

**Testimony of
Chairman Pat Wood III
Federal Energy Regulatory Commission
before the
Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs of the
Committee on Government Reform
United States House of Representatives**

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Mr. Chairman and Members of the Subcommittee:

Thank you for the invitation to this hearing on natural gas capacity and infrastructure constraints, and the promotion of healthy natural gas markets, especially in California. Let me begin by assuring you that the Commission will do its part to ensure that America's energy markets function smoothly and that the FERC's Commissioners and staff stand with President Bush and Congress at this pivotal time.

In my testimony today, I would like to make three basic points. First, the Commission's role in natural gas markets focuses principally on transportation, not commodity prices. The Natural Gas Wellhead Decontrol Act of 1989 completed the deregulation of the prices producers charge for gas sold at the wellhead in 1993. As a result, the Commission has no direct authority to regulate the prices charged by natural gas producers. The Commission retains only limited jurisdiction over certain sales for resale in interstate commerce. The Commission's primary natural gas jurisdiction is to:

- (1) authorize the construction of interstate pipeline transmission and storage facilities;

and, (2) set the rates, terms, and conditions of service for interstate transportation and storage of natural gas. In short, our central role in the natural gas industry is to serve the growing demand for natural gas by enabling the construction and use of that pipeline infrastructure at just and reasonable rates, terms and conditions of service, and without undue discrimination.

Second, since wellhead price decontrol and the advent of the Commission's open access transportation program, there has been a well-functioning, competitive market for the sale of the natural gas commodity. From the mid-1980s until last winter's heating season, competition among natural gas producers and others resulted in readily available supplies at low prices. Last winter prices rose primarily because of an imbalance between supply and demand. Since then, natural gas producers significantly increased drilling activity, and the increase in gas supplies led to lower prices, a market response that is more nimble and less expensive than any legislative or regulatory "fix." While some of the reasons that the price of natural gas has now dropped significantly are warmer weather, record storage fills, and a slow-down in the general economy, the basic demand-and-supply response we have seen is a clear sign of a well-functioning market. I will not make any predictions about what prices will be this winter (although, as I discuss later, the Energy Information Administration (EIA) has predicted lower prices for this winter), but I firmly believe that allowing the competitive wellhead market to work through a robust continental delivery system is the best way to obtain adequate gas supplies at the lowest reasonable price.

Third, notwithstanding the fundamentally sound nature of the natural gas market, the Commission can help ensure the availability of reasonably priced natural gas by certifying new pipeline projects in a timely manner so that newly developed supplies can reach the market. One of the Commission's top priorities is to ensure that needed energy infrastructure is built. If increased gas supply is to help bring prices down, there must be adequate transportation facilities to move newly developed gas supplies to delivery markets. Also, current bottlenecks limiting the transportation of natural gas to areas where demand is highest must be eliminated. We will do everything in our power to ensure that the Commission quickly processes applications for new pipeline projects that will meet these needs. To that end, Commission staff is looking at creative ways to expedite the processing of applications for new pipeline capacity to serve critical areas of the country.

However, to the extent transportation bottlenecks fall within state jurisdiction, the states must similarly undertake initiatives to improve their infrastructure. I assure you I recognize the critical importance to your constituents, and to our country, of having an adequate natural gas transportation infrastructure.

I must note that the Administrative Procedures Act and the FERC's ex parte rules prohibit me from discussing the merits of cases pending before the Commission; therefore I cannot discuss the merits of the complaint that was filed at the Commission by the California Public Utilities Commission and Southern California Gas Company against El Paso Merchant and El Paso Pipeline. I can tell you, however, that the Chief

Administrative Law Judge has issued an initial decision and the Commission will act on this matter as expeditiously as possible.

I will now turn to the specifics of these matters in greater detail.

I. The Federal Energy Regulatory Commission's Role in Natural Gas Markets

The Commission's role in the natural gas industry is largely defined by the Natural Gas Act of 1938. This Act enables the Commission to grant construction authority to interstate natural gas pipelines and related facilities, such as storage and compression. It also authorizes the Commission to set the rates and terms of service for the resale and transportation of natural gas in interstate commerce. States regulate retail sales and local distribution of natural gas and the production and gathering of natural gas. Controls on the wellhead price of natural gas, which the Commission previously regulated pursuant to a 1954 Supreme Court decision, were gradually phased out by the Congress. This started with the Natural Gas Policy Act of 1978, and culminated in the Natural Gas Wellhead Decontrol Act of 1989, which lifted all remaining wellhead price controls as of January 1, 1993.

