Van Ness Feldman LLP

# Revised FERC Policy on ROE and Proxy Group Composition May Have Positive Impacts for Pipelines

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On May 21, 2020, the Federal Energy Regulatory Commission (FERC or Commission) issued a Policy Statement which set forth a new methodology for determining the return on equity (ROE) of natural gas and oil pipelines. Under the new methodology, the Commission will determine pipeline ROE by giving equal weight to the results of two methods—the Discounted Cash Flow (DCF) model and the Capital Assets Pricing Model (CAPM). In adopting this methodology, the Commission abandoned its past practice of relying solely on the DCF.

The Policy Statement addressed several other ROE-related matters, including adding flexibility to the Commission's approach to proxy group formation, and requesting that oil pipelines file revised FERC Form No. 6, page 700s for 2019 reflecting the revised ROE policy.

## Background

The Policy Statement follows a Notice of Inquiry (NOI) issued in March of 2019, summarized here, in which the Commission sought comments on whether to modify its policies concerning ROEs for public utilities and for natural gas and oil pipelines. This was part of a broader Commission effort that followed the U.S. Court of Appeals for the District of Columbia Circuit's remand of a Commission order in *Emera Maine v. FERC*, after which the Commission issued several orders proposing a new policy for setting ROEs for electric utilities, along with the general NOI. In November of 2019, in a proceeding involving electric transmission owners in the Midcontinent Independent System Operator, FERC issued Opinion No. 569, in which it established a new methodology for evaluating electric public utilities' ROEs. On May 21, 2020, concurrently with the Policy Statement, the Commission issued Opinion No. 569-A adopting changes to its policies concerning electric public utility ROEs. The Commission determined in the Policy Statement that with certain exceptions to account for the differences among the industries, the policy changes adopted in Opinion No. 569-A would be applied to natural gas and oil pipelines.

## New Methodology for Evaluating Pipeline Return on Equity

Under the Policy Statement, the Commission will determine pipeline ROE by averaging the results of the DCF and CAPM, a departure from its previous policy of relying solely on the DCF. Citing a finding FERC first made in *Trailblazer Pipeline Company*, the Policy Statement explained that pipeline investors, like investors in electric public utilities, use multiple financial models to make investment decisions, and thus including the CAPM model in its ROE determination would better reflect how investors make decisions. The Commission's use of two models for pipeline ROE determination differs from the Commission's use of three models—DCF, CAPM, and the Risk Premium model—for electric public utility ROE determination as set in Opinion No. 569-A. The Policy Statement explained that Risk Premium is not appropriate for natural gas and oil pipelines.

The Commission declined to adopt any changes to the two-step DCF model but made the following decisions concerning its use of the CAPM methodology:

- Under CAPM, the Commission will calculate the market risk premium using the 30-year U.S. Treasury average historical bond yield over a six-month period, a forward-looking approach based upon a one-step DCF analysis of the dividend paying members of the S&P 500, excluding companies with growth rates that are negative or in excess of 20%.
- FERC found it reasonable to use the *Value Line* adjusted betas in the CAPM analysis, but stated that it would consider use of alternative beta sources in individual proceedings. The Commission also found it reasonable to use the size premium adjustment based on the New York Stock Exchange.

- The Commission stated that while it still prefers the use of Institutional Brokers' Estimate System (IBES) for short-term growth projections in the two-step DCF analysis, under CAPM it would allow participants to propose using *Value Line* as the source of short-term projections in the one-step DCF analysis embedded within the CAPM.

## Formation of Pipeline Proxy Groups

In the Policy Statement, the Commission clarified its policies governing the formation of proxy groups, stating that it would continue to apply a flexible approach if needed to obtain a proxy group of at least five members, permitting companies to relax the general criteria that the pipeline business account for at least 50% of a proxy group member's assets or operating income over the last three years. In addition, the Commission noted it will consider proposals to include otherwise-eligible Canadian entities in the proxy group in future proceedings. Lastly, the Commission stated that it would consider further adjustments as necessary to reflect difficulties in forming a sufficiently-sized proxy group due to the COVID-19 pandemic.

## Oil Pipeline Form No. 6, Page 700s

The Commission encouraged oil pipelines to file updated FERC No. Form 6, page 700 data for 2019 reflecting its revised ROE methodology. The Commission also stated that pipelines that have already filed Form No. 6 for 2019 should either (a) confirm that their previously filed Form No. 6 was based solely upon the DCF model or (b) provide the real ROE and resulting cost of service based solely upon the DCF model as it was applied to oil pipelines prior to this Policy Statement. The Commission stated that it would issue a notice affording pipelines two weeks to file updated page 700 data reflecting the revised ROE methodology.

## Implications

FERC's Policy Statement includes several positive developments for pipelines. The increased flexibility in the formation of proxy groups, particularly FERC's openness to inclusion of Canadian entities, may allow pipelines to propose more representative proxy groups.

The addition of the CAPM model to FERC's framework for determining ROE is likely to produce ROEs that are approximately thirty to fifty basis points higher, because the CAPM ROE tends to be higher than the DCF ROE. This conclusion is based on ROE results from recent data for multiple proxy groups. However, as the composition of proxy groups and the underlying market data changes, so will the results. There is no guarantee that the CAPM ROE will continue to be higher than the DCF ROE.

## FOR MORE INFORMATION

Van Ness Feldman professionals have extensive experience litigating pipeline ROEs in rate cases, including the *Trailblazer Pipeline* case which FERC cited in the Policy Statement. If you are interested in additional information on the new policy statement or related matters, please contact Paul Korman, Phil Mone, Michael Diamond, or any member of the firm's Oil, Gas, & LNG practice in Washington, D.C.

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