



Friday, July 28, 2006 Vol. 9

## FERC Chief Touts New Era of Enforcement

*A special to New Power Executive from the editors of SNL Energy's PowerDaily North America*

**FERC Chairman Joseph Kelliher is Poised to Start Using Enforcement Authority Granted Under the Energy Policy Act of 2005** to ensure compliance with commission orders. The law gives FERC new authority to impose civil penalties of up to \$1 million a day per violation.

"We have seen problems in the past years with compliance with commission orders, but it is a new day," Kelliher said July 26 at a Platts "Newsmaker" forum in Washington, DC. FERC has been very careful in how it exercises the new enforcement authority granted under the Energy Policy Act, Kelliher said, noting

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## FERC Report Finds Demand Response Works Best With Incentives

*A special to New Power Executive from the editors of The Foster Electric Report*

**At its Open Meeting on July 20,** staff briefed the Federal Energy Regulatory Commission on its recent assessment of demand-response programs and advanced metering in the electric utility industry. The Energy Policy Act (EPA) of 2005 directed FERC to publish a report by Aug. 7. Over the past year, staff opened a docket for comments, held a technical conference to get some regional perspectives and studied regional transmission

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## Emissions Market Watch

**Scientists and Environmental Groups Had No Kind Words** for last week's G8 Summit statement on energy security, chiding the group for a weak move that emphasizes nuclear power and makes only vague noises about continuing the good fight.

The St. Petersburg, Russia, summit was offset by protests in the streets and statements to the press on a range of global issues, but even French President Jacques Chirac got on the global warming bandwagon. "We cannot discuss en-

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## Around the Northeast Market

### Maine Customer Choice Works

As Maine looks to put its new energy law into practice, the state must be careful not to slip back into the habits of the regulated era, Constellation NewEnergy and other Constellation Energy companies told Maine regulators last week.

At issue is the Act to Enhance Maine's Energy Independence and Security, a new package of energy legislation that Gov. John Baldacci signed into law last month. The law focuses heavily on the role of renewable energy in the state's future power supply, requiring the state to increase the amount of power it draws from cost-competitive new renewable energy projects by 1 percent beginning in

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## Do Most Oil and Gas Firms Use Derivatives?

*Carlos Blanco, Ph.D., managing director, Black Swan Risk Advisors, LLC*

**S&P Recently Issued a Report<sup>1</sup> Based on Energy and Gas Firm Disclosures** of derivatives use. One of the interesting report findings is that "just about all US oil and gas producers and refiners use derivatives to manage risks related to oil and gas commodity prices, albeit at varying degrees, using a variety of financial instruments and hedging practices."

The S&P report also pointed out the wide variation and limitations of current quantitative and qualitative financial disclosures related to derivatives use, and

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## EXECUTIVE FORUM

*Commentaries from inside the market*

## Market Intel Desk

### Will Peace Deal Curb First Data's Appetite?

*By Diane Borska, president, The Borska Group*

When First Data Corporation announced it had acquired Auckland, New Zealand-based Peace Software for "an undisclosed amount" this month, the news didn't seem to start industry tongues wagging. But this deal does have some implications for utilities and energy service

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## Power Moves

### Run of the Mill or More Likely Not

*Original market commentary by Dr. Robert Michaels, professor of economics, CalState, Fullerton*

Don't go looking too hard for it (I'm not giving out the URL), but I think I have found the most gruesome document ever produced by a regulatory agency. It's the California Energy Commission's *Guide to Raptor Remains*, 100 pages of color photos of the bodies and bones of birds done in by wind gen-

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## Terzic on Strategy

### Return of Rate of Return

*By Branko Terzic, Deloitte Services, LP*

One candidate for the award of Understatement of the Decade goes to my friend Professor Roger Morin for his observation, "The cost of common equity capital is controversial, and a major share of regulatory proceedings is devoted to the fair rate of return of common equity." This statement is from his 1994 textbook, *Regulatory Finance: Utilities' Cost of Capital*. Roger told me last year that a used copy of his book was going for over \$400 on eBay. No wonder that last week he alerted me to the fact that a 2006 version of *Regulatory Finance* is now available from Public Utility Reports. The demand has been created by the "back to basics" strategy

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*(POWER MOVES from page 1)*

erators and arcing wires. It makes you wonder about wind power.

There are other reasons to wonder. Last Monday the California ISO delivered its all-time high peak of 50,270 MW. On a whim I called up the American Wind Energy Association to see what I'm getting for the 1.8 cent/Kwh production tax credit I have generously given them for so long. I asked them how much energy California's wind capacity had contributed to meeting Monday's peak. The person I talked said that AWEA only tracked capacity because they were too far away from production.

Getting closer to production, I obtained data for the first 25 days of July. At the moment of the record peak, California's 2,323 MW of wind capacity was producing 254.6 MW. That figure was actually the median for peak production on my sample days – the range is 84.5 to 624.4 MW. Check the scatter of peaks and windpower production in the figure below. The times when windmills are most needed are the times when they produce the least, and the estimated relationship has some statistical credibility.

What to make of it? In its 71 pages, the California Energy Commission's June 2006 "Wind Performance Report Summary 2002-2003" contains one (1) occurrence of "peak." The report shows that 68 percent of California's wind energy is produced in the second and third quarters, and remarks that this "corresponds well with California's peak demand for electricity during the summer months." (at 24). In my little dataset, peak-hour wind generation was 26.9 percent of capacity on its very best day. Some correspondence.

