UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs	))	Docket No. PL17-1

Affidavit of Robert B. Hevert

I, Robert B. Hevert, state under penalty of perjury that the foregoing is true and correct to the best of my knowledge and information:

1. I have been asked by the Interstate Natural Gas Association of America ("INGAA") to review and comment on the Federal Energy Regulatory Commission's ("FERC") March 15, 2018 Revised Policy Statement on the Treatment of Income Taxes (the "Revised Policy Statement", or the "Statement") based on my experience in financial and regulatory matters.

   I am a Partner with ScottMadden, Inc., and my business address is 1900 West Park Drive, Westborough, Massachusetts. I hold a Bachelor's degree in Business and Economics from the University of Delaware and an MBA with a concentration in Finance from the University of Massachusetts. I also hold the Chartered Financial Analyst designation. I have worked in or with regulated industries for nearly 30 years, having served as an executive and manager with consulting firms, a financial officer of a publicly-traded natural gas utility (at the time, Bay State Gas Company), and an analyst at a telecommunications utility. In my role as a consultant, I have advised numerous energy and utility clients on a wide range of financial and economic issues, including corporate and asset-based transactions, asset and enterprise valuation, transaction due diligence, and strategic matters. As an expert witness, I have provided testimony in over 200 proceedings regarding various financial and regulatory matters before the FERC, numerous state utility regulatory agencies and the Province of Alberta.

I. Introduction

2. In its Revised Policy Statement, the Commission stated it will no longer permit any interstate natural gas pipeline organized as a Master Limited Partnership ("MLP") "to recover an income tax allowance in [its] cost of service."[1] In large measure, the Revised Policy Statement rests on the Commission's assumption that the Discounted Cash Flow ("DCF") model estimates a "pre-tax" required return which, when included in the revenue requirement for MLPs, results in a "double recovery" of income taxes.

3. That assumption is not supported in theory or practice. The DCF model, like all models used to estimate investors' required returns, is based on actual market prices. Prices are set by the buying and selling behavior of numerous market participants, whose decisions are motivated by any number of factors. Those factors, which may be related to broad market conditions, investment-specific risks, investor-specific circumstances, or near-term trading strategies, may change over time and across market conditions. Because they are varied and significant, any or all those factors may subsume any assumed effect of taxes.[2]

4. Whether they are buyers or sellers, market participants are not homogeneous; their motivations, risk perceptions, return expectations, and circumstances vary. With few exceptions, the extent to which any may be tax-paying entities now, or in the future, cannot definitively be determined. Nor can investors' expected holding periods, or the nature of distributions received while holding the investment, be assumed with any confidence. Consequently, the assumption that the DCF-based ROE necessarily includes a measure of expected taxes for all investors, at all times, cannot be corroborated

[1] *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, 162 FERC ¶ 61,227 (2018), at Para. 2.

[2] *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, 162 FERC ¶ 61,227 (2018), at Para. 33.

5. The Commission has not shown that removing the income tax allowance for MLPs necessarily would create parity in returns, or in risk, with corporate entities. Rather, the Revised Policy Statement may introduce elements of risk that would require increments of returns to adequately compensate MLP investors, and to maintain the financial integrity required to access capital. Because investors understand regulatory commissions have long looked to the *Hope* and *Bluefield* requirement that the authorized return should maintain the subject company's financial integrity and enable access to capital markets at reasonable costs and terms, a change in policy viewed as contrary to those standards creates a degree of risk that should be reflected in the returns allowed MLPs. The immediate and severe market reaction to the Revised Policy Statement is a clear indicator of investors' perceptions regarding those risks.

6. Lastly, the Revised Policy Statement does not recognize the many possible forms of MLP ownership structures and how those structures may affect the recovery of an income tax allowance. Those differences likewise may create the condition in which a further addition to the return allowed MLPs would be required to meet some level of parity with the returns available to their corporate counterparts.

II. The Theoretical Assumption Underlying the Conclusion That MLP Investors Recover Taxes Twice Is Inconsistent with Financial and Regulatory Principles

7. The theoretical basis of the DCF method is that the value of an investment is measured by the net present value of the cash flows derived from its ownership. As it relates to common stock or MLP units, the market price equals the present value of cash flows associated with the ownership of the security. Under that construct, the Cost of Equity is the discount rate that sets the stock's current market price equal to the present value of its expected cash flows including dividends or distributions, and the eventual selling price. Simply put, the observed market value reflects the expected cash flows associated with owning the investment, discounted at a rate that reflects the risks associated with those cash flows.

