Regulation of Natural Gas Storage: Time for Change

EnCana Gas Storage Inc.

July 11th, 2004

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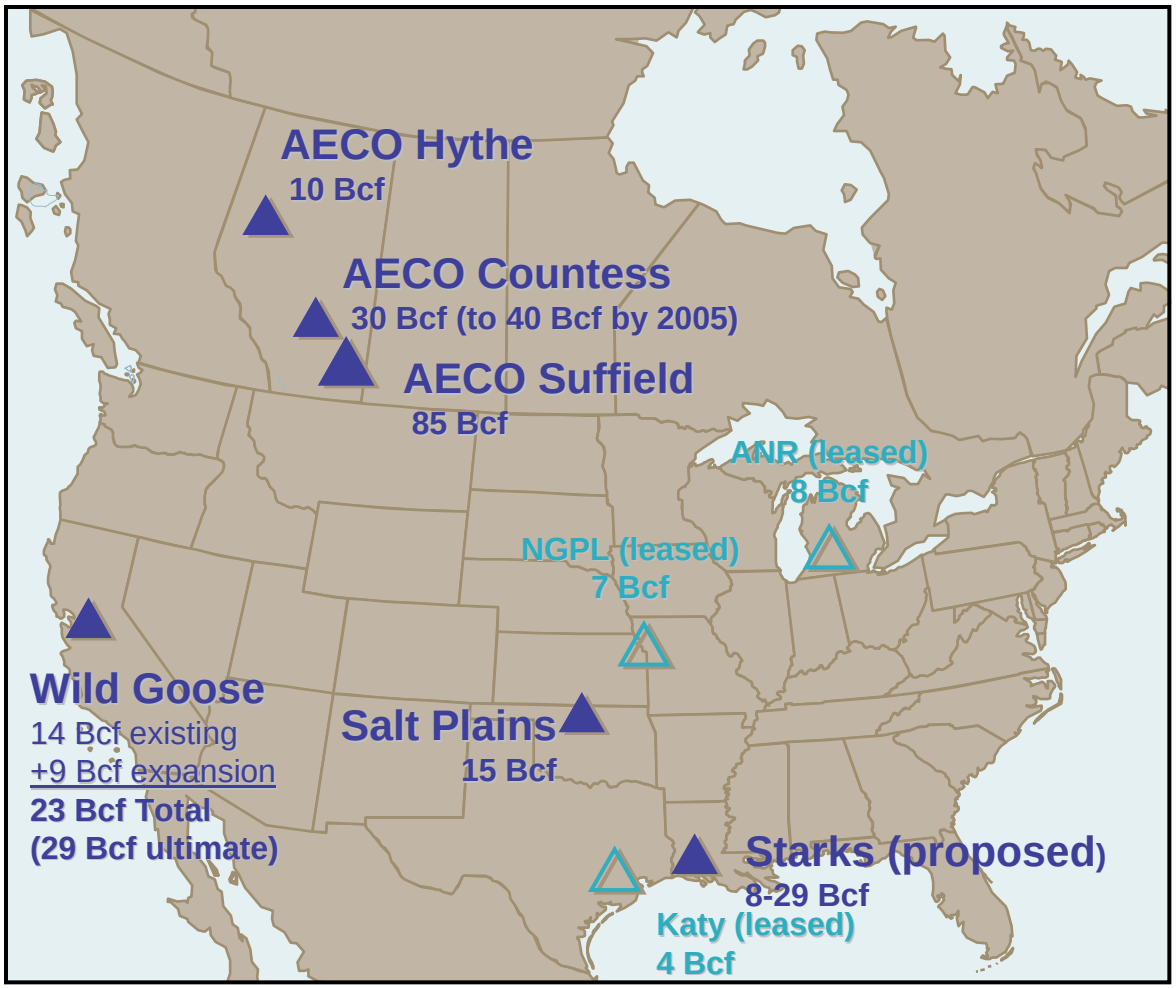
OVERVIEW

- Introduction of EnCana Gas Storage
- Changing nature of gas demand
- Inadequacy of current gas delivery infrastructure
- Independent vs. traditional utility storage
- Barriers to investment in new infrastructure
- Regulatory change to encourage investment by independent storage

EnCana Gas Storage

North America's Largest Independent Gas Storage Operator



Storage Capacity:

Current or to be constructed:

180 Bcf

Proposed:

8 – 29 Bcf

Max Withdrawal Rate*

2004: 3.6 Bcf/day

2005: 4.0 Bcf/day**

2006: 4.2 Bcf/day**

* *Does not include Starks*

** *Estimated*

EnCana Gas Storage Business Model

- EnCana's business model developed in Alberta, a jurisdiction which does not apply utility regulation to storage
- EnCana is the only storage operator that:
  - Optimizes uncontracted or underutilized capacity
  - Employs sophisticated 'yield management' risk-modeling techniques that integrate:
    - Facility performance curves vs. expected customer behaviour,
    - Optimization to reduce risk or to capture opportunities, and
    - Commodity risk associated with trading and storage use
- Many jurisdictions including the FERC, have rules that prohibit this business model