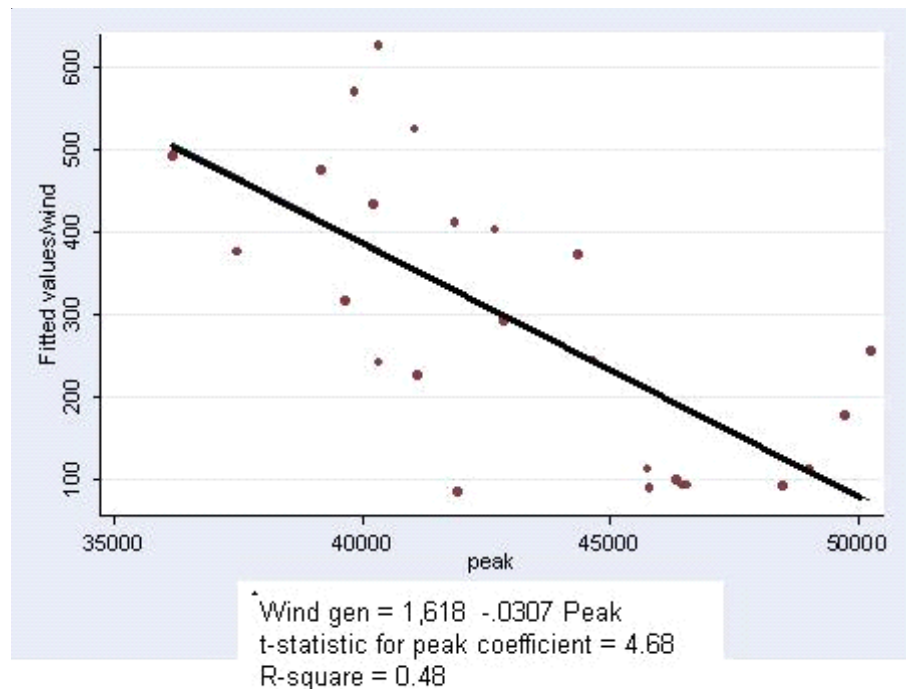
Make you wonder where the research came from? Go to the CEC's wind index and look at the 13 reports (not related to birds) that it issued in 2005-06. Three are staff documents, one is by a professor, and three are from consulting firms. OK so far. The remaining six come from the California Wind Energy Collaborative, an organization at the University of California, Davis, whose site does not list its membership. It does, however, say that its mission is to "support the development of safe, reliable, environmentally sound and

affordable wind electric generation capacity within the state of California." Does support equal disinterested research?

Maybe, maybe not. Let's first note that the Energy Commission's wind publications all seem to come from its Public Interest Energy Research Program. Then go back to the page where the collaborative recounts its origin:

*Based on input from the wind industry, the PIER Program has determined a need to establish the California Wind Energy Collaborative and address specific tasks to support the California wind industry.*

Do I have this right? A state agency that regulates several competing energy industries meets with representatives from one of them. They agree to establish an organization that will advance that industry's interests, using taxes to fund research that will become official agency reports. Imagine how this would fly if we substituted "fossil generation" for wind.



## NEW POWER EXECUTIVE

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**(FERC CHIEF TOUTS NEW ERA from page 1)**

the commission issued an enforcement policy statement in October 2005 modeled on the policies of other agencies, including the US Justice Department.

The commission decided that it would be unfair to impose a civil penalty for violations that preceded the enactment of the Energy Policy Act on Aug. 8, 2005. "We have not yet imposed civil penalties," Kelliher said, "but we've been conducting investigations over the past year and we probably will start imposing civil penalties at some point in the near future."

Kelliher said that NiSource Inc.'s Columbia Gulf Transmission Co. has not complied with commission orders concerning an interconnection request. In 2004, Tennessee Gas Pipeline Co., a subsidiary of El Paso Corp., filed a complaint against Columbia Gulf seeking an interconnection in Egan, LA, on the Blue Water Project. FERC agreed with Tennessee Gas and ordered Columbia Gulf to allow the interconnection. The case has been referred to the FERC Office of Enforcement, Director Susan Court said on July 25.

"In our view, Columbia Gulf has not complied with our orders that were issued after that and they've actually persisted in noncompliance," Kelliher said, adding, "If they continue in that course, they will likely be subject to civil penalties."

Ultimately, Kelliher said that the commission "will see compliance with its orders. We will either see them with imposition of civil penalties or without them."

In another policy area, Kelliher said that FERC is considering whether to exercise its discretionary authority under the Energy Policy Act to issue rules or orders to ensure greater transparency in electricity markets.

"We haven't acted to exercise that authority yet but we have developed an internal straw man – or straw person – to figure out" what reasonable options to exercise it, Kelliher said. "We are not hellbent on exercising that authority, but we want to

make sure if we don't exercise it" that it is the result of an affirmative decision.

The commission staff has been consulting with outside stakeholders to solicit their views on how FERC might exercise this authority and is considering holding a public technical conference in the Fall to discuss possible options, Kelliher said.

After more than a year of operating with just three members, FERC now is a commission of four, Kelliher noted. Commissioner Philip Moeller started voting on July 24, just a few hours after being sworn in. Commissioner Marc Spitzer was sworn in on July 21. Kelliher said he expects that Jon Wellinghoff will be sworn in on July 31.

Having a full roster of five members, including current Commissioner Suedeen Kelly, "will change things a bit, but we will proceed the same on major orders," Kelliher said. He plans to consult with his colleagues and try to develop a majority, or even a super-majority on important orders.

"If something is of real significance, you want to make sure it's a super-majority. Unanimity is something you always like," Kelliher said. "I have a gavel but only one vote."

Currently, the commission issues about 1,500 orders a year, which works out to an average of four or five orders a day, and the chairman plans to continue moving ahead at the same pace.

