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 THE NATURAL GAS SUPPLY ASSOCIATION ON NOTICE OF INQUIRY

Pursuant to the procedures set forth in the March 21, 2019 Notice of Inquiry issued in the above-referenced proceeding,[1] the Natural Gas Supply Association ("NGSA") hereby provides these initial comments on whether the Commission should change its policies concerning the determination of the return on equity ("ROE") for natural gas pipelines. The short answer to this question is, "No, the Commission should not change its policies concerning the determination of the ROE for natural gas pipelines." For the reasons set forth herein, while the discounted cash flow ("DCF") methodology is not perfect, no capital market evaluation technique is. But the DCF methodology is the soundest, most robust, most accepted, and most reasonable methodology the Commission has for determining investor expected ROEs for natural gas pipelines. Moreover, the courts and the Commission have repeatedly determined that the DCF methodology provides investors with a return that will attract capital to the pipeline company. Given these factors, NGSA requests the Commission to leave intact its DCF methodology for determining natural gas pipeline

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

ROEs. In other words, the DCF methodology is not broken, so the Commission should not seek to fix it for the determination of natural gas pipeline ROEs.

NGSA also encourages the Commission to continue its policy of relying on evidence produced on the record in individual proceedings to flexibly determine which companies are "comparable enterprises" for determining an appropriate proxy group for the DCF methodology.

I. INTEREST OF THE NGSA

Founded in 1965, NGSA represents integrated and independent energy companies that produce and market domestic natural gas and is the only national trade association that solely focuses on producer-marketer issues related to the downstream natural gas industry. NGSA's members trade, transact and invest in the U.S. natural gas market in a range of different manners. NGSA members ship billions of cubic feet of natural gas on interstate pipelines on a daily basis and are greatly impacted by the outcome of this proceeding.

NGSA encourages the use of natural gas within a balanced national energy policy and supports the benefits of competitive markets. NGSA has consistently advocated for well-functioning natural gas markets, policies that support market transparency, efficient nomination and scheduling protocols, just and reasonable transportation rates, non-preferential terms and conditions of transportation services and the removal of barriers to developing needed natural gas infrastructure. NGSA has a long-established commitment to ensuring a public policy environment that fosters a growing, competitive market for natural gas. NGSA also supports a balanced

energy future, one which ensures a level playing field for all market participants and eliminates inappropriate regulatory barriers to supply.

II. COMMENTS

A. Introduction

As noted above, the NGSA urges the Commission not to fix what is not broken. The DCF methodology comports with the requirements of *Hope* and *Bluefield*, which require that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[2] Given that the DCF methodology uses the current value of the equity being examined to determine an expectation of future growth and earnings (*i.e.*, return on the initial investment), the DCF methodology is consistent with the *Hope* and *Bluefield* requirements.

The Commission has successfully and exclusively relied upon the DCF methodology to determine natural gas pipeline ROEs for the past forty years.[3] The Commission has found that the DCF methodology is "a reliable and market-based

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[2] *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("*Hope*"); *see also Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692-93 (1923) ("*Bluefield*"). *Hope* also requires the Commission to balance the interests of consumers with the interests of investors. *See Hope*, 320 U.S. at 603.

[3] *See*, *e.g.*, *Consolidated Gas Supply Corporation*, 24 FERC ¶ 61,046 at 43-48 (1983), *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, "Policy Statement," 123 FERC ¶ 61,048 at P 2, *reh'g denied*, 123 FERC ¶ 61,259 (2008) ("Proxy Group Policy Statement").

tool."[4] There has been no evidence presented to date that the DCF methodology is no longer reliable or market-based for determining natural gas pipeline ROEs. In fact, there is ample evidence that ROEs determined using the DCF methodology have been more than adequate to attract investment in pipeline companies and infrastructure. One need look no further than (1) the multiple certificate applications that have been filed over the last several decades, and (2) the NGSA's annual survey of natural gas pipelines' actual weighted ROE,[5] to see evidence that pipeline ROEs are healthy enough to attract investment in infrastructure and natural gas pipeline companies. Accordingly, the Commission should continue to rely upon the DCF methodology because it works for the determination of natural gas pipeline ROEs that are sufficient to attract capital to natural gas pipelines.

Further, the DCF methodology helps to reduce the number of issues that are subject to litigation in pipeline rate case proceedings.[6] Adding more analyses and methodologies to the determination of natural gas pipeline ROEs will only further complicate the litigation process and make achieving settlement of rate proceedings more challenging. The FERC should, therefore, continue with a time-proven methodology that has simplified the litigation of natural gas rate proceedings.

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[4] *Ozark Gas Transmission System*, 68 FERC ¶ 61,032 at 61,104 (1994).

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

[6] *El Paso Natural Gas Co.*, "Opinion No. 528," 145 FERC ¶ 61,040 at P 593 (2013) (describing the standardization of inputs into the DCF formula, which reduces the opportunity for litigation on matters).

Moreover, the DCF methodology has been flexible enough to handle modest changes to the inputs, while still providing ROE results that comport with the requirements of *Hope* and *Bluefield*. For example, the Commission has adjusted the weighting of short-term and long-term growth rates,[7] calculated MLP companies' long-term growth rates differently,[8] and eased somewhat the requirements for proxy group companies.[9] In each situation, particular issues arose on the record that provided the Commission a reasoned basis for deviating from its prior practice to adjust the DCF methodology to ensure a pipeline ROE that was sufficient to attract capital. Given this, the Commission should retain the DCF methodology for determining natural gas pipeline ROEs but continue this case-by-case approach to allow case-specific variations, when the evidence adduced in a particular proceeding supports a variation.

