UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Inquiry Regarding the Commission's Policy for Determining Return on Equity	)))	Docket Nos. PL19-4-000

COMMENTS OF THE
MASTER LIMITED PARTNERSHIP ASSOCIATION

Pursuant to the Notice of Inquiry ("NOI") issued by the Federal Energy Regulatory Commission ("FERC" or the "Commission") on March 21, 2019, in the referenced proceeding,[1] the Master Limited Partnership Association ("MLPA") hereby respectfully submits these comments. MLPA is a national trade association that has represented master limited partnerships ("MLPs") and their service companies and industry partners for over three decades, including representation before the U.S. Congress and in Commission proceedings. Among the over 57 MLPs that MLPA currently represents, there are 29 MLPs whose business operations include gathering or transportation of natural gas, natural gas liquids ("NGLs"), crude oil, and refined products with rates regulated by FERC. MLPA also has 18 Associate Members representing a large swath of the pipeline investor community, who collectively invest billions of dollars in U.S. energy infrastructure.

In the NOI, the Commission seeks information and stakeholder views regarding potential modifications to the Commission's policy on determining a return on equity ("ROE") for use in setting the jurisdictional rates charged by regulated entities. MLPA is offering its expertise on the characteristics of MLPs, including developments in the structure

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

and financing model utilized by MLPs that directly affect assumptions previously relied upon by the Commission in establishing its ROE policy related to MLPs. Given important changes in the marketplace in recent years, MLPA supports a methodology that recognizes these characteristics. MLPA defers to the pipeline trade associations, with their expertise in ratemaking, for technical analyses of the specific methodologies for calculating ROE.[2]

In support hereof, MLPA states as follows:

I. BACKGROUND

Under the Commission's current policy, the appropriate ROE for use in setting a pipeline's rates is determined based on a range of ROEs calculated for a set of proxy group companies using the two-stage discounted cash flow ("DCF") methodology. The DCF methodology adds the current dividend yield (dividends divided by share price, or for MLPs, distributions divided by unit price) to the projected future growth rate of dividends.[3] The projected growth rate is based on both short- and long-term growth, with the calculation weighted so that two-thirds of the rate is based on short-term growth and one-third is based on long-term growth. The short-term growth rate, in turn, is based on analysts' three-year to five-year earnings forecasts as published by the Institutional Brokers Estimate System ("IBES"), and the long-term growth rate is based on projections of gross domestic product ("GDP") growth.[4]

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[2] MLPA understands that the Interstate Natural Gas Association of America and the Association of Oil Pipe Lines will be filing such analyses in this proceeding regarding interstate natural gas pipelines and oil pipelines, respectively. Section 7704 of the Internal Revenue Code does not extend the definition of publicly traded partnerships to include public utilities. 26 U.S.C. §§ 7704(d)–(e). Hence, MLPA is not opining on any matters concerning the determination of ROE for public utilities regulated under the Federal Power Act ("FPA").

[3] NOI at P 5.

[4] *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 6 ("Proxy Group Policy Statement"), *order dismissing request for reh'g or reconsideration*, 123 FERC ¶ 61,259 (2008).

With respect to MLPs included in a proxy group, the Commission currently alters the methodology by discounting the long-term growth rate for MLPs by one-half of the GDP growth-rate estimate.[5] The Commission decided to discount MLP growth on the assumption that "the collective long-term growth rate for MLPs will be less than that of schedule C corporations."[6] This determination was based on the Commission's view of the "relative potential" for long-term growth of MLPs in light of the "unique financial structure" of MLPs.[7]

In March 2019, FERC initiated the NOI to reevaluate its ROE policy following the decision of the U.S. Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") in *Emera Maine v. FERC*.[8] While *Emera Maine* concerned the application of FERC ROE policy under the FPA, FERC extended its general inquiry to seek comment on whether ROE policy changes "should be applied to interstate natural gas and oil pipelines."[9] The NOI then summarizes *Emera Maine* and the FPA cases that led to the decision, as well as FERC's response in post-*Emera Maine* proceedings.[10]

The atmospherics surrounding these FPA proceedings are, in many respects, also applicable to oil and natural gas pipelines regulated under the Natural Gas Act and Interstate

[5] *Id.* at P 42.

[6] *Id.* at P 94.

[7] *Id.* at P 92–94.

[8] 854 F.3d 9 (D.C. Cir. 2017) ("*Emera Maine*").

[9] NOI at 1.

[10] NOI at PP 18-27 (referencing and summarizing *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*"); *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923) ("*Bluefield*"); *S. California Edison Co. v. FERC*, 717 F.3d 177, 181-182 (D.C. Cir. 2013); *Martha Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030 at PP 34, 36 (2018); *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 165 FERC ¶ 61,118 at PP 36, 38 (2018); *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, Opinion No. 551, 156 FERC ¶ 61,234 at P 67, PP 275-276 (Sept. 28, 2016); *Coakley, Mass. Attorney Gen. v. Bangor Hydro-Elec. Co.*, Opinion No. 531, 147 FERC ¶ 61,234 at PP 142, 145, 151-152, *order on paper hearing*, 149 FERC ¶ 61,032 (2014), *order on reh'g*, 150 FERC ¶ 61,165 (2015)).

Commerce Act. Specifically, for all three industries, market conditions have changed since the current version of the DCF model was adopted, particularly since the financial crisis of 2008-2009. Despite these changes, it remains universally true that ROEs must be consistent with "the *Hope* and *Bluefield* capital attraction standards."[11] As the NOI recognizes, FERC's ROE policy must be adequate to ensure that "the return to the equity owner" is "commensurate with the return on investments in other enterprises having corresponding risks," and that the return is "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[12]

Recognizing that market conditions have changed, the NOI identifies the fact that "investors use other financial models in addition to the DCF model to evaluate investments."[13] It notes that FERC, in recent public utility proceedings, "considered certain other financial models when determining the just and reasonable ROEs for public utilities."[14] These alternative models are the Capital Asset Pricing model, Expected Earnings model, and Risk Premium method, or some subset of these models. The Commission emphasized in those proceedings that "investors do not rely on any one model to the exclusion of others," therefore, relying on multiple models for the Commission-derived ROE "makes it more likely that the Commission's decision will accurately reflect how investors make their investment decisions."[15] Hence, the NOI has a distinct focus on ensuring that ROE methodologies align with current market conditions and the way in which investors inform

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[11] *See* NOI at P 18 (citing *Hope*; *Bluefield*).

