

The Natural Gas Roundtable Washington, D.C.

"The View From The Commission - - Pending Natural Gas Issues"

Remarks by

**William L. Massey
Commissioner**

**Washington, D.C.
February 25, 2003**

Good afternoon. I'm glad to be here with my distinguished Natural Gas Roundtable friends.

Early in the new year is an excellent time to reflect, to take stock of both our personal and professional lives; to set goals; and establish a plan for achieving them. Regulators do this, just the same as more normal people.

Broadly stated, the Commission's goal is to make electricity and natural gas markets work for consumers. Achieving this sometimes elusive goal has required a steady evolution of Federal regulatory policies. The issue is no longer – and hasn't been for quite a number of years – whether to have wholesale markets for electricity and natural gas. The first Bush Administration championed 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 bad 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 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. All of these agencies have solemn responsibility to pursue these matters, and must do so vigorously. Nevertheless, these investigations 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. Richard Kaufman of Credit Lyonnais 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 merchants have billions in debt to refinance over the next two years. Kaufman called for a stable regulatory environment, effective monitoring of energy markets to ensure credible performance, and patience.

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 echoed the call for clear market rules and structure, reasonable and stable regulation, forceful market monitoring and oversight to ferret out abuses, and patience. He was optimistic for the return of capital to the industry over time, but not in the short term.

The ratings agencies, Fitch, Standard & Poor, and Moody's, were unapologetic about the sharp and rather precipitous downgrades they imposed on energy merchants and trading entities as their credit profiles weakened. Richard Hunter of Fitch did confess, however, that early on the analysts had underestimated market volatility when assessing the leverage of merchant companies. Downgrades occurred when the ratings agencies saw unregulated businesses with capital structures not commensurate with risk. The credit ratings agencies argued that they simply had no choice but to downgrade. "What else would have been the appropriate response?" asked Fitch's Hunter. Nevertheless, the seemingly arbitrary timing of some of the downgrades wreaked unnecessary havoc on stock prices, charged Carol Coale of Prudential Securities.

In general, the witnesses were optimistic that capital would return over time. 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 rules, with oversight, with effective monitoring, markets that are hard to manipulate.

Indeed, events of the last three years have made it obvious that the Commission will need more effective oversight and monitoring to make certain that energy markets operate in a fair and transparent fashion. To his credit, Chairman Pat Wood established the Office of Market Oversight and Investigations, or OMOI, headed by Bill Hederman. OMOI is developing the highly motivated multidisciplinary staff necessary for this Herculean task.

OMOI serves as the Commission's early warning system for problems in the industry. It is like a FERC radar system. In the short-term, OMOI will provide investigative prowess and will propose remedial action when it finds violations of regulations and tariffs. It will also anticipate more generic long-term issues and industry trends for the Commission to consider. As an example of the latter, OMOI recently issued the 2003 Natural Gas Market Assessment, which I commend to you. It notes a number of both immediate and long-term issues facing the natural gas industry. It is an excellent report. The issue that looms the largest is the deteriorating financial condition of market participants. I have already discussed the view from Wall Street and note here that natural gas companies with heavy investments in energy trading appear to be the most vulnerable. The recent announcements of yet another round of asset sales by companies like Dynegy, El Paso and Williams underscore the seriousness of the problem. These are companies that have also built generation and laid pipe – all necessary infrastructure for wholesale markets to thrive.

- Pipeline Creditworthiness Proposals

Deep concerns about financial health have found expression in recent efforts by a number of pipelines to amend their creditworthiness standards to guard against defaults

by their shippers. This is surely a legitimate concern, but some of the proposals have been rather stiff – large collateral amounts required to be ponied up quickly. The January 29 Commission agenda included two natural gas pipeline proposals to tighten creditworthiness standards and a complaint challenging a pipeline’s creditworthiness provisions. In the Tennessee and Northern Natural cases, the Commission required each pipeline to make changes in its tariff proposals. Our orders require objective criteria for measuring creditworthiness, reasonable collateral requirements, and non-discriminatory application. In the complaint case brought by E prime against PG&E Transmission-Northwest, E prime alleged that the pipeline’s twelve-month pre-payment requirement for a noncreditworthy shipper was unlawful. In this case, the Commission held that, while the pipeline was correct in determining that the shipper did not meet the tariff’s creditworthiness standards, it would reserve judgment on the 12-month prepayment requirement. This is because PG&E-Northwest asserted that the pipeline’s lenders require it to obtain one year’s worth of demand charges from non-creditworthy shippers. The pipeline was directed to provide supporting documentation for this requirement.

Thus far, the Commission is dealing with the creditworthiness issue on a case-by-case basis, although developing generic principles appeals to me as well. NAESB is tackling this issue and will perhaps propose a generic solution by June.

Last August, the Commission in its monitoring and oversight role issued a Notice of Proposed Rulemaking to prevent the abuse of cash management and money pool arrangements among regulated entities such as pipelines and their affiliates. Such abuse could arise where cash from a pipeline, for example, is transferred to an unregulated parent or affiliate. If the parent were to develop financial difficulties or file for bankruptcy, it could leave the pipeline without sufficient cash flow to maintain reliability and a high level of service. The Enron bankruptcy highlighted this problem, but the pooling practices of other corporate families raised the eyebrows of FERC auditors as well.

