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 LIQUIDS SHIPPERS GROUP

Pursuant to the procedures set forth in the Notice of Inquiry Regarding the Commission's Policy for Determining Return on Equity ("NOI"), which the Federal Energy Regulatory Commission ("FERC" or "Commission") issued in this proceeding on March 21, 2019,[1] the Liquids Shippers Group[2] ("LSG") hereby submits these Initial Comments on the NOI.

I. EXECUTIVE SUMMARY

In the NOI, the Commission is considering whether to adopt a solution in search of a problem, and to replace its standardized discounted cash flow ("DCF") return on equity ("ROE") model with a new, unwieldy ROE model (the "4-Part ROE") that has created needless uncertainty and is unlikely to produce just and reasonable ROEs for oil

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

[2] For purposes of these Initial Comments, the LSG includes: Anadarko Energy Services Company, Apache Corporation, Cenovus Energy Marketing Services Ltd., ConocoPhillips Company, Devon Gas Services, L.P., Encana Marketing (USA) Inc., Equinor Marketing & Trading US Inc., Fieldwood Energy LLC, Marathon Oil Company, Murphy Exploration and Production Company-USA, Noble Energy, Inc., and Pioneer Natural Resources USA, Inc.

pipelines.[3] The problems with the 4-Part ROE model are particularly egregious for oil pipelines, given the relative lack of rate review for oil pipeline ROEs and rates.

Therefore, the LSG submits that the Commission should retain its existing DCF ROE model for oil pipelines. The Commission should make only targeted changes to the DCF model, as necessary, to address any demonstrable changes in market conditions or problematic inputs that may arise on a case-by-case basis.

Further, the FERC's rate regulation for oil pipelines relies heavily on pipelines' self-reported Form No. 6 Page 700 cost and revenue data, as opposed to cost-of-service rate review. The NOI has already undermined the transparency and validity of the ROEs and the overall cost-of-service figures that pipelines report on their Page 700s. The NOI also has the potential to permanently distort oil pipelines' index-based rates. The principles of good and lawful governance therefore require a remedy.

Accordingly, the Commission should issue an interim order stating that oil pipelines must only use a DCF ROE in their Form No. 6 Page 700 cost-of-service calculations. Further, if the Commission does revise its ROE policies for oil pipelines, then oil pipelines should only be able to rely on the non-DCF ROE models in the context of litigated cost-of-service rate cases. This remedy would maintain parity between oil pipelines and jurisdictional electric utilities and natural gas pipelines, and limit oil

[3] References to "oil pipelines" in these comments include all liquids pipelines subject to the Commission's jurisdiction, including crude oil pipelines, refined products pipelines, and natural gas liquids ("NGL") pipelines.

pipelines' efforts to manipulate their self-reported Page 700 ROEs to their benefit, and to the detriment of the rest of the industry.

II. THE LIQUIDS SHIPPERS GROUP

The members of the LSG are crude oil and/or NGL producers and/or marketers in the United States and/or Canada. Each member of the LSG is a shipper on, and/or supplier to, one or more FERC jurisdictional crude oil and/or liquids pipelines. The LSG was formed in 2013 for the purpose of participating, on an *ad hoc* basis, in regulatory proceedings before the Commission in order to advance positions that reflect its members' common interests. Two of the LSG's primary advocacy positions are: 1) enhancing the transparency of jurisdictional oil pipelines' financial reporting; and 2) ensuring that oil pipeline rates are just and reasonable under Section 1(5) of the Interstate Commerce Act ("ICA").[4] The Commission should adopt the LSG's recommendations herein, to address the fact that the 4-Part ROE model in the NOI lacks transparency and validity, and is unlikely to produce just and reasonable ROEs for oil pipelines.

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[4] 49 App. U.S.C. § 1(5) (1988).

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IV. BACKGROUND

A. Oil Pipeline Returns and Rates

In 1984, the Court of Appeals for the D.C. Circuit issued *Farmers Union Central Exchange, Inc. v. FERC* ("*Farmers Union II*") and affirmed that a jurisdictional oil pipeline's return must be high enough to afford the pipeline the opportunity to "maintain...credit and attract capital."[5] To do this, the return must be "commensurate with returns on investments in other enterprises having corresponding risks."[6] At the same time, the return must be low enough, "so that exploitation by the regulated

[5] *Farmers Union Cent. Exchange, Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir. 1984) ("*Farmers Union II*").

[6] *Id.* (*quoting City of Chicago, Ill. v. FPC*, 458 F.2d 731, 750-51 (D.C. Cir. 1971)) (internal quotations omitted).

business is prevented."[7] The Court also reiterated the basic principle that where an oil pipeline's rates afford it returns that are higher than necessary to maintain credit and attract capital, then those rates are excessive, unjust, and unreasonable, in violation of Section 1(5) of the ICA.[8]

In response to certain rulings in *Farmers Union II*, the Commission issued Opinion No. 154-B, and adopted "trended original cost" ratemaking for oil pipelines. As is relevant to this proceeding, "trended original cost" ratemaking uses an inflation-adjusted ROE (or, the "real" ROE).[9] Several oil pipeline cost-of-service rate cases were litigated in the years that followed Opinion No. 154-B.[10]

In 1992, Congress issued the Energy Policy Act ("EPAct") and required the Commission to adopt a "simplified and generally applicable ratemaking methodology for oil pipelines" that still produces just and reasonable rates, in compliance with

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7 *Id.* (internal quotations omitted).

