

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

Saltville Gas Storage Company L.L.C.)	
)	Docket No. RP08- -000
)	

**PREPARED DIRECT TESTIMONY
OF
ROBERT B. HEVERT**

1 **I. INTRODUCTION AND QUALIFICATIONS**

2 **Q.1. Please state your name, affiliation, and business address.**

3 A. My name is Robert B. Hevert, and I am President of Concentric Energy Advisors,
4 Inc. (“CEA”), located at 313 Boston Post Road West, Suite 210, Marlborough,
5 Massachusetts 01752.

6
7 **Q.2. On whose behalf are you testifying?**

8 A. I am testifying on behalf of Saltville Gas Storage Company L.L.C. (“Saltville Gas
9 Storage”, the “Company”, or the “Facility”).

10
11 **Q.3. Please describe your experience in the energy and utility industries.**

12 A. I have previously served as an executive and manager with other consulting firms (*i.e.*
13 REED Consulting Group and Navigant Consulting, Inc.), and as a financial officer
14 of Bay State Gas Company. I have provided testimony regarding strategic and
15 financial matters, including the cost of capital, before several state utility regulatory
16 agencies and the Federal Energy Regulatory Commission (the “FERC” or the
17 “Commission”), and have advised numerous energy and utility clients on a wide

1 range of financial and economic issues including both asset and corporate-based
2 transactions. Many of those assignments have included the determination of the cost
3 of capital for transaction and valuation purposes. A summary of my professional
4 and educational background is provided in Exhibit No. SGS-16 to my Direct
5 Testimony.

6
7 **Q.4. Please describe CEA's activities in energy and utility engagements.**

8 A. CEA provides financial and economic advisory services to a large number of energy
9 and utility clients across North America. Our financial advisory activities include buy
10 and sell-side merger, acquisition and divestiture engagements; due diligence and
11 valuation engagements, including the provision of fairness opinions; project and
12 corporate finance services; and transaction support services. Our economic and
13 market analysis services include utility ratemaking and regulatory advisory services,
14 energy market assessments, market entry and exit analysis, and energy contract
15 negotiations.

16
17 **II. PURPOSE AND OVERVIEW OF TESTIMONY**

18 **Q.5. What is the purpose of your testimony?**

19 A. The purpose of my testimony is to present evidence and provide a recommendation
20 regarding the Company's return on equity ("ROE"). My analyses and
21 recommendations are supported by the data presented in Exhibit No. SGS-17
22 through Exhibit No. SGS-24.

23

1 **Q.6. What are your conclusions regarding the appropriate ROE for Saltville Gas**
2 **Storage?**

3 A. Based on my analyses, I have concluded that the Company should be provided the
4 opportunity to earn a ROE in the range of approximately 12.54 percent to
5 approximately 14.34 percent. Taking into consideration the risks currently facing the
6 facility, it would be reasonable to recommend an ROE toward the upper end of that
7 range. Nonetheless, the Company has elected to request an equity cost rate of 13.50
8 percent, which is approximately the midpoint of that range.

9
10 **Q.7. Please provide a brief overview of the analyses that led to your conclusions.**

11 A. Consistent with Commission precedent, my analyses and recommendation are based
12 primarily on the two-stage Discounted Cash Flow ("DCF") model. My application
13 of the DCF model and analytical results are based on third-party analyst growth
14 projections, as well as market-based information including current annual dividends
15 (or distributions), and recent stock (or unit) prices. In applying and assessing the
16 results of my DCF analyses, I considered certain costs and trends, including the
17 fundamental business risks currently facing the natural gas pipeline industry in
18 general and the Company in particular.

19 The Commission, Saltville Gas Storage and other interstate gas companies are at a
20 crossroads in re-evaluating the methodologies employed in their application of the
21 DCF model for purposes of determining ROE. As a result of industry
22 consolidation, financial instability, and diminished involvement in regulated interstate
23 gas pipeline operations, the historical proxy group no longer provides a reasonable
24 comparison for a financially stable interstate gas pipeline. As a practical matter, there

1 is only one corporate pipeline company (The Williams Companies) that possibly
2 could be considered a proxy for Saltville Gas Storage. As such, I have relied upon
3 the DCF approach to estimate the cost of equity, and for the reasons discussed later
4 in my testimony, have incorporated certain Master Limited Partnerships (“MLPs”) in
5 my analysis.

6

7 **Q.8. What has the Commission’s position been with respect to establishing the**
8 **proxy groups for return on equity analysis for interstate natural gas pipelines?**

9 A. In assessing the reasonableness of proposed proxy groups, the Commission has
10 consistently looked to certain screening criteria. Over time, fewer corporate pipeline
11 companies were eligible to serve as proxy companies due to mergers, credit
12 concerns, and re-organizations as MLPs. Consequently, in prior proceedings the
13 Commission has included distribution companies with interstate pipeline operations
14 as proxies for interstate natural gas pipeline companies in its determination of
15 interstate pipeline ROEs. As the Commission correctly noted in *Kern River*,¹
16 however, distribution companies tend to be less risky than interstate pipeline
17 operations and as such, median ROE results based on proxy companies with
18 substantial distribution operations would require a subjective adjustment, i.e.,
19 movement to a point above the median, to reflect that incremental risk.²

¹ *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006).

² *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077 at para. 172 (2006). See also *Petal Gas Storage, L.L.C. v. FERC*, Case No. 04-1166 (D.C. Circuit August 7, 2007) (“*Petal*”) in which the United States Circuit Court of Appeals for the D.C. Circuit held that the Commission included natural gas distribution companies in the proxy group without an analysis of relative risk.

1 **Q.9. Is there legal precedent for the composition of a proxy group in gas pipeline**
2 **and storage rate of return determinations?**

3 A. Yes. On August 7, 2007, the United States Court of Appeals for the District of
4 Columbia Circuit returned a decision in the case of *Petal Gas Storage, L.L.C., Petitioner v.*
5 *Federal Energy Regulatory Commission, Respondent, et al.* In its decision, the Court
6 reaffirmed the emphasis on the determination of the appropriate risk profile of the
7 subject company through the proper determination of the proxy group. The Court
8 held that the specified rate of return must logically fall from the proxy group analysis,
9 in that if the proxy group is determined to have less risk on average than the
10 company in question, the specified rate of return should reflect this and fall to the
11 high side of the range of possible returns. The court refused to prescribe a set of
12 rules for the composition of a proxy group, stating that:

13 *What matters is that the overall proxy group arrangement makes sense in terms*
14 *of relative risk and, even more importantly, in terms of the statutory command to*
15 *set "just and reasonable" rates, 15 U.S.C. § 717c, that are "commensurate with*
16 *returns on investments in other enterprises having corresponding risks" and*
17 *"sufficient to assure confidence in the financial integrity of the enterprise . . . [and]*
18 *maintain its credit and . . . attract capital," Hope Natural Gas Co., 320 U.S.*
19 *at 603.*

20
21 The court recognized the shifting nature of public markets in its decision and
22 specifically left open the opportunity for the FERC and others to utilize available
23 data in making a determination of the appropriate risk profile of a particular
24 company. Similarly, the court did not rule out the use of master limited partnerships
25 (MLPs) in a proxy group, as long as the risk profile of the proxy group is weighed
26 against the perceived risks of the subject company.

27

1 **Q.10. Have there been changes in the Commission's position regarding use of MLP**
2 **entities in proxy groups for return on equity analysis?**

3 Yes. On July 19, 2007, the Commission issued a Proposed Policy Statement in
4 Docket No. PL07-2-000, addressing the composition of proxy groups for
5 determining gas and oil pipeline return on equity. In the Proposed Policy Statement,
6 the Commission is proposing to update its standards concerning the composition of
7 the proxy groups used to decide the ROE of natural gas and oil pipelines, since firms
8 engaged in the pipeline business are increasingly organized as MLPs. Therefore, the
9 Commission proposes to modify its current policy regarding the composition of
10 proxy groups to allow MLPs to be included in the proxy group.

11
12 **Q.11. Did the Commission express concerns with the inclusion of MLP's in the**
13 **proxy group for the purposes of setting a natural gas pipeline return on**
14 **equity?**

15 A. In its Proposed Policy Statement the Commission identifies three concerns with the
16 use of MLPs in the proxy group; 1) the Commission states that its primary concern
17 regarding MLP distributions has arisen from the "interaction" between the DCF
18 model, (which includes projections of distributions) and the depreciation allowance,
19 which provides for a return of capital to the subject company. The Commission
20 suggests that in order to ensure that ROE results based on MLPs are not distorted,
21 DCF analyses should exclude cash distributions "in excess of earnings"³, although
22 the issue as to what constitutes "earnings" has been left unaddressed. 2) In addition,
23 the Commission has acknowledged that the higher payout ratios associated with

³ Docket No. PL07-2-000, *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, para. 19.

