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BEFORE THE

**SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
TECHNOLOGY, AND ECONOMIC GROWTH**

OF THE

**COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES**

JUNE 13, 2001

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee in response to its request for testimony by the Department on the reauthorization of the Defense Production Act of 1950. The Subcommittee's invitation letter requests the Department to address, in particular, the Defense Production Act's energy-related authorities and their past use and ways in which those could be useful in meeting future energy needs of the country.

It would be helpful in addressing these topics to describe the most recent use of the Defense Production Act in responding to an energy crisis situation. I am referring to the Department's use, as directed by former President Clinton, of the Defense Production Act in responding to actual and threatened interruptions of natural gas supplies in northern and central California in January of this year.

The circumstances that gave rise to the interruption of natural gas supplies in northern and central California actually began with the cumulative effects of electricity sales within the State under California's 1996 electricity restructuring legislation. Under that structure State-regulated electric utilities were required to sell electricity to their customers at frozen rates that could not be adjusted upward to reflect increased acquisition costs of wholesale electric power. At the same time, the State required Pacific Gas and Electric Company ("PG&E") and other State-regulated electric utilities to purchase their electricity supplies in the day-ahead or real time spot market (in

contrast to long-term contracting, which permits hedging), provided for partial divestiture of the utilities' fossil generation assets, and required utilities to sell their electricity into the Power Exchange rather than use it to serve their customers. In addition, growth in electricity demand far outpaced growth in electricity supply. Between 1996 and 1999, demand in California rose 5,500 MW, while supply rose only 670 MW. This combination of factors put the utilities in the position of buying wholesale power for as much as 30 cents per kilowatt-hour, while only being allowed to sell it for 3 cents.

Beginning in May 2000, State-regulated electric utilities began to accumulate huge debts in the form of unrecovered wholesale power costs as a result of the rate freeze. These unrecovered wholesale power costs significantly weakened the financial health of the utilities and, in many cases, the utilities approached insolvency. PG&E's debts alone totaled \$6.6 billion.

The reluctance of electricity generators and marketers to sell to PG&E and Southern California Edison, the other major State-regulated electric utility that accumulated large unrecovered wholesale power costs, deepened as the financial condition of the utilities worsened. In order to prevent loss of electricity supplies to the customers of the utilities, then-Secretary of Energy Richardson issued an emergency order under the Federal Power Act on December 14, 2000, directing certain electricity generators and marketers to continue to sell electricity upon request by the California Independent System Operator, a nonprofit corporation established by the 1996 California electricity restructuring law charged with operation of the transmission system and assuring system reliability in California. This type of emergency order ultimately was extended to 3:00am EST on February 7, 2001.

The poor financial condition of PG&E also led some natural gas suppliers to terminate sales to the utility, out of concern that the losses the utility was incurring in its electricity operations would lead to insolvency, notwithstanding the fact that PG&E's gas operations themselves could recover costs under its tariff. Unlike Southern California Edison, PG&E is both a gas and electric utility. On January 9, 2001, one supplier, which supplied approximately 14 percent of PG&E's core gas supplies, terminated sales to PG&E. Other gas suppliers soon followed suit and still others threatened to stop deliveries absent prepayments or credit guarantees. About 25 percent of PG&E's January baseload supply of natural gas was terminated and substantial additional volumes were threatened.

PG&E serves 3.9 million "core" gas customers in California, both residential consumers and small businesses. PG&E also transports natural gas to about 5,000 "noncore" customers, including industrial consumers and electricity generators. If PG&E experienced a shortage in gas deliveries, it would have to increase withdrawals from gas already in storage and divert gas from noncore customers. Diversion from noncore customers would exacerbate the California electricity shortage, since two-thirds of PG&E's noncore gas is used for electricity generation.

PG&E and Southern California Edison first sought redress at the State level by applying to the California Public Utilities Commission for retail electricity rate increases. On January 4, 2001, the California Public Utilities Commission increased retail electricity rates by a surcharge of one cent a kilowatt-hour among its classes of customers. It did so for a period of 90 days, and did not otherwise alter the rate freeze under which PG&E and Southern California Edison were

operating. PG&E also sought action from the State to prevent a loss of gas supplies. PG&E asked the California Public Utilities Commission for emergency authorization to draw on the gas supplies of the other major gas utility in the State. The California Public Utilities Commission never acted on this request.

On January 10, 2001, PG&E and its parent filed a Form 8-K with the Securities and Exchange Commission in which they announced suspension of dividend payments and postponement of release of financial results for the fourth quarter of 2000. The stated reason for postponing release of financial results was that the outcome of then on-going State and Federal efforts involving the California electricity market could result in measures that “significantly and adversely affect” PG&E Corporation’s financial results.