8 *Id.* (*quoting FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979) and *Permian Basin Area Rate Cases*, 390 U.S. 747, 797 (1968)). The Court stated, "[w]e begin from this basic principle, well established by decades of judicial review of agency determinations of just and reasonable rates: an agency may issue, and courts are without authority to invalidate, rate orders that fall within a zone of reasonableness where rates are neither less than compensatory nor excessive." *Id.* (internal quotations omitted). The Court also noted that while the Commission has the discretion to rely on non-cost factors in its ratemaking policies, any over-recoveries must be specifically justified by, and calibrated to, the relevant non-cost factors. *Id.* at 1502-03, 1530.

9 *Williams Pipe Line Co.*, Opinion No. 154-B, 31 FERC ¶ 61,377 (1985) ("Opinion No. 154-B").

10 *See Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Order No. 561, 58 Fed. Reg. 58,753 at 58,755 (Nov. 4, 1993) ("Order No. 561").

Section 1(5) of the ICA.[11] In response to the EPAct, the Commission issued Order No. 561 and adopted an index-based ratemaking scheme for oil pipelines in 1993.[12] In 2016, the Commission acknowledged that indexing has supplanted cost-of-service rate review as the Commission's predominant means of setting oil pipeline rates.[13]

In fact, unlike a jurisdictional natural gas pipeline or an electric public utility, it is common for an oil pipeline to establish and subsequently increase its rates, without *ever* submitting to any form of cost-of-service rate review at the Commission.[14] This is because oil pipelines can establish their initial rates without providing any cost-of-service data to support those rates.[15] Under indexing, oil pipelines can also increase their rates up to an index-adjusted ceiling rate without providing any cost-of-service data to support the rate increase.[16] The Commission has also said that it is not inclined

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[11] Energy Policy Act of 1992, Pub. L. No. 102-486 Sec. 1801(a), 106 Stat. 3010 (Oct. 24, 1992); 49 App. U.S.C. § 1(5) (1988).

[12] Order No. 561, 58 Fed. Reg. 58,753.

[13] *Revisions to Indexing Policies and Page 700 of FERC Form No. 6*, Advance Notice of Proposed Rulemaking, 157 FERC ¶ 61,047 at P 1 (2016) (stating, "the Commission's index ratemaking methodology has become the predominant mechanism for adjusting oil pipeline rates under the [ICA].").

[14] *See Endicott Pipeline Co.*, 55 FERC ¶ 63,028 at 65,140-41 (1991) (Initial Decision explaining that electric utilities and natural gas pipelines must provide detailed cost and revenue data to support their rate changes, while oil pipelines do not).

[15] Under 18 C.F.R. § 342.2 (2018), oil pipelines can establish initial rates by filing "a sworn affidavit that the rate is agreed to by at least one non-affiliated person who intends to use the service in question," or by filing cost and revenue data to support the proposed rates. The vast majority of oil pipelines rely on affidavits to establish their initial rates.

[16] *See* 18 C.F.R. § 342.3(a) (2018).

to exercise its authority under the ICA to investigate an oil pipeline's rates, *sua sponte*, even when those rates are clearly excessive.[17]

In the absence of cost-of-service litigation, the Commission now relies almost entirely on oil pipelines' self-reported cost-of-service (*e.g*. ROE) and revenue data to regulate oil pipeline rates. Specifically, the Commission uses the data reported on oil pipelines' Form No. 6 filings at Page 700 to: 1) calculate the annual index that is used to adjust oil pipeline rates every year;[18] 2) accept or reject a shipper's protest to an oil pipeline's indexing rate increase, under the Commission's existing "percentage comparison test;"[19] and 3) accept or reject a shipper's complaint against an oil pipeline's existing rates.[20]

Given that the FERC heavily relies on oil pipelines' Page 700 data to set rates, oil pipelines have a significant incentive to manipulate their Page 700 ROEs to their advantage, and to the detriment of their shippers. For example, by merely increasing its Page 700 ROE by 300 basis points, an oil pipeline may be able to convert an over-

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17 Order No. 561, 58 Fed. Reg. 58,753 at 58,796.

18 *See id.* at 58,760 (stating, "[t]he Commission will use the Form No. 6 information for this purpose, and will review the choice of index every five years"); *Five-Year Review of the Oil Pipeline Index*, Order Establishing Index Level, 153 FERC ¶ 61,312 at P 12 (2015).

19 *Calnev Pipe Line L.L.C.*, 130 FERC ¶ 61,082 at PP 10-11 (2010) (explaining that "[t]he Commission will not consider protests that raise arguments beyond the scope of the percentage comparison test," which relies on Form No. 6 Page 700 data).

