

# AMERICAN PUBLIC GAS ASSOCIATION

February 24, 2010

The Honorable Ed Whitfield  
Chairman  
Subcommittee on Energy and Power  
Committee on Energy and Commerce  
Washington, DC 20515

Dear Chairman Whitfield,

On behalf of the American Public Gas Association (APGA), I want to draw your attention to the Natural Gas Supply Association's (NGSA) recently released study, "Pipeline Cost Recovery Analysis," (see attached NGSA executive summary).

The NGSA study is released on an annual basis and analyzes the return on equity for 32 major interstate natural gas pipelines over a five-year period (2005-2009). The study concludes that, for the 2005-2009 period, "using 12% as a nominal target allowed return, these 32 pipelines over-recovered their costs by approximately \$4.1 billion...even taking into account those pipelines that under-recovered." This conclusion simply reaffirms the conclusions of previous NGSA studies: Congress must finally fix Natural Gas Act (NGA) Section 5.

Just as Congress fixed Federal Power Act (FPA) Section 206 in 1988 to provide the Federal Energy Regulatory Commission (FERC) with the authority to provide refunds for over-recovering, Congress should now provide FERC with that same authority under NGA Section 5. The FERC's ability to exercise its authority under FPA Section 206 is not retroactive ratemaking. Therefore, to harmonize FERC's NGA Section 5 authority to FPA Section 206 would not provide the FERC with retroactive ratemaking authority. Any refund of monies, charged and collected by a pipeline in excess of its rate of return, would only include those sums collected from and after the date a NGA Section 5 complaint is initiated against the offending pipeline.

APGA is the national trade association representing over 700 municipally and publicly-owned local natural gas distribution systems that work to meet the daily energy needs of over 5 million customers in 36 states. Publicly-owned gas systems are not-for-profit retail distribution entities that are owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities, almost all of which

rely on a single pipeline provider to transport their gas supplies from the wellhead to the city gate. The Natural Gas Act is their only protection against paying excessive rates.

In this study, it is notable that seven of the 32 pipelines exceeded 18% return on equity. These are dollars that could have gone into local businesses, paying food bills, mortgages, or into a child's education. Instead, these local dollars continue to flow upstream into the pipelines' coffers. These are also dollars that can affect job creation since many industrial concerns, such as chemical and fertilizer manufacturers, are heavily dependent upon natural gas and they pay the same excessive rates as everyday citizens.

The reason for this situation is very straight-forward—the FERC is currently unable under NGA Section 5 to effectively restrain pipeline over-recovery because of the absence of refund authority under NGA Section 5. This was also the situation under the complaint section of the Federal Power Act (Section 206) until 1988, when Congress took stock of the situation and amended FPA Section 206 to give FERC the authority to order refunds from and after the date a complaint was filed. Thus, under FPA Section 206 if a utility is found to have overcharged customers, that utility must refund the overcharges to its customers, whereas by contrast FERC does not have the same authority under the NGA to provide for reimbursement to overcharged gas transportation customers.

Since under NGA Section 5 the FERC may only rule that a rate reduction take effect prospectively *after* FERC's order is issued, the pipelines have an obvious and strong incentive to delay the proceeding interminably (since no refunds can be ordered under NGA Section 5 during the interim even if the pipelines are determined to have overcharged their customers). All FERC commissioners, without regard to party affiliation, have decried this absence of refund authority under NGA Section 5.

One of the arguments raised in the past by the pipeline lobby against providing FERC with this consumer protection tool is that it would have a negative impact upon a pipeline's ability to attract new capital, and this in turn would have an adverse impact on infrastructure investment. This argument is a red-herring with no basis in fact. The FERC, in establishing just and reasonable rates, provides for the recovery of all costs, including debt costs and a fair return on equity. And a fair return on equity must, as the Supreme Court long ago mandated, permit the regulated utility to go to the marketplace to raise capital at reasonable rates. In addition, most new infrastructure projects are undertaken by pipelines pursuant to negotiated rates that would not be impacted by amending NGA Section 5 to provide relief for recourse rate customers such as the members of APGA.

