WACHOVIA SECURITIES

Look Out Below

March 05, 2006

Downgrading Sector To Market Weight--Downgrading Ratings On Four Stocks

Sector Rating: Integrated Electric & Gas, Market Weight
Sector Rating: Integrated Natural Gas, Market Weight
Sector Rating: Natural Gas Pipeline, Market Weight

				FY EPS				FY P/E	
Ticker	Stock Rating	Chng. Y/N	Price	2005E	Chng. Y/N	2006E	Chng. Y/N	2005	2006
Integrated Electric & Gas									
D	2	Y	$73.85	$4.53 A	N	$5.15	N	16.3x	14.3x
SRE	1	N	46.65	3.65 A	N	3.50	N	12.8x	13.3x
Integrated Natural Gas									
EP	2	Y	12.97	0.47 A	N	0.92	N	27.6x	14.1x
EQT	1	N	36.73	1.80 A	N	1.98	N	20.4x	18.6x
LNG	1V	N	41.07	(0.92)	N	(1.10)	N	NM	NM
NI	2	N	20.24	1.35 A	N	1.47	N	15.0x	13.8x
STR	2	Y	74.43	3.86 A	N	4.60	N	19.3x	16.2x
SUG	1	N	24.70	1.44	N	1.75	N	17.2x	14.1x
WMB	2	Y	21.67	0.86 A	N	0.91	N	25.2x	23.8x
Natural Gas Pipeline									
OKE	1	N	29.97	2.55 A	N	2.21	N	11.8x	13.6x

Source: Company data and WCM, LLC estimates *NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*
1 = Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile

- **We are downgrading our rating on the Integrated Natural Gas sector to Market Weight from Overweight, and are also downgrading our ratings on four stocks in this group to Market Perform from Outperform: Dominion (D), El Paso (EP), Questar (STR), and Williams (WMB).** This is a six to twelve month view, and we emphasize that our long-term gas and gas infrastructure theses remain intact. But we believe near-term catalysts increasingly favor the downside and we believe investors will have another opportunity to overweight this group.
- **We remain long-term natural gas bulls**, but in recent weeks, we have grown **increasingly concerned about the growing surplus of gas in storage**, which against a backdrop of robust production, likely sets up gas-on-gas competition as storage contracts expire near the end of the heating season.
- As pipeline guys, we don't have an "official" natural gas price forecast, but believe **another leg downward is possible from the current $6-7 level.** It's March, and storage is just shy of 2Tcf, almost 50% above historical average. As such, we don't think a $5 or even a $4 handle can be ruled out near-term.
- Most of our E&P names appear fairly hedged on 2006 production, so we don't see significant earnings downside. But downward guidance revisions are certainly possible as unhedged volumes get sold into a bearish market. For Rockies producers, we believe this impact could be exacerbated by a basis blowout similar to what happened in 2002.
- On the pipeline side, a **FERC Administrative Law Judge recommended decision in the pending Kern River case calls for a 9.34% return on equity**, about 300 basis points below what we view as a generally accepted pipeline norm.

Utilities

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Please see page 7 for rating definitions, important disclosures and required analyst certifications.

Look Out Below

Natural gas prices have been under a lot of pressure in recent weeks. In our view, things could—and likely will—get worse. Natural gas is sloshing over the sides of storage caverns, backing up in the pipes, and you couldn't attract an LNG tanker to the U.S. for love or money. There was no winter, gas is going to have to come out of storage, and in our view gas prices could see another leg down from here.

Why are we concerned? Let's take a look at the factors that would support gas and those that might undermine it. On the plus side, crude oil remains north of sixty dollars, which on a Btu parity basis would suggest ten dollar gas. We're hearing that industrial loads are returning as gas prices have come down from their double digit peaks; fertilizer production, for instance, has resumed. Petrochemicals certainly favor using natural gas liquids over refinery naphtha at these levels, and it's possible that electric power generation could turn to gas as we enter the nuclear refueling outage season. And, there's always summer, which some weather pundits are predicting will be a scorcher this year.

