

**Docket No. RP07-\_\_\_\_\_**  
**Black Marlin Pipeline Company**  
**Notice of Rate Change**

**STATEMENT P**  
**CHARLES E. OLSON**

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

**Black Marlin Pipeline Company**

)

**Docket No. RP07-\_\_\_\_**

**PREPARED DIRECT TESTIMONY  
OF  
CHARLES E. OLSON**

1   **Q.    Please state your name, occupation and address.**

2   A.    My name is Charles E. Olson and I am an economist. My address is  
3       10822 Alloway Drive, Potomac, Maryland 20854.

4   **Q.    Please summarize your education and experience.**

5   A.    I attended and received the following degrees from the University of  
6       Wisconsin at Madison: B.B.A. in 1964 (Senior Honors), M.S. in 1966, and  
7       Ph.D. in 1968. My doctoral dissertation analyzed the structure of the  
8       electric power industry.

9       I joined the University of Maryland in 1968 as an Assistant Professor  
10      and taught full-time in the College of Business and Management. I taught  
11      graduate courses in managerial economics, public utilities and  
12      transportation, and undergraduate courses in public utilities and  
13      transportation.

1           In 1971, I was appointed Associate Professor and held that  
2           position until I left in September 1976 to join Zinder Companies, Inc.  
3           ("Zinder") as Senior Economist. In December 1977, I was elected Vice  
4           President and in December 1979, I was elected Senior Vice President. In  
5           September 1980, I resigned to organize my own firm. I returned to Zinder  
6           in December 1986 as its President. In November 2000, I resigned as  
7           President of Zinder. Currently, I am a Tyser Teaching Fellow at the  
8           University of Maryland, Robert H. Smith School of Business, where I teach  
9           courses in economics to MBA students and am Director, Business  
10          Honors. I am also a public utility and pipeline rate consultant.

11          During the past 35 plus years, I have authored and co-authored  
12          various papers, articles, reports and other published material. These have  
13          been published in the Public Utilities Fortnightly, Land Economics, the  
14          Transportation Journal, Business Horizons, and the Highway Research  
15          Record. The Institute of Public Utilities at Michigan State University  
16          published a revised version of my thesis, which is titled "Cost  
17          Considerations for Efficient Electricity Supply." I have also contributed to  
18          two other volumes, Regional Economic Effects of Alternative Highway  
19          Systems (Ballinger Publishing Co., 1974) and Studies in Electric Utility  
20          Regulation (Ballinger Publishing Co., 1975).

21          I have given speeches, workshops and papers to many groups,  
22          both academic and business. I was a coordinator and lecturer in the

1 American Gas Association's Annual Rate Fundamentals Course at the  
2 University of Wisconsin from 1971 to 1996. The topics on which I have  
3 lectured in this course include pricing, utility accounting, rate level  
4 determination, cost of capital and cost of service analysis. I also have  
5 lectured at other American Gas Association short courses.

6 During the past 35 plus years as a consultant, I have worked on  
7 more than 400 rate and certificate cases and have presented testimony  
8 more than 300 times. I have testified before the Federal Communications  
9 Commission, the Postal Rate Commission, the Federal Energy Regulatory  
10 Commission ("FERC"), the Interstate Commerce Commission, the New  
11 York Energy Planning Board, the Dallas and Beaumont City Councils and  
12 public utilities commissions in 40 states, the District of Columbia and three  
13 Canadian provinces. The cases involved electric, gas, water and  
14 telecommunications utilities. I have also testified in oil pipeline and taxi  
15 cases. My testimony covered numerous subjects, including fair rate of  
16 return, rate base, revenue requirements, revenue and expense  
17 adjustments, pricing and rate design.

18 In addition, I have been a consultant on numerous other projects  
19 and studies, including a study of the Uniform System of Accounts for  
20 telephone companies and a study of entry and fare determination policies  
21 for the taxicab industry in Washington, D.C. Working for the Development  
22 Advisory Service of Harvard University, I advised the government of

1 Colombia on public utility rates in 1969. From 1977 to 1978, I directed a  
2 demand study for the gas distribution utilities in New York. Finally, I also  
3 directed a study on gas rate design for the Economic Regulatory  
4 Administration from 1977 to 1978.

5 I have also done a significant amount of community service work,  
6 testifying in a number of cases on a pro bono basis. I have presented  
7 testimony before two congressional committees. I was a member of two  
8 Federal Power Commission ("FPC") National Power Survey Advisory  
9 Committees. In 2005, I testified before a Maryland Senate Committee.  
10 Finally, I was Vice Chairman of the former FPC's Gas Policy Advisory  
11 Council: Transmission, Distribution and Storage-Technical Advisory Task  
12 Force-Rate Design.

13 I am a member of the Transportation and Public Utilities Group and  
14 I am listed in Who's Who in America.

15 **Q. Dr. Olson, what is the purpose of your testimony?**

16 A. The purpose of my testimony is to provide an estimate of the cost of  
17 common equity to Black Marlin Pipeline Company ("Black Marlin" or "the  
18 Company").

19 **CALCULATING BLACK MARLIN'S COST OF EQUITY**

20 **Q. Please explain the methodology you used to estimate the rate of**  
21 **return on common equity capital in this case.**

1 A. I used the same discounted cash flow ("DCF") methodology FERC  
2 historically has used. This methodology is based on certain fundamental  
3 economic principles that, at least in theory, drive investment decisions.

4 **Q. Please explain.**

5 A. Equity owners share in the residual that remains from revenues after  
6 expenses, including interest, are paid. Thus, there is no contractual  
7 relationship as to required earnings between the common stockholder and  
8 the corporation. Earnings on equity can only be judged in terms of  
9 whether they produce market prices for the common shares that permit  
10 capital attraction on terms that are considered fair and reasonable.

11 From an investor's viewpoint, the cost of common equity of a given  
12 company is the minimum expected return which will induce him to buy  
13 stock at the going market price. Thus, the focus must be on what a  
14 reasonable investor -- and not the analyst -- would consider a reasonable  
15 return.

16 For illustrative purposes, consider the following simplified  
17 example: If an investor will buy a stock that is selling at \$20.00 per share  
18 but will not buy it at a higher price, and expects to receive \$1.20 in  
19 dividends and to sell it in exactly one year at \$21.20, the cost of capital is  
20 12 percent, as shown below:

21 
$$\text{Dividend Yield} = (\$1.20 \div \$20.00) = 6\%$$

22 
$$\text{Growth} = (\$21.20 \div \$20.00) - 1 = 6\%$$

1                               Cost of common equity (k) = 12%

2           Unfortunately, the task is not this easy because we do not know what  
3           investors really expect when they decide to buy a given stock.

4                       In my opinion, the most reasonable way to go about estimating the  
5           cost of common equity is to utilize the DCF approach. The DCF approach  
6           to estimating the cost of equity capital is based on the premise that the  
7           investor is buying two things when he purchases common stock:  
8           dividends and growth. Investors in American corporations have come to  
9           expect growth in earnings and dividends per share of common stock  
10          because of a public policy that is committed to increasing Gross Domestic  
11          Product ("GDP"). In addition, the experience of most U.S. corporations  
12          since the end of World War II has been one of increased dividends and  
13          earnings per share. The cost of equity capital using the DCF method is  
14          that discount rate which equates a given market price of a stock with the  
15          expected future flow of dividends and expected rate of growth in earnings.

16                      The DCF is frequently expressed as a formula in which "k," the cost  
17          of capital, is equal to D/MP (dividends divided by market price), the  
18          dividend yield, plus "g," expected growth in dividends. Thus:

19                               
$$k = D/MP + g$$

20                      In utilizing this formula, it must be assumed that "g" can not exceed  
21          "k" because that implies negative dividends. It must also be assumed that  
22          a growth rate, "g," that is equivalent to a constant rate of growth to infinity

1 can be estimated. Mathematically this is true, but it is not important for  
2 purposes of application.

3 Implementation of the DCF approach requires the exercise of  
4 considerable judgment concerning the views of investors. The real  
5 question is what affects investor expectations. Estimating investor  
6 expectations is a difficult task because of the many factors that affect  
7 capital markets in general and common stocks in particular. The current  
8 state of the economy, federal budget uncertainty, the trade deficit, fiscal  
9 policy, expected inflation, foreign exchange rates and Federal Reserve  
10 Board policy all impact significantly on investor judgments. In addition to  
11 these factors, the appropriate return on equity for Black Marlin is governed  
12 by all of the specific factors that influence its particular situation.

13 **Q. What information is available and useful for purposes of making a**  
14 **DCF estimate of the cost of equity capital for Black Marlin?**

15 A. Investors are aware of current conditions in the economy. Significant  
16 factors include the current budget and trade deficits, concerns about  
17 higher inflation, unemployment and uncertainty regarding fiscal policy.  
18 This type of information is available in detail, particularly in this age of the  
19 internet. Presumably, investors utilize it, understand the state of the  
20 economy, and have their own expectations about GDP growth, interest  
21 rates and other factors. These opinions influence their return expectations  
22 and thereby determine the maximum price they will pay for various types



1 of securities. Thus, because investors take the economic situation into  
2 account in their decision-making, information concerning the economy is  
3 reflected in the prices of stocks and bonds at any given time.

4 **Q. Please explain generally how the Commission's DCF model is**  
5 **applied to establish a pipeline's rate of return on equity.**

6 A. FERC has utilized the DCF approach in gas pipeline cases for over 20  
7 years. The DCF methodology generally has been implemented by using  
8 the publicly traded holding companies that own FERC-regulated pipeline  
9 companies and imputing the results to the pipeline for which rates are  
10 being determined. Public companies that were used in the past included  
11 Coastal Corporation ("Coastal"), Panhandle Eastern Corporation, Sonat,  
12 Inc., Transco Energy Company, The Williams Companies, Inc.  
13 ("Williams"), El Paso Natural Gas Company ("El Paso"), Enron  
14 Corporation ("Enron") and others. The group changed over time as  
15 consolidation reshaped the industry, but the focus was always on finding  
16 appropriate -- i.e., comparable -- proxies for jurisdictional gas pipeline  
17 companies. Thus, when El Paso was owned by a railroad, Burlington  
18 Northern, it was not part of the group. However, after it was spun-off and  
19 acquired Tennessee Gas Pipeline, it became part of the comparable  
20 group. In a similar fashion, when Duke Energy ("Duke") acquired  
21 Panhandle Eastern Corporation, Duke was not included in the group  
22 because it was primarily a large electric utility with extensive retail electric

1 customers and numerous coal and nuclear generating units. Usually, the  
2 FERC pipeline proxy group had between 4 and 6 companies, depending  
3 on the ownership pattern. The group usually included most of the major  
4 operating gas pipelines in the U.S.

5 **Q. How has the consolidation within the industry altered the proxy**  
6 **group selection process for DCF purposes?**

7 A. Obviously, the universe of suitable proxy companies has been reduced in  
8 recent years. There is no longer a conventional, generally accepted proxy  
9 group for use in pipeline rate proceedings. As a result, the identification  
10 and selection of appropriate proxy companies has become a more difficult,  
11 and often contentious, issue in rate case litigation. And because the  
12 reliability of any DCF analysis is necessarily a function of the reliability of  
13 the proxy companies used, selection of proxies that are not reasonably  
14 comparable (in terms of business and financial risk profiles) will produce  
15 inappropriate results.

