TASK GROUP REPORT

TRANSMISSION AND DISTRIBUTION

For purposes of organization, and in acknowledgement of the differing issues of the major pipeline transmission and distribution market segments, the Transmission & Distribution Task Group (T&D Task Group) has chosen to separately report on the areas of pipeline transmission, distribution and storage. In aggregate, the subsections form a coherent analysis, just as the separate but conjoined efforts of the study's Task Groups (Demand, Supply, and Transmission & Distribution) have been combined into an integrated document.

I. Study Approach

In order to incorporate a wide range of industry expertise, the T&D Task Group was comprised of 26 U.S. and Canadian representatives from the following natural gas industry sectors: pipeline transmission; distribution; storage; marketing, and production. When issues arose outside of the specific participant knowledge areas, experts within the represented companies, as well as firms not directly represented on the panel, were contacted for their views. Care was taken to coordinate with the other Task Groups (Supply and Demand) through liaison members. This liaison approach was also followed with the important ad hoc groups, such as Arctic Gas and LNG Imports. Government representatives included participation by DOE, FERC, and EIA.

The analysis relied upon supply and demand data provided by the other Study groups as well as data from the Energy Information Administration (EIA), the American Gas Association (AGA), the Interstate Natural Gas Association of America (INGAA), and other industry associations. NPC member companies also provided data. Early in the study, the T&D Task Group determined and set the major exogenous variables required for the analysis. Examples of these determinations included: selecting pipeline capacity expansions and newbuilds within the first five years; setting the "lag" or delay between a price signal and the construction of a required pipeline developed subsequent to the first five years; determining the cost differentials for construction (pipeline, storage, and distribution) by region; and estimating the amount of storage required for human needs (residential/small commercial) services.

With regard to the issues facing the T&D Task Group, the model makes economically justified decisions to route natural gas, expand pipeline capacities, and construct new storage facilities. The modeling software consists of a complex nodal (physical flow) structure which is fundamentally based on unit pricing concepts. Decisions to flow gas through existing facilities and/or decisions to build pipelines between nodes, add incremental storage facilities, build additional facilities at the citygate, etc., are "calculated" in the model on a year-by-year basis. The network used in the model incorporates 115 supply/demand nodes and 317 transportation corridors (see Figure T-1). The model will always attempt to utilize existing facilities to their maximum, while at the same time looking for pricing signals that would support facilities expansion either to existing facilities or with greenfield projects.

Model output was then carefully reviewed by the T&D Task Group to search for and correct any anomalies. Once the results of the major scenarios (Reactive Path and Balanced Future) were approved, sensitivities of the Supply and Demand Task Groups (which result in differing data inputs to the T&D model) were also

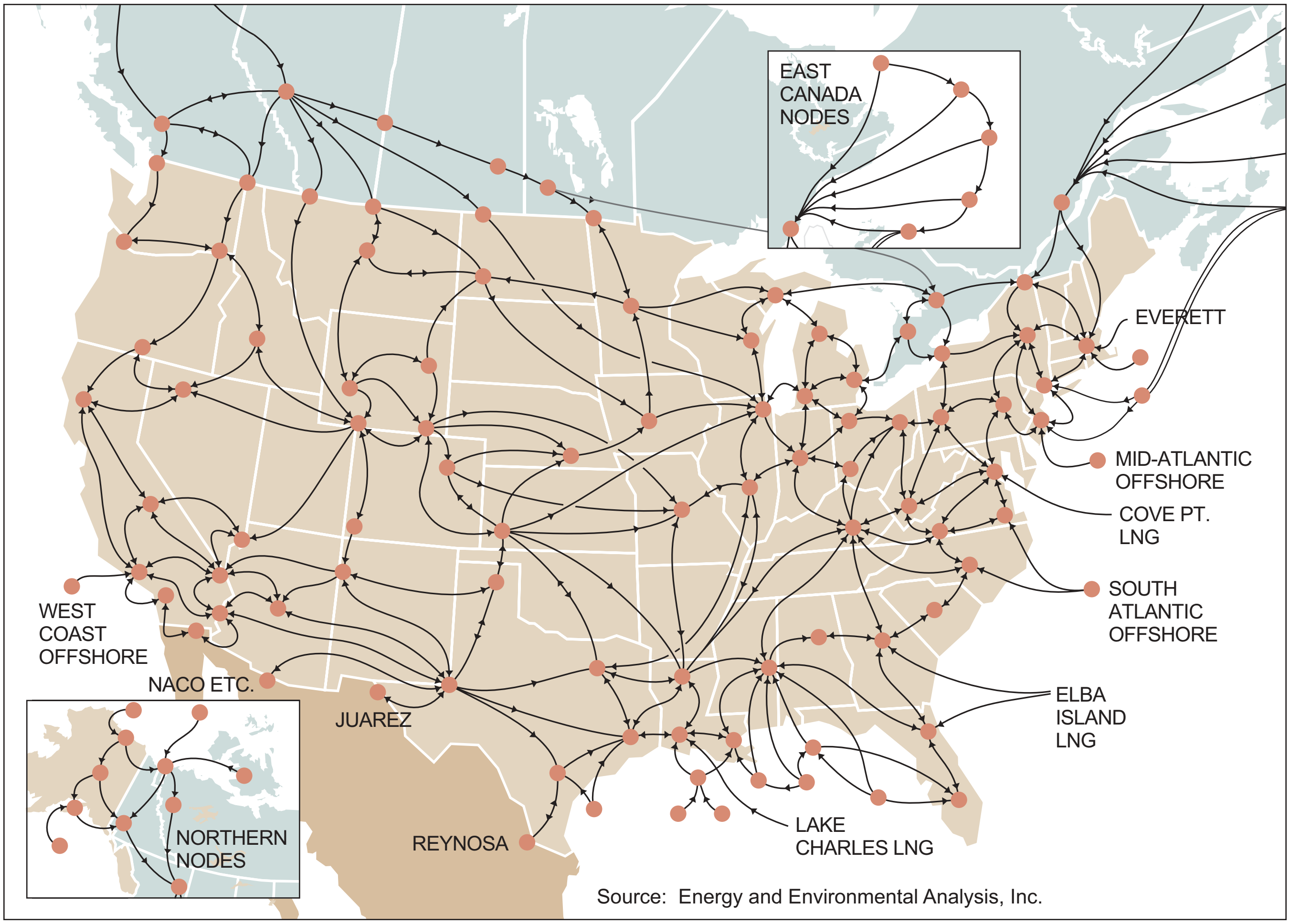


Figure T-1. Supply/Demand Nodes and Transportation Corridors

reviewed for their impact on T&D results. In addition, the T&D Task Group chose to evaluate its own sensitivities to validate certain stresses upon North American infrastructure.

II. Summary of Results

The study shows that continued expansion of gas transmission, storage, and distribution facilities will be required to meet the future needs of gas consumers and suppliers, but there remains a critical dependency on the existing natural gas infrastructure. Needed expansions or enhancements include increasing the capacity of existing infrastructure, developing pipeline laterals connecting new supply, storage and generation facilities, expanding distribution networks, and building multi-billion dollar pipelines that link Arctic supply regions to the North American grid.

Two scenarios and multiple sensitivities were analyzed with respect to the timing and location of new major supply sources as well as cases related to demand reduction. A status quo approach to natural gas policy yields undesirable outcomes because it discourages economic fuel choice, new supplies from traditional basins and Alaska, and new LNG terminal capacity. The NPC developed two scenarios of future supply and demand that move beyond the status quo. The two scenarios were the Reactive Path and Balanced Future. The Reactive Path scenario assumes continued conflict between natural gas supply and demand policies that support natural gas use, but tend to discourage supply development. This scenario results in continued tightness in supply and demand leading to higher natural gas prices and price volatility over the study period. The Balanced Future scenario builds in the effects of supportive policies for supply development and allows greater flexibility in fuel-switching and fuel choice. This results in a more favorable balance between supply and demand, price projections more in line with alternate fuels, and lower prices for consumers.

The major results for the Balanced Future scenario are summarized as shown below. These results will be compared to the Reactive Path scenario in the Scenarios and Sensitivities section later in this volume. A summary of model input assumptions can be found in Appendix C at the end of this volume.

Pipeline and distribution investments will average $8 billion per year, with an increasing share required to sustain the reliability of existing infrastructure.

Estimated expenditures for new North American transmission pipelines, including sustaining capital, are $2.7 billion/year (2002 dollars) over the study period, from 2004 to 2025. This compares to $3.5 billion/year expended between 1996 and 1999. Peak construction years occur when Arctic pipelines are under construction (2008-2013).

While capital for new infrastructure is decreasing, especially in the later years, sustaining capital is increasing and becoming an increasing percentage of total capital requirements. This is a result of investments for continuing compliance with the Pipeline Safety Improvement Act and the fact that increasing investments are required for an aging infrastructure to assure its safe and reliable operation.

Estimated expenditures for new North American distribution pipelines, including sustaining capital, are $5.3 billion/year (2002 dollars) over the study period, from 2004 to 2025. This is the same as was expended between 1996 and 1999. The successful development of this distribution system infrastructure will depend on several key factors, including:

- Obtaining inter-agency coordination and regulatory certainty in all permitting processes;
- Obtaining access to expansion capital;
- Maintaining the historical levels of reliability and flexibility of natural gas services as gas demand grows and load patterns change;
- Developing mechanisms to foster research and development.

Estimated expenditures for new North American storage facilities, including sustaining capital are $0.4 billion/year (2002 dollars) over the study period from 2004 to 2025. This is slightly larger than that expended between 1996 and 1999. It is important to note that these estimates do not include the cost of base gas, which is projected to be one of the largest components of future storage expenditures. Other observations related to storage infrastructure are:

- Projected growth in weather sensitive demand will require up to 700 billion cubic feet (BCF) of additional capacity by 2025;
- Given that the geologic base for potential storage capacity is highly exploited, new storage facilities may be located further from the markets they serve and may be increasingly expensive to develop.
- A return to normal weather (30-year average) would require utilization rates above those experienced in the 4 years prior to December 2002;
- Demand for gas storage can be as much as 25% higher than normal in a year in which winter weather is significantly colder than normal. North American storage capacity has not been tested by such a winter for many years and, as such, it is likely that current storage capacity will be severely challenged to meet such demands.

