 to equal the sum of lines 2a and 2b. (See: Exhibit No. S-
19 12, page 34) Line 2a and 2b show the allocations among corporate partners, active

1 **Q. What do these figures mean in regard to NB's income tax allowance?**

2 A. Although the exercises above are complicated and cumbersome, they illustrate a
3 number of points. First, the partnership agreements dictate the cash distributions
4 and income allocations among partners, and can have a significant impact on net
5 income allocations to the limited partners, and thereby the income tax liability they
6 may bear. Second, the NB partnership is a simple general partnership where cash
7 and net income flow directly through to the partners in a pro rata basis. There is
8 no incentive distribution to the general partner, so its net income allocations do not
9 tend to lower the allocations to limited partners, if there were any. Third, the MLP
10 partnership agreements do complicate matters, tending to build a divergence
11 between cash distributions and income allocations that make them attractive tax
12 shelters, and establishing a low income tax status for the ultimate holders of NB
13 income tax liability. Fourth, the tax returns for NBP suggests that despite being a
14 profitable enterprise, some mechanism is at work causing negative net income
15 allocations to the limited partners as a whole and to most in particular, again
16 resulting in a low tax burden for the holders of NB's ultimate income tax liability.

17

18

1 **b) Book v Taxable Income**

2 **Q. Earlier, you described how the partnership agreements dictated the allocation**
3 **of income between the general partners and the limited partners on a “book”**
4 **basis. How does the partnership agreement affect the allocations on a “tax”**
5 **basis?**

6 A. The examples I provided earlier examined the breakdown of the cost of service
7 revenue requirement in terms of available cash, and its consequent allocation of
8 both cash and gross income to the general partner, and how these affected the
9 limited partners’ cash distributions and net income allocations from a book basis.
10 Now I will show how the same revenue requirement figures convert into taxable
11 income for the partners due to the use of accelerated depreciation.

12 **Q. How does the general and limited partners fair in the cash distribution and**
13 **gross income allocation for tax purposes?**

14 A. The difference in this simplified cost of service model is that I am using an
15 accelerated depreciation expense of 150% of the book depreciation expense. Since
16 we are only looking at the tax consequences, the total revenue requirement stays
17 the same. The difference between book and accelerated depreciation comes out of
18 the net income figure, which is the intent so that the partner’s taxable income is
19 reduced. The interaction of return and the tax allowance gross up factor results in
20 the reduced figures shown below. Assuming that NBP’s cash distribution and

1 income allocation provisions apply directly to the simplified cost of service model,
2 the cash distributions remain the same as shown earlier: this partnership's
3 available cash amounts to \$4.68/unit triggering a cash distribution to the general
4 partner of approximately 50%. The remaining cash is distributed to the limited
5 partners giving them about \$2.34 per unit.

6	Partnership Cost of Service – Available Cash:		
7	Operating Expenses	\$31,000,000	
8	Debt Costs	\$40,250,000	
9	Taxes Other than Income	\$31,400,000	
10	Accelerated Depreciation	\$129,000,000	} Available Cash:
11	Return on Equity	\$53,800,000	
12	Income Taxes	\$32,800,000	
13	Total Revenue Requirement	\$318,250,000	\$215,600,000
14	Available Cash	\$215,600,000 / 46,000,000 units = \$4.68	
15	General Partner Share	<u> </u> x <u> </u> 50%	
16	General Partner Distribution	\$107,800,000	
17	Limited Partners Share	\$107,800,000 / 46,000,000 units = \$2.34	

18 However, the income allocation provisions, under the NBP provision, look quite a
19 bit different. The general partner still gets a dollar amount of gross income equal
20 to its cash distribution. An allocation out of gross income by necessity still
21 reduces net income by the same amount. But now, the gross income allocation to
22 the general partner exceeds the taxable net income, leaving the limited partners to

1 share a loss of \$21 million. We can see some of the attraction of the partnership
2 investment as a tax shelter; while the limited partners received a \$2.34/unit cash
3 distribution, their taxable income amounted to a loss of \$0.47/unit.

4 Partnership Cost of Service – “Taxable” Net Income to LPs:

5	Operating Expenses	\$31,000,000	
6	Debt Costs	\$40,250,000	
7	Taxes Other than Income	\$31,400,000	
8	Accelerated Depreciation	\$129,000,000	
9	Return on Equity	\$53,800,000	} Net Income:
10	Income Taxes	<u>\$32,800,000</u>	
11	Total Revenue Requirement	\$318,250,000	
12	Net Income	\$86,600,000 / 46,000,000 units = \$1.88	
13	General Partner Allocation	- <u>\$107,800,000</u>	
14	Net Income Allocation to LPs	- \$ 21,200,000 / 46,000,000 units = (\$0.47)	

15 **Q. How does the limited partner fair in the cash distribution and income**
16 **allocation for tax purposes under the scenario of the general partner receiving**
17 **only 13.5% of the cash distributions?**

18 A. Under the scenario where the general partner receives just 13.5% of the available
19 cash, the general partner is allocated gross income of \$29 million leaving the
20 limited partners to share \$186.5 million cash distribution, or \$4.05/unit.

21

1	Partnership Cost of Service – Available Cash:		
2	Operating Expenses	\$31,000,000	
3	Debt Costs	\$40,250,000	
4	Taxes Other than Income	\$31,400,000	
5	Accelerated Depreciation	\$129,000,000	} Available Cash:
6	Return on Equity	\$53,800,000	
7	Income Taxes	\$32,800,000	
8	Total Revenue Requirement	\$318,255,000	\$215,600,000
9	Available Cash	\$215,600,000 / 46,000,000 units = \$4.68	
10	General Partner Share	<u> </u> x <u> </u> 13.5%	
11	General Partner Distribution	\$ 29,106,000	
12	Limited Partners Share	\$186,494,000 / 46,000,000 units = \$4.05	

13 The taxable income allocations to the limited partners are not so drastic this time.
14 Here, after the general partner is allocated the matching \$29 million in gross
15 income, the limited partners share \$57.5 million for a per unit net income
16 allocation of \$1.25.

17	Partnership Cost of Service – “Tax” Net Income to LPs:		
18	Operating Expenses	\$31,000,000	
19	Debt Costs	\$40,250,000	
20	Taxes Other than Income	\$31,400,000	
21	Accelerated Depreciation	\$129,000,000	} Net Income:
22	Return on Equity	\$53,800,000	
23	Income Taxes	\$32,800,000	
24	Total Revenue Requirement	\$318,250,000	\$86,600,000
25	Net Income	\$86,600,000 / 46,000,000 units = \$1.88	
26	General Partner Allocation	- <u>\$29,106,000</u>	
27	Net Income Allocation to LPs	\$57,494,000 / 46,000,000 units = \$1.25	

1 The net income allocation in the last two examples does not take into consideration
2 the partner's §743(b) depreciation which will further reduce their individual
3 taxable income, which will be discussed below.

