BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

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IN THE MATTER OF: :

CAPITAL AVAILABILITY FOR : Docket No. AD03-3-000

ENERGY MARKETS :

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Commission Meeting Room

Federal Energy Regulatory

Commission

888 First Street, N.E.

Washington, D.C.

Thursday, January 16, 2003

The above-entitled matter came on for a meeting, pursuant to notice, at 9:30 a.m.

PRESIDING: CHAIRMAN PAT WOOD

PRESENT: Commissioners Brownell and Massey

Commissioner David Svanda from Michigan; Dennis O'Keefe.

Panel I - Capital Investors:

Richard Kaufman, First Vice President & Manager, Credit Lyonnais

Doug Kimmelman, Managing Director, Goldman Sachs

Kit Konolige, Managing Director, Morgan Stanley

Donald Peterson, Senior Vice President, GE Structured Fiance

Kara Silva, Vice President, MBIA Insurance Corp.

Evan Silverstein, President, SILCAP, LLC

Joachim Schnabel, Managing Director, Teachers Insurance & Annuity

Panel II - Market Analysts:

Carol Coale, Senior Vice President & Senior Natural Gas Analyst, Prudential Securities

John Diaz, Managing Director, Moody's Investors Service

Steve Fleishman, Managing Director, Merrill Lynch

Richard Hunter, Managing Director, Global Power Ratings, Fitch Ratings

Suzanne Smith, Director Corporate & Government Ratings, Standard & Poor's

Christine Tezak, Electricity Analyst, Schwab Capital Markets WRG

Jone-Lin Wang, Director of North American Power, Cambridge Energy Research Associates

PANEL III - Market Participants:

Larry Downes, Chairman & CEO, New Jersey Natural Gas, Representative, American Gas Association (AGA)

James Fuller, Senior Vice President & CFO, Municipal Electric Authority of Georgia, Representative, American Public Power Association (APPA)

Michael Gorman, Principal, Brubaker & Associates, Inc., Representative, Electricity Consumers Resource Council (ELCON)

Kathryn Houtsma, Vice President & Controller, ComEd, a subsidiary of Exelon Corporation

Robert Kelly, Chief Financial Officer, Calpine Corporation

Urban F. O'Brien, III, Director Governmental & Regulatory Affairs, Apache Corporation

Keith Rattie, President & CEO, Questar Corporation, Representative, Interstate Natural Gas Association of America (INGAA)

William Transier, Executive Vice President & Chief Financial Officer, Ocean Energy, Chairman, Natural Gas Supply Association (NGSA)

Panel IV - Regulatory & Private Agencies/Organizations:

Neel Foster, Member, Financial Accounting Standards Board

Rick Matton, Senior Economist, Federal Reserve Bank of Chicago

Mike Smith, Executive Director, Committee of Chief Risk Officers

Blaine D. Stockton, Assistant Administrator - Electric Program, Rural Utilities Service, U.S. Department of Agriculture

P R O C E E D I N G S

(9:38 a.m.)

CHAIRMAN WOOD: Good morning. This open hearing of the Federal Energy Regulatory Commission will come to order to consider the matter in Docket AD03-3, Capital Availability of Energy Markets, which was posted for this time and place.

Before we begin, however, please join us in the Pledge to the Flag.

(Pledge of Allegiance recited.)

CHAIRMAN WOOD: Good morning. I'd like to welcome you all, the panelists and members of the audience, and in the spillover room, as well, to our Technical Conference for today on Capital Availability for Energy Markets.

One of the three prongs of the Commission's strategic plan is enacting policies to ensure adequate energy infrastructure in this country, and certainly the events of the recent past with regard to restrictions on capital availability in those markets, can and does have an impact on the sufficiency of energy infrastructure, not only in the present, but, more importantly, in the future, which we look toward.

A key part of our market oversight is understanding the underlying activities and underlying issues that underpin our three critical goals, which, again, are sufficient infrastructure, balanced market rules, and vigilant oversight of the nation's energy markets.

So I appreciate the wonderful, diverse set of panelists that we have, not only on this panel, but for the four panels for the day. Do my colleagues have anything to add?

(No response.)

CHAIRMAN WOOD: I would like to add that we have an additional colleague today representing the state commissioners, the President of the National Association of Regulatory Utility Commissioners, Commissioner David Svanda from Michigan. We're pleased, David, as always, to have you here with our panel.

I'd like to invite any of my colleagues to add anything. David?

MR. SVANDA: I would just respond that I very much appreciate the opportunity to be here with you. There isn't a more important undertaking or subject than this, and it is high on the list of priorities that NARUC has established for itself in the course of the next year, and certainly high on the list of priorities for the State of Michigan, as we move forward as a state, too.

So, thank you. I very much look forward to the opportunity to learn great lessons today. Thanks.

CHAIRMAN WOOD: Mr. Hederman will be our MC for today, so we'll turn it over to the Director of our Office of Market Oversight and Investigations, Bill Hederman.

MR. HEDERMAN: Thank you, Mr. Chairman. I'll just take a moment to than our panelists for coming today and give you a sense of how we will proceed.

As you can tell, the panels are large. We've found our technical conferences to be an excellent way to help educate both ourselves and the rest of the industry, and we expect a lot of insight today.

What I will do is ask each of you to introduce yourself, as I call on you. You've got five minutes for your presentation. There's a clock here in front of you. We'll give you a visual clue as we're coming to the end, and because of the size of the panels and the day, I will have to be rude at some point, if someone's running over, so please accept my apologies up front.

We also, Mr. Chairman, have Congressional Staff and sister agency staff here with us today, observing, and I want to thank then for their interest.

The last point I'd make is, please switch your mike on as you're speaking. There's a switch there, and just go on and off as you are speaking. And if we could start the first panel then, we have a group of investors of capital who we would like to help provide insight to us on how decisions are made about how to invest capital, what's their thinking and opinions on investing capital in the energy industry today, and what can we as a Commission be doing to make this work better for the infrastructure investment needs that our jurisdictional industries have?

Mr. Kimmelman, could you please start our conversation?

MR. KIMMELMAN: Sure, thank you very much. It's a pleasure to be here today. I'm Doug Kimmelman, with Goldman Sachs. We are an investment banking house involved in advising power companies, as well as maintaining an active energy marketing and trading business, as well as an investor in power generating facilities.

It's my belief that we remain in the midst of an extreme crisis in our energy markets, and I define that crisis in a host of ways: I think, first of all, we have a crisis in investor confidence. I believe we have a crisis of a lack of viable market participants.

I believe we have a crisis of capital availability, a crisis of adequately maintaining our existing fleet of generation in this country, and, lastly, a crisis in terms of lack of clarity of market rules and regulations.

I think we certainly need to do all we can to avoid another, if not worse, supply crisis in this country, and we need to create the framework for an effective competitive marketplace.

There are three quick solutions I'd like to touch on, and I think they lie in, number one, time, time to mend the weakened balance sheets of many of the industry participants, time to convince investors that market participants can behave in a responsible manner.

Secondly, quick resolution to the cloud of investigations, refund claims, and contract uncertainties; and, third, institute market rules and design that give clarity, transparency and structure to allow market participants to get involved, take risks, and create liquid and effective markets.

Separately, I would like to touch quickly and make the connection to recent economic stimulus proposals to eliminate the double taxation of dividends. Just a quick point that I think that this, additionally, could be a real catalyst to return capital to power companies that can pay dividends, which would be much more valuable to investors under these proposals, and I would urge the industry to get behind these proposals.

In summation, competitive markets need creditworthy participants. We now have few of them.

Capital has other places to go. Billions have been lost investing in power companies. Adequate capital will not come back on its own, without major action within market participants and within the markets that we all hope to participate in. Thank you very much.

MR. HEDERMAN: Thank you. Mr. Konolige, could you please share you remarks with us?

MR. KONOLIGE: Good morning. Thank you for having me. I'm Kit Konolige, and I'm a Managing Director at Morgan Stanley in the Equity Research Department.

Morgan Stanley invests in the energy markets itself. We have stock investments that are affected by energy markets, and on my side of the house, we analyze and advise investors on energy markets, so clearly we have many connections and issues that we focus on in the area.

Let me break this into a couple of brief areas, in answer to some of the questions that were presented to us:

First of all, problems of capital investment in the markets, from an equity investor's viewpoint, it's a fairly straightforward situation. There are low or sometimes no or even negative returns and relatively high risk, and this is a bad, very bad combination for those who are thinking of investing.

I would characterize some of the factors here as beyond the immediate control of regulators or policymakers. For example, I think we clearly have an overbuild of power plants in the U.S. relative to current demand. Time and the economy as a whole will have to take care of that.

I think that the volatility in the trading markets and the impact on the capital markets was something that, while accentuated by situations like the California issues, shall we say, I think the volatility surprised everybody and made the issue of investing in energy markets more complex.

But then, finally, I'd emphasize something that I think policymakers can do something about, and that's the kind of legal and regulatory uncertainty that overhangs the industry.

Before I get into what those are, let me just point out that, in my view, the effects of these factors on attractiveness of investment in energy, it's quite low, clearly. In fact, if anything, we see what we call disinvestment.

The stockholders of many of these companies favor companies who are exiting businesses such as energy trading, who are selling power plants. And here we'd want to distinguish between the more strictly state-regulated, traditional utilities, on the one hand, versus the more competitive markets.

And from a stockholder's viewpoint, as of today, the perception is that an exposure to the unregulated side of the electricity and gas markets is a much more difficult place to be and a harder place to make money, and a harder place to get reasonable returns for what's perceived to be high risk.

Let me address one of your questions as to barriers. Certainly the Holding Company Act seems to me to be fighting a war that was more or less over 70 years ago, and there are people on record indicating they'd invest more if that didn't exist. Why you need to prevent somebody from owning two or three small utilities that are next to each other seems peculiar to me.

I think this industry certainly suffers from overlapping and sometimes conflicting federal and state jurisdictions. That is something that investors talk to me a lot about.

We do have complex and difficult environmental issues to deal with. I don't know if those are ever going to get clarified enough. They may be a permanent condition of any capital-intensive, large-scale industry.

Finally, let me address some items that I think that policymakers and, perhaps, FERC, in particular, can address. I think, broadly, I would say that speed and consistency in applying rules are critical.

For example, it seems to me that years into the open markets era, we still have no real definition of just and reasonable. It's very difficult for people to invest, not knowing whether what they are doing is just and reasonable, and that's the critical issue.

More specifically, the hearings on Western contracts, I think, have dragged out at great length. The subissues that get raised there are important ones to people, and I would say wrapping those up more quickly is certainly a key.

So, I'll leave it there, with my time having run down.

MR. HEDERMAN: Let me ask you a quick question: In terms of overbuilding, overbuilding on the power plants, underbuilding on the transmission that might help that power plant have more value, do you have any observations about the transmission side?

MR. KONOLIGE: Yes, I do. I think that the transmission grid certainly appears to me to be a straightforward way to improve the efficiency of the delivery of electricity, in general, and to -- I don't know that it would immediately have a great impact on an overbuild of capacity, but certainly if there were an ability to invest in transmission and generation, with the same level of difficulty from a government perspective -- and I would say now it's much easier to build power plants in some areas than to build transmission -- then capital would go to where it was most efficiently used.

We certainly, I think, perceive many areas where transmission would be a much better investment, where we have pockets of higher-cost and lower cost overbuild and underbuild, not too far apart, and some greater transmission connection would be the logical way to make that entire market more efficient and produce -- more efficiently use the capital that's available.

So, I do perceive that I think principally environmental and local opposition to building new transmission lines hurts the grid as a whole and the efficiency of the electricity market as a whole.

MR. HEDERMAN: Thank you.

MR. SVANDA: As long as we've interrupted, if I could have a couple of followon comments, that same issue -- you did make the broad statement that there is too much generation today, and that might be true overall.

However, there are pockets where there isn't enough generation today. How can we get to the point of having investors differentiate between the broad statement that maybe the country has too much generation right now, but the reality that in certain places in this country and in certain regions of this country, there is not too much generation and we, in fact, need investment.

I guess it also is consistent with the question of transmission. There are places where we don't have enough investment today in transmission.

MR. KONOLIGE: With respect to investors and the adequacy or excess or inadequacy of either transmission or generation, you know, I know very well from many talks with investors, that they aware of areas of shortage, of overbuild.

We have many -- a good number of deep-pocketed investors who are interested in the area, and the principal issue, the reason that there are areas of shortage and areas of overbuild are principally that it has been easier to build in one area than another.

And I think the reason for that typically is pretty straightforward. Some states, in particular, make it very difficult to build a power plant, for example, and other states make it relatively easy to build a power plant.

So, you know, all other things being equal, at a point where there is a shortage in both of those states, you will see a build in the easier-to-build state.

I think some states probably have policies that just make it too difficult, period, and the policies include things like public denunciation of people who own power plants in their states, without naming any states.

And this puts, naturally -- you know, when a group of investors gets together and goes to their board to decide, do we want to build a power plant in this state, somebody tends to raise the issue of whether they want us there. And if they don't want us there, what kind of regulatory policies can they impose on us that will make the return of our capital and the return on our capital difficult.

And, of course, investors also look back at the last few years, and try to determine where has it been easier to have a reasonable chance at a reasonable return, assuming that the investors have correctly predicted the market and not that there has been a disruption by a change in policy. And that is, I think --

I think it's, again, the consistent messages; it's the changes in policy and the lack of definition of policy that make it difficult. There can be people who will build in states that have, for example, very strict environmental laws and have less strict environmental laws.

One is more expensive to build and one is cheaper to build in. As long as the returns on the investment have a reasonable probability of being adequate, that is, that the laws of the capital returns -- that affect capital returns, then are dealt with straightforwardly, evenhandedly, transparently, you will find people who will invest more in the expectation of reasonable return on that greater investment.

MR. HEDERMAN: Okay, Mr. Kaufman, could you give us your remarks?

MR. KAUFMAN: Yes. I work for Credit Lyonnaise, a large European financial institution involved in both commercial and investment banking activities.

We are a significant provider of capital to the energy industry, and, in particular, the power industry. The bank's exposure certainly exceeds $5 billion and, again, a considerable portion of that is in the power sector.

The past two years have represented a watershed period for the power industry. The Enron debacle, combined with the accounting irregularities, the implosion of the merchant model, the unrelenting headline risk, the constant barrage of ratings downgrades, and the continuation of litigation and allegations in California have resulted in unprecedented market disruption and turmoil.

In light of the market turbulence, financial institutions, including my institution, have come under significant pressure from shareholders and senior management teams to reduce, not increase, exposures to this industry segment, both on the merchant as well as on the non-merchant side.

With limited near-term relief for the merchant exposure, financial institutions are being forced to reduce their exposure levels with stronger names in their portfolios, regardless of credit quality.

The primary factors for this downsizing pressure is summarized as follows: One, the rating agencies have aggressively lowered the credit profiles of most companies involved in the merchant model to below investment grade, in large measure, a reaction to Enron's implosion.

The ratings of certain regulated utilities have likewise come under pressure, especially those with involvement in the wholesale energy sector.

The unpredictable actions of the rating agencies resulting from the evolving rating system, as their risk criteria were adjusted over time, have caused investor fatigue and substantial liquidity shortfalls.

As a result, banks are significantly overexposed to the power industry, especially into highly-levered, below-investment-grade names. The ratings migration, combined with the move toward risk-adjusted return models that most banks use today, has resulted in poor returns and rates of return for banks on their invested capital.

With the exodus of the commercial paper market, banks are now the key providers of liquidity to an industry starving for liquidity. While the credit default-swap market certainly provides some relief to credit providers, this market is not very liquid, and, in fact, quite inefficient today.

Bad loan provisions, writeoffs, and bankruptcies are certainly bad for bank stock prices. Accounting scandals have deteriorated the confidence level of financial information, the transparency of financial data is in question.

The demise of the merchant model has severely disrupted investor confidence and market liquidity. As a result, merchant players are ill-equipped to manage the nearly $25 to $30 billion of debt to be refinanced over the next two years.

If you drop a frog in a pan of hot water, the frog will immediately react to the heat by jumping out of the pan, but if you carefully place the same frog in a pan of comfortably cold water, then slowly raise the temperature of the water a degree at a time, the frog will accept this change, perhaps without noticing it, and stay in the water until the heat kills it. All we financial institutions are trying to do is stay out of the hot water.

So what's the road to future capital? Well, the merchant model isn't, and shouldn't be dead. Several players are clearly on life support. As previously noted, commercial banks should not be expected to lead the charge for new capital.

Accordingly, meaningful capital will need to be raised in public and private markets to alleviate the currently overburdened bank sector.

On the positive front, recent signs in 2003 would suggest that the bond and equity markets have started to show interest in some of this as stronger players, but with an aversion to merchant.

We expect this to result in a clear decision of have's and have not's for the fight for capital. In keeping with FERC's vision, several things need to happen to attract capital for future infrastructure and for its goal of an open and competitive and vibrant wholesale energy market:

One, regulatory uncertainty must be eliminated. While FERC has moved closer to resolving California's lingering issues, final resolution will be required to alleviate investor fears.

California-type issues must not be allowed to surface again. In this regard, FERC's hands-on oversight will be required to move its agenda forward. Jurisdictional utilities and the various state regulatory agencies and bodies will need to work closely with FERC to resolve their differences over the recently-issued NOPR regarding standard market design.

The rating agencies must be willing to recognize improvements in corporate credit profiles, just as rapidly as they have on the way down.

The return of long-term contracts between power producers and end users will be needed to stabilize the earnings and cash flow profiles of the merchant producers. New infrastructure will require long-term contracts to attract financing.

The era of the mini-perm is essentially over.

SEC and FERC investigations need to be concluded, new rules clearly laid out for all wholesale players.

Accounting guidelines need to be clearly laid out and understood by all market participants. And the model for energy marketing and trading must be encouraged to promote a more liquid environment for buyers and sellers of gas and power in the wholesale energy market.

The energy sector is clearly the most capital-intensive industry in North America. While the power sector, and, particularly, the merchant component appear to be in an overbuild situation today, capital will be required to build new infrastructure from pipelines to generation to power transmission lines in the future, especially in light of the U.S. economy rebounding.

These long-term investment requirements will require near-term actions by the various governmental agencies regulating the power industry.

Capital can and will come back to this industry, assuming that a solid and workable regulatory framework is established and financial discipline of the various players is adhered to. Thank you.

MR. HEDERMAN: Thank you. We'll expect your recipe for frog soup in the record.

(Laughter.)

MR. HEDERMAN: Ms. Silva, could you give us you remarks?

MS. SILVA: Thank you, and good morning. I'm Kara Silva, Vice President of MBIA Insurance Corporation and the Global Utilities Sector Manager.

MBIA is the premiere financial guarantee insurance company in the world. We are a AAA-rated monoline financial guarantee insurance company, regulated primarily by the New York State Insurance Department.

As opposed to multiline insurance companies, monoline financial guarantee insurance companies engage in only one line of insurance, financial guarantee insurance.

Our AAA ratings from Moody's, Standard and Poor's and Fitch, enable us to offer qualified issuers, the ability to borrow money in the public markets, at the lowest possible interest rate.

Once these debt obligations are sold, MBIA guarantees, unconditionally and irrevocably, the timely payment of principal and interest to bondholders. We effectively step into the shoes of the bondholders and represent their interests in the capital markets.

I am responsible for managing MBIA's global utility portfolio, which consists of over 1300 issuers worldwide, and which has a total par value of over $63 billion.

My primary responsibilities include monitoring this portfolio to identify and mitigate credit decline of financially troubled obligors. Because MBIA tracks the performance of utilities so closely, we are often among the first to see problems within this sector.

The domestic electric investor-owned utility sector has undergone profound changes in recent years. Many IOUs are experiencing financial distress because of aggressive expansion sanctioned by recent deregulation.

The regulatory safety net has not performed as expected, and the electric IOU sector has experienced several shocks, due to ill-conceived restructuring plans and instances of corporate malfeasance.

As a result, the risk profile of the electric IOU sector has changed significantly. What were formerly safe utility credits are now performing like corporate credits in other sectors. In order to understand the effects of this change on the ability of IOUs to access the capital markets, it's important to focus on the legislative, corporate, regulatory, business, and financial risk points. In each of these areas, exposure to risk has been heightened.

From a legislative standpoint, the sector faces risk as states enact inconsistent legislation and utility customers that are most at risk have open access to choose alternative providers.

The ability to recover stranded costs in the sale of generating assets, all increase risk exposure as restructuring occurs.

On the corporate side, we carefully monitor mergers and acquisitions, particularly as utilities expand into deregulated or international lines of business.

We have seen an unusual high number of distressed parent companies, as well as heavy litigation and governmental investigations into corporate activities.

Regulatory risk at the state level comes from rate caps, combined with the inability to pass through costs, as well as from differences in state regulatory decisionmaking.

On the federal level, regulatory uncertainty comes from the possible repeal of the Public Utility Holding Company Act and the potential elimination of the Commission's merger authority.

Finally, the sector faces business risks from capacity issues, a core business highly impacted by weather and the economy, and a high cost structure with impending competition, not to mention fuel supply and environmental costs.

These factors combine to create a significant financial risk in this sector. Poor non-utility investment decisions have led to weak balance sheets. Weak balance sheets have led to liquidity problems and downgrades by the rating agencies.

Downgrades have led to collateral calls and other rating-related triggers that accelerate the liquidity problem. Furthermore, overbuilt capacity reduces the value and planned asset sales meant to reduce debt and improve liquidity.

Weak balance sheets, poor liquidity, and uncertainty of restructuring plans have made access to the capital markets very difficult and very expensive.

For the utility industry, the Commission stands as the guardian at the gate, and MBIA urges the Commission to exercise its full authority towards the beginning of a solution. By convening this conference, the Commission has chosen a time-honored and constructive path.

We urge the Commission to consider its authority over issuances and sales of securities under Section 204 of the Federal Power Act, which can restrain corporate financings that are harmful to the utility.

MBIA recommends that the Commission focus on debt issuances and engage in a rigorous evaluation of how the debt will be used to finance core regulated utility operations or to finance riskier, non-core investments.

To quote a recent Wall Street Journal article, "Utilities are being nudged to buy assets from affiliates, make loans to down-at-the-heels siblings, or pass more money to their parent companies."

I can attest to the fact that these financial activities are taking a toll on the regulated IOU sector. By taking a stronger role in investigating issuances when utility assets are used to collateralize non-core investments, the Commission can use its mandate to protect against shifts in capital that ultimately harm utilities, investors, and ratepayers. Thank you.

MR. HEDERMAN: Thank you. I have a quick question related to your last point. The issue around debt issuances and the regulated versus nonregulated side, do you see the greatest danger in terms of using the assets of the regulated side, or is it the shift of actual cash, or is it liens against the assets that is the greater danger?

MS. SILVA: I think all three things, you know, certainly are a danger to the structure, because when the debt is issued, it's not clear to me and it's not clear to other participants, where that money will be used.

Certainly there has been debt issued at the regulated utility level. If those assets are not pledged as collateral on other financings and that dilutes the existing holders of that debt, I would rank them together.

MR. HEDERMAN: Okay, thank you. Mr. Peterson, could you share you remarks with us?

MR. PETERSON: Good morning, I'm Don Peterson from GE Structured Finance, a unit of General Electric. We have been a significant capital provider to the energy industry for over 30 years.

We make investments into all financing structures, from senior secured debt to common equity. In the past two years alone, we have funded and retained $4.6 billion of investment in the industry, and we currently have an energy-related portfolio of $9 billion, so you can see that we are serious about our commitment to this industry.

Provided we find the risk-reward environment suitable, we have the capacity and appetite to continue investing substantial funds in the industry.

Our energy investing activities began with lease financing for investor-owned utilities and cooperatives in the 1970s. The 1978 PURPA legislation creating the independent producer power industry provided the impetus for us to invest significant amounts of capital.

From the beginning, investments in this industry have been attractive, in part due to a stable regulatory framework, a point I will amplify in a moment.

Over the years, we have provided either all of a portion of the capital for hundreds of transactions to the industry. While our bread and butter has been the financing of domestic and international independent power generation projects, we also finance related assets such as transmission lines, gas-gathering systems, pipelines, storage facilities, refineries, mining equipment and reserves of gas, oil, and coal.

Let's return to my point about the necessity for a reliable regulatory framework. Whether these investments are underwritten as projects, based on the cash generation ability of a single facility, or as credits supported by the balance sheet of a creditworthy entity, each investment relies on a consistent regulatory framework as a key component of that underwriting decision.

There is no margin in financing these assets. Each facility must be able to generate sufficient cash to pay operating expenses, debt service, and, hopefully, a profit to its owners. The source and certainty of that revenue stream is a key element of our underwriting.

There are two fundamental points that energy investors such as GESF ask regulators and legislators to keep in mind as they consider changes to the industry: The first is sanctity of contracts.

The large capital costs and long life of generation assets require long-term financing. That's why lease and debt terms at 20 to 30 years is common in the industry. In order to have capital providers continue to offer long-term financing, it is critical that regulations upon which investment decisions are made, remain in force for the life of the financing.

For example, if capital recovery is based on a 30-year power purchase agreement, FERC and state regulatory bodies must allow those contracts to remain in place for their full term.

Changes to the regulatory framework that would prevent either party from performing its contractual obligations, must allow those arrangements to be grandfathered, so that each party can retain the benefit of its bargain.

Additional financial burdens must not be imposed without establishing some mechanism for compensating the party whose economics have been impaired.

To cite one example, projects financed based upon contracts for firm transmission at set rates, should be exempt from incurring congestion costs as a consequence of implementing the standard market design.

The language of the SMD Notice of Proposed Rulemaking and statements made by the Commission, would indicate that the Commission agrees with this; nevertheless, the recent Commission decision seems to suggest otherwise.

The uncertainty that results from conflicting messages about respect for existing contracts, can only discourage financial commitments to this sector.

My second fundamental point, which may be more properly aimed at state regulators and legislatures, is to carefully consider what effect proposed changes have on the credit rating of entities standing behind contractual or repayment obligations.

For example, deregulation legislation and its related rulings should not bankrupt counterparties that are an integral part of our project financings. Contract sanctity with a bankrupt entity is of little comfort to us.

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Our investment decisions weigh heavily on the reasonable certainty that purchases of generation and transmission capacity will have the long-term viability and thus the ability to honor those agreements.

In summary, our message is simple: Large amounts of capital are needed to finance the U.S. energy industry to make available, adequate generation and well functioning markets for all of us. Capital providers need the assurance of a stable, consistent regulatory environment and protection from regulatory change for existing investments made in good faith.