The NOPR proposed two threshold requirements for cash management programs involving jurisdictional entities: 1) a minimum 30 percent equity capitalization for the jurisdictional entity and, 2) an investment grade credit rating for both the jurisdictional entity and its parent. The NOPR also proposed stricter recordkeeping requirements.

Commenters generally supported the Commission’s efforts to establish standards, but many expressed concerns that the threshold requirements are too restrictive and that the proposals conflict with the SEC’s oversight under PUHCA. INGAA, EEI and AOPL filed joint comments urging the Commission to adopt guidelines rather than rules on cash management practices. This is an important initiative, all comments are before us, and I anticipate that the Commission will be acting on this NOPR shortly.

- Shaken Confidence in Price Discovery Methods

Now let me turn to the critical issue of 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 natural gas 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 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. The fallout includes the nullification of existing natural gas contracts pegged to indices, and the reluctance of parties to enter into new index-based contracts.

Accurate price indices are also 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.

Given the prevalence of price index information in pipeline tariffs and contracts, it is imperative that there be trustworthy indices. As a first step, the Commission will probably adopt minimum standards for the natural gas price indices used in pipeline tariffs or new contracts. We will sponsor a technical conference this spring to explore price index issues and various proposed remedies.

The Commission is also analyzing natural gas price index issues in its massive ongoing Western market manipulation investigation. This investigation has already found significant manipulation of published price indices that were used by traders, pipelines, and power generators. These indices also had been used by the Commission in establishing a formula for determining refunds of overcharges arising from the dysfunctional electric western power markets. FERC staff has recommended that the Commission modify the refund formula to eliminate any reliance on manipulated indices. Hundreds of millions of dollars, perhaps billions of dollars, are at stake in that huge

refund proceeding. This only underscores that reliable price discovery methods are an imperative in well-functioning natural gas and electric markets.

- Continuing Need for Efficient Investment in Infrastructure

This winter has been one of the coldest in years in the Northeast, Mid-Atlantic and Midwest states, 29 percent colder in these regions than last year. Demand is up, and so is the price of natural gas. Storage is being drawn down more rapidly than was expected, and it looks like the winter heating season will continue at least for several more weeks. The sustained cold weather brought prices at the Henry Hub up to the \$ 4 to \$ 5 range early in the winter, and this price has risen steadily as the winter weather has persisted without much letup. Today's Henry Hub prices are \$11.82 at the mid-point, with \$16.00 prices reported.

Natural gas exploration and production activity, as reflected in the number of gas drilling rigs, has increased over time, and will no doubt increase more in response to these powerful price signals. Yet, it takes time to develop a gas well – and it sometimes takes up to 18 months from new drilling until gas finally flows to market. This puts more pressure on the existing pipeline infrastructure, including storage, to meet winter demands.

Where pipeline infrastructure is constrained, prices will rise as capacity markets tighten. Basin differential price data lead to the conclusion that perhaps several regions of the country are now short of natural gas transmission capacity: the Rockies, the New York metropolitan area, other parts of the Northeast and Mid-Atlantic Coast, the Southeast and Florida. What is striking to me is that there are only a few major pipeline construction applications pending at the Commission. Our Office of Energy Projects tells me that there are 11 major pipeline certificate applications pending Commission approval, totaling 4.0 Bcf/day in new capacity and covering about 783 miles of new pipeline. Compared to certificate activity in 2001, these projects amount to just over half the capacity that was under consideration at that point. In January, 2001, the Commission had under consideration project proposals for about 7.3 Bcf/day of new capacity and over 2,200 miles of additional pipeline.

Traditionally, the pipeline industry has responded to price signals and contracted with shippers to support capacity expansions, but the deteriorating health of the industry and sharply reduced capital availability is a cause for concern.

Clearly, constrained areas are more prone to price spikes and to market manipulation than are non-constrained areas. This puts a premium on the Commission's ability to process expeditiously applications for approval of new infrastructure additions,

while balancing the need for full participation by affected parties in the NEPA process. Our track record is solid and getting better. From 2001 to the present, the Commission has certificated 4,814 miles of new pipeline infrastructure, with a total capacity of 15.8 Bcf/day. The Commission remains committed to responding promptly to facilitate the approval of necessary infrastructure projects. A vibrant market demands a solid infrastructure foundation.

- Continuing Potential for Market Manipulation

Alas, there are so many issues to discuss and so little time. I'm just getting rolling here. I'm out of time and haven't even discussed our outstanding NOPR addressing affiliate issues. Suffice it to say that the potential for abuse of the affiliate relationship remains a focus of Commission concern. Our NOPR would expand the definition of energy affiliate to include affiliates engaged in the physical or financial trading of both natural gas and electricity. Pipelines that have such affiliates would be subject to the separation of function requirements and information sharing prohibitions in our standards of conduct.

Predictably, the Commission has received a veritable blizzard of comment. Some viewed the proposal as a necessary and timely step to curb affiliate abuse. Regulated entities slammed it, saying that it is overly broad. LDCs that are affiliated with interstate pipelines have expressed concern that the rule will create operational difficulties and unnecessary duplication of functions.

We will take all of these concerns into account, and it is my hope that we can deal with this matter in the spring.

I have not even touched on electric policy, but suffice it to say that our natural gas and electric policies are joined at the hip, and I'll take questions on any subject you want to raise.