BEFORE THE

FEDERAL ENERGY REGULATORY COMISSION

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IN THE MATTER OF:	:	
COMPOSITION OF PROXY GROUPS FOR	:	Docket Number
DETERMINING GAS AND OIL PIPELINE	:	PL07-2-000
RETURN ON EQUITY	:	

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Hearing Room 1

Federal Energy Regulatory Commission

888 First Street, NE

Washington, D.C.

Wednesday, January 23, 2008

The above-entitled matter came on for technical conference, pursuant to notice at 1:00 p.m.

Commissioners Present: Commissioner Marc Spitzer and Philip D. Moeller.

FERC Staff: Penny Murrell and Frank Strzelecki - Office of Energy, Markets & Reliability.

Richard Howe - General Counsel's Office

Justin Adder - OEMI

Participants: Professor J. Peter Williamson on behalf of the Association of Oil Pipelines; Mr. J. Betram Solomon on behalf of the American Public Gas Association; Mr. Michael J. Vilbert on behalf of the Interstate Natural Gas Association of America; Mr. Park Shaper & Mr. Yves Siegel on behalf of the National Assocation of Publicly Traded Partnerships, Mr. Patrick Barry on behalf of the Public Service Commission of New York; Mr. Thomas Horst on behalf of the State of Alaska and Mr. Paul Moul on behalf of TransCanada Corporation.

P R O C E E D I N G S

(1:00 p.m.)

MR. ROBINSON: Good afternoon. This is a technical conference in Docket Number PL07-2, to discuss the methodology to be used for determining the growth rate of the equity cost of capital of Master Limited Partnerships for MLPs.

Thank you for taking the time to join us on this complex subject. Joining us today, is Commissioner Spitzer, for whom we have reserved a seat at the table.

We may also be joined by Commissioner Moeller and we have several Commissioner assistants, as well. Commissioner Spitzer intends to, as I understand it, participate for the entire conference, and ask questions of the panel, in addition, as well as the Staff.

Now, for the Staff, to my right, I have Penny Murrell from the Office of Energy Markets and Rates; Frank Strzelecki, from the same office; to my left, Richard Howe from the General Counsel's Office, like myself, and Justin Adder is also from OEMI.

Now, this conference is open to the public and does not involve ex parte communications, under the Commission's Rules, since it's a proceeding of general applicability.

However, to assure that there are no ex parte statements, we will not discuss the specifics related to any individual proceedings involving MLP issues, and the parties should refrain from mentioning any such cases.

Moreover, in preparing any final statement, we rely only on the written comments that are submitted at the end of the conference, and the conference transcript.

After the initial remarks by the Commissioners, we will have five-minute presentations by each of our panelists, to be followed by questions and discussion with the Staff panel and the Commissioners, if they so desire.

After a short break, we will have an open mike with questions to the panel, limited to today's topic, and wrap up on further steps. The order of the speakers, is as follows: Mr. Park Shaper, Mr. Bertram Solomon, Professor Peter Williamson, Mr. Patrick Barry, Mr. Michael Vilbert, Mr. Thomas Horst, Mr. Ed Siegel, and Mr. Paul Moul.

Please state your name for the record and your affiliation, before you speak. Thank you again for joining us. Commissioner, is there anything you would like to say at this time?

COMMISSIONER SPITZER: Thank you. I would like to pose questions later, but would make maybe some brief opening remarks, if you'd like.

MR. ROBINSON: Certainly, sir.

COMMISSIONER SPITZER: This is an issue of some interest to me. It's esoteric, but, in terms of the big picture, pipeline capacity is important to this country.

ROE matters are, arguably, more art than science, but it's still a basic governmental principle of balancing competing interests, the interests of the applicant in an adequate return and the interest of the ratepayers in just and reasonable rates.

And so we strive to balance, in a proper way, those competing interests. I reached the conclusion that an amicable way of looking at this, is maybe to go back in history.

In the old days, you had dividend stocks and growth stocks, and the line got blurred over time, but there's still the demarcation between yield and long-term growth. It struck me that an appropriate way of dealing with the fact that the MLPs throw up cash, is to analyze the growth aspect, rather than in the formula, rather than an arbitrary cap on distributions.

And so you've got the formulas. I've read all the materials and I'm very appreciative of all of the materials that have been submitted.

Some of the parties have commented on the issue of the entity return versus unitholder return on the MLP side. I'm interested in observations, both on the IBES and on the long-term GDP issue, as to whether there are potentials for asymmetry between the C-corporation and the MLP.

Also, there is quite a bit of interesting and valuable discussion on the IDRs, and what consequences attend to the payment of the IDRs to the general partners, for management.

And, again, there's are very interesting and complex issues regarding symmetry with respect to C-corps, some of which are, to what extent does management compensation C-corps symmetrical with the IDRs?

I know that there was a great debate on the proper treatment of stock options. Stock options grew in popularity after the 1992 tax legislation limiting management compensation to C-corporations, and to create, instead, a stock plan, arguably, aligned with the interest of shareholders, with that management.

But until -- my understanding -- and, certainly, we've got a panel of experts who know far more than I -- will correct me if I'm wrong, that these options were not treated as a drag on earnings when they were issued, but only when they were exercised.

So, that's a form of compensation analogous to an IDR. Management compensation, in C-corp states, other forms, too, that tend to reduce entity-level earnings, the asymmetry -- country club dues, drivers, cars, airplanes --

and I could go on and on and on -- perks of management, of C-corporations that are a form of compensation that are reductions of earnings.

The IDRs, of course, are not, for financial accounting, treated as reduction of entity-level, partnership-level earnings. Obviously, they affect the return at the unitholder level.

So I guess I'm looking for what I think is appropriate symmetrical treatment between the C-corporation and an MLP, taking into account that there are unique aspects to compensation of management and unique aspects to the return to the unitholder, as opposed to the corporate shareholder.

And then, I guess, one final observation would be, you've got the references made to the favorable tax treatment to the MLPs, that they're not, of course, subject to the double-level of taxation.

I think we at FERC need to be respectful of our friends in the U.S. Congress in the policy determinations that are made at the Congressional level in the Tax Code, and find a way to do our job and set just and reasonable rates, giving due recognition to Congressional policy.

I also saw some discussion of the fact that there was a tax preference to corporate dividends, as opposed to distributions to unitholders of MLPs, and would want some discussion as to whether, given the subset of that provision, at, I think, 2011, is that transitory, and have there been -- we've had preferences in capital gains over the years, we've had preferences in divided distribution over the years, but the code has changed.

Many of the parties to this proceeding, have already said they'd like some certainty and predictability in terms of how the FERC is going to analyze, are we given cases that -- we're still deciding a case and the -- I'm enough of a lawyer to believe that the case and any applicant, any parties to a proceeding at FERC, are entitled to have each case decided on the facts of that particular case.

So there's another balancing that needs to be done. But the fact that the Internal Revenue Code is going to change over time, and this current preference for corporate dividend distribution to shareholders, as opposed to MLP distributions to unitholders, may not be one that survives three or four years, much less to last the test of time.

So, with that, John, I'd like the parties to feel free to respond, as appropriate, to some of the issues that I've raised here.

MR. ROBINSON: Commissioner Moeller has joined us. Would you like to make any introductory remarks, sir?

COMMISSIONER MOELLER: They will be brief. I certainly appreciate having a tax attorney by my side right now.

(Laughter.)

COMMISSIONER MOELLER: I know I've dabbled enough in a previous life in these issues, at least in terms of legislative policy, to be dangerous, but I want to thank everyone for their efforts, the staff, the panelists, the audience, the 13 parties that submitted comments specifically related to day.

My main interest is the effect that this Policy Statement will have on rates, and I'll keep an open mind. The current method of projecting growth in the DCF model, may not adequately reflect the lower growth potentials of MLPs, but I'm here to listen and learn. Thank you all of you for your efforts and participation, and the fact that Commissioner Spitzer is by my side.

MR. ROBINSON: All right, we'll start with the panel. I've given the order. We have five minutes for your initial remarks. I'm, in particular focused on the long-term growth issues in the Notice, although other issues have been raised, as well.

We have a timer here. Justin Adder will be operating it. When the yellow light goes on, you have one minute. So, Mr. Shaper?

MR. SHAPER: All right, well, thank you. Hopefully this is working, and you can hear me. It's kind of dangerous to put me in charge of operating, even something that simple.

I am Park Shaper. I'm the President of Kinder Morgan Energy Partners. I appreciate you all having me here on the panel.

I think it's an important issue; it's a very complicated issue, as several of you have alluded to.

You know, there are a few points that I want to make, since you all have given me the time. First, MLPs are not a transitory structure. MLPs are very viable, long-term, effective financial structure, especially in which to own qualifying energy assets.

A subset of those assets happen to fall under FERC regulatory purview, interstate natural gas pipelines, interstate product pipelines. We happen to own assets of that character.

Again, they are an effective structure of owning that -- they have been an effective structure for owning those assets for decades. I expect that they will be around for many more decades.

Their equity market cap currently exceeds $100 billion, and exceeds it by a substantial margin, and it's growing fairly rapidly.

So, the MLP structure is here. I don't think it's going to go away.

I also do not believe that distribution policy -- and this applies to dividend policy, as well -- changes an entity's ability to grow. There is economic theory, financial theory, that falls along these lines.

But MLPs can grow and they can grow to at a similar rate to C-corps, and truthfully, I'll even make some arguments that they can grow at a more rapid rate than C-corps, even though they distribute all of their cash.

So, why is that? There are a number of reasons for it: First of all, there's a subset of growth that doesn't require any investment. So whether you retain your cash or whether you distribute your cash, it doesn't matter. There are some areas of growth that are just pure organic growth that an entity can have, regardless of what it does with its cash.

Second -- and MLPs have demonstrated this -- MLPs have access to the capital markets to fund growth projects that do require investment. MLPs have raised a significant amount of equity, raised a significant amount of debt in the capital markets, and they will continue to have that access.

That's been in good markets, and it's been bad markets. We've raised equity and raised debt in some very unattractive markets, and we've done it because we wanted to invest that capital.

Now, in truth -- and this is where I'll argue that there are some aspects to the structure that actually can lead to higher growth than a C-corp. The discipline of going back to the capital markets, in order to fund expansion projects, probably leads to better investments than retaining cash and trying to find an investment for that cash.

So, we as an MLP, we find projects and then we go and raise capital for those projects. We don't retain cash and then say, hey, I have to go find someplace to invest that. What that means, I believe, is that we typically make better investment decisions, which lead to fewer bad investment decisions, which leads to greater growth.

The other aspect of an MLP that I believe can lead to higher growth in the C-corp, is the general partner incentive. The general partner is motivated to grow the distributions to the limited partners. It's a very powerful incentive, and, again, can lead to higher growth than what you'll see in a C-corp.

Proof of that: We at KMP, if you just look at our regulated assets -- now, some of the assets, actually, in our product pipelines segment, aren't regulated and some of our natural gas pipelines are intrastates, but if you look at our product pipelines segment and our natural gas pipeline segment, we've invested north of $3 billion, just in expansion projects -- doesn't include acquisitions -- just in expansion projects over the last 11 years that this entity has been KMP.

And we have earned very significant returns. We've grown our distributions to our unitholders at 17 percent per year. That's the average annual rate over those last 11 years.

Again, that's just proof that this can happen, and we don't expect it to slow down, Next year, we expect to grow our distribution to our unitholders at 16 percent.

One other point that I'll make -- two points, real quick: One, I think the growth of an MLP is comparable to the growth of a C-corp, and, for simplicity's sake, comparing the two that way, is fine.

I do think you need to look at the entity level. Basically, what the equity holders, which, in an MLP situation, is a limited partners and the general partner, decide to do with the cash, with the return to them, is essentially their business and doesn't have any impact on the overall growth rate of the entity.

So if you look at the return on equity at the entity level, you're looking at it on a comparable basis to a C-corp. And you can gross up your limited partner growth and yield, in order to get there.

Since I'm out of time, I will pass it on. Thank you.

MR. ROBINSON: Mr. Solomon?

MR. SOLOMON: Thank you. My name is Butch Solomon, and I'm appearing on behalf of APGA. I apologize for my voice. I'll try to make myself heard.

We believe the Commission got it right in its Kern River and -- Offshore System Orders, where it found that the square pegs of the MLPs, did not fit the round hole of the pipeline proxy groups.

Of course the subject of this conference is to discuss how MLP growth rates should be determined, if they included in the proxy groups, which the DCF method will be applied.

If the Commission now finds that MLPs are perhaps more octagonal and might be a better fit, we believe it should at least not cut off some of the edges to make it better fit.

At this stage, while there are a number of disagreements, there are some general agreements among the comments: One, the various components of the DCF model, do interact with each other and should be determined in a consistent manner.

Secondly, it is expected that long-term growth increases per share, that it's needed for the DCF model, not earnings per share.

Three: MLPs normally have lower expected growth rates than corporations, at least as to IBES-projected short-term rates.

Four: MLPs normally have greater distribution yields than corporations.

Five: It is the earnings-per-share growth rates that are reported by IBES, and not dividend growth rates.

Here, the agreement stops. Some commenters argue that the Commission should simply apply its current pipeline growth rate determination methodology without adjustment, and if there is adjustment, to reduce the weight applied to the long-term growth rate.

I believe that would constitute error, in light of the very significant difference between corporations and MLPs, adjustments are needed to be made in determining the DCF-based investor-required ROEs or MLPs.

If the IBES short-term growth rate projections are to be used, the first adjustment would be to follow the suggestion of the Commission in its proposed Policy Statement and cap the distributions used in the dividend yield term, at no higher than the level of earnings.

That would accomplish two things: First, it would prevent double recovery of depreciation expense, as has been recognized; second, it would properly align the determination of the dividend yield term, which growth rate term of the DCF.

Alternatively, the Commission could take the suggestion of the State of Alaska and where the MLP distributions exceed its earnings, apply the ratio of the earnings per share to the distributions per share, to the IBES growth rate.

The second adjustment that's needed, is to reduce the long-term GDP growth rate component, because not only the short-term, but also the long-term growth rates of MLPs, are expected to be lower than those of corporations, their dividend yields are higher.

Thus, even with lower growth rates, the MLP DCF results will reflect investor-required rates of return.

In light of the great uncertainty with respect to the sustainability of MLP growth rates in the long-term, we have suggested that the long-term GDP growth rate be reduced by 50 percent for MLPs.

As an alternative, the Alaska suggestion could be used, as well, to apply the ratio of the earnings per share to the dividends per share.

In our additional comments, we provided some analysis that, based upon the sustainable growth rate formula for the use of -- the Commission routinely uses on the electric side, because it allows looking at each individual component of the sustainable growth, and it shows that MLPs actually have a negative growth rate when the G-equals-BR-plus-SV formula is applied.

We're not proposing that that substitute for the long-term growth rate, but we do suggest that it shows the need for reduction in the long-term growth rate.

Finally, since I'm about out of time, I have prepared an exhibit, which shows that TransCanada's Appendix A is incorrect, and we will make that available. I apologize for not being able to get all the way through these comments, but we will make them available.

MR. ROBINSON: Thank you, sir. Professor Williamson?

MR. WILLIAMSON: My name is J. Peter Williamson, and I'm here on behalf of the Association of Oil Pipelines.

In reviewing some of the submissions that have been made in this proceeding, I see attempts to do forecasting of long-term growth for MLPs, that are really very seriously deficient, and, of necessity, they are seriously deficient.

In actual cases, we look at real proxy MLPs, but to do these long-term forecasts, people have to think of a hypothetical single MLP. This can be particularly limiting, because there is no opportunity to look at the different characteristics of MLPs.

There's another important shortcoming, and that is that none of these that attempt to do long-term forecasts, take any account of management behaviors. We have examples already where managements have taken steps to increase or at least preserve growth rates of distributions to the public limited partners.

Enbridge Energy Partners formed Energy Management; Kinder Morgan formed Kinder Morgan Management. Both of those companies invest in the underlying MLP, by way of non-dividend, non-cash-dividend-paying units.

The result is that the total outflow of cash in the form of distributions to the public owners, can be substantially reduced, and what appears to be a big gap between income and cash distributions, can narrow quite a lot.

There have been recent years in which the cash distributions to the public owners of Kinder Morgan and of Enbridge, have been less than the income, measured on a per-unit basis, per-public-unit basis.

Another even that's taken place, that is ignored in all of these projections, is the 2002 decision by Enterprise Products Partners, to reduce the split between the general and the public partners, from 50/50 to 25 percent to the general partner.

This clearly benefits the growth rate for the limited partners. And the MLPs all have strong reasons to want to preserve the growth rates and increase the growth rates for the limited partners.

That, after all, is the life blood of the MLP, the ability to issue new units to limited partners. It's hard to believe that the managements of any of these MLPs will permit the growth rates to diminish, that is, the growth rates for the limited partners, to diminish to the point where it's not possible to raise substantial amounts of money from them.

Now, all of this is missing from the hypothetical long-term forecast. But the Hope and Bluefield decisions don't direct us, anyway, to long-term growth forecasts; they direct us to what investors require.

And the most -- this is certainly what the Commission has followed for some years now. The best indication of what investors require in terms of growth rates, come from IBES or similar reports of analyst forecasts.

It appears that when MLP analysts report to IBES, they are likely to be reporting distribution growth, rather than income growth.