4 **c) The Character of the Tax**

5 **Q. Why would the “character of the tax” be important?**

6 A. The *Policy Statement* directed us to examine both the tax status of the partners and
7 the character of the tax. This important distinction separates who pays the tax
8 from what kind of tax is being paid. In pertinent part the *Policy Statement*
9 directed:

10 Thus, any pass-through entity desiring an income tax allowance on
11 utility operating income must be prepared to establish the tax status
12 of its owners, or if there is more than one level of pass-through
13 entities, where the ultimate tax liability lies and the character of the
14 tax incurred. (111 FERC ¶ 61,139 at P42)

15 Through out the *Policy Statement* the Commission repeated over and over that the
16 tax allowance in question related to the public utility income. The Commission
17 specifically limited the income tax allowance in P42 to income taxes on *utility*
18 *operating income*. As noted earlier, one consequence is that the income for which
19 we are determining an income tax allowance is limited strictly to the income
20 generated from the public utility and not all partners' income from all sources. A
21 second consequence is that the tax allowance in question is limited to the partner's

1 income from the partnership, not the partner's income from the sale of his interest
2 to some third party. The gain on a sale is not income generated through ratepayers
3 but through some new investor purchasing the partner's personal assets. The
4 character of the income is substantially different.

5 Ordinary income from utility operations accrues to the partners through net
6 income allocations credited to the partner through the capital account and taxed as
7 ordinary income, as described in earlier portions of this testimony. The
8 depreciation of the partner's share of the partnership assets flows through the cash
9 distributions and is recorded in the capital account. When the partner sells his
10 interest, the capital account captures his depreciated interest in the partnership and
11 any gain from the sale comes not from ratepayers, but from other investors.

12 **Q. Is cash distribution treated differently as a rate concept and a tax concept?**

13 A. Yes. I noted earlier that from a ratemaking perspective, cash distributions are
14 made up of depreciation, return on equity, and the income tax allowance. But from
15 an income tax perspective, cash distributions are a return of capital (unless the
16 capital account is in a deficit). (See: Exhibit No. S-24, page 3) This is so because
17 cash distributions are a reduction to the capital account and thus reduce the
18 partner's investment in the enterprise, *i.e.*, the partner is getting its investment
19 back. It's the interaction of these two concepts that converts ordinary income

1 from operations into a capital asset that will be taxed not as ordinary income but as
2 capital gains income. As the cash distributions reduce the partner's capital
3 account, the value of the partner's investment declines. By the same token, when
4 the partner sells its interest, the difference between the sale price and the capital
5 account value is a capital gain.

6 **Q. How does a partnership treatment of ordinary income affect the partner's**
7 **calculation of capital gain?**

8 A. In a nutshell, the difference between the partner's cash distributions and the net
9 income allocations affects the balance of the partner's capital account. Ordinary
10 income from utility operations is used, among other uses, to provide cash
11 distributions and net income to partners. As noted above, cash distributions reduce
12 the partner's capital account (the return of capital), while the net income, which is
13 also part of the available cash, is recorded as an increase in the capital account (the
14 return on capital). The cumulative difference between the cash distributions and
15 the net income allocations represents, generally, the depreciation of the partner's
16 share of the partnership assets. This difference rests in the capital account until
17 the partnership interest is sold. Upon the sale of a partner's interest in the
18 partnership, most of the difference between the sales price and the partner's capital

1 account will be treated as a capital gain subject to capital gains tax. (See: Exhibit
2 No. S-36, a Wachovia Primer on MLPs, page 21 (page 20 of original))

3 **Q. How do Sections 741 and 755 of the IRS tax code interrelate for capital gain**
4 **purposes?**

5 A. Section 741 of the tax code states:

6 The sale or exchange of an interest in a partnership shall, except to
7 the extent section 751(a) applies, be treated as the sale or exchange
8 of a capital asset, resulting in capital gain or loss measured by the
9 difference between the amount realized by the sale and the adjusted
10 basis of the partnership interest.

11 The underlying assets of the partnership in question here are pipeline assets, highly
12 capital intensive property. Thus there is a close relationship between the tax code
13 definition of the partnership interest and the vast majority of the assets held by the
14 partnership. There are some underlying assets, however, that are not capital assets
15 in nature. Under §751, to the extent a partner's gain on the sale of its interest in
16 the partnership represents un-recovered receivables or appreciated inventory,
17 which the partner would have earned had it held its units long enough, is treated as
18 ordinary income and taxed at ordinary income tax rates. But most of the value of
19 the partnership, particularly these partnerships, is a capital asset.

20 Section 755 of the ISR code requires a partnership to keep track of whether
21 its property is considered ordinary income property or capital asset property.

1 Upon the sale of a partner's interest in the partnership, the partnership informs the
2 partner about the relative portions of each class of property associated with the
3 sale.

4 **Q. Will the depreciation of partnership assets, which is reported on the partner's**
5 **K-1, be recaptured upon the sale of the interest?**

6 A. The partner's depreciation of the pipeline assets reported on the K-1 may be
7 recaptured if the partner realizes a gain on the sale of his or her interest. Some of
8 the gain on the sale of partnership interests may represent an increased market
9 value of the partnership units and some of the gain may represent the recapture of
10 depreciation that offset ordinary income.

11 **Q. Is the depreciation recaptured taxed as ordinary income?**

12 A. The conventional wisdom regarding the recapture of depreciation upon the sale of
13 a partnership interest seems to be that all of the depreciation recapture is treated as
14 ordinary income and taxed as such. (See: Exhibit No. S-35, page 6) For pipeline
15 partnerships, however, the assets being depreciated are not, in general, ordinary
16 income property. Under section 741, a partner's interest in a partnership is
17 considered by the IRS as a capital asset and the sale of that asset is to be treated as
18 capital gains subject to capital gains tax rates.

19

1 interest from transferor to transferee is difficult if not impossible.) The write-up of
2 partner's interest in the partnership occurs when the partnership makes an election
3 under §754 of the code, which then requires all partners to have and use a §743(b)
4 write-up and the depreciation of that write-up as well. The depreciation of a
5 partner's write-up of §743(b) interest in the partnership provides an additional
6 offset to the income allocated from the partnership to the partner, thus sheltering
7 more of the income generated by the partnership from income taxes.

8 **Q. What is the §743(b) depreciation deduction?**

9 A. Investors in a partnership have the option of depreciating their personal investment
10 in the partnership for their personal tax purposes wholly apart from whatever
11 depreciation allowances the Commission may permit to be included in the cost of
12 service. The tax code provides for the partner to depreciate its interest in the
13 partnership separate and apart from the depreciation of the partnership's assets.
14 The depreciation of a partner's adjusted basis interest in a partnership takes place
15 pursuant to §743-1(j)(4)(B)(2).

