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IN THE MATTER OF THE APPLICATION OF JOHNSON UTILITIES, LLC FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES FOR CUSTOMERS WITHIN PINAL COUNTY, ARIZONA.

Docket No. WS-02987A-08-0180

RUCO'S RESPONSE TO JOHNSON UTILITIES, LLC'S PETITION TO AMEND DECISION NO. 71854

The Residential Utility Consumer Office ("RUCO") submits this Brief in response to Johnson Utilities, LLC's ("Johnson or the Company") Petition to Amend Decision No. 71854 pursuant to A.R.S. §40-252. The Commission has requested that the parties provide their respective positions on the issues raised in the Petition in order that the Commission can make its determination whether to grant the Petition.

RUCO asserts that the Commission should not re-open the rate case. The purpose of a rehearing is to correct a mistake that the Commission believes it made in the underlying case. Its purpose is not to rehear the same evidence in order to give the Company a second bite at the apple. Its purpose is not to substitute a rate case for a workshop in order to promote a new Commission policy. That is not fair to all of the other stakeholders in the workshop who are not a part of the rate case. RUCO does not believe the Commission made a mistake in Decision

No. 71854 and that the Commission should not amend and/or rehear the matter. Decision No. 71854 is well-balanced, fair, consistent with precedent, and supported by the record. Nothing that the Company has raised in its Petition has caused RUCO to reconsider its prior positions.

Johnson's Petition seeks to amend Decision No. 71854 on eight issues. Five of the issues were issues raised by other parties. Of these issues, RUCO either did not take a position or supported Staff's position. It would be unfair and inappropriate for RUCO to change its positions on these five issues. Therefore, RUCO will only address the three issues raised by Johnson where RUCO made an independent analysis and took a position contrary to the Company's position. In summary, these contested issues are (1) unexpended hook-up fees; (2) the Commission's authorized rate of return; and (3) the exclusion of imputed tax expense.

1) RUCO continues to recommend the deduction from rate base of $6,931,078 in unexpended hook-up fees.

The Commission is well versed on this issue, having just changed its historical approach in the recent *Bella Vista* case[1]. RUCO argues that allowing a utility to delay booking hook-up fees as CIAC until the infrastructure is in operation opens the door to accounting oversight, unintentional mistakes and even overt trickery by a utility with little to no regulatory oversight. RUCO believes that the Commission's recent decision to deviate from the historical and standard accounting treatment of CIAC based on the timing of when plant is built and/or becomes used and useful is misguided.

In *Bella Vista*, this Commission determined that HUF funds meet the NARUC definition of CIAC:

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[1] Decision No. 72251 at 47.

> We find that HUF funds meet this definition and are appropriately deducted from rate base as non-investor supplied capital.[2]

From there, and without explanation, the Commission in *Bella Vista* leaped to the conclusion that the rate base deductions for the plant associated with the HUFs should not be deducted from rate base until the amounts have been expended for the plant. Aside from the argument that the Commission is redefining CIAC in a way that is inconsistent with the Commission's own rules and the NARUC definition, the end result places the responsibility on the utility to offset its own rate base when the plant in its judgment is built and/or goes into service. As a matter of sound public policy, HUF should be booked as CIAC upon receipt.

Deducting HUF from rate base is clearly counter to the shareholder's interests. Under *Bella Vista*, the utility will get the use of non-investor supplied funds until the utility builds the plant and/or the plant goes into service. Should the utility overlook the rate base deduction, be confused, or intentionally fail to make the rate base deduction, the plant paid for by the contribution will remain in rate base and the Company will earn an unjustified return unless or until Staff or RUCO catches it. This lax accounting will inevitably lead to a situation where Staff and/or RUCO will have to "chase the CIAC." Staff's witness, Ms. Crystal Brown, testified in *Bella Vista* that distinguishing CIAC by timing creates a definite problem for Staff, RUCO or even the Company to follow or "chase CIAC." [3] Ms. Brown testified if there was a turnover in the personnel of the Company or Staff, plant could be added without recognition of the unexpended CIAC, causing ratepayers to pay more money in rates because of the Company's failure to include the offsetting deduction or reduction to rate base. Id. Moreover,

