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Asset Management Agreements **Christopher Gulick**

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Asset Management Agreements (AMAs)

- Background on AMAs
- FERC Order No. 712: Background
- FERC Order No. 712: Exemptions for AMAs
- Elements of an AMA
- Benefits of AMAs
- How an asset manager makes money
- Selecting an asset manager
- Contents of an RFP
- The RFP process
- Regulatory concerns of state commissions and consumer groups
- Asset manager concerns
- “Ideal” portfolio management structure

Background on AMAs

- Started showing up in the mid-1990s
- Became more possible and profitable
 - FERC Order No. 636
 - Evolution of NYMEX and OTC geographic basis markets
 - Ability of LDCs to retain some margins from off-system sales and capacity releases
 - Increased sophistication of natural gas trading and risk management
- Served to outsource natural gas resource management
 - Transportation, storage, and supply contracts
 - Released at max rate to avoid bidding
 - Asset manager reimbursed for demand charges
 - Often tied to wholesale purchase and sales contracts
 - Did NOT usually outsource planning functions or management of on-system resources
- Suspended when the FERC raised concerns about capacity released at maximum rate tied to a gas supply priced at index-minus

FERC Order No. 712: Background

- Issued by FERC on June 19, 2008.
- FERC approved changes to pipeline capacity release regulations in order to allow the use of AMAs
 - Capacity release program (Order No. 636) assumed shippers would handle their own gas purchase and transportation arrangements
- FERC recognized benefits of allowing producers and users to outsource capacity optimization and supply and risk management services using AMAs
 - Observing that shippers were “releasing capacity for the primary purpose of transferring the capacity to entities that they perceive have greater skill and expertise both in purchasing low cost gas supplies, and in maximizing the value of the capacity when it is not needed to meet the releasing shipper’s gas supply needs.” FERC Order No. 712 ¶121
- FERC liberalized regulations on capacity releases, removed the price ceiling on short-term transactions, and provided exemptions for certain capacity releases from tying prohibitions and bidding requirements
- FERC did not remove the rate cap at which pipelines could sell capacity, citing the asymmetry in market power between shippers and pipelines

Source: Promotion of a More Efficient Capacity Release Market, 18 C.F.R. Part 284, FERC Order Nos. 712, <http://www.ferc.gov/whats-new/comm-meet/2008/061908/G-4.pdf> (June 19, 2008), 712-A, <http://www.ferc.gov/whats-new/comm-meet/2008/112008/G-2.pdf> (Nov. 21, 2008), and 712-B, <http://www.ferc.gov/whats-new/comm-meet/2009/041609/G-1.pdf> (April 16, 2009).

FERC acknowledged the benefits of widespread use of AMA’s in the development of secondary capacity release markets

FERC Order No. 712: Exemptions for AMAs

- Capacity releases that implement AMAs are exempt from the prohibition on tying a capacity release to any extraneous condition and from competitive bidding requirements in Part 284.8.
- Effect of Order 712 on structure of AMAs
 - A definition of AMAs that strikes a balance between facilitating AMAs and differentiating them from standard capacity releases
 - The asset manager must bear a purchase or delivery obligation to the releasing shipper for at least 5 months out of each 12-month period for up to 100% of the daily contract demand of the released capacity
 - Applies to entire contract path, including contracts upstream of the final delivering pipeline
 - For releases longer than 12 months, delivery obligation is for 5/12 of the incremental period
 - Delivery obligation periods need not be successive

Source: Promotion of a More Efficient Capacity Release Market, 18 C.F.R. Part 284, FERC Order Nos. 712, <http://www.ferc.gov/whats-new/comm-meet/2008/061908/G-4.pdf> (June 19, 2008), 712-A, <http://www.ferc.gov/whats-new/comm-meet/2008/112008/G-2.pdf> (Nov. 21, 2008), and 712-B, <http://www.ferc.gov/whats-new/comm-meet/2009/041609/G-1.pdf> (April 16, 2009).

FERC facilitated AMAs by relaxing the prohibition on tying and bidding requirements for certain capacity releases

Elements of an AMA

- Role of the asset manager
 - Commits to provide a reliable gas supply and manage upstream contracts and assets
 - Often pays a fixed fee for the right to optimize the LDC's contracts and assets
 - Sharing arrangements are also done, but are more labor intensive
 - Can be more common if asset manager is affiliated
 - Agrees to deliver gas to the LDC, as directed
 - Bases the price for gas on a reference to published indices
 - Least cost, WACOG, dispatch priority, predetermined order, etc.
- Role of the LDC
 - Agrees to receive and pay for the gas delivered by the asset manager
 - Releases all of the specified transportation and storage contracts
 - At max rate, reimburses asset manager for all or a portion of demand charges
 - At \$0, pays pipelines directly
 - Can designate asset manager as agent for 7C contracts, often excluded

Benefits of an AMA

- Natural gas market
 - Lower delivered costs for shippers
 - More efficient capacity utilization of interstate gas pipelines
 - Enhanced liquidity and added diversity to the mix of natural gas products and services
 - Increased load-responsive use of gas supply
 - Savings to end-use consumers
- LDC
 - Fixed payment hedges gas resource portfolio “savings”
 - Provides lower-cost access to embedded risk products
 - Usually fixed-price products
 - Transparent pricing
 - Potential to mitigate prudence review

How an asset manager makes money

- By exploiting a less conservative approach to managing upstream resources and storage
 - When storage capacity and injection/withdrawal are not well matched, there's an opportunity
- Through arbitrage opportunities that arise from managing multiple portfolios across geographically diverse markets
 - Prices move as cold fronts move from west to east, north to south
 - Moving gas to highest value markets, subject to delivery obligations
 - More aggressive capacity releases
- By trading on their own book against their forward delivery obligations
- The more load volatility in the releasing LDC's market, the greater the potential value
 - Lower load factors = greater sales/release opportunities
- Constraints on the use of the portfolio or specific contract requirements typically reduces the value to the asset manager
 - Commodity pricing can be key