1 MLP distributions are related to lower growth rates (approximately 300 basis points)
2 but has concluded that when using adjusted distribution yields such issues do not
3 render DCF results unreliable. 3) Finally, the Commission proposes that the
4 inclusion of MLPs in natural gas pipeline proxy groups would be conditioned upon
5 the ability to demonstrate the stability of past earnings, which presumably would
6 provide evidence of the sustainability of future distribution growth.

7
8 By issuing this Proposed Policy Statement, the Commission acknowledged the need
9 to consider including MLPs in pipeline proxy groups, subject to certain guidelines.
10 As discussed in more detail below, however, both the underlying premise and the
11 proposed approach to calculating adjusted MLP distributions are misplaced. Finally,
12 while cash flow and distribution growth sustainability are important characteristics,
13 forward-looking measures of financial stability are superior to backward-looking
14 reviews of historical earnings.

15

16 **Q.12. What are your preliminary observations regarding the Commission's concerns**
17 **about MLP distributions in excess of earnings and MLP payout ratios?**

18 A. As to the first point, the Commission's concern has arisen from the "interaction"
19 between the DCF model (which includes projections of distributions) and the
20 depreciation allowance (which provides for a return of capital to the subject
21 company). The Commission suggests that in order to ensure that ROE results based
22 on MLPs are not distorted, DCF analyses should exclude cash distributions "in

1 excess of earnings,”⁴ although the Commission has not addressed the issue as to
2 what constitutes “earnings.” As discussed later in my Testimony, absent a
3 corresponding change to one or both of the other DCF components, the
4 Commission’s proposed adjustment would produce unreasonably low DCF results.
5 Regarding the second point, the Commission has acknowledged that the higher
6 payout ratios associated with MLP distributions are associated with lower growth
7 rates (approximately 300 basis points) but has erroneously concluded that such issues
8 do not render DCF results unreliable using *adjusted* distribution yields.

9

10 **Q.13. Has the Commission proposed to address the concern related to stability of**
11 **future distributions?**

12 A. Yes. The Commission proposes that the inclusion of MLPs in natural gas pipeline
13 proxy groups would be conditioned upon an analysis demonstrating the stability of
14 past earnings; that analysis presumably would provide evidence of the sustainability
15 of future distribution growth.

16

17 **Q.14. Do you agree with the Commission that the proposed changes in**
18 **methodology and additional screening criterion are necessary to include**
19 **MLPs in the proxy group?**

20 A. No. As noted above, in issuing the Proposed Policy Statement, the Commission
21 appropriately acknowledged the need to consider including MLPs in pipeline proxy
22 groups, subject to certain guidelines. As discussed in more detail herein, however,
23 both the underlying premise and the proposed approach to calculating adjusted MLP

⁴ Docket No. PL07-2-000, *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, para. 19.

1 distributions are misplaced. Finally, while cash flow and distribution growth
2 sustainability are important characteristics, forward-looking measures of financial
3 stability are superior to backward-looking reviews of historical earnings.
4 Nonetheless, the selection of criteria by which comparability is assessed should be
5 left to the proponents and opponents of specific proxy firms.

6

7 **Q.15. Have you performed any analyses to address the concerns that have been**
8 **raised by the Commission in its Proposed Policy Statement?**

9 A. Yes. As discussed in more detail later in my testimony, in response to the
10 Commission's concern that MLP's cash distributions to unit holders may not be
11 comparable to the corporate dividends the Commission uses in the DCF analysis, I
12 first analyzed whether projected distributions are expected to be paid out of
13 operating cash flows (including distributions to the General Partner). In each case
14 for which such projections were available, I found that distributions were expected
15 to be made entirely from internally generated funds. Based on that analysis, I
16 concluded that the MLP distribution yields were not biased by the source of funds
17 underlying the projected distributions.

18

19 In order to address the Commission's concern that the comparatively high MLP
20 yields (relative to corporate entities) might unduly "distort" the expected growth
21 rates, I compared the relative contributions of the yield and growth components to
22 the DCF results for a proxy group of MLPs, The Williams Companies (which, as
23 discussed later herein, is the sole corporate pipeline company that is eligible to be
24 included as a proxy company) and the three LDCs referenced in *Kern River*. As

1 expected, the growth component represented a substantially smaller portion of the
2 DCF result for the MLPs relative to the corporate entities. I concluded, therefore,
3 that the MLP distribution yields appropriately result in lower expected IBES growth
4 rates.

5
6 To assess whether the MLPs' growth is more dependent on external financing than
7 the corporate companies, I examined the extent to which the analysts' consensus
8 growth estimates (as provided by I/B/E/S) exceeded the implied "sustainable
9 growth rate"⁵ (defined as the product of the earnings retained and the expected
10 return on equity) for the MLPs and corporate entities, respectively. That analysis
11 showed that analysts' growth expectations are considerably greater than the
12 "sustainable growth" estimate for both groups, indicating that external financing is a
13 significant element of expected long term growth for both MLPs and corporate
14 entities. I therefore concluded that there is no basis to assume that the consensus
15 MLP growth rates are "distorted" relative to corporate growth rates by virtue of
16 external financing.

17

18 **Q.16. How is the balance of your direct testimony organized?**

19 A. My remaining direct testimony is organized into five sections. Section III discusses
20 the regulatory guidelines and financial considerations pertinent to rate of return
21 estimates. Section IV discusses current economic conditions that have a bearing on
22 the determination of an appropriate rate of return. Section V discusses the criteria
23 and approach for the selection of my proxy group of comparable companies.

⁵ The sustainable growth rate is one measure of long term growth which by definition does not give effect to growth via external financing.

1 Section VI explains the data and methodologies in my analyses and my
2 recommendation of the appropriate ROE for Saltville Gas Storage. Section VII
3 summarizes my results and conclusions.
4

5 **III. REGULATORY GUIDELINES AND FINANCIAL**
6 **CONSIDERATIONS**

7 **Q.17. Please describe the guiding principles used in establishing the ROE for a**
8 **regulated utility.**

9 A. The United States Supreme Court's precedent-setting decisions in *Hope* and *Bluefield*
10 established the standards for determining the fairness or reasonableness of a utility's
11 allowed ROE. Among the standards established by the Court in those cases are: (i)
12 consistency with other businesses having similar or comparable risks; and (ii)
13 adequacy of the return to support credit quality and access to capital, while
14 maintaining financial integrity. The *Hope* and *Bluefield* cases read, in pertinent part:

15 A public utility is entitled to such rates as will permit it to earn a
16 return on the value of the property which it employs for the
17 convenience of the public equal to that generally being made at the
18 same time and in the same general part of the country on investments
19 in other business undertakings which are attended by corresponding
20 risks and uncertainties; but it has no constitutional right to profits
21 such as are realized or anticipated in highly profitable enterprises or
22 speculative ventures. The return should be adequate, under efficient
23 and economic management, to maintain and support its credit and
24 enable it to raise the money necessary for the proper discharge of its
25 public duties. A rate of return may be reasonable at one time and
26 become too high or too low by changes affecting opportunities for
27 investment, the money market and business conditions generally.⁶
28
29

* * *

⁶ *Bluefield Waterworks & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, at 692-693 (1923).

1 Rates which are not sufficient to yield a reasonable return on the
2 value of the property used at the time it is being used to render the
3 service are unjust, unreasonable and confiscatory...⁷
4

5 * * *

6 From the investor or company point of view, it is important that
7 there be enough revenue not only for operating expenses, but also
8 for the capital costs of the business. These include service on the
9 debt and dividends on the stock. By that standard the return to the
10 equity owner should be commensurate with returns on investments
11 in other enterprises having corresponding risks. That return,
12 moreover, should be sufficient to assure confidence in the financial
13 integrity of the enterprise, so as to maintain its credit and to attract
14 capital.⁸
15

16 **Q.18. Why is it important for a utility to be allowed the opportunity to earn a return**
17 **adequate to attract capital at reasonable terms?**

18 A. There is a long history regarding the allowed return on equity, the role of capital
19 structure, and the resulting cost of capital in the establishment of just and reasonable
20 rates for utility services. Among the themes common to many Federal, State and
21 Supreme Court cases is the principle that a utility's cost of capital (including its
22 capital structure and allowed return on common equity) must be reflective of other
23 enterprises having comparable risks acting independently in the financial markets. A
24 return that is adequate to attract capital at reasonable terms enables the utility to
25 provide safe, reliable service while maintaining its financial integrity. In keeping with
26 the *Hope* and *Bluefield* standards, that return should be commensurate with the returns
27 expected elsewhere in the market for investments of equivalent risk. The
28 consequence of the Commission's order in this case, therefore, should be to provide
29 the Company with the opportunity to earn a return on equity that is: (1) adequate to
30 attract capital at reasonable terms, thereby enabling it to provide safe, reliable natural

⁷ Id., at 690-692.

