

STANFORD WASHINGTON RESEARCH GROUP

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State & Federal Roles In Adequate Electric Supply

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Who we are...

- Stanford Washington Research Group provides institutional investors with “top down” analysis on how Washington (D.C.) impacts publicly-traded equities through Regulation, Legislation, and Politics.
- My focus
 - Federal electricity outlook
 - Federal pipeline outlook
 - Federal environmental outlook



Our Clientele

- Traditional utility funds (investing in electricity, natural gas pipelines, natural gas distribution utilities and telecoms) owning publicly traded entities
- Dividend and income funds (own companies in any dividend paying industry)
- Hedge funds who own publicly traded shares of market participants.
- We do not currently work with bondholders or private equity firms.



“Concurrent” Jurisdiction

■ Synonyms:

- Simultaneous
- Synchronized
- Parallel
- Coexisting
- Contemporaneous
- Agreeing
- In Accord
- Assenting
- Harmonizing

■ Antonyms:

- Conflicting
- Intersecting



The Federal Role

- The Federal Energy Regulatory Commission's responsibility is to regulate the terms, conditions and rates for electric transmission in interstate commerce. *No distinction between retail and wholesale.*
- In *New York v. FERC* the Supreme Court upheld this jurisdiction and upheld the FERC's decision to delegate the sales of transmission to the state if transmission service remained bundled in retail rates.
- **The FERC regulates the rates that *sellers* charge for generation. The states still regulate the procurement practices of load serving entity *buying* electric supply that is sold in retail service.**



Simultaneous Realities

- Electricity may be provided most efficiently on a larger scale, multi-state, regional basis (RTOs or large multi-state utilities).
- State public utility commissions are responsible for ensuring LSE's have sufficient resources. The states, however, do not regulate sellers.
- Many states have chosen to freeze retail rates as parts of retail choice programs.
- Pollution control obligations are set by the federal government but based on individual targets set on a state-by-state basis. Will change the underlying costs of generation plants since the utility industry is an "easy" target for reductions.

