Inquiry Regarding the Commission’s Policy for Determining Return on Equity

Docket No. PL19-4-000

REPLY COMMENTS OF THE ASSOCIATION OF OIL PIPE LINES

On March 21, 2019, the Federal Energy Regulatory Commission (“FERC” or “Commission”) issued a Notice of Inquiry (“NOI”) in the above-referenced docket, seeking comments on the Commission’s policies for determining the return on equity (“ROE”) to be used in calculating rates for regulated entities, including oil pipelines. *Inquiry Regarding the Commission’s Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 (2019). The Association of Oil Pipe Lines (“AOPL”) filed its initial comments on June 26, 2019.\(^1\) AOPL’s comments were supported by the affidavit of Dr. Michael J. Webb, an economist and expert on FERC regulation of oil pipelines. AOPL’s reply comments primarily respond to the comments submitted by the oil pipeline shipper entities, the Canadian Association of Petroleum Producers (“CAPP”), the Airlines for America (“Airlines”), and the Liquids Shippers Group (“LSG”) (collectively, “Shippers”).

As discussed in the NOI, the Commission recently proposed a new approach to determining ROE in which it gives equal weight to four financial models used by investors (*i.e.*, the discounted cash flow methodology (“DCF”); Capital Asset Pricing Model (“CAPM”),

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\(^1\) AOPL is a nonprofit trade association that represents the interests of oil pipelines regulated by the Commission. AOPL members transport approximately 96 percent of the crude oil and refined petroleum products shipped through pipelines in the United States.

As discussed in its initial comments, AOPL believes the Commission’s proposed four-part ROE approach is a reasonable method for calculating the ROE for an oil pipeline, subject to (i) certain modifications to account for the specific context of oil pipeline regulation (including an adjustment to the Risk Premium approach), and (ii) the underlying requirement that the result be commensurate with the return on investments in other enterprises having corresponding risks and be sufficient to assure confidence in the financial integrity of the regulated pipeline so as to maintain its credit and to attract capital.

With respect to the formation of proxy groups, AOPL also urged the Commission (1) not to adopt in the oil pipeline context the outlier screens that it has proposed for electric utilities, (2) to continue to require that oil pipeline operations constitute a significant proportion of the business of any firm included in the oil pipeline proxy group, but not impose a mandatory 50 percent threshold, and (3) to continue to apply its other guidelines for forming oil pipeline proxy groups in a reasonable way and not impose rigid screens that automatically exclude companies from the proxy group based on certain criteria.

AOPL also proposed that the Commission refine its current DCF methodology to remove the current 50 percent downward adjustment to the long term growth rate of master limited
partnership ("MLP") proxy group members and permit the use of Value Line in addition to IBES for short-term growth rates. AOPL’s comments regarding the MLP growth rate issue merit special attention from the Commission, particularly in light of the comments of other industry participants, which demonstrated that the factual assumption on which the lower MLP growth rate was based (i.e., that MLPs have less growth potential than corporations because they make distributions in excess of earnings) does not reflect market reality. See Comments of Plains Pipeline, L.P. at 6-7; Comments of the Master Limited Partnership Association at 6-14; Comments of the Interstate Natural Gas Association of America at 57-60.

AOPL also discussed the importance of ensuring that the Commission’s ROE policies reflect the oil pipeline industry’s unique market and regulatory landscape. AOPL’s comments were supported by several other commenters who discussed the significant risks faced by oil pipelines, which distinguish oil pipelines from traditional regulated utilities. See, e.g., Comments of SFPP, L.P. and Calnev Pipe Line LLC at 8-11 (the oil pipeline industry “faces tremendous risk and uncertainty”); Comments of Magellan Midstream Partners, L.P. at 2-3 (oil pipelines “face far more competition” than electric utilities); Comments of Tallgrass Energy, LP at 5 (oil pipelines have unique risks that “differ from the risks of the electric transmission industry”).