Figures T-2 and T-3 show capital expenditures for North America. As can be seen, there is significant volatility in the amount spent on transmission facilities, but expenditures generally decline in the outer years. In addition, as the established infrastructure ages, a significant portion of the ongoing transmission expenditures are used to sustain existing capacity. From 2000 to 2002, sustaining capital is estimated as 21% of total transmission expenditures. By 2020 to 2022, sustaining capital will increase to almost 75%. Sustaining capital for transmission, distribution, and storage is estimated as 21% of total expenditures for 2000-2002. By 2020, sustaining capital for the three segments is projected to be 45% of total expenditures.

Sustaining capital for transmission was calculated on the basis of replacing 700 miles of pipe and 77,000 horsepower of compression each year. This is viewed as a conservative estimate because it is a small fraction of the existing 290,000 miles of pipe and 16,000,000

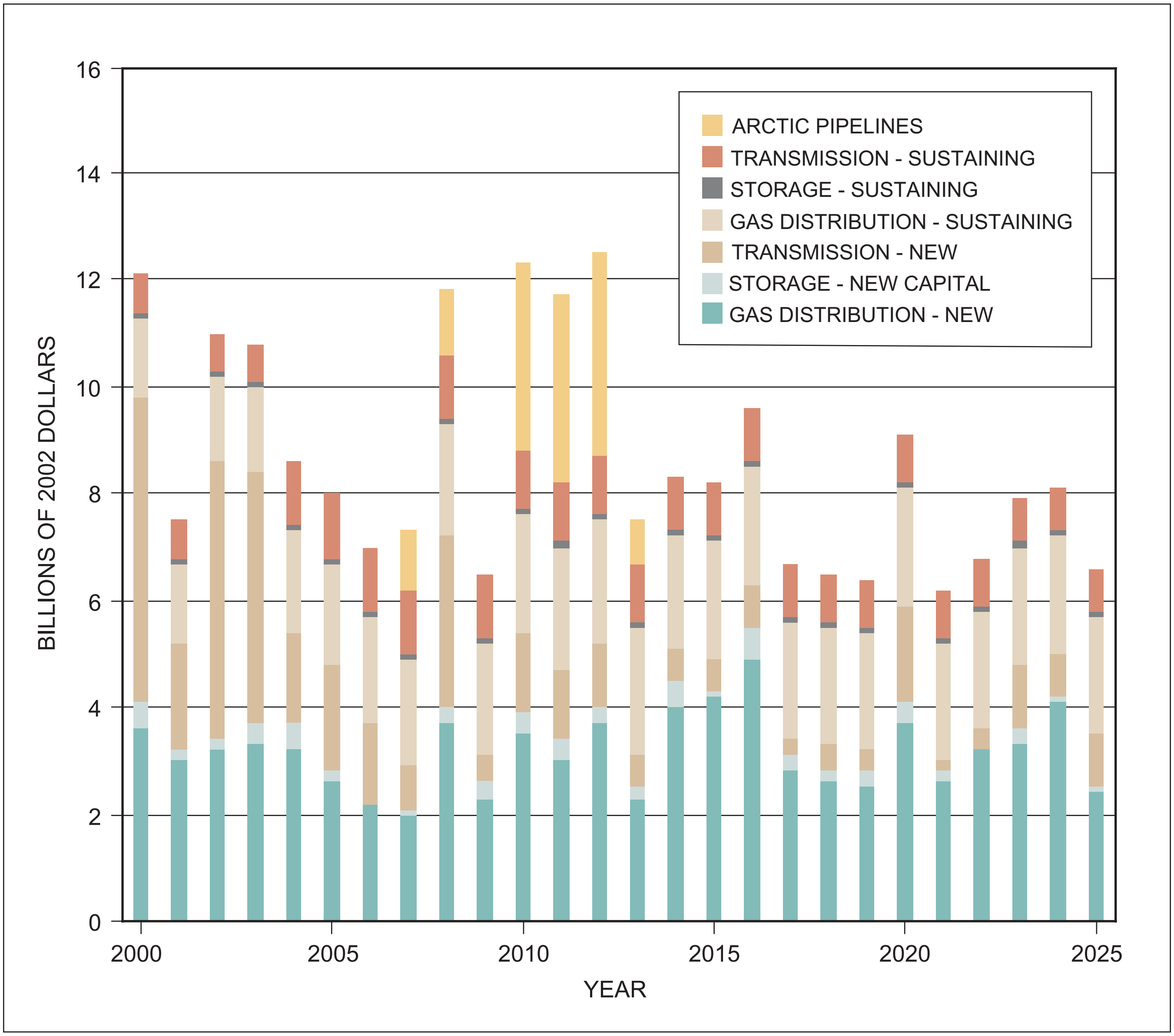


Figure T-2. Detailed North America Capital Expenditures for Transmission, Distribution, and Storage in Balanced Future Scenario

horsepower of compression, much of which is over 40 years old. For instance, if we assumed a 50-year life for pipelines, then the appropriate replacement rate for pipe would be over 5,800 miles per year. The basis for using the lower number is that it better matches the historical level of replacement. Because of the impacts of the Pipeline Safety Improvement Act of 2000, however, we doubled the historical levels for the purposes of the study. At some point in the future, though, the progressive aging of pipelines and compressors will result in a further significant increase in the miles of pipe and horsepower replaced per year.

Regulatory barriers to long-term contracts for transportation and storage impair infrastructure investment.

Pipeline and storage infrastructure developments have generally been financially supported by contracts with a term of ten to twenty years. In a free market, shippers make long-term commitments when they see the need for the service that will be provided. Recently,

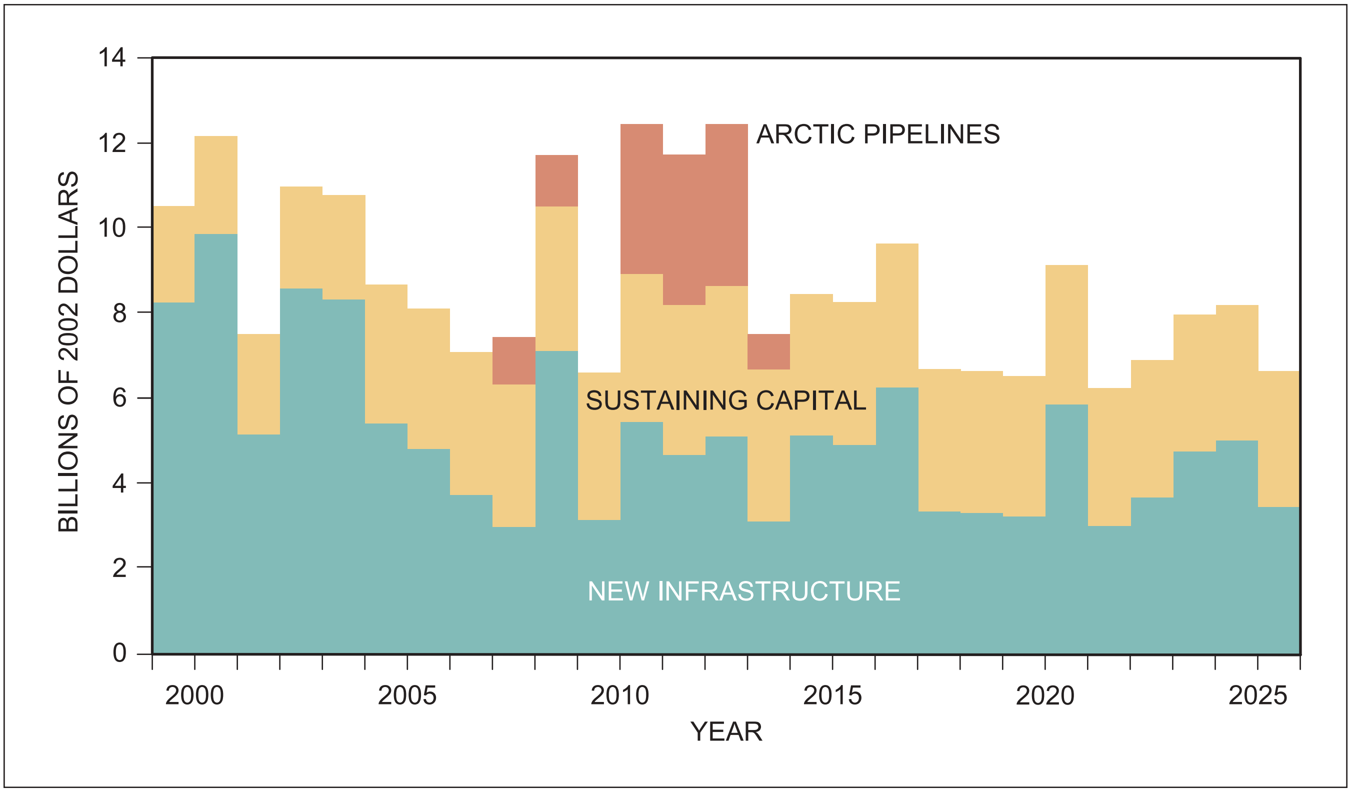


Figure T-3. Total North American Capital Expenditures for Transmission, Distribution, and Storage in Balanced Future Scenario

the average transportation contract term for new/proposed and existing pipeline and storage infrastructure has trended shorter. Much of the trend is the result of market choices, while some is caused by the impact of regulatory policies which may create barriers to choice. When such barriers exist to shippers making long-term commitments, investment in pipeline and storage infrastructure is impacted, as the related revenue stream is viewed as more short-term in nature and less likely to support long-term infrastructure investment.

III. Transmission

The Transmission Subgroup has divided its report into the following major sections: (1) Overview; (2) Future Environment; (3) Challenges to Building and Maintaining the Required Pipeline Transmission Infrastructure; (4) Construction Barriers; and (5) Operation and Maintenance of Existing Infrastructure. While each section may be read on its own, the Transmission Subgroup recommends reading the report in order and in its entirety as the different components are highly interrelated.

