123 FERC ¶ 61,048
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Suedeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

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

POLICY STATEMENT

(Issued April 17, 2008)

1. On July 19, 2007, the Commission issued a proposed policy statement concerning the composition of the proxy groups used to determine gas and oil pipelines' return on equity (ROE) under the Discounted Cash Flow (DCF) model.[1] Historically, in determining the proxy group, the Commission required that pipeline operations constitute a high proportion of the business of any firm included in the proxy group. However, in recent years, there have been fewer gas pipeline corporations that meet that standard, in part because of the greater trend toward Master Limited Partnerships (MLPs) in the gas pipeline industry. Additionally, there are no oil corporations available for use in the oil pipeline proxy group. These trends have made the MLP issue one of particular concern to the Commission and are the reason that the Commission issued the Proposed Policy Statement.[2]

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[1] *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity,* 120 FERC ¶ 61,068 (2007) (Proposed Policy Statement).

[2] After an initial round of comments and reply comments, the Commission concluded that it required additional comment on the issue of the growth rates of MLPs. After notice to this effect and the receipt of a round of initial and reply comments, staff held a technical conference involving an eight member panel on January 23, 2008 that was transcribed for the record. Comments and reply comments were filed thereafter.

2. After review of an extensive record developed in this proceeding, the Commission concludes: (1) MLPs should be included in the ROE proxy group for both oil and gas pipelines; (2) there should be no cap on the level of distributions included in the Commission's current DCF methodology; (3) the Institutional Brokers Estimated System (IBES) forecasts should remain the basis for the short-term growth forecast used in the DCF calculation; (4) there should be an adjustment to the long-term growth rate used to calculate the equity cost of capital for an MLP; and (5) there should be no modification to the current respective two-thirds and one-third weightings of the short- and long-term growth factors. Moreover, the Commission will not explore other methods for determining a pipeline's equity cost of capital at this time. The Commission also concludes that this Policy Statement should govern all gas and oil rate proceedings involving the establishment of ROE that are now pending before the Commission, whether at hearing or in a decisional phase at the Commission.

I. Background

A. The DCF Model

3. 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."[3] Since the 1980s, the Commission has used the DCF model to develop a range of returns earned on investments in companies with corresponding risks for purposes of determining the ROE to be awarded natural gas and oil pipelines.

4. 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's price is equal to the present value of the infinite stream of expected dividends discounted at a market rate commensurate with the stock's risk."[4] With simplifying assumptions, the DCF model results in the investor using the following formula to determine share price:

$$P = D/(r-g)$$

[3] *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).

[4] *CAPP v. FERC*, 254 F.3d 289, 293 (2001) (*CAPP*).

where P is the price of the stock at the relevant time, D is the current dividend, r is the discount rate or rate of return, and g is the expected constant growth in dividend income to be reflected in capital appreciation.[5]

5. Unlike investors, the Commission uses the DCF model to determine the ROE (the "r" component) 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 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:

$$r = D/P + g$$

6. Over the years, the Commission has standardized the inputs to the DCF formula as applied to interstate gas and oil pipelines. The Commission averages short-term and long-term growth estimates in determining the constant growth of dividends (referred to as the two-step procedure). Security analysts' five-year forecasts for each company in the proxy group (discussed below), as published by IBES, are used for determining growth for the short term. The long-term growth is based on forecasts of long-term growth of the economy as a whole,[6] as reflected in the Gross Domestic Product (GDP which are drawn from three different sources.[7] The short-term forecast receives a two-thirds weighting and the long-term forecast receives a one-third weighting in calculating the growth rate in the DCF model.[8]

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[5] *Id. National Fuel Gas Supply Corp*., 51 FERC ¶ 61,122, at 61,337 n.68 (1990). *Ozark Gas Transmission System*, 68 FERC ¶ 61,032, at 61,104 n.16. (1994).

[6] *Northwest Pipeline Company*, 79 FERC ¶ 61,309, at 62,383 (1997) (Opinion No. 396-B). *Williston Basin Interstate Pipeline Company*, 79 FERC ¶ 61,311, at 62,389 (1997) (*Williston I*), *aff'd*, *Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54, 57 (D.C. Cir. 1999) (*Williston v. FERC*).

[7] The three sources used by the Commission are Global Insight: *Long-Term Macro Forecast – Baseline (U.S. Economy 30-Year Focus)*; Energy Information Agency, *Annual Energy Outlook*; and the Social Security Administration.

[8] *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶ 61,084, at 61,423-4 (Opinion No. 414-A), *reh'g denied*, 85 FERC ¶ 61,323, at 62,266-70 (1998) (Opinion No. 414-B), *aff'd sub nom. North Carolina Utilities Commission v. FERC*, 203 F.3d 53 (D.C. Cir. 2000) (unpublished opinion). *Northwest Pipeline Co.*, 88 FERC ¶ 61,057, *reh'g denied*, 88 FERC ¶ 61,298 (1999), *aff'd CAPP v. FERC*, 254 F.3d 289 (D.C. Cir. 2001).

7. Most gas pipelines are wholly-owned subsidiaries and their common stocks are not publicly traded. This is also true for some jurisdictional oil pipelines. Therefore, the Commission must use a proxy group of publicly traded firms with corresponding risks to set a range of reasonable returns for both natural gas and oil pipelines. For both oil and gas pipelines, after defining the zone of reasonableness through development of the appropriate proxy group for the pipeline, the Commission assigns the pipeline a rate within that range or zone, to reflect specific risks of that pipeline as compared to the proxy group companies.[9] The Commission has historically presumed that existing pipelines fall within a broad range of average risk. A pipeline or other litigating party has to show highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines to overcome the presumption.[10]

8. The Commission historically required that each company included in the proxy group satisfy the following three standards.[11] 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 2003, the Commission's policy was that 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.[12]

9. However, in recent years fewer corporations have satisfied the Commission's standards for inclusion in the gas and oil pipeline proxy groups. Mergers and acquisitions have reduced the number of publicly traded corporations with natural gas pipeline operations. Most of the remaining corporations are engaged in such significant non-pipeline business that their pipeline business accounts are significantly less than 50 percent of their assets or operating income. At the same time, there has been a trend toward MLPs owning natural gas pipelines. This trend has been even more pronounced in the oil pipeline industry, with the result that there are now no purely oil pipeline corporations available for inclusion in the oil pipeline proxy group and virtually all traded

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[9] *Williston v. FERC*, 165 F.3d at 57 (*citation omitted*).

[10] *Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279, at 61,936 (2000).

[11] *Id.* at 61,933.

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

oil pipeline equity interests are owned by MLPs. Thus, for both oil and gas pipeline rate cases, the composition of the proxy group has become a significant issue, and the central question is whether, and how, to include MLPs in the proxy group.

B. The MLP Business Model

10. MLPs consist of a general partner, who manages the partnership, and limited partners, who provide capital and receive cash distributions, but have no management role. The units of the limited partners are traded on public exchanges, just like corporate stock shares. In order to be treated as an MLP for Federal income tax purposes, an MLP must receive at least 90 percent of its income from certain qualifying sources, including natural resource activities. Natural resource activities include exploration, development, mining or production, processing, refining, transportation, storage and marketing of any mineral or natural resource, including gas and oil.[13]

11. MLPs generally distribute most available cash flow to the general and limited partners in the form of quarterly distributions. At their inception, MLPs establish agreements between the general and limited partners, which define cash flow available for distribution and how that cash flow is to be divided between the general and limited partners. 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 make to maintain its current asset base and cash flow stream.[14] Depreciation and amortization may be considered a part of "available

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[13] *See* Wachovia Securities, *Master Limited Partnerships: A Primer*, November 10, 2003, (*Wachovia Primer 1*) at 1, 3-4, reproduced in full in Docket No. OR96-2-012, Ex. SEP ARCO-22 and also in *Kern River Gas Transmission Company*, Docket No. RP04-274-000, Ex. No. BP-19 filed October 25, 2005; J.P. Morgan, *Industry Analysis, Energy MLPS*, dated March 28, 2002 (*J.P. Morgan 2002 Energy MLPs*) at 5-6, reproduced in full in Docket No. OR92-8-025, Ex. No. SWST-18, filed October 20, 2005; Wachovia Capital Markets, LLC, Equity Research Department, *Master Limited Partnerships: Primer 2nd Edition, A Framework for Investment* dated August 23, 2005 (*Wachovia 2nd Primer*) at 8-9, reproduced in full in Docket No. RP06-72-000 at Ex. S-36, filed May 31, 2006); Coalition of Publicly Traded Partnerships, *Publicly Traded Partnerships: What they are and how they work* (undated) (*Publicly Traded Partnerships*) at 1-3, reproduced in full in Docket No. RP06-72-000 at Ex. S-35, filed May 31, 2006, and Docket No. OR96-2-012, Ex. No. BP-19, filed October 25, 2005; CAPP Reply Comments, Attachment A at 2-3; APGA Additional Comments dated December 21, 2007.

[14] The definition of available cash may also net out short term working capital

(continued…)

cash flow," because depreciation is an accounting charge against current income, rather than an actual cash expense. Thus, depreciation does not reduce the MLP's current cash on hand. The MLP agreement may provide for the general partner to receive increasingly higher percentages of the overall distribution if it raises the quarterly distribution. This gives the general partner incentives to increase the partnership's business and cash flow.[15]

12. The general partner has discretion not to distribute the entire amount of available cash flow for the proper exercise of the business, to create reserves for capital expenditures, for the payment of debt, and for future distributions. However, pipeline MLPs have typically distributed 90 percent or more of available cash flow. As a result, the MLP's cash distributions normally include not only the operating profit 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. The pipeline MLP's ability to distribute a high percentage of available cash flows reflects the stable cash flows underpinning its businesses.[16]

13. Because of their high cash distributions, MLPs have financed 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. These expansions financed through external debt are intended to provide a return equal to the cost of the capital plus some additional return for the existing unit holders, i.e., it is accretive. Thus, the return on any newly issued units is expected to be sufficiently high to avoid dilution of the current distributions to the existing unit holders.[17]

14. MLPs may also provide significant tax advantages to their unit holders. Some MLPs allocate depreciation, amortization, and tax credits to the limited partners and away from the general partner. In some cases, the limited partner may have no net taxable income reported on the income tax information document (the K-1) the limited partner

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borrowings, the repayment of capital expenditures, and other internal items.

[15] *Wachovia Primer 1* at 6-7; *J.P. Morgan 2002 Energy MLPs* at 5, 14; *Wachovia 2nd Primer* at 9, 15-19.

[16] *J.P. Morgan 2002 Energy MLPs* at 11-13; *Wachovia 2nd Primer* at 24-25; Enbridge Initial Comments Attachment A, Wachovia Capital Markets, LLC, *MLPs: Safe to Come Back Into the Water* (*Wachovia MLPs*) dated August 20, 2007, at 2-4.

[17] *Id.*

receives from the partnership each year, a pattern that may continue for years. In that case, the limited partner will not pay any taxes on the cash received from the partnership in the year of the distribution. To the extent a limited partner is allocated items of depreciation, credit, or losses that exceed the limited partner's ownership percentage, income taxes will be due on the difference when the unit is sold. However, this may not occur for many years. Over time the real cost of the future taxes declines while the future return of any tax savings that is reinvested increases. This can significantly increase the return to the investor over the holding period of the limited partnership unit.[18]

15. Moreover, distributions in excess of earnings are not taxed as long as the limited partner has a tax basis. Rather, the limited partner's tax basis is reduced and again any taxes are deferred until the unit is sold. By this tax deferral, the cash flow distributed in excess of earnings can be made available for reinvestment much earlier than would be the case of a corporate share.[19] This reduces the limited partner's risk because the limited partner's cash basis in the unit is reduced, but the distribution would not normally reduce the market price of the unit nor, if the firm has access to external capital, would this necessarily reduce its long term growth potential.

C. The Recent Cases on the Shrinking Proxy Group

1. Natural Gas Pipeline Cases

16. The Commission first addressed the problem of the shrinking natural gas pipeline proxy group in *Williston II*, 104 FERC ¶ 61,036 at P 34-43. In that NGA section 4 rate case, the Commission relaxed the requirement that natural gas business account for at least 50 percent of the corporation's assets or operating income. Instead, the Commission approved the 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. The proxy group approved in that case included four corporations that satisfied the Commission's historic standards[20] and

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[18] *See* PSCNY Initial Comments at 12-13 and Attachment 1 thereto at 2; *Wachovia Primer* at 4-5; *Publicly Traded Partnerships* at 2-3; *Wachovia 2nd Primer* at 1, 5, 20-22; *J.P. Morgan 2002 Energy MLPs* at 18-19.

[19] *Id.*

[20] The Commission noted that two of those four companies were in the process of merging so that in the future there would be only three pipeline corporations that satisfied our historic proxy group standards. *Williston II*, 104 FERC ¶ 61,036 at P 35.

five corporations with less pipeline business and more local distribution business than the Commission had previously allowed. The Commission set Williston's ROE at the median of this proxy group.

17. The Commission next addressed the proxy group issue in a 2004 order in *Petal Gas Storage, L.L.C.*, 97 FERC ¶ 61,097 (2001), *reh'g granted in part and denied in part*, 106 FERC ¶ 61,325 (2004) (*Petal*). In that case, a jurisdictional storage company with market-based rates had applied for a certificate under NGA section 7 to construct pipeline facilities to transport gas from its existing storage facility to a new interconnection with Southern Natural Gas Co. The Commission found that Petal was not a new entrant in the jurisdictional gas transportation business, but was simply expanding its existing business and had not shown that it faced any unusual risks. Ordinarily in such circumstances the Commission would use the pipeline's own currently approved ROE for its existing services in determining an initial incremental rate for the expansion. However, because Petal had market-based rates for its existing services, there was no such currently approved ROE to use. Therefore, the Commission calculated the initial rate for Petal's expansion using the same median ROE which it had approved in *Williston*, which was the most recent litigated gas pipeline section 4 rate case.

