

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

**Composition of Proxy Groups for Determining)
Gas and Oil Pipeline Return on Equity)**

Docket No. PL07-2-000

COMMENTS OF CROWLEY ENERGY CONSULTING

1. Pursuant to the Proposed Policy Statement issued by the Federal Energy Regulatory Commission on July 19, 2007, regarding changes to the composition of proxy groups for determining gas and oil pipeline return on equity, Crowley Energy Consulting submits the following comments addressing cost of service ramifications of master limited partnership (MLP) organizational structure and partnership agreement specifications, and the consequent implications for MLP return on equity considerations.

I COMMUNICATIONS

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II EXECUTIVE SUMMARY

2. The Commission's proposed policy statement on the use of master limited partnerships in proxy groups proposes to cap MLP distributions at the partnership return on equity so as to obtain a cleaner return on equity. However, the Commission should be mindful that partnership reported cash flows and earnings are not reflective of what investors will actually receive. What

investors require and what they get out of the ratemaking model can be quite different. The requirements of the partnership agreement regarding depreciation accounting and the Commission's recent Policy Statement on Income Tax Allowance lead inexorably to the conclusion that limited partners in an MLP that owns regulated pipeline assets may earn a zero return on equity while the general partner's return on equity may approach 1,000%. The distribution of cash and the allocation of income, as specified in the individual partnership agreements, result in cash flows and income allocations that differ between the general and limited partners such that the apparent partnership return on equity from regulated assets is substantially different from that of the general partner or the limited partners.

3. Further, the Commission's interest in finding criteria by which to incorporate MLPs into ROE proxy groups may be premature. First, as discussed more fully below, there are now five entities (soon to be six) suitable for inclusion in proxy groups that avoid the problems with MLP structures discussed below. Second, although the pipeline industry is shifting into MLP organizational umbrellas, every one of these MLP organizations has a corporation as its general partner, which in turn is wholly owned by a corporation. Rather than use the MLPs directly in the proxy groups, the Commission should utilize the holding companies of the general partners of those MLPS since they are still in extractive industry sectors, hold pipeline assets, and report dividends untainted by returning of capital problems inherent in the cash distribution of partnership reporting.

4. Finally, the large allocation of gross income to the general partner required by the MLP partnership agreements may distort the reported partnership "earnings per unit," leaving the limited partner investors with little or no actual net income from the regulated assets. If reported MLP earnings reflect inclusion of the general partner's gross income allocation as part of the net income of the partnership, then the ROE will be far greater than that which the investors actually

receive, distorting the derivation of just and reasonable return on equity for pipeline investments. The Commission should investigate whether earnings reports for MLP reflect net income prior to the general partner's gross income allocation or after.

III COMMENTS

5. The Commission's July 19, 2007 Proposed Policy Statement sought comments on the Commission's proposed changes to the composition of proxy groups for determining natural gas and oil pipeline return on equity and, more specifically, the standards that the Commission would require in order for an MLP to be included in the proxy group.

The DCF Model

6. The Commission uses a Discounted Cash Flow (DCF) model to determine a discount rate to quantify the return on equity (ROE) an investor requires from an investment. In short, under the DCF model, ROE equals current dividend yield plus projected growth of dividends. The dividend yield is simply dividend divided by share price. The growth rate is a two-step process that gives a 2/3rds weighting to a short-term projected growth and 1/3rd weighting to long term projected growth. The short-term growth reflects the Institutional Brokers Estimate System (IBES) five year forecasts of earnings per share for individual entities in the proxy group. Long-term growth uses estimates of the Gross Domestic Product.

7. The consolidation of independent pipeline entities into large multifaceted organizations and the conversion of corporations into partnerships, specifically MLPS, has made the search for comparable-risk pipeline companies appear nearly impossible. Yet, as will be discussed later, the MLP's all have general partners that are corporations, which in turn are owned by corporations. While these higher tier holding companies may be more diversified than traditional

pipeline holding entities, they are comparable to pipeline operations – some with greater risk some with less.

The MLP Attraction

8. MLPs are limited partnerships that engage in certain natural resource commodities and services for 90% or more of their income, such as oil and gas exploration, refining and processing, transportation and distribution. MLPs exist pursuant to IRS regulations, added to the federal income tax code in 1987 and amended in 1997, that created provisions permitting the public trading of partnership interests. The reason MLP focus so often on pipeline assets is that the Commission treats MLPs as corporations in the derivation of a cost of service, providing an income tax allowance that the pipeline, organized as a partnership, does not in fact pay.

