

The Role of OMOI and FERC in Market Monitoring and Challenges For Gas Markets Going Forward

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Purpose Of Today's Talk

- Overview of OMOI's Monitoring Role
- Discussion of challenges for gas market outlined in FERC's recently released Natural Gas Assessment 2003

OMOI Vision

Vigilant oversight and vigorous enforcement of proper market rules ensure dependable, affordable, competitive energy markets to benefit end use customers and other participants.

OMOI Mission

Guide the evolution and operation of energy markets to ensure effective regulation and protect customers through understanding markets and their regulation, timely identification and remediation of market problems, and assured compliance with Commission rules and regulations.

OMOI Functions

- **Assess market performance**
- **Ensure conformance with Commission rules**
- **Produce internal and external reports**

FUNCTION: Assess Market Performance

- **Analyze market structure**
- **Analyze policy (regulations, market rules)**
- **Acquire and analyze commercial data**
- **Conduct market research (possibly including models)**
- **Advise Commission**

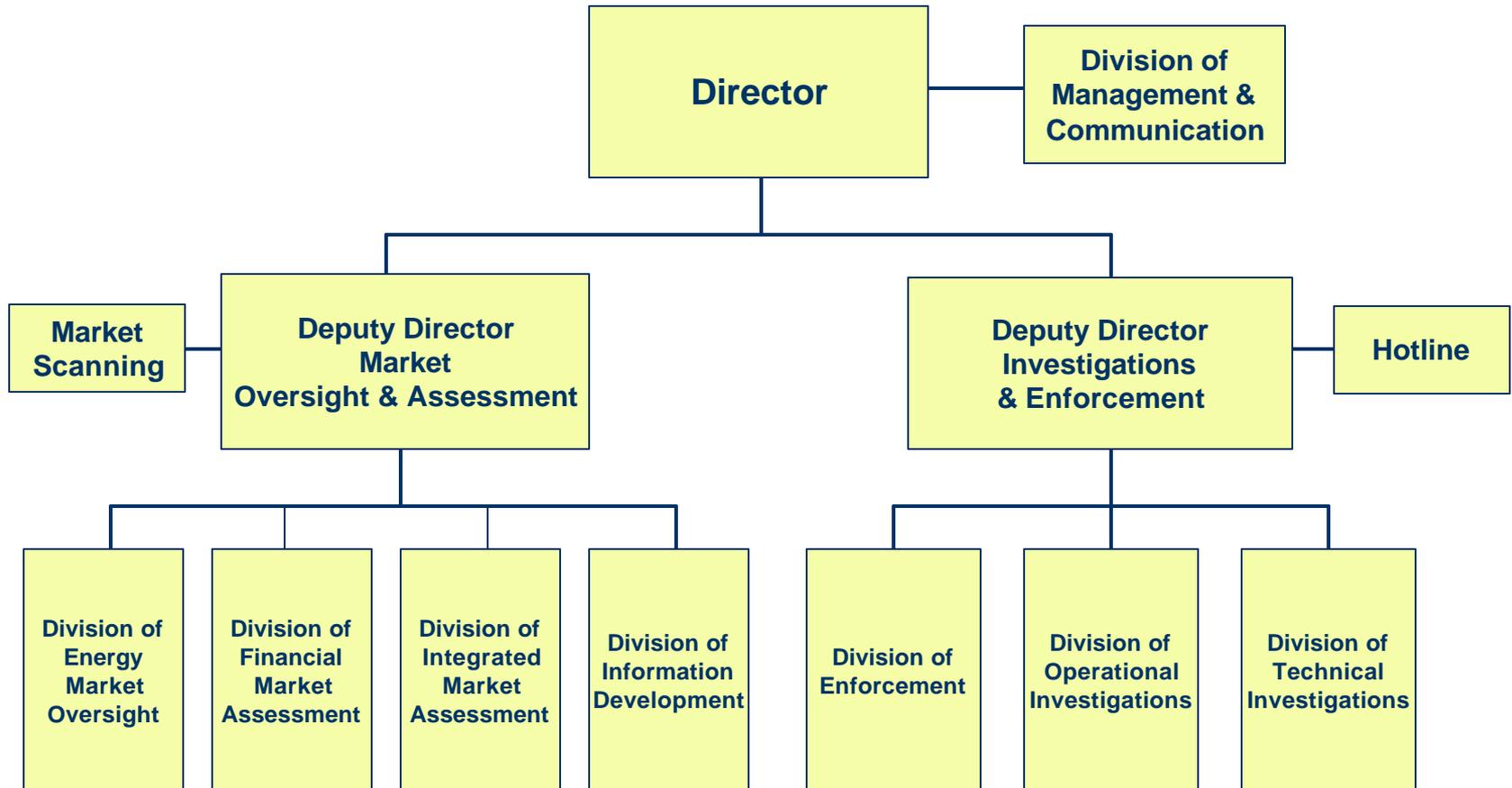
FUNCTION: Ensure Conformance With Commission Rules