Finally, while the Commission may determine to use other methodologies in the calculation of ROEs for electric utilities, the Commission should not take that step for natural gas pipelines. As set forth in greater detail below, the natural gas pipeline industry is different from the electric utility industry, and the Commission regulates both industries differently. Given that there is no evidence that the DCF methodology is so flawed as to no longer comport with *Hope* and *Bluefield*, NGSA urges the Commission to retain it, but allow for modest case-by-case adjustments when the

[7] *Transcontinental Gas Pipeline Corporation*, Opinion No. 414-A, 84 FERC ¶ 61,084 at 61,423-24 (1998).

[8] *See* Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 106.

[9] *See* Opinion No. 528, 145 FERC at 61,289-90.

record in a particular proceeding provides sufficient evidence to demonstrate that a modest adjustment is necessary to achieve a reasonable ROE.

B. Responses to Commission request for comments:

A-1. To what extent would the ROE methodology described in the Coakley and MISO Briefing Orders impact the predictability of ROE determinations and the costs for market participants of making or intervening in such proceedings?

NGSA is submitting comments solely with regard to the determination of ROEs for natural gas pipelines. To the extent this particular request for comment concerns natural gas pipelines, the NGSA urges the Commission not to create even more complexity and unpredictability in determining ROEs for natural gas pipelines. The introduction of multiple methodologies for determining ROEs in natural gas pipeline rate proceedings will hinder the ability of rate case participants to achieve a common understanding of the ROE outcomes, which, in turn will hinder the ability of rate case participants to achieve settlements of rate proceedings.

Natural gas pipeline proceedings, particularly if fully litigated, are costly in terms of both resources and timing. The most recent fully litigated rate case, *El Paso Natural Gas Company, L.L.C.*, Docket No. RP10-1398, was submitted to the Commission on September 30, 2010. The participants are still waiting for a final outcome on this proceeding, with a decision from the D.C. Circuit due at some point soon, almost nine years after the case was submitted to the Commission. In the meantime, multiple natural gas pipelines have reached settlements, both in filed and

pre-filed rate proceedings.[10] These settled outcomes provide participants with a lower-cost alternative to full litigation and provide more predictability of outcomes, sooner than a litigated outcome would.

If the Commission were to introduce additional methodologies for determining ROEs, the participants would face more protracted proceedings, which would lead to greater unpredictability of results and higher costs, potentially making it much more difficult, especially for smaller companies, to participate fully in the ratemaking proceedings that impact them and their customers.

A-2. How would using the ROE methodology described in the Coakley and MISO Briefing Orders affect an investor's ability to forecast the ROE the Commission would establish in a litigated proceeding and the ability of participants to propose, contest, and settle base ROEs as compared to using only the DCF methodology?

As noted above, introducing additional methodologies for determining natural gas pipeline ROEs would lead to longer, more protracted proceedings, which in turn, would lead to greater unpredictability of results and the inability of investors to forecast a particular ROE the Commission would establish in a particular proceeding.

[10] *See, e.g.*, *Southern Natural Gas Co., L.L.C.*, 163 FERC ¶ 61,161 (2018); *Northern Border Pipeline Co.*, 162 FERC ¶ 61,157 (2018); *Northwest Pipeline LLC*, 160 FERC ¶ 61,008 (2017); *WBI Energy Transmission, Inc.*, 148 FERC ¶ 61,115 (2014); *Trailblazer Pipeline Co. LLC*, 147 FERC ¶ 61,159 (2014).

A-3. Currently, public utilities in different Independent System Operators (ISOs) or RTOs may receive different ROEs, despite all using national proxy groups, due primarily to differences in when FPA section 205 or 206 proceedings were initiated. Are such variations justified, and, if not, should the Commission consider applying the same ROE to all utilities in RTOs/ISOs based on the most recent proceeding?

NGSA takes no position on this comment as it only involves the determination of public utility ROEs.

A-4. Should the ROE reflect the cost of capital at the time of the investment or be subject to adjustment to reflect the contemporary ROE required by investors?

Hope and *Bluefield* require that the "return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[11] In order to fulfill these requirements, the Commission should re-evaluate and adjust natural gas pipeline ROEs to reflect the contemporary ROE required by investors. Fixing an ROE at a specific point in time, without allowing for adjustment to reflect investor expectations at the time of subsequent rate filings, would violate the principles of *Hope* and *Bluefield* by failing to take into account the contemporaneous expectations of investors and the choices those investors make to invest capital in a natural gas pipeline or some other risk-similar enterprise.

[11] *Hope*, 320 U.S. at 605; *see also Bluefield*, 262 at 692-93.

In addition, *Hope* also requires the Commission to balance the interests of consumers with the interests of investors.[12] Establishing a fixed ROE at the time of investment would ignore occasions where the natural gas pipeline company earning an actual ROE greater than its "fixed ROE." If there were no mechanism to allow for review of pipeline ROEs to ensure that consumer and investor interests are balanced, the Commission would be in violation of *Hope*.

Finally, fixing an ROE at the time of investment would create additional complexities in identifying the particular vintage of each pipeline asset. For example, maintenance capital expenditures would occur at a specific point in time, but likely would apply to multiple classes of different vintages.

a. Should the Commission consider a "vintage approach," with ROE fixed for the life of the asset at the time that each asset was completed?

