Testimony of

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Mr. Chairman and Members of the Subcommittee:

Good morning. My name is Susan Court, and I am Director of the Office of Market Oversight and Investigations at the Federal Energy Regulatory Commission. I am accompanied today by my deputy director, Stephen J. Harvey. We appear today as Commission staff witnesses speaking with the approval of the Chairman of the Commission. The views we express are our own and not necessarily those of the Commission or of any individual Commissioner.

Thank you for the invitation to appear before you today to discuss the natural gas market and recent price trends. The Commission takes the high current price of natural gas very seriously, and I hope that we will be able to help answer your questions regarding what has driven these prices, and what the Commission is doing to monitor them to be certain that they are not the result of manipulation or the exercise of market power.

I will cover each of the six issues identified in your letter of invitation. But first, I'd like to summarize the current state of natural gas prices.

Over the past several years, wholesale spot natural gas prices have increased significantly, from lows in a range from $2.00 to $3.00 per million British Thermal Units (MMBtu) during late summer of 2001 to almost $17.00/MMBtu shortly after Hurricane Rita in 2005. More recently, wholesale spot prices have retreated to the $8.00 to $9.00/MMBtu range. In general, prices at their heights in late 2005 were about twice the previous year's level, and close to five times the level of 10 years ago.

Price increases of this magnitude will have real and undeniable effects on the larger U.S. economy, as well as the economies of vital regions like Minnesota. As President Bush stressed last week in his State of the Union, "[k]eeping America competitive requires affordable energy." To the extent that the price increases we have recently experienced truly and legitimately reflect the ongoing interplay of forces of supply and demand, the market is sending customers, suppliers, and policymakers important signals needed to plan our energy future. This would indicate a workably competitive market in natural gas, which Congress committed the Nation to using when it deregulated all wellhead prices in the 1980s. For its part, the Commission has a fairly limited role where legitimate market forces are acting on prices.

On the other hand, if these prices instead reflect inappropriate market activity, prices could send a misleading message. The Commission's job is to be certain that high prices are not the result of manipulation or the exercise of market power. It accomplishes this in two ways: through the regulation of rates for interstate natural gas transportation and storage services, and through the active enforcement of rules designed to prevent manipulation or the exercise of market power in natural gas markets.

Against this backdrop, let me respond to your questions.

(1) Discuss the factors that have contributed to high and volatile natural gas prices in recent years, including a discussion of demand and supply, and the extent, if any, of price manipulation or the unreasonable exercise of market power.

During 2005, the U.S. experienced extraordinary increases in prices for all types of energy, including natural gas, even before hurricanes Katrina and Rita. Natural gas prices had already risen by a third from the mid-$7.00 level in early April to almost $10.00/MMBtu before Katrina struck. Three factors appear to have been most significant in driving pre-hurricane natural gas price increases.

First, the balance between supply and demand for natural gas in North America has been tightening throughout the decade. Production has seen slight increases or outright declines, while a recovering economy has increased demand. The gas "bubble" prevalent in the late 1980's and early 1990's started to shrink by the end of the last century.

Second, the summer of 2005 was abnormally hot, the hottest on record, according to the National Climatic Data Center. With the heavy addition of natural gas-fired generation to the electric system over the past decade, increased electric demand drove increases in natural gas demand. Generation from natural gas increased by 20 percent for June and July compared to 2004.

Third, the price of oil rose 21 percent from about $9.40/MMBtu in early April to over $11.40 per MMBtu just before the hurricanes struck. Although the exact nature of the relationship between oil products and gas prices differs across the country depending on how easily the fuels can be switched, oil and gas prices have been loosely related for many years. As a result, increasing oil prices last summer put upward pressure on gas prices above and beyond the effects of increased electric demand.

By some standards, gas price volatility has also increased. As a percentage of price, volatility has remained fairly stable, but with higher price levels generally, price changes are magnified and have become large in absolute terms.

(2) Discuss what effect Hurricanes Katrina and Rita had on natural gas prices, and what gas prices are likely to be this winter.

Hurricanes Katrina and Rita had and still have significant effects on the entire natural gas industry in the Gulf Coast, which accounts for 20 percent of U.S. supply. These storms shut-in a significant amount of gas production, severely damaged natural gas processing plants, and wrought havoc on major parts of the transportation infrastructure. The hurricanes even shut down the key natural gas trading point at Henry Hub for some time in both August and September.