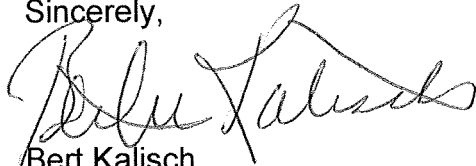
APGA strongly supports the growth and expansion of investor-owned interstate natural gas pipelines. However, it is absolutely critical that the healthy growth of these pipelines be achieved within the confines of the Natural Gas Act's mandate that the customers of

these pipelines pay “just and reasonable” rates for transportation of natural gas supplies, which are critical to America’s economic prosperity and security. This is especially so for shippers such as the vast majority of the members of APGA that purchase natural gas transportation from a single pipeline and hence cannot avoid paying excessive rates by shopping for (and negotiating with) another service provider.

Ironically, the pipelines never argue that they are not over-recovering their costs - only that if caught they should not have to refund the overcharges. The FERC Commissioners, all of whom support infrastructure improvement **and** the amendment of NGA Section 5 to provide for the establishment of a refund-effective date, understand that this is not an “either-or” proposition. The Congress should not allow itself to be fooled by arguments that are paper-mache thin and that are recognized by the regulators themselves to have no merit.

As the Committee considers developing an energy package, I urge you to include Section 5 reform legislation which provides natural gas consumers with the same level of protection from overcharges that currently exists for electric consumers.

Sincerely,



Bert Kalisch  
President & CEO

## NGSA Pipeline Cost Recovery Analysis

The Natural Gas Supply Association (NGSA) analyzed pipeline cost recovery to assess the actual return on equity earnings of thirty-two major interstate natural gas pipelines over a five-year period. The thirty-two pipeline companies evaluated represent approximately 80 percent of the capacity in the interstate market. This study examined relevant interstate pipeline costs and revenues using a cost-of-service model based on *FERC Form No. 2* (Form 2) reports. This analysis is NGSA's eleventh annual evaluation of major interstate pipeline return on equity earnings.

As the study highlights, there are a number of instances in which pipeline revenues exceed those necessary to recover costs and collect a fair return on investment. In fact, our analysis of thirty-two pipeline companies shows that over a five-year period pipelines earned roughly \$4.1 billion more than they would have collected with an average of 12 percent allowed return on equity. While many pipelines have clearly performed effectively for shareholders, there is a point at which rate of return levels require close FERC oversight. Below is a brief explanation of the methodology used to calculate the returns.

### Scope

NGSA's cost recovery analysis of thirty-two pipelines combines three elements to determine pipelines' return on equity: (1) rate base, (2) net revenues, and (3) total cost of service. For purposes of this study, NGSA selected 32 major interstate pipelines. NGSA reviewed the total population of major interstate pipelines and selected those pipelines that were large in terms of both revenue and physical assets as well as the amount of time lapsed since their rates were reviewed. For each pipeline examined, the analysis reviewed the most recent five years of financial data (2005 - 2009) available at the time the study was conducted.

### Methodology

NGSA developed its cost recovery analyses using annual financial data as provided in Form 2 for a five-year period (2005 - 2009). Using annual balance sheets as well as revenue and expense data from Form 2, NGSA built a cost-of-service model for each pipeline company. Using this information, we calculated each pipeline's annual actual return on equity. Consistent with FERC policy, these calculations used only the jurisdictional portion of the costs reflected in Form 2. For example, NGSA utilized methodologies consistent with those that would be used by FERC in a traditional rate case proceeding, such as those applied to the debt/equity ratio as well as in the determination of total rate base

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and revenues. In those instances where interpretation of Form 2 accounts was required, NGSAs used the more conservative options.

### *Three Elements*

We used the following data analyses and processing steps to develop the three elements needed to determine the return on equity of each pipeline.

1. *Rate Base.* Rate base includes gas plant in service, accumulated depreciation, gas stored-noncurrent, accumulated deferred income taxes (ADIT), working capital (including materials and supplies) and regulatory assets and liabilities.
2. *Revenues.* We calculated net revenues from total operating revenues by excluding revenues for transition costs and take-or-pay as well as sales revenues (Accounts 480-484).
3. *Cost-of-Service.* NGSAs developed the pipeline's total cost-of-service, including an annual allowed return on rate base, federal and state income taxes, other taxes, depreciation, and operation and maintenance (O&M) costs. Multiplying the total rate base by the weighted allowed rate of return on rate base yielded the pipeline's allowed return on rate base. To determine the weighted allowed rate of return on rate base, the debt and common equity costs of capital were multiplied by their respective capitalization ratios and added together. The capitalization ratios and current debt and equity cost of capital were obtained from Form 2 if the values were within a range FERC has historically approved. Otherwise, these data were obtained from the pipeline's most recent filed and/or approved section 4 rate case information.