In any case, this is where investors turn for their information and their best estimate of future growth.

I would be content, myself, to rely entirely on the IBES forecast, because it's my observation that that's what the investors do. The Commission, I believe, is acting quite appropriately in adding to those forecasts, a GDP forecast.

It tends to improve, I think, on the -- at least it certainly improves, in their judgment, and I think that's reasonable -- on the IBES forecasts, alone.

That model, using MLP proxies, has been used for nine years now, exclusively for oil pipelines, all MLP proxies, that same model that the Commission devised some years ago. It's been very successful, I think.

It has worked. If you look at the infrastructure, I think infrastructure for those nine years, has not been too low; it has not been too high. Clearly, now, there's a demand for new infrastructure.

The worst thing that can happen, is uncertainty. If the Commission will stick to that policy and make clear to the pipelines that it's sticking to that policy, I think we can expect the infrastructure that we need.

MR. ROBINSON: Thank you, sir. Mr. Barry.

MR. BARRY: My name is Patrick Barry and I represent the Department of Public Service, the Public Service Commission of New York.

I'd like to emphasize up front, that New York does not believe the Commission should include MLPs in the gas pipeline DCF proxy group. This is primarily because we are concerned that including MLPs in the group, will result in more, rather than less uncertainty in individual cases as parties litigate the issue of how and/or whether the Commission's policies should apply.

Unlike DCF-applied corporations, there is little or no financial literature, let alone consensus, on the proper growth rates for use in the DCF analysis on MLP.

As observed by the Natural Gas Supply Association, the very fact that the Commission felt the need to have a technical conference on the growth issue in the first place, augers poorly for the ease of implementing the policy without controversy, in individual cases.

With that said, I'd like to outline briefly, New York's views with respect to the questions raised in the Technical Conference Notice.

New York, like most commenters, believes it's useful to analyze short-term growth and long-term growth rates separately. For purposes of my comments, I assumed that the Commission does not cap the distributions used to determine the dividend yields for MLPs.

I also take as a given, that MLPs should have lower growth expectations than their C-corporations.

Regarding short-term growth, the Commission currently uses earnings-per-share growth projections published by IBES as a measure of short-term growth for the DCF analysis.

New York is unconvinced that using IBES projections alone, adequately reflects the lower growth potentials of MLP.

The principal support cited by the Commission for a conclusion that IBES estimates capture the relatively lower MLP growth rate, is the calculation of a 284 basis-point spread between the average corporate and MLP growth rates.

We are concerned that such a snapshot analysis does not really provide a great deal of assurance that IBES figures reflect the relatively lower growth of MLPs. I think we'd be more satisfied, if there was some back-casting done to see if that represents how it is overall, over a period of time. A snapshot, we don't think, is enough.

Furthermore, to some degree, New York shares concerns articulated by the Canadian Association of Petroleum Producers with respect to the reliability of even short-term growth estimates for MLPs, given their novelty, complexity, and lack of transparency.

Nonetheless, it would appear that, on average, IBES growth estimates for MLPs, do tend to be somewhat lower than EPS projections for corporations engaged in natural gas transmission.

Thus, to borrow from our fellow commenters at TransCanada, New York believes that using IBES projections for short-term growth, is likely to provide the least wrong answer with respect to short-term MLP growth.

I cannot emphasize enough, however, that if the Commission uses IBES projections for MLPs, it should allow parties in individual cases, to have an opportunity to challenge these IBES growth rates, to the extent that there are indications that IBES short-term growth rates are illogical or anomalous, or maybe there is a better alternative available.

Regarding long-term growth, the Commission currently uses projected growth in Gross Domestic Product as the long-term growth estimate in the DCF, applying the same GDP number to each proxy company.

If they want us to make the simplifying assumption that GDP is an appropriate long-term growth rate for corporations, then to remain consistent with that assumption, the long-term growth for the MLPs, must be somewhat lower than the GDP.

As New York and others have argued, there is a reasonable basis on which to conclude that MLPs will, in fact, grow more slowly than the economy as a whole, over the long term.

Indeed, New York does not believe there is a perfect solution to this problems, which tends to reinforce concerns with putting MLPs in the proxy group in the first place, however, we'd like to present one potential option, which would be to apply a sustainable growth analysis to the MLPs.

The sustainable growth analysis is composed of a retention growth component and a component known as an SV. As applied to an MLP retention growth in the equation, is likely to be zero, because retention growth is the measure to growth attributable to retained earnings.

Many MLPs consistently pay out more in distributions than the MLP earns. That leaves the SV portion of the equation, and this is what my fellow panelist, Kinder Morgan, was referring to as the external growth, where you go out and buy projects and finance additional projects.

Solving for SV, produces an estimate of the growth in book value attributable to the issuance of equity, which will provide a measure of sustainable growth for an MLP, derived from external sources.

Since rate base is funded by the book value of an MLP, growth in book value means that there will be a comparable growth in earnings and an increase, therefore, in the growth rate of the MLP in the proxy group equation.

Thus, SV can be used as a reasonable means of determining the sustainable external growth rate of the MLP, and would be suitable for use in a long-term growth rate in the DCF calculation.

New York agrees that further discussions of all these issues will be useful, and, accordingly, I look forward to your questions afterwards.

MR. ROBINSON: Thank you. I notice that we've been joined by John Moot, who is the Agency Chief of Staff. My apologies for not recognizing him. We have a place at the table, if you'd like to join us.

Mr. Vilbert?

MR. VILBERT: My name is Michael Vilbert, representing INGAA. First of all, I believe the MLP should be part of the proxy group.

Secondly, in principle, there's no reason at all that the MLP cannot grow as fast as a C-corporation. If there are good opportunities for investments, they'll take them in just like a C-corporation and grow every bit as fast.

However, I think it's critical, when speaking of MLPs, that we distinguish between the MLP, as a whole, the entity, and the LP units, because I believe that at least a portion of the seeming disagreement among the parties at this table, stems from failures to make that distinction when they are speaking.

For example, we can observe the distributions of the LP units and we can observe the price of the LP units, but we know that the distributions for the MLP, as a whole, is greater than that, because some of the distribution is going to the general partner.

I believe it's important to recognize that natural gas pipeline assets, whether they are held in an LP format or by a C-corporation, don't have different risk characteristics. In other words, the structure of the organization does not change the risk of the underlying assets. They are all regulated by FERC.

The way the equity holders divide up their portion of the risk and the return, does not affect the overall cost of capital for the assets.

I believe that IBES represents the best short-term information we have on growth rates for use in the model, and I also believe that distribution growth rates and earnings growth rates over any extended period of time, will be approximately the same, because, ultimately, just like dividends for corporations, dividends are paid from earnings.

I have proposed in my remarks, or provided in my remarks, a model that I call the Benchmark Model, and it's substantially more complicated than the more straightforward

FERC DCF Model. And I did that and called it the Benchmark Model, for a reason, which was to answer the question about whether or not the growth rate for MLPs, particularly when we're looking at the LP shares, are unrepresentative in some way.

You need a benchmark, I believe, to compare the results of applying the current FERC DCF methods to LP units. In that process, I built the Benchmark Model, and, by the way, if anyone at FERC Staff or anyone else would like to have a copy of that model, I'd be glad to provide the spreadsheets or whatever else you'd like to have, and full explanations of how I did everything.

But the bottom line of that is that by looking at the Benchmark Model, I believe that the Commission should feel confident that applying the current FERC DCF method to the LP units, does not result in cost of equities that are unreasonable, at least by measure of the Benchmark Model.

And, of course, all models are a tradeoff between complexity and hoped-for accuracy. The FERC model is particularly straightforward, I believe, and, in the case of pipelines, very easy to apply, and gives reasonable numbers.

I don't think it's worthwhile to try to mess with that.

Finally, I would note that the Benchmark Model is based entirely on public information. I didn't have access to MLP insiders or anything, to come up with it.

You can design everything I've done in the Benchmark Model, with reference to their own publications, IBES forecasts, and market prices of LP units.

I do caution, however, that it would be useful to periodically check the accuracy of the FERC model for MLPs, with the Benchmark Model, just to be sure that, while it's giving good results right now, that if things change in the future, it doesn't drift away from the accuracy that it seems to be providing right now. I have 28 seconds, and I'll quit early.

(Laughter.)

MR. HORST: I'm going to use this 28 seconds to pass out one additional handout, if I could. I just want to do this to facilitate the commenters' -- there's no real new information in here, compared to what was in my affidavit and the last two comments.

MR. ROBINSON: Mr. Horst, are you ready to proceed?

MR. HORST: Why don't we get these handed out to the Commissioners?

(Pause.)

Well, in my affidavit, which is attached to the comments of the State of Alaska, I took the charge seriously, to try to provide some constructive alternatives to the FERC, in making the DCF Model work as applied to MLPs.

I summarize in the first page of my handout, four alternative formulas, and I just want to call your attention to that briefly, to help you understand what the difference among them may be.

The first is the way FERC has traditionally done it, and I'm sure these basic formulas are familiar to everyone, but the issue really arises with MLPs of the difference between a cash distribution per unit, which is the D-term, and the expected growth rate from IBES, which is based on earnings, not on a cap's distributions.

And so what was in the FERC proposed Policy Statement, had this modification as to -- proposed modification as to how to calculate the distribution yield, and that's what's under my Category B at line 5.

What I did, I agreed with the commentators that said that that way of going at it, was probably not the best way, because cash is cash. This is a discounted cashflow method, and we shouldn't start by knocking down the cash distribution amount.

However, it did seem to me that there were problems with trying to apply a growth rate of earnings to a cash distribution amount. In looking into this, I found out -- I discovered that IBES actually publishes estimates for cash distributions, and I took a close look at those to see if they might be helpful.

Unfortunately, I've got the results summarized on the back of my sheet, which just summarizes how many IBES analysts were providing -- and it's indicated in Column B, earnings forecasts for the different oil and gas pipeline securities, versus how many were providing cash distributions.

As you can see there, in terms of forecasting distribution growth, in no cases, was there ever more than one analyst providing a forecast, and, in somewhat over half the cases, one analyst was providing a forecast, and, in a number of cases, nobody was giving a forecast.

So, in my view, that was really not offering a viable alternative to the FERC, to fix the problem.

I then hit upon a second way of doing it, which, if you go back to my first page, it is under Column D. Essentially, what I would do -- I'm proposing to be done, is to make a modification of the growth rate that is directly comparable to what FERC had proposed to do to the distribution yield.

You will see the obvious symmetry between -- as my Row 5, as indicated at the right, what would happen to the FERC proposal, to the distribution yield, versus what I would do to the growth rate on line 10 in here.

The idea here is essentially that if you look at total distributions, when distributions exceed earnings, there is an earnings component and an excess component, and while it may be reasonable to assume that the earning component is going to grow as the rate forecasted by IBES, I don't see any basis for assuming that the non-earnings portion of distributions, will grow at that same rate.

And this results, as you see here -- is the result of assuming that that amount is sustainable, it's flat, but it wouldn't grow over time. That's the logical underpinning for this second alternative.

I just would briefly call your attention -- in my affidavit, right at the end, there are two tables where I took 37 oil and gas pipelines -- some of them corporations, some of them MLPs -- and I estimated -- I showed in Table 1, what would happen to their DCF rates under -- as calculated now and under my alternative proposal, and then I have a summary of the results in Table 2 of my affidavit.

So, with that, why don't I stop there and have us go on to the next speaker.

MR. ROBINSON: Thank you. Mr. Siegel?

MR. SIEGEL: Thank you. Good afternoon. I appreciate the opportunity to speak with you.

I've been asked to give a presentation on behalf of the National Association of Publicly-Traded Partnerships.

I'm a Managing Director at Wachovia Capital Markets, covering MLPs. And for disclosure purposes, I do have to tell you that we do provide investment banking services for a number of the MLPs, and I personally owned Kinder Morgan since 1998, and also Pepco.

I thought it might be useful just to go over how we look at MLPs at Wachovia, and because the Commissioner did mention tax, let me just say that we believe that MLPs are generally a tax-efficient structure through which to pass cashflow to unitholders.

Let me also suggest that, from my experience, MLPs are here to stay, and it certainly looks like the trend is more, not less MLPs. I would also suggest, if you look at the dollars being committed to infrastructure and the expansion of the pipeline system in the U.S., MLPs are taking a leadership role in doing that.

And just three examples: Rockies Express, Mid-Continent Express, and Southern Access, in total, these projects are about $8 billion, so it's a significant amount of money that the MLPs are providing toward the U.S. infrastructure.

As it relates to how we look at MLPs, we focus on cashflow and the ability of MLPs to pay distributions, rather than on earnings.

Let me also comment on IBES. I think it's extraordinarily important that you review IBES, because I would suggest that the analysts, when asked for EPS growth rates, are more likely than not, talking about distribution growth rate.

I will tell you that I really focus my attention, again, on cashflow and not on earnings, and we are looking at distribution growth rates.

As it relates to the next point, we believe that MLPs have been good stewards of capital, because of the very nature of the MLP. The paradox that we are faced with, is, how does an entity grow, if they pay out all their cash in the form of distributions to their unitholders?

Well, the answer is simple: They have to rely on accessing external capital. If MLPs do not sustain or grow their distributions, they will not be able to essentially be in business for any length of time, so I think that, really, the structure, I think, adds to transparency.

So then I would also say that I would suggest that a negative growth rate, does not seem that plausible to me.

When we look at the capital structure of MLPs, we think of three components: The GP, the LP, and debt, and when we quote a distribution growth rate and look at the cashflow, we are looking at the LP, which is after the GP gets their cut.

When you think about IDRs, I totally am in agreement with Professor Williamson. At the end of the day, I think that companies will do what's in their best interest as it relates to IDRs, and I have tried to say that our LP distribution growth is after taking out the IDRs.

I think it's very, very plausible to think that companies will cut back the IDRs, if it makes sense, to sustain growth. We've seen examples of that.

Finally, just because folks have pointed to some of our research where we talk about long-term growth rates of 2.5 percent, I want to just set the record straight in that regard. In terms of forecasting, we forecast out for five years.

That's what our earnings and distribution growth models are designed to do. In terms of looking out beyond five years, we try to be conservative. We are using that long-term growth rate, if you will, to come up with a plausible valuation for the stocks that we follow.

And that is the intent; we want to be conservative, and we get paid, I get paid for picking stocks and trying to pick the guys that are going to be the winners, as opposed to the losers.

Those are really my comments. Thank you.

MR. ROBINSON: Thank you. Our last speaker is Paul Moul.

MR. MOUL: Good afternoon. My name is Paul Moul. I'm here today on behalf of TransCanada. I guess I'm the cleanup person here.

There are three points that I'd like to make in my opening statement here: One, to address the issue of why we're here; second, to make the point that the Commission should continue to use GDP growth in the second stage of the DCF Model; and, third, to comment on some of the alternative approaches that have been suggested to this point.

As to why we're here, the Commission appears to be seeking guidance on a robust and durable procedure to establish the growth rate for an MLP, if it chooses to include MLPs in the proxy group.

It's my position that the procedure to determine the growth rate for MLPs, should not represent a significant departure from the current process that the Commission is now using in the two-stage model.

At this point, the Commission should not make a significant change in the application to the DCF and to avoid, specifically, any steps backwards.

Now, as to my second point, the Commission should continue to use GDP growth in the second stage of the DCF Model, the Commission has acknowledged on many occasions, that forecasts into the distant future, are inherently less reliable than near-term forecasts.

And the way that I look at the way the Commission has -- I know the Commission Orders have expressed the first stage in terms of duration and time periods, but I actually look at the growth rates a little differently.

I look at the IBES growth rate, otherwise known as the first stage growth rate, as a company-specific growth rate. I look at the GDP, which the Commission has characterized as long-term growth rate, more as a generic growth rate.

So, what the Commission is essentially doing, at least in my mind, is coming up with a weighted average of a company-specific and a generic DCF growth rate.

Now, I believe that everybody in the room would agree that there exists, a need to attract capital to infrastructure investment, and a reduction of second-stage growth, as some have proposed, I believe, would send a negative signal from the Commission to the investment community, that the Commission would be, if it follows that approach, less supportive of infrastructure investment.

I see no reason to cut second-stage growth. Indeed, many pipelines that were formerly owned by corporate parents, are now part of MLPs, and the reorganization of pipelines from a corporate parent to an MLP, does not change their long-term growth potential. As has been mentioned earlier, it's the risk of the assets that we're really concerned with.

And what we found through empirical study, is that the evidence shows that the IBES growth rate in the DCF, actually understates the actual results that investors in MLPs have experienced historically.

That being the case, there's no need to further depress the DCF result by further undercutting either IBES or the GDP growth rate.

Now, the final point I'd like to make, deals with some of the other suggestions that have been set forth here this afternoon, and some of the comments.

One of them was the discussion of external growth, sometimes referred to as the SV-term. I've looked at some of the calculations that have been submitted in this proceeding, and what I found, is, there's just not adequate data available to implement that approach.

I look at, typically, nine MLPs that are involved in jurisdictional gas pipeline operations, and of those nine, there's only three companies that have adequate data from Value Line, in order to make those types of calculations, so I don't think that the amount of data available to implement that procedure, is adequate.

I also noticed that nobody made -- discussed the point, talked about flotation costs. I mean, if you're going to look at external financing and the need to raise new capital, I didn't see anybody at all address the issue of flotation costs, which would be another component of the required return.