18. When the Commission next addressed the proxy group issue, in *High Island Offshore System, L.L.C.* (*HIOS*),[21] and *Kern River Gas Transmission Company* (Opinion No. 486),[22] the *Williston II* proxy group had shrunk to six corporations. Moreover, the Commission found that two of those corporations should be excluded from the proxy group on the ground that their financial difficulties had lowered their ROEs to such a low level as to render them unrepresentative.[23] This left only four corporations eligible for the proxy group under the standards adopted in *Williston II*, three of whom derived more revenue from the distribution business than the pipeline business. The two pipelines contended that, in these circumstances, the Commission should include natural gas pipeline MLPs in the gas pipeline proxy group. They asserted that MLPs have a much higher percentage of their business devoted to pipeline operations than most of the corporations eligible for the proxy group under *Williston II*, and therefore are more representative of the risks faced by pipelines.

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[21] 110 FERC ¶ 61,043, *reh'g denied*, 112 FERC ¶ 61,050 (2005).

[22] 117 FERC ¶ 61,077 (2006), *reh'g pending.*

[23] *HIOS*, 110 FERC ¶ 61,043 at P 118. Opinion No. 486, 117 FERC ¶ 61,077 at P 140-141.

19. In *HIOS* and Opinion No. 486, the Commission rejected the proposals to include MLPs in the proxy group, and approved proxy groups using the four corporations still available under the *Williston II* approach of basing the proxy group on the Value Line Investment Survey's group of diversified natural gas corporations that own Commission-regulated pipelines. In *HIOS*, the Commission set the pipeline's ROE at the median of the four-corporation proxy group. In Opinion No. 486, the Commission took the same general approach as in *HIOS*, but set the pipeline's ROE 50 basis points above the median to account for the fact its pipeline operations have a higher risk than its distribution business.[24]

20. In rejecting the proposals to include MLPs in the proxy group in both cases, 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.[25] 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 Opinion No. 486, 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. For this reason, to the extent an MLP's distributions include a significant return of invested capital, a DCF analysis based

[24] *Id.* at P 171-176.

[25] *Id.* at P 147. *See also HIOS*, 110 FERC ¶ 61,043 at P 125.

> 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.[26]

21. 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 discussion in 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.[27] 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.

22. In addition, Opinion No. 486 pointed out that the traditional DCF model only incorporates growth resulting from the reinvestment of earnings, not growth arising from external sources of capital.[28] 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.

2. Oil Pipeline Cases

23. In some oil pipeline rate cases decided before *HIOS* and Opinion No. 486, 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.[29] 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 Opinion No. 486, which involved SFPP's Sepulveda Line.[30] The Commission approved inclusion of MLPs in the proxy group in

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[26] Opinion No. 486, 117 FERC ¶ 61,077 at P 149-150.

[27] Proposed Policy Statement at P 10-11.

[28] *Id.* at P 152.

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

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

that case on the grounds that the included MLPs in question had not made distributions in excess of earnings. The order found these facts sufficient to address the concerns expressed in *HIOS* and Opinion No. 486.

D. Court Remand of Petal and HIOS

24. Both Petal and HIOS appealed the Commission's orders in their cases to the United States Court of Appeals for the District of Columbia Circuit. The court considered the appeals together, and it vacated and remanded the proxy group rulings in both cases.[31] The court emphasized that the Commission's "proxy group arrangements must be risk-appropriate."[32] The court explained that this means that firms included in the proxy group should face similar risks to the pipeline whose ROE is being determined, and any differences in risk should be recognized in determining where to place the pipeline in the proxy group range of reasonable returns.

25. The court recognized that changes in the gas pipeline industry compel a change in the Commission's traditional approach to determining the proxy group, and the court stated that "controversy about how it should change has been bubbling up in a number of recent cases," citing both *Williston II* and Opinion No. 486. But the court found that the cases on appeal "seem[] to represent an arrival point of sorts for the Commission," pointing out that Opinion No. 486 had reversed an administrative law judge for deviating from the *HIOS* proxy group.[33]

26. The court held that the Commission had not shown that the proxy group arrangements it approved in *Petal* and *HIOS* were risk-appropriate. The court pointed out that the Commission had rejected the inclusion of MLPs in the proxy group on the ground that MLP distributions, unlike dividends, might provide returns *of* equity as well as returns *on* equity. While stating that this proposition is not "self-evident," the court accepted it for the sake of argument. Nonetheless, the court stated that nothing in the Commission's decision explained why the companies selected by the Commission for inclusion in the proxy group are risk-comparable to HIOS. The court stated that when the

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[31] *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695 (D.C. Cir. 2007) (*Petal v. FERC*).

[32] *Petal v. FERC*, 496 F.3d at 697, quoting *Canadian Association of Petroleum Producers v. FERC*, 254 F.3d 289 (D.C. Cir. 2001).

[33] Opinion No. 486 reversed the ALJ's inclusion of the two financially troubled pipelines in the proxy group

goal is a proxy group of comparable companies, it is not clear that natural gas companies with highly different risk profiles should be regarded as comparable.

27. The court further stated that in placing Petal and HIOS in the middle of the proxy group in terms of return on equity, the Commission expressly relied on the assumption that pipelines generally fall into a broad range of average risk as compared to other pipelines. However, the court stated, this assumption is decisive only given a proxy group composed of other pipelines. Thus, the court reasoned that if gas distribution companies generally face lower risk than gas pipelines,[34] a risk-appropriate placement would be at the high end of the group. The court stated that the Commission erred by failing to explain how its proxy group arrangements were based on the principle of relative risk.

28. Therefore, the court vacated the Commission's orders with respect to the proxy group issue. The court stated that on remand, it did not require any particular proxy group arrangement, but stated that the overall arrangement must make sense in terms of the relative risk and in terms of the statutory command to set just and reasonable rates that are commensurate with returns on investments in other enterprises having corresponding risks.

II. The Proposed Policy Statement

29. A month before the court's decision in *Petal v. FERC*, the Commission reached a similar conclusion that its proxy group arrangements for gas and oil pipelines must be reexamined. Accordingly, on July 19, 2007, the Commission issued a Proposed Policy Statement, in which it proposed to modify its policy to allow MLPs to be included in the proxy group. The Proposed Policy Statement found that:

> Cost of service ratemaking requires that firms in the proxy group be of comparable risk to the firm whose equity cost of capital is being determined 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 the proxy group to include MLPs whose business is more narrowly

[34] The court noted that this seems likely.

focused on pipeline activities would help provide a more representative proxy group.[35]

30. However, the Commission proposed to cap the cash distribution used to determine an MLP's return under the DCF method at the MLP's reported earnings. The Commission found that this was necessary to exclude that portion of an MLP's distributions constituting return *of* equity. The Commission provides for the return *of* equity through a depreciation allowance. Therefore, the Commission stated that the cash flows used in the DCF analysis should be limited to those which reflect a return *on* equity. The concern was the pipeline could double recover its depreciation expense. The Commission also proposed to require a showing that the MLP has had stable earnings over a multi-year period, so as to justify a finding that it will be able to maintain the current level of cash distributions in future years. The Proposed Policy Statement found that these requirements should render the MLP's cash distribution comparable to a corporation's dividend for purposes of the DCF analysis.

31. Under the Proposed Policy Statement, the Commission would leave to individual cases the determination of which specific MLPs and corporations should be included in the proxy group. The Commission proposed to apply its final policy statement to all gas and oil cases that have not completed the hearing phase as of the date the Commission issues its final policy statement. The Commission stated that it would consider on a case-by-case basis whether to apply the final policy statement in cases that have completed the hearing phase.

III. The Record in the Policy Statement Proceeding

A. Pre-Technical Conference Comments

32. Twenty-two initial comments and thirteen reply comments were filed in response to the Proposed Policy Statement[36] and fall into two categories: (1) those of gas and oil pipelines and the related trade associations (Pipeline Interests),[37] and (2) those of gas and

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[35] Proposed Policy Statement, 120 FERC ¶ 61,068 at P 17.

[36] Comments related to the technical conference are discussed *infra* and are characterized as conference comments or conference reply comments.

[37] The Pipeline Interests include: the Association of Oil Pipe Lines (AOPL); El Paso Corporation (El Paso); Enbridge Energy Partners, L.P. (Enbridge); the Interstate Natural Gas Association of America (INGAA); MidAmerican Energy Pipeline Group (MidAmerican); the National Association of Publicly Traded Partnerships (NAPTP);

(continued…)

oil producers and shippers, public and municipal utilities, state public service commissions, and related trade associations (Customer Interests).[38] Two comments were also submitted by individuals in their business or personal capacity.[39]

33. The comments focus on three issues: (1) whether MLPs should be included in the gas pipeline proxy group at all; (2) whether the proposed cap on the MLP cash distributions used in the DCF analysis is necessary or adequate; and (3) whether the short- and long-term growth component of the DCF model should be modified given the financial practices of MLPs. Secondary points include the potential distorting effects of: MLP tax treatment, the large payouts by MLPs, the general partner's incentive distribution rights (IDRs), and the relative returns to the limited and general partners.

34. All parties recognize that MLPs are the only available entities for inclusion in the oil pipeline proxy group. The Pipeline Interests also all assert that the Commission correctly proposed to include MLPs in the gas pipeline proxy group. In contrast, most of the Customer Interests assert that there are enough corporations available for inclusion in the gas pipeline proxy group and that there is no need to include MLPs.

35. Both the Pipeline and Customer Interests question the proposed earnings cap on MLP distributions, with the Pipeline Interests asserting the cap is unnecessary and the Customer Interests asserting the cap should be lower. The Pipeline Interests assert that an MLP's share price reflects investors' projection of all cash flows it will receive from the MLP, including distributions in excess of earnings. Therefore, any cap on the

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Panhandle Energy Pipelines (Panhandle); Spectra Energy Transmission, LLC (Spectra); TransCanada Corporation (TransCanada); and Williston Basin Interstate Pipeline Company (Williston).

[38] The Customer Interests include: the American Gas Association (AGA); the America Public Gas Association (APGA); the Air Transport Association of America; the Canadian Association of Petroleum Producers (CAPP); Indicated Shippers (consisting of Area Energy, LLC, Anadarko E&P Company LP, Anadarko Petroleum Corporation, Chevron USA Inc., Coral Energy Resources LP, Occidental Energy Marketing Inc., and Shell Rocky Mountain Production, LLC); the Natural Gas Supply Association (NGSA); the Process Gas Consumers Group; the Public Service Commission of New York (PSCNY); Tesoro Refining and Marketing Company (Tesoro); the Northern Municipal Distributors Group (NMDG) and the Midwest Region Gas Task Force Association filing jointly; and the Society for the Preservation of Oil Shippers (Society).

[39] The individual comments include Crowley Energy Consulting, supporting the Customer Interests, and Barry Gleicher, supporting the Pipeline Interests.

distributions while still using a dividend yield reflecting the full share price would lead to distorted results.[40] The Customer Interests agree that the adjustment to MLP distributions is necessary to remove a double count attributed to depreciation, but they also uniformly assert that the proposed adjustment is inadequate to compensate for a wide range of financial factors that distinguish MLPs from Schedule C corporations.

36. On the growth rate issue, the Pipeline Interests in their initial comments generally agree that, if MLPs have greater distributions than a corporation, then the MLP may have less growth potential than a corporation. However, they argue that this fact does not require any additional adjustment, since any lower growth potential would be reflected in a reduced IBES growth forecast. The Pipeline Interests also state that distributions in excess of earnings do not prevent reinvestment or organic growth. They assert that pipeline MLPs have ready access to capital markets given their stable cash flows and the projected expansion of the pipeline system, which can be the basis for organic growth.[41]

37. In contrast, the Customer Interests assert that MLPs have significantly lower growth potential than corporations due to their distributions in excess of earnings, particularly over the long term.[42] They cite studies by established investment firms suggesting that the long term growth potential of MLPs is less than the long term growth factor now included in the DCF model. Moreover, they argue that given the high level of MLP distributions and declining opportunities for acquisitions with high returns, MLP growth must now come from investment of external funds in projects that will enhance organic growth of existing business lines.[43]

38. Some of the Customer Interests further argue that there are inadequate investment opportunities to support capital investment, and in the relatively near future the present level of MLP distributions will be maintained only by borrowing or issuing additional

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[40] AOPL initial comments at 8, 10; INGAA initial comments at 13-14; Spectra initial comments at 4; NAPTP initial comments at 4.

[41] AOPL comments at 21-24 and attachments; Enbridge Energy reply comments at 5; INGAA comments at 22-24; TransCanada reply comments at 8-10.

[42] APGA reply comments at 11-15; CAPP initial comments at 1; CAPP reply comments at 6-7, and attachment at 3-4; NYPSC initial comments at 19-21, 23, including attachments of financial materials from major investment houses; NYPSC reply comments at 4-7; Tesoro reply comments at 25-27.

