

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Composition of Proxy Groups for Determining)
Gas and Oil Pipeline Return on Equity)

Docket No. PL07-2-000

**ADDITIONAL COMMENTS OF THE
NATURAL GAS SUPPLY ASSOCIATION**

Pursuant to the Federal Energy Regulatory Commission's ("Commission" or "FERC") Notice of Technical Conference and Request for Additional Comments issued November 15, 2007, the Natural Gas Supply Association ("NGSA") submits these Initial Comments in the captioned proceeding,¹ and respectfully states the following:

I. COMMUNICATIONS

Communications regarding these comments should be directed to the following individual:

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¹ Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity, "Notice of Technical Conference and Request for Additional Comments," Docket No. PL07-2-000, 121 FERC ¶ 61,165 (November 15, 2007) (hereinafter "NOTC").

II. IDENTITY OF COMMENTER

NGSA represents integrated and independent companies that produce and market domestic natural gas. Established in 1965, NGSA encourages the use of natural gas within a balanced national energy policy, and promotes the benefits of competitive markets to ensure reliable and efficient transportation and delivery of natural gas and to increase the supply of natural gas to U.S. consumers.

III. EXECUTIVE SUMMARY

In both its Initial and Reply Comments in response to the Commission's proposed policy statement concerning composition of the proxy groups used to determine gas and oil pipelines' return on equity ("ROE") under the Discounted Cash Flow ("DCF") method, NGSA explained that the DCF model will not provide a transparent or straight-forward approach to natural gas ratemaking in the long-run if master limited partnerships ("MLPs") are included in the proxy group.² The Commission's request for additional information with respect to how an MLP's growth should be projected for purposes of the DCF analysis, which comes after two rounds of extensive comments, heightens NGSA's concern that force-fitting MLPs into the DCF model will make ratemaking exponentially more difficult than it need be.³ This

² See Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity, "Initial Comments of the Natural Gas Supply Association," Docket No. PL07-2-000 (filed August 30, 2007); Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity, "Reply Comments of the Natural Gas Supply Association," Docket No. PL07-2-000 (filed September 19, 2007).

³ Given that the onus is primarily on pipeline shippers to file Section 5 complaints when a pipeline's rates are no longer just and reasonable, the ratemaking process should not require shippers to rely upon methods that require the expert knowledge of multiple corporate structures and how those structures must be modified to more appropriately fit into FERC's ratemaking process. This burden is too onerous to be justified.

technical conference will likely be the first of many necessary to analyze the series of fundamental breakdowns in the various components of the DCF methodology as the Commission attempts to apply this methodology to MLPs. Instead of force fitting MLPs into the DCF equation, the Commission should seriously consider other methods for calculating a rate of return on equity for interstate natural gas pipelines.

In addition to the problems described in NGSAs previous comments, the current issue of how to determine the appropriate MLP growth rate further illustrates that the DCF method does not provide a meaningful calculation of pipeline ROEs when MLP proxies are utilized. In fact, determining the appropriate MLP growth projection is particularly problematic, as the very concept of growth is flawed with respect to MLPs. Unlike C corporations, MLPs lack an economic incentive for organic growth of earnings, as MLPs are instead motivated to provide the best distribution payout for the partners. As a result, the commenters have agreed, and the Commission has recognized, that “MLPs will have lower growth potential than corporations, because of their distributions in excess of earnings.”⁴ While C corporation dividends are a direct reflection of earnings, thus providing a solid basis for determining expected “earnings” growth over a five-year period, MLP distributions, which are not reflective of earnings, provide no basis for a similar determination of “earnings” growth. Nevertheless, if FERC is determined to allow MLPs into the proxy group and retain the DCF model that includes a “growth” projection for MLPs, the Commission must ensure that the method

⁴ NOTC at 3.

it adopts for projecting growth be guided by the following principles: (1) growth should be estimated by a neutral third party; (2) the methodology used to estimate earnings growth should be transparent; (3) the growth estimate should offset the higher yields of an MLP; and (4) the long-term growth component of the Commission's DCF equation must continue to be a factor in the overall analysis.

IV. ADDITIONAL COMMENTS

A. The Current Method of Projecting Growth in the DCF Does Not Adequately Reflect the Lower Growth Potential of MLPs.

The Commission currently projects growth in dividends based on an average of short- and long-term growth projections, with two-thirds weight given to the short-term growth component and one-third given to the long-term growth component. The Commission uses security analysts' five-year growth forecasts for each individual proxy company, as published by the Institutional Brokers Estimate System ("IBES") for the short-term growth component, and bases the long-term growth estimate on forecasts of the economy as a whole, as reflected in Gross Domestic Product ("GDP"). The Commission has asked whether this method of projecting earnings growth adequately reflects the lower growth potential of MLPs.