The Commission still retains jurisdiction over certain sales for resale in interstate commerce, but that jurisdiction now accounts for only a small portion of the overall natural gas market. That jurisdiction is limited to sales for resale by interstate pipelines, intrastate pipelines, and local distribution companies and their affiliates, unless the sales are from their own production or from sources where we have a free trade agreement such as with Canada and Mexico. Although the Commission could amend the

authorizations to provide for some other pricing method, I do not believe that this would provide effective relief from high prices to customers, as sellers would find ways to move their supply to unregulated sales. Price controls on FERC jurisdictional resales would merely distort the market in the same way they prompted the industry in the 1970's to shift supplies from the interstate market to the intrastate market before the NGPA.

The Commission also authorizes natural gas pipeline siting and construction if found to be in the public convenience and necessity under Section 7 of the Natural Gas Act. Consideration of factors under the National Environmental Policy Act (NEPA), other appropriate statutes, and landowner interests are taken into account before approving a natural gas pipeline project. In addition to its certificate jurisdiction, the Commission has authority, delegated by the Secretary of Energy, over the siting and construction of facilities for the import or export of natural gas under Section 3 of the Natural Gas Act, and authority under Executive Order No. 1045 to issue Presidential Permits for such facilities if they are located at an international border.

II. Competitive Natural Gas Commodity Markets

The oil embargo of the mid-1970s, coupled with heavy-handed price regulation by the Commission (then the Federal Power Commission), led to shortages and supply curtailments of natural gas in the interstate gas market in those years. In response to these critical supply shortages, Congress passed the Natural Gas Policy Act of 1978, which began the decontrol of natural gas commodity prices.

In 1985, the Commission required open-access, non-discriminatory transportation of non-pipeline natural gas across the U.S. natural gas pipeline grid. In 1989, the Congress enacted the Natural Gas Wellhead Decontrol Act of 1989, which ended all remaining wellhead price controls as of January 1, 1993. In 1992, the Commission took further steps to ensure a well-functioning natural gas market by requiring interstate natural gas pipelines to unbundle, or separate, their transportation service from their own sales service. That removed the opportunity for pipelines to discriminate in favor of their own "merchant" business by providing a higher quality transportation service as part of their bundled transportation and sales service. Subsequently, pipelines exited the natural gas sales business completely and transferred their sales contracts to their marketing affiliates.

The Commission also established a program to permit holders of transportation capacity to resell their unused pipeline capacity rights, called "capacity release," creating a valuable and efficient secondary transportation market. Since then, the Commission has been monitoring the gas transportation and storage of natural gas to ensure the most efficient and effective natural gas delivery infrastructure for customers. Almost two years ago, the Commission revised its open-access transportation regulations in Order No. 637, with regard to scheduling procedures, capacity segmentation, and pipeline penalties, among other issues. When these changes are fully implemented, they should give shippers added flexibility to make more efficient use of the existing pipeline grid.

As a result of the pro-market policies pursued by Congress and the Commission, the natural gas commodity market is truly competitive. There are about 8,000 producers operating over 300,000 wells in the United States. In addition, the North American natural gas markets have been geographically integrated, permitting an increasing contribution of Canadian gas to meet U.S. market growth, and increased U.S. gas sales into Mexico. Natural gas buyers in general are no longer limited to buying from one pipeline. Instead, they have a wide range of supply options and various transportation and storage options. In addition, an active financial market has developed to allow buyers and sellers to hedge against price volatility, depending on their tolerance of risk.

Although different sources quote different numbers, no one disputes that this competition has produced substantial consumer benefits. In addition, reserve prospects for natural gas appear to be very promising. Estimates range from 1,200 trillion cubic feet (Tcf) to 1,700 Tcf, the equivalent of a 55-75 year supply at current and projected requirements. Pro-competitive policies, technological innovation, environmental policies, and low prices have led to increased demand for this clean-burning fuel, especially in the electric power generation area.

The success of the competitive market for natural gas is further reflected in the recent behavior of spot wellhead prices for natural gas. Last winter, natural gas prices roughly tripled to about \$10 per MMBtu nationwide. While the price increase focused a lot of attention on the natural gas industry by lawmakers and regulators, the market itself responded, without any need for new laws or new regulations. Producers of natural gas

increased the supply of natural gas, and the number of active natural gas rigs more than doubled in the past year and a half. The EIA last week projected that spot prices for natural gas will drop to an average of \$2.21 per mcf this winter from \$5.78 per mcf a year ago.