⁸ *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, at 603 (1944), ("Hope").

1 gas storage service; (2) sufficient to ensure the financial integrity of the Company's
2 gas storage operations; and (3) commensurate with returns on investments in
3 enterprises having corresponding risks. To the extent the Company is provided the
4 opportunity to earn its market-based cost of capital, neither customers nor
5 shareholders should be disadvantaged.

6

7 **Q.19. Please discuss the importance of the allowed rate of return from the**
8 **perspective of the capital markets.**

9 A. The financial community continues to put the pipeline industry under intense
10 scrutiny. There is little question, for example, that the rating agencies continue to
11 focus on financial profiles and business risks for all pipeline companies. To that
12 point, Standard & Poor's noted that:

13 When evaluating the creditworthiness of natural gas pipeline
14 companies, Standard & Poor's analysis begins with a qualitative
15 assessment of a company's business risk profile. The company's
16 financial metrics are then examined in light of its business risk
17 profile, since companies with higher business risk require stronger
18 financial metrics at the same rating category.⁹
19

20 Thus, the allowed rate of return should take into consideration capital market
21 expectations relative to both earnings and risk.

22

23 **Q.20. Has the Commission recognized the importance of establishing a rate of**
24 **return that is commensurate with the risks incurred by equity investors?**

25 A. Yes, in *SoCal*, the Commission concluded that "investors generally cannot be
26 expected to purchase stock, if debt, which has less risk than stock, yields the same

⁹ Standard & Poors, "Key Rating Factors for U.S. Natural Gas Pipelines", *Commentary Report* (10 August 2005): at 1.

1 return.”¹⁰ As discussed later in my testimony, that conclusion is relevant to the DCF
2 results for certain corporate pipeline and LDC companies in this case.
3

4 **Q.21. What is the basis for your recommended ROE for Saltville Gas Storage?**

5 A. My recommended ROE is based on a proxy group of publicly-traded corporations
6 and Master Limited Partnerships with significant interstate natural gas pipeline and
7 storage operations. My recommendation relies on a range of reasonableness,
8 determined by the high and low DCF results. By selecting a group of entities with
9 risks and business characteristics more comparable to Saltville Gas Storage, I have
10 ensured that my analysis in this proceeding comports with the *Hope* and *Bluefield*
11 standards upon which my recommendation is based, as well as the FERC standard
12 for natural gas pipelines, established in *Williston Basin*.¹¹ As such, my analyses result
13 in a recommended ROE that is both commensurate with the Company’s total risk
14 (i.e., business risk and financial risk) and sufficient to attract capital at reasonable
15 rates.
16

17 The Commission has stated its preference for the application of a Discounted Cash
18 Flow (“DCF”) model that incorporates both near-term earnings growth forecasts
19 and longer-term estimates of macroeconomic growth (referred to herein as the “two-
20 stage DCF” model). My testimony, therefore, relies heavily on the two-stage DCF
21 model.

¹⁰ SoCal Edison, 92 FERC paragraph 61,070 at 61,266 (2002).

¹¹ *Williston Basin Interstate Pipeline Company*, 104 FERC ¶ 61,036 (2003).

1 **IV. CURRENT ECONOMIC CONDITIONS**

2 **Q.22. Please describe the business environment and risks currently facing interstate**
3 **natural gas pipeline and storage companies.**

4 A. Natural gas pipeline and storage companies are faced with a series of regulatory,
5 business and economic risks that, in aggregate, continue to exert competitive
6 pressure, thereby influencing both business and financial risks. In general, shorter
7 contract durations, counter-party credit risk, and pricing pressure resulting from the
8 lower of cost or market based rates has increased the competitive nature of the
9 natural gas pipeline and storage business in general.

10
11 **Q.23. Is it your view that Saltville Gas Storage faces greater risk than other interstate**
12 **pipeline and storage companies?**

13 A. Yes. Based on my review of the Company's business and financial risks, Saltville
14 Gas Storage faces greater overall operating risk than other interstate pipeline and
15 storage companies. As discussed in the testimony of Mr. Gibson market conditions
16 as a whole have worked to establish prices for storage that are currently less than
17 Saltville's existing recourse rates. The influence of market forces on Saltville, a
18 regulated storage provider, that results in the inability to recover the Company's
19 revenue requirement distinguish Saltville from other interstate pipeline and storage
20 facilities. While Saltville operates under tariff based recourse rates, the Company
21 competes with storage providers operating under market based rates. Therefore,
22 Saltville must compete with market based rate facilities in off-peak periods,
23 discounting capacity to the market rate. However, in on-peak periods, when storage

1 facilities operating under market based rates can recover costs through higher storage
2 costs, Saltville's rates are capped at the recourse rate.

3
4 As Mr. Gibson explains, in response to this highly competitive business
5 environment, where pricing is often the lesser of cost based or market pricing, the
6 Company has been forced to enter into negotiated rates with the majority of its
7 customers. As Mr. Gibson notes, while the throughput from these contractual
8 commitments is considered in the calculation of the revenue requirement, once on
9 negotiated rates, the customer's rate no longer changes with tariff changes, thereby
10 posing a risk that the Company will not achieve its revenue requirement. Therefore,
11 the Company's competitive response results in a diminished return on equity.

12
13 Importantly, the business risks noted above distinguish the Company from other
14 natural gas pipeline and storage companies. Based on those risks an ROE above the
15 midpoint would be appropriate, however the Company is requesting 13.50 percent
16 return on equity.

17 V. PROXY GROUP COMPANIES

18 **Q.24. Why is it necessary to use a proxy group in the determination of an equity**
19 **return?**

20 A. The use of proxy groups is a widely employed analytical method to assist in
21 estimating the cost of equity for a particular company. As discussed in more detail
22 later in my testimony, the methods most commonly used by financial analysts to
23 estimate the cost of equity are based on company-specific market data and
24 projections. In the case of Saltville Gas Storage, the Company has no publicly traded

1 equity. As such, it is necessary to develop a group of publicly traded entities that are
2 comparable to the Company in certain fundamental respects. Since it is possible that
3 market data for a single company may reflect the effects of unusual or transitory
4 events, the primary benefit of using a group of comparable companies is that it
5 serves to attenuate the effects of anomalous events that may be associated with any
6 one company. Additionally, proxy groups include a range of characteristics for
7 companies deemed to be comparable to Saltville Gas Storage, and thus provide a
8 benchmark to gauge the reasonableness of ROE estimate results.

9

10 **Q.25. How did you select the companies included in your proxy group?**

11 A. Since there are no publicly traded storage companies, I relied on natural gas pipelines
12 as a reasonable set of proxy group companies. In order to ensure that the risks faced
13 by the proxy group companies are comparable to Saltville Gas Storage, I verified that
14 the companies that are included in my final proxy group own and operate storage
15 facilities.

16

17 **Q.26. How did you select the natural gas pipeline companies that were included in**
18 **your proxy group?**

19 A. I began with the six company group used by the Administrative Law Judge in her
20 initial decision in *Kern River*. These six companies are derived from the same group,
21 adjusted for divestitures and mergers, approved by the Commission in *Williston Basin*,
22 and today represent those corporate entities with the most significant natural gas
23 pipeline holdings. That group consists of El Paso Corporation; Equitable Resources,

1 Inc.; Kinder Morgan, Inc.; National Fuel Gas Company; Questar Corporation; and
2 The Williams Companies.

3

4 **Q.27. Have you adopted the six company group in its entirety as your proxy group?**

5 A. No, I have not. While all of those companies meet certain screening criteria, there
6 are varying degrees to which their financial performance relies on regulated, as
7 opposed to non-regulated operations. Moreover, several of those companies derive
8 only a small portion of their financial results from FERC-regulated natural gas
9 transmission. As discussed in more detail below, the effect of that criterion is to
10 substantially limit the number of corporate natural gas pipeline companies that
11 reasonably can be considered comparable to Saltville Gas Storage.

12

13 **Q.28. On what basis do you claim that certain of the six companies previously listed**
14 **as successors to the Williston Basin proxy group, fail to meet your screening**
15 **criteria?**

16 A. Equitable Resources and Questar fail to meet my requirement that natural gas
17 transmission represents a significant portion of the combined business segments.
18 Further, Equitable Resources failed to meet the criterion that a substantial portion of
19 its economic value is derived from interstate pipeline or storage operations. These
20 companies have been rejected by the Commission in the past due to the fact that
21 they are substantially local distribution companies with a significantly different risk
22 profiles than that of a FERC-regulated entity.¹² El Paso's financial condition
23 requires that it be excluded from my proxy group due to the reduction of its

¹² *Williston Basin Interstate Pipeline Co.*, 87 FERC ¶61,264 at 62,007 (1999).

dividend and its continued low credit rating. Finally, Kinder Morgan was taken private on May 30, 2007 and therefore cannot be included in the proxy group.

