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

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| Composition of Proxy Companies | ) | |
| For Determining Gas and Oil | ) | Docket No. PL07-2-000 |
| Pipeline Return on Equity | ) | |

# INITIAL COMMENTS OF THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA ON PROPOSED POLICY STATEMENT

In response to the Commission's "Proposed Policy Statement,"[1] issued on July 19, 2007, the Interstate Natural Gas Association of America ("INGAA") hereby submits the following comments. INGAA is a non-profit trade association that represents the interstate and interprovincial natural gas pipeline industry operating in North America. INGAA's United States members transport virtually all natural gas transported and sold in domestic interstate commerce, and are regulated by the Commission pursuant to the Natural Gas Act, 15 U.S.C. §§ 717-717w.

## I. Background

Prior to the last five years, the proxy group used by the Commission to calculate a return on equity ("ROE") for natural gas pipelines under the Discounted Cash Flow ("DCF") methodology included primarily natural gas pipeline companies. As a result of acquisitions, mergers, and other factors, progressively fewer companies met the Commission's original standard that a proxy company's pipeline operations constitute a high proportion (at least 50 percent) of the company's business. Proposed Policy Statement at PP 5-6. In two proceedings, the Commission lowered that standard by permitting inclusion in the proxy group companies that derived more revenue from

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

distribution than from pipeline operations, and rejected the inclusion of companies that were primarily natural gas pipelines because they were organized as Master Limited Partnerships ("MLPs"). In *High Island Offshore Sys., L.L.C.* ("*HIOS*"),[2] the Commission rejected the inclusion of MLPs due to a concern that an MLP's distributions included a return *of*, in addition to a return *on*, capital. In *Kern River Gas Transmission Co.* ("*Kern*"),[3] the Commission again rejected the inclusion of MLPs, but held that MLPs could be included in the future if a pipeline addressed its concern that growth of the MLP was based on external sources of capital.

In the Proposed Policy Statement, the Commission proposes to permit inclusion of MLPs. That proposal, however, is subject to two conditions. First, the Commission expressed the concern that allowing distributions in excess of earnings to be used in the DCF calculation would allow a pipeline to double recover depreciation expense by basing its return on equity, in part, on distributions that include a return of capital to unit holders. Proposed Policy Statement at PP 18-19. To address this perceived problem, the Commission proposes to cap the distribution used in the DCF analysis of any MLP at the level of the pipeline's earnings.

The second condition relates to a Commission concern that "an MLP's lack of retained earnings may render cash distributions at their current level unsustainable, and thus still unsuitable for inclusion in the DCF analysis." Proposed Proxy Policy at P 24. To address that concern, the Commission proposes to require proponents of MLP proxies

[2] *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 at P 126, n. 111-112, *order on rehearing,* 113 FERC ¶ 61,280 (2005), *vacated and remanded sub nom Petal Gas Storage, L.L.C. v. FERC*¸ Case No. 04-1166 (Aug. 7, 2007).

[3] *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077 at P 152 (2006).

"to provide a multiyear analysis of past earnings." *Id.* The Commission explained its view that such "[a]n analysis showing that the MLP does have stable earnings would support a finding that the cash to be included in the DCF calculation is likely to be available for distribution, thus replicating the requirement of the corporate model of a stable dividend." *Id.*

Finally, in a decision issued shortly after the Commission issued its Proposed Proxy Policy, the United States Court of Appeals for the D.C. Circuit vacated the Commission's orders in the *HIOS* and in a related proceeding. *See Petal Gas Storage, L.L.C. v. FERC*, Case No. 04-1166 (D.C. Circuit August 7, 2007) ("*Petal").* The Court held that the Commission failed to explain how the proxy group that it relied on there – one that included companies with substantial and less risky distribution operations and excluded MLPs with concededly comparable interstate pipeline operations – was based on the principle of relative risk. While the Court did not squarely address the Commission's rationale for rejecting MLPs, the Court stated that the Commission's concern that MLP distributions provided a return of equity was "not self-evident". Slip op. at 6.

## II. Executive Summary

The Commission's proposal to include MLPs in the proxy group used to determine a pipeline's ROE, and its recognition that proxy companies must be of comparable risk to the firm whose cost of equity is at issue, marks a significant improvement in the Commission's rate of return analysis. It also properly anticipated the similar conclusions reached by the D.C. Circuit less than two weeks later in the *Petal* case. This re-examination of the Commission's proxy group policy comes at a critical

juncture. The downward trend in the equity returns produced by the Commission's DCF model, which has been exacerbated by the ever-shrinking universe of suitable gas proxy companies, conflicts with pro-infrastructure policies embraced by the Commission and mandated by Congress.[4] INGAA respectfully submits that while the proposal to include MLPs in the proxy group is a step in the right direction, the proposal to cap MLP distributions for purposes of applying the DCF formula would add to the ROE dilemma rather than resolve it.

The proposed cap is logically untenable and should not be adopted. As established in the attached analysis of an economist with substantial experience in pipeline rate of return issues, Dr. J. Stephen Gaske, capping the distribution conflicts with the principal tenets of the DCF analysis itself. Exhibit A. The DCF analysis is, at root, an effort to determine the *cash* investors expect to receive from investing in the subject company, and to provide a pipeline with a return commensurate with those investor expectations. Obviously, MLP investors expect to receive the full cash distribution, not an artificially capped one.

Moreover, the cap is inconsistent with a key aspect of the Proposed Policy Statement itself. There, the Commission itself properly recognizes that the *market* corrects for any perceived distortions that may arise from high distribution levels, and specifically that higher MLP distributions (relative to those of pipeline corporations) are offset by relatively lower expected growth rates. Having reached this critical conclusion and having determined to employ the market-based DCF model, the Commission should

[4] *See, e.g., Gas Daily*, March 14, 2006, "Kern River Rate Case Decision Alarms Pipeline Industry Officials. S*ee also* "Report of Wachovia Securities," March 5, 2006 (available at www.ingaa.org\Documents\wachovia-sec.pdf) (reaction of financial community to proposed 9.34% ROE in Kern River's Docket No. RP04-274 rate proceeding).

resist the urge to tinker with and distort the application of that model by imposing adjustments that are contrary to the market-based decisions on which the model is based. In other words, the Commission should permit the DCF formula to utilize the market-based yield, which includes all cash distributions.

In addition, the Commission has not adequately explained its double recovery theory. To begin with, the Commission does not explain how the choices made by a *proxy company* regarding the allocation of its cash between distributions and growth can result in a double recovery of depreciation by the company whose rates are being set. Moreover, including MLP distributions in excess of earnings in the DCF analysis does *not* result in the recovery of a pipeline's depreciation expense in both the depreciation and return components of the pipeline's rates. A pipeline does not recover depreciation expense in the return component of its rates if distributions in excess of earnings are included in the DCF formula. The calculation of ROE under a DCF analysis is not solely a function of a company's cash distributions. To the extent that an MLP's distribution exceeds its earnings in any given year, the MLP's distributed cash flow may be higher in that year, but the other components of the DCF formula (*i.e.*, unit price and growth rate) adjust to arrive at the market-required rate of return. Thus, even assuming *arguendo* that depreciation is theoretically included in a distribution, it is also theoretically adjusted out through the DCF formula. Due to the market-based nature of the DCF model, a high distribution does not result in an "inflated" ROE as the Commission concludes. *See* P 19. Rather than preventing a double recovery of depreciation, an artificial cap on distributions will result in an under-recovery of ROE.

Stated another way, as applied to both corporations and MLPs, the DCF formula is based on the present value of the entity's future cash flows over the long-term. Therefore, it simply cannot be concluded that there is a specified return of capital or depreciation in any one year in an ROE calculated by the DCF formula. Likewise, investors expect to receive the return of their investment at some point during the course of receiving distributions, but not in any specific year. In valuing a security, investors are concerned with the cash distributions they will receive over long-term, not on theoretical distinctions concerning whether such distributions include a return of or on capital in any one year.

Furthermore, as a conceptual matter, INGAA disagrees with the Commission's conclusion that depreciation is included in the cash flow distributed by MLPs. Depreciation is an accounting concept that is used to calculate a pipeline's earnings and is no different than other costs in a pipeline's cost of service that are both recovered in rates and *indirectly* included in the *calculation* of cash flow available for distribution.

Finally, contrary to what is suggested in the Proposed Policy Statement, neither financial theory nor historical experience suggests that MLP distributions are not sustainable. No correlation has been established between recent earnings history and the ability of a pipeline to maintain or grow future distributions. Given this lack of evidence, the burden should be on those opposing inclusion of an MLP in the proxy group to demonstrate that a particular MLP's distributions are not sustainable. Moreover, the test should not be the stability of a company's earnings. Rather, parties should be free to provide any evidence tending to support or disprove the notion that a particular MLP will not be able to sustain the level of distributions included in the DCF calculation.

## III. Comments

### A. The Commission's Proposed Policy Statement Correctly Makes Commensurate Risk the Test For Proxy Group Eligibility

Prior to issuance of the Proposed Policy Statement, the Commission's response to industry consolidation had been to expand the universe of acceptable pipeline proxies to include diversified companies with high percentages of local distribution operations and assets. The default to such diversified companies marked a retreat from earlier decisions where the Commission acknowledged significant differences between lower-risk, state-regulated, franchised LDC operations and federally-regulated pipeline operations.[5] At the same time, the Commission rejected the inclusion of MLPs that were primarily natural gas pipeline companies for the reasons discussed above.

In the Proposed Policy Statement, the Commission correctly recognizes that commensurate risk, not organizational structure, is the ultimate criteria for inclusion in a proxy group. As the Commission acknowledges (at P 15), and as recently reiterated by the Court in *Petal,* there are two well-established prerequisites for setting a return on equity: (1) the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks; and (2) the return must be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.[6]

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[5] *See, e.g., Williston Basin Interstate Transmission Co.,* 87 FERC ¶ 61,264 at 62,007 (1999)("The Commission does not consider it appropriate to include any of the four companies [Equitable, Questar, KN Energy or Consolidated], which have focused primarily on gas distribution and are thus not recognized as being truly representative of the gas transmission business.")

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

### B. The Commission Reached the Correct Conclusion that Including MLPs in the Proxy Group is Appropriate.

The Proposed Policy Statement also appropriately proposes to permit inclusion of MLPs in a proxy group. As the Commission recognizes, most oil pipelines are structured as MLPs and there is a trend in the natural gas pipeline industry toward the use of the MLP organizational structure. Thus, the inclusion of MLPs in the proxy group at this time appropriately results in a proxy group that is representative of the risks of the company whose rates are being set.

In the Proposed Policy Statement (at 17), the Commission correctly acknowledges that if the proxy group is less than clearly representative in terms of risk, an adjustment to the equity return would need to be made, and that the inclusion of more representative MLPs may obviate the need for such an adjustment. Indeed, the Court in *Petal* commented specifically that if distribution companies were included in the proxy group, the pipeline whose rates were being determined would need to be placed at the high end of the range of proxy group companies. Slip op. at 6-7. Thus, including only MLPs whose risks are comparable to natural gas pipelines may avoid the necessity for such adjustments to either the equity return or placement within the proxy group's zone of reasonableness.

The Commission also reexamined some of the reasons provided in prior opinions for rejecting MLPs and correctly found them to be unfounded. First, the Commission recognized (at PP 21-22) that higher MLP distributions are offset with lower growth projections. The Commission reasoned that security analysts making the growth projections used by IBES must be presumed to have taken the level of an MLP's distribution into account when making such projections. As a general proposition, the

more cash a company pays out in distributions or dividends, the less cash is available to be invested in projects that produce growth in the company's earnings and stock price. While many corporations tend to pay less in current dividends and retain more for growth, MLPs tend to pay out more in distributions and therefore generally have lower projected growth rates. The Commission tested and validated this assumption by examining the data for five diversified energy companies and six MLPs. (P 22). Because the DCF methodology calculates a return by examining both the dividend (or distribution) yield and projected growth, the fact that the annual yield of MLPs tends to be relatively higher than that for corporations is not germane because these high yields are offset with lower growth projections in the DCF formula.

Second, the Commission found (at P 23) that the fact that MLPs may rely on external capital to generate growth is not a reason to exclude them. The Commission noted that corporations also rely on external financing sources. More importantly, the Commission reasoned that to the extent a company relies on funding through external sources, such funding is reflected in IBES projections, and a prudent investor will reasonably consider all relevant factors, including such external funding sources, when assessing the value of a security. Therefore, the Commission correctly concluded that "[s]ince a DCF analysis is a method for investors to estimate the value of securities, it follows that such an analysis may reasonably take into account potential growth from external capital."

In short, the Commission concluded that neither the observation that MLP distributions may be high relative to corporations, nor the fact that MLPs rely on external sources of capital, are reasons to disqualify MLPs from the proxy group. As the

Commission correctly reasoned, these facts do not disqualify MLPs because financial analysts and the investment community take them into account in determining the value of a security. In other words, as explained by Dr. Gaske, the DCF methodology is based on an "efficient markets" theory under which the market price of securities, and investors' growth rate expectations, incorporate all relevant information in adjusting to levels that yield the investor required rate of return. As will be explained in the following section, it is this same theory that explains why a cap on MLP distributions is unnecessary and would improperly skew the DCF analysis.

### C. An "Earnings-Cap" Adjustment to MLP Distributions is Unnecessary and Inappropriate.

The Commission proposes to cap an MLP's distributions at the level of the MLP's earnings because it believes that an MLP's distributions in excess of earnings include a depreciation component, which will result in a double-count of depreciation expense: once in the depreciation charge included in the company's cost of service and a second time in the return component to the MLP's investors. For the reasons explained below, and supported in the attached analysis of Dr. J. Stephen Gaske, INGAA demonstrates that the Commission's rationale is flawed. Including all of an MLP's distributions in the DCF formula does not result in a double-count or over-recovery of depreciation. Moreover, the Commission's rationale is inconsistent with the underlying theory of the DCF methodology, which measures the present value of an entity's cash distributions, not its earnings.

### 1. An "Earnings-Cap" Adjustment is Inconsistent with the Efficient Markets Theory that Underlies the DCF Methodology.

As the Commission correctly states in the Proposed Policy Statement, the DCF model is based "on the premise that a stock is worth the present value of its future *cash flows,* discounted at a market rate commensurate with the stock's risk." Proposed Policy Statement at P 2 (emphasis added), *citing Ozark Gas Transmission System,* 68 FERC ¶ 61,032 at 61,104, n. 16 (1994). *See also Williston Basin Interstate Pipeline Co. v. FERC,* 165 F.3d 54, 57 (D.C. Cir. 1999). The Commission further acknowledges that the DCF formula solves for the discount rate, which represents the rate of return that an investor requires in order to invest in a firm. *Id.* As explained by Dr. Gaske, the DCF formula mathematically solves for the discount rate by taking into account the following three variables: (1) cash distributions; (2) unit price; and (3) growth rate. Exhibit A at 2-6, 12-14. The DCF formula is a reverse engineering process that relies on these three variables to determine the required rate of return (*i.e.*, the discount rate) that investors implicitly used in setting the market price of the security. *Id.* at 51.

The fundamental principle of the DCF methodology is that the market price of securities, and investors' growth rate expectations, incorporate all relevant information in adjusting to levels where investors expect to earn the required rate of return. *Id.* at 10-11. Indeed, the Commission acknowledges this theory when it states that (1) the market data for MLPs corrects itself for "distortions" that may arise from high distribution levels; (2) financial analysts take into account the level of a company's distributions as compared to earnings when making the growth forecasts used by IBES; and (3) investors reasonably consider all factors relevant to assessing the value of a security when deciding whether to invest in that security. PP 21, 23. In other words, the Commission agrees that the market

takes into account the relationship of distributions, growth and unit price. Yet, in artificially capping MLP distributions at earnings, the Commission ignores these same market-based relationships.

The Commission's concern over whether distributions in excess of earnings include a return of capital ignores the inter-dependence of the three variables referenced above. First, an MLP's distribution yield is a function of the level of the distribution and the unit price of the partnership share. Thus, the DCF formula is a market-based approach that utilizes the market price of publicly-traded securities to estimate the required return. If there were a return of capital component in an MLP distribution, it would be reflected in the market price of the partnership units that is used to determine the distribution yield component of the DCF formula. Therefore, all other inputs used to determine the market price, including total cash flows, must be used in the DCF formula. Exhibit A at 11.