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[2] Decision No. 72251 at 47.
[3] Bella Vista Transcript at hearing: pp. 757-758.

if Staff or RUCO are unable to successfully chase or follow the unrecorded CIAC, the Company would end up with the unjust benefit of earning a return on the assets that were paid for by others and ratepayers would essentially pay twice: once through the hook-up fee and again through rates. Id.

This is a very real possibility. The change adopted in Bella Vista is far less structured in its application than the implementation of an adjustor mechanism – yet unbelievably, unlike the typical adjustor mechanism there are no safeguards. Despite the safeguards associated with the adjustor mechanism, the correct application and implementation of an adjustor mechanism is an on-going challenge. The Commission has recently dealt with an incident where a sophisticated water utility has overlooked collection under an approved adjuster mechanism for several years. See *In the Matter of the Application of Arizona-American Water Company – Paradise Valley Water Division for an Increase in Rates (Docket No. W-01303A-98-0507),* Decision No. 72208 (March 3, 2011). In the case at hand, the application of the approved CAGRD adjustor mechanism has caused much confusion for the parties and significant frustration for the Staff. Given the ever changing circumstances that occur within any given utility from day to day, there is no question that Ms. Brown's premonition will prove true. It is not a question of if, but a question of when a utility misapplies the Commission's new policy. For the sake of the ratepayers, Staff and/or RUCO will hopefully catch the mistake. The stakes are too high and the risks too great for the Commission to endorse this policy.

RUCO urges the Commission not to apply the accounting treatment of HUF from Bella Vista to the Johnson rate case. This change is so new in application and so impacting in scope. RUCO believes the Commission should treat its decision in Bella Vista as a "test case" to see how Staff and the utility track the unrecorded hook-up fees. There is no harm to a utility for the traditional accounting treatment. A utility which books CIAC sooner gets the CIAC off its books quicker.

2) RUCO would support an 8.18% rate of return for the Company based upon its weighted average cost of capital ("WACC") should the Commission approve a positive rate base for the Company's water and/or wastewater division(s).

In Decision No. 71854, the Commission found the utility had a negative rate base for both its water and wastewater divisions and determined that a 3 percent operating margin was appropriate. Decision No. 71854 at 50. The Company requests the Commission find the utility's divisions have positive rate bases and award a rate of return in the range of 8.18% to 11.89%.

RUCO continues to support its position in the underlying case. RUCO recommended an operating margin of 8.18 percent for the Company's water division and a WACC of 8.18 percent for the Company's wastewater division. RUCO's 8.18 percent WACC was derived through a cost of capital analysis which employed the same criteria and methodology that the Commission normally considers when ascertaining the cost of capital where the Company in question has a positive rate base. However, before the Commission can even consider awarding a rate of return, the Company has to have a positive rate base. Should the Commission be persuaded to amend Decision No. 71854, resulting in a positive rate base for either or both divisions, RUCO would recommend that the Commission award a WACC of 8.18 percent.

...

...

3) The exclusion of Imputed Income Tax Expense from Operating Expense was proper.

This is another issue that the Commission and the parties are well versed on. The question, as the Company points out, is one of the subjects in the ongoing water workshops (Docket No. W-00000C-06-0149). The Commission's current approach on this issue as it applies to LLCs has been to deny imputed income tax expense when an LLC requests it in a rate application. Until the workshop process is completed, RUCO believes it would be a mistake to change its current policy. A change in policy at this time would signal that on this particular issue the workshop itself is meaningless and the Commission puts no value in its outcome. More importantly, a change in policy at this time is unfair to all of the other stakeholders in the workshop who are not involved in the current rate case. RUCO recommends that the Commission reject the Company's request at this time.