Proven Regulatory Innovator

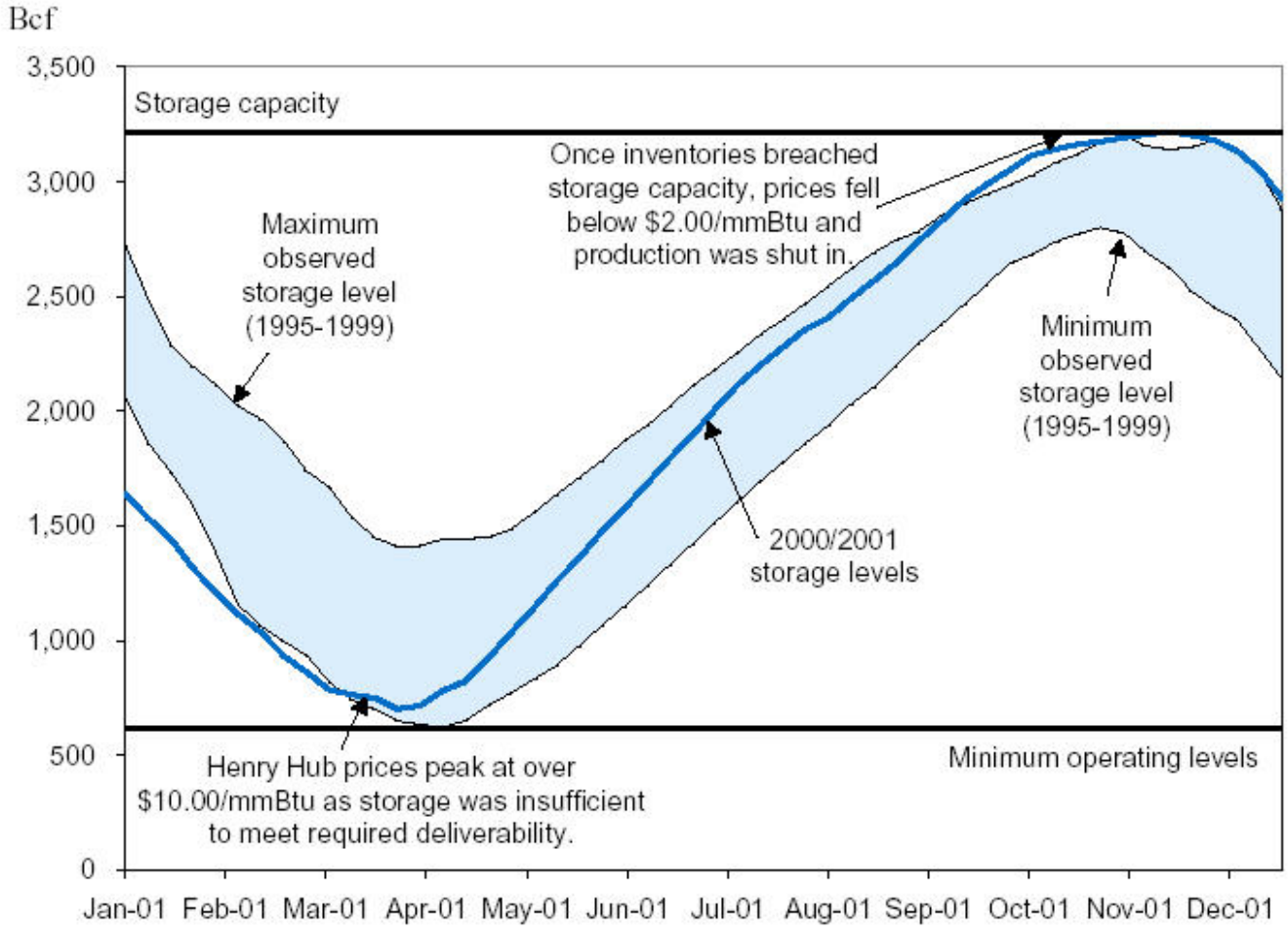
- First commercial storage in Alberta
  - Negotiated *pro forma* Crown Storage Agreement
  - Amended legislation to clarify storage vs. mineral rights
  - Nova tariff changed re storage: mainline extension policy, single tolling for round trip, system design to include withdrawals
  - Replaced TransCanada FST with storage services
- First independent storage in California
  - CPCN in 10 months, including CEQA approval
  - Market based rates, unique flexible tariff
  - Allocation of IT capacity on PG&E backbone
  - Eminent domain legislation changed

