BEFORE THE SENATE UTILITIES COMMITTEE

PRESENTATION OF THE

KANSAS CORPORATION COMMISSION

February 20, 2004

SB 522

Thank you Chairman and members of the Committee. I am Larry Holloway, Chief of Energy Operations for the Kansas Corporation Commission. I appreciate the opportunity to be here today to testify on SB 522.

This bill makes certain requirements on natural gas utilities for customers that purchase and transport their own natural gas, and upon the natural gas marketers that provide this service for these "transport" customers. Before commenting on the bill, I would like to provide a broad overview of this process and explain how customers transport natural gas. While I will not touch upon all of the details and nuances of the process, I do hope that this general discussion will be helpful.

Background on Natural Gas Transport

Until the late 1970s and early 1980s the price of natural gas produced at the wellhead was regulated. To address increasing scarcity of natural gas supplies, the price of natural gas was deregulated at the wellhead. This action allowed natural gas prices to fluctuate in response to supply and demand. The result was that private enterprise responded to the demand, and subsequently higher prices for natural gas, by increasing drilling and exploration. This additional investment and effort increased the supply of natural gas and actually stabilized natural gas prices throughout the 1980s and 1990s. Economists have a saying, “the cure for high prices is high prices.” Certainly the deregulation of natural gas caused a short-term price increase, but the response of private industry to increased commodity prices increased production and provided adequate natural gas supplies for many years.

While the price of natural gas had been deregulated at the wellhead, there was an increasing concern that most natural gas producers were forced to sell to the interconnected large gas pipelines. The gas pipelines then sold gas to the natural gas utility that distributed it to the retail customers. The natural gas utilities that provide this distribution service are called Local Distribution Companies or LDCs. In many cases the LDC and the larger natural gas pipeline were one and the same. In an effort to assure that natural gas producers would have ability to receive competitive prices for their product, the merchant function was removed from the transport function of the natural gas pipelines. Additionally, LDCs were separated from the natural gas pipelines. LDCs were then required to buy natural gas directly from the producers, and then pay the natural gas pipeline rates for transporting the gas they had purchased. As a result, the natural gas pipelines no longer have a monopoly on buying and selling gas to the LDCs, and instead provide only a transportation service.

Today, the distribution rates for the LDCs, and the transportation rates for the pipelines, are regulated, while the price for natural gas at the wellhead fluctuates in response to supply and demand, just like any other freely traded commodity. For many retail natural gas customers the change is transparent. The LDC simply purchases and transports the natural gas for these "sales" customers who repay the LDC gas costs through the purchased gas adjustment or PGA.

Because the natural gas utility, or LDC, has no direct interest in the pipeline or the natural gas it purchases for its customers, it began to make sense to allow larger and more sophisticated customers to transport their own natural gas. Larger and more sophisticated customers desired to purchase natural gas in a way that differed from the the LDC, or may simply wanted to hedge their gas costs differently, and for that reason these "transport" customers preferred to purchase natural gas and arrange their own pipeline transportation, while paying the LDC for its distribution costs. Nonetheless, because the pipeline no longer marketed natural gas, both the LDC and the transport customers are required to put the same amount of gas into the pipeline as they withdraw. This requirement to make sure that the LDC or the transportation customer puts in the same amount of gas that is withdrawn from the pipeline is known as "balancing".

While the transport customer buys gas and puts it in the pipeline, the pipeline delivers it to the LDC. The LDC then distributes the gas to the transport customer. For this reason the LDC is held responsible by the pipeline to balance both the requirements for the "sales" and the "transport" customers. This results in some complication because the LDC is assessed a penalty if it withdraws a different amount of gas from the pipeline then is put in, regardless of whether or not this "imbalance" is caused by the LDC incorrectly purchasing gas for its sales customers, or the transport customer incorrectly meeting its gas needs.

To address this problem LDCs attempt to recover any penalties they incur from the activities of transport customers by requirements and penalties to assure that the transportation customers have properly balanced their gas usage. This prevents sales customers from paying for penalties that were not incurred on their behalf and also encourages the transport customers to properly balance their requirements without "gaming" the gas and transportation purchased by the LDC for its sales customers. Needless to say this, is a complex process. Not only must transport customers and LDCs purchase gas, they must also arrange pipeline transportation and properly schedule deliveries of the gas they purchase. For many smaller natural gas transportation customers, and even LDCs, natural gas marketers handle this complicated purchasing and delivery function.

Comments on SB 522

Senate Bill 522 places several statutory requirements on natural gas utilities, or LDCs, and natural gas marketers. For both marketers and LDCs this bill limits the imbalance adjustments to a specified formula and requires 30 day notice for month of service. Additionally this bill requires natural gas public utilities to comply with the KCC's billing standards or be subject to penalty. We have several concerns with the language of this bill.

The Federal Energy Regulatory Commission, or FERC, sets imbalance penalties assessed by the pipeline to the LDC. While this bill would only allow the LDC to recover a specified amount from the transport customers, there is no guarantee that this would be the same amount that the LDC would have to pay the pipeline for any imbalance caused by the transport customers. Eventually, the LDC's sales customers would likely end up paying for the difference between the imbalance charge that the LDC is allowed to collect from transport customers under this bill, and the amount that the FERC allows the pipeline to impose on the LDC. This could

have the unintended consequence of raising the cost of natural gas service for many residential and small commercial customers.

The 30-day notice requirement is not unreasonable for normal monthly balancing requirements. Nonetheless, many pipelines go to a daily balancing requirement during emergencies, and we are concerned that this provision could be construed to make the LDC responsible for transportation customer imbalances in these situations when there is no possibility for a 30-day notice. While we do not believe the current language creates this problem, we are concerned it could be incorrectly construed to saddle the natural gas utility and its sales customers with daily imbalance costs caused by transport customers.

The bill also is unclear on who would enforce the notice and cashout requirements on marketers. While the KCC notes that this places a requirement on marketers, we also note that the bill does not grant the KCC jurisdiction over their activities. While we are certainly not proposing to take this jurisdiction, the bill is unclear on who would enforce the marketers to comply with these requirements.

While the bill does endorse the KCC's billing standards, we note that these are already requirements of jurisdictional gas utilities. We believe the KCC already has the authority to enforce compliance to this and other KCC requirements.

Finally, it should be noted that there are many different types of transport customers, varying from large industrial users to hospitals and schools. Certainly we are sympathetic to efforts to help transportation customers, and in particular school districts, to control their natural gas costs. Nonetheless, we note that this bill does not distinguish between the size and sophistication of these customers, and may create unintended opportunities for sophisticated

customers and marketers to "game" the system at the expense of small commercial and residential sales customers.