If the Commission is persuaded otherwise and wishes to address the Company's recommendation prior to the conclusion of the workshop, RUCO would oppose reconsideration of this issue and respond to the Company's petition as follows. For the most part, RUCO disagrees with the arguments raised by the Company on this issue. RUCO does agree, however, with the Company's suggestion that the resolution of the issue comes down to a policy call. From a policy standpoint, RUCO questions how the Commission or RUCO for that matter can explain to the ratepayer why he/she should have to pay for a utility's income tax when the utility itself has <u>opted</u> not to pay income taxes.

The Company argues that the Commission should adopt a policy of imputing income taxes because FERC has adopted this policy. It is true that from what can only be described as a long and tortured history FERC's current policy is to impute income tax to pass-through entities at the top marginal tax rate. It is also true, as the Company points out, that the District of Columbia Court of Appeals has upheld FERC's policy. However, the same Court of Appeals Judge who in 2004 struck down FERC's attempt to "...create a phantom tax in order to create an allowance to pass-through to the ratepayer", had a change of heart in 2007 and upheld FERC's new policy based on the ground that FERC had "justified its new policy with reasoning sufficient to survive our review." - hardly a glowing endorsement or even support for FERC's new policy of imputing income taxes at the maximum marginal tax rate. *See BP West Coast Products v. FERC*, 374 F.3d 1263, 1291, 362 U.S. App. D.C. 438, 466, 160 Oil & Gas Rep. 703 (2004), *Exxon Mobil Oil Corp. v. F.E.R.C*, 487 F.3d 945, 948, 376 U.S.App.D.C. 259, 262, 166 Oil & Gas Rep. 230, 233. The Court recognized that the question was clearly a policy choice which is FERC's responsibility and not the Court's, and the Court is limited to ensuring that FERC's decision making is "...reasoned, principled and based upon the record." *Exxon Mobil Oil Corp. v. F.E.R.C*, 487 F.3d 945, 953, 376 U.S.App.D.C. 259, 267.

The public perception of FERC's new policy is not surprisingly, far less supportive. David Cay Johnston, a *Tax Analysts'* columnist, said the following about FERC's policy in his column entitled, "Master Limited Partnerships; Paying Other Peoples Taxes[4]."

> Wouldn't it be fantastic if someone else paid your income taxes for you? Imagine all that extra money in your bank account. You could pay off your debts, save, and even splurge.
>
> Of course, for the person who paid your income taxes it would be awful. They would have to pay their own income taxes and then, out of what was left, pay yours.
>
> Congress would never enact such a law, right?
>
> The good news is that Congress has not enacted such a law. The bad news is that buried deep in the fine print of the *Federal Register* is a regulatory rule that has the same effect.

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[4] The FERC policy and the Circuit Court cases mentioned above which address the policy dealt with Master Limited Partnerships, which like LLC's are pass-through entities for tax purposes. The resulting FERC policy, however, addresses pass-through entities including LLCs.

> The requirement that forces you to pay the personal income taxes of others applies -- for now -- only to owners of rate-regulated pipelines organized as master limited partnerships, or MLPs.
>
> It is not surprising if you have never heard about this tax-shifting rule. Unless you dig into the inordinately arcane proceedings of the Federal Energy Regulatory Commission (FERC), a small government agency that wields enormous economic power, you would be in the dark. The commission gets almost no news coverage. The very few, and brief, news reports on the cases related to the MLP charge missed the tax issue. [5]

With regard to FERC's new policy and its cost to ratepayers, Mr. Johnston reported the following:

