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Remarks by
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Good morning. It is my honor to have the opportunity to address and interact with the distinguished attendees at this highly respected conference.

I am on a Western swing of sorts. I have spent the last few days in the Pacific Northwest meeting with market participants, state commissioners, and the Bonneville Power Administration to discuss energy market and customer protection issues.

All over the country, producers and transporters of energy want policies that encourage investment in critical infrastructure such as production wells, pipelines, high voltage electric transmission capacity, electric generation, and demand resources. Customers want the same things, plus assurances of reliability and reasonable prices. All seem to want a level playing field where everyone gets fair treatment. State regulators want their views respected. They want to be co-equal partners in regulatory policy, and

they insist on being in charge of ensuring reasonable prices and fair treatment for end use consumers of natural gas and electricity.

My fellow Commissioners and I at the Federal Energy Regulatory Commission agree with all of these goals and are working to achieve them.

Broadly stated, the Commission's mission is to make electricity and natural gas markets work for consumers. This has required a steady evolution of federal regulatory policies. The issue is no longer – and has not been for quite a number of years – whether to have wholesale markets for electricity and natural gas. The Reagan and first Bush Administration championed wholesale markets. The Clinton Administration supported markets, and President Bush named his Texas protege, Pat Wood, to continue the policy evolution.

The issue now is this – will we tolerate poorly structured markets, or will we insist on good markets, well structured markets that provide customer benefits?

This is an important question, because markets don't structure themselves and don't fix themselves. They don't oversee and monitor themselves. They don't establish or enforce the rules. These are the responsibilities of regulators.

Sadly, the tsunami of the western energy crisis, coupled with the collapse of Enron, have left a devastating wake within the industry. Investor confidence has been shaken by these events, by a declining national economy, indictments of energy traders, accounting irregularities, downgrades by rating agencies, and continuing investigations by the FERC, CFTC, the SEC and the Justice Department. These investigations are certainly necessary, and must leave no stone unturned. Nevertheless, they do have an impact on investor confidence and credit availability.

On January 16th the Commission heard a full day of testimony from Wall Street, representatives of investment and commercial banks, hedge funds, financial analysts, investment advisors and credit rating agencies. The conference was held to evaluate capital availability for energy companies and for infrastructure projects.

The flight of capital from the industry has been severe since the collapse of Enron. Witnesses pointed out that institutional lenders and investors have come under strong pressure from their own shareholders and senior management to reduce exposure to both the merchant and non merchant segments of the energy industry. Many sources of funds have dried up, yet energy companies have billions in debt to refinance over the next two years.

Evan Silverstein, the President of an investment firm known as SILCAP, did not mince words. He argued that cheap capital and greed in the late 1990's led to undisciplined investment, over leveraged balance sheets and significant over capacity. He said that the financial models used by some market participants were sharply out of line with the actual business risk they faced. He called for clear market rules and structure, reasonable and stable regulation, forceful market monitoring and oversight to ferret out abuses, and patience. In general, the witnesses were optimistic that capital would return over time, but not in the short term. No quick fixes were advocated. Several testified that investor and lender confidence would be restored by transparent debt disclosure and accounting practices, by prudent business models with strong balance sheets, and by the elimination of corporate malfeasance.

What could FERC do? Virtually all of the witnesses commented favorably on standard market design as a tool to create a more stable environment and more certainty for energy companies and thus for investors and lenders. All favored respect for sanctity of contracts. All urged the Commission to wrap up pending investigations of market manipulation as soon as possible. None of these suggestions surprised me.

I was somewhat surprised, however, by the explicit recognition repeated by several Wall Street representatives that a reasonable regulatory policy does not blindly trust unfettered market forces. In contrast, the tone of past conferences attended by Wall Street

representatives seemed to be "FERC should simply get out of the way and let the market work its magic." The tone of this conference was markedly different. Speakers wanted markets, yes, but markets with clear rules, with oversight, with effective monitoring, markets that are hard to manipulate.

