Trans Mountain Pipeline: Big Bucks for US Investors, Peanuts for Us

Thanks to clever US owner, firm pays minimal taxes here, sometimes none.

By Robyn Allan
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Kinder Morgan—the Texas-based multinational that owns and operates the Trans Mountain Pipeline System—claims Trans Mountain is a significant contributor to federal and provincial income tax revenues. The company is relying on this as proof it deserves a public license to triple its pipeline capacity in western Canada.

Pouring tax revenues into Canada is not the story Kinder Morgan tells its U.S.- based shareholders. Promoting Trans Mountain south of the border Kinder Morgan boasts of tax refunds—two in the past five years. From 2009 to 2013 Trans Mountain's combined federal and provincial Canadian corporate tax contribution averaged just $1.5 million per year.

How could this be? The answer lies in complexities of U.S. corporate tax regulation which I will do my best to explain here.

First, a bit of history about how Kinder Morgan came into being.

Kinder Morgan began as a publicly traded Enron tax shelter in 1992 called Enron Liquids Pipeline, L.P. (see page 62). Publicly traded limited partnerships in the US are called Master Limited Partnerships (MLPs). Ownership shares are units. MLPs are treated as a partnership for tax purposes and none of the income is subject to federal income tax. They combine the tax advantages of a partnership with the liquidity benefits of publicly traded stocks.

The Enron MLP held the energy giant's liquid pipeline assets as well as some gas processing and coal transfer and storage facilities. The general partner, Enron Liquids Pipeline Company, was the operator.

Richard Kinder, Kinder Morgan's current Chair and CEO, was instrumental is setting up the arrangement. When Enron Liquids Pipeline was established he was a member of the Enron Board, its president and Chief Operating Officer (COO) and became the general partner's first Chair. Kinder was the person responsible for setting the company's course years before he left Enron.

Beginning in 1995 Enron began to engage in a series of transactions that, according to the US Joint Staff Committee on Taxation (page 109) were designed to "satisfy the literal requirements of the corporate tax laws, yet produce results that were not contemplated by Congress and not warranted from a tax policy perspective. Several of the projects were structured to duplicate and accelerate tax deductions."

The first of these transactions was called Project Tanya. It was based on duplicating deductions between Enron companies—effectively claiming the same loss twice. Project Tanya resulted in federal tax savings of $66 million. The US Joint Committee on Taxation report (page 119) explained that as Director, president and COO, Richard Kinder was instrumental in delivering this strategy for Enron Board approval.

On February 14, 1997 Kinder and William Morgan acquired Enron Liquids Pipeline, L.P. from Enron Corporation by buying the wholly owned general partner, Enron Liquids Pipeline Company. Acquiring the MLP and the general partner was hardly an arms-length deal—Kinder continued to receive a paycheque from Enron until the day after he took over the company. Morgan, also a former employee of Enron had been on the Board of the general partner since 1994 (page 27).

With assets from Enron acquired to establish Kinder Morgan Energy Partners L.P. (KMP), Kinder and Morgan created their own board of directors and executive team for the general partner. The roster was heavily weighted with Enron insiders. Out of the nine original directors and officers, six were Enron employees and a seventh member of the team, Michael Morgan, was William Morgan's son. The Treasurer and Secretary of Kinder Morgan's company was an independent tax and accounting consultant underscoring the entity's continued emphasis on tax planning. Enron Liquids Pipeline Company's 141 employees came with the deal at their existing salaries.

Within months of acquiring the corporate entities KMP filed a prospectus with the U.S. Securities and Exchange Commission (SEC) issuing three million units of the MLP to the public. Kinder Morgan's 1997 prospectus—similar to the initial public offering in 1992—promoted the tax related properties available to maximize unit holder returns over what they would be if the limited partnership were treated as a corporation for tax purposes.

The prospectus explained that the U.S. tax code requires publicly traded partnerships be taxed as corporations. However, a "Natural Resource Exception" exists if the partnership earns 90 per cent or more of its income from the exploration, development, mining or transportation of any mineral or natural resource, including oil.

The Natural Resource exclusion means that KMP does not face corporate tax at the partnership level. This increases cash flow available for distribution to unit holders, including major unit holders like Kinder, and the general partner, wholly owned by Kinder Morgan Inc. (KMI), again with Kinder a major beneficiary.

Typically, distributable cash flow is paid quarterly and can wind up being treated in the hands of the unit holder as a considerable non-taxable return of capital. Thus KMP not only avoids corporate taxes as a "pass through" entity, taxes payable by unit holders are deferred or reduced over what they would be if the unit holder were a shareholder in a publicly traded corporation.

The special tax treatment—the government subsidy—the U.S. affords energy companies that are structured as MLPs is what has enabled Kinder Morgan to grow into the third largest energy company in North America.

Restructuring to save $20 billion in taxes

After 22 years of benefiting from this advantageous tax structure Kinder Morgan's MLP has matured. Because of a feature called Incentive Distribution Rights, as KMP grows, the money available to distribute to its unit holders—its cash distributions—grows but an increasing share flows through to the general partner. Kinder Morgan Inc. owns the general partner and, as a corporation is required to pay corporate tax on that growing income.