After Hurricane Katrina, the Minerals Management Service reported the immediate loss of close to 9 Bcf/d from the offshore Gulf of Mexico. Quick action returned all but about 3.5 Bcf/d by the time Rita hit at the end of September. Rita increased the loss of offshore Gulf production to almost 8 Bcf/d. That level of shut-in offshore gas has now dropped to about 2 Bcf/d. In addition, the Louisiana Department of Natural Resources reports another 2 Bcf of outages from the State of Louisiana immediately after Rita. That figure is now down to about a half a Bcf. Overall, about 10 Bcf/d of production from the Gulf of Mexico and Louisiana was shut in, representing a little less than one-fifth of U.S. average daily production. That number is now down to about 2.5 Bcf/d.

Since the hurricanes, prices have risen and fallen based on weather. Given the strains on U.S. domestic natural gas supplies represented by the hurricanes, we have been fortunate to experience unseasonably mild winter weather.

After price peaks due to hurricanes Katrina and Rita and brief early cold in late October, prices sagged to the relatively warm November. Prices peaked above $15.00/MMBtu again during a cold period in early December, only to drop with the sustained, abnormally warm weather from late December through early February. Recently, prices have ranged across the country from lows in the $7.00 range to as high as the mid $9.00s. These prices reflect supplies that are clearly adequate for the nation as a whole this winter, although severe cold weather in particular places could stress local service.

At current oil prices, it is unlikely that natural gas prices will fall much farther this winter. As I indicated, oil products compete with gas differently around the country, but oil prices do have a strong influence on gas prices. At current levels, they seem to have provided a floor at somewhere around $8.00 to $9.00/MMBtu.

Going forward, the effects of the hurricanes will continue to dissipate over time. High prices have also led to significant increases in production in some areas. There is even evidence that the high prices are encouraging reconsideration of drilling in places where low prices previously made production uneconomical. For example, in 2005, Pennsylvania issued a record number of oil and gas drilling permits, a 32.4 percent increase over the previous year's record of 4,567. Nonetheless, the longer-term tightness between supply and demand (exacerbated by increased electric demand) is likely to reassert itself with more normal weather. As a result, current futures prices for natural gas suggest that prices are likely to rise from current levels into the summer, though they are likely to remain below the crisis levels seen after the hurricanes.

(3) Discuss what the Commission is doing to respond to high gas prices to ensure that natural gas prices are a result of supply and demand, and not price manipulation and the exercise of market power.

The Commission has responsibilities in many areas of the energy sector, including regulation of interstate natural gas transportation rates and services. The Commission has limited jurisdiction over wholesale natural gas sales, and does not regulate retail sales or natural gas wellhead prices. Through the Natural Gas Policy Act of 1978 and the Natural Gas Wellhead Decontrol Act of 1989, Congress deregulated most wholesale sales of natural gas. Retail gas sales are subject to regulation by the states.

Nonetheless, the Commission has taken an active role through this winter in addressing concerns about natural gas prices and considering both the drivers of these prices and their implications. Starting at the Commission's October 12, 2005 conference on the State of Natural Gas Infrastructure and at every regular Commission meeting thereafter, my office has presented the Commission with detailed information relating to current market prices and analysis explaining those prices. The result of these presentations and the discussions among Commissioners and staff is a clear, public record of consideration of the serious natural gas market issues we are discussing today.

In the immediate wake of the hurricanes, the Commission urged state regulators and consumers groups to educate consumers on the likelihood of high natural gas prices this winter. Effective conservation must start with consumer awareness and an appreciation of the high level of gas prices. Normally, consumers receive a price signal for natural gas after the point of consumption, when they receive their monthly bill. The Commission believed that it was critical for consumers to expect high prices before consumption, so that they could increase their conservation efforts. The effectiveness of state conservation programs will be critical in moderating natural gas prices for the remainder of this winter. The Commission has encouraged its counterparts at the state level to make a maximum effort to strengthen their conservation programs. To date, there is no reliable information on the effectiveness of these programs.

The Commission has also acted to authorize more efficient use of the nation's existing gas infrastructure. The Commission has issued emergency orders to authorize exemptions and waivers for pipelines that allowed shut-in gas to flow to consumers. In two instances, the Commission issued emergency orders the same day these filings were received.