No, for the reasons stated above. Moreover, it is unclear from the question how a calculation of ROE at the time an asset was completed (*i.e.*, after the capital necessary to build the project was spent) would foster the ability of a natural gas pipeline to attract capital to spend on a project. Further, this approach appears to ignore projects that are debt-financed, rather than equity financed.

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

b. Would such a "vintage approach" need to be coupled with an annual national default ROE for investments made in that year, so as to minimize the need for numerous annual litigated ROE proceedings for each public utility that made an investment during that year? What procedure should be used to determine such a default ROE?

It is unclear from the question whether the Commission intends for this to apply to natural gas pipelines (*see* reference to "public utility" above). For the reasons set forth above, the NGSA does not support a vintage approach for natural gas pipelines.

B-1. 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?

No. The Commission has not established that there is any reasoned basis for deviating from its nearly 40-year history of using the DCF methodology as the preferred method for determining the ROE for natural gas pipelines.

B-2. The Risk Premium methodology approved in Opinion Nos. 531 and 551 relied to a large extent on ROEs set forth in numerous settlements involving public utility formula rates approved by the Commission over the preceding 15 or 20 years. Natural gas and oil pipelines have stated rates and settlements of their rate cases are typically "black box" settlements that do not specify an agreed-upon ROE. How could the Risk Premium methodology be implemented in natural gas or oil pipeline rate cases where there is no history of ROE settlements from which to develop a risk premium study of the type used in Opinion Nos. 531 and 551?

Due to the history of natural gas pipeline proceedings achieving settled outcomes of most rate cases through black-box settlements, there are not sufficient

data points to develop a risk premium study of the type used in Opinion Nos. 531 and 551.

B-3. Given the tendency of the Expected Earnings methodology to produce more high-end outliers than the other methodologies, would there be a sufficient number of natural gas and oil pipeline proxy members to implement the Expected Earnings methodology for gas and oil pipelines?

There should not be an issue with creating a proxy group of sufficient size for natural gas pipeline companies, provided the Commission is willing to continue its case-by-case approach of flexibly evaluating whether a particular pipeline company is a "comparable enterprise." For example, the Commission should consider whether Canadian companies with large U.S. natural gas pipeline assets should be included in a natural gas pipeline proxy group. In addition, the Commission has allowed companies into a natural gas pipeline proxy group, when the company's natural gas transportation assets represent less than 50 percent of total company assets.

B-4. 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?

First, the statutes that govern electric utilities, liquids pipelines, and natural gas pipelines, while sharing some similarities, are fundamentally different in one important aspect – the ability of the Commission to grant refunds for rates that the Commission has deemed to be no longer just and reasonable. The Federal Power Act ("FPA") and the Interstate Commerce Act both have provisions that allow for some level of retroactive application of rate changes to filed rates. The Natural Gas Act ("NGA") does not permit refunds below rates the Commission has previously deemed

to be just and reasonable. In the context of determining ROEs, this lack of refund authority is particularly significant and provides sufficient cause for the Commission to treat natural gas pipeline company ROEs differently from the other industries it regulates.

In addition, there are multiple differences between the regulation of public utilities and natural gas pipelines that the Commission has long recognized.[13] For example, the Commission has the authority under the FPA to grant incentive rate treatments,[14] which can consist of a basis point adder to an electric utility's return on equity, in order to support the development of facilities designed to "ensure reliability or reduce the cost of delivered power by reducing transmission congestion."[15] Natural gas pipelines do not have a similar statutory mechanism to increase the return on equity for projects.

Even after the Commission adopted the two-step DCF analysis for determining the return on equity for electric utilities, thereby using the same DCF methodology for both electric and natural gas industries, the Commission determined that the just and reasonable return on equity for electric utilities should be placed at the point that was

[13] *See*, *e.g.*, *System Energy Resources, Inc.*, 92 FERC ¶ 61,119 at 61,443 (2000) (referring to gas pipeline cases as not controlling on electric utility cases because they are different industries); *Southern California Edison Co.*, 92 FERC ¶ 61,070 at 61,261 (2000) ("[W]e believe that significant differences exist in the electric utility industry and the natural gas pipeline industry which warrant the continued use of difference growth rates in the DCF models.").

[14] *See* Energy Policy Act of 2005, Pub. L. No. 109-58, § 1241, 119 Stat. 594 (2005);

[15] "Order No. 679," *FERC Stats. & Regs.* ¶ 31,222 at P 76 (2006).

halfway between the midpoint and the top of the zone of reasonableness. In contrast, "absent highly unusual circumstances that indicate an anomalously high or low risk as compared to other pipelines," the Commission will use the median of the range of reasonableness to determine a natural gas pipeline's just and reasonable return on equity.[16] Thus, the Commission has treated the determination of returns on equity for natural gas companies differently from the determination of returns on equity for electric utilities.

Electric utility proxy groups also do not contain MLPs, while natural gas pipeline proxy groups may, subject to certain limitations.[17] The simple explanation for this difference is that MLPs must derive 90 percent of their income from "qualifying income," which does not include the transmission of electricity, but does include "the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof)."[18] Thus, electric utility proxy groups are fundamentally different than natural gas transmission proxy groups, due to differences in the companies that participate in each industry.

Finally, liquids pipeline companies and natural gas pipeline companies are also distinct, in that the Commission uses indexed rates for inflation and uses declaratory orders to establish initial rates for particular projects.