Beginning the first week in January, the Department was advised by PG&E’s General Counsel that debt rating agencies had reacted negatively to the California Public Utilities Commission’s January 4 Order, and that if PG&E’s outstanding debt were reduced to junk status that event would constitute a default under PG&E’s various natural gas supply contracts. Were that event to occur it would accelerate the payment obligation of all of PG&E’s natural gas supply contracts. While we understood that at the time PG&E had acquiesced in pre-paying some of its natural gas suppliers, the normal payment schedule of PG&E was that its contracts required payment in full on the 25th day of each month for the entire prior month’s deliveries of natural gas to PG&E for sale to its gas customers. While PG&E’s tariff with the California Public Utilities Commission enabled it to recover the full amount of increased acquisition costs for

natural gas resold by PG&E (unlike the case for electricity), because of PG&E's precarious operating revenue posture stemming from the electricity market, PG&E indicated that it could not continue to purchase the needed volumes of natural gas if it were required to pre-pay for them.

At about the same time, beginning January 9, 2001, then-Treasury Secretary Summers and then-Energy Secretary Richardson participated in extensive meetings that included the Governor of California, California legislative leaders and the President of the California Public Utilities Commission, the CEOs or Presidents of the major California electricity suppliers, and the CEOs of the California investor-owned utilities or their parents. While the objective of these meetings was to assist the State of California in formulating a solution to the evolving situation, no such solution was announced.

On January 12, 2001 the CEO of PG&E formally requested President Clinton to invoke emergency authorities in order to assure continuity of natural gas supplies through PG&E to its service territory in northern and central California. That letter was accompanied by an affidavit executed the same day by the Chief Financial Officer, Treasurer and Senior Vice President of PG&E that described in detail the circumstances giving rise to the threatened interruption of natural gas supply through PG&E to northern and central California. On January 13, 2001 Governor Davis sent a letter to President Clinton in which the Governor described his inquiry into the circumstances, his finding that there was an "imminent likelihood that natural gas supplies in northern and central California will be interrupted," and requested the assistance of

the President and the Secretary of Energy on an urgent basis.

On January 15, 2001 then-Deputy Energy Secretary Glauthier conducted a telephone conference that included operational executives of PG&E in order to ascertain further the logistical and operational circumstances that necessitated immediate action at the Federal level. On January 16, 2001 Reuters reported that Standard & Poor's had downgraded PG&E's debt to "low junk" status. President Clinton's instructions to the Secretary of Energy, and the Secretary of Energy's accompanying Order to PG&E and its natural gas suppliers, were issued on January 19, 2001. As the text of each document indicates, their issuance was based not only on the emergency provisions of the Natural Gas Policy Act of 1978, but also on the Defense Production Act of 1950. I now turn to the reasons that prompted the Department to formulate this approach.

When it appeared in early January that it might prove necessary to formulate emergency orders for continued delivery of natural gas through PG&E, we first examined the emergency provisions of the Natural Gas Policy Act of 1978, 15 U.S.C. 3361 - 3364. Those provisions appeared useful in that they authorized designation of continued use of natural gas for electricity generation as a "high-priority use" in an emergency, and authorized specification by the Federal Government of the "terms and conditions" including "fair and equitable prices" for natural gas delivered under an order. The ability to determine that continued use of natural gas was a "high-priority use" under the Natural Gas Policy Act was quite important because, without such Federal action, under California law, any reduction in gas volumes available to PG&E as merchant impairing its ability to serve its "core customers" (residences and small businesses) would result in mandated

redirection of gas volumes delivered through PG&E (but not owned by it) destined for non-core customers, including most significantly electricity generators. Were such redirection to occur it would have further reduced the volumes of natural gas available for electricity generation in California.

Despite the technical utility of section 302 of the Natural Gas Policy Act, 15 U.S.C. 3362, in these respects, we remained concerned that it only would “authorize” purchase, rather than also to require deliveries, of natural gas to enable PG&E to continue to distribute sufficient volumes of natural gas. During January PG&E advanced arguments asserting that the allusion to an “order” in section 302 suggested that it embraced an ability to impose a supply mandate. Based on textual analysis of the Natural Gas Policy Act we remained unpersuaded on this point. In forming our view of this question we also consulted with an attorney of the Federal Energy Regulatory Commission who had been designated by the Commission’s General Counsel to aid us in our examination of this question. Our textual analysis coupled with that of the Federal Energy Regulatory Commission attorney, together with our understanding of the provenance of section 302 as having had the original objective simply of permitting emergency sales into interstate commerce by non-jurisdictional gas producers without becoming thereby subject to then-existing wellhead price controls, prompted us to conclude that the Natural Gas Policy Act’s emergency provisions, standing alone, would not suffice if the Federal Government were to mandate continuity of natural gas deliveries through PG&E to all of its service territory in northern and central California.