On the other hand, we've heard arguments for a crude oil retreat, perhaps back to the low \$50s; certainly there is a geopolitical fear premium built in at this point, given Iran, Nigeria, and so on. The strength of the natgas--crude linkage can also be called into question; crude is a global commodity, gas is not, at least not yet. Fuel switching and returning industrial load can mop up some of the excess, but you can't burn natural gas in your SUV.

There is also the speculative element. A lot of fast momentum money came into natural gas late last year as it was running toward \$15. Certainly, it would seem that a lot of that has been chased out in the past several weeks, but perhaps not all of it. We'll know the party is over if an LNG tanker docks on the East River, knocks on the door of a Park Avenue hedge fund, and says "Here's your gas."

The thing that perhaps concerns us most is storage as we head to the end of a very light withdrawal season. Most U.S. gas storage is in the form of depleted gas reservoirs, which are usually only capable of handling one to two turns per year. The gas goes in during the summer and fall, and comes out in the winter. As we understand it, those cycles are critical to maintaining geological integrity.

Storage is nearly fifty percent above normal right now. Contractually, many owners of gas in storage are obligated to remove by the end of the season. If they don't want to remove it, they can ask the storage operator to hold on to it longer. To the extent they have capacity, storage operators can do that, but there are fees involved. And, there are probably a fair number of folks hoping for better prices trying to roll their gas right now, so the storage operator is in the driver's seat. And, keep in mind the cycling requirements noted above. Owners of gas can also try to "float" their gas on the pipeline system, which is common on weekends, but the pipelines can and will impose heavy penalties for that kind of behavior.

If the gas has to come out of storage, it begins to compete with flowing gas, which is flowing pretty good right now, given the drilling response to high prices. While some marginal drilling may retreat, we don't think the producers are going to retreat—especially the big guys, for political reasons if nothing else (see below). When physical gas-on-gas competition occurs because there's more supply than demand, well, get out your Econ 101 book if you don't recall.

So it becomes a question of capitulation. If you're sitting on an underwater position, are you going to throw good money after bad, or are you going to throw in the towel? We think some of the bulls may try to hang in there or double down, betting on a hot summer or a more active hurricane season. We note that famed hurricane forecaster Dr. William Gray of the Colorado State University issues his annual prognostication on April 4, 2006. We believe that will move the market.

The Low Spark of High Yield Noise

Politically, of course, the current situation is very convenient. Energy prices remain a hot button issue, right below the Middle East and all of its angles. It's an election year, poll numbers are in the tank, and we doubt that there are too many folks inside the beltway who would shed tears over a collapse in natural gas prices.

Apart from the odd lost campaign contribution, who cares if those New York speculators get fried in their own grease? Keep in mind also that the companies who have been taking most of the arrows on energy prices (can you say windfall profits tax?) are also the majors, who can and probably will drill right through a trough. Not only can they afford to, arguably they can't afford NOT to.

Bottom line, we think it's highly probable that natural gas could see another leg down from here. A five, or even four handle can't be ruled out. We discuss the potential impact to our stocks later in this note (page 5), but suffice it to say we think it could get ugly, and to the extent that earnings guidance rests on unhedged volumes being sold in the high single digits, we think there's risk. Risks to our near-term thesis include a quick warm up, followed by a hot summer, another bad hurricane season, and geopolitical issues that spook the energy markets.

What of our long term thesis? Despite all the gas that's sloshing around in the market right now, we continue to believe that North America's reserves are finite, that production in more mature basins will decline, and that replacing that will have to come from more distant (e.g. the Rockies, Alaska, offshore), deep / unconventional sources, and LNG. All of these will cost more. But for now, we've got more than we can burn.

Ready for The Next Punch?

"The lawful return on equity in this proceeding is 9.34%."

