UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

POST-TECHNICAL CONFERENCE INITIAL COMMENTS OF THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

In response to the Commission's December 13, 2007 Notice in the above-captioned docket, the Interstate Natural Gas Association of America ("INGAA") hereby submits its initial post-technical conference comments.

BACKGROUND

After receiving comments in response to its Proposed Policy Statement,[1] the Commission, in a Notice dated November 15, 2007, scheduled a technical conference to receive additional comments on growth projections used in the Discounted Cash Flow ("DCF") analysis. In this Notice, the Commission stated that the existing record was not sufficient for it to determine (1) whether its current method of projecting growth adequately reflects the purportedly lower growth potential of Master Limited Partnerships ("MLPs"), particularly over the long term, and (2) if not, what alternative method should be used to project the growth of MLPs. P 5.

At the January 23, 2008 technical conference, the Commission heard from a panel of experts chosen on the basis of written comments filed on December 21, 2007. INGAA's comments herein reflect the discussion at this conference.

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

SUMMARY OF POSITIONS

The panel of experts speaking at the technical conference included oil and gas pipeline, shipper and state interests. Both natural gas and oil pipelines, as well as a trade group of publicly traded partnerships, propose that the Commission continue to use gross domestic product ("GDP") as the long-term growth projection for both corporations and MLPs in the DCF formula. *See* Comments of INGAA, Association of Oil Pipelines ("AOPL"), National Association of Publicly Traded Partnerships ("NAPTP"), and TransCanada Corporation ("TransCanada").

INGAA's primary position, as expressed by its expert Dr. Michael J. Vilbert, is that the Commission's current DCF methodology for estimating the investor required rate of return on common equity, which utilizes GDP as the measure of long-term growth for both corporations and MLPs, produces reasonable results and need not be changed. Tr. 27, 62, 80. In an attachment to INGAA's comments, Dr. Vilbert explained the "Benchmark Model" that he used to estimate the cost of capital of MLPs.[2] This model confirmed that the Commission's existing simplified DCF model, at least at the present time, produces reasonable results, and that there is no need for change. Thus, Dr. Vilbert's primary recommendation in this proceeding is that the Commission retain its current method of using GDP as the measure of long-term growth for both corporations and MLPs.

Dr. Vilbert also offered an alternative proposal that could be adopted by the Commission as a compromise if it believes as a result of its review of all of the

[2] As offered by Dr. Vilbert at the technical conference, the Benchmark Model is being provided herewith electronically in Excel format, with all formulas intact. The model can be used to calculate the cost of equity for individual MLPs.

comments, that a change from GDP as the measure of MLP long-term growth is warranted. This compromise alternative would be to utilize, subject to periodic checks, a long-term growth rate for limited partnership ("LP") units equal to the average of GDP and the Federal Reserve Bank's target long-term Consumer Price Index rate of inflation.

Three other parties submitted proposals in their comments that would reduce the long-term growth rate for MLPs. The American Public Gas Association ("APGA") proposes to reduce GDP by 50% for MLPs. The Public Service Commission of New York ("PSCNY") proposes to utilize a sustainable growth analysis based on a function of (1) retained earnings, which PSCNY states for MLPs would be zero or negative; and (2) growth attributable to external financing. The State of Alaska proposes to reduce an MLP's expected growth rate by multiplying it by a ratio of expected earnings per share to distributions per share. These comments address the proposals made by these parties.

SUMMARY OF COMMENTS

As discussed in more detail below, the discussion at the technical conference revealed a great deal of agreement among the members of the panel. All experts agreed that GDP is an imprecise surrogate for the long-term growth forecast of individual entities, whether MLPs or C-corporations. As such, the use of GDP in the formula is not intended to measure the long-term growth of any individual company, but rather serves to create a smoothing effect on the results of the DCF analysis. While the use of GDP is imperfect, it may be the best measure currently available. Tr. 109.