A. Overview

The United States' pipeline transmission infrastructure has been developed over a period of eight decades and has provided the nation with reliable access to North American natural gas supply. The infrastructure grew rapidly in World War II to meet the needs of the burgeoning war-time economy and continued its growth during the industrial economic expansion of the 1950s and 1960s. In the 1970s, the pipeline transmission system grew from 255,000 miles to 266,000 miles and expenditures averaged $2.7 billion per year. With a belief in the late 1970s that natural gas was a scarce resource, a decision was made to eliminate natural gas as a fuel source for electric generation. With a major demand component reduced and despite the impacts of a faltering economy and gas supply price deregulation issues, the transmission system grew further in the early 1980s to 271,000 miles, ending 1989 at 276,000 miles. Expenditures during the 1980s were roughly equivalent with the 1970s at the $2.7 billion/year rate. In the 1990s, the relatively low cost and abundance of Canadian production and a corresponding decline of production deliverability from mature U.S. basins led to the creation of significant new cross-border pipeline transmission systems.

Average annual expenditures increased to $3.3 billion from 1990 through 1997.

U.S. natural gas consumption has grown significantly from its low point in 1986, rising from 16.2 TCF (44.4 BCF/D) to an estimated 22.6 TCF (61.9 BCF/D) in 2001.[1] During this period, the dominant growth sector was electric generation, including industrial combined heat and power, and the gas transmission grid in the United States grew from 281,000 miles[2] to 285,000 miles.[3] Growth factors for the electric generation segment were an annual average growth of 4.8%, as compared to 0.7%, 2.3%, and 2.0% for the residential, commercial, and industrial sectors respectively. The U.S. grid is a significant part of the North American system of large-diameter pipelines, which is shown on Figure T-4.

1. Historical Background and Statistics

New projects have significantly increased the capacity of the North American transmission grid. For example, the Alliance Pipeline, which runs from Northeastern British Columbia via Alberta to Chicago, has a capacity of 1.6 BCF/D, while Maritimes and Northeast Pipeline, which runs from Nova Scotia to the Boston area, has a capacity of 500 MMCF/D. In the decade from 1990 to 2000,[4] the 12,000 miles of U.S. transmission pipeline added has met demand requirements and improved the efficiency and reliability of North American natural gas markets. Despite the large amount of pipeline transmission growth over that decade, there have still been periods in which the demand for capacity has exceeded its supply. These pipeline capacity constraints have resulted in increased price differentials between upstream supply regions and downstream markets. For example, upstream Western Canadian supply prices were significantly below those of the downstream markets during the 1990s with price differentials sometimes greater than $1.25/MMBtu. As a result, capacity was added, i.e. Alliance Pipeline and the Northern Border expansions to the U.S. Midwest region.

[1] Energy Information Administration, Natural Gas Table 6.5, Natural Gas Consumption by Sector, 1949-2001.

[2] AGA Gas Facts 2002.

[3] Department of Transportation RSPA 7100.2-1.

[4] Ibid.

The California supply/demand imbalance during 2000 and 2001 also led to multiple pipeline construction projects including expansions on the Transwestern, El Paso and Kern River pipelines and the conversion of Southern Trails Pipeline from oil to natural gas service. In aggregate, these projects brought over 1.3 BCF/D of new capacity to California.

The one U.S. region that has experienced an ongoing capacity shortfall is the Rocky Mountain supply area. In response, a number of new export projects have been proposed for the region, including Advantage, Western Frontier, Front Range, Cheyenne Plains, Bison, Southern Trails, TransColorado/Silver Canyon, Powder River Basin North, Northwest Pipeline Rockies Expansion, and Ruby. Periodic constraints appear to be the result of a rapid growth in supply that surged ahead of potential shippers' commitments to the long-term pipeline contracts required to facilitate new pipeline construction. Market participants will decide which of the projects will move forward and when.

2. Results from the Study

In the United States, pipeline capacity utilization factors in the Reactive Path scenario are projected to undergo significant changes during the 22-year forecast period:

- The Mid-Continent production region (Oklahoma/Kansas) has some of the largest changes in capacity factors, with usage factors on pipelines running from the Mid-Continent to the Midwest market region dropping from 94% in 2000 to 54% in 2025.

- The Texas Intrastate market sees major flow realignment, with capacity factors on pipelines running from the Permian Basin to East Texas dropping from 81% at the start of the period to 7%. If Mexican production fails to grow at the rate forecast by SENER, then the steady growth in demand projected over the period may cause exports from the United States to Mexico to increase rather than decrease.

- Capacity factors from Northern Louisiana to the Midwest market areas drop from 75% to 57%, as Arctic supply replaces Gulf Coast gas in the Midwestern energy markets in the latter part of the study period. There is also some reduction in utilization factors in pipelines moving gas from the Gulf Coast to the Mid-Atlantic, assuming LNG landed in East Coast market centers helps to serve

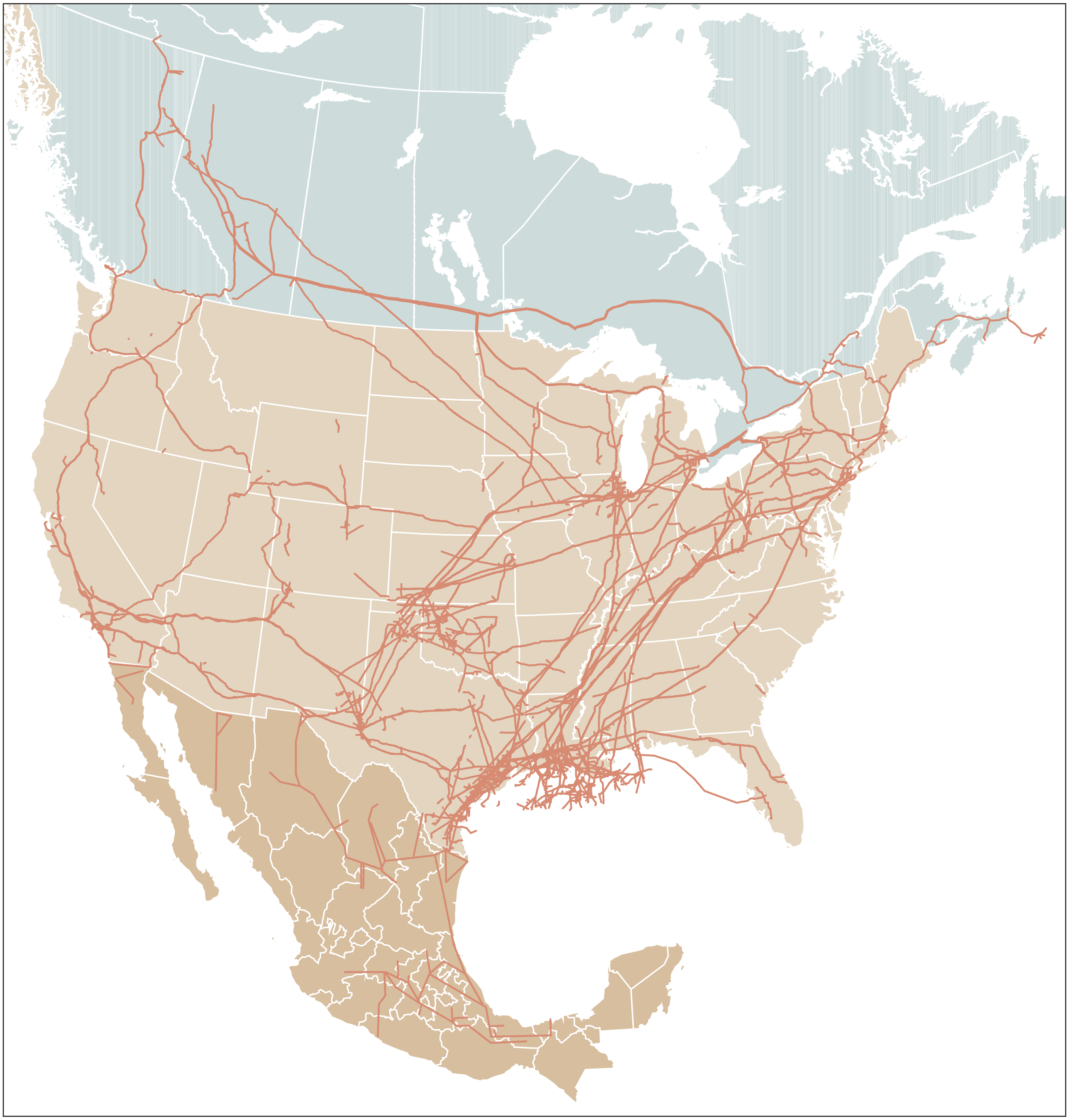


Figure T-4. North American Pipeline Grid (24" Diameter and Greater)

demand growth in that region as well as create additional upstream delivery capability through existing pipeline resources.

- The one supply basin showing little excess capacity is the Rocky Mountains. This region shows significant production growth over the study period, growing from 4.4 BCF/D in 2000 to 9.2 BCF/D in 2018 before experiencing a slow decline to 8.7 BCF/D in 2025. As a result of the increase in pipeline transmission capacity prior to 2018 and a subsequent decline in regional production, capacity factors on pipelines leading east of the region have a lower capacity utilization rate in 2025 than in 2000. The capacity factors on pipelines leading to California, however, are above 93% for the entire period.

- In Canada, Western Canada Sedimentary Basin (WCSB) production peaks at 17.9 BCF/D in 2005. Capacity utilization to eastern Canada drops from approximately 94% in 2000 to 81% in 2025. Production in the Maritimes area of Eastern Canada rises to 1.3 BCF/D in 2011, undergoes a gentle decline to approximately 1.0 BCF/D in 2019 and then rises once again to 2.2 BCF/D in 2025.