16 **Q. What approach is currently followed in selecting proxy companies?**

17 A. In my view, the current posture of the industry, i.e., following the recent  
18 spate of mergers and consolidations, and the fallout from the Enron  
19 bankruptcy, has made it difficult to land on a standard proxy group that  
20 could be reliably applied across the pipeline industry. As a result, FERC  
21 Staff and other parties have, on occasion, proposed to include gas  
22 distribution or electric utilities in the proxy group. The Commission,

1       however, has generally stuck to pipeline comparables in rate cases,  
2       though it has considered other approaches in certificate cases, such as  
3       Young Gas Storage Company, Ltd., 67 FERC ¶ 61,375 (1994) and Petal  
4       Gas Storage, L.L.C., 106 FERC ¶ 61,325 (2004).

5       **Q.     Please describe how the Commission's implementation of the DCF**  
6       **model has evolved over time.**

7       A.     FERC has consistently based its return on equity decisions on a group of  
8       pipeline holding companies (as previously discussed), using a two-stage  
9       DCF analysis to determine the required return. It has also used the  
10       middle of the range (midpoint or median) for rate setting purposes since  
11       the mid-1990s. (See Panhandle Eastern Pipe Line Company, 71 FERC  
12       ¶ 61,076 (1995) and Northwest Pipeline Company, 71 FERC ¶ 61,253  
13       (1995)). While the group of preferred proxy companies has evolved as a  
14       result of mergers and other factors, FERC has not deviated from the use  
15       of a two-stage DCF, generally adopting as the appropriate return the  
16       central tendency (midpoint or median) of the proxy group range of DCF  
17       results. More recent precedent indicates that the median should be used  
18       in setting gas pipeline returns.

19             Among recent orders on pipeline rate of return are Enbridge  
20       Pipelines, 100 FERC ¶ 61,260 (2002) and Williston Basin Interstate  
21       Pipeline Co., 104 FERC ¶ 61,036 (2003). In Enbridge, FERC determined  
22       that a proxy group of four pipelines was too small. Accordingly, the

1 Commission adopted a five-member proxy group recommended by Staff,  
2 which consisted of Coastal, Columbia Energy, El Paso, Enron and  
3 Williams. The Commission decided the appropriate return was 11.83  
4 percent, based on the median of the range.

5 In Williston Basin decided in 2003, the Commission relied on an  
6 expanded proxy group of nine companies proposed by the pipeline.  
7 However, five of the nine proxy companies, Columbia Energy, Equitable  
8 Resources ("Equitable"), Kinder Morgan, Inc. ("KMI"), National Fuel Gas  
9 Company ("National Fuel") and Questar Corporation ("Questar"), were  
10 diversified, vertically integrated companies that owned significant gas  
11 distribution assets. The Commission noted that this was the best group  
12 available on the record in that case. Staff presented an alternative proxy  
13 group that included LDCs and electric utilities, which the Commission  
14 rejected.

15 **Q. In your view, what is the viability and/or relevance of the proxy group**  
16 **determinations made by the Commission in Enbridge and Williston**  
17 **Basin?**

18 A. Since these decisions were issued, the industry has continued to  
19 experience significant change. Mergers and bankruptcies, for example,  
20 have reduced the Enbridge proxy group to three companies, and these  
21 remaining three have undergone organizational and/or economic changes.

22 **Q. Please explain.**

1 A. For starters, Coastal was merged into El Paso. In addition, Enron has  
2 gone bankrupt and Columbia Energy was acquired by NiSource, a  
3 combination electric-gas utility. El Paso and Williams have experienced  
4 severe financial difficulty. KMI is in the process of being taken private.  
5 These events have made it difficult to find a reliable proxy group that  
6 consists of four or more companies.

7 **Q. You indicated that KMI is in the process of being taken private. Are**  
8 **its shares still being traded?**

9 A. Yes, they are. However, the shares are trading based on expectations  
10 regarding the price at which investors will be bought out and when this will  
11 occur, and not on earnings growth expectations. Hence, FERC's DCF  
12 model will not produce an accurate estimate of the required return on  
13 common equity for KMI at this time.

14 **Q. What is your view of the proxy group used in Williston Basin?**

15 A. I believe that LDCs, or companies with significant LDC (or retail electric  
16 utility) assets, are not appropriate proxy companies for purposes of setting  
17 equity returns for interstate gas pipelines.

18 **Q. Please explain.**

19 A. The risk profile of LDCs and/or retail electric utilities is significantly  
20 different from the risk profile of typical interstate pipelines. LDCs enjoy a  
21 natural service monopoly, with relatively low income elasticity and price  
22 sensitivity and throughput risks. Retail electric utilities are operationally

1 similar to LDCs, with relatively stable and captive markets that provide  
2 fairly predictable revenue streams. The "franchise" structure of LDC and  
3 retail utility operations translates into lower overall business risk and lower  
4 investor expectations relative to interstate gas pipelines.

5 Gas pipelines and LNG operations are one or more levels removed  
6 from the end-use markets served by LDCs and retail utilities and enjoy no  
7 such service monopoly or territorial franchise. Indeed, the relative risk  
8 within the pipeline sector is largely a function of whether, and to what  
9 extent, a pipeline's firm capacity is subscribed by gas marketers or even  
10 LDCs that are one or more segments away from service to comparatively  
11 more stable and less price-sensitive market segments. Particularly when  
12 contrasted to the markets served and risks faced by Black Marlin, the use  
13 of LDCs, or companies with a high-percentage of LDC assets, as proxy  
14 companies does not produce a reliable or representative match.

15 **Q. As a general matter, Dr. Olson, are gas pipelines and storage**  
16 **operations riskier than electric transmission operations?**

17 Yes. Gas pipelines serve LDCs, electric generating plants and industrial  
18 gas users, either directly or through marketers. Electric transmission  
19 companies serve retail electric customers. In my view, there is less risk  
20 with the customer profile of electric transmission companies than pipeline  
21 companies. On average, the price and income sensitivity of retail electric  
22 customers is less than that of gas customers. There are substitutes for

1 gas in almost all applications, but no substitute for many retail electric  
2 applications. The higher price and substitution risk in retail gas markets  
3 carries through to pipeline and storage operations.

4 **Q. What are Black Marlin's business and financial risks?**

5 A. Black Marlin is a small offshore pipeline without any firm customers. Its  
6 2005 operating revenues were \$527,873, down more than 70 percent from  
7 2004. It had a loss of \$1,777,390 in 2005. Black Marlin's system is  
8 located in a mature offshore production area of the Gulf with generally  
9 declining production. Under its volumetric rate arrangement revenues are  
10 totally dependent on volumes which, in turn, are low and decreasing.  
11 Black Marlin is clearly a high risk pipeline.

12 Regarding financial risk, Black Marlin has none because it is 100  
13 percent common equity financed. In my opinion a 100 percent common  
14 equity ratio is appropriate and non-anomalous in this case. Black Marlin  
15 has no firm contracts; this means all of its revenue is at risk. Further, it is  
16 a very small operation with plant that is almost fully depreciated. These  
17 circumstances mean that stand-alone debt financing is impossible. I have  
18 recommended that the Company file its rates based on a 100 percent  
19 common equity ratio.

20 **Q. Have you determined an appropriate proxy group for deriving a rate**  
21 **of return on equity for Black Marlin using the DCF model?**

1 A. Yes. For purposes of this case, I have selected five entities that are  
2 primarily involved in the pipeline, processing and storage businesses.  
3 These activities constitute midstream activities in the supply chain that  
4 brings natural gas from the wellhead to the customer burner tip. For the  
5 most part, these companies all own gas pipelines or other midstream  
6 assets and do not have an extensive base of residential and small  
7 commercial customers. Thus, unlike gas distributors and retail electric  
8 utilities, they do not have the degree of monopoly power that is associated  
9 with a traditional public utility franchise. The five entities are:

10 Energy Transfer Partners (ETP)  
11 Enterprise Products Partners (EPD)  
12 Kinder Morgan Energy Partners (KMP)  
13 Oneok Partners (OKS)  
14 The Williams Companies, Inc. (WMB)

15 **Q. On what basis did you determine these companies to be comparable**  
16 **to Black Marlin?**

17 A. In my opinion, an analysis of Black Marlin's equity return requirements  
18 cannot be reasonably or accurately undertaken based on a proxy group of  
19 holding companies with high percentages of retail gas and electric  
20 customers. Such companies are not comparable to Black Marlin due to  
21 their lower risk and return requirements. Accordingly, a proper application  
22 of the DCF approach must use companies that, as closely as possible,  
23 match the risk of the pipeline being analyzed. The companies I have  
24 selected have risk profiles that are generally comparable to Black Marlin.



1 The comparables, like Black Marlin, are engaged in midstream supply  
2 chain activities and operations.

3 **Q. Would you comment further on the appropriateness of the recently**  
4 **used Staff and Williston Basin proxy companies for pipeline rate of**  
5 **return purposes?**

6 A. Yes. My objection to these proxy groups is based on their failure to reflect  
7 any risk-related distinctions between LDCs (or retail electric utilities) and  
8 interstate gas pipelines. This is a critical consideration. Gas pipelines  
9 provide wholesale service to gas distribution companies and sometimes to  
10 industrial users and electric generating plants. The gas pipeline network  
11 in the U.S. is well developed and this means that few gas pipelines have  
12 locational monopolies. Gas pipeline cash flow is stable and predictable  
13 only to the extent that there are firm, long-term contracts with investment  
14 grade distribution utilities and other customers. However, there is no  
15 monopoly power in comparison to LDCs and electric utilities which  
16 typically have exclusive franchises. This translates generally to lower  
17 investor perceptions of risk for retail gas and electric companies than for  
18 interstate gas pipelines. Hence, the use of vertically integrated proxy  
19 companies that include natural gas and electric distribution operations --  
20 whose large retail customer bases with captive pipeline operations are  
21 inherently more secure and more stable than typical pipeline markets -- is  
22 inappropriate.

1   **Q.   Did you analyze the various integrated companies that have been**  
2   **suggested as pipeline proxies in prior cases?**

3   A.   Yes. I began with the three companies that have significant electric  
4   operations. CenterPoint Energy ("CenterPoint") is an example of a gas  
5   and electric utility that has been inappropriately included as a proposed  
6   comparable company in the past. CenterPoint has 1.8 million retail  
7   electric customers and over 3 million retail gas customers in addition to its  
8   pipeline operation. The company's strategy puts the emphasis on low  
9   cost gas and electric operations. It is not comparable to Black Marlin  
10   because most of its revenue is derived from low risk electric and gas  
11   distribution activity. A part of its pipeline operation feeds its gas  
12   distribution system.

13           Dominion Resources is another example of an electric and gas  
14   company with a relatively minor pipeline operation that has been proposed  
15   as a gas pipeline proxy company. It has 2.2 million retail electric  
16   customers and 1.7 million retail natural gas customers. Dominion  
17   Transmission, Inc. ("DTI"), its gas pipeline subsidiary, is an integrated  
18   interstate gas transmission pipeline and storage system. DTI has some  
19   wholesale customers in addition to its affiliated LDC customers, but its  
20   overall business is very small relative to the total assets of Dominion  
21   Resources. Value Line classifies Dominion Resources as an electric  
22   utility; in my view, it does not belong in a group of gas pipeline

1 comparables. Certainly, Dominion Resources' substantial electric  
2 operation and business risk characteristics make it an especially  
3 inappropriate proxy candidate for a company such as Black Marlin.