Partnerships are pass-through entities for tax purposes, so no income tax liability exists at the partnership level. In general, partnership net income, or loss, passes through to the partners in proportion to their interest in the partnership and each partner pays a progressive income tax on his or her total income, which includes a share of the partnership net income.

9. The transportation sectors of the extractive industries that use cost of service rates regulated by FERC determine the charge to customers *a priori* through estimates of various cost-of-service components, including ROE and an income tax allowance. Unregulated sectors do not enjoy the protection of having a government body bless their pricing structure with the inclusion of federal income taxes built in. Consequently, non-transportation entities, organized as corporations, pay an income tax out of net earnings before shareholders receive any dividends whereas regulated pipelines incorporate income taxes into the net earnings prior to setting rates. An investor in an exploration entity would expect to see earnings reduced by the amount of corporate income tax; an investor in a regulated pipeline entity would expect the shippers, in

essence, to pay the income tax as part of the tariff derivation. Thus, a pipeline investor is shielded from the cost of corporate income tax. This up-front collection of corporate income taxes via regulated rates makes pipelines a relatively more attractive investment.

10. More importantly for this discussion, the Commission's ratemaking model treats partnership pipelines as though they are corporations and includes an income tax allowance regardless of the fact that partnerships, as pass-through entities, do not pay income tax. A pipeline organized as a partnership is at a comparative advantage over those organized as corporations because the corporation is required to pay an income tax (which is why it is included in the cost of service), where the partnership is not. The revenue generated by the inclusion of the income tax in tariff rates for a partnership pipeline flows through to the partners as return on equity. Inasmuch as the tax multiplier for determining the corporate income tax allowance is approximately 53% (times return on equity) for federal income tax alone, a partnership pipeline investor can expect profits to be over 50% greater than a comparable corporation pipeline, as illustrated below. Even using a blended average income tax rate for partnerships results in a tax multiplier in the neighborhood of 45%, providing the partnership investor with a 45% greater net income after taxes.

11.		<u>Corporate Investor</u>		<u>Partnership Investor</u>
	Equity Rate Base	\$1,000,000		\$1,000,000
	Return on equity	12%		12%
	Return	120,000		120,000
	Tax Multiplier	53% <u>63,600</u>	45%	<u>54,000</u>
	Cost of service	\$183,000		\$174,000
	Return to pipeline	\$183,000		\$174,000
	less pipeline income tax	-63,600		0
	Return to investors	\$120,000		\$174,000
	Investor income tax 28%	<u>33,600</u>		<u>48,720</u>
	Investor net income	\$86,400		\$125,280

12. It is no mystery then that MLPs focus on pipeline assets: not only is the income tax cost included up front in the regulated rates to shippers, the tax is included even if the pipeline does not pay the tax. To quote Dire Straits, “money for nothing and the chicks are free.”

Capping Distributions

13. Despite the focus on pipeline assets, the use of MLPs in proxy groups presents certain obvious and not-so-obvious problems in regard to risk comparability. As noted in the July 19th Proposed Policy Statement, MLPs’ quarterly distribution of “available cash” includes return of and return on capital. The mixing of depreciation and profits within available cash makes the use of distributions problematic as a stand-in for corporate dividends, which include only profits. Consequently, the partnership cash distributions often exceed reported earnings. (This in turn requires MLPs to finance expansion through additional debt or issuing new partnership units rather than retention of internal funds.) The use of distributions rather than dividends in the DCF model would overstate the return on equity required by investors. The Commission’s

proposed solution to this problem is to cap the distributions included in the DCF model at the earnings reported by MLP pipeline.