Shippers, by contrast, generally support continued sole reliance on the DCF model, essentially because they see “no need to change.” See Airline Comments at 1; see also CAPP Comments at 3; LSG Comments at 2. Shippers’ argument for maintaining the status quo and precluding the use of the other relevant financial models, however, fails to address the Commission’s fundamental finding that “investors do not rely on the DCF alone,” and that “relying on multiple financial models makes it more likely that [the Commission’s ROE
calculations] will accurately reflect how investors are making their investment decisions.”

Coakley Briefing Order at P 44.

The Airlines claim that “the Commission’s reasoning for proposing the composite method for calculating ROEs for electric utilities does not apply to oil pipelines.” Airline Comments at 5. But the Commission’s observations regarding the financial models used by investors apply to all investors, not just investors in electric utilities. There is no reason why the Commission’s logic that combining estimates from four models is more reliable than relying on a single model is not also applicable in the oil pipeline context.

CAPP states that “there is no explicit evidence that the DCF model fails to capture investor behavior.” CAPP Comments at 14. But CAPP fails to discuss the evidence relied on by the Commission, including filed testimony from the Coakley proceeding and the treatise of Dr. Roger Morin. See Coakley Briefing Order at PP 34-35 & nn.69-71 (“[i]nvestors have varying preferences as to which of [the four methods] or other methods they may use to inform their investment decisions,” and there “‘is no monopoly as to which method is used by investors’”) (citing Roger A. Morin, New Regulatory Finance 428 (Public Utilities Reports, Inc. 2006) (“Morin”)). Indeed, even CAPP acknowledges that investors likely make use of models other than the DCF, such as the CAPM. CAPP Comments at 27.

The LSG makes little attempt to substantively address the Commission’s reasons for changing its ROE methodology to better align it with investor expectations. Instead, the LSG launches a broadside attack on the NOI itself as a predicate to rehashing its unsupported allegations about oil pipeline Page 700 reporting. The LSG claims that issuance of the NOI itself has “undermined the transparency and validity” of oil pipeline ROEs, and that “the defining characteristics” of the Commission’s four-part approach are “chaos” and “manipulation.” LSG
Comments at 2, 17. Indeed, the LSG accuses “a significant number” of oil pipelines of “manipulating” their ROE calculations and filing “anomalously high,” “outrageous,” and “invalid” ROEs on their 2018 FERC Form No. 6, page 700. LSG Comments at 9, 18. Based on these accusations, the LSG also suggests that use of the four-part method could “permanently distort” oil pipeline indexed-based rates. LSG Comments at 2, 17.

The LSG’s unsupported accusations about oil pipeline reporting strain the bounds of fair advocacy and appear intended simply to distract from the fundamental issue here. Apart from heated rhetoric, LSG offers no evidence to rebut the Commission’s findings about the merits of employing a four-part composite methodology for setting ROEs. Further, the LSG’s concern with the opportunity for “manipulation” is baseless. Numerous inputs and assumptions within every cost-of-service model are subject to litigation, and there is no reason that using a four-part composite methodology that is feasible for electric utilities would prevent the determination of just and reasonable rates for oil pipelines. For the reasons explained in AOPL’s comments, the Commission’s four-part ROE approach is reasonable and based on findings regarding investor expectations that apply to oil pipelines as well as electric utilities. The LSG’s suggestion that oil pipelines should be barred from using the Commission’s four-part approach and restricted to the DCF in calculating their page 700 (LSG Comments at 2, 28-29), has no merit given the Commission’s finding that investors do not rely solely on the DCF and that the composite approach can better reflect how investors make their investment decisions. Further, to the extent LSG shippers believe individual oil pipelines rates are too high as a result of “invalid” ROE calculations (or otherwise), the Commission provides an avenue to challenge those rates. See 18 C.F.R. § 343.1 (2019).
In sum, as discussed in AOPL’s initial comments, the Commission’s proposed four-part ROE approach is a reasonable method for calculating the ROE for an oil pipeline, subject to certain modifications to account for the specific context of oil pipeline regulation, and the underlying requirement that the result be commensurate with the return on investments in other enterprises having corresponding risks and sufficient to assure confidence in the financial integrity of the regulated pipeline so as to maintain its credit and to attract capital. AOPL commends the Commission for initiating the NOI in order to address this important topic and appreciates the opportunity to comment.

Respectfully submitted,

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