8. Several methods exist for valuing enterprises by discounting their future cash flows. Some look to the value of after-tax cash flows to equity holders, others consider the value of the tax shield associated with debt, and still others discount the cash flows to all investors (debt and equity). None of those methods, however, includes the tax status of the individual investor.

9. The Commission's Two-Stage DCF model effectively is a rearranged version of the present value formula used to value an entity or asset. In the Commission's model, the discount rate (Cost of Equity) equals the sum of the expected yield (expected dividend or distribution divided by the current price) and the expected growth rate. The current price reflects investors' consensus views of expected growth, and their consensus perspectives regarding the risks associated with the investment's cash flows. Again, those two principal factors, growth and risk, do not contemplate the individual investor's tax status.

10. The price used in the DCF model is determined by the buying and selling decisions of multiple parties, with varying expectations and requirements, and differing risk tolerances and tax positions. Nonetheless, at any point in time there is only one price, which applies to all market participants. According to the economic principle of one value, that must be the case.

11. The DCF method is only one of several models that are used in practice to estimate the Cost of Equity. Other methods frequently used in practice, including the Capital Asset Pricing Model and variants of it, establish the Cost of Equity by reference to market prices, risk-free Treasury yields, and other factors meant to capture elements of risk significant in asset pricing. In those approaches, risk is measured by the dispersion of outcomes around an expected value, in particular the variability of security prices around an average. Again, those factors look to the risk of the investment, not the tax status of the investor.

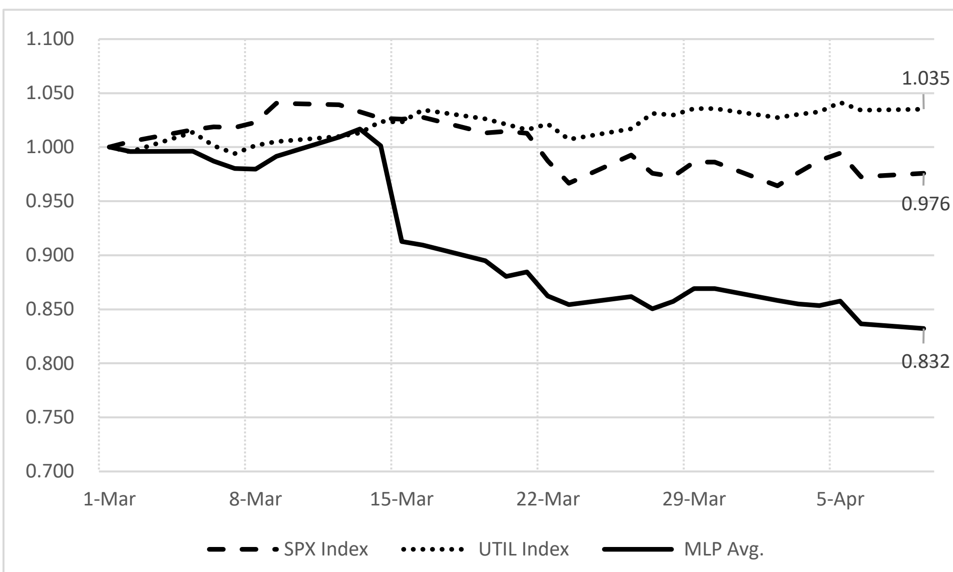
12. In summary, the Revised Policy Statement is at odds with financial principles and practice. It assumes, without basis, that the tax status of owners is a principal

determinant of the fair return to investors. That departure from financial principles and regulatory practice creates additional risks to investors that must be addressed in the authorized ROE.

III. Investors Reacted Quickly and Significantly to The Revised Policy Statement

13. The market reaction to the Revised Policy Statement was swift and significant. As shown below, between the release of the Revised Policy Statement and April 6, 2018, a group of six MLP pipeline companies lost (on average) approximately 17.00 percent of their market value, even as the Dow Jones Utility Average and the broad market remained approximately constant (see Chart 1, below). The significant market reaction concurrent with the Commission's release of the Revised Policy Statement is a clear indicator that investors had not anticipated the Commission's position.