But, Kelliher conceded that it is too soon to tell whether it will be easier or harder to lead a five-member commission. "It will depend on the chemistry of the five commissioners. Any multi-member body changes when there's a change of a single member," he said.

"It is dramatic to have three new members walk in at the same time," Kelliher said. "We're getting commissioners who are all very qualified."

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*(FERC REPORT from page 1)*

planning processes and efforts. As part of the proceedings, staff hired UtiliPoint International to conduct a voluntary Web-based survey on the use of advanced metering and demand response.

Using UtiliPoint's data, staff evaluated the resource contribution from demand response, its role in regional transmission planning, and regulatory barriers to its development. The analysis looked at both private and publicly owned utilities, and at retail and wholesale markets, including nonjurisdictional areas like the Electric Reliability Council of Texas (ERCOT), Hawaii and Alaska.

Staff's primary finding is that demand response can play a key role in both wholesale and retail markets. In wholesale markets, it can introduce responsiveness when prices spike and help reduce the ability of sellers to exercise market power. In retail markets, demand response can assist load-serving entities hedge their positions and meet load obligations at the least cost. The trick is to induce demand response by customers, when directed, either through time-based rates or other incentives.

The report identified three varieties of time-based rates. First, time-of-use rates provide customers with a rate schedule that varies by time periods, typically daily peak and off-peak hours. Second, critical peak pricing adds to standard rate blocks a peak period – only a few days or hours a year – of significantly higher prices. The timing and setting of the peak period is based on system needs or high wholesale prices. Staff cited Gulf Power's programs and pilot projects in California as evidence that this kind of pricing can reduce peak demand and still achieve high customer satisfaction. Third, real-time pricing exposes custom-

ers to hourly prices based on real-time or day-ahead wholesale prices. About 50 entities currently offer real-time pricing, mostly to large commercial and industrial customers.

Incentive-based programs offer some form of incentives or direct payments to customers to induce curtailment, usually for purposes of reliability. The report identified six kinds of programs: (1) direct load control involves remote control of appliances such as thermostats, air conditioners, or water heaters; (2) interruptible/curtailable customers receive discounted rates or credits when they curtail; (3) demand bidding/buy-back programs allow customers to bid load reductions into utility or ISO/RTO markets, and if their bids are accepted, they are obligated to curtail; (4) emergency demand-response programs pay customers to curtail, but they are not obligated to do so; (5) capacity market programs provide capacity payments to customers in exchange for curtailing; and (6) ancillary services market programs have fast-responding load reductions that can provide spinning, nonspinning and regulation services. The emergency response and capacity market approaches were used during the heat waves and peak demand in the New York ISO and California this past week.

The analysis concluded that current demand-response "capability or potential" is 3 to 7 percent in most regions. At close to 20 percent, one area served by the Midwest Reliability Organization (MRO) was clearly an outlier. The 3 to 7 percent range translates into about 37,500 MW of potential capability, the "vast majority" of which is attributable to incentives rather than time-based rates. The regions with the highest MW totals are ReliabilityFirst and the Southeastern Electric Reliability Council (SERC), and the regions with the highest capability as a portion of peak load are MRO and the Florida Reliability Coordinating Council. The source of capability varies by region. Regions such as MRO, SERC and the Western Electricity Coordinating Council (WECC) have a large industrial demand-response capability, while other regions such as Florida have high residential demand response capability. ReliabilityFirst and ERCOT have high wholesale demand-response levels because of ISO-sponsored demand-response programs.

Turning to advanced metering, staff concluded that the market penetration of enabling technologies is "small." The term "advanced metering" is defined as any system that records customer consumption hourly, or more frequently, and provides for daily or more frequent transmittal of measurements over a communication network to a central collection point. The survey indicated that advanced metering has a nationwide market penetration of about 6 percent, although the rate varies by region. The ReliabilityFirst and SPP NERC regions come in highest (close to 14 percent), while others come in lower than the national average.

On a state-by-state basis, Pennsylvania has the highest advanced metering penetration in the US. "What is also interesting," staff said, "is that advanced metering is in place throughout the United States, in restructured and nonrestructured states, in rural states and in more urban states. This suggests that advanced metering provides value across a wide variety of utility characteristics and customer types." It also shows that advanced metering varies by company type. Electric cooperatives show

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the highest penetration (about 13 percent), followed by investor-owned utilities (close to 6 percent), the report continued.

After staff completed its presentation, each commissioner commented briefly on the report, and David Kathan, of FERC's Office of Energy Markets and Reliability, took questions.

Commissioner Suede Kelly observed that electricity cannot be stored, unless one considers hydroelectric power a kind of storage. But demand response is "reverse storage" that holds "the biggest promise for reducing electricity costs," not to mention the need for more infrastructure. She cited one forecast that the constrained New England region will spend an additional \$700 million if it does not reduce the demand for electricity. On the other hand, the same forecast shows that cutting peak demand in New England by only 5 percent could save the region some \$600 million.

The commission has a role to play here, Kelly added. While states have authority over demand-response measures at the retail level, FERC has jurisdiction over certain aspects at the wholesale level. She anticipates a technical conference "soon" to explore how to promote demand reduction in cooperation with state regulators. She commended Jim Rogers, incoming president of the Edison Electric Institute (EEI), for a commitment to make demand response his number one issue for the coming year.

Kelly also touched on the merits of "decoupling" utility revenues and electricity sales. Today's higher electricity prices have made people more energy-conscious. Alternative rate designs may better align the interests of utilities and customers as

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well as regulators. Without "decoupling," there may be little incentive for utilities to promote demand reduction by customers. The question is how to "decouple" without putting utilities at risk of under-recovering their costs, a challenge that is now being tackled in New York, Oregon and California.