Second, the Commission's concern ignores the inverse relationship between distributions and growth rates. As the Commission itself recognizes at Paragraph 21, the higher cash distributions of MLPs result in, and are "offset" by, lower expected earnings growth. It is irrational to cap MLPs' distributions and still use their lower projected rates of growth, which are based on the very fact that MLPs generally devote relatively less cash flow to growth because they distribute more cash to unit holders. Therefore, reducing distributions without adjusting growth upwards will skew the DCF analysis and result in artificially low returns. Such an approach would violate the Supreme Court's requirement in *Hope* that pipelines be given a return that is commensurate with their risks

and that is sufficient to assure their financial integrity, and allow them to maintain credit and attract capital.

The Commission's focus on a company's earnings is also inconsistent with the premise of the DCF analysis. As its name implies, the DCF model is based on discounted "cash flow" to investors, not discounted "earnings." In effect, the Commission proposes to convert the DCF methodology to a "DEF" model, *i.e.*, discounted earnings flow. In valuing a company's securities, investors are concerned with the stream of cash distributions they will receive, not with whether the distributions exceed earnings or include a return of or on capital. As Dr. Gaske notes, financial analysts, as well, place more emphasis on MLP cash flow than earnings in valuing the company.[7] The proposed distribution cap discards the DCF formula that has been used for years in favor of a theoretically untested and flawed DEF model.

Cash flow to investors, by definition, includes all cash distributions, not an arbitrarily capped level of distributions. Put differently, the Commission recognizes that the DCF method is a method for investors "to estimate the value of securities." Proposed Policy Statement at P 23. Yet, investors would not value those securities nearly as much if their distributions were capped as posited in the Proposed Policy Statement. The Proposed Policy Statement never comes to grips with this important point. Thus, rather than preventing a double recovery by the pipeline of depreciation expense, the proposed cap would result in an *underrecovery* of return on equity.

[7] *See* Gaske analysis (Exh. A at 11), quoting an article from Wachovia Capital Markets, L.L.C.

### 2. Including All of an MLP's Distributions in the DCF Formula Would Not Result in a Double Recovery of Depreciation Expense.

In paragraph 9 of the Proposed Policy Statement, the Commission states that depreciation and amortization may be considered a part of "available cash flow," and as a result, an MLP's cash distributions normally include not only the net income component of "available cash flow," but also the depreciation component. Similarly, in paragraph 19, the Commission reasons as follows:

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

The Commission never explains how an MLP could recover depreciation expense through an "inflated ROE" under the DCF analysis, and thereby double recover its depreciation expense. As explained more fully below, the Commission's analysis is not theoretically sound for two reasons. First, it ignores the financial theory underlying the DCF formula, which bases a return not on cash distributed in any one year, but on the present value of cash distributions over the long term (*i.e.*, distribution yield plus growth). As demonstrated below, and in Dr. Gaske's analysis, if an MLP's distribution is relatively high due to the theoretical inclusion of "depreciation", the other components of the DCF formula will adjust to lower the return. Thus, the ROE will not be "inflated" and there is no double recovery.

Second, as more fully explained below, depreciation expense is not included in a pipeline's cash flow in any real sense because it is not a source of cash flow. Rather, it is accounting concept that requires the use of an asset to deducted proportionately over its life for the purpose of determining a company's annual income.

**a. MLPs Do Not Double Recover Depreciation When They Distribute More Than Their Earnings Because Any Theoretical Depreciation Included in Such a Distribution is Adjusted Out Through the DCF Formula.**

The primary flaw in the Commission's presumed double-count is its conclusion that depreciation expense is included in the return component of an MLP's rates. Quite simply, a pipeline's return is not based on an MLP's cash distributions in any one year. Rather, the return calculated by the DCF formula is based on the present value of the MLP's cash distributions over the long-term. This includes both current distribution yield, which is a function of unit price, and projected growth. As discussed above, all three variables operate interdependently in the formula to produce the rate of return required by investors to invest in that security. If an MLP distributed more cash than it earned in any one year, the DCF formula would adjust to the higher distribution through (1) a lower projected growth rate; and (2) a higher market price that would create a lower yield. Thus, even if an MLP's distribution may in some theoretical sense be viewed as including a depreciation component, the overall return produced by the DCF formula will self-correct to eliminate the effect of any theoretical depreciation included in that distribution.

Dr. Gaske demonstrates the above point through a regression analysis that tests the Commission's assumption that high distribution payouts result in greater ROEs. That analysis, attached at pages 7-9 of Dr. Gaske's study, demonstrates that there is no

statistically significant correlation between the extent to which an MLP's distributions exceed its earnings (*i.e.,* payout ratio) and the ROE calculated under the DCF model. This result could be expected because payout ratios alone do not determine an ROE under the DCF methodology.

Stated another way, both corporations and MLPs either distribute their cash flow or retain it for future growth. Over the long-term, investors of both types of entities expect to receive a return on their investment, and eventually a return of their investment. It is not accurate to conclude, however, that in any one year an investor receives a specified ratio of return *on* capital and return *of* capital or depreciation. From the perspective of the investor, it is not important to determine whether any part of a distribution in any given year is a return of capital to that investor, and if so how much.[8]

As a theoretical matter, it is possible that some part of an MLP distribution (or a corporate dividend) in any given year may be a return of capital depending on when during the life of the investment it is assumed the investor receives the return of the capital it invested. Thus, if an investor contributed $100 and receives $15 in distributions in years one through ten, in total it has received $150 on its $100 investment. Over the long-term, the investor assumes that it will receive the return of its investment, but it cannot be ascertained at what point over the course of receiving distributions that will occur.

It makes no more sense to cap a pipeline's distributions, whether it is an MLP or a corporation, because a return of capital (or depreciation) may be included in the current

[8] The question of whether a distribution includes a return of capital is different than issues relating to the tax implications arising from MLP distributions and allocations of partnership income.

year's distribution, than to cap the pipeline's growth rate because the return of capital may be included in future years. In other words, a company has two choices with respect to cash it generates. It either (1) pays out more cash in distributions, in which case a depreciation or return of capital component, under the Commission's theory, is included in the distribution yield element of the DCF formula or (2) the company invests the cash in projects to generate future growth, in which case the Commission's theory would suggest that the depreciation component is included in the growth rate element of the formula. While the Commission concludes that there is a double recovery of depreciation if an MLP pays out higher distributions, it does not conclude that a corporation that invests more cash for growth, and therefore has a higher projected growth rate, is double recovering depreciation in the growth rate component of the formula.

A cap on any one component of the DCF formula would artificially distort the DCF formula unless a corresponding increase in the non-capped components was permitted. In other words, if the depreciation theoretically included in a distribution is excluded from such distribution, and no corresponding adjustment is made to the projected growth rate to include the return of capital or depreciation that will be available for investment in new pipeline projects or other sources of growth in future years, the result is that a return of capital through depreciation is not included in the DCF analysis at all. Investors, however, do expect the return of their investment in the long-term. The Commission never explains how the imbalance in the DCF formula created by its failure

to account for the alternative use of the distributions in excess of the cap can be squared with the investor expectations that underlie that formula.[9]

Finally, the Commission does not explain how the choices made by a *proxy company* regarding the allocation of its cash between distributions and growth can result in a double recovery of depreciation by the company whose rates are being set. If a proxy company's distribution includes a depreciation component, that depreciation is not an expense of the pipeline whose rates are being set. Thus, even assuming *arguendo* that a proxy company's distributions in excess of earnings raise the subject pipeline's return calculated by the DCF formula (which it will not due to the aforementioned trade-offs in the formula), it will not cause the *subject pipeline* to double recover depreciation expense.

**b. Conceptually, There is No Depreciation Expense in an MLP's Cash Distribution.**

The underlying premise for the Commission's concern about a potential double recovery of depreciation relates to manner in which an MLP calculates "cash available for distribution". Thus, the Commission states "[t]o the extent an MLP makes distributions in excess of earnings, it is able to do so because partnership agreements define 'cash available for distribution' to include depreciation."[10] Proposed Policy Statement at P 19. Regardless of how "cash available for distribution" is *calculated*, however, depreciation is an expense. Expenses do not produce cash flow and cannot be

[9] On the other hand, if the Commission attempts to make an adjustment to the projected growth rates used in the DCF formula to compensate for the cap on distributions, it will be improperly substituting its judgment for decisions made by the market.

[10] As discussed *infra*, corporations are also able to distribute dividends in excess of earnings.

distributed. Depreciation is a generally accepted accounting principle that requires the investment in an asset to be expensed over the life of the asset for income reporting purposes. It is used to determine a company's earnings by charging future periods that benefit from an investment made in a prior period.

The Commission's conclusion that depreciation is included in the cash flow distributed by an MLP stems from the mechanical manner in which MLPs calculate "funds available for distribution." MLPs generally make cash distributions to their investors based on cash on hand at the end of each quarter, less reserves established by the general partner of the MLP. The amount to be distributed (*i.e.*, cash on hand less general partner reserves) is generally defined as "cash available for distribution".[11] These cash flows would be easily identifiable by MLPs from an accounting standpoint if they utilized the "direct cash flow method" allowed by Statement of Financial Accounting Standards ("SFAS") No. 95, *Statement of Cash Flows.* However, because a substantial majority of MLPs utilize the "indirect cash flow method" allowed by SFAS No. 95, general partners generally are required to estimate the amount of "operating cash flow" that can be distributed.

The indirect cash flow method is a short-cut approach that allows MLPs to approximate their operating cash flow by starting with net income. Obviously, net income takes into account a number of items that do not result in cash inflows and outflows to the MLP. One of these non-cash items that is deducted in arriving at net

[11] Cash available for distribution is normally based on the cash flow generated from the operations of the MLP, less: (a) any temporary changes in accounts receivable and payable, which are commonly termed "working capital"; (b) cash paid for interest expense; and (c) cash used for capital expenditures during the period.

income is depreciation.[12] Thus, under the "indirect" method, "cash available for distributions" is calculated by beginning with net income (*i.e.*, earnings) and adding back depreciation and other non-cash items. The reason depreciation is added back is that it was deducted in the first place to determine net income.

The following example demonstrates the point. Assume the following simplified financial data that ignores other non-cash expenses and income taxes:

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| Operating Cash Revenues | $100 |
| Operating Cash Expenses | -60 |
| Depreciation Expenses | -10 |
| Net Income | $ 30 |

In this example, the company's cash flow is the difference between the cash revenues received and the cash expenses disbursed, or $40. The company's net income is $30 because accounting rules require that non-cash expenses such as depreciation be deducted to arrive at net income. If the direct method of determining an MLP's available cash flow were utilized, the cash flow would simply be the difference between the cash receipts and disbursements of $40. Depreciation expense is not included in this calculation. The indirect method, however, requires an MLP to calculate available cash flow by starting at the $30 of earnings and adding the $10 of depreciation expense back (because it was deducted to calculate earnings), to arrive at the same $40. Thus, depreciation is included in cash flow only in the formulaic sense that it is included in the indirect calculation of cash flow. Cash flow, however, is the difference between cash

[12] Other non-cash items that are taken into account in the calculation of "cash available for distribution," for example, include (1) depletion and amortization; (2) bad debt expense; (3) impairments; (4) equity earnings that do not result in cash distributions; and (5) changes in fair value of items recorded at fair value in the financial statements.

receipts and disbursements, and does not include depreciation expense. Depreciation is not a source of cash flow and is not being recovered from ratepayers a second time through the return allowance when an MLP's cash flow is considered in the DCF calculation. *Id.*

Moreover, the Commission's suggestion that depreciation expense is being recovered twice could theoretically apply to many expenses in a regulated pipeline's cost of service, and to any pipeline regardless of organizational structure. As INGAA understands the Commission's concern, depreciation is purportedly recovered twice: once through the depreciation allowance in the pipeline's cost of service, and a second time through the inclusion in cash flow used to make the distribution included in the DCF analysis. However, assuming *arguendo* that depreciation is a part of a cash flow, the same could be said of many other costs in the pipeline's cost of service. This result is simply a function of the fact that a pipeline's rates, whether it be an MLP or a corporation, are cost-based. Because a pipeline's rates are cost-based, the pipeline's cash flow (*i.e.*, its revenues) is based on a recovery of the pipeline's costs, one of which is depreciation expense. In this sense, because a pipeline's rates are cost-based, it collects costs from its ratepayers and also bases a return under the DCF methodology on its cash flow, which includes such costs. The fact that a pipeline's costs are both recovered in rates and indirectly included in the cash flow used to calculate a return is neither a double-count that conflicts with the DCF methodology, nor is it unique to the MLP organizational structure.

Stated differently, there is no way to match a particular cash distribution with the specific source of such cash distribution, as the Commission assumes. As the

Commission recognizes, both MLPs *and corporations* continually receive funds from external sources, and there are a number of non-cash expenses in addition to depreciation expense that reduce earnings.[13] As discussed above, a pipeline's cash flow generally is a function of cash receipts less cash disbursements. In fact, MLPs make several adjustments to arrive at cash available for distribution, such as cash paid for interest expense and cash used for capital expenditures. Earnings, on the other hand, are a function of accounting concepts and include such items as accrued expenses and revenues, depreciation, amortization, deferred taxes and other than non-cash expenses. Thus, it cannot be concluded that MLP distributions in excess of earnings are depreciation expenses or a return of capital. Cash flow and earnings are a function of many variables and cannot be reconciled in the simplified manner the Commission suggests.

**3. The Proposed Cap on MLP Distributions is Inconsistent with the Commission's Treatment of Corporate Dividends in the DCF Model.**

Finally, the Commission's cap on MLP distributions conflicts with the long-term nature of the DCF methodology. The purpose of the DCF model is to examine cash flow over the long-term, and the fact that MLP distributions may exceed earnings in any short-term period such as a year is irrelevant. In fact, corporate dividends may exceed earnings in any given year as well. *See* Exhibit B attached hereto, which is an exhibit relied upon by the Commission in the *HIOS* proceeding that shows that several corporations had annual dividend payout ratios in excess of 100 percent.[14] The Commission has never

[13] *See* footnote 12, *supra.*

[14] *See* the payout ratios of National Fuel Gas Supply Corporation, El Paso Corporation, Dominion Resources and NiSource that have been underlined in Exhibit B. This exhibit was attached to the testimony of Staff Witness Franklin D. Knight in *Trailblazer Pipeline*

suggested that including corporate dividends in excess of earnings in a DCF analysis results in a double collection of depreciation expense or an improper return of capital to a corporation's investors. The Commission has never proposed to cap a corporation's dividends at the level of its earnings in the DCF analysis, and correctly so. It would be inconsistent, however, with the treatment of corporations to cap MLP distributions.

### D. The Proposed Policy Statement's "Stable Earnings" Standard Should Be Clarified and Refined.

The Commission states that an MLP's lack of retained earnings may render cash distributions at their current levels unsustainable, and therefore not suitable for inclusion in the DCF analysis. To address this possibility, the Commission proposes to require participants proposing to include MLPs in a proxy group to provide a multi-year analysis of past earnings. The Commission stated that an analysis showing that an MLP has stable earnings would support a finding that the cash to be available in the DCF calculation is likely to be available for distribution, and would support the inclusion of that MLP in the proxy group. P 24.

INGAA does not agree with the inference that an MLP's lack of retained earnings may render cash distributions at their current levels unsustainable. Since pipelines owned by MLPs are long-lived assets by the very nature of their business, the inference should be just the opposite. As discussed below, the evidence to date demonstrates that pipeline MLP distributions are indeed stable. Given the lack of evidence to suggest that the

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*Co.*, Docket No. RP03-162-000, and was relied upon by the Commission in *HIOS*. to support the notion that MLPs pay out more in distributions than corporations do in dividends. *See High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 at P 126, n. 111-112, *order on rehearing*, 113 FERC ¶ 61,280 (2005), *vacated and remanded sub nom Petal Gas Storage, L.L.C. v. FERC*¸ Case No. 04-1166 (Aug. 7, 2007).

distributions of MLPs as a rule are unsustainable, and the fact that pipelines are increasingly using the MLP structure, the burden should be on opponents of the inclusion of any MLP in a proxy group to demonstrate that the level of distributions reflected in the DCF analysis for that particular MLP cannot be sustained. Rather than limiting the inquiry into the stability of an MLP's earnings, as the Proposed Policy Statement suggests, parties should be free to rely on any evidence indicating that the distribution level of a particular MLP is, or is not, sustainable. The relevance of any evidence proffered, as well as the time period reviewed, should be decided on a case-by-case basis.