[12] *See* NOI at P 4 (quoting *Hope* at 605; citing *Bluefield* at 692-693 (1923) (*Bluefield*); *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 (1989)) (internal quotations omitted).

[13] NOI at P 13.

[14] *Id.*

[15] *Id.* at P 24.

their investment decisions.[16] To the extent the Commission adopts a new ROE policy, the NOI recognizes that it must be consistent with *Hope* and *Bluefield*.

The NOI seeks comment on eight "general topics," including "the role of the Commission's base ROE in investment decision-making and what objectives should guide the Commission's approach," whether it is "appropriate and advisable" to apply its base ROE policy uniformly across the electric, interstate natural gas pipeline, and oil pipeline industries, the "performance of the DCF model," and "model mechanics and implementation."[17] In addition to these general topics, the Commission sets forth a number of questions regarding the assumptions of the DCF model and three alternative ROE methodologies identified above, including questions related to "the robustness of the DCF model over time and under differing investment conditions,"[18] whether GDP is an appropriate proxy for long-term growth under the DCF model, and how the Commission should "weight short-term and long-term earnings/dividend growth projections."[19]

II. COMMENTS

MLPA applauds the Commission for taking a holistic view of its policies given "the potentially significant and widespread effect" of its ROE policies.[20] It agrees with the Commission's goals in reviewing its ROE policy, particularly its consideration of changed market conditions and investor expectations. However, given that the NOI was borne out of FPA proceedings, MLPA cautions against any apples-to-apples comparisons between public

[16] *See, e.g., id.*

[17] *Id.* at P 29.

[18] *Id.* at P 33.

[19] *Id.* at P 37.

[20] *Id.* at P 3.

utilities and regulated pipelines with respect to appropriate investor returns. FERC must consider the inherent risks associated with pipeline investment not present with respect to public utilities. For pipeline companies, the ROE policy should reflect current market conditions, including the current financial model utilized by MLPs and the implications of that model on the long-term growth of MLPs.

Rather than locking itself and regulated entities into a rigid ROE policy with fixed inputs and weighting, the Commission also should maintain the flexibility to allow its ROE methodology to accurately reflect market conditions, recognizing that conditions may change over time. Finally, MLPA agrees with the Commission's approach of focusing on investor analyses and expectations of ROE and related policy. The Commission must consider the effect of its ROE policy on investors—a fact amply demonstrated by the effect of recent Commission policy on MLPs and their investors.

A. *The Commission's 2008 modification to the DCF methodology to discount the long-term growth rate for MLPs does not reflect market conditions, as shown by the relevant data, and is no longer appropriate for the Commission's ROE analysis.*

As noted above, the current DCF methodology employed by the Commission discounts the long-term growth rate of any MLP included in the proxy group. When this policy was developed in 2008, the Commission explained that "MLPs' unique financial structure" would result in less access to capital markets than C-corporations, and specifically identified "greater exposure to interest rate risk, the increased cost of capital that a high level of [Incentive Distribution Rights ("IDRs")] imposes on an MLP, and lower future returns from either acquisitions or organic investments as the MLP industry matures" as key factors driving the conclusion that MLPs will have limited growth relative to C-corporations.[21] By

[21] Proxy Group Policy Statement at P 92.

contrast, the Commission explained that C-corporations "have greater opportunities for diversification because their investment opportunities are not limited to those that meet the tax qualifying standards for an MLP," and that C-corporations can "assume greater risk at the margin because of less pressure to maintain a high payout ratio."[22] The Commission also looked at "whether investors expect MLP long-term growth rates to be less than projections of growth in GDP," and found that while certain investment firms based long-term growth projections for corporations on the long-term growth of the economy as a whole, many investment firms projected the long-term growth of MLPs at a lower rate.[23]

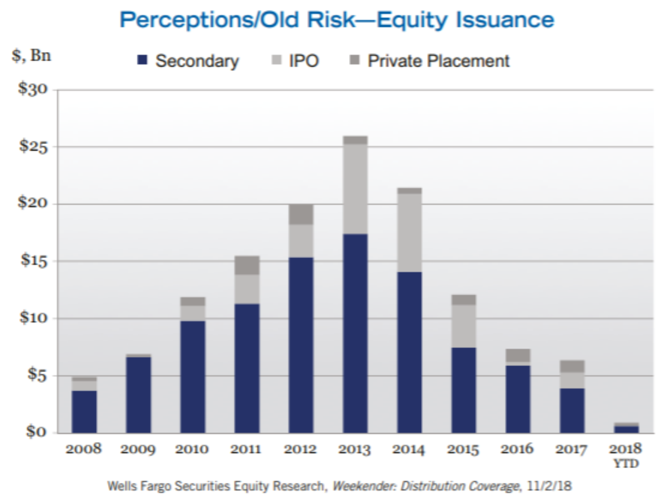
The MLP industry has matured considerably since the Proxy Group Policy Statement was issued. Hence, the Commission's former assumptions regarding the financial structure of MLPs no longer hold. The Commission's ROE policy, therefore, should be modified to reflect the current financial structure of MLPs and investor expectations regarding MLPs. Specifically, it is no longer appropriate to discount the growth rate of MLPs in relation to C-corporations.