The experts also agreed that as a matter of economic theory, a company's ability to grow depends on the nature of its assets and not its organizational structure. There also seemed to be a consensus, if not unanimous agreement, that a company's growth potential is not affected by the extent to which the company retains versus distributes cash because companies grow by either investing internally-generated funds or externally generated capital, or both.

The issue, therefore, is whether there is any theoretically valid basis for reducing the long-term growth rate used in the DCF formula below GDP just for MLPs. INGAA submits that the answer is no. The only thorough technical DCF analysis submitted in this proceeding is Dr. Vilbert's Benchmark Model. The results of this model confirm that the Commission's existing DCF model utilizing GDP as the measure of long-term growth produces reasonable results, *i.e.* that there is no material difference between the investor required return as measured using the Commission's current methodology and Dr. Vilbert's more precise Benchmark Model. Dr. Vilbert's model appropriately estimates the cost of capital for the MLP as a whole and compares the results to the simpler FERC model. As Dr. Vilbert explained at the conference, his model takes into account the impact of the general partner's incentive distribution rights on all components of the DCF formula, whether they increase or decrease the overall return. None of the experts at the conference disagreed with Dr. Vilbert's analysis.

In sum, there is no evidence or theoretical basis supporting the notion that MLPs will grow at a slower rate than C-corporations in the long-term. While the use of GDP in the DCF formula is imperfect, it is the best measure of long-term growth currently available and produces reasonable results. Certainly, given the fact that GDP is itself a surrogate for forecasts of the long-term growth of the proxy group companies, there is no reason to arbitrarily reduce the growth rate for MLPs to something less than GDP. If the Commission nonetheless believes that some adjustment is warranted, it should adopt Dr.

Vilbert's alternative compromise of using the average of GDP and the Federal Reserve Board's target rate of inflation.

COMMENTS

A. The Written and Oral Comments Support the Continuing Use of GDP as the Measure of Expected Long-Term Growth of MLPs in the DCF Model.

1. Dr. Vilbert's Benchmark Model Confirms the Reasonableness of the Results Produced by FERC's Current DCF Model.

The panel at the technical conference appeared to be in unanimous agreement that estimating the cost of capital was more of an art than a science. Tr. 132-33 (Williamson); Tr. 133 (Vilbert); Tr. 134 (Solomon). The panel was also in substantial agreement that GDP, in particular, was at best an imperfect measure of the expected long-term growth rate of any company, whether the company used the corporate or MLP form. *See* Tr. 35, 113-14 (Moul); Tr. 108-09 (Vilbert); Tr. 109-10 (Williamson). The Commission itself has recognized that GDP is an imprecise estimate of long-term growth. *See Northwest Pipeline Co.*, 79 FERC ¶ 61,309 at 62,382 (1997); *Transcontinental Gas Pipe Line Corp.*, Opinion No. 414-A, 84 FERC ¶ 61,084 at 61,423 (1998). As the commenters pointed out, the effect of using GDP is to smooth out the use of the IBES short-term growth forecasts of individual companies by applying a one-third weighting to a generic estimate of growth in the economy. Tr. 61. GDP is used because it is the best measure currently available of long-term growth. Tr. 109.

The current DCF model utilized by FERC examines the yield and growth rate of the LP units only. Because this model does not take into account the distributions provided to the General Partner ("GP"), it does not capture the cost of capital to the entire enterprise. Therefore, Dr. Vilbert devised a model designed to test whether the FERC's simplified model produces reasonable results for MLPs. This Benchmark Model attempts to measure the expected long-term growth rates of the MLP as a whole, giving appropriate recognition to the impact of the GP's IDRs on both the expected growth rate of the MLP, as well as the value of the GP's share. As Dr. Vilbert explained, his model captures the risk of the entity as whole by grossing up both the distribution *and price* of the GP shares. The price adjustment reduces the distribution yield and has the effect of lowering the overall rate of return. Tr. 75-76.