20 *See* Order No. 561, 58 Fed. Reg. 58,753 at 58,768; *Arco v. Calnev Pipe Line, L.L.C.*, 97 FERC ¶ 61,057 at 61,311 (2001) (explaining that the Commission expects shippers to use Page 700 data to form the basis for their complaints).

recovery into an under-recovery, which would impact a shipper's ability to file a complaint challenging its rates.[21] An oil pipeline could also convert its annual cost-of-service decrease to a cost-of-service *increase* by merely manipulating its ROE, which would impact a shipper's ability to challenge its indexing rate increase under the "percentage comparison test."[22] If a significant number of oil pipelines filed anomalously high Page 700 ROEs (*e.g.*, a 16.19% inflation-adjusted ROE), that could also distort the Commission's analysis of the oil pipeline industry-wide cost changes, relative to the Producer Price Index for Finished Goods ("PPI-FG"), which forms the basis for the Commission's index.[23]

As discussed in detail below, the Commission's standardized DCF ROE calculation played a significant role in limiting oil pipelines' efforts to exploit this problematic regulatory structure. Conversely, the NOI has already undermined the transparency and validity of the ROEs and the cost-of-service figures that pipelines are reporting on their Page 700s, and it has the potential to permanently distort oil pipelines' index-based rates.

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21 *See id.*

22 *See Calnev Pipe Line L.L.C.*, 130 FERC ¶ 61,082 at PP 10-11.

23 *See* Order No. 561, 58 Fed. Reg. 58,753 at 58,760; *Five-Year Review of the Oil Pipeline Index*, Order Establishing Index Level, 153 FERC ¶ 61,312 at P 12.

B. ROE Notice of Inquiry

The NOI arose from *Emera Maine v. FERC* ("*Emera Maine*"), where the Court of Appeals for the D.C. Circuit vacated and remanded Opinion No. 531, after finding that the FERC failed to provide evidentiary support for the way it chose to revise its ROE policies.[24] In Opinion No. 531, the Commission observed that the midpoint DCF ROE for certain electric utilities was lower than the ROEs approved by state commissions, and may reflect anomalous market conditions.[25] Based on that information, the Commission concluded that the midpoint of the DCF ROEs in that case may not be sufficient to maintain credit or attract capital for a group of electric utilities.[26] The Commission then considered the results of three other ROE models in the record—the Capital Asset Pricing model ("CAPM"), the Risk Premium model, and the Expected Earnings model—and selected an ROE (10.57%) above the midpoint DCF ROE.[27] In its order vacating and remanding Opinion No. 531, the Court in *Emera Maine* found that the Commission failed to cite record evidence to support its decision to set the utilities' ROE at 10.57%, as opposed to some other value above the midpoint of the DCF ROEs.[28]

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[24] *Emera Maine v. FERC*, 854 F.3d 9, 28-30 (D.C. Cir. 2017) ("*Emera Maine*").

[25] *Martha Coakley, Mass. Attorney Gen. v. Bangor Hydro-Elec. Co.*, Opinion No. 531, 147 FERC ¶ 61,234 at PP 145-151 (2014) ("Opinion No. 531").

[26] *Id.*

[27] *Id.*

[28] *Emera Maine*, 854 F.3d at 28-30.

In response to the Court's remand, the Commission issued *Martha Coakley, Massachusetts Attorney General v. Bangor Hydro-Electric Company* ("*Coakley* Briefing Order") on October 18, 2018, and requested briefs on a new 4-Part ROE model proposal, which would calculate a single ROE for electric utilities by averaging the results of the DCF, CAPM, Risk Premium, and Expected Earnings models.[29] The 4-Part ROE relies on at least thirteen different inputs, variables and assumptions,[30] and parties across industries have subsequently applied modifications and injected even more variables into the 4-Part ROE proposed in the *Coakley* Briefing Order.

On March 21, 2019, the Commission issued the NOI. The NOI "seeks further information as the Commission re-evaluates its ROE policies following the *Emera Maine* decision."[31] Specifically, "[t]he Commission...seeks comment on whether any changes to its policies concerning public utility ROEs should be applied to...oil pipelines."[32]

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[29] *Martha Coakley*, *Mass. Attorney Gen. v. Bangor Hydro-Electric Co.*, 165 FERC ¶ 61,030 at P 44 (2018) ("*Coakley* Briefing Order").

[30] *See id.* at Appendix. The variables include the six-month study period and proxy group, as applicable, the short term growth rate, the long-term growth rate, the stock prices and indicated dividend for the DCF model, the risk-free rate, beta, and expected return for the CAPM, accounting data or book value estimates for Expected Earnings, and method for selecting the returns and the bond rates for the Risk Premium model.

[31] NOI, 166 FERC ¶ 61,207 at P 3 (*citing Emera Maine*, 854 F.3d at 28-29)).

[32] *Id*. at P 1.

Subsequently, the Commission reiterated that its DCF ROE remains a valid approach for calculating a regulated entity's just and reasonable return.[33]

V. INITIAL COMMENTS

A. The FERC's Standardized DFC Model Produces Meaningful and Transparent ROEs That Are Driven By Market Data, Rather Than Assumptions.

