UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
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Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity — Docket No. PL07-2-000

PROPOSED POLICY STATEMENT

(Issued July 19, 2007)

1. In this proposed Policy Statement, the Commission is proposing to update its standards concerning the composition of the proxy groups used to decide the return on equity (ROE) of natural gas and oil pipelines. Firms engaged in the pipeline business are increasingly organized as master limited partnerships (MLPs). Therefore, the Commission proposes to modify its current policy regarding the composition of proxy groups to allow MLPs to be included in the proxy group. This proposed Policy Statement explains the standards that the Commission would require to be met in order for an MLP to be included in the proxy group. The Commission proposes to apply its final Policy Statement to all gas and oil pipeline rate cases that have not completed the hearing phase as of the date the Commission issues its final Policy Statement. The Commission intends to decide on a case-by-case basis whether to apply the final Policy Statement in cases that have completed the hearing phase. Finally, the Commission is requesting comments on this proposed Policy Statement. Initial comments are due 30 days after publication of this order in the *Federal Register*, with reply comments due 50 days after publication in the *Federal Register*.

I. Background

2. Since the 1980s, the Commission has used a Discounted Cash Flow (DCF) model to develop a range of returns earned on investments in companies with corresponding risks for determining the ROE for natural gas and oil pipelines. The DCF model was originally developed as a method for investors to estimate the value of securities, including common stocks. It is based on "the premise that a stock is worth the present value of its future cash flows, discounted at a market rate commensurate with the stock's risk."[1] Unlike investors, the Commission uses the DCF model to determine the ROE to be included in the pipeline's rates, rather than to estimate a stock's value. Therefore, the Commission solves the DCF formula for the discount rate, which represents the rate of

[1] *Ozark Gas Transmission System*, 68 FERC ¶ 61,032 at 61,104, n. 16 (1994).

return that an investor requires in order to invest in a firm. Under the resulting DCF formula, ROE equals current dividend yield (dividends divided by share price) plus the projected future growth rate of dividends.

3. The Commission uses a two-step procedure for determining the constant growth of dividends: averaging short-term and long-term growth estimates.[2] Security analysts' five-year forecasts for each company in the proxy group, as published by Institutional Brokers Estimate System (IBES), are used for determining growth for the short term; long-term growth is based on forecasts of long-term growth of the economy as a whole, as reflected in the Gross Domestic Product. The short-term forecast receives a 2/3 weighting and the long-term forecast receives a 1/3 weighting in calculating the growth rate in the DCF model.[3]

4. Most gas pipelines are wholly-owned subsidiaries and their common stock is not publicly traded, and this is also true for some jurisdictional oil pipelines. Therefore, the Commission uses a proxy group of firms with corresponding risks to set a range of reasonable returns for both natural gas and oil pipelines. The Commission then assigns the pipeline a rate within that range or zone, to reflect specific risks of that pipeline as compared to the proxy group companies.[4]

5. The Commission historically required that each company included in the proxy group satisfy the following three standards.[5] First, the company's stock must be publicly traded. Second, the company must be recognized as a natural gas or oil pipeline company and its stock must be recognized and tracked by an investment information service such as Value Line. Third, pipeline operations must constitute a high proportion of the company's business. Until the Commission's 2003 decision in *Williston Basin*

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[2] *Northwest Pipeline Co.*, 71 FERC ¶ 61,309 at 61,989-92 (1995) (Opinion No. 396), 76 FERC ¶ 61,068 (1996) (Opinion No. 396-A), 79 FERC ¶ 61,309 (1997) (Opinion No. 396-B), *reh'g denied*, 81 FERC ¶ 61,036 (1997) (Opinion No. 396-C); *Williston Basin Interstate Pipeline Co.*, 79 FERC ¶ 61,311, *order on reh'g*, 81 FERC ¶ 61,033 (1997), *aff'd in relevant part, Williston Basin Interstate Pipeline Co.,* 165 F.3d 54 (D.C. Cir. 1999)(*Williston Basin*).

[3] The Commission presumes that existing pipelines fall within a broad range of average risk, and thus generally sets pipelines' return at the median of the range. *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶ 61,084 at 61,423-4 (1998) Opinion No. 414-A, *reh'g*, 85 FERC ¶ 61,323 (1998) (Opinion No. 414-B), *aff'd North Carolina Utilities Commission v. FERC*, 340 U.S. App. D.C. 183 (D.C. Cir) (unpublished opinion).