We've discussed the potential for pressure on ROE in the context of natural gas utility rate proceedings in recent weeks. As gas prices have moved up and driven higher all-in costs to end-use customers, it's natural for state utility regulators to look for ways to keep a lid on ever-rising utility bills. There's not much they can do about the commodity price, but they can affect the cost-of-service side of the equation. As such, we've been concerned about the potential for lower return on equity as a salve to the consumer wounds being inflicted by higher gas prices, and indeed, there have been some single-digit ROE's recommended in recent utility rate proceedings.

The quote above, however, is not from a state proceeding. It is from a FERC administrative law judge in docket RP04-274-000, a pending rate proceeding involving Kern River Gas Transmission Company, which is owned by MidAmerican Energy Holdings, a Berkshire Hathaway company. ***A nine handle? From FERC?***

Historically, pipeline equity returns have been in the low double digit range—say 12% or so. As the pipeline business has become more competitive, we've argued that the opportunity—not the guarantee—of more robust returns is warranted by the sector's growing risk profile. Unlike a gas distribution utility, a pipeline is NOT a natural monopoly. Pipelines compete against one another, and routinely negotiate rates below allowed tariffs at arm's length with shippers and utilities.

Investors have been willing to allocate capital to pipelines in recent years for several reasons. One, the sector has been recovering from its post-Enron collapse. Two, while we're awash in gas right now, the increasingly tight long-term U.S. gas supply picture favors a shift in production to new regions (e.g. the Rocky Mountains), which calls for new transport infrastructure to move that gas to market. Three, the market has perceived FERC as an enlightened and less political regulator that perceives the long term value in affording the opportunity to earn a superior (we didn't say outrageous) return for building infrastructure essential to long-term energy supply stability and security.

Background

MidAmerican bought Kern River from Williams in 2002 as the latter was having a massive yard sale to pay the rent back. MidAmerican promptly carried out the expansion plans that WMB had shelved for lack of capital, and as part of that process agreed to come before FERC with a cost of service filing three years later; hence, the pending rate case. At the time, Kern negotiated rates at arm's length with the shippers on the expansion. Ironically, one of those shippers (BP) submitted testimony in this case suggesting the 9.34% ROE that the ALJ is proposing to adopt.

With respect to ROE, the ALJ recommendation examines three proposed gambits. Kern proposed a 15% ROE, reflecting the expected yield plus growth on a basket of master limited partnership owned pipelines. Since Kern isn't an MLP, one could make an argument on that one. FERC Staff recommended 9% using a basket of utility and pipeline companies that appears to have included Williams and El Paso. There's an argument in that one as well, as both of those companies were near death a couple of years ago and, while recovering, barely pay a dividend today.

BP, the shipper (one that presumably was party to the negotiated rates a few years ago) recommended that ROE be keyed to the yield plus growth of a basket of names that includes El Paso, Equitable Resources, Kinder Morgan Inc. (NOT KMP), National Fuel Gas, Questar, and Williams. Curiously, the analysis suggests a weighted average return of 9.34% for this group. And FERC's ALJ bought it.

Over the past five years, the dividends on shares of Williams and El Paso didn't pay much. Questar stock doesn't pay much of a dividend—it's tied to the Salt Lake gas utility, which is a small part of the story—but its stock has increased substantially as its Wyoming gas production business has flourished. EQT presents a similar profile...investors haven't bought its shares for the opportunity to own a utility in Pittsburgh.

Our point? We believe staff and BP's peer group is unreasonable on its face. In our opinion, this basket of stocks is half erstwhile basket cases and half E&P plays. Apply a dividend discount model? We don't think so. There's either no dividend, or if there is, it appears to be an afterthought.

Politics, Again.

Will FERC adopt the ALJ recommendation? Hard to say; we are personally acquainted with all three of the sitting commissioners, and hold each in high esteem. Collectively and individually, we view the commissioners as astute, perceptive, independent, and largely apolitical. We also note that FERC's Number 1 over-arching goal, per its website, is to "promote development of a robust energy infrastructure."

That said, FERC is a regulator, and the commissioners sit in judicial roles. They must be objective, impartial, accountable and responsive to all constituencies that petition their agency.