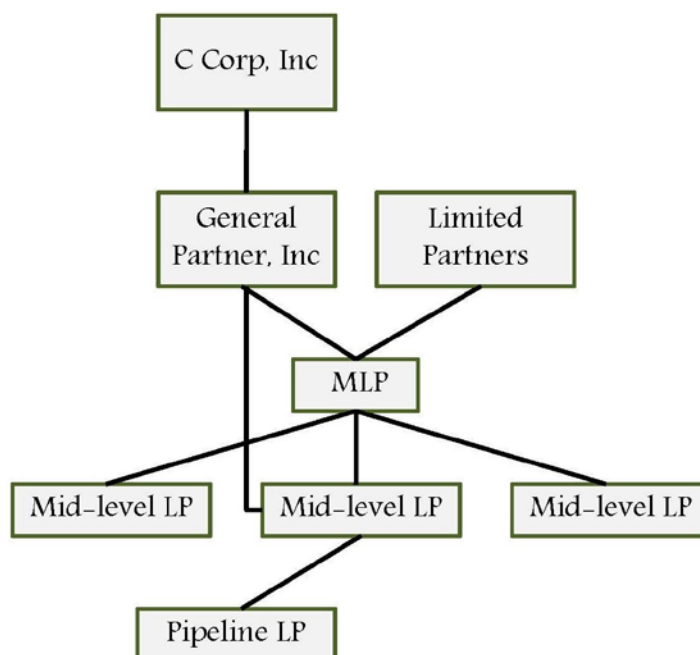
14. The Commission's capping proposal brings forth more questions. What earnings are the MLPs reporting – the pipeline, the MLP partnership, the general partner, or the limited partners? Should the DCF model incorporate the return on equity to the limited partners or include the full gross income allocation to the general partner? Are the reported earnings for the pipeline reflective of what the investors actually receive? The cost of service calculation of return on equity pivots on the equity ratio, raising the next question: whose equity ratio is used – the pipeline, the MLP, or the MLP's general partner? As one follows the money through the FERC ratemaking model and the partnership agreement allocation requirements, one finds that income allocation between the general partner and limited partners of an MLP is enormously different, giving rise to vastly different return on equity. If reported MLP earnings reflect inclusion of the general partner's gross income allocation as part of the net income of the partnership, then the ROE will be far greater than that which the investors actually receive, distorting the derivation of just and reasonable return on equity for pipeline investments. To understand how the Commission's proposal may impact investors, the Commission needs to be mindful of how the MLP partnership agreements are structured and operate.

MLP Partnership Agreements

15. Master Limited Partnerships are contracts formed by the partners specifying, among other things, the methods and proportions of cash distributions among partners as well as the methods and proportions of income allocation among partners. The requirements of the partnership agreements are critical to determining how net income allocation and cash distributions affect reported net income, which underpins the DCF model calculations when applied to MLPs as

proxy group entities. The simplified cost of service model below demonstrates the sources and sinks of cash and income as affected by the partnership agreement requirements.

16. It should be kept in mind that MLPs are parts of complex business organizations and are generally two or three tiers removed from the actual pipeline entity. The pipeline itself is likely to be a partnership wholly owned by an intermediate partnership, owned by a general partner and an MLP. The MLP is owned by a general partner (likely the same entity that acts as general partners to the intermediate partnership) and perhaps hundreds of thousands of limited partners. The pipeline itself is unlikely to be an MLP. The general partner is most likely a corporation as is its holding company.



Distributive Shares & Capital Accounts

17. When using distributions or earnings per share as reported by MLPs, the first problem arises in defining what is meant by “distributive shares.” A distributive share is the individual

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

18. A partnership capital account reflects the investor's distributions and earnings. Capital accounts are the measure of each partner's equity interest in the partnership. Each partner's capital account increases by the partner's capital contributions to the partnership and allocated net income from the partnership; and decreases by cash distributions from the partnership to the partners and various partnership deductions. The balance in the capital accounts may be used to determine whether cash distributions are taxable income in any given tax period. The general partner in an MLP usually has a relatively low ownership percentage, either 1 or 2%. Yet the general partner garners an overwhelmingly large share of the cash distribution and income allocation, which has a great impact on the measurement of earnings by the limited partners – the investors.

19. The Internal Revenue Service (IRS) code requires that income allocation match cash distribution in some manner so that partnership agreements cannot be structured to allocate income one direction and income tax in another, a principle known as the substantial economic effect rule. [26 CFR §704-1(b)(2)(ii)] MLP partnership agreements require that anywhere from 25% to 50% of the quarterly available cash is to be distributed to the general partner in recognition of its management of the enterprise. The substantial economic effect rule requires that this cash distribution to the general partner must be matched by an income allocation to ensure that the general partner pays tax on the financial reality of its earnings. However, the general partner's capital account reflects such a small share of ownership that its pro rata share of *net income* cannot match the cash distribution required by the partnership agreement, thus violating the IRS substantial economic effect rule. Consequently, the general partner must be allocated *gross income* rather than net income. The partnership agreement specifies that this greater proportion of cash and gross income is in recognition of its managerial services – a clause that has its own ramifications. One consequence is that although I refer to the general partner's "return on equity," the general partner's income from the MLP is a payment for services rendered not a reward for ownership risk.