To calculate the federal income taxes, the total allowed return on rate base was multiplied by the ratio of the weighted return on equity to the total return on rate base and then multiplied by the federal tax factor pursuant to FERC regulations. Federal income taxes were then included as a component of the cost-of-service. We used the actual state income tax rates where readily available. For others, the state income tax rates were estimated individually for the pipeline using the federal taxable net income and state taxes charged during the year as provided in Form 2. The individual state taxes were added together and then calculated as a percentage of federal income taxes. State tax percentages were confirmed by examining several of the test years, and state income taxes were then added to the total cost-of-service.

Several cost components for O&M expenses listed in Form 2 also needed to be removed such as sales and compressor fuel expenses to

appropriately determine a pipeline's non-gas cost of service in order to properly align costs with reported revenues. Depreciation expenses and other taxes from Form 2 were added to determine the total cost of service.

### *Calculation of Return on Equity*

Finally, we calculated the pipeline's over- or under-recovery of costs by subtracting the total cost of service from net revenues. Because the study's total cost of service calculation already includes the pipeline's allowed return, the difference between the cost-of-service and net revenues reflects the pipeline's actual over or under recovery of costs. The formula to calculate actual earned rate of return on equity is as follows:

$$ROE = \frac{\left[ \left( CR - \left( CR * \left( \frac{FGIT}{1 + FGIT} \right) \right) \right) - (CR * (SIT * FGIT)) \right] + \left( AR * \left( \frac{ER}{TR} \right) \right)}{RB * EC}$$

Where:

<i>ROE</i>	=	Actual Earned Rate on Equity
<i>CR</i>	=	Cost Over- or Under- Recovery
<i>FGIT</i>	=	Federal Grossed-Up Income Tax Rate
<i>SIT</i>	=	State Income Tax Rate as a Percentage of FIT
<i>AR</i>	=	Allowed Return on Rate Base
<i>ER</i>	=	Allowed Equity Return on Rate Base rate
<i>TR</i>	=	Allowed Total Return on Rate Base rate
<i>RB</i>	=	Total Rate Base
<i>EC</i>	=	Equity Capitalization Ratio

The annual rates of return on equity for each of the thirty-two pipelines were weighted across the five-year period based on the equity portion of rate base to calculate a weighted average rate of return on equity for each pipeline.

In addition, NGSAs conducted a separate analysis to determine the pipelines in the cost recovery analysis that do not appear to employ a fuel tracking mechanism to true-up their fuel costs during the analysis period based on a review of their tariffs. NGSAs's analysis determined that 9 of the 32 pipelines analyzed do not appear to employ a true-up mechanism during the analysis period. NGSAs developed a valuation over five years (2005 - 2009) of excess retained fuel for these pipelines. The results of the fuel recovery analysis are included in the calculations of pipeline returns summarized in this report.

## Study Results

Using the methodology described above, NGSAs analysis shows that over a five-year period (2005 - 2009) the average after-tax returns on equity (ROE) for eighteen pipelines were at or exceeded an average allowed return of 12 percent, while fourteen of the thirty-two pipelines fell short of 12 percent. Seven pipelines experienced average ROEs over the five-year-period of 18 percent or higher. Using 12 percent as a nominal target allowed return, these 32 pipelines over-recovered their costs by approximately \$4.1 billion before taxes over the five-year period, even taking into account the pipelines that under-recovered. Just looking at the eighteen pipelines that over-recovered, the cost over-recovery for the five-year period is nearly \$5.5 billion.

NGSA, like every segment of the natural gas industry, strongly supports healthy returns for interstate pipelines so they will have the incentive to build infrastructure to bring gas to market. When pipeline returns continually exceed the average allowed rate of return on equity, FERC must call into question whether pipelines are adequately being held accountable for their earnings. At the very least, this sustained period of over-recovery, reflected herein, suggests that there may be additional efficiencies to be shared with the marketplace. How those efficiencies may be shared, without impinging on the pipelines' need to be compensated for their market risks, is a fruitful area for the industry as a whole to continue to explore.