[43] *Id.*

limited partners' units.[44] Therefore, they argue, sustainability of MLP growth is a major issue that must be examined in rate proceedings as this implies a lower equity cost-of-capital component in the pipeline's rate structure.[45] The Customer Interests also assert that the Commission's traditional DCF model has never permitted the inclusion of externally generated funds in the growth component of the model. Thus, to the extent the IBES projections include such external funds, they assert that this compromises the forecasts.

39. Finally, NGSA urge the Commission to initiate a new proceeding to consider alternatives to the DCF methodology for determining gas pipeline ROEs. AGA requests a technical conference to discuss the issues further, which as noted, the Commission granted with regard to the growth factors.[46] Two commenters assert that any change in policy should apply prospectively and should not apply to proceedings for which the hearing record is completed, e.g., the *Kern River* proceeding.[47]

B. Technical Conference and Post-Technical Conference Comments

40. After review of the initial comments summarized above, the Commission issued a supplemental notice on November 15, 2007, requesting additional comments solely on the issue of MLP growth rates, and establishing a technical conference to discuss that issue. The technical conference was held on January 23, 2008. The Commission concluded that supplementing the record before the Commission could resolve the issue of how to project MLP growth rates assuming that the Commission ultimately decides to permit the use of MLPs in the proxy group. The Commission focused the technical conference on the appropriate method for determining MLP growth and, in particular, that which should be used if the Commission did not cap the distributions used to determine the dividend yield. Thus, whether to include MLPs in the proxy group or to limit the distributions to earnings were not issues before the technical conference. The technical conference was transcribed for use in the record herein.

41. Thirteen parties submitted comments in response to the November 15 notice, on three main topics: (1) the short-term growth component; (2) the long-term growth

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[44] Crowley Energy Consultant initial comments; Society at 5-6.

[45] *Id.*

[46] AGA initial comments at 8.

[47] *Id.* at 8, 25; NGSA initial comments at 3, 11.

component; and (3) the weighting of these two components.[48] Of these, eight parties requested to participate on the panels and the Commission accepted all of the individuals proffered by these parties.[49] To summarize, two of the panelists represented parties that continued to assert that MLPs should not be included in the ROE proxy group.[50] More consistent with the premise of the conference, three panelists stated that there needed to be an adjustment to the long term GDP component the Commission currently uses in its DCF model.[51] Two stated that MLPs would grow at a slower rate than corporations in the long-term phase of growth. However, six other panelists asserted that an MLP as a whole could grow as fast as a corporation in the terminal phase, but most conceded that the use of an incentive distribution rights (IDRs)[52] would cause the limited partnership interests to grow at slower rate than the MLP as a whole.[53] In addition, three panelists questioned the reliability of the IBES forecasts for use in developing the short- term

[48] APGA, AOPL, CAPP, Enbridge, INGAA, MidAmerica, NAPTP, NGSA, PSNYC, State of Alaska, Tesoro, TransCanada, and Williston.

[49] Professor J. Peter Williamson on behalf of the Association of Oil Pipelines, Mr. J. Bertram Solomon on behalf of the American Public Gas Association, Mr. Michael J. Vilbert on behalf of the Interstate Natural Gas Association of America, Mr. Park Shaper and Mr. Yves Siegel on behalf of the National Association of Publicly Traded Partnerships, Mr. Patrick Barry on behalf of the Public Service Commission of New York, Mr. Thomas Horst on behalf of the State of Alaska, and Mr. Paul Moul on behalf of TransCanada Corporation.

[50] PSCNY and APGA. CAPP, NGSA, and Tesoro supported this position but did not participate on the panel.

[51] PSCNY, APGA, and State of Alaska as well as the NGSA.

[52] As discussed further below, an incentive distribution provision in an MLP partnership agreement provides for an increasing large percentage of distributions to the general partner as the cash distributions per limited partnership share increase over time. The maximum incentive distribution to the general partner varies with the partnership agreement, but may be as high as 47 percent. .

[53] Two spoke for NAPTP and one each for AOPL, INGAA, the State of Alaska, and TransCanada. Williston, Enbridge, and MidAmerican also asserted that there is no reason to conclude the growth would not at least equal GDP. They did not speak to the issue of the limited partner growth rate that might be lower as a result of the incentive distributions to the general partner.

projection[54] and one stated that the longer term growth component of the formula should be weighted at no greater than 10 percent.[55]

IV. Discussion

42. Based on its review of all the comments and the record of the technical conference, the Commission is adopting the following policy concerning the composition of the natural gas pipeline and oil pipeline proxy groups: (1) consistent with the Proposed Policy Statement, the Commission will permit MLPs to be included in the proxy group for both gas and oil pipelines; (2) the proposed earnings cap on the MLPs' distributions will not be adopted; and (3) the Commission will use the same DCF analysis for MLPs as for corporations, except that the long-term growth projection for MLPs shall be 50 percent of projected growth in GDP.

A. Whether to Include MLPs in the Gas and Oil Pipeline Proxy Groups

1. Comments

43. The first issue is whether to include MLPs in the proxy group used to determine a pipeline's return on equity. No commenter contests the Commission's statement that, in oil pipeline proceedings, MLPs are the only firms available for inclusion in the proxy group.[56] In addition, the Pipeline Interests all assert that the Commission correctly proposed to include MLPs in the gas pipeline proxy group. They agree with the Commission that this will result in a more representative proxy group that reflects long-term trends within the gas pipeline industry and assert that the resulting returns will encourage further investment in both the gas and oil pipeline industries. Including MLPs in the proxy group would reduce the need for difficult adjustments to projected equity returns to accommodate differences in risk among the different types of firms that might reasonably be included in the proxy group.

44. In contrast, most of the commenters representing the Customer Interests assert that there are enough corporations available for inclusion in the gas pipeline proxy group that there is no need to include MLPs. They further argue that the differences between the

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[54] APGA, PSCNY, and State of Alaska.

[55] TransCanada, Additional Comments dated December 21 at 12.

[56] AOPL initial comments at 5. Tesoro initial comments at 2. *See also* Society initial comments addressing the possible inclusion oil pipeline MLPs in the proxy group.

MLP and corporate business model render any use of MLPs inconsistent with the DCF model. APGA expressly states that the Commission should abandon the Proposed Policy Statement.[57]

45. The NMDG asserts that the Commission has not established that there is any reason to issue the Policy Statement or to relieve a pipeline applicant of the burden of establishing why any MLPs should be included in the proxy group. In this vein, Indicated Shippers assert that the Commission should consider alternative procedures for defining the proxy group, and that the improvement in El Paso Natural Corporation's and the William Company's financial situation and the creation of the Spectra Group suggest that the corporate gas proxy group is becoming more representative.

46. Finally, NGSA urges the Commission to initiate a new proceeding to consider alternatives to the DCF methodology for determining gas pipeline ROEs. NGSA generally supports including MLPs in the proxy group, subject to adjustments, as a means of continuing to use the DCF method on a temporary basis. But it argues that a better long-term solution to determining gas pipeline ROEs would be to stop using the DCF method, and instead adopt a risk premium approach to determining ROE. It asserts that the risk premium approach is used in Canada and does not require adjustments to account for variations in corporate structure.[58] INGAA states in its reply comments that the DCF methodology is not necessarily the only financial model that may be used, and asks the Commission to clarify that parties may propose other approaches in individual rate cases.[59]

2. Discussion

47. As the Commission pointed out in the proposed policy statement, the Supreme Court has held that "the return to the equity owner should be commensurate with the return on investment 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."[60] In order to attract capital, "a utility must offer a risk-adjusted expected rate of return sufficient to attract

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[57] APGA initial comments at 14.

[58] NGSA initial comments at 13-15.

[59] INGAA reply comments at 18.

[60] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1044).

investors."[61] In other words, the utility must compete in the equity markets to obtain capital.

48. The Commission performs a DCF analysis of publicly-traded proxy firms to determine the return on equity that markets require a pipeline to give its investors in order for them to invest their capital in the pipeline. As the court explained in *Petal Gas Storage, L.L.C. v. FERC*, the purpose of the proxy group is to "provide market-determined stock and dividend figures from public companies comparable to a target company for which those figures are unavailable. Market-determined stock figures reflect a company's risk level and when combined with dividend values, permit calculation of the 'risk-adjusted expected rate of return sufficient to attract investors.'"[62] It is thus crucial that the firms in the proxy group be comparable to the regulated firm whose rate is being determined. In other words, as the court emphasized in *Petal*, the proxy group must be "risk-appropriate."[63]

49. The Commission continues to believe that including MLPs in the gas and oil proxy groups will, as required by *Petal*, make those proxy groups more representative of the business risks of the regulated firm whose rates are at issue. While there has been some modest expansion of the number of publicly-traded diversified natural gas companies that could be included in the proxy group, this does not change one basic fact. This is that more and more gas pipeline assets are being transferred to publicly-traded MLPs, whose business is narrowly focused on pipeline activities. As a result, these MLPs are likely to be more representative of predominantly pipeline firms than the diversified gas corporations still available for inclusion in a proxy group. As such, including MLPs in the gas pipeline proxy group should render the proxy group more "risk-appropriate," consistent with *Petal*. Moreover, MLPs are the only publicly traded ownership form for oil pipelines and are the most representative group for determining the equity cost of capital for oil pipelines.

50. As the court also emphasized in *Petal*, when a proxy group is less than clearly representative, there may be a need for 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.

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[61] *CAPP*, 254 F.3d at 293.

[62] *Petal*, 496 F.3d at 697, quoting *Canadian Association of Petroleum Producers v. FERC*, 254 F.3d 289 (D.C. Cir. 2001).

[63] *Id.* 6.

Expanding a proxy group to include MLPs whose business is more narrowly focused on pipeline activities should help minimize the need to make adjustments, because the proxy group should be more representative of the regulated firms whose rates are at issue.

51. While this Policy Statement modifies Commission policy to permit MLPs to be included in the proxy group, the Commission is making no findings at this time as to which particular corporations and/or MLPs should be included in the gas or oil proxy groups. The Commission leaves that determination to each individual rate case. In order to assist the Commission in determining the most representative possible proxy group in those cases, the parties and other participants should provide as much information as possible regarding the business activities of each firm they propose to include in the proxy group, including their recent annual SEC filings and investor service analyses of the firms. This information should help the Commission determine whether the interstate natural gas or oil pipeline business is a primary focus of the firm and whether investors view an investment in the firm as essentially an investment in that business. While the Commission is not precluding use of diversified corporations or MLPs in the proxy group, the probable difference in the risk of the natural gas pipeline business and the risk profile of a diversified gas corporation with substantial local distribution activities has been highlighted by the parties and specifically recognized by the court in *Petal*.[64]

52. As discussed further below, the Commission recognizes that there are significant differences in the cash flows to investors and growth rates of corporations and MLPs. However, as discussed below, the Commission believes that those issues may be accounted for in a correctly performed DCF analysis, and therefore these differences do not preclude inclusion of MLPs in the proxy group.

53. Finally, the Commission has concluded that it will not explore other methods of determining the equity cost of capital at this time. The DCF model is a well established method of determining the equity cost of capital,[65] and other methods such as the risk premium model have not been used by the Commission for almost two decades. In the Commission's judgment, the uncertainty that would be created by reopening its procedures to include other approaches outweighs any limitations in its current pragmatic

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[64] *Id.* at 6-7.

[65] *See Illinois Bell Telephone Co. v. FCC*, 988 F.2d 1254, 1259 n. 6 (D.C. Cir. 1993), stating, "The DCF method 'has become the most popular technique of estimating the cost of equity, and it is generally accepted by most commissions. Virtually all cost of capital witnesses use this method, and most of them consider it their primary technique.'" *quoting J. Bonbright et al., Principles of Public Utility Regulation* 318 (2d ed. 1988).

approach to the financial characteristics of MLPs. Therefore the alternatives suggested by certain of the parties will not be pursued further here. Nothing submitted at the January 23rd technical conference warrants different conclusions.

B. The Proposed Adjustment to MLP Cash Distributions

1. Comments

54. Both the Pipeline and Customer Interests attack the proposed earnings cap on MLP distributions, with the Pipeline Interests asserting the cap is unnecessary and the Customer Interests asserting the cap should be lower. The Pipeline Interests assert that there is no need to adjust the distributions included in the DCF model. They argue that investors include all cash flows that are generated by an MLP in applying a DCF model and do not distinguish between a return of investment and a return on investment[66] since depreciation is an accounting concept that is used to calculate an MLP's earnings that is not relevant to determining the cash flows included in a DCF analysis.[67] The Pipeline Interests further assert that an unadjusted DCF calculation does not result in the double recovery of the depreciation component of an MLP's cost-of-service.[68]

55. Moreover, the Pipeline Interests assert that, because all parts of the DCF model are linked, if the distribution component is reduced, this will necessarily affect the growth component of the model. They assert that any adjustment limiting the distributions used to earnings will result in below market returns to investors and thus any such adjustment is arbitrary.[69] As an alternative, they suggest that if an MLP's distributions are unrepresentative, it is wiser to exclude that MLP from the sample as an outlier.[70] They further assert there have been corporations in the proxy group that have distributed

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[66] AOPL initial comments at 16, 18; Spectra Energy initial comments at 14; NAPTP initial comments at 3.

[67] INGAA initial comments at 5-6, 15-18; NAPTP initial comments at 4-5; MidAmerican initial comments at 5; Panhandle initial comments at 3 and attachment; Williston initial comments at 11.

[68] INGAA initial comments at 15-17 and 20-21.

[69] AOPL initial comments at 8, 10; INGAA initial comments at 13-14; Spectra initial comments at 4; PAPTP initial comments at 4.