While Commissioner Nora Mead Brownell was pleased that her own state of Pennsylvania ranked first in the use of advanced metering, she urged caution in interpreting statistics on market penetration. The availability of meters does not mean that customers are using them, she said, although utilities may be doing so. She also pointed out that the cost of advanced metering is coming down, which will make it more affordable. EEI or some other entity should provide guidance on advanced metering programs so that individual states do not have to reinvent the wheel, Brownell commented.

Finally, Chairman Joseph Kelliher had a question for David Kathan. Did the team find that some demand-response programs are more or less effective? The prevalence, not comparative effectiveness, of such measures was the purpose of the survey, Kathan said, although he did suggest that incentive-based programs appear to work better.

*For more information, go to [www.foster-fa.com](http://www.foster-fa.com).*

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of many utilities in need of fundamental rate relief for regulated services. This means that regulators and companies alike are dusting off the old books and buying new ones in search of answers to the question: "How did we do that?"

The return of rate case applications has renewed interest in all kinds of dormant regulatory issues, like the question of regulated rate of return found in rate cases. One difference this time around for many regulators and interested parties will be the non-uniformity of the electric utility industry of the 21<sup>st</sup> century. For most of the 20<sup>th</sup> Century, state regulators were dealing with vertically integrated electric utilities providing generation, transmission, distribution and "marketing" services to a franchised service territory. There were more companies then too. The 1998 issue of C.A. Turner Utility Reports lists 142 publicly traded electric, combination electric and gas, and gas distribution and gas pipeline utility companies. The 2006 AUS Utility Reports (the Turner report's successor) lists a comparable 96 utilities.

Within the electric utilities and combination electric and gas companies are a number of recent significant differences affecting the ability of analysts to determine the appropriate cost of service. These new differences make the search for a peer group or listing of comparable companies more difficult, for example, when it comes to estimating a return on equity component of the cost of capital.

Some companies operate in states that have restructured. In those states, the companies may have specific risk issues related to the unbundling of services and tariffs. The issue of "provider of last resort" (POLR) risks comes to mind. Also, electric utilities in these states may not own electric power generation as they did before restructuring. This divides the industry into generation-owning and non-generation-owning utilities. A further complication is whether the owned generation is "in rate base" or functioning as merchant generation.

A significant number of mergers have occurred, reducing the universe of companies available for analysis. Utilities that were once independent may also now be under a holding company umbrella heretofore not subject to a full rate case review in their new status as utility subsidiaries.

In short, Morin's observation remains valid that "the cost of common equity capital is controversial." For the reasons cited above, parties to utility rate cases face the reality that a major share of regulatory proceedings in the future will continue to be devoted to testimony regarding the determination of a fair rate of return on common equity. And clearly, it won't be any easier to determine that fair return today than it was in the past. Now where did I leave that copy of Bonbright's *Principles of Public Utility Rates*?

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providers, as well as incumbent business process outsourcing (BPO) service providers.

First Data is an established behemoth in the back-office transaction processing business serving the financial services industry, but it is perhaps best known as the parent of electronic funds transfer leader Western Union. So it has been engaged in solving the all-too-familiar growth dilemma. As the banking industry emerges from a wave of consolidation in the 1990s and 2000s, First Data has worked to stabilize its large credit card transaction processing business, as its client banks were sold to those that used competitors or did the credit card processing inhouse.

After significant client losses, First Data has had to get leaner and meaner, cutting staff and evaluating the sale of some business divisions. The company made the strategic decision to spin off Western Union and keep its focus on the payment processing and transaction services. Facing fierce competition in the back-office transaction processing business, it had to get scale to stay in the game, so it has been hunting for ways to use its high-volume processing systems, bill printing presses, card embossing machines and mailing machines for something besides credit cards. The answer was to apply its infrastructure to the utility and health care industries.

Its labors in health care have begun to bear fruit. In early June, the company announced a contract with PayFlex Systems USA, which maintains employee health care and benefits spending accounts – things like FSAs, HSAs, HRAs – for a number of employers. Just as it does for the credit card issuers, First Data will print and emboss the account cards and process the transactions of PayFlex enrollees. PayFlex cards account for nearly 1 million transactions a year.

Things have moved a bit more slowly in the utility industry. In 2004, First Data announced its expansion into utility BPO services, offering a meter-to-cash solution including CIS processing data hosting, bill print and mail, payment processing, customer care, receivables management and EDI transaction management. First Data made a big splash under the leadership of Mike Foley, formerly of Utilipro, an early entrant in the hosted services arena formed by AGL Resources when the Georgia gas market deregulated.

First Data bid on a number of deals at the 2005 CIS conference, but none of the deals came to fruition. The company seemed to take a step back, and its booth at this year's recent CIS conference shrank into the background. But with last week's announcement of the Peace acquisition, it seems there has been much activity behind the scenes. According to a number of industry folks we spoke with, First Data has been sniffing around CIS product companies, Peace as well as others, for the last 18 months or so. As we heard it, First Data made an offer on another CIS firm that turned it down. But at this point, the Peace deal looks like a nice match for First Data.

If the once high-flying Peace Software has been off your radar for a while, here's a recap. It was founded in 1984 by one Brian Peace of New Zealand, an early participant in the deregulation wave. Peace rode the dereg wave into the North American market, capturing a number of large CIS implementations, both hosted and inhouse. A 2004 company fact sheet stated that Peace software is responsible for billing 13.5 million customers worldwide, representing \$5.9 billion in utility revenues. It has some

pretty high-profile customers in North America, including Direct Energy, the Centrica affiliate with a big customer base in Ontario and Texas, Xcel Energy and MidAmerica. The company is no stranger to BPO arrangements, with Alliance Data Systems operating Peace software for Direct Energy's Texas operations and IBM Global services using Peace on behalf of Xcel Energy.

