UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

Petal Gas Storage, L.L.C. Docket No. CP01-69-002

ORDER ON REHEARING

(Issued March 30, 2004)

1. On November 26, 2001, Petal Gas Storage, L.L.C. (Petal) and Interstate Natural Gas Association of America (INGAA) filed requests for rehearing of the Commission's October 25, 2001 Order (October 25 Order) which rejected Petal's request for a rate of return on equity (ROE) of 15 percent and imposed an ROE of 12.60 percent based on a Discounted Cash Flow (DCF) analysis.[1]

2. As discussed below, the Commission grants in part and denies in part rehearing of the ROE adopted by the Commission in the October 25 Order. We grant rehearing in part on the issue of the appropriate proxy group[2] to use in setting an ROE for Petal, and find that the Commission's recent decision in Williston Basin Interstate Pipeline Company (Williston Basin)[3] supports the use of a 12.48 percent ROE.

Intervention

3. INGAA filed an untimely motion to intervene on November 26, 2001, which also requested rehearing and clarification. INGAA's untimely motion was sought after the

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[1]Petal Gas Storage, L.L.C., 97 FERC ¶ 61,097 (2001).

[2]A "proxy group" is a group of comparable companies used to determine a zone of reasonableness of rates of return, and to establish what the proper rate of return should be for the company under consideration.

[3]104 FERC ¶ 61,036 (2003).

issuance of the October 25 Order disposing of Petal's application. In those circumstances, the prejudice to other parties and burden upon the Commission of granting the late intervention may be substantial. Thus, movants bear a higher burden to demonstrate good cause for the granting of such late intervention. The Commission has determined to grant INGAA's intervention because it is unopposed and raises issues concerning the October 25 Order's adoption of a new policy related to the appropriate proxy group for determining ROE.

Background

Petal's Application and Amendment

4. On January 23, 2001, Petal filed an application pursuant to Section 7(c) of the Natural Gas Act, for authority to construct and operate 59 miles of pipeline, compression and appurtenant facilities commencing at the terminus of Petal's storage header facility near Hattiesburg, Mississippi[4] and terminating adjacent to Southern Natural Gas Company's (Southern) compressor station near Enterprise, Mississippi. Among other things, Petal sought authority to charge initial recourse rates for firm and interruptible transportation services over the pipeline facilities under Rate Schedules FTS and ITS, respectively. The proposed rates were derived using 15 percent ROE, an 8.75 percent cost of debt, 11.875 percent overall rate of return, and a capital structure comprised of 50 percent debt and 50 percent equity.

5. On June 19, 2001, Petal filed an amendment to its original application revising its discount agreement for the firm transportation rate that it will charge to Southern Company Services, Inc. (Southern Company). Petal stated that 100 percent of its pipeline's firm transportation capacity is subscribed by Southern Company for a period of 20 years. Petal also revised its proposed recourse rates to depreciate the pipeline facilities over a 40 year life (using a 2.5 percent annual depreciation accrual rate), in lieu of the 20 year life originally proposed, but it made no changes to the capital structure or rate of return on equity reflected in its original application.

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[4]For its storage facilities, the Commission accepted Petal's proposal to continue to charge market-based storage service rates, as conditioned in the certificate proceedings underlying its other storage services, Petal, 97 FERC at 61,521 (2001). See also Petal Gas Storage Co., 64 FERC ¶ 61,190 (1993), Petal Gas Storage Co., 86 FERC ¶ 61,224 (1999), and Petal Gas Storage Co., 92 FERC ¶ 61,220 (2000).

The October 25 Order

6. The October 25 Order issued a certificate of public convenience and necessity to Petal authorizing the construction and operation of the facilities described above. However, the October 25 Order also rejected Petal's 15 percent ROE. While Petal claimed that its cost of equity was derived from its parent company, El Paso Energy Partners, L.P. (El Paso Energy),[5] the Commission determined that Petal failed to provide the calculations that support its proposed ROE.[6]

7. The October 25 Order stated that the Commission uses the DCF method for establishing the ROE for regulated pipeline companies. Further, using the DCF methodology discussed in Transco,[7] the Commission selected eleven companies to use as a proxy group in developing the ROE for Petal. The proxy group was comprised of: CMS Energy, Duke Energy, El Paso Energy, Equitable, Kinder Morgan, MDU Resources, National Fuel Gas Company, NiSource, Questar Corp., Reliant Energy, and The Williams Companies. The equity costs for each company in the proxy group form a zone of reasonableness for ROE under the Commission's DCF method. Based on the dividend yields and growth rate estimates for these proxy group companies, the DCF method resulted in a range of equity costs between 10.31 percent and 15.52 percent with a median of 12.60 percent.

