

**POLICY RECOMMENDATIONS ON LONG-TERM
CONTRACTING FOR NATURAL GAS TRANSPORTATION,
STORAGE SERVICES AND LIQUEFIED NATURAL GAS
DELIVERY**

NARUC/IOGCC JOINT TASK FORCE

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*Commissioners Donald L. Mason
and John K. Norman, Co-Chairs
October 19, 2005*

Background

The U.S. natural gas industry has undergone fundamental changes over the past twenty-five years. These changes reflect increased competition, in large part fostered by federal and state initiatives. One conspicuous feature of today's natural gas industry is a popular movement toward shorter-term commercial transactions for gas procurement and transportation services. The evidence shows that this trend stems from a combination of market-driven and regulatory-induced factors.

Many industry leaders and organizations have raised the concern that the heavy reliance on short-term transactions may jeopardize the ability of gas-delivery sponsors to adequately finance expanded capacity sufficient to meet our country's growing demand for reasonably priced natural gas. Virtually all studies of this trend affirm that if new capacity is not available, or is delayed, natural gas and electricity consumers will suffer economically. For example, the reliability of utility service may erode and future gas prices will be higher and more volatile. Overall, the consensus among industry observers is that the United States must expand its gas delivery infrastructure to adequately accommodate growing natural gas demand, and that long-term contracting may be a requisite for achieving this objective.

The National Association of Regulatory Utility Commissioners (NARUC) and the Interstate Oil and Gas Compact Commission (IOGCC) formed a Joint Task Force ("Joint Task Force") to offer policy recommendations "on the advisability of encouraging government support of long-term natural gas transportation and storage agreements as a way to increase investment in natural gas and LNG delivery infrastructure." The Joint Task Force focused on State regulation, particularly as it affects the incentives and ability of gas utilities to transact long-term contracts for delivery service. The Joint Task Force devoted particular attention to whether State regulation has erected barriers to long-term contracting that could jeopardize the future development of the gas-delivery infrastructure in the United States.

Comments of Parties to the Notice of Inquiry (NOI)

The NARUC/IOGCC Joint Task Force obtained information pursuant to its NOI in two ways: (1) a workshop held in Washington, D.C. on August 18, and (2) written comments submitted by interested parties in response to five specific questions. Four parties made presentations at the August 18 workshop and twelve parties forwarded written comments. The information received by the Joint Task Force came almost exclusively from industry groups, gas suppliers, pipelines or retail gas utilities, with the exception of two State regulators submitting written comments. The following discussion highlights the comments provided by parties to the two forums.

Workshop Comments

Table 1 contains a summary of major comments four parties presented at the workshop. The comments reflect a common view that delivery infrastructure development in the natural gas industry is crucial and that State regulators can play an important role in this development. The parties, in general, acknowledge that long-term contracts may be needed to finance new capital projects and that State regulators should seriously consider changing their practices so as to not discourage gas utilities from entering into such contracts. The commenters observed that State regulators should evaluate long-term contracts from a multi-year perspective and avoid second guessing utilities because contracts could later be deemed unattractive during a limited timeframe.