4 Duke is another electric utility that sometimes has been proposed  
5 as a proxy for pipelines because it owns some pipeline assets. On April 3,  
6 2006, Duke completed its merger with Cinergy. The merged company has  
7 5.5 million retail electric and gas customers, many of them in Canada.  
8 After the merger was completed, Duke announced that it would spin off its  
9 gas business, making it a stand-alone entity. Duke is classified by Value  
10 Line as an electric utility. In my opinion, it is not an appropriate pipeline  
11 proxy.

12 **Q. What about El Paso?**

13 A. El Paso has long been used as a comparable pipeline in the determination  
14 of pipeline rate of return. While El Paso is primarily a natural gas pipeline,  
15 it heavily invested in the merchant generation and trading businesses,  
16 which contributed to its widely reported financial difficulties. El Paso is  
17 currently going through a restructuring process that involves the sale of  
18 assets to reduce its risk.

19 Value Line (March 17, 2006) reports that "the company still has  
20 much work for the years ahead." It has a sizeable portion of non-core  
21 operations to divest. The true picture is still unclear, with numerous  
22 nonrecurring items reported in the fourth quarter of 2005. Its debt ratio is

1 81 percent, well above the historical average for a pipeline holding  
2 company. In my view, it is still inappropriate to use El Paso as a  
3 comparable or proxy company at this time.

4 **Q. Please turn now to Equitable, National Fuel and Questar. Are these**  
5 **companies appropriate proxies for a pipeline cost of equity analysis?**

6 A. No. According to Value Line, Equitable distributes natural gas to 275,000  
7 customers in Pennsylvania, parts of West Virginia, and Kentucky. Its  
8 pipeline operates in the same states, providing gas supply to its  
9 distribution customers. It obtains 30 percent of its gas supply from its own  
10 gas wells; its gas supply operations provide a high percentage of its  
11 earnings. Clearly, Equitable is a vertically integrated, low risk operation  
12 and is not viewed as an interstate pipeline company by investors. Value  
13 Line classifies Equitable as a diversified natural gas company.

14 In early March 2006, Dominion Resources announced the sale of  
15 its gas distribution utilities in Pennsylvania and West Virginia to Equitable  
16 for \$970 million. This will add 473,500 retail gas customers to Equitable's  
17 base, moving it further in the direction of being largely in the distribution  
18 business. While Equitable continues to add some midstream assets, it  
19 certainly is not viewed by investors as a "pipeline" play.

20 National Fuel is an integrated natural gas utility with more than  
21 700,000 retail gas customers in New York and Pennsylvania. Its pipeline  
22 and storage division has pipelines in these states that serve its distribution

1 business and other customers as well. It also operates an oil and gas  
2 production company. Quite clearly, the pipeline operation was established  
3 to connect the contiguous distribution properties in New York and  
4 Pennsylvania and not as a production-area-to-market-area transportation  
5 system. Thus, while its larger diameter interstate pipe is a "pipeline" in the  
6 legal sense, it is not in an economic sense.

7 Value Line makes the following observation relative to National  
8 Fuel's pipeline business: "The company's pipeline and storage division  
9 owns gas pipelines between Pennsylvania and the New York/Canadian  
10 border near Buffalo." This is a relatively compact area. If the so-called  
11 pipeline property were within the boundaries of a single state, it would be  
12 considered distribution property. Contrast this with California. Sempra  
13 Energy and PG&E Corp. both own pipeline facilities much larger than  
14 those of National Fuel that connect their distribution nodes with interstate  
15 pipelines at various border points. Yet these operations are not  
16 considered pipelines and the companies are not used as proxies in  
17 pipeline rate proceedings. National Fuel should not be a proxy simply  
18 because its gas lines cross state boundaries.

19 Questar is also involved in natural gas production, transportation,  
20 storage and distribution, with 750,000 end-use customers in Utah,  
21 Wyoming and Idaho. Its pipeline income is about 20 percent of total  
22 income and some of it is derived from the company's gas distribution

1 subsidiary. Again, this is another example of a company that cannot be  
2 viewed as a reliable proxy for setting the rate of return for an interstate  
3 natural gas pipeline.

4 In summary, these three companies (Equitable, National Fuel and  
5 Questar) are primarily involved in gas distribution, with secondary  
6 involvement in gas production. Midstream operations are relatively minor.  
7 In all three instances, these companies have FERC regulated pipelines  
8 because they own lines that serve their affiliated gas distribution  
9 customers in more than one state. However, in an economic sense, the  
10 pipelines are not true midstream operations that connect production areas  
11 with market areas. They are viewed differently by investors because they  
12 possess substantial monopoly power in their respective gas distribution  
13 service areas.

14 **Q. Hasn't FERC used Equitable, National Fuel and Questar as proxies in**  
15 **the past?**

16 A. Yes, on two occasions. However, in both instances, the selected proxy  
17 group was a function of evidentiary limitations or other distinguishing  
18 factors. In Williston Basin Interstate Pipeline Co., 104 FERC ¶ 61,036  
19 (2003), the Company proposed a group of proxies that included Equitable,  
20 National Fuel and Questar. Williston requested a return based on this  
21 proxy group, perhaps because it is a pipeline that connects its affiliated  
22 gas distribution customers, which are scattered over several states. The

1 only other potential proxy group in the record in that case included electric  
2 utilities and gas distribution companies. However, even with its lower risk  
3 characteristics, FERC granted Williston a return on common equity of  
4 12.48 percent.

5 Likewise, in High Island Offshore System, L.L.C., 110 FERC  
6 ¶ 61,043 (2005), order on reh'g, 112 FERC ¶ 61,050 (2005) ("HIOS"), the  
7 Commission again departed from past practice to rely on a proxy group  
8 that included the same three companies, based on the record in that case.  
9 Among other things, FERC noted that the gas moving through HIOS is  
10 largely captive to the system and has no direct alternative means of  
11 transportation. In this regard, its business is similar to that of a natural gas  
12 distribution business with a franchised service territory.

13 In short, while Equitable, National Fuel and Questar have been  
14 used as proxies in the past, the decisions appear to have been case  
15 specific. At the time, both cases were unique and apparently involved low  
16 risk pipelines. This contrasts with the high-risk situation faced by Black  
17 Marlin today.

18 **Q. Please describe the business/organizational profiles of the proxy**  
19 **companies you chose for your DCF analysis.**

20 A. Again, the five companies I chose are: Energy Transfer Partners,  
21 Enterprise Products Partners, Kinder Morgan Energy Partners, Oneok  
22 Partners and The Williams Companies, Inc. Energy Transfer Partners

1 engages in the midstream activities of transportation and storage of  
2 natural gas in the United States. The company's midstream segment  
3 gathers, compresses, treats, processes and markets natural gas, primarily  
4 in Texas. Its transportation and storage segment transports natural gas  
5 from various natural gas producing areas through connections with other  
6 pipeline systems, as well as through the company's various pipelines. Its  
7 assets exceed \$4 billion.

8 Kinder Morgan Energy Partners owns gas, oil and carbon dioxide  
9 pipelines, liquids terminals, and dry bulk transfer facilities. A substantial  
10 portion of its revenue appears to be somewhat at risk. While the  
11 ownership of oil pipeline assets is not ideal from a comparability  
12 perspective, such assets are closer in risk to a gas pipeline than are  
13 distribution assets.

14 Oneok Partners engages in gathering, processing, storing and  
15 transporting natural gas in the United States. It owns pipelines and other  
16 midstream energy assets in the upper Midwest and Mid-Continent area.  
17 The company operates four business segments: gathering and  
18 processing, natural gas liquids, pipelines and storage, and interstate  
19 pipelines. Its interstate pipelines include Northern Border, Midwestern,  
20 Guardian and Viking. It is probably the "cleanest" gas pipeline equity  
21 vehicle that is available to investors.



1 Enterprise Products Partners is an integrated provider of natural  
2 gas and natural gas liquids storage, transportation and processing. While  
3 some of its operations are unregulated, it clearly operates on the  
4 wholesale side of the natural gas industry. This makes it more  
5 comparable to Black Marlin than a gas distribution or an electric utility  
6 business.

7 Williams has long been used by FERC as a gas pipeline proxy  
8 company. Williams was negatively impacted by the Enron bankruptcy and  
9 had to sell assets to reduce its debt. The company has recovered and  
10 currently has a larger percentage of gas pipeline assets than it did several  
11 years ago. In addition to gas pipelines, it has a large gathering and  
12 storage operation, a natural gas exploration business, and an energy  
13 trading and marketing business.

14 **Q. I note that four of your comparable companies are Master Limited**  
15 **Partnerships (“MLP”). Has FERC addressed the use of MLPs as**  
16 **proxy companies in gas pipeline rate cases?**

17 A. Yes, the FERC’s 2005 decision in HIOS is significant because it  
18 addressed the issue of selecting comparable companies in a context that  
19 reflects the post Enron meltdown and the use of MLPs. On the other  
20 hand, the decision has some limitations, as it was based on the record  
21 that was developed in that particular case.

1           In my view, there are several key findings the Commission made in  
2     HIOS that are of relevance. First, the Commission apparently agreed with  
3     the Staff recommendation in that case that El Paso and Williams should  
4     be excluded from the proxy group because financial difficulties have  
5     resulted in lowered dividends for these companies. In the context of this  
6     case, I believe that Williams has recovered and can be used and El Paso  
7     cannot.

8           Second, the Commission found in HIOS that the proxy group  
9     proposed by Staff Witness Manganelo of Equitable, KMI, National Fuel  
10    and Questar was the best available proxy group in that case, based on the  
11    record. These four companies were what remained of the original nine-  
12    company Williston group. I explained earlier in my testimony why KMI is  
13    no longer a viable proxy and why Equitable, National Fuel and Questar  
14    are inappropriate proxies for this case.

15          Third, the Commission discussed the differences between MLPs  
16    and corporations and the appropriateness of MLPs as proxy companies.  
17    The Commission observed that, although it has used MLPs as proxies for  
18    oil pipelines, it will not consider including MLPs in the proxy group for gas  
19    pipelines unless the record demonstrates that the MLP distributions used  
20    as the dividend include only a payment of earnings and not a return of  
21    investment.

22   **Q.   How does the Commission's decision in HIOS relate to this case?**

1 A. HIOS is relevant in two respects. First, while FERC ruled out the use of  
2 MLPs in HIOS, it also suggested that they would be considered again in  
3 the context of more information. Second, the HIOS decision indicates that  
4 any witness who proposes to use proxy companies that have electric or  
5 gas distribution assets which are not integrated with pipeline assets  
6 carries a heavy burden. I would also again note that utilities with  
7 integrated distribution and pipeline operations are far less risky than non-  
8 integrated gas pipelines. The characterization of their midstream activities  
9 as being interstate is more a matter of geography and law than it is  
10 economics.