In sum, the operation of the interstate natural gas market remains sound, as evidenced by the dramatic increase in drilling activity in response to market signals.

III. Why Were Natural Gas Prices So High Last Winter?

As explained above, natural gas is now a commodity that is sold in an open market where the laws of supply and demand determine the price. Weather, economic growth and the price for other fuels are all factors that affect the demand for gas. Last winter several factors converged at once to produce very high spot natural gas prices.

Demand for natural gas has increased in all sectors over the last decade due to economic growth. In addition, a significant number of new gas-fired electric generators has come on-line in the last few years. While these generators produce power in an environmentally friendly way using clean-burning natural gas, they are creating a year-round demand for a commodity that has traditionally been used more in the winter than in the summer. Increased use of gas by electric generators has also affected overall demand in the winter.

Weather also affects the demand for natural gas. After warmer-than-normal winters in many areas of the country for several years, temperatures in November and December of 2000 were either below, or well below, normal in all but five states. This

significantly increased the demand for natural gas, and other heating fuels such as propane and fuel oil. This condition was compounded in the West by the near record drought which very abruptly removed several thousand megawatts of hydroelectric power from the power market. Natural gas-fired power generation filled the sudden void, and this additional natural gas demand put a strain on both the natural gas supply and delivery systems in that region of the country.

Although the demand for natural gas has grown in recent years, supply somewhat lagged behind this demand. After the prices for natural gas and oil collapsed in 1998, producers invested less capital in the exploration and production of natural gas. In January of 1998, there were over 633 drilling rigs in operation. By April of 1999, after a sustained period of low gas prices, the rig count dropped to 362. While there are plentiful reserves in the ground, maintaining adequate deliverable gas supplies requires a steady drilling program. The reduction in gas drilling reduced supply. This trend was reversed in late 1999. Although there were 905 active drilling rigs on February 16 of last year, historical experience shows there is a time lag (between three months to eighteen months or more) between increased drilling and a significant supply response.

Finally, while spot prices rose quite high in some areas of the country last winter, it is important to understand that local distribution companies and end-users need not, and generally do not, buy all their gas on the spot market. Today's competitive market provides gas purchasers a number of options for achieving greater price stability than is available on the spot market. Gas purchasers can, for example: (1) enter into long-term

supply contracts; (2) purchase gas during cheaper, off-peak periods and place it in storage for use during peak periods; (3) forward contract using gas futures; and, (4) purchase financial hedging instruments. Through such strategies, gas purchasers can keep their overall gas costs substantially below spot market levels. For example, in January of last year, when spot market prices at New York City gates rose above \$18 per MMBtu, the overall gas costs of the two major New York local distribution companies, Con Edison and Brooklyn Union, were in the \$8 to \$10 per MMBtu range.

IV. Pipeline Construction

Adequate natural gas pipeline transmission and storage capacity is critical to support the continued functioning of the competitive market for the gas commodity. If that market is to ensure an adequate supply of natural gas at the lowest reasonable cost, all gas sellers must be able to reasonably reach the highest-bidding gas buyers, and all gas buyers must be able to reach the lowest-selling producers. For this to continue, it is clear that additional pipeline capacity must be built. As new gas supplies are developed in response to the continued growth in natural gas consumption and increased prices, new pipeline facilities will be necessary to allow those supplies to reach the market.

In the last seven months, the Commission has issued certificates for seven interstate projects, with total capacity of almost 962 MMcf/d of capacity, that could benefit the western area of the country, and, in particular, California. My colleagues and I are committed to moving quickly on pending projects. The Commission is actively pursuing ways to expedite the approval of infrastructure needed to serve California and

the West, including raising the current dollar limit on automatic authorizations. This will allow pipelines to construct needed facilities without lengthy regulatory proceedings as long as they comply with all applicable environmental regulations. We are also encouraging applicants to work closely with our staff at the earliest stages of project development to expedite the certification process. Early staff involvement may include getting a head start on meetings with stakeholders and the preparation of environmental documents. This may significantly speed the certification of appropriate projects.