INGAA refers the Commission to the analysis of Dr. Gaske, who concludes that the Commission's concern over the sustainability of MLP distributions is not supported by either financial theory or historical experience. In his study, Dr. Gaske includes an analysis of the financial performance of several MLPs that demonstrates that MLP cash flow per share, distributions per share and earnings per share have increased during the past decade, and can be expected to continue to grow. Exhibit A, at 31-33 & Appendix A. Dr. Gaske explains that the Commission's concern over the sustainability of MLP growth is based on the misconception that retained earnings are the sole source of growth. Instead, MLPs (like many corporations) have grown primarily by reinvesting free cash flow and using external financing sources to make investments that are accretive to earnings. Thus, while MLPs generally do not rely as much on retained earnings to fund growth as corporations, they can grow and have grown through accretive investments and other sources. Exhibit A, at 21-31.

There is no reason, and certainly no evidence, to suggest that MLPs cannot continue to pay high distributions relative to corporate dividends. However, such inquiry

should not be limited to a review of the stability of an MLP's earnings. Earnings may fluctuate for a number of reasons, including one-time charges due to acquisitions or extraordinary items that may occur in any given year such as the sale of an asset, weather-related events or changes in accounting procedures that could produce a significant one-time gain or loss. In addition, market downturns in the industry could produce reduced earnings, or losses, over prolonged periods. Parties opposing inclusion of an MLP for reasons of "unsustainability" should be free to point to any evidence supporting their position, and proponents of the inclusion of that MLP should likewise be free to show through any evidence that the MLP distributions are sustainable.

### E. Parties Should be Free in the Future to Propose Other Changes to the DCF Methodology or Different Methodologies for Determining Return on Equity

In the Proposed Policy Statement, the Commission requested comments on its proposed policy of permitting MLPs in the proxy group, alternative proposals for determining a representative proxy group and the relevance of the stability of an MLP's earnings. Notably, the Commission did not request comments to address other potential modifications to the manner in which the Commission applies the DCF methodology, such as the use of gross domestic product to measure second stage growth, or other alternative methodologies to the DCF method. Accordingly, INGAA's comments should not be construed as foreclosing INGAA's or any of its members' rights to advance additional modifications and alternative methodologies in individual proceedings or future rulemakings. Indeed, if the Commission does not remove the proposed cap, additional modifications to the DCF model and/or alternative methodologies would be required.

## CONCLUSION

INGAA appreciates the Commission's recognition that inclusion of MLPs in a proxy group used for determining a pipeline's return on equity under the DCF model is appropriate. To be consistent with the market-based nature of the DCF methodology, however, the proposed cap on MLP distributions must not be adopted. In addition, the burden should be on any party opposing inclusion of an MLP in the proxy group to show that a particular MLP's distributions are not sustainable.

Respectfully submitted,

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UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

# The Use Of MLPs In DCF Analyses Of Interstate Natural Gas Pipeline Companies

A Report Prepared For
The Interstate Natural Gas Association of America

By

J. Stephen Gaske, Ph.D.
Zinder Companies, Inc.

August 30, 2007

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A Paper Prepared on Behalf of the
Interstate Natural Gas Association of America

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## Chapter I: THE RATE OF RETURN ON EQUITY PREDICAMENT

During the past 24 years the Commission has relied on the Discounted Cash Flow ("DCF") model to set allowed rates of return on common equity for interstate natural gas pipelines. For most of this period, the DCF approach evolved to produce results that on a generally consistent basis satisfied the just and reasonable standard under the Natural Gas Act, which "involves a balancing of the investor and the consumer interests." *FPC v. Hope Natural Gas Co.*, 320 U.S. 691, 603 (1944). Still, it has become increasingly apparent that the DCF model applied to the historical proxy groups may no longer yield results that achieve the balance required by the law. During the nine years since the last significant adjustment to the Commission's application of the DCF model to the interstate pipeline industry[1] -- a change in the method used to calculate the DCF growth rate -- the composition of the proxy group and the characteristics of publicly-traded pipeline companies have changed substantially. The rates of return generated by the historically approved proxy groups have declined precipitously to levels that many pipeline companies believe are considerably less than their cost of capital.

[1] In Opinion No. 414-A the Commission began estimating investors' expected growth rates for natural gas pipeline proxy companies by taking a two-thirds/one-third weighted average of (i) investment analysts' forecasts published by Thomson (IBES), and (ii) a forecast of the U.S. GDP long-term growth rate.

Recently, the Commission issued its Proposed Policy Statement, "Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity," in Docket No. PL07-2, 72 Fed. Reg. 41,744 (August 1, 2007) (hereinafter "Proposed Proxy Policy"), in which it proposes to accept Master Limited Partnerships ("MLPs") as appropriate proxies, subject to several conditions. As part of this paper, I will address the conditions on including MLPs in the proxy groups and why these conditions are neither appropriate nor necessary.

As a result of mergers, asset sales, corporate reorganizations and financial distress, the universe of publicly-traded natural gas pipeline companies that are organized as subchapter C corporations for purposes of federal tax law has declined precipitously. As the Commission recognized in its proposed Policy Statement, this has affected the ability to construct a proxy group limited to subchapter C corporations that accurately reflects the risk that would be faced by a stand-alone interstate natural gas pipeline company.

The key insight for evaluating the validity of any DCF approach is that market prices for stocks act as a self-correcting mechanism to ensure that investors can expect to earn a return commensurate with risks. The dividend distribution (D) for an MLP should not be manipulated without making offsetting changes in other variables, such as the stock price (P) and expected growth rate (g). An efficient market will automatically make these offsetting adjustments because the risk of an investment – not the level of any single variable – is the element that determines the level of return required.

While the Commission proposes to modify its policy to allow MLPs to be included in the proxy group for pipeline rate cases, it also continues to express concern

about including within the DCF calculation MLP distributions that exceed earnings. See Proposed Policy Statement 10-14, 18-19 and 24. The Commission's concern is misplaced, in large part because this focuses only on a single variable in the DCF model, the distribution (D), and does not adequately recognize that a high distribution relative to earnings will affect the other two variables in the model: market price (P), and/or the expected growth rate (g). As the Commission recognized in its Proposed Proxy Policy (PP 21 and 22), relatively high MLP dividend yields are offset by lower growth rates. The price per share of stock (or partnership unit) and the expected growth rate for a company reflect investors' understanding of the company's prospects and the process by which it generates cash to pay dividends or distributions. This is borne out by the Commission's own review of recent IBES growth forecasts. See Proposed Proxy Policy at P 22. Thus, when all three variables (D, P and g) are considered together, the fact that MLPs might pay distributions that exceed earnings, and the fact that they have relatively high dividend yields, does not provide any reason for inferring that a DCF analysis of MLPs will produce an overstated, *rate-of-return estimate* compared to a DCF analysis of comparable corporations.

Section II-A and Appendix B of this paper show the results of several statistical tests that were conducted to determine whether there is any factual basis for suggesting that high earnings payout ratios cause higher DCF estimates of the required rate of return for MLPs. These analyses show that it is factually incorrect to assert that high payout ratios cause higher DCF results and, in particular, when an MLP pays distributions that exceed its earnings, its DCF results are overstated in direct proportion to the amount by

which distributions exceed earnings.[2] The data show that there is virtually zero relationship between DCF results and an MLP's payout ratio, and literally zero relationship between the DCF results and the amount by which distributions exceed earnings.

For these reasons, the Commission's proposal to adjust an MLP's cash distribution to exclude any distribution amounts that exceed earnings is misconceived. The accuracy and level of the DCF analysis is unaffected by whether the "D" in the DCF formula constitutes a return *on* or *of* capital; the market price and investors' expected growth rate will reflect the level and source of "D" so that an unadjusted DCF analysis should produce an accurate estimate of the required rate of return in either circumstance. Accordingly, if the new policy ultimately places a cap on an MLP's "D", an accurate DCF analysis will require offsetting adjustments to increase the investors' expected growth rate (g), or reduce the price (P), or both. Such adjustments to the market price or expected growth rate, although necessitated by the ill-advised distribution cap, would be a further departure from the real world of investor expectations. Thus the "distribution cap" would render the DCF approach an unwieldy tool of dubious validity.

The concerns expressed about "double recovery" of the depreciation allowance through an inflated ROE are misplaced for the same reason. (Proposed Proxy Policy at P 19) This vague assertion reflects a fundamental misunderstanding of the dynamic characteristics that cause a DCF analysis to provide an accurate estimate of investors' required rate of return. A return of capital to shareholders does not matter to the results of a proper DCF analysis because the required rate of return depends upon the risk of the

[2] The proposed distribution "cap" adjustment would reduce dividend yields of MLPs in direct proportion to the amount that distributions exceed earnings.

investment, not the level of distributions. Any expected level of cash flows – with or without a return of capital – will give the same DCF results because the market price of the stock and/or the expected growth rate move up or down to ensure that the results are always commensurate with the risk.[3] Thus, because it is wrong to suggest that returning capital to the shareholders overstates the DCF results, it is also wrong to assert that the DCF results would lead to a double-recovery of depreciation.

Characterizing any dividend distributions in excess of earnings as a "double recovery" of depreciation is doubly misplaced, because it mistakenly suggests that the DCF results are somehow overstated as a consequence, and it implies that customers pay twice for depreciation costs that they actually pay for only once. If an otherwise comparable MLP (or corporation, for that matter) whose earnings include a distribution of cash available from book depreciation or other sources of cash is included in the proxy group, there is no double recovery, because (i) a return of investment *from the customers to the company* is very different from (ii) a return of investment *from the company to the stockholders.* Customers pay a return *of* investment only once. It appears that the Commission is confusing (a) the establishment of rates for the pipeline that has filed the rate case, i.e., an instance where there is a distinction between the various components of the cost-of-service rates such as ROE and depreciation, and (b) the DCF for proxy companies which is not a cost-of-service ratemaking exercise but rather is an attempt to establish the return on equity for an investment with like kind risk. The Commission is introducing regulatory accounting concepts into an exercise in which such distinctions have no relevance.

[3] This concept is demonstrated in Appendix C of this paper.

The flaw in the proposed Policy Statement's argument concerning "double recovery" of depreciation is further shown by considering that when pipeline earnings derived from ratepayers are re-invested to produce growth, there has never been a legitimate concern that the reinvestment of earnings dollars results in a double recovery of earnings. If the distribution of depreciation dollars is to be excluded from the DCF analysis because it represents a "double recovery" of dollars already paid by the ratepayer, why doesn't the same objection apply to the use of such dollars for investment in projects that will generate growth -- another DCF formula variable that makes a positive contribution to ROE? In both cases, ratepayer dollars provide the new stream of dollars that the company can either invest or distribute to the owners.

In sum, although payment of distributions in excess of earnings does not cause a DCF analysis to overstate the required rate of return *on* investment, the required rate of return would certainly be increased by the perceived increase in regulatory risk associated with a policy that consistently understates the required rate of return in setting pipeline rates. The primary results of a policy that erroneously excludes from the DCF calculation a portion of the cash distribution on which the market price and expected growth rate are based would be an increase in risk for pipeline investments, impairment of the value of existing investments, and strong discouragement of new investments. For the foregoing reasons, MLPs should be included in the proxy group without any cap on distributions.

## Chapter II: LACK OF FOUNDATION FOR A DISTRIBUTION CAP

The policy statement suggests that when a dividend distribution includes a return of capital, a DCF analysis should reduce the dividend yield by the amount of the return *of capital* to prevent:

(i) a DCF analysis from overstating the required rate of return (P. 10)

(ii) the company from double-recovering its depreciation (P. 18-19)

The reasons given for the proposed adjustment suggest an assumption that there is a strong relationship between an MLP's earnings payout ratio and its DCF results. That is a testable hypothesis that, as shown below, cannot be supported. In addition, there appears to be some confusion about both the difference between a corporation and its shareholder and the underlying theory of the DCF method. An evaluation of these conceptual problems also demonstrates that the proposed distribution cap cannot be supported on conceptual grounds.

### A. Empirical Tests Contradict the Need for a Distribution Cap Adjustment

In order to test the assumption that DCF results are overstated for MLPs that pay distributions that exceed their earnings, DCF results for MLPs for which data were available were calculated using the Commission's standard approach each year from 2004 to 2007. In addition, the earnings payout ratios (i.e., distributions divided by earnings) were calculated for the MLPs for each year. Chart II-A shows a scatter plot of the relationship between payout ratios and DCF results. The data shown on the chart and the results of the statistical analyses are shown in Appendix B. Two regression analyses were conducted on the entire set of data. One regression used the DCF results as the

dependent variable and the payout ratios as the sole explanatory variable. There was no statistically significant relationship found. A second regression used two explanatory variables, the payout ratios and, because there might be differences in the DCF results due to using multiple years, a second explanatory variable was used to control for the effects of changing costs of capital from year to year. Again, there was no significant relationship between payout ratios and DCF results.

Because the Proposed Proxy Policy Statement suggests that a distribution cap adjustment is necessary only for companies that pay distributions that exceed their earnings (i.e., have payout ratios greater than 1.0), an analysis was done to determine whether there might be a relationship between payout ratios and DCF results only for MLPs that pay out more than their earnings. A scatter plot of those MLPs is shown in Chart II-B and the result is even less statistically significant. The R-Square statistic for these MLPs is zero (0.0), which means that there is absolutely no statistically meaningful relationship between payout ratios and DCF results for MLPs that pay out more than their earnings. In order to accept the assumption in the proposed Policy Statement, there would need to be a high R-Square and a very high statistical significance to these results. Consequently, the assumption that there might be a double-recovery of depreciation, or an overstatement of the required rate of return, is not supported by the data.

**Chart II-A**
**Relationship Between Earnings Payout Ratios**
**and DCF Results for MLPs 2004-2007**

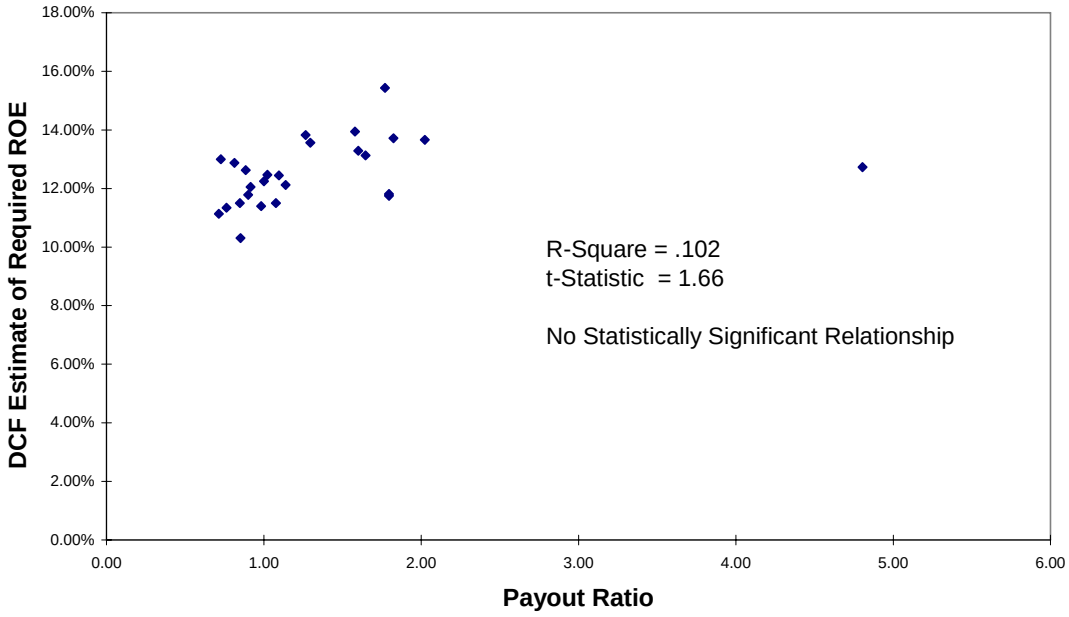
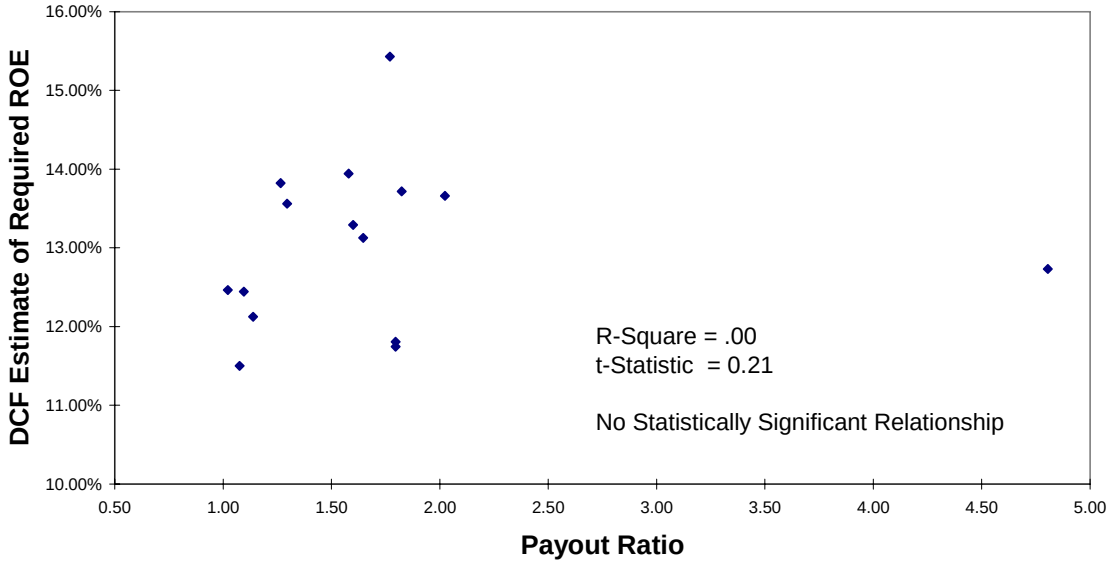