Funded in part by venture capital investors Insight Venture Partners, Kinetic Ventures and UBS Capital, Peace has begun to struggle financially with the dearth of CIS deals in the large utility sector. A recent story in the Auckland press reported that Peace posted a \$3.2 million loss on revenues of \$24 million in 2004, following a 2003 loss of \$3.7 million. In 2005, Peace cut 55 staffers and now has a headcount of about 170, half of whom are based in Auckland. Given these numbers, we speculate that First Data, a firm that does \$10 billion in annual revenues, didn't have to break the bank to acquire the firm.

For Peace, the deal gives it a fresh source of capital to retool and upgrade the product, something we hear it has had difficulty funding. First Data has reportedly told Peace that the base of operations can remain intact in Auckland, a "keep doing what you're doing" message. First Data gets a firm entrée into the utilities space with Peace's installed base and with its overall scale (a \$10 billion firm vs. the \$1 billion Alliance Data Systems). It probably has lower transaction processing costs and should be able to offer some pretty aggressive pricing on BPO services.

Execution will be key, of course. First Data will need a strong team to run an ASP/BPO operation for utilities, especially in the customer support area. It will also need someone to manage the very domain-specific service level agreements that are a part of utility/energy services BPO deals. It remains to be seen how well First Data can pull that off. But the deal suggests that more acquisitions are on tap to fuel the utility services BPO engine.

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2007. The state wants to reach increased renewable generation in the state by 10 percent by 2017.

Under the law, state regulators will be able to include energy conservation and energy-efficiency in standard offer service products for power customers. It also calls for transmission and distribution utilities to enter into long-term contracts for cost-effective efficiency and conservation programs and renewable power.

The Maine Public Utilities Commission asked for comments on these plans, and many companies who offer competitive retail electric power services were among those who offered their own ideas. Most retail suppliers cautioned that the commission must be careful that its authority to set long-term contract lengths and terms doesn't end up as a return to stranded costs and other problems of the era before customer choice. A decade ago, "utilities were allowed to recover costs that had been incurred under the regulated industry structure that were considered unrecoverable in competitive markets," the Constellation companies reminded the PUC.

"It is difficult if not impossible to predict energy prices on a long-term basis past three years. Requiring energy contracts for long terms such as 10 years may lead to the creation of new stranded costs, to the extent that such contracts are ultimately at substantially above-market prices," Constellation said. That won't help the commission achieve its goal of lower costs for consumers.

For that reason, long-term contracts should be limited to capacity-only contracts with terms of five to 10- years, strictly for renewable resources. The new long-term renewable energy contracts should be linked to the existing auction for standard offer service to small commercial and residential customers. No additional infrastructure would be needed to handle the new renewable power, as the management of utility contracts is part of the standard offer service contract.

Constellation also cautioned that not all renewable energy is the same – some kinds of "green power" produce the same capacity and energy output. That means any long-term contracts should clearly define the amount they want, and whether that amount is based on hourly or annual energy consumption. "Energy parameters should be set to ensure that the right tech-

nology and quantity are procured, and leave other parameters, such as the right mix of short-and long-term contracts, to be determined by the market.

"The commission should be mindful that it is difficult at this time to procure energy contracts greater than five years in length, as the energy markets may be sufficiently liquid to support energy contracts only five years forward," Constellation said. "Suppliers are wary of risks affecting liquidity within the wholesale markets...and thus have difficulty predicting prices beyond (a five-year) term. Suppliers may include in their prices significantly higher risk premiums for contracts greater than five years in length in order to account for such perceived risks. In this way, energy contracts greater than five years in length raise the risks of new stranded costs."

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**Heat Wave: New York Sets Record**

No one needs to tell you that we've been going through a heat wave, just step outside. The New York ISO reported that the heat caused a new all-time record for statewide electricity usage on Monday, July 17.

The hourly average peak load hit 32,634 megawatts between 4 and 5 p.m. on Monday, beating the July 26, 2005, record of 32,075 MW. Last year's record was actually broken in three consecutive hours today as usage in the hour beginning at 2 p.m. reached 32,316 MW. In the 3 p.m. hour, the peak load was 32,519 MW, the ISO reported.

The ISO called on demand-response customers to reduce their load on Tuesday, lowering demand by 650 megawatts. Companies enrolled in the state demand-response plan, under which business users are paid to reduce their electricity usage when demand on the grid peaks, allow NYISO to cut up to 1,470 MW of power demand from the grid when needed.

"We predicted in May that the Summer of 2006 would be a record-breaking Summer in terms of electrical usage," NYISO President and CEO Mark Lynch said. In its annual Summer forecast, NYISO had predicted that peak load would reach 33,296 MW this Summer. "Despite the increased usage, New York's bulk electric grid has sufficient supplies of electricity for New Yorkers this year."

NYISO is also calling for New York's state legislature to reinstate Article X, the expired law that streamlined the siting of power plants in the state. Speaking before a US House of Representatives energy subcommittee last week, Lynch said: "Notwithstanding the success of the NYISO markets in sending economic signals to incent development, longstanding institutional barriers continue to impact the development of needed infrastructure."

But he added that new generation is only part of the solution for ensuring New York's long-term electric reliability and economic growth. "Further growth of the NYISO's demand-side management programs and improved transmission facilities are also very important to satisfying continued load growth. While nearly 1,000 MW of transmission capacity has been added, or is in the process of being added between New York and other control areas, in recent years overall investments in transmission have been modest."

The ISO is compiling a comprehensive reliability plan (CRP), the first-ever overview of New York's electric power demand. The report will include recommendations on the

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**(AROUND THE NORTHEAST MARKET from page 7)**

actions needed to ensure the state maintains reliable electric service over the next 10 years.