20. The allocation of gross income rather than net income to the general partner has substantial impacts on the net earnings of the partnership and the allocations of net income to the limited partners. Consequently, the reported net income, or ROE, of the partnership gets carved up in such a manner that much of what appeared to be net income for the partnership becomes an expense to the MLP to pay the general partner for its managerial services, leaving the MLP with substantially lower net income to allocate among the limited partners, as will be illustrated below.

MLP Partnership Cash Distribution

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

22. Cash distributions to the investors are drawn from "available cash." From a ratemaking perspective, available cash (and therefore cash distributions) may be thought of as representing some combination of return of capital, return on capital, and income tax allowance. Looking at a simplified cost of service example, the only sources of available cash are depreciation, return on equity, and income tax allowance. The return on equity here is based on a 14% ROE applied to an equity rate base of \$575,000,000 and an income tax multiplier of 45%. Inasmuch as the pipeline partnership is a pass-through entity, the cost of service model used here will focus on the pipeline's revenue requirements and "follow the money" up through the MLP partnership agreement requirement to see who really gets pipeline income and who does not.

Partnership Cost of Service – Available Cash:

Operating Expenses	\$31,000,000	
Debt Costs	\$40,250,000	
Taxes Other than Income	\$31,400,000	
Book Depreciation	\$86,000,000	} Available Cash
Return on Equity	\$80,500,000	
<u>Income Taxes</u>	<u>\$36,166,667</u>	
Total Revenue Requirement	\$305,316,667	

Cash distributions are only taxable to the extent the distribution exceeds the partner's capital account. Cash distributions in excess of a partner's capital account signify that it has recovered its capital contribution and therefore the partner's cash distributions have caught up with its allocated net income, which makes the cash distribution taxable income to the partner.

23. MLP partnership agreements require that the general partner receive a share of the partnership available cash graduated in such a manner that the more cash generated by the partnership, the greater the share of cash distributed to the general partner. Some MLP cash distribution provisions max out the general partner's share at about 50%; others max out at approximately 25%. The partnership agreements state that the greater than pro rata share of cash distribution is in recognition of the general partner's management of the partnership, making the cash distribution and its matching income allocation payment for services rendered to the partnership, not a return on equity invested in the partnership.

MLP Income Allocation

24. MLP partnership agreements require that general partner receive a *gross income* allocation *equal to the dollar amount* of the cash distributions awarded to the general partner.

After the deduction of gross income from partnership earnings, the *net income* is allocated among the limited partners, including the general partner, in a pro rata fashion.

25. Gross income, as defined by the Code of Federal Regulations 26 CFR §1.61, is the total income from all sources including income realized in any form whether in money, property, stocks, or services. It should be noted that gross income does not include the return of capital, *i.e.*, depreciation. While the depreciation component of a cost of service revenue requirement is included in gross revenue, it is not included in gross income. Therefore the general partner's allocation of gross income can be drawn only from partnership return on equity and income tax collections.

26. Net income is a defined term in the partnership agreements. In pertinent part they specify that "Net Income" means the excess, if any, of the partnership's items of income and gain over the partnership's items of loss and deduction. The items included in the calculation of Net Income are spelled out in the agreement and specially do not include any gross income allocated to the general partner. Therefore the net income or profitability of the partnership excludes depreciation and gross income allocations to the general partner.

27. Generally, net income can only be allocated if there is some measure of net income left after costs are extracted. The allocation of *gross* income to the general partner may diminish the *net* income so much that the limited partners earn little or no income from the partnership investment. The gross and net income derivations demonstrated below use the same simple cost of service model. (In the figures below, the depreciation component moved to the top to emphasize that depreciation is not a component of gross income.)

