UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

INITIAL COMMENTS OF TALLGRASS ENERGY, LP

Pursuant to the Notice of Inquiry issued on March 21, 2019 by the Federal Energy Regulatory Commission ("FERC" or the "Commission"),[1] Tallgrass Energy, LP ("Tallgrass")[2] respectfully submits these initial comments concerning natural gas and oil pipelines.[3] For Return on Equity ("ROE") determinations for natural gas and oil pipelines, Tallgrass supports a switch from sole reliance on the Discounted Cash Flow ("DCF") model to reliance on the results of multiple models. However, any new policy applicable to natural gas or oil pipelines concerning ROE and proxy group development should be general and flexible rather than prescriptive. For a variety of reasons, as detailed below, the rigid framework adopted by the Commission in the recent *Martha Coakley v. Bangor Hydro-Electric Co*. order[4] concerning electric transmission utilities in New England is not entirely appropriate for oil and natural gas pipeline ROE determinations. Tallgrass also generally supports the initial comments submitted in this NOI

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

[2] Tallgrass owns (in whole or in part) and operates more than 8,300 miles of natural gas pipelines and more than 800 miles of oil pipelines, including Rockies Express Pipeline LLC, Trailblazer Pipeline Company LLC, Tallgrass Interstate Gas Transmission, LLC, Iron Horse Pipeline, LLC, Powder River Express, LLC, and Pony Express Pipeline, LLC.

[3] Tallgrass' Comments do not address these issues in the context of electric utilities and instead only address the oil and gas pipeline industries.

[4] *See Martha Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030, at P 38 (2018) ("*Coakley* Briefing Order").

today by the Interstate Natural Gas Association of America ("INGAA") as well as those submitted by the Association of Oil Pipe Lines.

I. The Commission Should Adopt a Policy That Has Significant Flexibility

In the *Coakley* Briefing Order, the Commission switched from sole reliance on DCF for public utility ROE determinations to reliance on multiple models. In justifying its rationale for ending its sole reliance on DCF, the Commission stated that using multiple models instead of a single model reduces the risk of misidentifying the just and reasonable ROE (referred to as "model risk.").[5] Adding further justification, the Commission stated that sole reliance on DCF does not capture how investors view utility returns because investors do not rely on the DCF alone.[6] Tallgrass submits that the same reasoning should be applied to oil and gas pipeline ROE determinations. An ROE determination supported by results of multiple models tends to be more reliable and better matches how investors analyze oil and gas pipeline industries, because the investor community uses a variety of models to assess oil and gas pipeline returns.

If the Commission adopts a new policy applicable to natural gas or oil pipelines concerning ROE and proxy group development, the policy should be general and flexible rather than prescriptive. A prescribed policy with formulaic rules almost ensures that, at some point in the future, the policy will need to be changed once again, while a flexible policy can respond to changes in the context of an individual rate case. Financial markets are constantly changing. An example of this is the genesis of *Emera Maine*[7]—the Commission's attempt to account for changes in the financial markets (i.e., "anomalous capital market conditions"). A flexible policy will be workable for many years because it will allow the Commission to incorporate into ROE

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[5] *Coakley* Briefing Order at P 38.

[6] *See id* at PP 38, 40.

[7] *Emera Me. v. FERC*, 854 F.3d 9 (D.C. Cir. 2017).

determinations in specific cases any future anomalies and other changes in the financial markets or industry conditions.

The policy should be flexible enough to accommodate the fact that the analytical tools used by investors are varied and change over time. There is not broad agreement that investors currently use the four methods—and only the four methods—that the Commission has specified, or that weighting their results equally is anything more than an arbitrary convenience. Nor have proponents of these four methods suggested that investors will not rely on other methods in the future. An exclusive list of models currently used by investors would be difficult to assemble and the list would certainly change in future years. Accordingly, the Commission should adopt a more general policy that calls for support from multiple models rather than reliance on any single method. But the Commission should not specify how much weight each model should be accorded, nor even require a certain number of models (as long as there is more than a single one).

