

HIGH NATURAL GAS PRICES: **THE BASICS**



“Effective conservation must start with early consumer awareness of the high level of gas prices. Under most circumstances, the consumer receives a price signal after consumption, when the consumer receives a bill from the gas utility. If the consumer understands ahead of time that gas prices will be high this winter, they are more likely to conserve.”

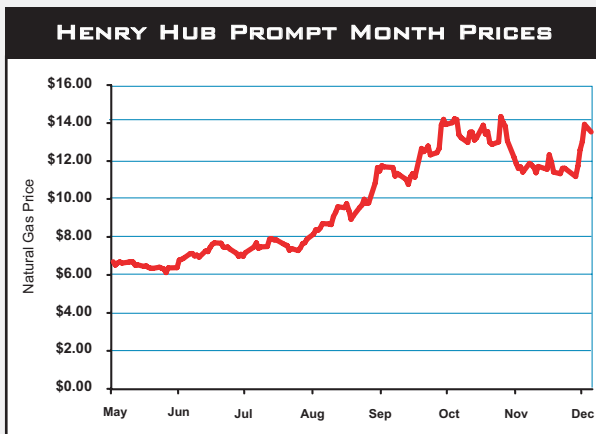
Chairman Joseph T. Kelliher





Natural gas prices have reached historically high levels.

Natural gas prices have risen significantly in 2005, trading for as much as \$16.00 per MMBtu in national production-area spot markets during the early fall. Gas prices were rising even before Hurricanes Rita and Katrina, but without question these two natural disasters greatly affected those prices. Before the hurricanes, prices rose about 50 percent (from around \$6.00 at the beginning of the year to about \$9.00/MMBtu). After the hurricanes, they rose by as much as another 65 percent. Futures markets suggest that prices are likely to remain high during the winter.



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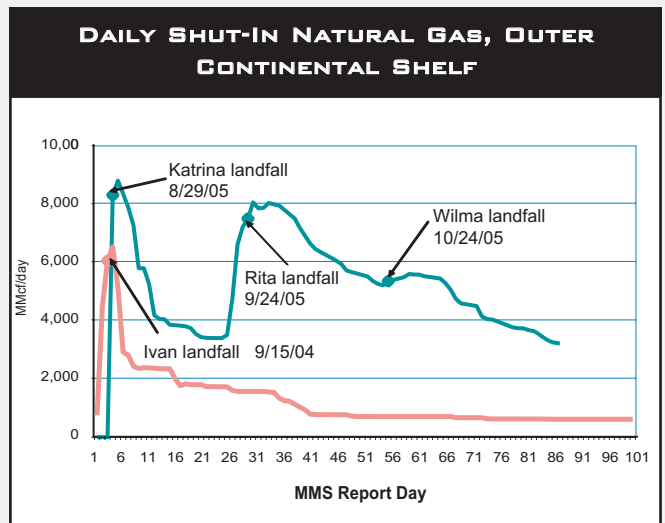
Before the hurricanes, prices rose because supply fell compared to demand.

Natural gas production in the United States has fallen slightly in the past few years, and imports have grown only slightly. Meanwhile, demand continues to grow, both from the natural growth of the economy and from rapid growth in the gas-fired sector of electric generation. These basic forces of supply and demand have led to price increases every year since 2002, although never as much as in 2005.

The hurricanes worsened the underlying tightness of supply and demand.

By shutting in a significant part of the Nation's production for the year, supply tightened. So far, the hurricanes have shut in about 500 billion cubic feet (Bcf) of gas, almost three percent of the Nation's annual production. Recovery efforts have succeeded in getting more than 70 percent of Gulf of Mexico production on line. Nonetheless, about 2.65 Bcf per day of gas production remains shut in today. The 2005 hurricanes were substantially more destructive than Hurricane Ivan in 2004.

Even with supply disruptions, companies continued to fill gas storage against the possibility of a cold winter. That will help protect the Nation against problems this winter, although it put continuing upward pressure on prices in the weeks after the hurricanes. Storage is now at relatively high levels historically. However, with significant levels of productive capacity still shut in, supplies through the winter are likely to remain tight. As a result, forward prices for the winter remain higher than before the hurricanes.