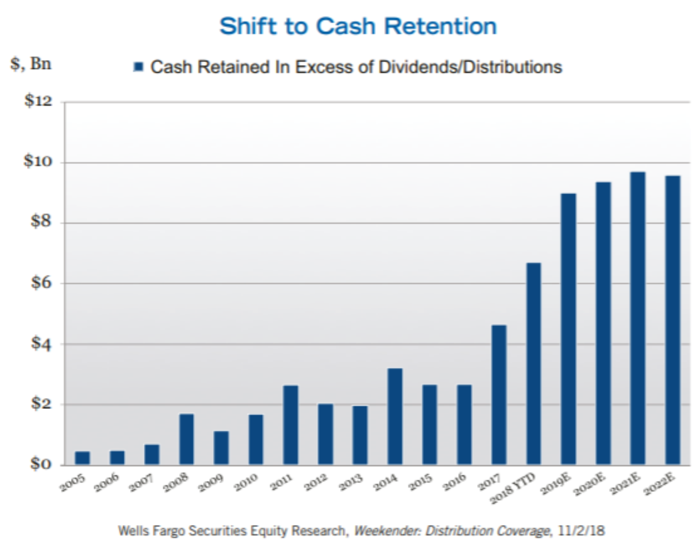
Following financial down cycles and in response to investor demand, MLPs have restructured and revamped in fundamental ways that enable MLPs to operate more like C-corporations and appeal to a broader set of investors. Recent market conditions resulted in changes to the financial model pursued by most MLPs, with many partnerships restructuring their financial priorities following these market challenges: "Diminished and punitive access to external funding left MLPs with virtually no choice but to pivot towards internal

[22] *Id*. at P 93.

[23] *Id.* at P 88-89.

self-funding, forcing the prioritization of financial strength over distribution growth."[24] While MLPs remain reliant on debt financing, MLPs no longer issue equity to fund growth projects or acquisitions in the same manner as before. This is illustrated in the two graphs below:[25]





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24 Griffith Lee, *Maturation of MLPs*, TCW (October 4, 2018), *available at* https://www.tcw.com/en/Insights/Viewpoints/10-04-18_Maturation_of_MLPs (last accessed June 24, 2019).

25 *Midstream Updated: Fourth Quarter 2018*, CHICKASAW CAPITAL MANAGEMENT (January 1, 2019), *available at* https://www.chickasawcap.com/sites/default/files/pdf_downloads/CCM_MLPUpdate_Q42018.pdf (last accessed June 24, 2019).

By orienting toward self-funding, MLPs retain greater amounts of cash and use the retained cash to fund growth projects.[26] This focus on self-funding makes MLPs more disciplined in light of limited financial resources. While the specific restructuring steps taken may vary by MLP, "the common narrative" of these efforts has been "restoring balance sheet strength, improving the partnership's cost of capital, pivoting towards greater self-funding, and simplifying the investment story devoid of structural complexity such as IDRs and multiple classes of units."[27]

The capital markets are responding to this restructuring with "an improved and more competitive [weighted average cost of capital]."[28] Larger, more diversified and restructured MLPs trade at a valuation premium. Indeed, self-funded growth significantly changes the long-term growth prospects of MLPs, decreasing exposure to interest rate risk and capital market volatility, and freeing those MLPs to grow without the same limitations on capital assumed by the Commission when it issued the Proxy Group Policy Statement in 2008. MLPs no longer face the same pressure to increase payouts, a limiting factor that had distinguished MLPs from C-corporations, as MLPs can now retain cash to fund growth and increase benefits to investors over the long-term.

The self-funding model is demonstrated by the increased retention of cash reflected in the ratio of distributable cash flow generated in a given period to the total cash

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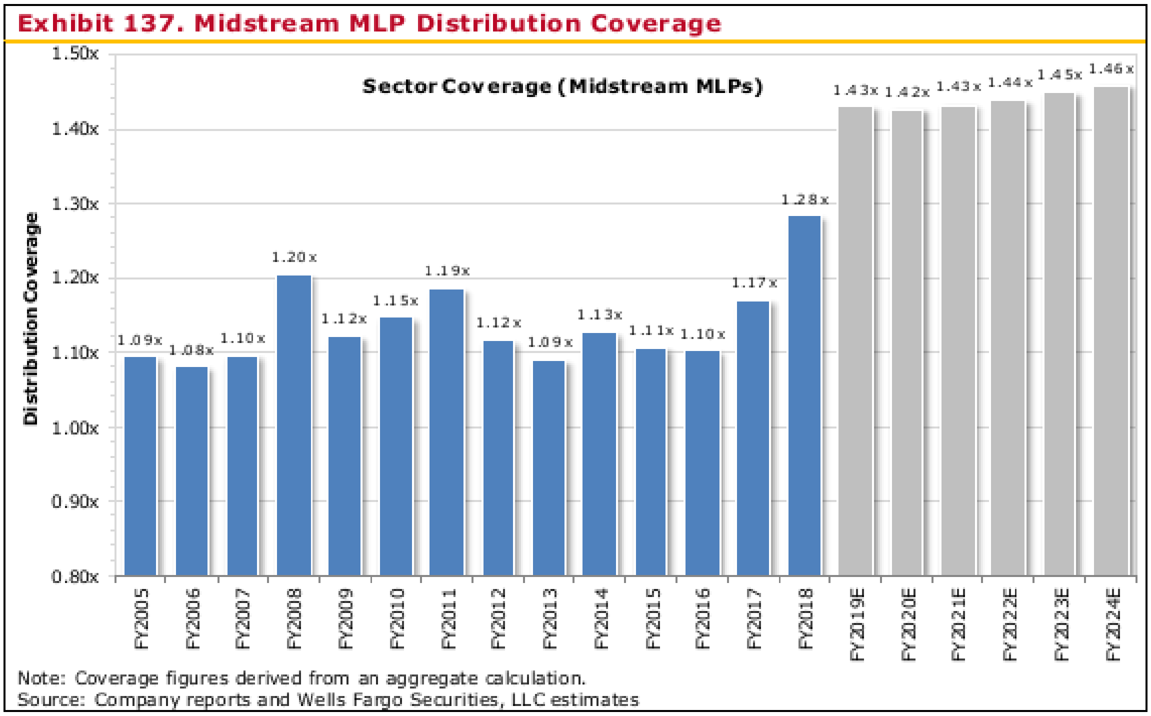
[26] *See id.*; Stacey Morris, *MLPs: Come for the Yield, Stay for the Total Return*, ALERIAN (June 4, 2019), *available at* https://www.alerian.com/mlps-come-for-the-yield-stay-for-the-total-return/ (last accessed June 24, 2019); Stacey Morris, *Is Self-Funding an MLP Pipe Dream?*, ALERIAN (May 8, 2018), *available at* https://www.alerian.com/is-self-funding-an-mlp-pipe-dream/ (last accessed June 24, 2019); Daren Fonda, *MLPs Look Attractive Again, and Yield as Much as 8%*, BARRON'S (April 21, 2018), *available at* https://www.barrons.com/articles/mlps-look-attractive-again-and-yield-as-much-as-8-1524270733 (last accessed June 24, 2019) (noting that MLPs are "pledging to finance more capital expenditures internally," and describing the process of elimination of IDRs and self-funding by MLPs).

