Prepared Comments of

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Remarks for Panel III: Future of the Pipeline Industry

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Introduction and Executive Summary

Good morning. And thank you again for asking me to join you today.

I am Martha Wyrsch, President and CEO of Duke Energy Gas Transmission.

Duke Energy Gas Transmission operates more than 17,500 miles of natural gas transmission pipelines from Texas to New England. We have investments in Maritimes and Northeast, a pipeline bringing gas and, in the future, we hope LNG imports into the growing New England market from outlets in Eastern Canada. We have a stake in Gulfstream Natural Gas System, a pipeline serving the expanding Florida market. Duke owns and operates approximately 250 billion cubic feet of natural gas storage capacity. And we also own and operate two significant businesses in Canada – a natural gas gathering, processing, and transportation business in British Columbia and Alberta; and Union Gas, a local distribution business in Ontario.

For purposes of this panel considering the Future of the Pipeline Industry, I am speaking on behalf of The Interstate Natural Gas Association of America. Over the next hour, I look forward to hearing a number of meaningful ideas that will enhance our already sound regulatory policies and spur the development of natural gas pipeline infrastructure.

The pipeline industry has invested nearly $20 billion in new infrastructure over the last decade. But even more serious challenges lie ahead. The Commission and the pipeline industry should be proud of our success, but we cannot be complacent.

I would like to discuss some of the pipeline industry's challenges and opportunities in this area and, in the process, make five constructive recommendations to the Commission that we think can make a real difference in how we move gas from where it is found to where it is consumed.

We all know this is critical to the well being of the American economy. The Commission has voiced its concern that without sufficient delivery infrastructure, some suppliers won't be able to enter the market, customer choices will be limited, and prices will be needlessly volatile. But to maintain existing systems, relieve bottlenecks, and deliver increasing quantities of natural gas to market in an efficient and cost-effective manner, we are going to need billions of new pipeline investment dollars.

A recent INGAA report estimated that of the 26,000 miles of pipe needed to meet market demands, 10,000 miles at a projected cost of $16 billion would be needed to simply replace existing pipe. That's a serious and significant investment. To attract this kind of capital and to serve our communities well, pipelines need supportive regulatory policies and clear processes and procedures.

- **STABLE, LONG-TERM CONTRACTS MUST BE ENCOURAGED FOR BOTH NEW AND EXISTING FACILITIES**

This brings me to the first of our recommendations.

By working to encourage stable, longer-term contractual relations, the Commission can foster an environment favorable to investment in both new *and* existing facilities. A 2005 INGAA survey reported that 36 companies spent nearly $20 billion for interstate pipeline infrastructure between 1993 and 2004. This is an industry committed to serving for the long term. But pipelines rarely have contracts that cover the entire life of their investment when the facilities are built. Long-term contracts obviously are important when facilities are first built, but they are equally important for existing facilities.

Long-term contracts provide a cheap insurance policy against harmful price spikes and also help pipeline companies recover their financial investments in infrastructure. The importance of this issue is illustrated by the fact that NARUC and IOGCC this summer instituted a proceeding, in which INGAA and DEGT participated, to explore what could be done to encourage long-term contracting. The Commission should also look for ways to encourage pipeline and storage contracts for both new *and* replacement capacity.

- **THE COMMISSION SHOULD HELP EXPEDITE POST-CERTIFICATE CONDITIONS**

The Commission has done a good job over the last decade in expediting its own certification process. Pipelines must, however, comply with other federal statutes such as the Clean Water Act and are regularly asked by the Commission to coordinate with state authorities. Today many of the most serious delays occur after the Commission has certificated a project.

In the EPAct/05, Congress specifically made FERC the lead agency to coordinate and set a schedule for all federal authorizations pursuant to the National Environmental Policy Act. This is a critically important step toward the faster construction of pipeline and storage facilities. Consequently, our second recommendation is that the Commission must remain focused on projects after certificates have been issued. Certainly, environmental laws and regulations must be observed and the environment protected. But this Commission can play an important role in assuring that infrastructure development is not needlessly delayed by other state and federal agencies.

