UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Composition of Proxy Groups	)	
for Determining Gas and	)	**Docket No. PL07-2-000**
Oil Pipeline Return on Equity	)	

POST-TECHNICAL CONFERENCE REPLY COMMENTS OF THE NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS

The National Association of Publicly Traded Partnerships (NAPTP) submits these comments in reply to the initial post technical conference comments ("Comments") submitted by, in particular, the American Public Gas Association ("APGA"); the Public Service Commission of New York ("PSCNY"); and the Canadian Association of Petroleum Producers and the Natural Gas Supply Association ("CAPP/ NGSA") (collectively, the "opposing associations"). NAPTP continues to believe that the evidence submitted to date, including the testimony at the technical conference and the post technical conference comments, have presented no reasonable basis for imposing a different DCF calculation on MLP proxies than on corporate proxies. The evidence does not support a conclusion that the growth rate of pipeline MLPs is so inherently different from that of C-corporations that the DCF model must be changed for MLPs..

As several panelists emphasized at the technical conference, any MLP has the potential to grow at a rate equal to or greater than an equivalent corporation, and whether it does will be determined not by its organizational structure but by the nature of the assets it holds and the skill and foresight of its managers. Moreover, to the extent a company's growth rate is expected to be lower in the short term, this expectation will

already be reflected in the IBES projections. In the long term, NAPTP believes it has been demonstrated that MLPs can in fact sustain substantial growth. There is nothing to suggest that the long-term growth rate for MLPs is so significantly different from that of corporations (or indeed, that it is different at all) that it necessitates a downward adjustment to the GDP rate, which all agree was never intended as a precise measurement.

I. MLPs Should be Recognized as a Major Component of the Pipeline Industry

The opposing associations clearly are unhappy with the fact that MLPs now constitute a large and growing proportion of pipeline ownership with whom they must deal. Unable to accept the reality that pipeline ownership is increasingly in the hands of MLPs, they characterize the returns that MLPs offer to their investors as unnecessarily high and producing "distorted results" (APGA Comments at 1-2), rather than consider the possibility that these are the returns that investors will need if the investment in pipeline infrastructure necessary for the future is to occur. They ask the Commission to make adjustments to the DCF model in order to artificially lower the resulting average and median returns "so that the DCF analysis produces results that are in line with the results produced as applied to C Corporations." (*Id.*)

Despite the general acceptance by the Commission and others that MLPs are now established and important components of the pipeline industry, the opposing associations attempt to characterize MLPs as a "novelty" (NYPSC Comments at 5, citing December 21, 2007 comments of CAPP) and a temporary aberration in the market that should be shunned rather than accommodated. In fact, the evidence is indisputable that MLPs are neither. MLPs of various sorts have been around for over a quarter century,

and pipeline MLPs for two decades. The oil pipeline MLPs already being used in proxy groups and the gas pipeline MLPs under consideration for such use have been operating for a number of years and show no signs of going away.

Throughout these proceedings, the opposing associations have protested the inclusion of MLPs in proxy groups at all, and they continue to do so even at this late stage. They state that inclusion of MLPs in proxy groups would somehow unreasonably "inflate" ROE, and term MLP returns "windfall profits," as if the returns MLPs earn for their investors were somehow illegitimate rather than an efficient use of resources.[1] (APGA Comments at 2-3) They ask that growth rates for MLPs be adjusted downwards in the DCF analysis, not because MLPs are inherently unable to grow at rates similar to corporations, but so that the analysis "produces results that are in line with the results produced as applied to C corporations" (APGA Comments at 2)—even if these are not the returns in equity that many or most investors now earn and expect to earn in the future. The opposing associations also want to ensure that the Commission avoids "the use of MLPs with unrepresentative growth rates." (NYPSC Comments at 2)

The simple fact is that, like it or not, a growing number of pipelines are owned and operated by MLPs. Pipeline MLPs did not come into existence simply upon a whim. Corporate owners have been shedding their pipelines for other investments for several years, and MLPs have been buying them, because their business models has proven to be better suited to the ownership and operation of these assets. The Commission should not be faulted for recognizing this reality, nor should the pipelines be faulted for advocating such recognition. As the proportion of MLPs among pipeline owners

[1] Their argument for this is that MLP distributions contain a "return on investment" component; however, as we have stated before, this is purely a tax construct. The MLP investor, like the corporate investor, does not make such fine distinctions with regard to the cash he or she is receiving.