We then considered whether the Defense Production Act provided the authority to complement the emergency provisions of the Natural Gas Policy Act such that the entities (largely resellers and not producers) that had recently provided PG&E with natural gas could be directed to continue to make similar volumes available to PG&E. We concluded that the Defense Production Act would provide this authority.

Title I of the Defense Production Act authorizes the President to require the priority performance of contracts or orders in certain circumstances. Under section 101(a), 50 U.S.C. App. 2071(a), the President may require performance on a priority basis of contracts or orders that he deems “necessary or appropriate to promote the national defense.” In determining what the national defense requires, it is clear the President may consider the potential impact of shortages of energy supplies. In the Energy Security Act Congress specifically designated energy as a “strategic and critical material” within the meaning of the Defense Production Act and also added language to its Declaration of Policy that establishes a link between assuring the availability of energy supplies and maintaining defense preparedness. The Defense Production Act’s Declaration of Policy, 50 U.S.C. App. 2062(a)(7), states:

[I]n order to ensure national defense preparedness, which is essential to national security, it is necessary and appropriate to assure the availability of domestic energy supplies for national defense needs.

PG&E's customer base in northern and central California includes a number of defense (including "space," as the term "defense" is defined in the Defense Production Act) installations and defense contractors that use natural gas and electricity and that clearly would be adversely impacted by interruption of natural gas service. Continuity of supply to these facilities was threatened in the same fashion as other industrial natural gas consumers in PG&E's service territory.

Section 101(c) of the Defense Production Act, 50 U.S.C. App. 2071(c), authorizes the President to require priority performance of contracts or orders for goods to maximize domestic energy supplies if he makes certain findings, including that the good is scarce and critical and essential to maximizing domestic energy supplies. In the situation existing in California in mid January, natural gas supplies would have become acutely scarce had the withholding by PG&E's suppliers continued and expanded to more suppliers than those that already had terminated deliveries. Moreover, continuity of natural gas supply is critical and essential in PG&E's service area to electric energy generation, petroleum refining, and maintaining energy facilities. These factors seemed directly to bear on the terms of section 101(c) of the Defense Production Act relating to continuity of energy production.

Accordingly, we structured the emergency natural gas order to include the supply obligation authorized by the Defense Production Act. Our understanding of the Defense Production Act regime was that it is broad enough to embrace mandates for priority performance of new orders to vendors, as well as priority performance of existing contracts. Thus this authority fit well in a

transactional sense in which some vendors' contracts to supply gas might have expired by their terms just before the order.

This aspect of the Defense Production Act regime permitted the Department to impose a temporary supply assurance for natural gas to northern and central California comparable to that done with the electricity orders for the area of the State served by the California Independent System Operator by the Department's prior orders under section 202(c) of the Federal Power Act. The emergency natural gas order issued by former Secretary of Energy Richardson on January 19, 2001 and extended by Secretary Abraham on January 23, 2001, was directed just to the group of suppliers that had provided PG&E natural gas on commercial terms during the 30-day period prior to issuance of the order. This approach was chosen as the least intrusive means that would achieve the public health and safety and defense preparedness objectives of continuing for the near term natural gas supplies into PG&E's service area. The order is best understood as an emergency, temporary action designed to afford California the opportunity to abate the emergency by its necessary further actions.

As a result of the Department's emergency orders natural gas supplies continued to flow through PG&E into northern and central California, averting a natural gas supply crisis. Despite the apprehensions about payment by PG&E that had prompted the threatened interruptions of natural gas deliveries, every natural gas supplier named in the emergency orders was paid in full by PG&E on the schedule required by those orders.

Prior to its use in the emergency natural gas supply orders described above, section 101(c) of the Defense Production Act was used in the late 1970's and again in the 1980's and early 1990s to facilitate petroleum production development of the Alaskan North Slope.

Finally, you have asked me to address ways in which the Act's authorities could be useful in addressing future energy needs of the country. Whether the Defense Production Act authorities placed in the President might be useful in addressing energy needs of the country in the future would be highly fact-dependent. Because the Act's use would require a fact-dependent judgment, it would be difficult to predict whether circumstances might arise that would prompt the President to conclude that direct Federal action under this authority was warranted.

The Department fully supports extending these Defense Production Act authorities which have proven so useful in a variety of circumstances in making a contribution to the national security, including energy security, for three years.

This concludes my prepared statement. I will be pleased to respond to any questions the Subcommittee may have.