Chart 1: Relative Performance (March 1 – April 6, 2018)[3]

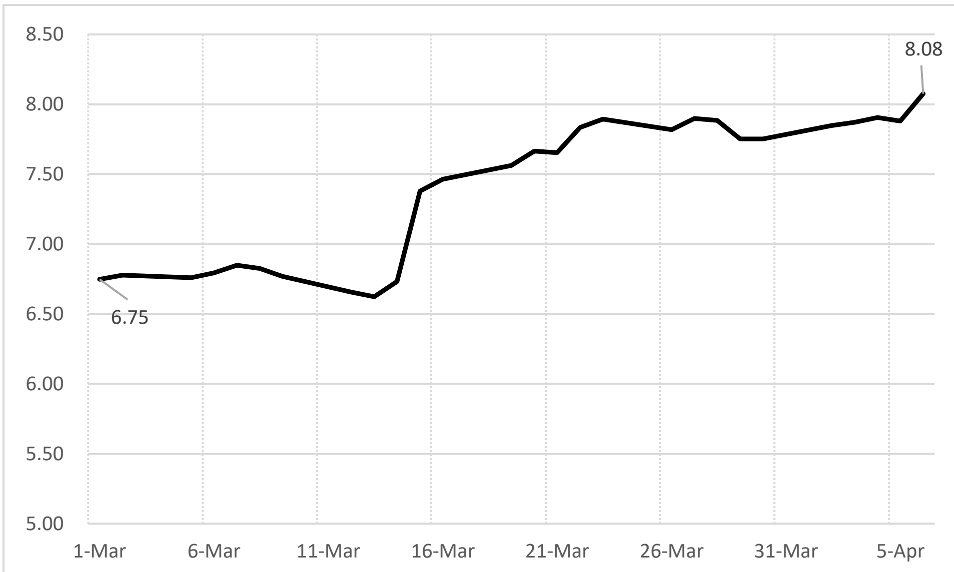


Taken from another perspective, these same six companies (in Chart 2, below) lost nearly $9 billion in aggregate market value. Coincident with that decline in value, the MLP group's average yield increased by 133 basis points (1.33 percent), from 6.75 percent to

[3] Source: Bloomberg Professional.

8.08 percent (see Chart 2, below). It remains too soon to understand the complete effect of the change in prices on the Commission's DCF method, if only because it is not yet clear whether or how expected growth may change in response to the Revised Policy Statement.

Chart 2: MLP Group Average Yield (March 1 – April 6, 2018)[4]



IV. Assuming *Arguendo* That Taxes Are Included in Investor Returns, And MLPs Are Not Provided with A Tax Allowance, Adjustments Must Be Made to Ensure That the Equity Returns to Corporate and MLP Investors Are Comparable

A. The Revised Policy Statement Creates Incremental Risks That Should Be Reflected in MLPs' Authorized Returns On Equity

14. In light of the additional risks associated with the Revised Policy Statement, and given the financial and regulatory principles noted above, if the Commission is to remove the income tax allowance for MLPs, the ROE authorized for them should be increased to the incremental risk created by that change. Those risks would include, but may not be limited to: (1) investors' views of heightened regulatory risk; (2) the dilution of Earnings Before Interest and Taxes ("EBIT") and Earnings Before Interest, Taxes,

4 Source: Bloomberg Professional.

Depreciation, and Amortization ("EBITDA"); (3) increased financial leverage and financing requirements; (4) reduced retained earnings and the resultant need to access external capital to fund investments; and (5) the continued reduction in authorized ROEs resulting from the Commission's Two-Stage DCF model (as applied to MLPs). Together, those risks would increase the returns required by investors, and diminish the ability of MLPs to attract capital.

15. Regulatory risk is an important consideration to both debt and equity investors. For example, the nature of regulation (in particular, the regulatory framework, and the ability to recover costs and earn returns) accounts for 50.00 percent of the factors that Moody's Investors Service considers in arriving at ratings determinations.[5] Assuming, for example, the dilution in EBITDA coverage resulted in a two notch decrease in creditworthiness, the increase in debt costs currently would be in the range of 45 basis points, depending on the subject company's credit profile. Putting aside the potentially diminished ability to access capital during constrained markets, the increase in debts costs would be borne directly by ratepayers.

16. The increase in debt costs is not likely to be a full measure of the expected increase in the Cost of Equity. Debt and equity investors face similar risks, but only to a point. Debt investors have protections not available to equity investors, have a priority claim on cash flows, and are exposed to risk only during the term of the debt instrument as opposed to the perpetual risk borne by equity investors. Because equity investors bear "residual risk", the return they require exceeds the returns required by debt investors. Consequently, the incremental cost to equity investors would be greater than the incremental cost to debt investors.

17. Aside from the increase in regulatory risk engendered by the Revised Policy Statement, the loss of the income tax allowance creates several new risks for MLPs, including those arising from the potential dilution of earnings and cash flow. Under U.S.

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[5] Moody's Investors Service, *Rating Methodology: Regulated Electric and Gas Utilities*, December 23, 2013, at 6.