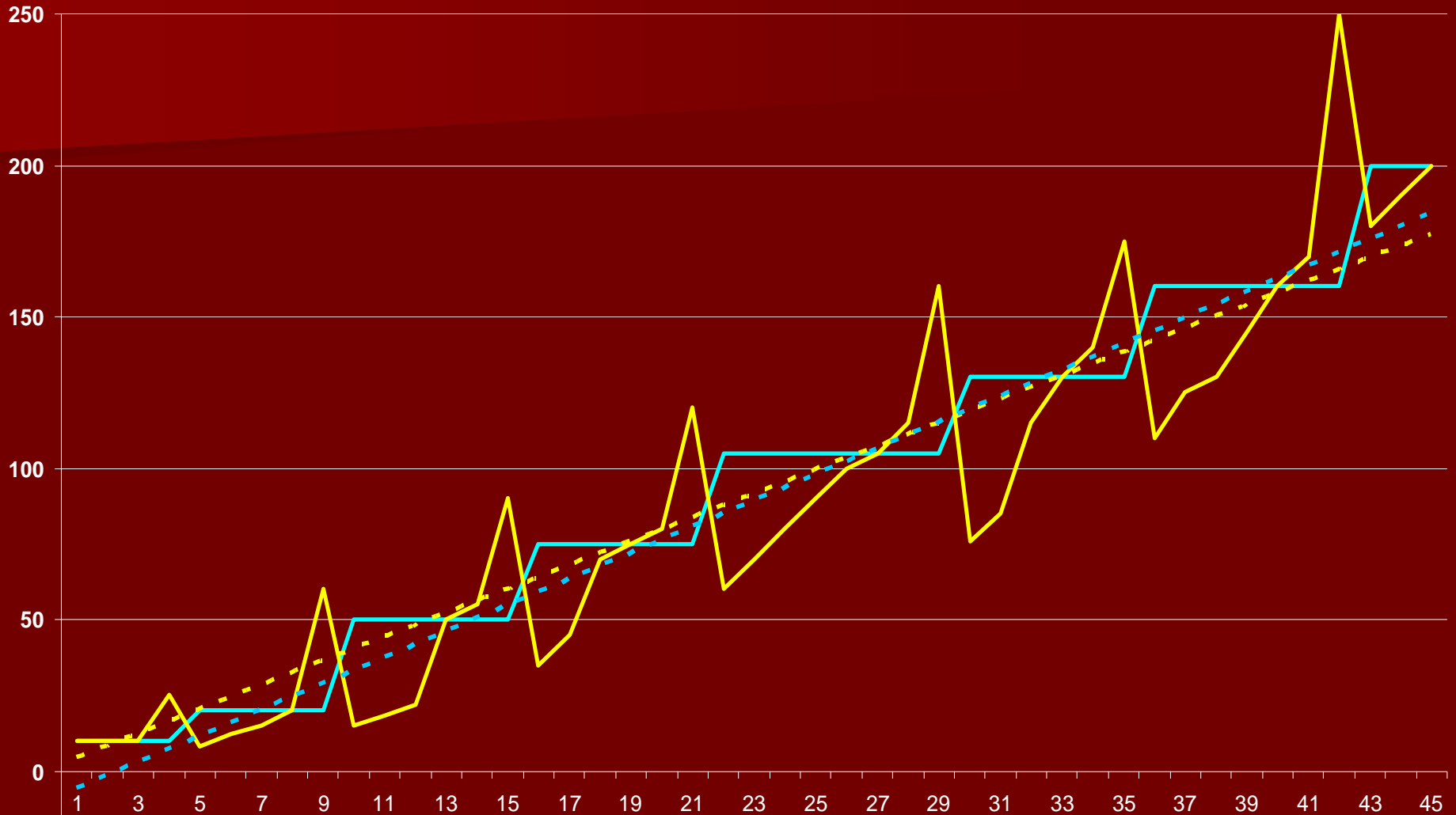


Competitive Markets

- Assumed to provide lower costs through the more efficient utilization of assets *over the long term...*
 - Not 5
 - Not 10
 - Maybe 30-50 years
- The transition to competitive markets was sold as a permanent rate cut.
- This was a mistake, but there is nothing we can do about it now but acknowledge reality and move on.



"Traditional" v. "Competition"



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What Risk Shifting Means

- *Classical utilities* finance large capital expenditures (coal plants vs. gas) with 50% debt – 50% equity *and* get to collect funds while the project gets built

Cash flow from operations (net income, depreciation/amortization)

Cash flow from investing (add/dispose assets, investments)

Cash flow from financing (borrowing = debt)

- Entire project will be collected from ratepayers, guaranteed. In fact, the collection can begin *before* the project is operational!



What Risk Shifting Means

- *Non Regulated Generators* finance large capital expenditures do not collect funds while the project gets built, and to make the project more affordable should put up more equity.

Cash flow from operations (*net income*, depreciation/amortization)

Cash flow from investing (add/dispose assets, investments)

Cash flow from financing (borrowing = debt)

- In order to compensate for poor prospects of recovering debt without regulation, the *net income* (e.g. profits) make it safe to lend to these participants at no cost to ratepayers.



Looking at it Side by Side (Risk Shift)

	Classical Utility	Non-Regulated Generator	Non-Regulated Generator w/ leverage
Operating Cash	1,000	1,500	750
Investing Cash	-	-	-
Financing Cash	1,000	500	1,250
Project Cost	2,000	2,000	2,000
Cost of Equity	11.0%	16.0%	16.0%
Cost of Debt	5.5%	5.5%	5.5%
Return to Owner	8.3%	13.4%	9.4%
Total return project	165	268	189
	<i>guaranteed</i>	<i>possible</i>	<i>possible</i>

