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

COMMENTS OF THE
AMERICAN PUBLIC GAS ASSOCIATION

The American Public Gas Association ("APGA") submits these comments pursuant to the Notice of Inquiry ("NOI") issued by the Federal Energy Regulatory Commission ("Commission") concerning its policy on return on equity (ROE).[1] In this NOI, the Commission seeks information and stakeholder views regarding whether, and if so how, it should modify its policies concerning the determination of the ROE to be used in designing jurisdictional rates charged by public utilities. The Commission also seeks comment on whether any changes to its policies concerning public utility ROEs should be applied to interstate natural gas and oil pipelines. APGA comments only on interstate natural gas pipelines.

I. BACKGROUND

APGA is the national, non-profit association of publicly owned natural gas distribution systems, with over 730 members in 36 states. Overall, there are approximately 1,000 publicly owned systems in the United States. Publicly owned gas systems are not-for-profit retail distribution entities that are owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA members purchase interstate natural gas transportation services from pipelines at rates and under terms and conditions that are regulated by the Commission. Most are captive

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[1] *Inquiry Regarding the Commission's Policy for Determining Return on Equity,* Docket No. PL19-4, Fed. Reg. 11769 (Mar. 28, 2019) ("NOI").

to a single pipeline. APGA therefore has an interest in ROE policies that are a main driver in establishing the recourse rates that they pay.

II. COMMENT SUMMARY

Without explicitly recognizing the Diamond Anniversary of *Hope,* decided January 3, 1944,[2] the Commission has picked a nice time to assess its ROE policies. APGA also appreciates the work underlying the NOI presentation. APGA believes that the Commission should examine how its ROE methodology captures the "corresponding risks" of enterprises compared to regulated interstate pipelines "to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[3] In the main, that risk for interstate natural gas pipelines is overstated, so the Commission could improve its methodology.

As for this NOI, APGA is of two minds. On the one hand, APGA's members are mostly captive recourse rate shippers on a single pipeline, dependent on rate regulation, desiring the lowest ROE's possible to reduce recourse rates. On the other hand, APGA members are gas distributors dependent upon safe and available pipeline capacity to supply their systems. Yet the costs of pipeline safety should be moderate and monitored, and pipelines should not be constructed in the absence of public need. APGA member loads in the main are flat and new capacity is not generally required; pipeline growth has been prompted mostly by gas-fired electric generation and proliferating production in the past couple of decades. Therefore, APGA looks for the Commission to keep ROEs low and determinations transparent when implementing the Discounted Cash Flow (DCF) methodology.

The Commission should appreciate the gap between the results of its interstate natural gas pipeline ROE proceedings and those in the states that regulate natural gas distribution companies: the states produce lower ROEs. On the surface, the explanation for that is the

[2] *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944)(Hope).
[3] *Id.* at 605.

monopoly franchise awarded to a local distributor. But competition among interstate pipelines is mitigated by FERC policies, and bullish markets for natural gas have driven up effective returns. Some pipes have “honeypot” markets where producers in particular are paying profitable rates under long-term contracts because they are desperate to get their product to the (international) market. The pipeline’s location locks up that profitable market. A pipeline’s location also determines how many captive shippers it will serve, and some pipelines benefit from that lack of competition more than others.

There are regulatory factors that favor interstate pipelines. First, rate design: a straight fixed variable rate design ensures the collection of a pipeline’s fixed costs provided that its rates are determined on an accurate contract base. Second, a selective discount policy: the Commission’s stubborn adherence to the old saw that discounts help captive shippers shifts the risks and costs of competition to captive shippers. Third, rate trackers and surcharges: despite the preference against them, pipelines have trackers and the opportunity for surcharges including a modernization surcharge under Commission policy.

In summary, APGA does not see a need to deviate from the DCF methodology. Change may be more pertinent to the RTO markets given the decentralization of electricity production. Interstate natural gas pipelines have been enjoying healthy ROEs as demonstrated by the 2018 Form 501-G filings. But the Commission should take a more realistic view of competition and risk in the interstate natural gas pipeline market.

A. Role and Objectives of the Commission’s Base ROE Policy

The Commission seeks comment on the role of base ROE in investment decision making and what objectives should guide the Commission’s approach to our base ROE policy apart from the basic *Hope/Bluefield* standard.

