

123 FERC ¶ 61,117
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.

Texaco Refining and Marketing, Inc.

Docket No. OR96-2-012

v.

SFPP, L.P.

ARCO Products Company
Mobil Oil Corporation

Docket No. OR96-10-008

v.

SFPP, L.P.

Ultramar Inc.

Docket No. OR96-17-005

v.

SFPP, L.P.

SFPP, L.P.

Docket No. IS98-1-000

ORDER ON REHEARING AND
ESTABLISHING PAPER HEARING

(Issued May 2, 2008)

1. This order addresses requests for rehearing of the Commission's December 8, 2006¹ Order in this proceeding in so far as those address return on equity issues

¹ *Texaco Refining and Marketing, Inc., et al. v. SFPP, L.P.*, 117 FERC ¶ 61, 285 (2006) (December 2006 Order).

stemming from SFPP, L.P.'s (SFPP) status as a master limited partnership (MLP). It also establishes a paper hearing on those issues, which is to be consistent with the Commission's recent policy statement on the composition of gas and oil pipeline proxy groups.² The other pending requests for rehearing of the December 2006 Order will be addressed in an order following the completion of the paper hearing. That subsequent order will also address the comments on SFPP's compliance filing dated February 7, 2007 in the captioned dockets. 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 dockets.

I. Background of the Instant Case

2. The December 2006 Order addressed an initial decision (ID) dated August 24, 2005, which concluded that SFPP, L.P.'s charges and rates for interstate shipments over its Sepulveda Line are not just and reasonable and have not been so since the filing of a complaint in December 1995.³ While the December 2006 Order dealt with numerous issues in the ID, the relevant ones here are those dealing with the proper equity cost of capital for SFPP in this proceeding. As discussed in that order, after the Commission's *HIOS* decision issued in January 2005,⁴ both SFPP and the shipper parties supplemented the record in February and March 2005 and addressed and briefed the issue to the Administrative Law Judge (ALJ). Following the Commission's analysis in *HIOS*, the ALJ concluded that if a return of capital were included in an MLP distribution, this would lead to an overstatement of the equity cost of capital.

3. After noting that the most important thing was the source of distributions and not their characterization, the ALJ further concluded that earnings growth cannot be used as a proxy for income to determine if MLP distributions are the equivalent of dividends. He further concluded that the unit holders of an MLP would never pay any income taxes on the cash distributions they received, which would also overstate an MLP's equity cost of capital. After reviewing the record, the ALJ held that SFPP failed to establish that the distributions by the MLPs included in the proxy group were derived from income and were not a distribution of capital. As such, the proxy group did not meet the *HIOS*

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

³ *Texaco Refining and Marketing Inc. v. SFPP, L.P.*, 112 FERC ¶ 63,020 (2005) (ID).

⁴ *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*).

concern and as a result SFPP's rate of return on equity was too high.⁵ To correct these perceived limitations, the ALJ set SFPP's cost-of-equity at the lower end of the range of reasonableness used to develop an equity cost of capital, in this case a real equity cost of capital of 8.77 percent for 1996. The ALJ adopted a real return of 10.29 percent, the median of the range for 1995. While stating that the lower end of the range should control, he did not state what the actual number should be used for 1995.⁶

4. In reviewing the ID, the Commission concluded that the so-called *HIOS* issue was not present in the instant docket because five of the six oil pipeline MLPs included in the proxy group had earnings in excess of distributions in the 1995 and 1996 test years used in the instant proceedings. Thus, as regards five MLPs included in the proxy group, there was no need to adjust the equity rate of returns for the MLPs.⁷ The Commission also concluded that the record established that all members of the proxy group had a history of stable or increasing earnings and therefore there was no need to be concerned that future distributions would be unstable. However, in order to simplify the proceeding, the Commission excluded Enron Liquids Pipeline, L.P. (Enron) from the proxy group as it was the one member of the proxy group that had distributions in excess of earnings.⁸

5. The Commission also reversed the ALJ's conclusion that SFPP's return should be placed at the lower end of the proxy group to adjust for the fact that MLPs often have distributions in excess of earnings and that this may lead to overstated equity returns absent an adjustment.⁹ However, the Commission was concerned that the tax deferral elements of MLPs might lead to an excessive return on equity absent some downward adjustment of the return of equity component of an MLP's regulatory cost of service. Therefore the Commission required a downward adjustment of the equity cost of capital to reflect the additional return the Commission concluded would flow from the tax deferral features of pipeline MLPs.

6. SFPP and Indicated Shippers¹⁰ filed requests for rehearing of the December 2006 Order. SFPP argued that the Commission improperly excluded Enron from the proxy group and improperly focused on earnings instead of distributions in determining whether

⁵ ID at PP 55-56, 79-82.

⁶ ID at P 142.

⁷ December 2006 Order, 117 FERC ¶ 61,825 at P 26-27.

⁸ *Id.* P 29-30.

⁹ *Id.* P 33-35.

¹⁰ Indicated Shippers are BP West Coast Products LLC and ExxonMobil Corporation filing jointly.

an MLP pipeline should be included in the proxy group. It argued that investors treat dividends and distributions the same when using a discounted cash flow (DCF) to determine the price of an equity instrument or the required return. SFPP also asserted that the Commission erred in selecting the portions of the record it relied on to determine the equity returns for the 1995 and 1996 test years. It asserted that this resulted in the use of inconsistent methodologies that provided the lowest possible return. SFPP also asserted that stability of earnings is not relevant to the cost of equity determinations in this proceeding. It also asserted that the Commission's adjustment to reflect income tax deferrals was unnecessary and improper because there are no tax savings to the investors and the result violates the Commission's stand alone policy.

