UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Inquiry Regarding the Commission's Policy for Determining Return on Equity	)))	**Docket No. PL19-4-000**

REPLY COMMENTS OF THE NATURAL GAS SUPPLY ASSOCIATION ON NOTICE OF INQUIRY

Pursuant to the procedures set forth in the March 21, 2019 Notice of Inquiry issued in the above-referenced proceeding,[1] the Natural Gas Supply Association ("NGSA") hereby provides these reply comments to the comments of the Interstate Natural Gas Association of America ("INGAA") ("INGAA Comments"). In responding to the INGAA Comments, NGSA is also responding to similar comments submitted by the Kinder Morgan Natural Gas Entities, Boardwalk Pipeline Partners, LP, Tallgrass Energy, LP, and TC Energy Corporation, which largely supported INGAA's comments. None of the comments submitted in this proceeding provided adequate justification for the Federal Energy Regulatory Commission ("FERC" or "Commission") to abandon its exclusive use of the Discounted Cash Flow ("DCF") methodology that it has relied on to determine natural gas pipeline returns on equity ("ROE") for the past four decades. In addition, there has been no evidence produced that demonstrates that the DCF methodology, as the Commission applies it to natural gas pipeline ROEs, no longer fulfills the twin mandates of *Hope* not only (1) to

[1] *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, "Notice of Inquiry," 166 FERC ¶ 61,207 (March 21, 2019) ("NOI").

provide a return high enough to maintain credit and to attract capital, but also (2) to balance the interests of consumers with the interests of investors.[2] Thus, the Commission should continue to rely exclusively on the DCF methodology for determining natural gas pipeline ROEs. The Commission should also maintain its approach of flexibly addressing the inputs to the DCF methodology, when evidence produced on the record in a proceeding demonstrates that input flexibility is necessary to fulfill the mandates of *Hope*. In short, NGSA appreciates the Commission's inquiry into whether its ROE policies continue to fulfill the Commission's legal obligations, but the record does not support any deviations from the Commission's established policies.

Response to INGAA's Initial Comments[3]

At page 14 of its comments, INGAA argues that the Commission should not adopt a "one-size-fits-all" ROE policy. NGSA agrees with the spirit of this comment, in that the Commission should maintain its approach of using the DCF methodology, but should allow for a case-by-case review of the inputs that populate the DCF methodology in order to ensure that the pipeline's ability to attract capital and maintain its credit are properly balanced with consumer interests.[4]

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[2] *See Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

[3] These reply comments by NGSA do not directly address those issues that are clearly inconsistent with the initial comments NGSA submitted on June 26, 2019 in this proceeding. NGSA's silence in reply comments should not be deemed to have waived its initial comments.

[4] *Id.*

At pages 16-17 of its comments, INGAA argues that the natural gas pipeline industry has "greater inherent risk" than the electric transmission industry. NGSA notes that, if true, this risk differential is yet another reason for treating the determination of natural gas pipeline ROEs differently from that of public utilities.

At pages 17 to 20 of its comments, INGAA provides a description of the competition that natural gas pipelines face, including pipeline-on-shipper competition in the capacity release market. But INGAA does not suggest that this "competition" has resulted in financial impacts that necessitate a different approach to determining natural gas pipeline ROEs, just that natural gas pipeline ROEs are not high enough. Moreover, nothing in this litany of "competition" is new and the capacity release rules have been in place long enough for investors to properly account for the impacts, and arguably, ROE's reflect such impact.

In spite of this "competition," the natural gas pipeline industry has been earning very healthy ROEs for quite some time.[5] In addition, natural gas pipelines have the ability to capture prices above the maximum tariff recourse rate for short-term contracts through negotiated rate index-based deals.[6] Natural gas pipelines have been using these more frequently to capture valuable spreads, resulting in rates that

[5] *See Gas Daily*, "NGSA Analysis of Pipe Rate of Return on Equity (%)," at 5 (published Feb. 21, 2019).

[6] *See, e.g.*, Kern River Gas Transmission, FERC Gas Tariff, Sheet Nos. 451A 453N (describing index-based negotiated rates); *Trailblazer Pipeline Company LLC*, Docket No. RP19-1360 (submitted July 1, 2019) (describing a $0.0000/Dth reservation rate and revenue sharing based upon the value of the daily spread); Northern Natural Gas Company, FERC Gas Tariff, Sheet No. 66B.13a to 66B.33 (describing multiple negotiate rate contracts with index-based rates).

allow the pipelines to receive revenues that greatly exceed what would otherwise be collected through the maximum tariff recourse rates.