**Natural Gas Supply Association  
Actual Pipeline Rate of Return on Equity  
NGSA Analysis - 32 Pipelines**

Pipeline Name	Year Ended 2005	Year Ended 2006	Year Ended 2007	Year Ended 2008	Year Ended 2009	5-year Average Weighted by Equity Ratebase
• 1 Natural Gas Pipeline Company of America LLC 1/	34.0%	39.7%	38.3%	42.2%	37.2%	38.4%
• 2 Kinder Morgan Interstate Gas Trans. LLC	24.6%	38.2%	24.9%	27.7%	25.7%	28.1%
• 3 Dominion Transmission, Inc. (formerly CNG Trans.)	24.0%	19.4%	24.4%	25.5%	26.0%	23.5%
• 4 Great Lakes Gas Transmission Ltd. Partnership	19.8%	21.5%	20.3%	20.9%	23.7%	21.2%
• 5 Kern River Gas Transmission Co.	9.7%	15.9%	26.5%	35.3%	23.7%	21.0%
• 6 Panhandle Eastern Pipe Line Company, LP	33.2%	33.8%	22.1%	16.2%	15.0%	20.9%
• 7 Northern Natural Gas Company	13.2%	18.1%	18.8%	24.6%	19.4%	18.9%
• 8 Northern Border Pipeline Company	17.4%	17.2%	18.4%	20.0%	14.6%	17.5%
• 9 Mojave Pipeline Company 2/	21.1%	27.5%	15.4%	9.6%	12.3%	17.3%
• 10 National Fuel Gas Supply Corporation	19.3%	17.6%	15.8%	17.4%	15.3%	17.0%
• 11 CenterPoint Energy Gas Trans. (formerly Reliant)	21.8%	15.4%	11.9%	16.9%	14.3%	15.3%
• 12 Colorado Interstate Gas Company	12.4%	20.1%	19.4%	13.2%	13.2%	15.1%
• 13 Florida Gas Transmission Company, LLC	13.9%	17.2%	17.1%	14.9%	13.2%	15.1%
• 14 Transwestern Pipeline Company, LLC	19.7%	17.2%	15.4%	16.6%	9.7%	14.7%
• 15 Columbia Gas Transmission, LLC	11.5%	14.3%	14.1%	12.8%	17.2%	13.8%
• 16 Texas Eastern Transmission, LP	13.5%	12.2%	15.6%	9.9%	14.6%	13.2%
• 17 Transcontinental Gas Pipe Line Company, LLC	13.1%	9.4%	12.2%	14.8%	13.6%	12.6%
• 18 ANR Pipeline Company	17.0%	13.1%	12.4%	10.7%	10.6%	12.5%
• 19 Questar Pipeline Company	11.1%	15.0%	11.0%	13.0%	10.2%	11.9%
• 20 Southern Star Central Gas Pipeline, Inc. (formerly Williams)	10.7%	12.5%	10.6%	9.5%	12.3%	11.1%
• 21 Tennessee Gas Pipeline Company	13.2%	12.1%	11.4%	11.2%	8.0%	10.9%
• 22 Gas Transmission Northwest Corp. (formerly PG&E)	10.2%	8.5%	10.9%	11.4%	12.5%	10.6%
• 23 Southern Natural Gas Company	10.9%	10.9%	10.6%	11.0%	9.8%	10.6%
• 24 El Paso Natural Gas Company	7.9%	12.2%	10.6%	10.3%	11.5%	10.5%
• 25 Columbia Gulf Transmission Company	9.5%	7.1%	10.4%	15.6%	8.7%	10.4%
• 26 Trunkline Gas Company, LLC	8.5%	9.6%	9.0%	9.0%	11.9%	9.7%
• 27 Northwest Pipeline GP	9.8%	5.0%	10.5%	10.7%	10.3%	9.2%
• 28 Gulf South Pipeline Co., LP (formerly Koch Gateway)	16.4%	23.0%	8.2%	5.6%	6.6%	8.7%
• 29 East Tennessee Natural Gas, LLC	7.2%	7.8%	9.1%	8.4%	10.0%	8.6%
• 30 CenterPoint Energy Mississippi River Transmission	5.8%	4.4%	4.9%	9.0%	10.6%	7.2%
• 31 Equitrans, LP	7.2%	11.6%	6.1%	3.8%	5.9%	6.0%
• 32 Sea Robin Pipeline Company, LLC 3/	-18.8%	-2.7%	-6.0%	-1.3%	-7.4%	-6.2%
Simple Average	14.0%	15.8%	14.4%	14.9%	13.8%	14.4%
Weighted Average by Equity Ratebase	14.4%	14.6%	14.7%	14.7%	13.9%	14.4%

• Pipelines NGSA's analysis determined do not have a fuel tracking mechanism to true-up their fuel costs at the end of the five-year analysis period.

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