11 **Q. Do all of the five proxy companies that you have chosen for this case**  
12 **pay dividends or distributions?**

13 A. Yes. I have prepared various schedules that support my testimony. They  
14 are attached as Exhibit No. BMP-11 through Exhibit No. BMP-18. Exhibit  
15 No. BMP-11 shows dividend/distribution yields for each of the five entities  
16 for the months of January 2006 through June 2006. The average of the  
17 monthly dividend yields is presented in the right hand column. They range  
18 from a low of 1.4 percent for Williams, to a high of 7.1 percent for  
19 Enterprise Products Partners and Oneok Partners.

20 The first step in the yield calculation process was the collection of  
21 price and dividend or distribution data. This information was obtained  
22 from Yahoo Finance, a widely used and free data base that is available on

1 the internet. For each month from January 2006 through June 2006, the  
2 monthly high and low prices were averaged. They were then divided by  
3 the most recent average annual dividend rate. For example, in May 2006  
4 Kinder Morgan Energy Partners' annual distribution payment rate was  
5 \$3.24 per unit. This amount was divided by an average price of \$45.85 to  
6 obtain a distribution yield of 7.1 percent, as shown on Exhibit No. BMP-11.

7 Step 2 in the yield calculation process is averaging the yields over  
8 the six month period from January 2006 through June 2006. For example,  
9 the six monthly figures on Exhibit No. BMP-11 for Enterprise Products  
10 Partners were averaged, resulting in a figure of 7.1 percent as shown in  
11 the last column. These averages are then carried forward to the first  
12 column of Exhibit No. BMP-14.

13 **Q. How does FERC determine the earnings growth rate for gas**  
14 **pipelines?**

15 A. In gas pipeline cases, FERC prefers a two-stage DCF growth model. The  
16 first stage is the five-year earnings growth rate; first-stage growth is given  
17 a weighting of two-thirds in the FERC model. I obtained the five-year  
18 growth rates from the Yahoo Finance website; the data are provided to  
19 Yahoo by Thompson First Call. Thompson recently bought IBES, which is  
20 the source of five-year earnings forecasts in the FERC model. In that  
21 these growth rates are available at Yahoo Finance, it is clear that  
22 investors have ready access to them.

1           The growth rates in earnings per share for the five selected proxies  
2           are shown on my Exhibit No. BMP- 12. They range from 5.0 percent for  
3           Oneok Partners to 15.0 percent for Williams. Exhibit No. BMP- 13  
4           presents the calculation of the FERC two-stage growth rate that combines  
5           the five-year growth rates with the forecasted long-term GDP growth rate  
6           of 5.8 percent. The long-term GDP growth rate is taken from the Energy  
7           Information Administration's Annual Energy Outlook 2006. Finally, Exhibit  
8           No. BMP- 14 presents the cost of equity calculation for the five proxy  
9           pipeline companies. The range is from 12.6 to 14.7 percent and the  
10          median is 13.8 percent.

11   **Q. In HIOS, FERC noted that the distribution made by MLPs may also**  
12   **include a return of the partners' original investment, unlike a**  
13   **corporate dividend. Does this invalidate the DCF model for MLPs?**

14   **A.** No. There are several issues here. The first is that the DCF approach is  
15          conceptually valid as a financial tool to estimate the cost of equity for an  
16          MLP. DCF, after all, stands for discounted cash flow. The model is a  
17          variant of the net present value model, which also is based on cash flows.  
18          Investors and analysts evaluating an MLP clearly look at and value the  
19          cash flows they expect to receive, not accounting-based definitions of  
20          income. In doing the discounted cash flow analysis for an MLP, investors  
21          realize that large current cash distributions reduce the ability to increase  
22          earnings later. Thus, the higher distributions that are reflected in the yield

1 result in lower projected earnings growth rates than would be the case  
2 with greater cash retention. There is no double counting by Thompson and  
3 the analysts and no conceptual problem associated with the application or  
4 interpretation of the DCF model. Thus, use of the DCF model to evaluate  
5 the cost of partnership (equity) capital does not produce “skewed” results.

6 Second, at page 19 of the HIOS order on rehearing, FERC states  
7 that MLP distributions may include a return of the partners’ original  
8 investment, “unlike a corporate dividend.” This is incorrect. Corporate  
9 dividends may also include a return of capital to the extent that they  
10 exceed retained earnings. Conceptually, there is no difference in this  
11 regard between an MLP and a corporation. Indeed, during the late 1970s  
12 and early 1980s, there were many electric utilities whose “dividends”  
13 included a return of capital. FERC never found that the DCF model was  
14 “skewed” in those situations.

15 Third, the return of capital concept cited by FERC in HIOS is an  
16 accounting and income tax concept, rather than an operating and financial  
17 concept. MLPs do not borrow to return capital to investors. All of the  
18 MLPs that were used in HIOS had significant expected growth rates in  
19 earnings per share. This would have been impossible if they were  
20 borrowing to pay distributions. Instead, distributions are paid from  
21 operating cash flows and are not reducing the year-to-year capital

1 available to the entity. Alternatively, the return of capital component  
2 relates to what is taxable to the individual.

3 Finally, ever since the earlier cited Northwest and Panhandle  
4 decisions, FERC has recognized that it is analyst estimates that drive  
5 share prices. To the extent that distributions exceed accounting earnings  
6 per share, analyst growth estimates will be lower. There is no need to  
7 reduce distributions to make the DCF model work; analysts' estimates  
8 take care of that.

9 **Q. Does the divergence between the level of distributions for the MLPs**  
10 **in your group of comparables and their accounting earnings make a**  
11 **difference in their FERC derived costs of capital?**

12 A. Yes. My distribution yield calculation for Energy Transfer Partners was  
13 based on distributions of \$2.00 and \$2.20; expected accounting earnings  
14 for 2006 are \$2.99. For Oneok Partners, the numbers are also close, with  
15 earnings of \$3.32 and distributions of \$3.20 and \$3.52. The difference for  
16 Enterprise Products Partners is greater, with expected earnings of \$1.09  
17 and a distribution level of approximately \$1.75. This would reduce the  
18 cost of equity for Enterprise Products Partners from 14.7 percent to about  
19 11.9 percent if adjustments were made to reflect the HIOS concerns.  
20 Likewise, the Kinder Morgan Energy Partners number would decline from  
21 13.9 percent to about 12.1 percent.

Exhibit Nos. BMP- 15 and BMP- 16 present earnings-yield-based DCF results. Energy Transfer Partners is earning more than its distribution and there is no adjustment. For Enterprise Products Partners, Kinder Morgan Energy Partners and Oneok Partners, earnings are used in place of distributions in these alternative yield calculations. The recalculated yields are presented on Exhibit No. BMP- 15. The earnings numbers are 2006 estimates from the same Yahoo Finance site that provides the Thompson consensus estimates. The estimates are \$1.09 for Enterprise Products Partners, \$2.31 for Kinder Morgan Energy Partners and \$3.32 for Oneok Partners. Exhibit No. BMP- 16 shows the alternative cost of equity estimate. The median in this case is 12.6 percent, 120 basis points less than the cost of common equity derived for the same group when no adjustment is made to limit distributions to current earnings.

**Q. Is the alternative 12.6 percent less than the cost of common equity for Black Marlin?**

A. I believe it is. Relative to the information shown on Exhibit No. BMP- 14, the alternative rate is at the bottom of the proxy group range. There is no basis, however, for reducing the market-driven DCF result based on the notion that because an MLP distributes more than it "earns," the result is "skewed." Quite clearly, the Wall Street consensus is that growth will continue, regardless of present distribution levels. If the DCF model is



1 appropriate, its result should be driven by the data and not by other  
2 considerations.

3 **Q. A FERC Administrative Law Judge (“ALJ”) recently addressed the**  
4 **question of using MLPs in the proxy group for determining**  
5 **appropriate allowed rates of return for natural gas pipelines. Are you**  
6 **familiar with that proposed decision?**

7 A. Yes. On March 2, 2006, an ALJ issued an initial decision in a Kern River  
8 rate proceeding, Kern River Gas Transmission Company, 114 FERC ¶  
9 63,031 (2006). In that case, the ALJ chose to not include MLPs in the  
10 proxy group, based on her assessment that there had not been an  
11 adequate explanation in the record concerning the issues that had been  
12 raised in HIOS. The proxy group the ALJ chose instead used other  
13 proxies, including some companies whose business activities are  
14 dominated by local distribution activities. The resulting recommendation  
15 for the rate of return on equity was 9.34 percent, the median point of the  
16 selected proxy group range.

17 **Q. What reactions from the investment community have you observed**  
18 **concerning this initial decision?**

19 A. Investor analysts and commentators about regulatory and industry  
20 developments have reacted strongly to this recommended result,  
21 indicating their surprise at such a low ROE and pointing out its  
22 inconsistency with FERC’s current policies encouraging the development

1 of needed pipeline infrastructure. Examples of the reactions of investor  
2 analysts and commentators include reports or publications generated by  
3 (1) Samuel Brothwell, Senior Analyst, Wachovia Securities, entitled "Look  
4 Out Below," dated March 5, 2006 (reprinted with permission from the  
5 author), (2) article published in INSIDE FERC, "Kern River Rate Case  
6 Puts Pipeline Industry On Edge," dated March 13, 2006 (reprinted with  
7 permission from Platts), and (3) article published in Gas Daily, "Kern River  
8 Rate Case Decision Alarms Pipeline Industry Officials," dated March 14,  
9 2006 (reprinted with permission from Platts). Copies of each of these  
10 reports or articles are included in my Exhibit No. BMP- 17.

11 **Q. How does the recommendation of the Kern River ALJ decision**  
12 **compare with the Commission's past determinations concerning**  
13 **allowed rate of return on equity?**

14 A. With the assistance of Williams' legal staff that are supporting this rate  
15 proceeding, a study was made of natural gas pipeline rate cases over the  
16 past thirty years where the final, allowed rate of return on equity was  
17 determined by the Commission through litigation. The results of that study  
18 are shown in the listing of the Commission's decisions that is presented in  
19 Exhibit No. BMP- 18. While the Commission's determinations are the  
20 product of various different return on equity assessment models, vary from  
21 pipeline to pipeline, and are highly dependent upon economic conditions  
22 that prevailed at the time each case was filed, the overall results show

1 that, in litigated cases, the Commission has approved rates of return on  
2 equity ranging from 11.0 percent to 16.5 percent. The clear majority of  
3 such determinations have fallen within the range of 12 percent to 15  
4 percent. Based upon this review, I am of the opinion that the  
5 recommendation of the ALJ in the Kern River decision represents a clear  
6 departure from thirty years of litigated results before the Commission.

7 **Q. Most recently, on October 19, 2006, the Commission issued Opinion**  
8 **No. 486 reversing the ALJ's initial decision and setting Kern River's**  
9 **rate of return on equity at 11.2 percent rather than the 9.34 percent**  
10 **recommended by the ALJ. Can you comment on that decision?**

11 A. No, I cannot at this time. Due to the fact that this decision was only very  
12 recently issued, I have not had an adequate opportunity to fully consider  
13 and analyze the Commission's findings and conclusions, and, therefore, I  
14 am unable to provide a deliberative reaction to that decision at this time.