As the NOI explains, the current DCF model has been standardized over a period of more than 30 years.[34] Since the 1980s, the Commission has developed a body of precedent that adopts the same common approach, across cases, for identifying or calculating each element of the DCF calculation. As of 2019, the Commission has standardized: 1) the approach to selecting a proxy group; 2) the length of the study period; 3) the method for calculating the dividend yield for each member of the proxy group; 4) the short-term growth rate, the long-term growth rate, and the weighting for each rate in the composite growth rate; 5) the treatment of master limited partnerships ("MLPs") in the proxy group; and 6) the use of the median DCF to determine a just and reasonable ROE for pipelines of average risk.[35] Importantly, there are also many Court

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[33] *See e.g. Trailblazer Pipeline Co.*, 166 FERC ¶ 61,141 at PP 48, 52 (explaining that the pipeline in that case may use the DCF "either alone or in conjunction with other ROE methodologies" to determine its ROE).

[34] *See* NOI, 166 FERC ¶ 61,207 at PP 7-10, and n. 20.

[35] *See id.*

cases affirming the validity of the DCF model as a means to calculate a regulated entity's ROE.[36]

Under the FERC's standardized DCF model, the only true variables are the proxy group companies and the six-month study period. Accordingly, if all of the parties in a case were to use the same proxy group and the same six-month study period, then they would be using the same market data (*e.g.*, to determine the dividend yields and composite growth rate), and their DCF results would be the same. The relative lack of variables means that oil pipelines have a limited ability to manipulate the DCF model to produce higher ROEs. Further, a shipper can currently determine if an oil pipeline's ROE is unjust and unreasonable by calculating its own DCF ROE and comparing its results with the pipeline's proposed ROE. To the extent that an oil pipeline's ROE departs from the DCF ROE, shippers can rely on that divergence to file a protest or a complaint challenging its proposed or existing rates.

Therefore, the Commission's standardized DCF model promotes predictability and regulatory certainty for oil pipelines and their shippers. It also produces relatively transparent and meaningful results that are less likely to be driven by assumptions (and

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[36] *See e.g. Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1211-13 (D.C. Cir. 1991) (explaining that the Commission is "quite wedded" to the DCF model, and remanding the Commission's decision to rely on a risk premium ROE to set the low end of the zone of reasonableness); *Illinois Bell Telephone Co. v. F.C.C.*, 988 F.2d 1254, 1259-1263 (D.C. Cir. 1993) (affirming the Federal Communications Commission's decision to primarily rely on a DCF model over other models—including the risk premium and expected earnings models—to estimate the cost of equity).

therefore, less likely to be subject to manipulation) than alternatives. Conversely, as discussed in detail below, the 4-Part ROE model lacks transparency and validity, and is unlikely to produce just and reasonable ROEs for oil pipelines.

B. The Commission's DCF ROE Model Is Still Producing Just and Reasonable ROEs For Oil Pipelines.

The D.C. Circuit's order in *Emera Maine* did not undermine the validity of the Commission's DCF ROE model for calculating oil pipeline ROEs. The Court's holding in *Emera Maine* was simple, and limited to the facts and circumstances of that case. Specifically, the Court accepted the Commission's decision to set the ROE for a group of electric utilities above the midpoint of the DCF ROEs, but held that the Commission failed to cite evidence to support the ROE that it chose over the other ROEs above the midpoint.[37]

Emera Maine does not address oil pipeline ROEs. Based on its order, the Court is also expecting the Commission to rely on the record evidence in the *underlying electric utility rate case*, and not a new oil pipeline ROE policy, to support its order on remand.[38] The Court's *Emera Maine* decision therefore has no bearing on oil pipeline rates. This conclusion is supported by the fact that the Commission has since acknowledged that

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[37] *Emera Maine*, 854 F.3d at 28-30.

[38] *See id.*

the DCF remains a valid method for calculating ROEs, notwithstanding the Court's remand in *Emera Maine*.[39]

Moreover, there is no basis to conclude that the DCF is producing inaccurate ROEs for oil pipelines. The Commission considered oil pipeline ROEs after Opinion No. 531 issued, and did not find that the median DCF ROEs were too low to attract capital, or were otherwise anomalous. Specifically, in the *Seaway Crude Pipeline Company LLC* ("*Seaway*") rate case, the Commission relied on market data from the six-month period ending December 2012.[40] The Commission relied on data for the six-month period ending March 2013 in Opinion No. 351.[41] Thus, in *Seaway*, the Commission used three months of market data from the *same period* the Commission found may produce anomalous ROEs for electric utilities in Opinion No. 531.[42]

However, unlike Opinion No. 531, in *Seaway* the Commission held that the median DCF ROE (10.75%) based on market data for the six-month period ending December 2012 was sufficient to attract capital and maintain credit for an average-risk oil pipeline.[43] Therefore, the Commission's finding in Opinion No. 531 that the DCF

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39 *See e.g. Trailblazer Pipeline Co.*, 166 FERC ¶ 61,141 at PP 48, 52.

40 *Seaway Crude Pipeline Company LLC*, 154 FERC ¶ 61,070 at P 194 (2016) ("*Seaway*").

41 Opinion No. 531, 147 FERC ¶ 61,234 at P 4.

42 The Commission's DCF model relied on data for the period October 2012 through December 2012 in both *Seaway* and Opinion No. 531.

43 *Seaway*, 154 FERC ¶ 61,070 at P 194. The LSG is using Seaway's nominal ROE of 10.57% for this analysis, which is not adjusted for inflation and therefore is comparable to the ROE that the Commission would calculate for an electric utility.

may have produced anomalous ROEs for public utilities during 2012 and 2013 does not apply to oil pipelines.