Table 1: Presentations at Workshop

Organization	Major Comments
Interstate Natural Gas Association of America (INGAA) Foundation	(1) Long-term contracts may be a critical factor for timely infrastructure projects; (2) much new gas infrastructure will be needed over the next several years, to a large extent to accommodate gas supplies from new sources (LNG, Arctic, Rockies); (3) long-term contracts are important for managing risks to all participants in infrastructure development; (4) delays in infrastructure developments can be extremely costly to gas, as well as electric, consumers; (5) gas utilities see "asymmetric risk" in long-term contracts -- for example, regulatory risk from prudence reviews, fear of stranded costs from customer choice programs, partial recovery of costs; (6) disincentive for power generators to sign long-term contracts for pipeline capacity; (7) shippers' preference for contracts of 5 years or less do not match the 20-30 year cost recovery period for new projects -- financing becomes more difficult and expensive; (8) currently over 40% of pipeline capacity is held by gas utilities; (9) State regulators could grant pre-approval of long-term contracts for cost recovery; (10) State regulators could also review customer choice programs (e.g., switching rules, capacity assignment, reliability standards for non-LDC marketers)
Enbridge	(1) Obstacles to building new infrastructure need to be overcome if future energy needs are to be met; (2) need for long-term commitment to Alaskan gas; at least one example where lack of long-term contracts led to delay of pipeline construction; (3) PUCs need to provide stable, predictable regulation and clear rules of engagement, as well as to allow gas utilities to support infrastructure development; (4) pre-approval of long-term contracts to provide regulatory certainty and to avoid the potential for cost disallowances; (5) long-term contracting needs to be revisited as we look at emerging challenges facing the gas industry; (6) pipeline project proponents need to reduce risks of major investments -- one way to do this is to have long-term commitments from shippers, which in turn requires regulatory certainty upfront that long-term contracts are prudent
Dominion Resources	(1) Generally, gas utilities are not willing to contract for long-term capacity, fearing being second-guessed in prudence reviews; (2) State regulators must recognize the importance of long-term contracts for entities providing service to human needs customers in addition to removing impediments for parties to enter into such contracts; (3) long-term contracts for capacity should be coupled with similar contracts for supply; (4) regulatory approaches must be flexible enough to address different environments; (5) State regulators need to reduce uncertainty for utilities; (6) hedging and long-term contracting decisions share certain features (e.g., the application of a portfolio approach, optimal decisions are utility specific, the importance of full cost recovery, no second-guessing); (7) just as State regulators now endorse prudent hedging to promote price stability, they should consider endorsing prudent long-term contracting to promote reliability; (8) there are several ways that State regulators can encourage long-term contracts, including pre-approval, mandatory capacity assignment and the submittal of long-term strategic capacity and supply plans
Cheniere Energy	(1) Future gas supplies must come from new areas, including other countries; (2) a proactive approach in view of the current tight market situation would be to supplement gas supplies from new sources, which will be needed to meet future demand; (3) LNG offers benefits in the form of supply security, supply diversity and price moderation; (4) State regulators and gas utilities can play an important role in LNG development

Some parties identified the “asymmetric risk” in long-term contracts as a hindrance to gas utilities’ willingness to include such contracts into their portfolio of gas purchases and transportation services. This risk appears when regulatory regimes prevent a utility from fully recovering costs associated with a long-term contract. Dominion Resources endorsed a portfolio approach whereby a utility would structure a gas procurement/capacity strategy that features risk-management objectives as an explicit element. For example, hedging gas supplies and arranging for long-term contracting of pipeline service can be an appropriate part of a prudent portfolio strategy. The INGAA Foundation also recognizes the role of long-term contracting as a potentially effective risk-management mechanism.

Overall, the comments identify regulatory barriers at the state level as a major reason for why gas utilities have been reluctant to sign long-term contracts for delivery services. Several commenters advise how these barriers can be lifted. Some encourage the pre-approval of prudent long-term contracts, the application of a portfolio approach to delivery-service acquisitions, assurances against stranded costs resulting from customer choice programs and, in general, the assignment of higher weights to the benefits of long-term contracting.

Written Comments

Tables 2-6 summarize the major written comments submitted by twelve parties (two of these parties, in addition, made presentations at the August 18 workshop). Commenters responded to five questions. Comments identified specific regulatory barriers to gas-delivery infrastructure investments and initiatives State regulators can take to encourage such investments and long-term contracting.

Several major areas of agreements among the parties can be observed:

- Regulatory barriers have discouraged gas utilities from considering long-term transactions regarding gas delivery services. Commenters argued that State regulators have specifically erected barriers by (1) making their policies toward long-term contracts unclear, (2) inappropriately exploiting the possibility of 20/20 hindsight in

prudence reviews to disallow costs for unanticipated events, (3) leaving a utility exposed to stranded costs associated with long-term contracts when customers switch to marketers, (4) placing undue emphasis on short-term transactions and (5) slighting the benefits of risk management resulting from hedging and portfolio diversification. One commenter, Xcel, however, remarked that state regulatory policy has not been a barrier to securing long-term contracts; instead, Xcel recommends the implementation of incentive mechanisms or “safe harbor” rules to correctly balance the risk/reward relationship for gas-delivery services.