- **THE COMMISSION SHOULD ALLOW GREATER PRICE FLEXIBILITY**

Our third recommendation is that the Commission should allow greater flexibility in the way pipelines can price their services.

For example, current rate policies under price interruptible transportation and artificially cap released capacity at below-market prices. The removal of the price cap on IT and capacity release would improve market efficiency, mitigate the adverse effects of the current cost-based rate designs, add to competition and transparency, and remove obstacles to long-term capacity contracting. This will go a long way toward encouraging longer-term, more stable contractual arrangements. If shippers are allowed to defray some of their costs by receiving more revenue from capacity release transactions during peak periods, long-term contracts will be more attractive and will, ultimately, spur investment.

Another example of where greater price flexibility would encourage more infrastructure investment is in contracting with anchor shippers. We believe the Commission can promote greater infrastructure development by providing flexibility for developers to negotiate firm contracts, early in the development process. When a shipper is willing to sign up for capacity prior to pipeline development – as a project is being sized – this guidance provides a more realistic view of the size and need for the project. Pipelines and anchor shippers must be protected against reallocations resulting from an open season later on. Without this kind of shipper commitment, project development will be more risky and less attractive.

A third example where greater price flexibility would encourage infrastructure is index-based negotiated rates. In our view, the Commission should reconsider the policy announced in FERC Docket No. PL03-3, which prohibit the use of index-based negotiated rates. Allowing index-based negotiated rates would promote flexibility and assure those who enter into long-term contracts that risk allocation will remain proportional over time.

- **THE COMMISSION SHOULD FOCUS ON BROADER MARKET BENEFITS IN DECIDING WHETHER TO ROLL IN RATES**

Our fourth suggestion concerns the Commission's policy concerning incremental rates.

There is currently a bias in favor of incremental rates. But often the expansion or extension of a facility benefits an entire market, not just the new shipper, by reducing the commodity price and price volatility in the entire market. The inequity of having only new shippers bear the cost of new facilities discourages shippers from signing up and paying for incremental capacity. This, in turn, dampens and deters investment. The Commission should focus on the broader market benefits when it decides whether to roll in the costs of new facilities.

- **THE COMMISSION SHOULD REMAIN COMMITTED TO LIGHT-HANDED REGULATION**

Finally, we recommend that the Commission focus on the linkage between light-handed regulation and capital attraction, and continue its current light-handed regulatory regime.

We bring this up because we have seen some signs that the FERC may be considering a shift away from this approach. For example, when pipelines are granted an incentive return on investment to encourage building new facilities, they invest with a belief that those returns will remain intact over the life of the project, or at least the life of the contracts entered with initial shippers. When a pipeline commits the capital for a greenfield pipeline based on a given return over a given period, it needs to be certain that requirements for 3 year cost and revenue requirements, Section 5 rate reviews, or other regulatory "hooks" will not undercut this guarantee. This practice introduces a level of risk to the investment which discourages construction of new facilities.

As part of its commitment to light-handed regulation, the Commission should revisit its guidelines for market-based rates for both storage and transportation. We believe allowing market forces to send timely price signals will encourage infrastructure development in storage and transmission. A revised market-based rates policy should recognize changes over the last decade in the transparency of the marketplace as well as changes in the entities that actually control capacity.

We hope these suggestions – all five of them – are the basis for a healthy dialogue that will result in policies and practices that ensure a strong and vibrant natural gas industry and infrastructure supportive of our Nation's consumers and the American economy.

I.

The Commission Should Build on its Success to Encourage More Infrastructure Development

INGAA and its members commend the Commission for holding this conference on the development of natural gas pipeline infrastructure. This Commission has consistently recognized that pipeline infrastructure is critical for the health of the American economy. The Commission's Strategic Plan for fiscal Years 2003-2008 stated:

> [w]ithout sufficient delivery infrastructure, some suppliers will not be able to enter the market, customer choices will be limited, and prices will be needlessly volatile. For the nation to continue enjoying affordable, reliable...gas service, we will need ... continued gas pipeline storage, and LNG terminal investment to link gas producing and consuming regions.[1]