- **Verify compliance with rules and reporting requirements**
- **Investigate actions**
- **Facilitate dispute resolutions**
- **Enforce market rules**

FUNCTION: Produce Internal and External Reports

- **Present state of energy markets**
- **Analyze trends and occurrences**
- **Provide early warning**
- **Make recommendations**

OMOI Organization Design



FERC Hotline

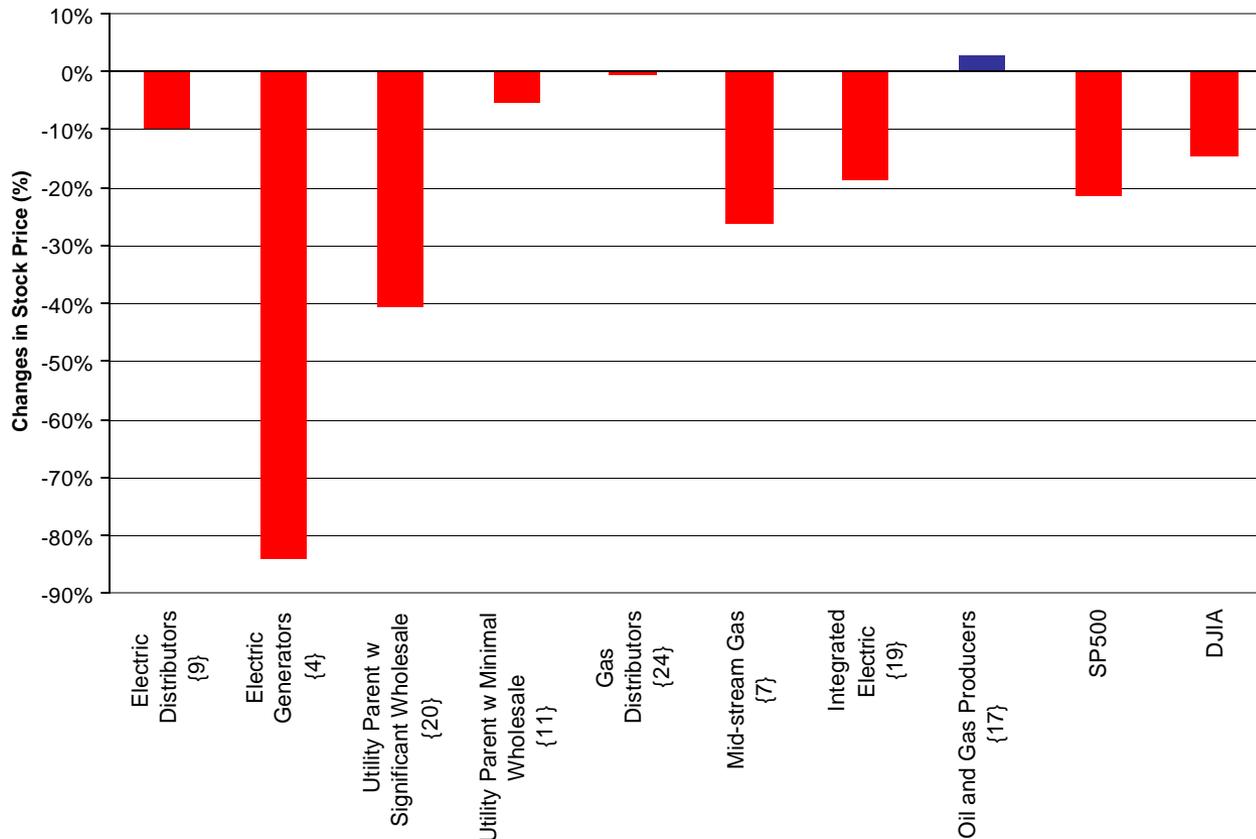
Enforcement Hotline (toll free)

1-888-889-8030

Natural Gas Assessment: What is it?

- Provides Commission with an “early warning” on market issues.
- Guides short run oversight and investigation priorities.
- Communicates priorities to market participants.