Soap Box Time

In this case, a major gas producer and shipper (BP) has proffered a position that would result in the affected pipeline company earning not only well below its sought-after return on equity, but also well below what we believe is a historic norm that investors have generally come to accept. We have argued, and will continue to argue, that the strictures of a competitive market—rewards for superior and efficient operation, and penalties for inferior performance—can and should be brought to bear in this sector.

In large measure, FERC's policies have already fostered a market environment. Pipelines compete with one another for customers, and routinely discount rates below allowed tariffs. Recent disclosures on the planned Rockies Express pipeline reflect that; agreed upon rates were well below the maximum $1.40 tariff. Contract terms have also grown shorter, meaning that pipeline operators must provide good and valuable service or risk losing business. New projects are subject to rigorous evaluation by both the energy and capital markets; again, the current race to bring gas east from the Rocky Mountain region is prima facie evidence of that.

Natural gas is a finite resource, and must increasingly be sourced from non-traditional fields and methods. It's still out there, but it's also deeper, farther away, and trickier and more costly to get. There's risk involved. The biggest part of that risk occurs at the drill bit, where tens of millions of dollars can be committed to a dry hole. Doesn't happen as often as it used to, but it still happens. The downstream end of the business—the pipes and plants—is less risky by definition, but its risk profile has grown.

Pipelines face a number of business risks today that they didn't face ten to fifteen years ago when 12% ROE was the norm. Decline curves have gotten steeper, meaning that your forty year pipe investment may need to pay out in ten years or less. Pipes compete with one another and routinely discount below allowed tariffs.

Contract terms have gone from ten and twenty years down to one to three. These risks increase the hurdle rate.

However, pipeline tariffs are still set in a cost-of-service / rate of return context reminiscent of bygone days when contract terms were long, competition was minimal, and pipelines were a low risk business. Yet today, it's possible to commit capital to needed new capacity, as Kern River has done, and wind up having a customer that you negotiated with in good faith turn around and haul you in for a rate cut after you've committed a lot of capital over a multi-year time horizon.

Pipelines aren't as risky as drilling, but aren't as safe as a utility. And, they're very needed, especially as long-term trends portend a shift to production in places where takeaway capacity is lacking, such as the Rockies or in new areas offshore. Investors have been willing to commit capital to new pipeline projects and expansions, but we doubt that equity capital would flow as readily if returns are going to start running three hundred basis points below expectations.

Looked at from another angle, the ALJ recommendation is something of a reverse self-fulfilling prophecy; a jarring recommendation of this nature sends a signal to the market about regulatory risk. As we've noted, FERC has been viewed as less political and more forward-looking than some of its counterparts at the state level. Shaking that view will arguably add to the industry's perceived risk in the capital markets, which in turn could cause investors to demand a greater risk premium.

It's important to keep this in perspective; ***this is an ALJ recommendation, not a FERC decision***. We have seen FERC tested on similar issues in the recent past (e.g. the Lakehead issue on partnership owned pipes), and FERC has put forth decisions consistent with the need to continue attracting capital to achieve Goal Number One. Our confidence remains with the Commission at this juncture, but this ALJ sends a bad message at a bad time; it is an issue that bears very close watching in the coming months.

Downgrading Ratings on D, EP, STR, & WMB

We are downgrading our ratings on the following stocks to Market Perform from Outperform: Dominion (D), El Paso (EP), Questar (STR), and Williams (WMB). Our broad rationale is what you just read; we summarize the specifics for each of these four below. ***Our thesis could backfire***; *unusually cold or warm weather, a shift to gas generation, return of industrial loads, or even a revision of EIA's gas storage numbers (it has happened in the past) could touch off short-covering and cause natural gas prices to spike, likely moving stocks up in the process.* Both the commodity and the stocks are presently on a knife's edge, in our opinion. As for the pipeline rate case recommendation, we emphasize it is just that, and does not at this point represent FERC policy, which remains to be determined.