Thus, it's sensible to argue that the successful growth of the MLP means Kinder Morgan should now face an increasing income tax burden. Think of it as reasonable payback to a system that afforded stellar growth because taxes in its formative years were avoided. But instead of treating income taxes as a price for living in a civilized society, Kinder Morgan is relying on its sophisticated corporate structure, a reorganization and accounting savvy to keep its tax payments as low as possible.

Kinder announced last August that his energy empire would undergo a makeover. The restructuring will see Kinder Morgan Inc. (KMI) purchase the other three publicly traded entities consolidating them into KMI.

The reorganization, by its leader's own reckoning, reduces Kinder Morgan's taxes payable by more than $20 billion over 14 years.

Kinder explained this to investor analysts in a conference call shortly after the announced restructuring. He characterized the deal as a "tax shelter" because the purchase price sets a higher value for the assets than keeping them on the books at their historical depreciated cost. He said, "From the purchase price alone, including the step-up, we will realize over 20 billion dollars in cash tax savings over the next 14 years."

Effectively KMI gets to work the intricacies of the accounting system. It will buy assets from its subsidiaries at a premium price and then depreciate these assets as if they were brand new. The deal creates a hefty $1.4 billion in tax savings each year for at least two decades. The market's reaction to the reshuffling of Kinder Morgan's corporate structure is likely why Rich Kinder, KMI's largest shareholder, pocketed an extra $800 million the day after the announcement.

None of this is illegal under U.S. law. However, it's fair to conclude what makes a doubling of the growth rate in KMI's dividend to its shareholders possible—it's a paper-based consolidation designed to inflate the value of assets and redirect tax revenue that could flow to governments into the pockets of U.S. shareholders instead.

And given the history I've outlined here, it is also fair to say that sophisticated use of corporate structures to minimize tax, maximize distributable cash flow, and minimize disclosure and transparency, is key to Kinder Morgan's corporate culture.

Canada's tax landscape is different

MLPs do not exist in Canada. Their close cousins—Canadian Income Trusts—lost their special corporate tax privileges with legislative changes brought in by Finance Minister Jim Flaherty in 2006. The changes ensured that all special tax benefits of publicly traded non-real estate related trusts would be removed. Flaherty was concerned about significant tax revenue lost as established businesses in Canada rapidly converted from corporate to trust structures. He called the behaviour a "growing trend to corporate tax avoidance." He said "it's not right and it's not fair."

But Kinder Morgan has shown it knows how to acquire a Canadian firm and absorb it into its U.S. operations, converting it, effectively, into a U.S. MLP.

Remember a company called Terasen? In late 2005 Investment Canada approved the purchase by KMI of the shares of Terasen Inc.—a publicly traded Canadian corporation with its head office in Vancouver—at a steep premium. Terasen held natural gas and oil pipeline assets, including the Trans Mountain pipeline system.

Kinder Morgan delisted Terasen from the Toronto Stock Exchange. Despite what the company says in its promotional literature that Trans Mountain's expansion means "as Canadians we will have an asset that unlocks access to world markets and continues to support our economy," Trans Mountain is not a Canadian asset benefiting Canadians. Canadians own less than two per cent of KMP.

After the purchase of Terasen, KMI engaged in a number of inter-company transfers involving many sophisticated entities including an Unlimited Liability Company (ULC) registered in Nova Scotia. The Trans Mountain Pipeline assets were eventually sold to KMP. In Kinder Morgan's words they were "dropped down" to the MLP. This is how Trans Mountain came to be under KMP's indirect full ownership control by 2007. The Terasen share purchase and related inter-company paperwork effectively turned Trans Mountain into a U.S. based MLP.

This is but one example of how Kinder Morgan has made an art form out of minimizing taxes in Canada and the U.S. The company has, in Kinder's own words, a "convoluted complicated structure" with more than 250 separate corporate entities. Upwards of 20 are registered in Canada with at least six of them registered as ULCs (page 193).

The ULC is not a very familiar form of incorporation. Only Nova Scotia, Alberta and B.C. allow them. U.S.-based energy sector investors who are expanding into Canada increasingly rely on ULCs. Their unique features enable them to elude a 25 per cent

withholding tax that would otherwise be applicable under the Canada-US Tax Treaty. In 2009 the Treaty introduced anti-hybrid rules in Article IV(7) which were intended to deny the special treatment, but some companies have developed sophisticated repatriation strategies and so are able to work around the rules.

Request denied

I have gone into such detail here in order to show that fully understanding from a Canadian perspective Kinder Morgan's structure, and tax implications, would demand an expert analyst with all the facts.

However, there is a paucity of publicly available financial information related to Trans Mountain because Kinder Morgan reports on its Canadian operations to the US SEC on a consolidated basis as part of KMP. This means there are no separate detailed financial statements filed related to Canadian activities. This makes evaluation of the company's Canadian operations difficult.