[4] *Williston Basin* at 57 (*citation omitted*).

[5] *Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279 at 61,933 (2000).

Interstate Pipeline Co.,[6] the third standard could only be satisfied if a company's pipeline business accounted for, on average, at least 50 percent of a company's assets or operating income over the most recent three-year period.

6. As a result of mergers, acquisitions, and other changes in the natural gas industry, fewer and fewer interstate natural gas companies have satisfied the third requirement. Thus, in *Williston*, the Commission relaxed this requirement for the natural gas proxy group. Instead, the Commission approved a pipeline's proposal to use a proxy group based on the corporations listed in the Value Line Investment Survey's list of diversified natural gas firms that own Commission-regulated natural gas pipelines, without regard to what portion of the company's business comprises pipeline operations.

7. In *HIOS*[7] and *Kern River*, the only fully litigated section 4 rate cases decided since *Williston*, the Commission again drew the proxy group companies from the same Value Line list. When those cases were litigated, there were six such companies: Kinder Morgan Inc., the Williams Companies (Williams), El Paso Natural Gas Company (El Paso), Equitable Resources, Inc., Questar Corporation, and National Fuel Gas Corporation. The Commission excluded Williams and El Paso on the ground that their financial difficulties had lowered their ROEs to a level only slightly above the level of public utility debt, and the Commission stated that investors cannot be expected to purchase stock if lower risk debt has essentially the same return. This left a four-company proxy group, three of whose members derived more revenue from the distribution business, rather than the pipeline business. In *Kern River*, the Commission adjusted the pipeline's return on equity 50 basis points above the median in order to account for the generally higher risk profile of natural gas pipeline operations as compared to distribution operations.

8. In both *Kern River* and *HIOS*, the Commission rejected pipeline proposals to include MLPs in the proxy group. The pipelines contended that MLPs have a much higher percentage of their business devoted to pipeline operations, than most of the corporations that the Commission currently includes in the proxy group.

9. Unlike corporations, MLPs generally distribute most available cash flow to the general and limited partners in the form of quarterly distributions. Most MLP agreements define "available cash flow" as (1) net income (gross revenues minus operating expenses) plus (2) depreciation and amortization, minus (3) capital investments the partnership must

[6] *Williston Basin Interstate Pipeline Company*, 104 FERC ¶ 61,036 at P 35, n. 46 (2003).

[7] *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, *reh'g denied*, 112 FERC ¶ 61,050 (2005), *appeal pending*.

make to maintain its current asset base and cash flow stream.[8] Depreciation and amortization may be considered a part of "available cash flow," because depreciation is an accounting charge against current income, rather than an actual cash expense. As a result, the MLP's cash distributions normally include not only the net income component of "available cash flow," but also the depreciation component. This means that, in contrast to a corporation's dividends, an MLP's cash distributions generally exceed the MLP's reported earnings. Moreover, because of their high cash distributions, MLPs usually finance capital investments required to significantly expand operations or to make acquisitions through debt or by issuing additional units rather than through retained cash, although the general partner has the discretion to do so.

10. In rejecting the pipelines' proposals in *HIOS* and *Kern River* to include MLPs in the proxy group, the Commission made clear that it was not making a generic finding that MLPs cannot be considered for inclusion in the proxy group if a proper evidentiary showing is made.[9] However, the Commission pointed out that data concerning dividends paid by the proxy group members is a key component in any DCF analysis, and expressed concern that an MLP's cash distributions to its unit holders may not be comparable to the corporate dividends the Commission uses in its DCF analysis. In *Kern River*, the Commission explained its concern as follows:

> Corporations pay dividends in order to distribute a share of their earnings to stockholders. As such, dividends do not include any return *of* invested capital to the stockholders. Rather, dividends represent solely a return *on* invested capital. Put another way, dividends represent profit that the stockholder is making on its investment. Moreover, corporations typically reinvest some earnings to provide for future growth of earnings and thus dividends. Since the return on equity which the Commission awards in a rate case is intended to permit the pipeline's investors to earn a profit on their investment and provides funds to finance future growth, the use of dividends in the DCF analysis is entirely consistent with the purpose for which the Commission uses that analysis. By contrast, as Kern River concedes, the cash distributions of the MLPs it seeks to add to the proxy group in this case include a return *of* invested capital through an allocation of the partnership's net income. While the level of an MLP's cash distributions may be a significant factor in the unit holder's decision to invest in the MLP, the Commission uses the DCF analysis solely to determine the pipeline's return on equity. The Commission provides for the return of invested capital through a separate depreciation allowance.