And the Value Line forecasts, which are sometimes relied upon, only go out to -- the average years is 2010 to 2012, which would not conform with the Commission's view of long-term growth in the second stage.

Finally, the SV factor is already reflected in growth rates of earnings per share, at least by Value Line, who is making the forecast.

I would suspect that analysts that contribute to IBES, having knowledge of the external growth rate, would also be factoring that into their determination of the growth rate that they submit to IBES in developing that sort of consensus.

So, in summary, what I'm urging the Commission to do, is to implement a process of selecting growth that must avoid the invitation to create a lot of continuing disputes and must provide a predictable and reliable outcome from the process. I appreciate your time and look forward to your questions.

MR. ROBINSON: I guess we'll go to Staff questions at this point. I thank my colleagues indulgence, since I'd like to ask the first question.

And give me a moment to gather my thoughts, because it's been touched on by several of the panelists. Now, I've seen quite a bit of Professor Williamson's statement, so I'm starting from the premise that, in theory, the firm that has a lower retention rate, just inside our DCF model, putting less investor -- the investor looks less for growth and more for distributions, or vice versa.

If you have a higher distribution, higher retention rate, lower distribution, lower retention rate, and the emphasis is on growth; that's classic DCF analysis.

Mr. Horst referred to his concern that if you apply that classic formula, how do you account for the portion of the MLP growth in distribution, or, I would believe, also in earnings, from my own point of view, that doesn't come from reinvestment.

Let me finish my question, if I might. So, given the lower retention rates of MLPs, I'd like a further discussion of how we believe that an MLP can grow in the long run at the same rate as a corporation, that is, Gross Domestic Product, how, and specifically, mechanically, why that will happen?

So, moving beyond the general statements, a greater detail, more focus on the technical points that were raised by Mr. Horst, and are implicit in the remarks that were made, I believe, by Mr. Shaper and by Professor

Williamson, and I'd like to start with Mr. Shaper, since he's in the business. How do you do it?

MR. SHAPER: Yeah, and, I mean, mechanically how? Just starting at the end of your question, is really what I was getting at before.

I mean, there are a number of sources of growth. Some sources are organic and don't require any investment, you know. Entities have those opportunities for growth, whether they are structured as a C-corp or structured as an MLP, and that happens without any reinvestment.

We've grown our distribution by 17 percent a year since the entity became Kinder Morgan in February of 1997, so almost 11 years. Eleven years is a long timeframe; 17 percent a year, is a pretty significant growth rate.

We have done it by finding opportunities to invest capital at rates of return that are in excess of our cost of capital, and going to the financial markets and asking for capital to go and invest in those projects.

So, I mean, the way it happens, is, again, we have now an extended history of investing at reasonable returns, so generating decent returns, so our debtholders can be comfortable that they will get paid off; our equityholders can be comfortable that they'll earn a reasonable return, and of identifying projects and going to them and saying, hey, we want additional debt or we want additional equity, here are the projects that we are going to invest them in, here's why we think that those projects are going to earn us a reasonable return, give us the capital to go and do it.

And in a purely theoretical perspective, if there were no limit to the amount of projects that we could identify, that would earn us a reasonable return and that we could convince somebody that we would earn a reasonable return, there should be no limit to our growth rate, because we go out -- and, again, if we can find those projects and convince people that we are actually able to earn a reasonable return, we can go and raise the capital for investing in those projects.

So our growth rate could be considerably higher than what it is. Now, I mean, you look forward. It has been 17 percent over the last 11 years, you know, pretty significant growth.

If you look forward, what can we do, going forward? As I mentioned, next year, we expect that distribution to go up by 16 percent, so, in our 12th year, it's not going to be considerably lower than what it has averaged for the prior 11 years.

Now, that's a little bit higher than what we would expect on a recurring basis, going forward. What we expect, on a recurring basis, going forward, is that we'll grow at around eight percent a year, but that's still a pretty attractive growth rate, and, you know, is not dependent upon our retaining cash to make those investments.

It is dependent upon our identifying projects. When you get beyond our organic growth rate, it is dependent upon our identifying projects that we can invest in and earn a reasonable return.

You know, we have a set of those that we're investing in now, we have a set of those that we're working on, and if we can get customer commitments, which is what we require in order for the risk to be diminished enough for us to move forward, if we can get customer commitments, then we'll pursue those projects.

MR. ROBINSON: Thank you. If I could move on down the panel on the same question, given the framing of that answer, I'll throw in a couple of additional refinements: First of all, since we're regulators, assume that all the incremental investment were to be capped at the regulatory cost of capital, would the answer be the same; and, secondly, as a regulator, since this investment is outside our traditional DCF model, how do I quantify it in a consistent fashion, as a regulator, that could allow me to rely on it, rely on -- or how can I evaluate it methodologically, in a way that says, okay, I can just rely on external capital to see that you meet the long-term growth rate equal to the economy as a whole?

MR. SHAPER: Yes, I mean, in response to your first question, if you allow returns that are reasonable and that allow us to recover our cost of capital, then, you know, assuming we can continue to identify projects, which really is just an assumption that there continues to be a need for additional investment in infrastructure in the U.S., assuming that we can continue to identify projects, then we will continue to pursue those projects and earn a reasonable return and they'll get implemented and the MLP will grow.

In this respect, it's no different than a C-corp. I mean, whether we retain our cash or whether we distribute our cash, in order for that cash or, you know, the subsequent distribution of the case, in order for the entity to grow through investment, it has to identify projects that will earn its cost of capital.

I mean, if it goes and invests in projects that earn it below its cost of capital, the entity is actually going to shrink; it's going to be value-diminishing investment.

So, if you assume that those projects are there and you assume an efficient financial market, then MLPs or C-corps will be able to identify those projects and go and make the investment.

Now, the second part of your question, I'm not sure I completely understood. Would you mind repeating it?

MR. ROBINSON: Okay, well, my apologies on that, because I think I may have commingled the short- and long-term growth rate. But we assume that corporations grow at the same rate as GDP, and hidden behind that assumption, is that they will grow and they will continue to invest, you know, at a rate really extending the DFC model forever, assuming that they are reinvesting earnings and they're growing after five years at the same rate as GDP.

And you may have answered my question, but since the MLP has a lower retention rate, we have to make a logical jump to say that the external financing approach that you're discussing, describing, like the panel will discuss, is sufficiently consistent that we can equate MLPs with a corporation.

MR. SHAPER: Yeah. I mean, for simplicity's sake, imagine a world where there were only MLPs and there were not C-corps. So everybody distributes out all of their cash to their investors.

Again, as long as there are projects out there that are required, which means customers will support them, and that will earn your cost of capital, then that set of MLPs will go out and make that investment and that growth will happen.

Again, it's independent of whether the entity is distributing its cash, or whether it's retaining it's cash.

Similarly, you can imagine a world where there are only C-corps and nobody pays out any dividends and all the cash is retained, but there aren't any investment opportunities; there's no new infrastructure that needs to be made, well, then you're going to have a C-corp that's not going to have that portion of growth, right?

It's not going to grow at GDP, because it's going to be sitting on that cash. My point there is, again, I think that that growth and I think using GDP as an estimate of long-term growth for MLPs and C-corps, is a reasonable approach, but that growth is independent of whether you're distributing cash or retaining cash.

MR. ROBINSON: All right. Mr. Solomon, I'm not sure you would agree.

(Laughter.)

MR. SOLOMON: I would respectfully disagree. I would make two points: The first point is, what the Commission is trying to do here with the DCF, what the DCF is trying to do, is determine what expectations investors have when they commit funds in the marketplace.

Kinder Morgan, as Mr. Shaper says, may, in fact, have been able to grow distributions at 17 percent per year, compounded annually over a significant period of time. The question in investors' minds is, how long will that continue?

And I believe the information in the marketplace suggests that they don't believe that will continue indefinitely.

In fact, the second point to link onto that, Mr. Shaper himself says we've got a great track record of 17 percent per year, but even we think it will drop to less than half, after a period of time.

I think the evidence is that when you look at the utilities the Commission used in its proposed Policy Statement, and as the Commission pointed out, the IBES growth rates for the MLPs, are on the order of 280 to 300 basis points lower than for the corporations, I went back and looked at the six-month average dividend yields for the six months ending in May, which is the timeframe within which the statement was published.

And I found that the dividend yields were about 400 -- actually, a little over 400 basis points higher for the MLPs.

Now, that tells you something about the expectations of investors. They are not expecting MLPs to have an ability to continue to earn and to make high rates of distribution growth in the future.

I certainly think Mr. Shaper would hope that he could continue eight percent or 17 percent, but I think the investors in the public, are viewing that with some skepticism and I think it's shown in the relatively high dividend yields that are required for MLPs.

MR. ROBINSON: My apologies to Professor Williamson, since I'd like to go to Mr. Vilbert, because he spoke directly to this point in his testimony.

MR. VILBERT: Thank you, sir. The first test of the B times R model, I think, is, as Mr. Shaper suggested, go back and look at history. That model is supposed to work any year, not just in the long run. It's supposed to work every year.

And, of course, it doesn't begin to work to explain the history of MLPs up to this point. In addition, I included as at least one exhibit in the earlier submission in this proceeding in this Docket, showing where the cash comes from to make investments.

Some of it come from net income; a great deal comes from other sources. This B times R business, is an extraordinarily simplified model for growth.

It says that the only place you get any money, is from net income, and it seems to imply that your net income, of course, will be all cash, because the investments have to be made in cash.

Well, net income is not by any means, all cash, and there are other sources of cash, apart from net income. The exhibit that I presented, showed that there is plenty of cash flowing through a company like Kinder Morgan, and, indeed, all of the MLPs we use, to provide for generous distributions, and substantial investment.

And when you look at all of those sources of cash, income, it's true, is one, but it doesn't nearly account for the distributions and the investments. There's a greater pattern here, and, in fact, the contribution of net income, depends a great deal on your accounting.

Put in high -- take high depreciation, net income drops and B times R looks pretty bad, but the depreciation has nothing to do with your cashflow.

Cut the depreciation, follow a depreciation policy that shows very little depreciation, net income will suddenly be high; you get a high B times R. The cashflow hasn't changed a bit.

It's a very poor predictor. It was first proposed by Mike Gordon, and economist who was at the University of Toronto. He proposed this as a -- Mike actually takes credit for the DFC model, quite improperly, since it was invented by J.D. Williams, back in 1938.

(Laughter.)

MR. VILBERT: But Mike produced a version of the

DCF model that gives you a cost of capital. And he thought that the B times R was a terrific way to forecast growth.

He made a public statement at a meeting I attended of the Institute for Quantitative Research and Finance, after the IBES forecast became available. He said, by all means, go to IBES forecasts; don't use my B times R model. He was satisfied that that was the place to get good forecasts of growth.

I think he was right; it's not a good model, and it certainly does not fit the MLPs that we've been using as proxies. It's a great device, if you want the lowest possible allowed cost of equity.

It's not surprising that it would be a favorite of those who want low costs of equity, because B times R, at least at the present, will be a zero, and it doesn't matter what the growth expectations of investors are, you can get a wonderful low number to present to the Commission.

MR. ROBINSON: Mr. Barry?

MR. BARRY: I can see that happening perhaps in the competitive environment, but I look at the world of regulation, and when you look at a new project for growth, what's going to happen?

You go to the debt market to access debt for it, you go to the equity markets to access equity.

Now, in the regulation, they're going to put the cost of debt and the cost of equity in amounts that were added to the capital structure and put it all into the capital structure used for ratemaking.

Therefore, the cost of debt is going to be recovered on a one-for-one basis and the cost of equity is going to be recovered at the overall cost of equity of the firm.

The equity capital, that is, will be recovered at the overall cost of equity for the firm. I don't see that there is any great amount of growth in earnings available out there.

I do see that because the stocks are selling above book value, that there is accretion available to the company, but as far as hyper growth rates, I just don't see that in a regulated environment, because the Commission has an obligation to set a fair rate of return and a fair rate of return is the weighted average cost of capital and that will include what is the cost of the debt, the contractual cost of the debt, and it will include what is obtained to be the fair rate of return on equity.

And I just don't see how going out and investing in projects, will evolve into and necessarily equate to super growth rates like 16 percent. It's just beyond me; I just don't understand it.

MR. ROBINSON: Mr. Vilbert?

MR. VILBERT: Starting sort of from the beginning of your question, the payout of more than earnings, is not a problem, as long as the MLP has access to the capital markets, because both the C-corp and the MLP, will do capital budgeting, and they will say, what is the rate of return we'll earn from our investment? What's our cost of capital? Do we make enough money to make this investment?

And if you have access to the capital markets, then you can always go out and sell new debt and new LP units to finance your investment, and you can grow the MLP or the C-corp, if you have good investments.

I think this discussion is also one of the times where keeping the distinction between the MLP and the LP units, is important, because there's nothing to keep the MLP from growing as rapidly as it would like to invest. Its earnings will grow then, but the question is, how fast do the earnings and distributions grow for the LP units, particularly if you're financing with more LP units.

So, in general, the LP unit's growth will be lower. I actually built a model that answers the question that you've asked, because I was curious about this myself, some time ago.

And what you can observe is that there are a number of ways to grow distributions and pay out all your money. Part of it comes from what Mr. Barry mentioned, which is that if you can sell LP units at 2:1 or 3:1 market-to-book ratios, you take that 3:1 and invest it in your regulated assets, get a regulated rate of return, and that will make the earnings per share of the entire set of LP units, grow.

You can do it with leverage, by using debt. You can also use regulatory lag, because rates are set, then two or three years later, the rates may get reset again, and, in that interim, you get to earn by efficiency and organic growth and so forth.

The bottom line is that you can grow both distributions -- you can grow the MLP and you can grow the distributions to the LP units, by a combination of these techniques, assuming, in my model, perfect regulation, which is to say they only earn the allowed rate of return, they have the standard depreciation rates and so forth, and you can do it.

Again, I can give you the model, if you want to see it. It's a bit messier than the other one, but I can show it to you.

MR. ROBINSON: I'd appreciate that, and I think you can see some in this question, and, I think, the questions you'll get from my colleagues, we're using a very technical approach in this conference, because we want to really understand these technical financial issues, as much as we can, so when you give us your subsequent comments, if you could focus on that aspect of the conversation and not general policy, it would be most helpful. Yes, I would like to see the model.

Mr. Horst, you're next up.

MR. HORST: Just a couple of things: I think I agree with what Mr. Vilbert just said, but let me restate it in my own words, to make sure that I'm agreeing with what I want to agree with.

(Laughter.)

MR. HORST: It seems to me that you have potentially -- I mean, this is oversimplifying things, but suppose you have a corporate and an MLP side-by-side, and they're both growing at, you know, the rate of growth in the economy.

A corporation, hypothetically, is funding it out of retained earnings, and the MLP is funding it out of -- it's paying out all its cash as distribution and it's going back to the market and raising new capital, they can both grow at the same rate, they'll have the same earnings and all that, but what will be quite different for them, is the growth in their earnings per share, because, hypothetically, the corporation hasn't grown its number of units, whereas the MLP has grown its number of units.

Now, what's very important here, is to then focus on what is the growth in earnings per share, not total earnings, but earnings per share, and that is exactly what IBES forecasts, is the growth in earnings per share, not in total earnings.

And I think the IBES forecasts are just fine as a forecast for earnings per share. Unfortunately, I've not seen any evidence that when the analysts are submitting those forecasts, that they're really thinking about total distributions instead.

Indeed, what I found was, was that there was an opportunity for them to forecast total distributions, and most analysts decline the invitation to provide those forecasts and provide only forecasts of earnings per share.

So, what quandary that I'm left with, and I think the Commission is left with, is, well, what do you do with that remaining portion of cash distributions, the one that's over and above earnings per share? Where do you go to get your forecast for that?

I don't think you can go to the IBES forecasts of earnings per share and get that.

MR. VILBERT: Excuse me. I was being agreed with, and I want to be sure that we're all being agreed with the same way.

I agree that the result will be that earnings per share for the LP units will be lower than for the MLP as a whole, which is why the Benchmark Model that I provide, looks at the enterprise as a whole and looks at the MLP as a whole. It take into consideration, all of the distributions, both to the LP units and to the GP units.

Also inherent in that, is a higher growth rate than IBES growth rate, because the IBES growth rate is for the LP units; the GP is taking some of the distributions, and so the growth rate must be higher than is being provided to the LP units, to do that.

So the bottom line is, if you do that in the Benchmark Model, you come out about the same place as you came out with the FERC model, doing it on the LP units in a very simplified way.

MR. ROBINSON: So your response to Mr. Horst might be, is the non-earnings growth in IBES, which is, in fact, the IBES analyst has claimed, you assume that there's cashflow generated by all the sources of investment? Is that your answer?

MR. VILBERT: Well, Yves is sitting here, but his model, as I understand it, looks at the entire MLP, and he can speak better than me for himself.

MR. SIEGEL: Thank you. Number one, I really don't focus on earnings. We have an earnings model and we forecast earnings per unit, but what we really focus on, is distributed cashflow, how much cashflow is left to pay to the unitholders?

And when we submit estimates to IBES, I do not -- first of all, I don't get involved in that, but, you know, we have a sheet, and I'll talk about distribution growth.

I'm not thinking about earnings growth, number one. It's distribution growth.