[27] Lee, *supra* note 24; *see also Evolution of Midstream Energy* TORTOISE ADVISORS (2018), *available at* https://tortoiseadvisors.com/media/2578/evolution-of-midstream-energy.pdf (last accessed June 24, 2019).

[28] Lee, *supra* note 24.

distributions paid in that period, also known as the distribution coverage. The graph below prepared by Wells Fargo Securities, LLC reviews the changes in Midstream MLP Distribution Coverage, and observes an increase from 1.09x in 2005 to 1.28x in 2018, with an estimate of 1.43x in 2019.[29]



The Alerian MLP Infrastructure Index confirms this increase. The distribution coverage ratio for midstream MLPs has increased from approximately 1.2x in the fourth quarter of 2016 to 1.4x in the fourth quarter of 2018, and of the 22 MLPs in the Alerian MLP Infrastructure Index, the number with a coverage ratio of 1.2x or better has increased from eleven to seventeen.[30]

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[29] WELLS FARGO SECURITIES, LLC, MIDSTREAM MONTHLY OUTLOOK: JUNE 2019 at Exh. 137 (June 5, 2019).

[30] Stacey Morris, *MLP 4Q18 Distribution Coverage … Now Featuring Payout Rations!*, ALERIAN March 5, 2019 *available at* https://www.alerian.com/mlp-4q18-distribution-coverage-now-featuring-payout-ratios/ (last accessed June 24, 2019).

Additional restructuring efforts have further improved long-term growth prospects of MLPs since the Commission's 2008 Proxy Group Policy Statement. The MLP industry is eliminating IDRs,[31] one of the key limiting factors identified by the Commission in the 2008 Proxy Group Policy Statement.[32] At the time, the Commission explained its belief that the prevalence of IDRs would increase cost of capital for MLPs and thereby limit long-term growth. Now, however, MLPs have or are moving toward "(i) cancelling IDRs by exchanging them into additional common units and (ii) consolidating (or collapsing) the [general partner] and [limited partner] entities into a single entity."[33] Fewer and fewer MLPs are maintaining IDRs, meaning MLPs are no longer required to pay out increasing levels of distributions to the MLP parent. As of March 2018, Tortoise Advisors stated that:

> Currently more than half of the MLPs that comprise the Tortoise MLP Index® (TMLP) no longer have IDRs, including six of the seven largest MLPs, and we expect that trend to continue. By the end of 2019, we anticipate that nearly 80% of current TMLP constituents will not have IDRs, including all of the 10 largest MLPs." In 2019, approximately 78.1% operate or are expected to soon operate without IDRs.[34]

As shown in the chart below, the current percentage of MLPs without IDRs is dramatically higher than when the Commission issued the Proxy Group Policy Statement, when all but 3.9% of MLPs on the Tortoise MLP index had IDRs.

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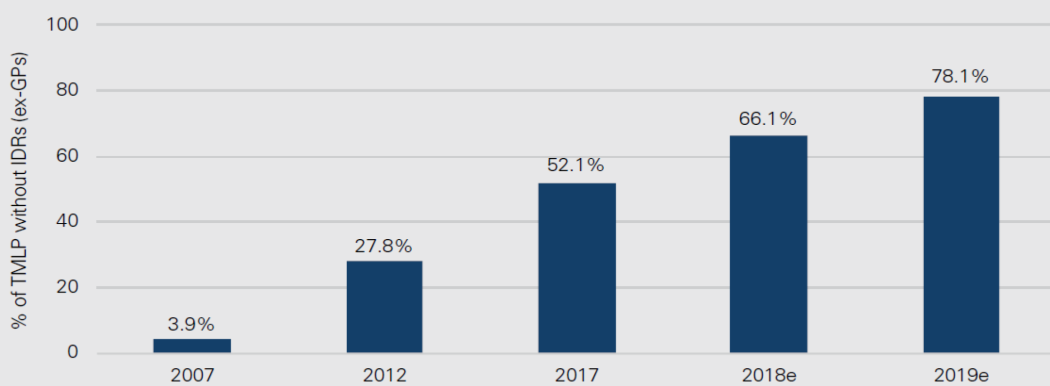
[31] *See* Stacey Morris, *MLP Structural Simplifications: Part 2 – IDR Eliminations*, ALERIAN (March 13, 2018), *available at* https://www.alerian.com/mlp-structural-simplifications-part-2-idr-eliminations/ (last accessed 6/24/2019); TORTOISE ADVISORS, *supra* note 24.

[32] Proxy Group Policy Statement at P 92.

[33] Lee, *supra* note 24.