To more adequately reflect the lower growth potential of MLPs, at least one of the short- or long-term growth forecasts used by FERC in the DCF calculation would have to produce a lower growth rate for an MLP than a C corporation. However, under the current method of projecting growth, both the short- and long-term components fail to account for the lower growth potential of MLPs because: (1) the IBES five-year

growth forecasts for MLPs appear to be similar, if not higher, than those for C corporations; and (2) GDP growth is a constant for both MLPs and C corporations.

1. IBES Five-year Growth Forecasts for MLPs Are Similar, if Not Higher, Than the Rates for C corporations.

The short-term growth component of FERC's DCF model fails to account for the lower growth potential of MLPs because IBES five-year growth rates for MLPs are not dissimilar from the rates for C corporations, as the Commission found in *Kern River Transmission Company* ("Kern River").⁵ Kern River had argued that the increased "dividend" resulting from the fact that an MLP's cash distributions include a return of capital would ordinarily be expected to reduce an MLP's growth projections below those of a similar C corporation, and thus balance out the increased distribution yields. After explaining that its concerns about the use of an MLP could be alleviated "[i]f this expectation were borne out in the growth projections of an MLP proposed for inclusion in a proxy group," the Commission concluded that while assertions of reduced growth may be generally true over the long term, "during the shorter term reflected in IBES growth projections MLPs may have other means of financing growth apart from retained earnings, including the issuance of additional debt or equity."⁶ Because MLP's distributions are fundamentally different from the dividends of C corporations and growth is measured by IBES by examining these two distinct types of cash-flows, it is a mistake to assume that the growth rates for these two very distinct corporate structures

⁵ *Kern River Transmission Company*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486) at p. 66, *reh'g pending*.

⁶ *Id.*

can be sufficiently comparable to allow for one's "growth" to substitute for the other.

In addition to the Commission's findings in *Kern River*, NGSA's own research confirms that 5-year growth projections used as the short-term growth component in the DCF equation for potential MLP proxy companies remain similar to, and may in fact be higher than, those of comparable C corporations holding interstate pipeline assets. Except for a couple of C corporations that are now "bouncing back" after going through economic turmoil, MLPs continue to garner short-term growth rate estimates that are similar or higher than C corporation pipeline companies. For instance, analysts currently project a short-term projection for National Fuel Gas, a C corporation, of 4.35% growth over the next five years, whereas Enterprise Product Partners LP, an MLP, has a 9.47% growth estimate.⁷ Similarly, C corporations NiSource Inc. and Spectra Energy Corp. have growth estimates of 3.34% and 6.3%, respectively, whereas MLPs Enbridge Energy Partners, Equitable Resources, Inc., and Kinder Morgan Energy Partners have growth rates of 5%, 11.2%, and 7.6%, respectively. Given that MLPs continue to garner short-term growth rate estimates similar to C corporation pipeline companies, FERC can not assume that short-term growth rate component of the DCF equation will account for the return of capital through MLP distributions.

⁷ NGSA has referenced Yahoo! estimates because they are available free of charge, whereas IBES growth projections require a significant financial investment to obtain. Additionally, although not all potential proxy companies have growth estimates listed on Yahoo!, NGSA chose Yahoo! estimates because Yahoo! information is provided by Thompson, the same company that publishes IBES.

2. The Long-Term Growth Component Also Fails to Account for the Lower Growth Potential of MLPs Because FERC Uses GDP, Which is a Constant for Both MLPs and C Corporations.

If the short-term growth estimates used for MLPs are the same or greater than the estimates for C corporations, the only way the current method of projecting growth could adequately reflect the lower growth potential of MLPs would be if the long-term growth component used in the DCF equation for MLPs yielded a lower growth rate than the long-term growth forecasts for C corporations. However, under the current method, the long-term forecasts for MLPs and C corporations will be identical because FERC uses the same long-term input, GDP growth, for both. As a result, the long-term growth component of the DCF model also fails to account for the lower growth potential of MLPs because the GDP forecast will be identical regardless of whether the Commission is looking at an MLP or a C corporation.