8. The Commission stated that it begins the risk analysis for proposed projects with the assumption that pipelines generally fall into a broad range of average risk.[8] Absent highly unusual circumstances that indicate an exceptionally high or low risk as compared

[5] At the time, El Paso Energy was the parent of Crystal Gas Storage, the parent of Petal.

[6] In the June 6, 2001 response to the May 17, 2001 Staff Data Request No. 7, Petal indicated that the current capital structure of El Paso Energy was comprised of 53 percent debt and 47 percent equity, 9.27 percent cost of debt, 15 percent rate of return on equity (ROE), and an 11.963 percent overall rate of return; however, Petal did not support or propose to use this updated capital structure in its June 19, 2001 amendment to its original application.

[7] Transcontinental Gas Pipe Line Corp., 90 FERC ¶ 61,279 (2000). See also Transcontinental Gas Pipe Line Corp., Opinion No. 414, 80 FERC ¶ 61,157 (1997).

[8] 97 FERC at 61,519, citing Transco, 90 FERC at 61,936.

to other pipelines, the assumption is made that a pipeline faces average risks (though an examination of a particular pipeline's risk factors may warrant adjusting the ROE higher or lower than the middle of the zone of reasonableness established by the proxy group).

9. The October 25 Order noted that Petal did not justify placement at the upper-end of the zone of reasonableness. Consequently, the Commission concluded a reasonable ROE for Petal is the median of the range of the above-described proxy group or 12.60 percent. The October 25 Order further required Petal to revise its FTS and ITS recourse rates and to make a restatement filing at the end of its first three years of actual operation to justify its existing recourse rates.[9]

Petal's Request for Rehearing

10. In its request for rehearing of the October 25 Order, Petal claims that the Commission inappropriately lowered its requested return on equity without explanation or justification. Petal requests the Commission accept Petal's proposed 15 percent equity return based on the cost of equity capital for El Paso Energy, Petal's publicly traded parent company, or alternatively, utilize a group of proxy companies comparable to that approved in Order No. 414-A[10] and evaluate Petal's risk relative to the risks of the companies comprising the proxy group, in order to place Petal within the range of equity returns determined from the proxy group.

11. Petal also requests that in the event the Commission denies the relief requested above, it clarify that the determination of a proxy group in this certificate proceeding, and any analysis of Petal's risk compared to the proxy group, shall not be binding on Petal when it submits its three year restatement filing, and also that it shall not be deemed binding precedent or a "settled practice" in the next rate case. Petal states that it should be permitted to rely on the Commission's long standing policy regarding appropriate proxy groups announced in Opinion No. 414-A or any successor policy developed on the basis of a record in its upcoming rate case.

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[9]Petal's pipeline facilities went into service on July 1, 2002.

[10]Transcontinental Gas Pipe Line Corp., Opinion No. 414-A, 84 FERC ¶ 61,084 (1998), reh'g denied, Opinion No. 414-B, 85 FERC ¶ 61,323 (1998), petition for review denied, North Carolina Utilities Commission v. FERC, D.C. Cir. Case No. 99-1037 (February 7, 2000) (per curiam)(Transco).

12. Petal asserts that the Commission failed to engage in reasoned decision-making when it rejected its proposed equity return, adopted an unprecedented group of proxy companies for purposes of setting Petal's return on equity, and placed Petal in the middle of the range of return indicated by the proxy group, without any examination of the relative risks of Petal compared to the proxy group.

13. Petal states that the Commission's decision with respect to Petal's return on equity was not based on substantial record evidence.[11] Further, Petal contends that the Commission selected a completely unprecedented group of companies as a proxy group, with no record evidence or explanation, and placed Petal in the middle of the range with no analysis of the relative risks of Petal versus the other companies making up the proxy group, and that the Commission's 12.6 percent rate of return on equity is devoid of any record support.