Storage Supply & Demand: Overview

- Storage capacity appears to be fully or near fully utilized
  - Supply is a mid-term problem
  - Deliverability or rate limitations are the immediate issue
- Gas demand will continue to grow, with weather sensitive demand growing even faster
- Storage capacity may already be insufficient to meet demands of colder than normal winters.
- Demand for storage capacity will be strong, and storage supply may have difficulty keeping pace. Incremental storage will be expensive.
- Alternatives to expanded storage capacity are not positive for the long term health of the gas market:
  - Customers live with price volatility, seasonal price spikes
  - Or they 'vote with their feet' (seasonal demand destruction and fuel switching)

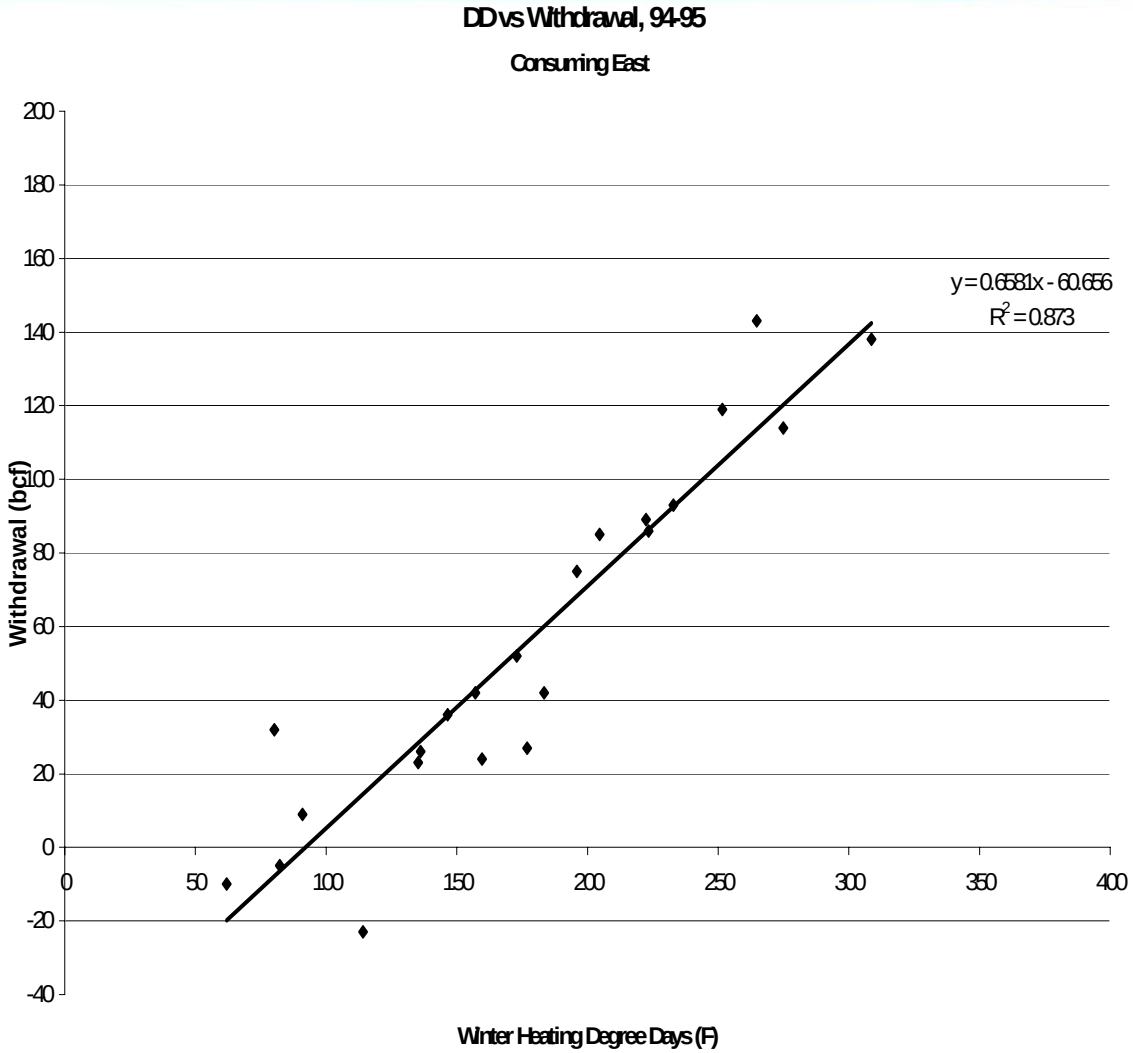
How Much Storage Is There?

Exhibit 2: Lack of storage capacity constrains the market's ability to adjust.