The FERC observed in its 2005 State of the Markets Report: "Overall, gas infrastructure investment in North America has been an important market success story for many years."[2] During the 10-year period from 1995 to 2004, the interstate pipeline industry added new pipeline capacity capable of transporting over 70 billion cubic feet per day.[3] Thirty-six pipeline companies responding to a 2005 INGAA survey report they spent $19.6 billion for interstate pipeline infrastructure between

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[1] Strategic Plan for Fiscal Years 2003-2008, Federal Energy Regulatory Commission, September 2003.
[2] FERC, STATE OF THE MARKETS REPORT, JUNE 2005 at 145.
[3] Energy Information Administration Status of Natural Gas Pipeline System Capacity Entering the 2000-2001 Heating Season, NATURAL GAS MONTHLY, at Figure SR-4 (Oct. 2000); ENERGY INFORMATION ADMINISTRATION, U.S. NATURAL GAS PIPELINE AND UNDERGROUND STORAGE EXPANSIONS IN 2003 at Figure 1 (2004).

1993 and 2004.[4] Natural gas markets – and all categories of natural gas consumers – have benefited from this expanding infrastructure, because new infrastructure creates access to natural gas supply and relieves capacity bottlenecks both upstream in supply basins and downstream in consuming markets.

The industry and this Commission have done a good job encouraging development of natural gas infrastructure. But there remain challenges for both the industry and the Commission. Some Commission policies may have the unintended effect of discouraging infrastructure development. The Commission should preserve the policies that have produced the successes that have been achieved thus far, while working to solve the remaining challenges for infrastructure development.

The significant challenge facing the natural gas industry and this Commission is accurately captured in the following comments by FERC's Office of Market Oversight and Investigations in the 2004 State of the Market Report:

> [d]eveloping new natural gas pipeline capacity in the Northeast remained challenging in 2004 because: ... [d]evelopers will not build new pipeline capacity without long-term, firm transportation contracts. It is unclear, however, who will sign up for firm transportation service.[5]

The report continues, stating that LDCs will have only a limited need for additional firm service and that "gas-fired power generators continue to limit their exposure to firm transportation reservation charges by not contracting."

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[4] 2005 INGAA survey results presented in Policy for Selective Discounting by Natural Gas Pipelines, Docket Nos. RM05-2 and RM97-7, *Comments of the Interstate Natural Gas Association of America in Response to NOI*, filed March 2, 2005.

[5] "2004 State of the Markets Report," issued June 2005 at p. 172.

Removing this uncertainty concerning who should sign up for firm capacity is essential not only in the Northeast but in all regions. Long-term, firm contracts are the starting point for a sound infrastructure development policy.

II.
Stable Long-Term Contracts Must Be Encouraged For Both New And Existing Facilities

The interstate natural gas business is premised on firm contracts between willing sellers and buyers. Billions of new pipeline dollars will be needed to maintain existing systems, relieve bottlenecks and increase deliverability. Much of the construction needed in the near future will be replacements and expansions of existing facilities. A recent study prepared for INGAA found that during the next years, the industry must build 26,000 miles of pipe at a cost of approximately $61 billion.[6] Of this, 10,000 miles, at an estimated cost of $16 billion, would be needed simply in order "to replace existing pipe." Pipelines need the assurance of long term contracts and favorable regulatory policies to attract this level of investment.

Since most pipeline companies do not recover their investments under the initial set of long-term contracts, they must have a reasonable opportunity to secure quality, long-term new or renewal contracts to cover the remainder of the financing period. It is of critical importance, then, to have regulatory policies that do not

[6] *An Updated Assessment of Pipeline and Storage Infrastructure for the North American Gas Market: Adverse Consequences of Delays in the Construction of Natural Gas Infrastructure*, prepared for The INGAA Foundation, Inc. by Energy and Environmental Analysis, Inc., July 2004. This study is available at http://www.ingaa.org/Documents/Foundation%20Studies/Final%20Capacity%20Update.pdf.

discourage, and hopefully that encourage, long-term contracting on *existing facilities* as well as long-term contracts to underwrite *new facilities*.