- Most commenters argued that State regulators can best promote investment in the gas-delivery infrastructure by encouraging, or at least not discouraging, long-term contracting by gas utilities. Commenters generally resorted to the same points they made on how long-term contracts can best be encouraged. Cinergy argued that State regulators should issue guiding principles clarifying, for example, the criteria for cost recovery and articulating the general features of an acceptable strategy involving gas-delivery services. Dominion Resources offered the view that regulators should take a long-term perspective by encouraging gas utilities to submit long-range supply/capacity plans, which could be reviewed by regulators and approved if deemed prudent. The INGAA Foundation advocated a policy, by both State regulators and FERC, of encouraging long-term commitments from shippers in support of infrastructure development (for example, through interstate-pipeline pricing policies). The Missouri Public Service Commission singularly warns of the downside of pre-approving contracts and giving other assurances to utilities for recovering their entire costs: they fear exposing consumers to higher risks from contracts that turn out “bad.”
- The predominant view of commenters was that regulators should encourage long-term contracts when new gas-delivery infrastructure

investments are warranted. Xcel argued that long-term contracts are necessary to finance new investments in the gas-delivery infrastructure. Some parties alluded to the benefits of long-term contracting as a hedging-type mechanism for gas utilities and their customers. Cinergy stated that long-term contracting can bolster investments in gas-delivery capacity, which in turn can improve reliability and promote supply diversity. National Fuel commented that long-term contracts are more justified in a growing and tight market where a long-term commitment by a gas utility may be a requisite to acquiring interest in storage and transportation facilities needed for future reliable-utility service. The Missouri Public Service Commission commented on both the upside and downside of long-term contracts. The Arizona Corporation Commission remarked that the need for long-term contracts is case specific dependent upon the actual conditions in a state or region.

- Finally, no party advocated mandatory securing of long-term contracts by gas utilities. (One party, Anadarko Petroleum, however, suggests State regulators should consider specifying that a minimum proportion of gas supply needs be met through long-term contracts.) Most commenters suggested that long-term contracts should be evaluated within a portfolio approach, or some other framework that accounts for the special circumstances faced by individual gas utilities.

Table 2: What Are State Regulatory Barriers Hindering Investment in the Energy Delivery Infrastructure? (Q1)

Organization	Comments
Arizona Corporation Commission	Unclear state policies or perception of such
Missouri Public Service Commission	State regulators affect infrastructure investments via (1) LNG siting issues, (2) how a utility's supply and delivery contracts are evaluated and (3) cost-recovery policy (no specific barriers identified)
Duke Energy Gas Transmission (DEGT)	Lack of appreciation for long-term contracts, plus lack of commitment to creating a good environment for long-term contracting
ProLiance Energy	
Xcel Energy	State regulatory policy is not a major obstacle to securing long-term contracts for gas supply, transportation and storage services; there should be no regulatory mandate requiring gas utilities to enter into long-term contracts; instead, state regulators should implement incentive mechanisms or "safe harbor" provisions, which reduce risk to the utility and provide incentives to address residual risks, that are practicable; FERC should play an active role in encouraging the necessary changes to make long-term contracting more prevalent
Dominion Resources	The biggest obstacle are after-the-fact prudence reviews resorting to 20/20 hindsight; another one is the uncertainty over state regulatory policy on "stranded" costs (associated with contracts) resulting from customers changing to transportation-customer status -- need for appropriate capacity assignment and cost-recovery mechanisms
Natural Gas Supply Association (NGSA)	Prudence reviews based on 20/20 hindsight; overall, regulatory uncertainty that jeopardizes the timely recovery of all costs associated with long-term contracts
Edison Electric Institute (EEI)	Second guessing by state regulators; the absence of pre-approval
Cinergy	Uncertainty over cost recovery
Interstate Natural Gas Association of America (INGAA) Foundation	Overemphasis on short-term transactions, which may deprive consumers of long-term benefits (for example, reduced risk and lower capital costs) from contracts of longer durations; two major general categories of barriers: (1) prudence reviews and retail choice programs (with the potential for stranded costs), and (2) absence of policies and procedures that encourage risk management by gas utilities via portfolio diversification and hedging
National Fuel	Uncertainty over the treatment of potential stranded costs attributable to customer choice programs
Anadarko Petroleum	The most significant is the absence of cost-recovery assurances for long-term agreements, which make gas utilities reluctant to secure such agreements