Without this certainty, our appetite for investment in energy will be significantly reduced and likely restricted to refinancing existing projects with contracted cash flows in regions that do provide a consistent regulatory environment.

Furthermore, those investments will be for far shorter terms at higher rates. Any such restriction of capital, we believe, is detrimental to the energy industry and ultimately to the consumer. Thank you for the opportunity to share our views.

COMMISSIONER MASSEY: Mr. Peterson, let me ask you a question. Did you see the gas and electric industries as separate in terms of your investment decisions, or do you see them both subject to the same risks right now?

MR. PETERSON: I would say that we view them differently, although we view them differently, although our underwriting criteria for financing still is based on our ability analyze the expected cash flow from any investments that we make.

So whether it's a contract where you analyze the ability of that contracting party's ability to maintain the decent credit rating and honor its contracts, or a project that ultimately has contracts backing it, is that the analysis is the same.

Now, obviously we have a different set of criteria for looking at gas transmission types of regulatory environments, and from those of the electric generation that we participate in.

COMMISSIONER MASSEY: Do you see gas investments as more attractive than electric or it just depends on --

it's a case-by-case basis.

MR. PETERSON: Most of our investment decisions are made after a thorough analysis of what we perceive to be the risks, and analyzing the risk return ratios that we see, and clearly, the more senior part of the balance sheet you invest to, you expect to have fewer risks and less of a return.

I would say that we're looking for good investments in both areas.

MR. SVANDA: If I might, Commissioner Massey's question is an excellent one. Could you take it one step further? Is there any differentiation between electric transmission or electric generation?

MR. PETERSON: Yes. Most of our experience has been with electric generation, and we have, generally speaking, relied on the existing transmission system to move the power from our plants to the power buyer's location.

We have recently made some investments in the transmission industry as it has started to be open for investment. Certainly our experience is that we have a long history of understanding the generation side, and we're trying to see if we can develop the same model for financing transmission.

CHAIRMAN WOOD: Mr. Peterson, you alluded on your second point about congestion costs being overlaid on top of an existing contract.

There was an allusion to a Commission decision or action contrary to the desired outcome. Do you happen to recall the context of that decision?

MR. PETERSON: Yes, sir. Since it's in the process of a rulemaking, I don't want to violate any ex parte rules, but it is the December decision on the NEPOOL, some of the NEPOOL issues that affect us.

CHAIRMAN WOOD: Okay.

MR. HEDERMAN: Okay, thank you. Mr. Schnabel, could you please give us your remarks?

MR. SCHNABEL: Thank you for the opportunity to do this. My name is Joachim Schnabel, I'm a Managing Director for TIAA-CREF investment management, and my job there is to advise CREF on the issues of resources. I spend about two-thirds of my time on energy and about half of that time on utilities.

The good news is that in the U.S., capital for infrastructure is generally available. In fact, my research has shown that there is usually more capital available than necessary, but more than half the capital invested fails to generate the expected return. That's the mathematical construct.

In utilities, you've seen a recent cycle of such where there has been a mass of overcapitalization of the generation business. So the question then comes, well, since it comes in cycles, obviously how can you steer and dampen the cycle, should you want to do that?

The cycles cannot and should not be repealed, because capital markets are very efficient at removing failure and it's the cycles that do so.

But how do you affect the cycle to attract capital into an area that you want? There are two things:

Potential returns must rise through appropriate incentives, and, of course, risks must be mitigated by the amelioration of the barriers to these returns.

First, on the incentives: There has to be an opportunity for differential rates. In the utility industry, the most exciting thing there is the incentive-based ratemaking, so that someone who does things right, can, in fact, earn a superior return, and that that return is not taken away.

The innovative and efficient must be rewarded. Another thing that has to be done, I think, is that ratemaking should favor marginal returns on capital. Now, I know that this is controversial to some of my people on this panel, but this is the way that failure is removed and efficiencies rewarded.

If you have ratemaking on average return basis, you only protect the old technology. I know this is very difficult to steer the medium ground on that, but I would favor, clearly, a marginal return ratemaking.

And the rules also must be clear, so that the companies in which we invest can tell us, can articulate a clear return on capital policy that can be translated into bond ratings and into dividend policies, which are the two critical issues that we use to value any kind of mathematical valuation formula.

Going to the barriers, one of the biggest barriers, the thing that accelerates the cycles currently and really repels, to some extent, investment at the bottom of the cycle, is the tax policy that favors debt. I know that there are proposals within the Bush Administration to somewhat ameliorate that, but basically this aggravates the cycles, it raises the risks, it raises the cost of capital in the long run, even though in any short run, it would seem like debt would be the lower cost of capital, but, because of the risk premium over time, that is not true.

I would say that one should set regulatory returns to get the AA ratings that seem expensive in the short run, but over the long run, that will take away the risk premium. You need to also enhance a corporate governance that is consistent with an AA rating.

And the two things there are, one, that somewhere over the last 30 years of my career, the independence of accountants was lost. Now the auditors and the accountants are the same, which I find a conflict of interest that somehow crept in there that is very irrational.

And also, I objected in the late '80s when corporations gave directors the -- the made directors whole for malfeasance, and I said at the time that this would make directors fall asleep, and in the case of Enron and others, we see that was exactly the case, that directors now have no incentive to direct the companies.

I don't know how you solve that, but that's where we are.

Obviously, we could use a clear energy policy. Energy policy lacks rationality and predictability, especially in the environmental area, and we also need more public information on things like, for example, like transmission, which you're all greatly involved in now, and that is probably the single best way to solve our energy problem.

If you eliminate line losses by bringing the transmission system to the current state of the art, you could save more BTUs in the economy than we import in energy. So, this is tremendously important, and yet on the state level debate, I never see that issue raised.

There are some other irrational issues, but my time has run out.

MR. HEDERMAN: Thank you very much. Evan Silverstein, President and Head Portfolio Manager of SILCAP, LLC.

MR. SILVERSTEIN: Commissioners, thank you so much for the opportunity to speak on the status of the energy markets. I've been involved in the analysis in the investment utility sector for more than 27 years. In my role, I have spent years assessing the status and trends of our industry, on both the macro and micro economic framework in assessing the fundamental condition and the risks and returns associated with the companies.

Spending my whole professional career associated with this industry, I view myself as an expert, a student of the industry, and feel some sense of emotional attachment. And it's from this platform that I wish to address you today.

Over the past 27 years, I have experienced various periods of severe dislocation. The energy and inflation shocks of the 1970s and the nuclear fallout of the 1980s are two of the most severe that come to mind.

There is no question that today's condition of the industry equals or exceeds the location uncertainty of those times. The conditions that have brought us here are well known.

The failed experiment with deregulation in

California, the questionable behavior of marketing participants, the significant failure of many companies, overbuilding, and a weakening economic environment, have brought us to a level of uncertainty and have developed a credibility crisis that has effectively shut down reasonably-costed capital to segments of the industry, and helped promoted a liquidity crisis.

The pullback in lending from the banks because of the overexposure to the merchant industry, and the tremendous risk aversion on the part of investors, has made capital availability way too tight and costly.

While I cannot condone unethical or illegal behavior, we should not be totally surprised by the condition we find ourselves in today. The existence of cheap and easily-available capital in the late 1990s and the presence of human trade of greed, propelled us into a period of undisciplined capital investment, the underuse of leverage, and significant overcapacity.

It's these conditions, along with the problems specific to the industry structure that has brought us to where we are today. So what do we do now?

To be sure, I firmly believe that over time, capital will return to the industry. As a matter of fact, we are starting to see non-traditional sources of capital showing up already, although it's costly and difficult.

Nevertheless, we have to ensure that, over time, the capital can be raised on reasonable terms for the development of an industry and its market structure. At this point, I would say that the major hurdle that needs to be overcome in order to achieve this goal is uncertainty.

We need to resolve the issues of the past, and provide significantly more certainty about where we are headed for the future. There is no environment where capital is more costly than one that is dominated by a high degree of emotion and uncertainty.

We need to get clarity on the market structure and the rules and regulations that will govern it in order to achieve our objectives. I emphasize that I believe, even today, a company or entity that is unencumbered by merchant or trading exposure can raise capital on reasonable terms for infrastructure development in transmission and distribution.

However, we do need regulatory models that provide incentives and opportunities for those entities to earn reasonable rates of return. I applaud FERC's efforts to provide incentives on the transmission side.

Earning a good profit on an investment should be accepted, as long as the broader goals of dependable, affordable energy are met. I share FERC's view that a competitive market is the preferred structure, and we should not let the events in California deter us from recognizing that competitive markets are functioning in other areas of the country.

Frankly, the lessons learned from the past few years should be applied to ensure a better and more workable structure in the future. It's my view that to ensure we have credible and acceptable structure, transmission needs to be independently operated and functioning in the manner to support deregulated markets.

And we need the markets to be properly monitored to track and detect unacceptable behavior as it pertains to pre-prescribed rules. We cannot limit our judgment of whether the structure is working, to whether prices are low or high. Prices need to be reasonable, provide the proper signals, and allow for reasonable returns on investment.

In my view, the job of any model is to achieve the most efficient, not necessarily the lowest price of the product. We need to allow for the application of ingenuity and creativity that comes along with deregulation to help solve our energy needs.

Commissioners, I don't envy your task. Bringing certainty to this industry at a time when political reaction is problematic, states are being protective, our energy policy is in disarray, and our environmental policies uncertain, is quite daunting. Nevertheless, if we can get everybody to put their selfish self interests aside and recognize the importance of the task at hand, it can be done.

I am confident and optimistic. Thank you.

CHAIRMAN WOOD: So that's why we put you last.

(Laughter.)

CHAIRMAN WOOD: I'm confident and optimistic, too, but I want to make sure we're confident and optimistic about solutions we can achieve in the near future, and not be thinking in 2010, gosh, if we had just done that, so I appreciate the diversity -- frankly, more than I expected, frankly -- and the depth of the thoughts expressed. Obviously there's time to allow us to chat some more.

I had a question, Doug, from your first slide, and you left it -- you concluded your remarks -- but it kind of implied -- and I have heard -- and we certainly appreciate the thoughts about what we can do, but I am curious to think, from -- or to hear from all of you, any kind of shopping list of things that need to happen by other folks in the industry as well, to bring the cost of capital down and bring it back to the investment in the various sectors that comprise the energy industry. So what is it that the outside world thinks what sort of actions are needed for people, for market participants to take, other than behave? What more?

MR. KIMMELMAN: I had made a comment as well in terms of mending the weakened balance sheets, and to some extent, maybe capital is self-correcting here.

But the industry cannot just rely on regulatory change and structure to bring them out of their crisis of liquidity. And it does go beyond just ethical, appropriate behavior in the trading markets and the like.

I think they, you know, certainly share some of the burden, and I think Evan made the comment in terms of the kind of incredible leverage that was put on this industry in almost a reckless way in the past five years, that the financial models that were built by many of these companies absolutely bore no connection to the business risk that is just the nature of any type of commodity business.

And I think market participants need to realize that they've got to take financial risk out of their companies, and it's going to take time. It may mean that they have to sell some assets that they otherwise would like to hold on to. It may mean that they may need to more aggressively trim their overhead and expense structures.

It may mean that they may have to go out and raise what might seem, in the short term, expensive equity capital or outside equity investment in the company to clean up the balance sheets so that they are a viable competitor. Because if they don't, I think no matter what structural changes are put in the marketplace, we are going to see a significant number of bankruptcies and important market participants exist from the market and market participants that are just not going to be able to have the capital to maintain the fleet that they have, which I think is another consideration that we all need to think about.

It's not just building for the future, but it's spending the maintenance capital on the existing infrastructure so that it is a reliable system. And I think we all ought share concerns that so many of the participants have no access to capital, that they may not survive, and that the power plants that they are running may not survive.

CHAIRMAN WOOD: I think Evan might have ended up with this, but the sources of capital coming from non-traditional spots, what are those?

MR. SILVERSTEIN: Well, there are a lot of funds around that have been supplying very costly capital to a lot of the distressed companies. You know, effectively, the way I see it, the banks have been pulling back because of their overexposure, but there is some capital out there that's filling in those places.

CHAIRMAN WOOD: At what price? I mean, what kind of ranges are we talking about?

MR. SILVERSTEIN: We're talking about doubledigit rates. This not capital to build infrastructure over the long run; this is capital to --

CHAIRMAN WOOD: Plug the dike.

MR. SILVERSTEIN: -- take advantage of companies that are under severe duress, and nobody wants to take the risk. I mean, that's not the kind of capital we're seeking.

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With Doug's view, I mean, I think the industry, on its own, is going to re-liquify over time. I'm not sure a lot of the players that have been damaged to this point are going to be the ones we're going to see on the other side, running those generating plants.

I think they have to move hands. And one of the things that I think is missing from this industry is the ability to rationally move the assets into the right hands and have the consolidation and other phase that goes along with a financially distressed industry.

That's one of the quickest ways to move this -- to get stronger players to participate in the next wave of building that will come.

But I think that's going to take time. I mean --

CHAIRMAN WOOD: What are the obstacles to those assets getting into --

MR. SILVERSTEIN: They have to go through the bankruptcy proceedings, the creditors, and the various parties fighting about who gets what. Those proceedings have to move along to the point where -- well, to move along to the point where new owners, which could be the creditors, who certainly don't want to operate the plants, but they own them, will then move to put them in the hands of people who can operate them and support them.

MR. KONOLIGE: If I might interject on that point, one of the issues that comes up when we talk to people who might want to invest in the industry is, there are many assets such as transmission lines and older power plants that have a very low cost basis, and the cost of selling these plants would create a very large tax bill.

There might very well be some thought given to some modification of tax policy with respect to these very old, heavily-depreciated assets, but nevertheless retain a lot of economic value that might go towards getting them more efficiently int the hands of people who, for example, might want to put more investment into them, take them out of the hands who would be happy to sell them, who might have other problems and need to strengthen their balance sheets by selling valuable assets.

MR. SILVERSTEIN: If I could just add. It seems to me like the deregulation that occurred in the '90s was premature because we didn't have the transmission structured in a way to support it. I think we put the cart before the horse.

I think there's excess capacity right now that gives us some time, although there's places of pockets that I think we'll find there are solutions. I think we've got to deal with the big picture. We've got to get the structure right, and it starts with our transmission policy and transmission independence and so on, and get that started in the right direction to support the model we want to get to. And I think that's the mistake we made the first time around.

The other thing, as I do believe --

CHAIRMAN WOOD: That mistake in places other than California? Are we paying a consequence for that cart/horse, or was the cart before the horse only in that one state?

MR. SILVERSTEIN: I think California magnified the mistake in my view, by forcing the utilities overnight into the spot market and not allowing for contracting back to protect themselves in that marketplace. So it really put that market into total disarray, and I think maybe those who perceived the model thought there was going to be excess, and that would have driven the prices down that model, but it turned out to be shortfalls and it drove prices up.

I still think that my vision is, when you have generation associated with transmission and you're trying to go to a merchant model, there's a conflict of interest either in substance or perception. And to have the credibility of the structure preserved, you need to have independent transmission and see how that operates.

What we always get is the transmission system was not designed to move power in a competitive market. So we need to see how it works and allow capital to come in and improve it to a point where we can have certainty.

Mr. Hederman before suggested that with transmission, the value of generating plants can go up. Well, the value of some can go down as well, as electrons start moving differently as you improve the transmission system. We need to understand that to get the right signals to build generation in my view.

COMMISSIONER MASSEY: I have a question. I'm intrigued by the fact that Ms. Silva asks the Commission to adopt a stronger Section 204 policy. And Mr. Silverstein is advocating market monitoring. And I like both those messages actually, but I'm surprised to get those from Wall Street.

Four or five years ago, I would guess the message we would have gotten was just get out of the way and let the beauty of the markets work. I like you're message. I'm intrigued by it. You support, it seems to me, a credible policy and a credible market structure, because one that's incredible, one that seems too good to be true, won't endure and won't last. And I must say that you're preaching to the choir in that respect.

But I'd like Ms. Silva to tell me more about what you think our 204 policy ought to be and have any other comments.

MS. SILVA: Okay. Well, to speak to the broader issue, I think the broader issue under 204 in terms of the financing, is when capital is invested in these companies you need to know the financing structure is going to, you know, stay in place as you envision it.

If you get down at the regulated utility level -- and of course I'm speaking from the bondholder's perspective -- and within the corporate family, those assets can then be pledged to other lenders, that dilutes the existing bondholders. But that's something that can be looked at when the authorization is requested for that financing to take place.

So I think it's a review of the corporate family understanding that there are different business models now within the same corporate family, and how those business models work. One could be cashflow-based, and the other is regulated rate of return.

And so what we're asking for is that when you look at the request, the financing request, you understand where those monies will be used within the corporate family and what it will do to the existing lenders.

COMMISSIONER MASSEY: Mr. Silverstein, please respond to my comment about market monitoring. That intrigues me.

MR. SILVERSTEIN: I don't think our views are totally in conflict. He made a point about the big cycles. And in the '90s was a cycle of -- people didn't focus on risk. They focused on making money. And they didn't care. They weren't differentiating between risk. And some of the issues that Ms. Silva talks to, not specifically to her, wasn't looked at then. It wasn't considered then. It only became obvious when the strain on the industry occurred and people started to realize what was underneath. That's when the analysis in detail really began.

My concern is, we have lessons learned. And I think it seems obvious now, having totally nonregulated merchant market when all the commodities markets are regulated in some other way was not the way to go. I'm concerned that the pendulum will swing too far and we start thinking that we're going to overregulate.

There's a medium in between. When we start correcting the problems of the '90s, we don't want to overcorrect. I believe there has to be more market monitoring. This is an industry in its infancy development. Actually, we know a lot more about it today than we did five years ago, and we have to provide some protections until it gets mature and it's able to truly function in the manner that it can.

And plus, we all know electricity is very different than the other markets in its instantaneous need versus other commodities that have storage capability.

So I think there has to be some more market monitoring. There has to be some more oversight than we've seen in the '90s, but I'm not suggesting that we overcorrect that and push out the ingenuity and the creativity that we need to bring in.

It's hard for me to believe that the model of building transmission and building central station generation that's been in existence for 40 years is the only way to solve the needs. There has to be some other creative ways to do it, and I think we need a model to recognize that.

MR. HEDERMAN: I have a follow-up question on that, having more than a passing interest in how we monitor. The finance industry is often mentioned as a model for how we should be doing some of the monitoring activities. I wonder if any of the panelists have an observation or a suggestion on that.

Is the OCC a way for us to go? Are there other models that we should be looking at as we're learning how to do this? Go ahead.

MR. SILVERSTEIN: I don't have any direct knowledge of that, but generally it's been viewed, and we'll have a crisis in the financial industry in the next month and it'll be discredited. But the fact is their balance sheets are very strong. They're big, and they're used to taking risk. And they have regulation of oversight.

I don't know how easy it is to scour through those 10-Ks and those annual reports to really understand the financial models and the financial risks that these companies are taking. I think there's some issues there that cannot be analyzed.

But they've been viewed as the model because of their capability of handling risk and the strength of their balance sheet and their understanding of how to manage the risk of those balance sheets. That's what I know.

MR. HEDERMAN: Thank you.

COMMISSIONER BROWNELL: I have a question that's a little bit off the beaten track. The message that I've heard this morning is more attention to transmission, more incentives, consistency of rules, closure to the open cases in terms of investigation.

I want to ask a question about consistency of rules. We've heard from various parts of the country that the unique features of each region require regional solutions. How much tolerance for regional differences do the markets have, and what guiding principles as we make these decisions would you suggest to us in evaluating the kinds of differences that need to be addressed?

MR. SCHNABEL: I'll take a quick cut on that. I think regional differences will always exist because of the transportation costs of energy, both in terms of its raw form -- oil, gas coal, uranium -- and also in terms of transmitting it once it's converted and then used.

In natural resources, the cost of moving the resource in virtually all cases is the single largest cost. I think nuclear power may be an exception, but they have other costs. And to minimize that cost requires good information for the users. And also education of the users in that information.

I think one big progress we've made is that many utilities now give their customers a list of what it is they're paying for. We're paying for generation and we're paying for other junk, and here's your total cost. That in itself -- that kind of information is critical.

In the case of utilities and as investors to invest in them and to understand the regional differences, to price them correctly, we really need to see an unbundling of the accounting statements that we get. Our biggest complaint is that some of the big utilities which are a big part of the market do not give us any more information than they have to, and that we do not know what the value is of their transmission assets that they have now in virtually all cases. We know what the generation assets are worth because they have separated them and in many cases spun them off, and in case they put them out. We don't know what their merchant activity is except maybe on a revenue basis, which is irrelevant.

So there's very little information for the investors to go by to make these regional decisions and evaluate the differences that will always be there.

MR. KONOLIGE: If I can add a comment on that. It seems to me from the investor perspective that investors would be comfortable with regional differences in, for example, transmission rules, transmission organizations, as long as these are clearly stated and steadily and even-handedly applied.

It seems to me that a key point is what was mentioned by Mr. Peterson before. That is that existing contractual arrangements should be grandfathered in those situations and that would apply to generation and transmission agreements.

So I think what the market dislikes and fears most and, importantly, for this discussion, what causes the cost of capital to rise, is again this concern about uncertainty.

And so if the admittedly good goal of even-handedness going forward is allowed to override the goal that sanctity of contracts is a fundamental of doing business, then it's my view that overriding sanctity of contracts or throwing questions over sanctity of contracts or having a prolonged period where people wonder about the sanctity of contracts, that that causes higher cost of capital and more ongoing uncertainty and damage than is likely to be resolved by whatever rules eventually occur, which then face the same issue, which is the messengers say, I wasn't sure that the prior arrangement lasted as long as the contracting party said it did. Why would I be sure that this new arrangement is going to last for the long lives of these assets that I might want to invest in?

MR. KIMMELMAN: Just a quick comment. I think all of us agree that the ultimate goal are competitive marketplaces that work. And I don't think it's appropriate to argue that the regional differences in this country are so extreme that certain regions of the country have enough factors that would cause them to opt out of a competitive marketplace.

Clearly there are differences in terms of access to natural resources and different types of natural resources that might make one region hydro rich and another region coal rich and another region gas rich. And I think those are the primary differences. And I don't think those differences are adequate to say just say no and no competitive markets for us.

Certainly when there is less access to multiple fuels and resources, you might have a heavier dose of contracted arrangements as opposed to a heavier dose of fully open market-type arrangements to get to a competitive marketplace. But I think it's more subtle and minor changes as opposed to ten different models across this country, which I think would give most of us investors problems if it was that radically different.

MR. SILVERSTEIN: It seems to me our job is to, at least mine, to assess opportunity and risk, and there should be no problem in us being able to assess that on a regional basis as long as we understand what the differences are and the rules are and how the markets operate in each one of those regions.

For years we invest in different states, which have different regulatory constructs and different sets of risk and rewards. As long as we're able to assess what those risk and rewards are, the markets will adjust. And again, the key factor is uncertainty -- the inability to assess the risk and rewards will drive up the risk premiums dramatically.

MR. SCHNABEL: I'll give you a hurdle. An industrial conglomerate now breaks down their financial statements by -- in revenues, income, capital spending and assets -- by the areas in which they operate. An energy conglomerate for some reason is not doing that.

COMMISSIONER BROWNELL: Why?

MR. SCHNABEL: It's rulemaking. The accounting rules and also rules by yourselves and state regulators don't require it.

And of course the big guys having to protect turf don't want to disclose that.

CHAIRMAN WOOD: Who makes the industrial conglomerate?

MR. SCHNABEL: Excuse me?

CHAIRMAN WOOD: Who makes the industrial conglomerate display his data that way?

MR. SCHNABEL: It's FASB. One of the problems of FASB, and there's a lot of argument in that, some companies do more,a nd some companies do just the minimum, but within FASB, the rules generally force you to break out by SIC code. And the SIC codes, I'm not sure how they are set, but they for industrials are for more -- far more tightly defined than they are for utilities.

And I think partly because everybody always thought that utilities are separately regulated and so you don't have to do that.

MR. HEDERMAN: We have somebody from FASB on a later panel, so I hope Mr. Foster gets ready for that question.

COMMISSIONER MASSEY: Mr. Kaufman, you in your list of what the FERC should do, which I found very helpful, eliminate regulatory uncertainty. You believe long-term contracts will be needed in the future. Wrap up the investigations, deal with the past issues, move on to the future.

Number four, we need to promulgate clear new rules for markets and trading. I think I heard you say that. And you say that it seems to me because you believe that will encourage investment in the marketplace.

MR. KAUFMAN: Actually what I really meant by that comment is I think utilities today will be ill equipped to deal with the open market and buying and selling commodities. They have not been doing that certainly for the last two or three years in an open market. They've been doing it in more of a monopoly-type fashion.

If you want a true open market, you're going to have to have a marketing and trading business to complement the generation and the transmission that goes along with it. Utilities can't be expected to buy and sell commodities on their own in this new market.

The players will certainly change. The merchants that are in that business today, the marketing and trading, don't necessarily have the credit quality that is going to be required to be a trader in tomorrow's market. You're going to see much stronger entities, predominately at least A-rated entities playing a role in that business, as well as the financial institutions that will be filling a large part of that gap, including, you know, some of the players at this table.

MR. KIMMELMAN: Just a follow-up comment with regards to the issue of scale and viable players and creditworthy. And it has to do with the fragmentation of this industry.

This is arguably the most capital-intensive industry in this country. Yet at the same time it is the most fragmented industry in this country. The largest market player has approximately 5 percent market share. I can't think of another industry in this country where the largest player only has a 5 percent market share.

Industry participants are faced with a myriad of risks and capital needs. Yet there are significant roadblocks at the federal and state level to consolidation to create companies with the scale so that they can see their way through these risks so that they can be viable marketers and traders.

To be a trader of a commodity, you need a big balance sheet. It's why you're probably going to see a different industry, probably the financial industry be the players, because the energy players are just too small. And frankly, they've thrown up their arms on the consolidation front, and for the most part I think the companies have even stopped trying to find a way around the various state and federal barriers to consolidation, because it's jus been so hard and so uncertain.

And I think that issue of dealing with how we move away from such a fragmented, weak market is one that ought not be forgotten in all of these regulatory policies.

COMMISSIONER MASSEY: I had one more question of Ms. Silva. I think I heard you say that the risk profiles of utilities have changed dramatically. They're more like the rest of corporate America.

MS. SILVA: Mm-hmm.

COMMISSIONER MASSEY: Is that a bad thing, from your perspective?