At page 20, INGAA comments that the majority of natural gas pipeline revenues are now derived from negotiated and discounted rate contracts. INGAA draws no connection, though, between higher revenues from negotiated and discounted rate contracts, and financial hardships for natural gas pipeline companies. While discounted rate contracts must be below the maximum tariff recourse rate, there is no such restriction for negotiated rate agreements. Under the Commission's negotiated rate policy, shippers are required to have the option of choosing the recourse rate over a negotiated rate, but the fact is that many do not. In addition, when negotiated rates are agreed to, recourse rates may fall below the negotiated rate during the negotiated rate term.[7] Thus, there is no correlation between higher revenues associated with negotiated rate contracts and the Commission's ability to meet the mandates of *Hope* through the use of the DCF methodology for determining natural gas pipeline ROEs.

In addition, there are multiple examples where pipelines have negotiated rate contracts in excess of a just and reasonable rate. For example, several pipelines in their Form 501-G proceedings argued that no rate change was necessary, despite significantly over-earning its ROE, because most or all of its revenues were derived

[7] *Compare* Southern Natural Gas Co., L.L.C., FERC Gas Tariff, Section 2.1.1 *with* Section 2.7 (where multiple negotiated rate contracts are listed with rates greater than the recourse rates).

from negotiated rate agreements.[8] Thus, the fact that pipelines are receiving a greater proportion of their revenues from negotiated rate contracts may mean that pipelines are more likely to over-recover their approved ROEs than under-recover them.

At pages 21-22, INGAA argues that the Commission's "recent initiatives" to deny Master Limited Partnerships ("MLP") a double recovery of the income tax allowance and to initiate Section 5 investigations against natural gas pipeline companies that are over-earning their approved ROEs (by a significant margin),[9] have increased "business risks" for natural gas pipelines. This argument lacks a reasonable basis because, if successful, INGAA would have the Commission provide pipelines with higher ROEs so that the Commission could later reduce those higher ROEs, pursuant to its statutory mandate. Investors are aware that natural gas pipelines are subject to regulation, and that the Commission is required to fulfill the mandates of the NGA.

In addition, the ratemaking process under Sections 4 and 5 of the Natural Gas Act ("NGA"), as well as the "filed rate doctrine" ensure that pipelines have minimal

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[8] *See*, *e.g.*, *Elba Express Company, L.L.C.*, Docket No. RP19-268 (submitted Nov. 8, 2018) (ROE estimated at 21.3%); *Gulfstream Natural Gas System, L.L.C.*, Docket No. RP19-52 (submitted Oct. 11, 2018) (ROE estimated at 20.5%); *ETC Tiger Pipeline, LLC*, Docket No. RP19-80 (submitted Oct. 11, 2018) (ROE estimated at 30.5%); *El Paso Natural Gas Co., L.L.C.*, Docket No. RP19-73 (submitted Oct. 11, 2018) (estimated ROE of 21.4%).

[9] *See*, *e.g.*, *Dominion Energy Overthrust Pipeline, LLC*, 162 FERC ¶ 61,218 at P 4 (2018) (finding an approximate ROE of 23.4% in one year and 19.9% in the next); *ANR Storage Co.*, 137 FERC ¶ 61,136 at P 5 (2011) (finding an approximate ROE of 130.38% in one year and 153.71% in the next); *Bear Creek Storage Company L.L.C.*, 137 FERC ¶ 61,134 at P 5 (2011) (finding an approximate ROE of 22.43% in one year and 29.16% in the next).

regulatory risks. Once the Commission has accepted a filed rate (no longer subject to refunding), that rate becomes the floor for any future rate decreases. Even if a complainant were successful under Section 5 of the NGA in getting a rate reduction, that reduction would only take place prospectively from a Commission order on the rates. Thus, investors should know that there is no risk of a pipeline being forced to reduce revenues retroactively, when a pipeline's rates are above a just and reasonable level. Moreover, under Section 4 of the NGA, natural gas pipelines have the ability to seek to increase rates, at the time the natural gas pipeline company chooses to do so, with rates going into effect (subject to refund) within five months of the Commission's suspension order. Given this one-sided nature of the Commission's ratemaking authority, there is little credibility to INGAA's arguments regarding the increased "business risks" for natural gas pipelines under the NGA, and the Commission's exercise of its statutory authority thereunder.