We wish to strongly emphasize ***Market Perform, not sell***, and our actions here in ***no way reflect a change in thinking on any particular company's underlying value potential***, strategy, management capabilities other company-specific fundamentals. However, in our view, each of these companies faces either risk to falling gas prices and/or widening basis differentials, pipeline rate case exposure, or some combination of the two. Coupled with what is, in our view, an over-arching near-term negative bias towards natural gas in the market, we believe the shares of these four companies lack adequate near-term positive catalysts and are likely to trade sideways in the coming months.

At the same time, we have **maintained Outperform** ratings on four other stocks in this group: **Equitable Resources, Oneok, Sempra, and Southern Union.** Again, this view is not a comparison of fundamentals between the two groups; these names are also likely to be pressured by negative sector sentiment, gas prices, etc. However, we believe each of these companies faces less exposure to the risk factors raised in this report; two actually stand to potentially benefit from lower gas prices. And all four have possible catalysts that could still drive near-term upside, in our view.

Dominion (D), while largely hedged (at low levels) on 2006 production, is also driven in the near-term by continued return of 2005 production lost to hurricanes, as well as business interruption insurance proceeds. While the market should look through it, the sale of the Peoples and Hope gas utilities to Equitable will likely be somewhat earnings dilutive, as we believe proceeds will be applied to reduce debt. We also believe that D may have some pipeline rate exposure at CNG. Our positive view on Dominion has been and remains focused on the value of its individual parts, weighted beyond 2006. That said, we believe that, at least in the near term, the negative macro catalysts likely counterbalance any near term positives. Longer term, we remain attracted to a compelling valuation thesis supported by a big gas reserve base with significant growth potential, the repricing of the Virginia electric utility fuel clause, and D's attractive gas infrastructure position, which spans pipelines, LNG, and the nation's largest gas storage operation. We remain confident in our 12 to 18 month $85-91 valuation range (based on our NAV analysis, as well as a low teens multiple to our $6.25 2007 EPS estimate). Risks to achieving this valuation range may include a significant decline in energy prices, power plant operating problems, an adverse regulatory ruling, or rising long-term interest rates.

El Paso (EP) has done well since late last year, and we believe its shares are getting deserved credit for having stabilized the E&P business and—more importantly in our view—owning and growing the nation's largest gas pipeline franchise. That said, we believe EP remains vulnerable to downside risk in natgas prices; its E&P business has made some impressive repositioning strides, but breakeven economics are at $5.50 gas and the 2006 earnings outlook is based on $8.00 gas. As noted above, our near term bias is closer to the former than the latter. El Paso's pipeline rate case exposure is probably no greater than any of its competitors, but it is far and away the biggest pipeline operator in the U.S., and therefore at least statistically could face heightened exposure on that front. Finally, EP has publicly committed to issuing new equity to fund its 2005 Medicine Bow E&P acquisition, probably by the middle of this year. Given all that, we believe El Paso's shares are reasonably priced—near term.

Questar (STR) should have no concerns on the pipeline rate front, but its stock is highly levered to natural gas prices, with beta heightened by basis differentials, which have already been widening as growing gas production in the Rockies exceeds existing pipeline takeaway capacity. This is a temporal problem, and STR is doing its part to alleviate it by participating in the upstream end of the Kinder Morgan / Sempra Rockies Express gas pipeline, which has gained sufficient shipper commitment to go forward. Near-term however, we note that STR's $4.60 to $5.00 2006 earnings guidance was premised on a $9.00 to $11.00 Henry Hub for its unhedged production volumes. Given our increasingly bearish view on near-term gas market conditions, as well as the potential for a 2002-style basis blowout in the Rockies, we see growing risk to STR's guidance as well as to our current $4.60 2006 EPS estimate.