The results of Dr. Vilbert's model demonstrate that FERC's current simplified approach produces reasonable results.[3] Thus, Dr. Vilbert concluded that FERC's existing model is straightforward, easy to apply, gives reasonable numbers and should not be changed. Tr. 27. Importantly, Dr. Vilbert's Benchmark Model is the only theoretical analysis presented in this record that attempts to determine the return on equity for MLPs. Given that (1) the use of GDP is imprecise to begin with; (2) GDP is the best measure of long-term growth currently available for use in the DCF formula; and (3) evidence that the use of GDP produces reasonable results, INGAA submits that there is no reason or basis for the Commission to deviate from its current methodology, or to make an adjustment that ultimately must be somewhat arbitrary.

2. There Is No Basis for the Conclusion That Long-Term Growth Rates of MLPs Must Be Lower Than C-Corporations.

In its November 15 Notice of Technical Conference (at P 7), the Commission stated that the "commenters generally agree that MLPs will have lower growth potential than corporations, because of their distributions in excess of earnings." It was this

[3] Using a sample proxy group of MLPs, Dr. Vilbert's Benchmark Model produces an average return on equity of 12.79% as compared to FERC's simplified model of 12.94%. *See* pages 20- 21 of Appendix A to INGAA's Additional Initial Comments.

assumed agreement that apparently led the Commission to question whether its use of GDP as the long-term growth rate for MLPs was appropriate.

INGAA believes, however, that the Commission read too much into the comments of INGAA and other pipeline parties. INGAA agrees that there is an inverse relationship between dividend/distribution yields and short-term growth rates projected by IBES analysts for both MLPs and corporations. As the Commission acknowledged in its Proposed Policy Statement (at P 22), and as INGAA reiterated in its comments, MLPs exhibit high distribution yields but correspondingly lower IBES short-term growth projections, while corporations exhibited lower dividend yields but higher IBES growth projections. There is no evidence, however, that in the long-term MLPs will grow at a slower rate than corporations, or that GDP is not an appropriate measure of long-term growth for both types of organizational structures.

Indeed, as the discussion at the technical conference made clear, there is no reason that MLPs cannot grow as fast as corporations. All experts agreed that long-term growth is based on the assets owned by the company, not its organizational structure. As Dr. Vilbert stated:

> In principle, there's no reason at all that the MLP cannot grow as fast as a C-corporation. If there are good opportunities for investments, they'll take them in just like a C-corporation and grow every bit as fast. . . . In other words, the structure of the organization does not change the risk of the underlying assets.

Tr. 25-26. *See also* Tr. 51, 103.

Kinder Morgan Energy Partners' ("KMEP") President, Park Shaper, explained that KMEP has been able to generate a return of 17% on average over the last 11 years by obtaining capital in the financial markets to fund profitable investments. Tr. 40-41, 44-

45. As Mr. Shaper pointed out, if there are good opportunities for investment, both organizational forms will grow regardless of how much earnings the companies retain or distribute. *Id.*

Even the experts proposing to reduce the long-term growth rate of MLPs acknowledge this basic concept. Consider the following response of Mr. Patrick Barry on behalf of the PSCNY to the testimony of Mr. Shaper:

> Shaper: The ability to grow is the same, regardless of corporate structure and dividend policy. I think that's traditional economic finance theory.
>
> Barry: *I would agree with that as being part of finance theory*, but, also, the ability to cut the IDRs to the GP, I don't think that's an unlimited source.

Tr. 102 (emphasis added). While Mr. Barry was making a separate point with respect to the extent of an MLP's ability to reduce GP distributions to finance growth, he agreed with Mr. Shaper's inescapable conclusion that neither organizational structure nor dividend/distribution payout policies affect the growth prospects of the entity.

Similarly, Mr. Horst, testifying on behalf of the State of Alaska, agreed that high distribution payouts do not limit growth potential:

> A corporation, hypothetically, is funding it out of retained earnings, and the MLP is funding it out of – it's paying out all its cash as distribution and it's going back to the market and raising new capital, they both can grow at the same rate[.]