Table 3: How Can State Regulators Encourage Investment in the Energy Delivery Infrastructure? (Q2)

Organization	Comments
Arizona Corporation Commission	Clear state policies: clear, open and ongoing communications between state regulators and private entity; in certain situations, pre-approval may be necessary
Missouri Public Service Commission	State regulator's review of gas supply and pipeline contracts and cost-recovery policy; pre-approval, while lowering risks for investments, can expose consumers to economic risk; best approach involves commission review of utility's long-term strategic resource plans and/or prudence review of utility supply and capacity purchases
Duke Energy Gas Transmission (DEGT)	State regulators should appreciate the benefits of long-term contracting and create an environment conducive to long-term contractual commitments
ProLiance Energy	
Xcel Energy	Pre-approval of long-term contracts and assurance of cost recovery; adopt policies that consider the benefits of long-term contracting and encourage utilities, either through incentives or risk reduction, to enter into such arrangements
Dominion Resources	The most important is pre-approval of long-term contracts; the Task Force should recommend a specific regulatory template for states to adopt; regulators should encourage utilities to submit periodically long-term (10-year minimum) strategic capacity and supply plans
Natural Gas Supply Association (NGSA)	State regulatory policies should allow for the use of long-term contracting, for both supply and transportation, and the recovery of the associated costs
Cinergy	State-regulator issuance of a policy statement containing guiding principles (for example, criteria for cost recovery and the general features of an acceptable capacity plan)
Edison Electric Institute	Collaboration between utilities and state regulators to avoid second guessing; FERC should examine the natural-gas infrastructure needs of the wholesale electricity market
Interstate Natural Gas Association of America (INGAA) Foundation	(1) Pre-approve long-term contracts, (2) protect the utility from "stranded costs" and (3) assign more weight to the "reliability" benefits of long-term firm pipeline and storage capacity (for example, offering higher capacity payments for electric generators that have firm, longer-term contracts for gas supply and transportation) and (4) advocate before FERC policies that encourage long-term commitments supporting infrastructure development
National Fuel	Take a long-term perspective on gas supply/transportation planning
Anadarko Petroleum	Create a favorable regulatory environment by assuring cost recovery of long-term agreements

Table 4: Should Long-Term Natural Gas and Storage Agreements Be Encouraged to Increase Investment in the Energy Delivery Infrastructure? (Q3)

Organization	Comments
Arizona Corporation Commission	Yes, subject to unique circumstances in individual states and regions; long-term contracts should be examined as to their role in ensuring reliable and reasonably cost utility service
Missouri Public Service Commission	Encouraging long-term contracts can be both good and bad: good for funding investments but can result in uneconomic outcome and stranded cost funded by consumers; pipelines should be offering term-differentiated rates -- selective rate discounting for long-term contracts is not an adequate substitute for non-discriminatory term-differentiated rates; it may be preferable to invest in energy efficiency/conservation and technologies for recovery of various domestic non-renewable and renewable energy resources, rather than in LNG and the transportation delivery infrastructure
Duke Energy Gas Transmission (DEGT)	Yes, as they increase investment incentives for gas pipelines and storage providers; long-term contracting can act as an inexpensive hedge in providing a utility with access to cheaper gas supplies during periods of peak demand; long-term contracting can provide consumers with insurance, especially against sharp price spikes during times of peak demand
ProLiance Energy	
Xcel Energy	Yes, as current contractual arrangements are typically for much shorter durations than necessary to support development of important new future sources of gas supply, such as LNG and Alaskan gas; overall, the development of the gas-delivery infrastructure will require long-term contracts to support much needed capital intensive projects
Dominion Resources	Yes, as major gas delivery infrastructures require long-term contracts to provide necessary market support and financial assurances; also, as capacity markets become tight, the absence of long-term commitment by a gas utility may foreclose some capacity options that could otherwise benefit consumers in the long run
Natural Gas Supply Association (NGSA)	Yes
Edison Electric Institute (EEI)	Yes, when the market signals a need for long-term gas transportation and storage agreements
Cinergy	Yes, to improve reliability, to create greater supply diversity and to develop a robust energy infrastructure
Interstate Natural Gas Association of America (INGAA) Foundation	Yes, as necessary for the financing of gas infrastructure developments that will be required over the next several years
National Fuel	Not clear, but more justified in growing/tight markets; long-term contracts may be required for gas utilities to acquire interest in storage and transportation facilities needed to assure reliable service
Anadarko Petroleum	Yes, as long-term contracting is necessary to support the financing of LNG, as well as other delivery infrastructures