PJM Interconnection also hit a record demand of 139,746 MW on July 17, almost 6,000 MW more than the previous record of 133,763 MW set on July 26, 2005. Despite the record power demand, PJM did not need to put any special demand-response, interruptible load, customer conservation or other measures into place. PJM's mid-Atlantic region, which includes New Jersey, hit a demand peak of 59,465 MW on July 17. That record was broken on July 18, with demand peaking at an all-time high of 60,286 MW.

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**NY Transmission Project Hits Snags**

The New York Regional Interconnect, a major transmission project for the state, is experiencing some backlash in the form of a piece of legislation that would stop gas and electricity companies from using eminent domain. The bill, which received strong support in the state Assembly and Senate, doesn't mention the project, but its sponsor has said the legislation is aimed at halting the proposed 190-mile high-voltage transmission line. The company says it is disappointed by the legislation, which was pushed through at the end of the state's legislative session.

The NYRI builders are also concerned about a lawsuit filed by officials in Utica, NY, that would stop a railroad from giving them the rights of way to build the transmission line. Utica officials claim the New York Susquehanna & Western Railway has an unauthorized contract. They further say the NYRI's proposed path for transmission line is not actually on land owned by the railroad.

State Sen. William Larkin held a public meeting this week to brief locals in New Windsor on the power line, which would travel from Oneida County to Orange County across much of central New York with New Windsor as its destination. Larkin said he is concerned about the potential health issues of living

near the 1,200-megawatt power line, as well as economic impacts, environmental issues, and the affect of the major transmission project on the region's environment and the "beauty and landscape" of the largely rural region. "If New York City wants power, then ... let them build these facilities in New York City. Let's not destroy Upstate New York to benefit the City of New York," Larkin said at the meeting.

Resistance to the controversial power line caused lawmakers in Herkimer County last week put aside \$10,000 to cover costs related to their opposition of the power line, even though the county is only a possible alternate route if the power line isn't allowed in Oneida County as planned. Other counties have been holding meetings on the impact of the proposed line. Even New York Sen. Charles Schumer has expressed reservation about the scope of the transmission project.

Despite the uproar in Upstate New York counties, the project's developers continue to emphasize that the \$1.6 billion transmission line is needed to meet the increasing power needs of the expanding population in southern New York. Recent ISO New York data shows that New York will set a new record for peak electricity consumption this Summer. New York City and the lower Hudson Valley will need 500 additional MW of capacity from new transmission, power plants or energy conservation.

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**Long Island Debates Wind Power Project**

Hearings taking place earlier this month about a major proposed wind farm off the southern coast of Long Island brought out over 600 residents and others to voice their opinions of Long Island Offshore Wind Park, which would erect 40 aquatic wind turbines five miles southeast of Jones Beach and southwest of Robert Moses State Park.

Most spoke in favor of the wind power project, which would generate 140 megawatts of new electricity for the area. But some continue to be concerned about the effect of the wind turbines on the aesthetics of the popular shorefront area and the resulting impact on the local economy. Oyster Bay Supervisor John Venditto, for instance, wants to postpone the project until federal guidelines for the construction of wind farms are in place.

The hearings came about because the federal Minerals Management Service said it would prepare an Environment Impact Statement on the proposed wind park. That document is expected to be released early next year

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**NY Sees Natural Gas Boom**

Wells in New York State are producing a record amount of natural gas, and it's a trend that will continue, according to the New York Department of Environmental Conservation. The state's wells produced 55.2 billion cubic feet (Bcf) of natural gas last year, up 18 percent from 2004. In-state production facilities now meet 5 percent of New York's total natural gas consumption, up from 1 percent in 2001.

Natural gas producers are tapping mile-deep reserves of natural gas in the Trenton-Black Reservoir, as well as in the Finger Lakes and Southern Tier. The activity generates \$440 million in the state, as well as \$13 million in local taxes for the rural areas where the wells are located.

With many large oil and gas companies increasingly interested in New York's potential as a natural gas resource, state officials expect private investment in new production to continue to increase in coming years.

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**(EMISSIONS MARKET DESK from page 1)**

ergy security while standing still on climate change,” he said. Chirac’s comment that “humanity is dancing on a volcano” received widespread press attention.

Chirac wants the world’s industrialized nations to talk constructively about addressing global warming after the Kyoto Protocol’s requirements expire in 2012. “Our goal must be an ambitious accord that commits us all, along with emerging market countries, to objectives equal to the threat that is weighing on humanity,” he said.

Last year the group had issued an “action plan” that acknowledged the role of energy from fossil fuels “and other human activities” as the main culprit in climate change, and promised to promote clean power and address global warming. This year’s statement is largely a rehash.

Those speaking out against the G8 energy plan have targeted a leaked document that recommends the group of major industrialized nations invest some \$17 trillion in “nonrenewable” energy infrastructure. Some see this as a betrayal of last year’s talk about promoting sustainable energy infrastructure. It ranks protesters that the G8 countries, which include 15 percent of the world’s population but emit 45 percent of GHGs, are hanging the other 4.5 billion folks on the planet out to dry.

The argument’s not entirely without merit, but a less reactionary view of the G8 statement on energy security finds a lengthy document hitting all of the key points that have become the pillars of new energy-related agendas: nuclear power, renewables, new energy technology, energy efficiency and conservation. This has become the *de facto* agenda for fossil fuel-driven societies attempting to address all the energy issues – security, sustainability, environment, expansion. Some would call the G8’s statement a plodding bureaucracy’s committee-style answer (government being in the pocket of big business and all that) to an exploding crisis. Others see it as the first attempts to shift a heavily entrenched infrastructure while trying to accommodate ever-growing demand for energy worldwide.