[70] INGAA initial comments at 13; Spectra Energy initial comments at 5, 19-20.

dividends in excess of earnings for years and the Commission has never required an adjustment.[71] They claim that in any event there are practical problems with an earnings cap because earnings are reported quarterly (unlike distributions which are reported monthly) and such reports are unedited and may require seasonal adjustments.[72]

56. The Customer Interests support the Commission's initial conclusion that an adjustment to MLP distributions is necessary to remove a double count attributed to depreciation, but they also uniformly assert that the proposed adjustment is inadequate to compensate for a wide range of financial factors that distinguish MLPs from Schedule C corporations. Thus, they assert that further adjustments to the distributions should be made to reflect the tax advantages that flow to MLPs,[73] the alleged distortions that result from incentive distributions to the general partner,[74] and the fact that distributions may also include cash derived from the sale of assets, bond issues, and the issuance of further limited partnership units.[75] Several also assert that for an MLP's distribution to be comparable to that of a corporation, the percentage of the MLP's distribution included in the DCF model should be no higher than the percentage of earnings corporations typically include in their dividend payments, or about 60 percent.[76] Finally, to the extent that INGAA and others assert that depreciation is not a direct source of cash flow for distribution, the Customer Interests cite to investor literature and MLP filings with the SEC disclosure that state exactly the opposite.[77]

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[71] INGAA initial comments at 18; MidAmerica initial comments at 6.

[72] AOPL initial comments at 24-25; Spectra Energy initial comments at 17-18.

[73] Crowley Energy at 2; Indicated Shippers initial comments at 24; PSCNY initial comments at 12-13; Society initial comments, *passim*.

[74] APGA at 7-8; Crowley Energy at 2; Indicated Shippers comments at 24; NGSA at 6; Society initial comments *passim*.

[75] Crowley Energy initial comments; Society, *passim*; Tesoro reply comments at 26.

[76] CAPP initial comments at 3, 6; Indicated Shippers initial comments at 23; PSCNY initial comments at 6; Tesoro initial comments at 15.

[77] APGA initial comments at 11; CAPP reply comments at 3-4; NGSA reply comments at 9-10; Tesoro reply comments at 19-21.

2. Discussion

57. The Commission concludes that a proposed earnings cap on the MLP distributions that would be included in the DCF model should not be adopted. On further review, the Commission concludes that its concern with the distinction between return *on* capital and return *of* capital improperly conflates cost-of-service rate-making techniques with the market-driven DCF method used for determining the pipeline's cost of obtaining capital in the equity markets. This is inconsistent with the DCF model's internal structure.

58. The fundamental premise of the DCF model is that a firm's stock price should equal the present value of its future cash flows, discounted at a market rate commensurate with the stock's risk. No commenter seriously contends that an investor would distinguish between cash flows attributable to return *on* capital, and those attributable to return *of* capital, in performing a DCF analysis. In short, under the DCF model, all cash flows, whatever their source, contribute to the value of stock. The Commission agrees that, since the DCF model uses the total unadjusted cash flows to determine a stock's value, it is theoretically inconsistent to use lower adjusted cash flows when using the DCF model to determine the return required by investors purchasing the stock.

59. More specifically, the investor first determines what risk should be attributed to a prospective investment and the related return that would be required in order to make the investment. For example, the investor may conclude that the minimum return from the investment must be 10 percent on equity. The investor then looks at the total cash flows from all sources over time, including the current distribution (or dividend) and its projected growth. The DCF model yields a price for the share that reflects the present value of those cash flows at the discount rate.

60. In contrast, the Commission solves the DCF formula for the return required by the investor, not the price of the stock. This results in the Commission calculating the proxy firm's ROE as the sum of (1) the proxy firm's dividend yield and (2) the projected growth rate. The Commission determines dividend yield by dividing the proxy firm's cash distribution (or dividend) by its current stock price. As the court in *Petal* pointed out, both the stock price and distribution (or dividend) figures of the proxy firms are market-determined. Moreover, an investor's projection of the MLP's growth prospects would be affected by the actual level of its distributions, with distributions in excess of earnings generally perceived as reducing the growth projection because less cash flow is available for reinvestment in the firm.[78] The pipeline industry generally acknowledged

[78] Because a corporation typically retains a portion of its earnings, general financial theory suggests that it is able to use internally generated funds to obtain a higher growth rate. An MLP's higher level of distributions theoretically produces a lower projected growth rate. In fact, the most recent IBES projections for the four corporations

(continued…)

this fact in earlier rate proceedings as well as in this proceeding, or at least until its later phases.[79] As illustrated in Appendix B to this Policy Statement, a DCF analysis using market-determined inputs for each of the variables in the DCF formula appropriately determines, consistent with *Petal*, the percentage return on equity a pipeline must offer in the equity market in order to attract investors, whether the proxy firms are corporations or MLPs.

61. If the Commission were to cap the distribution used to determine an MLP's dividend yield at below the market-determined level, but use the actual market price of the MLP's publicly traded units and a growth projection reflecting the actual level of distributions, the DCF analysis would fail to achieve its intended purpose of determining the return the equity market requires in order to justify an investment in the pipeline. That is because there would be a mismatch among the inputs the Commission used for the variables in the DCF formula. The DCF analysis presumes that the market value of an MLP's units is a function of the entire present and future cash flow provided by an investment in those units. Given this interlocking nature of the variables in the DCF formula, INGAA and the other pipeline commenters are correct that limiting the distribution input to earnings, while using market values for the other inputs to the DCF formula, would result in the calculation of a return below that implied in the share price.[80]

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included in the gas pipeline proxy group in Appendix A average 10.5 percent, while the IBES growth projections for the six MLPs average only 6.67 percent.

[79] *See* AOPL Initial Comments, Williamson Aff. at 6-7; AOPL Reply Comments at 6-7; Panhandle Initial Comments, Attachment dated August 30, 2007, *Analysis of the Use of MLPs in the Group of Proxy Companies Used For Determining Gas and Oil Pipeline Return on Equity* at 10-11; *Transwestern Pipeline Company, LLC*, Docket No. RP06-614-000, Ex. TW-56 filed September 29, 2006, at 23-24; *High Island Offshore System, L.L.C.*, Docket No. RP96-540-000, Ex. HIO-73 filed August 26, 2006 at 28-29; *Texaco Refining and Marketing Inc, et al. v. SFPP, L.P.*, Docket No. OR96-2-012, Ex. SEP SFPP-56 dated February 14, 2005 at 9-10; *Mojave Pipeline Company*, Docket No. RP07-310-000, Ex. MPC-70 dated February 2, 2007 at 28-32 (including tables and charts on the relative growth rates of corporations and MLPs); *Kern River Gas Transmission Company*, Docket No. RP04-274-000, Ex. KR-107 at 17.

[80] The earnings cap on the distribution would artificially reduce an MLP's dividend yield below that assumed by the investor in valuing the stock. Adding the artificially reduced dividend yield to a growth projection that reflects the MLP's reduced growth prospects due to its high actual distributions would inevitably result in an ROE lower than that actually required by the market.

62. In addition, use of a proxy MLP's full distribution in determining ROE will not cause a double recovery of the depreciation component included in the pipeline's cost-of-service rates. In a rate case, the Commission determines the dollar amount of the ROE component of the cost-of-service of the pipeline filing the rate case by multiplying (1) the percentage return on equity required by the market by (2) the actual rate base of the pipeline in question. Having found that use of a proxy MLP's full distribution is necessary for the DCF analysis to accurately determine the percentage return on equity required by the equity markets, it necessarily follows that the same percentage should be used in determining the dollar amount of the ROE component of the pipeline's cost of service. Awarding the pipeline an ROE allowance based on that percentage of its own rate base will give the pipeline an opportunity to provide its investors with the return on their investment required by the market. Such an ROE allowance does not implicate the separate depreciation allowance the Commission also includes in a pipeline's cost of service to provide for return of investment.

63. The Commission therefore concludes that it is not analytically sound to cap the distributions to be included in the DCF model by the MLP's earnings. As discussed below, the record is more convincing that if any adjustment is required, this issue centers on the projected growth of the MLPs. Given this, it is not necessary to discuss the appropriate level for any earnings cap.

64. Having concluded that an earnings cap adjustment would be inappropriate, the Commission also concludes that it is not necessary to address the long term sustainability of MLPs as a whole, or those of the particular MLP whose rates are under review. As has been discussed, the DCF model has two components. One is the cash distribution in the current period and the second is the discounted value of the anticipated growth in that distribution. The increase in distribution is driven by the anticipated growth in earnings that generates the cash to be used for the distribution. If projected earnings suggest that the distribution cannot be sustained, this will be reflected in the projected cash flow for the firm and ultimately the MLP unit price.[81] In this regard, some MLPs will inevitably do better and others not as well, and from the Commission's point of view, this will be reflected in the required rate of return developed by the DCF model.

65. For this reason, as the Pipeline Interests suggest, if an MLP's financial condition or growth rate is outside the norm for the industry, or is unrepresentative, the best way to deal with this issue is to exclude that particular MLP from the proxy group sample, just

[81] The investor requires a minimum return that reflects the perceived risk of the investment. Thus, if the cash flows decline, so will the price of the stock assuming the percentage return required remains the same.

as the Commission has done with unrepresentative diversified gas corporations. Finally, the Commission has previously held that the issue of whether MLPs are an appropriate investment vehicle for the pipeline industry as a whole is a matter that is best left for Congress, the body that authorized MLPs in the first instance. Thus the Commission will not address that issue, or the appropriateness of the tax deferral aspects of MLPs further in this proceeding.[82] Nothing presented at the technical conference warrants different conclusions.

66. The Commission now turns to the issue of how to project the growth rates of MLPs. For the reasons discussed below, the Commission finds that the differences between MLPs and corporations, and particularly the MLPs' lower growth prospects due to their distributions in excess of earnings, are appropriately accounted for in the growth projection component of the DCF model.

C. The Short Term Growth Component

67. This section of the Policy Statement discusses whether changes should be made to the short-term growth component of the DCF model. For the short-term growth estimate the Commission currently uses security analysts' five-year forecasts for each company in the proxy group, as published by IBES. IBES is a service that monitors the earnings estimates on over 18,000 companies of interest to institutional investors. More than 850 firms contribute data to IBES to be used in its projections and the information is provided on a subscription basis.

1. Comments

68. The Pipeline Interests support the continued use of five-year IBES forecasts for short-term growth projections in the DCF model with regard to MLPs. In general, they argue that, while no growth forecast is perfect, IBES provides the best available information regarding what investors expect in companies. They state that IBES estimates are unbiased and publicly available. They add that since IBES estimates are company-specific, they already adjust for any differences among the entities analyzed, including whether the company is organized as an MLP or corporation.

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[82] *See SFPP, L.P.*, 121 FERC ¶ 61,240, at P 20-61 (2007) for an extensive discussion of these income tax allowance and tax deferral policy issues relating to MLPs. Moreover, any tax advantages are normally reflected in the MLP unit price. See also INGAA Reply Comments at 12-13; MidAmerica, Reply Comments at 4-5; AOPL Reply Comments at 11-12; Tr.121-22; AOPL Post-Technical Conference Comments at 14.

69. For example, NAPTP supports the IBES estimates because the various items that may affect the growth rate expected by the market, such as the effect of IDRs to the general partner, are already factored into IBES projections.[83] Williston Basin argues that since IBES data is drawn from many financial analysts, and since the information is widely accepted in the financial industry, use of IBES helps reduce subjectivity when estimating appropriate short-term growth forecasts.[84] TransCanada acknowledges that IBES may underestimate short-term growth for MLPs, but argues that modifying IBES would only further understate short-term growth rates and compound any problems brought on by trying to estimate growth for MLPs.[85] The AOPL similarly argues that studies have shown that IBES estimates understate short-term growth rates for MLPs and therefore the growth projections are conservative.[86]

70. However, certain parties recommend that the Commission discontinue using IBES estimates for MLPs to project short-term growth rates in its DCF model. These parties argue there is considerable uncertainty of whether the individual forecasts IBES is reporting reflect earnings growth or distribution growth. The State of Alaska asserts that IBES growth estimates of distributions per share are incomplete and unreliable for use in the DCF calculation. It argues that there are not a sufficient number of stock analysts providing IBES with distribution per share growth estimates to get a reliable estimate for the purposes of calculating the cost of equity for pipeline companies. Speaking for the State of Alaska, Dr. Thomas Horst notes that of the 37 gas and oil companies he examined data for, there was not a single case where IBES received two or more estimates of distributions per share growth rates.[87]

71. APGA states that through communications with personnel at Thompson Financial, the owner of IBES and the publisher of its forecasts, it verified that the five-year analysts' growth rate projections reported by IBES for MLPs are projections of earnings per unit, and not distributions per unit.[88] PSCNY also considers IBES projections unreliable, since

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[83] NAPTP, Initial Technical Conference Comments at 3.

[84] Williston, Additional Comments dated December 21 at 2.

[85] TransCanada, Additional Comments dated December 21 at 12-13.

[86] AOPL, Initial Technical Conference Comments at 5, Williamson Post-Technical Conference Aff. at 3, 8.

[87] State of Alaska, Reply Comments dated February 20 at 5.