The policy should also be flexible enough to accommodate the constant changes in the oil and natural gas industries. The market and financial risks faced by oil and natural gas pipelines are not static. One example of this is the broad-based corporate restructuring and consolidations that have been occurring since March 2018 as many pipelines are converting from Master Limited Partnerships ("MLPs") to C-corporations. The Commission expressed concern about these rapid industry-wide changes in the pipeline industries in the NOI itself.[8] It is difficult to set policy that will endure for the long term in a dynamic and ever-changing industry like the

[8] NOI at P 34 (D11) ("Can the Commission continue to construct proxy groups of sufficient size for natural gas and oil pipeline companies using the DCF methodology, or in general for the alternative methodologies, particularly considering the increased amount of merger and acquisition activity involving [MLPs] and the multiple recent conversions of MLPs to C-corporations?").

pipeline industry. Accordingly, a policy with substantial flexibility is advisable, as it would allow both current and future changes to be addressed without requiring another policy change.

The *Coakley* Briefing Order adopts a rigid framework for public utility ROE determinations that should not be used for natural gas or oil pipelines ROE determinations. The *Coakley* Briefing Order: 1) requires four methods be used, 2) specifies the four methods—DCF, Capital Asset Pricing Model, Risk Premium, Expected Earnings), and 3) requires the results of each method be weighted equally.[9] Such a rigid policy with prescribed rules may not be workable in the future, or have the ability to incorporate the ever-changing nature of financial markets and the analyses that investors use to assess the pipeline industries. If the Commission adopts a new policy applicable to natural gas or oil pipelines, the policy should be general and flexible so that it can respond to the dynamic nature of the natural gas and oil pipeline industries.

II. Comments on Certain NOI Questions[10]

B. ROEs for different Commission-regulated industries

B1. In Opinion No. 531, the Commission found that the same DCF methodology should be used to determine an ROE for all its regulated industries, including public utilities, as well as gas and oil pipelines. If the Commission departs from our sole use of a two-step DCF methodology for public utilities, should the new method or methods also be used to determine natural gas and oil pipeline ROEs?

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[9] *Coakley* Briefing Order at PP 4, 15, 17.

[10] In these Initial Comments, Tallgrass only comments on certain questions posed by the Commission. Tallgrass reserves the right to address other questions posed by the Commission—including any not responded to below—in Reply Comments.

Tallgrass Comment:

The Commission's underlying rationale for ending its sole reliance on DCF for public utility ROE determinations applies equally to ROE determinations for natural gas and oil pipelines. Using multiple models instead of reliance on a single model reduces the risk of misidentifying the just and reasonable ROE. Further, the investor community uses a multitude of methods to assess oil and gas pipeline returns. The Commission should use multiple methods to better reflect how the investor community analyzes these industries. The appropriate use and applicability of any models or methodologies should be evaluated on a case-by-case basis, duly considering the facts and market circumstances in effect at the time of evaluation.

B4. What, if any, differences between public utilities on the one hand and natural gas and oil pipelines on the other would justify using different methodologies to determine their ROEs?

Tallgrass Comment:

The oil and natural gas industries have risks that are unique from each other and that differ from the risks of the electric transmission industry. This is borne out by a standard financial metric, Beta. Beta is a measure of the volatility of a security in relation to the market as a whole. The Beta of the market is 1, a higher risk security has a Beta above 1, and lower risk securities have a Beta lower than 1. Publicly available calculations of Beta show that utility securities are much less risky than natural gas securities.[11] The Commission has historically recognized differences among the industries by applying different policies to each. For more than a decade, until 2014, the Commission used a one-step DCF methodology for public utilities and a two-step DCF methodology for natural gas and oil pipelines. The Commission was comfortable treating these industries differently in the context of ROE determination for years.

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[11] Betas by Sector (US) (Data used is as of January 2019), http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html (last visited June 26, 2019).

There is no strong justification for why identical treatment increases the likelihood of an appropriate just and reasonable ROE determination. Tallgrass asks the Commission to utilize a flexible approach in determining ROE for the oil and natural gas pipeline industries, on a case-by-case basis, thereby ensuring that the most accurate and applicable ROE is determined in each individual proceeding.

D. Proxy Groups

D1. Should proxy groups for electric utilities, as well as natural gas and oil pipelines, consist only of companies with corresponding regulated businesses?