MS. SILVA: Well, from an investor's perspective, you know, looking back at the original indentures. A lot of these financings were originally contemplated. They go back to 1920 and 1930. Again, this is a capital-intensive industry. So these -- and I'm speaking from the bondholder's perspective. So we're looking 30 years out. And we're looking at the multiple layers of regulation that were put in place to protect these companies.

BRIDGE FROM TAPE 6 financings is not particularly a lot of protections within the financing structure itself because we had expected that on the state and federal level that the companies would remain financially solid. And so as we move to a different environment and a different type of financing it is a concern because we don't know if the company you invest in today is going to be the type of company two years out, five years out or ten years out.

And so again, reiterating the uncertainty issue on the financing side it is an uncertainty and we don't know what the rules of the game are going to be, so it's hard to go in long term.

MR. SCHNABEL: Just another perspective though. From a shareholder's point of view, the old system discouraged investment in utilities from an equity basis because the returns were too regulated too certain and there was no incentive to earn an excess return. At TIAA CREF, for example, we generally did not analyze utilities and invest positively in utilities until we saw deregulation coming for the generation side, in which case I actually took this on and was a totally neglected area. So it is the opportunity to earn competitive returns that attracts the equity investor.

CHAIRMAN WOOD: All right I've got to ask it because you raised it in it's probably the undesired item in the punch bowl category but you were taking about ratemaking should favor marginal returns on capital. Walk me through how that would play out.

MR. SCHNABEL: Schemfeder, the famous economist, talks about the creative destruction cycles of capital and they are clearly with us. And the reason, from my perspective over time, the reason deregulation really happened was that the state of the art for generating, and at that CREF we made a lot of money in independent generators before these became popular. They were called co-generators which was a bunch of bullshit. Pardon the term.

I think it was Boeing that really shocked everybody by taking a GE Aircraft Turbine and having Stewart and Stephenson Company in Texas create a power generator from this that would undercut the rates of Bonneville Power which was not an easy thing to do, that being a hydro-based government entity.

So that kind of thing, the state of the art, very much like the computer industry and everywhere else is just accelerating change and it's hitting the utility industry hard.

If we could replace the entire transmission system with the current physics of transmission, the energy savings in the country would be enormous. Now obviously we can't get from here to there without a lot of construction time and regulatory time and capital investment time and all that.

What happens on an average cost ratemaking basis is that the old technology is protected and the new technology is discouraged, you know, very much like AT&T. I remember when I built a house in 1975, I knew that I could, in Canada, buy stuff that I personally could install and at a cheaper rate than AT&T with better quality but the regulatory system protected AT&T and you had to have the black phone and you couldn't have an electronic dial, you couldn't have any of these things. And finally the system couldn't stand it anymore, the telecommunications industry was deregulated.

The same thing I think goes on in the electric power, and to have marginal rates of return. In other words a marginal rate of return is a rate that incents new capital into the industry even if that new capital coming in somehow obsoletes the old capital.

There's a fine line to draw here but if you wait too long, you're going to have 20, 30 year live assets protected under an average ratemaking structure which really should be replaced.

MR. HEDERMAN: You have one last question, Commissioner Svanda?

MR. SVANDA: Mr. Chairman with your indulgence, I understand we're out of time but I have two specific small questions and one large question. Specifically to Ms. Silva, you had a prescription or some suggestions to my federal friends and colleagues about what FERC could do utilizing Section 204. Do you have any similar suggestions back to state houses around the country, the issue of relationships between parent and regulated utility, parent holding company and regulated utility, are obviously of huge significance in state houses, and yet in certain ways that horse is out of the barn.

You have suggestions for us?

MS. SILVA: Well I think that it is very important first to understand how the corporate family works. There are companies that have multiple operating companies under holding company structure that integrate those operating companies as one system. And then there are other holding companies that basically take individual operating companies and leave them as stand alone entities.

So understanding how the system interplays and what's going on within that corporate family is the key to understanding how that financing will impact the utility.

And then I would also suggest that a very clear linkage between the financing and the regulated rate base and the ability to service that debt within the rate base is looked at.

MR. SVANDA: Thank you. Mr. Schnabel, you suggested that the president's stimulus package include something that should be exciting for all of us to care about this issue and that is a focus or to do something about the focus or the inequality and the consideration of debt. Are there other pieces in that stimulus package that we should also be trumpeting on behalf of moving all of us to an end state that we'd like.

MR. SCHNABEL: I have to admit that I did not pay any attention to any other part of it except the dividend tax exemption.

MR. SVANDA: On the weight of it alone, should we all be out there trumpeting that this is something that's going to be good for investment infrastructure in this country?

MR. SCHNABEL: The comment has been made by many economists that the president's package really is more of a long run positive than perhaps a short run stimulus, and I would agree. In the long run, this is one of the big positives. Now it's really a back door way of doing it which is, you know, kind of clumsy. An equal treatment of dividends and interest would be the most preferable thing. You know tax them one way or the other for everybody equally everywhere.

Now what the president is proposing is a remedy by the back door exempts some of the dividend taxation but not all of it. Whereas in the front door, it's still totally unequal. You know that's not the preferable way of going about it but given politics perhaps that's the only thing you can get at this time. I can't make that assessment obviously.

MR. SVANDA: And my last large question I guess for anybody who would want to take it up is my sense is -- and I was listening to terms like investor fatigue and others in your comments, that doesn't suggest to me that it is the investment community that's prepared to step forward and lead us out of the morass that we are in. Where will that leadership come from that will allow you some comfortable followership and moving in a similar direction.

MR. SILVERSTEIN: I think we have to take up on what he mentioned earlier. This is a big cycle and it will evolve. Investors will be there over time. It's going to happen, and the only thing that's going to solve it is time and effort and movement in moving in the direction.

Investors are, you know they put a disproportionate amount of their capital in the equity markets over the last ten years. They've lost a lot of money in the last three years. They're tight. They're very risk averse right now. So why do we have economic troubles. There's not capital being spent in our economy, it's being pulled out of a lot of areas including the merchant business right now.

One of the positives that Doug pointed on is the crossover now between capital expenditures and cash flow they're evolving the electric utility sector. '03 we're going to almost break even. In '04, we'll probably be cash generation. That in itself will relieve the pressure on the industry but that should not relieve our focus and intensity of creating a model to work for the longer term. So I think it will evolve over time. The cash will be there. When you spend too much money on end, the cycle forces you to constrain on the other end.

And maybe there's an over correction and that's why I suggest let's not over correct in the rules of the game that we create going forward and make that one that can create a thriving market.

CHAIRMAN WOOD: What would an example of a regulatory over correction be?

MR. SILVERSTEIN: Too much oversight, too much regulation. In not allowing for an equal opportunity to earn returns and not earn returns, creating a market that dictates how merchants should act rather than allowing the market to let them act within rules. I'm a big believer in incentive regulation, providing rules and efforts in the Merchant Model that can allow them to operate under a model of incentives and protection is more challenging than a distribution model of incentive regulation. But I'm a big believer that you have to allow people to be incented.

For all the years that I've been watching state regulation, when they used to focus on return on equity, when that represented such a small percentage of the overall bill to customers. If they incent them right on purchase power, they incent them right on how to generate electricity, they could have saved customers hundreds and hundreds of millions of dollars but they rather cut them a hundred basis points in return on equity and cut it $10 million. I mean, it never seemed to be the right balance. It's a political process and I just that kind of effort is what doesn't make sense.

MR. HEDERMAN: We appreciate much your coming here and the discussion's been very helpful to us so we appreciate it. We'll just take a minute to switch to the new panel.

(Applause.)

MR. HEDERMAN: Please take your seats, we need to get moving.

(Pause.)

MR. HEDERMAN: Okay, our next panel is a

combination of equity analysts and debt analysts and we appreciate your coming to join us today. We are hoping that we can get another prospective to integrate into what we're doing here, and if we could start with Ms. Coale, appreciate it.

MS. COALE: Thank you. I appreciate being invited to address the Commission today on the subject of restoring investor confidence into the energy sector.

My name is Carol Coale. I'm the Senior Vice President of Equity Research at Prudential Financial. I serve as the senior analyst covering the stocks of the natural gas pipeline companies if those still exist, gas utilities and integrated gas and power companies. For 13 years, I have observed the stocks of these companies on a daily basis and have studied there performance in the context of the overall marketplace.

I would like to state for the record that I'm here in my capacity as an equity analyst to offer my personal and professional opinion about the state of the financial markets and I do not wish to advocate or oppose the passage of any particular regulation or make any comments about market conditions that might be implied by Prudential Financial.

Being on the second panel is quite challenging to come up with something new to talk about. I heard some resonant themes today which I'm sure you did too. One is to eliminate uncertainty, two to expedite the resolution of pending litigation and investigations, and three to create incentives.

One thing that you had asked us to address that I haven't heard much talk about is why should investors be attracted to this sector in the first place? Just to reiterate, the capital markets are obviously in shambles. The decline in the stock performance was very swift and very extreme.

The market was down 23 percent last year but these stocks lost, on average, more than 60 percent of their value. However, so far this year and actually beginning in mid-December, the group has shown signs of possibly gaining momentum. We think that this might be an indication that the worst is over.

The two greatest risks that I see in front of us are credit rating, downgrade risk, and regulatory risk although I believe that is moderating somewhat. But as investors fled the market, obviously the companies have lost access to capital from external funding in the equity market, and the degradation of credit among the utilities and the merchants have limited the use of debt funding.

The companies are scaling back their investments in capital projects. These projects were proposed infrastructure expansions in many cases that are likely to be proposed indefinitely. And without the traditional financial resources and discretionary growth capital spending it's unlikely that these are going to be the builders of future capacity in the U.S.

In my view, the next 12 months will be treacherous for the investment community that are looking at this sector. I think the earnings comparisons for the integrated gas and power companies are still likely to be negative in 2003. This is the result of asset sales, higher debt costs, and I think stock valuations will continue to be at the low end of historical measures.

The stocks are likely to continuing trading close to break up value which we also call net asset value, and these are reflecting distressed net asset values. As Evan indicated on the earlier panel, the buyers of many of these assets are not traditional investors in this infrastructure or this sector. So therefore traditional methodology such as priced earnings multiples or discounting cash flow analysis have been thrown out the window. And there's very little certainty of earnings power and liquidity going forward.

The only investors that have really been stepping up to the plate that I've seen are risk tolerant value driven investors or day traders and hedge phones.

So what's the good news? Why would any investor be attracted to this sector? Well some would argue that there is some value to be found at these distressed levels. But also as a result of restructuring the quality of the earnings of the merchant and utility stocks should improve, and this could improve valuation if the stocks returned to trading off more normal metrics such PE's price-to-earnings ratios and price-to-earnings grow ratios.

But again until investor confidence is restored the question remains of who will build the grid and I doubt that the private sector or the government wants to take that role on, particularly given the unattractive risk and reward.

I'm going to touch on a few factors. We've already addressed uncertainty today. I do think that the rating agencies have been over reacting to the situation. The abrupt shifts in posture last year we think are largely to blame for the horrendous stock performance in this sector, and as you know many of these companies are teetering on the brink of bankruptcy.

We think the rating agencies are going to maintain their negative look toward the group citing high liquidity risk, debt loads and refinancing risks. One thing that seems contradictory to me is that they were required -- they being the companies, were required to sell off assets while increasing liquidity and yet these assets were cash producing assets which I see a disconnect here.

The other thing that concerns me is that assets are being divested but yet assets may be needed to be pledged to secure future financing. And this again concerns me.

Addressing regulatory intervention and moderate market monitoring, I do think if the government is going to be involved at all, it should establish incentives to encourage the expansion of the electric grid rather than establish price controls and limit profits.

The establishment of price caps on electricity specifically or any other commodity I think discourages the development of new power facilities. You can argue that restrictive price caps were one of the contributors to the enormous inefficiencies in the western market.

I also think the adverse regulatory and political bias toward energy trading has decimated what we still think is a viable business. As was mentioned on the earlier panel that marketers are still needed to just simply aggregate supply and deliver it to the customer. They're also needed to create liquidity and provide financial products and services.

Looking ahead without the aggregators, we may be looking at a more volatile, less efficient market. Gas prices could ride even further from current levels and further squeeze power markets.

The earlier panel did suggest what they think the FERC should do. I'm going to add a few others instead of reiterate what was already said. I do think the FERC, in its oversight, should avoid price controls such as price caps and allow the free markets to develop. Lessons can be learned from mistakes and inefficiencies. Their format advocating rational regulatory oversight, rather than new or renewed regulation.

We also think that in the event that settlements can't be reached between states in the west, for example, and individual companies that the FERC may want to propose a global settlement that would work out contract and litigation issues on issues that can't be settled on an individual case-by-case basis.

Thank you for letting me speak today.

MR. HEDERMAN: Thank you very much. I have a quick, clarifying question about your concern about price control. Would you include in that concern any of the price mitigation that takes place on a temporary basis in response to price spikes?

MS. COALE: Yes.

MR. HEDERMAN: Thank you.

MR. MASSEY: I have another question

clarification. Did you say you thought regulatory risk was decreasing?

MS. COALE: No, moderating.

MR. MASSEY: Moderating?

MS. COALE: Well that would imply decreasing.

MR. MASSEY: What are the signs of that as far as you are concerned?

MS. COALE: The fact that you're having this conference today is one of the reasons.

MR. MASSEY: That's the right answer.

(Laughter.)

MR. HEDERMAN: Mr. Fleishman, could you give us your comments.

MR. FLEISHMAN: Thank you Commissioners for letting me speak today. I'm Steve Fleishman, a Managing Director for Merrill Lynch. Similar role to Carol as an equity research analyst covering the utility sector and my main role is advising institutional and retail investors on utility stocks.

And obviously at Merrill Lynch we have very sizable investment, particularly in the retail area in the utility industry, and most of the companies that you all deal with are owned anywhere from five to as much as 20 percent within Merrill Lynch's retail system.

I wanted to start a little bit by somewhat defining the problem that we have in terms of how much investors have been hurt over the last couple of years. We take a look at the top 25 market capitalization companies in the sector. And if you go back to the beginning of 2001 and you added all them up, they totaled about 370 billion of market capitalization. That's equity capitalization.

At the end of 2002, that number was 212 billion, or down about 43 percent. And it's actually worse than that, because during this period there was about 38 million of new equity issued by the sector. So on an average stock basis, the fall in value is even worse.

And I would emphasis that this doesn't just affect high-flying investors. This does affect many mom and pop, people's retirements and the like, jobs as well as many of the companies.

As a result of this loss of real money and loss of industry confidence, investors are looking for companies in the industry to reduce its risk and manage down their capital spending.

During 2002, we did a study of looking at capital spending and cashflow. The top 20 utilities had negative cashflow of $10 billion. What that means is that the cashflow after capital spending and paying dividends was negative $10 billion.

And in total, there was $9 billion of dividends paid. So that means that pretty much all the dividends paid by this group had to be financed externally, either with debtor equity. And on top of that, even some of the capital spending also essentially had to be financed externally.

For some companies that got into liquidity crises as discussed before, the cost of that financing was very high. We saw some secured utility-level financings that were 12 percent or higher in some cases.

The good news for investors is that cashflow outlook is improving, and we project the same group of companies by 20004 will be generating excess cashflow. They will have internal cash that can cover their capital spending, can pay their dividends and in fact use some more to actually pay down some debt. The bottom line here is the industry starts living within its means.

Now there's a mixed message here in that nearly all of this cashflow improvement will come from lower capital spending. We estimate this group of companies will spend $10 billion less in 2004 than they did in 2002, which is down about 30 percent. While this trend should lead to financially healthy market participants, it obviously flies in the face of the sector's long-term needs for capital investment.

So the obvious question is how do we finance new investment. We do think you really need to split this thought up between the generation sector and the transmission distribution sector. In the generation sector, investors have had very negative experience in merchant power over the past couple of years, and we think it will be very difficult for companies to convince investors to support an increase in spending in this area.

There are many hurdles, but they all really do come down to uncertainty and risk. Some of these are basic economic-related, like the low and volatile energy prices, and the fact that we think from now really on, more equity will be required, as opposed to debt, to fund generation investments which raises the required returns.

Some of these do reflect more regulatory issues that could we think have some resolutions. These include market rules having to be more defined. Right now we view them as in constant flux, and that includes even the implementation of existing rules.

The other point I'd make is similar to Carol's, that we either need to remove price caps or support a system that has a capacity market for generation, particularly for peaking power. And I'm sure some of us have all noticed a few examples recently where companies have announced plans to close generation plants, particularly older peaking plants, and then had to work out special deals, for example, in New England and Texas, with the ISOs to keep the plants running because suddenly we find out they really are needed.

So I think that's an ad hoc way of fixing things, but it's a sign that something is not right in how the system is working on its own when these ad hoc deals have to be worked out.

I mentioned on the regulated T and D side, we do believe that the low business risk and consistent returns make it very viable for capital investment. Transmission has its unique issues on regulatory certainty and probably more important, the long dated nature of the siting requirements and the like that may require higher returns, mainly for the time and risks involved.

Let me end with a couple of additional suggestions. We really think FERC and the states need to come together to set market rules that have staying power and that can be relied upon by the companies when they make investments.

I've also been involved with the DOE Electricity Advisory Board, and we did a piece on transmission that took a lot of time and effort this past summer, and it had involvement of all the different parties involved, including both sides of this equation.

And we're very proud of that. I think what I've been distressed about is the fact that there just seems to be very much a strong difference in opinion and difference in philosophy between the FERC and the states in certain areas, that even if we come to some arrangements to meet regional differences and the like, investors might distrust the staying power of those arrangements.

It's not just getting a deal done. It's a believe that people on both sides really believe the deal has some lasting power. That's part of this kind of long-term certainty that we really need.

I would also emphasize the point I made on either price caps going away or capacity market being put in place. Some more support for consolidation in activity, and a need to put behind us the issues related to California and contract sanctity.

One last positive I see is that we do think the industry and other participants are moving forward in fixing the energy trading business. We think there have been some constructive accounting changes that have been made that will help confidence. We think there's movement on improving the collateral and cash needed in the business, and we do think the change in players, weaker credits leaving and hopefully stronger credits coming, will lead to a rebound.

So if we can fix these other issues, I think the market participants can move forward in fixing the markets.

Thank you.

MR. HEDERMAN: Thank you. Ms. Tezak, could you please give us your remarks?

MS. TEZAK: Yes. Good morning. My name is Christine Tezak. I'm an Electricity Policy Analyst for Schwab Capital Markets Washington Research Group.

And the role I play in the advising of institutional clients is our group provides a top-down view of how legislation, politics and regulation impact the publicly traded groups as a sector. We position our research as complementary to that provided by my counterparts, Ms. Coale and Mr. Fleishman.

The fortunate thing about having a very wide panel is that we don't have to go over stuff people have already said, so I'd like to narrow my comments to a couple of things. First to answer Commissioner Svanda's question about leadership from Wall Street. If you think there's a conflict of interest now, you don't want us advocating specific polices. It's not appropriate. We can price them very quickly, but that's not what we do.

First off, I thank you very much for including members of Congressional staffs and other agencies in this meeting today. I feel that I have had the opportunity to speak with each of you on what some of Wall Street's perspectives are, and I welcome the opportunity to share it with representatives of states as well as Congressional delegations.

One thing I would like to say is a barrier to investment is recent consumers' amnesia about how prices are formed in the market. For example, since when did we forget that certainty costs something? And that a long-term contract is likely to be differently priced than a spot one?

Secondly, I would say the one thing that frustrates me immensely, and I see it very often in rhetoric from certain members of commission staffs at the state level, is this misassumption that the transmission system in particular belongs to the ratepayers. The owners of those systems are the equity holders and the bond holders who lend the financing to create it.

What the ratepayers receive is a service. It's what happens when they turn the switch. And that is something I think that particularly members of Congress need to remember and need to understand. There are truths here that are regularly distorted by the rhetoric and all of the insanity that has surrounded the California meltdown.

As far as potential solutions and what different parts of the equation can do from industry's side, I would say that there's certainly more self-policing that could be done by market participants. I think from the investment community, we should have higher investment standards. I think we should reward companies with integrity, not reward those who can manipulate their balance sheets. And I think that a rational approach to investing will be helpful. We should not be pushing company shares up to $105 a share because we believe that they're going to promise 70,000 megawatts in capacity which no one will agree that we ever had the natural gas to fuel.

As far as FERC policy, I think that you all know very well my complaints. Finish California. Finish the forward contracting dockets, and faster enforcement resolution. To have an oral argument on El Paso 340 days after the remand I think speaks to process that is being deprived of this particular stakeholder group.

The other thing that I think would be encouraging is to finish the policy development, and I have of course a very specific list here. The affiliate standards. If you want to see better corporate governance, let's get your side of the table out as well.

What's going on with the electronic quarterly reports? Where is that data we were promised? Are we going to have a policy on Mobil Sierra so we know where we're going on forward contractings?

Of course we need to finish Standard Market Design, and the transmission pricing policy that we saw yesterday certainly is being supported by the comments you're hearing here today.

Most importantly, I think the discussion Mr. Schnabel brought up on what we can do to bring technology into the grid is very important.

As far as other regulatory agencies, I believe that one thing that state commissions need to understand is the Supreme Court's decision in March 2002 which upheld the Energy Policy Act of 1992 which put transmission as well as wholesale generation into the purview of the FERC.

Second, I think that continued cooperation and coordination between federal agencies is something that was begun under the watch of this FERC and something that I think is positive to continue. The Office of Energy Projects in particular, and I was going to mention this before you sat here on the bench, has worked very hard to bring pipeline environmental siting periods down from 16 months to 11 months by coordinating with other federal agencies. Certainly that is low-hanging fruit and something that we would encourage to see more of as we run into an economy that's going to be recovering, the speed with which regulatory agencies can move to facilitate reinvestment will help.

And lastly, the coordination that Mr. Hederman's office has done with the CFTC and DOJ I think will be very informative in informing us once and for all what was illegal and what wasn't, and let's get on with it.

Thank you very much.

MR. HEDERMAN: Thank you. Mr. Diaz, could you give your remarks and move on to the rating agencies?

MR. DIAZ: Thank you very much for the opportunity to be here today. I appreciate it. My name is John Diaz. I'm the Managing Director of Moody's Power and Energy Team. Moody's is the oldest credit rating agency in the world, and we provide independent and objective credit opinions on fixed income issuers.

To recap, 2002 was a very difficult year. In 2002 we downgraded over a third of all families involved in the power industry and merchant energy area. More than 80 percent of these downgrades were tied to merchant activities, namely, trading as well as overinvestment in merchant capacity.

Today most of the companies with significant merchant exposure have negative outlooks. By way of contrast, most of the companies with little or no merchant exposure have stable outlooks.

The causes have been talked about at length here. I will outline briefly. First of all, energy trading was shown to be a flawed model because it married a confidence-sensitive activity with what at the time were low investment-grade ratings. And that confidence was shaken with revelations of questionable accounting, wash trades. And these led to liquidity issues and distress for many of these companies.

In addition, there is substantial overcapacity in merchant generation today across the country, and most of this capacity was funded with debt, which leaves too much leverage in the system. Further, there's been poor attention to liquidity management. Many of these assets, long-term assets were funded with short-term debt, be it commercial paper, mini perms or bridge loans. This has exposed companies to refinancing risk.

All of this has led to a loss of investor confidence and a challenging financing environment. Also, in some cases, management credibility has become an issue.

The outlook is poor for the near term. We expect things to bottom out sometime this year or perhaps in early next year. We don't see real recovery before 2005 at the earliest. We expect to see continued low power prices and low spark spreads.

We do believe that energy trading is a viable economic activity, but it is ancillary to most companies' overall business plans. We don't expect to see energy trading being the driving force of a company's growth strategy.

We do expect to see trading taking place through bilateral contracts through the use of exchanges and the stepped-up activity of financial institutions with strong balance sheets.

Down the road we see asset sales taking place, which will probably lead to some writedowns as companies become more realistic about the true value of those assets.

The leveraging of the system is critical, and we do note that is taking place today. Most companies are making that a priority for 2003 and 2004.

Improving cashflow is key. It is important for companies to generate free cashflow after capital spending and dividends, because this will help to pay down debt and to shore up liquidity. Eventually we do see consolidation in the sector as things stabilize.

What is needed to restore confidence more than anything: Time. It's going to take some time for the glut to diminish and for confidence to return. In the meantime, companies can help themselves by improving overall disclosure and transparency in their financial statements. We'd like to see realistic asset valuations. If companies have invested in plants, and the returns on those plants are going to be lower than expected, that should be reflected in the financial statements.

In addition, we like to see earnings and cashflow have significant correlation so that we do not end up with overvalued book equities.

We'd like to see more attention to liquidity management, because good alternate liquidity can help a company get through a stress period.

We'd like to see disclosure of all contingencies that companies have, and that includes rating triggers. Rating triggers have had an almost lethal impact on a lot of the energy traders. And down the road, we'd like to see more conservative financing strategies, meaning that companies should have a capital structure that reflects the risk that they're taking. It is not realistic to fund a plant at 60 percent of the capital if they are competing in an unregulated environment. Oil companies don't do that. Chemical companies don't do that.

Finally, I do agree with a lot of the comments about what the FERC can do, and probably the most important thing is consistency of rules and clarity and transparency around those rules.

Thank you very much.

MR. CHOO: John, may I ask one clarification question? Could you explain what mini permits to those of us who don't know what it is?

MR. DIAZ: Mini permits, it can have a wide range of definitions. Basically debt that was financed, for example, to fund a project over say a three-to-five-year period with the expectation -- with a bullet repayment with the expectation that it would be refinanced in the capital markets. And what's happened in a lot of cases is that is coming due at the same time that there's lack of access to capital markets, therefore creating a problem.

MR. HEDERMAN: Ms. Smith, could we have your comments please?

MS. SMITH: Good morning. I'm Suzanne Smith, a Director in Corporate & Government Ratings for Standard & Poor's in New York. Standard & Poor's is a leading global credit rating company.

I follow the utility and energy industry trends in general and specifically I'm responsible for assessing the creditworthiness of integrated utilities, energy merchants, and project finance.

There's been a lot said about the problems of capital availability for energy markets over the last six months and year. The industry's attention has been focused on the dozen or so large, diversified energy and energy merchant companies and developers who are indeed ensnared in a web of collapsing financial health.

These problems are not symptomatic of the entire energy industry. Many participants, particularly those that are regulated, remain fairly healthy. And this is borne out by our ratings distribution which does still show an average rating of about Triple B plus if you look at the broader definition of the industry.

But for companies operating in competitive power markets, there has not been any single reason why capital has dried up. But there has been an unprecedented collision of increased business and financial risks that has caused the problem to elevate into a downward spiral and financial crisis for some companies.

