

REPORT OF THE FINANCE AND TRANSACTIONS COMMITTEE

I. Public Utility Holding Company Act of 2005/Federal Power Act Section 203.....	347
II. Natural Gas Pipelines	347
A. Kern River Gas Transmission Company	347
B. Proxy Group.....	348
C. Risk Analysis/Placement in Zone	351
D. Other Issues.....	352
III. Renewable Energy	352

I. PUBLIC UTILITY HOLDING COMPANY ACT OF 2005/FEDERAL POWER ACT SECTION 203

In light of the significant developments under Federal Power Act section 203 and the Public Utility Holding Company Act of 2005 over the past year, members of the Finance and Transactions Committee and the Electricity Regulation Committee have worked together to provide a comprehensive presentation of these matters in the Corporate/Affiliate and Section 203/Merger Developments sections of Electricity Regulation Committee Report. For a discussion of these developments, to which the Finance and Transactions Committee contributed, please see the Electricity Regulation Committee Report in this issue.

Provided below is a report of significant financing and transactional developments that have occurred in the past year in the energy and utility industries.

II. NATURAL GAS PIPELINES

A. *Kern River Gas Transmission Company*

On October 19, 2006, the Commission (FERC or the Commission) issued Opinion No. 486 in the *Kern River Gas Transmission Company* rate case.¹ The proceeding was closely watched by stakeholders in the gas pipeline industry particularly with respect to the rate of return on equity issue. In Opinion No. 486, which Commissioner Suedeen Kelly described as the “roadmap” for pipeline rate cases for the foreseeable future, the Commission allowed Kern River a return on equity of 11.2%, reversing the administrative law judge’s March 2, 2006, initial decision recommending a 9.34% return on equity for the pipeline.²

The Commission’s decision stems from an April 30, 2004, rate filing in which Kern River proposed a return on equity of 15.1%. Kern River proposed a proxy group that included master limited partnerships (MLPs) and claimed that a return on equity of 15.1%, which was the highest in the zone of reasonableness,

1. *Kern River Gas Transmission Co.*, 117 F.E.R.C. ¶ 61,077 (2006) [hereinafter *Kern River*].

2. *Id.* at P 2.

was appropriate because of its high level of risk.³ Arguing against the inclusion of MLPs in the proxy group, other parties in the case proposed a return on equity in the nine to ten percent range at the median of the zone of reasonableness. In the initial decision, the judge rejected Kern River's proposal to include MLPs in the proxy group, finding that the result was an artificial inflation to the returns.⁴ The judge also rejected the Commission Staff's proposal to include electric utilities in the proxy group. Instead, the judge used a proxy group consisting of El Paso Corp., Equitable Resources Inc., Kinder Morgan Inc., National Fuel Gas Co., Questar Gas Co., and the Williams Cos. to determine an appropriate return on equity for Kern River. This proxy group had returns on equity ranging from 7.31% to 13.62%.⁵ The judge also adopted the proposal of several parties to place Kern River at the median of the zone, which resulted in a return on equity of 9.34%.⁶

B. Proxy Group

In Opinion No. 486, the Commission upheld the judge's decision to exclude MLPs and electric utilities from the proxy group, but modified the proxy group chosen by the judge. Instead, the Commission used the same four-company proxy group that it adopted in *High Island Offshore System, L.L.C.*,⁷ and which excluded El Paso and Williams, and concluded that the median return on equity for Kern River should be 10.7%.⁸

The Commission reaffirmed its use of the discounted cash flow (DCF) methodology to determine return on equity for natural gas pipelines. The DCF method calculates an investor's expectation of income from the investment in the future (based on current yield and expected growth). In order to determine a reasonable return for the pipeline in question, the DCF calculation is applied to the yields of a proxy group consisting of similarly situated publicly traded entities. This results in a zone of reasonableness of expected returns for those companies. Then, depending on whether the pipeline in question is of average risk, more risky than average, or less risky than average, it will be assigned a return on equity somewhere within this zone of reasonableness.