[8] The definition of available cash may also net out short term working capital borrowings, the repayment of capital expenditures, and other internal items.

[9] *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486) at P 147, *reh'g pending.*

> For this reason, to the extent an MLP's distributions include a significant return of invested capital, a DCF analysis based on those distributions, without any adjustment, will tend to overstate the estimated return on equity, because the 'dividend' would be inflated by cash flow representing return of equity, thereby overstating the earnings the dividend stream purports to reflect.[10]

11. The Commission stated that it could nevertheless consider including MLPs in the proxy group in a future case, if the pipeline presented evidence addressing these concerns. The order suggested that such evidence might include some method of adjusting the MLPs' distributions to make them comparable to dividends, a showing that the higher "dividend" yield of the MLP was offset by a lower long-term growth projection, or some other explanation why distributions in excess of earnings do not distort the DCF results for the MLP in question. However, the Commission concluded that Kern River had not presented sufficient evidence to address these issues, and that the record in that case did not support including MLPs in the proxy group.

12. In addition, *Kern River* pointed out that the traditional DCF model only incorporates growth resulting from the reinvestment of earnings, not growth arising from external sources of capital.[11] Therefore, the Commission stated that if growth forecasted for an MLP comes from external capital, it is necessary either (1) to explain why the external sources of capital do not distort the DCF results for that MLP or (2) propose an adjustment to the DCF analysis to eliminate any distortion. The Commission's orders in *HIOS* reached the same conclusions.

13. In some oil pipeline rate cases decided before *HIOS* and *Kern River*, the Commission included MLPs in the proxy group used to determine oil pipeline return on equity on the ground that there were no corporations available for use in the oil proxy group.[12] In those cases, no party raised any issue concerning the comparability of an MLP's cash distribution to a corporation's dividend. However, that issue did arise in the first oil pipeline case decided after *HIOS* and *Kern River*, involving SFPP's Sepulveda Line.[13] The Commission approved inclusion of MLPs in the proxy group in that case on the grounds that the MLPs in question had not made distributions in excess of earnings. The Sepulveda Line order therefore analyzed the five MLPs that have been used to determine SFPP's ROE: Buckeye Partners, L.P., Enbridge Energy Partners, L.P., Enron

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[10] *Id.* at P 149-50.

[11] *Id.* at P 152.

[12] *SFPP, L .P.*, 86 FERC ¶ 61,022 at 61,099 (1999).

[13] *SFPP, L.P.*, 117 FERC ¶ 61,285 (2006) (SFPP Sepulveda order), *rehearing pending*.

Gas Liquids (Enron),[14] TEPPCO Partners, L.P., and Kaneb Partners, L.P. (later Valero Partners), now NuStar Energy, L.P**.** The order reviewed each entity for the year 1996 and the previous four years, and held that four of the firms had had income (earnings) in excess of distributions and that their incomes (earnings) were stable over that period with minor exceptions. The order found these facts sufficient to address the concerns expressed in *HIOS* and *Kern River*. The fifth firm, Enron, had distributions in excess of income (earnings) in four of the five years. While the Commission did not preclude use of such MLPs, Enron did not meet the *HIOS* test and was excluded as unrepresentative.

II. Discussion

14. As discussed below, the Commission proposes to permit inclusion of MLPs in a proxy group. However, the Commission proposes to cap the "dividend" used in the DCF analysis at the pipeline's reported earnings, thus adjusting the amount of the distribution to be included in the DCF model. The Commission would leave to individual cases the determination of which MLPs and corporations should actually be included in the natural gas or oil proxy group. However, participants in these cases should include as much information as possible regarding the business profile of the firms they propose to include in the proxy group, for example, based on gross income, net income, or assets.

15. The Supreme Court has stated that "the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[15] The Commission is concerned that its current approach to determining the composition of the proxy group for determining gas and oil pipeline return on equity is, or will, require the use of firms which are less and less representative of either natural gas or oil pipeline business risk.