Q.29. Please describe the basis on which you determined whether the candidate companies were substantively engaged in natural gas transmission.

A. As summarized on Table 1 (below), as of December, 2006, the percentage that pipeline operations contributed to revenues, operating income and utility assets varied significantly among the six corporate natural gas pipeline companies:

Table 1: Business Segment Information¹³

COMPANY	% REVENUE FROM PIPELINE OPERATIONS	% OPERATING INCOME FROM PIPELINE OPERATIONS	% ASSETS FROM PIPELINE OPERATIONS	OVERALL WEIGHTING
El Paso Corporation	63%	[1]	55%	59%
Equitable Resources	5%	7%	[2]	6%
Kinder Morgan, Inc.	61%	66%	56%	66%[3]
National Fuel Gas	10%	37%	21%	23%
Qwestar Corp.	6%	13%	[2]	10%
Williams Companies	11%	37%	26%	25%

[1] The percentage of historical operating income from pipeline operations for El Paso was volatile over the 2004-2006 period and therefore has not been included.

[2] Equitable Resources and Qwestar did not report assets by business segment in the 2005 and 2006 SEC form 10-K.

[3] Overall weighting for Kinder Morgan, Inc. excludes 2006 Operating Income.

For the purposes of my ROE recommendation, I have considered those companies with an overall weighting for interstate natural gas pipeline operations of greater than 25 percent to be significantly engaged in interstate natural gas transportation. In my view, this approach is somewhat more inclusive than the approach taken in *Williston* wherein the Commission stated that it determined whether a company's pipeline operations constituted a high proportion of its business based on whether on average

¹³ Source: SEC Forms 10-K and 10-Q. The percentages in the table represent the average of 2006 and 2005. Refer to Exhibit No. SGS-18.

1 over the most recent three year period, approximately 50 percent or more of “total
2 dollars” was produced in at least one of two areas, including operating income and
3 total assets.¹⁴
4

5 As indicated in Table 1 (above), my analysis of Equitable Resources indicates that
6 only 6 percent of its combined operations were derived from natural gas pipeline
7 operations, whereas 24 percent of its operations are related to its LDC activities and
8 52 percent relate to natural gas supply. Questar’s natural gas pipeline operations
9 comprise only 10 percent of its business, while its gas distribution operations total 24
10 percent and its exploration and production operations contribute 66 percent of its
11 total. National Fuel’s natural gas pipeline operations represent approximately 23
12 percent of its operations, while its LDC operations make up 42 percent, and the bulk
13 of the remainder is attributable to exploration and production. In the case of
14 Questar and Equitable, there is little question that interstate pipeline and storage
15 services constitute too small a percentage of consolidated operations to be
16 considered comparable to Saltville Gas Storage.
17

18 **Q.30. Why have you excluded National Fuel from your proxy group?**

19 A. First, the DCF result for National Fuel Gas is considerably below any reasonable
20 estimate of required equity returns for natural gas utilities, much less interstate
21 pipeline and storage companies. As the Commission pointed out, investors cannot
22 be expected to invest in common equity if debt “yields essentially the same return.”¹⁵
23 At that time, the DCF model produced ROE estimates for El Paso and Williams that

¹⁴ Kern River Gas Transmission Company, 117 FERC ¶ 61,077, fn 225.

¹⁵ *Southern California Edison Company*, 92 FERC ¶ 61,070 at 61,266 (2002). Referred to herein as “SoCal”.

were approximately 110 basis points above the Moody's utility index bond yield. As shown on Table 2 (below), the current spread (*i.e.* the implied equity risk premium) between the DCF result for National Fuel and the six-month average yield on the Moody's Baa utility bond index is approximately 157 basis points. Even that risk premium, however is inadequate to attract new investment. The spread between Commission-authorized natural gas pipeline returns and the Moody's Baa utility bond yield demonstrates that the required risk premium is far greater than 157 basis points. As shown in Table 2 (below), the spread between the Moody's Baa utility bond yield and the allowed return in *Kern River* was 495 basis points. Furthermore, the average spread between the Moody's Baa utility bond yield index and the average Commission-authorized pipeline returns from 2000 through the January 2008 is 465 basis points. The 157 basis point risk premium implied by the National Fuel Gas DCF result, therefore, is unrealistically low.

Table 2: Equity Risk Premia

	NATIONAL FUEL GAS	KERN RIVER	AUTHORIZED PIPELINE RETURNS¹⁶
DCF Result	8.00%	11.20%	11.68%
Moody's Baa Utility Bond Yield	6.43%	6.25%	7.03%
Equity Risk Premium	1.57%	4.95%	4.65%

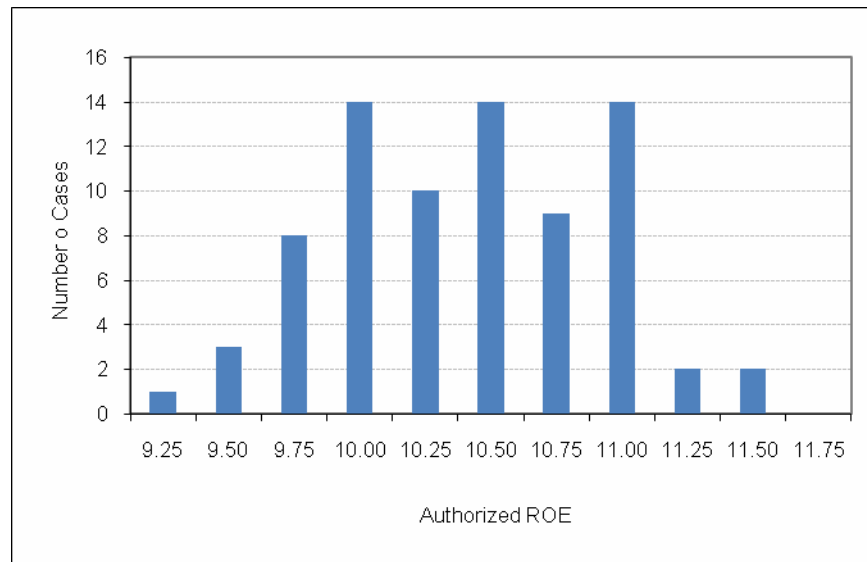
It is also important to note that National Fuel derived approximately 23 percent of its consolidated operations from interstate gas pipelines and storage services. Since that level of operations is below my 25 percent threshold, in my view, National Fuel does not have sufficient interstate pipeline and storage operations to be considered comparable to Saltville Gas Storage.

¹⁶ *Northwest Pipeline Corporation*, Docket No. RP06-407, Exhibit No. NWP-43, sponsored by Charles E. Olson

Q.31. Is there another benchmark that can be used to assess the reasonableness of the DCF results for National Fuel?

A. Yes. As the Commission pointed out in *SoCal*, there is no dispute that LDCs are less risky than interstate pipeline companies. As shown on Chart 1 (below) since 2004 there has not been a single natural gas utility ROE award that has been below the 9.10 percent that was recently awarded to National Fuel Gas. In addition, during that same time period the average spread between authorized gas LDC ROEs and the concurrent yield on the Moody's Baa utility index (i.e., the equity risk premium) was over 400 basis points. National Fuel's 8.00 percent DCF result, therefore is clearly well below the return that would be expected for the comparatively low risk LDC group, much less than would be expected for interstate pipeline and storage companies. Consequently, it would be inappropriate to include National Fuel in the Saltville Gas Storage proxy group.

Chart 1: LDCs Allowed Return on Equity



1 **Q.32. Why have you excluded El Paso from your proxy group when it has the**
2 **highest percentage of natural gas pipeline operations of all the companies?**

3 A. El Paso, although it is owner of a large pipeline network, continues to suffer from a
4 weakened financial and credit profile. For example, in 2003 El Paso reduced its
5 dividend. In addition, while the rating agencies have provided mixed signals on the
6 outlook for El Paso, they have noted significant concerns with the company's
7 balance sheet and its exploration and production business unit. Standard and Poor's
8 ("S&P's") risk assessment for El Paso remains high "based on [its] view of the
9 struggling exploration and production (E&P) segment, which has proven to be very
10 volatile."¹⁷ Furthermore, S&P notes that EP's balance sheet is 'highly leveraged,'
11 making it difficult to turn around the E&P segment.