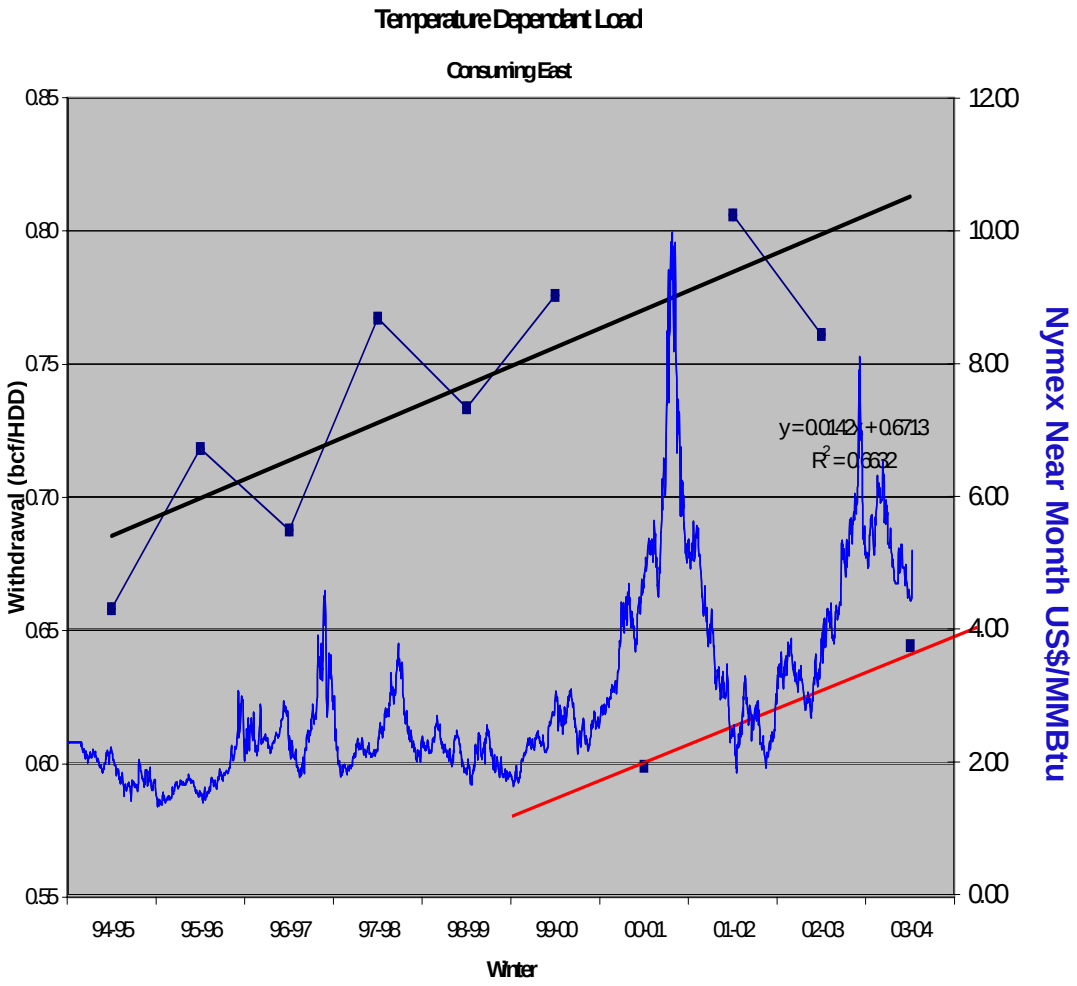
Source: DOE and Goldman Sachs Research.