Securities and Exchange Commission ("SEC") guidelines, publicly traded companies (including MLPs) provide five years of "fixed charge" coverage ratios in Exhibit 12 to their SEC Forms 10-K. Generally speaking, those metrics relate to the ratio of EBIT to interest expense. In that calculation, revenues related to the allowance for income taxes would decrease, but interest expense would remain constant. It is reasonable to consider, therefore, that the loss of the income tax allowance would dilute EBIT coverage, increasing perceived risk among MLP investors, requiring an increase to their authorized ROE.

18. Just as the elimination of the income tax allowance would reduce EBIT, it also would reduce EBITDA. EBITDA is an important measure to investors; the ratio of Debt/EBITDA is one of the two "core" ratios used by Standard & Poor's ("S&P") to assess financial risk.[6] S&P also reviews the volatility of EBITDA and EBITDA margin (EBITDA/Sales) in its assessment of profitability.[7] The loss of the income tax allowance would reduce EBITDA, putting downward pressure on key measures of creditworthiness and cash flow.

19. In that important respect, a reduction in EBITDA would be directly related to a reduction in distributable cash. Because (under the DCF method) the market price equals the present value of expected distributions, the dilution of EBITDA would directly reduce market value (all else remaining equal). The reduced market value would have several additional dilutive effects. For example, as internally generated cash diminishes, companies would require additional external financing. Because the market value would be diminished, more units would be issued to raise a given amount of equity. That increase in the number of units would dilute existing positions, further increasing the risk to investors, and the return required by them.

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[6] Standard & Poor's Rating Services, *Corporate Methodology*, November 19, 2013, at 30. Depending on the subject company's capital intensity, S&P also may review the supplementary ratio of Free Operating Cash Flow to Debt (at 32).

[7] Standard & Poor's Rating Services, *Corporate Methodology*, November 19, 2013, at 15.

20. In a similar fashion, the reduced credit metrics associated with diluted EBITDA levels and multiples would increase the risk to debt investors. That increased risk not only may increase the cost of additional debt, if markets become constrained the ability to access the debt markets likewise may be constrained. In those cases, companies may choose to retain additional amounts of internally generated cash, and/or issue additional equity. In either case, existing equity investors would become diluted. If, however, companies choose to address the cash flow dilution associated with the lost income tax allowance by issuing additional debt, financial leverage (that is, the proportion of debt in the capital structure) likewise may increase. Because the Cost of Equity is directly affected by financial leverage, that additional debt may cause equity investors to increase their required returns.

21. Whether due to reduced internally generated cash or as a result of constrained access to external capital, the limited ability to fund capital investments may limit MLPs' ability to develop a diversified portfolio of projects. When multiple assets are combined, their differing risk profiles provide a degree of diversification that cannot be realized by a less diversified portfolio. To the extent the returns of the individual projects are less than perfectly correlated, the effect of multiple assets is to reduce the overall portfolio risk relative to its expected return. For example, a single adverse event could severely affect a large portion of given company's return if its operations were focused on that single asset. In comparison, companies with a larger, more diversified portfolio of assets do not face that concentration of risk.

22. The reduced cash flow and potentially constrained capital market access potentially brought about by the Revised Policy Statement may limit the ability of MLPs to diversify their portfolio of projects, concentrating risk to a degree not contemplated by equity investors.

23. Other aspects of Commission policy also may weigh against MLPs' expected returns and their ability to attract capital if the Revised Policy Statement is implemented. As noted in its *Proxy Group Policy Statement*, the Commission's preferred DCF method,

the two-stage growth model, includes forecast earnings per share growth rates as near-term growth rates, and a measure of Gross Domestic Product ("GDP") as the long-term growth rate. Under the Commission's preferred approach, the near-term growth rate receives two-thirds weighting, and the long-term growth rate receives one-third:

> Over the years, the Commission has standardized the inputs to the DCF formula as applied to interstate gas and oil pipelines. The Commission averages short-term and long-term growth estimates in determining the constant growth of dividends (referred to as the two-step procedure). Security analysts' five-year forecasts for each company in the proxy group (discussed below), as published by IBES, are used for determining growth for the short term. The long-term growth is based on forecasts of long-term growth of the economy as a whole, as reflected in the Gross Domestic Product (GDP) which are drawn from three different sources. The short-term forecast receives a two-thirds weighting and the long-term forecast receives a one-third weighting in calculating the growth rate in the DCF model.[8]

24. The Commission reasoned investors would assume the lower retention ratios and presumably more limited investment opportunities associated with MLPs necessarily would result in lower growth rates relative to their corporate counterparts. Noting that the key issue is whether or not MLPs are likely to have the same relative growth potential as corporate entities, the Commission considered that "the collective long term growth rate for MLPs will be less than that of schedule C corporations."[9] Based in large part on that consideration, the Commission determined that the long-term growth rate for MLPs should be 50.00 percent of the long-term projected GDP growth rate (as opposed to the full long-term projected growth rate that continues to be used for corporations).[10]

25. There is little question that MLPs' attractiveness relative to their corporate counterparts depends on their ability to maintain and increase distributions to investors. Their ability to do so has been enabled by continuing access to external capital. I am unaware of

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8 *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return Equity*, 123 FERC ¶ 61,048 (2008) ("*Proxy Group Policy Statement*, at Para 6.