> The math here is stunning. When rates include a tax that does not exist, the investors make out like, well, bandits. Investors in an MLP pocket 75 percent more in after-tax profits than they would if they invested in a traditional corporation owning a pipeline.
>
> You will not find this math in Judge Sentelle's 2007 decision. Had he done the math, would the outcome have been different?
>
> ....
>
> The tax shifted to consumers looks to be as much as $1.6 billion a year for gas pipelines and $1.3 billion more for petroleum pipelines. Industry data show oil pipeline profits are an eye-popping 42 percent of revenues, more than four times the margin for the 12,000 largest corporations.
>
> This estimate has to be heavily hedged because, amazingly, FERC does not issue any statistical reports on either the cost of this tax transfer or of the underlying data from which a solid estimate could easily be calculated. A new law requiring either truth, or at least transparency, in regulations that shift tax burdens would help here, but the Wall Street-friendly Obama administration seems unlikely to take up such a cause.

Id. at 3.

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[5] David Cay Johnston, *Master Limited Partnerships: Paying Other Peoples Taxes*, Tax.com, June 21, 2010, at http://www.tax.com/taxcom/taxblog.nsf/Permalink/UBEN-86LJ4E?OpenDocument (See Exhibit A at 1).

Mr. Johnston goes on to make many other points concerning FERC's misplaced policy. RUCO understands that the article is journalism and subject to bias, but nonetheless, the points raised in the article are supported factually and show the transparent flaws associated with FERC's policy. It has been suggested in the workshop that imputing income taxes can actually save ratepayers money. Mr. Johnston's article suggests otherwise, however, RUCO remains open to the idea provided reliable evidence can support it through the workshop process.

Perhaps these same flaws explain why there is no support for the policy among the eastern commissions.[6] See Survey of Other Jurisdictions, Docket No. W-00000C-06-0149 (March 25, 2011). In fact, it appears that very few states have adopted this policy.[7] Arizona has always been proud of its independence. Arizona also has different policy considerations than does the federal government. Arizona should not adopt a policy just because the federal government has chosen to do so. The policy must make sense for Arizona. Neither the Company nor the industry has shown why it makes sense for ratepayers to pay a utility's income tax when the utility itself has chosen not to be taxed. The Commission should reject the Company's recommendation.

4) If the Commission grants rehearing and schedules the matter for hearing, the Company is required to give notice to its ratepayers.

If the Commission determines that a rehearing is appropriate, the Commission's Rules require the Company to provide notice to its customers of the rehearing. A.A.C. R14-2-105 requires "Every public service corporation **shall** give notice to customers affected of **any**

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[6] Florida, Indiana, Illinois, Kentucky, New Hampshire and Vermont

[7] The "Survey" refers to the "Kansas Doctrine" and the "New Mexico Rule" which adopt different versions of the policy. These versions appear to be followed in Kansas, Pennsylvania, Wisconsin, New Mexico and Texas. Id.

hearing at which the fair value of that corporation's property is to be determined and just and reasonable rates and charges are to be established." Customer is defined as "the person or entity in whose name service is rendered, as evidenced by the signature on the application or contract for that service, or by the receipt and/or payment of bills regularly issued in his name regardless of the identity of the actual user of the service." A.A.C. R14-2-401(9). The definition of customer includes those specific persons or entities that had contracts for service at the time of rehearing.

The Rule is clear – notice is required when the Commission holds a hearing where the fair value of a Company's property is to be determined. In Arizona, it is a generally accepted legal axiom that Courts will "... not look beyond the plain language of a statute, unless it is unclear." *State v. Tyszkiewicz,,* 209 Ariz. 457, ¶ 5, 104 P.3d 188, 190 (App.2005), *quoting Fell,* 203 Ariz. 186, ¶ 6, 52 P.3d at 220, *State v. Dixon*, 216 Ariz. 18, 20 162 P.3d 657, 659 (App. *2007).* In examining the language of a statute, "we give words their plain and ordinary meaning," absent a clear legislative intent to apply a special meaning. *State v. Cotton,* 197 Ariz. 584, ¶ 6, 5 P.3d 918, 920 (App.2000).