The uncertainty concerning who will contract for firm capacity is in part attributable to the success of Order Nos. 636 and 637. Before unbundling of Order 636 and the enhanced flexibility of Order 637, pipelines could contractually restrict how customers used the pipeline system. The contractual restriction created a reserve of "system" flexibility that the pipeline could use to provide swing capability and enhanced reliability. It also made it easier for pipelines to sell services because services, were not easily substitutable for one another.

In today's environment shippers can use multiple receipt and delivery points on a secondary basis, can freely segment and release capacity and can take advantage of arbitrage opportunities associated with imbalance resolution procedures. These highly flexible services are broadly available to all shippers and are created by the efficiency of the system as a whole. While this flexibility may have lowered costs for shippers in the short run, it has also decreased the apparent comparative value of true firm service.

But in the long run—which is now increasingly close—the industry must face serious questions. As the ability of the existing system flexibility is used up, who will create new flexibility of a comparable nature for expanding demand? The short answer is no one will step up to pay for the facilities that make such service flexibility possible if others can capture the benefits of this increased flexibility for "free."

INGAA emphasizes that it is not suggesting a retreat from the unbundling and flexibility of Order 636 and Order 637. But the Commission can look for other ways to encourage infrastructure development. As will be discussed below, allowing greater price flexibility, taking a broader view of the benefits of new facilities when considering whether to roll in rates, and making a recommitment to light-handed regulation would materially encourage infrastructure development.

Pipeline and storage contracts for both new and existing capacity provide a cheap insurance policy against price spikes, which price spikes usually occur when gas needs are at their peak. NARUC and IOGCC recently instituted a proceeding, in which INGAA and DEGT participated, to consider how it could encourage long-term contracting as a catalyst for infrastructure investment. The FERC should also look for ways to encourage long-term contracting.

III.

The Commission Should Help Expedite Post-Certificate Conditions

The Commission has done an outstanding job expediting its handling of certificate applications. But the Commission often conditions its certificates on the pipelines obtaining other environmental authorizations from other state and federal agencies. The most significant delays often may occur after the Commission grants a certificate.

The Commission should continue to issue pipeline construction certificates expeditiously under its NGA authority. Efficient handling of applications by the Commission is critically important. But it is equally important to assure that other state and federal agencies do not unduly delay construction.

Congress endorsed the goal of expediting certificate applications in EPAct/05 by making FERC, for all NGA section 3 and 7 applications, the lead agency to coordinate and set a schedule for all federal authorizations pursuant to the National Environmental Policy Act (NEPA).[7] The Commission should use this authority to monitor the progress of other agencies in granting authorization. Where appropriate, it should use its status as "lead agency" to encourage the timely action on other necessary authorizations.

IV.
The Commission Should Allow Greater Price Flexibility

Current rate policies systematically underprice interruptible transportation (IT) and artificially cap released capacity at below-market prices. FERC-regulated pipelines are forced to price IT service so that it often appears to be a cheaper alternative to FT. By keeping the recourse rate price of IT service artificially low, a customer is encouraged to take the risk that service will be interrupted during peak periods.

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[7] Energy Policy Act of 2005, Pub. L. No. 109-58, §313, 119 Stat. 594 (2005).

A similar problem exists for shippers that rely on release capacity. Firm shippers are prevented from obtaining the true value of the capacity that they might release during constrained periods, because they cannot release capacity at above regulated rates. This keeps them from being made whole on the cost of their capacity, because competition prevents them from obtaining the regulated rate during off-peak periods. This inability to release capacity at its true market value hurts shippers, pipelines and ultimately consumers.

Unrealistically low IT rates, and caps on released capacity, discourage users from entering into long-term, firm contracts and discourage infrastructure development. INGAA urges FERC to consider ways to price both IT service and released capacity at their true market value. Such policies would improve market efficiency, mitigate the adverse effects of the current cost-based rate designs, increase competition, and encourage contracting for long-term capacity.

The Commission can also promote infrastructure development by providing flexibility for developers to negotiate firm contracts with anchor shippers early in the development process. Shippers willing to sign up for capacity prior to pipeline development (when the project is being sized) should be able to rely on contracted-for capacity without the risk of *pro rata* reallocation if additional shippers request capacity at a later date. Unless anchor shippers are provided protection against reallocations resulting from an open season, there is little incentive to make an early commitment. Without such commitments, project development will be more difficult.