continues to grow, it becomes increasingly implausible that the Commission can arrive at a just and reasonable rate that reflects market expectations through the use of proxy groups without including MLPs in those groups. As Michael Vilbert noted in his December 21, 2007 report (at 13), "The sample of C-corporations is now so small that it calls into question the reliability of the cost of equity estimates." If the results of the DCF calculation for a proxy group that includes MLPs differ from those obtained by including C corporations in the proxy groups, that is an accurate reflection of a pipeline industry with diminishing ownership by C corporations. If the resulting ROEs are higher than those obtained using only corporate proxies, that is because those are the returns the market demands (there is, after all, a reason why the growth in this industry has come principally from MLPs). Contrary to the assertion of the APGA (Comments at 3), it is ignoring such a large segment of the industry as MLPs now represent in setting rates, not including them in proxy groups, that would be "contrary to the NGA requirement that rates be just and reasonable."

II. IBES Projections are the Appropriate Measure of Short-Term MLP Growth

Even the opposing associations have been forced to accept that the IBES projections of dividend growth[2] are the best available measure for short-term growth of MLPs as well as for corporations; however, based on the supposed aberrant nature of MLPs, the opposing associations find the projections for these entities somehow untrustworthy, and insist that they be allowed to "look behind' the IBES growth projections for particular MLPs in individual cases." (NYPSC Comments at 6).

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[2] To clear up the confusion expressed by NYPSC and CAPP/NGSA in their comments, distribution growth *is* the projection the Commission should use. The only basis for using EPS would be if no distribution projections were available.

NAPTP objects to the assumption that MLPs are such a novelty and analysts' projections of short-term MLP distribution growth are so characteristically unreliable and prone to overstatement-- even "intentionally inflated " (NYPSC Comments at 5)-- that they cannot be taken at the same value as projections of corporate growth. To the contrary, as pointed out earlier, pipeline MLPs have been in business long enough to develop a track record, and analysts like Yves Siegel have been following MLPs for several years and are thoroughly versed in their intricacies. There is no reason to believe that these analysts' distribution projections will be any more "anomalous and illogical," as the NYSPC put it (Comments at 6), than the projections of corporate analysts. Moreover, the idea that analysts' projections for MLPs are likely to be overstated or inflated was directly contradicted at the technical conference by Yves Siegel, who stated that, "as an analyst my bias is to be conservative rather than aggressive" (Tr. 139). As Mr. Siegel pointed out, consistently overestimating the returns an investor will receive from an MLP would not exactly help an analyst win and retain clients. And on behalf of the analysts in our membership NAPTP takes strong exception to the implication that any would deliberately inflate forecasts.

The opposing associations assert that an unadjusted DCF model is not correct for MLPs because it calculates a rate of return for MLPs that is higher than the rate produced when proxy groups consist solely of corporations. APGA also repeats the argument initially raised by the Commission that because distributions "include both earnings and a return on investment," to count the entire distribution in the DCF calculation would "would skew the DCF results, since the dividend yield would appear higher than it actually was." (APGA Comments at 1, note 1). NAPTP hopes that the Commission and

other interested parties now understand that the distribution is treated as a return on investment for tax purposes only. The investor considers the entire distribution to be part of his or her yield, and so does the market.

The simple fact is that MLPs, on average, provide their investors with a higher yield and a higher rate of return than corporations. *That is why investors buy MLP unit*s, why so many are willing and eager to accept the "many intricacies" of MLP investment that CAPP/NGSA highlight in their effort to characterize MLPs as an exotic new security riddled with "idiosyncrasies" (CAPP/NGSA Comments at 3, note 1), and why it is MLPs that are coming up with the majority of the capital to fund energy infrastructure.

III. The Commission Should not Alter the Current Formula for Long-Term Growth

The opposing associations continue to marshal a number of reasons why the GDP should not be used in the long-term growth formula for MLPs while ignoring two simple facts. First, MLPs have in fact sustained growth over the long term at rates equal to or higher than GDP. Second, as noted in NAPTP's February 11 post technical conference comments, an important point made at the technical conference, with which there was no real disagreement, was that GDP is used in the long-term growth component of the DCF model not because anyone is predicting that each and every pipeline company will grow at the rate of GDP, but because growth rates over the truly long term are essentially unknowable. The GDP rate serves as a reasonable but far from exact proxy for the average of all companies over the long term; not as a precise calculation which should be adjusted upwards and downwards based on a view of particular companies' potential for growth.