Declining profitability from low spark spreads, combined with high debt leverage, has proven to be a serious problem for energy merchants. Companies found themselves without enough capital at a time when they needed more capital to cushion losses and to meet collateral calls.

This also happened during a period of increasing regulatory uncertainty, investigations, and amid an overall environment of failures in corporate governance across many industries.

That energy marketers operate predominately bilaterally and rely on their own models to value energy contracts played a role in the loss of investor confidence.

It caused distress about the adequacy of disclosure and exposed companies' ability to aggressively manage earnings and valuations.

The presence of ratings triggers in many trading agreements and loan documents also made the situation worse by increasing capital requirements at the same time that creditworthiness and liquidity were declining.

Amidst these problems, though, it's also important to remember that capital is still available for regulated investments in transmission, distribution and generation. In these areas, barriers to investment have more to do with regulatory and permitting hurdles than lack of capital availability.

Each day we continue to rate new bond issues int he energy sector. No single capital structure can be said to be the best. In order to obtain investment grade ratings, there must be a balance between business and financial risks. In the context of energy markets, this means that regulated businesses will always be a lot less risky than businesses that are exposed to market forces.

Low business risk ventures such as regulated transmission services will be able to carry more debt and an investment grade rating than competitive power operations that are exposed to commodity risk and ever changing counterparty credit risk and market exposure.

Trading operations will require much higher equity layers to reach investment grade ratings. Stand-alone trading and marketing operations may require all equity, because the profitability may not be sustainable enough to support fixed charges.

As currently structured, energy trading is an equity-intensive business. This is why so many companies have announced an exit from the business and are looking for partners. It's also a business that is fundamental for functioning competitive energy markets.

Energy trading activities require capital support credit market and operational risks, and this capital is a function of the size, strategy and management of the trading operations, something that varies substantially from firm to firm.

It's also clear that trading operations that conduct derivative trading businesses require high investment grade ratings. And this is different from what many companies thought they could do when they entered the business.

Right now, capital for merchant generators is largely unavailable, but this should change. One big hurdle now is the determination of the appropriate valuations for the merchant plants that have been built within the last several years. These valuations are lower than what was initially anticipated, but how much lower?

This will be determined over the next year as distressed borrowers and lenders will be faced with decisions on how to handle merchant energy debt. Valuations will need to be established, and they will set the stage for restructuring and consolidation.

The industry should support a wide range of capital structures, combinations of investment grade, noninvestment grade, project and balance sheet financings can certainly work.

As far as solutions go, I offer three, many of them already discussed. The first of course is better disclosure on marketing and trading and better clearing mechanisms for energy marketing and trading in order to reduce capital required.

The second is more clarity on regulation, which has been mentioned several times already. And lastly, the industry needs to complete the process of refinancing, restructuring and consolidation. And also, many companies in the last year have dramatically changed their strategies going forward.

And what this means is that there's an enormous amount of strategy execution that needs to be done within the next year and a half.

So what takes place this year in terms of refinancing and strategy execution will certainly set the stage for 2004 and beyond.

MR. HEDERMAN: Thank you very much. Mr. Hunter, could we have your remarks?

MR. HUNTER: Yes. Good morning. Thanks, ladies and gentlemen, for the opportunity to speak to you. My name is Richard Hunter. I'm a Managing Director at Fitch Ratings. I head up the Power Utility Rating Group there, one of the three nationally recognized statistical rating organizations, and we cover 300 utilities or so in the U.S.

Again, our point of view, as you already heard, is very much that of the fixed income investor from the credit side.

Obviously we've had a lot already today about how do we get here, so I thought it might be useful just to focus and try and keep very close to my five minutes on just a couple of issues.

One is just to look at the fact that really one of the things that are happening is a polarization of credit profiles inside specific companies. Some things within specific legal entities, if we look at a company like Aquilla for example. There's one example where perhaps regulation that has encouraged people to avoid a particular type of regulatory act has actually forced some companies to put risky and non-risky business next to each other.

But basically what we're looking at is a polarization of stable businesses and volatile businesses in the same entities. And unfortunately, as you already heard with very much the same capital structures. It was very much the stability of the income profile of the regulated businesses that were supporting leverage in U.S. utilities that was significantly above the average leverage for other industrials in the U.S. and also materially above the average leverage for utility sectors elsewhere in the world.

So obviously this cashflow has been significantly diluted for those companies that have got more involved in the unregulated side of things. But it's very important that we look at this as being companies that are in the same boat or issues that are in the same boat.

If we look at the debt that's maturing this year, regulated utilities, just capital markets debt. So forget about bank loans that are coming due. Have about $12.5 billion in debt we calculate coming due in the course of 2003.

Parent companies have about $8 billion of debt coming due. The parents are far more tied to the credit profiles and the weaknesses of the unregulated or wholesale businesses. Just to give you some statistics on the ratings, one in four of our ratings at the moment in the U.S. in the utility sector are on rating watch negative or outlook negative. Forty percent of utility parent company ratings are on watch negative or outlook negative.

So that gives you some idea of where the actual negative risks are skewing. From that you can deduce that the biggest risk or one of the biggest barriers to regulated company investment is in fact contagion from parent companies. It hasn't prevented investment per se.

We've heard, as Mr. Fleishman mentioned, there have been some examples of even regulated utilities having to fork out extremely large margins to secure financing, but mercifully there have been relatively few cases of that. In most cases it has been limited to an optic in the margin for the bond issue or perhaps a smaller issue or perhaps a slightly shorter tenor. But nonetheless, it is an issue that does have to be addressed going forward.

The issue of separation. It's interesting that when we talk about cashflow in the prospect of rating analysis, we always talk about cash waterfalls. And yet when we talk about protection, we talk about ring fences. Now as any physicist will tell you, a ring fence is not watertight. All it can do is protect you against progressively smaller or larger articles passing from one side of a fence to another.

It's unrealistic to expect any type of separation that you're realistically going to be able to put in at the federal or at the state level to be watertight. So we have to have a realistic goal. What are we trying to do?

Effectively what you're trying to do is get maximum separation at the point of stress. And that might mean in practical terms you could have a regulated parent holding company that has maybe a Triple A plus rating, and maybe the regulated operating company has an A-minus. Maybe it's only a notch or two better.

The position you're really worried about is when you get further down the scale and you have something like a parent company in a single B rating level. And then you want to make sure that your regulated utilities have had sufficient separation, maybe separate treasuries, maybe segregated accounts, maybe separate signees, whatever.

The rating agencies are going to feel more comfortable tiering out those ratings. So you could have a single B, very deeply junk rated parent company, and maybe a just speculative grade-rated utility. And they might even get the first mortgage bonds into the investment grade.

What you're trying to avoid effectively is a scenario like Dynegy and Illinois Power where you have a very complicated intercompany note structure there that actually means certainly on our scale we have Dynegy the holding companies and the utility rated at exactly the same level.

So how do you achieve this? You're not going to get a rule book. U.S. accounting and U.S. tax codes are probably the poster children of the law of unintended consequences. Rule books are not really going to be the most adept way of doing this. Whenever you come with a rule -- some things you can enforce. Separate treasury you could police. Even something as apparently simple as a prohibition on intercompany loans. Realistically, if they have a management company, if they overprice some other service they provide between parent and subsidiary. There's any one of a number of different ways you can move cash from one to another.

So what you really have to maybe focus on is say let's have a code of practice, and let's ask the issuers to pursue that. Make it incumbent upon the issuers to actually be pursuing that separation, because actually frankly, it's as much in their interest as it is in anyone else's.

So that's one area where you could say looking at the regulated utilities, maybe actually it's the issuers who have the most flexibility to do something about that and demonstrate to the rating agencies that they are putting increased separation in place.

Just again, you're not going to get complete delinkage. A general counsel frankly won't buy bankruptcy regulated utilities no matter what a state commissioner puts in place.

For the unregulated businesses, there's no easy answer. We're slightly more optimistic perhaps than Moody's. We think it might possibly get better in mid-2004 rather than 2005. So, again, there's no really quick answers.

Bottom line, return on capital for the unregulated businesses is typically lousy. We've yet to see a deregulated model in the U.S. or elsewhere where the capital price, the actual capital return you need, is really being returned, and it's actually being guaranteed and is encouraging new generation and so on and so forth.

So generation is likely to be either on the balance sheet of utilities going forward, those who can, or contract base in a project finance-type structure. There really aren't any alternatives. There's really no prospects to hedge out say at 18 months at the moment. Merchant energy just isn't going to get any buyers at the moment, so you're really going to have to move towards a contractual structure.

We've heard a lot today about people saying we need better mechanisms for the wholesale market. I don't know how much faith we could accord better mechanisms until we've seen a track record of them working. Because we have a fair track record of mechanisms in the marketplace not working and not allowing the incentives that people do feel they need to keep the generation on line.

This does have, from the regulated perspective, it does require preservation of sanctity of contract wherever possible. In fact, the track record in the U.S. on sanctity of contract is actually better than you might believe from a lot of the public rhetoric, although I think what happened to the gas companies here in the late 1980s is every present in people's minds.

Reform certainly needs to be a gradual process. In this regard, the most recent developments in SMD with both a lengthy transition process and the recognition of regional variations we think is a positive development.

Just one last thing I wanted to squeeze in there. The clock's actually stopped. On accounting, wouldn't parent company financial statements audited and put in the public domain be nice? It would be nice for investors. It would even be nice for us. As a rating agency, we get parent company financial details, but I think even we'd be happier to know that that was subject to audit and was also put in the public domain.

The extra disclosure segmental. We've heard about segmental accounting today. It's not been a stellar performance from the industry thus far on segmental accounting as far as telling exactly where the cash was moving. The proposals from the CCROs are a huge step forward. We don't expect 100 percent compliance. I don't even expect 50 percent compliance, but it is definitely a step forward.

And one last thing. When regulators are sitting looking at financial criteria they want to set for financial solvency, debt-to-capital ratios. Please no more debts to total cap ratios. If you look at everything that's going on in the balance sheets of a lot of these companies, we don't have an awful lot of faith in the full value of that balance sheet, as you can see when companies themselves are going out just now getting secured facilities.

So debt-to-capital base leverage figures I think you'll find will tend to make the financial community happier than a total debt to total cap.

And on that rather arcane point, that was the end of the comments.

MR. HEDERMAN: Thank you very much. Ms. Wang, could you please share your comments with us?

MS. WANG: I'm Jone-Lin Wang. I'm a director at Cambridge Energy Research Associates. Cambridge Energy offers comprehensive research and insights on energy markets, industry dynamics, technology, politics, and the investment strategy. Our expertise covers all energy sectors: Oil, natural gas and electric power.

My work at CERA focuses on power market fundamentals and power market structure. So over the next few minutes, I would like to speak about CERA's view on the state of the power business as well as several of the most important issues related to capital investment.

Many factors have contributed to the power industry's difficult situation today. The prolonged muddled transition from regulation to competitive markets is certainly one of the important factors. Today, ten years after the Energy Policy Act of 1992, only 40 percent of generating assets are deregulated, and only half of the states allow for retail competition.

Most wholesale markets remain ill-defined, with no standards for rules and institutions. To improve the investment climate, we need workable competitive power markets with well-defined and stable rules. Many critical elements have been laid out in FERC's proposed Standard Market Design ruling.

Let me quickly go over the condition of the sectors. In power generation, a severe boom-bust cycle has led to oversupply of physical capacity but much financial distress. Over the past three years, the U.S. has added more than 130 gigawatts of new power generating capacity. Another 80 gigawatts is currently under construction.

This wave of new supply has not only made up past deficiencies but has also pushed most power markets into oversupply.

Even with the large number of cancellations over the past year, CERA expects that power markets will have adequate or excess generating capacity over the next five years, with the possible exception of a few transmission constrained load pockets.

The probability of a supply shortage over the next five years is very small.

Many factors contributed to this costly cycle and the resulting financial duress. Over-optimism on the part of the investors is one. CERA believes that poorly structured markets where power producers rely on shortage-induced price volatility for capital recovery are another important factor.

When power price volatility exceeded politically acceptable levels, regulators in some instances imposed price caps, which truncated the opportunity for capital recovery and led to the flight of capital.

To avoid repeating this costly cycle in the future, we need to create and nurture healthy capacity markets. Capacity markets balance power supply and demand and thus mitigate extreme price volatility. They therefore help avoid the political intervention that typically discourages investment.

Certain current practices such as subsidies for renewable energy and demand-side management tend to distort and depress capital markets. They should be avoided in order to establish healthy capital markets.

In addition, were are in a hybrid system. We have 40 percent of the generation assets in the market-based camp. The rest, 60 percent, earn their returns through cost of service.

We have oversupply, and the low prices are sending signals for producers to stop building. But regulated utilities may still have the incentive to continue to build and earn their return through cost of service. They're not subject to -- they're not necessarily subject to the discipline of the market and therefore may not respond to the price signals. And this is a long-term problem, because we seem to be stalled in this 40/60 hybrid system and perhaps for many years to come.

Power transmission, on the other hand, as suffered from underinvestment. The conventional wisdom is that we have a poorly designed, fragmented system that needs massive investment to remove myriad bottlenecks. We are now asking the question, could this be wrong?

CERA believes that the implementation of the proposed Standard Market Design would eliminate some of the artificial bottlenecks.

In addition, we believe that the 130 gigawatts of new generating capacity added over the past three years has relieved some of the physical bottlenecks and has altered the dynamics of the transmission networks.

CERA has just started a comprehensive study to assess what transmission bottlenecks do exist now and are likely in the future in light of the recent dramatic increase in generating capacity, and what new transmission investments can be justified.

Regardless of whether transmission networks suffer from gross under-investment or modest under-investment, a lot will have to happen to attract more investment.

One key issue is whether the regional grid transmission planning process to be led by the RTOs, can accurately assess the systemwide cost/benefit tradeoffs required to develop efficient investment plans, and whether RTOs can facilitate timely execution of the plan.

The process could turn out to be cumbersome, and could allow various NIMBY-motivated groups to block construction of future plants.

In addition, after the expansion plans have been decided, local transmission owners that have demonstrated independence, should be given the first opportunity to build and own new facilities. This would improve network economics.

Let me move on to trading. Trading is a necessary part of the energy business, but the potential size and profits of trading was oversold a few years ago. The right size of trading is probably somewhere between what some people had envisioned a few years ago and today's situation.

To review the trading sector, we need to restore credibility by improving market oversight. And CERA recommends that the CFTC be the common regulator across all commodity markets, including electric power. Thank you.

MR. HEDERMAN: Thank you very much for your remarks. Commissioner Brownell?

COMMISSIONER BROWNELL: I just want to be sure I heard the consistency of message here that I think I heard. I heard some concern about the taint of the unregulated affiliate on the regulated body, but I didn't hear that the regulated entity is the only model.

I heard, I think, everyone say, indeed, that the competitive market should, in fact, be pursued, sooner rather than later; that restructuring needs to be complete, and, indeed, there will be many different capital structures and business models, albeit, different from today, in the marketplace.

Is that a correct assessment?

MS. WANG: (Nods affirmatively.)

COMMISSIONER BROWNELL: Then the second thing that I think I heard everyone say in one form or another is that better and more complete financial disclosure for both the regulated and the unregulated entities would facilitate a stronger investment climate; is that also the case?

MS. WANG: (Nods affirmatively.)

COMMISSIONER BROWNELL: Thank you.

CHAIRMAN WOOD: And also in the category of what have we heard between you all and the last panel, let me have two buckets here, a fixed and an almost fixed, still needing attention.

The fixed and almost fixed, accounting issues, including mark-to-market, perhaps, wash trading, the fundamentals of mis-estimating supply and demand, that being out of whack; the ratings triggers being the triggering device; Western investigations and related issues, which is on our side of the fence; regulatory clarity, which would be the RTO functions, SMD on the electric side; probably not a lot of open issues on the gas side, although Ms. Tezak mentioned a few of our rulemaking dockets that are on track to be wrapped up.

Still needing attention bucket: Clearing other credit procedures for -- or other institutions that would perform the same function; the refinancing and restructuring that will just happen as those dates come up; federal-state coordination, which is an effort that all of us are working on; PUCA, perhaps some other Congressional issues, but that's one I think I have heard from at least three folks of the first two panels.

Is that categorization right, and what else needs to be in each bucket? I'm kind of a task-oriented type. Yes, ma'am?

MS. TEZAK: Well, I think one of the things that is useful with a panel like this is that there's got to be better information out there. I think that there is still a lot of misperception, particularly politically, at both the state and the federal levels, as to what happened and what the professionals in these respective businesses are attempting to put back together and move forward with.

I think that if there is still a perception that this industry is merely a bunch of black hats from Houston, then I think that there's never going to be the political will to lead us out of the morass we're in.

I think that there has been an absurd amount of mischaracterization, particularly by two members of Congress, as to what happened and to what is going on now. And I think that, as you alluded to, you know, at this stage of the game, having the technical conference now when we're close to seeing resolution, I hope, on the California issues, on those open dockets, you know, I think is helpful.

But I think that there still has not been the information gap filled as to what really happened and what is going to go on going forward, and an understanding, as Mr. Schnabel mentioned, that the customer needs to understand what's going on.

What restructuring of the business means for him, what part of it is fuel costs, what part of it is transmission, what part of it is financing, and how it's going to take time, especially as my colleagues have suggested, for that financing cost to decline, that the customer needs to understand that these are all parts of the business, and, just like gas prices don't go up overnight just because; electricity prices didn't go up overnight just because, and that it will take time to reach equilibrium.

So, I think that the burden of bringing that information out is something that your Commission, in particular, could help with.

CHAIRMAN WOOD: So that transparency of information needs to be on the still-needs-attention bucket.

COMMISSIONER BROWNELL: I think that, frankly, industry could make their own contribution here by getting the issues behind them. I have used the term that we are going to set up a confessional on the 11th floor, but the reality is that some of the damage is self-created by this dribbling out of information.

So I think that we have obligations and responsibilities, but I think the industry could really help themselves. I think the CCRO work is terrific. I think other have done terrific work, but I think we need some help here in getting this behind us.

CHAIRMAN WOOD: Any other issues that I'm missing? You two panels are a good frame for the afternoon as well. Ms. Coale?

MS. COALE: I just wanted you to clarify exactly what's legal and what's illegal. I think Christie brought this up earlier.

If it's legal to wheel power out of a state because it's not economic to produce power because price caps have been put on the price of power, but not on the price of gas, then what, exactly -- how do you define what laws were broken?

And I think that rather than establishing new rules, I think we need to clarify what the existing rules are, in addition to establishing new rules. So I'm just not really clear on what laws were broken in the Western markets.

CHAIRMAN WOOD: I expect that our Commission will weigh in with our view of that when we conclude our investigation in the next couple of months, so that's an almost fixed but not fixed.

MS. COALE: Almost fixed, okay.

MR. FLEISHMAN: This is another comment on the paying attention to. As you're moving toward the regional independent markets, RTOs, ISOs, et cetera, obviously we're working very hard on getting the structures right and getting them in place, but one of my concerns is that these entities' interest will be showing to everyone involved, and particularly the states and consumers, that the markets are working well and doing an effective job.

And I think this was mentioned on the other panel, but many times that's defined as keeping prices low. And to the degree that we settle these regional independent entities up, prices go up again because we have tight supply, and then we go through another round of 20/20 hindsight in reviews, et cetera.

We're pretty much back where we were on an even more decentralized basis, so that is one of my concerns. There needs to be a clear definition for these regional entities, that their goal is to make the markets work efficiently, have a good market monitoring role, but that really cannot be defined as keeping prices low, because part of getting investment ultimately will be that prices do need to go up at times. That's one of my main lingering concerns.

CHAIRMAN WOOD: That's a good one. And how would you -- if you were sitting here, how would you codify that? Or how would you really ensure that that vagary doesn't really enter into the operation of the market?

MR. FLEISHMAN: I think it's a very difficult thing. I think it will get down to some of the issues of governance, of how the -- who is involved in determining the success of these regional entities.

But it gets back to this issue of the FERC and states really being onboard, not just for near-term solutions, but for the long-term, because I do believe these organizations could become an easy entity to blame when prices go up again one day.

So that would be my concern, that there is a long term. And, frankly, there are issues like this that exist right now. There are cost-capping of plants in certain pools that the owners did not know would be cost-capped, you know, and become must-run plants without their knowledge beforehand.

And they go back and forth at times, so there are some of these issues that occur, as we speak today.

COMMISSIONER BROWNELL: You know, it would be helpful if -- not today -- but the members of the two panels would give some thought to the criteria we've talked about, an RTO report card, a market report card. You know, what are the five or six things that we ought to define as success?

I think that you've hit on the key issue, and certainly a key issue for the state commissioners, is that we have always defined, and, therefore, over-promised that markets would bring lower prices. And, of course, that isn't always going to happen, so help us out, and if the smart guys would give some thought to this, we'd like to hear from you.

COMMISSIONER MASSEY: Mr. Diaz, you heavily emphasized that this will take some time, which seemed to me to be a message of, you know, all these problems can't be quick-fix. It seems to me your message to this agency is do what you can for a clarity in market structure for certainty in market structure, but this is just going to take some time for capital to flow back into this industry and for things to get squared away.

MR. DIAZ: It will take time. It will take time for the overhang and supply to be whittled down. And, more importantly, it will take time for the confidence of investors to come back.

So, to the extent that they have more confidence in the rule-setting, that's positive. But I think companies can do a lot to help themselves. I think they are starting to do that. We've seen that, beginning at the end of last year.

They need to reduce the debt, and have better liquidity for facilities. One of the problems has been that as the banks have backed away from lending to the companies, in some cases, you've created liquidity stress.

So, to the extent that companies are less concerned about the cost of these facilities and are more willing to have flexibility, that gives them room, that buys them time for the markets to come back.

So those are the kinds of things that I think will -- it will take probably a couple of years before enough confidence comes back that companies can then access, hopefully, the equity markets and then help to reduce that even more.

In the meantime, anything they can do to improve transparency, whether it's segmented information, whether it's parent company information, all that will be very helpful to the case.

COMMISSIONER MASSEY: Well, let me ask this question: Virtually everyone who has testified has said we need more regulatory certainty. We don't need to be changing policies, yet one of the criticisms is that the rating agencies change the rules in the middle of the game themselves. What is your response to that criticism, Ms. Smith?

MS. SMITH: I heard it before.

(Laughter.)

COMMISSIONER MASSEY: Is it true?

MS. SMITH: But I don't believe that that's the case. I think there are -- that the rating agencies pretty much responded to a deterioration in creditworthiness that began awhile ago. I mean, if you look at the distribution of our rating actions over the last several years, you already identify a negative trend that didn't begin this year or last year; it began several years ago as a result of companies entering into largely unregulated businesses that were far more risky and not balancing their capital structure to reflect that risk.

So I think what we saw was more or less a rapid acceleration of a trend that had already existed. Secondly, you know, I think that the rating agencies definitely identified deteriorating creditworthiness as it occurred.

But we certainly weren't the only parties that were doing that. I mean, given the number of counterparties that were trading with each other, you did see a great deal of reaction on the part of counterparties to the creditworthiness of the parties they were trading with.

I think that also contributed to a rapid worsening of creditworthiness, which then causes the credit rating companies to respond more quickly to a rapidly deteriorating situation.

And then, thirdly, ratings triggers, I think nobody really focused on them before Enron, but in the post-Enron environment, ratings triggers became a real devastating issue for this industry. I mean, they cause a downward spiral where you can have, you know, a negative trend in creditworthiness, but combined with the presence of a ratings trigger, you have a spiral, which might not exist without that trigger.

So I don't think the rating agencies, you know, should be criticized for taking the actions that they did.

COMMISSIONER MASSEY: Mr. Hunter?

MR. HUNTER: Yes, I would agree with an awful lot of what Susanne said. There's obviously an element of shooting the messenger when the agencies took the actions that we did. I'm quite happy to say that at Fitch, we underestimated the volatility of the unregulated businesses when we were assessing the leverage of these companies.

We did underestimate that when we saw what was going wrong, precipitantly, with the unregulated activities. We took more severe action.

I'm not quite sure what the contra argument is, what the suggestion should be that we should have avoided taking rating action, because we hadn't taken rating action before. I'm not quite sure what the appropriate response is, if a company, for instance, up and says we have to find $600 million by next Tuesday, how we would respond to that, other than with a multi-notch downgrade.

(Laughter.)

MR. HUNTER: If somebody had run up that scale of telephone bill on the headquarters, we would have regarded it as a negative event. The fact that a lot of these events, again, were not disclosed in terms of the rating triggers and the enormous collateral requirements that went with them, is difficult to see how we could have responded.

Now, yes, there was a negative trend, I think, in all of our ratings prior to this. As far as I'm concerned, the trend was obviously not negative enough. We had 140 downgrades last year, and that's not a sign of success for us.

But you can accept that some of those are because the situation got worse, but obviously not all of them. But, again, I'm really not quite sure what the contra argument is when people say the agencies provoked this.

We were reflecting weakening credit profiles at the companies, and we'd be doing an even greater disservice if we didn't reflect that in our ratings when we learned that information.

COMMISSIONER MASSEY: Mr. Hunter, you're a really smooth talker.

(Laughter.)

MR. HUNTER: I apologize.

(Laughter.)

COMMISSIONER MASSEY: I think your answer is a very good one, actually, but I wanted to raise the point to give you the opportunity to respond. Mr. Diaz?

MR. DIAZ: Yes, I mean, I would very echo the comments of my colleagues. I would give as an example that the biggest area of rating -- of rapid rating action took place with the companies exposed to energy trading.

At the beginning of the year, following the Enron situation, we took a hard look at what was happening in the merchant trading sector and came to a conclusion that, number one, the cash flows that were being generated from that sector were woefully inadequate to support the big debt load that had been taken on to buy some of the assets around which these companies wanted to trade.

And the only way to fix that problem at the time was for companies to de-leverage, and there were three ways of doing it: One was to raise equity in the markets; the second one was to sell assets, and the third one was to generate enough cash flow to reduce debt on their own.

As the year progressed, a couple of things happened: First of all, the equity markets reacted negatively and cut off access to these companies; number two, as they all came to the market to sell assets at the same time, there was a glut of assets for sale and very few buyers, if any.

And, number three, as Mr. Hunter said, as it became clear that as counterparties traded with each other, they were shying away from trading with each other. The cash flow of the trading business began to decline rapidly.

So suddenly you didn't have the ability to reduce debt out of any of these companies. So from our point of view, then we took rating action and, in some cases, dropped the company below investment grade.