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[16] *Portland Natural Gas Transmission System*, 134 FERC ¶ 61,129 at P 265 (2011).

[17] Proxy Group Policy Statement, 123 FERC ¶ 61,048 at P 106.

[18] Internal Revenue Code § 7704(d)(1)(E).

Given these differences, there are ample reasons for the Commission to treat the determination of natural gas pipeline ROEs differently than ROEs for public utilities and liquids pipelines.

C-1. The DCF model assumes stock prices are equal to the present value of projected future cash flows. Is there evidence of situations when these assumptions are inaccurate?

NGSA is not aware of any evidence to suggest that investors no longer view the current stock price of an entity as equal to the present value of projected future cash flows.

C-2. Have current and projected proxy company earnings over the last 10 to 20 years increased in a manner that would justify any increases in their stock prices over the same period, consistent with DCF model assumptions?

Specific to the natural gas pipeline industry, natural gas pipeline proxy group companies' earnings have increased and decreased over the last 10 to 20 years in a manner that would justify increases or decreases in their stock prices over the same period. While there have been some short-term fluctuations in the correlation (*e.g.*, when the Commission revised its income tax allowance policy to preclude Master Limited Partnerships from taking an income tax allowance), pipeline share prices decreased over the short-term, but have rebounded. These increases and decreases are accounted for in the DCF methodology's use of share price value.

C-3. How does the DCF methodology perform over a wide range of interest rate conditions?

NGSA is not aware of any evidence that the DCF methodology has failed to provide a sufficient return for natural gas pipelines to attract capital to their enterprises in any particular interest rate environment.

a. What specific assumptions of the DCF model, if any, do not work well in low or high interest rate environments?

The DCF methodology assumes efficient markets and, thus, the DCF model should work well regardless of the interest rate environments. In addition, as noted above, NGSA is not aware of any evidence that the DCF model has failed to provide a sufficient return for natural gas pipelines to attract capital to their enterprises. In fact, there have been several analyses demonstrating that billions of dollars have been invested in interstate natural gas pipeline infrastructure.[19]

[19] *See, e.g.*, The INGAA Foundation, Inc., "North America Midstream Infrastructure through 2035, Significant Development Continues," at 9 (June 18, 2018) ("The industry's greatest spending was on new transmission pipelines which represents over one-third of the capital expenditure, averaging $23 billion per year."); "Natural Gas Market Summer Outlook 2019," Energy Ventures Analysis for Natural Gas Supply Association, at 19-20 (May 2019)<< https://www.ngsa.org/wp-content/uploads/2019/05/FINAL-NGSA-Report-2019-Summer-Outlook-for-Natural-Gas.pdf>> (describing infrastructure build out in the Northeast and Permian Basin areas).

b. Is there evidence that the volatility of price-to-earnings ratios over the last 10 to 20 years, assumed to be constant in the DCF methodology, has been driven by the wide swings in interest rates over this period? If so, would the constant P/E assumption impact the award of reasonable ROEs?

NGSA is unaware of any evidence that would suggest that the wide swings in interest rates have resulted in natural gas pipeline ROEs calculated pursuant to the DCF methodology that failed to comply with *Hope* and *Bluefield*.

D-1. Should proxy groups for electric utilities, as well as natural gas and oil pipelines, consist only of companies with corresponding regulated businesses?

Yes. *Hope* and *Bluefield* require that the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks. Companies with corresponding regulated businesses are the best proxy for complying with these requirements.

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?

Yes, but the Commission should allow for evidence to be presented in individual pipeline rate proceedings as to the appropriate level of ownership. The Commission should, however, maintain its preference for 50 percent ownership of regulated assets,[20] when feasible.

[20] *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036 at 61,104 (2003).

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

There are sufficient numbers of companies that are enterprises comparable to interstate natural gas pipeline companies to achieve an adequate proxy group for determining natural gas pipeline ROEs, provided the Commission maintains its flexible approach to determining what natural gas companies are "comparable enterprises" for inclusion in a natural gas proxy group, as noted in response to D-1.a. above. For example, the Commission should continue to consider, in individual natural gas pipeline proceedings, whether to allow as a proxy, companies that own sufficient levels of U.S. pipeline assets, but are not headquartered in the United States. In addition, the Commission should consider whether to allow proxy companies whose interstate natural gas pipeline transportation and storage assets represent at least a threshold percentage of the total assets of the company. By continuing with this flexible policy, the Commission will be best able to determine what particular group of companies are comparable enterprises based upon the record of an individual proceeding.

D-2. Should risk be considered both in the proxy group selection and in the placement within the zone of reasonableness?

While risk should be utilized as a limiting factor where the proxy group has more than enough members to develop a range of reasonableness, the Commission should consider this on a case-by-case basis. The Commission should continue its practice of using business and financial risk measurements to place a particular natural gas pipeline company either above or below the median of the proxy group

range of reasonableness, based upon the record evidence presented in a particular natural gas pipeline rate case. Given that the Commission has placed natural gas pipelines' ROEs above the median of the range of reasonableness to account for above-average business or financial risk, NGSA emphasizes that if the record evidence demonstrates that a natural gas pipeline has below average business and/or financial risk, the Commission should also consider establishing the ROE for that natural gas pipeline in the lower quartile of the range of reasonableness.