Further, in the *Coakley* Briefing Order, the Commission explained that the new 4-Part ROE model produced a preliminary ROE of 10.41% for the electric utilities for the six-month period ending March 2013.[44] It is true that electric utility and oil pipeline ROEs are not directly comparable, because they measure the risks associated with two distinct industries. However, it is telling that the 4-Part ROE for an electric utility is still lower than the DCF ROE for an oil pipeline, during a substantially similar period. This comparison indicates that even assuming that the 4-Part ROE model is needed to produce ROEs (*e.g.*, 10.41%) that are sufficient to attract capital for electric utilities, the DCF ROEs (*e.g*., 10.75%) are *already* sufficient to attract capital for oil pipelines.

In any event, the Commission has previously found that the DCF relies on market data that responds to anomalous market conditions, and that—given time—the inputs self-correct.[45] Accordingly, for pipelines, the Commission typically addresses changing market conditions by selecting the six-month study period that either avoids,

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[44] *Coakley* Briefing Order, 165 FERC ¶ 61,030 at PP 56-59.

[45] *Portland Natural Gas Transmission System*, 134 FERC ¶ 61,129 at P 246 (2011) (explaining, "[w]hen a financial crisis causes a sudden drop in stock prices, the immediate effect is to increase a proxy firm's dividend yield, which significantly increases the ROE produced by a DCF analysis. The other inputs to the formula, which may have an offsetting downward effect, typically do not adjust as quickly to the changed circumstances produced by the financial crisis. For example, as the economic effects of a financial crisis become clear, financial analysts may reduce their five-year IBES growth projections for the firms in the proxy group, thereby lowering the growth component of the DCF analysis. Thus, the use of data from a later time period may capture some of those delayed adjustments.")

or captures the market's corrective reaction to, those conditions.[46] Given that the Commission regularly litigates electric utility rate cases (*e.g.*, in serial ROE complaints), the Commission may not be able to avoid anomalous market data when setting electric utility ROEs. But this has never been a problem for oil pipelines, where the time between Commission orders on cost-of-service rate cases can stretch to several years or more.

In sum, there is simply no need to adopt the 4-Part ROE model for oil pipelines. Therefore, by considering unnecessary and destabilizing changes to its ROE policies for oil pipelines, the Commission risks repeating its mistakes from Opinion No. 531. Namely, if the Commission decides to revise its long-standing ROE policies and adopt the 4-Part ROE model for oil pipelines without a rational basis for doing so (and the LSG submits that there *is no* rational basis for adopting the 4-Part ROE model for oil pipelines), then it risks reversal in the courts.

C. Unlike the FERC's Standard DCF Model, the 4-Part ROE Model Lacks Transparency and Validity, and Is Particularly Problematic For Oil Pipeline Ratemaking.

As explained above, standardization is the hallmark of the Commission's DCF ROE model. Conversely, chaos and manipulation are currently the defining characteristics for the 4-Part ROE model that the Commission is considering in the NOI.

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[46] *See id*. (selecting a six-month study period that captured both anomalous conditions and the market's reaction to those conditions); *SFPP, L.P.*, 134 FERC ¶ 61,121 at P 209 (2011); *vacated and remanded on other grounds*, *United Airlines, Inc. v. FERC*, 827 F.3d 122 (D.C. Cir. 2016) (using an earlier six-month study period, to avoid the anomalous market conditions in 2008 and 2009).

This is because oil pipelines are now relying on their own invalid ROE models, and manipulating the inputs for the non-DCF ROE models in the *Coakley* Briefing Order, to produce higher ROEs.

After the FERC issued the *Coakley* Briefing Order proposing the 4-Part ROE model to address anomalous market conditions for electric utilities, oil pipelines' proposed ROEs immediately and dramatically increased. On December 12, 2018, SFPP, L.P. ("SFPP") filed a Motion to Reopen the Record in Docket No. OR16-6-000 ("OR16-6 Motion"), and argued that using a 4-Part ROE model increased its Administrative Law Judge-approved DCF ROE, from 10.56% to 13.0%.[47]

In April 2019, oil pipelines also uniformly included an inflation-adjusted ROE of 16.19% in their Form No. 6 filings at Page 700.[48] The Commission uses an unadjusted ROE for jurisdictional gas pipelines and electric utilities, and removing the inflation adjustment in the oil pipelines' 16.19% ROEs produces an outrageous 18.09% unadjusted ROE.[49] Before the *Coakley* Briefing Order, those same pipelines included a

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[47] *Chevron Products Co. v. SFPP, L.P.*, Docket No. OR16-6-000, "Motion of SFPP, L.P. to Reopen the Record" at 2, 8 (filed on Dec. 12, 2018) ("OR16-6 Motion") (*citing SFPP, L.P.*, Initial Decision, 160 FERC ¶ 63,006 at P 439 (2017)).

[48] The LSG performs its own internal analysis of certain oil pipelines' Form No. 6 Page 700 data, and more than half of the Form No. 6 Page 700s that the LSG reviewed included a 16.19% real ROE for 2018.