[88] APGA, Reply Technical Conference Comments at 5-6.

they do not account for such parameters as IDRs. It questions whether analysts can truly estimate MLP growth beyond two years. It also questions whether lower earnings retention necessarily would translate into lower short-term IBES growth rates relative to corporations.[89] CAPP expresses concerns that the analysts that produce IBES growth estimates continue to be concentrated within the same financial institutions that also underwrite the securities of the subject companies, invest in those securities, and furnish other financial services to the subject enterprises[90] and also notes the uncertainty of whether the forecasts are for earnings or distributions.[91]

72. However AOPL maintains that historical records confirm that what analysts actually report to IBES is distribution growth. It adds that Yves Siegel, Wachovia's representative, confirmed that Wachovia provides projected MLP distribution growth to IBES, and not earnings growth.[92] NAPTP asserts that, for projecting the short-term growth rates of MLPs, the Commission should use analysts forecasts of growth in the MLP's distributable cash flow for all of its equity holders and that, while not perfect, this is the best information that is available.[93]

2. Discussion

73. The Commission's longstanding policy is to use security analysts' five-year growth forecasts as reported by IBES to determine the short-term growth rates for each proxy company. In *Opinion No 414-A*,[94] the Commission explained that the growth rate to be used in the DCF model is the growth rate expected by the market. Thus, the Commission seeks to base its growth projections on "the best evidence of the growth rates actually expected by the investment community."[95] Moreover, the Commission stated, the growth rate expected by the investment community is not, quoting a Transco witness, "necessarily a correct growth forecast; the market may be wrong. But the cost of

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[89] NYPSC Initial Technical Conference Comments at 5-6.

[90] CAPP Supplemental Comments dated December 21 at 3-4.

[91] CAPP Initial Technical Conference Comments at 7.

[92] AOPL Initial Technical Conference Comments at 4-5.

[93] NAPTP Post-Technical Conference Comments at 1-3.

[94] 85 FERC ¶ 61,323 at 62,268-9.

[95] *Id.* at 62,269.

common equity to a regulated enterprise depends upon what the market expects not upon precisely what is going to happen."[96]

74. The Commission held that the IBES five-year growth forecasts for each company in the proxy group are the best available evidence of the short-term growth rates expected by the investment community. It cited evidence that (1) those forecasts are provided to IBES by professional security analysts, (2) IBES reports the forecast for each firm as a service to investors, and (3) the IBES reports are well known in the investment community and used by investors. The Commission has also rejected the suggestion that the IBES analysts are biased and stated that "in fact the analysts have a significant incentive to make their analyses as accurate as possible to meet the needs of their clients since those investors will not utilize brokerage firms whose analysts repeatedly overstate the growth potential of companies."[97]

75. Based on the comments, the Commission concludes that the IBES five-year growth forecasts should also be used for any MLP included in the proxy group. While the Commission recognizes that there may be some statistical limitations to the IBES projections, the record here demonstrates that it remains the best and most reliable source of growth information available. IBES publishes security analysts' five-year growth forecasts for MLPs in the same manner as for corporations. No party questions the Commission's findings in past cases that investors rely on the IBES projections in making investment decisions, because they are widely available and generally reflect the input of a number of financial analysts. Also, since IBES projections are company-specific, they should already adjust for any differences among the entities analyzed, including any reduced growth prospects investors expect due to the fact an MLP makes distributions in excess of earnings. In fact, the most recent IBES projections for the seven MLPs included in the gas pipeline proxy group in Appendix A, Table 1, average 6.86 percent, while the IBES growth projections for the four corporations average of 10.75 percent. Thus, those MLP growth projections are about 400 basis points below those for the corporations.

76. As discussed above, several parties assert that the security analysts' five-year growth forecasts appear generally to be forecasts of growth in earnings, rather than distributions. They point out that the relevant cash flows for the DCF model are the MLP's distributions to the limited partners, and therefore the growth projections used in the DCF analysis should be growth in distributions, not earnings. Despite these concerns, the Commission again concludes that the IBES short-term growth projections provide the

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[96] *Id.*

[97] *Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279, at 61,932 (2000).

best estimate of short-term growth rates for MLP distributions. Professor J. Peter Williamson, on behalf of AOPL, reviewed historical IBES five-year growth forecasts for five oil pipeline MLPs since the mid-1990s. IBES had published five to nine growth forecasts for each the MLPs, with a total of 39 forecasts. Williamson compared each of these 39 forecasts to the MLP's actual growth in earnings and distributions during the subsequent five-year period. He found that 29 of the 39 IBES five-year forecasts, or 74 percent, were closer to the actual average distribution growths over that time span than the actual earnings growths. In his study, Williamson also found that historical records fail to support any claims that the IBES forecasts are biased or tend to overstate future growth.[98] In fact, 22 of the 39 forecasts were lower than the actual distribution growth, and 17 were higher. Thus, far from showing a pattern of overestimating actual growth in distributions, the IBES growth projections underestimated growth in distributions 56 percent of the time, a conservative result. Accordingly, regardless of whether financial analysts stated they are reporting projected earnings growth or projected distribution growth for MLPs, the Commission finds the five-year growth rates that IBES reports are acceptable since they closely approximate distribution growth for MLPs, which is the short-term input for the DCF model.

77. As noted, the State of Alaska expresses concerns that there are an insufficient number of stock analysts providing IBES with estimates which are expressly identified at forecasts of MLP distribution per share growth to obtain reliable short-term growth projections for MLPs. At the technical conference, Mr. Horst presented a chart showing the number of IBES report counts for 37 oil and gas pipeline companies – both corporations and MLPs. The chart breaks the analyst report counts down into earnings reports and distribution reports. It shows that analysts made an average of 3.1 earnings reports for each MLP and an average of 0.8 distribution reports for each MLP.[99] However, as discussed above, Williamson's analysis of a historical period suggests that actual MLP growth in the short term tracks IBES earnings projections better than distribution projections. Moreover, Mr. Horst's averages include many smaller, less frequently traded MLPs and thus understate the number of analysts that are likely to follow the larger, more established pipeline MLPs likely to be included in a proxy group. The Commission therefore concludes that the number of reports made by analysts for oil and gas companies MLPs is acceptable for use in the DCF model.

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[98] AOPL, Post-Technical Conference Comments, Williamson Aff. at 2-6.

[99] State of Alaska, Comments dated December 21, Second Horst Aff. at 4-5; Reply Comments dated February 20 at 5, Third Horst Aff. at 16-17, 21.

78. Some of the Customer Interests are agreeable to the continued use of IBES forecasts, but only under certain conditions. Specifically, PSCNY contends that, should the Commission continue to use IBES forecasts in its DCF model, any MLP the Commission allows in a proxy group must be market-tested and representative of a natural gas pipeline company. PSCNY contends that IBES would be acceptable if the MLP is tracked by Value Line, has been in operation for at least five years as an MLP, and derives 50-percent of its operating income from, or has 50 percent of its assets devoted to, interstate natural gas transportation operations. PSCNY also contends that the Commission should exclude MLPs from proxy groups when their growth projections are illogical or anomalous.[100]

79. The Commission agrees in principle with PSCNY's position that IBES forecasts should only be used for an MLP that is tracked by Value Line, has been in operation for at least five years as an MLP, and derives at least 50 percent of its operating income from, or 50 percent of its assets devoted to, interstate operations. Thus, when developing its proxy group, a pipeline should select MLPs that are well established and have assets that are predominantly gas and oil pipelines. Such pipelines are those most likely to have risk comparable to the pipeline seeking to justify its rates. However, there may be particular MLPs that do not satisfy these criteria, but are still appropriate for inclusion in the proxy group. The pipeline must justify including such an MLP in its proxy group. Thus, while the Commission encourages pipelines to follow the guidelines suggested by PSCNY, it will not make them a condition of including a particular MLP in the proxy group. As suggested by the parties, the Commission will continue to exclude an MLP from the proxy groups if its growth projection is illogical or anomalous.

80. Two parties state that, should the Commission continue to use IBES projections to estimate short-term growth rates in its DCF model for MLPs, it must modify the estimated rates. Tesoro states that, if the Commission makes no adjustments to dividend distributions of MLPs, it should significantly reduce its IBES short-term growth estimates to recognize the fact that an MLP cannot indefinitely sustain its operations when distributions consistently exceed earnings. It argues that, if the Commission caps MLP distributions at earnings, it would still have to reduce IBES rates in order to recognize the fact that proxy group members would not be reinvesting retained earnings in ongoing operations, thereby achieving lower growth rates. Tesoro only recommends no adjustments to short-term growth estimates if the Commission caps distributions at a level below earnings, offering 65-percent of earnings as an example.[101]

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[100] PSCNY Supplemental Comments dated Dec. 21 at 3-5.

[101] Tesoro, Comments on Growth dated December 21 at 3-4, 5-7.

81. The State of Alaska recommends that if a pipeline company's distributions per share exceed its earnings per share (as is frequently the case with pipeline MLPs), then the expected growth rate of the pipeline's distributions per share should be adjusted to equal (1) the expected growth of its earnings per share, multiplied by (2) the ratio of the pipeline's earnings per share to its distributions per share. According to Alaska, if a pipeline company distributes more cash than its current earnings, then the projected growth in earnings per share should also be adjusted by the ratio of the pipeline's earnings per share to its distributions per share.[102]

82. The Commission rejects these proposals by Tesoro and the State of Alaska. As already discussed, to the extent investors expect an MLP's distributions in excess of earnings to reduce its growth prospects, that fact should be reflected in the IBES five-year growth projections themselves, without the need for any further adjustment. MLPs must publicly report their earnings and distribution levels. Therefore, the security analysts are aware of the degree to which each MLP is making distributions in excess of earnings. The security analysts presumably take that information, together with all other available information concerning the MLP, into account when making their projections. Moreover, these proposals would have a similar effect as capping the distributions used to calculate dividend yield at or below the level of the MLP's earnings. For the reasons previously discussed, the Commission finds that any cap on an MLP's distributions used in the DCF model at a level below the actual distribution is inconsistent with the basic operation of the DCF model. Thus, using a straight IBES five-year projection without modification presents the best method of estimating an MLP's short-term growth rate.

83. APGA further suggests revising IBES growth rates by averaging them with the comparable growth forecasts reported by Zacks Investment. It states that this averaging could help remove anomalous or outlying growth rates. It offers as an example, on December 10, 2007, IBES projected a five-year growth rate of 7.60 percent for Kinder Morgan Energy Partners (KMEP), whereas Zacks Investment projected a 33.70 percent growth rate for that company. APGA argues that the Commission should also use Value Line reports to test the reasonableness of projected growth rates for MLPs.[103]

84. The Commission will not require that IBES growth rates be averaged with the corresponding company's growth rates as reported for Zacks Investment at this time, or

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[102] State of Alaska, Comments dated Dec. 21 at 3-4; Second Horst Aff. at 2-3, 5-11.

[103] APGA, Additional Comments dated Dec. 21 at 3, 9-10.

that Value Line reports be used to test the reasonableness of projected growth rates for MLPs. Finally, PSCNY requests that the Commission clarify that Thomson Financial Data posted on Yahoo.com may be used in the DCF formula, since Thomson Financial owns IBES.[104] The Commission clarifies that the growth projections to be used in the DCF model are those reported by IBES. If they are the same growth projections posted by Thomson Financial Data on Yahoo.com, then they are acceptable for the DCF model.

D. The Long Term Growth Component

1. Comments

85. As this point the critical issue is whether the long term growth component of the Commission's DCF methodology should be modified in determining the equity cost of capital for an MLP. As has been discussed, for more than a decade the Commission has required that projected long-term growth in GDP be used as the corporate long term (terminal) growth component of the DCF calculation. The discussion at the technical conference disclosed four general positions. The AOPL,[105] NAPTP,[106] INGAA,[107] and TransCanada[108] asserted that the use of long term GDP is equally applicable to MLPs as to corporations.[109] However, the APGA,[110] PSCNY,[111] and the State of Alaska[112] all

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[104] PSCNY, Supplemental Comments dated Dec. 21 at 5.

[105] AOPL, Post-Technical Conference Comments at 7-9, 13.

[106] NAPTP Additional Comments dated Dec. 21 at 1, 10-11; Post-Technical Conference Comments at 4-8.

[107] INGAA, Additional Initial Comments dated Dec. 21 at 2-3; Post-Technical Conference Reply Comments at 3-6.

[108] TransCanada Post-Technical Comments at 2-5.

[109] MidAmerican and Williston supported this position.

[110] APGA Additional Comments dated Dec. 21 at 4, 7-8; Initial Post-Technical Comments at 2, J. Bertram Solomon Aff. at 4-8.

[111] PSCNY, Supplemental Comments dated Dec. 21 at 5, 8-9 and appended Prepared Statement of Patrick J. Barry for the January 23, 2008 Technical Conference; Initial Post-Technical Conference Comments at 14-16.

[112] State of Alaska, Comments dated Dec. 21 at 3-4 and Second Horst Aff. at 3, 5-

(continued…)

made suggestions for a reduction to the GDP growth projection to reflect the different retention and investment practices of MLPs.[113] In a different vein, INGAA suggested the use of the average of the projected long term inflation rate and projected long term GDP as a proxy for the lower growth rate of the limited partnership interests, but only if the Commission concluded that some reduction in the MLP long term growth rate was warranted.[114] NAPTP further argued that there must be an upward adjustment of the limited partnership growth rate to reflect the equity cost of capital of the limited and general partners, and thus that of the entire firm.[115]

86. The Pipeline Interests also generally assert that an MLP's terminal growth can be at least equal to that of a corporation, and perhaps exceed it. They assert that MLPs are able to raise external capital in a tax efficient manner. Because an MLP does not retain cash it does not immediately need and can distribute without the tax penalty, it is under less pressure to invest idle capital. Rather, an MLP can wait until sounder investment opportunities are available and pursue them more discreetly, which results in a more consistent return from the projects selected.[116] Moreover, while the computation is very complicated, the tax-deferral aspects of MLP limited partnership interest normally result in a higher per unit price when issued and thus a lower cost of equity capital to the issuing MLP. For these reasons the Pipeline Interests conclude that MLPs should readily find profitable investment opportunities despite their lower retention ratios.[117]

87. The Pipeline Interests further assert that the record demonstrates that MLPs have a long term history of growing distributions and an overall growth rate that has at times been higher than that of corporations.[118] They cite to the example of KMEP in particular

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7. Reply Comments dated February 20, 2008 at 6.