Now, in most instances, getting dropped below investment grade should not cause a distress. The probability of default for a BA rated company is 20 percent over ten years. Eighty percent of the companies survive ten years.

The problem then becomes rating triggers. Once you do that, you've got a cliff because everything comes due and there is no access to the capital markets.

So, a lot of the rapid downgrades and a lot of what's happened reflects exactly that. The rating triggers were in place, the bed had been made years before, because that's how the industry allocated credit amongst themselves.

MR. O'KEEFE: I had a question. To what extent, if at all, does the contingent legal liability get factored into ratings, and as subpart to that, the prospect of possible regulatory enforcement action; does that get factored in at all, and how?

MR. DIAZ: Yes, it does. For companies that are under investigation, for example, that have -- there's potential, if they are found guilty of wrongdoing of some sizeable lawsuits, and we try to estimate what that may be and how they will be likely to fund that, and also whether or not any conclusions would change these companies to change the way they do business, and would that be a negative.

So it's clearly and overhang on the ratings of companies that are under investigation.

MR. HUNTER: Yes, just to say there's a process that goes through evaluating each one, to say is this purely a vexatious piece of litigation? I mean, we've seen an awful lot of shareholder litigation lawsuits recently, which we don't ourselves perceive as being particularly massive hangovers over a company's rating, because any settlement that does come with that is likely to be relatively modest.

You can obviously take that right away out the continuum to a sort of Texaco scenario where you'd say obviously that was a significant litigation effect for them.

So there's various stages. You can either look at this and say it's vexatious, it's insignificant, you can then look at it and say, well, actually, it might be reasonably material, but it's not a rating case, so you might just say, well, we're looking at it, and there's a reasonable case for being pursued, but we're not going to take rating action.

Or if you think there's a chance it could be significant, then it's a reasonable case, and we put it on watch or, in an extreme case, actually take the rating down.

MS. SMITH: I would agree. We do make an assessment of the severity of the legal situation and the lawsuit, but we don't try to predict litigation outcomes. That would not, I think, be possible to do.

But if we feel there's the potential for a huge legal liability, that certainly has to be reflected in a corporation's debt rating.

MR. HUNTER: One thing I would add to that is that we have had investors sit across the table from us when we go out to talk to them and say one thing you have to tell FERC -- and fingers are being jabbed in our direction, so this would seem to be the forum -- is, we have met an awful lot of investors who are very sensitive to the idea of regulatory investigation overhang, and certainly, I think, even more sensitive than we were to the idea. So maybe to give you an idea of relative quantum of concern, the investors are perhaps even more concerned than we are.

MR. O'KEEFE: Is there any way to quantify the amount of overhang in your ratings that pertains just to regulatory -- the prospect of regulatory action, or not?

MS. SMITH: I don't think we've done that, no.

MR. O'KEEFE: Okay. And I had one more question for Ms. Tezak about the EQRs. It's something that I'm interested in.

Do you have a frank assessment about the nature of the information that's currently required in the EQR and what more might be required?

MS. TEZAK: Other than we'd like to see it and have it presented in a way that's intelligible, you know. If that data is ready now, I know that before Christmas we were still waiting to have it come up on the web and to be able to see it and validate it. I think it would be useful in two respects:

The first would be, we would be able to make an assessment on whether or not, as we sort out where we're going on price indices, how big a problem the trade publications really are or may not be. There's huge concern about the robustness of their data collection, and it would be nice to be able to say, well, you know, this is what third quarter looked like; these were the transactions that were actually done; these were the prices that were made; how close or how far away were they from the transactions that were reported as price indices in data? I think that would be very helpful.

I think it would also be hugely helpful to get that information out to state and Congressional members so that they see that this is what the market is. You know, when people are throwing around x-number of billion dollars has been saved, it will be lot easier to sell, well, you know what? In 2002, this is what the third quarter looked like; in 2003, this is what the third quarter looked like, so that you can actually have coverage for a regulatory who is advocating continued deregulation of the markets and continued competition that you actually have those benchmarks.

Right now, we've got competing assessments of cost and benefit. You know, you've collected the data, help us understand it.

CHAIRMAN WOOD: Building on that, is there -- when you're evaluating a contract that a company has and trying to determine if that's in the money or out of the money -- I mean, clearly, mark-to-market has taken a black eye or two, but what indicia, other than what Ms. Tezak was mentioning, what indicia do you all that are evaluating the risks or potential upside of all your companies, look at on the electricity side for any sort of forward data?

MS. SMITH: We have been grappling with that for several years now, since the advent of merchant energy and the financing that goes along with that.

We have been presented with a lot of market forecasts that are prepared by industry consultants that we think are relatively flawed, and we are somewhat reluctant to rely on them as long-term forecasts.

You also see right now for price markets that may not really be pricing the product appropriately because there is low liquidity in the markets.

So I think it's a definitely an issue. These are difficult markets to project prices for. We look at things on a cost basis. To some extent, our analysis has caused us not to have to rely on market forecasts, because we're looking at economics of new entrants as a replacement for market forecasts.

But it would be much better to find something we could feel comfortable relying on, but we do have, you know, we see a great deal of variance in industry forecasting. And it is a problem.

CHAIRMAN WOOD: This is one I could have asked the first panel too. But since y'all are here. It's been a pretty gas-oriented investment industry for the growth in electric generation for the last ten years or so.

A lot of people wander into office, including one yesterday from the nuclear industry, that worry about what is a competitive market that we've got now that Europe is definitely moving toward even more swiftly than we -- what does the long-term market mean for the coal and the nuclear investment, assuming the other issues relating to nuclear are dealt with, with regard to some sort of long-term, even expanded hydro development, particularly north of the border -- how do those work for the companies that you all do coverage for? What kind of thoughts, if any, would they ever have to have in the way of market structure or regulatory apparatus in place to justify those type of investments?

Let's take as a posit higher gas prices and assume that that's probably here to stay.

MR. FLEISHMAN: I think that in and of itself is probably the real problem is that over time as gas-fired generation becomes more and more the marginal fuel throughout all the regions of the U.S., the power markets will become even more dependent on gas prices. You've already seen the correlation go up significantly. And we have a much different supply/demand profile in natural gas than we do in power plants right now.

So right now the existing nuclear and coal fleet, hydro fleet, looks very attractive. And in fact if you believe this price environment continues they could add some capital investment to existing plants. And you've seen that in the nuclear industry with up rates and the like.

I think the issue becomes this clear trend over time toward more environmental spending on coal. You will likely see some coal plants, some of the older coal plants shut down over time. And we are, you know, really betting on one horse here for the long term. That is a real risk for long-term energy policy.

And I think that's something that needs consideration as you're viewing -- it's almost a separate issue, because the only way competitive markets are going to reflect that is going to be with high prices most likely where you could argue for a very large, up-front investment in a coal or nuclear plant, it's either going to be high prices or some form of again long-term capacity market which we talked about before that reflects these long-term trends in gas.

So it is a very important long-term issue.

MS. COALE: This is not a direct answer, but I think the disappearance of the marketing and trading intermediaries as we have traditionally known them could threaten the reliability of the delivery of natural gas and its reputation of being reliable and inexpensive, not just looking at the current market today, which is affected by other factors, but looking longer term, could be threatened by this. And I'm not convinced that the financial institutions have the willingness or the incentives to take on that role of aggregating supply and demand for gas.

So our outlook is we are looking for generation margins to remain very narrow, but we also are concerned that the forecast made by some of the other industry groups that gas will be supplying 95 percent of new power generation and will grow to and demand for gas will grow to 30 tcf largely driven by that generation sector can ever be accomplished.

CHAIRMAN WOOD: And again, that's because the ability to really provide gas as a packageable fuel is impaired by the absence or the exit of traders from the market that have been doing that function?

MS. COALE: Yes. And of course they can't operate because they don't have the credit, and you don't see the financial institutions jumping in and making a success of it.

I mean, look at what happened with Enron's trading. UBS was not able to successfully implement and adopt their book, and I'm not even sure today that that's even a viable entity. Most of the people that moved down to Houston to take that over I think have gone back home.

So we're in a transition. Now I hear from critics of the industry, they say who needs these guys? Someone will step in in an efficient market, someone will step in and take over this role, and that's true. And consolidation will occur.

But the need is now. And I don't know how many years investors can wait, the regulators can wait, the rating agencies can wait until consolidation and a reemergence of a new aggregator can take place.

So we're in a vicious cycle. I had to bite my tongue when I was listening to the rating agencies talk about the flood of assets and how the asset values had deteriorated. My only comment that I'd like to say about that was the timing and the swiftness and the sort of what appeared to be irrational timing of some of the downgrades.

For example, El Paso was downgraded the day before they came up here for oral arguments, yet their financial condition in my opinion didn't change the day before. It was based on past events. But from a Wall Street perspective, we were not prepared for a downgrade the day before they went into the FERC oral arguments. And it surprised the Street and the stock took a hit.

So it's the timing and the swiftness that I had a problem with, not so much the downgrades themselves. I don't disagree that this was an industry that was over-levered.

MR. DIAZ: There is no good time to be downgraded.

(Laughter.)

MR. HEDERMAN: Commissioner Svanda, you had a question?

MR. SVANDA: We've heard from a number of panelists both in the first panel and this one that time is going to be one of the necessary healing agents here. We heard some people say that the corner has been turned, that things are looking brighter today. I've heard some people say it's going to be next year. And I think the bleakest outlook was 2005.

How much is that a measure -- how much of those estimates and your sense of things -- measures of the fixes that are necessary and that we've been talking about here this morning in the regulatory climate and some of those things? And how much is just an estimation of what you expect the overall economy to be doing and what you expect it to be looking like later this year and next year and in 2005?

And I guess that gets to the heart of the question then further, and that is will this sector, when the economy turns and when we all have the sense that the economy has turned, will this sector attract capital in equal proportions to the rest of the overall market?

MS. WANG: Let me say a few words about CERA's view on that. A lot of the financial difficulties are related to the oversupply situation. And we see oversupply worse this year than last year, and perhaps this year we will hit the bottom.

But after this, we will have to go through a long period of working off of the oversupply. So it's moving up perhaps in '04, but it will be a multi-year recovery. And the financial distress would reflect the low prices that come along with oversupply.

MR. SVANDA: There are a couple of possibilities that I see causing that oversupply. One is being in the transition zone that we're in right now, and the other one is the overall downturned economy, which is most important of those two factors?

MS. WANG: Well, the oversupply is caused primarily by too much new generation. If you change the demand side a little bit, if we had not had the recession, it wouldn't have made much of a difference.

So if we are thinking about a 2 percent real GDP growth versus a 3.5 percent GDP growth going forward, we probably would not change the timing of recovery by more than a year.

So it is going to be a gradual recovery. Either the GDP grows at 2 percent or 3.5 percent or even 4 percent. So it would take a dramatic change in GDP or in the intensity of electricity use in GDP, which we don't see. We see the intensity of the economy in terms of kilowatt hour consumption per real dollar of GDP continue to decline as it has over the past decade.

The demand side, if you stretch the imagination from 2 percent to 4 percent GDP growth is not going to make a lot of difference.

MR. SVANDA: But it could certainly make regional differences. My home state has very adequate supplies today. Had we remained in a go-go economy, we would be in desperate straits today without additional supply.

MS. WANG: Certainly the regional differences would make a difference. I'm talking more on the overall situation.

MR. FLEISHMAN: One of the ways we look at it is that 2003 really is a year of bottoming in two fronts. The first is that's the last year where supply growth will exceed demand growth. It's also hopefully the last year where cash outflows will exceed internal cashflow. And when you're an equity investor, stock investor, you tend to try and view the change and turn around ahead of time.

So when we think of kind of nearing a bottom, we're thinking this is the last year. This is really when we hit bottom, and as we look out two to three years out, we see at the very least cashflow improving and at least a positive momentum in terms of the extent of excess supply.

So that's kind of the viewpoint of the bottom. And hopefully, stock prices will react in step with that.

MS. TEZAK: One thing I would add, though, is that none of the expectations that Wall Street expects to see as far as price recoveries as we work off an oversupply will happen if there's not the political will to allow prices to increase.

Because if we're going to have right now this -- like California had in '98 and '99, where prices were very, very low because of surplus, and as soon as they started to strengthen, they tried to put all the caps on, and all that did was cause power to flee out. Then as far as your prognosis for investment in this business, I wouldn't want to be near it.

So I think that that's something that concerns me dramatically. As we can outline the fundamentals and that we can get to a supply/demand balance. But that assumes that the politicians will let prices change.

CHAIRMAN WOOD: The prices that you're talking about are those in the energy market? I heard I think one of each panel say --

MS. TEZAK: And the bilateral market if we're going to leave those open for renegotiation.

CHAIRMAN WOOD: Well, that's up to the contracting parties as to what terms they want those to be I suppose.

But is in your mind there a significant interest in people that are planning to make a business plan out of, you know, $500 per megawatt hour prices in the energy market?

MS. TEZAK: No. But I think that it has to be, you know, when you look at what was offered in the bilateral markets in California, what was a reasonable price in October of 2000, which the buyers put their noses up at because they believed that they were not in a shortage, is inappropriate.

I think that there has to be -- and this is again where education comes in is if you have an understanding of the situation you're looking at, if you understand that it takes natural gas to make power and that if you're sitting on a finite pipeline, then you're going to have a problem when the rain stops falling in the Northwest.

And I think that one of the things that concerns me is that there's not the political will now, particularly at the state level, to have any sort of fluctuation. And now that we've had several years of a recession and prices have come back, that any strengthening at all, even if it is modest, is going to be a real problem.

CHAIRMAN WOOD: What kind of fluctuation do you think is politically unacceptable? Because I do note it's significantly up above what it was last year.

MS. TEZAK: Well, it seems that the balance of the country in 2000 could withstand $7, $8, $10 gas, natural gas prices, on a temporary basis, and certainly then $40 on the California border was considered too high.

So I think that, you know, on a relative basis, if you're coming off very cheap power, like in the Pacific Northwest, a 40 percent rate increase looks like a lot in the newspaper, but when you look at what it's costing the average consumer, it's not necessarily something that's going to put large pockets of the demography into financial distress.

So I think that, again, this is the regional differences. But I think that one thing that concerns me dramatically is that if we're coming off this recession where customers are used to seeing companies in distress and negative spark spreads and more power than we have available, then if, God forbid, we had 3.5 percent growth and worked that surplus off faster than we expected, and all of a sudden somebody's $20 power goes to $55, which is considerably below a thousand dollar bid cap in PJM, but it's twice and then some what they were paying, you know, the year before.

And that's what I'm concerned about is that even when you're not talking $500 power but you're talking maybe you need to bring some more intermediate guys in in the $50 to $70 range, there's going to be resistance to that. Because not every kilowatt of power is provided at 2 cents.

CHAIRMAN WOOD: You're making a good case for signing the contract right now.

(Laughter.)

CHAIRMAN WOOD: But I'm not in that business right now. But we are in the business of lunch. So we will take a break and come back at a quarter to two and begin our next panel at that time.

(Whereupon, at 12:46 p.m., the Technical Conference recessed, to be reconvened at 1:45 p.m. the same day.)

AFTERNOON SESSION

(1:50 p.m.)

MR. HEDERMAN: Please take your seats. Thank you. We are continuing this afternoon with a change from Wall Street to Main Street and beyond. We have a number of participants from we hope just about every segment of the energy industry relevant to the Commission's jurisdiction.

Before we start that, I'd like to take a moment to thank the Commission Staff that put this together. I think you can see a lot of thought went into this, and as each of you know, it's hard to get people to commit and get here on the same day. Karen Mucha, Anita Herrera, Lee Choo, Jo Tolley and a number of people from the other offices in the Commission, as well as the staffs of each of the Commissioners, put a lot of work into getting this together very quickly, and I'd just like to acknowledge all of their hard work.

If we can start this afternoon. As I said, we'll have market participants who have either been seeking capital or then applying the capital. We look forward to getting insights about how that part of the process has moved forward. And if we could start with Mr. Downes' remarks from New Jersey Natural, I'd appreciate it.

MR. DOWNES: Thank you. And Commissioners, good afternoon and thanks for the opportunity to be here today.

My name is Larry Downes. I'm Chairman and CEO of New Jersey Resources Corporation. We are the parent of New Jersey Natural Gas Company and are one of the fastest-growing local distribution companies in the United States.

I'm here today not only to share my views on behalf of the company but also on behalf of the American Gas Association, which as you know has 191 members that importantly serve more than 50 million customers throughout the United States.

When we look at our industry, I think we can agree once again we find ourselves at the crossroads. We have a future that is so filled with promise with the expectation of growth. But in order to meet that growth, we really have very significant infrastructure demands. In fact, based upon studies that we've done, we estimate that that could approximate $100 billion over the next 20 years.

But unfortunately, as a result of a number of the well publicized issues surrounding our industry, including corporate scandals and all the rest that you heard about this morning, capital markets are now significantly tighter than they've been in a while.

We have been faced, some in our company, excuse me, have been faced with weak stock valuations, which has made access to the equity markets challenging and on the debt side, as we heard from the rating agencies today, lenders have tightened their standards, which has made access to that market difficult also.

We have seen instances on the short side where access has also been prohibitive. There have been instances where companies have paid 30 percent for access to capital, and I think we would all agree that that is not a positive situation for anyone.

And it is not just that capital availability is limited for energy trading and other diversified activities that have not performed as expected. We've seen it spilling over to plain vanilla LDC financing in terms of terms that banks are now looking for.

But that's what brings us to the crossroads, and I think the question before us all obviously is how do we address that.

I want to share with just a couple of points of a plan that AGA has put together, working together with its members on behalf of the industry, which we believe will improve the industry's ability to attract capital at reasonable cost.

It's got three main elements. The first one deals with expanding communications. We have to make it clear to the financial and regulatory community that they understand the fundamentals that we have. Because we do have a good story to tell.

I want to share with you just some of the points. First of all, our customers trust us. They look to us for reliability. That's the primary thing that we provide, that reliability.

Secondly, the fuel that we provide -- natural gas -- is clean, it's plentiful and it's domestic.

Third is the potential for return to our shareowners. If you look at different ranges of potential earnings growth opportunities in the range of 3 to 5 percent plus a yield of 5 percent, you can get a sense of what the return potential is. And when you compare that to the risk of the marketplace, I think we can agree that that potential is attractive.

We heard a lot about financial profiles this morning. I'm happy to say that the financial profiles are improving, but we have to be realistic about the timeframes over which that's going to occur. And also we expect that natural gas demand will continue to increase for the foreseeable future.

When you put all of that together, I think you can see that the potential is there for natural gas to be viewed as a solid industry opportunity, but we need to communicate that message.

The second point is the elimination of the double taxation of dividends. We are obviously pleased that the

President has made this critical initiative an important element of his economic plan. It obviously will benefit customers. It will benefit shareholders, and it will facilitate access to the market. Customers will benefit ultimately because we will be able to be better positioned to access capital on favorable terms.

Shareowners will see a lower tax bill in addition to increasing the attractiveness of an equity investment in a natural gas company, but it will also help dividend-paying companies to attract the equity capital that they need to improve their balance sheets, which is critical in the environment that we're in right now.

And then finally and I think very importantly, is regulatory innovation. That is regulatory programs that use the marketplace to create tools that help LDCs manage risk. There is a very successful story to be told on the natural gas side emanating from the changes that have been made in the wholesale market. At our own company we've been able to use those as a way to provide savings to our customers over the past ten years, and I think that that blueprint is one that we can very much build upon to help address some of the issues that we heard about this morning in terms of price volatility and ultimately meeting the needs of customers.

There have been a number of states around the nation that have embraced those changes, and we look forward and hope that that will continue to expand going forward. Because the reality is, a lot of those benefits that have been created have been done by using the market.

I want to make one more point, again, responding to something from this morning. I think it is essential that as we begin to rebuild confidence in our industry that we focus on the fundamentals, because I believe a lot of the things that have happened in our industry is because of a lack of focus on the fundamentals. Providing safe, reliable service, maintaining a strong financial profile, generating an appropriate return for investors.

If we adhere to these fundamentals, among others, I think that we will meet the needs of the many stakeholders who have placed their trust in us.

Thank you very much.

MR. HEDERMAN: Okay. Thank you. Let's stay along the pipeline, move upstream here. Mr. Rattie, could you comment please?

MR. RATTIE: Thank you. First of all, appreciate the opportunity to appear here before you. My name is Keith Rattie. I'm President and CEO of Questar Corporation. I'm here today representing not only Questar but also the Interstate Natural Gas Association of America, of course a pipeline industry representative.

We are an integrated energy company. We have an

E&P business. We have a FERC-regulated pipeline business, and we have a state-regulated natural gas distribution business. I guess I'd like to assert that means that the perspective that I'm going to share with you is not weighted either towards a producer perspective or a utility perspective or a pipeline perspective, but I hope from one that represents a balance of the interests across all of those parts of the natural gas chain.

I've got four themes I'd like to introduce in my initial comments today. The first is that by and large over the past decade, natural gas markets have worked pretty well. FERC policies over the past decade have placed greater emphasis on market forces in competition, and these polices by and large have worked fairly well.

Let me point to a couple of examples. In 1998, '99, 2000, we had a boom in gas-fired power plant construction. In response to the signals from the marketplace, we also had a mini boom in pipeline construction and pipeline capacity expanded to serve those new markets.

I would also argue that the market performed remarkably well in the wake of the Enron debacle. We had a player by some accounts handled 15 to 20 percent of the gas and electricity on any given day disappear from the market. Sellers found buyers for their gas. Buyers found sellers for their gas. There was a little bit of an increase in volatility initially, but the market -- other players stepped in to fill the void. And that's what you expect when you rely mostly on market forces. That's what happens in a competitive market.

I can comment on specific aspects of FERC policy for which there are some issues, but I want to keep the emphasis on the fact that by and large, natural gas markets are working pretty well.

Now let me move to theme two, and that is supply. And this is where I think the biggest issue facing energy policymakers in this country today is a question of whether or not natural gas supply will be adequate to serve the market appetite for gas at a price that we can afford from an economics point of view.

And let me give you a statistic here that I think helps put this into perspective. If today we were to stop drilling for natural gas in the lower 48, if all 750 rigs that are currently looking for gas in the United States were to stop drilling today, one year today, natural gas supply would be about 25 to 30 percent lower than it is right now.

The rate of decline in natural gas supply has increased. I think the other representatives of E&P business on this panel will acknowledge that. And the reasons why should be a matter of great concern for policymakers in this country.

Let me move to theme three. Pipeline investment risk is rising and risk-adjusted returns may not be keeping pace. One of the things we found as we tried to develop new pipelines in the Rockies -- and the Rockies is the one region of the country where we've got success from a supply standpoint. The supply from the Rockies is growing. The resource base there is enormous. It's underexploited. The whole industry recognizes that.

We can drill more wells. We aren't drilling enough wells. We're also not building enough pipelines. And our experience recently has been we've been unable to get contract support for pipeline expansions that, at least from our vantage point, are justified by the market.

And I think what this does, this points to, among other things, is the fact that there's an era of uncertainty with respect to new capital investment into pipelines these days.

Other panelists this morning emphasized the importance of stability and regulatory certainty. Let me underscore that point. It is absolutely critical.

With have seen with the problems on the IPP side of the business and the merchants as well, those were the entities that stepped up and entered into the long-term contracts that underwrote the investment in pipelines in '99 and 2000-2001. They're not out there right now. The only players that can underwrite this investment in pipeline capacity are the producers and the LDCs. And I expect that over time if we provide the certainty with respect to supply development in some of the key regions of the country, that those investments will be made.

So that is the number two theme. Three is policy towards the pipeline business should continue to rely on market forces. I think the lesson from California, the market didn't fail in California. California's market design failed. The prevailing mindset with respect to new policies or new proposals for new rules and regulation of the natural gas pipeline industry ought to be if it ain't broke, don't fix it.

And I'd like to suggest that the FERC also call into question whether or not lowest cost today represents the right emphasis, the right focus of policy. We have a critical need to expand this nation's pipeline infrastructure and lowest cost over the long term really ought to be the criteria.

And I would also suggest that for any proposed change in policy with respect to the regulation of the industry ought to proceed with an analysis that starts with a sheet of paper with four columns:

Column one would be the proposed change; column two the expected benefit; column three, the cost; and column 4, and this is the most important, what are the potential unintended consequences?

The law of unintended consequences clearly is at work. We saw it in California and it is very evident in the activities of this industry. I think other panelists have emphasized today that the sanctity of contracts is a very important issue as well. The sanctity of contracts is being called into question in some of the proceedings in California.

In the Q&A -- I've run over, so I'm going to stop now. But in the Q&A I'd also like to comment on a couple of other issues that I think are relevant to this discussion today, and that's the call by some independent producers for calling in pipelines who are earning above their allowed returns. I would like to suggest that's a wrong approach at the wrong time. Pipeline risk is rising and to call pipelines in because they've been efficient and found ways to boost capacity and might be over-earning, at least in the short-term, in a $5 natural gas market would be the wrong policy at the wrong time. And I'll elaborate on that if there is any interest in Q&A.

Thank you very much.

MR. HEDERMAN: Thank you. Mr. Transier?

MR. TRANSIER: Thank you for inviting me to participate today. My name is Bill Transier. I'm Executive Vice President and Chief Financial Officer of Ocean Energy. I also represent the National Gas Supply Association as Chairman here today, an organization that represents integrated and independent companies that produce and market natural gas in the United States.

What we've witnessed over the last couple of years is a significant shift in capital availability to the energy markets. Frankly, there's just a loss of confidence in all energy markets because of what has happened in the last couple of years, particularly in the merchant trading business.

To put it simply, the markets today are just not willing to invest capital in an E&P sector that has so many uncertainties. I can't really blame them. Several executives of marketing and trading companies are under investigation. The Securities and Exchange Commission is administratively challenging how exploration and production companies account for their approved undeveloped reserves. The rating agencies have become overly cautious with their ratings, adding concern to an already skittish market.

If someone had told me a couple of years ago that we'd have a commodity price environment of $33 oil and $5 and $6 natural gas and that E&P companies would be reluctant to drill, I would have told them that they were out of touch with reality. But that's exactly what's happening today.

You ask why. Well, domestic E&P companies are quickly depleting the inventory of prospects that can be economically and quickly produced. A recent DOE study showed that reserve additions per well in the Gulf of Mexico have dropped to 3 bcf a well versus a long-term average of somewhere between 5 and 7, almost double that.

The situation we have today is smaller reserve size, faster production rates because of technology, and higher costs resulting in an overall lack of growth in production for the industry, somewhat like running up a down escalator for the industry.