Tr. 53.

In short, neither financial theory nor historical evidence would support a downward adjustment to GDP in the DCF formula for MLPs. While the IBES forecasts exhibit lower growth rates for individual MLPs offsetting their relatively higher distributions, this same relationship is not present in the context of a generic long-term growth indicator such as GDP. In other words, given that the use of GDP is itself not theoretically based on the growth expectations of individual companies or types of companies, there is no theoretical basis for assuming that GDP is appropriate for one organizational structure and not another.

This point was confirmed by TransCanada witness Paul Moul, who testified that once you switch over from company-specific IBES forecasts to a generic surrogate measure for long-term growth like GDP, there is no reason to treat MLPs and corporations differently. GDP is a nationwide proxy based on the theory that all companies will eventually grow at the rate of the economy, and therefore this rate should be the same for all companies. Tr. 115. Unlike IBES forecasts, which measure investor expectations of the growth of individual companies, GDP is a *substitute* for the expectation of investors. *See* Tr. 97 (emphasis added). There is no rational basis in financial theory to make any adjustment to GDP based on organizational structure.

3. If the Commission Nonetheless Believes an Adjustment to GDP Is Appropriate, Dr. Vilbert's Alternative Proposal Should Be Adopted, Subject to a Periodic Checking of the Results.

While Dr. Vilbert agreed with most commenters that MLPs can be expected to grow over the long term at the same rate as corporations, he thought it important to distinguish between the MLP as a whole, and the LP units. Due to the GP distributions, Dr. Vilbert noted that the LP units will grow at a slower rate than the MLP as a whole. Because FERC's current model measures the growth of the LP units (as opposed to the MLP as a whole), Dr. Vilbert developed his benchmark model to test the validity of the results of the current methodology. Tr. 25. In other words, looking at the growth rates of distributions to LP units *in isolation*, Dr. Vilbert concluded they could be expected to grow more slowly than distributions for the MLP as a whole. The impact of the GP distributions, however, could not be determined in isolation because they affect other components of the DCF formula. When all the impacts of the GP distributions on the DCF formula are considered, Dr. Vilbert's Benchmark Model illustrates that the FERC's existing methodology is currently producing reasonable results and need not be changed.

The fact that LP units can be expected to grow at a lower rate than corporate dividends does not militate in favor of an adjustment to GDP in FERC's DCF model. That is because, as discussed above, the use of GDP is itself merely a surrogate used to measure long-term growth in the DCF model. Therefore, it could just as easily be concluded that the use of GDP in the DCF model understates the long-term growth rates for corporate shares, and the correct way to adjust for the difference in growth rates between LP units and corporate shares is to utilize GDP for LP units and increase the growth rate for corporate shares. Given the inability to determine whether GDP understates the growth rate of corporate shares, or overstates the growth rates of LP units, INGAA submits that a reasonable approach would be to continue to utilize GDP as the measure of long-term growth for both types of investor.

In any event, if, as Dr. Vilbert suggests, the Commission is uncomfortable with using GDP for MLPs, his proposal of using the average of GDP plus the Federal Reserve's target inflation rate should be considered, subject to periodic review as to the reasonableness of the results of this alternative. Tr. 61.

B. The Proposals Made by PSCNY, APGA, and Alaska Are Unsupported and Should Not be Adopted.

1. The Sustainable Growth Analysis Is Flawed.

PSCNY proposes to use a sustainable growth analysis to measure the long-term growth of MLPs. Conceptually, this approach measures growth attributable to retained earnings ("br") plus growth attributable to external financing ("sv"). PSCNY notes that this approach has been used by the Commission to establish returns on equity ("ROEs") for electric utilities. APGA also references this analysis in its comments in an effort to question the sustainability of the growth of MLP distributions. APGA, however, does <u>not</u> propose that the Commission adopt this methodology. APGA Additional Comments at 6, Tr. 64.