7. Regarding the return on equity issue, Indicated Shippers assert that the Commission incorrectly abandoned the dividend component of the DCF model without explaining such a radical change in the law. They assert that the Commission did not adequately follow the distinction in *HIOS* between a return on and return of capital and therefore failed to recognize that cash distributions are not income. They further assert that earnings per share do not have the same characteristics as a dividend and therefore the emphasis in the instant docket on earnings per share is misplaced. Indicated Shippers further assert that there is no correlation between income and cash distributions and the relationship between the two can vary widely. They assert that since an MLPs cash distributions are not dividends, the reliance on earnings would greatly inflate the equity return of each member of the proxy group. Indicated Shippers therefore conclude that *HIOS* and a related case, *Kern River*,¹¹ correctly concluded that MLPs cannot be included in the proxy group because they have no income to support their distributions.

8. Indicated Shippers further argue that the Commission erred in concluding that five of the six MLPs included in the proxy group had income in excess of distributions and that this conclusion overrules *HIOS* and *Kern River* without explanation. They further argue that the Commission erred in preventing them from arguing whether any of the six MLPs at issue were appropriately included in a proxy group. Indicated Shippers also assert that the Commission erred in adjusting the return for income tax deferrals because MLPs have no tax liability and therefore there are no deferrals at issue. They again conclude that in any event there is a *HIOS* problem and that the Commission erred in attempting to correct it through the tax deferral adjustment. Rather, argue Indicated Shippers, the Commission should accept the ALJ's pragmatic adjustment of reducing SFPP's return to the lower end of the range of reasonableness and erred in rejecting it.

9. The requests for rehearing were filed on February 7, 2007. 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 DCF

¹¹ *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486) (*Kern River*).

model.¹² 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 now no oil corporations available for use in the oil pipeline proxy group. Therefore the Commission proposed to modify its policy to allow MLPs to be included in the proxy group.

10. 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.

11. 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*,¹³ 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.*¹⁴ 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.¹⁵ The technical conference was held on January 13, 2008 and extensive comments and reply comments were submitted before and after that conference.

¹² *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 120 FERC ¶ 61,068 (2007) (*Proposed Policy Statement*).

¹³ *Petal Gas Storage v. FERC*, 496 F. 3d 695 (D.C. Cir. 2007) (*Petal*).

¹⁴ *Petal Gas Storage, L.L.C.*, 97 FERC ¶ 61,097 (2001), *reh'g.*, 106 FERC ¶ 61,325 (2004) (*Petal Gas*).

¹⁵ *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 121 FERC ¶ 61,165, at P 1 (2007).

12. 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 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.¹⁶

II. Discussion

13. The requests for rehearing 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.¹⁷ 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.

14. Since *Williston Basin Interstate Pipeline Co.*,¹⁸ 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 *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

¹⁶ *Proxy Group Policy Statement, passim.*

¹⁷ 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.

¹⁸ *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036 at P 35 (2003).

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.¹⁹

15. 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.²⁰ 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.²¹

16. The Commission therefore grants rehearing of SFPP's request that Enron is an MLP that might be included in the proxy group. 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. Given this, there is no longer any need to exclude Enron from the proxy group on the grounds that its distributions exceeded earnings.²² For the same reason, the Commission grants rehearing of the SFPP's and Indicated Shipper's assertion that distributions, not earnings, are the proper inputs for the DCF model. Indicated Shippers' remaining arguments regarding the relevance of the *HIOS* and the *Kern River* decisions are rejected given the cited conclusions in the *Proxy Group Policy Statement*. The Commission also grants SFPP's request that the return on equity be calculated in a consistent manner for the 1995 and 1996 test years so that any ultimate conclusion on the ROE issue in this proceeding will be drawn from the same testimony.

¹⁹ *Proxy Group Policy Statement*, 123 FERC at P 95-96, 106.

²⁰ *Id.*, P 47-53.

²¹ *Id.*, P 116.

²² *Id.*, P 57-63.

17. Given the rationale of the *Proxy Group Policy Statement*, the Commission denies Indicated Shippers' request on rehearing that no MLPs be included in the proxy group. For the same reason the Commission also affirms its rejection of the ALJ's pragmatic adjustment to SFPP's rate of return and denies Indicated Shipper's request for rehearing in that regard. The ALJ's pragmatic adjustment has been superseded by the Commission's conclusion that in the case of MLPs the long term growth component of its DCF model should be fifty percent of projected long-term GDP. The Commission also grants the rehearing requests asserting that stability of earnings should not be an issue in these proceedings given the conclusion in the *Proxy Group Policy Statement* that any uncertainty in this regard is reflected in price of the equity of the MLP at issue.²³

18. Finally, the tax deferral adjustment to the return on equity in the December 2006 Order is related to an income tax allowance issue, namely whether the equity rate of return derived from the Commission's ROE methodology should thereafter be adjusted to reflect investor benefits derived from the income tax allowance. As such, this issue is not relevant to the determination of the level of the return on equity itself. Thus, the parties should focus on the equity rate of return itself and not address the issue of any adjustment that should or should not be made to reflect the benefits of income tax allowance deferrals. As discussed, that issue will be addressed in the subsequent order dealing with the income tax allowance issues before the Commission on rehearing in this proceeding.

19. Given the foregoing, the Commission will apply its new policy regarding the proxy group to be used to determine the return on 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 after this order issues, and rebuttal briefs and testimony 105 days after this order issues.

The Commission orders:

(A) The requests for rehearing regarding SFPP's equity cost of capital are granted and denied in part as stated in the body of this order.

(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

²³ *Id.*, P 64-65.

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)

Kimberly D. Bose,
Secretary.