- The Balanced Future scenario features increased supply access to the Rocky Mountain and Offshore Continental Shelf regions. As a result, flow patterns change from those in the Reactive Path. For example, the Mid-Continent to Midwest capacity factor is 74% in 2025 in the Balanced Future versus 54% in the Reactive Path. Other notable changes in the Balanced Future include over 1.5 BCF/D of production from the Atlantic offshore that flows into East Coast markets, a drop in capacity factors from Canada to the Pacific Northwest from 70-80% to 50-60%, and a drop in west-to-east Canadian long-haul utilization of 81% to 73%.

Pipeline capacity must also be constructed to transport gas from storage to high consumption centers. This is particularly true for storage developed to serve the Mid-Atlantic and New England markets. As noted in the Storage section of this volume, these regions will require an additional 135 BCF of working gas storage by 2025. Because the nearest suitable and undeveloped reservoirs exist in the western portions of Pennsylvania and New York, Eastern Ohio, and Ontario, incremental pipeline capacity of approximately 2.0 BCF/D will have to be constructed to link new storage capacity to the coastal market centers, which include New York City, Boston and Philadelphia.

The incremental pipeline capacity required by 2025 is shown in Figure T-5.

B. Future Environment

1. Throughput Trends

In describing throughput trends, it is illustrative to examine the balance of flows into major market regions. For this purpose, a major market region is defined as one in which consumption exceeds production (New England, Northeast, Mid-Atlantic, South Atlantic, Florida, East South Central, Midwest, Upper Midwest, West North Central, Pacific Northwest, and California).

Between 2000 and 2010, there is an aggregate net consumption growth (consumption minus intra-regional production) of 4.5 BCF/D in the primary market regions. Incremental LNG deliveries into these market regions are projected to account for 3.3 BCF/D of this increased demand. As such, only 1.2 BCF/D of additional long-haul deliveries are needed from net supply to net consumption regions.

Between 2010 and 2020, lower-48 consumption in the major market regions has a further increase of 3.6 BCF/D. In this period, LNG imports into net market areas is projected to increase by 1.5 BCF/D, resulting in a need to increase long-haul transport from traditional supply regions such as the Gulf of Mexico. From 2020 to 2025, net demand in major market regions is projected to remain stable. During this period the net market area increase in consumption is exceeded by projected increases in LNG deliveries. Thus, no additional long-haul capacity development is required.

In Canada, net consumption growth in the major market regions (defined as regions where demand exceeds supply, namely Ontario, Quebec, and Manitoba), is 0.36 BCF/D from 2000 to 2010, or 1.0% per year. Between 2010 and 2020, growth is again projected to be 1.0% per year or 0.4 BCF/D. From 2020 to 2025, the net consumption is projected to decline slightly. Over the study period, there will be no growth in long-haul capacity to eastern Canada as demand growth will be met through enhancement and utilization of existing pipelines.

2. Changes in Flow Patterns (Geographic)

The projected changes in flows across the major North American pipeline corridors are displayed in Figures T-6 (2004 to 2010) and T-7 (2010 to 2020), which are both taken from the Balanced Future scenario. As a result of the decreasing supply in the mature regions of the United States, pipelines connected to these areas will see a gradual decline in throughput. This should be particularly true for the southern sections of pipelines serving the West Texas/Permian Basin to Midwest corridor. The middle/northern sections of these systems (i.e. Kansas, Nebraska, etc.) will be re-supplied, however, by growing Rocky Mountain production fed eastward via new pipelines, such as the completed Trailblazer expansion, the Cheyenne Plains project, the Advantage proposal, and the Western Frontier proposal.

Figure T-5. New Pipeline and LNG Capacity Change from 2003 to 2025 in Balanced Future Scenario (Million Cubic Feet Per Day)

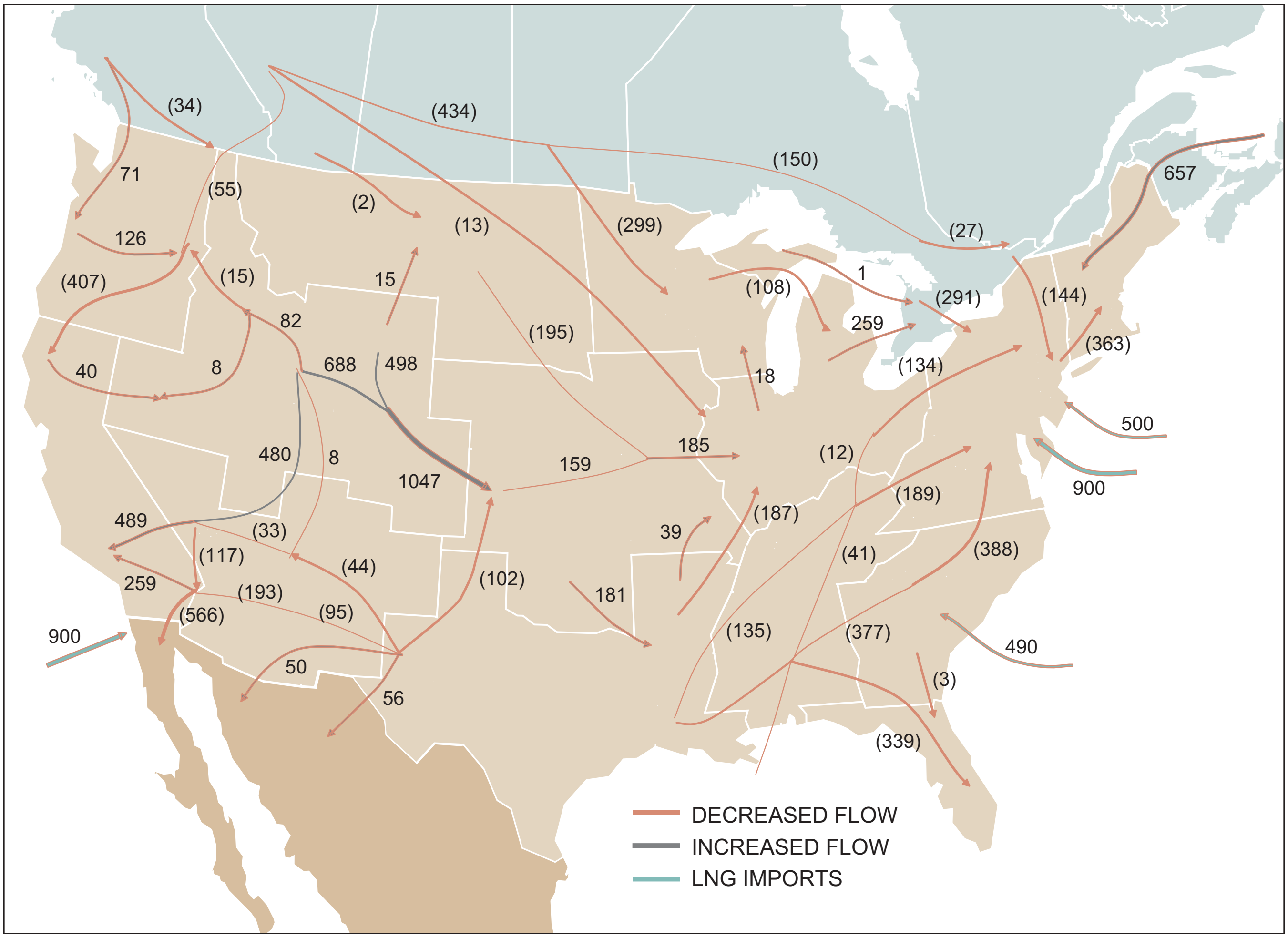


Figure T-6. Flow Change from 2004 to 2010 in Balanced Future Scenario (Million Cubic Feet per Day)

A significant source of new supply is LNG imports, which rise from less than 0.6 BCF/D in 2000 to almost 6 BCF/D in 2010 and then to 12-15 BCF/D by 2025. Figure T-8 shows the LNG imports projected in the Reactive Path scenario.

When located on the Gulf Coast, these supplies help to maintain throughput in pipelines originating from this region. When located directly in market regions, these facilities will access demand typically with only short-haul infrastructure expansion required. LNG received in the market regions also has the effect of increasing upstream pipeline delivery capability, as gas that previously used the long-haul path will be displaced to potential upstream markets by the LNG received downstream.

As mentioned above, production from the Western Canada Sedimentary Basin (WCSB) peaks in 2005, and then undergoes a long-term decline to 2025, when production drops to 14.3 BCF/D. Part of the production decline is replaced by Arctic gas from Mackenzie Delta and Alaska. The first flow from Mackenzie Delta into Alberta is expected in 2009 at 1.0 BCF/D, increasing to 1.5 BCF/D in 2016. The Alaska production is expected to begin in 2013 at 2.5 BCF/D and then increase to 4.0 BCF/D for the remainder of the forecast period. The combined Arctic flows more than offsets the expected decline in Western Canadian production in the early part of the study. To accommodate these changes in supply, however, major new pipeline systems will need to be constructed from the frontier regions to interface with existing pipeline infrastructure in northern Alberta.