16 **Q. How does the §743(b) depreciation deduction affect the income tax liability**
17 **for the partners?**

18 A. As noted earlier, Schedule M-1 on page 4 of Form 1065 derives the taxable net
19 income that will be allocated among the partners on lines 2a and 2b of page 4.

1 Schedule M-1 converts the MLP partnership book income to the partner's taxable
2 income by taking into account the accelerated depreciation of partnership assets
3 and the partners' §743(b) depreciation write-up of their interest in the partnership,
4 both of which offset net income for tax purposes. Consequently, the K-1s in the
5 K-1 data base provided in response to Trial Staff data request TAX-2.19 reflect the
6 partner's taxable income as sheltered by the accelerated depreciation of the
7 pipeline assets and the depreciation of the partner's individual write-up of its
8 §743(b) interest in the partnership. Because the partner's income from the
9 partnership is sheltered by these various depreciation offsets, the partner's taxable
10 income tends to fall into a lower income bracket and is subject to a lower income
11 tax rate.

12 **Q. What does a gain on the sale of a partnership interest have to do with the**
13 **taxable income of the partner as it relates to the cost of service income tax**
14 **allowance?**

15 A. It is a long-standing principle of ratemaking policy that capital gains are not an
16 appropriate element for inclusion in the cost of service for a regulated entity. The
17 gain on the sale of a partnership interest does not inure to the benefit of the
18 ratepayers in any way and consequently the ratepayers ought not be burdened by
19 the income tax associated with that gain. Therefore, for ratemaking purposes, the
20 capital gain on the sale of a partnership interest should not be treated as ordinary

1 income and thereby bump up the taxable income and associated income tax bracket
2 to create a regulatory income tax liability where none exists.

3 **E) NB's Weighted Average Marginal Income Tax Rate**

4 **1) The Federal Income Tax Rate**

5 **Q. Have you calculated a weighted average tax rate for use in the cost of service**
6 **income tax allowance?**

7 A. Yes, I have. Using the K-1 data base provided in response to Trial Staff data
8 request TAX-2.19, I grouped the partners of NBP and TCP by ownership class and
9 income tax bracket. I then weighted the percentage of total partnership interest
10 represented by each class of owner/tax bracket by the tax rate for that tax bracket.
11 The cumulative weighted federal income tax for NBP and TCP 's partners is
12 1.76%. The worksheet for this calculation is in Exhibit No. S-26.

13 **Q. Why did you weight the tax rates applicable to each partner rather than the**
14 **income allocated to each partner?**

15 A. I weighted the income tax rate applicable to each partner rather than the income
16 allocated to each partner because the *Policy Statement* instructs us to look to the
17 tax status of the partners. The tax status of the individual partner is determined by
18 the tax rate under which that partner falls due to the net income allocated by the
19 partnership. Some states tax the same level of income at different rates ranging

1 from no income tax at all to rates over 10%. Hence, it's not the dollars themselves
2 that determine the status but the tax rates associated with those dollars.

3 **Q. Did your calculation take into account the gross income allocations to the**
4 **general partners?**

5 A. The general partners were not included in the data base of K-1 reports. For
6 reasons I have discussed in detail above, the gross income allocations to the
7 general partners are not, from a ratemaking perspective, taxable income to the
8 partnership (although they are to the general partner) and therefore not subject to
9 an income tax allowance in the cost of service revenue requirement. Moreover,
10 even if the large gross income amount were incorporated into the template I
11 developed, since the four general partners (NPNGC, PBGC, NBGC, and TCPGP)
12 together represent only four of the over [begin protected xxxxxx end protected]
13 unit holders and consequently the tax rate applicable to them would carry little
14 weight in the whole of the weighted average income calculation. Recall that I am
15 calculating the weighted average tax *rate* for partners, not the weighted average
16 tax. The tax status attaches to partner, not the income or the number of units held,
17 although those aspects figure into the tax status.

18 **Q. What federal weighted average marginal income tax rate do you recommend**
19 **for the NB cost of service?**

1 A. I recommend a weighted average marginal income tax rate of 1.76% for NB's cost
2 of service.

3 **Q. Do you believe your recommendation is too low?**

4 A. No, to the contrary, my recommended rate could be considered generous by some
5 because the rate I developed does not calculate income tax rates in a progressive
6 manner, which is the founding principle of our tax structure – the more you earn,
7 the progressively more you pay in taxes. My calculations assume that each partner
8 pays as an average tax rate a rate that is only paid on the marginal income.
9 However, the extra effort that would be required to create a progressive income tax
10 calculation for each partner, which is where that calculation would have to take
11 place, is beyond the time frame available in this docket. I believe the weight of
12 the evidence presented above is more than adequate justification for my
13 recommended rate of 1.76% in calculating the federal income tax allowance.

14 **Q. Your weighted average federal income tax rate recommendation is based on**
15 **2004 data; have you made a similar assessment based on 2005 data?**

16 A. No, I have not. I do believe, however, that it would be helpful to have such an
17 analysis prepared for a number of years so that a track record can be established
18 that would demonstrate the pattern of actual income tax burden shouldered by the
19 ultimate holders of NB's income tax liability.

1 **2) The 28% Rebuttable Presumption**

2 **Q. Will you comment on the Commission’s rebuttable presumption of a 28%**
3 **income tax for individuals for SFPP?**

4 A. On December 16, 2005, the Commission issued an order in *SFPP, L.P.* 113 FERC
5 ¶61,277 (2005) (Dec. 16th Order) that established a *rebuttable* presumption for that
6 proceeding that the weighted average federal tax rate paid by the individual (non-
7 corporate and non-municipal) owners of SFPP’s parent organizations is 28%. The
8 Commission based its 28% presumption on a 1999 IRS study of tax rates and tax
9 shares that contain a myriad of statistics on the U.S. taxpayer. (See: Exhibit No. S-
10 28) The Commission read the studies to suggest that the average income tax rate
11 paid by American taxpayers is 28% and therefore adopted the 28% as a rebuttable
12 presumption in the SFPP, L.P. docket. The fact that Commission used the term
13 “rebuttable” indicates that it welcomes discussion on the presumption, which I will
14 do below.