[34] TORTOISE ADVISORS, *supra* note 24.

Percent of TMLP without IDRs



As of 3/31/2018. Source: Tortoise. Note: Anticipated simplifications assume MLPs remains outstanding for forecast period.

The effect of these structural changes is not only theoretical, but is shown in the long-term growth expectations of investors as well. As noted by Wells Fargo, the historical growth rate of MLPs was half that of C-Corporations whereas the future projected growth rate is the same.[35]

DCF Per Unit Metrics

$ per unit / share	Ticker	Historical DCF/Unit 2 2013A	2014A	2015A	2016A	2017A	2018A	DCF/Unit CAGR 4	Forecasted DCF/Unit 2019E	2020E	2021E	2022E	2023E	2024E	DCF/Unit CAGR
C-Corp Median								10%							5%
MLPs Median								5%							5%
All Midstream Median								6%							5%

Notably, long-term distribution growth rates are no longer as important as they were when the Commission issued its Proxy Group Policy Statement. As discussed above, MLPs are retaining more cash in order to foster long-term growth, and the metric of distribution growth rates is now less important to investors when determining valuation. To the extent MLP distribution growth rates have gone down, market expectations concerning distribution

[35] WELLS FARGO SECURITIES, LLC, MIDSTREAM MONTHLY OUTLOOK: JUNE 2019 at p. 102 (June 5, 2019).

growth also have waned, with the understanding that those changes will foster additional long-term growth of the MLPs.

Finally, while MLPs do face some restrictions on the types of investments the MLP itself can make, those restrictions are theoretical only and do not adversely affect long-term growth. There is no indication that, but for qualifying income restrictions, entities formed as MLPs would seek to expand into non-qualifying income-producing businesses. To the extent an MLP or a sponsor of an MLP determines it is appropriate to invest in other business, there are options available to capture that opportunity. MLPs can, for example, hold interests in C-corporations, with those C-corporations having the same investment opportunities as the C-corporation pipelines. Regardless, qualifying income restrictions facing MLPs are not seen as a limitation on growth given the expansive opportunities to transport new sources of oil and gas and related industries created by the shale boom.

As a practical matter, there is not a material difference in the investments pursued by C-corporations versus MLPs: C-corporations that own pipelines hold mostly the same assets as MLPs in the pipeline industry and are not leveraging other industries in order to create greater long-term growth, and the theoretical possibility of having different investments has no effect on investors' long-term growth expectations. In fact, many pipeline C-corporations in place today are the result of General Partner / Limited Partnership strategic restructurings that took place between 2014 and 2018. In many cases, while the corporate structure changed, the underlying assets have remained the same.

As demonstrated by these analyses, the fundamental assumptions regarding MLPs and the financial model relied upon by MLPs have shifted. Hence, the Commission's decision to discount the long-term growth rate of MLPs in a proxy group can no longer be supported. The change in financial model puts MLPs on roughly the same footing as C-corporations, freeing up additional funds and loosening structural restrictions on MLPs' long-term growth potential.

B. The Commission Must Consider the Impact of Its ROE Policy on Midstream Companies Maintaining and Attracting Capital.

The investment community has played a vital role in support of the reliable access to low-cost energy currently enjoyed by U.S. consumers. Pipeline operators' access to the capital markets promoted the buildout of thousands of miles of energy infrastructure, enabling low-cost, domestically sourced oil and gas to be transported to markets nationwide. This build-out, when coupled with FERC's policies, continues to foster competition for new markets and new sources of oil and gas, resulting in increased shipper-leverage for discounts and rate relief.[36] With flattened basis differentials, transport costs have been reduced or restrained, allowing for lower consumer energy costs.[37] It would be a mistake to assume that our nation's ready access to energy would be possible without appropriate ROE policy, guided by the principles set forth in *Hope*.[38] The NOI acknowledges that "the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital."[39] To ensure that U.S.

[36] *See generally*, Initial Comments of the Interstate Natural Gas Association of America, Docket No. PL19-4-000 (filed Jun. 26, 2019).

[37] The Commission is aware of the impact basis differentials have had on pipeline pricing. *See e.g.*, WBI Energy Transmission, Inc., Docket No. RP19-165, Prepared Direct Testimony of Barry E. Sullivan (filed Oct. 31, 2018) (testifying to the impact of basis differentials on transport costs); *see also*, *Jefferson Island Storage & Hub, L.L.C.*, 163 FERC ¶ 61,049 (2018) (granting a regulated natural gas storage provider market based rates, in part, on the basis of a market power study indicating that low basis differentials limit the price it can charge for services).

[38] *See Hope*; *see also Bluefield*; *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

[39] NOI at P 4 (quoting *Hope* at 605).

consumers continue to benefit from a robust and financially sound midstream sector, it is vital that FERC policy continue to foster these *Hope* principles.

Investors in midstream assets, including FERC-regulated oil and gas pipelines, consider multiple factors and use numerous valuation techniques when making investment decisions. The ROE set in a litigated proceeding using the two-stage DCF methodology, or as determined through review and analysis of Commission-required filings, such as the FERC Form No. 2 and recent 501-G filings, is an important component of this dataset. Other common methods for assessing value include the Enterprise Value ("EV") / Earnings Before Income Tax Depreciation and Amortization ("EBITDA") ratio, Price/Earnings ratio, Dividend Yield, and Distributable Cash Flow Yield. Investors also will take a holistic approach when determining whether to invest in infrastructure companies. These factors include, but are not limited to asset quality, customer contracts, counterparty risks, market positioning (e.g. supply push, demand pull, volume growth outlook), regulatory environment, management quality, long-term marketplace trends, and environmental, social and corporate governance ("ESG"). Thus, a company with a high total return potential can still be an unattractive investment if other less positive factors are present.

