APGA Annual Conference

Remarks by
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U.S. Federal Energy Regulatory Commission

"FERC Agenda for 2002"

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I. Introduction

Good morning. I appreciate the opportunity to address the APGA Annual conference in this beautiful Wyoming setting.

I have been a Commissioner for more than nine years, and the challenges we face now are greater than ever. We have had our hands full with an electric policy agenda that seems to know no end, and I expect that will continue. Our recently initiated standard market design rulemaking proposes the same set of market rules for all wholesale electric markets. We assert jurisdiction over all transmission services and sharply separate transmission from merchant interests. The Commission's resources will be put to the test in trying to finalize this bold yet controversial rule by the end of the year.

We have devoted significant staff time to an ongoing investigation of Western electric and gas markets, in the wake of the Western energy crisis and the Enron debacle. But we have also been quite busy processing Order No. 637 compliance filings. And there are many issues pending at the Commission that will be of special interest to APGA members, such as the secondary market price cap and the right of first refusal.

II. FERC's Credibility – As Market Regulator

Over the past several months, the Commission has been assailed by members of Congress and by reports by the General Accounting Office expressing doubt about the Commission's commitment to effective market oversight, and we have been criticized for our failure to protect consumers when markets spiraled out of control in the Western United States. The heady confidence in markets acting as a surrogate for traditional cost-of-service regulation has eroded somewhat.

The disclosure of the now infamous Enron trading strategies such as Fat Boy and Get Shorty depicted some traders as ruthless and greedy market participants who would even jeopardize grid reliability to make a buck, and the disclosure of sham round trip trading by several market participants, coupled with highly questionable accounting practices, has severely eroded investor confidence in many entities that engage in the trading of gas or electricity.

All of this funny business has called into question the integrity of energy marketing and trading. Whether this is fair or not is the subject of debate, but damage has been done. Many states have backed away from their restructuring plans. Energy trading stocks have plummeted on Wall Street.

Critics in Congress have denounced power suppliers for market manipulation, and the Commission for ineffective monitoring and intervention, and for failing to uncover such activity until now. One Senator announced that he might vote to abolish FERC. We must be prepared to heed these clarion calls to improve our performance. We must not turn a deaf ear to these concerns.

Two General Accounting Office reports published in June questioned the Commission's readiness to deal effectively with market dysfunctions. According to the GAO, "FERC has not yet adequately revised its regulatory and oversight approach to respond to the transition to competitive energy markets. . . . To date, FERC's initiatives to monitor competitive markets have served more to help educate FERC's staff about the new markets than produce effective oversight efforts." These are harsh indictments, yet I agree that, we must sharply improve our regulatory performance to restore confidence both in energy markets and in the Commission itself.

I believe that the Commission has learned from its mistakes and has embarked upon a multi-pronged strategy to restore necessary confidence. We have ordered refunds for customers who suffered from the out of control prices in western markets, and hearings to determine the level of refunds are ongoing. We have set for hearing numerous long-term power contracts negotiated when spot market prices were soaring. Yes, we respect the sanctity of contracts, yet contracts that resulted from market power must be examined and reformed if necessary.

In February, we initiated a thorough investigation of Western market manipulation. Just last week our staff issued an interim report concluding that the published indices for natural gas spot markets in California are unreliable and may have been manipulated by market participants. Staff concluded that the formula for calculating refunds in Western electricity markets could not reasonably rely upon such indices and would have to be modified. The Commission immediately issued an order asking for comment about how the refund formula should be modified.

We also opened new 206 proceedings against six market participants suspected of manipulation or violations of the Commissions' standards of conduct, and we will pursue these cases aggressively.

The Commission has created a new market monitoring and investigations unit to act as our early warning system, to advise the Commission immediately if a market is spinning out of control. We are heeding the GAO criticism that we must retool internally if we are to adequately monitor for market power and protect customers from market manipulation.

The Commission remains committed to a market-based approach, but vigilance, monitoring, effective remedies and customer protection are the watchwords at the Commission these days. This is a very healthy development.