15 **Q. What do the IRS studies present?**

16 A. These 1994 and 1999 “Individual Income Tax Rates and Shares” tax studies,
17 which the Commission relied upon, present figures showing the amount of revenue
18 raised by several groupings of taxpayers by tax rate brackets. The IRS publishes a
19 study examining the same phenomena every year. The first paragraph of the 2002

1 study notes that the average tax rate has fallen to 14.1 percent. The source of this
2 figure is found in Figure B in the column labeled Total and is derived by dividing
3 total income tax collected by the total adjusted gross income for all returns. Figure
4 A of these studies presents a table showing the number of returns filed, the tax
5 collected, and the average tax rate by year for 14 years. (See: Exhibit No. S-28,
6 page 2 of 38) Figure B of these studies presents a table showing the average tax
7 rate for several brackets of adjusted gross income for the most recent two years.
8 (See: Exhibit No. S-28, page 3 of 38) Figure C of these studies presents a table
9 showing the tax dollars generated by each marginal tax rate class for the current
10 report year. (See: Exhibit No. S-28, page 4 of 38)

11 **Q. What part of these studies did the Commission rely upon?**

12 A. The Dec. 16th Order at P 31 summarizes Figure C from the 1994 and 1999 studies.
13 The Order states that Figure C for 1999 states that some 79.5 percent of taxes
14 were paid by Form 1040 taxpayers in the 28% bracket or higher. The Commission
15 appears to have assumed that because the largest share of tax dollars was generated
16 from the 28% tax bracket and above, the 28% tax rate must represent the weighted
17 average tax rate called for in the *Policy Statement*.

18

1 **Q. Do you believe the Commission misread the studies?**

2 A. Yes. I believe the Commission misread the IRS tax studies in three ways. First,
3 the Commission examined the wrong data; the relevant information desired is the
4 weighted average tax rate paid by taxpayers, not the weighted average tax rate that
5 generated the tax dollars. Second, the Commission examined the wrong class of
6 taxpayers; the relevant tax rate information desired is the weighted average tax rate
7 for all taxpayers, not the weighted average tax rate for wealthy tax payers. Third,
8 the Commission utilized the wrong premise; since NBP and TCP act as tax
9 shelters, as the Commission noted in the Dec. 16th Order at P 32, its owners,
10 however wealthy they may be, are avoiding taxation, so the use of a tax rate based
11 on high taxable income is inappropriate.

12 **Q. Why do you believe the Commission examined the wrong data?**

13 A. The Dec. 16th Order relies on Figure C of the 1999 IRS tax rates study, which
14 reports the amount of tax revenue generated by each tax bracket. This is quite a bit
15 different concept than the average tax rate paid by taxpayers. For example, assume
16 ten taxpayers, nine of whom earn \$100,000 apiece and one who earns \$1,000,000.
17 Using the 2002 IRS tax rate study, Figure B tax rate reports, the nine taxpayers
18 earning \$100,000 pay taxes at a tax rate of 15.8% while the one who earns
19 \$1,000,000 pays at a tax rate of 27.9%. However, the millionaire's tax payments

1 constitute 66.24% of all tax dollars generated by the group, hence, 66.24% of all
2 tax dollars are generated by the 27.9% tax bracket. However, the weighted
3 average tax rate for the whole group is 22.17% and the simple average tax rate is
4 just 17.01%. So when you look out at the group and ask ‘what is the group’s
5 average tax rate,’ the answer is either 17.01% or 22.17%, depending on how you
6 want to define the term “average.” But clearly, the average tax rate for these
7 taxpayers is not 27.9%, which is merely the tax rate that generated the most tax
8 dollars. The Commission’s reliance upon the IRS studies’ Figure C tax collection
9 sources simply examines the wrong data altogether.

10 **Q. Why do you believe the Commission examined the wrong class of taxpayers?**

11 A. The Commission’s *Policy Statement* instructs us to make a determination of the
12 weighted average marginal tax rate of the owning partners. To get around the
13 purported difficulty of obtaining income and tax bracket information on the myriad
14 of owners of partnership interests, the Commission looked to the IRS tax shares
15 studies to find a readily available proxy for the weighted average marginal tax rate
16 for the owners of KMEP, the ultimate owner of SFPP, L.P. The Dec. 16th Order
17 chose a tax rate for taxpayers in a relatively high tax rate bracket despite noting
18 that the owners of KMEP could fall in a wide range of tax brackets (at P 31). If
19 KMEP’s owners fall into a wide range of tax rates, and those rates are unknown, it

1 would seem the most logical and conservative approach would be to assume an
2 average tax rate for all taxpayers. In our case, there is no evidence in this record to
3 suggest that the partners of NB are all wealthy individuals, nor what the average
4 income range is for these partners. In deed, as revealed in my Exhibit No S-26,
5 the vast majority of NBP and TCP partners receive little or no net positive income
6 on a per unit holder basis, which on a stand alone basis would place these partners
7 in a zero tax bracket.

8 **Q. How do you believe the Commission should have used the IRS tax studies**
9 **when developing its rebuttable presumption?**

10 A. I assume the Commission used the IRS study as a substitute for using actual data,
11 which were not available at the time of Dec. 16th Order. My recommendation
12 would be that the IRS study not be used at all and that in every case we undertake
13 an investigation of the actual income tax burden experienced by the ultimate
14 holders on income tax liability for any given regulated partnership entity.
15 However, if the IRS study is to used, I would suggest that since the Commission
16 has stated that the partners of KMEP were drawn from a wide range of tax
17 brackets, the wisest course of action would be to assume the partners of NBP and
18 TCP are similarly drawn from the average taxpayers, paying the average tax rate of
19 14.1%.

1 **Q. Has any NB witness proposed using the 28% rebuttable presumption for the**
2 **federal income tax allowance?**

3 A. No. Neither of NB's tax witnesses, Mr. Peters or Mr. Faber, incorporated or
4 proposed using the 28% rebuttable presumption figure in their recommended
5 federal income tax allowance.

6 **Q. Do you propose using the 28% income tax rate?**

7 A. No. As noted previously, that rate was simply a rebuttable presumption
8 established for that proceeding, and relative to the NB situation, an overly
9 generous one at that. I believe the evidence in this case is more than sufficient to
10 calculate the weighted average marginal income tax rate actually experienced by
11 NB's ultimate holders of income tax liability.

12 **III The State Income Tax Rate**

13 **Q. What did NB propose in regard to a state income tax allowance in the cost of**
14 **service?**

15 A. NB witness Mr. Peters recommended a 5.4% state income tax allowance for the
16 cost of service. Schedule H-3(1) of NB's filing presents the calculation of the
17 state tax allowance. (Reproduced : Exhibit No. S-29)

18 **Q. Do you concur with NB's estimate of the weighted average state marginal**
19 **income tax rate?**

1 A. No, I do not. What Mr. Peters calculated is only the state income tax rate on
2 partners that are corporations. He has not calculated the state income tax rate for
3 partners that are not corporations; hence, he has not calculated a weighted state
4 income tax rate. The *Policy Statement* called for the derivation of a weighted
5 average marginal federal income tax rate and, to be consistent, it is incumbent
6 upon us to derive a weighted average marginal state income tax as well.

7 **Q. How are state income taxes assessed?**

8 A. State income taxes are assessed differently for corporations than for individuals.
9 Generally, state corporate income taxes are levied based on the location of the
10 economic activity, *i.e.*, where the income is earned. In general, individual income
11 taxes are levied based on where the individual lives. This leads to a very complex
12 state income tax derivation mechanism that will be described below.