“The global nature of these challenges and the growing interdependence between producing, consuming and transiting countries require strengthened partnership between all stakeholders to enhance global energy security. We agree that development of transparent, efficient and competitive global energy markets is the best way to achieve our objectives on this score. We recognize that governments and relevant international organizations also play an important role in addressing global energy challenges,” the G8 statement says. The statement also includes a lengthy section on improving the investment climate in the energy sector...

Speaking of leaks, emissions and investments, the International Energy Agency (IEA) issued a statement supporting the G8’s focus on energy security and characterized the maligned G8 energy charter as an agreement “to increase efforts to adopt ways that are technically feasible and economically justified to address tensions in the energy markets and put the world on a more sustainable energy path,” according to IEA Executive Director Claude Mandil. The G8 statement is a call for stronger policy coordination to address the world’s energy challenges, he said.

Based on last year’s G8 energy statement, the IEA has already created a set of concrete actions that could improve en-

ergy efficiency through existing technologies “at low or even negative costs” and would reduce energy demand and lower CO<sub>2</sub> emissions, Mandil said.

It was apropos that the summit was held in Russia, currently riding high as a leading oil and gas producer. A new IEA report notes that the country could save one-fifth of its natural gas exports per year if it invested in available technology to reduce gas flaring and improve energy efficiency. The G8 has cited the need to reduce gas flaring, which wastes about 150 billion cubic meters (Bcm) of natural gas each year worldwide. Nearly one-third of that is in Russia, which loses “at least 30 Bcm” each year to gas flaring. The change wouldn’t just mean more gas to export, it would reduce about 150 million metric tons of CO<sub>2</sub> equivalent that could be sold on emerging carbon markets, Mandil said...

Meanwhile, Britain’s chief scientist last week minced no words on a government report he says willfully ignores the reality of climate change. The global scientific consensus is in, and that means it’s time to act, he said.

“It is a sad fact that a lot of the economic commentary on climate change in the media has seriously downplayed current scientific knowledge, even suggesting that climate change is just another scare story or that the challenges can be met merely by treating them as questions of domestic economics,” Lord Martin Rees, president of the Royal Society, Britain’s esteemed scientific academy, said.

He blasted the UK House of Lords’ economic affairs committee for misrepresenting climate change science and focusing on the holes in scientific understanding of global warming “to support its contention that the scientific context is one of uncertainty.” Lord Rees noted that “the higher the greenhouse gas levels climb, the bigger the adverse impacts will become, and the more we will have to do to mitigate and adapt.” Most risk managers would probably agree on that score...

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(DO OIL AND GAS FIRMS USE DERIVATIVES from page 1) concluded that current disclosures by many firms are insufficient. S&P also points out that “additional disclosures for derivative, natural hedges and pricing risks related to crude oil and natural gas commodities would be helpful in analyzing a company’s credit position.”

With market volatility at historically high levels for many energy and commodity prices, disclosure of market as well as other risks related to trading and risk management are crucial for stakeholders to effectively evaluate the exposure of a firm to market fluctuations.

Many firms are increasing the size of their trading operations, including BP whose supply and trading business employs more than 6,000 people who generated \$2.8 billion from trading oil, gas and power derivatives in 2005, and ConocoPhillips, mainly because of recent acquisitions. This makes improved disclosure of income or loss generated by trading activities, as well as the risk taken to generate it, even more important to evaluating the quality and sustainability of a firm’s earnings. The fact that many large firms conduct trading through joint ventures and partnerships makes it even more difficult to interpret the results in context of the firm, and therefore clear disclosures would allow analysts to understand the nature of the risks taken and the results of those trading operations.

The S&P report points out the considerable disparity and inconsistencies in market risk disclosures by US oil and gas firms. Differences in reporting are accentuated by the fact that the SEC offers firms a range of options to disclose market risk, e.g., VaR, sensitivity analysis or list of derivatives. In addition, some firms include the impact of related hedging activities, and different metrics are used, e.g. cash flow, earnings, etc.

Some firms such as BP and Sempra provide disclosures on the trading revenues as well as market risk levels and risk-adjusted return on capital (see Table 1 and 2). BP discloses the

profit and losses for the various trading units, and provides VaR numbers for each desk. For example, even though Sempra Trading’s average daily VaR tripled between 2005 and 2006, profits also increased substantially, and their RAROC was stable.

**Table 1 and 2: BP and Sempra Trading and Risk Disclosures**

<b>BP Trading</b>	<b>Average daily VaR (millions)</b>	<b>Profits/Loss (millions)</b>	<b>RAROC (95%)<sup>2</sup></b>
Interest rate trading	–	10	32.1%
Foreign exchange trading	2	162	18.7%
Oil price trading	33	1,552	34.7%
Natural gas price trading	15	1,312	-3.6%
Power price trading	7	(64)	32.1%

<b>Sempra Trading- Q1 2006</b>	<b>2006</b>	<b>2005</b>
VaR at 95%	\$22	\$8.5
Risk Adjusted Return on Capital (RAROC) <sup>3</sup>	37%	38%

Source: BP 2005 Annual Report. Sempra 10-Q. Black Swan Risk Advisors, LLC.

S&P provides some interesting insights on how it interprets certain signals from the various firms’ risk-management programs and activities. That information can assist risk managers in energy firms to manage the dialogue with the rating agencies and ensure that their message is consistent with the risk strategy of the firm.