There is no "special" meaning contained in A.A.C. R14-2-105. The Commission's process is an open process and the purpose of notice is to inform the public of possible rate increases so that those interested may participate in the process. Absent notification, the public does not have notice that its rates are subject to change. The effect is a closed process, not an open one.

Notice to customers who existed at the time of the original hearing does not satisfy the requirements of R14-2-105. A substantial period of time has passed since the Commission approved Johnson's rate increase. A ratepayer could reasonably believe that this matter has come to a conclusion. Notice of re-opening the rate case is required. Furthermore, the Company may have lost or gained customers since the original hearing. It is likely that some of the Company's current customers were not customers at the time of the original hearing. However, for the sake of argument, even in the unlikely event that the current customers are the same customers that existed at the time of the original hearing, absent notice of the rehearing the current customers will only be on notice of a change in rates as authorized in Decision No. 71854. Imagine how confused the ratepayers will be when they experience yet another change in their rates should the Commission amend the Decision. Not only will the ratepayers be confused, but they will be justifiably upset because they did not have notice and an opportunity to participate in the rehearing process - a process that by its public nature and the Commission's own rules should be as open as possible. If the Commission believes its process should be open, the Commission should side with more notice, not less notice if and when there is a question.

Moreover, the fair value of the Company's property determined in Decision No. 71854 will be the subject of the rehearing and hence, additional notice is required. The Commission should not compromise its rules or the integrity of its open process for the sake of the minor inconvenience and expense required to provide notice of the hearing.

The Commission has discretion in determining the form and manner of notice. RUCO would recommend that notice be reasonable and consistent with the way it is done in every rate case.

5) RUCO's recommended procedure following the Company's reply

Procedurally, the Commission, upon receipt of all of the pleadings, could simply not act. ARS § 40-252 provides for a procedure where the Commission upon its own action may amend a prior decision. The statute does not require the Commission to take action. RUCO recommends the Commission not take further action. RUCO does not believe that a hearing should be scheduled for the purpose of providing additional information for the Commission's consideration of whether or not to rehear the matter. The paperwork provided by the parties, in addition to the underlying record, should be more than sufficient for the Commission to determine whether to rehear the matter. A hearing on the initial determination would be duplicative, wasteful and not likely to provide any significant additional information.

If the Commission decides that it would like to rehear the matter after it has received the replies, RUCO recommends the Commission schedule another procedural conference to determine how to proceed forward. The parties are not in a position to recommend a procedural calendar in that instance since at least one party, Staff, may raise additional issues as part of the proceeding. Until all of the issues that will be the subject of the rehearing are known, the Commission should not establish a procedural calendar.

RESPECTFULLY SUBMITTED this 1st day of June, 2011.

Daniel W. Pozefsky
Chief Counsel

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RUCO's Response To
Johnson Utilities, LLC's
Petition to Amend Dec. No.71854
Docket No. WS-02987A-08-0180

EXHIBIT A

Master Limited Partnerships: Paying Other People's Taxes

David Cay Johnston | Jun. 21, 2010 10:40 AM EDT

Wouldn't it be fantastic if someone else paid your income taxes for you? Imagine all that extra money in your bank account. You could pay off your debts, save, and even splurge.

Of course, for the person who paid your income taxes it would be awful. They would have to pay their own income taxes and then, out of what was left, pay yours.

Congress would never enact such a law, right?

The good news is that Congress has not enacted such a law. The bad news is that buried deep in the fine print of the *Federal Register* is a regulatory rule that has the same effect.

The requirement that forces you to pay the personal income taxes of others applies -- for now -- only to owners of rate-regulated pipelines organized as master limited partnerships, or MLPs.

It is not surprising if you have never heard about this tax-shifting rule. Unless you dig into the inordinately arcane proceedings of the Federal Energy Regulatory Commission (FERC), a small government agency that wields enormous economic power, you would be in the dark. The commission gets almost no news coverage. The very few, and brief, news reports on the cases related to the MLP charge missed the tax issue.