Partnership Cost of Service – Gross Income:

Book Depreciation	\$86,000,000	
Operating Expenses	\$31,000,000	} Gross Income: \$219,316,667
Debt Costs	\$40,250,000	
Taxes Other than Income	\$31,400,000	
Return on Equity	\$80,500,000	
<u>Income Taxes</u>	<u>\$36,166,667</u>	
Total Revenue Requirement	\$305,316,667	

Partnership Cost of Service – Net Income:

Book Depreciation	\$86,000,000	
Operating Expenses	\$31,000,000	} Net Income: \$116,666,667
Debt Costs	\$40,250,000	
Taxes Other than Income	\$31,400,000	
Return on Equity	\$80,500,000	
<u>Income Taxes</u>	<u>\$36,166,667</u>	
Total Revenue Requirement	\$305,316,667	

28. If the general partner receives a gross income allocation equal to half of the available cash calculated above, [$\$202,666,667/2 = \$101,333,333$], the partnership net income calculation has, in essence, a new cost of service element: the GP's gross income allocation that must be drawn from the return on equity and income tax allowances. Hence, the partnership's reported net income of \$116,666,667 falls to \$15,333,333. So, what is the impact of these calculations on a per unit bases for the investors? If the MLP has approximately 150,000,000 units outstanding,

<u>Partnership Available Cash</u>	<u>Partnership</u>	<u>General Partner</u> (50%)	<u>Limited Partners</u> (50%)
Book Depreciation	\$86,000,000		
Return on Equity	\$80,500,000		
<u>Income Taxes</u>	<u>\$36,166,667</u>		
Available Cash	\$202,666,667	\$101,333,333	\$101,333,333
<u>Partnership Income Allocation</u>	<u>Partnership</u>	<u>General Partner</u> Gross income = cash	<u>Limited Partners</u> Net revenue – GP Gross
Return on Equity	\$80,500,000		
<u>Income Taxes</u>	<u>\$36,166,667</u>		
“Net” Income	\$116,666,667		
Less GP Gross allocation	<u>\$101,333,333</u>	\$101,333,333	
Partnership actual Net Income	\$15,333,333		\$15,333,333

Assuming a rate base of \$1,150,000,000 and an equity ratio of 50%, the equity rate base is \$575,000,000. The resulting return on equity then falls out as follows:

<u>Partnership per unit stats –</u>	<u>Partnership</u>	<u>General Partner</u>	<u>Limited Partners</u>
Equity Rate Base	\$575,000,000	\$11,500,000	\$563,500,000
Gross Income	\$219,316,667	\$101,333,333	
Available Cash	\$202,666,667	\$101,333,333	\$101,333,333
Net Income	\$116,666,667		\$15,333,333
Total return *		\$101,333,333	\$15,333,333
Outstanding units	150,000,000	3,000,000	147,000,000
Income per unit	\$0.7778	\$33.7778	\$0.1043
ROE (Income/Equity Rate Base)	20.29%	881.16%	2.72%

(* Note the GP is also a limited partner and earns a share of the net income as well as the gross income allocation.)

29. The general partner’s gross income allocation is an “off the top” slice of the revenue and does not represent profits or net income to the partnership but is rather a cost to the MLP that is

subtracted, pursuant to the partnership agreement, prior to the calculation of profits by the partnership. Thus the only measure of earnings that is relevant to the investors is that related to the limited partner net income per unit. The reported earnings by the partnership as a whole do not account for the deduction from gross income going to the general partner in recognition of its management services on behalf of the partners. While the gross income allocation to the general partner is taxable income to the general partner, it is a cost to the partnership, and a deduction from net income as far as the investors are concerned.

30. Consequently, we see that the claimed 14% ROE used in developing the cost of service model becomes a 20.29% ROE for the pipeline as a whole, but the limited partners realize only 2.72% ROE. Although the general partner's gross income allocation is a managerial payment for services rendered, if looked at as a return on its 2% ownership of the units, the general partner walks off with over 880 % return.

31. One must question therefore whether the "earnings per share" used in the DCF model reflect the partnership as a whole or reflect the return on equity to investors. If a substantial portion of the pipeline's return on equity flows to the general partner a compensation for managing the partnership, that portion of pipeline return on equity cannot be considered return to investors. If the Commission's proxy group proposal caps the distributions used for return calculations in the DCF model at the ROE reported by Value Line, rather than the ROE realized by investors, the ROE may way overstate the actual return to investors.

32. Wait, it gets worse.

MLP Equity Ratios

33. It is well established regulatory practice that financial analysis of return on capital looks not to the regulated entity alone but to the entity that controls the financial conditions, i.e., the parent organizations. More often than not, the parent's common equity structure is more highly leveraged than the pipeline. Where the pipeline would file a claimed cost of service reflecting a 50% equity ratio (some go as high as 60% equity!), the parent may well have a 40% equity ratio. Since equity is more expensive than debt, a change in the equity ratio has substantial impacts on the cost of service, cash distributions and income allocations for MLP owned pipelines.