Number two, I think there's also a misnomer in saying that MLPs do not retain cashflow. Again, when we model, we take out maintenance capital, so there is a portion that is retained and there is, typically, a little bit of a cushion that's retained, also, because the MLP mantra, if you will, is, never, ever cut your distribution, and I think MLPs take that very, very seriously.

Then just this notion of what investors are looking at or not looking at, I can tell you that the question that I get, is, can you tell me what you think the distribution is going to be this year, next year, and, occasionally, the year after that.

I really think it's a myth that investors are looking out that long. The question that I get, is, tell me what the yield is from the LP perspective, and tell me how fast do you think the distribution is going to grow over the next several years. That's what the investors are focusing in on.

I'd also suggest that, you know, 17-percent distribution growth, is not sustainable, but if you look at our models over the next three to five years, at least next year, we're looking at ten percent, and over a three- to five-year period, I would suggest that you would probably see somewhere in the magnitude of six to eight percent.

So, anyway, that's the way we're forecasting at Wachovia.

MR. SHAPER: Can I add something real quick? I'm sorry to interrupt.

There's been a lot of discussion about earnings and distributions. Why don't we talk about the difference, real quick?

I mean, from the back of the envelope -- and this captures, you know, 90 to 99 percent of the differences -- what MLPs will do, distributable cashflow that Yves was talking about, is actually even greater than distributions.

Typically, MLPs will distribute some amount that's under their level of distributable cashflow, so distributable cashflow is the measure of cash that they've generated.

Well, all that really is, is net income or earnings. Adding back depreciation -- depreciation is a non-cash item; it is an accounting item. The amount of depreciation that any entity recognizes, is dictated by

GAAP, and there is some flexibility in there, but it has nothing to do with what you're actually spending in order to maintain your assets.

So you add back depreciation, because that's not a cash item, and then you take off the cash that you actually are spending in order to maintain your assets, which is sustaining capital expenditures or maintenance capital expenditures, depending upon what you want to call it.

And that gets you to the number that Yves talks about, that I talk about, that MLP investors pay attention to, which is distributable cashflow, and the distributions are some level under that.

There is nothing about distributable cashflow, that is not sustainable and that cannot grow. Yes, in many cases, it is greater than net income, and it's greater than net income -- think about the two adjustments I just talked about: You add back depreciation, you take off your sustaining capital expenditures.

If your sustaining capital expenditures are less than your DD&A, less than your depreciation, then you're going to end up with a number, your distributable cashflow is going to be greater than your earnings.

But there is nothing about that, that is not sustainable. There's nothing about that in here -- I mean, let me be clear again that I'm talking about accounting depreciation. There's nothing about that, that can't grow.

And so adjusting a growth rate to say only the earnings portion of that can grow and this remaining portion that is greater than earnings, can't grow, in my mind, is completely arbitrary, and I don't think reflects reality, and I don't think reflects investors' expectations.

MR. MOUL: I'm not sure what else I can add to what already has been said, but I will make three points, and I'm not so sure I'm helping you out on the technical aspects.

One thing you really have to keep in mind, is the role that management plays. To the extent that management can get more productivity out of a given set of assets, you're going to have growth.

The models that we're talking about now, really don't capture that type of impact that management has on a business.

The second thing I want to mention that has already been brought up, is changes in capital structure. You can produce growth by changing the mix of debt and equity in the capital structure, so that's another source of growth.

And the third thing is not exactly related to what has been said so far, but think about C-corps and the situation when they go out and acquire Treasury stock. You would think, under some of the models we've talked about, BR plus SV, that a company going out and reacquiring its stock for the Treasury, is really shrinking its enterprise, but, what, if fact, happens?

Earnings-per-share growth is higher than otherwise and share price goes up. I mean, why else would corporations go out and reacquire their stock? So, in fact, the C-corps themselves, get reduced growth outside of the R plus SV, through merely reacquiring their own stock.

MR. ROBINSON: Do you have a question you'd like to ask?

MS. MURRELL: In looking at the comments, it looks like there are a couple of proposals, if the Commission wanted to pursue setting GDP -- or long-term growth at something less than GDP, for the MLP unit, I believe Mr. Vilbert, I didn't hear this in your initial comments, but it sounded like you had an idea where the Commission could look at averaging GDP with the Consumer Price Annual Inflation Rate?

MR. VILBERT: It was a target inflation rate that the Fed talks about. As I mention in the Benchmark Model, I used that to consider -- to compare and evaluate what would happen if you applied the standard FERC method and that number comes out to be 25 basis points higher than my

Benchmark Model.

And so I was looking and thinking about, well, what kind of modification, how much should it be lower, and I agree with everybody in the room who says it's very difficult to know if the LP units will grow more slowly and how much more slowly it will grow.

And so the alternative that I proposed, is, if the Commission is uncomfortable with using GDP, was this average of GDP plus the Fed's target inflation rate. In this case, I think the target inflation rate right now, is about two percent, and, averaged with GDP, it drops the -- since you weight it by one-third, it drops roughly 50 basis points from using the current model, on average.

I thought a long time about what to use for that alternative. It's a tough problem, because, as everybody has already acknowledged, you know, it depends on what you define to be the long term. How far out is it? How much below GDP? What' the role of GDP in the model? It's sort of a smoothing as some people have talked about.

What is it you're really trying to do? It makes the problem very difficult to come up with a reasonable alternative, and I confess that the best I could do, is what I proposed, this combination of inflation and GDP.

MR. ROBINSON: Not to put you on the spot, but a followon question: I read your testimony as saying there was a correlation and not causality, and if you just looked at the relationships, that's where it came out.

MR. VILBERT: That's right. In other words, I believe the Benchmark Model is the best estimate we have right now, you know, modestly speaking, of the estimate of the cost of capital for MLP.

And, therefore, if you use it as a benchmark, it's telling you, I believe, that the current FERC method, unadjusted, is getting you reasonable numbers. But if you feel that that's too high and you want to acknowledge that perhaps LP units, as opposed to the MLP, as a whole, will grow more slowly, then I propose an alternative that is also observable, in other words, GDP is observable, they forecast inflation -- or the target inflation rate is observable, and so it's something that you can use in the alternative.

That seems reasonable to me, and the Benchmark Model says it's very close.

MS. MURRELL: I'm just curious, when you picked the CPI Index, where -- is that readily published? Is it published annually or quarterly? And did you ever look at the trend and how it compares to GDP over time?

MR. VILBERT: I want to be clear that I'm talking about the target, the Fed target inflation rate. They publish that information periodically, and the most recent one I was able to find, was Chairman Bernanke saying two percent.

It's not the same as the GDP forecast that you see. This is something that's going to come out much less frequently.

The reason that I chose that, is that inflation itself -- and we're now going into an era, potentially, of higher inflation, which, because the GDP you're using in your model, is nominal, you're going to expect to see the GDP forecast be higher in the future, even though, you know, the target will still probably stay two percent, or it may creep up, if inflation starts to get out of control.

But, in other words, what I wanted, is to have something that would reflect economic conditions and change with economic conditions, and what's happening with the inflation target, is that it just modifies that a little bit, so that it doesn't move quite as much as it would have.

MR. ROBINSON: Would you like a comment from panelists that have a different view?

MS. MURRELL: Well, first, let me just ask, there was another proposal from, I believe, Mr. Solomon, and you were recommending the Commission could look at the use of 50 percent of GDP?

MR. SOLOMON: Yes.

MS. MURRELL: I was wondering if you could elaborate a little bit on if that was developed out of uncertainty in the long term, so you chose 50 percent or what the basis of that would be.

MR. SOLOMON: A good question. To some extent, uncertainty, however, one of the things that I did do, as I mentioned earlier, is to apply the now maligned BR plus SV growth rate, which includes the SV term, not just the BR term, to recognize the potential impact for future growth from external sources.

I'm not suggesting that MLPs can't grow and I don't think people here would suggest that, but I do think the expectation is for lower growth for MLPs. I think the theory holds that -- I think the practical -- what is in the marketplace, demonstrates that, plus, while I'm not suggesting applying the G equals BR plus SV formula for growth in the gas situation, although it's used routinely for electric utilities, I do think it's helpful to look at the results of applying it to test whether or not it appears likely that MLPs can grow at higher rates indefinitely.

And when I did that application, it actually came up with negative growth rates for most MLPs. One MLP that had a practice of paying out less than earnings, does show a positive growth rate.

So that suggests to me that while MLPs surely can grow in the future, it's not reasonable to expect them, nor does the investing public expect them to grow at the same rate as corporations, and the long-term growth rate should be less than the projected growth rate of GDP.

And so, yeah, the question is, where should -- what kind of adjustment should you make, and, really for lack of a better place, I decided to cut it maybe in half.

Mr. Horst suggested using the ratio of earnings per share to distributions per share, and I would think that would be a reasonable alternative. It does make sense from the standpoint of the higher your distributions are above earnings, I think the more and more difficult -- what it means is, the payout ratio has grown, and I think it's very difficult to theoretically, and, ultimately impossible, to continue to grow the payout ratio indefinitely at such high rates, and, therefore, it certainly makes sense to reduce the long-term growth rate.

Mr. Horst's ratio methodology probably would also be reasonable. I don't know if you could hear that. I apologize.

MR. HOWE: I have a question on the BR/SV. As you say, we do use that, the Commission does look at that on the electric rate side.

And when I looked at Opinion 445 in the SoCal Edison case, that Opinion contains in it, both the BR/SV calculation, plus the IBES growth rates.

And it was a very, very close correlation there between the two. But when I looked at your exhibit and compared your calculations VR/SV plus your IBES numbers for the gas and oil MLPs, there's very little or no correlation.

For example, Kinder Morgan came out with a negative 10.47 BR plus SV, whereas the IBES projection was plus-7.6 percent.

So, why is it that the BR/SV calculation seems to work well on the electric side, but from the numbers, appears not to represent at all, the investor expectations reflected in the IBES numbers?

MR. SOLOMON: I think that's a good question. I think the answer lies, really, in the payout ratio.

I'd give you -- for example, look at --

(Pause.)

Utilities, electric utilities, like gas C-corporations, do have a tendency to retain earnings, and, therefore, have payout ratios that are less than 100 percent.

When -- applying the methodology, when you have payout ratios that are greater than 100 percent, tends to very negatively affect the growth rate calculation.

And that's the primary reason. If you look at Boardwalk Pipeline, for example, it is an MLP that does retain earnings. The BR plus SV is a little over six percent, which is more in line with what IBES projects for earnings growth rates.

So, the short answer is that there is a significant difference in payout ratios get above 100 percent. I think that's the difference between what we're seeing on the electric side and what you see for MLPs.

MR. HOWE: For Mr. Barry, you're proposing that we use the SV formula for the long-term growth rate. If the overall formula really just doesn't work for the gas MLPs, is that a reason why we can use the SV half?

MR. BARRY: Yes, that's basically it. The B times R is the retention growth. You typically see negative retention growth. I would just assume, for simplification purposes, that there is zero growth from retention.

So that leaves the companies to go out to the market and then, as the gentleman from Kinder Morgan explained and some of the other panelists, they'll go out, they'll identify projects and they'll go out to the market.

Now, where I diverge from some of the panel, is that I don't see any huge growth expectations from going out to the market for capital, given a regulated structure.

Basically, the only way for a utility to grow consistently, is to grow their book value per share, to grow their, in fact, ultimately, rate base. That's where everything is going to come.

Capital costs can go up or down, but as long as your rate base is growing over the long term, that is your growth rate.

Now, there's nothing coming from retention into the rate base and there's nothing coming from retention into book value, but what is coming into retention in the current market, is that shares can be issued by MLPs and by the C-crops, in general, in a proxy group, at above-book value.

To the extent it can issue above-book value, these incremental shares, this excess in book value, accrues to each unit of the MLP. To the extent that the unit-per-share value grows, therefore, when you set a return on it, on a rate base that has also grown along with the unit per share, there is growth from that.

And that's the growth I see from SV, but I don't see it becoming 16 percent. It looks like it's considerably less at around two to three percent. That sometimes -- well, one of my examples had three, close to four percent.

I think it's really due to the accretion in the share price, related to the issuing share prices above book value.

MR. ROBINSON: Let me follow on to my colleague's question, and Mr. Shaper may also want t respond to this.

What if the MLP itself is 50 percent private, regulated, and 50 percent non-regulated, so that it has a wider range of investment opportunities? We're still only going to look at the MLP as it trades in the market. Will that change your answer?

MR. BARRY: Yeah, I think, necessarily, it has to change the answer, if some of the -- if some of it is not related to regulated operations.

The problem then is, if you're using that company, you're not developing a fully-regulated return, then; you're developing a return that is for a company that's 50/50.

I know we do this for corporations that we're probably bound now at the FERC to 50 percent to qualify for coming in, but I think that with the MLPs, you really have to look at the -- look specifically at the regulated piece, because it doesn't make sense to have -- I think it's more -- I don't have the studies to prove it, unfortunately, but it would seem to me that MLPs that are 50/50, that have an unregulated component to them, probably would be more influenced than their C-corp brothers, but I can't really say for sure.

But I think the idea is, when we're setting returns, is that you want to try and set the regulated return, and I don't whether I was clear about that.

MR. ROBINSON: Mr. Shaper?

MR. SHAPER: Well, I mean, I agree. You know, when I talk about our growth rates, clearly, we have a substantial portion of our business that's not regulated, and that's impacting that growth rate.

The other thing that I'll add, is, you know, what we're talking about here, is the growth rate component in the rate of return or in the cost of capital.

By definition, you have that growth rate component in there, and investors are expecting that, they're expecting the MLPs to grow.

Even in a regulated asset, if you're allowed to earn that return, you're earning not just, you know, your yield, your distribution, but also that growth portion, and so you can grow.

I mean, so we go, as a regulated entity, and make an investment and we earn our regulated return. Some portion of that is a function of growth, and so we are able to grow our distributions.

You know, we were talking about the different sources of growth, and I think that's one that we just overlooked.

MR. ROBINSON: Thank you.

MR. VILBERT: Well, the only thing I was going to add, is, the fact that you have unregulated assets as part of the MLP, is part of the explanation why the market-to-book ratio may be greater than one, which allows the regulated units, the regulated part of the business, to sell LP units, invest, as you say -- and I agree with that as a source -- you sell it at greater than book value, you invest in the regulated assets at book value, and you can get a return on book value, because the unregulated assets are making the market-to-book ratio higher than it would otherwise be, the regulated portion can grow at a faster rate than it might otherwise be able to grow, if it was only function of equity at 1:1.

MR. HOWE: I have a few questions on this issue of doing the DCF analysis for the entire MLP, versus doing the DCF analysis for just the limited partners.

And I see in comments with Mr. Vilbert and the National Association of Publicly-Traded Partnerships, to the methods proposed to do that.

So, starting with Mr. Siegel, in Table 3 on page 12 of your comments, you lay out adjustments to be made in order to do the DCF for the partnership, as a whole.

And I see adjustments in the Columns C and G there, to the growth rate, to increase the growth rate and increase the dividend yield to account for the general partner's increasing share of distributions under their incentive distribution rights.

But under the DCF theory, a higher growth rate of the general partner's distributions, should lead to a higher share value, which, in turn, would lead to a lower dividend yield. So, shouldn't that also be taken into account, leading this Table 3 to overestimate?

MR. SIEGEL: I'm not sure if overestimates. I think the first thing, again, just to reflect, when we do our model, we take into account, the amount of cashflow that goes up to the GP.

And what this table shows, if you look at Boardwalk, for example, you have a -- the entity growth is grossed up -- let me just start again.

When you look at the entity yield, you need to take into account, the amount of cash that goes up to the GP. So, if the LP is getting two percent -- I'm sorry, if the GP is getting two percent of the cashflow, which is the example here with Boardwalk, the entity yield is grossed up to 5.5 percent.

The growth rate is the growth rate that we see for the MLP as an entire entity, and so if you add those two numbers together, you're getting the entity return on equity.

MR. HOWE: But when you're calculating the entity yield there and you're taking into account, an increased value for the general partner shares, over the market value of the publicly-traded limited partner shares?

MR. SIEGEL: I'm sorry, say that once again.

MR. HOWE: Have you taken into account in calculating the entity yield -- well, starting with Column A, I take Column A to be the distributions to the limited partners, divided by the limited partners' --

MR. SIEGEL: Stock price.

MR. HOWE: Stock price. And then when I go to Column G, it looks like you adjusted that upward to account for the increased distribution to the limited partners, but I don't see that you adjusted through what Mr. Vilbert says, in his model, you have to take a look at the fact that with the increased growth potential for the distributions to a general partner, the value of the general partner's shares actually would increase.

MR. SIEGEL: That's right. This model differs from his model in that regard.

MR. SHAPER: Actually, I might be able to clarify this a little bit here. I think that part of its perspective.

The model that's in the PPT filing, is really coming from the perspective of a new investment, so a new pipeline.

Now, if that pipeline were to be constructed, it calculates the return that would be required in order to deliver to the limited partners, that return on equity and that growth.

And in order to calculate that return, what's going to get to the limited partners -- now, again, this has been -- this is coming from a market-based focus, in terms of what those limited partners are requiring in terms of yield and growth.

In order to deliver that to them, in the context of a new investment, you have to be able to deliver what goes to the general partner, as well.

Now, the market fully understands that sharing mechanism and how the general partner gets a portion of the cashflow, but in order to deliver that market-based return to the limited partners, you have to earn the return that's calculated on that page.