We have also proposed a standard market design for wholesale electric markets that is patterned after the PJM market structure – an organized day ahead Market, LMP, security constrained dispatch, coupled with effective monitoring and market power mitigation tools. We want wholesale electric markets across the country to have the same touch and feel. We will no longer tolerate poorly structured markets. We will insist that a market based approach actually works for customers. We will not countenance affiliate abuse or markets that are dominated by a few incumbents.

A. 637 Issues – Removal of Price Cap

The Commission also has a number of pressing gas issues to deal with in the months ahead. A prominent feature of Order No. 637 was the removal of the price cap on secondary pipeline capacity. This was a 2½ year experiment that, by its own terms, will sunset in September of this year. Extending the removal of the price cap would require a rulemaking, a process initiated in May when the Commission issued a notice requesting comments on whether we should reimpose the rate ceiling, remove the ceiling permanently, or continue the experiment to gain further information.

Staff's evaluation of capacity release information collected during the course of the experiment shows that above cap releases accounted for seven percent of all (short-term and long-term) capacity releases. From this, we observed that it did not appear as if the waiver of the price cap had a substantial effect upon the market overall.

This would square with the experience of your association. The APGA comments noted that "Some few members of APGA are listed as having consummated releases at above the maximum rate, and so there has been some limited commercial advantage for certain APGA members."

We are reviewing the comments that were filed in response to the Commission's notice, and I would expect the Commission to take some action in the weeks ahead, given the fact that the waiver will expire at the end of September. I had reservations about removing the price cap in the first place and will have to be persuaded that leaving it off is in the public interest. The core issue for me is whether the lack of a price cap makes the market more liquid and efficient, or does it simply impose additional and unnecessary costs on consumers.

B. Market Transparency and the Importance of Market Monitoring

Now let me turn to the issue of affiliate abuse. I note with interest that APGA has joined with a number of other interested parties to form the Coalition for Energy Market Integrity and Transparency, or EMIT. According to the Mission Statement, one of EMIT's goals is to eliminate the potential for an energy market participant to manipulate price and/or exercise market power." To achieve this goal, EMIT believes that the Commission must ensure that regulated affiliates of energy merchants are effectively separated from the merchant's activities.

I could not agree more, and to this end, I strongly supported the Commission's proposed standards of conduct for energy affiliates. The Commission's policy is to keep the pipeline and its gas marketing affiliate at arms' length to guard against self-dealing. Under existing policy, gas pipelines and their marketing affiliates must maintain functional separation, and any information disclosed to a pipeline's marketing affiliate is disclosed simultaneously on the pipeline's website.

There is a growing concern, however, fueled in part by the significant changes in the energy industry. The brisk pace of mergers and consolidations in both the gas and electric sectors has increased the number of physical and financial transactions between pipeline affiliates. The current regulations governing the relationship between transmission providers and their gas affiliates must be strengthened and inclusive of all energy affiliates, not just gas marketing affiliates.

Last September, the Commission issued a Notice of Proposed Rulemaking that would cover the relationship among all of the affiliates of a pipeline or transmission provider. The objective of the proposal was to prevent information concerning transmission operations or confidential customer information from being used to benefit any energy affiliate, including affiliates engaged in financial trading of gas and electricity instruments. Pipeline affiliates that engage in electronic trading or energy-related financial transactions would be subject to the separation of function requirement and information sharing prohibitions of the standards of conduct.

As I understand the EMIT Mission Statement, our proposal should hit the mark. However, it was quite controversial, and pipelines have asserted that it is unnecessary and will have unintended consequences. Some LDCs also have criticized the proposal, arguing that it will limit legitimate dealings between a pipeline and its LDC-affiliate.

I believe that our affiliate standards must be updated, and strengthened. I support the basic thrust of the NOPR, but the Commission should guard against any unintended consequences that would diminish legitimate operational efficiencies. We have received extensive comment and have a full record before us.

I note that EMIT and APGA support market transparency and energy transaction accounting methods that would entail appropriate disclosures about market structure, participants and transaction-specific information such as volumes, receipt and delivery locations and pricing information. I agree with these goals and have supported measures to require real-time availability of transactional information to ensure that access to the nation's pipeline and electric transmission grids truly is open and transparent.