Table 5: If the Answer is "Yes" to the Previous Question, How Can State Regulators Encourage Long-Term Natural Gas and Storage Agreements? (Q4)

Organization	Comments
Arizona Corporation Commission	The commission has used pre-approval; it appears that some longer-term contracts may be needed for the development of natural gas delivery infrastructure
Missouri Public Service Commission	See response to Q2; whether long-term contracts should be encouraged depends on the circumstances
Duke Energy Gas Transmission (DEGT)	(1) Encourage FERC to adopt rate policies that promote long-term, firm contracting, (2) avoid second-guessing gas utilities and (3) adopt policies that adequately compensate electric generators operating during peak pipeline operating periods, for entering into long-term, firm contracts
ProLiance Energy	
Xcel Energy	Strong partnership between State regulators and gas utilities; the current environment in most states has discouraged contracts of longer than 5 years; one idea is for regulators to encourage utilities to have a certain percentage of their supply portfolios as long term -- this would promote a diversified portfolio; other possible policies include: (1) incentive mechanisms encouraging long-term contracting by providing for revenue sharing or risk sharing between the utility and its customers, (2) pre-approval of contracts, (3) utility recovery of imputed debt costs from long-term contracts and (4) consideration of long-term contracts as a standard part of a utility's supply portfolio
Dominion Resources	State regulators should view long-term contracting similarly to hedging, which has been used to promote price stability: (1) a long-run view should be encouraged, (2) a portfolio approach should be implemented, (3) cost recovery should be assured and (4) decisions should be evaluated based on the information available at the time they were made; it is important to have a uniform policy across the states; also, states should consider emulating FERC's pre-filing process for certificate application
Natural Gas Supply Association (NGSA)	(1) Foster a stable, transparent and consistent regulatory environment for gas infrastructure development and contracting decisions, (2) allow gas utilities to use long-term contracting (for example, as a risk management tool) for managing their portfolio and (3) timely recovery of prudent costs associated with long-term contracts (i.e., no 20/20 hindsight review)
Edison Electric Institute (EEI)	State regulators should not mandate long-term contracts for electric generators -- for some generators long-term contracts may be economical, while for others (for example, gas-fired generators with a low capacity factor) they would not
Cinergy	The best action would be to issue policy statements containing guiding principles; also, recommended would be to reduce cost-recovery risk and to address the "stranded cost" issue regarding the switching of sales customers to transportation-customer status
Interstate Natural Gas Association of America (INGAA) Foundation	(1) Implement a policy of pre-approving prudent long-term contracts, with a "safe harbor" status granted to those contracts, (2) implement a policy of protecting gas utilities from stranded costs, for example, when retail customers switch to third-party marketers, (3) assign greater weight to the "reliability" benefits from gas utilities as well as electric generators holding long-term firm pipeline and storage capacity
National Fuel	When long-term contracts are required, State regulators should ensure that stranded costs are avoided; if cannot be avoided, State regulators should endorse mechanisms that allow gas utilities to recover stranded costs (e.g., mandatory capacity assignment to marketers); also, prudence reviews should take a long-term perspective; State regulators should adopt a flexible approach, recognizing the need to balance long-term concerns with short-term cost minimization
Anadarko Petroleum	(1) Pre-certification procedures (e.g., pre-approval of long-term agreements), (2) "safe harbor" rules (e.g., specifying terms and conditions to assure cost recovery), (3) portfolio standards (e.g., specifying a minimum proportion of gas supply needs be met through long-term contracts), (4) incentive programs (e.g., the gas utility retains savings as measured by the difference between contract prices and current market prices)