Additional pipeline capacity will also be required to export Alaska gas from Alberta to U.S. and Canadian markets. Options for transporting this gas include using existing capacity spared by a decline in WCSB production, expanding existing pipelines, and constructing new pipelines. The NPC analysis suggests that an additional 0.5 to 2.0 BCF/D of new or expan-

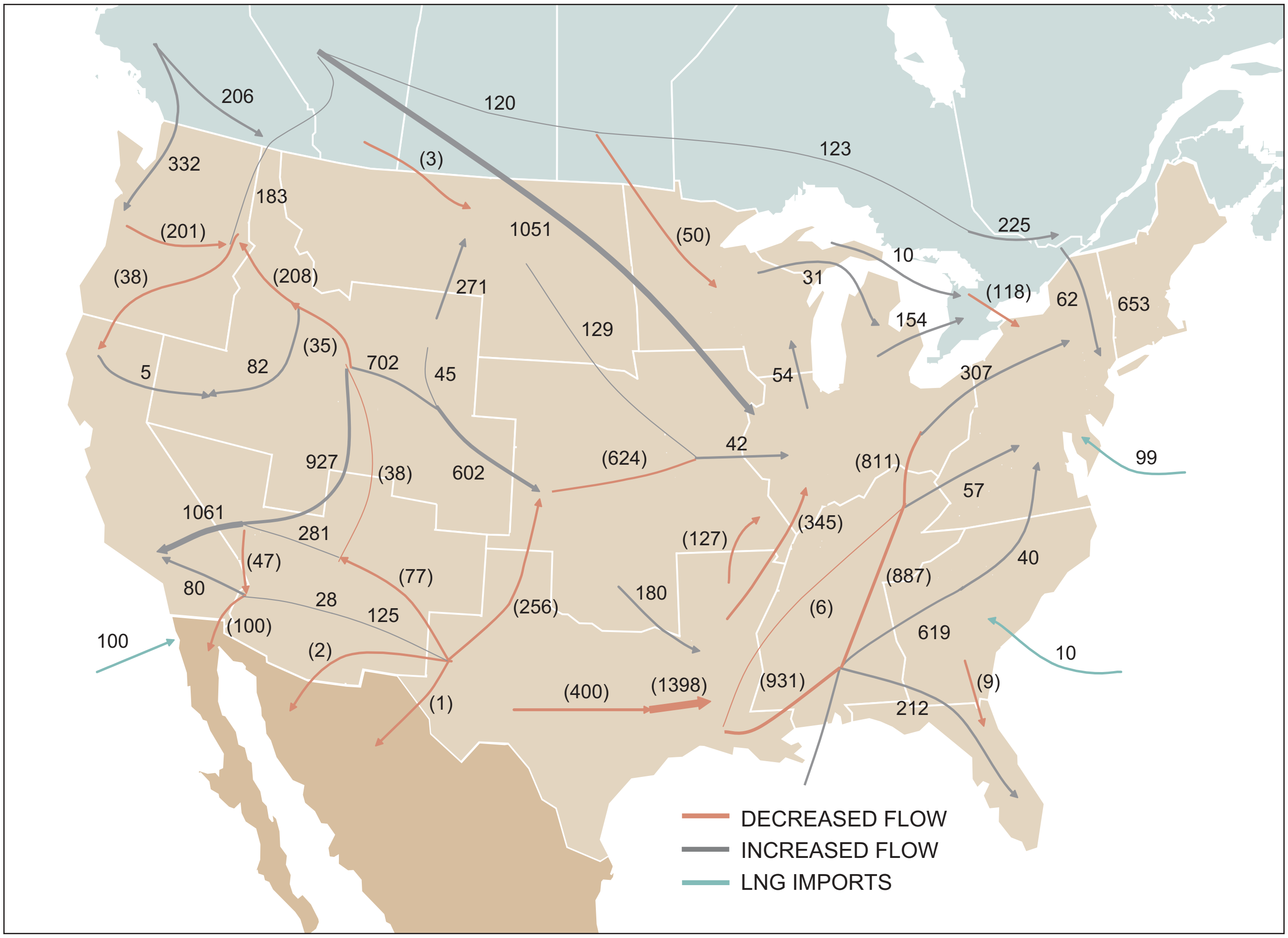


Figure T-7. Flow Change from 2010 to 2020 in Balanced Future Scenario (Million Cubic Feet per Day)

sion capacity may be needed to move the gas from Alberta to downstream markets. The amount of export capacity is very sensitive to changes in the western Canada supply/demand balances and could change significantly by the time investment decisions are made regarding Alaska gas.

3. Required/Assumed Infrastructure Additions (Costs)

Future development costs for long-haul pipeline infrastructure and for connection of the transmission grid to new storage and powerplant facilities are forecast to be slightly below historical levels. The cost to construct the new North American pipeline facilities is expected to average $2.0 billion/year (2002 dollars) over the period to 2025. The projected investments are somewhat front-loaded, with the average for the years 2003 to 2010 expected to be almost $2.3 billion/year. These capital expenditure levels compare to an investment rate of $3.5 billion/year, which occurred between 1996 and 1999. The expected decline in the rate of capacity development results from several factors, including a substantial increase in LNG imports delivered to major market centers and the flow of new supplies into existing pipelines that currently have or are forecast to have spare capacity. Both of these actions promote efficiency by maximizing utilization of existing infrastructure while minimizing the need for new construction.

4. Scenarios and Sensitivities

The two scenarios generated results that were very close in terms of total North American transmission pipeline miles constructed and expenditures. The Reactive Path projection had 41,200 miles of interstate pipeline constructed over the 2003 to 2025 period at a cost of $1.98 billion/year. In the Balanced Future forecast, the analogous numbers were 43,500 miles and $2.02 billion/year. These cost projections in both cases are below actual expenditures for the last decade,

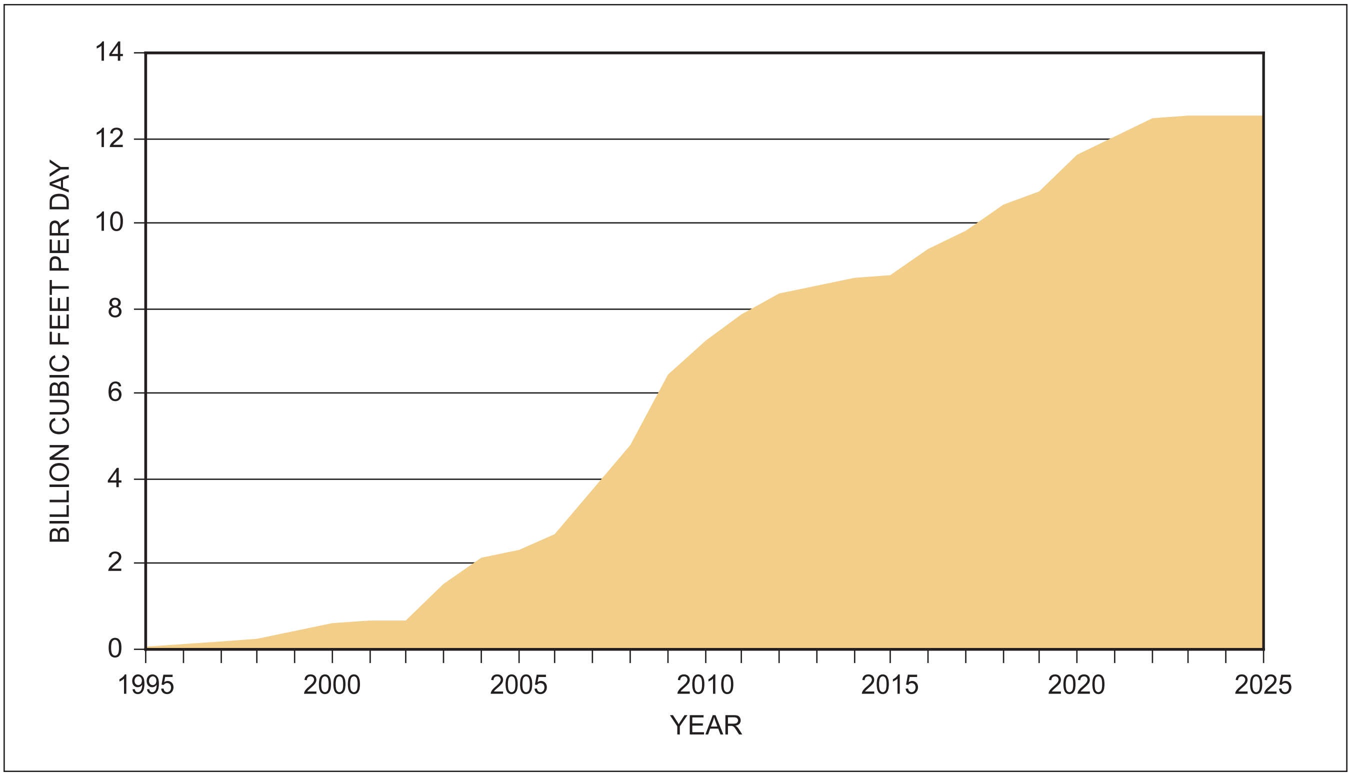


Figure T-8. North American LNG Imports

which indicates interstate pipeline development should not be a limiting factor in achieving the necessary supply/demand balance.

The location of the infrastructure costs varied between the two cases, however, with more of the Balanced Future's expenditures occurring in the United States versus Canada. The Balanced Future shows a decline in infrastructure requirements for both eastern and western Canada due to increased production from U.S. areas currently limited by access restrictions. Since the Balanced Future postulates improved access to U.S. domestic resources, more infrastructure is required in the United States. Spending in the United States is thus $77 million per year higher in the Balanced Future while Canadian expenditures decline by $37 million per year.

An important sensitivity is the one in which new LNG import facilities are not approved for construction in the Mid-Atlantic and Northeast regions, causing that LNG to be landed at sites within the Gulf of Mexico. Although no new transmission capacity is required for the Reactive Path, incremental pipeline capacity of approximately 0.3 BCF/D must be built from the Gulf Coast to Florida markets in the Balanced Future scenario to accommodate the incremental LNG proposed in that case. Although little incremental infrastructure is required, this sensitivity results in higher prices in the Mid-Atlantic and Northeast markets than those in the Reactive Path due to a tighter supply/demand balance and pipeline capacity constraints. According to the results of the sensitivity analysis, the delivered costs to New York City are about $0.07/MMBtu higher by 2010. The variance between the two cases widens to $0.30/MMBtu in 2015 and to $0.44 in 2025. The analysis quantifies the higher gas prices associated with not allowing facilities to be built in the region that consumes approximately 8.6 BCF/D or 14% of the current U.S. total. For instance, for a consumption of 8.6 BCF/D, the difference in delivered prices of $0.30/MMBtu in 2015 results in an increased energy cost of $942 million for that year alone.