You would never know from looking at your utility bills and gas station receipts that the federal government has let one type of big business drill a hole in your pocket to collect income taxes, just as when looking across the surface of the planet, you cannot see the rich deposits of oil and natural gas buried under miles of water, soil, and rock. The cost is embedded in the sums your local utility or gas station pays for the natural gas and petroleum delivered via pipeline.

While you may not have heard about MLPs, readers of *Barron's* and other publications for savvy investors have. In approving cover stories, *Barron's* and other investment journals tout MLPs as a way for investors to earn returns of 8 percent or more each year while paying little or no income tax.

In the shadows, business can use government to drill holes into consumer and producer pockets through inflated prices. Now one industry has applied this to taxes. This column casts a focused light on such activity to encourage disclosure, integrity, and fairness in taxation.

If this tax-shifting policy continues unchecked, you can expect one thing: well-funded and determined efforts to expand it to other rate-regulated monopolies. Given the complexity of the issue, hiding the tax shifting would be easy -- or at least it would have been until now -- by obscuring the issues in an era when few news organizations report on regulations. Pipelines are big, but small-time compared with electric, gas, cable, water utilities, and the railroads. Your interest is too small to put up a fight against this tax shift, but is big enough to encourage owners to ask the government to enable more such tax gouging. Get government to concentrate just a penny a day from every American and you collect a billion dollars annually year after year. You and I probably will not fight against being ripped off for a few bucks a year, but any enterprise will fight for a slice of a billion.

All that is needed to expand this tax shifting is a change in federal law -- a change so minor it does not even require a sentence to be added to section 7704 (d)(1)(E), a list of industries that can be owned through publicly traded partnerships without being subject to the corporate income tax. As one lawyer deeply involved in the pipeline case told me: "The electric utilities would be master limited partnerships now except that when the law was changed, the Edison Electric Institute was uncharacteristically asleep at the switch."

At the core of the tax issue are two long-standing principles of rate regulation that are fundamental to fairness and integrity. The first is that owners of legal monopolies are entitled to recover all of their costs and earn the return on equity needed to attract capital for their level of risk. The second is that customers can only be charged actual expenses so that regulated prices, called rates, are just and reasonable.

The FERC pipeline policy, and the court decision upholding *FERC*, destroy both of these principles. They don't just harm them, they destroy them, something Judge David Sentelle and two other appeals court judges somehow failed to realize in the specious reasoning they used to justify this tax-shifting outrage in 2007. (For the case, see *ExxonMobil Oil Corp. v. FERC et al.*, 487 F.3d 945, 376 U.S. App. D.C. 259 (D.C. Cir. 2007).)

The tax-shifting issue arises because Congress imposes two levels of taxes on corporate profits, but only one on partnerships. Historically pipelines were organized as corporations. To determine the rates charged to customers, a pipeline includes all of its costs and a rate of return set by FERC or, for intrastate pipelines, a state-level regulatory agency. For a traditional corporate-owned pipeline, these costs include the corporate income tax on company profits. However, the income taxes of individual investors have never before counted as a cost of providing service.

Forcing You to Pay Other's Individual Income Taxes

Corporate profits are taxed twice, partnership profits only once, yet the government lets pipelines owned by partnerships collect the same tax as corporations. The result: Partnership investors get a 75 percent larger return because you pay the partners' personal income taxes.

This chart assumes a monopoly pipeline is allowed a 10 percent after-tax return of equity	**Corporation Under Actual Cost Rules at 42.7 Percent**	**Master Limited Partnership Under Actual Cost Rules**	**Master Limited Partnership Under New Fake Tax Rules**
Pre-tax profit Under Government Set Prices	$175	$100	$175
Less 42.7% Corporate Income Tax Paid on Profit	$(75)	$—	$—
Net Pipeline Profit After Taxes	$100	$100	$175
Less Owner's Personal Income Tax at 35 Percent	$(35)	$(35)	$(61)
Owner's After-tax Income	$65	$65	$114
Increase in after-tax income to owner by including fake tax			$49
Percent increase in after-tax income			75%

Source: Calculations by author from Federal District Court of Appeals decision in *BP West Coast*

The 1986 Tax Reform Act allowed publicly traded partnerships in the pipeline business to escape double taxation even though their shares, called units, trade on the New York Stock Exchange and other bourses just like shares of a corporation. With an MLP, thanks to this law, pipeline profits and losses flow through to the partners, and so does any income tax obligation.

