

Client Alert

May 2020

FERC Revises Policy for Analyzing Pipeline Return on Equity

On May 21, 2020, the Federal Energy Regulatory Commission (“Commission”) issued a Policy Statement on Determining Return on Equity for Natural Gas and Oil Pipelines in Docket No. PL19-4-000, that revises its policy for analyzing the return on equity (“ROE”) for interstate natural gas and oil pipelines based on the methodology established for analyzing electric utility ROEs in Opinion Nos. 569 and 569-A, with certain exceptions to account for the “statutory, operational, organizational and competitive differences among the industries.”¹ Specifically, the Commission stated that it will: (i) determine just and reasonable natural gas and oil pipeline ROEs by averaging the results of the Discounted Cash Flow (“DCF”) model and the Capital Asset Pricing Model (“CAPM”) analyses, giving equal weight to both models; (ii) retain the existing two-thirds/one-third weighting for the short-term and long-term growth projections in the DCF model; (iii) exclude the Risk Premium model as modified in Opinion No. 569-A; (iv) consider using *Value Line* data as the source of the short-term growth projection in the CAPM; (v) consider proposals to include Canadian companies in pipeline proxy groups while continuing to address outliers in pipeline proxy groups on a case-by-case basis, refraining from applying specific outlier tests; and (vi) encourage, or perhaps require, oil pipelines to file updated FERC Form No. 6, page 700 data for 2019 to reflect the revised ROE policy established in the Policy Statement. Importantly, parties are not permitted to seek rehearing of the Policy Statement because it is only a statement issued to provide guidance and regulatory certainty.²

¹ *Inquiry Regarding the Commission’s Policy for Determining Return on Equity*, Policy Statement on Determining Return on Equity for Natural Gas and Oil Pipelines, 171 FERC ¶ 61,155, at P 2 (2020) (“Policy Statement”). The Policy Statement is a result of comments received by the Commission to a Notice of Inquiry issued in the same docket on March 21, 2019. *Inquiry Regarding the Commission’s Policy for Determining Return on Equity*, Notice of Inquiry, 166 FERC ¶ 61,207 (2019) (“NOI”). The NOI was issued as a result of the decision in *Emera Maine v. FERC*, which reversed and vacated Opinion No. 531, in which the Commission applied the same two-step, constant-growth DCF model to public utility cases that had been used in natural gas and oil pipeline cases. 854 F.3d 9 (D.C. Cir. 2017) (“*Emera Maine*”). In *Emera Maine*, the D.C. Circuit held that the Commission failed to demonstrate that the New England Transmission Owners’ existing base ROE was unjust and unreasonable and failed to adequately demonstrate that the new base ROE it established was just and reasonable, noting that the fact that the existing ROE did not equal the just and reasonable ROE that the Commission would have set using the current DCF analysis inputs did not necessarily indicate that the existing ROE fell outside the statutory zone of reasonableness. *Id.* at 22-30. Following the decision in *Emera Maine*, the Commission issued two briefing orders in which it proposed to change its approach to determining base ROE for public utilities by giving equal weight to all four financial models instead of primarily relying on the DCF methodology. See *Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030, at PP 15-17 (2018); *Ass’n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 165 FERC ¶ 61,118, at PP 16-18 (2018).

While the NOI was pending, on November 21, 2019, the Commission issued Opinion No. 569 adopting portions of its proposal set forth in the proceedings following *Emera Maine*. *Ass’n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, Opinion No. 569, 169 FERC ¶ 61,129, at P 18 (2019). Specifically, the Commission found that it would use the DCF model and CAPM in its ROE analyses under Federal Power Act section 206, giving equal weight to both models, but declined to use either the Expected Earnings analysis or the Risk Premium model. Opinion No. 569, 169 FERC ¶ 61,129 at PP 1, 18, 31, 200, 276, 340, 425. In Opinion No. 569-A, the Commission modified the methodology established in Opinion No. 569 in several respects, including reducing the weighting of the long-term growth projection in the DCF model from one-third to 20% and adopting a modified version of the Risk Premium model, and explained that it would give equal weight to the DCF, CAPM, and Risk Premium analyses. *Ass’n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, Opinion No. 569-A, 171 FERC ¶ 61,154 at PP 57, 78, 104-114, 141, 154. For a more thorough discussion of Opinion Nos. 569 and 569-A detailing the methodology for determining ROE for public utilities in effect at the time the Policy Statement was issued, see [FERC Again Revises Methodology Governing Public Utility Return on Equity: Opinion No. 569-A](#) under Alerts on our website.