15 **Q. What do you conclude the cost of common equity is for Black Marlin**  
16 **based on the analysis you have performed?**

17 A. The DCF study supports a return on common equity capital of no less than  
18 12.6 percent and no more than 14.7 percent. Commission guidance in  
19 Opinion No. 396-B indicates that pipelines should be placed at either the  
20 low end, the median, or the high end of the continuum. Black Marlin's  
21 business risks are above average. It has no financial risk with an equity  
22 ratio of 100 percent. This combination is consistent with the middle of the

1 overall risk continuum. Therefore, I recommend an equity return at the  
2 median of the indicated range, or 13.8 percent.

3 **Q. Does this conclude your direct testimony?**

4 **A. Yes.**

**VERIFICATION**

THE STATE OF Maryland  
COUNTY OF Howard

)  
) SS  
)

CHARLES E. OLSON, being first duly sworn, deposes and saith that he is the same CHARLES E. OLSON whose Prepared Direct Testimony accompanies this verification; that such testimony was prepared by him; that he is familiar with the contents thereof; that the facts set forth therein are true and correct to the best of his knowledge, information and belief; and that he does accept the same as his sworn testimony in this proceeding.

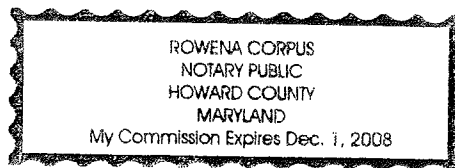
  
\_\_\_\_\_  
CHARLES E. OLSON

SUBSCRIBED and SWORN to before me this 26 day of October, 2006.

(seal)

My commission expires: 12/1/08

  
\_\_\_\_\_  
Notary Public



**Black Marlin Pipeline Company**  
**Dividend/Distribution Yields**  
**Comparable Gas Pipelines**  
**January - June 2006**

**Yields**

<u>Company</u>	<u>Jan-06</u>	<u>Feb-06</u>	<u>Mar-06</u>	<u>Apr-06</u>	<u>May-06</u>	<u>Jun-06</u>	<u>Average</u>
Energy Transfer Partners	6.2	6.0	6.3	5.8	5.5	6.1	5.98
Enterprise Products Partners	6.8	7.1	7.2	7.1	7.1	7.3	7.10
Kinder Morgan Energy Partners	6.1	6.7	6.8	6.8	7.1	7.1	6.77
Oneok Partners	7.2	7.0	6.8	7.2	7.1	7.1	7.07
The Williams Companies, Inc.	1.2	1.3	1.4	1.3	1.4	1.6	1.37

**Black Marlin Pipeline Company**  
**Five Year Earnings and Earnings Growth Rates,**  
**Comparable Gas Pipelines**  
**July-06**

<b>Companies</b>	<b>Five year Growth</b>
<b>(A)</b>	<b>Rate</b>
Energy Transfer Partners	8.50%
Enterprise Products Partners	8.00%
Kinder Morgan Energy Partners	7.50%
Oneok Partners	5.00%
The Williams Companies, Inc.	15.00%
Average	8.80%
Median	8.00%

Source: Yahoo Finance, July 17, 2006

**Black Marlin Pipeline Company**  
**Weighted Average Growth Rate, Five-Year Earnings and GDP Growth**  
**Comparable Gas Pipelines**  
**July-06**

<u>Company</u>	<u>Five Year Growth Rate</u> <u>(2/3 Weight)</u>	<u>GDP Growth (1/3</u> <u>Weight)</u>	<u>Weighted Average</u>
(A)	(B)	( C)	(D)
Energy Transfer Partners	8.50%	5.80%	7.60%
Enterprise Products Partners	8.00%	5.80%	7.26%
Kinder Morgan Energy Partners	7.50%	5.80%	6.93%
Oneok Partners	5.00%	5.80%	5.26%
The Williams Companies, Inc.	15.00%	5.80%	11.93%



**Black Marlin Pipeline Company**  
**Cost of Equity Capital**  
**Comparable Gas Pipelines**  
**Jul-06**

<b>Company</b>	<b>Dividend Yield</b>	<b>Average Growth</b>	<b>Adjusted Yield</b>	<b>Cost of Equity</b>
(A)	(B)	(C )	(D)	(E)
Energy Transfer Partners	6.00%	7.60%	6.20%	13.80%
Enterprise Products Partners	7.10%	7.30%	7.40%	14.70%
Kinder Morgan Energy Partners	6.80%	6.90%	7.00%	13.90%
Oneok Partners	7.10%	5.30%	7.30%	12.60%
The Williams Companies, Inc.	1.40%	11.90%	1.50%	13.40%
Median				13.80%
Mean				13.70%

**Black Marlin Pipeline Company**  
**Dividend/Earnings Yields**  
**Comparable Gas Pipelines**  
**January – June 2006**

**Adjusted Yields**

<u>Company</u>	<u>Jan-06</u>	<u>Feb-06</u>	<u>Mar-06</u>	<u>Apr-06</u>	<u>May-06</u>	<u>Jun-06</u>	<u>Average</u>
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
Energy Transfer Partners	6.2	6.0	6.3	5.8	5.5	6.1	6.00%
Enterprise Products Partners	4.3	4.4	4.4	4.3	4.4	4.4	4.40%
Kinder Morgan Energy Partners	4.6	5.0	5.0	5.0	5.5	5.1	5.00%
Oneok Partners	7.9	7.5	7.0	6.8	6.7	6.7	7.10%
The Williams Companies, Inc.	1.2	1.3	1.4	1.3	1.4	1.6	1.40%

**Black Marlin Pipeline Company**  
**Dividend/Earnings Based Cost of Equity Capital**  
**Comparable Gas Pipelines**  
**July-06**

<u>Company</u>	<u>Dividend Yield</u>	<u>Average Growth</u>	<u>Adjusted Yield</u>	<u>Cost of Equity</u>
Energy Transfer Partners	6.00%	7.60%	6.20%	13.80%
Enterprise Products Partners	4.40%	7.30%	4.60%	11.90%
Kinder Morgan Energy Partners	5.00%	6.90%	5.20%	12.10%
Oneok Partners	7.10%	5.30%	7.30%	12.60%
The Williams Companies, Inc.	1.40%	11.90%	1.50%	13.40%
Median				12.60%
Mean				12.70%

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Inside F.E.R.C.

March 13, 2006

## **HEADLINE: Kern River rate case puts pipeline industry on edge**

An administrative law judge's initial decision on a proposed rate hike by Kern River Gas Transmission has triggered alarm in the gas pipeline industry that it might set a precedent for lower returns on equity for major pipelines, especially those serving expanding Rocky Mountain gas producers.

If the commission upholds the decision of ALJ Charlotte Hardnett, Kern River's proposed return on equity of 15.1% would be ramped down to 9.34%, based on a median ROE for other pipelines with similar market risks, including El Paso Natural Gas, Equitable Resources, Kinder Morgan Interstate Gas Transmission, National Fuel Gas Supply, Questar Pipeline and Williams.

In the nearly two-year-old rate case (RP04-274), Kern River has taken the position that it should be placed at the high end of the zone of reasonableness because it has extraordinary financial and business risks. Kern River testified that it had a highly leveraged capital structure, resulting in lean equity capitalization, the ALJ's decision noted, adding the pipeline claimed its shippers are poor credit risks and gas supply problems are exacerbated by competition for customers.

The judge and those who testified on behalf of the proxy group disagreed. "Kern River did not carry its burden of proving that it should be placed at the high end of the zone of reasonableness. The evidence shows that Kern River should be at the median or broad range of average risk," Hardnett concluded.

Hardnett said Kern River failed to show that "high unusual circumstances" exist to avoid the commission's presumption that existing pipelines fall within a broad range of average risk. The judge noted that, contrary to "every participant weighing in on the issue" and most investors, Kern River argued that information provided by credit analysts such as Moody's and Standard & Poor's were unreliable.

"Participants are quite convincing in making the points, among others, that Kern River has: great credit ratings, good supply and demand, impressive number of firm contracts, little risk from the Mirant bankruptcy and otherwise shows no extraordinary risk," the judge said. "It is especially telling that although Kern River claims to be the most risky pipeline, its witness admitted he had not done a study of the credit risks of the pipelines in the Kern River proxy group."

The judge also rejected Kern River's proposal to blend its debt costs at a 6.62% interest rate for two debt issuances. In doing so, the judge disagreed with the FERC staff position that the blended debt cost in the Kern River case would be just and reasonable. Staff concluded that neither pricing policy nor a certificate issued for a pipeline expansion in 2003 precluded blending debt cost. The expansion was designed to serve new electric generation and boost delivery capacity to 1.7 Bcf/day (IF, 21 April '03, 18).

Hardnett ruled instead that Kern River failed to prove that a weighted-average blended cost of debt would result in just and reasonable rates. Therefore, separate costs of debt should be used for the rolled-in system and the expansion, she concluded. "Blending the cost of debt inappropriately raises the rates charged to the 2003 expansion shippers when they are already paying incremental rates."

The rate case began in mid-2004 when FERC suspended and set for hearing the pipeline's proposed rate hike (IF, 7 June '04, 6). Besides the 15.1% ROE, the tariff filing reflected a \$40 million rise in jurisdictional cost of service to about \$347 million, and a decrease in projected throughput from 630 million Dt to 572 million Dt.

The Kern River system, which began service in 1992, stretches 900 miles from Wyoming through Utah and Nevada, to the San Joaquin Valley in California. It was built to provide 700,000 Mcf/day of year-round services.

The pipeline asserted that because it is relatively young compared with other pipelines, a limited amount of its capital investment has been recovered. It proposed an increase in annual depreciation accrual rates for transmission facilities.

The March 2 initial decision, which now will be taken up by the full commission, caught the attention of Donald Santa, president of the Interstate Natural Gas Association of America. Expressing disappointment with the decision, Santa warned that it sends a negative message to investors. When the ALJ decision reaches commissioners' desks, their decision will be a "litmus test" for how serious they are about encouraging further development of pipeline infrastructure.

"It kind of looks like no good deed goes unpunished if this is what they're going to end up with for an ROE," he said, noting that the industry has invested heavily in recent projects to transport stranded Rocky Mountain gas to consumer markets east and west.

Santa asserted that pipelines face an increasingly uphill battle when they get caught up in rate cases at FERC, and the commission appears less inclined to fully recognize the risk factors.

"They rarely get to the top of the zone of reasonableness. They never seem to get there," Santa said. "The pipeline industry faces greater commercial risk with respect to shorter duration contracts and shipper creditworthiness, and with respect to pipe-on-pipe competition. It's a different competitive dynamic. There doesn't really seem to be much recognition of that."

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Gas Daily

March 14, 2006

## **HEADLINE: Kern River rate case decision alarms pipeline industry officials**

An initial decision on a proposed rate hike by Kern River Gas Transmission has triggered concerns in the gas pipeline industry that it might set a precedent for lower returns on equity?especially for systems serving Rocky Mountain producers.

If the Federal Energy Regulatory Commission upholds the ruling by Administrative Law Judge Charlotte Hardnett, Kern River's proposed return on equity of 15.1% would be cut to 9.34%. The proposed change is based on the median ROE for other pipelines with similar market risks, including El Paso Natural Gas, Equitable Resources, Kinder Morgan Interstate Gas Transmission, National Fuel Gas Supply, Questar Pipeline and Williams.

Donald Santa, president of the Interstate Natural Gas Association of America, expressed disappointment with the ALJ's decision, saying it sends a negative message to investors.