Even though the MLP does not pay the corporate income tax, FERC lets MLP pipelines include income tax in the rates charged to customers. FERC policy assumes the top marginal tax rate. Since the only income tax paid is by individual owners, this means that the rates include the individual income tax the MLP investors owe. In other words, you are forced to pay the income taxes of the MLP investors when you buy natural gas or petroleum products that were transported on such a pipeline.

Just how the income taxes you pay for others are assigned is another matter. But you must pay regardless of how the tax money is divvied up under the agreement between the general partner and the limited partners.

Actually, it is worse than that. The regulatory rule, upheld by the court of appeals, is that you must pay the income taxes of the pipeline partners even if they are only "potential" taxes. No actual income tax need be paid.

What exactly can be just or reasonable about forcing you to pay the income tax of another person who may not even pay tax?

Government regulation of monopolies like pipelines, electric utilities, and railroads is supposed to act as a proxy for the market. But just as a market requires buyers and sellers who are equally informed and are not coerced, regulated pricing requires treating both owners and customers equally. The introduction of MLPs into pipeline ownership created opportunities for the owner side to tilt the economic playing field, and FERC went along, going out of its way to rationalize this unfair tax policy.

Regulatory agencies often become captives of the industries they are supposed to regulate, seeing the world through the eyes of the regulated and blinding themselves to the concerns of customers. This is a natural human tendency, seen also in those journalists who identify with their sources rather than their audience, a now widely recognized problem in Washington coverage.

Judge Sentelle and his colleagues acted like they too have been captured by the pipeline industry, applying faulty reasoning that does not merely damage the just and reasonable standard but destroys it.

The first time the issue arose, in a 2004 case known as *BP West Coast Products*, Judge Sentelle and two other associates stood steadfast for fairness for only including actual taxes in rates (*BP West Coast Products LLC v. FERC et al.*, 374 F.3d 1263, 362 U.S. App. D.C. 438 (D.C. Cir. 2004)).

In *BP West Coast*, Judge Sentelle and his colleagues held that only actual taxes can be included in pipeline rates. FERC had included a 42.7 percent income tax allowance in rates for the SFPP Pipeline, an MLP pipeline whose creation traces back to the Santa Fe railroad rights of way.

"There is no question," Judge Sentelle held in *BP West Coast*, "that as a general proposition a pipeline that pays income taxes is entitled to recover the costs of the taxes paid from its ratepayers." (See *City of Charlottesville v. FERC*, 774 F.2d 1205, 249 U.S. App. D.C. 236. (D.C. Cir. 1985).)

Judge Sentelle walked through the history with nuanced clarity and then walloped FERC: "We cannot conclude that FERC's inclusion of the income tax allowance in SFPP's rates is the product of reasoned decision making."

After hitting FERC with a metaphorical two-by-four, Judge Sentelle made a crucial observation. He quoted FERC's own policy:

> Because the corporate tax is an extra layer of taxation, the Commission includes an element for the corporate taxes in the cost-of-service to ensure that the regulated entity has the opportunity to earn its allowed return on equity. However, there is no allowance for the taxes paid by the owners of the *corporation*.

The court held that regulators "cannot create a phantom tax in order to create an allowance to pass through to the ratepayer" and that a regulated limited partnership pipeline company cannot be allowed to collect "for the phantom income taxes it did not pay."

You would think that would be the end of it. But not when vast sums are at stake.