**Chart II-B**
**Relationship Between Payout Ratios**
**and DCF Results for MLPs with**
**Distributions Greater Than Earnings**



A second test of the validity of the proposed adjustment is whether it produces plausible results. However, the magnitude of the flawed capping of distributions can be seen in three of the DCF calculations for MLPs that would be affected:

**Table II-A**
**Inadequacy of "Distribution Cap" Returns**

| | (1) DCF Estimate of ROE | (2) "Distn-Cap" Adjustment | (3) Adjusted ROE |
|---|---|---|---|
| **2007** | | | |
| Enbridge Energy Partners | 11.54% | -2.75% | **8.80%** |
| Enterprise Product Partners | 13.18% | -3.31% | **9.87%** |
| **2005** | | | |
| Enbridge Energy Partners | 12.73% | -6.06% | **6.67%** |

DCF estimates of the cost of common equity such as the 6.67 percent or 8.80 percent shown on Table II-A are clearly implausible. Thus, the available evidence suggests that the proposed *ad hoc* adjustment is not valid. These inadequate results are to be expected because basic analysis of the DCF theory demonstrates that the "distribution cap" proposal will always produce inaccurate and inadequate DCF results when the cap is applied without offsetting adjustments to the market price and/or expected growth rate.

### B. A Distribution Cap Is Incompatible With the DCF Theory

A distribution cap is not necessary to prevent DCF results from being overstated. At the outset it should be stressed that the primary problem with the Commission's proposed approach is that it assumes that financial markets are inefficient. Such an assumption has never been supported. Yet, the distribution cap modification proposed by the Commission in the Proposed Policy Statement is only necessary if the financial

market is somehow inefficient. The fundamental principle of efficient markets in financial theory is that the market price of securities, and investors' growth rate expectations, incorporate all relevant information in adjusting to levels where investors expect to earn the required rate of return. In this modern internet age, investors have all kinds of information available to them including the source of MLPs' distributions. An interested investor could discover significant financial accounting and operational information with minimal effort. To the extent that a return of capital is reflected in the market price of partnership units, an accurate DCF analysis must reflect the same cash flows that are incorporated in the market price. For example, according to Wachovia Capital Markets, L.L.C.:

> **Valuation--Cash Is King**
>
> Unlike traditional corporations, earnings for MLPs are less relevant in considering valuation, in our view. Thus, we do not pay as close attention to price-to-earnings (P/E) multiples as we believe the focus for MLPs should be on cash flow rather than earnings. This is due to the fact that cash flow determines how much can be paid out to unitholders in the form of distributions.

The fact that investors include the value of an expected return of capital in the discounted present value used to discover market prices for MLP partnership units means that the return of capital does not skew the results of a proper MLP DCF analysis.

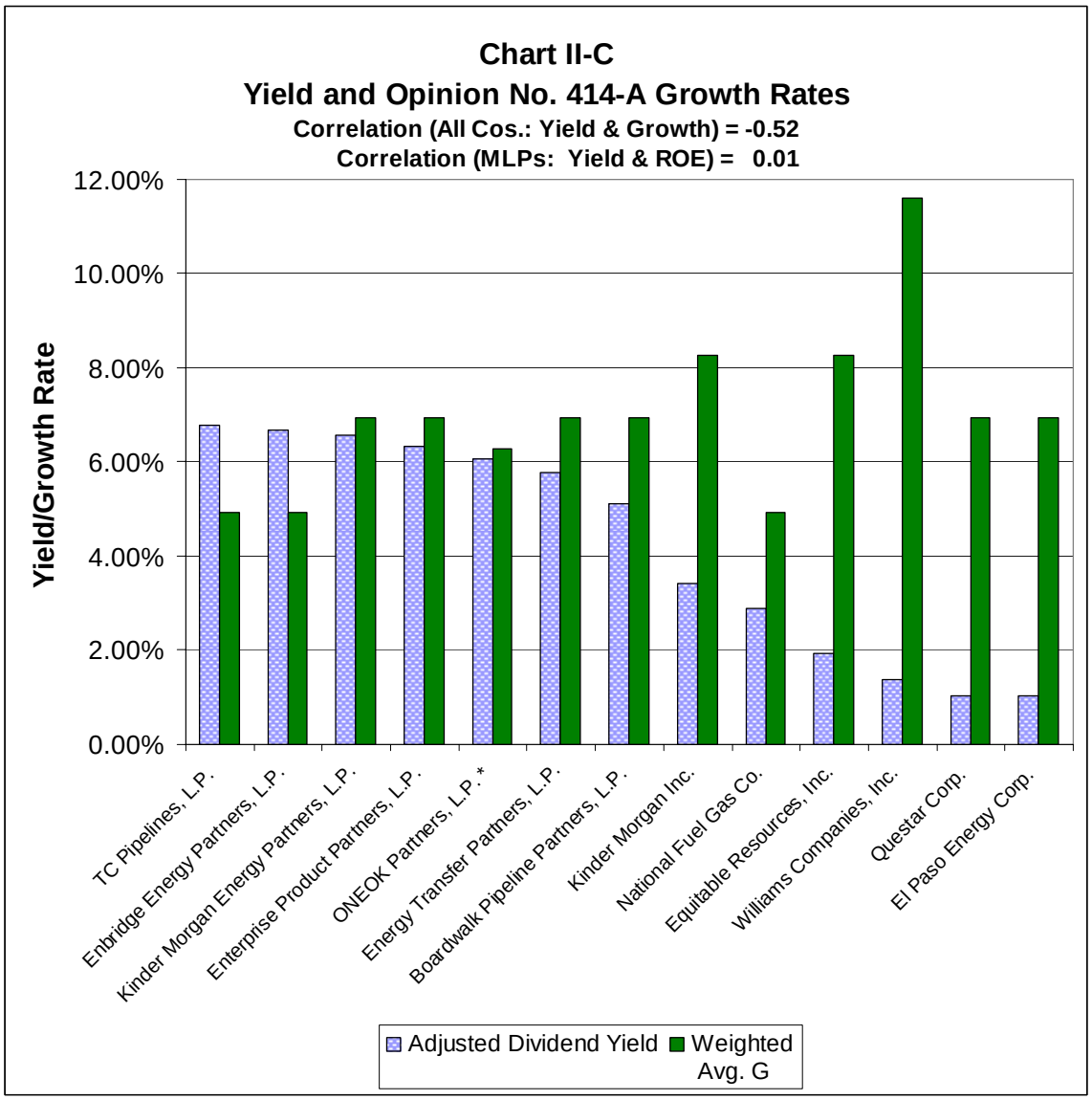
In analyzing whether the Commission's concern regarding the distinction between a return *on* and *of* capital in the Proposed Proxy Policy (P 18) makes a difference for purposes of performing a DCF analysis, it is important to recall that the only requirement in the DCF model is that an investment distribute cash to its investors. For purposes of the DCF model, a dollar of cash is a dollar of cash regardless of whether it is labeled as a distribution, a dividend or a coupon. It also is important to note that companies may

pursue different business strategies and yet still have the same cost of capital. For example, one company may choose to pay high distributions and maintain a lower growth rate, while another company may choose to pay low distributions in order to retain more cash to fund a higher growth rate. *Relative risk*, not distribution yield, is what determines whether two entities will have comparable after-tax costs of capital. The fact that MLPs generally have high *distribution yields* does not mean that a DCF analysis of MLPs will produce a different *rate-of-return estimate* than a DCF analysis of comparable corporations that have lower dividend yields. The decision to disqualify MLPs because they have high *distribution payouts* is a decision to focus on only a *single variable* -- distribution -- in the DCF formula. This decision ignores the fact that the DCF estimate of the cost of capital is based on *three* variables – distribution, unit price, and growth rate – that interact to ensure that the DCF estimate of the cost of capital reflects the risk associated with a company.

Similarly, an MLP should not be rejected as a proxy company because it has a higher *distribution yield* than a corporation. Yield is based on *two* variables, distribution and stock/unit price, while the DCF analysis requires all *three* variables to estimate a rate of return that reflects risk. Consequently, from the standpoint of financial theory, the analyses that disqualify MLPs solely on the basis of either high distribution payouts, or high distribution yields, are incomplete, because they ignore the inverse relationship between payouts and the expected growth rates.

For example, Chart II-C shows potential proxy companies ranked from left to right by their dividend yields (the left-hand vertical bar for each company, shown in

blue).[4] All of the MLPs are on the left, because they have the highest dividend yields. Chart II-C also shows the expected growth rate for each of the potential proxy companies (the right-hand vertical bar for each company, shown in green) derived using the current method for computing growth rates for natural gas pipeline proxy companies. It is clear that the potential proxy companies that are corporations consistently have higher projected growth rates than the potential proxies that are MLPs.




[4] Yields in Chart II-C are based on stock prices for the six months ending July 31, 2007.

Chart II-C demonstrates a strong tendency for companies with high dividend yields to have low growth rates, and vice versa. Because the total DCF rate of return estimate for each company is the sum of the dividend yield, plus the growth rate, the negative correlation between dividend yields and growth rates shown on this chart highlights the fact that a high dividend distribution alone is incapable of indicating whether a DCF analysis of an MLP is overstated. (The negative correlation would be even stronger if National Fuel is excluded, because its results appear to be a significant outlier and unreliable.)

Chart II-C suggests that it is most likely that high dividend payouts, including a return of capital for book accounting purposes, have affected the market price of partnership units, and thus affected the dividend yield, as well as investors' expected growth rates. In other words, the interdependency of the variables in the DCF model captures the principle that, to the extent MLPs have earnings retention rates that are significantly lower than the retention rates of corporations, the stock prices (P) and expected future growth rates (g) for MLPs will adjust to ensure that the DCF analysis produces a rate of return that properly reflects the *risk* of the investment.

### C. Additional Conceptual Flaws with the Proposed Distribution Cap

Unfortunately, the proposed policy statement appears to equate (i) a return of investment *from the customers to the company* with (ii) a return of investment *from the company to the stockholders.* At paragraphs 18-19 it mistakenly suggests that because a depreciation allowance in the cost of service is a payment (i) from customers to the company, then a DCF analysis that includes a possible return of capital (ii) from the

company to shareholders would cause the investment to be recovered from customers twice. That conclusion is wrong on two counts.

First, when dollars flow from customers-to-company-to-shareholders, there are two payments involved (customer to company and company to shareholder), but the company collects the dollars from the customers and merely passes the same dollars along to the shareholders. There is no double-recovery from customers when distributions to customers exceed earnings in a given year.

Second, whether there is, or is not, a return of capital to shareholders does not matter to the results of a proper DCF analysis because *any* expected level of cash flows will give investors an opportunity to earn the *same* required rate of return. Because the DCF analysis produces the same result both with and without a return of capital, there can be no "double-recovery" of depreciation when a return of capital is part of the distribution. A DCF analysis will be correct if it accurately reflects the cash flows that stockholders expect to receive when they set the stock (or bond) price in the market. However, a DCF analysis that omits some of the expected cash flows would produce an inaccurate and deficient rate of return estimate.

To further illustrate the incongruity of the proposal to cap distributions at earnings, Appendix C explains the distortion that occurs when return of capital is excluded in calculating required yield on mortgage obligations. Also included in the appendix is a discussion on how this same problem extends to common stocks or MLP partnership units. The examples offered there demonstrate why the DCF approach is particularly useful for regulatory proceedings *when it is applied properly*.

Finally, the Commission's Proposed Proxy Policy raises questions regarding the interaction of its proposed adjustment and the market-based DCF analysis. Thus, the Commission observes (at P 21) that "[t]he market data for the MLPs used in the DCF analysis should itself correct for any distortions remaining after the adjustment to the cash distribution described above." The meaning of the suggested "correction" is not clear: If the Commission is suggesting that, for purposes of the DCF analysis, the adjustment of D in the DCF analysis will result in an offsetting increase in g, the resulting cost of equity would remain the same. Why make the adjustment at all? On the other hand, if the Commission is suggesting that, as part of the DCF analysis of the proxy companies, it will require applicants to provide their forecast of what the price and growth variables would have been had the MLP chosen to limit its distributions solely to its accounting earnings, this would make the DCF results for the proxy companies purely hypothetical and break the link between the ROE established in the rate case and the ROE required by real world investors to invest in a company with similar risks. Furthermore, it would introduce into the rate case yet another point of contention, as it is unlikely that interveners and Commission litigation staff would agree with the applicant about the price and growth rate that should apply to the proxy company once the adjustment is made.

A third possibility is that the Commission is suggesting that, for purposes of the DCF analysis, it should be assumed that the dollars that no longer are part of the distribution will disappear. In other words, should it be assumed that management throws these dollars into the corporate bonfire? This would further remove the exercise from reality

and diminish its value as a proxy for the return that would be demanded by investors in order to invest in a company with similar risk.

In summary, any application of the adjustment proposed by the Commission, whether as an isolated adjustment to the dividend or distribution variable or with compensating adjustments to the other DCF formula variables, would transform the DCF analysis of proxy companies into a purely hypothetical exercise. That outcome would undermine its value for determining the return that investors would require in order to invest in companies whose risks were commensurate with those of the pipeline that had filed a section 4 rate case.

### D. Conclusion Concerning Conceptual Flaws in the Cap Proposal

The Commission's proposed earnings cap on distributions to be used in the DCF formula appears to be based on the assumption that DCF results are overstated for MLPs that pay distributions that exceed their earnings. Charts II-A and II-B show that there is no statistically meaningful relationship between payout ratios and DCF results for MLPs, especially MLPs that pay out more than their earnings. Moreover, test applications of the proposed adjustment confirm that the adjusted ROE results are demonstrably inadequate as measured by historical standards.

That the assumed basis for the proposed cap is conceptually flawed is also demonstrated by Chart II-C, which shows that high yields tend to be offset by lower growth rate projections, suggesting that, for MLPs in particular, the dividend yields are completely unrelated to the level of the DCF estimates. All of these analyses strongly suggest that stock prices and expected growth rates for MLPs adjust to differences in earnings retention rates in order to ensure that the DCF analysis produces a rate of return

that properly reflects the risk of the investment. Thus, it does not matter to the results of a proper DCF analysis whether the company is paying out 10 percent of its earnings or 110 percent of its earnings; a DCF analysis will be correct if it accurately reflects the cash flows that stockholders expect to receive when they set the stock (or unit) price in the market. The Commission's proposal to adjust the DCF with an earnings cap will not only undermine the utility of the DCF approach by divorcing it from the real world capital market, but will produce an inaccurate and deficient rate of return estimate.