Williams (WMB), unfortunately, sits in the cross hairs of all the issues we raise in this report. Stock upside has, in our opinion—rightly or wrongly—been largely driven by natural gas prices and attendant value in its enviable, big, and fast growing northern Rockies reserve base. We don't think WMB is quite as exposed on basis as STR, but it remains vulnerable to lower gas prices; 2006 guidance assumes a $7.32 net to well price. On the regulated side, Williams is likely to spend a fair amount of time in front of FERC in the coming months. Transcontinental Pipeline is going in for a rate review in June, and WMB is investing several hundred million dollars in an ongoing upgrade and expansion of Northwest Pipeline. Those capital dollars, needless to say, are being invested with the expectation of a reasonable return on equity at the back end of the process. For planning purposes, we expect that the hurdle on that investment was north of 9.34%. Our sum-of-parts valuation on WMB remains $28-30. Our valuation range is based on an 8.5-9.5x EBITDA multiple to our 2007 pipeline EBITDA outlook, 8.0—9x for Midstream, 2-3x for Power, & a $2.00-2.30/Mcf valuation range for an expected natural gas reserve base of 3.7Tcf. We further incorporate market value for the Williams Partners LP units and ascribe modest upside potential for the value of the general partner interest and the net present value of tax net operating loss carryforwards. Risks include natural gas commodity prices, particularly regional basis differentials in the Rockies; energy sector sentiment; pipeline regulation and competition; possible further mark to market losses in Power.

And The Stocks That Remain Outperform Rated…

We are sticking with Outperform ratings on Equitable, Oneok, Southern Union, and Sempra. While we believe these names have less exposure to the two central issues raised in this report, it should also be noted that they are by no means immune, and will likely face the headwind of negative energy sentiment in coming weeks and months. Our main reason for sticking with these stocks is the potential for near-term positive catalysts, such as MLP formation, asset sales, or in some cases, their potential to benefit from lower natural gas prices.

Equitable Resources (EQR), while also a major gas producer, is less subject to earnings variability due to changes in gas prices this year. With production close to major consuming markets, EQT is also less sensitive to basis than those in the Rocky Mountains. EQT also has some potentially value accretive stock catalysts in the coming months, including the possible formation of a master limited partnership to house its growing midstream and short haul pipeline assets (and help finance the equity portion of its planned acquisition of Pennsylvania and West Virginia gas utilities from Dominion). Risks to Equitable in the near term include negative gas sector sentiment, a possible credit rating downgrade or accelerated need to issue equity, and complications such as tax issues that might hinder strategic actions we believe are under consideration, such as MLP or LLC formation.

Oneok (OKE) just announced a highly strategic and value accretive plan to move its midstream business into Northern Border Partners, L.P., of which OKE is the general partner. This rebalances the business portfolio favorably from a risk standpoint and, in our view, there is significant further value upside in the latter as NBP grows its business and therefore the allocation of cash flows to the GP. We also note that OKE/NBP's midstream business actually stands to benefit from falling natural gas prices, as natural gas liquid processing and fractionation spreads should improve. OKE's energy services business could also benefit in a more volatile market. Risks here include the fact that NBP's Northern Border Pipeline company is FERC regulated and currently has a pending cost of service case. Like others, OKE could be pressured by negative sector sentiment.

Southern Union (SUG) does have exposure to energy prices through its recently acquired Sid Richardson Energy midstream business in eastern New Mexico, although most of that has been hedged for the current year, and like OKE, SUG might benefit from falling gas prices as processing and frac spreads improve. SUG's pipeline rate case exposure also appears manageable; Transwestern likely under-earning following a loss of some volumes in its recent recontracting. In addition, we believe SUG could see some near term positive catalysts, such as the possible formation of a master limited partnership for its midstream and / or LNG terminal assets. While the risk of additional equity issuance has been mitigated by recent utility sale announcements, we believe SUG remains a higher risk name, prone to doling out surprises.

Sempra (SRE) shares have pulled back considerably on a recent competitor downgrade, but we believe SRE is actually a stock that can benefit in a bearish energy market, especially given the opportunities that its marketing and trading unit can seize in periods of volatility, which certainly remains the case. SRE faces a potential earnings lull as it rotates out of its Texas power plants and gears up to develop LNG terminals and the new Rockies Express pipeline with Kinder Morgan. However, the plant sales, as well as the company's upcoming analyst conference at the end of this month, could be near-term positive catalysts. However, Sempra's risk profile is growing with trading's earnings, and we continue to believe that SRE will need to address the growing profile of this business relative to its balance sheet and the potential risks that exist to its single A credit rating.