² Commissioner Glick issued a strongly-worded partial dissent to Opinion No. 569-A, arguing that the Commission’s findings may have been directed by the results. Opinion No. 569-A, 171 FERC ¶ 61,154, *Glick, concurring in part and dissenting in part*, at P 3. Unlike the Policy Statement, parties may seek rehearing of Opinion No. 369-A.

Background to the Policy Statement

At the outset of the Policy Statement, the Commission recited the history of its ROE policy for natural gas and oil pipelines, starting with the Supreme Court's finding that "the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."³ The Commission noted that since the 1980s, it has determined natural gas and oil pipeline ROEs using the DCF model, which estimates "the return necessary for the pipeline to attract capital based upon the range of returns that the market provides investors in a proxy group of publicly traded entities with similar risk profiles."⁴ The Commission explained that the DCF model estimates the required rate of return for each member of the proxy group using a formula under which an investors' required return is estimated to equal current dividend yield plus the projected future growth rate of dividends based upon the weighted averaging of short-term and long-term growth estimates.⁵ In the two-step DCF model, the Commission computes the expected growth rate by giving two-thirds weight to a short-term growth projection and one-third weight to a long-term growth projection.⁶

The Commission further explained that for natural gas and oil pipelines, it uses a proxy group of publicly traded firms with corresponding risks to set a range of reasonable returns.⁷ The firms in the proxy group must be "risk appropriate," *i.e.*, comparable to the pipeline whose ROE is being determined, and the range of the proxy group's returns produces the zone of reasonableness in which the pipeline's ROE may be set based on specific risks.⁸ Absent a showing of circumstances that the pipeline faces anomalously high or low risks, the Commission sets the pipeline's cost-of-service nominal ROE at the median of the zone of reasonableness.⁹

Interestingly, the Commission noted that in the NOI, it sought comment on other financial models it has used when determining ROE for public utilities, including the CAPM, which measures the cost of equity relative to risk, the Expected Earnings model, which calculates the earnings an investor expects to receive on the book value of a particular stock, and the Risk Premium model, which directly inputs interest rates to determine the equity risk premium for a utility.¹⁰ Such models have been used in natural gas pipeline proceedings as well.

The Policy Statement

Each of the Commission's findings will be briefly discussed below.

³ Policy Statement at P 3 (citing *FPC v. Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944) (other citation omitted) ("*Hope*").

⁴ Policy Statement at P 4.

⁵ Policy Statement at P 4.

⁶ Policy Statement at P 5 (citation omitted).

⁷ Policy Statement at P 6 (citation omitted).

⁸ Policy Statement at P 6 (citations omitted).

⁹ Policy Statement at P 6 (citations omitted).

¹⁰ Policy Statement at PP 7-11; NOI at PP 13-17.

A. Use of the DCF and CAPM analyses

The Commission observed that comments were divided on the issue of whether the Commission should expand its methodology for determining natural gas and oil pipeline ROEs to consider multiple models rather than only the traditional DCF model. The Commission stated that commenters representing natural gas and oil pipeline shipper interests urged the Commission to continue relying solely on the DCF model to determine pipeline ROEs, while commenters representing natural gas and oil pipelines and trade associations argued that it would be reasonable to consider other models in addition to the DCF, subject to modifications to recognize the unique risks and regulatory framework applicable to natural gas and oil pipeline industries.¹¹ The Commission decided to revise its methodology to determine pipeline ROEs by using both the DCF model and CAPM, but in contrast to the methodology for public utilities, the Commission decided not to use the Risk Premium model.¹² The Commission's decision was based on its view that expanding the methodology to include the CAPM analysis would better reflect how investors measure cost of equity and result in a ROE analysis producing more accurate estimates of the ROE a pipeline must offer in order to attract capital.¹³

The Commission noted that comments regarding the weighting of the growth projections in the DCF model were divided on whether the Commission should retain the existing weighting, with some commenters proposing adjustments and others not.¹⁴ The Commission decided to retain the existing two-thirds/one-third weighting for the short and long-term growth projections because short-term growth projections of pipelines have not declined to the same extent as those of public utilities and the distinctions between public utilities and pipelines support continuing to afford one-third weighting to the long-term growth projections in analyses of pipeline ROEs.¹⁵