34. Adjusting the previous illustrated cost of service model to reflect a 40% equity ratio provides the following cost of service:

Partnership Cost of Service with 40% equity ratio:

Operating Expenses	\$31,000,000	
Debt Costs	\$48,300,000	
Taxes Other than Income	\$31,400,000	
Book Depreciation	\$86,000,000	} Available Cash
Return on Equity	\$64,400,000	
<u>Income Taxes</u>	<u>\$28,933,333</u>	
Total Revenue Requirement	\$290,033,333	

We see that the lower equity ratio reduces the partnership ROE and the associated income tax allowance. Although debt costs are now higher, the overall cost of service revenue requirement is lower. Following the same procedure as above, the cash distributions, income allocations, and return on equities fall out as follows:

<u>Partnership per unit stats</u>	<u>Partnership</u>	<u>General Partner</u>	<u>Limited Partners</u>
Equity Rate Base	\$575,000,000	\$11,500,000	\$563,500,000
Gross Income	\$204,033,333	\$89,666,667	
Available Cash	\$179,333,333	\$89,666,667	\$89,666,667
Net Income	\$ 93,333,333		\$3,666,667
Total Return		\$89,666,667	\$3,666,667
Outstanding units	150,000,000	3,000,000	147,000,000
Income per unit	\$0.6222	\$29.8889	\$0.0249
ROE (Income/Equity Rate Base)	16.23%	779.71%	0.65%

As implausible as it seems, the claimed 14% ROE in the pipeline's filing becomes a 16.23% realized return for the pipeline, yet the limited partners – the investors – receive only 0.65% return on equity. These figures reflect a required distribution of 50% of available cash to the general partner.

35. Wait, it gets worse yet.

Accelerated Depreciation

36. MLP partnership agreements require that the MLP accounting be done in conformance with the IRS accounting, *i.e.*, the MLPs must use accelerated depreciation in calculating net income. Because the pipeline partnership and intermediate partnerships pass through the book depreciation-derived net income, the MLP must reverse the straight line depreciation and substitute accelerated depreciation in Schedule M of the IRS 1065 to report partner's net income from the partnership. Thus the MLP's reported earnings reflect greater tax write-offs against the same level of available cash, providing investors with a lower taxable income vis-à-vis the cash distributions. However, the general partner's income allocation remains tied to the available

cash and gross income, resulting in an income allocation to the limited partners that may be negative.

37. Again adjusting the previous illustrated cost of service model to reflect a 40% equity ratio and now the use of accelerated depreciation provides the following cost of service (for discussion purposes I used an accelerated depreciation at 1.5 times the straight line depreciation):

Partnership Cost of Service with 40% equity ratio & accelerated depreciation:

Operating Expenses	\$31,000,000	
Debt Costs	\$48,300,000	
Taxes Other than Income	\$31,400,000	
Book Depreciation	\$129,000,000	} Available Cash
Return on Equity	\$64,400,000	
<u>Income Taxes</u>	<u>\$28,933,333</u>	
Total Revenue Requirement	\$333,033,333	

Following the same procedure as above, the cash distributions, income allocations, and return on equities fall out as follows:

<u>Partnership per unit stats</u>	<u>Partnership</u>	<u>General Partner</u>	<u>Limited Partners</u>
Gross Income	\$204,033,333	\$111,166,667	
Available Cash	\$222,333,333	\$111,166,667	\$111,166,667
Net Income	\$ 93,333,333		(\$17,833,333)
Total Return		\$111,166,667	(\$17,833,333)
Outstanding units	150,000,000	3,000,000	147,000,000
Income per unit	\$0.6222	\$37.0556	(\$0.1213)
ROE (Income/Equity Rate Base)	16.23%	966.67%	-3.16%

Using accelerated depreciation as required by the partnership agreement, generates greater available cash than the book accounting that governs FERC filings. The greater level of available cash, the greater the general partner's share of cash and gross income allocation.

Consequently, the general partner's guaranteed payment of a gross income share equal to half the available cash eats up more than all the partnership net income, leaving the limited partners to share the loss. Again, as implausible as it seems, the claimed 14% ROE in the pipeline's filing becomes a 16.23% realized return for the pipeline, yet the limited partners – the investors – receive negative return on equity. These figures reflect a required distribution of 50% of available cash to the general partner.