While the Commission's regulations and policies do not necessarily dominate an investment decision, they certainly drive them. This is apparent from the market's response to the Commission's "Revised Policy Statement on Treatment of Income Taxes" issued March 15, 2018 ("Revised Policy Statement").[40] The Revised Policy Statement had a particularly deleterious effect on market confidence in MLPs. As MLPA and others

[40] *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, 162 FERC ¶ 61,227, *order on reh'g*, 164 FERC ¶ 61,030 (2018) ("Revised Policy Statement").

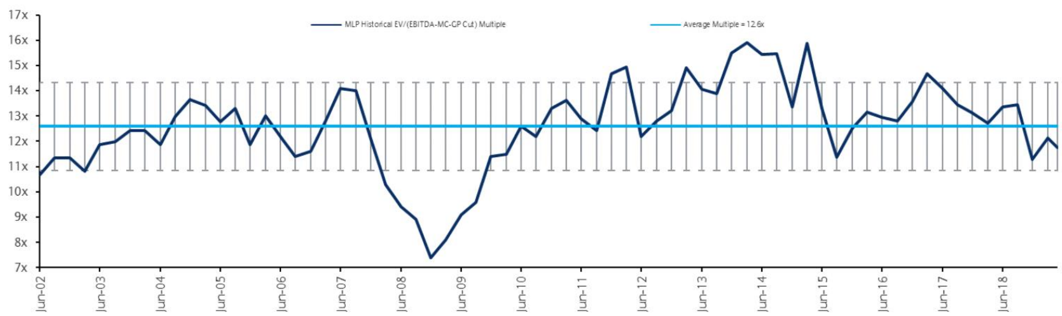
explained in comments filed following its issuance, by the close of trading on March 15, 2018, the date of the Revised Policy Statement, energy-focused MLPs had lost billions of dollars in market capitalization, with particular impact on those MLPs with the highest composition of FERC-regulated assets.[41] Therefore, in this NOI proceeding, FERC must be vigilant about the impact of its policies on the investment community, a vital and necessary component of the country's ability to continue to deliver low-priced energy from competitive sources to U.S. consumers.

As noted above, MLPA's members include several investment firms active in the midstream sector. It has learned from its membership that required return thresholds to invest in public midstream equities, including oil and gas infrastructure, is much higher than historical return thresholds, particularly in light of regulatory changes advanced in the Revised Policy Statement. This is borne out by the data, which indicates that, despite strong market fundamentals, investment interest has softened. For example, gas and oil production rose rapidly in 2018, along with supportive commodity prices. Yet, midstream and MLP valuations still fell to cyclical lows. This is illustrated in the chart below showing historical MLP EV/EBITDA multiples dipping below historical averages in 2018. A similar decrease last occurred briefly in 2015-2016 following collapsing commodity prices and declining

[41] *See e.g.*, Request for Clarification or Rehearing and Expedited Action of Dominion Energy, Inc. at 9, Docket No. PL17-1-000 (filed Mar. 20, 2018) (estimating "that in the ten trading days following the Commission's announcement, MLPs lost nearly $30 billion in market value."); Request for Clarification of the Master Limited Partnership Association at 12, Docket No. PL17-1-000 (filed Apr. 13, 2018) (stating that "[b]y the close of trading on March 15, 2018, the date of the issuance of the Revised Policy Statement, energy focused MLPs had lost $15.8 billion in market capitalization"); Request for Clarification, Reconsideration and Rehearing of the Interstate Natural Gas Association of America at 28, Docket No. PL17-1-000 (filed Apr. 16, 2018) (explaining that six natural gas MLPs lost nearly $9 billion in aggregate market value between March 15, 2018 and April 6, 2018); Comments of OFI SteelPath Inc. on the Revised Policy Statement on the Treatment of Income Tax at 6, Docket No. PL17-1-000 (filed June 21, 2018).

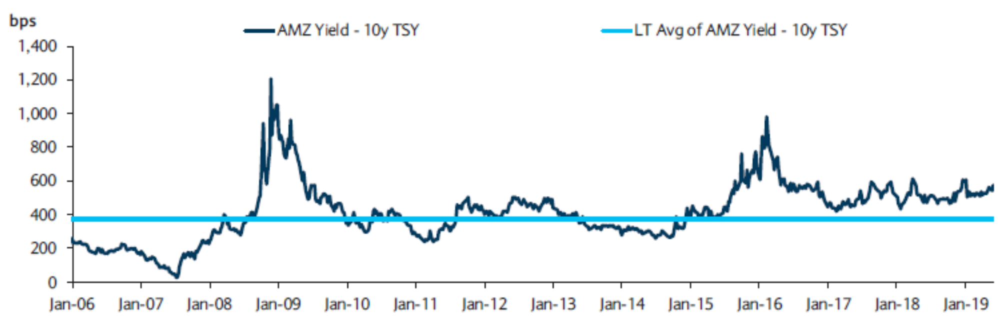
U.S. oil and gas production, and occurred in the most pronounced fashion during the financial crisis of 2008-2009:[42]

FIGURE 14
MLP Historical EV/Adjusted EBITDA* Multiple (Market cap weighted)



In another representation of this phenomenon, the chart below shows historical MLP yield spreads above historical averages, implying that MLP investors have higher total return expectations than they had in prior years:[43]

FIGURE 16
AMZ Spread to 10 YST



Notably, this higher yield expectation comes when distribution coverage is at a much higher level than historical periods, implying that market participants currently require exceptionally high DCF yields to compensate for increased risks.