Selecting an asset manager

- Assess supplier capabilities
 - Proposed management fee
 - Quality and cost of proposed natural gas supply
 - Creditworthiness
 - Other positions in a regional market
 - Experience managing natural gas pipeline and storage assets, and gas sales
 - Knowledge of the regional gas market
- Choose between Request for Proposal (RFP) versus targeted negotiation
 - RFP process is typically used by LDCs to choose an asset manager
 - Enables a broad range of proposals to be considered
 - Allows evaluation of multiple proposals using the same criteria
 - Leverages a utility's negotiating ability and purchasing power
 - Some states mandate that LDCs use an RFP process, and review and approve all AMAs
 - Targeted negotiation might be preferable when there is a prominent marketer or a unique contract
 - A single marketer may have unique knowledge of the region, management experience, and expertise in gas supply or storage and transportation optimization
 - LDCs might be restricted to least-cost criteria in RFPs and unable to select an asset manager based on other criteria (e.g., creditworthiness or expertise)

Contents of an RFP

- Basic functions of the RFP
 - Provides potential asset managers with the issuing LDC's daily firm requirements and temperature data for a period of time – usually one year
 - Identifies the contracts to be released
 - Specifies the requested services
 - Seeks bids for the specified services – often subject to regulatory approval
- Additional RFP functions
 - Describes preference on how storage inventories will be transferred or sold
 - Defines the dispatch criteria or cost metric preferred
 - Sets out the preferred term of the AMA
 - Specifies the bidding process and time line to be followed
 - Lists evaluation criteria to be used
 - Economic (e.g. annual payments and swing costs)
 - Credit worthiness
 - Breadth and depth of upstream market and operational experience
 - Reputation and strength of guarantees
 - FERC compliant (e.g., approval for state-mandated direct access, delivery obligations, etc.)
 - Provides a sample AMA
 - Details release requirements for direct access programs

The RFP process

- Sequence of the competitive bidding process
 - Preparation and issuance of the RFP
 - Identify resources to be managed
 - Specify timing and expectations
 - Evaluation and selection of final bidders
 - Initial review and ranking; re-bid and re-rank
 - Select preferred bidder
 - Post-bidding contracting and negotiation
 - Regulatory approval
- Evaluation usually relies on a scoring system that ranks bidders on individual criteria and calculates an overall score
 - Objective approach minimizes critique from 3rd parties
 - Some jurisdictions strictly adhere to scoring results
 - Other jurisdictions also consider qualitative criteria (with supporting analyses)

Regulatory concerns of state commissions and consumer groups

- Safeguards against oversubscription of storage and capacity assets
 - The length of multiyear agreements
 - Transparency in gas supply pricing
 - Adherence to affiliate transaction guidelines
 - Oversight of affiliated relationships
 - Prioritizing the needs of retail customers so money is not being transferred from ratepayers to shareholders
 - Reporting requirements
 - Asset manager compensation and profits
 - Monitoring creditworthiness
 - Utility oversight of outsourcing agreements
 - Limitations of RFPs
 - When there is a decreasing number of bidders
 - When utilities are restricted by least-cost criteria
 - Effect of the asset management relationship on hedging and performance-based regulation
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- Several states have mandated that utilities use an RFP process and review and approve all arrangements, and in recent years some states have adopted new RFP procedures to address these concerns

Source: Ken Costello, "The Outsourcing Option: Are There Some Gas Utility Functions That Others Can Do Better?"

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Asset manager concerns

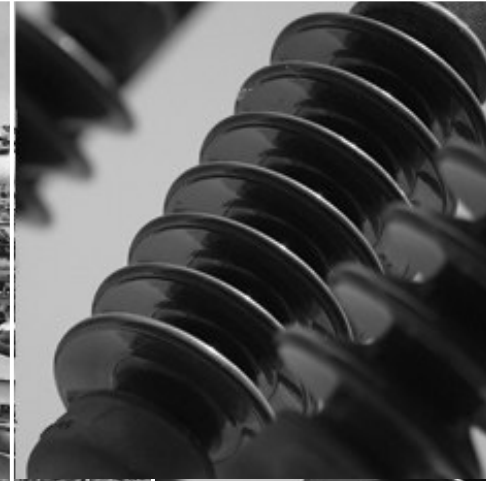
- RFP/bidding process often makes some opportunities unattractive
 - New entrants underbid to “buy” the business
 - No buyer loyalty to asset managers who have “learned the LDC’s business”
 - No repeat business means asset managers might not get compensated for learning curve in previous agreements
 - Margins pushed so low that the RFP becomes economically unattractive
- State-mandated, direct access programs can complicate offers
 - Uncertainty regarding the amount of capacity available from month-to-month
 - Replacement shippers that do not meet asset managers’ credit criteria

Ideal portfolio management structure ... it depends

- Selected approach tends to vary by the size of LDC
- Smaller LDCs appreciate shedding personnel costs associated with T&E and gas accounting
- Some larger LDCs prefer to mix self-managed contracts with an AMA to counter loss of off-system market intelligence and personnel expertise
 - Also prefer to use direct negotiations to select a manager for discreet “problem child” contracts
- Multistate LDCs would prefer to be able to manage their portfolio using a consistent set of rules across all states (or to select an asset manager who can)
 - Not all that common – have been tried, but return to managing each LDC’s gas resource portfolio separately
 - Heavy scrutiny in one state can make a program unattractive for a number of states
- Successful programs are those that consider these issues up front, and work with stakeholders to resolve concerns prior to implementing

Source: Bates White research

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