Table 6: Other Comments Relevant to the NOI (Q5)

Organization	Comments
Arizona Corporation Commission	
Missouri Public Service Commission	
Duke Energy Gas Transmission (DEGT)	
ProLiance Energy	State regulators should encourage (not specified) investments in natural gas infrastructure; assistance by State regulators in any manner can help to improve long-term natural gas investment opportunities and reliability
Xcel Energy	
Dominion Resources	Case specific as to the appropriate duration of a long-term contract -- for example, it depends on a utility's specific situation and the nature of its optimal diverse-capacity portfolio
Natural Gas Supply Association (NGSA)	
Edison Electric Institute (EEI)	
Cinergy	
Interstate Natural Gas Association of America (INGAA) Foundation	
National Fuel	"One-size-fits-all" approach is ill-advised; the gas industry needs to take a "big picture" approach to improving the natural-gas infrastructure situation
Anadarko Petroleum	

Analysis of Comments

A conspicuous trend in the natural gas industry over the past twenty years has been the predominance of short-term commercial transactions for both gas supplies and gas-delivery services. This transformation has imposed additional risk on gas-delivery operators by increasing the uncertainty of their future revenue stream. As the natural gas industry embarks on new investments in gas-delivery infrastructure, by almost all accounts required to meet the growing demand for gas and to accommodate gas supplies from new sources, it is appropriate at this time to identify possible barriers to this development. As shown by the recent INGAA and National Petroleum Council (NPC) studies, delays in gas infrastructure development can have a chilling effect on future natural gas market conditions. Delays may be attributable to the absence of long-term commitments by shippers (notably, gas utilities), with potentially substantial costs to gas as well as electricity consumers. Several factors affect the risk of constructing new transportation/storage facilities, with the level of revenue assurances being one of the most important. For some pipelines, long-term contracting may be a requisite for financing new projects. For example, the Alaskan gas pipeline sponsors will require large financial commitments when the potential for stranded costs, because of the pipeline's remote location, undisputedly exists. Overall, long-term contracting reduces risks to pipelines, underpins financing for new investments and allocates risk among project operators and consumers.

NOI comments identified specific regulatory barriers to long-term contracting. As elaborated below, they include regulatory uncertainty over the recovery of costs associated with long-term contracts and FERC's pricing policies that have resulted in short-term transactions for pipeline service being more economically attractive to shippers relative to long-term transactions. Overall, these barriers may be hindering the development of new capital projects that will enhance gas-delivery capability and, ultimately, benefit consumers.

NOI comments also suggested that both market participants and regulators should assign a higher weight to long-term transactions. Because of the high uncertainty surrounding future market conditions, shippers as well as State regulators have taken a

short-term, if not myopic, perspective regarding market transactions for gas supplies and gas-delivery services, a situation that may be jeopardizing the financing of new gas-infrastructure projects.

One way to address this problem would be for gas utilities to apply a portfolio approach to gas procurement and transportation acquisition (which some commenters endorsed). Following this practice, regulators would encourage gas utilities to more explicitly strike a balance between moderating risks and providing reliable service at the lowest possible cost. The risks would be managed in accordance with corporate and regulatory objectives. A portfolio approach, which gas utilities have increasingly applied in recent years largely because of the high volatility in wholesale gas prices, would consider alternative transactions on the basis of a combination of different factors, including cost, risk and reliability. A portfolio approach takes into account both short-term and long-term transactions of gas supplies and transportation and, in general, the balancing of objectives over different time horizons. Within the confines of a portfolio approach, a prudent long-term strategy may encompass long-term contracts for pipeline and storage services. The Joint Task Force concludes that long-term contracting may be a prudent way to develop an appropriate balance between cost, risk and reliability. The optimal mix of long-term contracting within a portfolio would likely vary by gas utility because of the unique conditions facing individual utilities. For example, a situation for which long-term contracting might be attractive occurs when pipeline capacity becomes so restricted in a region that a utility must prudently guarantee adequate future capacity by making a long-term commitment to new capacity.