In addition, the Commission should consider a natural gas pipeline's overall rate of return on rate base and capital structure when factoring where to place a natural gas pipeline company in the range of reasonable returns. In Order No. 849, the Commission noted that the average capital structure of the pipelines in the El Paso Natural Gas Company, Docket No. RP10-1398, proxy group was 57 percent equity and 43 percent debt, and that this was "consistent with the capital structures the Commission typically approves in litigated rate cases for pipelines that do issue their own publically [*sic*] traded debt."[21] In a natural gas pipeline rate case filing where the pipeline proposes a capital structure that exceeds this equity level of 57 percent, the

[21] *Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate*, "Order No. 849," 164 FERC ¶ 61,031 at P 115 (2018), *citing*, *Transok, Inc.*, 70 FERC ¶ 61,177, at 61,554 (1995) (58.49 percent equity ratio); *Panhandle Eastern Pipe Line Co.*, "Opinion No. 395," 71 FERC ¶ 61,228, at 61,827 (1996) (61.79 percent equity ratio); *Panhandle Eastern Pipe Line Co.*, "Opinion No. 404," 74 FERC ¶ 61,109, at 61,359 (1996) (59.97 percent equity ratio); *Transcontinental Gas Pipe Line Corp.*, "Opinion No. 414-A," 84 FERC ¶ 61,084, at 61,419 (1998) (57.58 percent equity ratio).

Commission should determine that the natural gas pipeline company's financial risk should lead to placement below the median ROE of the range of reasonable returns.

a. Should the Commission's approach to proxy group selection change depending on which financial models it considers when determining the just and reasonable ROE and, if so, how?

No. In order to comply with the requirements of *Hope* and *Bluefield*, the Commission should continue to examine whether an enterprise has a corresponding risk to the natural gas pipeline company at issue in a particular rate proceeding.

D-3. Should the Commission consider non-energy companies when selecting proxy groups?

No. Energy companies, particularly companies that engage in the transportation of natural gas, have a unique regulatory structure and unique business structures that are not replicable in other non-energy industries. Thus, in order to comply with *Hope* and *Bluefield*, the Commission must limit its review enterprises having a corresponding risk to the natural gas pipeline company at issue in a particular rate proceeding.

a. What non-energy industries or securities have comparable risk to public utilities and natural gas and oil pipelines, if any?

NGSA does not believe the Commission can comply with *Hope* and *Bluefield* if it includes non-energy industries in the proxy group evaluation.

b. Do certain non-energy industries or securities feature fewer outliers?

See response to D-3.a. above.

D-4. What, if any, are appropriate high- and low-end outlier tests?

The Commission does not use a formal "outlier test" for the development of natural gas pipeline proxy groups. Instead, the Commission relies upon the median of the proxy group. NGSA believes the Commission should continue to use the median to determine the central tendency of natural gas pipeline proxy groups.

a. The Commission currently excludes from the proxy group companies whose ROE fails to exceed the average 10-year bond yield by approximately 100 basis points. Should the low-end outlier test continue to be based on a fixed value relative to the costs of debt or (a) should it be based on its value relative to the median (i.e., less than 50 percent of the median); or (b) still reflect the cost of debt but vary based on interest rates?

This question does not apply to natural gas pipelines. Accordingly, NGSA does not take a position on this question.

b. How, if at all, should the Commission's approach to outliers vary among different financial models?

This question does not apply to natural gas pipelines. Accordingly, NGSA does not take a position on this question.

D-5. How, if at all, does the Commission's use of credit ratings in ROE determinations incentivize public utilities to behave in certain ways, such as issuing more debt, and does this affect public utilities' credit ratings?

This question does not appear to apply to natural gas pipelines. In general, in recent years, natural gas pipelines have filed rate cases with relatively high equity ratios in their capital structures. Thus, if this question is intended to address natural gas pipeline companies, the Commission's use of credit ratings does not appear to have caused natural gas pipeline companies to have issued more debt.

D-6. What would be the impact of the Commission modifying the credit rating screen to include all investment-grade utilities in the proxy group?

This question does not apply to natural gas pipeline ROEs because the Commission does not have an absolutist position on the use of investment-grade companies in natural gas pipeline proxy groups.[22] NGSA believes the Commission should continue to use the criteria specific to natural gas pipelines in determining the appropriate proxy group companies.

D-7. To what extent do credit ratings correspond to the ROE required by investors?

Generally speaking, lower credit ratings mean higher financial risk and higher credit ratings mean lower financial risk. If the Commission is convinced that there is sufficient record evidence of highly unusual circumstances that would justify placing a particular company above or below the median of the proxy group, the Commission could grant the pipeline a higher or lower ROE.

D-8. 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?

Yes. The Commission's rationale for excluding companies with merger activity is sound. The Commission should, however, allow for evidence in a particular rate proceeding that would demonstrate that a company otherwise eligible for inclusion in the proxy group may be used, if the merger activity has had a negligible effect on the company's ROE.

[22] *See* Opinion No. 528, 145 FERC ¶ 61,040 at 61,289-90.

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

The Commission should consider whether the recent activity of partnership roll-ups into a corporate parent constitute merger and acquisition activity sufficient to distort the returns applicable to a particular proxy group company.

D-9. 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)?

The Commission has, in the context of natural gas pipeline company evaluations, looked to whether there are highly unusual circumstances that justify deviating from the median of the proxy group. NGSA believes the Commission should continue with this case-by-case determination based upon the evidence presented in the record of each proceeding.

D-10. The Commission currently uses midpoints to determine the central tendency of the zone of reasonableness when determining RTO-wide ROEs. Should the Commission adopt a policy of using medians for this purpose?