(4) Discuss the Commission's monitoring system and enforcement policy including the effect of additional enforcement abilities set forth in the Energy Policy Act of 2005, and the Commission's progress in implementing these provisions.

The Commission is committed to assuring that the high natural gas prices caused by the loss of supply from Hurricanes Katrina and Rita do not go higher still because of market manipulation. We have done that in several ways. The Commission actively monitors natural gas markets to determine whether price movements are the result of market manipulation or market fundamentals. Our market oversight and enforcement staff is continually reviewing market activity for any possible manipulation that might also affect prices. In close coordination with enforcement staff, market oversight staff performs a detailed review of natural gas prices and market activity on a daily basis with the intent of identifying areas of possible manipulation. If we identify price anomalies that are not explained by market fundamentals, my office is authorized by the Commission to begin an investigation.

The Commission's ongoing enforcement efforts are generally initiated as non-public investigations pursuant to 18 C.F.R. Part 1b, and, consequently, I cannot elaborate on active investigations related to recent market activity. As reported to Congress last March, however, the public record of completed enforcement efforts undertaken by the Commission speaks strongly to how seriously we take our enforcement responsibilities. We will be pleased to submit a copy of that report for the hearing record. Since that time, the Commission has also publicly approved settlements in the millions of dollars arising out of enforcement investigations into violations of FERC rules and regulations, including the prohibition against favoring affiliates, and the companies' own tariffs.

Furthermore, to assist our monitoring effort, the Commission entered into a Memorandum of Understanding with the Commodity Futures Trading Commission to assure the smooth flow of information between the two agencies and improve our ability 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 it in two months, in part because we want to be in a position to better monitor gas markets this winter.

The Commission also acted quickly to exercise the new anti-manipulation authorities in the Energy Policy Act. On January 19, the Commission issued rules to prevent market manipulation by <u>any</u> entity, not just the companies traditionally subject to the Commission's jurisdiction, with respect to jurisdictional natural gas and electric sales and transportation. The new rules, in conjunction with the new civil penalty authority in the Energy Policy Act, will provide a strong deterrent to market manipulation. Under our new civil penalty authority, the Commission can impose a penalty of up to $1 million per day for a violation of the Commission's anti-manipulation rules. Indeed, under the Energy Policy Act, this penalty authority now extends to <u>all</u> violations of the

Commission's natural gas organic statutes, the Natural Gas Act and the Natural Gas Policy Act. With this in mind, a few months ago, the Commission issued an Enforcement Policy Statement to alert the industry to the factors the agency will consider in exercising this penalty authority.

(5) Discuss what steps the Commission has taken to promote increased LNG imports, including actions to streamline the LNG terminal approval process and foster LNG capital investment.

The Commission plays a critical role in strengthening the U.S. energy infrastructure. Since 2000, the Commission has certificated over 8,400 miles of pipeline. We have steadily improved our regulatory process, and the average length of a major pipeline proceeding is now less than a year. The Commission's December 2002 "Hackberry Policy," which removed economic regulation of LNG terminals, resulted in a significant increase in proposals to construct LNG import terminals. The Energy Policy Act codified that policy, and also gave the Commission exclusive jurisdiction over the siting, construction, expansion, or operation of LNG terminals. Since "Hackberry," the Commission has approved eight new LNG terminals, two new pipelines from the Bahamas, and expansions at two existing terminals that, if constructed, will more than quadruple our LNG import capability.

The Commission is also proposing to provide greater incentives to expand natural gas storage through pricing reform, again with additional authority from Congress in the Energy Policy Act. Since 1988, gas storage capacity has expanded only 1.4 percent, while demand has increased 24 percent. Greater storage capacity may help mitigate gas price volatility. We issued proposed rules in December to reform storage pricing in order to reduce price volatility. Pricing reform can promote storage capacity expansion, at both existing and new facilities, although it will not bring relief this winter.

(6) Discuss any recommendations the Commission may have to address the above issues.

At present, the Commission has not announced any recommendations for further legislative action. The Commission generally believes that the Energy Policy Act has delegated adequate new powers to the agency to secure improved energy infrastructure and to police bad behavior in the energy markets and prevent the abuse of market power by jurisdictional energy companies.

Thank you. We would be happy to answer any questions that the Subcommittee may have.