The Commission should also reconsider the policy announced in FERC Docket No. PL03-3, which prohibited the use of index-based negotiated rates.[8] Allowing negotiated rates indexed to basis differentials would permit flexibility to allocate market risks among parties as those risks vary over time. In addition, this policy would assure parties to long-term contracts that risk allocation will remain proportional over time, and would enhance the likelihood that parties will consider longer term contracts – to the benefit of all industry players.

Reinstatement of the ability of parties to agree to various index-based negotiated rates is consistent with FERC's policy on alternative rate design,[9] and mirrors the Commission's current policy permitting the use of index-based pricing in discounted rate transactions.[10] The Commission's new basis differential policy denies contracting parties the full range of options for designing market-sensitive negotiated rate agreements. Since an index-based rate structure can only be the result of negotiation and agreement, there should be no concern that such rates can

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[8] Policy Statement on Natural Gas and Electric Price Indices, 104 FERC ¶ 61,121 (2003).

[9] Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines and Regulation of Negotiated Transportation Services of Natural Gas Pipelines, 74 FERC ¶ 61,076 (1996) ("1996 Policy Statement"), order on reh'g, 75 FERC ¶ 61,024 (1996).

[10] Northern Natural Gas Co., 105 FERC ¶ 61,299 (2003). In addition, the Commission has stated that increased participation in gas price indices in 2004 signals increased confidence in using the indices. FERC, STATE OF THE MARKETS REPORT, JUNE 2005 at 147.

be imposed unilaterally upon a shipper by a pipeline, nor is there any evidence that pipelines either have the ability to manipulate or have in fact manipulated the gas commodity market by withholding capacity.

V.
The Commission Should Focus on Broader Market Benefits In Deciding Whether to Roll In Rates

Often an incrementally priced project is not economic for new shippers. The Commission should apply its current policy in a manner that considers the broad benefits that a new project may bring to an entire gas-consuming region. New facilities that bring gas into a market will generally reduce the commodity price for all consumers in that market. It is inappropriate to allocate all costs to a handful of new shippers when all consumers in the market may experience lower commodity costs resulting from the entry of new supplies into the market.

Such new facilities also create system "flexibility" that can be used by other shippers on an interruptible or secondary basis. When non-investing shippers, and the public generally, reap the benefits of construction, it is inappropriate to require that only a few shippers bear the incremental cost of those facilities. Expecting only the new shippers to bear the cost of new facilities creates a "free ride" for anyone not contributing toward the new facilities. This "free ride," which may be enjoyed by competitors of the new shipper, discourages shippers from signing up, and hence paying for, incremental capacity. This, in turn, discourages investment. To address this problem, FERC is encouraged to apply its existing cost allocation policy in a manner that more readily facilitates the roll-in of mainline expansion projects.

VI.
The Commission Should Remain Committed To Light-Handed Regulation

Finally, the importance of avoiding a return to the over-regulation of past periods cannot be overstated. Investor perceptions about the stability and predictability of the regulatory regime greatly affect the industry's ability to attract capital for maintenance and repairs, upgrades, and expansions. Markets have come to expect a light-handed approach to regulation. An increased emphasis on traditional rate regulation would disrupt market expectations.

The damage associated with what could be called "over regulation" is demonstrated by the rate treatment that has been advocated for some new Greenfield pipelines. Even though such pipelines were given an incentive return to encourage construction, some have advocated that they be given drastically lower rates of return shortly after the pipeline has been built. Long-term financing decisions, and indeed even the assessment of whether a project is economic and should be built at all, are based upon the return granted at project certification. Moreover, not all projects are successfully developed. Granting a "development" return and then taking it away as soon as possible inevitably will reduce infrastructure development. To encourage pipeline development, pipelines must be able to rely upon the expectation that they will recover a higher development return over the entire life of facilities that are placed into service or, at a minimum, the life of the initial contract.