The math here is stunning. When rates include a tax that does not exist, the investors make out like, well, bandits. Investors in an MLP pocket 75 percent more in after-tax profits than they would if they invested in a traditional corporation owning a pipeline.

You will not find this math in Judge Sentelle's 2007 decision. Had he done the math, would the outcome have been different?

The broad issues here have continued through five administrations, so the makeup of the commissioners is bipartisan. The commissions have always issued decisions that tended to favor owners over consumers, but during the George W. Bush administration things went further.

FERC responded to the 2004 decision not by reopening the formal rate-making process, but by inventing something outside regulatory law. The commission in 2005 called this extraordinary procedure a "statement of policy."

Because that statement was not a formal case, it meant that there was no prohibition against lobbyists meeting privately with commissioners. That is, the ex parte rules did not apply. The commission considered four options after *BP West Coast, including ignoring* taxes and what it ultimately did, which was to find that if any tax might be owed by some owner, the maximum tax rate should be included in the authorized rates charged customers.

Judge Sentelle made clear that his panel could have found grounds to reject the new policy, but then he approved it, resting his decision on the thinnest of reeds by finding that FERC "justified its new policy with reasoning sufficient to survive our review."

"We hold that the Commission's income tax allowance policy was not arbitrary or capricious or contrary to law," the decision stated.

The tax shifted to consumers looks to be as much as $1.6 billion a year for gas pipelines and $1.3 billion more for petroleum pipelines. Industry data show oil pipeline profits are an eye-popping 42 percent of revenues, more than four times the margin for the 12,000 largest corporations.

This estimate has to be heavily hedged because, amazingly, FERC does not issue any statistical reports on either the cost of this tax transfer or of the underlying data from which a solid estimate could easily be calculated. A new law requiring either truth, or at least transparency, in regulations that shift tax burdens would help here, but the Wall Street-friendly Obama administration seems unlikely to take up such a cause.

The commission, at this writing, is conducting an inquiry into the gaps in its natural gas pipeline financial reporting systems, which mix incompatible accounting theories and fail to ask for some basic data. The oil pipeline data reporting is so loosely administered that 1 in 4 pipeline companies evidently does not even file the required annual reports, known by the bizarre name of "Page 700." Maybe someday we can determine just how much is being taken from you to pay the income taxes of individual pipeline investors.

The tax shifting is also inflated by a curious FERC practice. FERC has acknowledged that there is some over-collection by oil pipelines and yet it continues to grant rate hikes based not on costs, but on an index. This only worsens the over-collection from customers. Because there are virtually no added costs, the over-collection is pure profit except for the income tax burden, which is shifted to customers. This forces consumers to pay even more to cover assumed income tax costs even though no taxes may be going to the government. This is neither just nor reasonable and that two branches of government, the executive and the courts, allow this should be investigated by the third branch of our government, Congress.

Whatever the tax-shifting cost, it could easily balloon to much more -- well north of a billion dollars per month for customers of utilities and railroads. Adding them to the list of industries eligible to have publicly traded MLPs that are subject to just one tier of tax would force anyone who boils water or drives a car to pay the individual income taxes of a thin slice of wealthy investors. Given the stakes, it is more than reasonable to expect those who want you to pay their income taxes to exploit FERC's ridiculous policy and Judge Sentelle's faulty reasoning to form the basis for expanding the new rules.

The one ray of hope is that the California Public Utilities Commission had a recent case involving the portion of the SFPP that operates within the Golden State. A proposed decision would flatly reject the idea that an untaxed entity can collect income taxes in its rates.

Taxes should not be hidden, as David Ricardo and Adam Smith taught. They should also not be shifted from those who gain to those who are captive customers of monopolies. But the trend in America under both parties is away from markets and toward a subtle expansion of corporate socialism, under which profits are concentrated through government action and losses are socialized through bailouts. Now we have income tax burdens forcibly shifted from the wealthy few to the many through regulation.

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