In considering the long-term growth forecast, NGSa notes that the Commission has drawn particular attention to the issue of whether or not the current method of projecting growth adequately reflects the lower growth potential of MLPs over the long term.⁸ In so doing, the Commission has presented Wachovia's projected "assumed" long-term growth rate of 2.5% as a contrast to the GDP projection of 4.5%.⁹ Depending on the MLP, it appears that Wachovia assumes either a 2.5% or 3.0% long-term growth rate. Wachovia does not provide any additional information in its report regarding

⁸ NOTC at 3 n.2 (citing *MLPs: Safe to Come Back into the Water*, Wachovia Capital Markets, LLC, Equity Research Department, at 9-10 (August 20, 2007)).

⁹ *Id.*

how this long-term growth rate was determined. Also, there is no indication that the 2.5% would actually differ for MLPs as opposed to C corporations. Moreover, we simply can not be assured that this presumed rate would remain stable in the future and warrant adoption in the Commission's ratemaking process. Therefore, NGSAs does not see how a change from GDP to Wachovia's projection would accomplish an offset for MLP distributions and their associated return of capital.

As Indicated Shippers stated in their August 30, 2007 comments, "the very nature of MLPs, whose distributions are comprised of a return on capital and a return of capital, means that their growth cannot continue for the indefinite future, absent growth through acquisition. Even this is limited, however, as the number of available energy acquisitions is finite." To maintain distribution growth, MLPs will continually require new acquisitions and increasingly larger projects from year-to-year.

Indicated Shippers also quotes from a 2005 Citigroup Smith Barney report that, "Our investment thesis continues to be that **MLP performance will depend more on monetary policy and the direction of interest rates** than on the underlying business fundamentals." (emphasis added)¹⁰ When MLPs have payout ratios in excess of 100% of earnings, maintaining earnings growth for MLPs is simply not sustainable in the long-term. Although long-term growth of MLPs is not sustainable, that does not translate into elimination of the long-term growth component of the DCF methodology as a solution. In fact, just as for C corporations, a long-term, more stable component

¹⁰ *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, "Initial Comments of Indicated Shippers," at 21, Docket No. PL07-2-000 (filed August 30, 2007) (emphasis in original).

must be part of the overall growth rate in order to offset the volatility inherent in the short-term growth component, which only reflects growth potential for an individual proxy company.

3. The Failure of the Current Method of Projecting Growth Potential of MLPs Underscores the Complexities of Using the DCF Method to Calculate Pipeline ROEs Using MLP Proxies.

As demonstrated above, the current inputs used to project growth in the DCF calculation do not adequately adjust for the use of distributions of MLPs as opposed to the earnings of C corporations. Therefore, if the Commission does not cap the MLP distributions at earnings as it proposed, the ratemaking process will be skewed.

In *HIOS*, the Commission recognized that the, “[u]se of a distribution payment that includes both earnings and a return of investment as an MLP’s ‘dividend’ for purposes of a DCF analysis would skew the DCF results, since the dividend yield would appear higher than it actually was.”¹¹ Thus, the Commission explained that it “will not consider including an MLP in the proxy group, unless the record demonstrates that distribution used as the ‘dividend’ includes only a payment of earnings and not a return of investment.”¹²

¹¹ *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, *reh’g denied*, 112 FERC ¶ 61,050 (2005), *appeal pending*, at n.112. The Commission explained further:

That the DCF results could be significantly skewed is shown by the fact that two of the MLPs in *HIOS*’ proxy group, El Paso Energy Partners and Northern Border Partners, over the 2001-2003 time period, averaged a 301.3 percent payout ratio, which indicates that two-thirds of their payout distributions are a return of capital and not a return on capital. Exh. IND-17 at 3-4. By comparison, the payout ratios for the group of gas pipeline companies over the same period averaged 73.78 percent, demonstrating that their dividends represent a return on capital and not a return of capital.

¹² *Id.* at p. 126.

As the *HIOS* decision reflects, the DCF model is designed to measure earnings, as represented by the cash dividend paid out by corporations. This growth measurement makes sense for C corporations because corporate dividends consist entirely of earnings. As the Commission has explained, such dividends “are assumed to be a distribution of stable long term surplus earnings not required for future growth.”¹³ In contrast, MLP distributions are generally comprised of both earnings and a return of capital, and distributions to Limited Partners may contain no earnings at all. In fact, if the Commission does not cap distributions at earnings, the DCF model will reflect only an MLP’s distribution growth, instead of earnings growth as intended.