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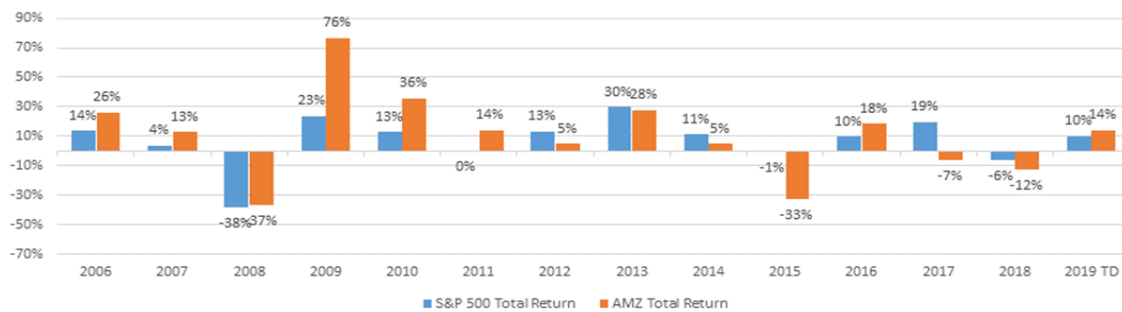
[42] Barclays – *Energy Infrastructure Weekly* (June 3, 2019).

[43] *Id.*

The plot line of the MLP investment story clearly has changed since the Commission last considered MLP ROEs at a holistic level in 2008.[44] Between 2009 and 2015, the Alerian MLP Index ("AMZ") generated strong total returns, which drove capital flows to the sector. As discussed above, the AMZ experienced negative total returns between 2015 and 2016 due to falling commodity prices, but started to bounce back in 2017. This is illustrated below:

<u>S&P 500 Total Return vs. AMZ Total Return[45]</u>



Due in large part to the Revised Policy Statement's issuance in early 2018, current MLP capital flows have all but evaporated. As a result, the combined public equity issuances

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[44] *See* Proxy Group Policy Statement.

[45] *Alerian MLP Index*, ALERIAN, *available at* https://www.alerian.com/indices/amz-index/ (monthly total return values indexed to 100 as of December 31, 2004 through May 31, 2018). The data reflects compound

in 2018 and 2019 to date is materially less than public equity issuances in 2008, during the financial crisis. By all accounts, the strong market fundamentals described above should have resulted in strong returns in 2018, but for regulatory changes at FERC and generalist market trends restricting access to capital in the energy space. Midstream infrastructure faces considerable headwinds when investors are determining where best to deploy capital to earn a return. Among these is the broader ESG movement, which generally is not supportive of the oil and gas industries,[46] opposition to FERC-certificated projects in the form of lawsuits at the local, state, and federal level,[47] and long-term uncertainty about a hydrocarbon-focused economy.[48] There also is a public debate amongst other FERC constituents about statutory changes to the Natural Gas Act's refund authority and the role of greenhouse gas emissions in pipeline reviews that create investor uncertainty on regulatory stability and consistency. This is exacerbated by concerns that FERC support for certain industries will shift with different political leadership. Combined, these factors have been a drag on specialist and generalist investors in energy, as evidenced by the S&P 500

total return with dividends reinvested on ex-date.

[46] There have been several high-profile divestitures of major investors from pipeline infrastructure, such as PNB Paribas SA. *See e.g.*, Valerie Volcovici, *French bank BNP sells its share in $2.5 billion Dakota Pipeline loan*, REUTERS (April 5, 2017, 1:18 PM), https://www.reuters.com/article/us-north-dakota-pipeline-idUSKBN1772H1.

[47] For example, the U.S. Court of Appeals for the District of Columbia Circuit recently questioned FERC's rationale for not reviewing the indirect effects of greenhouse gas emissions in a certificate proceeding, creating new uncertainty for how FERC will consider certificate applications under section 7 of the Natural Gas Act. *See Birckhead v. FERC*, Case No. 18-1218, 2019 WL 2344836 (D.C. Cir. Jun. 4, 2019).

[48] In addition to the Green New Deal, a number of states have announced initiatives to reduce fossil energy. For example, New York's Climate Leadership and Community Protection Act would require that state to reduce its greenhouse gas emissions to 85 percent below 1990 levels by 2050. *See* Jesse McKinley & Brad Plumer, *New York to Approve One of the World's Most Ambitious Climate Plans*, N.Y. TIMES (June 18, 2019), https://www.nytimes.com/2019/06/18/nyregion/greenhouse-gases-ny.html?searchResultPosition=2. A number of other states have their own "Clean Electricity Standards" that strive to eliminate oil and gas from their energy economies. *See* FACT SHEET: STATE AND UTILITY CLIMATE CHANGE TARGETS SHIFT TO CARBON REDUCTIONS, TECHNOLOGY DIVERSITY, CLEAN AIR TASK FORCE (2019); *available at* https://www.catf.us/wp-content/uploads/2019/05/State-and-Utility-Climate-Change-Targets.pdf.

Index, of which five percent (5%) currently is attributed to energy firms, as compared to twenty-one percent (21%) attributed to technology companies.[49] By comparison, energy has represented as much as fifteen percent (15%) of the index within the past fifteen years.[50]

In response, investors are reluctant to invest in midstream assets without some assurances that they will meet return targets and benchmarks. Anecdotally, MLPA has learned that some institutional investors are looking for companies to only invest and develop midstream assets that generate internal rates of return ("IRRs") of at least fifteen percent (15%). It currently is believed that these levels are necessary to compensate investors and companies for putting capital at risk. Moreover, MLPA has learned that investors often require IRR thresholds for FERC-regulated interstate pipelines that are higher relative to non-FERC regulated infrastructure assets, on account of perceived regulatory risks. This signifies a reversal from perceptions prior the issuance of the Revised Policy Statement when FERC regulated assets garnered significant valuation premiums relative to non-FERC regulated asset valuations. Certainly, this is the case for retail investors in energy infrastructure.

As explained above, MLPA does not necessarily support one ROE-setting methodology over another. What is critical, however, is that the methodology FERC ultimately prefers or prescribes must provide for flexibility, given the considerable investment risk related to investing in midstream infrastructure. The two-stage DCF methodology currently employed by FERC lends a certain familiarity, given the decades in

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[49] S&P 500 TICKER: SPX, *available at* https://us.spindices.com/indices/equity/sp-500 (last visited June 24, 2019).