"It kind of looks like no good deed goes unpunished if this is what they're going to end up with for an ROE," Santa said, noting that the pipeline industry has invested heavily in recent projects to transport stranded Rocky Mountain gas to markets to both the east and west.

In the nearly two-year-old case (RP04-274), Kern River has taken the position that its rates should have a higher-than-average return because it has extraordinary financial and business risks.

But the ALJ disagreed. "Kern River did not carry its burden of proving that it should be placed at the high end of the zone of reasonableness. The evidence shows that Kern River should be at the median or broad range of average risk," Hardnett concluded.

She said Kern River failed to show that "high unusual circumstances" exist to avoid FERC's presumption that existing pipelines fall within a broad range of average risk.

The rate case began in mid-2004, when FERC suspended and set for hearing the pipeline's proposed rate hike. Besides the 15.1% ROE, the tariff filing reflected a \$40 million rise in jurisdictional cost of service to about \$347 million, and a decrease in projected throughput from 630 million Dt to 572 million Dt.

The Kern River system, which began service in 1992 with capacity of 700,000 Mcf/d, stretches 900 miles from Wyoming through Utah and Nevada to the San Joaquin Valley in California. A \$1.2 billion expansion that more than doubled its capacity to 1.7 Bcf/d went into service in 2003.

The pipeline asserted that because it is relatively new compared with other pipelines, a limited amount of its capital investment has been recovered.

INGAA's Santa said FERC's consideration of the ALJ's decision will be a "litmus test" for how serious the commission is about encouraging further development of pipeline infrastructure. He asserted that pipelines face an increasingly uphill battle when they get caught up in rate cases at FERC, and the commission appears less inclined to fully recognize the risk factors.

"They rarely get to the top of the zone of reasonableness. They never seem to get there," Santa said. "The pipeline industry faces greater commercial risk with respect to shorter duration contracts and shipper creditworthiness, and with respect to pipe-on-pipe competition. It's a different competitive dynamic. There doesn't really seem to be much recognition of that."



# WACHOVIA SECURITIES

## Look Out Below

March 05, 2006

### Downgrading Sector To Market Weight--Downgrading Ratings On Four Stocks

Sector Rating: Integrated Electric & Gas, Market Weight

Sector Rating: Integrated Natural Gas, Market Weight

Sector Rating: Natural Gas Pipeline, Market Weight

Sector Rating: Natural Gas Pipeline, Market Weight										
Ticker	Stock Rating	Chng. Y/N	Price	FY EPS				FY P/E		
				2005E	Chng. Y/N	2006E	Chng. Y/N	2005	2006	
Integrated Electric & Gas										
D	2	Y	\$73.85	\$4.53	A	N	\$5.15	N	16.3x	14.3x
SRE	1	N	46.65	3.65	A	N	3.50	N	12.8x	13.3x
Integrated Natural Gas										
EP	2	Y	12.97	0.47	A	N	0.92	N	27.6x	14.1x
EQT	1	N	36.73	1.80	A	N	1.98	N	20.4x	18.6x
LNG	1V	N	41.07	(0.92)	N		(1.10)	N	NM	NM
NI	2	N	20.24	1.35	A	N	1.47	N	15.0x	13.8x
STR	2	Y	74.43	3.86	A	N	4.60	N	19.3x	16.2x
SUG	1	N	24.70	1.44	N		1.75	N	17.2x	14.1x
WMB	2	Y	21.67	0.86	A	N	0.91	N	25.2x	23.8x
Natural Gas Pipeline										
OKE	1	N	29.97	2.55	A	N	2.21	N	11.8x	13.6x

Source: Company data and WCM, LLC estimates. NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful  
+ = Outperform, = = Market Perform, - = Underperform, V = Volatile

- We are downgrading our rating on the Integrated Natural Gas sector to Market Weight from Overweight, and are also downgrading our ratings on four stocks in this group to Market Perform from Outperform: Dominion (D), El Paso (EP), Questar (STR), and Williams (WMB). This is a six to twelve month view, and we emphasize that our long-term gas and gas infrastructure theses remain intact. But we believe near-term catalysts increasingly favor the downside and we believe investors will have another opportunity to overweight this group.
- We remain long-term natural gas bulls, but in recent weeks, we have grown increasingly concerned about the growing surplus of gas in storage, which against a backdrop of robust production, likely sets up gas-on-gas competition as storage contracts expire near the end of the heating season.
- As pipeline guys, we don't have an "official" natural gas price forecast, but believe another leg downward is possible from the current \$6-7 level. It's March, and storage is just shy of 2Tcf, almost 50% above historical average. As such, we don't think a \$5 or even a \$4 handle can be ruled out near-term.
- Most of our E&P names appear fairly hedged on 2006 production, so we don't see significant earnings downside. But downward guidance revisions are certainly possible as unhedged volumes get sold into a bearish market. For Rockies producers, we believe this impact could be exacerbated by a basis blowout similar to what happened in 2002.
- On the pipeline side, a FERC Administrative Law Judge recommended decision in the pending Kern River case calls for a 9.34% return on equity, about 300 basis points below what we view as a generally accepted pipeline norm.

#### Utilities

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Natural gas prices have been under a lot of pressure in recent weeks. In our view, things could—and likely will—get worse. Natural gas is sloshing over the sides of storage caverns, backing up in the pipes, and you couldn't attract an LNG tanker to the U.S. for love or money. There was no winter, gas is going to have to come out of storage, and in our view gas prices could see another leg down from here.

Why are we concerned? Let's take a look at the factors that would support gas and those that might undermine it. On the plus side, crude oil remains north of sixty dollars, which on a Btu parity basis would suggest ten dollar gas. We're hearing that industrial loads are returning as gas prices have come down from their double digit peaks; fertilizer production, for instance, has resumed. Petrochemicals certainly favor using natural gas liquids over refinery naphtha at these levels, and it's possible that electric power generation could turn to gas as we enter the nuclear refueling outage season. And, there's always summer, which some weather pundits are predicting will be a scorcher this year.

On the other hand, we've heard arguments for a crude oil retreat, perhaps back to the low \$50s; certainly there is a geopolitical fear premium built in at this point, given Iran, Nigeria, and so on. The strength of the natgas--crude linkage can also be called into question; crude is a global commodity, gas is not, at least not yet. Fuel switching and returning industrial load can mop up some of the excess, but you can't burn natural gas in your SUV.

There is also the speculative element. A lot of fast momentum money came into natural gas late last year as it was running toward \$15. Certainly, it would seem that a lot of that has been chased out in the past several weeks, but perhaps not all of it. We'll know the party is over if an LNG tanker docks on the East River, knocks on the door of a Park Avenue hedge fund, and says "Here's your gas."

The thing that perhaps concerns us most is storage as we head to the end of a very light withdrawal season. Most U.S. gas storage is in the form of depleted gas reservoirs, which are usually only capable of handling one to two turns per year. The gas goes in during the summer and fall, and comes out in the winter. As we understand it, those cycles are critical to maintaining geological integrity.

Storage is nearly fifty percent above normal right now. Contractually, many owners of gas in storage are obligated to remove by the end of the season. If they don't want to remove it, they can ask the storage operator to hold on to it longer. To the extent they have capacity, storage operators can do that, but there are fees involved. And, there are probably a fair number of folks hoping for better prices trying to roll their gas right now, so the storage operator is in the driver's seat. And, keep in mind the cycling requirements noted above. Owners of gas can also try to "float" their gas on the pipeline system, which is common on weekends, but the pipelines can and will impose heavy penalties for that kind of behavior.

If the gas has to come out of storage, it begins to compete with flowing gas, which is flowing pretty good right now, given the drilling response to high prices. While some marginal drilling may retreat, we don't think the producers are going to retreat—especially the big guys, for political reasons if nothing else (see below). When physical gas-on-gas competition occurs because there's more supply than demand, well, get out your Econ 101 book if you don't recall.

So it becomes a question of capitulation. If you're sitting on an underwater position, are you going to throw good money after bad, or are you going to throw in the towel? We think some of the bulls may try to hang in there or double down, betting on a hot summer or a more active hurricane season. We note that famed hurricane forecaster Dr. William Gray of the Colorado State University issues his annual prognostication on April 4, 2006. We believe that will move the market.

## The Low Spark of High Yield Noise

Politically, of course, the current situation is very convenient. Energy prices remain a hot button issue, right below the Middle East and all of its angles. It's an election year, poll numbers are in the tank, and we doubt that there are too many folks inside the beltway who would shed tears over a collapse in natural gas prices.



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Apart from the odd lost campaign contribution, who cares if those New York speculators get fried in their own grease? Keep in mind also that the companies who have been taking most of the arrows on energy prices (can you say windfall profits tax?) are also the majors, who can and probably will drill right through a trough. Not only can they afford to, arguably they can't afford NOT to.

Bottom line, we think it's highly probable that natural gas could see another leg down from here. A five, or even four handle can't be ruled out. We discuss the potential impact to our stocks later in this note (page 5), but suffice it to say we think it could get ugly, and to the extent that earnings guidance rests on unhedged volumes being sold in the high single digits, we think there's risk. Risks to our near-term thesis include a quick warm up, followed by a hot summer, another bad hurricane season, and geopolitical issues that spook the energy markets.

**What of our long term thesis?** Despite all the gas that's sloshing around in the market right now, we continue to believe that North America's reserves are finite, that production in more mature basins will decline, and that replacing that will have to come from more distant (e.g. the Rockies, Alaska, offshore), deep / unconventional sources, and LNG. All of these will cost more. But for now, we've got more than we can burn.

**Ready for The Next Punch?**

"The lawful return on equity in this proceeding is 9.34%."

We've discussed the potential for pressure on ROE in the context of natural gas utility rate proceedings in recent weeks. As gas prices have moved up and driven higher all-in costs to end-use customers, it's natural for state utility regulators to look for ways to keep a lid on ever-rising utility bills. There's not much they can do about the commodity price, but they can affect the cost-of-service side of the equation. As such, we've been concerned about the potential for lower return on equity as a salve to the consumer wounds being inflicted by higher gas prices, and indeed, there have been some single-digit ROE's recommended in recent utility rate proceedings.

The quote above, however, is not from a state proceeding. It is from a FERC administrative law judge in docket RP04-274-000, a pending rate proceeding involving Kern River Gas Transmission Company, which is owned by MidAmerican Energy Holdings, a Berkshire Hathaway company. *A nine handle? From FERC?*

Historically, pipeline equity returns have been in the low double digit range—say 12% or so. As the pipeline business has become more competitive, we've argued that the opportunity—not the guarantee—of more robust returns is warranted by the sector's growing risk profile. Unlike a gas distribution utility, a pipeline is NOT a natural monopoly. Pipelines compete against one another, and routinely negotiate rates below allowed tariffs at arm's length with shippers and utilities.

Investors have been willing to allocate capital to pipelines in recent years for several reasons. One, the sector has been recovering from its post-Enron collapse. Two, while we're awash in gas right now, the increasingly tight long-term U.S. gas supply picture favors a shift in production to new regions (e.g. the Rocky Mountains), which calls for new transport infrastructure to move that gas to market. Three, the market has perceived FERC as an enlightened and less political regulator that perceives the long term value in affording the opportunity to earn a superior (we didn't say outrageous) return for building infrastructure essential to long-term energy supply stability and security.