Although the Notice of Technical Conference does not explicitly define “growth rate,” NGSAs assume the Commission is concerned with projecting potential future earnings growth of the proxy (and thus the regulated pipeline), not distributions growth. Simply projecting the growth rate of MLP distributions estimates cash-flows, including non-cash expenses like depreciation, but reveals very little about MLP earnings growth. An MLP’s distributions, unlike corporate dividends, are not a transparent indicator of future earnings potential. As a result, it is clear that the current method of projecting earnings growth for C corporations is unworkable for determining growth of earnings in MLPs, and the DCF model on the whole is an unreliable method of calculating pipeline ROEs when MLP proxies are utilized. For that reason, NGSAs

¹³ *Kern River Transmission Company*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486) at p. 66, *reh’g pending*.

requests that the Commission initiate a proceeding to consider a more stable long-term approach to calculating return on equity for natural gas pipelines.

B. If FERC is Determined Nevertheless to Make a Growth Projection for MLPs, There Are a Number of Factors that Should be Part of the Growth Determination.

For the reasons set forth above, and in NGSAs prior comments on this issue, NGSAs does not believe that the DCF growth component is an appropriate calculation method for MLPs. Growth of distribution cash yields and growth of dividend yields are not comparable. Nevertheless, if FERC is determined to move forward with determining “growth” for MLPs, NGSAs urges the Commission to make that determination based on the following four principles: (1) growth should be estimated by a neutral third party; (2) the methodology used to estimate growth should be transparent; (3) the growth estimate should offset the higher yields of an MLP; and (4) long-term growth should continue to be a significant stabilizing factor in the overall analysis. Each of these principles is discussed further below.

Any entity or group used to estimate growth should be neutral and free from even the appearance of conflicts of interest.¹⁴ Many financial groups or investment firms represent client interests that could potentially cause conflicts with respect to

¹⁴ For instance, see the list of members that signed on behalf of the National Association of Publicly Traded Partnerships (“NAPTP”) in their comments filed in support of including MLPs in the proxy group. Eight of NAPTP’s members—Credit Suisse, UBS, Wachovia Capital Markets, RBC Capital Markets, Goldman Sachs, Citigroup, Oppenheimer & Co., and Banc of America Securities—analyze financial indicators for companies in the energy industry, including pipeline companies. These investment companies may own an interest in or receive compensation from energy-related companies. The bulk of the remaining membership of NAPTP is comprised of pipeline companies with assets held in the MLP capital structure.

ratemaking. Clearly, to ensure a reasonable and fair rate, the company or group used to estimate an MLP's growth rate should be a neutral party that is free from such conflicting interests.

A second, but closely related core principle is that the methodology used to determine the growth rate should be transparent. Adding transparency to the growth rate determination will make ratepayers more comfortable with the growth estimates that are used.

Third, the Commission should ensure that the growth estimate offsets the higher yields of MLPs. As demonstrated above, the current IBES growth estimates for MLPs are similar to or higher than those for C corporation pipeline companies, and the long-term growth component of GDP is identical for MLPs and C corporations. As a result, the current method results in MLP growth projections that are equal to or higher than the growth rates for C corporations, and the higher dividend yields of MLPs do not appear to be offset by their growth rates. At the very least, the Commission should be cautious when considering whether to adopt a growth rate input for MLPs when that growth estimate is not reflective of the lower growth that is generally expected of those corporate structures.¹⁵

Finally, when seeking to modify the growth estimate for MLPs, some parties may urge the Commission to alter the current weighting of short- and long-term growth estimates. As stated earlier, in order to offset short-term volatility, however, the

¹⁵ FERC stated in the instant Notice that the “commenters generally agree that MLPs will have lower growth potential than corporations, because of their distributions in excess of earnings.” (pages 2-3).

Commission should ensure that a long-term growth component, which is less volatile than individual proxy companies' growth estimates, remains a significant factor in the overall growth rate determination in the DCF equation.

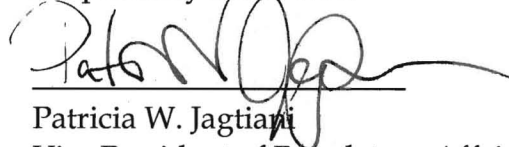
V. TECHNICAL CONFERENCE

At this time, NGSAs does not intend to request a speaker at the January 8, 2008 Technical Conference. Nevertheless, NGSAs will attend the conference and we urge the Commission to allow for full participation and Q&A by all attendees at the conference so that all interested parties can gain a full understanding of any proposals submitted that ask the Commission to alter the current method of projecting the growth of MLPs.

VI. CONCLUSION

In consideration of the foregoing, NGSAs respectfully requests that if the Commission allows MLPs into the proxy group and retains the DCF model, that it follow the principles outlined above in creating a more reliable method of projecting MLP growth rates.

Respectfully submitted,



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