Testimony of
The Honorable Joseph T. Kelliher
Chairman
Federal Energy Regulatory Commission
before the
Subcommittee on Energy and Air Quality
Committee on Energy and Commerce
United States House of Representatives
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Mr. Chairman and Members of the Subcommittee:

Good afternoon, Chairman Hall and members of the Committee. My name is Joseph T. Kelliher, and I am Chairman of the Federal Energy Regulatory Commission (FERC or Commission). I want to thank the Subcommittee for the opportunity to address expected high gas prices this coming winter, FERC's role in the pricing of natural gas and home heating oil, and the development of energy infrastructure.

The Commission has responsibilities in many areas of the energy sector. In the natural gas area, the Commission authorizes the construction of interstate natural gas pipelines and storage facilities, as well as import/export facilities including liquefied natural gas (LNG) import terminals, and it is responsible for the operation and safety of LNG facilities. It also regulates natural gas transportation rates and services in interstate commerce and has limited authority (discussed below) over sales in interstate commerce of natural gas for resale. In the area of electricity, the Commission regulates public utility sales for resale of electric energy in interstate commerce as well as wholesale and unbundled retail transmission rates and services in interstate commerce. It also has authority over certain corporate transactions involving public utilities. In addition, the Commission is responsible for non-federal hydroelectric licensing, administration, and safety. Finally, the Commission regulates the interstate transportation rates and services of crude oil and petroleum products pipelines. The Commission does not regulate home heating oil prices. With these general jurisdictional parameters in mind, let me begin by briefly reviewing the damage to energy infrastructure and domestic natural gas production in the Gulf of Mexico caused by Hurricanes Katrina and Rita, and then discuss steps the Commission is taking in response, including infrastructure issues.

As of October 31, 2005, the Minerals Management Service (MMS) reported that two months after Hurricane Katrina, approximately 68 percent of the daily oil production and 54 percent of the daily natural gas production in the Gulf of Mexico remains shut-in. According to the Energy Information Administration (EIA), as of October 28, 2005, petroleum refinery shutdowns in the Gulf of Mexico totaled approximately 991,000 barrels per day. A number of natural gas processing plants in Louisiana and Texas, with capacities equal to or greater than 100 million cubic feet per day, are not active. Recent industry press reports indicated that 45 percent of oil and gas pipelines in the Gulf were operational; while 30 percent needed repairs and 25 percent were undamaged but could not be used due to onshore bottlenecks. The Association of Oil Pipelines reported that as of October 14, 2005, all onshore petroleum pipelines have resumed 100 percent normal operation capacity. However, some systems continued to experience reduced availability of products to transport.

The hurricanes have caused the loss of a significant portion of our natural gas supply. It is much greater than the loss last year resulting from Hurricane Ivan, and the recovery of offshore production has been much slower. We will not be able to offset this loss of domestic gas production through higher imports from Canada due to Canada's flattening production and increasing demand. Nor will LNG be able to offset the production loss. Most LNG is locked up in long-term commitments, while the U.S. market, at existing terminals, tends to trade in the short-term or spot market. The U.S. may be losing out on these short-term supplies due to European competition, where prices are expected to be close to our prices this winter, and shipping costs are lower due to shorter distances, thus keeping additional LNG supplies away from the U.S. in the short term.

In testimony before both the House and the Senate, the Administrator of the EIA stated that domestic dry natural gas production in 2005 is expected to decline by 3.0 percent, due in large part to the major disruptions to infrastructure in the Gulf of Mexico. Gas prices, prior to the hurricanes, were already high due to the strain of a hot summer and the anticipation of tight supplies. EIA estimates that the average consumer's natural gas bill may be as much as 48 percent higher this winter than last, if there is an average winter. Natural gas prices will be higher this winter because of this loss of supply. Of course, other variables can affect winter gas prices, either negatively or positively. These factors include the timing of the recovery of offshore Gulf of Mexico production. The sooner the recovery occurs, the less upward pressure there will be on prices. Another factor, and the least controllable, is the weather. A mild winter can buy the industry time to repair or replace infrastructure and to get gas production back on line by reducing demand and dampening price levels. And, conversely, a colder than normal winter will drive up prices even higher.

