THE US OIL PIPELINE INDUSTRY--FUNDAMENTALS

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North American Liquids Pipelines
From Crude Production to The Gas Pump
# What About Natural Gas Liquids?

<table>
<thead>
<tr>
<th>Natural Gas Liquid</th>
<th>Chemical Formula</th>
<th>Applications</th>
<th>End Use Products</th>
<th>Primary Sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethane</td>
<td>C₂H₆</td>
<td>Ethylene for plastics production; petrochemical feedstock</td>
<td>Plastic bags; plastics; anti-freeze; detergent</td>
<td>Industrial</td>
</tr>
<tr>
<td>Propane</td>
<td>C₃H₈</td>
<td>Residential and commercial heating; cooking fuel; petrochemical feedstock</td>
<td>Home heating; small stoves and barbeques; LPG</td>
<td>Industrial, Residential, Commercial</td>
</tr>
<tr>
<td>Butane</td>
<td>C₄H₁₀</td>
<td>Petrochemical feedstock; blending with propane or gasoline</td>
<td>Synthetic rubber for tires; LPG, lighter fuel</td>
<td>Industrial, Transportation</td>
</tr>
<tr>
<td>Isobutane</td>
<td>C₄H₁₀</td>
<td>Refinery feedstock; petrochemical feedstock</td>
<td>Alkylate for gasoline; aerosols; refrigerant</td>
<td>Industrial</td>
</tr>
<tr>
<td>Pentane</td>
<td>C₅H₁₂</td>
<td>Natural gasoline; blowing agent for polystyrene foam</td>
<td>Gasoline; polystyrene; solvent</td>
<td>Transportation</td>
</tr>
<tr>
<td>Pentanes Plus*</td>
<td>Mix of C₅H₁₂ and heavier</td>
<td>Blending with vehicle fuel; exported for bitumen production in oil sands</td>
<td>Gasoline; ethanol blends; oil sands production</td>
<td>Transportation</td>
</tr>
</tbody>
</table>

C indicates carbon, H indicates hydrogen; Ethane contains two carbon atoms and six hydrogen atoms.

*Pentanes plus is also known as “natural gasoline.” Contains pentane and heavier hydrocarbons.
The Previous High-Profile Boomers

Source: EIA/RBN
But Then There’s the Permian

Source: EIA/RBN
Welcome to Boomtown—the Permian
Interstate Transportation of Liquids

» Regulated on a 1980s version of the Interstate Commerce Act (which is not the current ICA).

» Transactions are regulated, not the pipelines—that is, if oil doesn’t leave the state, its transportation is not federally regulated, even if everything else in the pipeline is.

» Committed Shipper rates can be set based on cost of service or based on an arms-length third party agreement, then follow annual indexing based on a FERC annual statement of inflation plus or minus an adjustment.

» Uncommitted (“walk-up”) rates are set based on committed plus or minus an increment, or based on the residual cost of service not covered by committed services—at least 10% of capacity is generally reserved for uncommitted.

» Rates can also be market-based, if the pipeline can show it has no market power.
So Here’s the Problem

» The Permian boom has caused fierce competition.
» Interstate oil pipeline tariff rates cannot be discounted.
» So what if:

» With a fixed tariff, how do you meet the market?
Marketing affiliates have been used to adjust to the competitive market, without changing the pipeline’s rate.

The parent company still makes 80 cents on the deal, even though the affiliate loses money.

This is what the Magellan order said was a no-no.
There Are Other (Less Attractive) Ways to Reach the Same Result

» Gas pipelines use discounting and negotiated rates by the pipeline to meet the market.

» However, they have had to accept a huge overlay of affiliate restrictions, reporting, proof of reasons for discounts, etc. that would be very unattractive to the less regulated oil pipeline industry.

» The pipeline could reduce its rates for everyone: Kind of an automatic most-favored-nations approach where the most competitive haul sets rates for everyone—for pipelines with cost-based rates, this would mean always underrecovering cost of service.
Every business day, 1,500 words with charts and maps, on gas, oil, or NGL issues—AND IT’S FREE.

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How Does *Magellan* Affect Oil Pipelines and Their Marketing Affiliates?

April 5, 2018

Daniel Poynor
Steptoe & Johnson LLP
FERC Oil Pipeline Regulation: Brief Background

- Interstate Commerce Act
  - Hepburn Act (1906)
  - 1977 Transfer to FERC
- Common carriage
- Unregulated entry and exit
- Competitive industry
- Unique regulatory model
Magellan Petition for Declaratory Order


- Sought FERC approval of a proposal to establish a marketing affiliate that would transport crude oil on the Magellan pipeline and enter into various transactions with other parties with respect to those shipments, including:
  - Selling crude oil or entering into exchanges at terms that effectively provided discounts below the filed rate; and
  - Participating in open seasons offered by the pipeline and then remarketing the capacity to others at terms that might differ from the pipeline’s contracts

- Magellan claimed that other pipelines had marketing affiliates and that it was at a competitive disadvantage
“The creation of a Marketing Affiliate by an oil pipeline is permissible under the ICA, and does not require the Commission’s express permission.” P 12

It is permissible for affiliated shippers to ship on the affiliated pipeline and participate in open seasons. P 12.

Common carrier oil pipelines must treat all shippers equally whether affiliated or non-affiliated. P 12.

FERC’s jurisdiction does not cover sale of petroleum products. P 11 n.8

Pipelines may ship product in their own name. P 12.
Commission Order Denying PDO


- Magellan’s proposal would create an “unlawful rebate.” P 13. The ICA anti-rebate provisions prohibit “Marketing Affiliates from shipping in situations where the [commodity] price differential is insufficient to cover the filed tariff rate and the pipeline subsidizes those losses.” P 19.