The Commission recognized that fewer and fewer companies meet the Commission's standard for inclusion in the proxy group.⁹ The Commission previously addressed this problem in *Williston Basin Interstate Pipeline Co.*,¹⁰ and *HIOS*, and selected proxy groups based on the companies included in the Value Line Investment Survey group of diversified natural gas companies whose business includes Commission-regulated natural gas pipelines. The Commission agreed with the judge that the six-company proxy group based on the Value Line Investment Survey list of diversified natural gas companies with Commission

3. *Kern River*, *supra* note 1, at P 45.

4. *Id.*

5. *Kern River*, *supra* note 1, at P 122.

6. *Id.* at P 162.

7. *High Island Offshore Sys.*, 110 F.E.R.C. ¶ 61,043, *reh'g*, 112 F.E.R.C. ¶ 61,050 (2005) [hereinafter *HIOS*].

8. The proxy group consists of National Fuel, Questar, Equitable Resources, and KinderMorgan.

9. *Kern River*, *supra* note 1, at P 123.

10. *Williston Basin Interstate Pipeline Co.*, 104 F.E.R.C. ¶ 61,036 at P 35 (2003).

regulated pipelines provides the best starting point for determining the proxy group in this case.¹¹

With respect to the exclusion of companies with significant electric operations from the proxy group, the Commission explained:

We have previously distinguished between electric utilities and natural gas pipelines in developing our approach to establish return on equity for companies in each industry, based on the different levels of maturity in each industry, and are reluctant, on this record, to abandon that practice at this time by including electric utilities in the proxy group used to establish return on equity for a natural gas pipeline.¹²

The Commission noted that changes in the structure of the natural gas industry “makes it difficult to pick a representative proxy group. However, in this case . . . the proxy group used in *HIOS* is a reasonable representative group of natural gas companies and nothing in this record has convinced us at this time of the need to include electric entities.”¹³ The Commission added that it may revisit this issue in the future if electric and gas companies continue to combine.

The Commission concluded that the financial circumstances of El Paso and Williams made them inappropriate for inclusion in the proxy group:

The losses experienced by El Paso, and similarly by Williams, were largely related to their respective energy trading and related risk management operations, rather than to their gas pipeline businesses. These businesses proved to be much more volatile and risky than those of the gas pipeline industry. Thus, their financial difficulties are not representative of the gas pipeline industry. . .¹⁴

The Commission explained that the estimated costs of equity for El Paso and Williams were 7.31% and 7.32% respectively, barely above average yield for the public utility debt for the relevant period in this case.¹⁵ The Commission noted that in prior cases it has held that “investors generally cannot be expected to purchase stock, if debt, which has less risk than stock, yields essentially the same return.”¹⁶

In finding that Kern River did not meet its burden to support inclusion of MLPs in the proxy group, the Commission concluded that the evidence presented did not adequately address how the significant differences between a corporation’s dividends and an MLP’s distributions should be evaluated under the DCF model, nor did the evidence address how the Commission’s DCF model might be adjusted to account the differences between dividends and distributions.¹⁷ While noting that it was not making a generic finding that MLPs

11. *Kern River*, *supra* note 1, at P 139.

12. *Id.* at P 158.

13. *Kern River*, *supra* note 1, at P 159.

14. *Id.* at P 141.

15. *Kern River*, *supra* note 1.

16. *Id.* at P 140 (citing *Southern Cal. Edison Co.*, 92 F.E.R.C. ¶ 61,070, at p. 61,266 (2002)).

