CIBC PRIVATE WEALTH MANAGEMENT

CIBC Private Wealth Blog

FERC Final Ruling - Incrementally Positive For MLPs

Paul McPheeters, CFA

July 23, 2018

On July 19th, the Federal Energy Regulatory Commission (FERC) issued a final ruling as a follow-up to its announcement on March 15th that had caused significant weakness across the MLP sector. The final ruling was a positive development for the sector as we detail below.

To help understand the incremental improvement in the final ruling, it's important to understand what the primary concerns were following the initial March 15th announcement:

1. Income Tax Allowance (ITA) would no longer be included in the rate base for Interstate Natural Gas Pipelines that use a "Cost of Service" structure AND are owned by a MLP (those with negotiated rates and those wholly owned by C-corps would not be directly impacted). This could cause some pipelines to lower their rates.

2. Accumulated Deferred Income Taxes (ADIT) balances on these pipelines could need to be refunded back to shippers if it is determined that their rates need to drop by losing the Income Tax Allowance mentioned above. This could come in the form of a 1-time payment or amortization over the remaining life of the contracts.

3. FERC commented that in 2020 it would factor in its revised view on ITA when next updating the liquids index that goes into effect in mid-2021. This would apply to interstate liquid pipelines owned by MLPs that use the FERC indexing structure for pricing escalators.

In our view, below are changes with the final ruling on July 19th. Please note, this is a 200 page legal document and we have already seen some different interpretations.

1. ITA's can now be left in the "Cost of Service Structure" for a 3 year period as long as their ROE is reasonable after giving them the benefit of the ITA staying in. In addition, FERC made comments that have led many analysts to conclude that a MLP can permanently leave ITA in their rate structure if the pipelines are consolidated at a parent C-corp level for tax purposes. However, considering all of the comments FERC made in this document, we think it will be a case by case situation going forward. The higher the percent of ownership by a C-corp, the better chance a large portion or all of the ITA may be left in the calculation. This is still a much better situation than the concerns from the original March 15th announcement.

2. ADIT – "Home Run" announcement for the sector. Not only would companies be safe from any refunds (in a situation where future rates do drop for a pipeline), but in situations where ITA is no longer being included in rate base, ADIT can now be excluded as well. Removing ADIT materially increases the rate base for many pipelines offsetting a large portion of the negative effect from the ITA reduction.

3. FERC did not make additional comments on its plan for the liquid index escalators in 2021, but we can speculate that they may treat them similar to how they've treated natural gas pipelines using the "Cost of Service" structure. Removing ADIT will be a great offset for removing ITA. Combined with many of the company comments over the last few months, we think the actual impact in 2021 will be minor for those companies that have assets under the structure.

CIBC PRIVATE WEALTH MANAGEMENT

In conclusion, while the analyst and media commentary may continue to argue the significance of the FERC announcements on ITA and ADIT and what it means for companies and the sector, we think many have missed the real impact of these announcements. In the end, ADIT will offset a portion of the ITA impact and the net effect, we believe, will be muted for most companies. However, FERC has had two significant indirect impacts on the sector with their actions:

1. Game is up for any FERC regulated interstate natural gas pipeline that has been materially overearning (outside of these tax changes) – we believe these events will serve as catalysts to bring their rates more in-line with where they should have already been.

2. The trend of consolidation by C-corps and MLPs had already been picking up steam as corporate tax rates dropped and investors have pushed more for simplification. Since the March 15th announcement, we have seen a significant acceleration in those merger announcements. Those include announced buy-in transactions of Williams Partners, Boardwalk Partners, Tall Grass Energy Partners, Spectra Energy Partners and Enbridge Energy Partners. Many of these may have occurred anyways over time for other reasons, but the FERC news has served as a significant catalyst.

To be clear, we view the July 19th announcement as a pleasant surprise and we think it reduces the risk for a number of companies and improves sentiment, but we have found some of the analyst commentary and headlines a bit misleading.

Paul McPheeters is the lead portfolio manager for CIBC Private Wealth Management's Energy Infrastructure strategy, which he developed in 2003.