13 **Q. What state income tax rate do you recommend?**

14 A. I recommend a state income tax rate of 0.52%, *i.e.*, half of one percent.

15 **Q. How is the state corporate income tax allowance derived?**

16 A. As noted above, the state corporate income tax rate is derived based on where the
17 economic activity is located. Defining where economic activity is located can be
18 done through a Massachusetts Formula that weights various measures of economic
19 assets and performance. NB's corporate income tax schedule uses six measures of

1 activity: traffic units, miles of pipe, property, sales (POD), sales (MOP), and
2 payroll. NB's Schedule H-3(1) calculates each state's portion of each of these
3 measures and derives a weighting factor for each state's corporate income tax rate.
4 (See: Exhibit No. S-29) The sum of the weighted state tax rates equaled 5.4%.

5 **Q. Do you accept NB's corporate state income tax rate estimate?**

6 A. Yes, I do. However, the state corporation income tax rate is only a piece of the
7 whole state tax burden.

8 **Q. How are individual state income tax rate allowances derived?**

9 A. As noted above, the individual state income tax rates are based on where the
10 individual lives, not on where the income is earned. Like the federal income tax,
11 most state income taxes are progressive in nature so that the more one earns the
12 higher tax burden is placed on them, although several states do use a flat income
13 tax and some have no income tax at all.

14 **Q. How did you incorporate individual state income taxes into the state income
15 tax allowance for the NB cost of service?**

16 A. Using the K-1 income tax data base provided in response to Trial Staff data
17 request TAX-2.19, I divided the individuals category of partners into separate
18 groups for the respective states. I then developed a template showing each state's
19 income brackets and associated income tax rates for individuals. Using the tax

1 brackets, I counted the number of partners falling in each tax bracket for each
2 state. Then I developed a ratio of each subgroup to the total number of partners
3 and multiplied each group's ratio times the income tax rate for that group to arrive
4 at a weighted income tax rate, by state, for each group. The sum of the weighted
5 averages then provides the state income tax rate for individuals. The corporate
6 partners were included in this calculation at the 5.45 income tax rate. The
7 combined state income tax rate for both NBP and TCP partners is 0.52%, *i.e.*, half
8 of one percent.

9 **Q. How did you incorporate the other categories of partners into your**
10 **recommended state income tax rate?**

11 A. I have not yet made those calculations. Some categories of partners are not subject
12 to income tax, as noted earlier. I have not yet been able to determine how the
13 states levy income tax on the other categories. I note that NB's witnesses have not
14 incorporated any category of partner other than corporations into their state income
15 tax allowance recommendation.

16

1 **IV Accumulated Deferred Income Tax**

2 **A) Why An ADIT?**

3 **Q. What is the ADIT balance and how does it affect the cost of service?**

4 A. The IRS tax code permits businesses to compute income taxes using accelerated
5 depreciation to offset income. The accelerated depreciation reduces taxable
6 income and thereby temporarily reduces the tax burden on the enterprise.

7 However, for FERC regulatory purposes, the cost of service rates are computed on
8 a book basis using, in virtually all cases, straight line depreciation. In general,
9 accelerated depreciation reduces, albeit temporarily, the taxes due the government
10 in comparison to the taxes that are computed reflecting book depreciation. The
11 differential reverses itself at some point as the tax depreciation is exhausted but the
12 book depreciation continues. Because the tax effect of the difference between
13 straight line and accelerated depreciation is temporary, eventually the taxes
14 avoided on offset income early on become due later when, for tax purposes there is
15 no depreciation left to offset income and income taxes are then higher than they
16 would otherwise be under simple straight line depreciation.

17 The accumulated deferred income tax (ADIT) balance keeps track of all
18 tax-book timing differences that lead to differences in taxable income, the largest

1 of which is depreciation. The ADIT balance may be deemed to be the source of
2 funds to pay the income tax that had been “deferred.”

3 **Q. How does the ADIT balance affect the rate base?**

4 A. Under established regulatory principles, the ADIT balance acts as a reduction of
5 the rate base under the notion that the ADIT represents a cost-free source of capital
6 to the pipeline. As noted in Order No. 144 (90 FERC ¶ 61,017), it is simply a way
7 of reflecting the fact that a certain portion of the rate base is not financed by
8 investor funds so that there is no “interest” cost to the utility on a portion of its rate
9 base. The ratepayers are provided protection against paying a return on this cost-
10 free capital by having the ADIT balance subtracted from the rate base before
11 applying the recommended rate of return on equity.

12 **Q. What happens if the tax rate changes between the time the embedded**
13 **deferred tax is collected and the time it gets paid to the government?**

14 A. When the book-tax differential reverses itself, the reversal will occur at a lower tax
15 rate if the income tax rates have declined in the meantime, which means the
16 current ADIT balance is over-funded. Over-funded ADIT balances are generally
17 amortized through a so-called reverse South Georgia adjustment that reduces the
18 income tax component of the cost of service and concurrently reduces the rate base
19 deduction in the rate base calculations of the cost of service.

1 **Q. What are South Georgia and reverse South Georgia adjustments?**

2 A. In the event of an increase in income tax rates between the time the tax is collected
3 and when it is paid, the South Georgia adjustment takes care of under-funded
4 ADIT balances in the deferred tax account by including an additional provision for
5 deferred taxes in the income tax calculation and a similar adjustment to ADIT.
6 The deficiency is thereby eliminated over a period of time such as the remaining
7 book life of the facilities. A reverse South Georgia takes care of an over-funding
8 of ADIT by a credit provision for deferred taxes and a debit to the ADIT balance.
9 The treatment of the adjustment to income taxes must work in tandem with the
10 adjustment to rate base. In other words, to stay in synch, the ADIT balance should
11 be adjusted on a going forward basis as the amounts are amortized and used as an
12 offset against current income tax charges; there should not be a one time
13 adjustment to the ADIT balance followed by the amortized recovery.

14 **B) Partnerships & ADIT**

15 **Q. Since partnerships do not pay income tax directly, do they calculate a**
16 **deferred tax?**

17 A. For tax purposes partnerships do not calculate a deferred tax. A deferred tax is a
18 rate making concept only, used to keep track of contributions by the ratepayer
19 toward income taxes that will be due in the future due to the timing differences
20 noted earlier. Partnerships do calculate an accelerated depreciation for tax

1 purposes for their partner's distributive shares of partnership items of income and
2 deduction. This calculation shows up on the IRS Form 1065, page 4, Schedule M-
3 1, line 7. (See: Exhibit No. S-16) As noted earlier, Schedule M-1 converts
4 partnership book income, using straight line depreciation, into the partners' taxable
5 income, using accelerated depreciation. This allows the partners to take advantage
6 of the tax code provisions to shelter income through accelerated depreciation
7 offsets to net income.