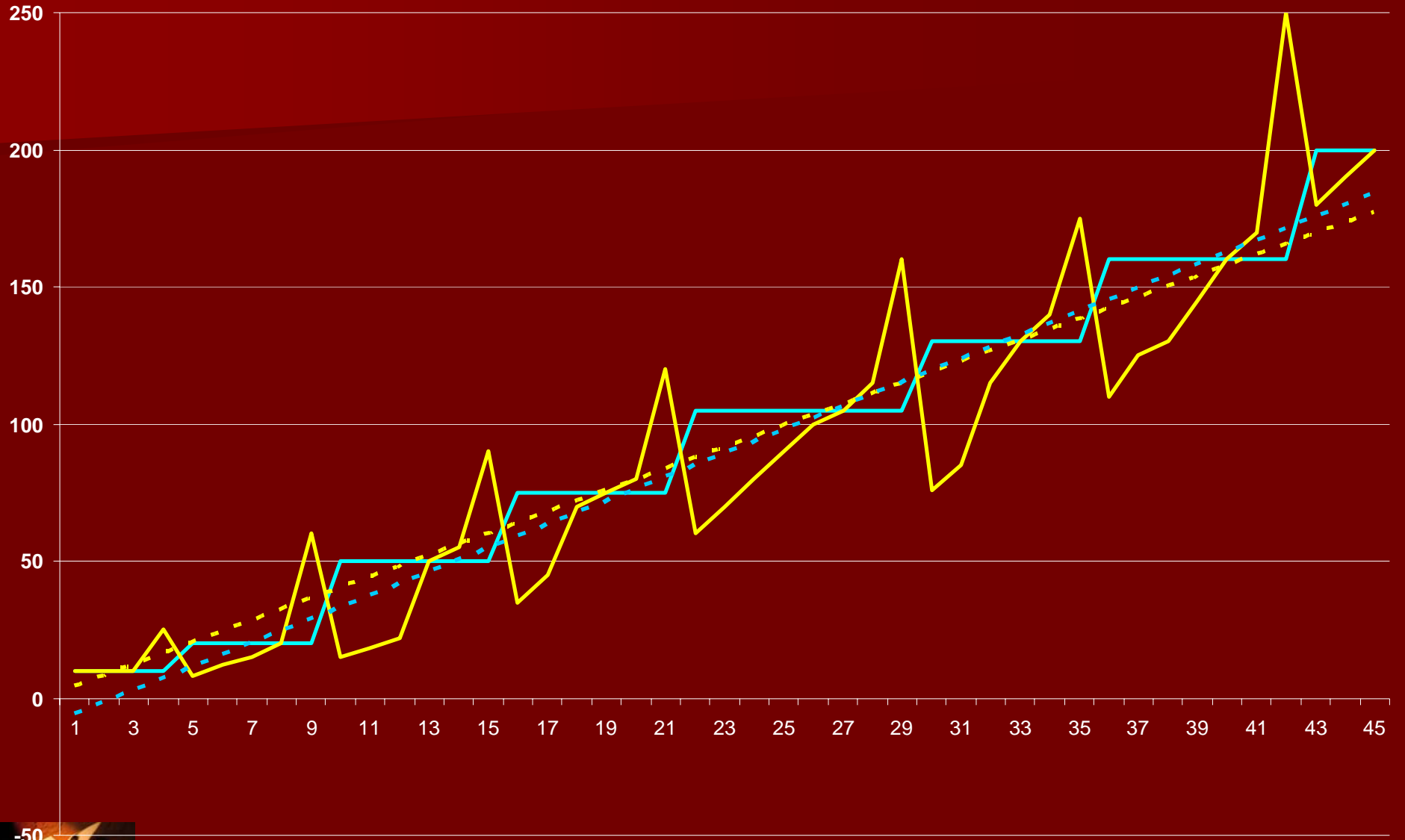
Reality – The ratepayer benefits from never having to pay for capacity before it is needed and because oversupply *will* happen in cyclical markets.



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"Traditional" v. "Competition"



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So What's Not Working?

- Market mitigation means that net income (profits) is insufficient to support the entry of net new assets or the replacement of old assets with newer ones from the operating cash flow of non-regulated market participants.
- This is the “*missing money*” that resource adequacy programs (capacity markets) are supposed to address.
- Capacity markets are the proxy for advancing funds to the suppliers to build ahead of market signals.

*Maryland Panhandle Example –
customers paying more but the solution isn't happening!
Leads to concerns that “competition is broken.”*



What Would Work?

- If the market functions properly new capacity will be financed with cash flows and risk borne by investors, not ratepayers.
- New entry occurs when someone is willing to make just a little bit less than the market incumbents (the American Way!)
- Ratepayers benefit because 1) cyclical markets result in the removal of less efficient assets from the market over time; and 2) the fact that some market participants will not always guess correctly.
 - Assets can decline in value during oversupply, a new owner will wind up incurring lower costs to run them when bought at a discount.



Why Even High NatGas Prices are OK

- It is a change in the relative value between supply sources.
- Sends a signal that more investment should take place in nuclear and coal resources, not natural gas.
- What this tells us is the overall demand has increased and that it is time to add the higher baseload capacity that has lower fuel risk but higher capital expenditure.
- Let me let you in on a little secret – if the market is clearing at the price of natural gas the likelihood of there really being significant amounts of cheap coal and nuclear participating in the spot market is low unless it is being imported!



Not all “Investors” are the Same!

- Bond investors (debtholders) and traditional utility investors seek stable returns. They will accept lower rates on return in exchange for stability.
- Cyclical investors tolerate volatile returns. They will accept good years and they will accept bad years. They must, however be able to count on the existence of *both!*
- Cyclical investors believe they are smart enough to buy low and sell high!
- Sustainable losses = sustainable ratepayer savings.
- “The lower of cost or market” is not a viable proposition.



Investors Seek “Stability”

- Duration of investment horizon / payback period
 - Risk assessment
 - Financing rate
- Investors know that some projects win and some projects lose.
- The purpose of “deregulating” supply was to put the investment decisions in the hands of more risk tolerant cyclical investors and take it off the shoulders of ratepayers.
- Cyclical investors know that some years are good and some years are not. Stability of returns is less important than the stability of a reality that the cycle will take place in its entirety.



What is “Uncertainty”?

- The absence of a decision, an event to move forward – conflict between federal and state regulators stops decisions!
- Positions are taken in anticipation of an event
 - Funds are obligated and then not released (no growth)
 - Funds are directed elsewhere (other industries)
- When stagnation hits, risk/reward proposition can change and investments change in value – people lose money.
- Long-term contracts and longer forward curves are needed when the market is new – we don’t know how long or how deep the cycles in the market will be. No history...



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