[113] NGPA and Tesoro also supported a lower long term growth rate for MLPs.

[114] INGAA Additional Initial Comments dated Dec. 21 at 3-4 and Vilbert Report attached thereto, *passim*;

[115] NAPTP Reply Comments dated Sept. 19 at 2-4; Additional Comments dated Dec. 21 at 9-12.

[116] NAPTP Post-Technical Conference Comments at 9; TransCanada Post Technical Conference Comments at 8-9.

[117] NAPTP, *id.* 2, 5-6. TransCanada, *id.*

[118] NAPTP Additional Comments dated Dec. 21 at 4-8,

and that KMEP has been able to grow its distributions in good or poor financial environments.[119] They therefore conclude that there is no reason to conclude that MLPs cannot continue to grow at least as fast as corporations or that the relatively high distribution growth rate for the industry as a whole will not be sustained.[120] However, INGAA concedes that even if an MLP as a whole can grow as fast as a corporation, the limited partnership interests would grow less rapidly than the MLP as a whole because of the IDRs[121] most MLPs have granted their general partners.[122] The Pipeline Interests also argue that investors will not invest in enterprises that have a projected growth rate that is less than GDP and that such firms are likely to fail.[123]

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[119] NAPTP Additional Comments dated December 21 at 8.

[120] NAPTP and Post-Technical Conference Comments at 11-12 AOPL Post-Technical Conference at 9-10 and Williamson Post Technical Conf. Aff. Ex. at 1 and 2.

[121] IDRs operate as follows. Most MLP agreements provide that the limited partners own 98 percent of the equity when the firm is first created and the general partner 2 percent. Thus, given a distributable cash of $1,000, the limited partners would obtain $980 (98 percent) and the general partner $20.00 (2 percent). The partnership agreement also provides that as the total cash available for distribution increases, a greater share goes to the general partner, including that which would be available in liquidation. For example, the partnership agreement may provide that once distributable cash is $3,000, the general partner will receive 2 percent based on its partnership interest and 48 percent based on the IDRs.

At that point the limited partners' share of the distribution is $1,500 (50 percent) and the general partner's share is also $1,500 (50 percent). Thus, while the limited partners' distribution has grown in the relevant time frame (by 50 percent), it has not grown as fast as it would have absent the general partner's IDR. Absent the IDR the general partner's share would only be $60. Since a proportionately smaller share of future value flows to the limited partners in the initial years, the projected long term growth rate for a limited partnership interest will be lower. Therefore the limited partnership interests have lower return than that of the general partner.

[122] INGAA Additional Initial Comments dated December 21 at 5; TransCanada.

[123] AOPL, Post-Technical Comments at 7-8. TransCanada, Additional Comments dated Dec. 21 at 2, 4-5.

2. Discussion

a. Should the MLP long-term growth projection be lower than projected growth in GDP?

88. As discussed in the previous section, in determining the appropriate growth projections to use in its DCF analysis, the Commission seeks to approximate the growth projections investors would rely upon in making their investment decisions. This principle applies equally to the long-term growth projection, as to the short-term growth projection. When the Commission first established its policy of basing the long-term growth projections on projected growth in GDP in Opinion No. 396-B and *Williston I*, the Commission stated in both cases, "The purpose of using the DCF analysis in this proceeding is to approximate the rate of return an investor would reasonably expect from a pipeline company." [124] The Commission found, "the record shows that Merrill Lynch and Prudential Bache do not attempt to make long-term growth projections for specific industries or companies in doing DCF analyses. Instead they use the long-term growth of the United States economy as a whole as the long-term growth forecast for all firms, including regulated businesses."[125] The Commission thus relied heavily on evidence concerning investment house long-term growth projections in deciding to base its long-term growth projections for corporations that were properly included in the proxy group on the long-term growth of GDP. In affirming this aspect of *Williston I*, the D.C. Circuit similarly relied on the fact that the record "demonstrated that major investment houses used an economy-wide approach to projecting long-term growth . . . and that existing industry-specific approaches reflected investor expectations and many unfounded economic assumptions."[126]

89. Consistent with this precedent, the key question in deciding what long-term growth projection the Commission should use in its DCF analysis of MLPs is whether investors expect MLP long-term growth rates to be less than projections of growth in

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[124] Opinion No. 396-B, 79 FERC ¶ 61,309 at 62,383. *Williston I*, 79 FERC at 62,389.

[125] Opinion No. 396-B, 79 FERC ¶ 61,309 at 62,382. *Williston I*, 79 FERC ¶ 61,311 at 62,389. As the Commission pointed out in a subsequent case, the exhibits in both the Opinion No. 396-B proceeding and *Williston I*, describing Prudential Bache's methodology stated that it used a lower long-term growth projection for electric utilities, because of their high payout ratios. *System Energy Resources, Inc.*, 92 FERC ¶ 61,119, at 61,445 n.23 (2000).

[126] *Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54 (D.C. Cir. 1999).

GDP. The record established here shows that at least two major investment houses project terminal growth rates for MLPs that are notably lower than the current 4.43 percent projected growth in GDP. Citicorp Smith Barney (Citicorp)[127] projects a 1 percent terminal growth rate for pipeline MLPs. Wachovia projects terminal growth rates for individual MLPs that vary from zero to 3.5 percent.[128] The Wachovia projection for each MLP which the Commission is likely to include in a proxy group[129] is for a 2.5 percent terminal growth rate.[130] The Pipeline Interests did not submit any evidence of a major investment house projecting long-term growth rates for MLPs equal to or above the growth in GDP. Thus, applying the same approach as that in Opinion No. 396-B and *Williston I*, the record supports a finding that investors project MLP growth rates significantly below the growth in GDP.

90. To counter this conclusion, the Pipeline Interests argue that these lower figures reflect the investment houses' desire to use "conservative" estimates in order to prevent unrealistic investor expectations. However, as discussed above, the Commission has found in earlier cases that investment houses try to give the most accurate information to their investors. In any event, it is appropriate for the Commission to use growth

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[127] Society, Reply Comments at 11, citing: *Citicorp Master Limited Partnership Monitor and Reference Book,* Citigroup Investment Research (March 2007) at 28, Figure 24.

[128] Comments of Enbridge Energy Partners, L.P., Attachment A, Wachovia Equity Research Paper dated August 20, 2007 at 9-12; Wachovia Equity Research dated January 30, 2008, *MLP Outlook 2008: Cautious Optimism* at 39-44.

[129] These are the MLPs listed in Tables 1 and 2.

[130] NAPTA, in its Post-Technical Conference Comments, provided a publication by Morgan Stanley Research which, among other things, reported on our January 23, 2008 technical conference. That publication, at page 3, states, "At Morgan Stanley, we assume an MLP will increase its cash flow – 1.5%-3.0% per year beyond 2012. Importantly we make the same assumption in forecasting long-term growth for our C-Corp companies." *Pipeline MLPs: What's in the Pipeline*, Morgan Stanley Research at 3. These projections are also less than the current projection of 4.43 percent long-term growth in the economy as a whole. However, we give greater weight to the Citigroup and Wachovia publications, because those publications include specific long-term growth projections for individual MLPs, whereas the Morgan Stanley publication simply sets forth a general range it uses without specifying how that range is distributed among individual firms. Also, the Citigroup and Wachovia analyses were not issued in response to the technical conference.

estimates that reflect the investment houses' view of what investors should realistically expect from an investment in an MLP. Moreover, the fact that some MLPs have grown rapidly in the past does not mean necessarily that they will maintain the same growth rate in the future. In fact, KMEP's projected growth rate is expected to drop in future years.[131] This record also demonstrates that a rate of long term growth is dependent on the base years selected. Thus, the Customer Interests focus on more recent years to show that the growth rate has slowed for many MLPs.[132]

91. The Pipeline Interests also argue that investors will not invest in entities with a projected long term growth rate that is less than the long-term growth in GDP.[133] However, the fact is that, despite major investment houses advising their clients that MLPs will have long-term growth rates below GDP, investors have continued to invest in MLPs, and in increasing amounts through 2007. Historically this was true even though the Commission's analyses continue to indicate that the IBES five-year growth projections for MLPs are lower than those for corporations.[134]

92. At bottom, the key financial assumption advanced by the Pipeline Interests is that MLPs and corporations have equal access to capital. However, the Customer Interests advance credible reasons why MLPs may not have as ready access to capital markets in the future given the MLPs' unique financial structure. This would reduce the total capital pool available to the MLPs, thus reducing their growth prospects. These include a greater exposure to interest rate risk,[135] the increased cost of capital that a high level of IDRs imposes on an MLP,[136] and lower future returns from either acquisitions or organic

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[131] APGA, Post-Technical Conference Reply Comments, Solomon Aff. at 4.

[132] APGA, Post-Technical Conference Reply Comments at 4-5 and attached Solomon Aff. at 4-9.

[133] TransCanada, Additional Comments at 5; AOPL Post-Technical Conference Comments at 8.

[134] See Appendix A, which displays in part the comparative corporate and MLP short term growth projections. *Cf.* PSCNY Post Technical Conference Comments at 7-8.

[135] Indicated Shippers Initial Comments at 21, citing Citicorp Smith Barney; AGPA Reply Comments at 5; Wachovia August 20, 2007 Report, *supra*, at 1-2;

[136] PSCNY Supplemental Comments at 3, n. 8 and Initial Post-Technical Conference Comments at 12.

investments as the MLP industry matures.[137] This latter point is of greater importance to MLPs because they are limited by law to a narrower range of investment opportunities than a schedule C corporation. These arguments suggest why the long term forecasts by investment houses investors rely on could conclude that the long term growth rate for MLPs would be less than the long term GDP the Commission uses for corporations. Each addresses the consistency of investment opportunities and as such consistency of access to capital markets that MLPs are dependent on to maintain long term growth.

93. In particular, the Commission concludes that corporations (1) have greater opportunities for diversification because their investment opportunities are not limited to those that meet the tax qualifying standards for an MLP and (2) are able to assume greater risk at the margin because of less pressure to maintain a high payout ratio. It is a corporation's higher retention ratio that allows this greater flexibility. This is consistent with the fact that Prudential Bache projected the long-term growth rates of electric utilities to be less than that of the economy as whole because of their greater dividend payouts and lower retention ratios.[138] Therefore, investors would quite reasonably conclude that MLP long term growth rates would be lower than that of tax paying corporations, because MLPs have fewer opportunities to participate in the broad economy that underpins the Commission's current use of long-term growth in GDP.

94. Thus, while it is true that the Commission uses GDP as a proxy for long term growth, the point here is not whether some firms, including MLPs may have a growth rate that is more or less than the proxy over time. The issue is whether MLPs have the same relative potential as the corporate based economy that has been the basis for the Commission's assumption that a mature firm will grow at the same rate as the economy as whole. For the reasons stated, the Commission concludes that the collective long term growth rate for MLPs will be less than that of schedule C corporations regardless of the past performance of MLPs the Pipeline Interests have inserted in the record.

b. What specific projection should be used for MLPs?

95. We now turn to the issue of exactly what long-term growth projection below GDP should be used in MLP pipeline rate cases. As the Commission recognized when it established its policy of giving the long-term growth projection only one-third weight, while giving the short-term growth projection two-thirds weight, "long-term growth

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[137] PSCNY Initial Post-Technical Conference Comments at 9-10 and cited Value Line attachments; Reply Comments at 5-6 citing Merrill Lynch, n. 16.

[138] *System Energy Resources, Inc.*, 92 FERC ¶ 61,119, at 61,445 n.23 (2000).

projections are inherently more difficult to make, and thus less reliable, than short-term projections."[139] Thus, as the Commission has stated with respect to the other aspects of its long-term growth projection policy, the Commission is "required to choose from among imperfect alternatives"[140] in deciding what specific long-term growth projection should be used for MLPs.

96. The technical conference panelists advanced four methods of determining long-term growth projections for MLPs which are less than the growth in GDP. After reviewing all four, the Commission adopts the APGA proposal to use a long-term growth projection for MLPs equal to 50 percent of long term GDP.[141] At present, that proposal results in a long-term growth projection of 2.22 percent. This is within the range of long-term growth projections used by investment houses for MLPs discussed in the preceding section. For example, Wachovia projects terminal growth rates for individual MLPs that vary from zero to 3.5 percent,[142] and its projection for each MLP which the Commission is likely to include in a proxy group is for a 2.5 percent terminal growth rate.[143] Therefore, in light of the inherent difficulty of projecting long-term growth, the 50 percent of GDP proposal would appear to result in a long-term growth projection that

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[139] *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶ 61,084, at 61,423 (1998).

[140] *Northwest Pipeline Corp.*, 88 FERC ¶ 61,298, at 61,911 (1999).

[141] APGA Additional Comments dated Dec. 21 at 2-3, 8; Outline for the Presentation of Bertrand Solomon on the Behalf of APGA dated January 23, 2008 at 3; Initial Post-Technical Conference Comments. J. Bertrand Solomon Aff. at 3-4, 6-7 and supporting exhibits.