In this vein, the Commission announced a Notice of Proposed Rulemaking to establish limits on the amount of funds that can be taken from a regulated subsidiary by a parent company under a cash management program. The impetus for this rulemaking arose from an audit of several pipelines and their parent companies by the Commission's Office of Chief Accountant. Our inquiry was based on the concern that pipelines might be left in precarious financial straits if their parent corporations' cash management programs are not managed appropriately. Pipelines must have sufficient funds to operate and must account appropriately.

The Commission recently extended the comment deadline until August 28, but Staff apprises me that their goal is to have a final rule ready for our consideration by the September 18 Commission meeting.

In addition to the Commission's rulemaking proceeding, the Office of Chief Accountant issued a detailed guidance to all jurisdictional public utilities, natural gas pipelines and oil pipelines on how jurisdictional entities must account for money pool arrangements, and the types of documentation that must be maintained.

C. Feinstein Bill

Enron's collapse and the trading scandals that have become a frequent feature of the nightly news have led to a growing awareness of the need for regulatory oversight of energy trading markets, including energy derivatives. Our own investigation has uncovered what we believe to be the use of false information and deceit in attempts to inflate wholesale electricity prices. To the extent that pending legislation, such as Senator Feinstein's S. 2724, would strengthen federal authority over energy trading markets and derivative trading, it has my support.

D. Right-of-first-refusal

While otherwise affirming Order No. 637, including the waiver of the price cap on released capacity, the U.S. Court of Appeals remanded three major issues to the Commission: the matching term limit on the right-of-first-refusal, the ability of a shipper to segment capacity and use forward hauls and back hauls to the same delivery point in excess of contract demand, and the need for a waiver from the posting and bidding requirements for prearranged releases by LDCs as part of state unbundling programs. The Commission solicited comments on the issues remanded by the court.

On the right-of-first-refusal, the court found that the five-year matching term requirement was not adequately supported. Most commenters, including APGA, advocated retention of the five-year matching term cap as a way of protecting shippers against the exercise of market power by pipelines. On the other hand, pipelines advocated elimination of the requirement or increasing it substantially to 13 or more years.

My own view is that Section 7 (b) of the Natural Gas Act guarantees abandonment protection to holders of pipeline capacity, a purpose that is served by the right-of-first-refusal. Without some matching term limit, pipelines would be able to use their monopoly power to lock shippers into longer contract terms than they otherwise might want. That said, I must admit to being somewhat frustrated by the remand of this issue, because I really thought that we had adequately supported five years as a term limit.

The court also remanded the question of whether the regulatory right-of-first-refusal is a self-executing right that applies regardless of any inconsistent tariff language, or whether tariff language is necessary to effect the right-of-first-refusal. I understand that APGA advocates requiring that all pipeline tariffs be revised to provide specifically for the right-of-first-refusal. I have an open mind on this issue, but am inclined to agree with you.

E. Negotiated Rates

The Commission is reevaluating its policy on negotiated rates in light of concerns over the propriety of provisions in contracts on Transwestern and PG&E Northwest that tie the price of capacity to certain price-index differentials. The Notice of Inquiry was announced at the Commission's July 17 meeting, so I have not seen any comments as yet. In the past, most concerns on negotiated rate agreements tended to focus on whether the agreement was actually a ruse for negotiated terms and conditions of service, which is prohibited under our regulations. I have not always been comfortable with our attempts to distinguish between what was a negotiated rate provision and what constituted a term and condition of service. I have an open mind and look forward to reading your comments about whether our policy or negotiated rates should be changed. My primary concern will be protecting pipeline customers from the potential exercise of monopoly power.

III. Conclusion

The Commission is no longer starry-eyed or naïve about markets. We remain committed to a market-based approach, but we understand that abuses can occur, that customers must be protected, and that aggressive market monitoring is essential. I think we have turned the corner. I know that APGA members will participate actively in Commission debates in the months ahead. I encourage you to do so.