## Chapter III: SUSTAINABILITY OF DISTRIBUTIONS

The Proposed Proxy Policy Statement states that:

> "…**an MLP's lack of retained earnings may render cash distributions at their current level unsustainable**, and thus still unsuitable for inclusion in the DCF analysis. . . . An analysis showing that the MLP does have stable earnings would support a finding that the cash to be included in the DCF calculation is likely to be available for distribution, thus replicating the requirement of the corporate model of a stable dividend." (P 24)

Accordingly, the Commission proposes to require rate case proponents of using MLPs in the proxy group to provide a multi-year analysis of past earnings.[5]

The Commission's concern with the sustainability of MLP earnings is misplaced. Companies have many ways of achieving growth and a narrow focus on the earnings retention rate would ignore the real-world economic results that investors have observed and realistically expect in the future. The Commission recognized as much when it pointed to the growth projections employed by investors. At P 21 of the Proposed Proxy Policy Statement, the Commission says:

> … the IBES growth projections represent an average of the growth projections by professionals whose business is to advise investors.[6] The level of an MLP's cash distributions as compared

[5] The Proposed Proxy Policy also raises several other questions concerning the sustainability of MLP distributions. See, e.g., P 20: "The Commission recognizes that it raised several concerns … as to **whether adjusting the MLP's cash distribution down to the level of its earnings would be sufficient** to eliminate the distorting effects of including MLPs in the proxy group. … The Commission also suggested that the DCF model is **premised on growth in dividends** deriving **from reinvestment of current earnings**, and **does not incorporate growth** from external sources, such as issuing debt or additional stock." See also P 21: "The Commission believes that these concerns should not render unreliable a DCF analysis using the adjusted MLP results. The market data for the MLPs used in the DCF analysis should itself correct for any distortions remaining **after the adjustment to the cash distribution described above**. …"

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

> to its earnings is a matter of public record and thus known to the security analysts making the growth forecasts used by IBES. Therefore, the security analysts must be presumed to take those distributions into account in making their growth forecasts for the MLP. To the extent an MLP's relatively high cash distributions reduce its growth prospects that should be reflected in a lower growth forecast, which would offset the MLP's higher "dividend" yield.

**A. Analysts' Knowledge and Expectations**

It is reasonable to assume that investment analysts are aware of the practices of the MLPs when the IBES growth rate projections are made and that the market price and growth rate projections adequately reflect all of these conditions. Thus, it would be incongruous to make any downward adjustment to the cash distributions.

In fact, the analysts describe and explain why it is wrong to base expectations solely on earnings retention rates:

> … over the past few years a new breed of growth MLP has emerged, offering unit holders above average current yields, capital appreciation potential, distribution growth well above inflation rates, plus the added benefit of tax deferred income. While all of these variables are important, the key valuation driver is distribution growth potential. In our opinion, top tier growth MLPs exhibit balanced, sustainable growth in distributable cash flow (DCF), which should ultimately lead to above-average distribution growth and capital appreciation.
>
> * * * *
>
> MLPs grow mainly by making accretive acquisitions.
>
> -- A.G. Edwards, *MLP Primer, pp. 8 and 10*

Merrill-Lynch also notes that MLPs tend to generate significant growth despite high payout ratios:

> **A compelling blend of growth and income**
>
> …. MLPs typically pay out the bulk of their operating cash flow in the form of quarterly distributions, with an objective of growing these cash distributions over time. … We project Energy MLPs' robust cash

> distribution growth will continue, and expect it to average 5-8% over the next several years.
>
> … we believe Energy MLPs are a still emerging asset class that should continue to offer investors annual 10-15% total return potential, in our view, comprised of a 6.7% current yield and 5-8% annual cash distribution growth.

Merrill-Lynch elaborates on some of the drivers of MLP growth in the following passage:

> MLP cash distribution growth should be driven increasingly by a focus on growth from internal projects, as MLPs undertake needed energy infrastructure projects related to changing energy supply and demand dynamics. We expect these projects will provide MLPs with attractive and high-returning organic growth opportunities that should drive cash distribution growth. We also expect growth to be supplemented by other internal initiatives (for example, fee increases) which, along with acquisitions, have been historically relied upon for distribution growth.[7]

**B. Sources of Growth**

The Proposed Proxy Policy proposes a special "stable earnings" showing requirement for MLPs that appears to be based in part on a belief that companies cannot grow or sustain for very long dividend distributions that equal or exceed earnings. However, retaining and reinvesting earnings is merely one of many ways that companies grow. For example, existing shareholders generally experience growth in earnings, cash flow and distributions per share when a company pursues any of the following strategies:

[7] Merrill Lynch, "An investor guide to Energy MLPs." 21 November 2006, page 4.

1. **reinvesting cash flow in the company,**
2. **selling new common equity to invest in assets that increase the earnings per share for existing shareholders (i.e., "accretive investments),**
3. **paying down debt to reduce interest expenses, or,**
4. **borrowing to invest in projects that have a return that exceeds the cost of debt.**

This section describes some of these other ways that companies grow in order to demonstrate the fallacy in the assumption that MLPs cannot sustain long-term growth while maintaining high payout ratios.

### 1. Distinction Between Free Cash Flow and Retained Earnings

Most companies retain and reinvest a portion of their free cash flow in order to increase the amount of earnings that are generated per partnership unit, or per share of common stock, in the future. The earnings retention growth rate can be estimated by multiplying the expected retention rate (b) times the rate of return on common equity (r) that a company is expected to earn in the future. However, free cash flow is generally greater than retained earnings because several types of non-cash expenses are deducted in order to calculate the net income of a company. As the following example shows, operating income is calculated by deducting from revenues expenses for operations, maintenance, depreciation and amortization. Income taxes are then subtracted from operating income to get Net Income.

**Table III-A**

**Income Statement Example**

| **Income Statement** | | |
|---|---|---|
| Revenue | | $35,000 |
| Operating Expenses | $8,000 | |
| Maintenance | $2,000 | |
| Depreciation & Amortization | $2,500 | $12,500 |
| **Net Operating Income** | | **$22,500** |
| Taxes: | | |
| Taxes Paid | $4,500 | |
| Deferred Taxes | *$2,500* | $7,000 |
| **Net Income** | | **$15,500** |

Depending upon its particular business strategy, the company generally pays a dividend to shareholders (or partners), and also retains and reinvests the remaining portion of earnings in order to grow. In this example, the company pays dividends of $6,200, which equals 40 percent of its net income. Retained Earnings, used in the calculation of Earnings Retention growth rates, are computed as follows:

**Table III-B**

**Earnings Retention Rate**

| **Retained Earnings** | | Pct. of Net Income |
|---|---|---|
| Net Income | $15,500 | |
| Less: Dividend Distributions | 6,200 | 40% |
| **Retained Earnings** | **$ 9,300** | **60%** |

Because the dividend payout ratio in this example is 40 percent, the earnings retention rate is 60 percent. If the company reinvests the retained earnings to earn a return of 15.5 percent, its **earnings retention growth rate** can be calculated as:

**60% x 15.5% = 9.30%**

Operating Cash Flow tends to be greater than Net Income, and Free Cash Flow tends to be greater than Retained Earnings, because the "expenses" recorded on the income statement include many items that do not involve any cash expenditures during

the year. Thus, the actual cash available to the company for dividends and reinvestment is almost always far greater than net income:

**Table III-C**

**Cash Flow Retention Rate**

| **Operating Cash Flow** | | Pct. of Net Income |
|---|---|---|
| Cash Revenues | $100,000 | |
| Cash Expenses: | 79,000 | |
| Cash-Basis Income | 21,000 | |
| Changes in Working Capital, etc. | (500) | |
| **Operating Cash Flow** | **$20,500** | |
| Less: Capital Exp. For Maintenance[8] | 1,000 | |
| **Free Cash Flow** | 19,500 | |
| Less: Dividend Distributions | 6,200 | 40% |
| **Retained Cash Flow** | **$13,300** | **85.5%** |

In this example, Retained Cash Flow ($13,300) is equal to 85.5 percent of net income ($13,300/$15,500 = 85.5%) and, following the previous example of earnings retention growth, if the Free Cash Flow is invested to earn a return of 15.5 percent, the **cash flow retention growth rate** would be:

**85.5% x 15.5% = 13.3%**

In other words, an earnings retention growth rate of 9.3 percent for this company would significantly understate the potential growth rate that can be achieved solely by reinvesting internally-generated cash flow.

[8] All pipelines spend substantial amounts on maintenance every year, but annual maintenance expenditures that are expensed on the income statement should be distinguished from capital expenditures for replacement that increase plant investment on the balance sheet and are depreciated on the income statement.

### 2. Issuing Common Stock to Increase Earnings and Cash Flow Per Share

The Commission is very familiar with the ability of companies to increase the earnings and distributions per share by issuing common stock because equity accretion has been a standard component of its growth rate calculations for electric utilities for many years:

> In the past, we have consistently applied a one-step, constant growth DCF model for calculating ROEs for electric utilities. … The sustainable growth rate is calculated by the following formula: g = 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**.[9]

Thus, in addition to the earnings retention growth ("br"), the Commission also adds a component for growth that comes from issuing common equity at a price greater than book value ("sv").

A company that is able to issue stock at a price that exceeds book value and invest the proceeds in new projects that generate returns and values similar to its existing projects can maintain a continual growth rate in the earnings and dividends of its existing investors even if it does not increase its rate of return or reinvest any of its earnings. This form of growth is known as "accretive" growth. Table III-D.1 shows an example of a company that has a market-to-book ratio of 2.0 and issues new shares of stock to steadily increase the number of shares outstanding by 10 percent each year. As long as the proceeds from the new shares are invested in projects that maintain the market-to-book ratio at a level of 2.0, the company in this example can achieve a growth rate in its book value per share of 9.09 percent per year. Table III-D.2 extends the example to show how

[9] *Southern California Edison Company*, 92 FERC ¶ 61,070 at 61,262-3 (2000), emphasis added.

this book value growth rate translates into an expected dividend growth rate of 9.09 percent per year.

## Table III-D.1

### Book Value Growth From Issuing Common Stock

| Year | (1) Beginning Equity from Prior Year | (2) Market-To-Book Ratio | (3) Market Value of Equity | (4) Beginning Number of Shares from Prior Year | (5) Price Per Share | (6) Stock Issuance Percent | (7) New Shares Issued | (8) Proceeds From Stock Issuance | (9) Total Equity Book Value After Issuance | (10) Total Shares After Issuance | (11) Equity Book Value Per Share |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 0 | | | | | | | | | $1,000 | 100.0 | **$10.00** |
| 1 | $1,000.00 | 2.0 | $2,000.00 | 100.0 | $20.00 | 10% | 10.0 | $200.00 | $1,200 | 110.0 | **$10.91** |
| 2 | $1,200.00 | 2.0 | $2,400.00 | 110.0 | $21.82 | 10% | 11.0 | $240.00 | $1,440 | 121.0 | **$11.90** |
| 3 | $1,440.00 | 2.0 | $2,880.00 | 121.0 | $23.80 | 10% | 12.1 | $288.00 | $1,728 | 133.1 | **$12.98** |
| 4 | $1,728.00 | 2.0 | $3,456.00 | 133.1 | $25.97 | 10% | 13.3 | $346.00 | $2,074 | 146.4 | **$14.16** |
| 5 | $2,074.00 | 2.0 | $4,148.00 | 146.4 | $28.33 | 10% | 14.6 | $415.00 | $2,488 | 161.1 | **$15.45** |
| 6 | $2,488.00 | 2.0 | $4,976.00 | 161.1 | $30.90 | 10% | 16.1 | $498.00 | $2,986 | 177.2 | **$16.86** |
| 7 | $2,986.00 | 2.0 | $5,972.00 | 177.2 | $33.71 | 10% | 17.7 | $597.00 | $3,583 | 194.9 | **$18.39** |
| 8 | $3,583.00 | 2.0 | $7,166.00 | 194.9 | $36.77 | 10% | 19.5 | $717.00 | $4,300 | 214.4 | **$20.06** |
| 9 | $4,300.00 | 2.0 | $8,600.00 | 214.4 | $40.12 | 10% | 21.4 | $860.00 | $5,160 | 235.8 | **$21.88** |
| 10 | $5,160.00 | 2.0 | $10,320.00 | 235.8 | $43.77 | 10% | 23.6 | $1,032.00 | $6,192 | 259.4 | **$23.87** |

10-Year Average Growth Rate **9.09%**

## Table III-D.2
### Dividend Growth From Stock Issuances

| Year | (1) Equity Per Share | (2) Return on Equity | (3) Earnings Per Share | (4) Payout Ratio | (5) Dividends Per Share | (6) Retained to Common | (7) Increase in Dividends |
|---|---|---|---|---|---|---|---|
| 0 | **$10.00** | 15.50% | $1.55 | 100% | $1.55 | $ - | |
| 1 | **$10.91** | 15.50% | $1.69 | 100% | $1.69 | $ - | 9.09% |
| 2 | **$11.90** | 15.50% | $1.84 | 100% | $1.84 | $ - | 9.09% |
| 3 | **$12.98** | 15.50% | $2.01 | 100% | $2.01 | $ - | 9.09% |
| 4 | **$14.16** | 15.50% | $2.20 | 100% | $2.20 | $ - | 9.09% |
| 5 | **$15.45** | 15.50% | $2.39 | 100% | $2.39 | $ - | 9.09% |
| 6 | **$16.85** | 15.50% | $2.61 | 100% | $2.61 | $ - | 9.09% |
| 7 | **$18.39** | 15.50% | $2.85 | 100% | $2.85 | $ - | 9.09% |
| 8 | **$20.06** | 15.50% | $3.11 | 100% | $3.11 | $ - | 9.09% |
| 9 | **$21.88** | 15.50% | $3.39 | 100% | $3.39 | $ - | 9.09% |
| 10 | **$23.87** | 15.50% | $3.70 | 100% | $3.70 | $ - | 9.09% |
| | | | | | | 10-Year Average Growth Rate | **9.09%** |

This example is based on the ability to issue new common stock at a price that exceeds book value plus any flotation costs and invest the proceeds in economically profitable projects. The new shareholders will pay a premium for their stock, and all shareholders, both new and old, will share in the additional earnings associated with the premium.

### 3. Earnings Accretion/Dilution v. Market Value Accretion/Dilution

The preceding section showed that a company can increase the earnings per share and dividends per share for its owners by either issuing common equity at a price that exceeds book value, or by issuing common equity that is invested in projects that earn more than the marginal cost of capital. At the same time, however, a company will dilute the market value of the existing shareholders' investment if it invests the proceeds of a new issuance in assets that earn risk-adjusted returns that are less than those earned by its

existing assets. Thus, there are two different types of accretion/dilution effects to consider: "Market-value accretion" and "Earnings-Per-Share accretion."
"EPS accretion" occurs when a company can raise capital at cost and then invest in projects that earn more than the marginal cost of capital. For example, a company that raises capital at 10% cost and invests the funds to earn 12% will add to the earnings of existing stockholders no matter what ROE the company's existing assets might be earning. Many MLPs, as well as numerous companies throughout the economy, have demonstrated a knack for investing in projects that earn more than their marginal cost of capital and "Earnings-Per-Share accretion" can be sustained indefinitely.

**4. Borrowing to Increase Earnings and Cash Flow Per Share**

If a company can borrow to fund new projects that earn more than the interest rate paid for the loan, the company can achieve growth in its earnings and dividends without either retaining earnings or issuing new common stock. For example, a company might borrow to invest in a project that earns an overall return of 15.5 percent. If the cost of debt is 8 percent, and the project also generates enough cash to repay the debt, the company can increase its earnings and dividends by undertaking this project. As shown on Table III-E.1, the company has an existing project (Project 1) that generates earnings per share of $1.55 per year. However, by also investing in Project 2 the earnings of the company in this example can grow at a geometric average rate of 6.5 percent per year for 10 years.

On Table III-E.2 the example continues by showing that the increase in earnings available to common shareholders occurs as the debt of the project is paid off over time.

Once the project has generated sufficient cash flow to repay the debt undertaken to finance Project 2, all of the available return will go to the owners.