So, again, it's in the context of a new investment. I believe Mr. Vilbert's analysis is more from a static perspective of, if you're just looking at the cost of capital of the entity at a particular point in time.

The other portion -- now, it is assumed in there, in essence, that one way to look at it is that general partner equity is valued on the same basis as the limited partner equity. It actually doesn't matter for the calculation.

What the general partner equity value is, is irrelevant to that calculation, because, basically, what you're doing, is, you're taking your market assumptions on what you have to earn for the limited partners, and you're just translating that into what the entity, the MLP needs to earn, in order to deliver that to the limited partners.

MR. HOWE: Mr. Vilbert?

MR. VILBERT: In spirit, the two models are similar, because they are trying to look at the entity, as a whole. This model is much less complicated than the one that I'm proposing as my Benchmark Model.

I would point out that I think what I heard Park say and what I believe Yves is saying, is that LP equity is only a portion of the total equity of the MLP, and, in fact, the LP units, if you think about it for a second, are much less risky or less risky, at least, than the GP equity.

The reason that's true, is that the GP absorbs variation in cashflows, because if earnings are -- distributions are higher, they get a higher percentage of those distributions, while they're in these lower tiers, and if it goes the other way, they absorb a much greater part of the loss or the reduction in growth rate, because of the IDRs.

And so what their model is doing, is capturing, I think, the risk of the entity as a whole; the Benchmark Model does that also, but in the Benchmark Model, since I'm trying to apply a standard DCF approach, I believe you must gross up the price to recognize the value of the GP shares, and, in fact, the GP shares, on average, are more valuable than the LP shares.

So I gross up the price more than I gross up the distributions in the Benchmark Model, which has the effect of lowering the overall rate of return.

But, in summary, his model is much simpler than the Benchmark Model. He's trying to get to the entire risk of the entity, which is what I was trying to do in the Benchmark Model, but I'm applying a standard DCF model and felt that you had to recognize the price of the GP equity in that model.

MR. SIEGEL: Could I comment again? Just for further clarification, when you asked the question about growth and if you don't retain cash, how can you sustain the growth, I can tell you, from a practical and a pragmatic standpoint, when we go through our models, it's this process that we look at.

We'll look at what the Master Limited Partnership is paying out in terms of cashflow, to the LP, as well as to the GP. And then it gets back to what Park is saying, which is if the MLP has an investment that they are looking to finance with equity, we'll go through our model and we'll assume what the incremental return from that investment will be, how many units we think that they will have to issue, and they will have to cover this hurdle rate of the cash that has to get paid to the LP and the GP, plus the growth.

And it has to be accreted in order for that model to work, and that's how we think about it and that is, I think, what this model is trying to describe.

MR. HOWE: And you come up then with a conservative long-term growth estimate of around 2.5, above or below, depending upon --

MR. SIEGEL: Well, the two -- the -- I don't want to misrepresent. That 2.5, when I'm saying it's a conservative number, when we're looking at our discounted cashflow, we have a distribution -- two-stage distribution discount model, in which we're trying to come up with valuation ranges for MLPs.

And within that process, we chose to use 2.5 percent to be conservative and to come back to what we think is a reasonable valuation rate for the stock price.

MR. HOWE: But did the Commission take that as evidence of the long-term growth rate that investors such as you are predicting for MLPs, is somewhat less than GDP?

MR. SIEGEL: Well, I can tell you that is not necessarily the way we think about it. That's not my approach. You know, I would be the first to admit that what we do, is not with that kind of precision, and I wouldn't want to sit here and suggest to you that I'm forecasting a long-term growth, with precision.

What I'm doing, is looking at where stocks are trading in the marketplace, and trying to figure out what's a reasonable valuation range.

And within that context of the model, we're using 2.5 percent growth rates. I think, from my vantage point, you know, the reason that we've evolved to that -- and our research is evolutionary -- is the fact that, you know, other would say that MLP XYZ should yield seven percent, and I would come back and say, well, why is seven percent a reasonable number?

And so that's sort of the thought process that went into, you know, coming up with a two-stage distribution discount model in terms of our valuation.

MR. HOWE: Mr. Vilbert, I read your testimony to say that because of the IDR rates and the growth potential for the limited partnership interest is lower, and, therefore, the limited partnership DCF result would be lower than for the overall partnership, but then when you do your Benchmark Model, which seems to be the most sophisticated one we have here, for the overall MLP, you're still reaching a result.

And you end up saying, well, once we take into account, all the different factors for the general partnership, we come so close to the result for the limited partners, and that's okay for the Commission to just look at the limited partner.

And then you proposed the lower growth rate for the limited partnership, based on the --

MR. VILBERT: Just to be clear, I believe the Benchmark Model is the one that takes into consideration, as many of the things as I could figure out about an MLP. And that includes the fact that you have two types of equity, as well debt; you have the GP and the LP.

The distributions to the LP, is only a subset of the distributions for the entire entity. The market is going to value the LP units, knowing all of that about the distributions and how they are split and so forth.

And so the Benchmark Model, when I do it, I say as carefully as I can -- and I don't claim it's perfect, but it's as carefully as I can do it -- comes up with a number that, when I compare it to what you're doing with the standard FERC DCF method applied to LP units, comes out very close.

To me, it's remarkable that it comes out that close. I was stunned when I got that result.

That is why I put the caution in my testimony, saying that you need to check this periodically, to be sure that that happy circumstance continues.

And I also want to be sure to emphasize that I believe the LP units are less risky than the entire equity of the firm, and I tried to explain that in my report.

The bottom line, use the FERC DCF method applied to the LP units, and you get reasonable numbers. If, for some reason, that makes you too uncomfortable that you think you need to recognize the possibility that growth for the LP units themselves, would be a bit lower in the long term, then I offered you an alternative there, as well.

But my primary recommendation is that the Benchmark Model is telling you that the rates of return that you get from your standard model, are pretty good.

MR. ROBINSON: I have a couple of followup questions. It seems to me, practically, Mr. Vilbert, that you get this to a different model situation than the table of results that are on page 12 of, you know, the National Association of Publicly-Traded Partnerships, because they are marking up the cost of equity, it looks like to me, to fix -- to reflect the general partner's share.

And I could see how that could give a regulator a hypothetical or theoretical heartburn, because if you look at some of the numbers that are in the right-hand column, if 43 percent of the cash in the general partner for Kinder Morgan, there is a collective equity for the firm as a whole of 20.4 percent, and then you look down at Energy Transfer

Partners, 30 percent to the general partner and 17.4 percent, and while the correlation is not liner, there does seem to be a suggestion here, based on this chart on page 12, that when you get a higher share of distributions to the general partner, the risk of the firm as a whole goes up, and the implicit cost of equity goes up significantly.

In other words, it's not a risk on the assets; it's a financial risk, and it drives the cost of projected return on equity, higher than anything that we, as regulators, would likely to consider reasonable. That's troubling.

MR. VILBERT: My response is that -- well, I didn't propose --

MR. ROBINSON: I understand.

MR. VILBERT: -- that model.

MR. ROBINSON: I'm trying to -- this is between yourself and Mr. Shaper.

MR. VILBERT: And the Benchmark Model, the higher the distributions are that's going to the GP, the more valuable the GP unit is, and so the concern that you mentioned earlier about that fact that the price of the LP unit was not being increased as the distributions are being increased, shows up in that point.

In my model, the Benchmark Model, the GP share goes way up when the distributions are that high, and, therefore, it has a de minimis -- that effect is taken out of it and you don't see that big swing, because I'm recognizing that in the limit, at some point, if you get to the top tier, theoretically, both the LP units and the GP, will be getting half, each of them will be getting half of the distributions of the MLP.

At that point, the value of the GP equity, as a whole, and the value of the LP equity, as a whole, will be equal, even though when the GP started, it had two percent of the equity.

Now, that's what's happening in my model, and it's -- because the simplified model that Yves is using, doesn't consider that, you're getting numbers that seem to suggest much, much higher ROEs than I think would be justified by the DCF model, based upon a grossed-up price for the GP share.

MR. ROBINSON: Then I suppose I should go both to Mr. Siegel and to Mr. Shaper.

MR. SHAPER: I'm happy to discuss it, and, actually, like I said before, the numbers that are in the PTP filing -- and this is just math -- what that is, is what is required to be earned on a new investment made by the MLP, in order to deliver to the limited partners, that yield and that growth.

And, you know, so you start with your limited partner yield and growth that are estimated, based upon the IBES numbers, and the yield, just what's out in the marketplace. You have to gross it up for the general partner's share, because the general partner takes their share.

Again, that's a function of the partnership agreement. It is known by all the limited partners.

You have to conclude that that's factored into where it trades, and so you gross those up and you get to that return.

Now, am I saying that we require, as Kinder Morgan, a rate of return of 20 percent on projects that we pursue? No. I am saying that that's the calculation, if you take that yield and that growth assumption and say that's what you need to deliver to the limited partners for an incremental project, then that's the calculation.

It results in a wide variety of outcomes. Truthfully, I don't think that you, as the Commission, ever single out one particular number and say this is the appropriate number. I think that's why you use peer groups, and I think you appropriately use peer groups, and you average across those groups, and that is, truthfully, a lot of what we've been talking about today.

And so I'm not arguing that you should use one particular number, our number from that page. In truth, I think that Mr. Vilbert's model is an entirely appropriate model.

I would like to make a couple of points about that, and you please correct me if I'm wrong, but, you know, I think Mr. Vilbert accurately talks about the fact that the limited partner growth rate is below the growth rate of the MLP, overall, but I don't believe that he says that an MLP, talking about the entity and not the limited partner units, that an MLP cannot grow at the same rate as a C-corp.

So I believe that -- and I think it's in his model -- that he thinks the MLP growth rate, not the limited partner unit growth rate, the MLP growth rate, long-term, is appropriate at GDP.

Now, the limited partner growth rate, unit growth rate, would be lower than that, absolutely.

He proposed a way to adjust GDP to get to that limited partner growth rate, but if you start with that number and you want to get back to what's the appropriate return of the MLP, which is the pipeline, what's the appropriate return for the pipeline, what you have to do, is gross that back up to get back to your MLP long-term growth rate, which, again, I believe what he uses in the Benchmark Model, is GDP.

MR. VILBERT: I want to be sure this one point doesn't get lost, because I do think it's very important, and that is, the reason I did the model at the MLP level, is because I wanted to capture the risk of all of the equity in the firm.

If you look only at the LP units, they're, in a sense -- and they're not clearly this way, entirely, but they're more like preferred stock than the common equity of a C-corp.

And so if you don't recognize the risk differential between LP units and GP units, you're risking material errors in the estimated cost of capital.

That's why I went to looking at the MLP, as whole, and when you do that, you see that the cost of capital is estimated reasonably well by the FERC DCF method, but that captures the risk of the GP and the LP together, as opposed to the LP alone, which is less risky than the GP shares.

MR. SIEGEL: I would just say, you know, two things: That in this table, you -- I don't think it changes the answer a whole lot, but when we look at the growth rate, I think this is double-counting when they grossed up. We're looking at the growth rate, after the GP gets their fair cut.

So, I think, for Kinder Morgan, it's probably more appropriate to look at 11.6 percent, plus the 6.3 percent, and that would be closer, I think, to the answer that I would get independently for Kinder Morgan's cost of capital.

And the other thing I would say -- and so I don't, in theory, really have a problem with saying that, incrementally, the cost of equities is fairly high, but I would also point back to what the Professor said before, Professor Williamson -- and I'm not speaking for Park, but this is the way I think from an independent analyst's perspective.

If, at some point in time, the IDR burden becomes too onerous for the MLP to be able t grow their distribution, I fully suspect that, at some point in time, they might very well have to cut back on the IDRs.

And I think that's why, you know -- again, I don't mean to speak for Professor Williamson, but I think that's why one would conclude that maybe the long-term growth rate, might be higher than you might think of in a static environment.

MR. SHAPER: In truth, if you'd go to the MLP, ignoring the dynamics between the limited partners and the general partner, then you don't have any of that noise. I mean, you go to the MLP and you figure out what the appropriate growth rate is at the MLP.

Granted, what you have measurable in the marketplace to start out with, is your limited partners' units and how they trade, but if you translate that back into what it means for the overall MLP, then these kinds of dynamics don't play in -- don't come into play.

MR. ROBINSON: I would like to go Commissioner Spitzer in just a moment. What I hear at least two people telling me, is that the growth component of the organization, as a whole, is, in fact, reflected in the price of the limited partner unit, because when a limited partner purchases that unit, the limited partner takes into account, the expected allocation of the distributions between limited and the general partner, so, therefore, we should not adjust the cost of capital that's reflected in a straight DCF analysis using the trading that's going on in the limited partnership interest. Is that a fair characterization?

MR. SHAPER: I agree. I think the value of the limited partner unit on the market, reflects the sharing arrangement between the general partner and the limited partner. And that sharing arrangement does result in a lower growth rate for the limited partner unit, than what you would see at the MLP overall.

Now, part of what that means, is, if you're just using the limited partner unit growth rate, as implied by the market, you actually have to adjust that -- and it goes up -- to get to the growth rate for the MLP, as a whole.

But I do think it's true, which is what you said, that that is already reflected in the limited partner price, because the limited partners understand that; it's public, how that sharing mechanism works.

And I also agree with Mr. Vilbert's analysis that because he backed into it and he compared the two numbers, that if you do just work off of the limited partner units and their growth rate, at this point in time, you get to a very close number, as if you had gone and done all of the analysis at the MLP, as a whole.

MR. ROBINSON: Commissioner Spitzer, I believe you had some more specific questions you wanted to ask?

COMMISSIONER SPITZER: We're coming up on the break, and I could jump in after the break.

MR. ROBINSON: Okay, after the break. I guess we'll take the break here and come back to the Commissioner. Let's take a 15-minute break.

(Recess.)

MR. ROBINSON: Thank you. If you all could take your seats, I think we're ready to go to start with Commissioner Spitzer.

(Pause.)

Are we ready to come to order here? I don't have a gavel.

(Pause.)

Okay, we're back in session, and, Commissioner Spitzer, you have the floor.

COMMISSIONER SPITZER: Thank you very much. I guess there's good news/bad news. I'm just a simple lawyer with these august academics, which is a daunting task.

The good news is, I did tax work for awhile, and I had more cases, actually, under Subchapter (k), than Subchapter (c) of the Code, so partnership taxation and those numbers in the 700s, don't, by themselves, paralyze me with fear.

And I'm used to the partnership forum and, in fact, when Congress repealed Gen Utilities as part of the 1986 Act, Arizona being a real estate-oriented economy, it became very clear that it was tantamount to malpractice to put land into a C-corp.

So, I wrote a lot of tax opinions in real estate syndications that, based on the information provided to me by the syndicator, this was an entity that qualified as a pass-through entity, under the Internal Revenue Code, rather than an entity to be taxable as a corporation.

So I am mindful of that issue, and then, of course, moved on to a regulatory environment, and, again, I'd repeat my opening comment that this is an important and challenging area, and maybe I can try and recast some of my thoughts and questions for you all to respond to.

Again, being a simple-minded lawyer, I wanted to keep a big picture and maybe explore two issues, and then maybe pose some specific questions.

In terms of the -- explore some differences -- and we had some interesting discussion beyond what was in the papers, on the distinctions between the MLP and the C-corp and how that -- how those distinctions play out in the regulatory process with the narrow question of determining a proxy for long-term growth.

Then I heard different views on, really, the concept of what is the GDP or some other variation that you've proposed, a proxy for?

Is it a proxy for the long-term growth of the enterprise, or is it a proxy for the long-term return to the investors?

We know that the distributions parts of the formula, they are what they are. In the IBES, they are what they are.

But there still seems to me, at least in my mind, some confusion about what is the GDP, a long-term growth proxy for?

Now, I assumed, from the long-term basis, the IDRs would be at 50 percent, and I heard some discussion that that is not the case, and, in fact, IDRs are less than that, and I assume that the level of the set in the organic MLP agreement, that stipulates an IDR at lower than 50 percent, would be part of the case-in-chief in a hearing.

But I'd like to hear from the shippers' representatives, if their views would change, if it were a fact that instead of distribution, the rate was less than 50 percent. Let me start with Mr. Solomon for the shippers.

MR. SOLOMON: No, they wouldn't change. I think the norm is currently that the IDRs, for the most part, are less than 50 percent.

COMMISSIONER SPITZER: Over the long term?

MR. SOLOMON: Well, I guess I don't know the answer to that, over the long term.

COMMISSIONER SPITZER: Mr. Barry, in your paper, you assumed at 50-percent IDR and it just stands to reason that the long-term growth diminished as a result of the enterprise paying 50 percent of its net earnings to other than the investors.

If the IDR were a lower amount, would that change your view?

MR. BARRY: Well, I would think that if the IDR was the lower amount, that there would be -- well, I haven't really thought of it, sir.

COMMISSIONER SPITZER: Okay. You can certainly feel free to supplement, but I took that as one of the takeouts from your filing, was clearly that nexus between IDRs and long-term growth, from the investor point of view.

Mr. Horst?

MR. HORST: Well, let me say that my focus was on the cost of capital for the LP units and not for the LP as a whole, so I didn't directly get into that.

COMMISSIONER SPITZER: Okay.

MR. HORST: But for certain, the market pricing of those units, would reflect the arrangements that were in place, including the level of expectations as to what the IDRs would be.