It was highly valuable to hear from Wall Street representatives. Not that we do their bidding or value their views more than others, but they have a voice that ought to be heard. It confirmed the wisdom of the Commission's current policy direction to achieve markets that work for consumers. With the right set of policies in place, such markets should spur the necessary infrastructure investment as well.

Markets that work – that is the clarion call at the Commission. Yet, we still have lost of old business to tend to. The Commission is now taking aggressive steps to take care of some old business even as we press a number of initiatives aimed at better markets.

The old business involves the herculean effort to resolve all of the pending issues and investigations arising out of the western energy crisis of 2000 - 2001. Last year, we charged our staff with getting to the bottom of all allegations of market manipulation and abuse in both natural gas and electricity markets. Within the next few days, they will present to the Commission a comprehensive report with recommendations for further

Commission action, including proposed remedies for any abuses they found. This may spur additional Commission proceedings necessary to ensure that justice is done.

This report will also have a bearing on the level of refunds that are necessary to make western customers whole for electricity prices during 2000 - 2001, that the Commission has already found were unjust and unreasonable.

This staff investigative report may also have relevance in resolving the pending Commission litigation over complaints about whether certain long term power contracts, negotiated when spot electricity prices were out of control, should be set aside by the Commission as either unjust and unreasonable or against the public interest.

The Commission must resolve these Western matters as soon as we can while ensuring that our investigation is thorough and our remedies appropriate.

Resolving this important old business involves huge levels of Commission resources. It provides a painful daily reminder that poorly structured markets can wreak economic havoc and fail miserably. The unfortunate result is loss of faith in markets, massive investigations, two year old refund cases, contract abrogation fights, and lots of uncertainty for investors, lenders, market participants and consumers.

There must be a better way. Why not insist that wholesale markets are well structured from the start? By that I mean a market structure that relies primarily on long term contracts negotiated in the context of a transparent spot market that is producing just and reasonable prices and locational price signals. I mean independent grid and independent market operation to create a level playing field on which all resources – supply and demand resources, renewable resources, distributed generation – can compete; where there is no tolerance for affiliate abuse; where clear rules define acceptable and unacceptable behavior; where reasonable customer protections, reasonable price mitigation measures, and solid market power screens are built in to the market design; where there is potential for a robust demand response, and where there is a highly professional and aggressive market monitoring unit on the ground to serve as an early warning device should problems arise.

What a radical concept. Wholesale markets that spur investment, produce just and reasonable prices, and provide substantial consumer benefits. After all, aren't these the core values that define our role as federal regulators?

These market design elements do not, however, simply fall into place in some Calvinistic fashion. As I've said, markets do not structure themselves, fix themselves or monitor themselves. Wholesale market structure must be defined by federal regulators.

For the first time, the FERC is shouting from the rooftops – no more bad markets, no more California – type markets, no more runaway markets. We are insisting that markets work. We took thousands of pages of testimony from experts from around the country and the world before we proposed our standard market design last summer. Now, it clearly needs some work, but that's what the comment period is for. We have received thousands of pages of written comments. We have had scores of outreach sessions and technical conferences. We have committed to publishing a white paper in April outlining significant refinements to our proposal, there will be Congressional hearings on the white paper, and additional comments from state commissions, market participants and customers will be expected.

We are clearly moving toward greater regional flexibility, greater deference to state regulators, and streamlining the rule to eliminate unnecessary detail.

Two other related areas of electricity policy evolution are also critical. The first is the establishment of regional grid operation and market platforms we call RTOs. RTOs will create a level playing field by operating without bias toward particular merchant interests, and they will eliminate the multiple transmission rates over regions that can make transactions uneconomic.

The second is our proposal to streamline the process and agreements associated with generator interconnection. The thorniest issue in the interconnection arena seems to be how to price the grid upgrades necessary for the new generator. Traditionally, our policy has been to roll in most of the cost over time, but state commissions and some utilities have argued that the upgrades should be paid for by the generator and the customers or ratepayers who benefit from the upgrade. This concept of beneficiary pays, often referred to as participant funding, has been proposed by the Commission in our SMD, and the concept is also being debated in the comments to our interconnection NOPR.