[50] *See S&P 500 Historical Sector Weightings*, BESPOKE https://www.bespokepremium.com/wp-content/uploads/2016/04/techwgts.png (last accessed June 25, 2019).

which it has been deployed to set rates for oil and gas pipelines. As explained in Section II.A, above, FERC must consider that metrics it uses to calculate the two-stage DCF have evolved in recent years. Regardless, MLPA urges the Commission not to embrace one methodology over another because the numerical results, when applied today, are higher or lower than those derived through the two-stage DCF methodology. The most important component is the total return expectations of public investors, combined with the recognition that pipeline infrastructure investment is inherently risky and must be compensated accordingly. In order to ensure the returns necessary to satisfy the *Hope* and *Bluefield* standards, the Commission's ROE policy must maintain this focus on investor expectations, including building in to the ROE methodology sufficient flexibility for market conditions to drive the ROE to the appropriate level given market conditions prevailing at the time of evaluation.

C. FERC's ROE policies should allow the flexibility necessary for the ROE to accurately reflect market conditions and for pipelines organized as MLPs to adequately compensate unitholders for their costs.

As demonstrated by the Commission's own NOI and the changes to the MLP industry since the Proxy Group Policy Statement was issued, changes in market conditions and the continued development of investment vehicles and structures affect not only the appropriate level of ROE, but also the appropriate method for determining ROE for regulated entities. The MLPA is not supporting any specific ROE methodology, but strongly encourages the Commission to implement an ROE policy that accounts for the unique needs and characteristics of natural gas pipelines and oil pipelines, respectively, and affords pipelines the flexibility to account for changes in fact or market conditions in determining ROE. This flexibility is necessary to ensure the resulting ROE more accurately reflects prevailing market conditions and investor expectations at the time ROE is calculated, and results in an ROE that adequately compensates the pipeline for its costs.

Maintaining a flexible approach is consistent with the Commission's goal that the Commission's ROE methodology "accurately reflect how investors make their investment decisions."[51] Investors do not rigidly apply a set of models and equally weight them to calculate a desired ROE for their investment. Investors also do not rely entirely on one model in the face of market conditions that indicate the model may be performing inadequately. Rather, investors analyze the appropriate return required for an entity in light of then-existing market conditions and expected changes;[52] the Commission's ROE policy should do the same. The alternative would be to lock the Commission in to a rigid methodology that may work intermittently but runs the perpetual risk of failing to satisfy the requirements of *Hope* and *Bluefield*.

MLPA also strongly encourages the Commission to consider the effect of its ROE policy on the various ownership forms and the potential for the policy to help eliminate, or further entrench, disparate treatment between MLPs and C-corporations. An ROE policy that treats MLPs and C-corporations differently based purely on organizational form would artificially create disparity where none exists, undermining the "confidence in the financial integrity" of the disparately treated enterprise and inhibit the ability of the pipeline to "maintain its credit and to attract capital." The Commission has the opportunity to rectify some of the disparity between MLPs and C-corporations embedded in current Commission

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[51] NOI at P 24.

[52] *See e.g.*, Stacey Morris, *Why Yesteryear's Valuation Metrics Aren't Sufficient for Today's MLP*, ALERIAN (June 4, 2019), *available at* https://www.alerian.com/why-yesteryears-valuation-metrics-arent-sufficient-for-todays-mlp/ (last assessed June 24, 2019).

policy by eliminating the assumption that MLPs have half the long-term growth potential as C-corporations.

Adopting an ROE methodology with inherent flexibility will further help eliminate disparities in favor of either MLPs or C-corporations by allowing individual entities to reflect relevant risk metrics in the calculation of ROE. As further discussed above, for example, MLP pipelines now face additional risks as a result of the Commission's elimination of the income tax allowance for MLP pipelines. In March 2018, the market clearly signaled that policies having such a disparate impact on one organizational form affect investors' expectations with respect to the disparately treated enterprise. The Commission's ROE policy should allow a pipeline the flexibility to argue that the risks resulting from this and similar Commission policies, as well as risks arising from other prevailing market forces and pipeline characteristics, should be reflected in the pipeline's ROE. This is consistent with the Commission's current policy, which permits pipelines to argue that their risk requires placement towards the upper bounds of the zone of reasonableness, as opposed to the midpoint or median.[53] Such flexibility must be maintained to achieve FERC's goal of setting an ROE consistent with investors' views of the regulated entity, as well as the requirement in *Hope* and *Bluefield* that "the return to the equity owner" is "commensurate with the return on investments in other enterprises having corresponding risks," and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

[53] *See Portland Natural Gas Transmission Sys.*, 142 FERC ¶ 61,197 at P 382 (2013) (Opinion No. 524) (explaining, "the Commission permits parties to present evidence to support any return on equity that is within the zone of reasonableness, and the Commission has recognized that an examination of the risk factors specific to a particular pipeline may warrant setting its ROE either higher or lower than the middle of the zone of reasonableness established by the proxy group."), *opinion and order on request for reh'g and compliance filing*, Opinion No. 524-A, 150 FERC ¶ 61,107 at P 187 (2015).

III. CONCLUSION

For the reasons set for the above, the MLPA requests the Commission eliminate from its ROE methodology the assumption that the long-term growth of MLPs is more limited than the long-term growth of C-corporations. MLPA also supports the Commission's proper focus on investor expectations, to ensure that the needs of MLPs and MLP investors are considered in a manner that ensures MLPs are able to maintain credit and attract capital. Finally, MLPA supports a ROE policy that accurately reflects the market needs of regulated entities, including the need for flexibility in determining the appropriate return on equity in light of all market conditions prevalent at the time of determination.

Respectfully submitted,

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Dated: June 26, 2019

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Houston, Texas this 26th day of June, 2019.

/s/ Tray Smith

Document Content(s)