- Magellan’s proposed resale of capacity by the marketing affiliate at something other than the tariff rate would violate the ICA requirement that rates be subject to FERC review as just and reasonable. P 20.

- Magellan’s proposal for the marketing affiliate to enter into contracts that vary from the TSA offered by the pipeline would violate the ICA’s anti-discrimination provisions. P 21.

- Magellan’s proposal would violate the ICA rate filing requirements, because it would “set rates actually paid by the affiliate at the variable cost of the transportation service, which presumably would not be published by the pipeline.” P 21.
Rehearing Requests

- Requests for clarification or rehearing filed by:
  - Enterprise Products Partners L.P.
  - Medallion Pipeline Company, LLC
  - Plains Marketing, L.P.
  - Energy Transfer Partners, L.P.
  - Magellan Midstream Partners, L.P.

- Various other parties sought to intervene

- On Jan. 22, 2018, the Commission granted rehearing for further consideration
Effect of Magellan Order

- What is the immediate effect of *Magellan*?
- Is it generally applicable or does it only apply to Magellan?
- What types of transactions are unlawful under *Magellan*?
- What types of marketing affiliate activities are appropriate in light of *Magellan*?
Potential Impacts on Oil and Liquids Pipelines From Recent Tax Code and Policy Changes

PRESENTED TO
EBA Oil & Liquids Committee
Energizer

PRESENTED BY
Daniel S. Arthur

April 5, 2018
Introduction and Agenda

• Overview of Ratemaking Methodologies for Oil & Liquids Pipelines

• Summary of FERC’s Recent Income Tax Allowance Policy Statement for Master Limited Partnerships (“MLPs”)

• Potential Impacts of the MLP Income Tax Allowance Policy on Oil & Liquids Pipelines

• Summary of 2017 Tax Act

• Potential Impacts of the 2017 Tax Act on Oil & Liquids Pipelines
# RateMaking Methodologies for Oil Pipelines

- **Cost-of-Service Rates**
  - Establishes test year cost-based rates via rate filing or shipper complaint

- **Indexed Rates**
  - Methodology establishes annual rate adjustment based on evaluation of industry-wide cost changes over a prior five-year period.
  - Annual adjustment to maximum ceiling rate is “PPI + Adder”, where Adder is based on calculation of average industry-wide cost changes relative to PPI over prior five-year period.

- **Market-Based Rates**
  - Permitted after demonstration of a lack of market power in relevant origins and destinations. Similarly can be revoked after demonstration of market power.

- **Negotiated/Settlement Rates**

- **Committed Rates**
  - Contract rates associated with expansion capacity
FERC’s 2018 Income Tax Allowance for MLPs Policy Statement

- Pipelines owned by MLPs no longer to be granted an income tax allowance in addition to return on equity in cost of service.
  - MLPs are pass-through entities that do not incur income taxes at the entity level. Individual investors are allocated a share of MLP’s taxable income and investors are responsible for paying taxes on that share.
  - Concludes that a return on equity (“ROE”) calculated by the “discounted cash flow” (“DCF”) method is a pre-investor tax return required to attract capital.
  - DCF ROE must provide a return sufficient to cover both the investor’s tax costs as well as provide the investor a sufficient after-tax return.
  - Concludes that granting an income tax allowance in addition to a DCF ROE results in a double-recovery of investor-level taxes.
  - Whether income tax allowance will be permitted for forms of pass-through entities other than MLPs to be determined in subsequent proceedings.
Implications of FERC’s 2018 Income Tax Allowance for MLPs Policy Statement

- Cost-of-service rates for pipelines owned by MLPs will not include an income tax allowance
  - Implemented in SFPP’s 2008 and 2009 rate proceedings concurrently with 2018 policy statement.
  - Any other pending cost-based rate proceedings for pipelines owned by MLPs likely to be impacted.
  - FERC will address treatment of Accumulated Deferred Income Taxes (“ADIT”) for MLPs in new Notice of Inquiry (Docket No. RM18-12-000).

- Index Ratemaking Adjustments
  - Pipelines owned by MLPs are to report 2017 (and going-forward) Form 6, Page 700 cost of service calculations without an income tax allowance.
  - Next 5-year review for 2021-2025 adjustment parameter will examine 2014-2019 change in costs, and cost-change for MLP-owned pipelines will reflect policy change.

- Other Potential Impacts
  - Decrease in MLP cash flow
  - Decrease in MLP Unit Price
  - Reduction in MLP credit assessments
2017 Tax Act & Potential Implications

• **Reduced Federal Tax Rate from 35% to 21% effective Jan. 1, 2018**
  - Reduce income tax allowance for corporate owned pipelines in a cost-of-service proceeding as well as in cost of service reported in 2018 and future Form 6s.
  - Next 5-year review for 2021-2025 index rate adjustment parameter to examine 2014-2019 change in costs, and cost-change for corporate pipelines will reflect tax rate decrease.
  - Reduction in federal tax rate for corporate pipelines creates over-funded accumulated deferred income tax ("ADIT") balance.
  - FERC will address treatment of ADIT for corporations in new Notice of Inquiry (Docket No. RM18-12-000).

• **“Bonus” depreciation increases for “qualified property”**
  - “Qualified property” defined to exclude certain public utility property, specified as electric and gas, but definition does not appear to exclude oil & liquids pipeline property.
  - Bonus depreciation taken as well as reduction in federal tax rate will impact ADIT balance for pipelines owned by corporations.
  - FERC will address treatment of ADIT for corporate pipelines in new Notice of Inquiry (Docket No. RM18-12-000).