Given that these series of questions specifically apply to electric utilities, NGSA does not take a position on these questions.

a. Would the use of multiple ROE methodologies, as proposed in the Coakley Briefing Order, undercut the Commission's current rationale for using the midpoint in RTO-wide base ROE?

b. Should the size of the proxy group be considered in this decision?

D-11. 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?

Yes. There are sufficient numbers of companies for the development of an appropriately sized proxy group for natural gas pipelines, provided the Commission is willing to continue its case-by-case approach of flexibly evaluating whether a particular pipeline company is a "comparable enterprise."

E-1. What models do investors use to evaluate utility equities?

Investors rely upon the DCF methodology as well as numerous other models for determining equity values and future growth prospects. But the Commission's focus should not be on which models investors use, but rather whether the results from a particular model provides a return that is sufficient to attract capital to the enterprise. The Commission and the courts have consistently found that the resulting ROEs from the DCF methodology fulfill this requirement.

E-2. What role do current capital market conditions play in the choice of model used by investors to evaluate utility equities?

The DCF methodology incorporates current capital market conditions by using the stock price of the proxy group companies as part of the methodology for calculating projected ROEs. NGSA does not believe that investors choose a model based upon capital market conditions, but rather choose an investment based upon capital market conditions.

a. If capital market conditions factor into the choice of model, how do investors determine and evaluate those conditions?

See response to E-2 above.

E-3. Are any models thought to be superior or inferior to others? If so, why?

As noted above, the Risk Premium model, using the study used in Opinion Nos. 531 and 551, is not a model that can be used for natural gas pipeline proceedings due to the lack of stated ROEs in natural gas pipeline rate settlements. Beyond that, each model has its benefits and its detriments in terms of the inputs and the outcomes that result from the analysis. In the context of natural gas pipeline rate proceedings, the DCF model is superior because it has been approved by the Commission and the courts through multiple proceedings. In contrast, the Commission has previously rejected both the CAPM and comparable earnings models for determining a natural gas pipeline's ROEs.[23]

E-4. How are alternative models redundant or complementary with each other and/or the DCF model?

CAPM and risk premium are largely redundant because both rely on a risk premium to calculate the required return.

[23] *See Consolidated Gas*, 24 FERC at 61,145-46 (rejecting both a CAPM and a comparable earnings analysis in favor of a DCF analysis).

E-5. To what extent do alternative models avoid any deficiencies of the DCF model and/or operate better in diverse capital market conditions?

It is not clear that any methodology avoids any or all deficiencies. Thus, the Commission should continue to use the DCF methodology for determining natural gas pipeline ROEs.

E-6. To the extent that investors use multiple models, should the Commission combine them in its analysis or use the "best" one that would apply in all market conditions?

Neither. As noted above, the Commission should not focus on what models investors use, but should rather focus on the results that the model produces and whether those results are sufficient to attract capital to the enterprise. The DCF methodology has consistently provided ROEs that all evidence indicates are sufficiently high enough to attract capital to invest in natural gas pipeline projects. Accordingly, the Commission should continue with its preference for the DCF methodology in determining natural gas pipeline ROEs.

E-7. If the Commission were to consider multiple models, how should it weigh them?

For the reasons set forth herein, NGSA does not believe there is a reason to consider alternative models beyond the DCF methodology in the context of natural gas pipeline ROEs. Other alternative models each come with their own deficiencies and only serve to introduce more complexities into the litigation process for no measured benefits.

E-8. To what extent is it reasonable for the Commission to use a simplified version of a model that does not reflect all the variables that investors consider?

It is reasonable for the Commission to use a simplified version of a model, as long as the results from the model provide a sufficient return to attract capital to the enterprise, consistent with *Hope* and *Bluefield*.

a. Is the use of a simplified model justified for ease of administration and predictability of result?

The use of a simplified model is justified for the predictability of results, and, to the extent a simplified model results in reduced costs to litigate natural gas pipeline ROEs, it can also be justified.

E-9. How, if at all, should the Commission consider state ROEs?

NGSA does not take a position on this issue.

a. How and why do state ROEs vary by state?

b. How are certain state ROEs more or less comparable to Commission ROEs?

E-10. If the Commission considers state ROEs, how should it compare FERC-jurisdictional transmission ROEs with state ROEs that apply to utilities that are (a) distribution and transmission companies; or (b) distribution, generation, and transmission companies?

This request for comment appears to apply to electric utilities, rather than natural gas companies. Accordingly, NGSA does not take a position on this issue.

E-11. To what extent, if any, should the Commission exercise judgment in using financial models to set ROEs under various capital market conditions?

The NGA provides the Commission with the responsibility and the discretion to determine just and reasonable natural gas pipeline rates. The Commission can apply this judgment and discretion in the application of its financial models to set ROEs, where the record evidence in a particular proceeding provides sufficient support to justify deviating from established precedent.

F-1. Does the mismatch between market-based ROE determinations and a book value rate base support current market values? Is this mismatch a problem?

NGSA does not take a position on this request for comment at this time.

F-2. Why have most or all utility market-to-book ratios consistently exceeded one?

NGSA does not take a position on this request for comment at this time.

F-3. How should the ROE level be set relative to the cost of equity?

The Commission should continue to use the well-established DCF methodology for determining the appropriate ROE level for natural gas pipelines.