### How Does Hedging Activity Affect Credit Ratings?

According to S&P, the tactical hedging strategy does not usually have a material impact in the credit rating of a firm. The reason is that tactical hedging, although it mitigates near-term cash-flow volatility risk, does not usually have long-term implications for a firm’s ability to service its debt. S&P also indicates that the hedging policy disclosures provides a signal regarding the level of market risk tolerance of the firm, although most companies have not maintained consistent hedging policies throughout the cycle, so that signal has to be interpreted with caution.

In addition, hedges can have potential margin and collateral implications that could hurt the financial liquidity of a firm. For example, Hess posted letters of credit in excess of \$3 billion as collateral during 2005, while the trading profits were a small fraction of that number.

### How Do Out-of-the-Money Hedges and Liabilities Enter into the Rating?

In general, S&P does not consider such derivatives liabilities as debt when calculating financial leverage ratios.

On a case-by-case basis, however, there may be implications. For example, S&P provides the case of Plains Exploration & Production Co.’s announcement in April 2006 that it would eliminate its out-of-the-money hedges for \$600 million in cash (approximately the current mark-to-market value of those liabilities at that point), which would likely be funded through issuing incremental debt. Even though in economic terms the transaction appears to be credit-neutral, the transaction has marginally negative implications.

The contract termination represents a departure from the company’s traditionally more conservative approach to hedg-

(Click to continue on page 11)



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(DO OIL AND GAS FIRMS USE DERIVATIVES from page 9) ing commodity price risk and taking an active market position. If it finances the liquidation of those underwater hedges with debt, that would worsen its debt ratios as well.

### Counterparty Risk Issues and Liquidity Triggers

S&P also remembered the need to take into account possible liquidity triggers in derivative contracts or cross-default and cross-collateralization provisions, allowing the derivative counterparties to benefit from a claim on a company's assets in the event of a default.

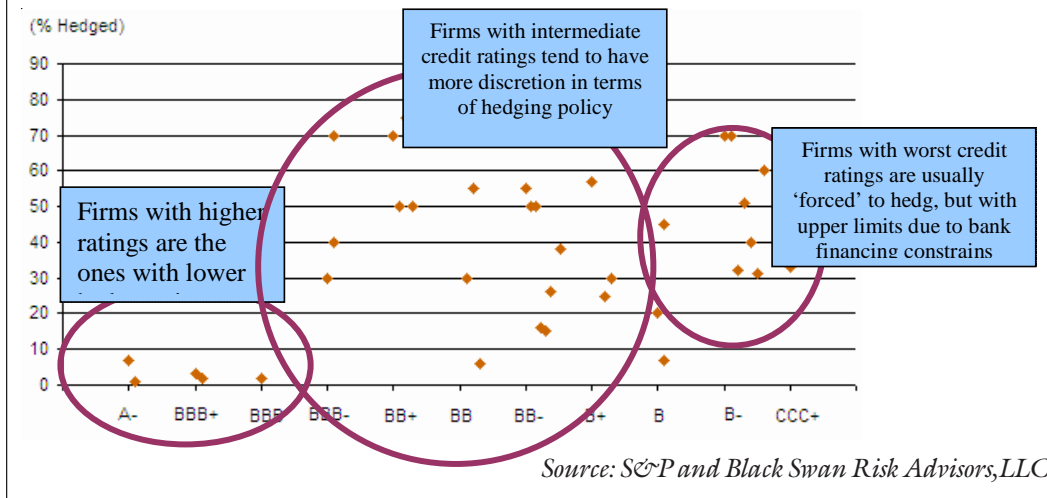
S&P makes the good point that many E&P companies hedge with banks that are members of their syndicated credit facilities, and in many cases do not require collateral for the hedges.

The lack of transparent and comparable information further complicated the difficult task of analyzing a firm's market risk for rating agencies and analysts. Despite attempts by the CCRO to standardize reporting of market risks of derivatives operations, there is still a long way to go. If the industry wants to send a clear signal, serious efforts would need to be undertaken to standardize reporting of derivatives operations. For example, if you open the annual report of any of the largest top 100 banks in the world, the risk disclosures are substantially better and more comprehensive than for most energy firms.

Difficulties in assessment result in potentially lower credit ratings due to the uncertainty around the disclosures. As S&P concludes, "additional disclosures for derivative, natural hedges, and pricing risks related to existing crude oil and natural gas commodities would be helpful in analyzing a company's credit position." At the moment, S&P and other agencies must resort in a time-consuming process of soliciting additional information and clarification of the limited information provided in disclosures to discern the actual changes in the risk profile arising from derivatives strategies.

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**Figure 1: 2006 Production Hedged for Oil and Gas Producers, according to Rating Level (as of Dec. 31, 2005)**



### Hedge Accounting and Operational Risk

One of the linkages between market and operational risk, both of which were due to internal and external events that could affect operations, related to the use of derivatives in hedge accounting. In order to qualify for hedge accounting in a given quarter, a firm must pass strict ex-ante and ex-post "hedge effectiveness." For example, after Katrina and Rita last year, many firms had to shut down some of their production and therefore lost hedge accounting treatment from the derivatives hedging that production. That loss resulted in higher P&L volatility. For example, Kerr-McGee (just purchased by Anadarko on June 23, 2006) recorded losses on discontinued hedges of \$119 million in the last half of 2005.

### Summary

Oil and gas firms should consider strengthening their public disclosures beyond the minimum requirements to increase market confidence and transparency in their risks and operations.

### (Endnotes)

- 1 US Oil And Gas Sector Makes Extensive Use Of Commodity Derivatives. Standard & Poor's RatingDirect, June 14, 2006.
- 2 Assuming 252 trading days. Expected loss and risk free rate not accounted for RAROC calculations.
- 3 Risk-adjusted return on capital calculated by dividing average daily trading margin by average daily VaR at 95 percent.

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