UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

COMMENTS OF THE
NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS

The National Association of Publicly Traded Partnerships ("NAPTP") hereby submits its initial comments on the Commission's July 19, 2007 Proposed Policy Statement in the referenced docket, 120 FERC ¶ 61,068 (2007).

I. SUMMARY OF POSITION

NAPTP strongly supports the Proposed Policy Statement's inclusion of master limited partnerships (MLPs) in the proxy groups used to determine return on equity ("ROE") for natural gas pipelines, and its continuation of the policy of including MLPs in the proxy groups for oil pipelines. We fully agree with Chairman Kelliher that the time has arrived when MLPs are such an important force in the pipeline industry that their inclusion is necessary if proxy groups are truly to reflect the market's expectations for ROE.

II. INTEREST OF NAPTP

NAPTP is an incorporated trade association established under section 501(c)(6) of the Internal Revenue Code to represent the interests of publicly traded partnerships (i.e., MLPs) and those who work with them. Its membership includes 60 MLPs, of which 36 own and operate natural gas, crude oil, or refined product pipelines.[1] We estimate that in aggregate, they own over 200,000 miles of gathering and transmission pipelines, including a substantial portion of interstate crude oil, natural gas, and products pipelines. All the MLPs which have FERC-regulated pipeline systems are members of NAPTP. NAPTP thus has the broadest and most direct interest of any likely commentator in the inclusion of MLPs in proxy groups for oil and gas pipelines.

III. COMMENTS

A. Background and Summary

As noted by the Commission in the Policy Statement, in order for MLPs to be included in the proxy group, the Commission has proposed to cap MLP distributions at the level of its reported earnings (or net income) for purposes of DCF analysis. The Commission is concerned that replacing dividend yields with "available cash flow" distribution yields would distort ROE and allow for a double counting of depreciation, for which there is already an allowance in the Commission's rate making methodology. In addition, the Commission has expressed some concern about whether an MLP's earnings are sustainable.

NAPTP believes that it is not appropriate to cap the distribution at earnings and that to do so would seriously understate the rate of return expected by investors in the marketplace. We urge the Commission to reject this aspect of the Proposed Policy Statement.

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[1] This figure includes seven general partners of pipeline MLPs which are themselves MLPs.

Detailed and well-crafted discussions of most of the reasons that NAPTP believes that the proposed cap should be rejected are found in the comments of the Interstate National Gas Association of America (INGAA) and the Association of Oil Pipelines (AOPL), with whom the NAPTP has a number of members in common. NAPTP endorses the comments filed by both of these associations and urges their careful consideration by the Commission. The points that we consider most important are listed and briefly summarized below; however, we do not find it necessary to repeat in detail the arguments already made and the evidence presented by these other associations:

1. The Commission's concern over inclusion of MLP distributions that exceed earnings in the DCF equation is misplaced because it fails to recognize that the components of the DCF equation (distribution, unit price, and growth rate) are interrelated. The market works efficiently so that a change in one variable produces an offsetting change in another, that is, the higher distributions of MLPs are offset by lower growth rates.
2. Terming a portion of a distribution a return of capital is a tax construct and does not reflect the way that distributions are viewed by the market. From the investor's point of view, it is irrelevant whether the cash he receives is called a dividend or distribution, or whether it is considered a return on equity or a return of equity. The investor cares only that the cash flow provides a return that is commensurate with the level of risk. Neither investors nor investment analysts treat distributions or dividends any differently in assessing return. Both are focused on cash that investors receive.

3. Because MLP distributions accurately reflect the return expected by MLP investors, capping the distributions will result in below-market rates of return. This would defeat the purpose of including MLPs in the proxy groups, that is, to ensure that the proxy groups more accurately reflect the expectations of the market.
4. Inclusion of uncapped distributions in the DCF equation will not result in double recovery of depreciation for the MLP any more than it would for a C corporation. Depreciation is an accounting determination that requires the use of an asset to be expensed over its economic life, as determined by GAAP. It does not affect cash flow for either a corporation or an MLP. To illustrate, assume that Company A, an MLP and Company B, a corporation, generate $100 in income, net of $10 in depreciation expense. Each has cash flow of $110; however, Company A pays out $110 while Company B pays out $80 (or 80% of its net income). Company B has $30 of remaining cash flow to invest in new growth projects, while Company A must raise capital for this purpose. Company A will have a higher current yield than Company B because it pays out all of its cash flow, but a lower growth rate because growth comes with the cost of new capital. In an efficient market both Company A and Company B should have the same overall return because the equity investors demand similar overall returns from investments of similar risk. Therefore, depreciation has no impact in either case. Rather than focus on whether any entity is double-recovering its investment, the more appropriate concern should be whether rates are set at the proper level to attract capital.
5. MLP earnings are sustainable. MLPs own pipelines which are long-lived assets that produce stable cash flow. In fact, one of the primary reasons many investors choose