One more factor that is controllable is conservation. Effective conservation must start with consumer awareness and an appreciation of the high level of gas prices. Under most circumstances, the consumer receives a price signal after consumption, that is, when the bill from the gas utility is delivered. If the consumers understand ahead of time that gas prices will be high this winter, they are more likely to conserve. The effectiveness of state conservation programs will be critical in moderating natural gas prices this winter. The Commission has encouraged its counterparts at the state level to make a maximum effort to strengthen their conservation programs. Hedging can also reduce the exposure of consumers to price volatility. The Commission recently met with state regulators from regions that will be most affected by high natural gas prices to discuss best practices in state conservation and hedging programs.

Natural gas prices will be higher this winter as a result of the loss of domestic production caused by Hurricanes Katrina and Rita. Just how much higher prices will go will be driven largely by these variables – rate of recovery of offshore production, weather and conservation.

The Commission is acting to assure prices do not go higher still because of market manipulation. Even though the majority of sales of natural gas are not subject to the Commission's jurisdiction, the Commission actively monitors natural gas markets to determine whether any price spikes are the result of market manipulation or the laws of supply and demand. To assist this effort, the Commission recently entered into a Memorandum of Understanding (MOU) with the Commodity Futures Trading Commission (CFTC) to assure the smooth flow of information between the two agencies. The MOU formalizes a close working relationship between the two agencies that has developed over the last five years. The MOU will improve the ability of the Commission to identify market manipulation. Under the Energy Policy Act of 2005, the two agencies were directed to enter into an MOU within six months of enactment. We accomplished this in two months, in part because we want to be in a position to better monitor gas markets this winter.

Importantly, with respect to the new anti-manipulation authorities the Congress gave the Commission in the Energy Policy Act of 2005, the Commission recently issued a notice of proposed rulemaking to prevent market manipulation with respect to Commission-jurisdictional natural gas and electric services. The Commission issued rules two years ago to help prevent the manipulation of gas and electric markets, but the new proposed rule, in conjunction with the new Natural Gas Act civil penalty authority in EPAct 2005, will provide a strong deterrent to market manipulation. The proposed rule, following the new statutory language, would make it unlawful for any entity, directly or indirectly, in connection with the purchase or sale of natural gas or transportation service subject to Commission jurisdiction, to:

- Use or employ any device, scheme, or artifice to defraud;
- Make material false statements or omit material facts; or
- Engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person.

As noted earlier, the Commission has limited jurisdiction over the price of natural gas. Through the Natural Gas Policy Act of 1978 and the Natural Gas Wellhead Decontrol Act of 1989, Congress deregulated most sales of natural gas, including imports from countries with which the United States has a free-trade agreement. The Commission's jurisdiction over wholesale sales is limited to sales of gas in interstate commerce by interstate pipelines, intrastate pipelines, local distribution companies (LDCs) and the affiliates of those entities (including marketers) for resale, so long as they do not produce the gas they sell. The Commission's regulation of such sales is through blanket certificates that were issued to entities that fall in these categories, authorizing them to make sales in interstate commerce (to anyone that is not a pipeline) for resale at negotiated rates.

As I mentioned at the beginning of my testimony, the Commission does regulate the interstate transportation rates for natural gas as well as crude oil and petroleum products. This regulation involves the rate to be paid for the transportation component of the delivered product, not the price of the commodity. Regarding natural gas, of the total delivered charge of approximately $17.00 per thousand cubic feet estimated by EIA to the Mid-Atlantic this winter, the interstate transportation portion from the production area would be about one dollar, or about 6 percent. For petroleum products, the amount that transportation contributes is approximately 1 percent of the total delivered cost.