9 *Id.*, at Para 94.

10 *Id.*, at Para 106.

any analyses or data supporting the proposition that in the past, MLPs had grown, or were expected grow, at a rate one-half of the growth in nominal GDP. Consequently, the Commission's existing application of the Two-Stage DCF model sets MLPs at a competitive disadvantage in the first instance. That disadvantage would be compounded under the Revised Policy Statement which, as explained above, introduces additional risks, and may further detract from MLPs' ability to attract the external capital needed to fund capital investments, and to support the growth expected by investors.

26. Because the Cost of Equity is unobservable, adjustments to it often require estimates. To some extent, eliminating the one-half GDP growth rate adjustment to the Commission's Two-Stage DCF method is an exception; the ROE would increase by [.50 x .33 x nominal GDP Growth]. By way of illustration, assuming the Commission's assessment of nominal GDP growth is 4.50 percent, the adjustment would be about 74 basis points. Still, as noted above the Revised Policy Statement introduces other elements of risk such that simply reversing the one-half GDP growth rate adjustment likely would not be sufficient to compensate MLP investors for those incremental risks.

27. As considered in the *Hope* and *Bluefield* "capital attraction" standard, the return authorized utilities should be sufficient, under efficient and economical management, to attract capital at reasonable costs and terms. As demonstrated in Chart 1, investors' reactions to the Revised Policy Statement created a significant loss of value, which in and of itself diminishes their ability to attract capital. That disadvantage likely is extended by the additional risks introduced by the Revised Policy Statement. To ensure continued capital market access, and to provide investors with an appropriate return, the Commission should reflect the additional risks in an increase to the return authorized for MLPs.

V. Adjustments for MLP Ownership Structures

28. Assuming there is an element of taxes included in the DCF-estimated ROE, the Revised Policy Statement does not distinguish between the tax rates applicable to non-corporate

versus corporate entities. As discussed below, if an MLP is majority-owned by a corporate parent, the majority, and possibly substantially all, of the MLP's income would be allocated to the corporate parent and included in the parent's tax return. In that circumstance, the MLP's income would be taxed effectively as a corporation, and the income tax allowance should be retained. If the MLP is owned by a combination of corporate and non-corporate entities, there should be some recognition of the corporate owners' tax position.

29. If the income tax allowance is removed for MLPs owned by a combination of non-corporate and corporate entities, an alternative method of ensuring parity in returns would be an adjustment to the authorized ROE. Assuming an MLP's owners were split evenly between corporate and non-corporate owners, the owners' average tax rate, taking into account the 20.00 percent deduction for pass through entities under the new law, would be 24.80 percent; taxable distributions from the MLP would be taxed at that rate. By comparison, dividends from a corporate entity would be taxed at 20.00 percent. By way of illustration, if the authorized ROE was 12.50 percent of the equity investment, MLP investors' after-tax return would be 9.40 percent,[11] whereas the return would be 10.00 percent if the distribution was in the form of dividends.[12] To reach parity, then, the authorized ROE for MLPs would be increased to 13.30 percent (an increase of 80 basis points),[13] such that the "after-tax" return is 10.00 percent.[14]

30. There are many possible ownership structures underlying MLPs or other pass-through entities that are not addressed in the Revised Policy Statement. As a result, investors face considerable uncertainty as to the cash flow, and returns, available to them. That risk is a consideration that would increase the return required by investors.

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11 9.40% = 12.50% x (1 – 24.80%)

12 10.00% = 12.50% x (1 – 20.00%)

13 The increase is calculated as: $\frac{1-.20}{1-.2483}\ x\ 12.50\%$

14 13.30% x (1 – 24.80%) = 10.00%

VI. Conclusion

31. The Revised Policy Statement, and the Commission's position that it no longer will permit MLPs to recover an income tax allowance, rests on the assumption that the Discounted Cash Flow model estimates a "pre-tax" required return. That assumption is supported neither in theory nor in practice, and its application may well increase risks to MLP investors, increasing the returns required by them.

Executed on April 16, 2018.

Robert B. Hevert