In this realm, the interests of for-profit corporations seem to have the louder voice if not the only voice. Investor perceptions are usually analyzed and presented at the Commission by entities sympathetic to higher returns for regulated companies. Few if any voices are heard from consumer-oriented entities. Consider for example the phenomenon of sustained lower interest rates in the U.S. economy. This historical average of annual yields on long-term government bonds was 5.23% from 1926 to 2010, but the long-term government bond stood at just 2.72% in 2016.[4] That has fallen to approximately 2.4% today. Have pipeline returns declined proportionately? No.

Instead of concluding that an equity return 2-3 times higher than the yield on government debt would *overjoy* equity investors, "experts" generally opine that low interest rates drive up demand for equites and inflate stock prices, requiring higher returns on equities. That conclusion does not seem logical. The Commission should not agree that higher returns for utility investment into interstate natural gas pipelines are called for in a low interest rate environment. Unfortunately, the Commission actually appears concerned that such systemic lower rates are unreasonably diluting pipeline ROEs.[5] This has driven the Commission to consider alternative valuation methodologies, *e.g.*, CAPM analysis, Expected Earnings analysis, and Risk Premium analysis. The Commission's conclusions that the comparisons to the other valuation methodologies supported setting the New England Transmission Owners' ROE above the midpoint of the DCF zone of reasonableness should have no bearing on pipeline ROEs.

At the same time the U.S. economy has moved toward systemic lower interest rates, commodity prices have fallen as well. No better example exists than natural gas. Those lower prices have created prosperous times for pipelines. Low-cost natural gas is a popular product dependent on transport by pipelines. Pipeline risk is lower as a result.

In the nearly 100 years since *Bluefield*, many capital market truths have held constant, but markets have changed. There have been market bubbles where investors spiked equity

[4] See Duff & Phelps Ibbotson Stocks, Bills, and Inflation (SBBI) 2017 Valuation Yearbook.
[5] *See* NOI at P 18, et seq.

returns. A lower long-term interest rate environment appears ensconced in the American economy. The interstate natural gas pipeline market has remained tame. Lower ROEs, not higher, are appropriate.

B. ROEs for Different Commission-Regulated Industries

The Commission seeks comment on whether to apply a single ROE policy across electric, interstate natural gas and oil pipeline industries. APGA believes that it is not necessary nor desirable to treat interstate natural gas pipelines the same as electric transmission providers or oil pipelines. The interstate pipeline industry has had growth but is relatively calm compared with the electric transmission market. Fundamental changes to the electric market have been wrought by regional transmission organizations, distributed generation, and renewables.

Within the regulation of pipeline returns, there are changes warranted to better reflect current financial market conditions. Unfortunately, the Commission has reaffirmed its policy that, in Section 7 proceedings, incremental recourse rates for expansion capacity must be designed using the rate of return from the pipeline's most recent general rate case in which a specified rate of return was used to calculate the rates.[6] Due to the prevalence of rate-case settlements that do not result in specified returns, this policy often leads to expansion rates that are based on severely outdated returns, some from more than a decade ago. The Commission's rationale for maintaining the policy is not sound. Accordingly, APGA recommends that the Commission take a more forward-looking approach to returns in certificate proceedings.

The factual circumstances of certain Transco proceedings and the Commission's response perfectly illustrate the problem. The certificate applications for three projects were

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[6] *Transcontinental Gas Pipe Line Co.*, *LLC*, 156 FERC ¶ 61,022 (2016), *reh'g denied*, 161 FERC ¶ 61,212 (2017); *Transcontinental Gas Pipe Line Co.*, *LLC*, 156 FERC ¶ 61,092 (2016), *reh'g denied*, 161 FERC ¶ 61,211 (2017); *Transcontinental Gas Pipe Line Co.*, *LLC*, 158 FERC ¶ 61,125, *order on reh'g*, 161 FERC ¶ 61,250 (2017). Petitions for review of all of these decisions were filed with the U.S. Court of Appeals for the D.C. Circuit and dismissed for lack of standing. *FERC v. PSCNY, et al.,* No. 18-1018 (D.C. Cir. Apr. 3, 2019). APGA is not here taking a position on the legal merits of the decisions; rather, APGA is urging a change in Commission policy on a going-forward basis**.**

filed in 2015. For each, the pipeline calculated incremental recourse rates using a pre-tax return of 15.34 percent, which was the specified return from Transco's general rate case approved by the Commission back in *2002*. That 13-year-old return was used despite evidence indicating that then-current financial market conditions supported a return on equity of less than 11 percent.[7]