Now, I think that one of the points is that the -- I think the level of IDRs may vary from LP to LP, and I think, for example, in Kinder Morgan, it might well be close to 50 percent, to my recollection of their information.

But I think I was seeing some other information that in a number of the other MLPs, the IDRs were a significantly lower percentage of total distributions, which may be the reason why there is some confusion as to what is the representative level.

COMMISSIONER SPITZER: Right. Okay, it seems to me clear that you can't take for a given, that the IDR is going to be 50 percent.

MR. HORST: No, but I think you can -- at least what I've taken as a given, is that, first of all, the forecast of the earnings per share that comes out of IBES, is the forecast for the limited partnership units, after taking out the IDR.

COMMISSIONER SPITZER: Right.

MR. HORST: Okay, so, I assume that the analysts are thinking long and hard about this, as I'm sure they do. They have in their minds, a forecast for the IDRs for that particular LP, you know, LP unit that they're trying to come up with the assessment for.

So, in some ways, I'm assuming -- I mean, I think it's reasonable to assume that those expectations as to what the IDRs are going to be, is one of the many factors that are embedded in the IBES forecasts of earnings per share.

COMMISSIONER SPITZER: And I am fairly comfortable with the IBES, based on that. As I said, the distributions of cash, that's real-world. Dividends, we know what they are; cash distributions, filing fees, we know what they are.

IBES is based upon analysts' view of the markets. The problem arises when you get to the GDP.

MR. HORST: Right.

COMMISSIONER SPITZER: And is the GDP -- there are arguments that the GDP needed to be reduced, including Mr. Vilbert. I want to know to what extent that assumption that the GDP was too high and needed to be reduced, was based upon a 50-percent IDR?

MR. HORST: I don't currently have a view on that, and I didn't express a view in my report.

COMMISSIONER SPITZER: I understand.

MR. HORST: All the calculations I did, were based a five-percent forecast for GDP, and I didn't make any adjustment to that number for, you know, LP units versus the limited partners as a whole.

COMMISSIONER SPITZER: Should the GDP be a proxy for the long-term growth of the enterprise, or should it be a proxy for the long-term return to the investors? We can go down the line.

MR. SHAPER: If you don't mind, I'll address, real quick, your prior question. I mean, from my perspective, there is no question that the higher you get in the split, that does have an impact on your limited partner distribution growth, everything else being held equal.

But it doesn't impact the MLP growth, and so, if you can move from the limited partners to the actual entity, that split doesn't have any impact on that.

And this then ties to your next question. I think GDP is a fair estimate for long-term growth of the entity.

And I think that's the relevant return that you should be looking at when you're setting rates, because, again, that equity will come out of whatever investment it is, you know, the pipeline. The return on equity will come out, and then it may be split, you know, according to the partnership agreement, but what you guys are talking about, is the return on the investment in the pipeline.

And that happens before you split it between the limited partners and the general partners. You know, I understand we're starting from limited partner market information, and so then you need to translate that into what it means for the MLP at the entity level.

But if, you know, what you're talking about, is a change in the general partner's share, actually, that change, again, doesn't impact the MLP, as a whole; it might impact your limited partners' growth, but the way you're grossing it back up to get from your limited partners to the MLP, as a whole, is a function of the general partner's share, and so, again, in that calculation, you end up in the same spot.

COMMISSIONER SPITZER: For the regulatory principle, though, you need to set an ROE sufficient to attract investment.

MR. SHAPER: Exactly.

COMMISSIONER SPITZER: What is the nexus, though? Investment, presumably, is in the eyes of the investor, as opposed to the enterprise value.

MR. SHAPER: It is, and so you start with the eyes of the investor from the limited partner unit, and you just translate that into what that means for the MLP, as a whole, in order to get that to the limited partners.

And, again, all that is, is a gross-up. You basically divide it by the share that the limited partner unitholder is getting. It's the calculation that Mr. Vilbert's done; it's the calculation that the PTP Partnership has.

And so you translate your limited partner yield, cash going to the limited partner, into what that means for the MLP, as a whole.

And, again, that calculation -- you can say that the growth rate may be impacted, if you increase your GP's share, but it gets netted back. That calculation takes that into account, so that when you go back to the MLP, your growth rate at the entity level, doesn't change.

And so, at the entity level, I think using GDP as an estimate for long-term growth, is entirely appropriate.

COMMISSIONER SPITZER: Who thinks it's not, under any regulatory principle? Mr. Solomon?

MR. SOLOMON: I can take a stab at that. I think the normal assumption, currently, by the Commission, is that the entities being regulated, will regress over the long term, toward the overall growth in the economy, the GDP.

I think it's very clear, and basically everybody has agreed that short-term growth rates expected for MLPs, because of, largely, their payout of something in excess of earnings, is expected to be lower.

The Commission found that in its limited sample that it included in the proposed Policy Statement. I think it's illogical to expect then the investors would expect longer-term, beyond five-year growth, at the same rate that is expected for C-corporations, and, therefore, the likelihood is that they would expect something less than the growth in distributions for the limited partnership interests than the GDP growth rate.

And I think Mr. Vilbert, in fact, provides some basis for that, but I think it seems to be clear in the marketplace, the expectation of growth for Master Limited Partnerships, is not equivalent to that for C-corporations.

COMMISSIONER SPITZER: The GDP is not a reflection of investor expectations, is it? GDP is an artificial means -- is a proxy.

MR. SOLOMON: Well, yes and no. It is a forecast of growth in the economy, but when the Commission uses it in current DCF methodology, it's using it as a substitute for the expectations of investors for the growth in dividends of the corporations over the long term.

COMMISSIONER SPITZER: So you think that GDP is used by the Commission as a proxy for the dividends, not the enterprise value; dividends to investors, as opposed to the --

MR. SOLOMON: Well, growth in dividends to investors, that's correct.

COMMISSIONER SPITZER: As opposed to -- let's take as C-corp -- as opposed -- dividends paid by a C-corp, as opposed to market value of the C-corp shares?

MR. SOLOMON: I think the answer is yes, but the expected growth is a component in the view of the mind of investors as they determine what price they'll pay at the marketplace.

COMMISSIONER SPITZER: Okay, let me -- I want to hear from everybody on this, but let me raise two issues that I see as distinctions between MLPs and C-corps, and then maybe you could respond to the GDP proxy issue, dividends to investors.

Obviously, in the case of MLP, it's a distribution to limited partners, as opposed to enterprise value.

It seems to me there's two -- there may be more, but two very salient distinctions between MLPs and C-corps. MLPs, again, because under Subchapter (k), you don't have a double tax, are tax-efficient, so they're going to operate year-to-year with a net savings of federal and state income tax, and there's a gross-up on the state, on the federal.

And this obviously is one of the reasons for the rise of MLPs, and suggests that MLPs are a tax-efficient means to raise capital to build needed infrastructure.

But there are some regulatory principles here, that are at play. In a regulatory construct, you look at the tax savings and how you apportion this tax savings in setting ROEs between the ratepayers and the investors.

But this tax savings is, it seems to me, a very substantial issue, as we set our rates.

Secondly, I think Mr. Shaper pointed out, right out of the chute, a big distinction between MLPs and C-corps, is the MLPs pay out cash distributions over depreciation expense, which is just a line item. And they can do that over time.

Now, we know that there are difference in distributions, we know that IBES analysts forecast growth distinctions, based on the fact that you've got this accounting item, this accounting entry that legally prohibits C-corps from paying distributions on that item. That same preclusion does not apply to MLPs, so the distributions from MLPs, are going to be structurally higher, and that has consequences for short-term growth.

The question is, what consequences attach to the fact that the MLPs can pay out, year-after-year, distributions over depreciation expense, in terms of the long term? So, I guess there's a three-headed monster here, and you can -- maybe the feed off of each other in terms of your response to my basic question, which is what do we do with this conundrum of the GDP and what, analytically, supports reductions from GDP for long-term growth for MLPs?

Mr. Barry, you're chomping at the bit.

MR. BARRY: Okay, I'll take a crack at the aspect of the GDP rate is probably too high for an MLP, given that it has to be externally financed.

When you're sending your cashflow -- and that includes depreciation -- out of the multiple Master Limited Partnership, you are essentially saying goodbye to that cash forever; it can no longer be used for a project; it's gone.

There is an aspect of the depreciation I'd like to touch on, too, as far as rate base goes. Once depreciation is gone, your rate base is decreased, therefore, the amount that a utility is earning on, is necessarily going lower.

That's another reason why I don't believe, in the long term, that the growth rates will be, for an MLP, greater than that of -- or greater than the GDP; in fact, they'll be quite a bit less.

Because there is no -- because the cash flows out of the company, you have to rely on projects being financed externally.

COMMISSIONER SPITZER: But, Mr. Barry, two points: One, some of the statements this afternoon, have suggested that if there is a problem in financing external growth for projects, the IDRs can be reduced to facilitate that, so the amount of the IDR is not set in stone.

Certainly, there are going to be some -- there's going to be compensation to the general partner, but, as I pointed out in my intro, C-corps compensate their management, as well, and with some of the stock option issues that, when they are exercised, reduce earnings, in the C-corp world, have been quite substantial.

Then, secondly, although corps can't pay out dividends over depreciation expense, corps can use the cash to finance external acquisitions.

So, it's not as if there's any cash management preclusion.

MR. BARRY: I like the point about cutting IDRs. I don't how sustainable that is. You can only go to zero. In the long term, is that a sustainable source? I'm not sure it is.

COMMISSIONER SPITZER: I don't think Mr. Shaper would be happy with zero.

(Laughter.)

MR. SHAPER: And I don't think the point was that it would go to zero. I mean, I think what it is, you cut that and it impacts your growth rate, and so this argument that there's some disparity between the growth rates, because of the IDRs, is diminished.

But, again, you know, I don't think that impacts the growth rate of the entity. The MLP itself, before you get to, you know, how it distributes its cash amongst its equity holders, the MLP itself, the assets that are owned in that MLP, have the same growth rate, whether they are owned in a partnership or in a C-corp.

The form of ownership and the distributions that go to the partners, don't impact that. The ability to grow is the same, regardless of corporate structure and dividend policy. I think that's traditional economic finance theory.

MR. BARRY: I would agree with that as being part of finance theory, but, also, the ability to cut the IDRs to the GP, I don't think that's an unlimited source. It's almost like a one-time option, or the GP is going to want to get out of the business.

I just don't see it as a source of long-term growth.

COMMISSIONER SPITZER: Mr. Vilbert, you obviously proposed a reduction from GDP. I don't know how grudgingly or willingly.

(Laughter.)

MR. VILBERT: I just thought I'd keep that to myself.

(Laughter.)

MR. VILBERT: I guess there are a number of questions on the table.

COMMISSIONER SPITZER: Sure.

MR. VILBERT: Let me start with a couple of them. First, as I said earlier, I do not believe that distribution policy prevents the MLP, as a whole, from growing every bit as fast as a C-corp. If capital markets -- if they have access to capital markets and you have a good place to put the money, investors will give it to you, if you have a reasonable reputation for using their money efficiently.

They will give you the money to invest, so you can grow, if you have the projects to put the money in. A C-corp can do the same thing; they get some of the money by retained earnings, they get some of the money by debt and issuing equity.

So I just don't see that part of it as an issue, and, again, this gets to the distinction between MLPs versus LP shares.

The tax question you've asked, as you probably know better than I, taxes are complex. The effect of taxes on rates of return, is a subject that financial economists like me, have thought about a lot over time.

And I will tell you that there's no universal answer to the effect of taxes on ROE. You may remember the big debates about, well, should you pay money out in dividends, which gets taxed, or should you keep it in the corporation and allow your investors to sell their shares and pay the lower capital gains tax when they're ready to get the money?

And there have been tests about whether that -- whether the rates of return were different for companies that pay dividends, and those that don't, and the answers were inconclusive.

COMMISSIONER SPITZER: I can tell you, as a lawyer, that when you had the bull market in the '90s, people were very happy with the growth model, but then if you recall, in 01, when the market declined, fund managers panicked and they started selling shares, and you ended up with depressed mutual fund prices, and investors got big K-1s in January of 02.

And you have a very unhappy client when his investment has gone down and he gets a bill from the IRS.

MR. VILBERT: And it's particularly bad when they bought it in December and lost money and get a capital gain charge to them in January.

COMMISSIONER SPITZER: Precisely. So, sometimes these investments -- the analysis of tax issues, is temporal.

I remember Mr. Horst pointed out that there was -- I hate to interrupt -- he had pointed out that there was another asymmetry, in that the MLP investors were taxed differently than those receiving corporate dividends, as a preference.

And, again, that is a temporal feature that you might disagree with. I'm sorry for interrupting.

MR. VILBERT: Well, I'm just going to piggyback on what you were saying. As you might have noticed, my report was substantially longer than everybody else's, and I can't help myself. I start thinking about these things and I get deeper into it, and I will confess at this point that I haven't figured everything about taxes yet and how the effect of taxes is --

COMMISSIONER SPITZER: You know --

MR. VILBERT: -- on the MLPs, but I will say that I don't believe that it's a simple problem that you can just point to one thing and say the difference between dividend tax rates, for example, and personal tax rates for distributions, and immediately conclude anything from that, for example, because distributions include -- a great percentage of them, many of them, are not taxable to the individual that receives them.

So the actual tax rates between those two things, the dividends versus the distributions, it's not clear that one is taxed at a higher rate than the other. That's just an example of the complexity of the tax question.

I don't have the answers yet, other than to say it needs a lot of thought.

COMMISSIONER SPITZER: But does the tax efficiency -- assume, arguendo, that these MLPs are tax-efficient and that there is a savings, ultimately, that flows through to the investors, by virtue of the tax efficiency.

MR. VILBERT: That's true.

COMMISSIONER SPITZER: What impact does it have on the long-term growth proxy?

MR. VILBERT: Well, I believe that there is tax efficiency, and if you think about it, I believe there's something like, well, 15 percent of so tax savings that goes to the MLP, because of that.

But the price that the investors will pay for an LP unit, reflects what they know about how the taxes will be handled at the MLP level. They then expect their distributions to reflect that tax savings, and the price, then, will reflect what they expect to receive in that -- from the tax savings efficiency of the MLP.

COMMISSIONER SPITZER: But for IBES, I understand. The problem is and maybe the heart of this, my concern with this, is that the GDP, as a proxy for long-term growth, doesn't incorporate those. It is indifferent to tax efficiency.

IBES is not.

MR. VILBERT: Fair enough.

MR. SHAPER: Given the tax efficiency, there is, I think, very good potential that long-term MLPs will grow at a more rapid rate than C-corps.

COMMISSIONER SPITZER: Does anyone disagree with that?

MR. VILBERT: I actually think they have the opportunity to grow at the same rate, but the tax efficiency does provide an incentive to form an MLP, in my view.

You asked about GDP in the model. To me, with all due respect to everyone in the room, the FERC model is exceedingly straightforward. It's two-thirds weight on short-term of IBES growth rates, and one-third weight on GDP, and we kind of wave our hands and say we're done, that's the cost of equity.

So, by your question, you're imposing, in some sense, perhaps more rigor on the model than exists, because you're asking, is it representing investor expectations of dividend growth? Is it representing some way to smooth the IBES forecasts, versus long-term and short-term information?

And it is, I believe, a placeholder in the model to say you have an estimate of the five-year growth rate forecast, and then you need something for the long-term, to apply to the model, and we have decided that GDP fills that role.

But nobody -- I think Professor Williamson said this -- nobody can point to anything concrete and say that GDP growth is the thing for the future. It's something that's in the model, that results in cost-of-capital estimates, that, according to the Benchmark Model that I use to make these judgments, gives you a reasonable rate of return for MLPs.

But to impose upon it, a lot more than that, probably goes beyond the rigor of the model that we've built.

COMMISSIONER SPITZER: And that rigor would apply to C-corps, as well. I mean, you can make the argument that what I was articulating, was somewhat of a rebuttal against those who say that the GDP is inadequate. Someone said they're all imperfect, but it's the best imperfect.

MR. VILBERT: That's my view. In other words, the GDP is a way -- the DCF model, if you think about its development, it's really a model that talks about dividends every year, out to infinity, literally, and then you take the present value of that and you get the very simple model.

Well, we've plugged in GDP as the long-term growth rate that we're going to use in that model, because it seems to be the best thing available. But it's kind of a -- it's ad hoc. You know, it's the best we have, but there's no real strong reason, one way or the other, that it has to be GDP.

COMMISSIONER SPITZER: Mr. Williamson?

MR. WILLIAMSON: As you pointed out, it's a number we come up with, the GDP, because we just don't know. We've got a variety of proxy companies and we don't know what their growth rates are going to be, 20 years from now.

So we plug in GDP, but if any of our proxy companies actually reach a growth rate for the limited partners, of GDP, they're very likely to go out of business.

I would expect that well before they reach that stage, the managements would figure out some way to get a higher growth rate for their limited partners.

Now, there are a number of ways they might do it: Reducing the general partner's share, for example, and going into different kinds of investments. We don't know what the portfolios will look like, 20 years from now.

And if they fail, if they simply cannot come up with growth rates greater than GDP, it seems to me that they will go out of business.

So, they've got to achieve rates that are greater than a GDP growth rate. So, a reasonable forecast, assuming that those proxy companies are still around, has to be higher than GDP.

