Item G-1: Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity (Docket No. PL07-2-000)

“Today, the Commission proposes a change in policy with respect to the composition of proxy groups for determination of returns of equity for natural gas and oil pipelines. This change will allow pipelines organized as master limited partnerships (MLPs) to be included in the proxy group for calculation of returns under the Discounted Cash Flow (DCF) model for natural gas pipelines, and clarify Commission policy with respect to inclusion of MLPs in the DCF analysis for oil pipelines.

This proposed change is made in response to structural changes that have occurred in both the natural gas and oil pipeline sector in recent years. Historically, the Commission has required that each company included in the proxy group for purposes of DCF analysis meet certain standards, including that pipeline operations account for at least 50 percent of a company’s assets or operating income. As a result of mergers, acquisitions, and other changes in the natural gas industry, fewer and fewer interstate natural gas companies have satisfied that requirement.

In recognition of the shrinking proxy group, the Commission relaxed this requirement a few years ago. We now include diversified natural gas companies in the proxy group, without regard to what portion of the company’s business comprises pipeline operations. In a Kern River, we adjusted the pipeline’s returns to account for the relatively lower risks of diversified companies compared to pipeline companies.

In the past, we have rejected natural gas pipeline requests to include MLPs in the proxy group. While it is true MLPs have a much higher portion of their business devoted to pipeline operations, we have been concerned that MLP distributions may not be comparable to corporate dividends the Commission uses in its DCF analysis.

However, we have included MLPs in the proxy group for oil pipelines for a number of years, on the grounds there were no corporations available for use in the oil proxy group. In a number of oil pipeline cases, no party raised any issue concerning the comparability of an MLP’s cash distributions to a corporation’s dividends. However, this has arisen recently.

In short, changes in both the natural gas and oil pipeline sectors have forced the Commission to revise the way it constitutes a proxy group for purposes of calculating returns on equity. The reality is both sectors have increasingly adopted the MLP structure as the framework for the pipeline business.

That raises a policy question: have we reached the tipping point, have we reached the point where the natural gas pipeline sector has adopted the MLP to such an extent that it is perverse to exclude MLPs from the proxy group? In my view, we have reached that point. It seems clear we reached that point with respect to oil pipelines some time ago.

In my view, regulators have a duty to consider changes in policy. Often policy change is driven by changes that occur in regulated industry. In this case, I believe the structural changes in the pipeline sector require us to modify our approach and allow MLPs to be included in the proxy group.
However, we continue to be concerned about the comparability of MLP distributions to dividends. In order to assure comparability in our DCF analysis, we propose to adjust the amount of the distribution that will be included in the analysis, by capping the dividend used at an MLP’s reported earnings.

The MLP structure is a proven vehicle for investment in pipeline infrastructure. I believe the time has come for Commission policy to adjust to the structural changes that have occurred in both the natural gas and oil pipeline sectors in recent years.”