Another significant impact to gas transmission requirements occurs in the Cold Weather sensitivity. In this forecast, one of the coldest 23-year sequences of weather over the last 70 years was used to determine winter demand. The years used in the forecast were 1956 to 1978, with the temperature patterns in 1956 shifted to 2003, 1957 to 2004, etc. The average price over the full 23-year projection was little changed, as the temperature average for the period was only 3% lower than the temperature pattern used in the

Reactive Path and Balanced Future scenarios. The standard deviation of the price, however, was much higher, as the 23-year forecast had episodes of weather that were much colder than normal. Thus, the standard deviation of the average price for the Reactive Path was $0.69/MMBtu whereas the standard deviation for the Cold Weather sensitivity was $0.98/MMBtu. The $0.29/MMBtu variation is sufficient to support the development of additional transmission or storage infrastructure. The effect of colder than normal or warmer than weather on annual prices is shown on Figure T-9.

C. Challenges to Building and Maintaining the Required Transmission Infrastructure

1. Contractual Challenges

During the first seven decades of its history, the natural gas transmission industry's development was underpinned by long-term contracts held by local distribution companies (LDCs). The LDCs ensured the financial integrity of pipeline construction projects by signing 20-year contracts under which pipelines were responsible for the bundled purchase and delivery of the gas to the LDC citygate.

This integral relationship between the transmission and LDC industries began to change in 1983 with the FERC's issuance of Order No. 380, which allowed LDCs to modify their existing gas purchase obligations with pipelines. Further changes occurred in 1986 when FERC, in Order No. 436, adopted open access policies on interstate pipelines, which allowed "shippers" to use a pipeline's capacity to schedule the delivery and receipt of gas. In combination, these Orders gave other parties the ability to compete directly with the pipelines for the gas merchant function.

FERC Order No. 636, adopted in 1992, further changed the competitive environment by essentially eliminating the historical pipeline gas sales function. As a result of this paradigm shift in future regulation, pipelines were restricted to providing transportation and storage services only and could no longer buy or sell natural gas, except for limited operational reasons. This "unbundling" of the transportation and storage functions required each upstream supplier and downstream consumer to inherit the responsibility to arrange for the purchase or sale of gas on their own behalf. New tariffs were written and contracts were entered into for unbundled transportation and storage services. In addition, FERC required that a secondary market in transportation and storage services be

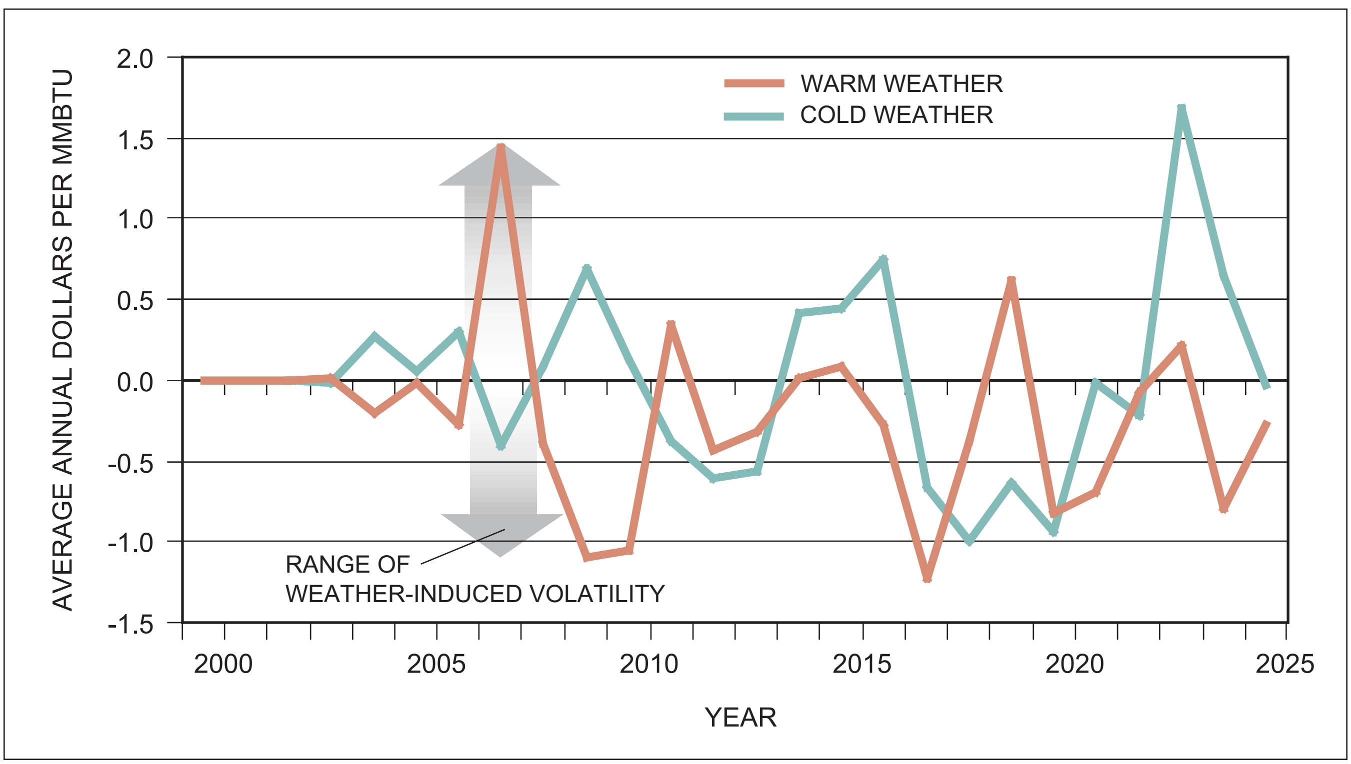


Figure T-9. Weather Sensitivity Minus Balanced Future (at Henry Hub) allowed to develop, wherein shippers could "release" a portion of their contracted capacity to a creditworthy third party for their use, either on a short-term or long-term basis.

Still, the LDCs remained the dominant purchasers of pipeline capacity during the 1980s and 1990s. Their long-term capacity contracts were crucial for the development of new pipelines and the expansion of existing ones. Contracting demographics began to change in the late 1990s with the evolution of the gas marketer business segment, and the unbundling (the separation of transportation and sales functions) of LDCs in many states. By the end of the 1990s, marketers had significantly expanded their role to include a broad portfolio (through the capacity release process or otherwise) of pipeline transmission and storage capacity contracts as well as acting as a managing agent of such resources for others. In their role as managing agent, marketer's goals were to optimize the use of pipeline and storage assets held by their counter parties, such as LDCs and industrial users, generally reducing these parties' daily participation in the evolving market. In such business structures, LDCs and end-users "swapped" use and optimization of these assets for ongoing gas management and reduced risk. Correspondingly, marketers saw such arrangements as opportunity and potential upside, as they could use them in a variety of ways which the LDCs and end-users might not.

When LDCs and other major consumers began purchasing gas supplies from marketers, their contracts were generally chosen to be of short duration, i.e. 1-3 years. In such a scenario, marketers often mirrored their risk, becoming short-term holders of pipeline capacity as a means of matching their overall contractual exposures. Some marketers did, however, subscribe to longer-term contracts to facilitate the construction of new infrastructure.

In this unbundled interstate pipeline world, the next market evolution was the unbundling in the 1990s of the sales and transportation functions of many LDCs. This unbundling of LDC services was mandated by state public utility commissions (PUCs) with the expectation that it would increase competition and lower prices to consumers behind the citygate. By the end of the 1990s, unbundling was complete in many states for the industrial gas and electric generation customers and was underway in some states in the residential and commercial sectors. One belief at many PUCs during this time was that unbundling LDCs, with the advent of competition, should no longer enter into long-term pipeline capacity contracts since their share of the future gas sales behind the citygate was uncertain. In fact, many LDCs were prohibited or discouraged from maintaining these contractual commitments.

During this period, producers became increasingly important as subscribers of new supply area pipeline capacity, especially capacity associated with greenfield developments (often referred to as a supply-push scenario). Where it made sense to commit to proposed infrastructure projects to assure their product was available to market, many producers have done such. The producer's goal was to ensure that they could reliably transport and sell their gas at a liquid, i.e. high volume, sales point where it could receive a market price that was not reduced by a capacity constraint.

Another subscriber to capacity during the 1990s was the marketing affiliates of interstate pipelines. Although the pipelines could no longer buy and sell gas themselves, they were allowed to have an affiliated company that did so. By the end of the 1990s, market affiliates were subscribing to large amounts of capacity in new transmission projects, particularly where third parties weren't willing to do so. For newly constructed capacity, the FERC required such contracting with their affiliate to be under an "at-risk" condition to the pipeline when it chose to build on this somewhat speculative basis, i.e. without demonstrating long-term contracts from third parties for the proposed capacity.

Today, the recent turmoil in the gas marketing sector has dramatically reduced the number of independent and affiliated marketers as prospective subscribers to existing and/or proposed pipeline transmission capacity. Even where such firms might want to contract for capacity, their current creditworthiness may make them too great a risk for pipelines to consider. With some LDCs still being discouraged or prohibited from entering into longer-term contracts by their PUCs, considerable uncertainty exists regarding the identity of the parties that will contract for unutilized capacity on existing pipelines or who will sign long-term capacity contracts for future pipeline projects.

2. Contracting New Capacity

As stated previously, a key concern for the pipeline transmission industry is the entity that will contract for new and existing pipeline capacity. To give a perspective, the Power Generation, Marketing, Production, and LDC sectors contracted for 91% of the firm transmission capacity subscribed in the United States as of December 2002. The percentage holdings of these sectors have, however, undergone a marked transformation over the last five years. The Marketing sector increased its share of total firm capacity from 13% to 24% over the period. With this business segment in turmoil over the last two years, this change has exacerbated the uncertainty surrounding the identity of companies that will contract for firm transmission capacity in the future.

The Power Generation and Production sectors' pipeline capacity holdings grew at a smaller rate of 5 BCF/D and 2 BCF/D, respectively. The LDC and Industrial sectors, the most important segments of industry growth as recently as ten years ago, were essentially unchanged over the interval. Table T-1 details these findings.

Another marked change within the industry relates to the expiration profile of firm transportation contracts (see Table T-2).