## Table III-E.1
## Earnings Growth Funded By Borrowing

| Year | (1) Value of Equity | (2) Return on Project 1 Equity | (3) Project 1 Earnings Per Share | (4) Project 2 Earnings Per Share | (5) Total Earnings Per Share | (6) Payout Ratio | (7) Dividends Per Share | (8) Retained to Common | (9) Increase in Dividends |
|---|---|---|---|---|---|---|---|---|---|
| 0 | $10.00 | 15.50% | $1.55 | **$ -** | $1.55 | 100% | $1.55 | $ - | |
| 1 | $10.00 | 15.50% | $1.55 | **$0.75** | $2.30 | 100% | $2.30 | $ - | 48.39% |
| 2 | $10.00 | 15.50% | $1.55 | **$0.83** | $2.38 | 100% | $2.38 | $ - | 3.48% |
| 3 | $10.00 | 15.50% | $1.55 | **$0.91** | $2.46 | 100% | $2.46 | $ - | 3.36% |
| 4 | $10.00 | 15.50% | $1.55 | **$0.99** | $2.54 | 100% | $2.54 | $ - | 3.25% |
| 5 | $10.00 | 15.50% | $1.55 | **$1.07** | $2.62 | 100% | $2.62 | $ - | 3.15% |
| 6 | $10.00 | 15.50% | $1.55 | **$1.15** | $2.70 | 100% | $2.70 | $ - | 3.05% |
| 7 | $10.00 | 15.50% | $1.55 | **$1.23** | $2.78 | 100% | $2.78 | $ - | 2.96% |
| 8 | $10.00 | 15.50% | $1.55 | **$1.31** | $2.86 | 100% | $2.86 | $ - | 2.88% |
| 9 | $10.00 | 15.50% | $1.55 | **$1.39** | $2.94 | 100% | $2.94 | $ - | 2.80% |
| 10 | $10.00 | 15.50% | $1.55 | **$1.47** | $3.02 | 100% | $3.02 | $ - | 2.72% |
| 11 | $10.00 | 15.50% | $1.55 | **$1.55** | $3.10 | 100% | $3.10 | $ - | 2.65% |
| | | | | 11-Year Average Growth Rate* | | | **6.50%** | | **7.15%** |

* 6.5% is the geometric average; 7.15% is the arithmetic average.

## Table III-E.2
## Project 2 Funded By Borrowing

| Year | (1) Project 2 Value Per Share | (2) Overall Rate of Return on Project 2 | (3) Overall Return on Project 2 | (4) Debt | (5) Cash Available for Interest Repayment | (6) Interest Rate | (7) Interest Payment | (8) Project 2 Earnings Per Share Available to Equity |
|---|---|---|---|---|---|---|---|---|
| 0 | | | | | | | | |
| 1 | $10.00 | 15.50% | $1.55 | $10.00 | $1.00 | 8.00% | $0.80 | **$0.75** |
| 2 | $10.00 | 15.50% | $1.55 | $9.00 | $1.00 | 8.00% | $0.72 | **$0.83** |
| 3 | $10.00 | 15.50% | $1.55 | $8.00 | $1.00 | 8.00% | $0.64 | **$0.91** |
| 4 | $10.00 | 15.50% | $1.55 | $7.00 | $1.00 | 8.00% | $0.56 | **$0.99** |
| 5 | $10.00 | 15.50% | $1.55 | $6.00 | $1.00 | 8.00% | $0.48 | **$1.07** |
| 6 | $10.00 | 15.50% | $1.55 | $5.00 | $1.00 | 8.00% | $0.40 | **$1.15** |
| 7 | $10.00 | 15.50% | $1.55 | $4.00 | $1.00 | 8.00% | $0.32 | **$1.23** |
| 8 | $10.00 | 15.50% | $1.55 | $3.00 | $1.00 | 8.00% | $0.24 | **$1.31** |
| 9 | $10.00 | 15.50% | $1.55 | $2.00 | $1.00 | 8.00% | $0.16 | **$1.39** |
| 10 | $10.00 | 15.50% | $1.55 | $1.00 | $1.00 | 8.00% | $0.08 | **$1.47** |
| 11 | $10.00 | 15.50% | $1.55 | $0.00 | $1.00 | 8.00% | $0.00 | **$1.55** |

### 5. Implications of Sources of Growth for the Proposed Policy Statement

This section showed several of the ways that companies can sustain long-term growth rates and it explains some of the reasons that analysts, such as those surveyed by IBES, often project long-term growth rates that are higher than a simple earnings retention growth rate might suggest. This background shows why the premise expressed in the proposed Policy Statement— that companies with high earnings payout ratios cannot sustain or grow their distributions for very long – is clearly misplaced. This background also shows why it is inappropriate to assume that MLP DCF results are overstated when distributions exceed earnings. Thus, the reasons suggested in the proposed Policy Statement for possible downward adjustments to DCF results, or possible exclusion of certain companies from the proxy group cannot be supported.

## C. Analysis of Ability of MLPs to Sustain Distributions and Growth

The assumption that high distribution payouts by MLPs prevent growth, or somehow invalidate investment analysts' estimates of future growth, is not supported by either financial theory or historical experience. One of several reasons pipeline MLPs have produced significant growth rates despite high distribution payouts is because they retain and reinvest cash flow. Table III-F shows the amount of operating cash retained and reinvested by each pipeline MLP in 2006.

Table III-F

**Master Limited Partnerships**
**2006 Retained Cash Flow**
($millions)

| | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| | **Operating Cash Flow** | **Maintenance Capital Expenditures** | **Distributions to Partners** | **Free Cash Flow Retained and Reinvested** | **Beginning Equity** | **Retained Cash Flow as a % of Equity** |
| Boardwalk Pipeline Ptnrs. | $ 255.55 | $ (60.00) | $ (136.39) | $ 59.16 | $ 988.67 | 6.0% |
| Enbridge Energy Partners | $ 321.60 | $ (33.23) | $ (227.40) | $ 60.97 | $ 1,363.80 | 4.5% |
| Energy Transfer Partners | $ 543.88 | $ (37.3) | $ (162.81) | $ 343.77 | $ 1,326.19 | 12.3% |
| Enterprise Product Partners | $1,175.07 | $ (132.46) | $ (850.27) | $ 192.35 | $ 5,679.31 | 3.4% |
| Kinder Morgan Energy Ptnrs. | $1,257.42 | $ (125.40) | $(1,171.48) | $ (39.47) | $ 3,613.74 | -1.1% |
| ONEOK Partners | $ 606.06 | $ (67.00) | $ (265.82) | $ 273.24 | $ 765.59 | 35.7% |
| TC Pipelines | $ 46.10 | $ (10.40) | $ (43.50) | $ (7.80) | $ 301.60 | -2.6% |
| | | | | | **Average** | **8.3%** |

These companies generally produced more than enough cash flow from their business operations to pay dividend distributions and also have cash left for investment in new plant. The proposed Policy Statement suggested the possibility of excluding an MLP from the proxy group, or making a downward adjustment to the DCF results, if the MLP pays distributions that exceed its earnings. However, companies that are able to pay distributions and retain cash for investment in new plant are often able to generate internal growth without adding to retained earnings. That is not to say that the MLPs *must* retain cash flow in order to maintain and increase their distributions. Instead, they also borrow and issue equity to add facilities that are accretive to earnings. Thus, although MLPs rely less on retained earnings than many corporations, they are able to generate significant sustainable growth in many ways.

Historical experience concerning earnings, distributions and earnings retention growth rates are shown for each of the proxy companies in the charts in Appendix A. It can be seen that there is virtually no relationship between earnings retention growth rates, which are commonly negative, and the positive trend in actual earnings and distributions for the gas pipeline MLPs. The experiences of the MLPs demonstrate that growth in earnings and dividend distributions experienced by MLPs comes from retaining and reinvesting a portion of free cash flow, as well as other sources of earnings growth that are not taken into account when the assumption is made that growth can only come from retained earnings.

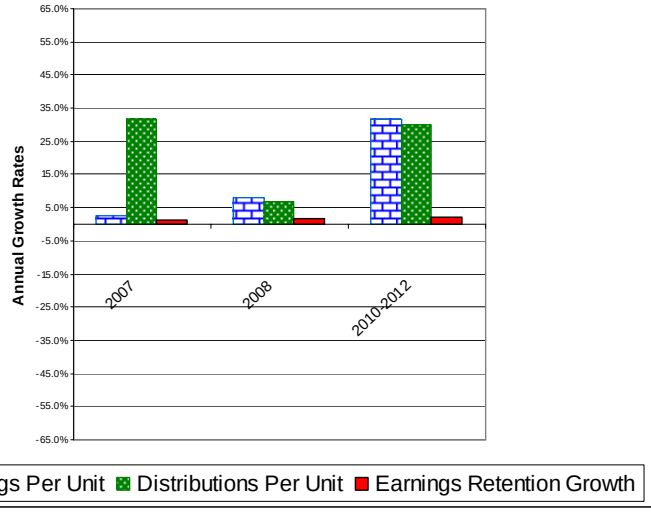
Although payment of distributions in excess of earnings does not cause a DCF analysis to overstate the required rate of return *on* investment, the required rate of return would certainly be increased by the perceived increase in regulatory risk associated with a policy that consistently understates the required rate of return in setting pipeline rates. Such a policy would impair the value of existing investments, and discourage new investments in needed infrastructure. Consequently, MLPs should be included in the proxy group without any cap on distributions.

# APPENDIX A

## Demonstration of the Sustainability of MLP Growth

## Chart A.1

**Boardwalk Pipeline Growth Rates**
**Earnings Per Unit, Distributions Per Unit and Retention Annual Growth**

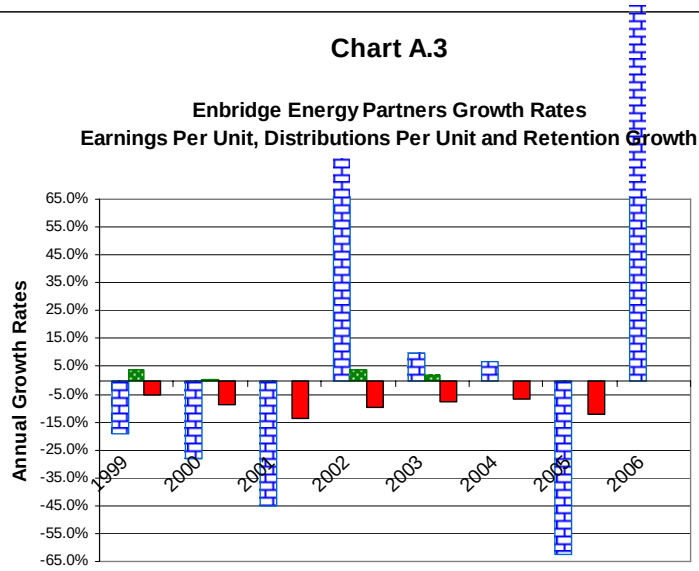



## Chart A.2

**Boardwalk Pipeline Cash Flow,**
**Earnings and Distributions Per Unit**

## Chart A.3

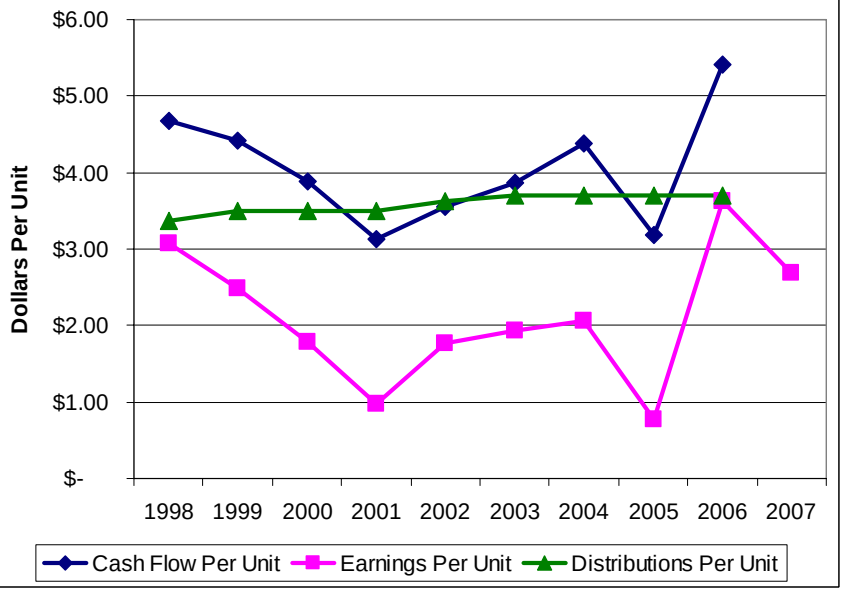
**Enbridge Energy Partners Growth Rates**
**Earnings Per Unit, Distributions Per Unit and Retention Growth**




Earnings Per Unit for 2002 and 2006 have been truncated for space reasons. The actual numbers are 79.6% and 370.1%, respectively.

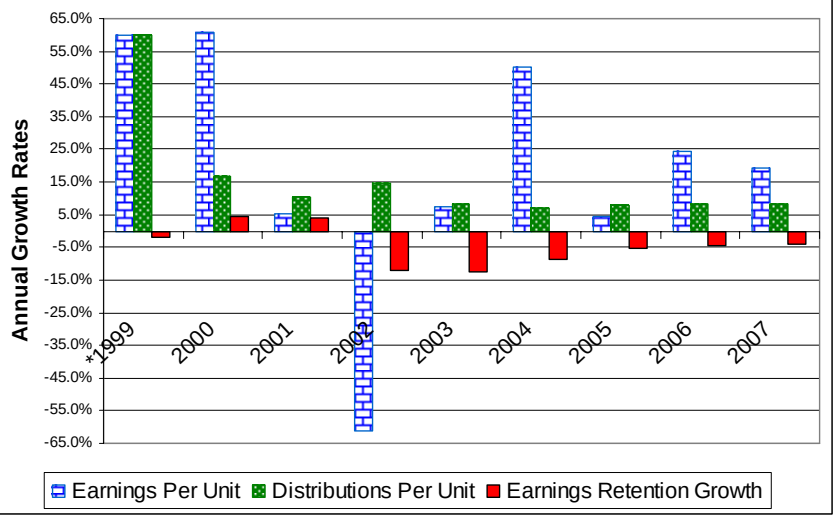
## Chart A.4

**Enbridge Energy Partners Cash Flow,**
**Earnings and Distributions Per Unit**



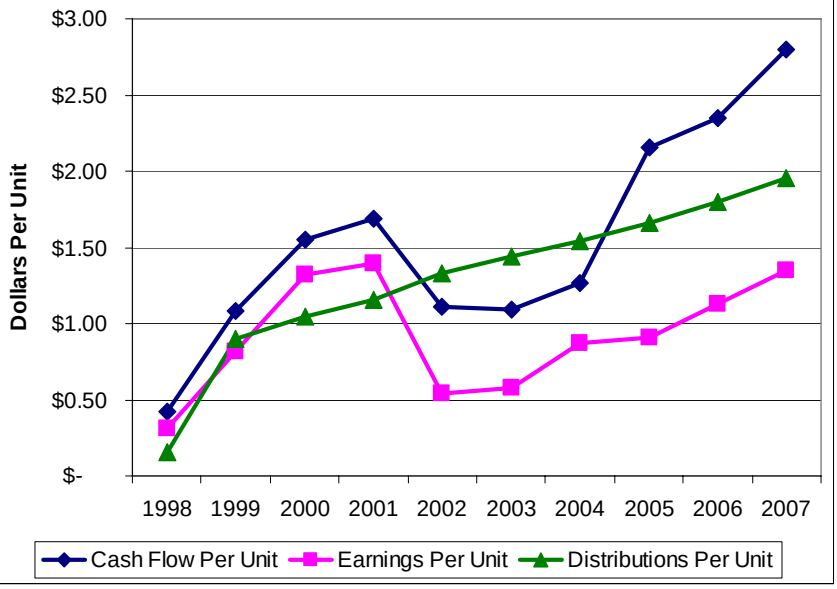
## Chart A.5

**Enterprise Products Partners Growth Rates**
**Earnings Per Unit, Distributions Per Unit and Retention Growth**



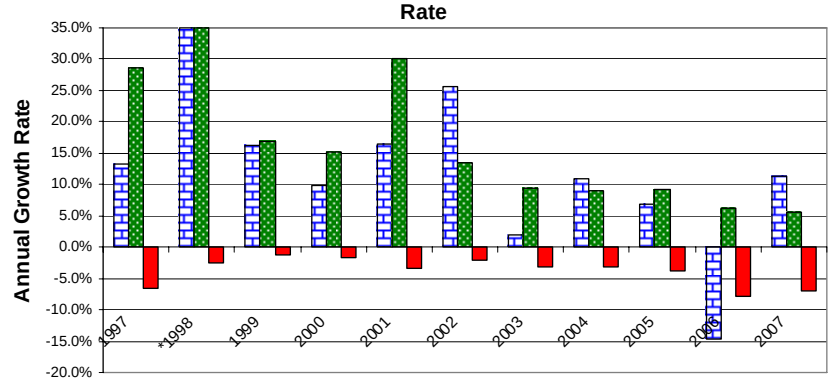

## Chart A.6

**Enterprise Products Cash Flow,**
**Earnings and Distributions Per Unit**



## Chart A.7

**Kinder Morgan Energy Partners Growth Rates**
**Earnings Per Unit, Distributions Per Unit and Retention Growth Rate**



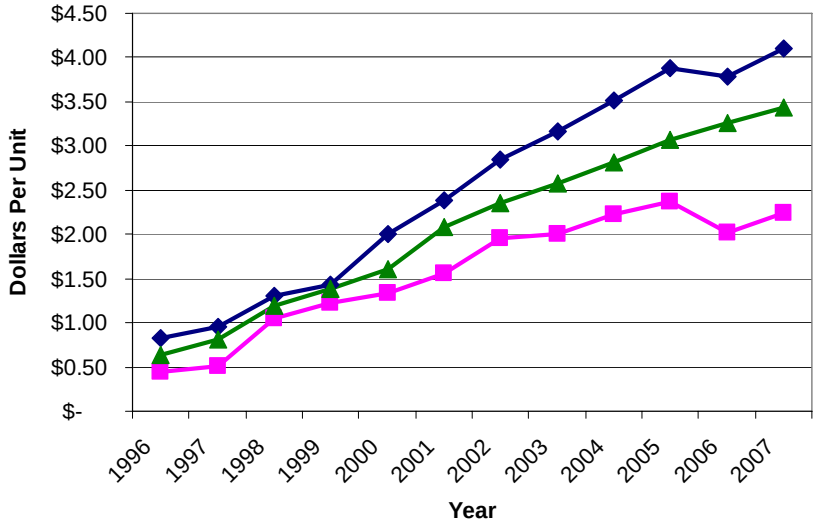

Earnings Per Unit and Distributions Per Unit are truncated for 1998. Actual number for both is 105.9%.