This we do know: Kinder Morgan Canada president Ian Anderson informed analysts in Houston, Texas, last January that the Trans Mountain system received a cash tax refund of $4.2 million in 2013. This even though Trans Mountain generated $167 million in distributable cash flow—net earnings plus non-cash items such as depreciation—available to its U.S. parent.

Anderson's figures also tell us Trans Mountain has contributed combined federal and provincial corporate taxes that averaged a meagre $1.5 million over the past five years. Trans Mountain received a tax refund in two of them.

Table 1

Trans Mountain — Distributable Cash Flow (DCF)

(Millions $ CDN)

	2009	2010	2011	2012	2013	Annual Average
Trans Mountain System	$168.3	$161.6	$167.6	$193.2	$167.1	**$172**
Cash Tax (refund)	($3.5)	2.9	$1.1	$11.1	($4.2)	**$1.5**

Source: Kinder Morgan Analysts Conference 2013 (page 4) and 2014 (page 3).
US dollar figures translated to Canadian using Bank of Canada annual exchange rate.

Trans Mountain files accounting information with the National Energy Board on its regulated assets, which are a subset of its overall activity in Canada. These files reveal that although Trans Mountain earlier told the regulator it would pay $7 million in taxes in

2013, instead its regulated pipeline assets realized a tax refund of more than half a million dollars. (ITS-21)

I asked Kinder Morgan to explain the discrepancy between its filing with the NEB, what it tells the Canadian public about Trans Mountain's contribution to fiscal revenues and what it tells U.S. investors and analysts. These questions were filed (see pages 30 - 44) in an information request as part of my right as a qualified intervenor in the current hearing. Kinder Morgan refused to answer.

I then asked the NEB to compel answers. Siding with Kinder Morgan, the Board denied my request. (page 105)

I believe Canadians are owed an explanation why this U.S. multinational pays so little in Canadian corporate income taxes related to Trans Mountain. The NEB seems content to buy Kinder Morgan's story that it will pay a corporate income tax rate of 25 per cent on its net income and that its expanded operation will lead to about $100 million a year in federal and provincial corporate income tax revenue.

Indeed, in arguing for the Trans Mountain expansion Kinder Morgan presents itself to Canadians as a significant tax contributor. Yet Kinder Morgan now repatriates an average of $172 million per year from the Trans Mountain system for distribution to its U.S. based owners, but faces an average cash tax obligation of only $1.5 million in Canada.

Canada's government owes us the facts

Bear in mind, too, that Kinder Morgan is Trans Mountain's sole source banker. Without taking you through more arcane financial details, this means the U.S. based parent company receives high returns on investment locked into toll rates that are approved by the National Energy Board (paragraph 4, page 2).

Kinder Morgan's restructuring will, as a result, mean huge windfall gain for the U.S. multinational on its regulated Canadian pipeline operations, guaranteed by the NEB. (paragraph 890 - 1408).

But that's just for the existing pipeline. Trans Mountain wants to triple its pipeline capacity and, because of economies of scale, will more than triple its financial drain from the Canadian economy. The NEB recently approved much higher tolls charged to Canadian shippers on both the existing pipeline and the proposed twin if the expansion goes through. These tolls reflect a cost of capital well above 12 per cent on $5.4 billion.

Today it costs about $2.75 to ship a barrel of oil to Chevron's Burnaby refinery on the existing Trans Mountain pipeline. If the expansion goes through the price to ship that same barrel to Burnaby will be more than $5. Pretty much the same transportation price lift exists for imported refined petroleum products.

Since 90 per cent of the gasoline supplied to the interior and south coast of B.C. comes via Trans Mountain as either crude or refined products, those higher transportation costs are passed onto us. Every time a southern B.C. resident fills up it lines Rich Kinder's pockets. If Trans Mountain's expansion is approved, that amount increases substantially.

Kinder Morgan told the NEB during the toll hearings it wouldn't bring the Trans Mountain expansion project forward if it didn't exceed a 12 to 15 per cent rate of return. Meanwhile as Trans Mountain's sole-source banker, it's going to cost Kinder Morgan less than 4.5 per cent to deliver project financing.

If Kinder Morgan's high return on equity in relation to its almost non-existent Canadian tax obligation does not concern the NEB, what remains, I would suggest, is for the federal government to step in and undertake a Canada Revenue Agency audit of all Kinder Morgan activities in Canada particularly the transactions related to the purchase of Trans Mountain and the complex inter-company transactions that followed.

The CRA would be well advised to include a full examination of the company's complex corporate structure, including its reliance on ULCs. It should include an examination of transfer pricing, particularly of debt and equity sourced by Kinder Morgan's Canadian subsidiaries through their U.S. parent. Canadians deserve the bottom line facts about what benefits flow here, rather than south of the border, as Kinder Morgan proposes expanding its pipeline operations on our soil.

Robyn Allan is an economist and former President and CEO of the Insurance Corporation of British Columbia. She is a qualified expert intervenor in the Trans Mountain Expansion Project public interest hearing currently being conducted by the NEB. www.robynallan.com *This article originally appeared in the* Tyee