In rejecting arguments by state commissions that the use of the old return was improper, the Commission first noted that in certificate proceedings it reviews initial rates for service under the "public convenience and necessity" standard of Section 7 of the Natural Gas Act, which is less rigorous than the just-and-reasonable standard under Sections 4 and 5. The Commission then relied on an efficiency rationale in support of its policy of using the pipeline's last specified return rather than looking at recent data:

> [T]he Commission does not believe that conducting discounted cash flow analyses in individual certificate proceedings would be the most effective or efficient way for determining the appropriate ROEs for proposed pipeline expansions. While parties have the opportunity in section 4 rate proceedings to file and examine testimony with regard to the composition of the proxy group to use in the discounted cash flow analysis, the growth rates used in the analysis, and the pipeline's position within the zone of reasonableness with regard to risk, it would be difficult, if not impossible, to complete this type of analysis in section 7 certificate proceedings in a timely manner and attempting to do so would unnecessarily delay proposed projects with time sensitive in-service schedules. The Commission's current policy of calculating incremental rates for expansion capacity using the Commission-approved ROEs underlying pipelines' existing rates is an appropriate exercise of its discretion in section 7 certificate proceedings to approve initial rates that will "hold the line" until just and reasonable rates are adjudicated under section 4 or 5 of the NGA.[8]

The problem with the Commission's analysis is that it presents a false dichotomy in which the choice is between (i) conducting a time-consuming, labor-intensive investigation in each and every individual certificate proceeding or (ii) simply relying on a return that may be

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[7] *See, e.g., Transco*, 158 FERC ¶ 61,125 at PP 34-35.
[8] *Id.* at P 39.

outdated by years or even decades. APGA submits that there is a third alternative that is superior to both.

As the Commission recognizes, precise ratemaking is not necessary in the context of certificate proceedings. That principle was affirmed by the U.S. Supreme Court, which explained that Section 7 procedures "hold the line awaiting adjudication of a just and reasonable rate."[9] In light of this, it is unnecessary for the parties to certificate proceedings to engage in detailed examinations of matters such as proxy group composition, growth rates, and risk positioning. On the other hand, the use of an extremely old rate of return that has absolutely no connection to the pipeline's current circumstances or to current market conditions in general is simply illogical.

Accordingly, APGA recommends that the Commission take a bifurcated approach to this issue. Specifically, in a certificate proceeding involving a natural gas company for which a fairly recent Commission-approved rate of return is readily available – for example, where a specified return for the company was set in a general rate case order issued less than five years prior to the filing of the certificate application – that return should be used in the certificate proceeding.

On the other hand, where no such recent return is readily available, an approach based on wider trends should be employed. The Commission could, for example, require the use of the average of the returns specified in the three most recent interstate pipeline cases in which a return was specified. While this would of course not take into account the specific circumstances of the company seeking the certificate authority, it would have far more connection to current realities and would therefore readily meet the statutory "public convenience and necessity" standard.

In the *Transco* orders, the Commission suggested that another option would be for parties to rate case settlements to agree upon a rate of return to be used in calculating initial

9 *Atlantic Refining Co. v. Public Service Comm'n of N.Y.*, 360 U.S. 378 (1959).

rates in future certificate proceedings.[10] While this might be a workable solution for some specific pipelines and their customers, APGA sees at least two potential problems. First, the need to reach an agreement on rate of return in a rate case could derail efforts to settle the case through the black-box approach, thereby resulting in more litigation. Second, even if a return were agreed upon for purposes of certificate proceedings, it too would become stale after several years. By contrast, the approach that APGA recommends would avoid both of these problems.

C. Performance of the DCF Model

The Commission seeks comment on the robustness of the DCF model over time and under differing investment conditions.

A criticism of the DCF model is that it measures only symmetric risks while pipelines are subject to asymmetric risk. The argument goes like this: investors do not share in the upside that accrues only to consumers while investors bear the downside risk of regulatory disallowance of costs. This criticism is absurd because pipelines have the ability to control downside risk by filing to increase rates at any time. Pipelines can react to adverse events and increase rates in as little as thirty days by persuading the Commission of the need for a one-day rate suspension. Conversely, the regulator and consumers have no meaningful way of restraining higher returns because there is no refund authority under Section 5 of the Natural Gas Act. The lack of symmetry between sections 4 and 5 of the Act is what is significant.[11] As the 2018 Form 501-G filings proved, it is much more likely that a pipeline over earns its allowed ROE than under earns it. Pipeline investors receive excess returns routinely.