This brings me to what I believe is one of the greatest issues confronting the U.S. produce community today, and that's one of the things that the Natural Gas Supply Association is working hard on. that's the need for greater access to governmental lands that hold larger reserves that can be developed more economically. We believe that the industry can balance the environmental needs of the world out there with the alternative uses of these lands while still capturing the vital energy resources for our consumers.

I know that this is not an issue that the FERC can address directly. However, we do need FERC support on Capitol Hill and action on the national energy policy. I also believe a focused agenda that prioritizes the country's energy needs would calm some of the fears in the capital markets as projects that support these national initiatives are developed and require financing.

It's our position at Ocean Energy and within the Natural Gas Supply Association that deregulation at the wellhead has created a highly competitive and diversified industry that is benefitting consumers. For that reason, we believe the government-mandated higher returns for any sector of the industry is not in anyone's best interest. There must be a level playing field, and that all segments of the industry must assume the risk associated with a competitive marketplace.

Over the past five years, the period between 1997 and 2001, E&P companies recorded on average a 7.5 percent rate of return on their net investment. A study performed by the NGSA and provided to the FERC shows that the top 30 pipelines had an average rate of return of 14.4 percent.

Three pipelines had returns in excess of 20 percent over this same five-year period. All investors deserve to receive a return that exceeds their cost of capital. The question here is what returns are just and reasonable commensurate with the associated risks that they have to take in their business.

You could argue with the facts presented that there is a transfer of wealth between the consumers, the E&P companies and the pipelines. At 7.5 percent return, investors are just not recovering their cost of capital.

What can FERC do to help? Well, we would suggest that you expeditiously resolve the ongoing investigations of pipelines and electric utilities to bring stability back to the market.

Second, expedite the review and approval of new pipeline projects, particularly those that promise access to new areas such as the Rocky Mountains. Take a look at the pipeline rates of return to ensure that the existing rates of return are just and reasonable and commensurate with the risks the pipelines have to take. And be an advocate for all of us on Capitol Hill for access to areas restricted for exploration activities.

Thanks very much.

MR. HEDERMAN: Thank you. If we could move to the other side of the spark spread. Mr. Kelly, could you give us your remarks?

MR. KELLY: Sure. Thank you. My name is Bob Kelly, I'm Executive Vice President and CFO of Calpine Corporation. We are an independent power producer or merchant generator.

We went public in 1996 and we owned a little over 500 megawatts of generating assets and about an $800 million balance sheet. We went public based on the theme of what we called repowering America with clean, reliable and affordable electricity, which incidentally is fairly consistent with FERC's view.

To fulfill our vision, we needed to raise a lot of money in the capital markets. And we had a fairly simple investment thesis for the providers of capital. And we've been doing this for the last five or six years. We told the investor we would build the lowest cost, most efficient generator, and we would compete in markets where we could sell into a competitive market where usually the lowest costs survived in the long run.

And secondly, we had a market where we had sanctity of contracts. When parties entered into deals, they wouldn't be changed, they wouldn't be amended, and they wouldn't be abrogated.

The theory really worked. Over the last six years, as a sub-investment grade, or as the rating agencies say, a junk-rated company, we raised over $26 billion and now own over 25,000 megawatts of the newest power plants in the country in some 22 different states.

In fact, it worked for a lot of people. As our industries invest I think something over $100 billion in the last five or six years in power generation. And we'll add something, I heard a number 130,000 megawatts this morning, up to 180,000 megawatts over the last four years. That's a tremendous economic investment which has been made in an industry. And we're at a conference here about capital availability. The capital did flow to the marketplace. The marketplace really worked.

We raised this money on the theory that we would be competing in these markets and our contracts would be valid. If the theory works, we are really struggling right now to raise the last billion dollars for our company to complete our megawatts. We have plants which are almost finished, 70 percent. It doesn't seem like a big number, a billion dollars, when you've done 26. Just another day at the office. It's a very difficult capital market out there.

Why is that? Well, the theory didn't really work. The lenders and investors have lost tremendous faith in the theory of competitive markets and contracts. I've talked to more investors and lenders I think than anybody in this room, and what they need to give us money to compete in the marketplace.

On the competitive side, we compete in some regions where we develop very efficient 7,000 heat rate plants, and incumbent utilities still dispatch older, less efficient plants, in some cases exceeding 12,000 heat rates. The difference on a marginal basis is plenty of money for us to make money.

Our plant is not running. The utilities at 13,000 heat rate is running. On an economic basis, the consumer is paying for that.

Lenders and investors don't see this as a sign of competitive market. The lowest cost, most efficient is not running. It's very challenging to forecast prices and create reliable forward curves when the market is seriously impacted by the ability of incumbent utilities to use the regulatory process to protect their own assets from competition.

That's when our plant's up and running. The lack of competitive markets affects us when we're even trying to get the plant operational. We've had many very challenging cases in getting to that stage as the long debates, delays and disadvantage economics of fairly priced interconnection impacts when capital is available. When you have to debate for a year or 18 months on what the cost of interconnection is, markets have moved, lenders have moved on, and investors have moved on.

Perhaps the thing I hear more than anything else from the providers of capital to the energy sector is the sanctity of contracts, and we've heard that a number of times here today. Whether it's the implied contract between the ratepayer and the load-serving entity, or the power supplier to the load-serving entity, the financial system has become very, very skeptical given the recent industry track record in contracts and disputes.

Anytime there is a perception, whether we end up in the right place at the end of the day, that perception really affects our ability to raise money. We're sitting here today as a company with some very good power contracts which two years ago, there would be no problem financing them. They're good power contracts. Good load-serving entities. We're having a difficult time raising the capital because they're not sure if the contract is going to be in place for the 20 years the load-serving entities set.

If it's hard to finance, we get it financed, we raise less capital, it's a higher cost of capital, and at the end of the day that got passed on to the consumer, and prices have to go up. And that's not what deregulation is supposed to achieve.

With this background, what can the FERC do to help? Most importantly, FERC has to execute its vision of fully competitive market. FERC understands what it takes to make a competitive market, and it should stand firm in putting these elements in place.

That said, there are some small, incremental steps, very critical, which the FERC can take in order to make the market more competitive.

FERC can finalize proceedings which are ripe for decision, such as the interconnection case, the affiliate code of conduct case, and the market power or supply margin assessment case.

In addition, and I think you've heard it many times today, we ask the FERC to conclude, if not expedite, the proceedings concerning long-term contracts. All of these discussions have a direct effect on our ability to raise capital.

Secondly, we need to address credit in this business. And I understand you're having a conference on that, and we hope to participate in that later. We have approximately $200 million of wasted capital put up for credit against interconnection, transmission, gas pipeline transportation service agreement. While we agree there's some level of collateral required, the monopoly nature of the service providers, their ability to extract capital is evident.

There's also things like the regulatory filings that are made in connection with transactions needed to be processed in a predictable and timely manner, especially when the filing doesn't raise any substantive legal or policy issues.

For example, there should not be a question when a party receives approval for a transaction to transfer a power contract from one sub to another. Calpine is not a monopoly service provider. It takes 20, 30, 45 days. In the capital markets today, our deal is gone in that period of time. Markets shift that quickly when you're waiting for regulatory approval on things.

In summation, we need to create an environment that's a competitive market and ensure that contracts are upheld.

Thank you.

MR. HEDERMAN: Thank you. Let me ask one quick question. Concerns were raised earlier about maintaining generation assets. Do you have any observations on that in terms of having the capital funds to maintain the facilities you have?

MR. KELLY: No. It's not a big concern of Calpine Corporation. Our assets are brand new. I think a lot of the comments are related to maintaining capital on older, less efficient assets and by definition, they should go out of the marketplace. But that's not a big concern of us.

MR. HEDERMAN: Thank you. Ms. Houstma, can you speak?

MS. HOUSTMA: Thank you. Good afternoon. I'm Katie Houstma, Vice President and Controller of ComEd, a subsidiary of Exelon Corporation, and I'm here today representing the views of Exelon.

Exelon's subsidiaries include two large utility companies, ComEd and Pico, as well as Exelon Generation, which owns or controls a diverse portfolio of over 40,000 megawatts of generation.

Exelon's power team is a business unit of generation and is a leading power marketer engaged in the business of selling electricity and electric capacity and energy products in markets across the U.S. And we appreciate the opportunity to be here today in the Commission's exploration of capital needs of the industry.

The Commission is concerned, and rightfully so, about the availability of capital to the industry for investment in infrastructure, for liquidity in the transaction market, and for long-term stability.

As you've heard over and over today, the energy industry has suffered a severe crisis of confidence that has eviscerated many competitors. The dwindling of available credit is impeding the development of robust competitive markets.

Our view is that regulatory certainty is one of the crucial linchpins to capital availability and stability in the energy markets. Regulatory certainty is important to assure recovery of investment and to assure a firm footing on which companies can develop business plans.

Regulatory certainty will help rebuild confidence in energy markets and foster investment in needed new infrastructure.

Regulatory certainty for wholesale electric markets was a key finding in three reports published by the DOE in 2002. The National Transmission Grid study and two DOE Electric Advisory Board reports recommended that regulatory certainty is essential for completing the transition to competitive wholesale electricity markets and restoring investor confidence in the marketplace.

In our view, settling standard market design rules to govern transmission operations and to stimulate market transactions, as well as to limit the liability of transmission owners and providers, will contribute the regulatory certainty and consequent stability to the business environment on which companies can build renewed financial confidence.

Exelon is a large, financially sound energy company with hard assets, a strong balance sheet and a good credit rating. And Exelon itself is not having trouble attracting capital for its business activities. But as you've heard today, many other companies are.

And the lack of standard market design rules has affected the availability of capital to energy companies in two significant ways. First, the regulatory uncertainty has exacerbated the ongoing crisis of confidence that has cut off credit and substantially diminished the liquidity of the wholesale energy trading market. And second, the regulatory uncertainty has impeded the flow of capital for investment in new transmission infrastructure.

The ability to offset physical risks to the trading and marketing of financial and physical rights is an essential element in all successful commodity markets. But such trading requires credit backing, and a growing number of companies are having trouble securing credit backing for their transactions, which has substantially impaired their ability to participate in the market.

With fewer market participants, the volume and duration of capacity and energy transactions also has dramatically diminished, thereby reducing the liquidity and transparency in the market.

The loss of liquidity and transparency results in fewer opportunities for companies to offset the risks associated with generating and transmitting electricity, thereby impeding wholesale competition.

In addition to forcing some companies out of trading altogether, the credit crunch is causing smaller and shorter-term transactions to dominate the marketplace. Companies that can get credit at all often are unable to secure enough credit to back more expensive, large and long-term transactions.

It goes without saying that a greater degree of liquidity in the marketplace would enhance competition and more long-term transactions would have a stabilizing effect on price volatility and would enhance reliability.

Implementation of standard market design nationwide would provide regulatory certainty and help restore confidence in energy markets and market participants. A more robust marketplace will provide a more stable trading environment, and stability will reduce risk for lenders who will loosen credit for market participants.

Our second point is that investment is needed in the near term in transmission infrastructure. In May of '02, the Department of Energy published a study identifying a number of significant bottlenecks in the nation's aging wholesale transmission systems.

The study found that savings of over $500 million could be realized if bottlenecks were addressed in four major regions. Expansion and upgrade of the transmission grid is a straightforward approach to addressing this need.

DOE has emphasized that investment in new technology is important to make the transmission grid more efficient and more secure. According to one analysis cited by DOE in its 2002 national study, maintaining transmission adequacy at its current level might require an investment of about $56 billion over the next decade.

Transmission upgrades also will enable market-based demand responses to be a meaningful part of the market. Moreover, while there currently is excess generation capacity in most regions, the overhang will not last forever. Companies must have access to capital to develop these projects and some certainty that they will operate in an environment that allows for an appropriate return on the investment.

The investment in infrastructure will not be forthcoming until the rules of the road are clear. Market participants need to know how they will recover their investment,a nd they need the certainty of competitive markets for the signals to build the most efficient upgrades and to build generation when and where it's needed.

A point we wish to emphasize, however, is that along with standard market design rules, FERC must also adopt tariff provisions limiting the liability of independent transmission providers and transmission owners under the tariff, as well as others who may act at the direction of an independent transmission company. Otherwise, FERC may inject some very real financial uncertainty into the energy business.

As the Commission heard at its technical conference on liability issues, the prospect of unlimited liability based on negligence or for consequential damages such a customer's lost profits, would create tremendous uncertainty and chill investment in energy companies and projects.

This concern came from every sector of the industry as well as from potential insurers and investment bankers.

Thus, we at Exelon urge the Commission to pursue regulatory certainty as well as financial certainty by including the limitations of liability provisions in the tariff so as to preclude all indirect damages and to limit the ITPs and transmission owner's liability to direct damages based on their own gross negligence or willful misconduct.

In closing, establishing fair, stable and consistent rules will encourage investors to build more necessary infrastructure. Exelon believes the Commission's vision of seamless electric markets across the country is not only possible but in the public interest. A thoughtful standard market design for wholesale electricity markets is imperative to the future health not only of the electricity supply industry but also to the nation's economic recovery.

Delaying or preventing its implementation would not only harm electricity consumers, it would also be deeply harmful to our national economy.

Thank you.

MR. HEDERMAN: Thank you. Mr. Fuller?

MR. FULLER: Thank you. Good afternoon. I'm Jim Fuller, Senior Vice President and Chief Financial Officer of the Municipal Electric Authority of Georgia, or MEAG Power headquartered in Atlanta, Georgia.

At the outset, let me thank the Commission for holding this conference on capital availability for energy markets and inviting me to participate on behalf of both the American Public Power Association and MEAG Power. I hope to give you some insight into the availability of capital for not-for-profit portion of the electric power industry.

APPA is a national trade association for the nation's 2,000 state, municipal and community-owned electric utilities. APPA members range in size from villages that distribute all electricity to a few hundred customers, to multi-billion-dollar vertically integrated electric utilities.

What these diverse utilities share is a common business model under which we provide electricity at cost to our customers, typically meeting our capital needs through debt financing or funds raised from utility revenues. As state and local utilities, there is an identity of interest between each utility and its customers in providing reliable electricity at the lowest possible cost consistent with our obligation to be stewards of the environment and responsible to our ratepayers and communities we serve.

This alignment of customer and utility interests leads to a somewhat contrarian point of view relative to our discussions today relating to capital availability. APPA members have no systemic problem raising capital to support the infrastructure needs of our customers. What we do see is an immense problem brought on by the financial implosion of many of our counterparties in the IPP and merchant trading segments of the industry.

Regulatory uncertainty brought on by the Commission's proposed standard market design as well as the birthing pains associated with creating RTOs have compounded these problems. But the root cause appears to rest with the speculative business model that many energy marketers and investor-owned utilities embraced in the late 1990s chasing the phantom profits posted by Enron and other traders.

Conversely, public power systems, MEAG Power included, continue to raise capital in the form of taxable and tax-exempt bonds at long-term rates of less than 5 percent.

Both market investors and their advisers are not dumb. Before lending us money, they closely scrutinize our operations, cashflows and business plans. And what they find is a low business risk model with low cost efficient organizations that are focused on the long-term needs of their core customer owners untainted by speculative activity.

Public power entities have been able to perform well through a combination of slower pace of deregulation, given the ability to decide locally not to opt into full retail competition, and holding onto their generation assets. This combination of these actions spare public power systems many problems caused by power shortages, extreme price volatility, and regulatory and political gridlock.

To illustrate this point, let me cite two examples. On December 17th, 2003, Fitch Ratings issued a special report, Outlook 2003, on the U.S. power and gas industry. On page 40 and 41, Fitch Ratings Service rates 93 state, municipal, cooperative and federally owned electric utilities, including 75 of the state and municipal utilities that APPA represents. The median senior debt ratings of these utilities was single A plus with a range from AAA to BBB minus. Only 11 of these utilities had any type of Sub A category ratings, according to Fitch.

In the case of MEAG Power, we have received upgrades from all three rating agencies over the last 18 months. We have a mid-A senior debt rating and stable outlooks from two of the three rating agencies and improving on the other.

This reflects well-founded, long-term customer focused business plan to grow our system in response to our customer needs.

MEAG Power is a municipal joint action agency created in the state of Georgia for the purpose of owning and operating electric generating and transmission facilities to supply vocal power to political subdivisions of Georgia. We stay close to our core business of providing reliable, competitive electricity to our customers.

In addition, we are a founding member of TEA, the Energy Authority headquartered in Jacksonville, Florida. Early on we recognized that the bulk power spot market was becoming increasingly volatile and complex. To optimize the use of generating resources that are surplus to our needs, MEAG joined with other public power systems that formed TEA, a joint marketing alliance, and placed them in charge of our wholesale trading activities.

Let me be very clear. TEA does not engage in speculative, uncovered trading. At the owner's instructions, codified in TEA's bylaws, trading takes place only if backed by physical assets. TEA also uses very conservative risk management policies to ensure the financial health of its counterparties on both sides, the buy and sell side.

In response to two questions posed by the

Commission in its January notice of agenda, what are the causes of the current problems of capital availability for the energy markets and what are the potential solutions varies in the energy industry.

Let me give this initial response. The capital markets can be supported in an environment of trust and opportunity, but when trust is broken and opportunity squandered, the capital markets and investors are unforgiving. Investors must be convinced the game is fair. Competent entities will succeed, and those abusing the rules will be discovered and disciplined.

Restoring investor confidence in the energy markets cannot be solved with one broad stroke, only through systematic improvements in financial reporting, risk management and corporate governance will investors' confidence be restored over time.

Thank you.

MR. HEDERMAN: Thank you. Mr. Gorman, would you share your remarks?

MR. GORMAN: Thank you. My name is Mike Gorman. I'm a Principal in the firm of Brubaker & Associates, and I'm here appearing on behalf of the Electricity Consumers Resource Council.

The capital markets we believe have responded efficiently and irrationally to the energy markets. When there was a clear need for new generating capacity, the capital markets provided capital for the development of the assets. When there is less of a clear need for generating assets, the capital availability has not been as robust. In cases, it has been rather limited.

Capital was abundant over the last five years as significant investments in generating resources were made and reserve margins in various regions went from a marginal 15 percent in 1997 to in excess of 20 percent currently.

As such, the need for new generating capacity today is more uncertain as it was five years ago. Consequently, attracting capital for new generating asset development today is much more difficult than it was five years ago.

We believe that this capital availability discipline is market efficiency at work.

There has also been capital constraints produced by certain market participants due to operating and financing decisions. Collateral requirements for trading operations have constrained participants' funding sources for asset development. Over-leveraged balance sheets have contributed to the deterioration of credit fundamentals and restricted some companies from attracting additional capital.

Importantly, as we heard several times this morning, the deterioration in corporate governance due to accounting and trading activities has eroded investor confidence in the industry. Also important is market discipline as enacted changes to many of these market participants' managerial decisions.

For example, many assets in common equity now are being sold to pay down debt and strengthen balance sheets. Business models are being rewritten to reduce their reliance on more higher risk speculative trading activities.

Also, corporate governance can be improved over time with integrity backing up statements by management and what they achieve and plan to do with their companies.

In short, for capital attraction, we believe that the discipline of the market has done what one would rationally expect it to do, provide capital when it's needed, when assets are clearly needed to be developed, and making capital more difficult and in some cases, more expensive when there's less of a clear need for new generating resources.

Transmission companies, we believe, are low-risk enterprises. Virtually all the major credit rating agencies have recognized that transmission companies don't have commodity risk; that is, the don't have the risk of buying fuel or generating power and selling it into a volatile wholesale power market.

These same companies balance themselves or finance themselves with balanced capital structures. They are a relatively low-risk enterprise.

Transmission investment has been constrained, however, by market participants' conflicts of interest. It has been widely recognized that many generation owners are able to increase generation profits when transmission constraints limit the availability of generation supply into specific market regions.

Many market players thus have a conflict of interest between making needed infrastructure investment and maximizing their generation profits. When the market player owns both the transmission system and the generation, it then has a true conflict between maximizing generation profits and making infrastructure investments.

In summary, capital markets have exhibited an efficient discipline to encourage or discourage generating capacity development, depending on the current supply and demand for new assets. Transmission investment is a low-risk investment. We believe that the FERC should ensure that transmission owners are provided adequate and fair compensation for the risk they take.

Transmission investments are, however, low risk investments. The Commission, we believe should not award excessive rates of return on current capital structures that are too heavily weighted with common equity. Doing that would ensure only that transmission prices are unnecessarily increased and investors' wealth is unjustifiably enhanced. Thank you.

MR. HEDERMAN: Thank you. Mr. O'Brien, I think we've held your remarks go into another dimension, and we've held you to last.

MR. O'BRIEN: Thank you very much. I appreciate the opportunity to be here. My name is Urban O'Brien, and I'm the Director of Governmental and Regulatory Affairs for the Apache Corporation.

Apache is a large, independent producer with extensive operations in North America and abroad. I'm also here to representing three state independent producers associations: The Texas Independent Producers and Royalty Association, the Oklahoma Independent Producers Association, and the Louisiana Independent Oil and Gas Association. Together, those three associations represent about 6,000 independent producers in those three states.

I'm here to talk about one particular problem, and for us, it's quite simple, and what I've learned from this morning is that after companies like Apache produce the gas and sell it and send it own downstream, things get significantly more complicated from our perspective on it.

But I what I want to talk today about is the tremendous lack of confidence, the utter lack of confidence in the wholesale prices for natural gas, the price indexes, the published price indexes.

For more than a year, we've heard all the horror stories about the incredible succession of events, months of daily revelations, admissions, indictments, convictions, continuing investigations. Even as late as Monday of this week, there was another announcement from the Justice Department of even more attempts to manipulate the natural gas indexes. And we believe this has all resulted in a general stigma of disrepute, attaching not only to the indexes, but to the industry as a whole, and it's hurt all of our credibilities.

As I said, for us, it's a pretty simple equation for independent producers. Market manipulation or attempts to do so equals no confidence in pricing. No confidence in prices means limited risk-taking and investment. That means limited drilling, that means reduced production and reserve additions. That means higher prices.

The higher prices for natural gas leads to the fuel switching to less environmentally friendly fuels -- coal and nuclear were mentioned here earlier -- and a greater reliance on imports, including imported crude oil and now the most recent interest in increasing LNG imports.

And we believe that it's a whole series of dominos, and several of those dominos have already fallen, and a couple of them are leaning, and make no mistake about it, the rest are in trouble, including the last one that I failed to mention, which is bad news for the economic recovery, both for producers and consumers, alike, as high prices continue.

You've all heard the stories, and I can give you quotes from the traders in their own words, about how they have admitted to trying to manipulate the gas prices. They've lied, they've cheated, they've stolen, not necessarily lessons that you learn at graduate business school.

So I, for one, learned that those were not proper behaviors when I was in third grade, but I guess for some, it takes a little longer.

This led up to the ultimate no-confidence in -- and some of you may not know this, and I want to read from Platt's November 2002 Inside FERC Gas Market Report. It contained an extensive footnote which said, in part, "Because of the lack of price reporting in the wake of all these revelations, Platt's has not been able to use its established methodology for the majority of pricing points in the November survey. However, to provide the market with its best determination of the price range, Platt's has reported an assessment at those points, based on differentials to other locations and other available market information."

Well, after you distill the legal jargon from that, essentially what the Platt's footnotes was warning readers is that because they weren't getting proper information or significant information from the people who used to report prices to them, Platt's was essentially making a guess.

And they guessed and they published the prices that they guessed at 50 of their traditional pricing points, including Houston Ship Channel and their Henry Hub price, where the substantial majority of the gas of the United

States is priced.

We've gone from traders making up numbers to the publications themselves making up numbers, so I don't think that there's really any -- anybody should be real surprised as to why there is no confidence in the indexes.

Operating a commodity production business like producing natural gas is tough enough, given the natural price volatility that's inherent in any commodity market. But it's impossible if you don't have any confidence in the prices at all.

Hardest hit by this, this lack of confidence, frankly, had been North American producers as they pulled back exploration and drilling activity. As Mr. Transier indicated, rig counts are low. Last time the price of natural gas was over $5, the natural gas rig count was 850 rigs, heading up to a high of 1,050. Monday, the natural gas rig count was 718.

Small domestic independent producers, the mom and pops, the people who traditionally find and produce 80 percent of the gas reserves found in the lower 48, it has been a particularly hard year for them.

According to the Texas Railroad Commission, the available capital for those small independents has essentially dried up. It's all but disappeared. The Railroad Commission records indicate that actually over 1500 independents have ceased to exist last year, just disappeared.

This has been difficult for us in Texas with that many producers disappearing, they've walked away from their wells, and now we've got about 63,000 abandoned oil and gas wells in Texas that somebody has got to plug.

So it's a continuing crisis. And even for companies as big as Apache and smaller big independents, mid-size independents, we've seen our capital for domestic projects cut almost in half.

Drilling activity has been down, even though prices have been up for the last several years, and there were some estimates that production estimates for 2002 will fall as much as 7.5 percent short of the production totals for 2001.

Again, I said that the current rig count is only 718. That's way below the thousand rigs that most of us believe are needed just to maintain production levels and reserve additions. We're having to run twice as fast to stay in the same place.

And, frankly, a lot of us are beginning to wonder, without a turnaround, whether or not the fuel of the future, natural gas, has one.

But as the Chairman said this morning, most of us try to be optimistic or we wouldn't be in this business, and we believe that there's actually a relatively simple way of bringing back the confidence of the markets and putting independent producers back to work in the United States, and, again, it's a pretty simple equation: Transparency in the price indexes, in the way natural gas is priced.

And for us, transparency means reporting. Greater reporting means confidence in prices, and that means an increased willingness to invest and take risks. That means more drilling, that means increased production and reserve additions, that means more reliable supplies of natural gas at reasonable prices, and that benefits everyone, the economy, the environment, producers and consumers alike.

Now, I want to be real plain, because we've been accused of a number of things at Apache, some of which are true, but most of which aren't.

To us, transparency means reporting, not re-regulation. We believe that all market participants must abide by a certain set of limited rules of engagement, and those rules must be enforced by an impartial referee with the appropriate authority, and, more importantly, the credibility to provide that kind of oversight.

In this case, we believe the referee should be this Commission and the mechanism for enforcing those rules would be quite simple: First, all market participants who trade physical gas, physical natural gas above certain volumes o a company-wide basis, should report all those physical transactions daily to the Commission.

The data reported must include date, time, locations, durations, volume, price, and counterparty information.

And that's going to be controversial because a lot of people don't want to give up counterparty information, but without counterparty information, there is no way this Commission, Platt's, or anybody else can do a real job of verifying that the data is correct.