[142] Comments of Enbridge Energy Partners, L.P., Attachment A, Wachovia Equity Research Paper dated August 20, 2007 at 9-12; Wachovia Equity Research dated January 30, 2008, *MLP Outlook 2008: Cautious Optimism* at 39-44.

[143] The Commission will not use the specific long-term MLP growth projections of the investment houses to determine the cost of equity for specific firms for the same reasons we have not done so with respect to the projections of long-term growth in GDP the Commission uses for corporations. As the Commission explained in *Michigan Gas Storage Co.*, 87 FERC ¶ 61,038, at 61,162-5 (1999) and *Williston Basin Interstate Pipeline Co.*, 87 FERC ¶ 61,264, at 62,005-6 (1999), there is no evidence as to how the investment house figures were derived which limits their utility in determining the cost of equity for an individual firm. However, as here, the Commission has relied on the perceptions of the investment community in developing a generic long term growth rate. See also Opinion No. 396-B, 79 FERC ¶ 61,309 at 62,384.

falls within any reasonable margin of error for such projections, while giving recognition to the fact that investors expect MLPs' long-term growth to be less than that of GDP.[144]

97. The Commission also concludes that the other three proposed methods of projecting MLP long-term growth rates all have flaws justifying their rejection. The State of Alaska and the NYPSC propose methods which would result in varying long-term growth projections for each MLP, based upon financial information for each of the MLPs to be included in a proxy group. These proposals are contrary to the Commission's policy of using a single long-term growth projection for all corporations, based on the fact that it is not possible to make reliable company-by-company long-term growth projections.[145] The State of Alaska and NYPSC have provided no basis to conclude that they have provided a more reliable way to make long-term growth projections for individual MLPs. Their difficulty in doing so reinforces the Commission's traditional practice in this regard.

98. The State of Alaska suggests adjusting the GDP long term growth projection used for each MLP based on its current positive or negative retention ratio.[146] Thus, if an MLP's retention ratio was positive, then 100 percent of long term growth in GDP would be used. If the retention ratio was less than one, then the long term growth in GDP would be reduced accordingly. This theory essentially caps the long term growth rate at the earnings of the entities involved. As such, it suffers from the same weakness as the original proposal to cap the distribution component included in the model at earnings. Consistent with the premise of the DCF model that a stock is worth the present value of all future cash flows to be received from the investment, investors base their DCF analyses on the MLP's entire cash distributions, including projected cash flows generated by external investments, which to date is the bulk of the investment for the MLP model. In addition, because MLPs rely substantially on external capital to finance growth, the fact one MLP currently pays out more of its earnings than another MLP does not necessarily mean that the first MLP's long-term growth prospects are less than the second MLP's. Moreover, Alaska's proposed method assumes each MLP's current retention

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[144] As the D.C. Circuit stated with respect to our choice of the relative weighting of the short- and long-term growth projections, the choice of the long-term growth component is also an exercise "hard to limit by strict rules." *CAPP v. FERC*, 254 F.3d at 290.

[145] Opinion No. 396-B, 79 FERC ¶ 61,309 at 62,382.

[146] State of Alaska, Comments dated December 21 at 3-4 and Second Horst Aff. at 3, 5-7. Reply Comments dated February 20, 2008 at 6.

ratio will continue indefinitely into the future, without any support for the accuracy of such an assumption.

99. The NYPSC recommends use of a modified form of the sustainable growth model the Commission uses to determine electric return on equity.[147] Under that method, the Commission determines growth based on a formula under which growth = br + sv, where b is the expected retention ratio, r is the expected earned rate of return on common equity, s is the percent of common equity expected to be issued annually as new common stock, and v is the equity accretion rate. The br component of this formula projects a utility's growth from the investment of retained earnings, and the sv component estimates growth from external capital raised by the sale of additional units. The NYPSC would assume zero growth from investment of retained earnings (the br component) and then base the long-term growth projection for each MLP on projected growth from external capital resulting from the sv component of the br + sv formula.

100. A fundamental problem with this approach is that the Commission has consistently held that the br + sv formula only produces a projection of short-term growth, similar to the IBES projections.[148] This follows from the fact that the inputs used in the formula are all drawn from Value Line data and projections reaching no more than five years into the future. In addition, there would be great uncertainties in projecting any of the inputs to the formula, such as the retention ratio, the amount and timing of equity sales, and the projected price of the sale for any longer period. Moreover, setting the br component at zero assumes that an MLP can only grow through the use of external capital. This does not reflect accurately the retention and investment flexibility vested in an MLP's general partners or the fact that some MLPs may reinvest a fairly high proportion of the free cash available. Therefore this methodology does not appropriately adjust the long term GDP component that the Commission now uses for corporations.

101. Finally, INGAA provided a complex model designed to calculate the equity cost of capital for an MLP as a whole.[149] This model was developed by Mr. Vilbert and

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[147] PSCNY, Supplemental Comments dated Dec. 21 at 5, 8-9 and appended Prepared Statement of Patrick J. Barry for the January 23, 2008 Technical Conference; Initial Post-Technical Conference Comments at 14-16.

[148] *See Southern California Edison Co.*, 92 FERC ¶ 61,070, at 61,262-3 (2000).

[149] INGAA, Additional Initial Comments dated Dec. 21 at 4-5 and *Report on the Terminal Growth Rate for MLPs for Use in the DCF Model* by Michael J. Vilbert dated December 21, 2007 (Vilbert Report), particularly at 10.

attempts to calculate the equity cost of capital for both the limited and the general partners. At their inception, MLPs establish agreements between the general and limited partners, which define how the partnership's cash flow is to be divided between the general and limited partners. Such agreements give the general partners IDRs, which provide for them to receive increasingly higher percentages of the overall distribution, if the general partners are able to increase that distribution above defined levels. The INGAA model recognizes that, as a result of these incentive distribution rights, a DCF analysis of the MLP as a whole should (1) include higher projected growth rates for the general partner interest than for the limited partner interest and (2) a correspondingly higher value for general partner interests than the MLP units which would, in turn, reduce the general partner's current "dividend" yield. However, since there are relatively few publicly traded general partner interests, in most cases the estimated equity cost of capital for the general partner can only be derived through various assumptions that markup the limited partner's cost of capital.

102. INGAA drew two significant conclusions from Mr. Vilbert's analysis. First, application of the Commission's existing DCF methodology solely to the limited partner interest in the MLP would generate returns relatively close to those that would be required to reflect the growth rate, and cost of equity capital, for the MLP as whole. Second, if the Commission remains concerned that a DCF analysis using data solely for the limited partner interest,[150] together with a long-term growth rate equal to the growth in GDP, may overstate the appropriate return based on the limited partners' projected growth, the long-term growth projection could be adjusted by averaging projected long term GDP and the projected long term inflation rate.[151] The latter would have to be updated regularly to test its accuracy.

103. Mr. Horst, the witness for the State of Alaska, responded that the INGAA model was mathematically correct, but that the model's assumptions about the rate of growth and incentive distributions were open to question and the results would overstate the equity for the MLP as a whole.[152] INGAA filed a reply to Mr. Horst's arguments by Mr. Vilbert that first calculates the actual DCF values for eight publicly traded general

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[150] In such a DCF analysis the dividend yield would be calculated by dividing the distribution to the limited partner by the limited partner share price.

[151] INGAA Additional Initial Comments dated Dec. 21 at 4-6; Vilbert Report at 18-19.

[152] State of Alaska, Reply Comments dated February 20, 2008 at 6 and Third Horst Aff. at 6-15.

partner interests.[153] Mr. Vilbert then compares the resulting value of the general partner interests for the same eight firms generated by the model. The results calibrate more closely to the eight market samples than the analysis produced by Mr. Horst but, like Mr. Horst's analysis, tend to overstate the value of the general partner interest.

104. The Commission will not use the INGAA model for several reasons. First, the internal operations of the model are relatively opaque, and the model appears to have a relatively wide range of error. Second, as the court stated in *Petal Gas Storage, L.L.C. v. FERC*,[154] the purpose of the proxy group is to "provide market-determined stock and dividend figures from public companies comparable to a target company for which those figures are unavailable." While INGAA used eight publicly traded general partner interests to test the validity of the model, most of those interests are not related to MLPs that have been proffered in rate proceedings before the Commission. In the absence of such market-determined figures for the general partner interest of the MLPs to be included in the proxy group, use of the INGAA model would necessarily entail deriving an estimated equity cost of capital for the general partner through various assumptions that markup the limited partner's cost of capital. In these circumstances, use of the INGAA model would be inconsistent with the purpose of the proxy group of providing a fully market-based estimated cost of capital.

105. INGAA alternatively suggested that the returns from the current methodology be reduced somewhat to reflect the admittedly lower growth rate of a MLP's limited partnership interests. However, its proposal to do that by averaging GDP growth projections with the Federal Reserve's target inflation rate appears to have no analytical basis. Therefore, INGAA's recommendations will not be accepted here.[155]

106. Based upon the above discussion, the Commission concludes that the long term growth component for an MLPs equity cost of capital should be 50 percent of long term GDP, rather than the full long term GDP currently used for corporations.

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[153] INGAA, Post-Technical Supplemental Comments dated March 12, 2008 at 2-4 and Vilbert Aff. attached thereto, *passim*. The Commission will accept INGAA's March 12 filing because INGAA had no earlier opportunity to reply to the material contained in the State of Alaska's February 20, 2008 filing.

[154] 496 F. 3d 695 at 699.

[155] See AOPL Post-Technical Comments at 3-4, which suggest that the complexity of Mr. Vilbert's model and the use of its assumption indicate that it is more appropriate to rely on the limited partners' distributions in a DCF analysis.

c. Proposed upward adjustments to the long term component

107. NAPTP asserted that the Commission should increase rather than decrease the long term growth component used to determine an MLP's equity cost of capital to reflect the general partner component of an MLP's equity.[156] It asserts that equity cost of capital must be determined for the MLP as a whole, not just for the limited partners. NAPTP asserts that the return, and hence the projected growth rate, must generate sufficient cash flows to support the IDRs provided the general partner under most MLP agreements. To this end, it marked up the growth rate of the limited partners to reflect the portion of the equity effectively controlled by the general partner through its IDRs. Thus, growth rate for the limited partners was 10 percent and general partner received a total of 50 percent of the distributions, the growth rate for the general partner could be as high as 20 percent. The Shipper Interest partners argued that this only rewarded the general partner for its excessive distributions and would inordinately increase the MLPs equity cost of capital.

108. Both INGAA's witness Vilbert and the State of Alaska's witness Horst rejected the NAPTP approach on mathematical grounds. Both argue that the gross-up fails to properly value the general partner's interest at multiples that reflect the general partner interest's relative risk to that of the limited partners.[157] Furthermore, Vilbert argues that the general partner's risk, while always greater than that of the limited partner, declines as the MLP matures and the general partner's share of distributions increases.[158] As this occurs, the growth rate of the general partner's interest slows and approaches that of the limited partner. Failure to adjust for both facts means that the general partner's interest is undervalued using the NAPTP method, thus overstating the yield, and thus the return, that would be incorporated in the DCF model. As such, the NAPTP approach is inappropriate.

109. The Commission agrees that the NAPTP method is mathematically and conceptually flawed. Moreover, it has the same basic limitation as the INGAA model in that there is simply not enough publicly generated, transparent information at this time to support developing an equity cost of capital for the MLP as a whole. INGAA likewise

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[156] NAPTP Additional Comments dated Dec. 21 at 3-4.

[157] State of Alaska, Reply Comments dated February 20, 2008 at 6 and Third Horst Aff. at 2, 4-5.

[158] INGAA, Post-Technical Supplemental Comments dated March 12, 2008 at 2-4 and Vilbert Aff. at 6-12.

attempted to develop an approach that would reflect the growth rate, and the return, of the MLP as a whole. The Commission has previously concluded that this approach has too many practical limits. Therefore the Commission will not pursue this issue further here.

E. The Weighting of the Growth Components

110. The third issue is whether to change the weighting of the short-term and long-term components now used in the Commission's DCF model. As has been discussed, the Commission's existing policy is to provide two-thirds of the weight to the short-term component and one-third to the long- term component. TransCanada suggested changing the weighting, so that the 90 percent of the weight should be to the short-term component.[159] MidAmerica recommended the use of a single stage model and abandoning the long-term component completely.[160] However, these suggestions received no support from the other parties and would serve to increase the overall returns by sharply diminishing or eliminating the long-term component of the DCF.

111. As discussed in the previous section, the Commission's longstanding policy is that the growth component of the DCF analysis of gas and oil proxy companies must include a projection of long-term growth, and the court affirmed that policy in *Williston I*. As the Commission has explained in numerous orders, the DCF methodology requires that a long-term evaluation be taken into account. In the preceding section, the Commission has fully discussed why the long-term growth projection for MLPs should be 50 percent of projected long-term growth of GDP.

112. The Commission established its policy of giving the long-term growth projection one-third weight, while the short-term growth projection is given two-thirds weight, in *Opinion Nos. 414-A*. The Commission explained its weighting policy as follows:

> While determining the cost of equity nevertheless requires that a long-term evaluation be taken into account, long-term projections are inherently more difficult to make, and thus less reliable, than short-term projections. Over a longer period, there is a greater likelihood for unanticipated developments to occur affecting the projection. Given the greater reliability of the short-term projection, we believe it appropriate to give it greater weight. However,

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[159] TransCanada, Reply Comments at 13-14; Additional Comments dated December 21 at 9-12.