Historical Relationship: Weather and Storage Withdrawals



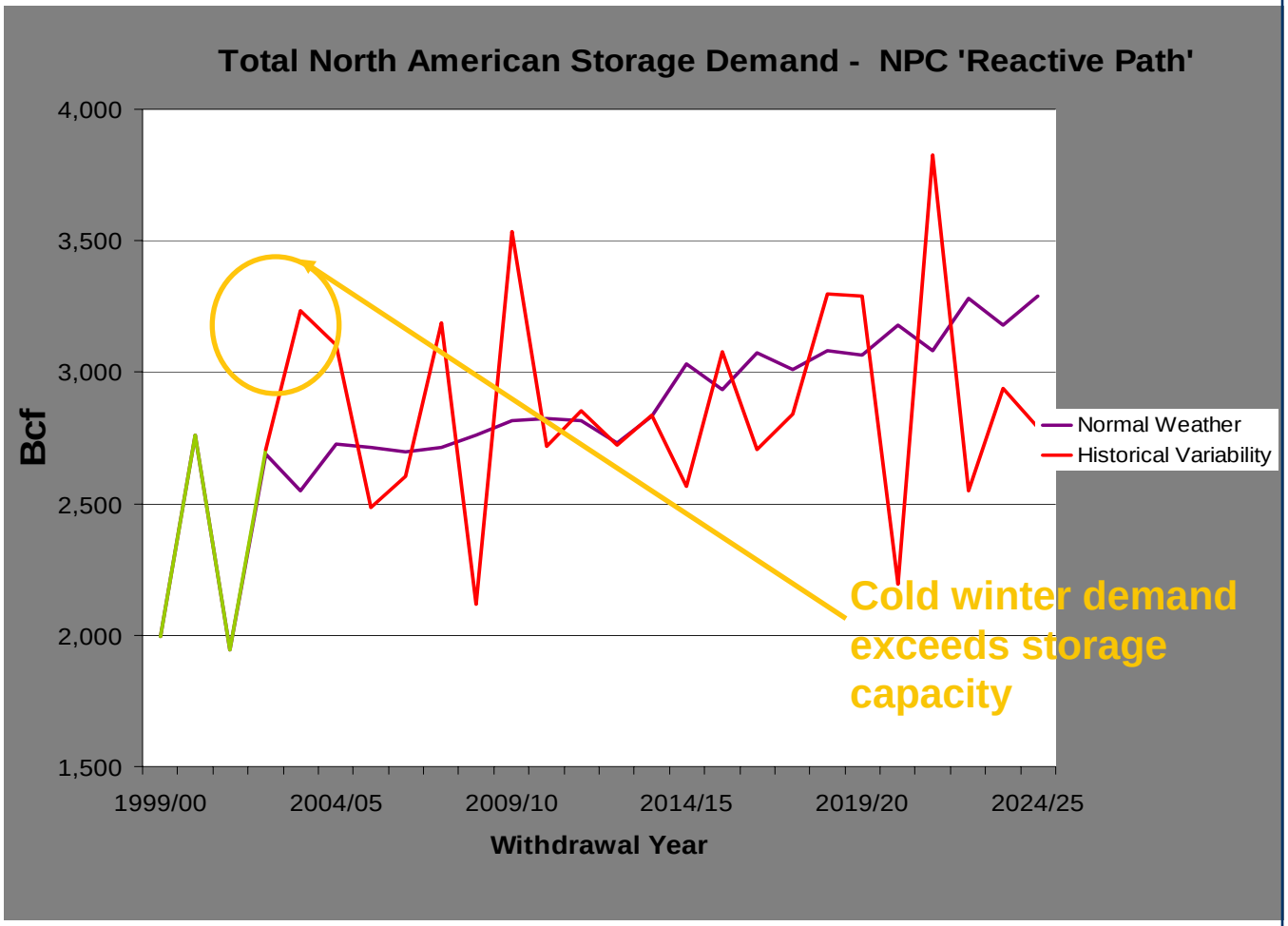
- Strong relationship between storage withdrawals and HDDs (heating degree days) in winter
- Regression analysis for each winter from '94-95, by region
- Example for 1994-1995 (Consuming East)
  - Withdrawals = .66 times HDDs – 60.7
- The 'x intercept' (92 HDDs) represents the HDDs that can be accommodated without storage withdrawals

Trend Interrupted when High Prices Force Loss of Gas Demand



- Excluding data from winters of high gas prices, the increased sensitivity to HDDs is more apparent
- At times of high gas prices withdrawals may be less than what HDD model would predict because:
  - Loss of gas demand (demand destruction, fuel switching)
  - Storage inventory and capacity constraints

Incremental Peak Delivery Infrastructure Required.



- Current Practical Capacity 2.9 TCF
- Cold Winter demand potential exceeds current capacity
- Incremental 700 BCF required to meet average needs over 20 years (35 BCF per year)