17. *Kern River*, *supra* note 1, at P 143. The Commission noted that Kern River is not an MLP, but a general partnership that is ultimately owned by a corporation. For ratemaking purposes, the Commission treats Kern River as a corporation. The Commission further observed that the record demonstrates significant differences between partnerships that are not organized as MLPs, such as Kern River, and MLPs as investment vehicles. *Id.*

cannot be considered for future proxy groups,¹⁸ the Commission explained why it was unable to accept Kern River's proposal based on the record in this case:

there can be significant differences between a corporation's dividends and an MLP's distributions. Corporations pay dividends in order to distribute a share of their earnings to their stockholders. As such, dividends do not include any return *of* invested equity to the stockholders. Rather, dividends represent solely a return *on* the stockholders' invested equity. Put another way, dividends represent profit that the stockholder is making on its investment. Moreover, corporations typically reinvest some earnings to provide for future growth of earnings and thus dividends. Since the return on equity which the Commission awards in a rate case is intended to permit the pipeline's investors to earn a profit on their investment and provides the funds to finance future growth, the use of dividends in the DCF analysis is entirely consistent with the purpose for which the Commission uses that analysis. By contrast, as Kern River concedes, the cash distributions of the MLPs it seeks to add to the proxy group in this case include a return *of* invested capital, in addition to a return *on* invested capital through an allocation of the partnership's net income. While the level of an MLP's cash distributions may be a significant factor in the unit holder's decision to invest in the MLP, the Commission uses the DCF analysis solely to determine the pipeline's return on equity. The Commission provides for the return *of* invested capital through a separate depreciation allowance. For this reason, to the extent an MLP's distributions include a significant return of investment, a DCF analysis based on those distributions, without any adjustment, will tend to overstate the estimated return on equity because the "dividend" would be inflated by cash flow representing return *of* equity, thereby overstating the earnings the dividend stream purports to reflect.¹⁹

The Commission also did not find persuasive Kern River's arguments that the increased "dividend" yield resulting from the fact that an MLP's cash distributions include a return of equity would ordinarily be expected to reduce an MLP's growth projections below those of a corporation, thus balancing out the increased "dividend" yield. The Commission noted that while Kern River's assertion of reduced growth may be generally true over the long term, during the shorter term reflected in Institutional Broker's Estimate System (IBES) growth projections MLPs may have other means of financing growth apart from retained earnings, including the issuance of additional debt or equity.²⁰ The Commission went on to explain that:

The short-term growth factor of the traditional DCF model is based on the additional dividends that will come from the growth that is caused by reinvesting a share of earnings in the company. Since the model is driven by growth in dividends derived from the reinvestment of current earnings, the traditional DCF model does not incorporate growth arising from external sources of capital such as issuing additional debt or equity. Therefore, a cost of equity capital analysis using MLPs in the proxy group should explain whether and how external sources of capital have affected the short term growth patterns of the subject MLPs. If the growth forecasted for an MLP comes from external capital, it is necessary either: (1) to explain why the external sources of capital do not distort the DCF results for that MLP; or (2) propose an adjustment to the DCF analysis to eliminate any distortion. On this record, we find that Kern River has not provided an adequate explanation concerning the short term growth patterns of its proposed MLPs, and thus has failed to carry its burden to demonstrate that the use of its proposed MLPs in the proxy group, without any such adjustments, resolve the differences between MLP

18. *Kern River*, *supra* note 1, at P 147.

19. *Id.* at P 149-50.

20. *Kern River*, *supra* note 1, at P 151.

distributions and corporate dividends and would produce just and reasonable rates.²¹

The Commission also rejected Kern River's proposal to reduce the cash distributions of the MLPs in the proposed proxy group by removing the return of investment on the theory that this approach assumed that the MLPs "paid 'dividends' equal to 100 percent of their earnings."²² The Commission was not satisfied that, based on the record in the case, the adjustment addressed its concerns because it ignored a "crucial assumption [] of the DCF model . . . that dividends, rather than earnings, constitute the source of value."²³ Noting that "retained earnings are a key source of dividend growth in the traditional DCF model, which reflects the fact that corporations normally do not pay out all of their earnings as dividends, and the dividends that are paid are assumed to be a distribution of stable long term surplus earnings not required for future growth[.]"²⁴ the Commission concluded that Kern River had not established that its proposed MLPs have stable long term earnings that would justify treating a distribution of 100% of their earnings as equivalent to a corporate dividend for use in the DCF analysis.²⁵ The Commission further stated, however, that it did not intend to preclude non-MLP pipelines from proposing to include MLPs in the proxy group, if there is an appropriate adjustment to reflect the differences between MLPs and corporations.²⁶