16. As has been discussed, there are fewer and fewer publicly traded diversified natural gas corporations that have interstate gas pipelines as their predominant business line, whether this is measured on a revenue, income, or asset basis. As such, there are fewer diversified natural gas companies available for inclusion in a natural gas pipeline proxy group which may reasonably be considered representative of the risk profile of a natural gas pipeline firm. Moreover, at this point the only publicly traded oil pipeline firms are controlled by MLPs, which makes the issue of a representative proxy group more acute.

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[14] Enron Gas Liquids was not affiliated with Enron, Inc. at that time, but was a former affiliate that was spun off in the early 1990's.

[15] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works & Improvement Co. v. Public Service Comm'n*, 262 U.S. 679 (1923).

17. Cost of service ratemaking requires that the firms in the proxy group be of comparable risk to the firm whose equity cost of capital is at issue in a particular rate proceeding. If the proxy group is less than clearly representative, this may require the Commission to adjust for the difference in risk by adjusting the equity cost-of-capital, a difficult undertaking requiring detailed support from the contending parties and detailed case-by-case analysis by the Commission. Expanding a proxy group to include MLPs whose business is more narrowly focused on pipeline activities would help ameliorate this problem. Thus, including MLP natural gas pipelines in the equity proxy group should reduce the need to make adjustments since the proxy group is more likely to contain firms that are representative of the regulated firm whose rates are at issue. Including MLPs will also recognize the trend to greater use of MLPs in the natural gas pipeline industry and address the reality of the oil pipeline industry structure.

18. The Commission's primary concern about including MLPs in the proxy group has arisen from the interaction between use of the DCF analysis to determine return on capital while relying on a depreciation allowance for return of capital. The Commission permits a pipeline to recover through its rates both a return *on* equity and a return *of* invested capital. The Commission uses the DCF analysis solely to determine the return *on* equity component of the cost-of-service. The Commission provides for the return *of* invested capital through a separate depreciation allowance. Given the purpose for which the Commission uses the DCF analysis, the cash flows included in that analysis must be limited to cash flows which may reasonably be considered to reflect a return *on* equity. Such cash flows include that portion of an MLP's cash distribution derived from net income, or earnings.

19. To the extent an MLP makes distributions in excess of earnings, it is able to do so because partnership agreements define "cash available for distribution" to include depreciation. This enables the MLP to make cash distributions that include return *of* equity, in addition to return *on* equity. However, because the Commission includes a separate depreciation allowance in the pipeline's cost-of-service, a DCF analysis including cash flows attributable to depreciation would permit the pipeline to double recover its depreciation expense, once through the depreciation allowance and once through an inflated ROE. Adjusting an MLP's cash distribution to exclude that portion of the distribution in excess of earnings addresses this problem.

20. The Commission recognizes that it raised several concerns in *Kern River* as to whether adjusting the MLP's cash distribution down to the level of its earnings would be sufficient to eliminate the distorting effects of including MLPs in the proxy group. The Commission pointed out that corporations generally do not pay out all of their earnings in dividends, but retain some earnings in order to generate future growth. The Commission also suggested that the DCF model is premised on growth in dividends deriving from reinvestment of current earnings, and does not incorporate growth from external sources, such as issuing debt or additional stock.

21. The Commission believes that these concerns should not render unreliable a DCF analysis using the adjusted MLP results. The market data for the MLPs used in the DCF analysis should itself correct for any distortions remaining after the adjustment to the cash distribution described above. For example, the IBES growth projections represent an average of the growth projections by professionals whose business is to advise investors.[16] The level of an MLP's cash distributions as compared to its earnings is a matter of public record and thus known to the security analysts making the growth forecasts used by IBES. Therefore, the security analysts must be presumed to take those distributions into account in making their growth forecasts for the MLP. To the extent an MLP's relatively high cash distributions reduce its growth prospects that should be reflected in a lower growth forecast, which would offset the MLP's higher "dividend" yield.

22. In order to test the validity of this assumption, the Commission reviewed the most recent IBES growth forecasts for five diversified energy companies and six MLPs in the natural gas business. The average IBES forecast for the corporations is 9 percent, while the average IBES forecast for the MLPs is 6.17 percent, or nearly 300 basis points lower.[17] Thus, the security analysts do project lower growth rates for the MLPs than for the corporations.