Finally, the Commission decided to adopt the policy established in Opinion No. 569 for public utilities as to the calculation of the CAPM market risk premium and the use of *Value Line* adjusted betas in the CAPM analysis in pipeline proceedings because the reasons supporting their use are equally as valid in the context of pipelines.¹⁶ Specifically, for calculating the CAPM market risk premium, the Commission will: (i) "use, as the risk-free rate, the 30-year U.S. Treasury average historical bond yield over a six-month period corresponding as closely as possible to the six-month financial study period used to produce the DCF study in the applicable proceeding," (ii) "estimate the expected market return using a forward-looking approach based on a one-step DCF analysis of all dividend paying companies in the S&P 500;" and (iii) "exclude S&P 500 companies with growth rates that are negative or in excess of 20%."¹⁷

B. Weighting of the models

The Commission observed that commenters proposed various approaches to weighting the models used to determine ROE for pipelines, ranging from giving the DCF model the majority of the weighting while giving other models a minority weighting to opposing equal weighting and proposing a flexible weighting approach that allows appropriate weight to be given to any model in light of prevailing financial conditions and the facts and circumstances of each case.¹⁸ The Commission found those proposals unpersuasive and adopted the rationale of Opinion Nos. 569 and 569-A to give equal weight to the DCF model and CAPM in determining natural gas and oil pipeline ROEs. The Commission held that neither the DCF model nor the CAPM is conclusively superior and, thus, giving both models equal weight mitigates the risks associated with the potential errors or flaws in any one model.¹⁹

¹¹ Policy Statement at PP 22-23.

¹² Policy Statement at P 24.

¹³ Policy Statement at P 28.

¹⁴ Policy Statement at P 30.

¹⁵ Policy Statement at PP 29-34.

¹⁶ Policy Statement at PP 39-42, 46-47.

¹⁷ Policy Statement at P 39.

¹⁸ Policy Statement at P 49.

¹⁹ Policy Statement at P 50.

C. Use of *Value Line* data as a data source

The Commission noted that comments were divided regarding the data source the Commission should use for the short-term growth projection in pipeline proceedings, with parties such as the Association of Oil Pipe Lines and the Interstate Natural Gas Association of America supporting the use of *Value Line* projections in part because they can supplement Institutional Brokers Estimated System (“IBES”) projections, and parties such as the Canadian Association of Petroleum Producers and the Natural Gas Supply Association opposing the use of *Value Line* projections in part as inferior to IBES.²⁰ The Commission adopted the public utility policy set forth in Opinion No. 569-A, thus, in pipeline proceedings the Commission will “(1) continue to prefer use of IBES three to five-year growth projections as the short-term growth projection in the two-step DCF analysis and (2) allow participants to propose using *Value Line* growth projections as the source of the short-term growth projection in the one-step DCF analysis embedded within the CAPM.”²¹ The Commission reiterated its belief that both data sources have their advantages and that diversifying the data sources used in the revised natural gas and oil pipeline ROE methodology can both better reflect the data sources investors consider and mitigate the effect of any unusual data in either source.²²

D. Proxy group construction

The Commission stated that commenters recognized the ongoing difficulties in forming sufficiently-sized pipeline proxy groups and generally supported the Commission’s policy of relaxing the historically applied 50% standard requiring that a proxy company’s pipeline business account for, on average, at least 50% of the company’s assets or operating income over the most recent three-year period.²³ The Commission observed that some commenters argued that the Commission should allow the inclusion of companies that do not satisfy the 50% standard but are nonetheless significantly involved in jurisdictional natural gas and oil pipeline operations, while others urged the Commission to adopt more drastic changes to its proxy group formation policies, such as allowing the inclusion of risk-appropriate non-energy companies in pipeline proxy groups or allowing for the inclusion of risk-comparable Canadian companies with significant U.S. interstate natural gas pipeline assets in natural gas proxy groups.²⁴

The Commission held that it would maintain a flexible approach to forming pipeline proxy groups and continue to relax the 50% standard when necessary to obtain a proxy group of five members.²⁵ Additionally, the Commission stated that in future natural gas and oil pipeline proceedings, it would consider proposals to include in the proxy group risk-appropriate Canadian entities that otherwise satisfy proxy group eligibility requirements because doing so could help alleviate the shrinking proxy group problem by adding new potential members.²⁶

E. Excluding the Risk Premium and Expected Earnings models

The Commission held that, contrary to its decision in Opinion Nos. 569 and 569-A regarding public utilities, it would not use the Risk Premium model in the revised ROE methodology for natural gas and oil pipelines. The Commission stated that there was insufficient data to estimate cost of equity using the Risk Premium model due to a lack of stated allowed ROEs in settlements or Commission decisions in pipeline proceedings, however, the Commission did not foreclose use of the Risk Premium model in future proceedings if parties could demonstrate that the concerns regarding data sufficiency have been addressed.²⁷ Moreover, the Commission held that it would not use the Expected Earnings model to

²⁰ Policy Statement at P 54.