APGA's analysis actually demonstrates why this approach is untenable. Because MLPs generally distribute all their available cash flow, their retention ratios are typically negative. APGA's analysis shows that of the four MLPs it analyzed, only one had a positive retention ratio, and the average of the four MLPs was -42%. When added to the Value Line projections of external growth used in the "sv" component of the formula, three of the four MLPs had a negative growth rate. In fact, KMEP, which has averaged an actual 17% return for the past 11 years, is projected by this approach to grow at a rate of *minus* 10.47%. *See* APGA Additional Comments at Exhibit APGA-1, page 2. Clearly, this approach is totally at odds with the actual experience of MLPs, would produce wildly unreasonable results, and could not pass muster under applicable Supreme Court precedent.[4]

[4] *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).

As noted by Staff at the technical conference, the acceptance of this approach in the electric industry is premised on the reasonableness of the results that the methodology produces in that industry. Tr. 65-66. In *Southern California Edison Co.,* 92 FERC ¶ 61,070 (2000), the Commission noted that the growth rate produced by the br + sv formula was within a few basis points of the IBES growth forecasts. Consequently, the Commission used both projections to frame the zone of reasonableness. *Id.* at 61,263. In the context of pipeline MLPs, however, not only is there no correlation between the results of this approach and IBES forecasts, the anomalous results found in this record demonstrate that the approach cannot reasonably be applied to MLPs. INGAA would also note that the Commission has previously rejected the application of this approach to set the return for natural gas pipelines because it would render the DCF calculations "more complex, opaque, and subject to the discretionary judgment of the witness conducting them." *Transcontinental Gas Pipe Line Corp.*, Opinion No. 414-A, 84 FERC ¶ 61,084 at 61,424 (1998).[5]

2. APGA's Proposal to Use 50% of GDP Is Arbitrary and Unsupported.

APGA's proposal to simply cut GDP in half has no support and should be rejected. When asked for the basis of his proposal, APGA's witness Mr. Solomon stated "for the lack of a better place, I decided to cut it maybe in half." Tr. 65. Mr. Solomon made no attempt to even test the reasonableness of his proposal by calculating the results under the DCF formula. Tr. 130-31. Instead of attempting to support his own proposal,

[5] *See also* Tr. 37, where Mr. Moul points out that there is a lack of adequate data to implement the approach with respect to projections of external growth.

Mr. Solomon instead suggested that the State of Alaska's proposal to use the ratio of earnings per share to distributions per share would be reasonable.

3. The State of Alaska's Proposal to Reduce the Long-Term Growth Forecasts of MLPs to Reflect Earnings Per Share Is Based on a Misconception of IBES Forecasts and Miscomprehension of the DCF Analysis.

The State of Alaska's witness, Thomas Horst, proposes that if a pipeline's distributions per share exceed its earnings per share, the expected growth rate of the pipeline's distributions per share should be adjusted to equal (i) the expected growth of its earnings per share, multiplied by (ii) the ratio of the pipeline's earnings per share to its distributions per share. Alaska Comments at 2, Tr. 29-31. The premise of Mr. Horst's proposal is that the IBES forecasts are projections of earnings growth, not growth in distributions. He then concludes that the non-earnings portion of the distribution will not grow at the same rate as the IBES forecasts of earnings growth, and an adjustment is therefore necessary. *Id.*

As a threshold matter, Mr. Horst's factual premise is incorrect. Mr. Yves Siegel, the Managing Director of Wachovia Capital Markets, testified that his projections of MLP growth are based on distribution growth, and that all analysts most likely are forecasting distribution growth. Tr. 33, 56. *See also* Tr. 19 (Williamson) ("when MLP analysts report to IBES, they are likely to be reporting distribution growth rather than income growth."). Analysts forecast distribution growth because LP investors are interested in the cash they will receive in distributions, not in the accounting measure of an MLP's earnings. Tr. 56.