F-4. Should the Commission revise our use of these models to account for the mismatch between market-based ROE determinations and book-value rate base? If so, how? For example, should the Commission adjust the dividend yield used in the DCF model to represent a yield on book value rather than a yield on stock price?

No. To the extent any mismatch exists for natural gas pipelines, the Commission has previously rejected the idea of adjusting natural gas pipeline ROEs to account for any "mismatch" between market and book value. The Commission

should continue to reject the idea of adjusting ROEs to account for any perceived mismatch.

F-5. Should the Commission consider adjusting ROEs to account for market-to- book ratios above or below one? Would doing so introduce circularity into Commission ROEs by setting the ROE at whatever level of earnings the market expected, rather than making an independent assessment of the appropriate ROE?

No. The Commission has previously addressed this issue for natural gas pipelines.[24] NGSA is not aware of any evidence that would suggest the Commission should deviate from its current approach.

G-1. How should the Commission determine if existing ROEs are just and reasonable?

This request for comments appears to be directed to electric utility proceedings, rather than natural gas pipeline proceedings. Accordingly, NGSA does not take a position on this question.

G-2. Is the quartile approach that the Commission proposed in the Coakley and MISO Briefing Orders appropriate? If not, how should the Commission revise this methodology?

See response to G-1 above.

[24] *See Orange and Rockland Utilities, Inc*., 44 FERC ¶ 61,253 at 61,952 (1988); *see also*, *Williston Basin*, 104 FERC at 61,106 ("The Commission's practice of setting the allowed return at the level that investors require on their investment avoids" the self-perpetuating cycle of whatever level of earnings is currently anticipated by investors.).

G-3. When a successive complaint is filed while the current ROE is being adjudicated (i.e., a pancake complaint), should the subsequent complainant be required to make a prima facie showing of sufficient change in market conditions to meet the Coakley and MISO Briefing Order's proposed determination of whether an existing ROE remains just and reasonable? If so, what type of information or showing should the complainant provide to demonstrate that market conditions have changed, and what standard should the Commission apply when assessing whether to deny the subsequent complaint without setting it for hearing?

See response to G-1 above.

G-4. In single utility rate cases, the Commission determines the central tendency of the zone of reasonableness based on the median of the proxy group ROEs. Is the approach outlined in the Coakley and MISO briefing orders appropriate in single utility rate cases given that the proxy company ROEs tend to cluster near the center of the zone of reasonableness, making the middle quartile relatively narrow?

See response to G-1 above.

G-5. Would it be reasonable to determine the central tendencies of the upper and lower halves of the zone of reasonableness for single utilities based on a midpoint analysis, so as to produce approximately equal ranges of presumptively just and reasonable ROEs for below average, average, and above average risk utilities?

See response to G-1 above.

H.1.1. Are IBES data a good proxy for "investor consensus?"

Yes. As the Commission found in *Northwest Pipeline*,

> Ever since *Ozark Gas Transmission System*, the Commission has used IBES data as the exclusive data source for the short-term growth rate for gas pipeline proceedings. While the Commission has refrained from mandating the exclusive use of IBES data in all gas pipeline rate of return cases, the Commission has stated that IBES data is the preferred data source for computing the short-term growth rate.[25]

[25] *Northwest Pipeline Corp.*, 92 FERC ¶ 61,287 at 62,001-02 (2000), *citing*, *Ozark Gas Transmission Company*, 68 FERC ¶ 61,032 (1994).

NGSA is unaware of any evidence that would demonstrate that IBES should no longer be the preferred source for computing the short-term growth rate.

H.1.4.a. If not, are there better alternatives, such as Bloomberg, Zacks, S&P Capital, Morningstar, and Value Line?

The Commission should proceed with caution in introducing additional data sources in determining investor consensus. Additional data sources will likely require the purchase of subscriptions, which could drive up the cost to litigate a natural gas pipeline ROE proceeding, which may limit the number of participants who are able to fully participate in the litigation. Given that NGSA is unaware of any evidence that demonstrates that IBES produces unreliable information, NGSA urges the Commission to rely on IBES.

H.1.4.b. Should the Commission combine data from multiple sources?

No. See response to H.1.4.a. above.

H.1.4.c. What weight, if any, should be given to an estimate if the number and identity of analysts contributing to the estimate is not available?

IBES uses multiple sources for its investor analyses. Thus, the Commission should accord it appropriate weight.

H.1.2. To what extent does model risk affect all ROE methodologies?

NGSA does not take a position on this question.

H.1.3. The DCF model incorporates data at the parent/holding company level (e.g., stock price). The Commission adjudicates cases at the operating company level, for which there is no public data like stock prices, growth rates, and betas. What impact does this disparity have on the results of the DCF and other models?

NGSA is unaware of any evidence to suggest that the Commission's methods for determining natural gas pipeline ROEs has suffered from any disparity through the use of parent/holding companies in the proxy group.

H.1.4. Should the Commission continue to rely on the efficient market hypothesis, which underlies the DCF and CAPM models? Why or why not?

Yes. To abandon the Efficient Market Hypothesis would ignore nearly 40 years of precedent in using the DCF methodology to determine natural gas pipeline ROEs. NGSA is unaware of any evidence that would suggest that this hypothesis is no longer valid.

H.1.4.a. If yes, should the Commission continue to employ outlier screens, M&A screens, etc., for the DCF and CAPM models since these models need to incorporate all relevant information?