I realize that thus far I have spoken almost exclusively about wholesale electricity markets, yet there are important natural gas issues pending as well. The wholesale natural gas market is more mature, and the market structure more well defined and well understood. Yet, the dramatic rise in the use of natural gas for electric generation, though welcomed by the industry and by environmentalists, has placed some strains on the production and delivery systems. The LDCs, the traditional customers of the pipelines, have expressed strong concerns that any special treatment or flexibility given to generators will erode the quality of service the LDCs have come to enjoy. I understand that negotiations may have produced a generic agreement between LDCs and pipelines that will be presented to the Commission soon.

The stresses and strains on the natural gas production, storage and delivery system were dramatically displayed the last week of February when Henry Hub prices soared, with some transactions as high as $19.00. It has been an unusually cold winter in the Midwest, Mid Atlantic and Northeast, and the cold weather has lingered. National storage levels are at the low end of a five year range. High production area prices and low storage levels may signal underlying production issues. Moreover, there is a rather large storage gap to fill this summer.

Was there price manipulation? The Commission is investigating the price spikes, both on our own initiative and because we have been asked to do so by Senators Daschle, Bingaman and Schumer.

The high prices are rippling through the economy, affecting consumers already suffering from an economic downturn. The Commission has an obligation to understand the causes of these rather dramatic price movements, and I feel certain we will make public our findings in the near future.

Another critical issue that both the natural gas and electric industries have in common is price discovery.

Market participants must have timely access to accurate information about prevailing prices. Price discovery, the ability to access this price information, helps customers determine the price they should pay for the service or commodity, helps sellers determine and recover their investment, and allocates resources to the customers who value them most. Over the last twenty years, the trade press has created price indices through the polling of market participants. The quality of the indices depends on the integrity of the information collected and the number of active traders who report. Accurate and credible price indices for natural gas and electricity are the foundation for natural gas and electric transactions nationwide. Unfortunately, the false reporting of price and volume information has shaken confidence in these indices.

Accurate price indices are required by pipeline tariffs. At a January 15 Commission meeting, Commission staff pointed to three areas of pipeline tariffs that refer to market price data: cash-out provisions, penalties and basis differentials. Most major pipelines have cash-out mechanisms that allow them to resolve system imbalances. Accurate price information is essential if cash-out mechanisms are to account for and minimize pipeline imbalances. The Commission has approved some pipeline penalty provisions based on market indices to deter shipper misconduct that can threaten system reliability. Finally, many negotiated rate transactions peg the transportation rate to the basis differentials between two or more price index trading points.

It is imperative that there be trustworthy indices. As a first step, the Commission will probably adopt minimum standards for the price indices used in pipeline tariffs or new contracts. There are of course other proposals as well. The Committee of Chief Risk Officers (CCRO) has been grappling with this issue and has some standards for the Commission to consider. Others have suggested that the Commission by rule require all jurisdictional entities to report accurately all transactions, including counter party information, to a designated data gathering entity – perhaps the Commission itself. The Barton legislation in the House would require the Commission to gather, and make public by electronic bulletin board, data with respect to electricity transactions.

So, there is a "whole lot of shakin going on" in the price discovery arena. We are sponsoring a conference this spring to explore various price discovery issues and proposed remedies. I have an open mind on what the appropriate Commission response should be. We must have high confidence, however, in the accuracy of price indices.

So, this is our vision – markets that work, markets that spur investment, markets that both investors and consumers trust. The elements are a level playing field, an appropriate reliance on long term contracts, good price discovery and locational price signals, clear behavior rules, transparent and well functioning spot markets, transmission rights, mitigation rules and appropriate customer protections, competent oversight and monitoring. These are not radical ideas. Much of it is common sense. But it doesn't

happen because all of the stars and planets are aligned. Regulators must implement policies to make it happen.

Thank you.