8 **Q. From a ratemaking perspective, does the partner's income offset due to**
9 **accelerated depreciation eventually become taxable when the temporary**
10 **timing difference reverses itself?**

11 A. Whether any given partner's current net income offset by accelerated depreciation
12 becomes taxable income when the temporary timing difference reverses itself
13 depends on whether that partner is still holding its partnership interest when the
14 reversal takes effect. If the partner sells its interest before the reversal takes effect,
15 it will not be receiving the income that, from the ratemaking perspective, is subject
16 to higher taxation. Hence, that particular partner will not be liable for the income
17 tax on the relatively higher income it would have received when book depreciation
18 exceeds tax depreciation. However, from the partnership's perspective, the timing
19 difference will reverse itself and the partnership will calculate a net income with a
20 an accelerated depreciation offset that is less than what the book depreciation

1 offset would have been on the Schedule M-1. The taxable net income allocations
2 to the partners will then exceed book net income subjecting those still holding
3 units of interest to a higher tax burden.

4 **Q. Does the partnership calculate a deferred income tax for ratemaking**
5 **purposes?**

6 A. Yes. Because of the timing differences inherent between book and accelerated
7 depreciation, and the consequent timing difference between net income and
8 taxable income, and therefore income tax, Commission Order No. 144 requires
9 regulated entities to keep track of the temporary tax/book timing difference in
10 income taxes. As noted above, the ADIT balance reflects the fact that a certain
11 portion of the rate base is not financed by investor funds so that there is no
12 “interest” cost to the utility on a portion of its rate base. The ratepayers are
13 provided protection against paying a return on this cost-free capital by having the
14 ADIT balance subtracted from the rate base before applying the recommended rate
15 of return. The problem encountered here is that partners appear to have little or no
16 actual income tax liability on income from the regulated entity; hence, the ADIT
17 balance that was calculated and collected under the assumed 38.5% composite
18 income tax rate, will be paid out to the government at a rate something more in the

1 neighborhood of 2.3%, if at all - meaning that the ADIT balance is extremely over-
2 funded.

3 **Q. How much is the estimated over-funding in the ADIT account?**

4 A. My estimate of the over-funding in the ADIT account is approximately \$339.5
5 million. The over-funded ADIT amount would generally be determined by
6 multiplying the difference between the straight line depreciation and accelerated
7 depreciation by the amount of the appropriate income tax rate, and then comparing
8 that figure to the existing ADIT balance. The difference would be refunded to the
9 ratepayers. The requisite depreciation figures are located in Statement H-3(2) of
10 the generic gas pipeline rate filing. However, NB did not include Statement H-
11 3(2) in its filing. In the absence of the requisite material, I arrived at the \$339.5
12 million figure by starting with NB's reported ADIT for the income tax collected on
13 the timing differences between book and accelerated depreciation: \$361,128,768,
14 as shown in Statement B-1, Account 282, of NB's filing. (Reproduced: Exhibit
15 No. S-32) This figure represents the timing differences multiplied by the
16 composite income tax rate. The appropriate ADIT balance should be \$21,570,005.
17 I arrived at this figure by dividing the \$361 million balance by the composite
18 income tax rate of 38.507% (from Statement H-3(1) of the filing (See: Exhibit No.
19 S-30)), to get back to the timing difference upon which the tax was calculated. I

1 then multiplied the timing difference by my recommended composite tax rate of
2 2.3%. The difference between the \$361 million and \$21.5 million is \$339.5
3 million to be refunded back to the ratepayers.

4 **Q. What do you recommend in regard to the ADIT over-funding?**

5 A. Order No. 144 requires that over-funded ADIT balances should be refunded back
6 to the ratepayers. The generally accepted refunding mechanism is to spread out the
7 excess over the remaining life of the facilities, using an amortization rate based on
8 the system composite depreciation rate. Using figures from NB's filing, the
9 amortization rate would be \$19 million per year.

10	\$2,508	Plant in Service (Statement C, Column K, Line 5)
11	<u>- 977</u>	Acc. Reserve for Depr. (Statement D, Column I, line 6)
12	\$1,531	Net Plant (Plant in Service less Acc. Res. Depr.)
13	\$86	Depreciation Expense (Statement A, Column C, Line 2)
14	18	Average Remaining Life (Net Plant/Depreciation Expense)
15	\$399	ADIT Over-funding
16	\$19	Annual ADIT Flow-back (ADIT Over-funding/ARL)

17 However, Trial Staff witness Ulomna Nwokeafor is recommending a depreciable
18 rate based on an average remaining life of 35 years; therefore, to be consistent, I
19 recommend using a 35 year amortization period for the flow-back of the over-
20 funded ADIT as well. The resulting calculations suggest an annual reverse South
21 Georgia adjustment of \$9.6 million per year.

1 **Q. Do you have any concerns that the ratepayers may not receive the full over-**
2 **funding of the ADIT?**

3 A. Yes. The ADIT balance can become due in full to the government upon the sale of
4 the pipeline. For a partnership, the transfer of 50% or more of the partnership
5 interests is, for tax purposes, treated as a sale of the partnership. The sale of the
6 partnership may, in turn, trigger the dissolution of the ADIT account prior to
7 completing a refunding of the overage to the ratepayers.

8 **Q. Why might the sale of the partnership trigger dissolution of the ADIT**
9 **balance?**

10 A. The dissolution of the ADIT balance upon the sale of a partnership was averred by
11 NB witness Robert P. Palmquist in Docket No. RP99-322 and RP96-45. Mr.
12 Palmquist suggests that when the partnership is sold, its assets are considered
13 retired and the ADIT balance, following the asset retirements, is dissolved. Given
14 the recent turnovers in ownership of NB and NBP, this gives rise to the possibility
15 that the ADIT balance, which the ratepayers have over-funded to the tune of about
16 \$339 million, could be dissolved before the refunding has been completed. Mr.
17 Palmquist's testimony contains the following statements.