to invest in MLPs is because of the stable cash they produce. The fact that MLPs may retain less cash than a C corporation as the result of their distributing available cash does not mean that they cannot sustain growth. MLPs, like other business entities, finance growth projects through a number of strategies. Although MLPs typically finance a higher proportion of these growth projects through the capital markets versus using retained cash, this is reflected in a lower growth rate. In addition, because of the stability of the underlying assets and the attractive current yield, historically MLPs have successfully raised capital in the public markets to finance growth projects across a variety of market environments.

B. The Effect of General Partner Distributions

An important point that is not mentioned in either the INGAA or the AOPL comments is the effect of distributions to the MLP's general partner on the MLP's return on equity. It is important to realize that even the MLP's uncapped current distribution yield plus the expected growth does not fully reflect the total return on equity. The distribution to the MLP's general partner must also be recognized and considered.

Typically, MLPs make distributions to their limited partner unitholders, as well as to their general partners. With respect to the general partners, these include distributions often referred to as incentive distributions that are in excess of approximately two percent of the cash flow of the MLP. These distributions typically begin at 2% of total distributions (with the limited partners receiving 98%). As the distributions to the limited partners pass specified thresholds, the general partner receives an increasing share of the marginal increase, eventually, in some MLPs, reaching 50% at the top margin. For example, a general partner might receive 2% of each

distribution up to $1.50, then 15% of the portion of each distribution between $1.50 and $1.75; 25% between $1.75, and so on.

Consequently, adding the limited partner yield of 6.5% to a growth factor of 5% to calculate a return on equity of 11.5%, excludes the portion of the cash that is distributed to the general partner. If , for example, an MLP were to declare a cash distribution of $1.00/unit for the limited partners, and based on the incentive sharing specified in the MLP partnership agreement the general partner received approximately 25% of the cash, then the true cash distribution is $1.00 / 75% or $1.33. Thus, the current yield would be 8.7% (6.5% divided by 75%).

In addition, the 5% growth factor reflects the growth in the limited partners' distribution after sharing a portion of that growth with the GP. While it is complicated to calculate in the context of these comments, it is fair to say that setting the ROE at 6.5% plus a 5% growth factor understates the expected return on the pipeline. In order for a limited partner investor to earn its expected return, the general partner incentive must be considered.

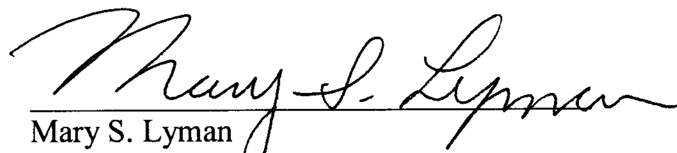
Suppose, for example, that the Commission sets the return on equity for the *pipeline* at 11.5%. Because the split between the general partner and the limited partner investors has not been taken into account, the LP investor will receive something less than an 11.5% return on its investment. If the investor expects to earn an 11.5% return (as demonstrated through the DCF analysis), but in fact does not, the stock price must decline for that to occur, negatively impacting current investors. Accordingly, unless the Commission takes into account the distributions to the general partner, limited partnership investors will be treated unfairly and will not be able to achieve the return on equity they expected to achieve, and unit prices will suffer. See the attached analyst reports from Wachovia and Merrill Lynch for greater detail.

IV. CONCLUSION

As the association representing MLPs, NAPTP commends the Commission for its recognition of the role that they play in the pipeline industry and in the market's expectation of return on equity. However, as demonstrated in detail in the INGAA and AOPL comments when using MLPs in a proxy group for determining return on equity for rate making purposes, it is important to recognize the manner in which the market adjusts to changes in the variables in the DCF model, and not to overstate difference between corporations and MLPs that are not considered by the investor contemplating a purchase of MLP units. Neither the fact that a portion of MLP distribution is termed a return of capital for tax purposes, nor the fact that MLPs may not retain as much cash as a dividend-paying corporation that owns similar assets justifies treating them differently for purposes of the DCF analysis.

In addition, the Commission should include in its consideration the incentive distributions to general partners. Failure to recognize the role of these distributions in overall distributable cash flow and, thereby, in overall return means that return on equity calculated solely on the yield to the limited partners will understate the MLP's cost of capital and result in an insufficient return on equity.

Respectfully submitted,



Mary S. Lyman
Executive Director
NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS
1801 K Street, N.W.
Suite 500
Washington, D.C. 20006
(202) 973-4515 (phone)
lyman@navigantconsulting.com