23. In addition, the fact MLPs may rely upon external borrowings and/or equity issuances to generate growth is not a reason to exclude them from the proxy group. Most pipelines organized as corporations also use external borrowings and to some extent equity issuances. To the extent that gas or oil pipelines are controlled by diversified energy companies with unregulated assets (either federal or state), the financial practices may be the same, although perhaps not as highly leveraged, and the results are likewise reflected in the IBES projections. A prudent investor deciding whether to invest in a security will reasonably consider all factors relevant to assessing the value of that security. The potential effect of future borrowings or equity issuances on share values of either MLPs or corporations is one such factor. Since a DCF analysis is a method for investors to estimate the value of securities, it follows that such an analysis may reasonably take into account potential growth from external capital.

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[16] Opinion No. 414-B, 85 FERC at 62,268-70.

[17] The IBES forecasts were prepared as of May 31, 2007 applying the current DCF model for the corporate sample and using distributions capped at earnings for the MLPs. Thus the short term growth rates for the five diversified gas corporations were: (1) National Fuel Gas Corporation, 5 percent; (2) Questar Corporation, 9 percent; (3) Oneok, Inc., 9 percent; (4) Equitable Resources Inc., 10 percent; and (5) Williams Companies, 12 percent. The short term growth rates for the six gas MLPs were: (1) Oneok Partners, L.P., 5 percent; (2) TEPPCO Partners, L.P., 5 percent; (3) TC Pipelines, L.P., 5 percent; (4) Boardwalk Pipeline Partners, L.P., 7 percent, (5) Kinder Morgan Energy Partners, L.P., 7 percent, and (6) Enterprise Products Partners, L.P., 8 percent.

24. The Commission does, however, recognize that an MLP’s lack of retained earnings may render cash distributions at their current level unsustainable, and thus still unsuitable for inclusion in the DCF analysis. Therefore, the Commission intends to require participants proposing to include MLPs in the proxy group to provide a multi-year analysis of past earnings. An analysis showing that the MLP does have stable earnings would support a finding that the cash to be included in the DCF calculation is likely to be available for distribution, thus replicating the requirement of the corporate model of a stable dividend.

III. Procedure for Comments

25. The Commission invites interested persons to submit written comments on its proposed policy to permit the inclusion of MLPs in the proxy group to be used to determine the equity cost of capital of natural gas and oil pipelines. The comments may include alternative proposals for determining a representative proxy group given that (1) few natural gas companies meet the Commission's traditional standards for inclusion in the proxy group, and (2) the only publicly traded oil pipeline firms available for inclusion in the proxy group are controlled by MLPs. Comments may also address the analysis advanced in this proposed policy statement, alternative methods for adjusting the amount of the MLP’s distribution to be included the DCF analysis, and the relevance of the stability of MLP earnings.

26. Comments are due 30 days from the date of publication in the *Federal Register* and reply comments are due 50 days from the date of publication in the *Federal Register*. Comments must refer to Docket No. PL07-2-000, and must include the commentor's name, the organization it represents, if applicable, and its address. To facilitate the Commission’s review of the comments, commentors are requested to provide an executive summary of their position. Additional issues the commentors wish to raise should be identified separately. The commentors should double space their comments.

27. Comments may be filed on paper or electronically via the eFiling link on the Commission's web site at http://www.ferc.gov. The Commission accepts most standard word processing formats and commentors may attach additional files with supporting information in certain other file formats. Commentors filing electronically do not need to make a paper filing. Commentors that are not able to file comments electronically must send an original and 14 copies of their comments to: Federal Energy Regulatory Commission, Office of the Secretary, 888 First Street N.E., Washington, D.C. 20426.

28. All comments will be placed in the Commission's public files and may be viewed, printed, or downloaded remotely as described in the Document Availability section below. Commentors are not required to serve copies of their comments on other commentors.

IV. Document Availability

29. In addition to publishing the full text of this document in the *Federal Register*, the Commission provides all interested persons an opportunity to view and/or print the contents of this document via the Internet through the Commission's Home Page (http://www.ferc.gov) and in the Commission's Public Reference Room during normal business hours (8:30 a.m. to 5:00 p.m. Eastern time) at 888 First Street, N.E., Room 2A, Washington D.C. 20426.

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31. User assistance is available for eLibrary and the Commission's website during normal business hours. For assistance, please contact the Commission’s Online Support at 1-866-208-3676 (toll free) or 202-502-6652 (e-mail at FERCOnlineSupport@ferc.gov or the Public Reference Room at 202-502-8371, TTY 202-502-8659 (e-mail at public.referenceroom@ferc.gov)

By the Commission.

(S E A L)

Kimberly D. Bose,
Secretary.