

123 FERC ¶ 61,116
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Sudeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

SFPP, L.P.

Docket No. IS05-230-000

ORDER ON EXCEPTIONS AND
ESTABLISHING PAPER HEARING

(Issued May 2, 2008)

1. This order addresses a limited number of exceptions directed to the return on equity rulings of an initial decision (ID) in the captioned docket dated September 25, 2006, addressing SFPP, L.P.'s proposed North Line rates.¹ This order also establishes a paper hearing to address those issues in light of the Commission's policy statement addressing the proxy groups to be used in determining the return on equity for gas and oil pipelines.² The remaining exceptions to the ID will be addressed in an order following the completion of the paper hearing. The Commission emphasizes that the paper hearing will be limited to the issues and guidance contained in the *Proxy Group Policy Statement*. Thus, income tax allowance and other cost of service issues are outside the scope of the paper hearing and will be addressed based on the existing record in the instant docket.

Background

2. This proceeding began on April 25, 2005, when SFPP filed increased rates to recoup the cost of replacing the Concord to Sacramento, California section of its North Line. The ID addressing numerous issues issued on September 26, 2006. Briefs on exceptions and reply briefs on exceptions followed. As noted, the only issues to be addressed here are related to the return on equity SFPP should receive in this docket. At bottom, the ID held that SFPP properly included master limited partnerships (MLPs) in the proxy group used to determine the equity cost of capital and that SFPP correctly

¹ *SFPP, L.P.*, 116 FERC ¶ 63,059 (2006) (ID). The Commission also issued a contemporaneous order with rulings similar to this order that addressed SFPP's Sepulveda Line. *See Texaco Refining and Marketing, Inc., et al. v. SFPP, L.P.*, 123 FERC ¶ 61,117(2008).

² *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 (2008) (*Proxy Group Policy Statement*).

treated MLP distributions as equivalent to dividends in applying the Commission's discounted cash flow model.³ The ID also held that no party had demonstrated that SFPP's risk was materially different than that of any other member of the approved proxy group.⁴ The remaining rulings in the ID on the cost of capital issues address such matters as SFPP's capital and debt structure and are not relevant here.

3. On exceptions, SFPP supported the ID's rulings on the use of MLP's in the proxy group and its relative risk. The Commission staff supported the ruling on the use of the MLPs but opposed the ruling on the issue of relative risk. The CVV Group,⁵ Tesoro Refining and Marketing Company, and Indicated Shippers⁶ assert that the ID erred by including MLPs in the proxy group because the MLPs at issue had distributions in excess of earnings. As such, they argue that the ID was inconsistent with the rationale and rulings of the Commission's decisions in *HIOS*⁷ and *Kern River*.⁸ In addition, Indicated Shippers asserted that the ID did not adequately recognize the distinction between distributions and income (or earnings) in reaching its conclusions. These three shipper parties also asserted that SFPP should be placed at the lower end of the proxy group.

4. On July 19, 2007, the Commission issued a proposed policy statement concerning the composition of the proxy groups used to determine gas and oil pipelines' return on equity (ROE) under the Discounted Cash Flow (DCF) model.⁹ The Commission noted that historically, in determining the proxy group, the Commission required that pipeline operations constitute a high proportion of the business of any firm included in the proxy group. However, in recent years, there have been fewer gas pipeline corporations that meet that standard, in part because of the greater trend toward MLPs in the gas pipeline industry. Additionally, there are no oil corporations available for use in the oil pipeline

³ ID, 116 FERC at P 89-99.

⁴ *Id.* P 99.

⁵ CVC Group is composed of ConocoPhillips Company, Chevron Products Company, and Valero Marketing and Supply Company, filing jointly.

⁶ Indicated Shippers are BP West Coast Products LLC and ExxonMobil Oil Corporation, filing jointly.

⁷ *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, *reh'g*, 112 FERC ¶ 61,050, *reh'g*, 113 FERC ¶ 61,280 (2005) (*HIOS*).