18 Regarding the partnership dissolution and reestablishment, he stated:

19 Upon the tax termination of the Northern Border partnership, the
20 assets of Northern Border were deemed to be distributed to its
21 partners. The assets are subsequently deemed to be recontributed
22 with a tax basis equal to the basis of the partner's interest in the

1 partnership (Treasury Regulation Section 1.708-1(b)(1)(iv), as in
2 effect in 1993). *(See: Exhibit No. S-33, page 4 (page 3 of original))*

3 Regarding the retirement of the accumulated reserve for depreciation:

4 Under the facts that I have assumed, there is no reserve for
5 depreciation at the beginning of the initial year of the new
6 partnership, much less one carried-over from the old partnership.
7 *(See: Exhibit No. S-33, page 5 (page 4 of original))*

8 Regarding the dissolution of the ADIT balance:

9 The tax regulations also require a reduction of the reserve for
10 accumulated deferred federal income taxes for asset retirements.
11 With respect to the terminated partnership, all the assets are retired
12 for tax purposes because they are deemed to be distributed to the
13 partners. Therefore, in accordance with the applicable tax
14 regulations, it is mandatory to reduce the deferred tax reserve for
15 these retirements (Treasury Regulations Sections 1.167(l)-1(h)(2)).
16 *(See: Exhibit No. S-33, page 6 (page 5 of original))*

17 **Q. Did NB reduce its ADIT balance in conjunction with the distribution**
18 **and re-establishment of NBP in 1993?**

19 A. No. Despite Mr. Palmquist's statement that it is mandatory to reduce
20 deferred tax reserves for the retirement of assets associated with a
21 distribution and reestablishment of a partnership upon the sale of 50% or
22 more units, NB did not do so in 1993.

23

1 **Q. Does it appear likely that the partners will still own their interests**
2 **when the timing difference reverses itself?**

3 A. There seems to me to be little incentive for a partner to hold on to MLP interests
4 for a long period for three reasons. First, because the cash distributions will
5 always exceed the net income allocations [cash equals depreciation, return and
6 taxes, while net income equals return and taxes] each partner's capital account will
7 tend toward zero as time moves on. When the cash distributions finally exceed the
8 capital account balance, the cash distribution becomes taxable income – time to
9 sell the units and buy into another MLP. Second, when the timing difference for
10 the deferred income tax on partnership income due to accelerated depreciation
11 reverses itself, the partner loses some of its sheltering effect on partnership income
12 and becomes liable for income taxes on that no-longer-sheltered income. In fact,
13 since the accelerated depreciation is a progressively declining number, the taxable
14 income reported to the partner is a climbing number, so that the tax burden on the
15 partner is also an increasing burden – time to sell the units and buy into another
16 MLP. Third, to the extent that cash distributions exceed net income allocations,
17 the capital account reflects a potential gain on the sale of the partnership units.
18 Since capital gains are generally taxed at lower rates than ordinary income, the
19 partner has an incentive to sell its units when the capital account closes in on zero.
20 As noted earlier in the discussion on partnership allocation provisions, if a limited

1 partner's capital account would otherwise become a deficit upon any given cash
2 distribution, the partnership must make an income allocation equal to the deficit.
3 This provision would tend to balance cash distributions with net income
4 allocations – a wash for the capital account, so the partner's value in its partnership
5 units becomes stagnant, other things being equal.

6 However, as long as the partnership continues to acquire new assets it can
7 maintain a relatively high accelerated depreciation component in its derivation of
8 taxable income reported to the partners. While the first tier partnership entity is
9 unlikely to be acquiring more assets than necessary to operate the pipeline system
10 in the public interest, the third or fourth tier partnership entity does have an
11 incentive to acquire more entities under its organizational umbrella to maintain the
12 offsets to taxable income for its partners. The tax shelter aspects of the partnership
13 would appear to last only as long as it continues to add new entities to the group.

14 **Q. Can the ADIT balance, and associated rate base deduction, be erased (thereby**
15 **eliminating the ratepayer benefit from rate base) even if the partnership**
16 **never pays the taxes due?**

17 A. Yes. We should keep in mind that NB has only two partners, NBILP and TCILP,
18 so that as an operating entity, NB could be sold easily to another entity. The
19 possibility therefore exists that NB could be sold by its general partners and the
20 ADIT balance erased. When this occurs, the tax code requires that for tax

1 purposes the partnership be deemed to be sold and recreated as a new partnership.

2 According to Mr. Palmquist, such a sale becomes a taxable event triggering the
3 dissolution of the ADIT account balance. If that were to happen, the ADIT
4 amount that the ratepayers over-funded might not yet have been fully refunded.

5 **Q. Is there a realistic chance of a transfer of ownership erasing the ADIT**
6 **balance?**

7 A. There appears to be a fair amount of volatility in the ownership structure of NB
8 and its affiliates. As shown in the organization charts in Exhibit No. S-10, the
9 relative shares of who owns who change from season to season. For example, in
10 March 2004, Enron transferred its interests in NPNGC, PBGC, and NBP Services,
11 LLC to CrossCountry Energy, LLC, which in turn was sold to ONEOK, Inc. in
12 November 2004. Then again in November 2004, ONEOK purchased an 82.5%
13 general partnership interest in NBP. (See: Exhibit No. S-11, page 2) In fact it
14 appears that one of the basic structure aspects for MLPs is that they must continue
15 acquiring new operating assets. (See: Exhibit No. S-36, page 22 (page 21 of
16 original)) This is a key weakness in MLPs. In order to maintain a relatively high
17 cash distribution level, the MLP must maintain a correspondingly high accelerated
18 depreciation level. As the accelerated depreciation draws down the net plant, there
19 is less offsetting of net income for tax purposes and the partners' net income

1 allocations rise, subjecting them to higher taxes. This places the MLP in a
2 constant acquisition mode and more likely to dispose of assets whose accelerated
3 depreciation advantage have run their course.

4 **C) §743(b) Deferred Income Tax & ADIT**

5 **Q. You noted earlier in your discussion of the §743(b) depreciation that it too**
6 **offsets income for tax purposes. Does that create a deferred income tax also?**

7 **A.** Yes, it does. To the extent ratepayers are held responsible for any income taxes
8 due from the partners on income earned through a chain of regulated entities, and
9 that income is not subject to income tax liability in the current period, there is
10 created a deferred income tax issue from a ratemaking perspective.

11 The §743(b) depreciation provisions in the IRS tax code allow partners to
12 shelter some partnership income from current income tax liability. However, when
13 the partner sells its interest in the partnership, some amount of the gain on the sale
14 will represent a recapture of the depreciation and, correspondingly, a recapture of
15 the offset income, which makes the deferred income tax due to the government at
16 that time. Since the ratepayers have already paid the tax on that income through
17 the income tax allowance embedded in the tariff rates, the taxpayer already has the
18 resources to pay the tax. This clearly represents a timing difference between when
19 the ratepayer contributed to the income tax and when the partner pays the tax.

1 In as much as the regulated entity is the conduit for the connection between
2 ratepayers and partners, the regulated entity must bear the responsibility for the
3 fact that partners are now in control of funds that, for some period of time, will not
4 be used for that purpose. That resource for the partnership should be deducted
5 from the rate base as would be any other prepaid tax. As discussed earlier, since a
6 certain portion of the rate base is not financed by investor funds, there is no
7 “interest” cost to the utility on that portion of its rate base. The ratepayers should
8 be provided protection against paying a return on this cost-free capital by having
9 an ADIT balance calculated on the income tax deferred due to §743(b)
10 depreciation and subtracted from the rate base before applying the recommended
11 rate of return.