Challenge #1: Deteriorating Financial Condition of Market Participants



Responses to Deteriorating Financial Conditions

Industry Actions

- Improving finances by cutting costs, selling assets, renegotiating debt.
- Developing best practices for energy trading and general business behavior.
- Increasing the use of exchanges.
- Encouraging new entrants – banks and brokerages.

FERC Actions

- Making policy as necessary.
- Monitoring the financial health of gas companies to ensure dependable delivery of natural gas and prevent inappropriate raiding of regulated affiliate assets.
- Monitoring the behavior of gas markets with particular attention to reductions in liquidity due to exits from natural gas trading.

Challenge #2: Need for Management of Credit Exposure

- Participants are using more sophisticated credit management approaches in gas markets including over-the-counter credit clearing.
- New approaches are beneficial but have limitations and are not well understood by market participants.

Responses to Need for Management of Credit Exposure

Industry Actions

- Need to educate themselves on new credit tools.
- Need to report on use of these new mechanisms in financial statements.

FERC Actions

- Co-sponsoring a technical conference on credit and credit clearing issues with the Commodities Futures Trading Commission on February 5th, 2003.
- Monitoring the use of new methods for managing credit exposure and showcasing positive developments.

Challenge #3: Shaken Confidence in Price Discovery Methods

- Weakened confidence in natural gas price indices.
- No serious alternative to existing price indices.
- Questionable quality of the methods used by the trade press to create gas price indices.
- Fewer natural gas traders contributing price information (in fear of lawsuits).
- Concerns:
 - Weakened price discovery via the price indices can decrease the efficiency of gas markets.
 - Difficulties could affect parties' willingness to enter new contracts and lead to the unraveling of existing contracts.

Responses to Shaken Confidence

Industry Actions

- Developing best practices for price reporting.
- Shifting transactions to exchanges, where prices are more transparent.

FERC Actions

- Staff recommending that in the future the Commission require that price indices meet certain minimum standards.
- Analyzing natural gas price index issues in its Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices in Western Markets.
- Planning a technical conference to address price index issues (tentatively April).

Challenge #4: Continuing Need for Efficient Investment in Infrastructure

- Current gas prices pose challenges for inducing new natural gas supply.
 - Prices are higher than they have been in the recent past and supply is tighter but the market does not believe these prices will last.
 - Production has not responded in a major way to recent price signal.
- Shifting supply and demand patterns challenge the market's ability to provide sufficient transmission and delivery infrastructure. Areas of concern include the Rockies, the New York metropolitan area, other parts of the Northeast, and parts of the Southeast.
- With gas supplies tight and prices high, more storage and pipelines are needed to operate efficiently.

Responses to Need For Efficient Investment in Infrastructure

Industry Actions

- Moving some proposed pipelines ahead.
- Maintaining existing infrastructure.
- Improving the performance of price discovery mechanisms.
- Working to create viable forward markets for forward capacity.
- Making use of risk management services.

FERC Actions

- Monitoring and assessing regional markets and potential capacity constraints and resulting price and reliability effects.
- Supporting development of forward markets to facilitate infrastructure investment.
- Encouraging state regulators to make rules that allow timely price signals to reach retail customers.

Challenge #5: Continuing Potential for Manipulation

- Manipulation has occurred in some U.S. natural gas marketplaces and may be continuing.
- Increased number of active FERC gas-related investigations.
- Investigations in five categories of price manipulation:
 - Controlling marketplaces that have weak liquidity.
 - Withholding of capacity in violation of regulations.
 - Manipulating illiquid physical marketplaces to affect prices in associated financial marketplaces.
 - Communicating market information from pipelines to their marketing affiliates.
 - Providing false data about prices or volumes to index publishers.

Responses to Potential for Manipulation

Industry Actions

- Individual companies are establishing and maintaining internal controls, conducting audits, and reporting inappropriate or suspicious behavior to authorities.
- Collective industry efforts on ethics are also taking place.

FERC Actions

- Formation of the Office of Market and Oversight (OMOI) – 67 open cases.
- Development of internal energy market briefings.
- Development of market metrics for gas and electric market.
- Operation of the Commission's toll free enforcement hotline.
- Increased coordination with other regulatory bodies.
- Other Commission efforts in this area are confidential.

Conclusion

- FERC will monitor the markets and work with stakeholders to ensure:
 - Deteriorating company financial health does not impair dependable delivery of natural gas, result in raiding of affiliated unregulated assets, or reduce the liquidity of gas markets.
 - New methods for managing credit exposure are used beneficially.
 - Price index issues are resolved.
 - Regional & national infrastructure exists to support market needs.
 - Any instances of manipulation are identified and addressed.
- FERC will also continue to monitor the market for new issues which need to be addressed.