12
13 Fitch further noted that "[w]hile the balance sheet improvement at El Paso is
14 significant, including a material reduction in external debt at the parent company
15 level, consolidated and parent company debt will remain sizeable at year-end 2007."¹⁸
16 Finally, Fitch stated that upstream operating results would have to improve and
17 credit measures would need to strengthen before it would consider taking a positive
18 rating action. Fitch currently assigns El Paso a BB+ rating with a "stable" outlook.

19
20 Standard & Poor's ("S&P") assigns El Paso a BB rating with a "positive" outlook,
21 citing as weaknesses "aggressive debt leverage, weak cash flow credit protection
22 measures and underperforming exploration and production operations."¹⁹ S&P

¹⁷ Standard & Poor's Stock Report, September 8, 2007, p. 1.

¹⁸ Fitch Ratings, Leveraged Finance Weekly, March 9, 2007.

¹⁹ Standard & Poor's Ratings Direct, ElPaso Corp, June 6, 2007, p. 1.

1 clarifies that its positive outlook reflects “the potential for the E&P segment to
2 produce the cash flow necessary for improved credit metrics in the next 18 to 24
3 months.”²⁰ S&P noted, however, that the E&P business unit has repeatedly failed
4 to meet its targets in recent years. Furthermore, S&P noted that “[f]ailure to meet
5 upstream targets or a deterioration in liquidity could dampen upward ratings
6 prospects.”²¹

7 While Moody’s assigns El Paso a positive outlook and a credit rating of Ba3,
8 Moody’s also states that the company’s credit rating hinges on the returns of the
9 E&P business segment. The E&P business segment, which represents
10 approximately one-third of the company’s EBIT is identified by Moody’s as the
11 company’s “predominant business risk.” Such a company cannot be expected to
12 share the same investment expectations as those for a company such as Saltville Gas
13 Storage.

14
15 Finally, El Paso has recently announced several asset sales and transfers including the
16 sale of 25 percent of Ruby Pipeline to Pacific Gas & Electric and the formation of El
17 Paso Pipeline Partners, to which El Paso Corporation has assigned partial ownership
18 interest in 12, 300 miles of pipeline and 89 Bcf of underground storage capacity.

19
20 **Q.33. Why did you not consider Saltville Gas Storage’s parent Company, Spectra**
21 **Energy Corp, for inclusion in the proxy group?**

22 A. Due to the circular logic that results from the inclusion of Spectra, the parent
23 company of Saltville Gas Storage, in the proxy group to establish the appropriate

²⁰ *Ibid*, p. 3.

²¹ *Ibid*.

1 ROE for the Facility, it generally is my practice not to consider the subject company
2 or its parent for inclusion in the proxy group.

3

4 **Q.34. What companies remain from the six that you considered for inclusion in the**
5 **proxy group?**

6 A. Only The Williams Companies remain and, therefore, there is no viable proxy group
7 using only publicly-traded pipeline corporations. The Williams Companies were
8 upgraded to investment grade in November 2007 by both Moody's and Standard and
9 Poors, following the sale of power generation assets, which removed a significant
10 cash flow overhang. However, The Williams Companies recently formed two master
11 limited partnerships that own and operate natural gas pipeline and storage operations
12 that were formerly owned by The Williams Companies. Typically, to obtain a group
13 of companies with comparable business risks, I would apply several screens to my
14 proxy group candidates including screens to verify that all companies were of
15 investment grade or better and were not parties to significant transactions.
16 Therefore, even in spite of the credit rating upgrade, if such a screening requirement
17 for all proxy group companies' were applied in this case, because of the spin-off of
18 assets, even Williams would have been excluded, leaving no corporate pipeline proxy
19 companies. However, since there are sufficient storage assets that remain in The
20 Williams Companies, I have included The Williams Companies as the only corporate
21 pipeline and storage company in my proxy group. Fitch has assigned Williams a
22 "positive" outlook suggesting a stronger credit profile than El Paso. S&P now
23 assigns Williams a rating of BBB- with a "stable" outlook, indicating that this

1 outlook will be upgraded to positive if Williams “continues to strengthen its credit
2 metrics and exercises greater capital discipline.”²² Furthermore, S&P notes that:

3 The rating also reflects the company’s improved financial metrics
4 resulting from strong business results across all business segments.²³
5

6 Moody’s rates Williams Baa3 with a stable outlook. In its commentary describing its
7 ratings rationale for The Williams Companies, Moody’s states:

8 The stable outlook reflects Moody’s expectation that Williams will
9 successfully execute the growth strategy it has outlined, including
10 growing its natural gas production and other natural gas businesses,
11 while not increasing its debt.²⁴
12

13 As part of Moody’s discussion, however, Moody’s makes clear that The Williams
14 Companies’ strategy of funding operations through the dropping down of assets into
15 its two MLPs is critical to the stability of William’s credit rating. Moody’s states:

16 While Moody’s does not expect Williams’ cash flow from operations
17 to be sufficient to meet capex and dividends requirements over the
18 next twelve months, the company has the flexibility to slow its
19 accelerated E&P capital spending plan. Additionally, as previously
20 noted, Williams’ strategy is to drop down assets to WPZ and the
21 proposed pipeline MLP to fund this negative free cash flow.²⁵
22

23 Consequently, it would not be unreasonable to include Williams in the proxy group.
24 Even if one were to include Williams, given the lack of fundamental comparability
25 issues associated with LDCs (discussed earlier) and the fact that Williams is the only
26 corporate pipeline that could be considered, it is necessary to expand the universe of

²² Standard & Poors, RatingsXpress, Williams Cos. Inc Upgraded to ‘BBB-’ and off creditwatch after completion of asset sale, December 7, 2007, p. 3.

²³ *Ibid*, p. 1.

²⁴ Moody’s Investor, Credit Opinion: Williams Companies, Inc., November 16, 2007, p. 4

²⁵ *Ibid*, p. 3.

1 potential comparison companies to include publicly traded interstate gas pipelines
2 structured on MLPs.

3

4 **Q.35. Please discuss the process by which you selected the companies included in**
5 **your proxy group.**

6 A. To ensure that my proxy group meets the comparability standard set forth in *Hope*
7 and *Bluefield*, I began by considering all of the companies that Value Line classifies as
8 the Diversified Natural Gas industry group. This industry group includes the
9 majority of the publicly-traded corporations and MLPs that have significant interests
10 in interstate natural gas transportation. As I have discussed, the publicly traded
11 corporations did not meet the criteria for inclusion in the proxy group. I then
12 considered MLPs with significant natural gas pipeline operations that were not
13 covered by Value Line. From this population, I applied the following criteria (see
14 also Exhibit No. SGS-17):

- 15 1) All of the companies have publicly-traded common stock or units;
- 16 2) All of the companies have significant involvement in natural gas transmission
17 and own 100 percent of at least one FERC-regulated natural gas pipeline;
- 18 3) All of the companies derive 50.0 percent or more of their revenues and
19 income from natural gas transmission;
- 20 4) All of the companies are currently paying cash dividends or distributions;
- 21 5) All of the companies are in sound financial condition with no pending
22 negative ratings actions that would significantly impact investors' perception
23 of risk; and
- 24 6) None of the companies are engaged in significant transactions involving
25 mergers or acquisitions.

26

1 The first two criteria are consistent with the Commission's Order in *EPGT Texas*
2 *Gas Pipeline L.P.*, 99 FERC ¶61,295 (2002), wherein the Commission commented on
3 screening criteria for proxy group companies in natural gas proceedings. To that
4 point, the Commission stated that "[t]he companies should be publicly-traded,
5 engaged largely in natural gas transmission, and own natural gas pipelines regulated
6 by the Commission."²⁶

7
8 In order to determine the extent to which the candidate companies are engaged in
9 pipeline operations, I developed a list of interstate pipelines owned by each of the
10 companies evaluated for potential inclusion in the proxy group (see Exhibit No.
11 SGS-18). For each of those companies, I gathered revenue, operating income, and
12 asset data by business segment for the years ended 2006 and 2005. Based on that
13 data, I calculated the percentage of revenues, operating income and assets associated
14 with natural gas transmission, an analysis that is critical to the selection of a
15 reasonable proxy group in identifying peer companies with risks comparable to those
16 of Saltville Gas Storage. (See Exhibit No. SGS-18).

17
18 **Q.36. Did you use the same proxy group screening criteria for the MLPs and the**
19 **corporate companies reviewed above?**

20 A. Yes, I have reviewed the publicly traded corporations and the MLPs engaged in
21 natural gas pipeline operations according to the thresholds discussed earlier.

22

26 99 FERC at 62,250.

Q.37. What is the final composition of your proxy group?