Changing the GP's Share

38. Not all MLPs are so generous to the general partner. In response to investor discomfort with such demanding general partners, some MLPs have moved to a less onerous guaranteed payment to the general partner equal to just 25% of the available cash. If we examine the last set of figures using a 25% cash distribution to the general partner, the numbers fall out as follows:

<u>Partnership per unit stats</u>	<u>Partnership</u>	<u>General Partner</u>	<u>Limited Partners</u>
Gross Income	\$204,033,333	\$ 55,583,333	
Available Cash	\$222,333,333	\$ 55,583,333	\$166,750,000
Net Income	\$ 93,333,333		\$ 37,750,000
Total Return		\$ 55,583,333	\$ 37,750,000
Outstanding units	150,000,000	3,000,000	147,000,000
Income per unit	\$0.6222	\$18.5278	\$0.2568
ROE (Income/Equity Rate Base)	16.23%	483.33%	6.70%

Under this scenario, the general partner's 25% share of cash causes the allocation of gross income to be far less than the 50% share MLPs. With a lower gross income allocation to the general partner, there is a higher net income left for the limited partners to share pro rata. Here, the 14% claimed ROE converts to a 16.23% overall return but a 6.70% return for the investors.

39. If we were to assume that the general partner takes only 10% of the available cash, then the net income allocation to the limited partner investors rises, giving the limited partners a 12.62% return on equity. Thus we see that the greater the MLP general partner's claim on available cash, the more distorted is the return on equity to MLP investors vis-à-vis the pipeline net income. Although we would like to look at the pipelines as stand-alone entities and simply plop in a rate of return on equity based on the MLP reported earnings, the fact is the partnership agreements create an entity that is much different from a pipeline partnership. The MLP, even though it is invested in pipeline assets, is such a different animal in how it allocates cash and income, that it is not comparable to regulated pipelines. Yet no matter what we choose for a proxy group, the end result as far as the MLP income allocation will be the same – little or no return on equity for the investors.

What's in it for the Investor?

40. The cost of service illustrations above highlight the fact that cash distributions are a return of the investor's own money, not a return on capital. The question arises then: why would an investor pay good money just to get his or her own money back with no net income?

41. The answer lies in the partner's capital account accounting. Recall that the cash distribution received by the partner reduces the partner's capital account, signaling a reduced equity holding in the partnership – the partner got its money back. That's why cash distributions are not subject to income tax; it's your own money. At the same time, because the limited partner is allocated little or no net income due to the accelerated depreciation accounting required by the partnership agreement, the value of the partner's investment in the partnership, as reflected in the capital account, continues to fall.

42. Keep in mind that the partner still owns the same number of units, which still have a market value attached to them. When the investor decides to shed its interest in the partnership, he or she sells the reduced valued units at the going market rate, earning a relatively large capital gain on the sale. While some of the gain on the sale should be traced back to the depreciation and recaptured as ordinary income (and taxed as ordinary income), the remainder of the gain represents non-depreciation return of capital that is now, through the alchemy of the capital account, capital gain return on capital, taxed at capital gains rates. The upshot for the limited partner investing in an MLP is that the cash distributions provide for the return of capital in fairly quick order while the income is deferred until the sale of the units providing for both a deferred and reduced income tax liability.

43. The valuation of the capital gain upon the sale of the units is itself problematic. When will the units be sold? What will the market value be at that time? What will the individual partner's capital account reflect at that time? How much of the gain on the sale will represent recapturable depreciation? What will the income tax rates be at the time? None of these questions is knowable, rendering the "deferred income" from the sale of the units useless in determining current net income for use in developing the ROE for MLPs. Further, can the capital gain upon the sale of the assets be deemed a deferred net income from operations?

Flow Through Policies for Partnership Tax & Return

44. There are fundamental problems with the Commission's pipeline income tax and return on equity policy positions. First, the Commission abandoned the stand alone principle in income tax allowance by requiring that the cost of service look past the regulated entity up through the chain of ownership to find the tax status of the ultimate owners. This is the quite analogous to complaint of the City of Charlottesville against the tax treatment of Columbia Gas: the parent

company had a lower income tax status and Charlottesville argued the pipeline and ratepayers should be treated as being in the same tax status and share the benefits of the consolidated tax treatment. Here, the pipeline's tax status is zero and the parents have income tax liability, and the Commission requires that the parent's tax status be applied to the pipeline and ratepayers, imposing a cost on ratepayer that the pipeline does not experience. Where Charlottesville requested flow through treatment of income tax status, the Commission and Courts ordered stand alone treatment, denying the costs and benefits of consolidated tax treatment to the ratepayers. The Commission's current income tax policy, while claiming pedigree from the stand alone principles, is in fact a flow through policy imposing on ratepayers the tax status of the owners.

