

From: [Steven Klekar](#)
To: [DOR Utility Forms](#)
Cc: [Hersh Mittal](#)
Subject: [EXTERNAL] Capitalization Rate Study feedback
Date: Thursday, April 13, 2023 3:02:58 PM
Attachments: [tax year 2023 industry nat gas cap rate study - final.pdf](#)
[tax year 2023 industry liquids cap rate study Final.pdf](#)

I would like to thank the MT DOR for providing industry an opportunity to review the applicable industry cap rate studies and for allowing a comment period whereby we can provide our feedback.

As my company, TC Energy, has a couple of interstate natural gas pipelines operating in the state (Bison and Northern Border), my feedback will pertain only to the Pipelines – Incorporated Study that the DOR has compiled for the interstate gas pipeline industry. But before providing feedback, I do want to note that I have attached to this email the industry cap rate studies for interstate natural gas pipelines as well as interstate fluid pipelines that would be used in the yield capitalization model. The studies were done by Bruce Nielsen, CPA who formerly was the Director of Taxation at the Williams Company but now heads up Nielsen Management Services, LLC. Bruce has over years of experience in pipeline property taxes and has presented his cap rate studies to numerous states over the last several years.

Comparing the attached Industry Study for interstate natural gas to the DOR’s Pipelines – Incorporated study for yield capitalization, I have the following observations/suggestions that I respectfully ask the DOR to consider in modifying their study:

1. As the number of comparable companies seems limited, I ask that the DOR reconsider adding Enbridge and TC Energy as these companies, while headquartered in Canada, do have stocks traded on a US exchange and have significant presence in the US, both in assets and personnel. Pembina, another Canadian based company with significant US presence that is traded on US stock exchanges, is another company I ask be considered for inclusion. Further, I ask that Energy Transfer and National Fuel Gas be considered as these companies operate in the interstate natural gas sector as well. This would provide for a more representative comparable group.
2. I ask that the DOR increase the capital structure equity % to reflect a better representation of comparable companies for the industry. Based on the comments in item #1 above and referring to industry study providing, increasing the number of comparable companies would place the equity to debt correlation to around 65% to 35%.
3. Interstate natural gas pipelines are regulated by the FERC and as such our ability to earn a return on assets has to be approved by the FERC in a process known as a rate case. In a rate case, the FERC goes through the steps of calculating a cap rate in order to capitalize a normal operating cash flow. For the cost of equity in a rate case proceeding, the FERC primarily uses a 2 stage DCF in which the 1st stage is comprised of the Dividend Yield and Earnings Growth and is weighted by 2/3; the 2nd stage comprised of Dividend Yield + Inflation + GDP growth is weighted by 1/3. The closest model that we see employed in the DOR’s study is the 3 stage DDM but based on the comments below in #4, we feel this model understates the cost of equity.
4. Multi stage models tend to understate equity rates because these models make the incorrect assumption that rates should be declining in the future. On the contrary, long-term yield curves would show higher future rates, not lower. To support this assertion, we can look to the long-term bond yields for various maturities. As shown in the table below, the longer the maturity term is then the higher the rate:

**2022 S&P Monthly Bond Yield's
Bloomberg Data Base**

Maturity	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+
5Y	5.23	4.99	5.07	4.75	5.16	5.26	5.48	6.09	6.83	7.61	8.66	8.05
10Y	5.49	5.28	5.34	5.27	5.56	5.62	5.98	6.54	7.26	8.03	8.63	8.85
15Y	5.58	5.54	5.59	5.58	5.89	5.92	6.28	6.68	7.52	8.78	8.55	10.28
20Y	5.63	5.56	5.61	5.59	5.93	5.87	6.3	6.61	7.64	11.62	8.59	11.42
25Y	5.8	5.43	5.27	5.41	5.9	5.74	6.2	6.79	7.63	9.53	8.75	11.29
30Y	5.86	5.48	4.95	5.29	5.96	5.64	6.2	7.18		9.07	8.53	11.17

Because equity is riskier than debt, then long-term equity rates would follow a similar pattern as the above debt rates

5. Looking high level at the cost of equity, it is concerning that the rate went down to 13.08% from the previous year’s rate of 13.90% given the fact that the debt rates have so significantly increased from the prior year. The DOR’s study places the majority weighting of debt on the December average per Mergent’s of Baa rated Corporate Bonds. This rate at the end of 2022 was 5.59%, up over 200 basis points from the 2021 December average of 3.37%. As it is universally accepted that equity is riskier than debt and if debt investors are expecting a higher rate of return based on the increase from the past year, then it is logical to assume that equity investors would expect a higher rate of return from the previous year as well. We can use a year over year analysis of both the risk free rate as well as the December average per Mergent’s of the Corporate Bond Yield to estimate where the tax year 2023 cost of equity should land. That analysis is as follows:

Treasury (Risk Free) Rate Based Comparison	
Montana's Cost of Equity - Tax Year 2022	13.90%
Less: 20 Year Treasury Bond Yield at 12/31/2021 (ie Risk Free Rate)	1.94%
Implied Equity Risk Premium	11.96%
20 Year Treasury Bond Yield as of 12/30/2022 (ie Risk Free Rate)	4.14%
Prior Year Risk Premium from above	11.96%
Equivalent Montana Cost of Equity - 2023	16.10%
Baa Corporate Bond Based Comparison	
Montana's Cost of Equity - Tax Year 2022	13.90%
Less: Mergent Baa Corporate Bond Yield for Corporate - December 2021 Avg	3.37%
Implied Equity Risk Premium	10.53%
Mergent Baa Corporate Bond Yield for Corporate - December 2022 Avg	5.59%

Based on the above analysis, we should expect Montana's equity rate to be around 16.00%.

Again, I thank the DOR for providing the opportunity to provide feedback that I hope will have you reconsider various inputs to your study that would lead to an increase to a more appropriate level.

Thanks for your consideration!

Regards,

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