[49] The 18.09% nominal ROE figure assumes that the inflation adjustment for 2018 was 1.9%, because 16.19% + 1.9% equals 18.09%. *See* "January 11, 2019 Consumer Price Index News Release," Bureau of Labor Statistics Economic News Release, available at: https://www.bls.gov/news.release/archives/cpi_01112019.htm (last visited June 25, 2019) (explaining that the Consumer Price Index increased by 1.9% in 2018).

12.22% real ROE in their Page 700s for 2017. Furthermore, there is currently no FERC mechanism to reduce the excessive 16.19% real (18.09% nominal) Page 700 ROEs to a just and reasonable level. Therefore, the *Coakley* Briefing Order and the NOI have already allowed oil pipelines to rely on *prima facie* unjust and unreasonable ROEs in their Page 700s and their cost-of-service rate filings.

Unlike the Commission's standardized DCF ROE model, the 4-Part ROE model has also undermined (and if adopted, would continue to undermine) the transparency and validity of oil pipeline ROEs. The sheer number of variables, inputs, and assumptions in the 4-Part ROE model means that the parties could use the same proxy group and the same six-month study period and still come up with *vastly different* ROEs.

Oil pipeline witnesses are also developing their own ROE models to supplant the *Coakley* Briefing Order 4-Part ROE model. For example, SFPP's OR16-6 Motion included an affidavit where Dr. Michael Webb admits that the Risk Premium model "would not work in the case of oil pipelines."[50] But instead of using a three-part ROE calculation, Dr. Webb used companies' excessive *earned* ROEs, instead FERC-approved just and reasonable ROEs, to calculate the fourth ROE his own four-part ROE model.[51]

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[50] OR16-6 Motion, Exhibit A-Affidavit of Dr. Michael Webb on Behalf of SFPP, L.P. at P 31.

[51] *Id.* at PP 31-32.

Dr. Webb also included a size premium in the CAPM analysis, and applied a novel adjustment to the Value Line data for the Expected Earnings ROE calculation.[52]

In the NOI, the Commission explained that it was considering the 4-Part ROE because investors use methods other than the DCF to estimate returns, and "relying on multiple financial models makes it more likely that the Commission's [ROEs] will accurately reflect how investors make their investment decisions."[53] But this justification is only valid if the non-DCF ROE models are designed to estimate just and reasonable returns (which, for example, Dr. Webb's proposed "risk premium" model does not), and the results are actually driven by the market data as opposed to the assumptions and adjustments. After the *Coakley* Briefing Order, oil pipeline ROEs are now wholly arbitrary, a measure of nothing (except, perhaps, the extent to which the pipeline thinks it can manipulate its ROE for its own self-interest). Therefore, it is not the case that the 4-Part ROE will "accurately reflect how investors make their investment decisions."[54]

Further, because oil pipelines are now inventing their own ROE calculations, there is no way for shippers to replicate or validate an oil pipeline's non-DCF ROE. This lack of transparency, in turn, makes it more difficult for shippers to decide whether to file protests or complaints against an oil pipeline's rates. Thus, the Commission's

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52 *Id.* at PP 22-23, 26-27.

53 NOI, 166 FERC ¶ 61,207 at P 24.

54 *See* NOI, 166 FERC ¶ 61,207 at P 24.

ratemaking structure for oil pipelines-which relies entirely on shipper protests and complaints-has already been undermined by the lack of transparency and validity associated with the 4-Part ROE model.

The uncertainty created by the *Coakley* Briefing Order and the NOI will also have a lasting impact on the industry, particularly for oil pipelines. The proposed 4-Part ROE would only achieve the same level of standardization, transparency, and validity as the current DCF model (if ever) after many litigated oil pipeline cost-of-service proceedings. This is because standardization only occurs when the Commission issues orders approving or rejecting parties' proposed ROE calculations. Further, the Commission's orders on the 4-Part ROE for electric utilities and gas pipelines would not necessarily be meaningful precedent for oil pipelines. For example, oil pipeline witness Dr. Webb agrees that the Commission's proposed Risk Premium model for electric utilities cannot be applied to oil pipelines.[55] Oil pipelines are also using their own modified versions of the other ROE models described in the *Coakley* Briefing Order to calculate their ROEs.[56]

The Commission can therefore only resolve this morass of industry-specific issues in oil pipeline cost-of-service rate cases. But, unlike electric utilities and gas pipelines, oil pipeline rate cases are few and far between, due to indexing. Given the

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[55] *See* OR16-6 Motion, Exhibit A-Affidavit of Dr. Michael Webb on Behalf of SFPP, L.P. at P 31.

[56] *See id.* at PP 22-23, 26-27, 31-32.

relative lack of rate review, it is likely that the Commission will *never* develop a standardized 4-Part ROE for oil pipelines. Additionally, oil pipelines are now empowered to include an arbitrary non-DCF ROE in their Form No. 6 Page 700s. For the vast majority of oil pipelines, those non-DCF ROEs will *never* be subject to a rate review at the Commission. Therefore, for shippers, the reality that oil pipeline ROEs now lack transparency and validity following the *Coakley* Briefing Order and the NOI could continue for the foreseeable future, if not indefinitely.