14. Petal proposed to use the cost of equity capital determined by reference to its own parent, El Paso Energy, because it is publicly traded, engaged in natural gas transmission business, and the owner of Petal. Petal claims that El Paso Energy's cost of equity capital is market-tested and highly relevant to the cost of capital for a pipeline company, such as Petal. Petal then states that El Paso Energy's cost of equity is 16.73 percent, purportedly supporting the use of the 15 percent ROE.

15. In the eleven-company proxy group selected by the Commission, Petal notes that only El Paso and The Williams Companies have been used in Commission decisions involving proxy groups, and only one other, Kinder Morgan would satisfy the Commission's criteria for inclusion in a pipeline proxy group. Petal characterizes the criteria for inclusion as a proxy group company to be whether (1) the company's stock is publicly traded, (2) the company is recognized as a natural gas pipeline company with its stock recognized and tracked by investment information services, and (3) pipeline operations constitute a high proportion of the company's business.[12]

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[11] See City of Charlottesville, Va. v. FERC, 661 F.2d 945, at 950 (D.C. Cir., 1981); Tarpon Transmission Co. v. FERC, 860 F. 2d 439 at 442 (D.C. Cir., 1988); and Greater Boston Television Corporation v. F.C.C., 444 F.2d 841 at 851 (D.C. Cir., 1970).

[12] The Commission's then-current criteria for selecting a proxy group for natural gas pipelines were as follows: (1) the selected company had to be publicly-owned with publicly-traded stock; (2) the selected company had to own one or more FERC-regulated interstate gas pipeline subsidiaries; (3) the selected companies were considered by investors to be reflective of the risks of natural gas pipelines as evidenced by their inclusion in such investor-oriented products as the analysis of diversified natural gas

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16. Petal states the Commission is silent on how the criteria support the use of the eleven-company proxy group. For example, the Commission does not provide data to support that the eleven proxy companies are recognized as natural gas pipelines by financial service companies or that pipeline operations constitute a large percentage of their businesses. In Transco, the Commission explicitly ruled that Duke Energy did not meet the criteria for inclusion in the proxy group, although the Commission included it in the new proxy group. Even though Duke Energy was found to be part of the appropriate proxy group for setting electric rates, Petal states it is not for a pipeline company. Moreover, Petal argues that the Commission rejected CMS Energy, Duke Energy, National Fuel and Equitable as proxy group companies in Williston Basin, due to the low percentage of operating income from gas pipeline business, or conversely, the high percentage of operating income from either electric business or gas distribution business.

17. Also, Petal states that the use of distribution companies as a proxy for a pipeline company is inconsistent with the Mountain Fuel Resources Co.,[13] because the distribution companies do not appear to meet the second and third criteria for selecting pipeline company proxy groups, i.e., they do not appear to be perceived as pipeline companies by investors, and do not appear to have a high proportion of their business in the pipeline sector. Petal explains that the only companies in the Commission's choice of proxy group that realize most of their income from pipeline activities are El Paso, Kinder Morgan and Williams, and indicates that the Commission is silent why it is not appropriate to use this group.

18. For these reasons, Petal asserts that the summary determination of a proxy group is contrary to the Commission's past recognition that determining an appropriate proxy group requires extensive analysis, and that the Commission's unsupported selection of eleven companies in this case was arbitrary and capricious, and otherwise not the product of reasoned decision-making.

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industry companies that appear quarterly in the Value Line "Investment Survey" publication, the gas transmission companies in Moody's natural gas industry averages, and Standard & Poor's Natural Gas Pipelines Index; and (4) the selected companies were companies for which the transmission of natural gas accounted for, on average, over the most recent three-year period for which data was available, approximately 50 percent or more of the total dollars in at least one of the two areas, operating income and total assets. See Williston Basin, 104 FERC at 61,103, n.46.

[13] 28 FERC ¶ 61,195 at 61,370 (1984).