At page 23, INGAA argues that the Commission's abandonment policies increase natural gas pipeline's business risks. This argument, too, lacks a reasonable basis. The Commission's enforcement of Section 7(b) is well-known to investors, and "[t]he fact that abandonment of public service requires Government approval symbolizes the special legal status and obligations of common carriers and public utilities." A natural gas pipeline's desire "to be rid of what it considers vexatious

servitude" is not a reason for granting its abandonment request, nor should it be a reason to provide a pipeline with a higher ROE.[10]

At pages 24 to 40, INGAA argues that the Commission should implement ways to bolster the natural gas pipeline proxy group. While NGSA agrees that some modifications to how the Commission evaluates whether companies are "comparable enterprises" for the purpose of determining whether a particular company is an adequate proxy, NGSA prefers the approach the Commission has adopted in individual pipeline proceedings, rather than implementing wholesale changes to this determination. For example, in individual proceedings, it may be appropriate to consider as proxies natural gas companies whose natural gas transportation business makes up less than 50% of the company's total business.[11] Allowing for a case-by-case determination of when to expand the proxy group would provide the Commission with sufficient flexibility to address any perceived deficiencies in the DCF methodology.

At pages 40 to 48 of its comments, INGAA argues for consideration of other return models (*e.g.*, CAPM and Expected Earnings) in addition to the DCF methodology, along with the ability to include or exclude one or more models based on the data of the case to establish ROEs. NGSA disagrees with this argument

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[10] *See Michigan Consolidated Gas Co. v. FPC*, 283 F.2d 204, 214 (D.C. Cir. 1960).

[11] *See*, *e.g.*, *El Paso Natural Gas Co.,* Opinion No. 528, 145 FERC ¶ 61,040 at P 635 (2013); Opinion No. 524, 142 FERC ¶ 61,197 at PP 304-307 (2013); and *Portland Natural Gas Transmission Sys.*, Opinion No. 510, 134 FERC ¶ 61,129 at PP 178-80 (2011).

because introducing additional methodologies would make an already complex and lengthy process even more so due to the complex nature of analyzing multiple models and financial conditions, putting the burden on the parties to fight over every input and which model to include or exclude in each proceeding. Further, allowing for additional methodologies would introduce higher costs to litigate rate proceedings, without ensuring results that are any more reliable in meeting *Hope* than the DCF methodology. Higher costs to litigate make it more difficult for intervenors to participate in individual pipeline rate proceedings. In addition, more methodologies for determining ROEs would hinder the ability of participants to reach settled outcomes.

But if the Commission were to entertain other methodologies for determining ROEs for natural gas pipelines, the Commission should only do so if the record demonstrates that the results from the DCF methodology do not comply with the requirements of *Hope* (1) to ensure a return sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital; and (2) balance the interests of consumers with the interests of investors.[12]

At page 49 of its comments, INGAA suggests that the Commission should adjust the calculation of its dividend yield to recognize that more cash may be available to companies in the future. INGAA states that the Commission need not adopt the Distributable Cash Flow model, but that the concept of "free cash flow" and

[12] *Hope*, 320 U.S. at 603.

"distributable cash flow" should cause the Commission to weight dividend yield as follows: 80% to the dividend yield and 20 percent to the Distributable CF yield.[13]

But the concept of "distributable cash flow" is fundamentally flawed in that it ignores growth capital spending. In addition, for most MLPs, the traditional measure of free cash flow, as measured by the net income from operations, is often less than the total of distributions paid. Given this, MLPs often fund "free cash flow" shortfalls with new debt and/or equity issuances.

In addition, the Securities and Exchange Commission has cautioned companies on the use of "free cash flow," stating that the term

> should not be used in a manner that inappropriately implies that the measure represents the residual cash flow available for discretionary expenditures, since many companies have mandatory debt service requirements or other non-discretionary expenditures that are not deducted from the measure. Also, free cash flow is a liquidity measure that must not be presented on a per share basis.[14]

Given this guidance, the Commission should not adopt this metric for determining dividend yield.

Alternatively, INGAA argues at page 51 of its comments that the dollar value of share repurchases should be added to the dividend yield. But the DCF methodology already accounts for share prices in the calculation of dividend yield. A share repurchase price would be factored into that part of the calculation, thus,

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[13] INGAA Comments at 50.

[14] SEC Non-GAAP Financial Measures, Question 102.07 << https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm>> (visited July 13, 2019).

potentially resulting in a double-counting of the effects of share repurchases. Further, adding in the percentage of total shares forecasted to be repurchased would add a measure of speculation as to what the percentage of shares will be that will actually be repurchased.

On page 52 of the its comments, INGAA proposes that the Commission adopt a quarterly DCF model, as opposed to an annual version. It is NGSA's understanding that most witnesses in natural gas pipeline rate proceedings are already adjusting their DCF calculations to account for changes in dividends as they are announced each quarter. In other words, in using a six-month lookback for determining dividend yield, analysts are using at least two (and up to three) different dividend values in their calculations (one for each quarter in the six-month review period). Thus, INGAA's suggested additional equation is unnecessary, and would unduly complicate the determination of ROE in natural gas pipeline rate proceedings.