Year

Earnings Per Unit | Distributions Per Unit | Earnings Retention Growth

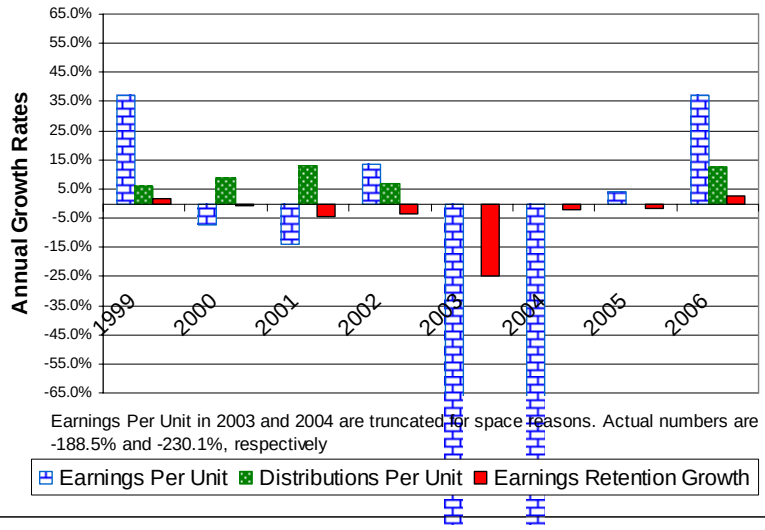
## Chart A.8

**Kinder Morgan Energy Partners Cash Flow, Earnings and Distributions Per Unit**



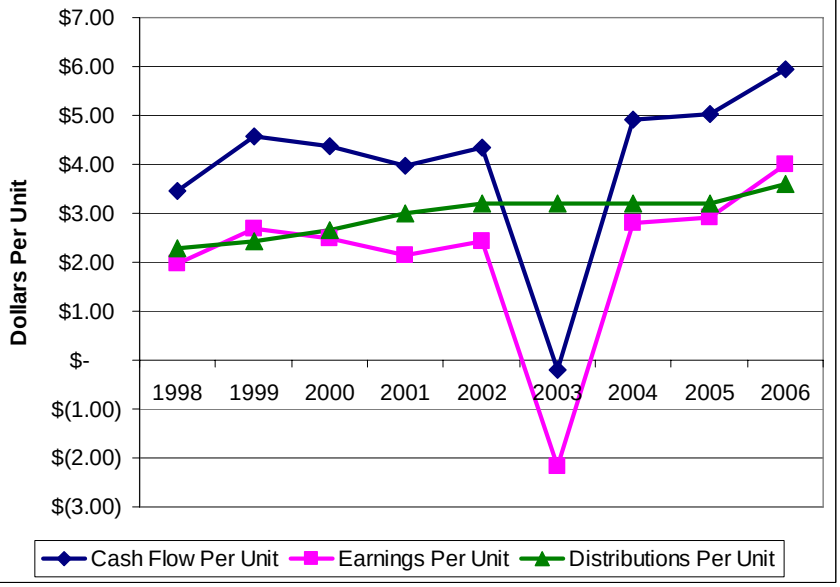
## Chart A.9

**Oneok Growth Rates, Earnings Per Unit, Distributions Per Unit and Retention Growth**



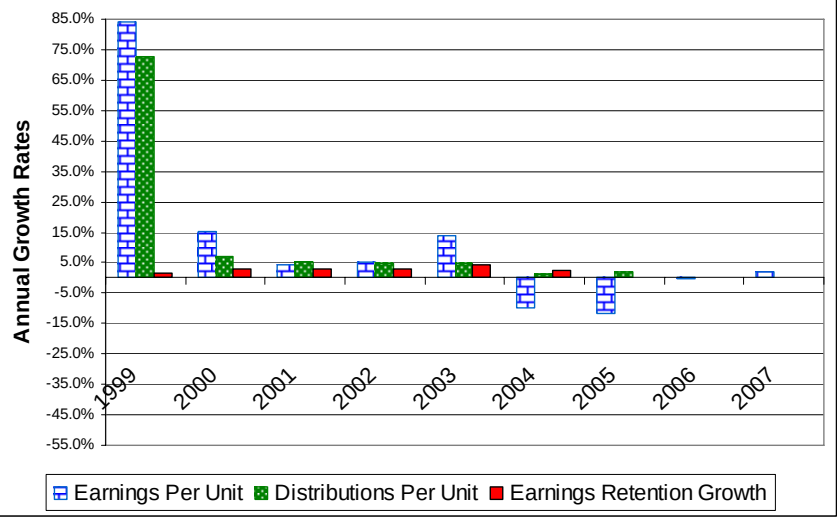

## Chart A.10

**Oneok Cash Flow, Earnings and Distributions Per Unit**



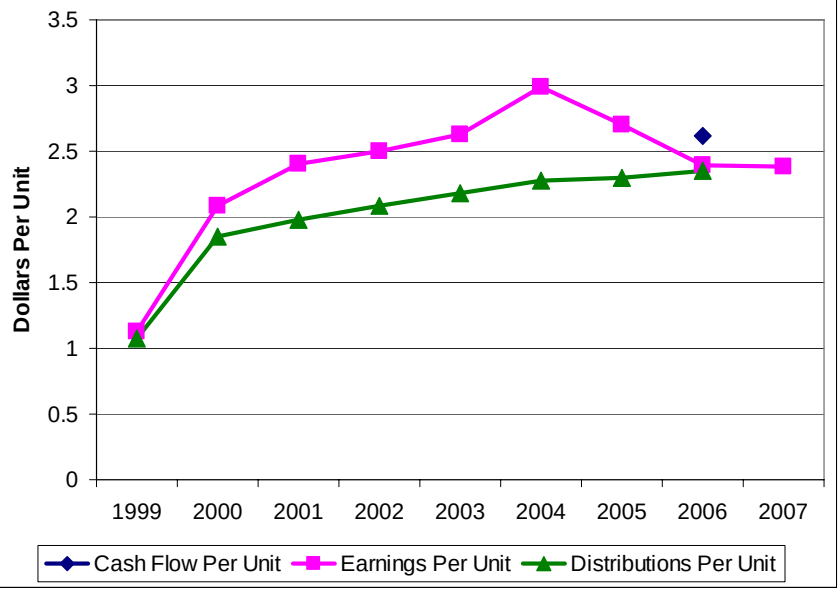
## Chart A.11

**TC Pipelines Growth Rates Earnings Per Unit, Distributions Per Unit and Retention Growth**




## Chart A.12

**TC Pipelines Cash Flow, Earnings and Distributions Per Unit**



# APPENDIX B

## Test of Relationship Between
## Earnings Payout Ratios and DCF Results

## SUMMARY OUTPUT OF PAYOUT RATIO v. DCF ESTIMATE

**DCF Result** **Y**
**Payout Ratio** **X**

| *Regression Statistics* | |
|---|---|
| Multiple R | 0.3206 |
| **R Square** | **0.1028** |
| **Adjusted R Square** | **0.0654** |
| Standard Error | 0.0108 |
| Observations | 26 |

ANOVA

| | *df* | *SS* | *MS* | *F* | *Significance F* |
|---|---|---|---|---|---|
| Regression | 1 | 0.00032 | 0.00032 | 2.74983 | 11.028% |
| Residual | 24 | 0.00278 | 0.00012 | | |
| Total | 25 | 0.003104 | | | |

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 0.1193 | 0.0042 | 28.671 | 0.000% |
| **Payout Ratio** | 0.0044 | 0.0027 | 1.658 | 11.028% |

## SUMMARY OUTPUT OF PAYOUT RATIO & YEAR VARIABLE v. DCF ESTIMATE

| | |
|---|---|
| **DCF Result** | **Y** |
| **Payout Ratio** | **X1** |
| **Year Variable** | **X2** |

| *Regression Statistics* | |
|---|---|
| Multiple R | 0.3282 |
| **R Square** | **0.1077** |
| **Adjusted R Square** | **0.0301** |
| Standard Error | 0.0110 |
| Observations | 26 |

ANOVA

| | *df* | *SS* | *MS* | *F* | *Significance F* |
|---|---|---|---|---|---|
| Regression | 2 | 0.00033 | 0.00017 | 1.38841 | 26.961% |
| Residual | 23 | 0.00277 | 0.00012 | | |
| Total | 25 | 0.00310 | | | |

| | *Coefficients* | *Std Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 0.1184 | 0.0049 | 24.065 | 0.000% |
| **Payout Ratio** | 0.0043 | 0.0027 | 1.599 | 12.342% |
| **Year Variable** | 0.0007 | 0.0019 | 0.356 | 72.479% |

## SUMMARY OUTPUT FOR MLPS WITH PAYOUTS GREATER THAN ONE

| | |
|---|---|
| **DCF Result** | **Y** |
| **Payout Ratio** | **X** |

| *Regression Statistics* | |
|---|---|
| Multiple R | 0.0586 |
| **R Square** | **0.0034** |
| **Adjusted R Square** | **-0.0732** |
| Standard Error | 0.0109 |
| Observations | 15 |

ANOVA

| | *df* | *SS* | *MS* | *F* | *Significance F* |
|---|---|---|---|---|---|
| Regression | 1 | 5.32E-06 | 5.32E-06 | 4.47E-02 | 83.576% |
| Residual | 13 | 1.54E-03 | 1.19E-04 | | |
| Total | 14 | 1.55E-03 | | | |

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 0.1291 | 0.00615 | 20.98 | 0.000% |
| **Payout Ratio** | 0.0007 | 0.00319 | 0.21 | 83.576% |

# REGRESSION DATA

| | | Ticker | DCF Results | Payout Ratio | Year Variable |
|---|---|---|---|---|---|
| 2007 | Boardwalk Pipeline Partners, L.P. | BWP | 12.05% | 0.92 | 0 |
| 2007 | Enbridge Energy Partners, L.P. | EEP | 11.75% | 1.80 | 0 |
| 2007 | Energy Transfer Partners, L.P. | ETP | 12.62% | 0.88 | 0 |
| 2007 | Enterprise Product Partners, L.P. | EPD | 13.29% | 1.60 | 0 |
| 2007 | Kinder Morgan Energy Partners, L.P. | KMP | 13.66% | 2.02 | 0 |
| 2007 | ONEOK Partners, L.P. | OKS | 12.24% | 1.00 | 0 |
| 2007 | TC Pipelines, L.P. | TCLP | 11.50% | 1.08 | 0 |
| 2006 | Boardwalk Pipeline Partners, L.P. | BWP | 11.14% | 0.71 | 1 |
| 2006 | Enbridge Energy Partners, L.P. | EEP | 12.46% | 1.02 | 1 |
| 2006 | Energy Transfer Partners, L.P. | ETP | 12.87% | 0.81 | 1 |
| 2006 | Enterprise Product Partners, L.P. | EPD | 13.94% | 1.58 | 1 |
| 2006 | Kinder Morgan Energy Partners, L.P. | KMP | 13.13% | 1.65 | 1 |
| 2006 | ONEOK Partners, L.P. | OKS | 11.79% | 0.90 | 1 |
| 2006 | TC Pipelines, L.P. | TCLP | 11.40% | 0.98 | 1 |
| 2005 | Enbridge Energy Partners, L.P. | EEP | 12.73% | 4.81 | 2 |
| 2005 | Energy Transfer Partners, L.P. | ETP | 13.00% | 0.73 | 2 |
| 2005 | Enterprise Product Partners, L.P. | EPD | 13.72% | 1.82 | 2 |
| 2005 | Kinder Morgan Energy Partners, L.P. | KMP | 13.56% | 1.30 | 2 |
| 2005 | ONEOK Partners (No. Border) | NBP | 12.44% | 1.10 | 2 |
| 2005 | TC Pipelines, L.P. | TCLP | 10.30% | 0.85 | 2 |
| 2004 | Enbridge Energy Partners, L.P. | EEP | 11.81% | 1.80 | 3 |
| 2004 | Energy Transfer Partners, L.P. | ETP | 11.50% | 0.85 | 3 |
| 2004 | Enterprise Product Partners, L.P. | EPD | 15.43% | 1.77 | 3 |
| 2004 | Kinder Morgan Energy Partners, L.P. | KMP | 13.82% | 1.27 | 3 |
| 2004 | ONEOK Partners (No. Border) | NBP | 12.13% | 1.14 | 3 |
| 2004 | TC Pipelines, L.P. | TCLP | 11.34% | 0.76 | 3 |