Source: National Petroleum Council

Emerging Demand Profile: Need for Peak Deliverability

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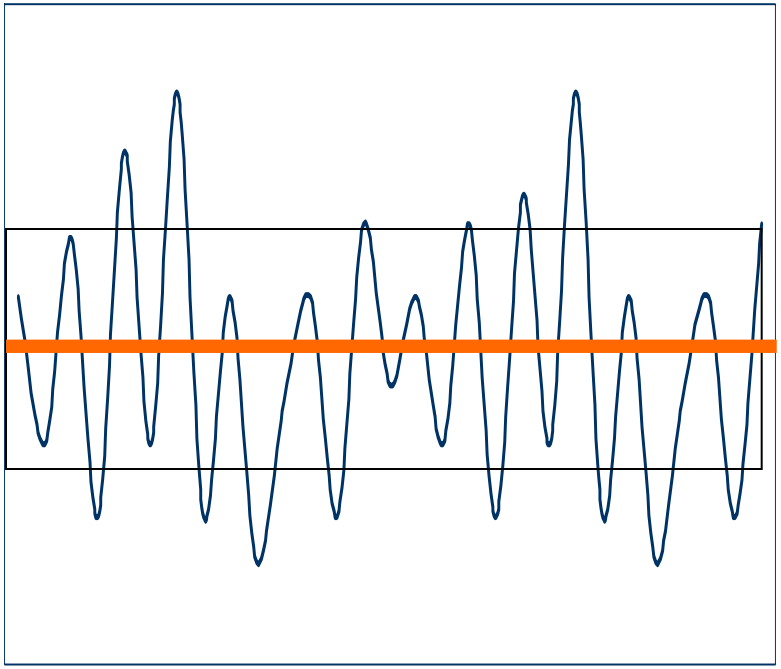
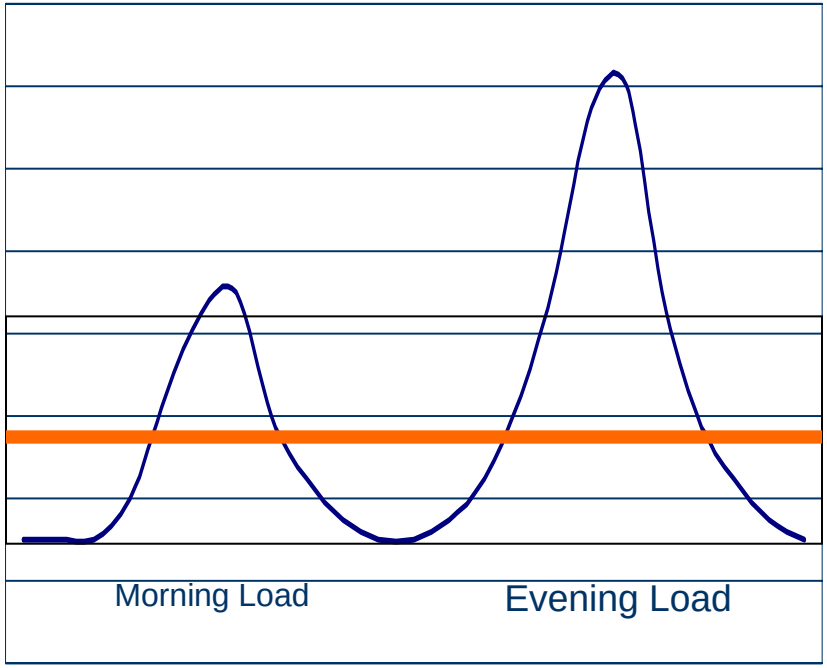
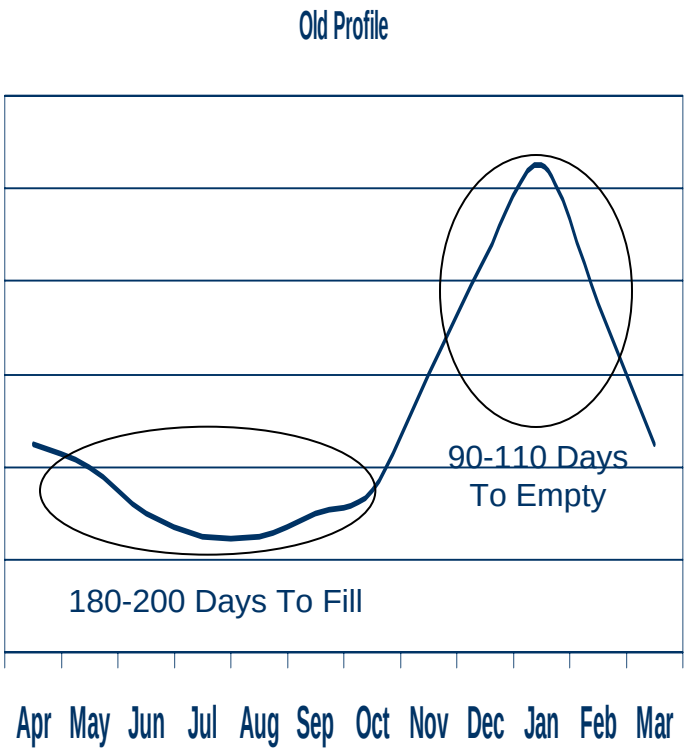
Day to Day Load Profile