At year-end 2002, 77 trillion Btu per day or 64% of the total firm transportation contracts were set to expire within the following five years. In 1998, the comparable amount was 51%. The 13% increase in expirations between the two five-year periods again indicates a continuing movement to shorter-term commitments. The result is that regulatory practices (prudence reviews and ratemaking) may be inhibiting efficient markets and discouraging the financial incentives to develop and maintain pipeline infrastructure. This information is displayed graphically in Figure T-10.

Given the importance of the Power Generation Sector to growth projections in this study, it is worthwhile to focus on that sector in more detail. The gas fueled power generation capacity increased approximately 128,000 megawatts from 1998 to 2002. This generation consisted of combined-cycle gas turbines (CCGT) installations that generally are intermediate dispatch and tend to operate more than their gas turbine counterparts, which are generally used for hourly electric peaks. If this generation capacity were to have been completely utilized, a significant amount of daily gas transmission capacity would have been required for supply to the plants. In a survey of nationwide contracts, however, firm gas transmission capacity for power generators increased by 13 BCF/D, indicating that participants in this sector chose to contract for less than 100% firm transportation capacity, determining that was within a manageable level of need and risk/exposure. Of the overall capacity contracted by the electric generation industry, utilities directly held 5 BCF/D and marketers, on behalf of merchant generators, held 8 BCF/D. The remainder of needed pipeline transmission capacity was secured by the power sector through either interruptible pipeline capacity and/or

				Share of Total	
	2002	**1998**	**Increase/ (Decrease)**	**2002**	**1998**
Power	18	13	5	15%	12%
Marketer	29	14	15	24%	13%
Producer	12	10	2	10%	9%
LDC	50	50	0	42%	46%
Industrial	4	4	0	3%	4%
Pipeline	6	10	(4)	5%	9%
Other	1	8	(7)	1%	7%
Total	**120**	**109**	**11**	**100%**	**100%**

Table T-1. Firm Transportation Contracts (Billion Cubic Feet per Day)

	2002		1998	
1 Year	27	22%	16	15%
2 Years	42	35%	30	27%
3 Years	58	48%	42	39%
4 Years	66	55%	48	44%
5 Years	77	64%	56	51%
All Remaining	43	36%	53	49%
Total	120	100%	109	100%

Table T-2. Cumulative Firm Contract Expiration Profile (Billion Cubic Feet per Day)

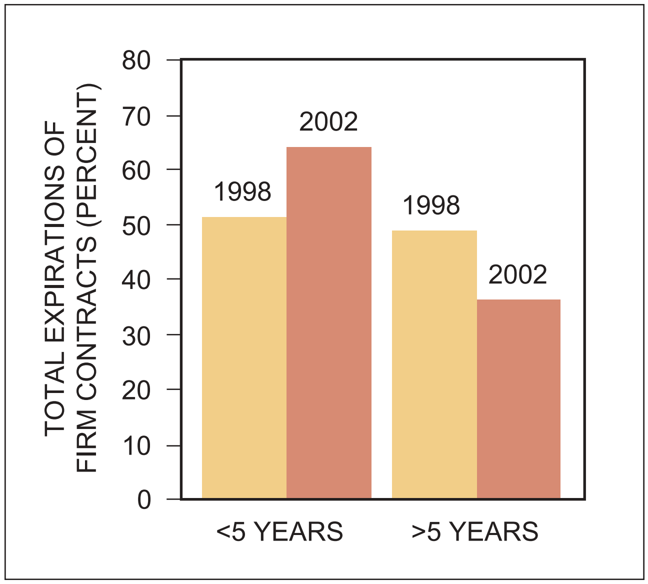


Figure T-10. Firm Contract Expirations

release of firm transmission capacity. These data are shown on Table T-3.

The 5 BCF/D of firm transmission capacity contracted by electric utilities during the past 5 years has an average contract term of about 7 years. These firm contracts often reflect durations necessary to cover the short-term, amortized costs of pipeline infrastructure construction to attach new generation facilities, both mainline capacity and lateral construction. Although there was a 62% increase in gas power generation capacity during a relatively short time-span, the expiration profile for this 13 BCF/D of new firm pipeline capacity is widely dispersed across many years.

The 8 BCF/D of firm transmission capacity contracted by the Marketing sector during the last 5 years, on behalf of merchant generators, had a much shorter-term trend, with an average term of 3 years. The expiration profile for the Marketer contracts is thus shorter in duration than those held by the electric utilities by about four years.

At year-end 2002, the Power Generation sector had 334,000 megawatts of total installed gas-fired capacity. Firm transmission capacity contracted by the power generators was 30 BCF/D. The expiration profile of the power sector's entire 30 BCF/D of firm transmission capacity at year-end 2002 (18 BCF/D utilities and 12 BCF/D marketers) is distributed across the next 20 years. However, the contracts are skewed in 2003, as the marketers tended to source numerous of these facilities with a short-term orientation/strategy, as can be seen in Figure T-11.

	Year-End 1997	Change 1998-2002	Year-End 2002
Gas Power Capacity (Megawatts)	206,000	128,000	334,000
Contracted Firm Transmission Capacity (BCF/D)			
Utilities	13	5	18
Marketers	4	8	12
Total	**17**	**13**	**30**

Table T-3. Power Sector Gas Transmission Summary

It is important to note, that approximately 190,000 megawatts (57%) of gas power generation capacity at year-end 2002 relies on non-firm gas transmission capacity. These were market choices, as the operators of these facilities have assumed the risk of service interruption by not securing firm contracts. Possible implications are as follows:

- As the utilization rate for these generation plants increase and surplus pipeline capacity declines, gas accessibility using interruptible pipeline capacity will become increasingly problematic.

- During the summer season, increasing power utilization will often conflict with traditional gas storage injections and will strain the pipeline and storage system resources. For example, gas injections may be pushed into only the evening hours and/or more injections may be required earlier or later in the summer season, i.e., in the shoulder months of April, May, and October.

- The current fleet of gas-fired generation – many of which do not have fuel flexibility to consider alternate fuels – and future power development facilities may not be able to depend on immediately available surplus pipeline capacity.

In recent years, several green-field gas transmission pipelines were constructed with the power sector as the primary shippers. These classic demand-pull projects include the Florida Gas and Kern River Expansion pipeline expansions. These pipelines share several unique attributes, such as a diverse customer base of merchant generators, municipal and integrated utilities, firm contract commitments for 10 to 20 years, which matches the financing duration for the new pipeline construction, and their location in markets that have historically utilized firm transportation to supply power generation. The total new capacity for these pipelines is 1.3 BCF/D. Therefore, much of the contracting activity by the Power Generation sector has occurred in the existing pipeline capacity market and is based on the historical pattern of seasonal capa city availability.

Fortunately, the natural gas industry has time to respond to any increased pipeline transmission requirements. The recent, rapid build-up of gas-fired generation has increased generation reserve margins

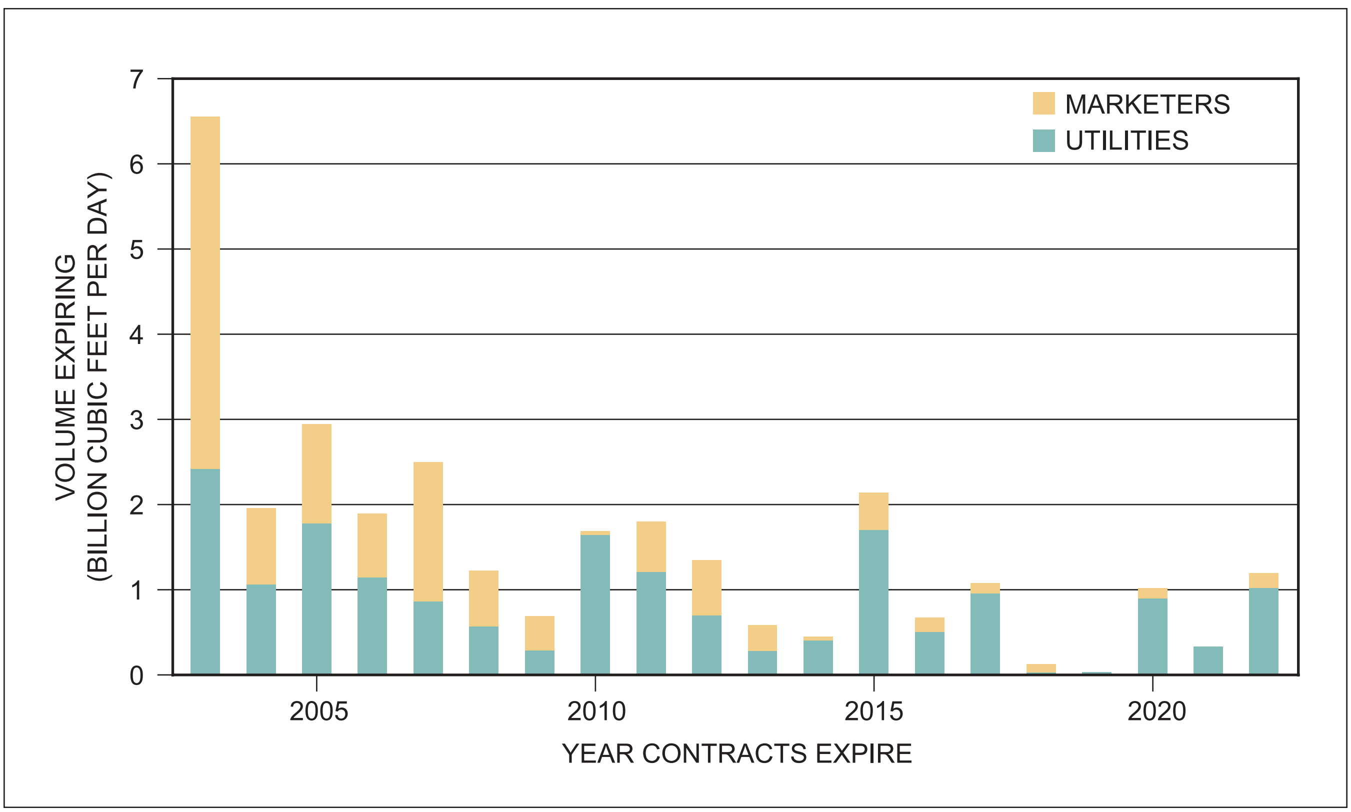


Figure T-11. Firm Contract Expiration by Year and by Shipper Class above the required levels in most regions such that little new generation construction is likely to occur over the next few years. Under projected power demand growth in this study, the levels of throughput on long-haul pipelines should increase over time as the new generators are increasingly utilized, but the full potential of their demand and the need for new supporting pipeline infrastructure should not be felt until after 2008. When the Power Generation sector resumes development post 2008, new gas transmission capacity will need to be added. Some new pipeline capacity for the power sector will require firm transportation contracts; these contracts are likely to be similar to those employed for the 13 BCF/D of firm capacity added during the 1998 to 2002 period.