Of course, any actions the Commission takes to expedite new interstate pipeline capacity for natural gas to serve California and the West can only be effective if there is available local intrastate capacity to deliver gas downstream of the interstate pipeline to the ultimate customer. The California Energy Commission in September issued its revised final report on Natural Gas Infrastructure Issues, which indicates that the intrastate gas transportation network in southern California is constrained; the CEC found that this constraint may, to some extent, have affected gas prices in that area, which have been among the highest in the nation. Recently certificated interstate capacity for southern California totals 755 MMcf/d, with 585 MMcf/d of intrastate take-away capacity authorized in southern California. I have attached a schematic map and a chart to my testimony to illustrate the gap between interstate and intrastate pipeline capacity. Local take-away capacity is provided primarily by local distribution companies, which are exclusively within the control of the state.

The Commission has consistently urged the State of California to eliminate any disincentives that may prevent expansion of intrastate infrastructure and provide relief to California customers. Interstate pipelines under our jurisdiction coordinate their efforts with local distribution companies, public utilities and state officials. The Commission will cooperate with the states to ensure that new facilities subject to state jurisdiction are properly integrated with the interstate grid. I should note here that recently the California Public Utilities Commission has authorized several storage-related proposals, and Southern California Gas Company has several expansions underway, totaling 375 MMcf/d.

On another California infrastructure front, there has been some significant activity this summer with respect to construction and expansion of electric generation capacity in California, although it has not matched the level of projections made earlier in the year. In August 2001, a number of organizations made projections for California power plant construction activity, including the California ISO (CAISO), the California Energy Commission (CEC) and the National Electric Reliability Council (NERC). CAISO made the most detailed projections, forecasting that up to 3,299 MW of new generating capacity would come on line during the summer, nearly two-thirds from large new plants. Almost 60 percent (1,947 MW) of the additions have actually been completed, and most of the other new capacity projected will be complete by the end of the year. The CEC had projected that 3,914 MW of new generating capacity would come on-line during the period. Similarly, in early 2001, NERC projected in its 2001 Summer Assessment that

3,471 MW of new capacity would come on line. However, late in the spring, NERC revised its projection downward to 1,500 MW, which came close to the 1,555 MW of generating capacity which actually came on line from June to August for the units included in NERC's survey.

By correlating the location of these plants to the gas pipeline infrastructure in California, it is notable that a large percentage of the new generation capacity will be served directly by interstate pipelines, rather than through local distribution company facilities; this lessens the issue of the "mismatch" of interstate and intrastate pipeline capacity.

Aside from the current situation in California, there is also a critical need to provide transportation for newly developed gas supplies to reach all U.S. markets. For example, the EIA projects a significant increase in imports of natural gas to the United States from Canada. Delivering that gas to U.S. markets will require increased pipeline capacity. I testified on October 2nd to the Senate Energy and Natural Resources Committee on the issues surrounding the development of Alaskan natural gas, and promised Congress that we will make every effort to process and act upon any applications for Alaska gas transportation projects as efficiently as possible, working with the applicants, other federal and state agencies, Native Americans, shippers, end users, and other interested parties, to ensure timely, reasonable decisions. I pledge my continued support for the construction of new pipeline infrastructure to meet these critical needs, and I will do everything I can to ensure that the Commission processes certificate

applications for proposed pipeline projects as quickly as possible, within our statutory obligations.

V. Conclusion

Last winter's increases in natural gas prices are a matter of serious concern for gas customers and indeed for the nation as a whole. Nonetheless, natural gas deregulation has been an extremely successful long-term policy and the fundamental structure of natural gas markets remains sound. Beginning in 1984, competition in the natural gas industry has led to fifteen years of prices that were lower than anyone anticipated. In fact, the low prices lasted for so long that it was easy to forget the inherent tendency of energy markets towards boom and bust cycles. Last year, producers responded to higher prices with increased drilling. At the same time, customers responded as well. For example, we hear of electric generators actively reconsidering their exclusive reliance on natural gas for new plants and are equipping their plants with dual fuel (oil) capability to permit peak day switching away from gas. Everyone has a role to play in moving demand and supply toward a balance where prices are publicly acceptable. The nation's competitive policy has produced a robust, flexible and responsive natural gas market.

The Commission's recently adopted Strategic Plan rests upon three pillars: development of an adequate energy infrastructure, adoption of clear and balanced rules that allow efficient trading between market participants, and ongoing market oversight. These key elements will allow for robust competition in energy markets, with resultant benefits to customers. We at the Commission will do our part to ensure that new

pipelines can be built to support a growing industry and that natural gas transportation supports flexible, innovative markets. By our continuing work together I am confident that states and other federal agencies will also do their part to put in place needed infrastructure and to mitigate short-term hardships.

Thank you. The Commission is always available to assist Congress in its deliberations about the nation's crucial energy industry.