C. Risk Analysis/Placement in Zone

The Commission retained its existing policy for deciding whether one particular pipeline is more or less risky than another. Since the proxy group adopted is small and includes companies with a relatively low proportion of pipeline business and substantial distribution operations, the Commission approved a fifty basis point adjustment above the median to account for the differences in risk between Kern River and the proxy group companies, resulting in an 11.2% return on equity for Kern River.²⁷

The Commission acknowledged that in *HIOS* it rejected the argument that the return on equity for HIOS should be adjusted upward to reflect the greater risks faced by an interstate pipeline compared to a local distribution company. The Commission explained that in *HIOS* it found that an adjustment above the median of the range was not warranted:

due in part to the large number of captive customers on the HIOS system . . . Kern River, in contrast, has fewer captive customers and faces a greater degree of competition from competing pipelines in the Rocky Mountain region. Much of Kern River's capacity is subscribed by merchant electric generators, other industrial users, and gas marketers, all of whose use of gas is sensitive to volatility in commodity prices. Only seven percent of Kern River's firm capacity is held by LDCs In addition, unlike HIOS, Kern River competes for its primary markets with a number of other interstate pipeline systems and with alternate energy

21. *Id.* at P 152.

22. *Kern River*, *supra* note 1, at P 152.

23. *Id.* at P 153.

24. *Kern River*, *supra* note 1, at P 153.

25. *Id.*

26. *Kern River*, *supra* note 1, at P 154.

27. *Id.* at P 2.

supplies such as LNG. Kern River's gas supplies compete with gas sourced in other regions of the continent."²⁸

Pointing to Kern River's "credit rating somewhat above the average" and various factors affecting the pipeline's long-term service commitments, the Commission rejected Kern River's contention that its risks are so far above average as compared to other natural gas pipelines as to justify a return at the top of the range.²⁹

D. Other Issues

The Commission affirmed the judge's approval of levelized rates, although Kern River was required to modify its rate methodology. The Commission ordered Kern River to include in its tariff "step-down" rates that will take effect after its current contracts expire. The Commission also reversed the judge's denial of Kern River's proposal to employ a weighted average cost of debt in rate design and its request for a corporate income tax allowance.³⁰

III. RENEWABLE ENERGY

The major focus of renewable energy financing in 2006 was the development of wind energy projects using the production tax credit (PTC) that is available under section 45 of the Internal Revenue Code. The PTC is available in support of a range of renewable energy power projects that pays a tax credit of 1.9 cents/kWh for ten years if the project comes on line by the end of 2008. A shortfall in the supply of wind turbines during 2006 led to an increase in the costs of equipment, construction, and engineering services.

One response to the shortage of wind turbines was the use of separate loans for turbines, which loans were available to mature projects prior to the commencement of construction under construction loans. There also was increased use of term-loans instead of back leverage loans, with tax equity playing an increasingly important role in project structure.³¹ Another focus of wind project developers was monetization of the tax benefits that were created by the PTC. This was achieved by placing the tax benefits into entities with a tax appetite through "partnership flip" transactions involving institutional investors. However, during 2006, the Internal Revenue Service (IRS) placed a temporary hold on further rulings regarding such transactions while it analyzes the continued advancement of these structures in the renewable sector.³²

Consumer demand for renewable energy increased in 2006. Renewable portfolio standards at the state level and the development of markets for renewable energy credits both helped to support project development. Long-term power purchase agreements (PPA) provided pursuant to these renewable

28. *Kern River*, *supra* note 1, at P 176.

29. *Id.* at P 177.

30. *Kern River*, *supra* note 1, at P 143.

31. Press Release, American Wind Energy Association, Wind Power Capacity in U.S. Increased 27% in 2006 and is Expected to Grow an Additional 27% in 2007 (Jan. 23, 2007), available at http://www.awea.org/newsroom/releases/Wind_Power_Capacity_012307.html.