On page 53, INGAA argues that the Commission should "supplement" IBES growth forecasts with Value Line forecasts. But the Commission has addressed this issue previously and determined that "IBES data reflects the average of the estimates of short term earnings growth by a number of important investors."[15] In addition, the Commission has already determined "there is no need to further adjust IBES short-term growth projections by averaging them with various Value Line short-term growth projections."[16] While INGAA suggests that using Value Line, in addition to

[15] *Northwest Pipeline Corp.*, 92 FERC ¶ 61,287 at 62,002 (2000).
[16] *Id.* at 62,003.

IBES short-term growth estimates would improve on the “consensus” approach that the Commission favors, this argument ignores the fact that IBES estimates already reflect a consensus of analysts’ estimates. Further, Value Line’s growth rate projections, which relies on the average of a three-year base period and the average of a three-year ending period to calculate short-term growth rates, can be significantly less accurate than the estimates provided by IBES analysts.[17] Thus, adding Value Line growth rates to the “consensus” would distort the accuracy of any DCF calculation.

At page 54 of its comments, INGAA argues that the Commission should change the weighting of long-term growth rates (compared to short-term growth rates) from 1/3 to 1/5. INGAA cites to the Commission’s Opinion No. 414-A in support of its proposal, but INGAA fails to cite to all of the relevant discussion in Opinion No. 414-A. The Commission stated that determining a ROE requires that a long-term evaluation be taken into account.[18] In addition, the Commission stated, “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.”[19] Importantly, the Commission found that the 1/3 weighting for long-

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[17] *See*, *e.g.*, Ramnath, Rock, and Shane, *Value Line and I/B/E/S Earnings Forecasts*, at 8 << http://leeds-faculty.colorado.edu/Rocks/RRSpaper.pdf>> (visited July 16, 2019) (finding that IBES estimates were significantly more accurate than Value Line forecasts).

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

[19] *Id.*

term growth in the DCF methodology was "consistent with the requirements of *Hope*."[20] Given that INGAA did not allege that the Commission's precedent stating that a 1/3 weighting for long-term growth no longer was "consistent with the requirements of *Hope*," the Commission should not adopt INGAA's proposal.

At pages 56-57 of its comments, INGAA argues that the Commission should "confirm" its holding in *Seaway* that the "g" factor used to derive the dividend yield should be based upon only the short-term IBES forecasts, and not the "g" that combines weighted short-term and long-term growth rates. The Commission should deny this request because the Commission's preferred DCF formula is:

$k=D/P\ (1+.5g) + g$

INGAA's comments would have the Commission use one calculation for determining the first "g" in the equation, but a different calculation for determining the second "g". This request would be mathematically inconsistent and is also inconsistent with the methodology the Commission has employed in natural gas pipeline proceedings.[21] In addition, the Commission explained its DCF formula in Appendix A to the Proxy Group Policy Statement and in the Emera Maine Briefing Order, which referred to "g" as the weighted growth rate (1/3 long-term and 2/3 short-term).[22] Finally, INGAA fails to provide any evidence that the Commission's ROEs determined using

[20] *Id.*

[21] *See*, *e.g.*, *El Paso Natural Gas Co.*, 145 FERC ¶ 61,040 at PP 637-41 (2013).

[22] *See Coakley v. Bangor Hydro-Elec. Co.,* 165 FERC ¶ 61,030 at Appendix (2018); *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at Appendix A, page 1 (2008).

the correct formulation is no longer consistent with the requirements of *Hope*. Thus, the Commission should deny INGAA's argument.

At page 57 of its comments, INGAA argues that the Commission should eliminate the 50% reduction in the long-term growth rate for MLPs. INGAA avers that the Commission's determination to eliminate the income tax allowance for MLP's makes these entities riskier. But this change in policy is not reason enough to change the determination of long-term growth rate for MLPs in the proxy. The removal of the income tax allowance for MLPs cured a ratemaking deficiency, it did not create one. Thus, any argument proposing some type of remedy for this effect is invalid. The Commission's original logic that MLP's pay out nearly all of their free cash flow as distributions, which has not changed, given the discussion of "free cash flow" above. Accordingly, the Commission should retain the 50% reduction to the long-term growth rate for MLPs.

Finally, at pages 65-72 of its comments, INGAA argues that the Commission should not have a high-end outlier test for eliminating companies from the proxy group but should have a low-end outlier test. This argument is logically inconsistent. In addition, as NGSA discussed in its initial comments, the Commission's use of the median of a range of reasonable proxy group returns eliminates the need for any outlier tests. Given this, the Commission should continue to use the median as the appropriate measure of the proxy group range of returns.

For the foregoing reasons, NGSA respectfully requests the Commission to retain the DCF methodology for determining natural gas pipeline ROEs, consistent with the NGSA initial and reply comments

Respectfully submitted,

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