19. Petal also objects to the Commission's placing Petal at the median of the range of required returns derived from its arbitrarily selected proxy group including mixed pipeline, LDC and electric companies, instead of a conventional pipeline company proxy group. For instance, states Petal, gas distributors have franchised service areas, but interstate pipelines do not; therefore, the risk of market loss is generally viewed as higher for pipelines than LDCs, and because the proxy group included at least six companies with substantial gas distribution assets, the overall range of risks for the proxy group is lower than the risks for interstate pipelines.

20. Likewise, Petal claims that there are important differences between gas companies and electric utilities, with the differences so great that the Commission uses a different methodology to determine growth rates for electric utilities than for pipeline companies. When picking a proxy group with lower risk LDCs and electric utilities, Petal believes that it is arbitrary for the Commission to assume that Petal would have average risk within that group in the absence of record evidence.

21. In applying the DCF methodology, once the proxy group is picked it is necessary to determine the investor expected growth rates for the companies in order to determine the cost of equity. Petal notes that the October 25 Order does not state what short term and long term growth rates were used, nor what the projections were for each proxy company or for the Gross Domestic Product (GDP). In addition, it claims the October 25 Order failed to identify important factors used, such as dividend yields, the stock prices or dividend payments. Finally, Petal argues the adopted proxy group is dramatically different than every litigated pipeline return on equity case since Opinion No. 414-A.

<u>INGAA's Request for Rehearing</u>

22. INGAA's rehearing request asserts that the October 25 Order used an eleven-company proxy group to set the ROE that substantially diverged from the proxy group and proxy group approach approved in Opinion No. 414-A. INGAA further requests clarification that the October 25 Order does not represent precedent that will be used in other pipeline rate or certificate proceedings, and that the Opinion No. 414-A methodology for the selection of a proxy group will not be changed without the benefit of record evidence.

<u>Discussion</u>

23. Petal proposes to use the 15 percent cost of equity determined by reference to its parent, El Paso Energy, because it is publicly traded, engaged in the natural gas transmission business, and the owner of Petal. In response to the October 25 Order's finding that Petal failed to provide supporting calculations for its cost of equity, Petal

presented a DCF cost of equity calculation (for its parent) deriving a 16.73 percent ROE for El Paso Energy to support its proposed 15 percent ROE (Appendix A attached to rehearing request).

24. The Commission rejects Petal's proposed 15 percent equity return based on the claimed cost of equity capital for El Paso Energy. Petal's parent is engaged in many non-pipeline operations and Petal has not demonstrated that its risks are similar to the risks of its parent. Additionally, Petal's reliance on System Energy Resources, Inc.,[14] to support the use of its parent's cost of equity is misplaced. In that case, which involved the Commission's ROE policy for an electric utility, there was no evidence that the parent engaged in non-jurisdictional activities to the same extent that Petal's parent does, and there appears to have been little question that the utility and the parent faced similar risks. The Commission has distinguished between electric utilities and natural gas pipelines in developing its approach in establishing return on equity.[15] Petal itself recognizes in its rehearing request that there are significant differences between the gas industry and the electric utility industry[16] and it has not explained why use of electric precedent is relevant here.

25. Moreover, the Commission's long-standing policy is to derive the cost of equity by use of a proxy group to set a range of reasonable returns for gas pipelines. This is because most gas pipelines are wholly-owned subsidiaries and their common stock is not publicly traded. We find this approach appropriate here.

26. However, we will grant rehearing of the October 25 Order's use of the eleven-company proxy group, including some electric utilities, for purposes of setting Petal's return on equity. Petal argues that it should be permitted to rely on the Commission's long-standing policy regarding proxy groups in Opinion No. 414-A[17] or any successor

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[14]Opinion No. 446-A, 96 FERC ¶ 61,165 (2001).

[15]Williston Basin, 104 FERC at 61,104; Southern California Edison Company, Opinion No. 445, 92 FERC ¶ 61,070 at 61-260-61,262 (2000).

[16]Petal's rehearing request at 11.