Now, I don't know of any way of saying how much higher, but the GDP is an ad hoc sort of plausible number to put in, in the absence of any good forecast relied on by investors.

And I don't think that investors really think about what the growth rate will be, 20 years in the future.

COMMISSIONER SPITZER: You don't dispute, though, that the long-term growth for MLPs, is going to be lower than that of C-corps, all things being treated equally?

MR. WILLIAMSON: Oh, I don't know what it will be at that point.

COMMISSIONER SPITZER: But it will be less than a C-corp, would it not?

MR. WILLIAMSON: Well, it might be. Maybe there will --

COMMISSIONER SPITZER: Two, similarly situated.

MR. WILLIAMSON: Maybe the general partner won't be getting anything at that point. I don't know.

The general partner might be getting a half a percent at that point. The management will figure out some way to get the growth rate up to a respectable level, so that he has some investors, or else he'll go out of business.

And the C-corp will face the same problem, of course. If the C-corp is growing at the GDP rate, they're not going to be able to attract investors.

Now, maybe they don't need to attract investors, but they're not going to be a very attractive target.

The C-corp management is going to be concerned that we offer investors a better growth rate than the GDP rate, so they would be confronted with the same problem, I think.

Now, how the problem differs from the MLP to the C-corp, will depend very much on the structure of the MLP, and we don't know what that will be in 20 years; we don't know how they may be restructured; we don't know whether the MLP will be succeeded by some other creature at that point.

But what I think we can be pretty confident of, is that if the MLP survives and the corporation survives, they've found some way to get a growth rate for their equity investors, that's better than a GDP rate.

COMMISSIONER SPITZER: Anyone else? Mr. Horst?

MR. HORST: I just want to say that I think there are important tax issues here, in terms of what the DCF returns are on MLPs, versus corporations, over and above and distinct from the impact on the growth rates.

I understand that's your interest, and I also understood that in terms of the invitation to submit comments, that that was not the topic that commenters were asked to address.

COMMISSIONER SPITZER: I'm interested in that issue, insofar as it affects the propriety of the GDP as a long-term growth proxy.

MR. HORST: Right, yes, and that issue, I don't have a view on. But there are the other tax issues that I assume we're not talking about today.

COMMISSIONER SPITZER: Correct. My issue is the long-term proxy, and, obviously, we've got a group that feels that GDP is appropriate.

MR. HORST: Right.

COMMISSIONER SPITZER: And we have a group that has proposed changes.

MR. HORST: Right.

COMMISSIONER SPITZER: And, you know, from the C-corp -- and, you know, I'm going to listen to more, but I've identified the tax efficiency issue as perhaps an organic issue that would lead to higher growth, in that you don't have the same investor-level expense, and then the issue of the disappearing cash phenomenon of the Subchapter (k) entity, and what long-term consequences attend to that.

And they are somewhat in conflict; they are somewhat conflicting forces.

MR. HORST: Right. And, as I say, I do not have a view on that, on what's the right long-term forecast, as to how that might be impacted by tax considerations. That's really not something that I have addressed in my testimony.

MR. MOUL: I think I'd like to add a thought or two about the GDP as a long-term growth rate. One of the difficulties I have in grappling with the use of GDP as a long-term growth rate, when we go back and look at the model, the original model that the FERC crafted after looking at what Merrill Lynch and Prudential Bache did or Prudential Securities did ten years ago or 15 years ago, whenever it crafted its model, it operated on the presumption that you had this high initial growth, you had transition to something lower, and then the growth rate stayed constant for the life of the firm.

Well, the hangup I have with that, is that the fact of the matter is -- well, there's two problems with that: The fact of the matter is that corporations or MLPs, have growth patterns that run in cycles.

Sure, you might have high initial growth, transition lower, but then the cycle can repeat, and what's missing in the use of GDP as the second-stage growth rate, is the lack of recognition that these cycles repeat over time.

I mean, look at companies that have been around for, like, very long periods of time, a DuPont, for instance, that has been in business for 200 years. I mean, why do they still have double-digit growth rates? Obviously, their growth rates go through cycles over time.

And to simply the model, you say, well, it has to be GDP, because it ranges from the life of the firm. I think it sort of oversimplifies the situation.

The other problem with use of the GDP, we're saying that after a certain period of time, after five years, this lower growth rate is going to transpire, but if you look back over time with the IBES growth rates, I've yet to find when we actually reach the long term.

I mean, we've had very high growth rates for decades on end for a lot of these companies, and I just --

COMMISSIONER SPITZER: You're referring to C-corps, as well?

MR. MOUL: C-corps, as well.

COMMISSIONER SPITZER: As opposed to MLPs.

MR. MOUL: I mean, that's where we first developed the notion of using GDP as a factor.

COMMISSIONER SPITZER: Right.

MR. MOUL: And that's why I'm so hung up with this notion, well, you have a five-year growth rate and then you have -- for the rest of the term. I just look at it entirely differently -- well, not entirely differently, but differently.

It's a blended growth rate in the simplified model. I mean, that's all you've really done. We're still using the simplified model and we're just blending two growth rates, one being company-specific and one being generic.

And the generic one, it seems to me, would apply to anybody and everybody, whether you're a corporation or an MLP.

COMMISSIONER SPITZER: So I suggest your view is that there's nothing inherent or intrinsic in an MLP, that would require a deviation for the GDP.

MR. MOUL: That's exactly right, because you've broken the link between the form of the entity, which is what's captured in the first growth rate from IBES, whether it's a C-corp or MLP, and you've gone to a generic number that, it seems to me, would apply to anybody and everybody, regardless of their structure.

COMMISSIONER SPITZER: Mr. Siegel?

MR. SIEGEL: I just had a couple points to make. One is, I'm not sure if GDP is the right long-term growth rate, as you define it, but it's not clear in my mind, why, if it's right for the C-corp, it shouldn't be right for the MLP.

And it gets back to this notion of, you know, how do I come up with 2.5 percent that we use in our valuation framework. I venture to guess that the analysts that are doing the similar type of work that I am on C-corps, are using a similar growth rate on the C-corps, as I am for my MLP model.

So I would submit that 2.5 percent is probably the same number they're using for C-corps, so, again, I'm not sure I understand that GDP is the right number, but I think you said, perfect and imperfect, along those lines.

And the second point is about the disappearing cashflow. The way that we do MLPs, is that the asset, the earning power of the existing asset base, is not eroding, because the MLPs are reinvesting cash in the terms -- well, the other way to say it, is, they are sustaining the asset base, so that asset base is still generating the same sort of revenue it would be in --

COMMISSIONER SPITZER: No, but the delta is the C-corps have this line item called depreciation, and they're not taking the cash and sticking it in their mattress.

MR. SIEGEL: I'm sorry, they're not?

COMMISSIONER SPITZER: They're not taking -- they have the same maintenance expense that the MLPs do, but the cash relating to the depreciation expense, that cannot be distributed as dividends to shareholders of C-corporations, is not idle.

MR. SIEGEL: Okay.

MR. SHAPER: But it's used to invest in other activities.

COMMISSIONER SPITZER: Right.

MR. SHAPER: They have the same maintenance capital expenditures as we do, and, of course, our distributions are after maintenance capital expenditures, where we're retaining that cash to fund those expenditures.

And so what they are doing, is, from a cash perspective, it's exactly the same. Depreciation isn't cash; all it is, is an accounting item.

And so what they do, is, they have their earnings, they have their depreciation on top of that and that's their total cashflow. They take off their maintenance capital expenditures, because they have to spend those, as well, and then they retain that remaining cash, and they use that to invest. Some of them pay some dividends and retain the rest; some of them pay no dividends and retain it all, but they're using it for investment.

MR. SIEGEL: And the third point that I wanted to make --

COMMISSIONER SPITZER: Please.

MR. SIEGEL: -- too, was, you know, just this notion that, you know, C-corps reinvest all their capital and grow, well, you know, obviously, if the C-corp goes out and does a $4 billion pipeline expansion project, they're going to have to access the equity markets to be able to do that project.

I would submit that an MLP going out to the equity markets with that same project, will be able to raise that capital, because they have that transparency and track record. I'd also submit that, you know, the value of that currency, on an enterprise valued on the cashflow basis, is probably higher at the MLP level than at the C-corp level.

So, when you get back into all that argument, I still come back to that underlying conclusion that would suggest that I'm not sure why a C-corp would necessarily grow faster than an MLP.

MR. ROBINSON: Would the Commissioner permit me to have a followup question?

COMMISSIONER SPITZER: Please.

MR. ROBINSON: In your last remark, I believe you said that the enterprise value would be higher for the MLP, I believe, is what you said, when they go out to the market.

MR. SIEGEL: What I'm looking at, is enterprise value, yeah, divided by EBITA.

MR. ROBINSON: Wouldn't that be, from the investor's point of view, to follow the Commissioner's concerns, isn't a portion of that value, as an investor in an MLP model, I can have substantial present value benefits from the tax structure of an MLP. As an investor, I have substantial present value tax benefits, because in the early years, the cashflow that's generated by that investment, is going to come back to me in distributions and I'm not going to have taxes on it, an immediate tax obligation.

I'm going to have a deferred tax relationship that means that I'm willing to pay more for the instrument, to bring down the cost of capital to the firm, so, doesn't the MLP have an advantage in that incremental situation, over the C-corp?

MR. SIEGEL: Well, I think, as you describe it, I think that's true. You know, the numbers are the numbers.

If you look at enterprise value to EBITA, MLPs are trading at a higher multiple of EBITA, than the C-corp, at least, you know, last time I looked at it.

MR. VILBERT: I think there is a potential confusion in some of this. First of all, I believe the MLP is tax-efficient, relative to the C-corp, so, in other words, the don't pay as much taxes at the corporation level as a C-corp.

But that's known and that's reflected in the price of the shares, and so, therefore, the question is, once you know the price of the shares and you're estimating the cost of capital, does that benefit, that tax efficiency, result in a different estimate of the cost of capital for the enterprise?

I don't believe -- up to now, my investigation of the tax issue, doesn't lead me to believe that you get a different cost of capital, because you have that known cashflow. Where it reflects itself, is in the fact that the price that you pay for your limited partnership shares, is greater than you would be, if it weren't tax-efficient.

And so the question then becomes, what -- when you're estimating the rate of return, is it different? I don't think the rate of return is different; I think the price you pay is different.

MR. ROBINSON: So you would say the cost of capital to both firms, would be the same, but the price that you would pay for the unit, is different?

MR. VILBERT: Sure. When you go out -- I mean, this is the idea of diversifiable, versus systematic risk. If impose upon you, some kind of a terrible thing that happens and you lose half of your investment overnight, and you don't expect that to ever happen again, is your cost of capital different, going forward?

No, but you would pay half as much for the asset than you would pay the day before, so it's a matter of whether or not this risk or this cashflow, is affecting the price, only, or whether it affects your expected rate of return.

MR. ROBINSON: Well, then, some of the numbers we've gotten -- if the Commissioner might indulge me one more question -- some of the numbers we've seen, I believe, in Mr. Horst's testimony, that indicate that MLPs are generating rates of return as high as 200 basis points higher than C-corps, based on applying the same DCF methodology, so I don't know how that comports with your last answer, Mr. Vilbert.

MR. VILBERT: Well, my answer was focused on the tax effect, which I think is the specific question that I was answering.

MR. ROBINSON: Yes, sir.

MR. VILBERT: And with all due respect, I read his paper, and I don't believe that you can state that the effective incremental tax rate on distributions to MLP limited partnership holders, is greater than the tax on dividends at 15 percent.

I did a few quick looks at just a few companies, and the percentage of the distributions that are not taxable, are high enough so that the rate of tax is not significantly different from the 15 percent.

MR. HORST: If I could comment on that, what you're leaving out of that, is the recapture of ordinary income when you sell the units, which you wouldn't have with corporate shares.

And, you know, there is some value to a deferral of five years, ten years, however long you hold the shares, but if that's all you have and the difference is paying tax on ordinary income, you know, at the regular marginal rates, rather than 15 percent, that's a fairly significant difference.

I also think that there are other classes of investors that are relevant here. Very important to stockholding, is pension plans, you know, foundations, you know, other tax incentives, where you get a total carveout from unrelated business taxable income for dividends, that you don't get for partnership units.

MR. VILBERT: I agree with everything you just said, and that's why I prefaced my remarks about taxes, by saying that I think they're very complicated.

And so what you just said, was, the incremental tax on the current distributions to LP holders, may be less than the dividend tax, but you have to pay for it later, and I agree with you that there are some deferred taxes that come later down the road. And you're now trying to figure out, what's that effect of all of those things together, on the cost of capital estimated for an MLP.

I'm simply saying that I don't think I know the answer to that, because it's a very hard problem, and I just haven't worked my way through it yet, but I saw your analysis and I'm not sure you have the answer yet, either.

MR. HORST: Well, the analysis I had, was on the achieved rates of return; it wasn't an analysis of tax burden. And, you know, quite frankly -- and I don't mean to get into this, you know, tax issue, but I don't think you actually have to be a rocket scientist to figure out that at the shareholder or partner level, that the taxes are heavier on the MLP units than they are on dividend income.

Where the big difference is, of course, is up at the entity level, where you have a full corporate income tax, but no tax on partnerships. And that's how you sort of put the two together and come up with a heavier tax burden overall on corporations, which is why everybody here in this room, I assume, would conclude that, you know, partnerships are tax-efficient structures, because of the way the combined tax burden is forecast out, and not the way they work out at the investor level.

But the investor level is where it gets reflected into the rates of return on equity.

COMMISSIONER SPITZER: And both the investor level and the enterprise level taxation, are, arguably, relevant.

MR. HORST: Yes, they are, arguably, relevant, but in terms of what's reflected in an observed return on equity, that's basically after the enterprise-level tax but before the investor-level tax.

MR. VILBERT: Like I said, taxes are very complex, and all I'm cautioning people in the room about, is rushing to judgment about the effect of taxes on the required rate of return for an MLP. I haven't seen anything yet -- and I haven't done it myself -- that does enough analysis of that question, to draw a conclusion at this point. That's all I'm trying to say.

I don't disagree with the points that MLP unitholders, will ultimately pay a deferred tax when they sell their units, and that will be different than what you would have to pay as a holder of a C-corp. That, I don't think, is in dispute.

COMMISSIONER SPITZER: Until 2011. The dividend preference then disappears.

MR. VILBERT: Is that right? So, I'm just saying that drawing a conclusion at this point, with the state of the analysis we have at this point on the effect of taxes on MLPs, I just don't think you're there, to be able to make any strong conclusions.

COMMISSIONER SPITZER: Mr. Williamson?

MR. WILLIAMSON: I think the problem is more complicated than it's been made out to be, because we have the income tax allowance issue on top.

COMMISSIONER SPITZER: Please.

MR. WILLIAMSON: On top of all the income taxes --

(Laughter.)

MR. WILLIAMSON: -- that are paid here and there. But that has an impact on the treatment of corporations versus MLPs.

Because of the way the income tax allowance is calculated, I think it's almost a hopeless case, not to accept the proposition that prices adjust as a function of tax consequences, and that will show up in a calculation of the required rate of return.

COMMISSIONER SPITZER: I would agree, and I thank the Staff for indulging my questions. I just lined up my thoughts.

MLPs are a reality, and the regulatory environment -- we have to deal with what is in the regulatory environment, and the entire process seems to me to be including MLPs as applicants and including MLPs in the proxy group, but doing so in a manner that is fair to the MLPs, but does not give them a preference over C-corps, which creates what I call a symmetry to the MLPs and the C-corps, and that's really what -- all the people to my right, are smarter than me.

(Laughter.)

COMMISSIONER SPITZER: And they can solve this dilemma.

MR. ROBINSON: Commissioner Moeller?

COMMISSIONER MOELLER: Thank you. I've enjoyed today's discussion, most of which I've stayed conscious for.

(Laughter.)

COMMISSIONER MOELLER: I have two quick questions, and I don't want people to read too much into this. Mr. Barry, thanks for coming down.

In your sustainable growth analysis, I'm just curious, who determines the S and the V portion of the equation?

MR. BARRY: Well, who determines the S and V, is, to a certain extent -- the S portion is determined by the managers of the company, whether they have the projects to go out to the market, because the S is driven by the issuance of the stock price -- or the stock shares, I should, or, in this case, the MLP shares.

The V is --

COMMISSIONER MOELLER: But you still have to make a guess as to what those numbers will be; don't you?

MR. BARRY: Well, yes and no. You can go to credit reports and see if there's anything planned as far as what the capital requirements are and what your plans are.

But Value Line itself gives the numbers out for three to five years on the amount of stock issuances planned in the future, and that's what I used when I developed my SV rates.

The V portion is determined by the market. That's the valuation of the stock above or below book value, which is the primary driver of that. That more or less drives the accretion.

COMMISSIONER MOELLER: Mr. Siegel, do you have any thoughts on that?

MR. SIEGEL: Yeah, the thought is that it becomes the same sort of academic question about GDP growth.

The bottom line is what I think Park was saying before, you know, unless they have a growth project, they're not going to issue equity, and if they do have a growth project, they are going to go to the market and issue equity to help finance that growth.

And so I think that's the flaw in the analysis. The S is going to be predicated on their ability, on management's ability to go out and develop projects.