A. My proxy group is comprised of the following five companies:

- The Williams Companies
- Boardwalk Pipeline Partners, L.P.
- Enterprise Products Partners, L.P.
- Kinder Morgan Energy Partners, L.P.
- OneOK Partners, L.P.

Exhibit No. SGS-19 provides a list of pipelines owned by each of the MLPs included in my proxy group.

VI. DETERMINATION OF THE APPROPRIATE ROE

Q.38. Please describe the DCF approach.

A. The DCF approach is based on the theory that an equity share's price represents the present value of all future expected cash flows. In its simplest form, the DCF model expresses the ROE as the sum of the expected dividend (or distribution) yield and long-term growth rate. The DCF approach estimates a firm's ROE as the rate that equates the discounted value of all future cash flows expected by investors with the value of its common stock (or limited partnership units). In its most common form, the DCF model is expressed as follows:

$$k = \frac{D(1+g)}{P} + g \quad [1]$$

where "k" equals the required return, "D" is the current dividend (or distribution), "g" is the expected growth rate, and "P" represents the subject company's stock (or

1 unit) price.²⁷ As noted later in my testimony, consistent with Commission precedent,
2 the two-stage form of the DCF model used in my analysis is essentially similar to
3 Equation [1], but for the fact that the growth rate, g , is calculated as the weighted
4 average of a near-term and a long-term growth rate.

5

6 **Q.39. What assumptions are required for the DCF model?**

7 A. The DCF model requires the following assumptions: (i) a constant average growth
8 rate for earnings and dividends; (ii) a stable dividend payout ratio; (iii) a constant
9 price-to-earnings multiple; and (iv) a discount rate greater than the expected growth
10 rate. In light of those assumptions, it is not uncommon for analysts to apply
11 considered judgment or to make specific adjustments to model inputs or results in
12 arriving at an ROE recommendation.

13

14 **A. Dividend (or Distribution) Yield**

15 **Q.40. How did you determine the dividend yield?**

16 A. In keeping with Commission precedent, I have used the current annualized dividend
17 (or distribution) together with the average of the high and low stock prices for each
18 of the most recent six-months for each of the proxy group companies as of January
19 31, 2008.²⁸ My calculation of the average stock or unit prices for each proxy group
20 company is shown on Exhibit No. SGS-20.

21

²⁷ Strictly speaking, MLPs make “distributions” to unit holders and corporations pay “dividends” to stockholders, but the DCF model makes no distinction between dividends and distributions. I have attempted to provide the alternate term, where appropriate, throughout the testimony.

²⁸ See *Williston Basis Interstate Pipeline Company*, 84 FERC ¶ 61,081, at 61,382 (1998).

1 **Q.41. Did you adjust the dividend (or distribution) yield to account for periodic**
2 **growth in dividends (or distributions)?**

3 A. Yes. Since companies tend to increase their quarterly dividends (or distributions) at
4 different times throughout the year, it is reasonable to assume that such increases will
5 be evenly distributed over calendar quarters. Given that assumption, it is reasonable
6 to apply one-half of the expected annual dividend (or distribution) growth rate for
7 the purposes of calculating the expected dividend (or distribution) yield component
8 of the DCF model. This adjustment ensures that the expected yield is representative
9 of the coming 12-month period. Accordingly, the DCF estimates provided in
10 Exhibit No. SGS-21 reflect one-half of the expected near-term growth in the
11 dividend (or distribution) yield component of the model.

12
13 **B. DCF Growth Estimates**

14 **Q.42. Is it important to select appropriate measures of growth in applying the DCF**
15 **model?**

16 A. Yes. The general form of the DCF model assumes a single growth estimate in
17 perpetuity. Accordingly, in order to reduce the future growth rate to a single
18 measure, one must assume a constant payout ratio, and that earnings, dividends (or
19 distributions) and book value will all grow at the same constant rate. Over the long
20 run, however, dividend (or distribution) growth can only be sustained by growth in
21 cash flow and earnings.

22

1 **Q.43. Why do you rely on forecasted, as opposed to historical, growth rates as the**
2 **basis for your growth rate projections?**

3 A. The ROE is a forward-looking concept that focuses on investor expectations
4 regarding future returns. The estimation of such returns, therefore, should be based
5 on forward-looking or projected data. Indeed, substantial academic research has
6 demonstrated the relationship between analysts' forecasts and investor
7 expectations.²⁹ In my view, I/B/E/S earnings growth rates, a source which provides
8 a consensus estimate of earnings growth by collecting five-year earnings growth
9 forecasts from a large pool of analysts on approximately 5,000 companies, and also a
10 source commonly used by the Commission in ROE proceedings, provide a
11 reasonable measure of growth estimates for use in the DCF model.

12
13 **Q.44. What sources of near-term growth have you used in your DCF analysis?**

14 A. In keeping with the Commission's preference, I have used the five-year growth
15 estimates in earnings published by I/B/E/S.³⁰

16
17 **Q.45. How did you incorporate your near-term growth forecasts into the two-stage**
18 **DCF analysis?**

19 A. In *Williston Basin* (84 FERC ¶ 61,081), the Commission affirmed the use of a simple
20 average of the near and long-term growth rate forecasts. Subsequently, in Opinion

²⁹ See, Robert S. Harris, *Using Analysts' Growth Forecasts to Estimate Shareholder Required Rates of Return*, Financial Management (Spring 1986) at 59. In a review of literature regarding the extent to which analyst forecasts are reflected in stock prices, Harris noted: "...Vander Weide and Carleton recently compare consensus financial analyst forecasts of earnings growth to 41 different historical growth measures. They conclude that "there is overwhelming evidence that the consensus analysts' forecast of future growth is superior to historically-oriented growth measures in predicting the firm's stock price...consistent with the hypothesis that investors use analysts' forecasts, rather than historically-oriented growth calculations, in making stock buy and sell decisions."

³⁰ Opinion No. 414-A, 84 FERC ¶ 61,084, (1998).

1 No. 414-A, the Commission modified the two-stage DCF analysis to “give greater
2 weight to the short-term growth rate than to the long-term growth rate.”³¹ That
3 approach, which applied weights of two-thirds and one-third to a short-term and
4 long-term forecast, respectively, was affirmed in Opinion 414-B.³² Consistent with
5 the Commission’s practice, therefore, I have given my near-term growth estimates,
6 based on I/B/E/S estimates, a weighting factor of two-thirds (as discussed below,
7 my long-term growth estimate is given a weighting factor of one-third).

8
9 **Q.46. How did you develop your long-term growth rate estimate?**

10 A. In Opinion No. 414-A³³ the Commission indicated a clear preference for the use of
11 measures of long-term Gross Domestic Product (“GDP”) growth as the long-term
12 component of the growth estimate. That Opinion affirmed the Commission’s
13 findings in *Williston Basin* that GDP is an appropriate estimate of long-term growth
14 because:

15 ...as companies reach maturity over the long-term, their growth
16 slows, and their growth rate will approach that of the economy as a
17 whole; second, the Commission concluded that, over the long-run, an
18 expectation that a regulated firm will grow at the rate of the average
19 firm in the economy is reasonable; third, the purpose of using the
20 DCF analysis in this proceeding is to approximate the rate of return
21 an investor would reasonably expect from a pipeline company, and
22 record in those proceedings showed that the long-term growth of the
23 economy is used by two large investment houses as their long-term
24 growth figure in conducting DCF analyses for investment purposes;
25 and fourth, witnesses in those proceedings used the long-term
26 growth of the economy as a whole as confirmation or support for
27 their analyses.³⁴
28

³¹ *Ibid.*

³² Opinion No. 414-B, 85 FERC ¶ 61,323 at 62,269-70.

³³ *Id.*

³⁴ 84 FERC ¶ 61,081, at 61,385.

1 **Q.47. What sources did you consider for your long-term growth rate estimate?**

2 A. My long-term growth estimate is derived from (1) the *Annual Energy Outlook*,³⁵
3 published by the Energy Information Administration; (2) Blue Chip Economic
4 Indicators Consensus Forecast³⁶; and (3) a market-based inflation estimate based on
5 the difference between 10-year Treasuries and 10-year Treasury Inflation Protected
6 Securities (“TIPS”).³⁷ The simple average of those three inflation adjusted sources
7 produces a long-term nominal GDP growth rate of 5.20 percent.

8 **Q.48. Please explain how you applied the DCF model to the MLPs.**

9 A. An MLP is a limited partnership, whose partnership interests are represented by
10 units that are publicly traded, much the same as a stock price represents a
11 shareholder’s interests in a corporation. As discussed earlier, MLPs do not pay
12 dividends, but rather make distributions to its limited partnership unit holders. I
13 have applied the distribution per unit in the DCF model in the same way that I have
14 applied the dividend yield per share of common stock. In addition, I have addressed
15 the quarterly payment of distributions and dividends in the same way, by multiplying
16 the dividend or distribution yield by $1 + \frac{1}{2}$ of the growth rate to obtain the expected
17 distribution yield. The cash distributions that are received by the unit holders are
18 analogous to dividends received by common shareholders. In both situations the
19 return to the investor is the cash flow received in quarterly distributions plus the cash
20 that would be received if the units or shares were sold upon a given valuation date.