²¹ Policy Statement at P 55.

²² Policy Statement at PP 56-57.

²³ Policy Statement at P 62.

²⁴ Policy Statement at PP 62-63.

²⁵ Policy Statement at PP 64-65.

²⁶ Policy Statement at P 66.

²⁷ Policy Statement at PP 69-71.

determine ROE for natural gas and oil pipelines for the same reasons it decided to exclude the Expected Earnings model from the analysis of public utility ROEs,²⁸ namely, that the evidence did not demonstrate that investors rely on Expected Earnings when making investment decisions and that the return on book value measured under the Expected Earnings model does “not reflect the value of an investment that is available to an investor in the market and thus does not reflect the ‘returns on investments in other enterprises having corresponding risks’ that we must analyze under *Hope*.”²⁹

F. Outlier tests in pipeline proxy groups

Contrary to the specific low-end and high-end outlier tests adopted for public utilities in Opinion Nos. 569 and 569-A,³⁰ the Commission declined to adopt specific rigid outlier screens for use in determining pipeline ROEs for two reasons: (i) as the commenters observed, the Commission’s use of the proxy group median in setting pipeline ROEs reduces the effect that low and high-end outliers may exert on the ROE; and (ii) adopting rigid outlier screens could further reduce the number of potential proxy group members and make it difficult to form pipeline proxy groups with a sufficient number of members.³¹ Instead, the Commission stated that it would “continue to address outliers in pipeline proxy groups on a case-by-case basis in accordance with our policy to remove ‘anomalous’ or ‘illogical’ cost-of-equity estimates that do not provide meaningful indicia of the returns that a pipeline needs to attract capital from the market.”³²

G. Oil Pipeline Page 700s

In light of the impending five-year review of the oil pipeline index, the Commission “encourage[d]” oil pipelines to file updated FERC Form No. 6, page 700 data for 2019 reflecting the revised ROE methodology established in the Policy Statement.³³ While the Commission stated that it would address the issue further in the five-year review, it noted that reflecting the revised methodology in page 700 data for 2019 may help it better estimate industry-wide cost changes for purposes of the five-year review.³⁴ However, the Commission stated that following approval of the voluntary information collection, it would issue a notice affording pipelines two weeks to file updated page 700 data reflecting the revised ROE methodology, which notice has the possibility of requiring a mandatory filing.³⁵

Conclusion

The Policy Statement itself is not finally determinative of any natural gas or oil pipeline ROE proceeding. The Commission issues policy statements to provide guidance and regulatory certainty regarding statutes, orders, rules, and regulations that the Commission administers. Policy statements typically discuss the factors that the Commission will use to evaluate future proceedings and, thus, do not have any precedential value on their own.³⁶ However, the Policy Statement does announce the Commission’s intentions as to how it will analyze ROE for interstate natural gas and oil pipelines in future proceedings, which differs in several significant respects from the ROE methodology used for pipelines prior to the Commission’s consideration of whether to make the ROE methodology for pipelines similar to that of public utilities, as described herein. Moreover, oil pipelines may wish, or could possibly be required, to file updated FERC Form No. 6, page 700 data for 2019 reflecting the revised ROE methodology established

²⁸ Policy Statement at PP 72-78.

²⁹ Policy Statement at PP 77 (citation omitted).

³⁰ Policy Statement at PP 79-85.

³¹ Policy Statement at PP 88-91.

³² Policy Statement at P 87 (citation omitted).

³³ Policy Statement at P 92.

³⁴ Policy Statement at P 92.

³⁵ Policy Statement at P 93.

³⁶ See, e.g., *Algonquin Gas Transmission, LLC*, 153 FERC ¶ 61,038, at P 37 (2015) (“A policy statement ‘is not finally determinative of the issue or rights to which it is addressed’ and only ‘announces the agency’s tentative intentions for the future.’ As a result, in future cases the Commission must support a policy set forth in a policy statement ‘as if the policy statement had never been issued.’” (citation omitted)).

in the Policy Statement in order to assist the Commission in its upcoming five-year review of the oil pipeline index.

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