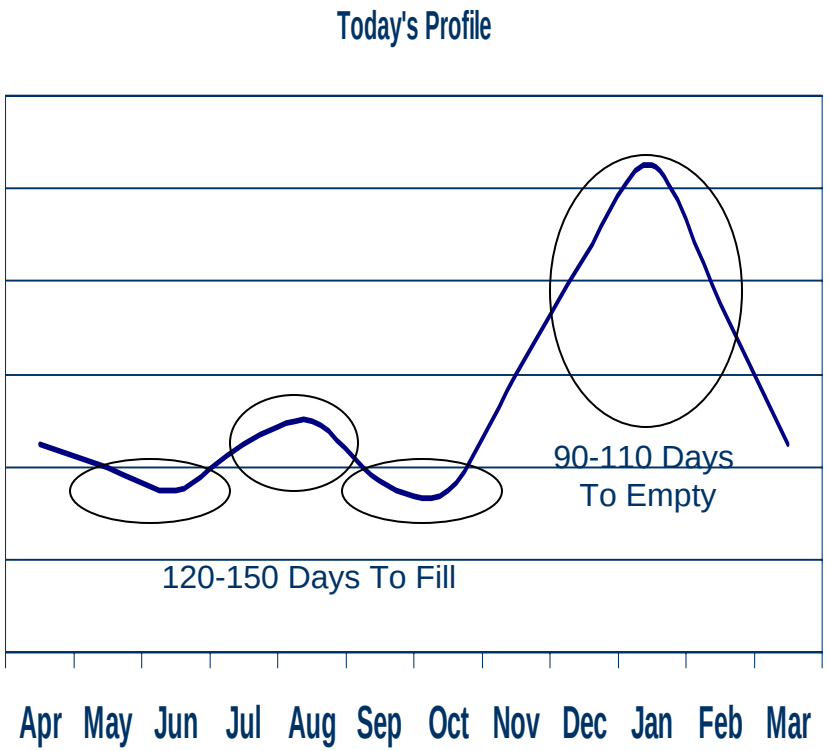


Hourly Load Profile

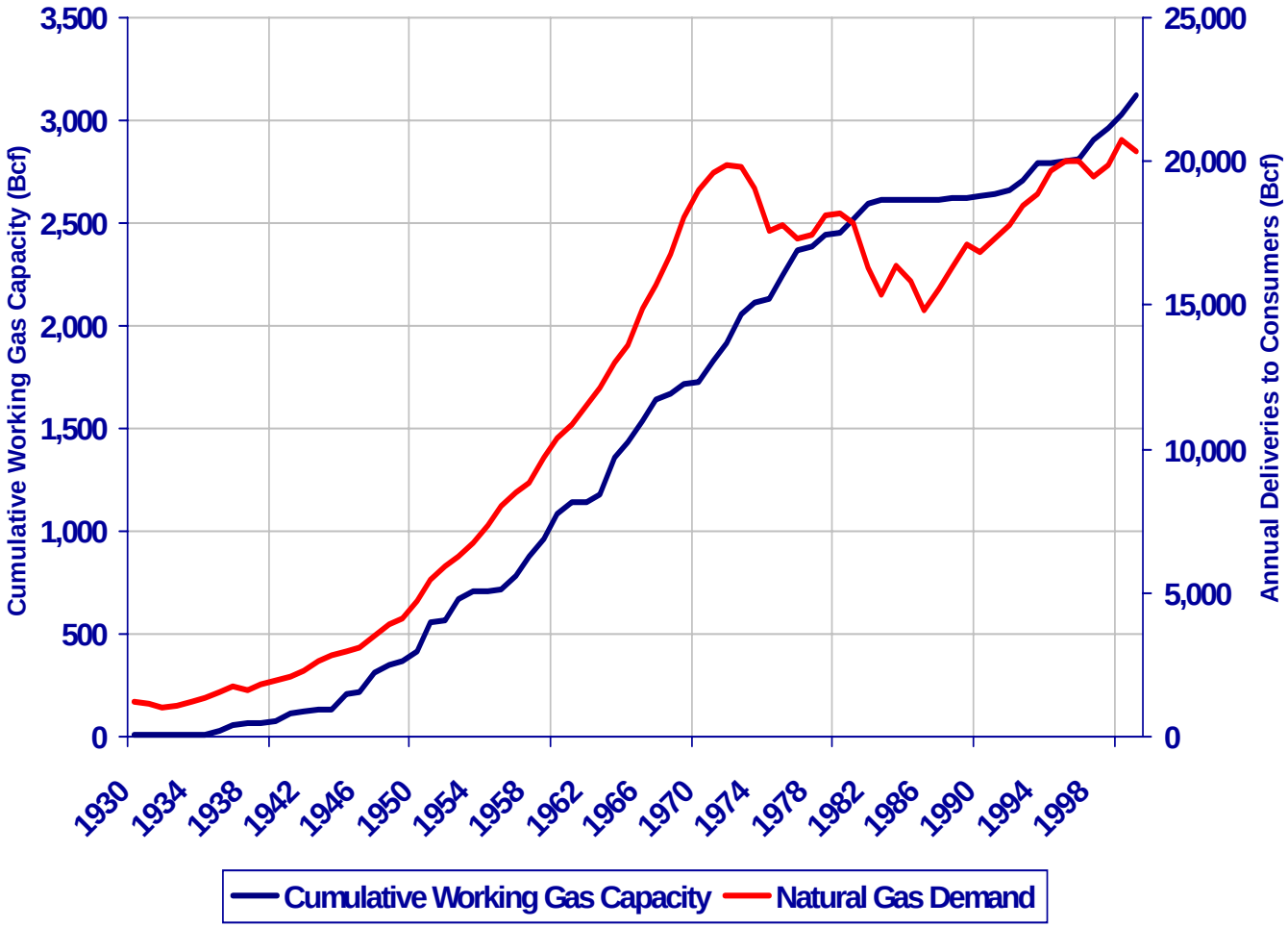


Annual Demand Profile: Impact on Storage Design





Can Storage Development Keep Pace?