21

³⁵ See Annual Energy Outlook 2007, February 2007.

³⁶ See Blue Chip Financial Forecasts, Vol. 26, No. 12, December 1, 2007, at 14

³⁷ The difference in 10-year Treasury yield and the year on 10-year TIPS is often considered to be as estimate of long-term inflation expectations. Nominal GDP growth is calculated as the product of $(1+i)(1+g)$ where i is the expected inflation rate and g is the long-term real GDP growth rate.

Q.49. Please summarize your application of the two-stage DCF model.

A. I calculated the DCF result for each of the proxy group companies using the following inputs:

- 1) Based on Commission precedent,³⁸ I have averaged the nearest six monthly low and high stock (or unit) prices for the period ended January 31, 2008. This is the most current data available to obtain a perspective on market conditions as I prepare my testimony for the term *P*;
- 2) The current annualized dividend (or distribution) per share as of January 31, 2008;
- 3) I have used the I/B/E/S forecast for each of the proxy group companies as the short-term forecast growth rate;
- 4) I have used the simple average of the long-term nominal GDP forecast by the EIA, Blue Chip Economic Indicators, and inflation, measured as the difference between 10-year Treasuries and the TIPS as the long-term forecast growth rate.

As discussed earlier, I adjusted the six-month average dividend yield by one half of the expected short-term growth rate to arrive at the expected dividend yield component of the model. Finally, in accordance with the Commission's past practice, I applied weights of two-thirds and one-third to the short-term and long-term forecast growth rates, respectively. Please refer to Exhibit No. SGS-22 for a tabulation of dividend yields and growth rates used in my DCF analysis.

Q.50. Please explain the approach by which you calculated your range of results.

A. I calculated my range of results in accordance with the Commission's past practice, which is to say that I calculated the two-stage DCF result for each company in the proxy group. I then established the range of reasonableness by reference to the low and high results of the group.

³⁸ Order rejecting partial settlement, establishing transportation and storage rates, and directing filings in *Cranberry Pipeline Corp.*, 112 FERC ¶ 61,268 (2005).

C. DCF Results

Q.51. Please describe the results of your DCF analysis.

A. Based on all the factors discussed in my testimony, and as shown in Exhibit No. SGS- 21, I have established a zone of reasonableness that is based on the high and low DCF results, for the comparable companies, from approximately 12.54 percent to 14.34 percent. I have tabulated the alternative measures of central tendency for my proxy group in Table 3 (below).

Table 3: DCF Results

	Low	Mean	Median	Mid-point	High
DCF Results	12.54%	13.54%	13.52%	13.44%	14.34%

D. Commission Proposed Modifications to the DCF model

Q.52. Please discuss the issues raised by the Commission in its Proposed Policy Statement pertaining to the DCF model.

A. First, the Commission referred to its concern, as stated in HIOS³⁹ and Kern River, regarding the accounting distinction between corporate dividends and MLP distributions. To that point, the Commission noted that it earlier had pointed out that “data concerning dividends paid by the proxy group members is a key component in any DCF analysis” and reiterated its concern that “an MLP’s cash distribution to its unit holders may not be comparable to the corporate dividends the Commission uses in its DCF analysis.”⁴⁰ Specifically, the Commission noted that:

... the cash distributions of the MLPs it [*i.e.*, Kern River] seeks to add to the proxy group in this case include a return *of* invested capital through an allocation of the partnership’s net income. While the level of an MLP’s cash distributions may be a significant factor in the

³⁹ HIOS, LLC., 110 FERC ¶ 61,043.

⁴⁰ Proposed Policy Statement, para. 10.

1 unit holder's decision to invest in the MLP, the Commission uses the
2 DCF analysis solely to determine the pipeline's return on equity. The
3 Commission provides for the return of invested capital through a
4 separate depreciation allowance. For this reason, to the extent an
5 MLP's distributions include a significant return of invested capital, a
6 DCF analysis based on those distributions, without any adjustment,
7 will tend to overstate the estimated return on equity, because the
8 'dividend' would be inflated by cash flow representing return of
9 equity, thereby overstating the earnings the dividend stream purports
10 to reflect.⁴¹

11 ***

12
13 The Commission stated that it could nevertheless consider including
14 MLPs in the proxy group in a future case if the pipeline presented
15 evidence addressing these concerns...such evidence might include
16 some method of adjusting the MLPs' distributions to make them
17 comparable to dividends, a showing that the higher "dividend" yield
18 of the MLP was offset by a lower long-term growth projection, or
19 some other explanation why distributions in excess of earnings do
20 not distort the DCF results for the MLP in question.⁴²

21 ***

22
23 In addition, *Kern River* pointed out that the traditional DCF model
24 only incorporates growth resulting from the reinvestment of
25 earnings, not growth arising from external sources of capital.
26 Therefore, the Commission stated that if growth forecasted for an
27 MLP comes from external capital, it is necessary either (1) to explain
28 why the external sources of capital do not distort the DCF result for
29 that MLP or (2) propose an adjustment to the DCF analysis to
30 eliminate any distortion.⁴³

31
32 Thus, the Commission remains concerned that MLP distributions overstate both
33 current yields and bias expected growth rates.
34

⁴¹ *Ibid.* [clarification added]

⁴² *Ibid* at para. 11.

⁴³ *Ibid* at para. 12.

1 **Q.53. What is your response to the Commission's concerns regarding the effect of**
2 **MLP distributions on DCF results?**

3 A. The Commission's concerns that MLP distributions overstate both current yields
4 and expected growth rates are misplaced. From a methodological perspective, the
5 DCF model is premised on the widely accepted principle that financial markets are
6 efficient with respect to publicly available information. As such, observed prices for
7 publicly traded assets such as MLP units reflect the collective beliefs of investors
8 regarding future prospects and risks at any given point in time, based on information
9 that is publicly available at that time. Since the DCF model specifies the current
10 price of a security (*e.g.*, MLP units) as a function of distributions, expected growth,
11 and required returns, it would be inappropriate to assume that one component
12 arbitrarily could be changed without a corresponding change to one or more of the
13 other components. In addition, and equally important, the general form of the DCF
14 model is based on estimates of cash flows as opposed to earnings. As such, the
15 Commission's focus on earnings, even as determinant of distributions, is misplaced
16 in calculating the yield component of the DCF model.

17
18 **Q.54. Is there market evidence to support the proposition that cash flow is the**
19 **relevant measure of value to investors?**

20 A. Yes. In a recent report, RBC Capital Markets notes that "Most investors look at
21 EBITDA [Earnings Before Interest, Taxes, Depreciation and Amortization] or DCF
22 [Distributable Cash Flow] as the key cash flow metric for the MLP group."⁴⁴

⁴⁴ RBC Capital Markets, *MLP Weekly Statistics*, January 10, 2008, at 8. [emphasis added]

1 Wachovia Capital Markets made a similar point, but clearly pointed out the
2 importance of cash flow as opposed to earnings in the valuation of MLP units:

3 Unlike traditional corporations, earnings for MLPs are not relevant in
4 considering valuation, in our view. Thus, we do not pay as close
5 attention to price-to-earnings (P/E) multiples as we believe the focus
6 for MLPs should be on cash flow rather than earnings. This is due to
7 the fact that cash flow determines how much can be paid out to
8 unitholders in the form of distributions. We believe that earnings
9 may misrepresent true economic value because of accounting
10 conventions for noncash items such as depreciation and
11 amortization. Instead, we tend to focus on cash flow metrics, in
12 particular, distributable cash flow, as this determines how much cash
13 flow can be paid out in the form of distributions.⁴⁵
14

15 Thus, in practice, investors and analysts focus on cash flow metrics, and the risks and
16 opportunities associated with the subject MLP relative to other investment
17 alternatives.
18