[160] MidAmerican Response to Request for Additional Comments dated December 21 at 9-11.

> continuing to give some effect to the long-term growth projection will aid in normalizing any distortions that might be reflected in short-term data limited to a narrow segment of the economy.[161]

The court affirmed this policy in *CAPP v. FERC*,[162] stating that "in an exercise so hard to limit by strict rules, it would likely be difficult to show that the Commission abused its discretion in the weighting choice."

113. The need to normalize any distortions that may be reflected in short-term data limited to a narrow segment of the economy applies equally to the IBES five-year growth projections for MLPs as for corporations. At the same time, the two-thirds weighting for the short-term growth projections recognizes their greater reliability. Moreover, TransCanada does not establish why the MLP short-term growth projections should be accorded a greater weight than that of corporations. In fact, as was discussed in the previous section, the record reasonably shows that investment houses include a long-term growth component in their DCF analyses of MLPs, and use a long-term growth projection that is lower than the projected long-term growth in GDP. Therefore the Commission will not modify the two-thirds to one-third ratio it now uses in its DCF model and will apply that ratio to all pending cases.

V. Pending Proceedings

114. The procedural issue here is whether this Policy Statement should be applied to all proceedings that are now before the Commission for which the ROE issue has not been resolved with finality. NGSA asserts that any new policy should apply only prospectively and not to cases now pending before the Commission. Indicated Shippers take the same position, asserting that application of the Policy Statement to pending proceedings would be administratively inefficient and would materially delay instituting new rates in the *Kern River* proceeding, which is now before the Commission on rehearing. Indicated Shippers further argue that in *Kern River* the Commission addressed and rejected the use of MLPs without some adjustment to reflect the fact that MLP distributions involve both a return of and return on equity. They also argue that there would be no inequity because Kern River could always file a new section 4 rate case if the existing proceeding proved unsatisfactory. Finally, Indicated Shippers assert that a policy change should not be applied retroactively because it does not have the force of

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[161] Opinion No. 414-A, 84 FERC at 61,423.

[162] 254 F.3d at 289.

law[163] and because policy statements are considered "statements issued by the agency to advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power."[164]

115. MidAmerica answered that the Policy Statement must be applied to all pending cases and *Kern River* in particular for two reasons. It states that in *Petal* the court both seriously questioned the Commission's analysis regarding MLPs and held that it was improper to include an entity of higher risk (a pipeline) and one of lower risk, such as a diversified natural gas company, in the same sample without adjusting the returns. MidAmerica argues that application of the *Williston* doctrine[165] requires that it be given an opportunity to address the return on equity issue further. This is particularly the case since the court suggested applying the upper end of the range of reasonableness as a way of compensating for the difference in risk. MidAmerica asserts that application of either this suggestion or use of the unadjusted MLP sample Kern River advanced at hearing would result in the same return on equity.

116. The Commission concludes that the instant Policy Statement must be applied to all proceedings now pending at hearing before an ALJ or before the Commission for which the ROE issue has not been resolved with finality. In *Petal v. FERC*, the court vacated and remanded the Commission's orders on the ROE issue in both *Petal* and *HIOS*. In both those cases, the Commission applied its current policy of using 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. The court found that the Commission had not shown that the proxy group arrangements used in those cases were risk-appropriate. In this Policy Statement we have reexamined our proxy group policy in light of the *Petal v. FERC* remand as well as current trends in the gas and oil pipeline industries, and determined we must modify our policy as discussed above. Therefore, because the Commission's current proxy group policies as applied in prior

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[163] *Citing Consolidated Edison of New York, et al., v. FERC*, 315 F.3d 316, 323-24 (D.C. Cir. 2003) (*Consolidated Edison*).

[164] *Citing American Bus Assn. v. ICC*, 627 F.2d 525, 529 (D.C. Cir. 1980).

[165] *See Williston Basis Interstate Pipeline Co. v. FERC*, 165 F.3d 54 (D.C. Cir. 1999) (*Williston*). MidAmerica cites to the related administrative proceeding, *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036 (2003), but the principles are the same. The cited Commission case was in response to the remand in cited court decision.

cases have not withstood court review, the Commission cannot and will not apply them in currently pending cases in which there has been no final determination of ROE issues.

The Commission orders:

(A) The Commission adopts the Policy Statement and supporting analysis contained in the body of this order.

(B) This Policy Statement is effective the date issued and shall apply to all oil and gas pipelines then pending before the Commission in which there has been no final determination of ROE issues.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

APPENDIX A

TABLE 1

DCF Analysis for Selected Corporations and MLPs Owning Jurisdictional Natural Gas Pipelines

Six-Month Period Ended 03/31/2008

Company	(1) 6-mos Avg Dividend Yield	(2) Growth Rate ("g") IBES (03/08)	(3) GDP (1/22/08)	(4) Composite	(5) Adjusted Dividend Yield	(6) Estimated Cost of Equity
Spectra Energy Corp.	3.65%	6%	4.43%	5.48%	3.75%	9.23%
El Paso Corp.	0.96%	11%	4.43%	8.81%	1.00%	9.81%
Oneok Partners, LP	6.66%	5%	2.22%	4.07%	6.80%	10.87%
Boardwalk Pipeline Partners, LP	6.29%	6%	2.22%	4.74%	6.44%	11.18%
Oneok, Inc.	3.10%	10%	4.43%	8.14%	3.23%	11.37%
TC Pipelines, LP	7.46%	5%	2.22%	4.07%	7.61%	11.68%
TEPPCO Partners, LP	7.31%	6%	2.22%	4.74%	7.48%	12.22%
Spectra Energy Partners	5.00%	10%	2.22%	7.41%	5.18%	12.59%
Enterprise Products Partners, LP	6.45%	8%	2.22%	6.07%	6.64%	12.71%
Kinder Morgan Energy Partners, LP	6.69%	8%	2.22%	6.07%	6.89%	12.96%
Williams Companies	1.17%	16%	4.43%	12.14%	1.24%	13.38%

Column (1) is taken from individual company analysis.

Column (2) is taken from I/B/E/S Monthly Summary Data, US Edition.

Column (3) is calculated from three sources: EIA, Global Insight, and SSA.

Column (4) = Column(2)*2/3 + Column(3)*1/3

Column (5) = Column(1)*(1 + 0.5*Column(4))

Column (6) = Column(4) + Column(5)

NOTE: This Appendix is for illustrative purposes only and does not prejudge what would be an appropriate proxy group for use in individual proceedings.

TABLE 2

DCF Analysis for Selected MLPs Owning Jurisdictional Oil Pipelines

Six-Month Period Ended 03/31/2008

Company	(1) 6-mos Avg Dividend Yield	(2) Growth Rate ("g") IBES (03/08)	(3) Growth Rate ("g") 50% GDP (1/22/08)	(4) Growth Rate ("g") Composite	(5) Adjusted Dividend Yield	(6) Estimated Cost of Equity
Buckeye Partners, LP	6.72%	5%	2.22%	4.07%	6.86%	10.93%
Magellan Midstream Partners, LP	6.16%	6%	2.22%	4.74%	6.30%	11.04%
NuStar Energy, LP	7.07%	6%	2.22%	4.74%	7.24%	11.98%
TEPPCO Partners, LP	7.31%	6%	2.22%	4.74%	7.48%	12.22%
Plains All American Pipelines, LP	6.74%	7%	2.22%	5.41%	6.93%	12.33%
Enbridge Energy Partners, LP	7.58%	6%	2.22%	4.74%	7.76%	12.50%
Enterprise Products Partners, LP	6.45%	8%	2.22%	6.07%	6.64%	12.71%
Kinder Morgan Energy Partners, LP	6.69%	8%	2.22%	6.07%	6.89%	12.96%

Column (1) is taken from individual company analysis.

Column (2) is taken from I/B/E/S Monthly Summary Data, US Edition.

Column (3) is calculated from three sources: EIA, Global Insight, and SSA.

Column (4) = Column(2)*2/3 + Column(3)*1/3

Column (5) = Column(1)*(1 + 0.5*Column(4))

Column (6) = Column(4) + Column(5)

NOTE: This Appendix is for illustrative purposes only and does not prejudge what would be an appropriate proxy group for use in individual proceedings.

Appendix B

In this Appendix, we illustrate with a simplified numerical example why a DCF analysis using a proxy MLP's full distribution, including any return of equity, does not lead to the award of an excess ROE in a pipeline rate case or the double recovery of depreciation.

In this example, we compare the results of a DCF analysis for two firms included in a proxy group, one a corporation and the other an MLP. We initially assume that the theoretical basis of the DCF methodology is sound. In other words, the DCF formula will lead to valid results for investors in pricing shares and returns. We further assume that each proxy firm engages only in jurisdictional interstate natural gas pipeline business. Therefore, each proxy firm charges cost-of-service rates determined by the Commission in the proxy firm's last rate case. We also assume that the Commission awarded the same 10 percent ROE to each proxy firm in its last rate case.

Based on these assumptions and the additional facts set forth below illustrating the typical differences between corporations and MLPs, we first set forth the DCF analysis an investor would perform to determine the value of the corporation's stock and the MLP's limited partner units. We then assume, consistent with the underlying premise of the DCF model, that the results of the investor's DCF analysis represent the actual share prices of the two proxy firms. Using those share prices, we then apply the DCF formula used in rate cases to determine the ROEs of the two proxy firms. As illustrated below, that DCF analysis arrives at the same 10 percent ROE for the proxy MLP, as for the proxy corporation, despite the fact the MLP's distribution includes a return of equity. Thus, the inclusion of return of equity in the MLP's distribution does not improperly distort the rate case DCF analysis.

Assumed Facts

The proxy corporation's rate base is $100. In its last rate case, the Commission awarded the proxy corporation an ROE of 10 percent, and found that its depreciable life is 25 years. So the proxy corporation's cost of service includes $10 for ROE, and $4 for depreciation. We assume that in its most recent year of operations, the corporation actually collected those amounts from its customers, and paid a dividend of $6.50, i.e., a dividend equal to 65 percent of its annual earnings. The corporation thus retains $7.50 in cash flow, which it reinvests the following year. This reflects the fact that corporations typically pay out less than earnings in their dividends. We also assume that that the corporation's composite growth rate is 8 percent.

The facts with respect to the MLP are the same, with two exceptions. First, the MLP paid its unit holders a distribution of $13, i.e., a distribution equal to 130 percent of earnings. The remaining $1 is distributed to the general partner of the MLP. Second, the

MLP's composite growth rate is only 5 percent.

DCF Analysis of Proxy Corporation

As discussed at P 2 of the notice, an investor uses the following DCF formula to determine share price (with simplifying assumptions):

D/ (ROE - g) = P

where P is the price of the stock at the relevant time, D is the current dividend, ROE is the discount rate or rate of return, and g is the expected constant growth in dividend income to be reflected in capital appreciation. Using that formula, investors would determine the rational stock price for the proxy corporation as follows:

$6.50 dividend/ (ROE of .10 – growth of .08) = Stock Price of $325

That is, investors would sell shares at a price above $325, and buy shares until the price reached $325. In a rate case for another pipeline, the Commission will determine the ROE of the proxy firm by solving the above formula for ROE, instead of share price. This rearranges the formula so that:

D/P + g = ROE

Using that formula and assuming the proxy corporation's actual stock price is $325, the Commission would determine the proxy corporation's ROE as follows:

$6.50 dividend/$325 stock price + growth of .08 = ROE of .10

Therefore, if the corporation was included in the proxy group for purposes of determining another firm's ROE in a new rate case, we would find, under the assumed facts, that the proxy corporation has the same 10 percent ROE as we awarded in its last rate case.

DCF Analysis of Proxy MLP

We now go through the same exercise for the proxy MLP to determine whether its distribution in excess of earnings distorts its DCF analysis so as to improperly inflate its ROE. Using the D/ (ROE - g) = P formula described above, investors would determine the proxy MLP's share price as follows:

$13 distribution/ (ROE of .10 – growth of .05) = Share price of $260

Assuming that the actual price of units in the proxy MLP is $260, we now determine the ROE of the proxy MLP, using the DCF formula used in rate cases (D/P + g = ROE).

Under that formula, we would calculate the proxy MLP's ROE as follows:

$13 distribution/$260 unit price + growth of .05 = ROE of .10

Therefore, if the MLP was included in the proxy group for purposes of determining another firm's ROE in a new rate case, we would, under the assumed facts, reach the same result as we reached for above proxy corporation: that the proxy MLP has the same 10 percent ROE as we awarded in its last rate case.

By contrast, if the Commission capped the proxy MLP's distribution at its $10 in earnings but continued to use the $260 share price, the ROE calculated for the proxy MLP would be only about 8.8 percent, and thus less than the 10 percent ROE the Commission awarded the proxy MLP in its last rate case and less than the results for the proxy corporation:

$10 distribution/$260 unit price + growth of .05 = ROE of .088

Conclusion

As shown by the above illustrative calculations, an MLP may be included in the proxy group and its full distribution used in the DCF analysis without distorting the results. This is because the level of an MLP's distributions affects both its share price and its projected growth rate. The MLP's inclusion of a return of equity in its distribution causes its share price to be higher than it otherwise would be and its growth rate to be lower. These facts offset the effect of the higher distribution on the DCF calculation of the MLP's ROE. Indeed, capping the MLP's distribution at earnings would lead to a distorted result. This is because there would be mismatch between the market-determined share price, which reflects the actual, higher uncapped distribution, and the lower earnings-capped distribution.

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