Yes, the Commission should continue its policies with respect to limiting proxy group companies. But the Commission should also allow for evidence to be presented in individual pipeline proceedings to determine whether there is a reasonable basis for allowing exceptions to these screens.

H.1.5. Should growth rates be based on Value Line, IBES, or alternative estimates?

IBES uses multiple investment advisor analyses and is, therefore, the best source for short-term growth rates.

H.1.6. Should the same growth rate sources be used across models, if more than one model is used to determine the ROE?

Yes.

H.2.a.1. Should the Commission continue to use a dividend DCF model or should the Commission use a different DCF model, for example, one based on free cash flow?

The Commission should continue to use a dividend DCF model.

H.2.a.2. Could terminal stock value be used in place of long-term growth projections? If so, how should terminal stock value be determined?

No. The Commission should continue to use GDP as a measure of long-term growth, given the Commission's policy and precedent stating that long-term growth rates for natural gas pipelines are consistent with the economy as a whole.

H.2.a.3. Do investment analysts project earnings/dividends growth beyond five years, and if not, why not, and is GDP an appropriate proxy for long-term growth?

Investment analysts typically look at short-term growth rates over no more than a five-year window. Longer term outlooks become less reliable and analysts may be reluctant to project expected growth beyond a short time period. Given the Commission's policy and precedent that state that long-term growth rates for natural gas pipelines are consistent with the economy as a whole, GDP is an appropriate measure for long-term growth.

H.2.a.4. How should the Commission weight short-term and long-term earnings/dividend growth projections?

The Commission's current policy of weighting short-term and long-term growth projections has been adopted by the courts and used by the Commission for

the last 20 years. NGSA does not believe a change to the Commission's current weighting (2/3 short-term, 1/3 long-term) is required.

H.2.a.5. The Commission uses a constant growth DCF model. Should the Commission consider using a multi-stage DCF model? If so, how would the Commission determine the length of each stage of a proxy company's growth?

This question does not appear to apply to the determination of natural gas pipeline ROEs because the Commission uses a form of a two-stage DCF model for determining growth rates for natural gas pipeline proxy group companies.

H.2.a.6. Are six months of average high/low historical monthly stock prices an appropriate measure for the current stock price "P"?

To the extent the Commission is engaging in a historical averaging of stock prices, a six-month look-back would be an appropriate window for mitigating some of the daily variability of stock prices.

H.2.b.1. If the market risk premium is determined by applying the DCF methodology to a representative market index, should a long-term growth rate be used, as in the Commission's two-step DCF Methodology?

Yes.

H.2.b.2. Beta is a measure of a security's risk relative to the broader market such as the S&P 500, not of its absolute risk. Do CAPM's assumptions break down if *both* utility stocks and the broader market become riskier over time on an absolute basis, but the relative increase in risk in utility stocks rises more slowly?

This request for comment appears to apply only to electric utilities. In the event the Commission intends for this to apply to natural gas companies as well, NGSA believes, for the reasons described herein, that the DCF methodology is the

most robust and well-accepted methodology for determining natural gas pipeline ROEs.

H.2.b.3. What are appropriate data sources for the beta value?

Value Line appears to be the best source for beta values.

H.2.b.4. Should the Commission employ more sophisticated versions of the CAPM model that consider more variables instead of only beta, such as the Fama-French Model?

No. Adding more complexity will not ensure better results and may increase the chance of input errors distorting the outcome.

H.2.c.1. Should the use of utilities in the proxy group for the Expected Earnings model be predicated on the Expected Earnings analysis being forward-looking?

The Commission should not consider the Expected Earnings model as a method for deriving natural gas pipeline ROEs because the model ignores capital markets given that it is an accounting-based model. Ignoring capital markets appears to violate the requirements of *Hope* and *Bluefield.*

H.2.c.2. What, if any, concerns regarding circularity are there with using the Expected Earnings analysis to determine the base ROE, as opposed to using the analysis for corroborative purposes?

See response to H.2.c.1.

H.2.c.2.i. If there are circularity concerns, are there ways to mitigate these concerns for the Expected Earnings analysis? If these concerns exist, are these concerns more significant than those surrounding the DCF methodology, which effectively separates Expected Earnings and ROE into its dividend yield and growth rate subcomponents?

See response to H.2.c.1.

H.2.d.1. H.2.d.1. Should the analysis be historical or forward-looking?

See response to H.2.c.1.

H.2.d.2. Is a Risk Premium analysis compatible with a finding of anomalous capital market conditions? Why or why not?

See response to H.2.c.1.

H.2.d.3. Unlike the financial models discussed above, the Risk Premium analysis produces a single ROE rather than a zone of reasonableness. Does this characteristic require the Commission to use the Risk Premium model differently than the other models?

See response to H.2.c.1.

H.2.d.3.i. Is there a method by which the Risk Premium ROE could be adjusted upward for an above average utility or downward for a below average risk utility? If not, is it reasonable to consider the results of a Risk Premium analysis when determining the ROE of an above or below average risk utility?

See response to H.2.c.1.

H.2.d.3.ii. Is it appropriate to use a Risk Premium analysis when conducting the first prong of the section 206 evaluation?

This request for comment does not apply to natural gas pipelines.

III. CONCLUSION

The DCF methodology has consistently given ROE results that are in line with investor expectations and comply with the requirements of *Hope* and *Bluefield*. Given this, NGSA respectfully requests the Commission to retain the singular use of the DCF methodology for determining natural gas pipeline company ROEs.

Respectfully submitted,

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