Further, interstate natural gas pipelines face almost no risk of cost disallowance for new facilities under the 1999 Certificate Policy Statement. Pipelines only build facilities when they

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[10] *See, e.g.,* 158 FERC ¶ 61,125 at P 40.

[11] APGA and other consumer interests have long advocated legislative reform to section 5, and FERC commissioners have supported such efforts.

have long-term contracts to support the investment. More often than not, facilities are constructed on an incremental basis for that reason. It is difficult to identify any meaningful facility cost disallowance or negative used-and useful finding in recent memory.

Famously, in *Hope* the U.S. Supreme Court intimated that all that matters is the "end result."[12] Under the present DCF methodology, there is room for the Commission to get to a more consumer-friendly end result.

D. Proxy Groups

The Commission seeks comment on the appropriate guidelines for proxy group composition, elimination of outliers, and placement of base ROE within a zone of reasonableness. Proxy groups have long been contested.

Because interstate natural gas pipelines regulated by the Commission are seldom stand-alone publicly traded companies, there is no market data of the cost of equity for them. Rather, the Commission estimates the cost of equity based on a proxy group of companies deemed "comparable." Since 1998, the Commission has made no changes in its two-step DCF methodology used for natural gas pipelines, except to require that, if a master limited partnership (MLP) is included in the proxy group, its long-term growth rate should be one-half the GDP growth estimates.[13]

Proxy groups for interstate natural gas pipelines are shrinking and are not "sufficiently large given the continued consolidation in the industries" as queried in the NOI. For example, most recently over just the past year, Boardwalk Pipeline Partners, LP, Dominion Midstream Partners, LP, Williams Pipeline Partners and Spectra Energy Partners, LP have been purchased and are no longer publicly traded. The Commission specifically queried in the NOI:

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12 *Hope* at 603 ("For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint.").

13 Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity, 123 FERC ¶ 61,048, at P 58 (2008) (citing Opinion No. 414–A).

"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?"[14] Given the declining risks of interstate natural gas pipelines, and issues with the number of possible like entities, APGA is of the mind that the Commission should be less rigid in the construction of proxy groups for natural gas pipelines so that they may be larger. Reliance on a limited handful of companies tends to yield more extreme results. The Commission should allow natural gas distributors to be included.

ROEs for natural gas distributors are set by state commissions and are lower than pipeline ROEs set by FERC. The S&P Public Utilities is a widely recognized index comprised of natural gas distributors and electric utilities. The index averaged 9.4% for the period 2013-2017. Several of the entities are very large combo utilities and not just gas distributors.

Consideration of gas distribution entities is not barred by the 2008 Proxy Group Policy Statement.[15] There, the Commission stated only its general agreement with the proposition that proxy group entities have at least 50 percent in company assets or operating income in natural gas pipeline operations; it did not "make [it] a condition of including a particular MLP in the proxy group."[16] It is not a hard and fast rule as the Commission has looked past it since.[17] APGA believes that transporting natural gas is the relevant differential. Risks at the various places in the transportation chain are similar. The Commission also can relax its screening tools to allow additional gas transportation companies with more diverse businesses—intrastate and

[14] NOI at D11.

[15] *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 11 61,048 (2008) (Proxy Group Policy Statement).

[16] *Id.* at P 79. FERC Trial Staff appears to be applying it as a rule. *See* Direct Testimony of Commission Trial Staff Witness Edward Alvarez III," Ex. No. S-0010 at pp. 12-17, filed in Northern Natural Gas Co., Docket No. RP19-59-000 (June 25, 2019).

[17] *See Kern River Gas Transmission Co.,* Opinion No. 486-B, 126 FERC ¶ 61,034, at P 83 (2009).

midstream units as well as interstate pipelines—and recognizing any higher risk of production in midstream activity by adjusting DCF results to take that risk differential into account.

III. CONCLUSION

APGA entreats the Commission to protect captive customers in its ROE policies.

Respectfully submitted,

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