To allow market forces to work as efficiently as possible, the Commission should revisit its guidelines for market-based rates for both storage and transportation. The Commission's existing market-based rate policy – as set forth in the 1996 Policy Statement – encourages pipelines to apply for market-based rates for transportation services in competitive markets. Yet FERC's implementation over a decade ago of this judicially-approved ratemaking methodology has essentially rendered this alternative to cost-of-service ratemaking unavailable.

Only one major interstate pipeline, Koch Gateway (now Gulf South), has requested market-based rate authority, and its request was denied for the entire five state region in which it operated.[11] Then-Commissioner Hébert expressed the concern in his concurrence in Koch that "if a pipeline such as Koch, which heavily discounts many of its services in order to meet competition cannot be found under the [1996] Policy Statement to be lacking market power, under what circumstances will it be possible for the [1996] Policy Statement to encourage market-based rates."[12] In fact, based on the result in Koch, pipelines have been discouraged from seeking market-based rates. The Commission's findings in Koch – as well as the

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[11] Koch Gateway Pipeline Co., 85 FERC ¶ 61,013 (1998), order on reh'g, 89 FERC ¶ 61,046 (1999).

[12] Koch, 85 FERC ¶ 61,013, at p. 61,047

1996 Policy Statement upon which the Koch decision was purportedly based – are outdated in light of industry changes and need to be revisited.

A revised market-based rates policy should recognize changes over the last decade in the transparency of the marketplace as well as in the entities that actually control capacity and make economic decisions as to how that capacity is made available to the marketplace. These changes include the implementation of Order Nos. 637 and 2004; increased growth in wholesale and capacity release markets; the development of a spot market; and increased competition in transportation markets as a result of the development of hubs.

As a result of these changes, the path analysis required by the 1996 Policy Statement is no longer relevant for all pipelines or all markets. An updated and improved policy would also recognize buyer market power. In today's market, most shippers are sophisticated market players, and many are large customers with multiple pipeline, storage, and supply options.[13] In addition, an updated policy would consider the appropriate HHI screen to be applied to natural gas storage and transportation services, and allow pipelines to obtain market-based rate authority for portions of their systems found to be competitive, rather than require the entire system to be competitive.

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[13] According to a recent Gas Daily survey, the top ten gas marketers each sell over 4 Bcf per day. Gas Daily, Sept. 14, 2005, at 7.

A final important step toward light-handed regulation would be for the Commission to eliminate the requirement that rates established under Section 311 of the National Gas Policy Act of 1978 be revisited every three years. The Commission is prohibited from imposing a similar triennial rate requirement on interstate pipelines under Section 4 of the NGA,[14] and in recent years has changed its policy to remove the requirement that Hinshaw pipelines file a triennial rate review.[15] The lingering triennial rate requirement for intrastate pipelines discourages the full development of the nationwide pipeline grid envisioned by the NGPA. Furthermore, its continuing utility in protecting consumers has been questioned repeatedly.[16]

CONCLUSION

The Commission has helped to develop infrastructure by establishing efficient procedures for obtaining certificates. The industry has responded by investing almost $20 billion in new pipeline infrastructure over the last decade. There is, however, more that must be done by both the industry and FERC.

INGAA has made five recommendations concerning how the Commission can help in meeting the infrastructure challenges faced by our nation.

- Encouraging Long-Term, Firm Contracts

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[14] Public Serv. Comm'n of New York v. FERC, 866 F.2d 487 (D.C. Cir. 1989).

[15] Consumers Energy Co., 94 FERC ¶ 61,287 (2001).

[16] See, e.g., Green Canyon Pipe Line Company, L.P., 98 FERC ¶ 61,041, at p. 61,123 (Brownell dissenting); The Union Light, Heat and Power Co., 101 FERC ¶ 61,288, at p.62,162 (Brownell dissenting).

- Expediting Post-Certificate Activities by Other Agencies
- Increasing Pricing Flexibility
- Adopting a Broader View of the Benefits of New Facilities
- Making a Recommitment to Light-Handed Regulation

These are important and achievable steps in fulfilling the nation's need for gas infrastructure. INGAA looks forward to working with the Commission to determine how best to move forward.