Tallgrass Comment:

Proxy groups are intended to reflect the risk of the target entity. For a gas pipeline, a proxy group consisting of companies with a substantial amount of regulated gas pipeline assets should be utilized. The same is true for an oil pipeline—the proxy group should consist of companies with a substantial amount of regulated oil pipeline business. But in both cases, the Commission should not impose a rigid eligibility requirement regarding a company's percentage of regulated business. This is particularly true in light of the fact that the oil and gas industries are becoming more consolidated, making it more challenging to assemble an appropriate group of proxy group members that meet each of the Commission's criteria.[12]

In addition, the comments of INGAA contain a detailed discussion on the use of Beta as a measure of comparable risk. Tallgrass supports using Beta as an additional tool to assist in

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[12] *See Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, at P 8 ("The Commission historically required that each company included in the proxy group satisfy the following three standards. First, the company's stock must be publicly traded. Second, the company must be recognized as a natural gas or oil pipeline company and its stock must be recognized and tracked by an investment information service such as Value Line. Third, pipeline operations must constitute a high proportion of the company's business.") (internal citation omitted), *reh'g dismissed*, 123 FERC ¶ 61,259 (2008).

assessing the appropriateness of inclusion of proxy group members in order to ensure that a proxy group of adequate size and risk comparability can be assembled and properly assessed.

D1.a. For companies with a combination of regulated and unregulated businesses, should a company be required to derive a certain percentage of its revenues from the applicable regulated business in order for that company to be included in the proxy group that is used to determine an ROE for a company in that regulated business?

Tallgrass Comment:

As noted above, not necessarily. The Commission should not have a policy that rigidly excludes potential proxy group members for being below a certain percentage of revenue or assets from the applicable regulated business. While proxy group members should have a substantial investment in pipeline assets regulated by the Commission, there should not be a hard line drawn. The Commission should be flexible in deciding what constitutes substantial, and decide it on a case-by-case basis so that industry changes in the future can be accommodated. The Commission has recognized the need for this flexibility in the past[13] and that reasonable policy should be continued.

D1.b. Are the corresponding proxy groups sufficiently large given the continued consolidation in the industries?

Tallgrass Comment:

Assembling a proper proxy group of adequate size for oil and gas pipelines has become more challenging in recent years. Smaller proxy groups, with four or fewer companies, may be too small a sample size to produce reliable results consistently. If the Commission were to

[13] *See Kern River Gas Transmission Co.*, Opinion No. 486-B, 126 FERC ¶ 61,034, at P 59, *reh'g denied*, Opinion No. 486-C, 129 FERC ¶ 61,240 (2009), *reh'g denied*, Opinion No. 486-D, 133 FERC ¶ 61,162 (2010).

impose rigid policies on proxy group formation, it will become even more difficult to assemble proxy groups with at least five members. Accordingly, to avoid proxy groups with less than five companies, the Commission's policy should be flexible as discussed above.

D2. Should risk be considered both in the proxy group selection and in the placement within the zone of reasonableness?

Tallgrass Comment:

Yes. The entire purpose of the proxy group is to approximate the risk of the target pipeline. Pipelines have different risks, which depend on numerous factors. For example, pipelines have varying risks due to the combination of the following factors, amongst others: 1) level of demand for transportation service from the contracting shippers on the pipeline; 2) the supply source of the gas or oil shipped on the pipeline; 3) the geographic location of the pipeline and the number and location of competing pipelines and the level of unsubscribed capacity on these competing pipelines; 4) the age and condition of the pipeline facilities; and 5) regulatory risk, including environmental and safety rules.

Consistent with current established practice, considering the risk of each entity included in a proposed proxy group increases the likelihood that the proxy group members will reflect the risk of the target pipeline. However, when selecting the ROE within the zone of reasonableness, the risk level of the target pipeline *relative* to the proxy group members must also be taken into account. This is especially true for oil and gas pipeline proxy groups, which often have a limited number of members. In those cases, it may be particularly difficult to assemble a proxy group that closely mirrors the risk level of the target pipeline. Thus, it is particularly important to consider the risk of the target utility when placing it in the zone of reasonableness. The target utility may or may not be at the median risk level of the proxy group of companies. The

Commission's policy should continue to recognize that the target utility may be more risky, or less risky, than its proxy group, and allow for placement within the zone to reflect that relative risk.[14]

D3. Should the Commission consider non-energy companies when selecting proxy groups?

Tallgrass Comment:

As a general matter, the inclusion of non-energy companies is likely to introduce difficulties in assembling a proxy group composed of members that have risks similar to those of the target entity, as required by *Petal Gas Storage, L.L.C. v. FERC*.[15] For many years, the Commission has required that pipeline proxy groups consist of companies with a substantial amount of regulated pipeline business, but without applying a rigid 50% minimum threshold. Tallgrass supports the continuation of this flexible approach.

