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Item No. G-1

Chairman Joseph T. Kelliher

Statement of
Chairman Joseph T. Kelliher
on
Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity

"Today, the Commission makes a change in policy with respect to the composition of proxy groups for determination of returns of equity for natural gas and oil pipelines. Under our new policy, pipelines organized as master limited partnerships (MLPs) may be included in the proxy group for calculation of returns under the Discounted Cash Flow (DCF) model for natural gas pipelines. The Policy Statement also clarifies Commission policy with respect to inclusion of MLPs in the DCF analysis for oil pipelines.

This proposed change is made in response to structural changes that have occurred in both the natural gas and oil pipeline sector in recent years. These structural changes have strained the Commission's prior approach towards proxy group composition to the breaking point. As a result of mergers, acquisitions, and other changes in the natural gas industry, fewer and fewer interstate natural gas companies have satisfied our prior requirements for proxy group composition.

Our policy change is born out of a practical recognition that the size of the proxy group used under our prior approach had shrunk dramatically. We made a series of adjustments to compensate for the shrinking proxy group. We relaxed our requirements and included diversified natural gas companies in the proxy group, without regard to what portion of the company's business comprises pipeline operations. We also adjusted returns to account for the relatively lower risks of diversified natural gas companies compared to pipeline companies. These adjustments were challenged in court in a series of cases.

The reality is that the natural gas pipeline sector has increasingly adopted the MLP structure. The oil pipeline sector adopted that structure some years ago. To insist on excluding MLPs from the natural gas pipeline proxy group in the face of these developments would seem to be perverse.

Moreover, shortly after we issued the Proposed Policy Statement last July, the U. S. Court of Appeals for the D.C. Circuit in *Petal Gas Storage* vacated and remanded our rulings in two earlier decisions where the Commission excluded MLPs from the proxy group. The court emphasized that "proxy group arrangements must be risk appropriate" and that changes in the structure of the gas pipeline sector compelled reform in the Commission's traditional approach towards proxy group composition.

We have been careful in our approach. We issued a Proposed Policy Statement and sought comments on our proposed new approach. We also carefully weighed the comments we received in development of this Policy Statement. We were persuaded by the record that our proposal to cap the cash distribution used to calculate an MLP's return at reported earnings should not be adopted. We examined whether Gross Domestic Product is a fair measure of the long term growth of MLPs. On this point, we determined that our record was inadequate to decide the question, and supplemented the record with a technical conference last January. Today, we embrace the proposal offered by the American Public Gas Association to use a long-term growth projection for MLPs equal to 50 percent of the long-term growth in GDP, as the measure of the long term growth prospects of MLPs best supported by the record.

We not only announce this new policy with respect to proxy group composition, but apply this approach in a series of cases, including the two cases remanded by the D.C. Circuit in *Petal*. We reopen the record in two of these proceedings, and allow parties an opportunity to submit evidence as to which MLPs and corporations should be included in the respective proxy group. We refer two other proceedings to settlement judges.

The MLP structure is a proven vehicle for investment in pipeline infrastructure. The time had come for Commission policy to adjust to the structural changes that have occurred in both the natural gas and oil pipeline sectors in recent years. I think the approach we establish today is a sound one."