12 **Q. What do you recommend in regard to the ADIT on §743(b) depreciation**
13 **offsets to taxable income?**

14 A. To the extent that the §743(b) depreciation represents offsets to income that will be
15 recaptured upon the sale of the partner’s interest in the partnership, the deferred
16 income tax related to that offset to the partner’s taxable income should be
17 accounted for in a sub account of the ADIT balance. If the conventional wisdom
18 regarding the recapture of such offsets as ordinary income is correct, then the
19 whole of the §743(b) depreciation amounts over time should be multiplied by the

1 composite income tax rate of 2.3% and placed in the ADIT sub account. If the
2 conventional wisdom is incorrect, and I am correct that most of the §743(b)
3 depreciation represents the depreciation of capital assets that will be taxed at the
4 capital gains rate, then the ordinary income amounts reported in Box 1 of the IRS
5 schedule K-1 would be the appropriate measure of each individual partner's
6 income from the regulated activities. Box 1 subtracts the §743(b) depreciation
7 from taxable income so that the partner is only paying ordinary income tax rates on
8 the remaining income. The income offset by the §743(b) depreciation may be
9 recaptured at a later date but will be taxed at capital gains rates, which are not
10 appropriate for inclusion in the cost of service for regulated services.

11 **V** **Summary**

12 **Q. What is your recommendation regarding the federal income tax allowance in**
13 **the NB cost of service?**

14 **A.** I recommend a federal income tax allowance of no more than 1.76% be
15 incorporated into NB's cost of service for the following reasons:

16 1) Neither NB's filing nor its testimony include supporting evidence that
17 NB's individual partners had any actual or potential income tax liability for 2004.
18 While Mr. Peters' testimony contained calculation of a weighted average tax rate
19 for entities at the top of their respective tax brackets, he failed to demonstrate that

1 his calculation had any connection to the individual partners of NB's parent
2 entities.

3 2) Most of NBP and TCP's limited partners, as a class, have been allocated
4 no taxable income for the base period 2004 and, consequently, can have no actual
5 tax liability, as a group, for 2004. Despite Mr. Peters' generous but unsupported
6 imputations of partners to the top tax bracket for ever category of owner, NBP's
7 Form 1065, page 4, line 2a and 2b demonstrate that, in fact, actual net taxable
8 income for NBP's limited partners was negative for almost all classes of partners.
9 In regard to TCP, while there was positive income allocations to the limited
10 partners as a whole, the amounts per partner were often negligible or zero.

11 3) The NBP and TCP partnership agreements, through which NB's taxable
12 income is allocated, are structured so that its limited partners are unlikely to have
13 cash distributions that exceed their capital accounts and consequently become
14 taxable income. Further, the partnership agreements allocate net income in such a
15 way that the limited partners are allocated modest taxable net income, if any.

16 4) NBP's gross income allocation to NPNGC, PBGC, and NBPC, as well as
17 TCP's gross income allocation to TCPGP, is a guaranteed payment condition
18 within the partnership agreement for services rendered, rather than a reward to

1 them as an owner, and as such should not be included in the income upon which an
2 income tax is calculated.

3 5) Even if the gross income allocation to the general partners by NBP as a
4 condition of the partnership agreement were to be considered a return on capital to
5 the general partners, it is a contractual obligation of NBP that works only in the
6 interests of the general partners of NBP, and provides no benefits to the ratepayers
7 under the NB tariff. As such, it should be excluded from calculation of the income
8 tax liability on NB's net taxable income for ratemaking purposes.

9 6) The evidence of actual income tax liability, as represented by the IRS
10 schedule K-1 reported to the partners of NBP and TCP, reflect that the actual
11 weighted average federal marginal income tax rate for NB's ultimate owners is
12 1.76%.

13 7) The effects of using accelerated depreciation for tax purposes on the
14 partner's K-1s creates a large taxable net income offset that shelters NB income
15 from taxation, thus leaving most partners in a low to zero income tax bracket.

1 **Q. What is your recommendation regarding the state income tax allowance in**
2 **the NB cost of service?**

3 A. I recommend a state income tax allowance of no more than 0.51% be incorporated
4 into NB's cost of service for the following reasons:

5 1) Neither NB's filing nor its testimony include supporting evidence that
6 NB's individual partners had any actual or potential income tax liability for 2004.
7 Mr. Peters' testimony contained a calculation of a weighted average state corporate
8 income tax rate, which he applied to all classes of partners regardless of whether
9 they were corporations or not.

10 2) As noted above for the federal income tax rate, most of NBP and TCP's
11 limited partners, as a class, have been allocated no taxable income for the base
12 period 2004 and, consequently, can have no actual tax liability, as a group, for
13 2004.

14 3) The NBP and TCP partnership agreements allocate net income in such a
15 way that the limited partners are allocated net income amounts that fall under the
16 lowest tax bracket rather than the highest.

17 4) The evidence of actual income tax liability, as represented by the IRS
18 schedule K-1 reported to the partners of NBP and TCP, reflect that the actual

1 weighted average states marginal income tax rate for NB's ultimate owners is
2 0.51%.

3 5) The effects of using accelerated depreciation for tax purposes on the
4 partner's K-1s creates a large taxable net income offset that shelters NB income
5 from taxation, thus leaving most partners in a low to zero income tax bracket.

6 **Q. What is your recommendation regarding the ADIT balance in relation to**
7 **your tax examination of NB?**

8 A. I recommend that NB refund its over-funded ADIT balance to the ratepayers over
9 the remaining depreciable life of its assets, namely \$9 per million year. I further
10 recommend that NB establish an ADIT sub-account to track the income taxes due
11 on the timing difference of the §743(b) depreciation offsets to partner net income
12 allocations.

13 **Q. Does this complete your prepared direct testimony?**

14 A. Yes, it does. In summary, NB has neither met the burden set out by the
15 Commission's *Policy Statement* to establish the income tax status of its individual
16 partners nor has it established the claimed actual or potential income tax liability of
17 its partners. Furthermore, my analysis of the actual or potential income tax
18 liability for NB's partners and ultimate holders of income tax liability indicates
19 that these ultimate holders of the income tax liability have little or no actual
20 income allocated to them, and consequently can have little or no actual income

1 taxes to pay or potential income tax liability. If an income tax allowance above
2 2.3% is incorporated into the cost-of-service derived tariff rates for the NB, I
3 believe the resulting rates will be unjust and unreasonable.

United States of America
before the
Federal Energy Regulatory Commission

Northern Border Pipeline Company)

Docket No. RP06-72-000

AFFIDAVIT OF Patrick R. Crowley

I, Patrick R. Crowley, do hereby declare that under penalty of perjury that I am the author of the foregoing affidavit, that the facts set forth herein are true and correct to the best of my knowledge.

May 31, 2006