## Data Used to Calculate DCF Estimates and Payout Ratio

| | Ticker | Annual PRICES High | Low | Average | VL Annual Dividend[10] | Yield | IBES Growth Forecast | GDP Growth | Wtd Avg. Growth | Adj. Yield x (1+.5g) | **DCF Results** | **VL EPS**[11] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2007 | BWP | $39.20 | $30.13 | $34.67 | $1.74 | 5.02% | 8.0% | 4.58% | 6.86% | 5.19% | **12.05%** | $1.90 |
| 2007 | EEP | $61.82 | $48.25 | $55.04 | $3.70 | 6.72% | 5.0% | 4.58% | 4.86% | 6.89% | **11.75%** | $2.06 |
| 2007 | ETP | $64.00 | $49.05 | $56.53 | $3.15 | 5.57% | 8.0% | 4.58% | 6.86% | 5.76% | **12.62%** | $3.56 |
| 2007 | EPD | $33.70 | $28.06 | $30.88 | $1.92 | 6.22% | 8.0% | 4.58% | 6.86% | 6.43% | **13.29%** | $1.20 |
| 2007 | KMP | $57.35 | $47.28 | $52.32 | $3.44 | 6.58% | 8.0% | 4.58% | 6.86% | 6.80% | **13.66%** | $1.70 |
| 2007 | OKS | $73.00 | $61.25 | $67.13 | $3.94 | 5.87% | 7.0% | 4.58% | 6.19% | 6.05% | **12.24%** | $3.94 |
| 2007 | TCLP | $43.20 | $35.14 | $39.17 | $2.54 | 6.48% | 5.0% | 4.58% | 4.86% | 6.64% | **11.50%** | $2.36 |
| 2006 | BWP | $31.64 | $17.98 | $24.81 | $1.32 | 5.32% | 6.00% | 5.00% | 5.67% | 5.47% | **11.14%** | $1.85 |
| 2006 | EEP | $50.99 | $42.00 | $46.50 | $3.70 | 7.96% | 4.00% | 5.00% | 4.33% | 8.13% | **12.46%** | $3.62 |
| 2006 | ETP | $56.00 | $33.55 | $54.19 | $2.56 | 5.67% | 8.0% | 5.00% | 7.00% | 5.87% | **12.87%** | $3.15 |
| 2006 | EPD | $29.98 | $23.69 | $26.84 | $1.80 | 6.71% | 8.00% | 5.00% | 7.00% | 6.94% | **13.94%** | $1.14 |
| 2006 | KMP | $56.22 | $42.80 | $49.51 | $3.26 | 6.58% | 7.00% | 5.00% | 6.33% | 6.79% | **13.13%** | $1.98 |
| 2006 | OKS | $66.74 | $42.00 | $54.37 | $3.60 | 6.62% | 5.00% | 5.00% | 5.00% | 6.79% | **11.79%** | $4.00 |
| 2006 | TCLP | $38.13 | $29.85 | $33.99 | $2.35 | 6.91% | 4.00% | 5.00% | 4.33% | 7.06% | **11.40%** | $2.39 |
| 2005 | EEP | $57.08 | $42.00 | $49.54 | $3.70 | 7.47% | 5.00% | 5.22% | 5.07% | 7.66% | **12.73%** | $0.77 |
| 2005 | ETP | $39.09 | $26.91 | $33.00 | $1.89 | 5.72% | 8.00% | 5.22% | 7.07% | 5.92% | **13.00%** | $2.60 |
| 2005 | EPD | $28.35 | $23.38 | $25.87 | $1.66 | 6.42% | 8.00% | 5.22% | 7.07% | 6.64% | **13.72%** | $0.91 |
| 2005 | KMP | $55.20 | $42.77 | $48.99 | $3.07 | 6.27% | 8.00% | 5.22% | 7.07% | 6.49% | **13.56%** | $2.37 |
| 2005 | NBP | $52.99 | $40.60 | $46.80 | $3.20 | 6.84% | 5.52% | 5.22% | 5.42% | 7.02% | **12.44%** | $2.92 |
| 2005 | TCLP | $41.28 | $30.11 | $35.70 | $2.30 | 6.44% | 3.00% | 5.22% | 3.74% | 6.56% | **10.30%** | $2.70 |
| 2004 | EEP | $61.82 | $51.60 | $56.71 | $3.70 | 6.52% | 5.00% | 5.35% | 5.12% | 6.69% | **11.81%** | $2.06 |
| 2004 | ETP | $59.50 | $34.50 | $47.00 | $2.93 | 6.22% | 5.00% | 5.35% | 5.12% | 6.38% | **11.50%** | $3.45 |
| 2004 | EPD | $25.99 | $20.00 | $23.00 | $1.54 | 6.70% | 10.00% | 5.35% | 8.45% | 6.98% | **15.43%** | $0.87 |
| 2004 | KMP | $49.12 | $37.65 | $43.39 | $2.81 | 6.48% | 8.00% | 5.35% | 7.12% | 6.71% | **13.82%** | $2.22 |
| 2004 | NBP | $49.54 | $35.70 | $42.62 | $3.20 | 7.51% | 4.00% | 5.35% | 4.45% | 7.68% | **12.13%** | $2.81 |
| 2004 | TCLP | $39.18 | $28.47 | $33.83 | $2.28 | 6.74% | 4.00% | 5.35% | 4.45% | 6.89% | **11.34%** | $2.99 |

[10] 2007 dividends for EEP, ETP, OKS and TCLP are based on annualized values of 10-Q or Value Line data for six or nine months depending upon availability. ETP is from S&P in other years. Other DPS values are from Value Line.

[11] 2007 earnings for EEP, ETP and OKS are based on annualized values of 10-Q or Value Line data for six or nine months depending upon availability. ETP is from S&P in other years. Other EPS values are from Value Line.

# APPENDIX C

## Distortion Caused When Distributions in Excess of Earnings are Excluded from a DCF Analysis

APPENDIX C

**Distortion Caused When Distributions in Excess of Earnings are Excluded from a DCF Analysis**

The "distribution cap" proposal would create a mismatch between the cash flows and the stock price that investors pay for those cash flows. This Appendix shows the mismatch between the market price and cash flows when the "distribution cap" is applied to DCF estimates of the cost of common equity.

By omitting a large part of the expected cash flows (those distributions that exceed the earnings), **and** continuing to use the market price in the DCF calculation, the "capped distribution" method produces results that are clearly incorrect for MLPs. For example, if the company pays out all of its earnings and cash flow at the end of each year, according to DCF theory its stock (or unit) price should be determined by the following equation:[12]

**EQUATION 1: General DCF Model for Stock Price**

$$\text{Price} = \frac{(E_1 + \mathbf{H_1})}{(1+k)^1} + \frac{(E_1 + \mathbf{H_1})*(1+g)^1}{(1+k)^2} + \cdots + \frac{(E_1 + \mathbf{H_1})*(1+g)^{N-1}}{(1+k)^N}$$

Where:

$E_1$ = earnings per share to be paid out as a dividend in the upcoming year
$H_1$ = cash per share in excess of earnings to be paid out in the upcoming year[13]
$D_1$ = dividends per share (not shown in equation); equal to $E_1$ and $H_1$ in the equation
g = future growth rate expected
k = the required rate of return given the risk of the company's stock.

[12] For demonstration purposes the example assumes that distributions are paid annually. This slightly simplifies the calculation by using (1 + g) as the distribution factor instead of (1 + .5g), which approximates the correct factor when a company pays dividend distributions quarterly.

[13] E1 and H1 are equal to earnings and additional cash flow in the most recent year, times the growth factor. In other words $E_1 = E_0*(1 + g)$, and $H_1 = H_0*(1 + g)$.

This is the basic DCF model that investors who buy and sell common stocks (or partnership units) use to determine the market price of an expected stream of cash flows.

### A. Note About the Sources and Uses of Cash Used to Pay Dividends

It is common to describe the cash flow in the numerator each year as a dividend distribution (D) because the source of the cash that the company uses to pay dividend distributions to shareholders is not important for the DCF model; it is only important that the model correctly represent the amount of cash shareholders expect to be paid. Nevertheless, the proposed policy statement seems to place great importance on whether the company pays dividend distributions that exceed earnings in any given year, and whether dollars that are designated as "depreciation" on the company's accounting books contribute to the amount of cash the company pays out in any given year. In order to address the confusion reflected in the proposed policy, Equation 1 and the examples that follow replace the concept of a company's *use of cash* to pay dividends (D), with two of the several *sources of cash* on a company's income statement, earnings and cash flow in excess of earnings (E and H). Wherever E and H appear in an example, it should be understood that they represent the amount of dividend distributions, where E indicates that a company pays out 100 percent of its earnings as a dividend distribution each year, and H indicates the amount by which dividend distributions exceed earnings in any given year.

### B. Formation of the Market Price

To illustrate the effect that occurs when the company passes cash in excess of earnings through to shareholders as part of a dividend distribution, suppose that a company has the following values:

$E_1$ = \$4.50 = earnings per share in the upcoming year
$H_1$ = \$3.00 = distribution per share in excess of earnings in the upcoming year
g = 5% = future growth rate expected.
k = 12.5% = the required rate of return given the risk of the company's stock.

**EQUATION 2: Initial Determination that Stock (or Unit) Price is \$100**

$$\text{Price} = \frac{(\$4.50+\mathbf{\$3.00})}{(1.125)^1} + \frac{(\$4.50+\mathbf{\$3.00})*(1.05)^1}{(1.125)^2} + \ldots + \frac{(\$4.50+\mathbf{\$3.00})*(1.05)^{N-1}}{(1.125)^N}$$

$$\mathbf{\$100} = \frac{\mathbf{\$7.50}}{(1.125)^1} + \frac{\mathbf{\$7.50}*(1.05)^1}{(1.125)^2} + \ldots + \frac{\mathbf{\$7.50}*(1.05)^{N-1}}{(1.125)^N}$$

Equation 2 shows how the market determines that the price of the stock (or partnership units) should be \$100 when the dividend distributions are equal to the company's earnings (\$4.50 per unit) plus additional cash flow (\$3.00), and the expected growth rate from sources other than retained earnings is five percent. The following examples show how:

1. Equation 2 is the basis for an accurate DCF analysis when the analysis uses accurate measures of price, dividend distribution and the expected growth rate; and,

2. The relationships in Equation 2 are violated, and the DCF analysis will produce an inadequate result, when an analyst uses a "capped distribution."

The relationships demonstrating these results are summarized in App. Table C-1, where an inadequate rate of return, 9.5 percent, is produced by a DCF analysis that adjusts only the dividend distribution without considering how the level of the dividend distribution determines the market price of the stock and the growth rate that investors expect. A "capped distribution" adjustment undermines the market basis of the DCF analysis by breaking the link between the actual distributions on the one hand and the actual market price and expected growth rate on the other hand.

App. Table C-1

| | Distortion Caused by the "Distribution-Cap" | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Adjustment to: | | | | Expected in Year 1 | | | | | |
| | Required Return | D | P | g | Stock Price | Earnings | Real Distn. | Capped Distribution | Dividend Yield | Growth Rate | DCF Results |
| 1. | 12.50% | | | | $ 100 | $ 4.50 | **$ 7.50** | | 7.50% | 5.00% | 12.50% |
| 2. | 12.50% | **X** | | | $ 100 | $ 4.50 | $ 7.50 | **$ 4.50** | 4.50% | 5.00% | *9.50%* |

### C. DCF Analysis Reverses the Market Price Formula to Determine the Required Return

Given that Equation 2 is how investors decided to pay $100 for the stock, we can "reverse-engineer" the DCF model to find the discount rate (k) that investors used in arriving at a price of $100. The implicit discount rate, or required rate of return, is found by solving the following equation:

**EQUATION 3: Actual Distribution Accurately Estimates Required Return (12.5%)**

$$k = \frac{(\$4.50 + \mathbf{\$3.00})*(1.05)^1}{\mathbf{\$100}} + 5\%$$

$$\mathbf{12.5\%} = \frac{\mathbf{\$7.50}}{\mathbf{\$100}} + 5\%$$

In other words, if investors are willing to pay $100 for cash flow that includes earnings of $4.50 and a payout of additional cash flow to investors of $3.00, and an expected growth rate of five percent, that information can be used to determine that investors implicitly used a discount rate (or required rate of return) of 12.5 percent when they set the stock price.

### D. "Capped-Distribution" Breaks the Link Between Market Price and Actual Distributions

The proposed policy statement mistakenly suggests that a distribution in excess of earnings somehow distorts the DCF results or double-collects the depreciation from customers. The proposed policy statement would attempt to remedy this perceived distortion by placing a cap on the distribution used to calculate the dividend yield component of the formula. The proposed cap would be applied in the preceding example by eliminating $3.00 from the calculation, the amount of expected distribution in excess of earnings:

**EQUATION 4: Cap on Distribution Distorts DCF Results**

$$k = \frac{(\$4.50 + \mathbf{\$0})}{\mathbf{\$100}} + 5\%$$

$$\mathbf{9.5\%} = \frac{\mathbf{\$4.50}}{\mathbf{\$100}} + 5\%$$

The adjusted (or "capped-distribution") DCF result of 9.5 percent understates the cost of common equity because the adjustment eliminated the firm's cash flow in excess of earnings – $3 in the first year – that is part of the value that investors purchased when they agreed to pay $100 per share. The error occurs because there are no commensurate adjustments to either the price ($100) or the growth rate (5%).

### E. Stock Price Would Have Been Different if Real-Life Distributions Were Capped

If distributions in excess of earnings are omitted from the DCF calculation, and without an offsetting increase in the expected growth rate, the market price of the stock would not have been $100. Instead, the stock price would have been:

**EQUATION 5: Stock Price Adjustment When Portions of Cash Flow Are Omitted**

$$\text{Price} = \frac{(\$4.50 + \mathbf{\$0})*(1.05)^1}{(1.125)^1} + \frac{(\$4.50 + \mathbf{\$0})*(1.05)^2}{(1.125)^2} + \ldots + \frac{(\$4.50 + \mathbf{\$0})*(1.05)^N}{(1.125)^N}$$

$$\mathbf{\$60} = \frac{\mathbf{\$4.50}}{(1.125)^1} + \frac{\mathbf{\$4.50}*(1.05)^1}{(1.125)^2} + \ldots + \frac{\mathbf{\$4.50}*(1.05)^{N-1}}{(1.125)^N}$$

This suggests that **P would have been $60 if the distribution had been capped at the level of earnings**, and there is no change in the expected growth rate. In other words, if stock-market investors had thought that the cash flows paid out by the company would include only a return *on* investment, and that a return *of* investment *from the company to the stockholders* would never occur, the stock would have been worth $60, not $100. The proposed policy statement does not say what happens to the money that is omitted from the distribution but, because that money is not accounted for in the model, the effect of the "distribution cap" on investors would be similar to the effect one would expect if the company's management were to keep any cash in excess of the cap out of the hands of shareholders by building a bonfire to burn $3.00 per share.

Obviously the $3.00 per share must go somewhere in the model, but the proposed Policy Statement does not explain what happens to the omitted portion of the distribution. Therefore, it is impossible to conduct any rigorous analysis that could support the claim that the "distribution cap" would correctly reflect either investor expectations or the

required rate of return. Instead, the analysis in this Appendix A demonstrates that the numbers in the "adjusted" formula will not produce a coherent DCF analysis.

Exhibit No. S - 20
Page 9 of 19

**Gas Pipeline**
**Staff Proxy Group**
**Payout Ratios**

| Centerpoint | 1998 | 1999 | 2000 | 2001 | 2002 | Averages |
|---|---|---|---|---|---|---|
| Earnings/Share | NA | NA | NA | $3.14 | $1.29 | $2.22 |
| Dividends/Share | NA | NA | NA | $1.50 | $1.07 | $1.29 |
| Payout Ratio | | | | 47.77% | 82.95% | 65.36% |

| Dominion Resources | 1998 | 1999 | 2000 | 2001 | 2002 | Averages |
|---|---|---|---|---|---|---|
| Earnings/Share | 2.75 | 2.81 | 1.85 | 2.15 | 4.82 | 2.876 |
| Dividends/Share | $2.58 | $2.58 | $2.58 | $2.58 | $2.58 | $2.58 |
| Payout Ratio | 93.82% | 91.81% | 139.46% | 120.00% | 53.53% | 99.72% |

| Duke Energy | 1998 | 1999 | 2000 | 2001 | 2002 | Averages |
|---|---|---|---|---|---|---|
| Earnings/Share | $1.71 | $1.13 | $2.38 | $2.56 | $1.22 | $1.80 |
| Dividends/Share | $1.10 | $1.10 | $1.10 | $1.10 | $1.10 | $1.10 |
| Payout Ratio | 64.33% | 97.35% | 46.22% | 42.97% | 90.16% | 68.20% |

| El Paso Corp | 1998 | 1999 | 2000 | 2001 | 2002 | Averages |
|---|---|---|---|---|---|---|
| Earnings/Share | $1.85 | -$1.06 | $2.44 | $0.18 | -$2.30 | $0.22 |
| Dividends/Share | $0.76 | $0.79 | $0.82 | $0.85 | $0.87 | $0.82 |
| Payout Ratio | 41.08% | -74.53% | 33.61% | 472.22% | -37.83% | 86.91% |

Source: S&P Stock Reports

**Gas Pipeline**
**Staff Proxy Group**
**Pay Out Ratios**

| Entergy | | | | | | |
|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002 | Averages |
| Earnings/Share | $3.00 | $2.25 | $2.97 | $3.13 | $2.64 | $2.80 |
| Dividends/Share | $1.50 | $1.20 | $1.22 | $1.28 | $1.34 | $1.31 |
| Payout Ratio | 50.00% | 53.33% | 41.08% | 40.89% | 50.76% | 47.21% |

| Kinder Morgan Inc | | | | | | |
|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002 | Averages |
| Earnings/Share | $0.92 | $1.92 | $1.60 | $1.97 | $2.50 | $1.78 |
| Dividends/Share | $0.76 | $0.65 | $0.20 | $0.20 | $0.30 | $0.42 |
| Payout Ratio | 82.61% | 33.85% | 12.50% | 10.15% | 12.00% | 30.22% |

| National Fuel Gas | | | | | | |
|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002 | Averages |
| Earnings/Share | $0.42 | $1.48 | $1.60 | $0.82 | $1.46 | $1.16 |
| Dividends/Share | $0.89 | $0.92 | $0.95 | $0.99 | $1.03 | $0.96 |
| Payout Ratio | 211.90% | 62.16% | 59.38% | 120.73% | 70.55% | 104.94% |

| NiSource | | | | | | |
|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002 | Averages |
| Earnings/Share | $1.59 | $1.27 | $1.08 | $1.01 | $2.00 | $1.39 |
| Dividends/Share | $0.96 | $1.02 | $1.08 | $1.16 | $1.16 | $1.08 |
| Payout Ratio | 60.38% | 80.31% | 100.00% | 114.85% | 58.00% | 82.71% |

| | |
|---|---|
| Average Payout Ratio | 73.78% |

Source: S&P Stock Reports