COMMISSIONER MOELLER: Well, that leads to the growth rate question. We've been talking a lot about GDP, but Tesoro's written comments point out that -- they recommend that we ought to actually take the Social Security Administrations growth estimates, which, obviously, are lower and more conservative, but probably more realistic than at least some of the GDP projections.

I guess I'd be curious as to your reactions to that, collectively and individually.

Professor Williamson? I know you did not include it in your estimates.

MR. WILLIAMSON: No, but I've included it in plenty of testimony.

My position is that Social Security, GDP growth forecasts, have a lot to do with determining whether the Social Security Trust Fund is adequate and how long it's going to last.

And they are, necessarily, very conservative forecasts. They were designed for Social Security; they weren't designed for anybody else.

The EIA and the -- oh, come on, I'm trying to come up with the name -- it was DRI and LIFA, but, you know -- global insight?

At any rate, those are general purpose forecasts of GDP. They're intended for people who are interested in doing GDP forecasts for business purposes, but not to protect a particular position, as the Social Security forecasts are.

On the other hand, they don't make a huge amount of difference. I don't think it's worth a big argument.

In representing my clients, I will give my opinions with respect to SSA forecasts, but I do provide them, because I know the Commission would like to have them.

So I don't think it's worth a lot of argument.

COMMISSIONER MOELLER: Any other thoughts.

MR. SOLOMON: I would agree --

MR. MOUL: I'm sorry. I share Professor Williamson's view. The SSA forecasts, I mean, who's aware of them, except for those within the Government that the report is prepared for? It doesn't receive a lot of dissemination in the investment community.

I just don't see what investors would rely on the SSA report, for the purpose of picking up a GDP long-term forecast. And the forecasts go out, what 80 or 100 years? Well, however long they go, and when you get that far out in the future, I mean, the reliability of those kinds of forecasts, just doesn't seem to be very relevant.

COMMISSIONER MOELLER: Okay, that concludes my thoughts. Thank you.

MR. ROBINSON: Thank you, Commissioner. Well, we have about a half hour to go, and I guess we can go to open mike. I guess we have some walk-around microphones that we can use for others to ask questions of the panel. Do we have them available, or are we going to use the podium?

Okay, who would like to go first and ask questions of the panel? Maybe -- no questions?

(No response.)

MR. ROBINSON: Well, I have another -- oh, we have a question there, okay. I thought we were maybe about to have open session for the panelists.

MR. SUNDBACK: Good afternoon. I have a question.

REPORTER: Your name, please?

MR. SUNDBACK: Mark Sundback. I have a question for Mr. Solomon. Have you used recently available data to compute the ROE levels that would result from implementing your proposal, and, if so, what is the resulting ROE level?

MR. SOLOMON: No, I haven't; I haven't made that analysis at this point.

MR. SUNDBACK: Fair enough. Mr. Barry, same question for you.

MR. BARRY: Assuming the --

MR. SOLOMON: Can I modify that slightly? One of the -- there are several reasons I haven't made that calculation. What I have done, is look at what the result would be currently, using existing methodology, which I think, as already has been alluded to, produces numbers that are anywhere from 100 to 200 and maybe more basis points more than currently produced for C-corporations.

And, you know, it begs the question of why is that? And then I think, largely -- I can't profess to know all the answers, but I think, largely, the answer resides in the fact that investors in MLP units, are using lower growth rate expectations than are reflected, for example, in the IBES projections and/or lower than the GDP estimates.

Therefore, they are reflecting relatively high distribution yields, risk associated with the inability to sustain current growth rates over the long term, and, therefore, the kind of adjustments that I had proposed and that others have proposed, should produce results that bring those more in line with what is normally seen for the C-corps.

MR. SUNDBACK: But, as I understand your first answer, you haven't actually done the calculations and this is a supposition on your part; is that correct?

MR. SOLOMON: It is correct that I haven't done the calculations, but it's a little more than supposition.

MR. SUNDBACK: Okay, since Mr. Solomon sort of expanded on the question, I wondered if any of the other panelists have a reaction to his expansion and extrapolation on his interpretation of the data.

MR. ROBINSON: I believe you're directing that to the fact that there's 100 to 200 basis points above on some of the C-corp and some of the numbers of the causality?

MR. SUNDBACK: Thank you, Mr. Robinson.

MR. ROBINSON: That would also be of interest to the staff.

MR. WILLIAMSON: I'll offer one comment. When I began testifying in the state of Vermont in the 1970s, I thought a cost of capital might lie between 13 and 15 percent.

And I didn't believe that I could get any more precise than that. After awhile, I thought maybe I could say between 13.5 and 14.5.

It was only when I began testimony here, that I discovered the Commission wants cost of equity to the nearest basis point.

(Laughter.)

MR. WILLIAMSON: It's ridiculous to assume that we know the cost of capital for any entity to the nearest basis point.

(Laughter.)

MR. WILLIAMSON: I think to get it to the nearest percentage point, may be possible. We may have some confidence that we've got it right, but these modest differences in basis points, really are meaningless in the context of a world in which you just can't get a precise number that you are sure is the cost of equity for a company.

You can manipulate the numbers. I mean, you can get five decimal points, if you want to try it, but you can't have a reliable number that is precise within, I think, even 100 basis points.

MR. VILBERT: Let me just quickly piggyback on that. I agree completely.

You asked me what my recommendation was on the Benchmark Model versus GDP or something less than GDP. And because the Benchmark Model turns out to be exactly in the middle between using the current FERC method for LP units GDP, and the modification that I proposed, which is about 50 basis points lower, and because of the discussion you just heard about the accuracy of doing cost of capital, I'm unable to come down and say -- pound the table and say, one way or the other is the absolute right answer, because we're just not that good at estimating the cost of capital, even though, as has been noted, I can calculate as many digits as you'd like to see after the decimal place.

I don't have any confidence in them, but I can give them to you. So, the point is, I think, given the level of difficulty in estimating the cost of capital, lack of precision, that the fact that it would be a change in your current methodology, you're better off just doing what you've been doing for C-corps, apply it to the LPs, test it periodically to be sure it's not messing up, but that's a perfectly reasonable way to proceed.

MR. ROBINSON: Mr. Solomon, you looked like you had an afterthought. Is there something more you'd like to say in response?

MR. SOLOMON: No, I can't disagree with the Professor. I think it's very -- you know, we apply greater precision in our analyses and results than probably is actually warranted.

Determining the appropriate ROE, the investor-required ROE, you know, is largely an art, as well as a science. You know, we're trying to read the minds of investors and we do that as best we can, but we certainly can't do that with precision.

MR. ROBINSON: Other questions?

(No response.)

MR. ROBINSON: Okay, we have -- the schedule runs until 5:00. We can wrap our remarks now, or we have a little time where we could go through any more questions from my colleagues and the Commissioners, or if there's any wrap-up, focused, technical wrap-up observations that the members of the panel would like to make, I think we only need about five minutes or ten minutes for kind of the wrap-up from the Staff on where we go from here.

Mr. Solomon?

MR. SOLOMON: If I might, we earlier passed out an exhibit that I would like to discuss very briefly.

Mr. Moul, earlier in his comments, made the point, I think, that TransCanada made in their additional comment that was based on an exhibit from Dr. Williamson, that purports to show that IBES growth rates have historically underestimated actual distribution growth.

And I would preface my remarks by saying, first, that I don't disagree with the numerical conclusion that's reached, but I think, upon further analysis, if you really look at the issue and the data, it shows just the opposite; that, in fact, the IBES estimated growth rates, have, instead, overestimated actual distribution share growth.

One of the, I guess, first issues I would point out, is, the actual distribution share growth that was calculated, was based on long and varying periods of time from ten to 14 years, in the analysis.

But the compound annual rates of growth are calculated using just the first year and the last year. And in most instances, the beginning years are instances where distributions were relatively low and in almost all instances, for payout ratios, they were less than 100 percent.

Then, of course, there is growth shown in distributions per share, but part of that is that in every instance, I believe, the payout ratios had grown to well over 100 percent.

So, by looking at the calculation for a such a long period of time and starting from a very low payout level, which is really not representative in this environment, the number is inflated.

But even more than that, it doesn't really test the hypothesis, because the IBES growth rates are five-year projections of growth, not ten and 15-year projections of growth.

So what I've done on this exhibit, is to use the consistent periods of time, starting in 1998, and compare the IBES growth rates for that point in time, with actual distribution growth over the coming five years.

And so the latest period that can be used for that, is 2002, where you have five years of history, subsequently. And what it shows -- I'll just try to be brief and skip to the bottom line -- is that in 17 out of the 25 instances, or 68 percent of the time, the IBES growth rate projections, which were actually for earnings per share, were actually lower than the subsequent actual distribution per-share growth rates.

So I think the more carefully you analyze the data and really test an hypothesis, it really shows the opposite of what Mr. Moul and TransCanada argue.

MR. MOUL: Well, I think we heard this morning about the growth rates. Well, let's just pick Kinder Morgan as an example, and I think what we heard early this afternoon, is that the growth rate that Kinder Morgan has been able to generate, are substantially higher than the growth rates that are shown on this schedule, over an extended period of time.

The original submission was intended to compare the actual returns. This is the internal rate of return from the collection of the distributions, plus the change in the stock price, versus what DCF was predicting, using a simple yield-plus-growth calculation.

It showed that by using the IBES growth rate to the DCF calculation, it was producing a return substantially less than what investors were actually -- what actually -- were able to realize over that time period.

This just doesn't change that reality, and the numbers shown here, I haven't had a chance to look at them in detail, but I don't see growth rates for Kinder Morgan Energy Partners that are shown on this schedule, that are anything close to what was discussed earlier today.

MR. WILLIAMSON: I've actually done just what Mr. Solomon describes. I don't have it with me, but I've prepared a schedule that showed, each year, what the five-year forecast was and what the actual growth in income per unit and distribution pre unit was.

And, as he said, the last one you can do, is the 2002. I can't, offhand, remember just what it showed, but I would be glad to send a copy to anyone who wants.

MR. ROBINSON: That would be very helpful, if that could be included in the record in the supplemental comments, after this.

MR. SOLOMON: I may just clarify the record. I may have said that this demonstrates that the IBES growth rates were lower than the actual distributions per share, and if I said that, I misspoke.

It shows that the IBES estimates are actually higher than the distribution growth rates actually turn out to be.

MR. HOWE: Remember, this is what the Commission is looking for, what investors are projecting growth will be, and so, therefore, IBES, we have said, is representative of what investors are projecting.

And whether it actually turns out to be true or not, it's not particularly relevant to our exercise.

MR. MOUL: You went right to the heart of it. It's what affects the stock price. I mean, if the IBES growth rates are what investors use in establishing price, then that is the right growth rate to use in this type of model, because that's really what's influencing investor expectations, the price per unit.

MR. SOLOMON: And I don't disagree with that. I was just responding to a comment that was made in the TransCanada comments, and to set the record straight.

MR. WILLIAMSON: I think Mr. Moul's comments are perfectly correct. I am thinking, though, of those who have alleged that the analysts deliberately exaggerate their forecasts, and the accuracy, I think, gives maybe some clue as to whether they deliberately exaggerate.

MR. HOWE: I've heard a number of you say that there's no reason why the MLP should grow at any different rate from corporations, but at least the IBES growth rates that we looked at previously, and with Policy Statement, seemed to show that the analysts were projecting lower growth for the MLPs than for the corporations. Do you have any reaction?

MR. SIEGEL: Just as an analyst, my bias is to be conservative, rather than aggressive, because it's been my experience that, you know, investors get disappointed when expectations are too high, and they take it out on the analysts.

(Laughter.)

MR. VILBERT: Plus, keep in mind that this the distinction between the MLP and the LP units, because the MLP is growing faster than what you observed the forecast to be for the LP units, and that's what you see.

So, again, we talk past each other when we don't keep those two concepts separate.

MR. HOWE: And the Commission -- I mean, the number one requirement the Commission has always had for inclusion in the proxy group, is that they have to be publicly-traded stocks, so we have a market price.

And since we only have that for the limited partner's share, is it really possible for us in our analysis, to take into account, the general partner's share?

MR. VILBERT: That is the primary weakness of the Benchmark Model. I do believe, however, that you can put some boundaries on what the price of the general partnership shares would be, and narrow that uncertainty down a great deal.

But, you're right; we don't have, for most cases, the market price of the GP equity, and that's a problem.

MR. SIEGEL: But you do know how much cashflow the GP is getting.

MR. VILBERT: Right, you know the cashflow, you know the growth rates of -- the forecast growth rates for the entire entity, for the five-year period, so it's not an insurmountable problem, but it does speak to the complete accuracy of the result.

MR. HOWE: I had just one more question for Professor Williamson. You said that the MLP would go out of the business or the corporation would go out of business, if it didn't indefinitely provide returns above the growth rate of GDP.

But wouldn't the only way they could do that, would be to go into other lines of business that had greater growth prospects? I mean, is it realistic to assume that the pipeline business, as a whole, can grow forever, higher than the GDP?

MR. WILLIAMSON: Oh, no. The might well, long before 20 years from now, they may be into other activities, and unregulated activities, perhaps. They might swing much more into unregulated activities, but we simply look at the -- we look today at these companies as proxy companies.

Ten years from now, they may be totally inappropriate as proxy companies. But we're making forecasts for those companies today, and I'm saying that it's unrealistic to make a forecast for any one of those companies, that it's growth will drop to a GDP level and it will still be a live company.

Now, it's not going to die overnight because its growth is no more than GDP, but once people begin to believe that that's the long-run future, there's not going to be any interest in that stock.

MR. HOWE: But we're setting up the return, just for the jurisdictional pipeline business, so isn't it reasonable for us just to look at how the pipeline business is going to grow, rather than --

MR. WILLIAMSON: No, because you're looking to the proxy to get the cost of capital; you're not looking to the regulated pipeline to get the cost of equity. You're going to the MLP, because Hope and Bluefield say the Commission has got to give the pipeline a chance to compete in the marketplace for equity, if it wants to issue equity.

And the only way we're going to find out what it would have to be able to offer to issue equity in the market, is to go and look at what people are now expecting and getting in the way of a rate of return, the people who might be persuaded to invest in the pipeline, if that became necessary.

So, we're looking strictly at the MLP now, to get the cost of equity to use for the regulated pipeline. And I believe it's the cost of equity to the limited partner. That's the person who will be the target when the operating pipeline decides it's got to go out and look for investors.

MR. ROBINSON: Okay, well, thank you. It's ten minutes of 5:00. We do have on my crib sheet -- let me go back to that -- I believe we have said that comments will be due on February 11th, and the first order of business is a practical question.

We've asked for comments by February 11th. This a very technical topic. I think the Staff has made it quite clear that we want -- we've been asked and been given technical answers to our questoins, and that's very good.

We'd like the comments to run in the same vein, so, subject to my principles, if the initial comments come in that are very technical and answer our technical concerns with formulas and examples of how all this stuff works, et cetera, et cetera, I guess we'd be receptive to a short period for reply comments, if the Commission would grant it.

What do you think, Mr. Howe?

MR. HOWE: Well, the Commission has set a deadline of February 11 for the first round of comments, and we can consider then, whether reply comments would be helpful.

MR. ROBINSON: Commissioners?

COMMISSIONER SPITZER: Well, my view would be that I'd rather have it done thoroughly, than fast, so we'll find out if more comments would be helpful.

COMMISSIONER MOELLER: I agree.

MR. ROBINSON: Okay, so we'll explore with our principals, probably a week to ten days, probably for reply comments. We'll modify the Order for that. Okay.

The next point is in the nature of the comments. Staff has three concerns: First of all, to the extent we are having economic theory advanced, and various arguments advanced, please identify for things that lie behind your methodology. You need to assure us that the numbers are relatively transparent.

I think that everyone that's spoken today, has pretty much satisfied our concerns in that regard, but it bears repeating, so, if you're coming with a logical flow of an analysis and you're using numbers, we have to have numbers that we can go out and get.

Now, it might be the SEC reports; it might be the Federal Reserve, but whatever it is, we need the source.

Secondly, I'll repeat, technical arguments are, because this is a technical problem, are going to be preferred over general arguments. I will make one point and then drop it, the fact that we happen to do something for the last 200 years, is not a justification.

So, that doesn't mean to change it, but the fact that we did something in the oil pipeline industry for the last ten years, doesn't mean that it can't change, because there's no technical difference between an oil pipeline and the gas pipeline, so the precedent does not necessarily control here.

If you can argue the case, argue it on the merits of the technical questions that have been asked by the Staff and the Commissioners.

The third thing: There are often citations to numerous documents and we don't see the whole record.

For example, there are citations to the Citicorp analysis or this Merrill Lynch analysis or this analysis or that analysis. If you're citing to it, give us the text. We're not interested in going to the Internet and trying to dig everything up to see if the citation is positive or whether we can rely on it.

If you're going to give us a citation to that type of technical journal or financial analysis, we want it attached.

So, those are the three general admonitions that I have on where we go in the next phase, and I will ask my colleagues and Commissioners if they have anything they would like to add?

(No response.)

MR. ROBINSON: Thank you very much. This has been very helpful and very informative. I particularly appreciate that the panel has been very responsive.

I think we would all agree that when we've asked narrowly-focused questions, we've gotten very precise answers. I think that's going to be reflected on the transcript. It's hard work and we do appreciate it.

We stand adjourned. Thank you very much.

(Whereupon, at 4:54 p.m. the technical conference was concluded.)