⁸ *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486) (*Kern River*).

⁹ *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 120 FERC ¶ 61,068 (2007) (*Proposed Policy Statement*).

proxy group. Therefore the Commission proposed to modify its policy to allow inclusion of MLPs in the proxy group.

5. The Commission proposed to cap the cash distributions used to determine an MLP's return under the DCF method at the MLP's reported earnings. The Commission found that this was necessary to exclude that portion of an MLP's distributions constituting return *of* equity. The Commission provides for the return *of* equity through a depreciation allowance. Therefore, the Commission stated that the cash flows used in the DCF analysis should be limited to those which reflect a return *on* equity. The concern was that the pipeline could double recover its depreciation expense. The Commission also proposed to require a showing that the MLP has had stable earnings over a multi-year period, so as to justify a finding that it will be able to maintain the current level of cash distributions in future years. The proposed policy statement found that these requirements should render the MLP's cash distribution comparable to a corporation's dividend for purposes of the DCF analysis.

6. On August 7, 2007, the United States Court of Appeals for the District of Columbia Circuit issued its decision in *Petal Gas Storage v. FERC*,¹⁰ remanding to the Commission two decisions in proceedings pursuant to the Natural Gas Act (NGA) involving issues regarding use of a proxy group, i.e., *HIOS* and *Petal Gas Storage, L.L.C.*¹¹ After review of the initial comments submitted in response to the July 19, 2007 proposed policy statement, the Commission issued a supplemental notice on November 15, 2007, requesting additional comments solely on the issue of MLP growth rates, and establishing a technical conference to discuss that issue.¹² The technical conference was held on January 13, 2008 and extensive comments and reply comments were submitted before and after that conference.

7. After review of the extensive record developed in that proceeding, the Commission concluded: (1) MLPs should be included in the ROE proxy group for both oil and gas pipelines; (2) there should be no cap on the level of distributions included in the Commission's current DCF methodology; (3) the Institutional Broker's Estimate System (IBES) forecasts should remain the basis for the short-term growth forecast used in the DCF calculation; (4) there should be an adjustment to the long-term growth rate used to calculate the equity cost of capital for an MLP; and (5) there should be no modification to the current respective 2/3 and 1/3 weightings of the short- and long-term

¹⁰ *Petal Gas Storage v. FERC*, 496 F. 3d 695 (D.C. Cir. 2007) (*Petal*).

¹¹ *Petal Gas Storage, L.L.C.*, 97 FERC ¶ 61,097 (2001), *reh'g.*, 106 FERC ¶ 61,325 (2004) (*Petal Gas*).

¹² *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 121 FERC ¶ 61,165, at P 1 (2007).

growth factors. Moreover, the Commission concluded it would not explore other methods for determining a pipeline's equity cost of capital at this time. The Commission also concluded that this Policy Statement should govern all gas and oil rate proceedings involving the establishment of ROE that are now pending before the Commission, whether at hearing or in a decisional phase at the Commission where the ROE issue had not been decided with finality.¹³

Discussion

8. The exceptions before the Commission in this proceeding regarding SFPP's ROE will be governed by the *Proxy Group Policy Statement* and the extensive discussion contained therein. As was discussed in detail in the *Proxy Group Policy Statement*, the Commission determines a pipeline's ROE by performing a DCF analysis of a proxy group of publicly traded firms with corresponding risks. Under the constant growth DCF formula used by the Commission, the cost of capital is equated with the dividend yield (dividends divided by market price) plus the estimated constant growth in dividends. The Commission determines dividend growth by averaging short-term and long-term growth estimates, giving two-thirds weight to the short-term growth projection and one-third weight to the long-term growth estimate.¹⁴ The DCF results for the proxy group companies produce a zone of reasonableness within which the pipeline's ROE and rate may be set based on specific risks.