- The best storage reservoirs were developed during the dramatic growth period of the industry from 1950 to the mid-70's.

Incremental storage will be increasingly:

- in poorer quality reservoirs
- farther from ideal locations
- using higher cost cushion gas
- and therefore more costly to develop and provide service

Storage is Part of the Solution

- Storage can more efficiently meet *peak system demands* than can additional pipeline capacity
  - Less exposure to facility outages
  - Supply cannot be diverted by upstream markets
  - Extra-jurisdictional risks reduced
  - Promotes higher overall system load factors
- Independent storage can play a vital role
  - Independents can see the developing fundamentals, and are prepared to assume risks of anticipatory investments
  - Independents have commercial and technical expertise that may not reside in utility

What is Independent Storage

- The fundamental distinctions between Independent and traditional utility storage include:
  - No cost of service or guaranteed rate of return
  - No exclusive franchise area
  - No captive ratepayers
  - No ability to subsidize at-risk operations by transferring value from or costs to other utility operations
  - No association with gas transmission or distribution
  - No market power

Barriers to Infrastructure Investment

- Lack of available capital due to
  - Poor rates of return
  - Creditworthy players unwilling to make long term commitments
  - Decline of Merchant Energy, a sector with the expertise and willingness to commit long term
- Risk adverse utility culture
  - Conflicting signals from regulators
  - Shareholder expectations
  - Lack of upstream expertise
- Energy policies & regulatory constructs that may have outlived their time

Other Barriers

- In some jurisdictions, incumbents regard Independent Storage as a competitor
- Examples of tactics used to frustrate full integration of Independent Storage into the delivery system of incumbent:
  - Oppressive interconnection requirements
  - Restricted access to interruptible transmission capacity
  - Discriminatory transportation tolling of storage volumes
  - Refusing Independent Storage the ability to compete for new balancing or core storage demand
- Most of these issues are within the purview of regulators, who could take steps to significantly improve the prospects for additional Independent Storage.

To Encourage Independent Storage

- Insist on unbundling storage from transportation service, to allow fair competition among storage providers.
- Allow independent storage providers greater flexibility to design services, negotiate rates, and make use of their uncontracted capacity. FERC's No. 2004-A provides a good example of where this flexibility has been shown.
- Adopt policies that prevent incumbents from using their market power to frustrate the ability of independents to provide supply storage and balancing services.

Conclusion

- Gas demand will continue to grow, with weather sensitive demand displacing baseload industrial demand
- Demand for storage capacity will grow, and storage supply may have difficulty keeping pace. Costs of incremental storage will be more expensive.
- Storage capacity may already be insufficient to meet demands of colder than normal winters
- Alternatives to expanded storage capacity are not positive for the long term health of the gas market:
  - Customers who must, will live with price volatility and seasonal price spikes
  - Others will 'vote with their feet' (seasonal demand destruction and fuel switching)
    - **With economic and environmental consequences**
    - **Reducing sales/throughputs for producers, pipelines, LDC's**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- BACK UP SLIDES

FERC and Independent Storage

- Unlike some jurisdictions, e.g. California, the FERC does not have a policy that recognizes independent storage
- Transportation oriented rules that grew out of the unbundling of merchant interstate pipelines should not apply to Independent Storage
- Examples include Order 2004 which restrict the interraction between the transmission operator and its energy affiliate

California's Independent Storage Policy

- Serves as an example of how to allow light-handed regulation within the traditional utility model
  - To date this policy has brought two new facilities, both of which are currently being expanded
  - Together those facilities bring over 1 Bcf/day of incremental capacity to the California market
  - Built with private capital, at no risk to the ratepayer
  - Independents compete with and dilute the market power of incumbernt utilities

7(c) Independent Storage?

- FERC should adopt an independent storage policy
  - Presently it does little to distinquish storage from transportation
  - Therefore storage is subject to the full weight of most FERC regulations
  - The consequence is to defeat the independent storage business model and force independents to pursue projects only in those jurisdictions - such as California - that embrace independent storage
  - If the storage operator has neither market power nor affiliation with the transmission system to which it connects, it should be allowed “light-handed” regulatory treatment

FERC Regulations: Key Reforms

- Exempt independent storage operator from the separation requirements of Order 2004
- Allow it to optimize by trading gas for its own account
- Streamline the approval process to allow at-risk expansions at discretion of facility owner
- Recognize the inherent conflict of interest that can result in anti-competitive behaviour by incumbent utilities that also provide storage or balancing services
  - Interconnection policies
  - Operating and Balancing Agreements
  - Access by storage customers to IT transmission capacity
  - Tolling of storage volumes