**Background**

MidAmerican bought Kern River from Williams in 2002 as the latter was having a massive yard sale to pay the rent back. MidAmerican promptly carried out the expansion plans that WMB had shelved for lack of capital, and as part of that process agreed to come before FERC with a cost of service filing three years later; hence, the pending rate case. At the time, Kern negotiated rates at arm's length with the shippers on the expansion. Ironically, one of those shippers (BP) submitted testimony in this case suggesting the 9.34% ROE that the ALJ is proposing to adopt.

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With respect to ROE, the ALJ recommendation examines three proposed gambits. Kern proposed a 15% ROE, reflecting the expected yield plus growth on a basket of master limited partnership owned pipelines. Since Kern isn't an MLP, one could make an argument on that one. FERC Staff recommended 9% using a basket of utility and pipeline companies that appears to have included Williams and El Paso. There's an argument in that one as well, as both of those companies were near death a couple of years ago and, while recovering, barely pay a dividend today.

BP, the shipper (one that presumably was party to the negotiated rates a few years ago) recommended that ROE be keyed to the yield plus growth of a basket of names that includes El Paso, Equitable Resources, Kinder Morgan Inc. (NOT KMP), National Fuel Gas, Questar, and Williams. Curiously, the analysis suggests a weighted average return of 9.34% for this group. And FERC's ALJ bought it.

Over the past five years, the dividends on shares of Williams and El Paso didn't pay much. Questar stock doesn't pay much of a dividend—it's tied to the Salt Lake gas utility, which is a small part of the story—but its stock has increased substantially as its Wyoming gas production business has flourished. EQT presents a similar profile...investors haven't bought its shares for the opportunity to own a utility in Pittsburgh.

Our point? We believe staff and BP's peer group is unreasonable on its face. In our opinion, this basket of stocks is half erstwhile basket cases and half E&P plays. Apply a dividend discount model? We don't think so. There's either no dividend, or if there is, it appears to be an afterthought.

**Politics, Again.**

Will FERC adopt the ALJ recommendation? Hard to say; we are personally acquainted with all three of the sitting commissioners, and hold each in high esteem. Collectively and individually, we view the commissioners as astute, perceptive, independent, and largely apolitical. We also note that FERC's Number 1 over-arching goal, per its website, is to "promote development of a robust energy infrastructure."

That said, FERC is a regulator, and the commissioners sit in judicial roles. They must be objective, impartial, accountable and responsive to all constituencies that petition their agency.

**Soap Box Time**

In this case, a major gas producer and shipper (BP) has proffered a position that would result in the affected pipeline company earning not only well below its sought-after return on equity, but also well below what we believe is a historic norm that investors have generally come to accept. We have argued, and will continue to argue, that the strictures of a competitive market—rewards for superior and efficient operation, and penalties for inferior performance—can and should be brought to bear in this sector.

In large measure, FERC's policies have already fostered a market environment. Pipelines compete with one another for customers, and routinely discount rates below allowed tariffs. Recent disclosures on the planned Rockies Express pipeline reflect that; agreed upon rates were well below the maximum \$1.40 tariff. Contract terms have also grown shorter, meaning that pipeline operators must provide good and valuable service or risk losing business. New projects are subject to rigorous evaluation by both the energy and capital markets; again, the current race to bring gas east from the Rocky Mountain region is prima facie evidence of that.

Natural gas is a finite resource, and must increasingly be sourced from non-traditional fields and methods. It's still out there, but it's also deeper, farther away, and trickier and more costly to get. There's risk involved. The biggest part of that risk occurs at the drill bit, where tens of millions of dollars can be committed to a dry hole. Doesn't happen as often as it used to, but it still happens. The downstream end of the business—the pipes and plants—is less risky by definition, but its risk profile has grown.

Pipelines face a number of business risks today that they didn't face ten to fifteen years ago when 12% ROE was the norm. Decline curves have gotten steeper, meaning that your forty year pipe investment may need to pay out in ten years or less. Pipes compete with one another and routinely discount below allowed tariffs.

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Contract terms have gone from ten and twenty years down to one to three. These risks increase the hurdle rate.

However, pipeline tariffs are still set in a cost-of-service / rate of return context reminiscent of bygone days when contract terms were long, competition was minimal, and pipelines were a low risk business. Yet today, it's possible to commit capital to needed new capacity, as Kern River has done, and wind up having a customer that you negotiated with in good faith turn around and haul you in for a rate cut after you've committed a lot of capital over a multi-year time horizon.

Pipelines aren't as risky as drilling, but aren't as safe as a utility. And, they're very needed, especially as long-term trends portend a shift to production in places where takeaway capacity is lacking, such as the Rockies or in new areas offshore. Investors have been willing to commit capital to new pipeline projects and expansions, but we doubt that equity capital would flow as readily if returns are going to start running three hundred basis points below expectations.

Looked at from another angle, the ALJ recommendation is something of a reverse self-fulfilling prophecy; a jarring recommendation of this nature sends a signal to the market about regulatory risk. As we've noted, FERC has been viewed as less political and more forward-looking than some of its counterparts at the state level. Shaking that view will arguably add to the industry's perceived risk in the capital markets, which in turn could cause investors to demand a greater risk premium.

It's important to keep this in perspective; *this is an ALJ recommendation, not a FERC decision*. We have seen FERC tested on similar issues in the recent past (e.g. the Lakehead issue on partnership owned pipes), and FERC has put forth decisions consistent with the need to continue attracting capital to achieve Goal Number One. Our confidence remains with the Commission at this juncture, but this ALJ sends a bad message at a bad time; it is an issue that bears very close watching in the coming months.

**Downgrading Ratings on D, EP, STR, & WMB**

We are downgrading our ratings on the following stocks to Market Perform from Outperform: Dominion (D), El Paso (EP), Questar (STR), and Williams (WMB). Our broad rationale is what you just read; we summarize the specifics for each of these four below. *Our thesis could backfire; unusually cold or warm weather, a shift to gas generation, return of industrial loads, or even a revision of EIA's gas storage numbers (it has happened in the past) could touch off short-covering and cause natural gas prices to spike, likely moving stocks up in the process.* Both the commodity and the stocks are presently on a knife's edge, in our opinion. As for the pipeline rate case recommendation, we emphasize it is just that, and does not at this point represent FERC policy, which remains to be determined.

We wish to strongly emphasize **Market Perform, not sell**, and our actions here in *no way reflect a change in thinking on any particular company's underlying value potential*, strategy, management capabilities other company-specific fundamentals. However, in our view, each of these companies faces either risk to falling gas prices and/or widening basis differentials, pipeline rate case exposure, or some combination of the two. Coupled with what is, in our view, an over-arching near-term negative bias towards natural gas in the market, we believe the shares of these four companies lack adequate near-term positive catalysts and are likely to trade sideways in the coming months.

At the same time, we have **maintained Outperform** ratings on four other stocks in this group: **Equitable Resources, Oneok, Sempra, and Southern Union**. Again, this view is not a comparison of fundamentals between the two groups; these names are also likely to be pressured by negative sector sentiment, gas prices, etc. However, we believe each of these companies faces less exposure to the risk factors raised in this report; two actually stand to potentially benefit from lower gas prices. And all four have possible catalysts that could still drive near-term upside, in our view.

**Dominion (D)**, while largely hedged (at low levels) on 2006 production, is also driven in the near-term by continued return of 2005 production lost to hurricanes, as well as business interruption insurance proceeds. While the market should look through it, the sale of the Peoples and Hope gas utilities to Equitable will likely

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be somewhat earnings dilutive, as we believe proceeds will be applied to reduce debt. We also believe that D may have some pipeline rate exposure at CNG. Our positive view on Dominion has been and remains focused on the value of its individual parts, weighted beyond 2006. That said, we believe that, at least in the near term, the negative macro catalysts likely counterbalance any near term positives. Longer term, we remain attracted to a compelling valuation thesis supported by a big gas reserve base with significant growth potential, the repricing of the Virginia electric utility fuel clause, and D's attractive gas infrastructure position, which spans pipelines, LNG, and the nation's largest gas storage operation. We remain confident in our 12 to 18 month \$85-91 valuation range (based on our NAV analysis, as well as a low teens multiple to our \$6.25 2007 EPS estimate). Risks to achieving this valuation range may include a significant decline in energy prices, power plant operating problems, an adverse regulatory ruling, or rising long-term interest rates.

**El Paso (EP)** has done well since late last year, and we believe its shares are getting deserved credit for having stabilized the E&P business and—more importantly in our view—owning and growing the nation's largest gas pipeline franchise. That said, we believe EP remains vulnerable to downside risk in natgas prices; its E&P business has made some impressive repositioning strides, but breakeven economics are at \$5.50 gas and the 2006 earnings outlook is based on \$8.00 gas. As noted above, our near term bias is closer to the former than the latter. El Paso's pipeline rate case exposure is probably no greater than any of its competitors, but it is far and away the biggest pipeline operator in the U.S., and therefore at least statistically could face heightened exposure on that front. Finally, EP has publicly committed to issuing new equity to fund its 2005 Medicine Bow E&P acquisition, probably by the middle of this year. Given all that, we believe El Paso's shares are reasonably priced—near term.

**Questar (STR)** should have no concerns on the pipeline rate front, but its stock is highly levered to natural gas prices, with beta heightened by basis differentials, which have already been widening as growing gas production in the Rockies exceeds existing pipeline takeaway capacity. This is a temporal problem, and STR is doing its part to alleviate it by participating in the upstream end of the Kinder Morgan / Semptra Rockies Express gas pipeline, which has gained sufficient shipper commitment to go forward. Near-term however, we note that STR's \$4.60 to \$5.00 2006 earnings guidance was premised on a \$9.00 to \$11.00 Henry Hub for its unhedged production volumes. Given our increasingly bearish view on near-term gas market conditions, as well as the potential for a 2002-style basis blowout in the Rockies, we see growing risk to STR's guidance as well as to our current \$4.60 2006 EPS estimate.

**Williams (WMB)**, unfortunately, sits in the cross hairs of all the issues we raise in this report. Stock upside has, in our opinion—rightly or wrongly—been largely driven by natural gas prices and attendant value in its enviable, big, and fast growing northern Rockies reserve base. We don't think WMB is quite as exposed on basis as STR, but it remains vulnerable to lower gas prices; 2006 guidance assumes a \$7.32 net to well price. On the regulated side, Williams is likely to spend a fair amount of time in front of FERC in the coming months. Transcontinental Pipeline is going in for a rate review in June, and WMB is investing several hundred million dollars in an ongoing upgrade and expansion of Northwest Pipeline. Those capital dollars, needless to say, are being invested with the expectation of a reasonable return on equity at the back end of the process. For planning purposes, we expect that the hurdle on that investment was north of 9.34%. Our sum-of-parts valuation on WMB remains \$28-30. Our valuation range is based on an 8.5-9.5x EBITDA multiple to our 2007 pipeline EBITDA outlook, 8.0-9x for Midstream, 2-3x for Power, & a \$2.00-2.30/Mcf valuation range for an expected natural gas reserve base of 3.7Tcf. We further incorporate market value for the Williams Partners LP units and ascribe modest upside potential for the value of the general partner interest and the net present value of tax net operating loss carryforwards. Risks include natural gas commodity prices, particularly regional basis differentials in the Rockies; energy sector sentiment; pipeline regulation and competition; possible further mark to market losses in Power.