45. The income tax allowance for MLP owned partnership pipelines creates a further problem in that the distributions of partnerships are not the equivalent of dividends from corporations. Hence, the DCF model for estimated required return on equity fails. Further, as we saw in the cost of service examples above, the Commission's tax policy coupled with the MLP partnership agreements and the standard ratemaking models leads to absurd results.

Reported net Earnings

46. Let's assume away the problems with partnership agreements, the income tax flow-through treatment, and the ratemaking model treatments of return and taxes. Can we just use the MLPs' reported net earnings and be done with it?

47. The answer depends on exactly what the MLPs are reporting. Given the discussion above showing how partnership agreement provisions require that very large measures of gross income get allocated to the general partner prior to the calculation of net income for partner allocation purposes, it is imperative that partnership net income statements are clear as to whether the net income reported is before or after the general partners gross income allocation. It

is not clear whether partnership net income is equal to the sum of the limited partners' net income. The general partner's gross income allocation is unlike any other operating cost, and is derived after all other costs are in and the gross income and available cash can be determined. There would appear to an interim net income required between the closeout of operating costs and the derivation of net income to limited partners. Is the net income reported in financial reports that derive "earnings per share" the interim net income or the final net income as allocated to the limited partners?

Locating Corporate Proxies

48. One of the concerns that gave rise to this inquiry about the criteria for inclusion in proxy groups is that so many pipelines are being acquired by MLP organizations that there are few non-MLP owning entities left with similar risk patterns. But if we look again at the diagram in paragraph 15, we find that the general partner, who actually operates the MLP and its underlying pipeline assets is a corporation, which in turn is wholly owned by another corporation. So if we turn the other cheek in this investigation, we find corporations with extensive experience in pipeline management, risk, and reward. Those that are publicly held corporations report dividends that are not tainted by cash distributions masquerading as return on capital. Consequently, the Commission's interest in finding criteria by which to incorporate MLPs into ROE proxy groups may be premature.

49. The phenomenon at work is that the pipeline holding corporations are setting up MLP partnerships to raise capital and hold the regulated assets, allowing the holding corporation to avoid corporate tax at the pipeline level (organized as a simple partnership), yet still garner almost all the pipeline income through the device of the guaranteed payment in the MLP partnership agreement. The holding corporation parent still exists, it's just another tier or two

removed from the pipeline entity. Even though these holding companies sit atop larger pyramids of generally extractive industry resources, they are still comparable to pipeline companies – some more risky than pipelines, some less so; an analysis best left to return analysts in individual rate cases. Rather than use the MLPs directly in the proxy groups, the Commission could utilize the holding companies of the general partners of those MLPS since they are still in extractive industry sectors, hold pipeline assets, and report dividends untainted by returning of capital problems inherent in the cash distribution of partnership reporting.

50. Setting the MLP issues aside, the search for corporate proxy groups has improved since the Commission's Kern River opinion, 117 FERC ¶ 61,077. The Commission's four proxy group entities (Kinder Morgan, Inc., Equitable Resources Inc., National Fuel Gas Co., and Questar Corp.) are now five: Equitable Resources, Inc., Questar Corp., Williams Energy Company Inc., National Fuel Gas Co., and Spectra Energy Corp. Williams Energy's improved financial conditions would now permit its inclusion in the proxy group. El Paso Corporation may soon join the ranks of proxy group eligibility as well. Consequently, the pressure to find alternative proxy group entities has abated for the time being.

I V CONCLUSIONS

51. Crowley Energy Consulting respectfully recommends the Commission use the existing five or six entities listed above as proxy group entities to avoid the problems inherent in the use of MLP cash distribution reporting in the DCF model. Second, if the Commission decides to use MLPs in the proxy group, the holding companies that own the general partners of MLPs can and should be used as proxy group entities since they are engaged in comparable activities and pay dividends like the group of five listed above, as well as avoiding the problems inherent in partnership cash distribution in the DCF model. Third, because the large allocation of gross income to the general partner required by the MLP partnership agreements may distort the reported partnership “earnings per unit,” leaving the limited partner investors with little or no actual net income from the regulated assets, the Commission should investigate whether earnings reports for MLP reflect net income prior to the general partner’s gross income allocation or after.

Respectfully submitted,

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