



CIBC Private Wealth Blog

## FERC Ruling Impacts MLPs

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The MLP and broader pipeline sector was negatively impacted yesterday by actions at the Federal Energy Regulatory Commission (FERC). We will learn much more in coming days and weeks on the issue, but we wanted to provide a general summary of what was announced and the implications.



As a backdrop, FERC regulates Interstate pipelines (those that cross state lines) and has historically allowed a Tax Allowance to be included in tariff rates where a pipeline is basing its rates off of cost of service and an acceptable rate of return. Regardless of whether the ownership was a C-Corp or an MLP, this tax allowance has been included with the view that taxes were being paid either at the corporate level or at the investor level in the case of the MLP structure. Based on surviving previous legal challenges by shippers, we believe most investors expected that structure to stay in place going forward with FERC simply reducing the tax allowance being included down to a 21% rate from the previous 35% corporate rate. This likely would have been a non-event for the security prices as we believe it was viewed as the likely outcome.

Instead FERC chose to leave the tax allowance in place (with the lower 21% rate) for C-corps and remove it completely for MLPs. This primarily relates to Natural Gas Pipelines and a few of the older crude oil pipelines that use a “Cost of Service” structure. This was a surprise and will have the effect of reducing tariffs on some pipelines (those under cost of service structure and owned by MLPs and not C-Corps). In addition, FERC plans to address tax changes for interstate liquid pipelines in 2020 that are based on an index that grows with inflationary escalators plus a margin. This would include some Crude Oil, Refined Products and NGL (Natural Gas Liquids) pipelines that cross state lines and use the index structure. We have seen conflicting views by experts on what the effect might be on the liquid side. Not clear yet whether MLPs and C-corps will have a different tariff pricing and also not clear whether this change will simply limit tariff increases in some situations or actually cause some tariff reductions.



#### What are the likely Implications?

1. This has no direct impact on negotiated rates with customers, which has become much more common in the industry. In addition, most rates are below the maximum rates allowed by FERC and therefore have a substantial cushion before having to change rates.
2. Many companies have additional costs (system upgrade, higher maintenance cost...) that can likely be included in the cost of service - had been little incentive to include those as many of their rates are already below the maximum - again additional offsets to work with.
3. This only affects Interstate Pipelines that do not use negotiated rates. Has no impact on Intrastate pipelines (within state lines), liquid (crude, NGL & Refined Product) storage, Gathering lines, NGL Processing and Fractionation, Marine logistics, LNG or Propane.
4. For companies directly affected that use the "Cost of Service" structure, we would expect an acceleration in simplifications (collapsing the MLP under a C-Corp structure when possible) to allow the 21% tax allowance to be in effect and eliminate the otherwise negative effect of this FERC order. We view this as the primary solution for three companies that have material exposure to this issue. As we approach 2020, we may see similar decisions made on the liquids side, but that's not as clear at this point. In our view, every movement from the MLP structure to a corporate structure is a positive for the future trading of the sector. Most companies will not pay much tax under a C-corp structure for years anyways (high depreciation), impact of corporate tax rate is much less than it once was and the available investor universe is much larger.

We have seen a majority of pipeline companies issue press releases since the FERC news release and the message has been very consistent: We expect the impact from this news to be Immaterial or De Minimis to cash flow going forward. There are three companies (approximately 4% of the AMZ MLP Index) where we anticipate a material impact from this FERC news. In 2 of those 3 situations, we would expect the related C-corp company entity to buy-in the MLP and mitigate the impact. Despite the minimal impact on company cash flows from this announcement, we would expect the sector to stay volatile in the short-term as a result of the negative headlines and potential confusion among some of the investor base about the issue. Longer-term, this will likely accelerate more use of the C-Corp structure for interstate pipeline assets, which we view as a positive.

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