[17]Transcontinental Gas Pipe Line Corp., Opinion No. 414-A, 84 FERC ¶ 61,084 (1994), reh'g denied, Opinion No. 414-B, 85 FERC ¶ 61,323 (1998), petition for review denied, North Carolina Utilities Commission v. FERC, 203 F.3d 53 (D.C. Cir. 2000) (per curiam).

policy developed on the basis of a record in a rate case. Subsequent to the October 25 Order, in Williston Basin,[18] the Commission recognized that changing conditions in the natural gas industry have resulted in few companies qualifying for use in the proxy group under the standards set forth in Opinion No. 414-A.[19] The Commission accordingly adopted a proxy group based on companies listed among the Value Line group of diversified natural gas companies that own FERC-regulated natural gas pipelines. Among other things, Williston Basin found no need at this time, for inclusion of electric utilities in the proxy group used to establish ROE for a natural gas pipeline.

27. In establishing an ROE for Petal, we find it is appropriate to rely on the Commission's decision in Williston Basin. In Williston Basin, the Commission performed a DCF analysis using the nine companies comprising the proxy group based on the new criteria. The result of that analysis was a range of equity returns from a low of 9.82 percent to a high of 13.76 percent, and approving a 12.48 percent ROE at the median of the range.

28. Our reliance on Williston Basin, which developed a policy regarding proxy groups on the basis of a record in a rate case, should satisfy INGAA's concerns raised in its rehearing request.

29. As we explained in the October 25 Order, we conduct our risk analysis with the presumption that existing pipelines fall into a broad range of average risk, absent highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines.[20] In this case, Petal has not made a sufficient showing that it is outside the broad range of average risk. Petal is not a new entrant to the gas business, rather it is an existing jurisdictional corporate entity engaged in providing jurisdictional storage services. Constructing a new pipeline to transport gas from the Petal storage facilities to Southern's pipeline interconnection is simply an expansion of its existing jurisdictional

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[18] Under the new proxy group criteria, a candidate has to derive at least half of its operating income (no mention of assets) from a regulated, energy-related line of business, whereas before it had to derive at least half of its operating income from or have at least half of its assets in the transmission of natural gas.

[19] Specifically, the Commission noted that proxy group the Commission used in proceedings subsequent to the consummation of El Paso's merger with Coastal in January 2001, was only three. Williston Basin, 104 FERC at 61,103.

[20] Transcontinental Gas Pipe Line Corp., 90 FERC ¶ 61,279 (2000).

business. Moreover, Petal proposed financing the pipeline internally through its parent, El Paso Energy, using a 50/50 debt/equity capitalization.[21] A review of the average capital structure of the proxy group used in Williston Basin shows it is comparable to Petal's capital structure, i.e., 50/50 debt/equity capitalization. Under these circumstances, we find that Petal has average business and financial risks, and overall is an average risk pipeline.

30. Consistent with the October 25 Order, we find that Petal has not justified placement at the upper-end of the range, therefore, we deny rehearing of the risk analysis we used for placing Petal within the zone of reasonableness. Consequently, we will approve the use of a 12.48 percent ROE using the median return in Williston Basin for Petal. Petal is directed to file revised rates within 30 days of the date of this order, consistent with this finding to be effective on July 1, 2002, the service commencement date of the pipeline. Accordingly, Petal is ordered to make required refunds, and file a refund report with the Commission within 60 days of the date of this order.

The Commission orders:

(A) Petal's request for a 15 percent return on equity is rejected, as discussed in the body of this order.

(B) Rehearing of the October 25 Order's selection of an appropriate proxy group used to derive Petal's return on equity is granted, as discussed in the body of this order.

(C) Rehearing of the October 25 Order's risk analysis that places Petal in the median of the zone of reasonableness is denied, as discussed in the body of this order.

(D) Within 30 days of the date of this order, we require Petal to make a filing revising its rates to be effective on July 1, 2002, to reflect the approved 12.48 percent ROE. Petal is required to make refunds and file a refund report within 60 days of the date of this order.

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[21] This contrasts with the highly leveraged, project financed pipelines, where the Commission has approved equity returns of up to 14 percent. See, e.g., Gulfstream Natural Gas System, L.L.C., 105 FERC ¶ 61,052 (2003) and 91 FERC ¶ 61,119 (2000), Georgia Strait Crossing Pipeline LP, 98 FERC ¶ 61,271 (2002), North Baja Pipeline, LLC, 95 FERC ¶ 61,259 (2001).

(E) INGAA’s late-filed motion to intervene is granted.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.