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1 = **Outperform:** The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY

2 = **Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD

3 = **Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

SECTOR RATING

O = **Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.

M = **Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

U = **Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

VOLATILITY RATING

V = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: March 05, 2006

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Inside F.E.R.C.

March 13, 2006

SECTION: Pg. 1

LENGTH: 885 words

HEADLINE: Kern River rate case puts pipeline industry on edge

BODY:

An administrative law judge's initial decision on a proposed rate hike by Kern River Gas Transmission has triggered alarm in the gas pipeline industry that it might set a precedent for lower returns on equity for major pipelines, especially those serving expanding Rocky Mountain gas producers.

If the commission upholds the decision of ALJ Charlotte Hardnett, Kern River's proposed return on equity of 15.1% would be ramped down to 9.34%, based on a median ROE for other pipelines with similar market risks, including El Paso Natural Gas, Equitable Resources, Kinder Morgan Interstate Gas Transmission, National Fuel Gas Supply, Questar Pipeline and Williams.

In the nearly two-year-old rate case (RP04-274), Kern River has taken the position that it should be placed at the high end of the zone of reasonableness because it has extraordinary financial and business risks. Kern River testified that it had a highly leveraged capital structure, resulting in lean equity capitalization, the ALJ's decision noted, adding the pipeline claimed its shippers are poor credit risks and gas supply problems are exacerbated by competition for customers.

The judge and those who testified on behalf of the proxy group disagreed. "Kern River did not carry its burden of proving that it should be placed at the high end of the zone of reasonableness. The evidence shows that Kern River should be at the median or broad range of average risk," Hardnett concluded.

Hardnett said Kern River failed to show that "high unusual circumstances" exist to avoid the commission's presumption that existing pipelines fall within a broad range of average risk. The judge noted that, contrary to "every participant weighing in on the issue" and most investors, Kern River argued that information provided by credit analysts such as Moody's and Standard & Poor's were unreliable.

"Participants are quite convincing in making the points, among others, that Kern River has: great credit ratings, good supply and demand, impressive number of firm contracts, little risk from the Mirant bankruptcy and otherwise shows no extraordinary risk," the judge said. "It is especially telling that although Kern River claims to be the most risky pipeline, its witness admitted he had not done a study of the credit risks of the pipelines in the Kern River proxy group."

The judge also rejected Kern River's proposal to blend its debt costs at a 6.62% interest rate for two debt issuances. In doing so, the judge disagreed with the FERC staff position that the blended debt cost in the Kern River case would be just and reasonable. Staff concluded that neither pricing policy nor a certificate issued for a pipeline expansion in 2003 precluded blending debt cost. The expansion was designed to serve new electric generation and boost delivery capacity to 1.7 Bcf/day (IF, 21 April '03, 18).

Hardnett ruled instead that Kern River failed to prove that a weighted-average blended cost of debt would result in just and reasonable rates. Therefore, separate costs of debt should be used for the rolled-in system and the expansion, she concluded. "Blending the cost of debt inappropriately raises the rates charged to the 2003 expansion shippers when they are already paying incremental rates."

The rate case began in mid-2004 when FERC suspended and set for hearing the pipeline's proposed rate hike (IF, 7 June '04, 6). Besides the 15.1% ROE, the tariff filing reflected a $40 million rise in jurisdictional cost of service to about $347 million, and a decrease in projected throughput from 630 million Dt to 572 million Dt.

The Kern River system, which began service in 1992, stretches 900 miles from Wyoming through Utah and Nevada, to the San Joaquin Valley in California. It was built to provide 700,000 Mcf/day of year-round services.

The pipeline asserted that because it is relatively young compared with other pipelines, a limited amount of its capital investment has been recovered. It proposed an increase in annual depreciation accrual rates for transmission facilities.