The opposing associations repeatedly assert in their comments that investors expect long-term growth rates of MLPs to be lower than GDP despite the fact that several long-term MLPs have maintained higher growth rates, but they provide no real evidence that this is so. The NYPSC Comments include a number of quotations from Value Line regarding lower growth rates of MLPs—but not one of those quotations states that MLPs will grow at a rate lower than GDP.[3]

With a number of analysts, closed-end funds, and other MLP investors in its membership, as well as the investor relations contacts at member MLPs, and frequent communication with investors at conferences and in individual communications, NAPTP and its members are in a reasonably good position to know about the expectations of MLP investors. To our knowledge, none of our analysts nor any of the investors with whom we have communicated has expressed an expectation that MLPs will grow at a below-GDP rate in the long run. We note that while the NYPSC stubbornly continues to insist that the long-term rates used by analysts in their valuation calculations represent their projections of actual long-term growth for MLPs (Comments at 10-11), two respected and knowledgeable analysts, including one cited by the CAPP/NGSA comments in another context (CAPP/NGSA Comments at 3, note 1), have stated clearly that this is not the case and that, moreover, exactly the same rates are used in valuing corporations as are used in valuing MLPs (s*ee* NAPTP Post Technical Conference

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[3] Moreover, the Value Line article in Attachment 3 to the NYPSC Comments contains serious inaccuracies in its description of MLPs, stating that "To maintain their tax-exempt status, MLPs must pay out most of their cash flow in cash distributions to their investors." The article in Attachment 2 also states that MLPs "must" distribute their tax flow. As anyone who has seriously studied MLPs is aware, they are not tax-exempt; rather, they are pass-through entities whose partners pay the tax on the partnership's earnings. More importantly, MLPs are not required to pay out one cent of cash flow in order to maintain their pass-through tax treatment: they could retain all their earnings and they would still be treated as partnerships for tax purposes, with tax paid by the partners rather than the MLP. The requirements for retaining partnership status relate to the nature of their income, not whether it is distributed. Value Line should thus perhaps not be cited as an unerring and authoritative source of information on MLPs.

Comments at 5-6). The NYPSC has presented no reason to believe that these analysts are not telling the truth.

The opposing associations also mischaracterize the testimony of the INGAA representative, Michael Vilbert, as saying that the Commission *should* use an average of the GDP growth rate and the inflation rate as the long-term growth component in the DCF model for MLPs, as if he had agreed with them that GDP is too high a rate of growth for MLPs. In fact, Mr. Vilbert stated that the analysis using his "benchmark" model showed that the current DCF model produced reasonable results and should be retained:

> But the bottom line of that is that by looking at the Benchmark Model, I believe that the Commission should feel confident that applying the current FERC DCF method to the LP units, does not result in cost of equities that are unreasonable, at least by measure of the Benchmark Model.
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> And, of course, all models are a tradeoff between complexity and hoped-for accuracy. The FERC model is particularly straightforward, I believe, and, in the case of pipelines, very easy to apply, and gives reasonable numbers. I don't think it's worthwhile to try to mess with that. (Tr. 37)

Mr. Vilbert offered the alternative formula, which produces results only 50 basis points lower than the unadjusted DCF, only as a simple way that the current model might be adjusted *if,* despite his findings, the Commission felt "uncomfortable" using the GDP rate (Tr. 61-62).

Finally, while the opposing associations insist upon the impossibility of finding a means to reflect the necessary return to the general partner equityholders in the DCF calculation, they overlook the simplest method of all of accommodating this concern: leave the formula as it is when applying it to MLPs. The IBES projections are based on the returns earned by MLPs in the current market, which, since these MLPs continue to invest and grow, clearly do cover all equityholders. Incorporating them with no

downward adjustment for “excessive” yields will allow the market to continue to work. Similarly, keeping the long-term growth portion of the DCF model as it is, rather than adjusting it downwards based on a theoretical view of MLPs’ ability to grow and investor expectations, will help ensure that MLP equityholders will earn the necessary returns so that the MLP can indeed continue to make appropriate investments in energy infrastructure and grow into the future.

IV. Conclusion

NAPTP applauds the Commission’s decision to recognize the reality that MLPs are a significant and growing portion of the pipeline industry which should be included in ratemaking proxy groups in order that the calculated ROEs will truly be representative of the market as a whole. With regard to the DCF model, we echo Michael Vilbert in saying that it’s not “worthwhile to try to mess with that.” The current formula, applied to MLPs, will accurately reflect the returns that MLP investors expect and that MLPs require to continue their role in building the nation’s energy infrastructure. Failure to include MLPs in proxy groups, as well as any downward adjustments urged by the opposing associations, would not result in just and reasonable rates, but only in “messing with” something that is now working well.

Respectfully submitted,

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