D8. The Commission excludes from the proxy group companies with merger activity during the six-month study period that is significant enough to distort study inputs. Should the Commission continue using our existing merger screen?

Tallgrass Comment:

The Commission should use a flexible approach when assessing merger activity that allows for merger activity to be assessed in individual cases based on the specific circumstances at that time. Companies should not be automatically excluded because of merger activity. The Commission should use a nuanced, flexible approach, rather than a binary approach that tends to

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[14] *See Portland Nat. Gas Transp. Sys*., Opinion, No. 524, 142 FERC ¶ 61,197, at P 382 (2013), where the Commission awarded Portland the highest DCF ROE produced from the proxy group—11.59%—instead of the median of 10.28%—because it found "that Portland's below investment grade credit rating, combined with its inability to reflect its unsubscribed capacity in its rate design, present highly unusual circumstances justifying setting Portland's ROE at the top of the range of reasonable returns."

[15] 496 F.3d 695, 700 (D.C. Cir. 2007).

exclude a company when almost any level of merger activity is on-going. Certain merger activity may have no or very little impact on market data.

D8.a. If so, should the Commission revise its standards for what conduct constitutes merger and acquisition activity?

Tallgrass Comment:

As noted above, the Commission should adopt a flexible approach that allows for merger activity to be assessed in individual cases based on the specific circumstances at that time.

D9. What circumstances or factors, if any, warrant an adjustment from the midpoint/median to other points within the zone of reasonableness (e.g., lower or upper midpoint/median)?

Tallgrass Comment:

The question is not conducive to a simple answer. As noted in Tallgrass' comment on D.2., adjustments may be appropriate and the risks that the target pipeline faces relative to the risks of the proxy group companies must be reflected in the placement of the target pipeline within the zone of reasonableness. Thus, the question of an adjustment must be determined in individual proceedings. In this NOI, all the Commission should do is indicate that parties are free to argue for adjustments in individual proceedings.

D11. Can the Commission continue to construct proxy groups of sufficient size for natural gas and oil pipeline companies using the DCF methodology, or in general for the alternative methodologies, particularly considering the increased amount of merger and acquisition activity involving master limited partnerships (MLPs) and the multiple recent conversions of MLPs to C-corporations?

<u>Tallgrass Comment</u>:

The Commission is right to be concerned. The number of MLPs eligible for inclusion under the Commission's current policy concerning proxy group membership has significantly decreased in recent months. The Commission's policy on proxy group formation should be flexible to allow for proxy groups of sufficient size in the wake of this broad industry change.

E. Financial Model Choice

E1. What models do investors use to evaluate utility equities?

<u>Tallgrass Comment</u>:

In the *Coakley* Briefing Order, the Commission recognized that investors rely on a variety of financial models and other factors to inform their investment decisions.[16] Tallgrass agrees that using more than one model is superior to the sole reliance on any single model. But prescribing an exclusive list of models used is difficult, if not impossible. Further, even if it were possible, it would represent the exclusive list of models used at this particular snapshot in time. As industries and technologies change in the future, it is likely that the models used and preferred by investors will also change. Therefore, as noted above, rather than requiring the use of specific models, and excluding all others used by some investors now or that may be used in the future, the Commission should allow for flexibility and adopt a more general approach that calls for the use of multiple models to calculate ROE applicable to a specific pipeline on a case by case basis.

[16] *Coakley* Briefing Order at P 35 ("Investors have varying preferences as to which of these or other methods they may use to inform their investment decisions. As Morin states, 'Investors do not necessarily subscribe to any one method, nor does the stock price reflect the application of any one single method by the price-setting investor. There is no monopoly as to which method is used by investors.' While some investors may give some weight to a DCF analysis, it is clear that other investors place greater weight on one or more of the other methods for estimating the expected returns from a utility investment, as well as taking other factors into account.") (internal citation omitted).

E7. If the Commission were to consider multiple models, how should it weigh them?

Tallgrass Comment:

As previously discussed, the Commission should adopt a flexible approach where weighting can be decided on a case-by-case basis to reflect the strength and reliability of the models and their input data at that time, rather than weighting each model equally.

Respectfully submitted,

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