The Commission would then cross-check and verify all data to assure accuracy, publish the aggregated data, keeping counterparty information confidential under the provisions of the trade secret sections of the Freedom of Information Act.

The aggregated data should be available to anyone who wishes to use it, even if they wish to use it to publish their own index prices. We believe that through this process, you can get at the real crux of the problem, which is the validity of the data.

The value added at most that most of the publishers add to the index price system is simply taking the data that is reported to them and working it through a weighted average.

I'm a history major. I think I could do a weighted average.

(Laughter.)

MR. O'BRIEN: It's just like any computer, if you get garbage in, you're going to get garbage out. And what we're trying to get at is the information and the numbers that go into that weighted average for those prices, those index prices, is valid and verifiable, and is correct and nobody is trying to game the system.

We further think the Commission could then go on to report a weighted average price for every delivery point and time period for which there is appropriate and valid data.

The Commission should also coordinate with EIA to ensure that all other natural gas market information such as supply, demand, and storage data, are reported accurately and in a timely and reliable manner to avoid the problems we've had with such things as the storage reports from both AGA when they were doing it, and now EIA.

And then, further, we think that the Commission should be granted further additional authority to impose civil penalties for deliberate reporting violations, and continue to refer findings to the Justice Department for possible criminal sanctions.

We believe, and in the text of my written comments there is a legal memo that outlines this, that the Commission has sufficient authority to implement this plan now, and it at least would be a good place for your attorneys to start their research.

We don't think this plan is onerous at all. In fact, we think it's far from it. Most of the information required to be reported to the Commission under this proposal is already reported to either this Commission or other federal and state agencies.

In fact, as one example, Apache is the largest producer of natural gas in the state of Oklahoma, and all of the information that I just outlined in this process, we already report to the state of Oklahoma, including counterparty information, to whom we sold our gas.

And as far as I know -- and I'm certainly not an expert in what this Commission does or anybody does on the electricity side -- but we've been told that this reporting requirement is much less onerous than the requirements imposed on the electricity markets.

We think it's a small price to pay to restore the trust, faith, and confidence in the natural gas marketplace, and to give the fuel of the future its future back. Thanks again for the opportunity, and I'd be happy to answer any questions.

COMMISSIONER BROWNELL: So, reporting

counterparty information hasn't been a competitive issue for you? It hasn't caused you problems in terms of confidentiality and business opportunity?

MR. O'BRIEN: No, ma'am.

COMMISSIONER BROWNELL: Okay.

CHAIRMAN WOOD: That's because the OCC does not release that information. Or is that public in Oklahoma?

MR. O'BRIEN: No, no, that is -- again, that is kept confidential by the Oklahoma Corporation.

CHAIRMAN WOOD: And how often does your reporting down there take place? Is it monthly?

MR. O'BRIEN: The way it works is, in Oklahoma, we have to report how much gas we've produced, where we produced it, when we produced it, and to whom we sold it and for how much.

And then the state of Oklahoma uses that information then to verify that we're paying the correct amount in severance taxes and state royalties.

In addition to our being required to report that, our first purchaser, the people to whom we've sold it, is actually responsible for paying our severance taxes. So they remit not only our severance taxes, but they remit both to the OCC and to us, the detail of all the information that I just provided to you. And it hasn't hurt us, and we'd be -- at Apache, we're getting ready to open up our own internal marketing group, and we'd be happy to report any counterparty information we have.

CHAIRMAN WOOD: Mr. Transier, you also are in the production segment. What's your reaction to what Mr. O'Brien just discussed?

MR. TRANSIER: Well, Mr. Chairman, that's why they call it an independent sector. He has an independent view.

(Laughter.)

MR. TRANSIER: I'm not sure that we would agree with that, what Obie has had to say here today, but we do have concerns like everyone else does about the gathering of information and the proper reporting of it.

We do believe that the markets work, that those that are publishing these price indices are in a competitive market themselves, and once you lose credibility, you'll be forced out of the market.

There needs to be a method to verify that information so that we can rely on it, but if you look at the fact that the industry itself has operated over the last 20 years using price indexes and it has worked reasonably well, the events of the last couple of years should not have us jump to conclusions and assume that the whole process is fraudulent, as he might suggest there.

So I would ask you to do a lot more research and a lot more information gathering before you make any conclusions about oversight.

COMMISSIONER BROWNELL: I'm getting an affirmative from Mr. Rattie, as well.

MR. RATTIE: Yes, we're also a producer, and while we, like everyone else in this room are appalled at some of the disclosures that we've -- some of the things that we've learned that have been going on in the industry over the last couple of years, we think that for the most part, the remedies exist.

I would also say that we've seen the amazing power of our system and our markets to correct to these kinds of abuses. The companies that have done this are gone or leaving, and I think the consequences of that have already had the deterrent effect, by and large.

While some of these things may have happened in the past, I would be stunned if we're getting people calling in with bogus price information of any consequence.

I would also urge the Commission to put these comments in the context of the market that we have today. The price of natural gas at Henry Hub today is somewhere in the order of $5.25.

Now, you've heard some allegations that some people reported prices that were two, three, four cents off, bogus for one reason or another. I think we've got to put it into context. It's a serious problem; it does hurt the trust of the industry; it's got to be fixed, but I think there's a forest and a tree issue here.

I would also comment as well that the concern about the returns the pipeline are earning also should be put into the context of their share, the pipeline's return share of the total natural gas value chain. Gas priced at $5 at the Henry Hub cost about 30 to 35 cents to move that gas on a pipeline up to Chicago's city gate. That represents less than ten percent of the total value chain to the city gate.

If you call the pipeline in -- and there are a couple represented in this room -- they might be earning a 14-percent return on investment that's been made in the past, and hack their returns by two or three cents and it's not going to have a huge impact on the performance of the upstream industry.

Other issues are much more important in terms of stimulating supply growth in this country, and they have been mentioned before -- access issues, eliminating the myriad conflicting, complex, overlapping jurisdiction of federal lands in the West, in particular, and the Rockies, in particular, and in the offshore areas, are absolutely the priority, and that ought to be where the independent producers's focus should be. That's where we would urge policymakers to put their focus.

CHAIRMAN WOOD: To follow up on a point you had raised earlier, Mr. Rattie, and I might have heard it actually on an earlier panel as well, with, I guess, the big growth customer of the gas pipelines across the board being electric gen with the pressure on electric gen, who becomes the anchor tenant, so to speak, for the expansion of the gas pipelines?

That used to be in the '90s, where you got your money to build, and we did our job to shorten our end as much as we could, and we'll continue to do so with the review of those expansions, but where does the money come from now for the electric gens? Is it all just LDC based at this point?

MR. RATTIE: Well, there are two sources, Chairman Wood. Right now, with the loss of the aggregators, by and large -- and they were the entities, the IPPs and the merchants were the ones that took the risk of holding long-term contracts that provided the financial support to get those pipelines built in the latter part of the 1990s.

With them gone now, the two remaining candidates are LDCs and producers. And I think the market will respond. I think the producers, certainly this producer, putting that hat on for just a moment, recognizes, as a key producer in the Rockies, the region where supply growth has been the greatest and the region where the lack of pipeline capacity is felt by producers to a much greater extent than it is anywhere else, we recognize that we're going to have to step up and take that risk.

You know, the problem there is that -- and, again, I'm wearing the producer hat -- we're not sure whether or not we're going to have access to federal lands for a long enough time to drill up the prospects that we have on those lands, to build the supply that will allow us to take capacity, to take a five- to ten-year risk in holding that capacity.

That's one of the problems that's prevented producers from stepping in and filing that void. I would hope also that if we allow market forces to work -- and I think a couple panelists spoke to this this morning, and the point is right on and needs to be underscored -- the market will respond.

There will be a new aggregator role that will emerge from this fiasco of the last couple of years. We need it. We need it to make our markets work efficiently.

The producers, by and large -- many of the producers don't want to get involved with. Many of the end users don't want to get involved with it, so there is a void here that will be filled if we allow the markets to work.

CHAIRMAN WOOD: As an electric generator, Mr. Kelly, I do notice that we've approved a number of pipeline certificates coming through here since Nora and I have been on the Commission, that really had the electric generator as the anchor tenant to basically cause a pipeline expansion to happen.

If, during some transitional period of time, Cal Pine and others that were really the drivers of those expansions are not able to, you know, add to what you already have as substantial collateral that's already in place, how do you get -- how do you bootstrap back into, I guess, growth that we're going to need for the electricity market, if you guys can't really finance the gas pipeline expansion and the pipeline expansion is not really driven by LDCs or producers who are the two that he identified?

MR. KELLY: It is very challenging. Essentially, as an electric generator, we're a converter. We take gas off the pipeline and put electricity on the wires. And we have to have access to both or what's in the middle is absolutely worthless, which some lenders are finding out today.

And if we can't get gas transmission because of the credit, we don't build the power plant. It is that simple.

What we have found in our history over the last couple of years is that we didn't see the pipeline companies reacting to the marketplace, and we actually went back into the pipeline business, proposing to build our own pipes.

And that's what you have to do at the end of the day. If there is the demand for power for your power generating station, you have to get the gas to the power station somehow. And I would debate a lot about the creditworthiness of some of the independents on paying the bills, because when we produce electricity, we have a revenue stream which pays the gas transmission.

What they're talking about, of putting up credit is a very -- and this is a topic of another panel -- but they discriminate a lot against the IPP, perceived weak credit, which only adds to the cost of power at the end of the day.

CHAIRMAN WOOD: You mentioned a minute ago in your opening remarks about the economic dispatch concern. Yes, there is it.

I think our general regulatory framework is that in order to benefit the customer, we have an expectation that the lowest cost plant will run, and that will be the one that's dispatched.

Is what you're saying is that that is not happening?

MR. KELLY: Absolutely.

CHAIRMAN WOOD: And it's not happening why?

MR. KELLY: Some markets where the incumbent utility is dispatching their existing plants, which are higher heat rates. We've run economics on some unnamed states, and if they just ran on a marginal basis, just run on strict heat rate, economics, forget operating costs or lower maintenance costs with the new unit, the consumer would save upwards to a billion dollars.

Somebody is paying for that inefficient marginal cost. Those are huge numbers in any state.

CHAIRMAN WOOD: What's the incentive for a utility to run something at higher variable costs than you can?

MR. KELLY: If I knew the answer to that one, I'd tell them.

CHAIRMAN WOOD: I mean, is it to run you out of the market? If it is, that's a problem that the Department of Justice is probably interested in.

MR. KELLY: It's a whole investment thesis as competitive markets, the lowest cost, most efficient would win in the long run. We would have cycles. We're in a cycle, but when we see something running and our plant is not running, there's something wrong.

COMMISSIONER BROWNELL: And that would be certainly happening in states without ISOs or RTOs?

MR. KELLY: That's correct.

COMMISSIONER BROWNELL: Would that be perhaps why some people might resist the advent of an ISO?

MR. KELLY: I would think so.

CHAIRMAN WOOD: We've got some work to do.

(Laughter.)

CHAIRMAN WOOD: Mr. Gorman, I kind of heard a similar point from you, that transmission investment is hindered, you said, I think, primarily by conflict of interest? Walk me through that, because you went through a lot of thoughts pretty quick, and that one grabbed me.

MR. GORMAN: One limitation for encouraging market participants to make transmission investments is the fact that for some of the participants, by doing so, it will drive down generation prices, and that will reduce profits that those participants will make on their generating assets.

So there's an economic conflict for certain market participants that own both transmission assets and generating assets who want to maximize their profits and do so at the minimal cost.

Well, by not making transmission investments, they're accomplishing that objective.

CHAIRMAN WOOD: Is capital more available for a company that does not have the mixed incentive, or is that indifferent or is it less available?

MR. GORMAN: I have not heard any concern by any of the credit rating agencies or equity security analysts concerning the available of capital to make transmission plant investments.

CHAIRMAN WOOD: Yes, and we didn't hear much of that this morning, either.

MR. GORMAN: No.

CHAIRMAN WOOD: Except the concern about how you would get your money back, which is a fair concern.

MR. GORMAN: Right. I mean, it's still a regulated investment and from that perspective, it's one of the lowest-risk regulated investments a company can make.

CHAIRMAN WOOD: On the gas side, I guess, Mr. Downes, I should probably talk to you and the three gentlemen down here.

What is the snapshot now? We're about a year behind because we get the permit after you've got the contracts and all that. Do we expect, in the next 24 months, that there is going to be an increased demand placed from your customers through the pipeline system, even from the far extreme that we're going to have pipeline expansions about the same pace we've been doing here? A little more? A little less? Is there any way to tell? Do you have any early indicators?

MR. DOWNES: I think it is fair to say that there will be more. I think it is difficult to quantify how much. I think it is regional, quite frankly.

I'd like to, if I could, come back to the point that you were raising about the payment for this and the role of the LDC. We are the ultimate stewards of reliability, and we serve a customer base that's 90-percent residential, so our perspective may be a little different.

But the way I come at that is that the LDCs are the ultimate stewards of reliability, and what has happened because of the success that we have seen on the natural gas side, is that there are new opportunities, new market opportunities that have been created that have enhanced our ability to continue to take on additional capacity to get into ne markets and do that efficiently for our customers.

It requires, I think, a different mindset. It requires LDCs to view pipelines as customers, not regulatory adversaries, because we have many of the same interests in mind. It requires us not to be looking at what this one did and what that one did or didn't do, but to keep the focus on the ultimate customer.

So I would say, and, again, with my focus primarily on a residential market, that responsibility will lie with the LDC because the LDC will ultimately be held accountable for reliability.

In our marketplace, because of the growth that we have, you know, we expect and are seeing indications of additional projects that would enhance capacity, but I cannot emphasize enough, the importance of how markets have developed, have led to creativity in terms of the enhanced use of capacity and creativity that has allowed us to continue to meet a growing customer base, so this for the LDC side of the house.

CHAIRMAN WOOD: And I was thinking about what Mr.

Fuller said about what his debt -- I mean, what his financing climate looks like. You mentioned this kind of briefly at the first of your comments, but can you reiterate, because he was pretty detailed about what the financing climate is like, actually for an end-use electric cooperative. What is it like for an end-use gas LDC?

I mean, the last time you went to the market would have been when?

MR. DOWNES: We just finished a bank financing, but I think the question is more one of that for companies that have managed their capital structures conservatively, they're not going to have a problem with access to capital.

What we have seen unfolding, unfortunately and tragically in some instances, the basic fundamentals of maintaining a strong financial profile have been violated. And the sad part is that we have come out -- we are in a difficult capital market environment right now.

But during the time when the capital markets were strong, unfortunately, in many instances, what we were we doing? We were overpaying for assets. I'm using "we" generally here, and not New Jersey Natural, of course.

But we were overpaying for assets, I'll make that clear. We were using debt. And what has that done? It's impaired our financial flexibility.

I think the issue that we have to be focusing on here is not that the rating agencies call it too early, too late, should he have know this? That's past us right now.

I think what we have to do is look at the core root of what has gotten us here. A lot of the discussion that we've seen here today is that it's almost like somebody else did this.

Decisions were made in terms of capital structure that impaired flexibility, and when we're looking at ways to get companies back to the market, to encourage capital back in, I think we've got to focus on those fundamentals.

The need is really job one, to get the strong companies to maintain the flexible capital structures which allows them access, no matter what the conditions may be.

CHAIRMAN WOOD: That was clearly what I heard this morning, too, which was, pay attention to the balance sheet, and everything else seems to more or less get resolved.

MR. DOWNES: It works every time.

CHAIRMAN WOOD: I'm learning that as a homeowner, too. I'm refinancing this month.

(Laughter.)

COMMISSIONER BROWNELL: But I think we need to remember what we also heard this morning, which is pay attention to fundamentals, clean up the balance sheet, but get the rules right.

Because if you have systemic and endemic discrimination in the system, no matter how healthy you start out, you can't stay that way. So I want to keep those in balance here.

CHAIRMAN WOOD: Fret not my friend.

MR. DOWNES: I think that on those two, there were certain givens that we have to have here. I think Mr. O'Brien said it well. He was taught not to steal in the third grade.

I think that the fear that has been created in the market is some of those things that we would have liked to have taken for granted, we were not able to, and that we will now go through this period of transition back to that, hopefully sooner than later.

CHAIRMAN WOOD: Well, it's our hope that we can do that, at least from our part, as soon as possible, so that at least the view about what's right and wrong from a public interest side of the fence can be extremely clear, if it wasn't clear before, that there are certain types of behavior that don't work in this market, and that goes for all players.

MR. DOWNES: I think, to your credit, the steps that you have taken to create Office of Market Oversight and Investigations is sending a strong signal to the market that that type of behavior is just not going to be tolerated.

CHAIRMAN WOOD: I agree with that, and certainly our commitment to this Office is a big part of what we've been doing lately. But, you know, it is important that the tools necessary for understanding what is going on in those markets are available. We certainly are finding out where we've got good tools and where we don't.

Certain electric markets are very transparent, for example, in the country, and others are not transparent at all. And it's very difficult to put your hand on the Bible and vow to protect the public interest if you have no idea what on earth is going on out there. So, we do have some work left to do.

Ms. Houtsma, to kind of cut to a specific issue, you raised one that actually hasn't gotten a lot of air time here, but I have heard it earlier in my career quite loudly and often. It's this limitation on liability.

Kind of in the post-9/11 environment, how is a wires company dealing with liability issue and insurability? Is that a big part -- has that bill gone up?

MS. HOUTSMA: Yes, our insurance bill has gone up, and I think getting insurance -- well, getting insurance has been much more difficult, in the first place, than it was prior, and the bill for what we have been able to get has gone up as well.

CHAIRMAN WOOD: One of the issues that came up in our SMD rulemaking on this specific issue was do we at the federal level, need to do a liability tariff when those exist today for transmission companies at the various state levels? Is that -- what's the difference? I mean, what's new that is different today than was existing maybe three or five years ago, that we need to put that in the federal tariff?

MS. HOUTSMA: Well, I think that we just want to be sure that there isn't anything in a federal tariff that would impose new liability on the utilities, on the transmission companies. We want it to be clear that there is not a -- that they're not held to a standard of being on the line for consequential or inconsequential damages.

So I'm not sure that -- and I can bring that back.

CHAIRMAN WOOD: I guess my question is really just -- and with David here, it's helpful, but are we treading in a place where states already have trod, or do we need to do this in order to make kind of multistate markets efficient?

MS. HOUTSMA: The liability?

CHAIRMAN WOOD: On the liability issue, yes.

MS. HOUTSMA: Well, I think -- and I guess I'm not in a position to speak about what has been done at the state level. I'd be willing to bring it back. I'm sure somebody at our company can speak to that, and, if it would be all right, I'd like to have somebody give you a better answer.

CHAIRMAN WOOD: Great. I think I remember from my job in Texas that that issue was extremely important in setting up our restructured market as defining clearly what the liability of the transmission owner, transmission provider was, vis a vis its customers and suppliers and the ISO.

And getting that right was actually a lot more difficult than I thought it was going to be, but I think it worked fine. But it was a hard issue. So I'm glad you put a spotlight on it today, because it is one that I know matters to the transmission owners.

MR. SVANDA: One point on the liability issue, I guess since you were working on that issue in Texas, it's become a lot more complex, based on some of the national security considerations that have been escalated recently. So, that is another set of variables that enters in.

I also have a followup question for Mr. Kelly. I was probably equally fascinated with your story, including the -- you have assets in 30 some states?

MR. KELLY: Twenty-two states.

MR. SVANDA: Is information available on your financial and your operations on a comparative basis, state-by-state, or region-by-region, that would be available for part of the public conversation?

MR. KELLY: There is -- we break out our assets by region, and in some of our contractual portfolio, by region, but we don't segment by geographic that we make x-dollars in this state or that state. We have a power generation company and a gas company and those are the two segmentations.

CHAIRMAN WOOD: Nora?

COMMISSIONER BROWNELL: Mr. Fuller, I just am interested -- I spent a little time with you and your colleagues at MEAG, and I appreciated the opportunity, but explain to us, are your assets wholly-owned by you or do you have other investors who share in certain transmission or generation assets?

MR. FULLER: The generation is owned by MEAG Power, and we have take-or-pay power sales agreements with our underlying municipal cities. In regard to the transmission in Georgia, the three main supplies, Ogelethorp Power, Georgia Power, and MEAG, jointly own the transmission, and we finance proportionally.

If MEAG has ten percent of the customers, we pay ten percent of the costs, and we can wheel power to any part of the state, so it's a joint transmission ownership, but we own our ten percent soley, and the assets are specifically apportioned, but we can use the other partners' transmission to wheel power anywhere in the state of Georgia.

COMMISSIONER BROWNELL: And what kind of excess power sales do you make in any given year? What's the typical?

MR. FULLER: Our revenues are approximately $550 million, and we might sell $25 million through the Energy Authority.

COMMISSIONER BROWNELL: Thank you.

MR. HEDERMAN: Thank you very much. We will take a minute to switch panels here, and we move on to the last group.

CHAIRMAN WOOD: Thank y'all.

(Pause.)

MR. HEDERMAN: This is our last group. We have something of a mixed bag here, but each of these organizations is one that is doing something important, relative to the capital formation, and we appreciate each of you coming to speak to us.

In a recent Public Utilities Fortnightly editorial, they mentioned this conference and they mentioned, well, the Commission should be having the Fed at it, and since we're having the Fed at this conference, can we start with your comments, Mr. Mattoon?

MR. MATTOON: Sure. Thank you very much, and I thank the Commission very much for inviting me to participate in this very interesting conference.

First of all, I do have to offer the standard disclaimer. My name is Rick Mattoon. I'm a Senior Economist with the Federal Reserve Bank of Chicago, and what I'm about to say reflects my own views, and not necessarily those of the Federal Reserve System or the Federal Reserve Bank of Chicago.

That having been said, I think I do represent a kind of potpourri panel perspective here. In many ways, what I'd like to do is sort of step back, give somewhat of a bigger picture to sort of put the utility capital situation into the context of other industries and within the greater economy.

Now, first of all, the institution I work for obviously only very indirectly influences sort of the condition of capital markets in the United States. Now, obviously we do that through the establishment of the discount rate and the Fed Funds rate.

The goal, obviously, of the institution, the Federal Reserve, is to make sure that there is sufficient liquidity in the economy to make sure that the economy continues to grow, without creating inflation.

With this in mind, in the last year and a half, the Fed's been particularly active. In 2001, the Fed cut the discount rate 11 times or 475 basis points and in 2002 we made another half-point rate cut, dropping the rate to the almost historic low of 1.25 percent.

What all this means is that essentially the cost of capital has been driven down rather significantly, and there is in many ways, significant liquidity in the system. However, one of the contexts in which the Fed has been examining this economy is, the last recession was largely a business-investment wed recession.

And within that, one of the nagging concerns has been getting the business investment going in the United States, regardless of what sector of the economy we're looking at.

In fact, some estimates have suggested that the business fixed investment fell by about 5.5 percent in 2002. So the utility sector, in many ways, wasn't really unique in the situation of facing a tough environment for investment.

One prominent Chicago economist recently referred to even the current climate for business investments as being, quote, "the wall or worry," suggesting that many business leaders are simply reluctant to expand into any new markets.

And he suggested that, of course, there are a number of logical factors, geopolitical risk, things having to do with the basic business models that most companies have been operating and have been called into question, and that this is forcing several reevaluation of a number of conditions and capital markets.

So with that having been said, let's get back to the utility industry and talk about some of the things that may affect the capital crunch, particularly in this business. First of all, I'd like to posit -- and I think a number of people touched on this throughout the day -- that there really is no utility sector any longer. There is really a whole fragmented group of companies which have very different business models that, of course, have to be analyzed sort of on an individual basis.

And that, of course, has made things very difficult. So, for example, I'll give you one somewhat humorous or anecdotal example.

I know of one holding company which went through the structure of essentially becoming sort of a fast-growth, slash-your-dividends kind of utility structure. This holding company spun off a service business; they had a regulated utility, and they did some trading operations.

At one point, I called them up when they had reported that they were particularly happy with the kind of results they were getting out of their service business, and I asked them what sorts of products did their service business provide?

Well, the suggested that they did some of the usual things that you would expect, such as they offered home energy audits and things like that, but they said that their number one selling product was a clock which had the faces of birds on it that chirped on the hour.

And part of me suggested what I thought about this when they told me that this was their number one selling product, saying I wonder how this really fit with their business model for how they were going to be a successful utility or a successful holding company?

MR. HEDERMAN: It was probably an electric clock.

(Laughter.)

MR. MATTOON: That's true and I hadn't thought about that.

Probably what I'm trying to point out is, again, part of what's been happening is calling into question, sort of these fundamental business models within the utility sector and suggesting whether there are sustainable ways in which they're going to make business in the future.

So, one of the things that I guess I take away from having heard all of the other participants this morning talk about is that much of this is a self-inflicted capital crisis on this sector.

That's not suggesting that there aren't things that can't be done to improve things, such as improved regulatory certainty, and to do things that will particularly attract investment into things like transmission, however, I think that what you have to realize at this point is that time will take care of some of the problems in these areas, but the other aspect, which, again, is a recurring theme throughout the day, is transparency in these markets is going to make a big difference.

Once again, investors know more clearly, what it is -- what businesses these companies are in, and how they plan to make money in the future, it will be more easy for them to make these sorts of better judgments in the future.

So with that, I will conclude and thank you again.

MR. HEDERMAN: Thank you. Mr. Smith?

MR. SMITH: I'm Mike Smith, the Executive Director of the Committee of Chief Risk Officers. Thank you very much for including us in this valuable assessment of capital availability for the energy markets and discussion of actions we can take to restore the investor confidence in our marketplace.

The Committee of Chief Risk Officers was formed in the Spring of last year in response to the need to better understand the role of energy merchant companies in supplying competitively-priced electricity an natural gas to utilities, cooperatives, federal agencies, and other wholesale buyers.

Our intent, as the industry's risk officers, is to recommend best practices for our industry, principally in the areas of risk management and energy merchant functions. Events over the past three years have demonstrated the need to increase the transparency of the energy merchant industry, ease comparisons among the energy trading companies, and increase confidence amongst investors and regulators.

They have also triggered very specific issues such as how market prices for electricity and natural gas are reported. The over 30 diverse companies that make up the Committee of Chief Risk Officers have committed thousands of hours for research, discussion, and efforts to the development of recommendations about what we think are or should be our industry's best practices.

We have put forth, for example, best practices for the governance and organization of energy trading and marketing operations within our corporations. We have offered specific ways to calculate the information management needs to understand the nature of the risks inherent in the energy merchant and power trading business.