9. Since *Williston Basin Interstate Pipeline Co.*,¹⁵ the Commission has based the proxy group on corporations listed among the Value Line Investment Survey's group of diversified natural gas companies that own Commission-regulated natural gas companies. However, in the contemporaneous *Proxy Group Policy Statement*, the Commission has reexamined its proxy group policy in light of the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Petal* and current trends in the gas and oil pipeline industry. As a result, the Commission modified its policy to permit MLPs to be included in the proxy group. However, the *Proxy Group Policy Statement* finds that the DCF analysis of MLPs should use a long-term growth projection of 50 percent of GDP, instead of the long-term growth projection equal to GDP used for corporations.¹⁶

¹³ *Proxy Group Policy Statement, passim.*

¹⁴ The Commission uses the five-year IBES growth projections as the short-term growth projection and the growth rate of the Gross Domestic Product (GDP) as the long-term growth projection.

¹⁵ *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036, at P 35 (2003).

¹⁶ *Proxy Group Policy Statement*, 123 FERC at P 95-96, 106.

10. The *Proxy Group Policy Statement* requires parties proposing to include particular firms in a proxy group to provide as much information about the nature of the firm's business activities including their recent annual SEC filings and investor service analyses of the firms. This information will enable the Commission to determine whether the interstate natural gas or oil pipeline business is a primary focus of the firm and whether investors view an investment in the firm as essentially an investment in the gas or oil pipeline business. The *Proxy Group Policy Statement* concludes that permitting appropriate MLPs to be included in the proxy group should render the proxy group more representative of the business risks of natural gas or oil pipelines, and thus reduce the need to make adjustments for differences in risk.¹⁷ Finally, as discussed above, the *Proxy Group Policy Statement* states that the new proxy group policy will govern all rate proceedings now before the Commission where the ROE issue was not finally decided.¹⁸

11. The Commission affirms the ID's conclusion that MLPs may be included in the proxy group. Like the ID, the *Proxy Group Policy Statement* concluded that the Commission's distinction between return of and return on capital was inconsistent with the basic theory of a discounted cash flow model and that as such there should be no adjustment to the distributions to be included in the model.¹⁹ Given the rationale of the *Proxy Group Policy Statement*, the Commission also denies the exceptions arguing that MLPs may not be included in the proxy group.

12. Given the foregoing, the Commission will apply its new policy regarding the proxy group to be used to determine the return of equity for oil pipeline MLPs in this case. Therefore, the Commission reopens the record in this case for a paper hearing in order to give all parties and participants an opportunity to submit additional evidence as to which specific MLPs should be included in the proxy group consistent with the policy statement and how the equity return should be calculated given the guidance in the *Proxy Group Policy Statement*. Given that the proxy group may change, the parties and participants may address the issue of SFPP's relative position in the proxy group. Initial briefs and testimony on the composition of the proxy group and the related determination of the equity return will be due within 60 days after this order issues, reply briefs and testimony 90 days thereafter, and rebuttal briefs and testimony 105 days thereafter.

The Commission orders:

(A) The exceptions to the rulings in the ID regarding SFPP's equity cost of capital are denied as stated in the body of this order.

¹⁷ *Id.*, P 47-53.

¹⁸ *Id.*, P 116.

¹⁹ *Proxy Group Policy Statement* at P 47-53.

(B) The Commission establishes a paper hearing on the issue of the composition of the return on equity proxy group, the DCF analysis of the firms included in the proxy group, and related issues of risk, as more fully described herein. The Commission directs interested parties to file initial briefs within 60 days after this order issues. Reply briefs are due 90 days after this order issues and rebuttal briefs 105 days after this order issues. Each party's presentations in its initial, reply, and rebuttal briefs should separately state the facts and arguments advanced by the party and include any and all exhibits, affidavits, and/or prepared testimony upon which the party relies. The statements of facts must include citations to the supporting exhibits, affidavits and/or prepared testimony. All materials must be verified and subscribed as set forth in 18 C.F.R. § 385.2005 (2007).

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.