**And The Stocks That Remain Outperform Rated...**

We are sticking with Outperform ratings on Equitable, Oneok, Southern Union, and Semptra. While we believe these names have less exposure to the two central issues raised in this report, it should also be noted that they are by no means immune, and will likely face the headwind of negative energy sentiment in coming weeks and months. Our main reason for sticking with these stocks is the potential for near-term positive

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catalysts, such as MLP formation, asset sales, or in some cases, their potential to benefit from lower natural gas prices.

**Equitable Resources (EQR)**, while also a major gas producer, is less subject to earnings variability due to changes in gas prices this year. With production close to major consuming markets, EQR is also less sensitive to basis than those in the Rocky Mountains. EQR also has some potentially value accretive stock catalysts in the coming months, including the possible formation of a master limited partnership to house its growing midstream and short haul pipeline assets (and help finance the equity portion of its planned acquisition of Pennsylvania and West Virginia gas utilities from Dominion). Risks to Equitable in the near term include negative gas sector sentiment, a possible credit rating downgrade or accelerated need to issue equity, and complications such as tax issues that might hinder strategic actions we believe are under consideration, such as MLP or LLC formation.

**Oneok (OKE)** just announced a highly strategic and value accretive plan to move its midstream business into Northern Border Partners, L.P., of which OKE is the general partner. This rebalances the business portfolio favorably from a risk standpoint and, in our view, there is significant further value upside in the latter as NBP grows its business and therefore the allocation of cash flows to the GP. We also note that OKE/NBP's midstream business actually stands to benefit from falling natural gas prices, as natural gas liquid processing and fractionation spreads should improve. OKE's energy services business could also benefit in a more volatile market. Risks here include the fact that NBP's Northern Border Pipeline company is FERC regulated and currently has a pending cost of service case. Like others, OKE could be pressured by negative sector sentiment.

**Southern Union (SUG)** does have exposure to energy prices through its recently acquired Sid Richardson Energy midstream business in eastern New Mexico, although most of that has been hedged for the current year, and like OKE, SUG might benefit from falling gas prices as processing and frac spreads improve. SUG's pipeline rate case exposure also appears manageable; Transwestern likely under-earning following a loss of some volumes in its recent recontracting. In addition, we believe SUG could see some near term positive catalysts, such as the possible formation of a master limited partnership for its midstream and / or LNG terminal assets. While the risk of additional equity issuance has been mitigated by recent utility sale announcements, we believe SUG remains a higher risk name, prone to doling out surprises.

**Sempra (SRE)** shares have pulled back considerably on a recent competitor downgrade, but we believe SRE is actually a stock that can benefit in a bearish energy market, especially given the opportunities that its marketing and trading unit can seize in periods of volatility, which certainly remains the case. SRE faces a potential earnings lull as it rotates out of its Texas power plants and gears up to develop LNG terminals and the new Rockies Express pipeline with Kinder Morgan. However, the plant sales, as well as the company's upcoming analyst conference at the end of this month, could be near-term positive catalysts. However, Sempra's risk profile is growing with trading's earnings, and we continue to believe that SRE will need to address the growing profile of this business relative to its balance sheet and the potential risks that exist to its single A credit rating.

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# LIST OF ROE CASES FOR THE PAST 30 YEARS THAT WERE LITIGATED TO FINAL RESULT\*

Company	Docket No.	Effective Date of Rates	ROE	Cite
Kentucky West Virginia Gas Company	RP73-97	11/01/1973	12%	2 FERC ¶ 61,139 (1978); Opinion and Order Approving in Part and Modifying in Part Decision of ALJ
Kentucky West Virginia Gas Company	RP76-93	10/31/1976	13%	4 FERC ¶ 63,023 (1978); Initial Decision Affirmed by 8 FERC ¶ 61,269 (1979); Order Affirming Initial Decision
Consolidated Gas Supply Corporation	RP78-52 and RP79-22	01/11/1980	12.5%	10 FERC ¶ 61,029 (1980); Opinion No. 70; Opinion and Order Affirming in Part and Modifying in Part Initial Decision
United Gas Pipe Line Company	RP77-107 and RP78-68	01/01/1978	12.5%	13 FERC ¶ 61,044 (1980); Opinion No. 99; Opinion and Order Affirming in Part and Modifying in Part Initial Decision
East Tennessee Natural Gas Company	RP78-12	05/01/1978	11.5%	13 FERC ¶ 61,227 (1980); Opinion No. 106; Opinion and Order Affirming in Part and Modifying in Part Initial Decision
Natural Gas Pipeline Company of America	RP77-98 and RP78-78	07/01/1977 (RP77-98) 12/01/78 (RP78-78)	12.8%	13 ¶ FERC 61,266 (1980); Opinion No. 108; Opinion and Order Affirming in Part and Modifying in Part Initial Decision
Algonquin Gas Transmission Company	RP80-72	08/01/1980	15%	22 FERC ¶ 61,279 (1983); Order Affirming Initial Decision and Reserving Issue for Later



LIST OF ROE CASES FOR THE PAST 30 YEARS THAT WERE LITIGATED TO FINAL RESULT\*

Company	Docket No.	Effective Date of Rates	ROE	Cite
				Determination
<b>Consolidated Gas Supply Corporation</b>	RP81-80	01/01/1982	15.3%	24 FERC ¶ 61,046 (1983); Opinion No. 180; Order Affirming in Part and Reversing in Part Initial Decision
<b>Alabama-Tennessee Natural Gas Company</b>	RP80-2	04/03/1980	11%	25 FERC ¶ 61,151 (1983); Opinion No. 196; Opinion and Order Severing Decision on Violation Matter and Establishing Just and Reasonable Rates
<b>Tennessee Gas Pipeline Corporation</b>	RP77-62, et al	02/01/1977	15.95%	26 FERC ¶ 61,109 (1984); Opinion No. 190-A; Order Granting in Part and Denying in Part Rehearing
<b>Distrigas of Massachusetts Corporation</b>	RP81-34	08/02/1981	16.50%	26 FERC ¶ 61,256 (1984); Opinion No. 210; Opinion and Order Establishing a Just and Reasonable Return on Equity
<b>Mountain Fuel Resources, Inc.</b>	RP82-14	06/01/1982	14%	27 FERC ¶ 61,171 (1984); Opinion No. 214; Opinion and Order Affirming Initial Decision
<b>Midwestern Gas Transmission Company</b>	RP82-117	01/01/1983	14%	31 FERC ¶ 61,317 (1985); Opinion No. 236; Order Affirming Initial Decision
<b>Arkansas Louisiana Gas Company</b>	RP82-75 and RP82-76	06/01/1982	15.4%	31 FERC ¶ 61,318 (1985); Opinion No. 235; Order Affirming in Part and Reversing in Part Initial Decision
<b>Ozark Gas Transmission System</b>	RP84-53	03/01/1984	14.64%	39 FERC ¶ 61,142 (1987); Opinion No. 273; Opinion and Order Affirming in Part and Modifying in

**LIST OF ROE CASES FOR THE PAST 30 YEARS THAT WERE LITIGATED TO FINAL RESULT\***

<b>Company</b>	<b>Docket No.</b>	<b>Effective Date of Rates</b>	<b>ROE</b>	<b>Cite</b>
				Part Initial Decision
<b>Williston Basin Interstate Pipeline Company</b>	RP84-62 and RP84-93	01/01/1985	14.5%	48 FERC ¶ 61,034 (1989); Order Affirming in Part and Modifying in Part Initial Decision
<b>Trailblazer Pipeline Company</b>	RP84-94, et al.	01/01/1985	14.0%	50 FERC ¶ 61,188 (1990); Order Granting Rehearing in Part, Dismissing Rehearing in Part, Granting Clarifications, Rejecting Proposed Settlement, and Affirming in Part and Reversing in Part Initial Decision
<b>Williston Basin Interstate Pipeline Company</b>	RP87-115	03/01/1988	14%	56 FERC ¶ 61,104 (1991); Order Affirming in Part and Reversing in Part Initial Decision
<b>Pacific Gas Transmission Company</b>	RP90-109, et al.	11/01/1990	12.6%	62 FERC ¶ 61,109 (1993); Opinion No. 381; Order Affirming Initial Decision in Part
<b>Transcontinental Gas Pipe Line Corporation</b>	RP92-137	09/01/1992	14.45%	76 FERC ¶ 61,096 (1996); Order on Rehearing
<b>Williams Natural Gas Company</b>	RP93-109	11/01/1993	13.46%	84 FERC ¶ 61,080 (1998); Order Granting Rehearing in Part
<b>Transcontinental Gas Pipe Line Corporation</b>	RP95-197 & RP96-44	09/01/1995	12.49%	84 FERC ¶ 61,084 (1998); Opinion No. 414-A; Order on Rehearing
<b>Iroquois Gas Transmission System, L.P.</b>	RP97-126	01/01/1997	12.38%	84 FERC ¶ 61,086 (1998); Order Affirming in Part and Reversing in Part Initial Decision
<b>Michigan Gas Storage Company</b>	RP96-290	08/01/1996	12.25%	87 FERC ¶ 61,038 (1999); Order on

# LIST OF ROE CASES FOR THE PAST 30 YEARS THAT WERE LITIGATED TO FINAL RESULT\*

Company	Docket No.	Effective Date of Rates	ROE	Cite
Northwest Pipeline Corporation	RP95-409	02/01/1996	12.22%	Initial Decision 87 FERC ¶ 61,266 (2000); Order Affirming in Part and Denying in Part Initial Decision
Transcontinental Gas Pipe Line Corporation	RP97-71	05/02/1997	12.40%	90 FERC ¶ 61,279 (2000); Order on Initial Decision
Williston Basin Interstate Pipeline Company	RP95-364	01/01/1996	12.36%	91 FERC ¶ 63,005 (2000); Initial Decision (Remanded by Commission)
Northwest Pipeline Corporation	RP93-5	06/11/1997	13.67%	99 FERC ¶ 61,305 (2002); Order on Remand
Enbridge Pipelines (KPC)	RP99-485	03/01/2000	11.83%	100 FERC ¶ 61,260 (2002); Order on Initial Decision
Williston Basin Interstate Pipeline Company	RP00-107	01/01/2000	12.48%	104 FERC ¶ 61,036 (2003); Order on Initial Decision
High Island Offshore System, L.L.C.	RP03-221	07/01/2003	11.22%	110 FERC ¶ 61,043 (2005); Order on Initial Decision and Settlement Offer

\* List does not include certificate proceedings or cases primarily involving storage companies and services. List also excludes the following cases that were settled after the Commission's Order on Initial Decision, with the result that the ultimate ROE determination was "settled" as opposed to "litigated": Ozark Gas Transmission System, 68 FERC ¶ 61,032 (1994); Panhandle Eastern Pipe Line Company, 71 FERC ¶ 61,228 (1995); Panhandle Eastern Pipe Line Company, 74 FERC 61,109 (1996); Williston Basin Interstate Pipeline Company, 79 FERC 61,311 (1997); and Trunkline Gas Company, 90 FERC 61,107 (2000).