DERIVED FROM MINERAL MANAGEMENT SERVICE (MMS).



What is the Commission doing to respond to high gas prices?

The Commission is acting to make sure that natural gas prices reflect the true balance between supply and demand, and not artificial constraints in the system or the exercise of market power. It has:

- Issued orders immediately after the hurricanes that let market participants move gas in new ways that avoided bottlenecks caused by the hurricane damage.
- Approved applications for a substantial expansion of the Nation's LNG terminals for overseas gas.
- Shown a strong record of approving applications for new pipelines both quickly and in an environmentally responsible way.
- Established a strong monitoring system for the market to make sure that it detects any market manipulation that might arise during this time of high prices.
- Strengthened its enforcement policy, proposing new market manipulation rules and implementing its new civil penalty authority in a manner to encourage a strong compliance program.
- Improved its ability to detect new market manipulation by implementing a Memorandum of Understanding with the Commodity Futures Trading Commission.
- Approved changes to pipeline tariffs to help pipelines force compliance with operational flow orders to maintain system reliability.

It is important to remember that the Commission does not directly regulate most wholesale natural gas prices, which were decontrolled in 1989 to prevent the severe inefficiencies and shortages of the 1970s from recurring.

What are gas prices likely to be this winter?

The best guess from the market is that prices will probably be much higher this winter than last winter. Weather will be the most important factor. With a normal winter, prices are likely to remain high, but may not rise much further. With an abnormally cold winter, prices could be considerably higher. Other factors will be the level of continuing supply outages from the hurricanes (longer, larger outages will tend to raise prices) and the amount of conservation people practice (more conservation will put downward pressure on prices).

In any case, natural gas prices have been among the most volatile or "spiky" in the economy for years. They will continue to be volatile through the winter - in tight markets, small fluctuations in demand can strongly affect prices.

Areas that depend heavily on production from the Gulf of Mexico are the most affected.

These areas include the Northeast, the Southeast and even Gulf coast areas in Louisiana, all of which have seen higher prices than the rest of the continent since the hurricanes. These areas are likely to remain the most vulnerable to higher prices through the winter, especially if recovery of Gulf of Mexico production is delayed. During a cold winter, the Northeast (especially New York and New England) is likely to see the highest prices, as the weather strains pipeline delivery capacity to that region.



Can imports make up the difference in supply?

The United States imports natural gas from Canada and from overseas as liquefied natural gas (LNG). Canada is part of the same basic market with the United States and sees the same tightness between demand and supply that we do. For overseas shipments, the United States must compete with other consuming countries in Europe and Asia. In many cases, foreign gas customers are state-owned and have long-term contracts. Such customers are often unwilling to sell gas on the spot market even at very high prices. Even where spot markets are active (for example, the United Kingdom), prices are sometimes higher than in North America. So it is impossible to be sure how much LNG the United States will receive this winter.

What will happen to retail bills this winter?

Some current estimates (such as Energy Information Administration's) suggest that winter gas heating bills could rise by 35-50 percent this year.

The Commission regulates only wholesale natural gas markets. State public utility commissions decide how retail rates will be set. In practice, most retail bills are almost certain to rise, although probably less than the spot price of gas. At least two factors would lessen the effect of spot wholesale prices on customers this year:

- First, changes in the price of gas do not directly affect transportation or distribution charges that make up part of the customer's bill.
- Second, many gas utilities and suppliers have bought part of their gas throughout the year, either by putting some gas into storage or by entering into forward contracts. Customers would pay an average of what the company paid through the year for such supplies.

Higher gas prices normally mean higher electric prices.

In many electric markets, prevailing prices depend on the cost of running the most expensive plant needed to meet demand – most often a generating plant that burns natural gas. In these situations, higher natural gas prices translate directly into higher power prices.

In any case, most of the new generating capacity built in the last ten years burns natural gas. Rising gas prices increase the cost of these units whenever they run. In most cases, such cost increases are passed on to consumers.

What can you as a customer do about high natural gas prices?

You can cut your own natural gas bill through conservation – see (for example) the Department of Energy's website <http://energysavers.gov> for practical suggestions on conservation. When you conserve, you also help everyone else, since reduced consumption lowers stress on the whole gas industry and tends to lower prices.

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