Barriers to Investment in New Infrastructure & Applicability of Current Policies and Regulations in the Natural Gas Sector

Presented by: Brian Ballinger, Manager
Financial Analysis & Customer Choice Section

December 5, 2008

Transparency in Market Assessment & Opportunity

- Market Assessment & Opportunity Factors:
  - Economy: Credit Crunch and the Housing/Real Estate downturn leading to conservation. Operating expenses on the rise.
  - Climate: Weather patterns produce revenue swings that threaten cost recovery, both from warmer/colder-than-normal weather and hurricane events.
  - Regulation: Many utilities realize insufficient and/or lagging returns, creating aged infrastructure and lower profitability. Impact M&A efforts as well.
  - Natural Gas Prices: Increasingly volatile, creating increased uncertainty in revenue streams. Elevated on historical basis.

Transparency in Market Assessment & Opportunity (Cont'd)

- Key Forms of Infrastructure Include:
  - Production, Underground Storage, Transportation and Regasification for LNG
    - Major storage capacity here in MI.
    - Production on the rise throughout industry and across country.

- Other Forms of Market Opportunity:
  - Gas Trading
    - Use of financial instruments to hedge certain financial positions.
  - Merger & Acquisition
    - Increase exposure to natural gas infrastructure through merging with mature operations, as opposed to new infrastructure.

Investment in the Regulated Natural Gas Sector in Michigan

- Eight natural gas companies regulated by MPSC.
- Two major natural gas companies serving Michigan customers:
  - Consumers Energy and Michigan Consolidated Gas Company.

Consumers		MichCon
$3.5 billion	Plant (2007)	$3.4 billion
$2.5 billion	Revenues (2007)	$1.8 billion
$87 million	Net Income (2007)	$76 million
1.7 million	Customers Served	1.0 million
~ $1.2 billion	2008-12 Investment	~ $1.0 billion
$263 million	~ 2009 investment	$200 million

Capital Resources and Liquidity

- Factors affecting a Company’s liquidity and capital requirements:
  - Results of Operations
  - Capital Expenditures
  - Energy Commodity and Transportation Costs
  - Contractual Obligations
  - Regulatory Decisions
  - Debt Maturities
  - Credit Ratings
  - Working Capital Needs
  - Collateral Requirements

Barriers to Investment in New Infrastructure

- Applicability of Current Policies and Regulations
  - Recovery of/on Capital (Regulated vs. Non-Regulated)
    - Finance long-term asset with long-term capital. Asset enters rate base. Asset earns return of and on invested capital. Utilities experience insufficient and/or lagging returns through regulatory process.
    - Non-regulated investments do not earn an authorized return and investors avoid much of the regulatory process, but simultaneously lack cost recovery assurance similar to that of a regulated investment.
    - After breakup of Constellation/FPL merger, more separation of regulated vs. unregulated assets expected throughout the industry.
  - Other Policy Concerns: Renewable portfolio standards, conservation and energy efficiency, political agenda (coal, nuclear, etc)

Barriers to Investment in New Infrastructure (Cont'd)

- Lack of Available Capital
  - Creditworthiness:
    - Business Risk
      - Management, markets served, regulatory climate, etc.
    - Financial Risk
      - Cash flow metrics (interest coverage), funds from operation, leverage.
    - Rating agencies desire certainty, predictability and stability
    - Regulatory actions measured by consistent and timely decisions, use of forward-looking measures and supportive actions during special situations
    - Michigan utilities have solid credit ratings which maintain and/or enhance the ability to obtain capital during economic downturns and tighter credit conditions

Barriers to Investment in New Infrastructure (Cont'd)

- Lack of Available Capital (Cont'd)
  - Financing Terms:
    - Equity vs. Debt Financing
      - Equity: Equity capital is more expensive than debt capital, but decreases financial risk to the utility. Equity investors seek a higher return based on their increased risk exposure.
      - Debt: Debt capital is cheaper than equity capital, but increases financial risk due to its fixed interest payment. Debt markets are increasingly volatile due to the tightening of the credit market. The credit crunch has caused utilities to obtain capital prior to (or after) project needs in order to secure more favorable terms.
      - Underwriting costs/fees for both debt and equity issuances have trended higher during the past few years for both debt and equity issuances.
        - » Equity Expenses: 3-3.5% Debt Expenses: 1-1.5%

Barriers to Investment in New Infrastructure (Cont'd)

- Lack of Available Capital (Cont'd)
  - Low Pricing:
    - Cost recovery of a company's capital expenditures is threatened with lower/falling natural gas prices.
    - Other pricing and cost recovery pressures:
      - Inflationary, real estate pricing and acts of terror, competition from other pipelines, demand-weather, types of contracts.
  - Rates of Return Deficits
    - Utility investors include banks, insurance companies, pension funds, mutual funds, private equity funds, etc.
    - An investor will seek other investment opportunities if it is not confident that it will earn its expected return (and timely).
    - Not as appealing as electric transmission investment (FERC approved 12-13% returns).
    - "New" investment are necessary but take time.

Barriers to Investment in New Infrastructure (Cont'd)

- Inadequacy & Improvement of Current Delivery System
  - Safety & Reliability
    - Cyber/Electronic disruptions much more problematic than physical infrastructure issues.
    - Age of Pipelines and Workforce.
- Incentive Structures
  - Long-Term Contracts vis-à-vis Consumer Economic Risk
    - LTC's offer revenue certainty (especially important to merchant plants) and usually match debt maturities.
    - LTC's mitigate risk during credit crunch and/or economic downturn.
    - Contract Types: Firm, Interruptible, Released Capacity, etc.
      - Match consumer preference with either indexed, fixed, spot or hedged pricing.