The March 2 initial decision, which now will be taken up by the full commission, caught the attention of Donald Santa, president of the Interstate Natural Gas Association of America. Expressing disappointment with the decision, Santa warned that it sends a negative message to investors. When the ALJ decision reaches commissioners' desks, their decision will be a "litmus test" for how serious they are about encouraging further development of pipeline infrastructure.

"It kind of looks like no good deed goes unpunished if this is what they're going to end up with for an ROE," he said, noting that the industry has invested heavily in recent projects to transport stranded Rocky Mountain gas to consumer markets east and west.

Santa asserted that pipelines face an increasingly uphill battle when they get caught up in rate cases at FERC, and the commission appears less inclined to fully recognize the risk factors.

"They rarely get to the top of the zone of reasonableness. They never seem to get there," Santa said. "The pipeline industry faces greater commercial risk with respect to shorter duration contracts and shipper creditworthiness, and with respect to pipe-on-pipe competition. It's a different competitive dynamic. There doesn't really seem to be much recognition of that."

LOAD-DATE: March 27, 2006

1 of 1 DOCUMENT

Gas Daily

March 14, 2006

SECTION: Pg. 3 Vol. 23 No. 49

LENGTH: 537 words

HEADLINE: Kern River rate case decision alarms pipeline industry officials

BYLINE: JK

BODY:

An initial decision on a proposed rate hike by Kern River Gas Transmission has triggered concerns in the gas pipeline industry that it might set a precedent for lower returns on equity?especially for systems serving Rocky Mountain producers.

If the Federal Energy Regulatory Commission upholds the ruling by Administrative Law Judge Charlotte Hardnett, Kern River's proposed return on equity of 15.1% would be cut to 9.34%. The proposed change is based on the median ROE for other pipelines with similar market risks, including El Paso Natural Gas, Equitable Resources, Kinder Morgan Interstate Gas Transmission, National Fuel Gas Supply, Questar Pipeline and Williams.

Donald Santa, president of the Interstate Natural Gas Association of America, expressed disappointment with the ALJ's decision, saying it sends a negative message to investors.

"It kind of looks like no good deed goes unpunished if this is what they're going to end up with for an ROE," Santa said, noting that the pipeline industry has invested heavily in recent projects to transport stranded Rocky Mountain gas to markets to both the east and west.

In the nearly two-year-old case (RP04-274), Kern River has taken the position that its rates should have a higher-than-average return because it has extraordinary financial and business risks.

But the ALJ disagreed. "Kern River did not carry its burden of proving that it should be placed at the high end of the zone of reasonableness. The evidence shows that Kern River should be at the median or broad range of average risk," Hardnett concluded.

She said Kern River failed to show that "high unusual circumstances" exist to avoid FERC's presumption that existing pipelines fall within a broad range of average risk.

The rate case began in mid-2004, when FERC suspended and set for hearing the pipeline's proposed rate hike. Besides the 15.1% ROE, the tariff filing reflected a $40 million rise in jurisdictional cost of service to about $347 million, and a decrease in projected throughput from 630 million Dt to 572 million Dt.

The Kern River system, which began service in 1992 with capacity of 700,000 Mcf/d, stretches 900 miles from Wyoming through Utah and Nevada to the San Joaquin Valley in California. A $1.2 billion expansion that more than doubled its capacity to 1.7 Bcf/d went into service in 2003.

The pipeline asserted that because it is relatively new compared with other pipelines, a limited amount of its capital investment has been recovered.

INGAA's Santa said FERC's consideration of the ALJ's decision will be a "litmus test" for how serious the commission is about encouraging further development of pipeline infrastructure. He asserted that pipelines face an increasingly uphill battle when they get caught up in rate cases at FERC, and the commission appears less inclined to fully recognize the risk factors.

"They rarely get to the top of the zone of reasonableness. They never seem to get there," Santa said. "The pipeline industry faces greater commercial risk with respect to shorter duration contracts and shipper creditworthiness, and with respect to pipe-on-pipe competition. It's a different competitive dynamic. There doesn't really seem to be much recognition of that."

LOAD-DATE: March 28, 2006