NOI comments repeatedly alluded to uncertainty created by State regulators as a deterrent to long-term contracting. Specifically, that concern pertains to the possibility that State regulators, subsequent to a hindsight review, could prevent a gas utility from recovering the full costs from long-term contracts. This might occur because of unanticipated and changing conditions resulting in a contract being perceived as “imprudent” (say) in the initial years of the contract. From a gas utility’s perspective, such a regulatory response makes the risk associated with a long-term contract asymmetric and, perhaps, unacceptable. As with hedging, long-term contracts are highly susceptible to 20/20 hindsight review. The NOI comment produced no empirical

evidence demonstrating the degree to which this regulatory practice, or its potential effect, has discouraged gas utilities from securing long-term contracts for gas-delivery service. It is more apparent, however, that it probably has had a chilling effect on the willingness of gas utilities to sign long-term contracts.

Finally, some comments identified FERC's pricing policy for pipeline service as slanting the market toward short-term transactions. In addition, other FERC practices might be hindering long-term contracting arrangements. It could be useful for FERC to immediately undertake a review of its policies that may be discouraging long-term contracting since new investments in the gas-delivery and storage infrastructure, as noted earlier, are so urgently needed over the next several years.

Policy Recommendations

Based on the NOI comments and the forgoing analysis, the Joint Task Force offers the following policy recommendations:

- *State regulators should take a more active role encouraging long-term gas supply/transportation/storage plans.* In certain circumstances some regulators and utilities may appropriately consider pre-approval of long-term contracts. State regulators and gas utilities should consider engaging in a meaningful and active posture upfront through a collaboration process, which could mitigate the uncertainty over the regulators' positions on long-term contracting. Regulators may wish to enact "safe harbor" rules, or establish guiding principles, that would mitigate the effects of hindsight reviews. Because of the nature of long-term contracting, and its potential effect on a utility's balance sheet or financial exposure,¹ it may sometimes be crucial and prudent for State regulators to support long-term contracts in advance. Cost disallowances could significantly affect a utility's net income or rate of return on equity.

¹ Most investment analysts view long-term contracts, with their fixed payment obligations, as imputed debt that a utility carries on its books as "off-balance-sheet" financing. In other words, such contracts act as debt-like obligation that would affect a utility's capital structure as well as other financial indicators.

- *As an extension of the above recommendation, State regulators should minimize second guessing and taking a short-term perspective when evaluating long-term contracts.* Because long-term contracts are by their very nature multi-period, they should be evaluated accordingly. The fact that they could be judged as less-than-optimal within a limited term should not reduce their overall value from a long-term perspective.
- *State regulators should recognize the urgent need for additional gas-delivery infrastructure to moderate the level, as well as the volatility, of future natural gas prices.* Major studies in recent years have revealed large costs to gas and electric consumers resulting from an insufficient gas delivery infrastructure. New infrastructure will be required to access new gas supply sources from LNG terminals and production regions. New infrastructure will ensure reliable service on existing pipeline corridors, adequate storage to accommodate market needs and the connection of new customers to the main trunk lines.
- *State regulators should consider long-term contracting as an appropriate mechanism to manage long-term price and volume risk within the confines of a gas utility's portfolio strategy.* Long-term contracts should be evaluated along with other transactional arrangements on the basis of advancing varying objectives, some of which may be conflicting in nature, and balancing these objectives in a prudent fashion.
- *State regulators should recognize the special features of certain infrastructure projects, specifically the Alaskan gas pipeline and multiple LNG projects, that will require substantial revenue guarantees.*
- *State regulators should consider requiring gas utilities to develop long-term strategies for pipeline capacity, gas storage and gas supply acquisitions, in the 10+ year range.*
- *FERC should revisit its policies for pricing different pipeline services, in addition to its other practices that may be stifling financing of, and contracting for, long-term gas-delivery services.*

- *At the minimum, State regulators should not outright discourage long-term contracts.* Such contracts can be prudent for a particular utility in a particular jurisdiction under the specific conditions faced by that utility. As noted above, long-term contracts should be evaluated in the context of a utility's long-term portfolio strategy.
- *State regulators, in addition to regional power operators, should recognize the benefits of electric generators holding firm, long-term capacity for pipeline transportation and storage.* These generators should possibly receive capacity payments to compensate them for the reliability benefits they provide to the regional electric-power grid.