D. The Commission Should Continue to Rely On Its Standard DCF Model to Calculate Oil Pipeline ROEs, and Make Targeted Changes to the DCF Model, As Necessary, to Address Any Demonstrable Changes In Market Conditions or Problematic Inputs That Arise On a Case-By-Case Basis.

As explained above, the Commission's rationales for proposing the 4-Part ROE in an electric utility rate case do not apply to oil pipeline rates. Specifically, there is no basis to conclude that the DCF model is producing returns that are too low to maintain credit and attract capital for oil pipelines, and finding otherwise in the NOI would conflict with the Commission's precedent in *Seaway*.[57] Additionally, given the relative lack of rate review for oil pipelines, it is unlikely that the Commission could *ever* credibly claim that the 4-Part ROE is sufficiently standardized to reflect investor expectations for oil pipelines.[58]

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[57] *See Seaway*, 154 FERC ¶ 61,070 at P 194.

[58] *See* NOI, 166 FERC ¶ 61,207 at P 24.

As the Commission noted in Opinion No. 511-A, it is essential that the FERC engage in "reasoned," and "judicious," decision making on issues related to oil pipeline ROEs, because the "*rate may continue indefinitely due to indexing*."[59] The LSG submits that the Commission should therefore engage in reasoned, judicious decision making, and continue to rely on its standardized DCF ROE, and not the 4-Part ROE (or *any* new ROE models), for oil pipelines. The Commission should also continue its effective practice of only making necessary changes to address demonstrable issues with the DCF model on a case-by-case basis, in on-the-record proceedings. There are many examples of the Commission successfully taking this more careful, considered approach to address issues with the DCF model in FERC precedent.

For example, in its Oil Pipeline Proxy Group Policy Statement, the Commission made limited, necessary changes to its DCF model to reflect the fact that many publicly traded pipeline companies were converting to MLPs, which frustrated parties' efforts to identify a properly-sized proxy group. In that proceeding, the Commission adopted narrow changes to the DCF model, to specifically address the issue related to MLPs. At the same time, the Commission expressly declined to adopt other ROE models, like the Risk Premium model in the NOI, because doing so would inject unnecessary

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[59] *SFPP, L.P.*, Opinion No. 511-A, 137 FERC ¶ 61,220 at P 258 (2011) ("Opinion 511-A"), *vacated and remanded on other grounds*, *United Airlines, Inc. v. FERC*, 827 F.3d 122 (emphasis in original).

uncertainty into the FERC's ratemaking policies.[60] Specifically, the Commission found that the DCF model "is a well established method of determining [ROE], and other methods such as the risk premium model have not been used by the Commission for almost two decades [therefore] the uncertainty that would be created by reopening its procedures to include other approaches outweighs any limitations" in the DCF model it adopted for MLPs in that proceeding.[61]

As another example, in *SFPP, L.P.*, Commission adopted an earlier six-month study period, because the market data during the later time period data reflected the stock market collapse in 2008-2009, and included a negative inflation rate.[62] In another rate case, *El Paso Natural Gas Company*, the Commission only relaxed the screens for the proxy group companies after thoroughly evaluating the record evidence, and determining that the proxy group would still include only those companies with risks that were comparable to the regulated pipeline.[63]

In sum, if the Commission *were* to identify issues with the DCF ROEs for oil pipelines (which, it currently has not), nothing suggests that the FERC cannot address those issues by making necessary and narrowly-tailored changes to its standardized

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60 *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at PP 51-53 (2008) ("Oil Pipeline Proxy Group Policy Statement").

61 *Id.* at P 53.

62 *See SFPP, L.P.*, 134 FERC ¶ 61,121 at P 209 ("*SFPP, L.P.*"); *vacated and remanded on other grounds*, *United Airlines, Inc. v. FERC*, 827 F.3d 122.

63 *El Paso Natural Gas Co.*, 145 FERC ¶ 61,040 at PP 627-635 (2013).

DCF model. Unlike the NOI, which is essentially a chaotic and unneeded solution in search of a problem, this approach would be consistent with the Court's requirement that the Commission engage in reasoned decision making when it changes course on its ROE policies.[64]

E. The Commission Should Take Immediate Action to Remedy the Fact that Oil Pipelines' Page 700 ROEs Lack Transparency and Validity Following the *Coakley* Briefing Order, and Limit Oil Pipelines' Efforts to Rely on the NOI to Manipulate Their ROEs and Rates.

If the Commission does revise its ROE policies for oil pipelines, then the Commission should find that oil pipelines can only rely on the non-DCF ROE models in the context of litigated cost-of-service rate cases. This would maintain parity between oil pipelines and jurisdictional electric utilities and natural gas pipelines, and place reasonable limits on oil pipelines' efforts to manipulate their self-reported Page 700 ROEs to their benefit, and to the detriment of the rest of the industry. The Commission should also take immediate remedial action and require oil pipelines that are not in compliance with the new policy to revise their Page 700 ROEs and cost-of-service data accordingly.

For jurisdictional electric utilities and gas pipelines, the 4-Part ROE model would only impact ratepayers *after* the regulated entity submits a rate filing that includes a 4-Part ROE, and the Commission issues an order adopting that ROE as just and

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64 *See e.g. Emera Maine*, 854 F.3d at 28-30.

reasonable. In other words, electric utilities and gas pipelines can only adopt a non-DCF ROE model to calculate their ROEs in the context of a cost-of-service rate case. The Commission's rate review also potentially limits ratepayers' exposure to the negative characteristics (*i.e.*, the lack of transparency and risk of manipulation) associated with the 4-Part ROE model.