In addition to the fact that Mr. Horst's factual premise is incorrect, his assumption that the non-earnings portion of an MLP's distribution cannot grow as fast as earnings is flawed. As explained by Mr. Shaper, "there is nothing about distributable cash flow that is not sustainable and that cannot grow." Tr. 58-59. Distributable cash flow represents the net cash that the MLP receives and is distributable, while earnings are a function of the accounting for non-cash expenditures such as depreciation. MLPs do not distribute depreciation, they distribute cash, and there is no reason to suggest that the portion of such distributions representing earnings will grow at a different rate than all of the MLP's distributable cash flow.

In fact, Mr. Horst explains that his proposal is a variant on the cap on MLP distributions that the Commission initially sought comment on in its Proposed Policy Statement. Tr. 30. Mr. Horst concedes that the proposed cap "was probably not the way to go, because cash is cash," and that "this is a discounted cash flow method, and we shouldn't start by knocking down the cash distribution amount." Tr. 29. Yet, unexplainably, Mr. Horst proposes "to make a modification of the growth rate that is directly comparable to what FERC had proposed to do to the distribution yield." Tr. 30.

In other words, Mr. Horst agrees that an earnings cap on distributions is unwarranted because "cash is cash" and the DCF method is based on cashflow. Yet, he proposes to reduce an MLP's growth rate based on the same flawed notion underlying the proposed cap: that the DCF model is based on only earnings, not cash. In short, "cash is cash" for purposes of both the distribution yield and growth components of the DCF model, and any limitation on either component based on earnings would be arbitrary and inconsistent with that model.

C. The Tax Efficiency Aspect of MLPs Suggests that MLPs May Grow Faster Than Corporations, But There Is Not a Sufficient Basis to Adjust the DCF Model to Account for Such Efficiencies at This Time.

At the conference, Commissioner Spitzer asked the parties to comment on whether the tax efficient nature of MLPs affects the long-term growth of MLPs as compared to corporations, *i.e.*, whether the tax savings generated by MLPs that are passed through to investors would lead to higher growth. Tr. 106, 112. In response to this question, Mr. Shaper stated his belief that the tax efficiencies result in the potential for MLPs to grow in the long term more rapidly than C-corporations. Tr. 107. Dr. Vilbert noted that the issue was complex and there may be a number of tax impacts that affect the cost of capital for an MLP. Tr. 103-07, 119-24.

Consequently, it appears intuitively reasonable, as Commissioner Spitzer's question suggests, that the tax efficiencies generated by MLPs would result in the long run in higher growth that is not reflected in the DCF formula. That having been said, there is not a sufficient record in this proceeding on this issue upon which to base an adjustment to the DCF formula at this time.

CONCLUSION

The evidence and analyses submitted in this proceeding, and discussed at the technical conference, demonstrate that the Commission's current methodology utilizing GDP as the measure of long-term growth for both MLPs and C-corporations is producing reasonable results and should not be changed. INGAA respectfully requests the Commission to expeditiously issue a Policy Statement providing guidance to the industry that (1) MLPs may be included in proxy groups used to establish the rate of return on equity for oil and gas pipelines; (2) no cap on MLP distributions is warranted; and (3) the

Commission's current DCF methodology utilizing GDP as the measure of long-term growth will be used to calculate the ROEs of both C-corporation and MLP proxy companies. Prompt issuance of a Policy Statement is needed to remove the uncertainty that presently exists with respect to this important issue.

Respectfully submitted,

s/s Joan Dreskin

Howard L. Nelson
Greenberg Traurig, LLP
2101 L Street, N.W.
Suite 1000
Washington, D.C. 20006
(202) 331-3100

Joan Dreskin
Timm Abendroth
Interstate Natural Gas
Association of America
10 G Street, N.W.
Suite 700
Washington, DC 20002
(202) 216-5928

Counsel for Interstate Natural Gas Association of America

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