In addition to setting rates for transportation of natural gas and monitoring for market manipulation in the commodity markets, the Commission stands ready to act on emergency filings to authorize more efficient use of our existing gas infrastructure in the Gulf of Mexico. For instance, the Commission received an emergency filing from Discovery Gas Transmission on October 11 at 10:30 AM requesting an exemption and waivers that would expedite the transportation of up to 300 million cubic feet per day of offshore natural gas. This gas supply was shut in as a result of hurricane damage to a

Dynegy Inc. processing plant in Venice, Louisiana. This authorization, which was approved by the end of the same day, allows Discovery to re-route gas flows from offshore production fields that previously went to the Venice Processing Plant. Without such an innovative request and a quick response by the Commission, this gas supply would continue to be unavailable to gas consumers. The Commission also received an emergency filing from Stingray Pipeline for a tariff waiver to allow shut-in gas to flow and approved it by the end of the same day it was filed.

Since 2000, the Commission has recognized that there was a growing gap between the demand for natural gas and the gas supply of the North American continent. In this regard, the Commission has taken steps to reduce the processing time for its analysis and consideration of infrastructure projects, most notably through its pre-filing process, that actually commences Commission analysis prior to the filing of a formal application. This has resulted in major projects being approved and constructed to deliver gas from the Rockies region to markets in California and the Midwest.

Since the beginning of 2000, the Commission has certificated over 8,400 miles of pipeline. Also, the Commission's adoption of the "Hackberry Policy", which ceased economic (i.e., rate) regulation of LNG terminals, resulted in a significant increase in proposals to construct LNG terminals to receive imported LNG. In the past few years, the Commission has approved eight new LNG terminals with 12 billion cubic feet per day of deliverability and expansions at two existing terminals that will increase deliverability by 1.3 billion cubic feet per day. The Commission has also approved 1.7 billion cubic feet per day of pipeline capacity that would transport Bahamian LNG to Florida. In total, FERC has approved 15.0 billion cubic feet per day of deliverability from LNG. Still, there are proposals pending at FERC for 16.7 billion cubic feet per day of deliverability at new and existing terminals. Also, there is another 0.5 billion cubic feet per day of pipeline capacity pending to transport Bahamian LNG.

Our ability to provide the country with the necessary natural gas infrastructure has been greatly improved by Congress' passage of the Energy Policy Act of 2005. Specifically, this legislation simplifies and streamlines the processes for considering natural gas infrastructure projects filed with the Commission. For this I would like to thank Congress and Chairman Barton, in particular, for his leadership in helping to guide this bill to passage. I note that almost immediately after passage of the Act, the Commission and the California Public Utilities Commission (CPUC) filed a joint petition to dismiss the litigation associated with the CPUC's assertion that it should be the decisional agency for the siting of an LNG terminal in California.

The Commission is exploring opportunities to provide greater incentives to expand natural gas storage through pricing reform. More natural gas storage capacity will increase the flexibility of the industry to manage available supplies and may help dampen peak prices. Since 1988, our total underground natural gas storage capacity has increased by only 1.4 percent, while total national natural gas consumption has increased by over 24 percent. Additional storage capacity will not bring price relief this winter but over the long term pricing reform can promote storage capacity expansion, at both existing and new facilities. Congress did supply additional tools to promote gas storage, by allowing gas storage to be priced at market-based rates even if the project sponsor cannot prove that it does not possess market power. It is now up to the Commission, in light of the new authority in EPAct 2005, to implement pricing reforms that expand storage capacity while protecting consumers.

Even with this progress, there is a danger that we will not be able to meet our expected growing demand for natural gas in the near term. Existing natural gas production has been flattening – and this was before the effects of Hurricanes Katrina and Rita. Also, the newly approved LNG terminals that will fill the gap between domestic and imported Canadian production will not be available until 2008 at the earliest. Further, new projects to extract gas from the Rocky Mountains and bring it to market are slated to begin in 2008. Given these potential shortages, there are still regional interests that make it difficult to site the needed infrastructure, especially in the Northeast, which is most dependent upon gas supplies from outside of its region. Inability to strengthen the energy infrastructure will likely result in higher prices and greater price volatility.

In closing, the Commission is working diligently within its authorities to promote adequate and reliable infrastructure and to prevent market manipulation. We will closely monitor gas markets in the coming winter and take appropriate steps within our authorities to protect customers to the maximum extent possible. I would be happy to answer any questions that members of the subcommittee may have.