Conversely, shippers on oil pipelines are already experiencing the negative impacts of the 4-Part ROE model. Specifically, oil pipelines are now free to create their own 4-Part ROE models, and include the resulting ROEs in their Page 700 filings. Given that oil pipelines uniformly included an outrageous 16.19% real (18.09% nominal) ROE in their Page 700s for 2018, the LSG believes that this has *already* occurred. As explained above, if an oil pipeline's Page 700 ROE departs from the DCF ROE, that ROE is now essentially a measure of nothing, except the extent to which a pipeline is willing to manipulate its ROE to its own advantage.

The fact that oil pipelines' Page 700 ROEs now lack transparency and validity is not merely an accounting or financial reporting issue. It has the potential to materially, and permanently, undermine the validity of the Commission's indexed rates. As explained above, if a sufficient number of oil pipelines filed anomalously high ROEs (*e.g.*, 16.19%) on their Page 700s, that could impact the calculation of the index during the next Five-Year Review proceeding, which will commence in 2020. For example, pipelines could report higher ROEs and total cost-of-service data then they would be

able to justify under a DCF ROE, and show cost increases that far exceed the changes in the PPI-FG data. Under that circumstance, the manipulated ROE data would be enough to arbitrarily increase the index for the five-year period beginning 2021. And because the Commission's index is cumulative, the arbitrary 2021-2025 index would continue to impact oil pipeline rates in perpetuity, for as long as the Commission maintains its indexing policies.

If oil pipelines are allowed to artificially inflate their Page 700 ROEs to unjust and unreasonable levels, that could also impact a shipper's ability to challenge their base rates or their indexing rate increases. For example, a pipeline could inflate its Page 700 ROE and the resulting cost-of-service so that its indexing rate filing does not meet the Commission's "percentage comparison test" for challenging an indexing rate increase. This would arbitrarily shield its indexing rate increases from rate review. A pipeline that is actually over-recovering could also inflate its Page 700 ROE until the resulting cost-of-service exceeds its revenues, which could impact a shipper's ability to bring a complaint to challenge the pipeline's excessive rates.

Further, shippers currently have no ability to directly challenge an oil pipeline's Form No. 6 Page 700 ROE. The Commission also does not currently review or provide any meaningful oversight for oil pipeline Page 700 ROEs, as evidenced by the fact that the Commission is not investigating the outrageous 16.19% real (18.09% nominal) ROEs included in oil pipelines' 2018 Form No. 6 filings. But oil pipelines' Page 700 ROEs

directly impact their rates, through indexing, and by shielding pipelines from shipper protests and complaints. Therefore, the Commission should take immediate action to ensure that oil pipelines' Page 700 ROEs—and the rate impact associated with those ROEs—are just and reasonable.

Specifically, the Commission should issue an interim order stating that oil pipelines can only include an ROE that results from the Commission's standard DCF calculation in their Page 700 cost-of-service calculations. Any pipeline wishing to advocate for something other than a DCF ROE can do so in a cost-of-service rate case, but in the absence of a FERC order on the proposed ROE, the pipeline must use a DCF ROE on its Page 700. The order should also require all pipelines to certify that their Form No. 6 Page 700s only used the Commission's standard DCF ROE model. If a pipeline used something other than the DCF model to calculate its Page 700 ROEs (*e.g.*, in its 2018 Page 700), that pipeline should be required to submit a revised Page 700 that uses a DCF ROE instead of the non-DCF ROE in the cost-of-service calculation. Further, all oil pipelines should be required to make their Page 700 ROE calculations available to interested shippers, on request.

This is a reasonable remedy that would preserve an oil pipeline's ability to use a non-DCF model to set its rates if the Commission revises its ROE policies, while also ensuring that ratepayers are not unduly impacted by the fact that the Commission's ROE policies are now in flux, and likely will not be resolved for oil pipelines for the

foreseeable future. It would also put oil pipelines on par with jurisdictional electric utilities and gas pipelines, which can only rely on a non-DCF ROE model to calculate rates if the Commission approves that ROE in a cost-of-service rate case.

IV. CONCLUSION

WHEREFORE, for the reasons discussed above, the LSG respectfully requests that the Commission: 1) retain its existing DCF ROE model, instead of adopting the 4-Part ROE model (or any new non-DCF models) for oil pipelines; 2) make only targeted changes to the DCF model, as necessary, to address any demonstrable changes in market conditions or problematic inputs that arise on a case-by-case basis; and 3) issue an interim order stating that oil pipelines can only adopt non-DCF ROE models in the context of a cost-of-service rate filing, and requiring oil pipelines that included a non-DCF ROE in their Page 700 cost-of-service calculation to submit a revised Form No. 6 Page 700 that complies with the new policy.

Respectfully submitted,

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Counsel for the Liquids Shippers Group

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.

/s/ Erica L. Rancilio
Erica L. Rancilio

Dated at Washington D.C.: June 26, 2019.