32. Michael T. Burr, *New IRS, FERC Policies Ambivalent Toward Projects*, PUB. UTILS. FORT. MAG. SPARK NEWSL., June 2006, at 5-6, <http://www.pur.com/pubs/spark/jun06.pdf>.

requirements, and a new “virtual PPA” structured around financial derivatives are being used to support long-term off-takes of the output of renewable power projects. The financial markets are moving toward longer term hedging of merchant output from these facilities, allowing projects to spread their return of capital over time at lower risks. In 2006, these developments facilitated the financing of hydroelectric, geothermal, solar, and biomass projects. Open loop biomass projects were placed on hold by the IRS as it evaluated further guidance on a series of issues, including non-biomass commingling with other fuels, co-firing and the role of emerging biomass technologies.³³ This created uncertainty for PTC availability in connection with certain biomass fuel projects.

In late April, 2006, the IRS received over 700 applications for clean renewable energy bond authority created under section 1303 of the Energy Policy Act of 2005 (EPAAct 2005).³⁴ Many of these applications were lodged by municipal utilities and rural electric co-operatives. While the IRS was managing an \$800 million dollar bond authority cap created by EPAAct 2005 for potential allocation,³⁵ awards were designated by year-end for projects which far exceeded the available bond funding authority.³⁶ Solar projects comprised a rapidly growing segment of the U.S. market in 2006 with a substantial number of new projects as well as several initial public stock offerings for solar development companies.³⁷ The federal government is effectively providing cost recovery for sixty percent of the capital costs of the typical solar project through investment tax credits and rapid depreciation. Many solar transactions are structured as leases to avail themselves of these benefits. State grants and tax incentives are also available in a number of jurisdictions, providing key enhanced opportunity for solar technology in residential, commercial, and light industrial markets.

In 2006, there was increased acceptance in the United States of geothermal, biofuels, and also of ocean thermal technology, which technologies are moving from the research and development phase to potential commercial applications. The biofuels sector has taken off with over 116 plants in operation and seventy-nine plants in construction, combined with eleven plant expansions, responding to the Renewable Fuels Standard in EPAAct 2005.³⁸ Biofuels projects continued

33. Notice 2006-88, 2006-42 I.R.B. 1, available at http://www.irs.gov/irb/2006-42_IRB/ar07.html.

34. Press Release, Internal Revenue Service, Clean Renewable Energy Bond Volume Cap Allocation Information (Nov. 20, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=164423,00.html> (noting that over \$2.5 billion in CREB funding was requested by applicants).

35. 26 U.S.C. § 54(f)(1) (Supp. 2006).

36. Press Release, Internal Revenue Service, Clean Renewable Energy Bond Volume Cap Allocation Information (Nov. 20, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=164423,00.html> (noting that over \$2.5 billion in clean renewable energy bond funding was requested by applicants).

37. SOLAR ENERGY INDUSTRIES ASSOCIATION, 2006 U.S. SOLAR INDUSTRY YEAR IN REVIEW 4-5 (2006), http://www.seia.org/Year_in_Solar_2006.pdf (projecting that photovoltaic installations in the United States in 2006 increased by 20 percent over 2005 levels and noting that plans have been announced to triple global polysilicon supply by 2010); J. Peter Lynch, *Sunshine in the Public IPO Markets*, RENEWABLE ENERGY ACCESS, Dec. 28, 2006, <http://www.renewableenergyaccess.com/rea/news/story?id=46950> (noting that seven solar-related IPOs were completed in 2006 and that at least four more were pending at the end of the year).

38. Lester R. Brown, *Distillery Demand for Grain to Fuel Cars Vastly Understated*, EARTH POLICY INSTITUTE, Jan. 4, 2007, <http://www.earth-policy.org/Updates/2007/Update63.htm>.

to access private capital and the special debt markets in their project financings in 2006.

Investment banks or merchant banks are beginning to see climate change as a driver of risk and rewards for publicly traded companies. During 2006, lenders escalated their efforts to integrate climate change into their lending policies, investment portfolios or overall strategy in lending, insurance, and structured finance for fossil fired and renewable energy projects.

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