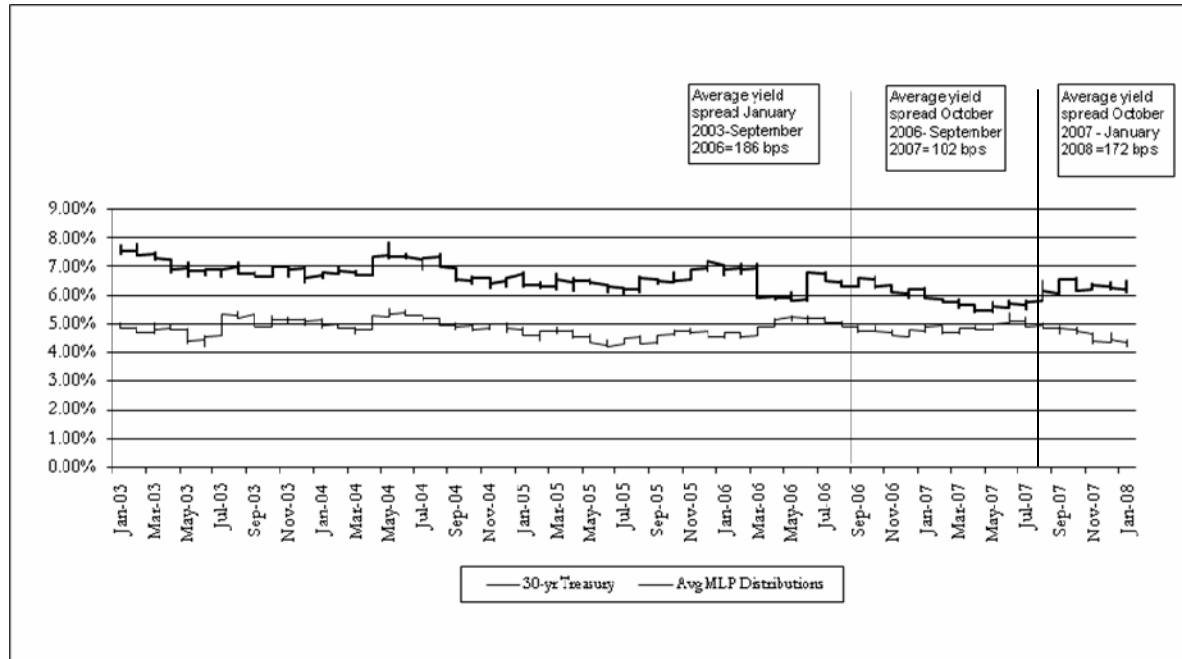
19 **Q.55. Have you considered the relationship between interest rates and distribution**
20 **yields in your analysis?**

21 A. Yes. I analyzed the yield spread between MLPs and long-term Treasury Bonds. As
22 shown in Chart 2 (below), the yield spread between the 30-year Treasury and MLP
23 distributions remained fairly constant from the beginning of 2003 through the third
24 quarter of 2006, averaging 186 basis points. Between the third quarter of 2006 and
25 the third quarter of 2007, the yield spread declined steadily to 102 basis points. Since
26 that time the yield spread has increased and is currently 172 basis points, only 13
27 basis points lower than the historical average. It appears, therefore, that MLP

⁴⁵ Wachovia Capital Markets, LLC, *Master Limited Partnerships: Primer 2nd Edition, A Framework for Investment*, August 23, 2005.

distribution yields are only slightly lower than otherwise would be expected based on long-term market relationships.

Chart 2: Historical Yield Spreads



Q.56. Do the relatively high distribution yields characteristic of an MLP cause the DCF analysis to overstate the ROE recommendation for a corporate pipeline company?

A. No. Investors understand that in general, there is a trade-off between distribution and expected growth. It is true that MLPs generally pay out a greater share of cash in distributions than a corporation would pay in dividends, as required by the tax code. However, it follows as a consequence of the high payout that MLPs have less cash available for reinvestment, and, as a result, their growth expectations are often lower than the growth expectations for corporations.

1 **Q.57. Have you performed any analyses to determine whether MLP distributions**
2 **are expected to result in a diminution of capital?**

3 A. Yes, to determine whether analysts other than Value Line expect
4 distributions to be made out of operating cash flows, I examined the projected
5 distributable cash flow and distributions for those MLPs in my proxy group that are
6 covered by RBC Capital Markets (“RBC”). As part of its coverage, RBC provides
7 detailed projections of distributable cash flows and distributions per unit. As shown
8 in Exhibit No. SGS-23, on average over the three year period, the “distribution
9 coverage” (i.e., the ratio of distributable cash flow to distributions) does not fall
10 below 1.0, indicating that distributions are expected to be paid out of distributable
11 cash flows.⁴⁶

12
13 **Q.58. Have you performed any analyses in response to the Commission’s concern**
14 **that MLP growth rates may be “distorted” as a result of external financing?**

15 A. Yes. The Commission’s concern appears to be premised on the proposition that
16 over the long term, corporate growth is largely financed by internally generated
17 funds. Internally generated funds, then, are a function of the return on equity and
18 the percentage of earnings retained (i.e., the percentage of earnings not paid out in
19 dividends). To the extent that MLPs distribute a large portion of their earnings or
20 cash flow, there is less cash available for reinvestment; their growth, therefore, must
21 be funded from external sources. At issue, then, is whether the corporate
22 companies’ expected growth rates also are significantly dependent on external

⁴⁶ Cash flows are based on maintenance capital expenditures, and include payments to the general partner. It should be noted that total capital expenditures are likely to include items in addition to maintenance capital expenditures.

1 financing. To the extent that is the case, it is unclear whether the MLP growth rates
2 are “distorted” by virtue of their dependence on external funds.

3
4 To determine whether the corporate companies’ growth rates are materially affected
5 by expected external financing, I calculated the internal growth rate (defined as the
6 product of the retention ratio and the expected return on equity)⁴⁷ for each of
7 Questar, Equitable, National Fuel Gas and Williams. As shown on Exhibit No.
8 SGS-24, the average internal growth rate for those four companies is 5.75 percent.
9 As also shown on that Exhibit, the average I/B/E/S growth rate is 10.59 percent.
10 The average difference of 4.84 percent, therefore, reflects the extent to which
11 expected growth is dependent on external financing. Thus for the four corporate
12 entities, external funding represents approximately 46 percent of expected growth.
13 While that is certainly lower than the extent to which MLPs are dependent on
14 external financing, it nonetheless is a significant portion.⁴⁸ Consequently, it is my
15 view that external funding does not “distort” the MLP growth rates relative to the
16 corporate growth rates.

17
18 Furthermore, as discussed previously, by Moody’s estimation, the sole corporate
19 member of the proxy group, The Williams Companies, will rely on external funding
20 and cash reserves to pay for planned capital expenditures and dividend payments

⁴⁷ This is just one measure of growth which by definition does not give effect to growth via external financing.

⁴⁸ As shown on Exhibit SGS-23, on a historical basis, total capital expenditures and dividends exceeded operating cash flows (on average) for the three LDCs, indicating that external financing has been required for growth.

1 over the next year, thus demonstrating that external financing plays a significant role
2 in the implementation of strategy regardless of organizational structure.
3

4 **Q.59. What are your conclusions with respect to the inclusion of MLPs in the proxy**
5 **group and whether MLP distributions constitute a return of capital for**
6 **purposes of developing an ROE estimate?**

7 A. The Commission should allow the inclusion of MLPs in the proxy group to the
8 extent that they reflect comparable risk to the subject company. With regard to the
9 issue of distributions including a return of capital, I agree with Spectra's position as
10 presented in the comments filed on the Proposed Proxy Statement. In these
11 comments, Spectra stated that investors in MLPs already trade the lower growth
12 rates of MLPs for their higher current cash flows. Therefore, to "the extent that a
13 proxy company's distributions/dividends exceed current earnings over a period of
14 time, either (i) the company's Institutional Brokers' Estimate System ("IBES")
15 growth projection included in the DCF model will be lower than companies whose
16 distributions/dividends are equal to or lower than earnings, or (ii) the company's
17 share/unit price will rise, resulting in a lower 'dividend' yield."⁴⁹ Furthermore, since
18 distributions are only counted once by investors when calculating the dividend yield,
19 it is not necessary to cap the distributions that are used to measure proxy MLP
20 returns.
21

⁴⁹ Docket No. PL07-2-000, Comments of Spectra Energy Transmission, LLC on Proposed Policy Statement, at 4.

VII. SUMMARY AND CONCLUSIONS**Q.60. Please summarize your recommended ROE for Saltville Gas Storage**

A. Based on all the factors discussed in my testimony, I find that the zone of reasonableness is from approximately 12.54 percent to approximately 14.34 percent. The median of that range, which is approximately 13.52 percent, represents the ROE for a natural gas pipeline of average risk. In my view, given the Company's risk profile relative to the proxy group, it would be appropriate to select a return above the midpoint DCF result, however the Company is requesting a return on equity capital of 13.50 percent.

Table 4: DCF Results

	Low	Mean	Median	Mid-point	High
DCF Results	12.54%	13.54%	13.52%	13.44%	14.34%

Q.61. Does this conclude your prepared answer testimony?

A. Yes, it does.