From our recommendations, merchant energy companies now can better value the output of their power plants, as well as the value of the fuels needed to run those plants.

We have recommended how to reduce the collateral required to operate a merchant trading company by as much as 75 to 90 percent by netting out obligations and utilizing multilateral clearing between trading entities.

This is an important benefit, not just to the industry but to the consumers in general. Last week we produced a model agreement to standardize existing contracts to support this effort. We have also offered specific and robust disclosure recommendations to make it easier, especially for those panelists this morning who expressed a concern in this area.

To evaluate individual companies and compare group performance in the management of merchant power plants and in the energy derivative trading and marketing activities. We have developed eight distinct disclosure tables that analysts and investors should find very helpful in separating the energy trading from the rest of a company's business and also in disaggregating the trading operations themselves.

Since we unveiled the first phase of our recommended best practices in November, the committee has seen a growing amount of interest not only in the breadth of our work but also in the details of the recommendations. We are more convinced than ever that the roles and responsibilities that we have taken on voluntarily will help everyone with a stake in our energy markets going forward, and we believe the comments you heard earlier today in reference to our group support our view.

In response to your agenda topics, permit me briefly to address the special role that coordination plays in the development of these best practices. When we begin to think about recommending specific best practices, we know we have the confidence and credibility hurdles that our industry currently faces.

Therefore we typically meet with the logical stakeholders to ensure we're striving to do not only what gets the job done but can do it within a very reasonable amount of time.

A stakeholder could be a regulatory commissioner or a senior staff member, a relevant industry trade association or coalition, buy and sell side security analysts on Wall Street, the Department of Energy's Electricity Advisory Board, or it could be accounting firms, credit rating agencies, federal lawmakers or consumer interest groups with a keen interest in energy policy.

For example, as we prepared a recommend best practices in the gathering of energy price data and reporting of price indices, we've invited organizations, such as Dow Jones, Platt's, and others, that publish price indices, to hear their views and concerns in Houston at a seminar last month.

We've also met with several of the groups that I've mentioned above, and I'd also like to say we've also met with Ubi O'Brian to get his perspective in this area as well.

And with regards to indices, we are striving to release our recommendations in this area in early February.

Among the trade associations who are familiar with our work include the Edison Electric Institute, the Electric Power Supply Association, the Energy Brokers Association, and the National Energy Marketers Association.

We have made sure that our work does not overlap with related efforts by any of these organizations, and for that reason and as an example, we applaud EEI for developing their master netting agreements and also EPSA for developing their code of ethics.

Just yesterday we met here in Washington with an organization that has been very critical of many energy merchant company activities, the Coalition for Energy Market Integrity and Transparency and look forward to any recommendations that they may choose to share and dialogue on in the coming weeks.

So you can see how firmly we believe in coordinating our work with others. Input from the relevant outside parties also will play key roles as we seek to determine and study the amounts of capital adequacy necessary to build and sustain a viable energy trading business.

We look forward to distributing those

recommendations to you some time in March. That I believe consumes my five minutes and I appreciate the opportunity to be here.

MR. HEDERMAN: Thank you. Mr. Foster?

MR. FOSTER: It's very gratifying to me to see all this focus on transparency. Obviously the mission of the FASB is to set accounting standards that improve the transparency of financial reporting and heretofore, we've gotten much resistance from most of our constituents. Most of the companies in the U.S. don't believe what I believe is an axiom that transparency results in less uncertainty and which also equates to a lower cost of capital and to see it's unfortunate that this industry is bearing the brunt of being the example, but if this industry is successful in becoming much more transparent and producing more reliable financial information, hopefully it will set an example for the rest of the nation.

I will address some of the things that in particular the FASB has done in the last year that will improve the transparency of financial information. Before I do that, I need to make the same disclaimer that Rick made. That is I do not speak on behalf of the FASB. The FASB's positions are only taken after extensive due process so what's you're going to hear are my views so that if I happen to piss some of you off, it's me you're mad at, not the

FASB.

(Laughter.)

MR. FOSTER: One of the big concerns that arose from Enron and is still a concern is that of off balance sheet debt. And most of that was achieved because, achieved through establishing special, special purpose entities which were not accounted for in the consolidated financial statements but which had substantial liabilities that were really the responsibility of the entity that set them up.

Tomorrow I believe, if not tomorrow, Monday, we will post a new standard on consolidation, and were calling it Variable Interest Entities because the term SPEs is widely used. Nobody really knows what it means and rather than having to define that, we created our own term. But it addresses when an entity ought to consolidate a variable interest entity, and it will result in a number of so-called special purpose entities being reflected in the financial statements going forward.

We also, in October-November last fall, issued a standard that addresses how to account for guarantees and clarifies what disclosures should be made including that the maximum amount of total loss that an entity is exposed to by issuing a guarantee needs to be disclosed, and also requiring that the fair value of a guarantee. That is the value of the obligation to stand ready to fulfill the guarantee in the event you're called on to perform has to be recognized at the time that the guarantee is issued.

And although I believe that our standards always require that, I'm one of the few people in the world that does believe that, so it will entail a change in practice and we will be seeing the values of guarantees in financial statements. *BRIDGE TO 26* abilities in equity obligations. In other words, when you issue a financial instrument that is an obligation, is it an equity security or is it a liability. People have been -- investment bankers in particular have been very creative in devising complex instruments that have the characteristics of both equities and liabilities, the idea being that you can classify the resulting payments to the holders of those interests as dividends rather than interest expense.

This project is a much broader project than what I'm going to describe but we're shortly going to issue a standard that deals with one of the practices that was prevalent at Enron and that was guaranteeing the people that were investors in special purpose entities against losses with a promise of issuing Enron stock. Among other things, this new statement would clarify the fact that in the event that you do enter into such a guarantee that it's in fact a liability and not an equity instrument which doesn't get accounted for in the financial statements.

Finally, I just wanted to touch base. In October, our emerging issues task force issued a Consensus 023 which rescinded Consensus or Issue 9810 and basically what this means is that energy trading contracts that are not derivatives can no longer be carried at fair value and mark to market in the financial statements.

While I want to make clear that the board and the EITF continue to believe that fair value is the most relevant measurement attribute for trading activities and energy contracts and derivative, but there was so much concern about the unreliability of the measurement of, in particular, some long term contracts, 30-year, 40-year contracts that the ITF concluded that those should no longer be carried at fair value.

I believe the intent of the ITF was that most transportation storage and capacity contracts would no longer be mark to market. However, I've heard that creative people can structure those contracts such that they're derivatives in which case they will still be mark to market. Whether that's so or not remains to be seen.

Thank you for your time and I'll be glad to answer any questions.

MR. HEDERMAN: Thank you. Mr. Stockton?

MR. STOCKTON: Thank you. My name is Blaine Stockton. I'm with the Rural Utility Service and Agency within the Department of Agriculture. And some may say, well what are they doing here.

Prior to our being the Rural Utility Service starting in 1994, when there was a reorganization, we were the Rural Electrification Administration, and what I can tell you is we have been providing capital into rural America for 67 plus years to rural electric cooperatives primarily, although we do have municipals that are borrowers of ours and investor-owned utilities can in fact borrow money from us.

Today the coop serve about 75 percent of the land mass. Our electric loan portfolio or outstanding balances today exceed $34 billion. I can tell you over the life of the program since 1935, we have lent in excess of $60 billion so we have a portfolio outstanding right now $34 billion. We have the largest federal investment in the electric infrastructure in the government.

Today we have approximately 720 borrowers. There are about 900 to 950 across the country. Over the last six to eight years, about 200 borrowers have bought out of the program and they get their capital primarily from the National Rural Utilities Cooperative Finance Corporation, CFC. We make supplemental loans with them and make 100 percent loans as well.

As I said, today we have about 718 borrowers that are still borrowing money. We call them active borrowers. They have assets totaling more than $57 billion. They serve approximately eleven million meters, if you will. We do say they are providing service to about 25 million Americans across the United States in rural America.

Our loan portfolio of recent date. In 2000 we lent $2 billion; in 2001 we lent $2 billion; in 2002 we lent $4.1 billion, and we will have to wait and see what Congress does here after January 31st to see what our total budget will be, but our requested budget for 2003 was $2.6 billion.

Those customers of ours are either local electric distribution cooperatives, which is the vast majority of them, and we have about 55 generation and transmission cooperatives that borrow from us. Now they are in fact owned by distribution systems in their particular states if the distribution members have gotten together and formed those what we call generation and transmission cooperatives.

The distribution borrowers have been getting about a billion dollars a year from us over the last few years, and the GNTs have been getting about a billion dollars from us.

In 2001, we lent, thinking in terms of transmission alone, we lent more than $300 million and that built approximately 105 miles of transmission line out in rural America. In 2002, we lent $300 million plus and that was used to construct 253 miles of transmission line.

We have in-house and depending upon what our budget numbers that Congress passes for us, we have in excess of $700 million worth of loan applications that we will more than likely loan, process and loan this year. And this is just for transmission lines for generation transmission cooperatives.

Since 1993, we have lent money to put in place 25 megawatts of new electric generation and that does include 1400 megawatts in the year 2000 for critically needed gas turbines for peaking power that our borrowers need.

What we have seen over the last few years is a an upswing as far as the demand for capital from our generation and transmission borrowers. There was a period for a number of years where our program was running along $3, $4, $500 million from the GNTs. But as the excess capacity was used up, and as peaking plants were needed, we have not lent from any base load plants and then the aging infrastructure as far as transmission, we have seen an upswing in the electric cooperative market. One of their own associations of GNT accountants did a survey a couple of years ago looking at the capital needs for the electric cooperative industry, and at that time the survey results were that over the next ten years, they were going to need in excess of $9 billion of capital for the generation and transmission side.

And please keep in mind that has nothing to do with the distribution borrowers; this is just the generation and transmission side of the house.

I was glad to hear a number of the speakers earlier, they talked about we need to get back to the basics. This is one of the things in the last two or three years that we have been preaching to our borrowers is to kind of get back to the basics. We do encourage them to look to see what they can do in their local rural communities from an economic development perspective but at the same time they need to pay attention to their core business.

I was glad to meet Mike Smith here today. We would hope that over the coming months we would coordinate with them as far as risk officers. One of the things we are emphasizing with our borrowers and our GNT borrowers is that they need to be looking at risk assessment and what will they be doing when they come to us as a part of their application, they do need to show us what they're doing with respect to risk assessment for the loans that they're looking at to borrow money from us. And they need to look at whether it's a buy option or a build-and-own option.

That is sort of in a nutshell what we do for a living and I'd be happy to answer any questions.

MR. HEDERMAN: Thank you. Mr. Mattoon, I think you had some experience in other regions than the midwest. I'd just be interested in your take in terms of regional development implications if some regions are moving forward in an RTO world versus others that aren't. Do you see that starting to have macro regional economic implications.

MR. MATTOON: I don't know whether it has, at this point, macro sort of implications. I think regionally I think obviously the midwest has been one of the regions that's move probably more aggressively an RTO than other regions. I think it will eventually pay off in some real sort of macro benefits for the region simply because you have a better transmission system, clear rules of the road, and I think they'll make it so that investment in the region will be seen as somewhat more attractive. But it's still, you know, the RTOs are in a very formative stage and I think until you have more confidence in kind of their performance, it's still too early to say.

MR. HEDERMAN: Thank you.

COMMISSIONER BROWNELL: Mr. Foster, this morning one of our speakers recommended very specifically and then I think a number of others agreed with the need for more detail and more granular reporting in regulated entities becoming more of an issue now that there is a perception that some of the regulated entities are being threatened by some of the risks that were taken by the unregulated entities. And there was specifically reference to an exemption to FASB rules for the granularity of disclosure.

Is that something that you're considering or would like to get further definition?

MR. FOSTER: We don't have anything on our agenda at this point. The standard that we have with respect to segment reporting is about three, maybe four years old, and what it requires is that companies disclose segmented information or information about their different kinds of operations, the same way in which they manage their business. Prior to issuing that standard, and to some extent still today, you would read the president's letter to the shareholders and they would say they were in these five different businesses, and then you'd turn back to the financial statements and they were in two different businesses, totally different than the ones they talked about in the letter to shareholders.

The idea was that if you thought you were in five different businesses, you'd report those five different businesses. Obviously, there's a difference between the regulated activities and the unregulated activities, and I would think that most companies would be structured so that they would be managed in different ways as well. But if they're not structured that way, the way that the standard reads now is they wouldn't be required report them separately.

Again I made some remarks about being gratified about this focus on transparency and what is really pleasing to me is the realization that the only way that you're going to able to access capital, is if you have transparency because that's not generally accepted in this country, believe it or not.

And what I would say is that if the analysts and some of the people that spoke in the capital providers insist on that kind of information, it appears that there's an appetite for providing that information and nothing prohibits anybody from providing additional information.

COMMISSIONER MASSEY: May I ask a question? Do the other panelists agree with that assertion that transparency leads to greater access to capital markets?

MR. FOSTER: We absolutely agree with that 100 percent and that had a lot to do with how we developed our recommendations in the area of disclosure. We, as risk officers, felt, and it's obvious there was a challenge to the confidence and credibility of our operations.

Our operations are detailed and sophisticated and complicated. And we were putting everything together and saying this is the results of our non-regulated energy merchant segment which includes our assets, could include hard assets and leased assets and trading and marketing and everything else and it was all put together and clearly with where our industry was and is, the analysts and the agencies and the banks and the stakeholders are saying that is not providing us enough information to understand your business. And so we, as the risk officers, the first thing we did was sit down with those parties and say okay give it to us with both barrels.

What would you like to see in disclosures because we want to raise an auspice here of best practice development, and best practice means we're restoring the confidence and credibility in the marketplace and providing our stakeholders with the information they need. And one of the things we heard consistently was everybody is giving us disclosures that are different. Wouldn't it be nice to get a standard set of disclosures so we would have not only he transparency that we need of all of your companies but also the comparability. We can actually compare all of you because you're all giving us the same information consistently.

And so we worked on these recommended disclosure tables, brought them back to those entities, and said, what do you think? And we got, we didn't think you guys could do it. You know, you've exceeded our expectations, this is great. But the challenges are still there and I think you heard the challenge this morning where you heard some comments about the CCRO is coming up with really good disclosures but they're voluntary and I bet you're going to see maybe 50 percent of the companies do that.

Well, my challenge back to that is I bet the capital markets we're dealing in will differentiate between the companies that are in the 50 percent that do it, and the companies that are in the 50 percent that don't.

So tying increased transparency with more capital availability I think there's a direct correlation there.

COMMISSIONER MASSEY: Do you agree with that, Mr. Mattoon?

MR. MATTOON: Yes. I think transparency is a real key and I think again part of it to change the overall environment, it's not just in this sector and the industry right now is under more pressure to be more transparent whether they're a large conglomerate or whatever and I think raising some signs the companies are being rewarded for that, or at least when they're coming clean with information, and not being penalized to the extent that they would have in the past.

COMMISSIONER MASSEY: Mr. Stockton, do you have a comment?

MR. STOCKTON: Over two years ago, we changed some of our accounting requirements so that in their audited financials we want to see more information particularly with respect to subsidiary operations and what-have-you. So we're wanting to see more information as far as the coops when they are requesting loans from us.

So in their annual financial audited statements, they've got to be showing these things.

CHAIRMAN WOOD: Why would anybody not participate in that? I mean after what we've been though in the last 18 months?

MR. SMITH: Not participate in --

CHAIRMAN WOOD: In the disclosure in the transparency -- well, not necessarily in the committee but in your result.

MR. SMITH: And going to --

CHAIRMAN WOOD: -- to the level of standardization --

MR. SMITH: -- the level of more disclosure, we think that they will. I'm a believer in capitalism in our free markets and I do believe that the pressures of the marketplace, if our stakeholders, and I can't say the word stakeholders. They drive the capital that's going to be available to us and if they want it and if they want these disclosures, entities that want access to that capital should be doing these disclosures. And they can be voluntary and recommended in open and free markets and not necessarily have to be regulatorily required to get them done.

CHAIRMAN WOOD: Do they require any tethering of what you all doing what FASB does?

MR. SMITH: When we recommended our disclosures obviously we wanted to make sure that we weren't getting crosswise with any accounting rules and that we were being consistent with accounting regulations. But with that said, our disclosures I think are giving information and disaggregating trading and marketing information for the analyst and the agencies that goes beyond what's required with the current accounting rules.

MR. HEDERMAN: The conflict in terms of disclosure is that gives a lot of information to your competitors that people would rather not give. So that's been the reason to hesitate in the past, a big part of it.

COMMISSIONER BROWNELL: That's the argument against disclosing anything always.

MR. HEDERMAN: Right. But having looked at a lot of competitors in my past, I know that it can be helpful.

CHAIRMAN WOOD: Mr. Foster, could you remind me of the emerging issues task force recommendations. Do they have to be approved by FASB ultimately? What status do they have?

MR. FOSTER: You probably don't want to get into as much detail as I can give you but they actually have very low status. There is a hierarchy of what we call GAAP, Generally Accepted Accounting Principles. FASB standards are level A GAAP. Some other standards are level B GAAP. EITF pronouncements are level C GAAP.

Currently they are not required to be approved by the board but we are in the process of instituting a change where all of their consensuses would have to be ratified by the board.

MR. CHOU: Kind of a follow-up question with you, Mr. Foster. It related to all this disclosure. I think there['s also a standard that you mentioned, the segment recording standard. Do you think or has there been any comments from analysts and so forth about why this has hampered the consistent comparison of business lines and so forth and may have clouded the financial performance information that companies are disclosing?

MR. FOSTER: We haven't done a formal survey and we get different views from different analysts as you might expect. It's interesting the standard for reporting segment data prior to the current standard which I said is only three or four years old was exactly that. You did lines of business and it defined how you determined the line of business. And most of the analysts, the reason we've changed is that most of the analysts told us that they would rather have insight into how management viewed its business and its various businesses that it operated, and they would give up the comparability both across lines and the consistency from period to period in order to have that insight. Not all analysts agree with that as you might have guessed but that was generally what we were told.

The International Accounting Standards Board, interestingly enough, issued about the same time that we did a standard that patterned our old standard, so there are two competing standards out there and at some point we will have to do the research to see which one people believe is more effective.

MR. CHOU: The reason I was following up on that is that it appears that maybe some of the companies that have failed in a particular industry have used this as a way to change how they segment their businesses from year to year and may have actually, you know, prevented people from discovering their financial disclosure, I mean their real financial condition earlier.

MR. FOSTER: If you do restructure the way that you approach the business from year to year, yes it will somewhat mask or hinder the ability to compare consistently from year to year, and probably as you say, enable people to obfuscate something.

MR. SVANDA: Mr. Smith, let me share my state perspective here. Are you organized to only operate at the national level or do you have local chapters that would be able to participate at the state level?

MR. SMITH: We are working right now as a committee of companies. We are an open organization. We will invite anybody in who has operations in this business. I will say we have a diverse set of companies. We currently have 32 companies involved ranging from the traditional companies you may expect, the Dukes, the Exelons, the Constellations, the Reliance, etc.

We've got the I'll call them the new foreign companies coming in. We've got the tractabels, the RWEs, etc. Blaine mentioned the interface that we have. We do have entities like TVA, the Energy Authority, ASIS Power involved. Really the requirement that we have to be a member is it's a company that has integrated operations where they have energy assets combined with risk management and marketing activities.

What we don't allow in are vendors who want to pitch risk products to us. We feel like we need to -- the products obviously are very important to implementing a lot of our recommendations but we feel the people that need to be working on the recommendations are the risk officers of the companies that are involved in the business.

MR. SVANDA: And a question for Mr. Mattoon. Were you here during this morning to hear the discussion of what was characterized as the over supply situation that we're in today. And I am troubled by and trying to reconcile today's over supply with how in a large sense the economy begins its recovery and upturn and how do we prevent our getting the situation where lack of infrastructure investment today in fact ends up as a drag on the recovery that we are all pinning great hopes on.

Did your regional analysis help with that,

MR. MATTOON: Yes.

MR. SVANDA: What's the turning point look like and does it apply across the country.

MR. MATTOON: Well, actually I agreed with your answer. I was in the room talking about regional differential. I mean obviously the economy won't pick up in a uniform pact throughout the country and also there is where we're particularly looking at the infrastructure, particularly transmission bottlenecks becomes particularly important because it's not so much you can't predict where the new generation is necessary to be needed, and some of it which may have been built now in fact might not necessarily have been needed. But in the long run, the important thing is being able to take the generation and move it to where their power's needed to be drawn.

And so I think that one of the things at this point is, as you said, every recovery has a sort of an uneven pace across the country, and that's where you have to be particularly attentive to these sort of regional infrastructure needs, and looking at how that ties in.

As you know in the midwest, being from the midwest, some states, such as Wisconsin, have significant transmission constraints at this point, and if that's a state that picks up well in the next recovery, they will be in trouble regardless of what new generation may be coming on line.

MR. HEDERMAN: Okay, well I guess we can call a close --

CHAIRMAN WOOD: I have another question. The mark to market deal clearly got a nice black eye in the last. Explain to me exactly what the October Emerging Issues Task Force decision was?

MR. FOSTER: I need to give you a little history. In 1998 the EITF Emerging Issues Task Force decided that to the extent that an energy company had a trading desk and engaged in trading activities, that those activities should be accounted for differently than other activities that it was more representationally faithful or more useful information if those contracts were mark to market. And I can give you the history. We've had people come and testify.

To make a long story short, it's my view that the

EITF was sort of led down the garden path as to how reliable the measurements of some of these contracts were. And it came to light as part of the general concerns about trading companies and the whole trading business that arose from the Enron debacle that in fact what these people are doing is marking these contracts to model. When they would enter into a contract, somehow the model would produce a big gain the next day. And as a result of that, even though the EITF believes that energy trading contracts, the most relevant measure would be fair value mark to market model.

Because of the inability to reliably measure these contracts, it decided that energy trading contracts should no longer be mark to market. Now it's interesting the Issue 9810 was issued before our Statement 133 which deals with derivatives and heads accounting was issued. And that statement calls for derivatives, if you meet the definition of a derivative, that those contracts be mark to market and reflected currently in income.

And the issue is so a number of energy trading contracts will continue to meet the definition of a derivative. And I'm told that even some of the long-term ones can be structured to meet the definition of a derivative, so they -- the jury's still out on the long-term ones. I don't know whether the commercial ramifications of structuring them as derivatives will cause them not to be structured that way or not.

But I guess the main point is is that a number of contracts that are entered into by energy companies, some of which are structured -- and I think Mike would tell you most of which are structured as to hedge operations or to otherwise minimize risks will be classified as derivatives and aren't required to be mark to market.

CHAIRMAN WOOD: Are those in the recommended format that you all are looking at Mike?

MR. SMITH: What we are doing with our disclosure recommendations -- obviously, sa you pointed out, there's a lot questions about mark to market, mark to model. When a company says this period I made x of gross margin or revenue, what our disclosures do is disaggregate that dollar of revenue. How much of it was real cash that came in this quarter and how much of it was unrealized income that was marked.

And then for that unrealized income that was marked, what is the source of that mark and what is the tenor of that allowance, or how far out into the future does it come, when can we see the cash. Because what the analysts want to know is of unrealized revenue that you're booking, how much of it is mark to market and how much of it is mark to model, and then when is it coming in. And as you can imagine, analysts, when they see something as being mark to model that comes in further out, they are heavily haircutting it in terms of their valuation of that dollar as one would reasonably expect they would do. But the concern now is absent these disclosures, mark to market and mark to model are coming under attack and so we're saying if there is somebody who's got a short-dated book where all of it is pure options that come to market within the next six months, they should lay these disclosures out and get the credit, because right now somebody's saying oh mark to market I'm going to give it zero value.

So you need to lay it out and then tell them exactly what is it, what's the source of the mark and when's it coming in, and that's what our tables do.

CHAIRMAN WOOD: Cooperative construction transmission lines, are there, in most cases for your borrowing members, are there additional state siting approvals required or do your members usually have a pass on that?

MR. STOCKTON: It depends on the state. Some of the states have -- the cooperatives are subject to state review or state siting, and some states do not have any involvement. Now, as far sa from our perspective, since it's federal dollars, we have to go through the NEPA process so we would require major transmission financing that we would have to go through, making sure that we follow our own

NEPA regulations and that they would have meetings out in the community, and get that kind of input -- but all states do not regulate coops as far as siting is concerned no.

CHAIRMAN WOOD: Just in the broader impact of what all's going on out there that we've heard a lot about today, what kind of impact is that having on the rural electric customer? I mean is it going by unnoticed or do the coops have difficulty getting lower cost power out of the open marketplace? Are there counterparties out there to do business with?

MR. STOCKTON: Some of the coops are finding it hard to get any long-term power contracts if they're out there purchasing as opposed to owning or building and owning. So in that respect, yes it's impacting them if they're out there simply buying power where they could have gotten a longer term contract in the past, those aren't available to them now. It makes them look harder at whether it's a self-build option or not.

CHAIRMAN WOOD: Do you all loan to the self-build option?

MR. STOCKTON: Yes. We provide loan guarantees and most of them would get their money from an arm of Treasury called the Federal Financing Bank.

CHAIRMAN WOOD: Do many of the coops that you all are familiar with engage in any sort of hedges of either their gas procurement or their power?

MR. STOCKTON: He mentioned ASIS and this is a new organization that's been created. And one of the things that a number of the coops that have joined ASIS, if their services, this is what ASIS looks at for them as far as risk and hedging type things and what they would be looking for going forward into the future. So some of them yes are doing it. Now we only have, of the 55 GNTs, a number of them are paper GNTs. They don't own any assets and they're just writing negotiating contracts and so we probably have about 30 that actually own hard assets.

MR. SVANDA: Mr. Stockton, we heard earlier in the day that we aren't, as a country, providing adequate incentives for investing in the new technologies that would in fact make the transmission grid system smarter. Does your agency provide any such incentives for forward-looking investments?

MR. STOCKTON: We are encouraging borrowers to participate or look at renewable options, and this year the administrator announced about a month ago that in this year's lending program out of our guarantee program if we get the $2 billion that's in the president's budget that it's not necessarily a set aside but the first $200 million of filling requests that come in for renewable type projects, we would put them in their own queue and they would get priority consideration. So from that perspective we are looking at renewable and there's no specific renewable that we're particularly interested in. Borrowers are looking at photo votex, wynn, any number of them.

CHAIRMAN WOOD: Good panel. Thank you all very much for hanging through the day.

(Whereupon, at 4:45 p.m., the meeting was adjourned.)