With regard to the Marketing sector, firm pipeline capacity held increased by 15 BCF/D between 1998 and 2002, which doubled their capacity. Marketers held 13% of pipeline capacity in 1998, and by 2002 their share had climbed to 24%. Marketer growth has been driven by several factors including development of non-utility power generation facilities, expansion of merchant trading, and retail deregulation. The contract expiration profile among Marketers reveals their preference for shorter-term contracts than either LDCs or traditional utility Power Generators. As can be seen in Table T-4, contracts expiring during the next 12 months after 1998 represented 41% of the total Marketer capacity. Corresponding values for LDCs and utility Power Generators were only 8% and 9% respectively. By 2002, Marketers continued to hold 37% of their capacity in contracts with 12 month or shorter durations.

A similar trend was observed for the five-year expiration profile. In 1998, 75% of Marketers' firm transportation contracts expired during the succeeding five years. Corresponding values for LDCs and Power Generation were 43% and 38% respectively. By 2002, Marketers still had 71% of their contracts expiring during the next five years. Although overall contracted firm capacity had doubled during this intervening period, Marketers have retained a short-term horizon for their pipeline contracts.

1998	**Marketer**		**LDC**		**Power**	
1 Year or less	6	41%	4	8%	1	9%
2 Years	7	48%	8	17%	2	18%
3 Years	8	57%	16	32%	3	27%
4 Years	10	70%	19	37%	4	28%
5 Years	11	75%	22	43%	5	38%
All Remaining	3	25%	28	57%	8	62%
Total	**14**	**100%**	**50**	**100%**	**13**	**100%**

2002	**Marketer**		**LDC**		**Power**	
1 Year or less	11	37%	9	17%	2	14%
2 Years	13	45%	18	37%	3	19%
3 Years	17	57%	25	50%	5	29%
4 Years	18	62%	29	59%	6	36%
5 Years	21	71%	35	71%	7	41%
All Remaining	8	29%	15	29%	11	59%
Total	**29**	**100%**	**50**	**100%**	**18**	**100%**

Table T-4. Cumulative Firm Contract Expiration Profile (Billion Cubic Feet per Day)

The overall contracting tendencies of Marketers can obscure important trends within different components of the sector. The Marketer sector is, in fact, composed of four major segments as can be readily discerned in Figure T-12, e.g. merchant power marketer, gas marketer, producer marketer, and retail distribution marketer. Each of these segments has been individually analyzed to determine the effect of their contracting trends on the future environment.

Marketers supporting merchant power have grown dramatically during the past five years, adding 8 BCF/D of firm pipeline capacity, about half of the growth in the total Marketer sector. Merchant power marketers held 12 BCF/D of firm pipeline capacity at year-end 2002. However, due to the recent significant overbuild in electric generation capacity, it is unlikely that merchant power marketers will support construction of any incremental pipeline capacity during the next five years. After 2008, when electric reserve margins have contracted and another phase of gas-fired generation construction is expected, then marketers supporting merchant power facilities are expected to play a renewed role in supporting new pipe line infrastructure.

Marketers focused on gas marketing, which includes merchant trading and retail choice programs, have increased firm pipeline capacity holdings by 2 BCF/D during the past five years. This marketer segment held 9 BCF/D of firm pipeline capacity at year-end 2002, but tended to have the shortest-term perspective, as about 55% of the contracts expire within two years. Thus, the pipeline transmission sector cannot depend on these short-term-oriented marketers for construction of new pipeline infrastructure.

Marketers supporting producers held 6 BCF/D of firm pipeline capacity at year-end 2002. In general, marketers supporting producers tend to have longer-term contract durations and have often been the major support for new pipeline infrastructure and capacity additions in the supply regions.

Marketers serving regulated distribution companies are a small segment, with 2 BCF/D of firm pipeline capacity at year-end 2002. This niche segment does not appear likely to support significant new future pipeline capacity development.

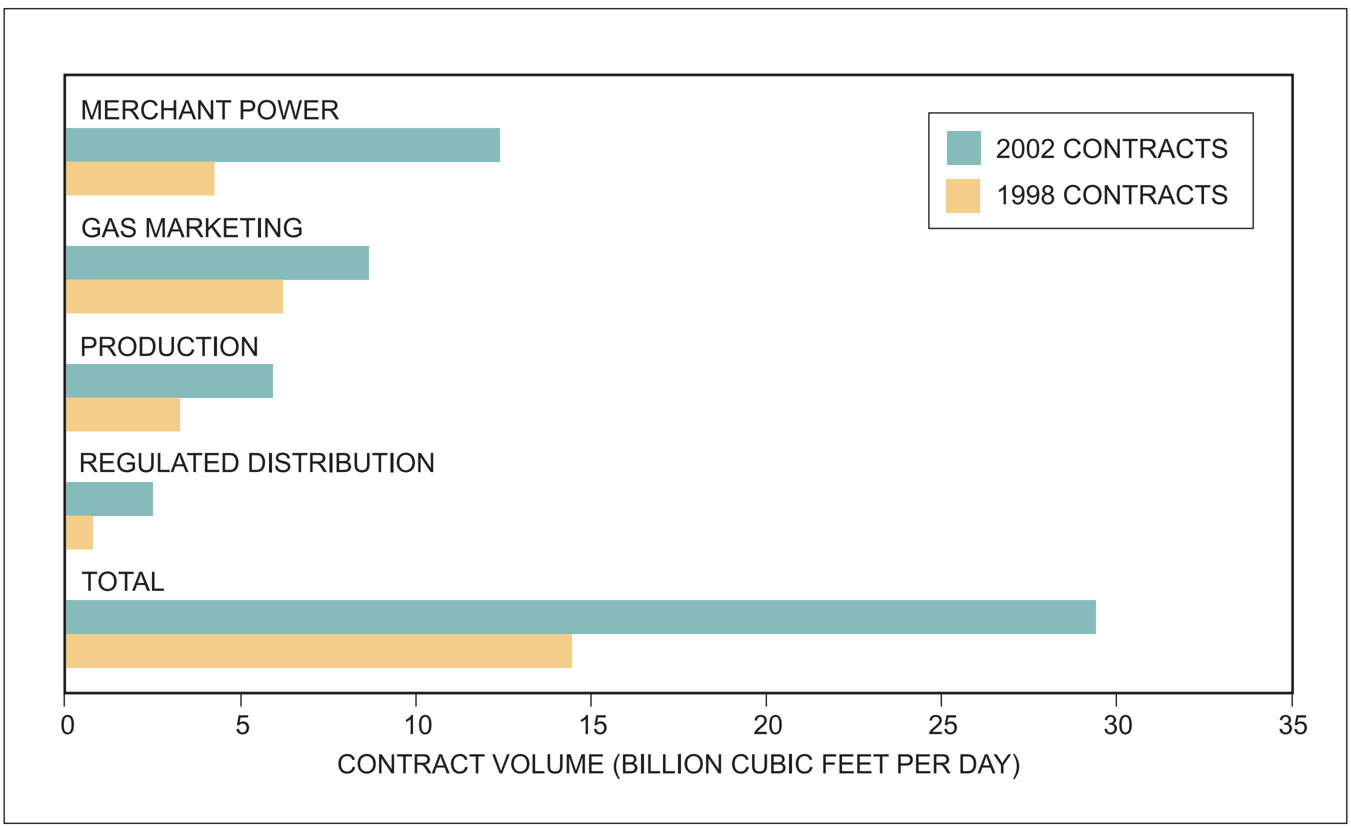


Figure T-12. Marketer Sub-Types, 1998 & 2002

Producers, viewed and reported separately from the Producer Marketer segment, held firm transportation capacity which increased by 2 BCF/D during the period from 1998 to 2002. The firm contracts added during this period had an average duration of 9 years. At year-end 2002, Producers held 12 BCF/D of firm pipeline capacity. The six largest gas producers in North America contracted for 52% of this capacity, with average contract duration of 10 years, as can be seen in Figure T-13.

Most of the increase in firm transportation capacity during the past five years was related to the development of supply basins. The developments included the Maritimes & Northeast Pipeline (Eastern Canada/Nova Scotia offshore), which was primarily supported by producer shippers with 15- to 20-year contracts, and the Alliance Pipeline (Western Canada Sedimentary Basin), which was based on producer shippers/owners with 15-year contracts.

The Producing Sector focuses on shipping their equity gas to market points. Where supply area pipeline constraints exist in conjunction with growing production, producers have often supported new transportation infrastructure projects to alleviate or minimize such constraints. In the Rockies, independent producers have contracted short-distance pipeline expansions to move their gas to more liquid points or points where they can access capacity that exits the region. The Medicine Bow Lateral in Wyoming is an example of such development. In the Gulf of Mexico, numerous pipelines have attached offshore pipeline developments to the existing onshore infrastructure. Recent examples of this latter type of development include the Discovery Pipeline, Destin Pipeline, and East Breaks Pipeline.

The timing and location of LNG import terminals will have a pronounced impact on the supply/demand balance during the study period. Terminals located in producing areas can be viewed as providing supply replacement for declining domestic gas production. Since these terminals, such as Lake Charles and Cameron LNG, are in an area of existing major pipeline transmission infrastructure, they will need only minimal incremental pipeline infrastructure development to obtain access to the current gas transmission grid. For terminals being developed or proposed in consuming market areas, such as the Baja and

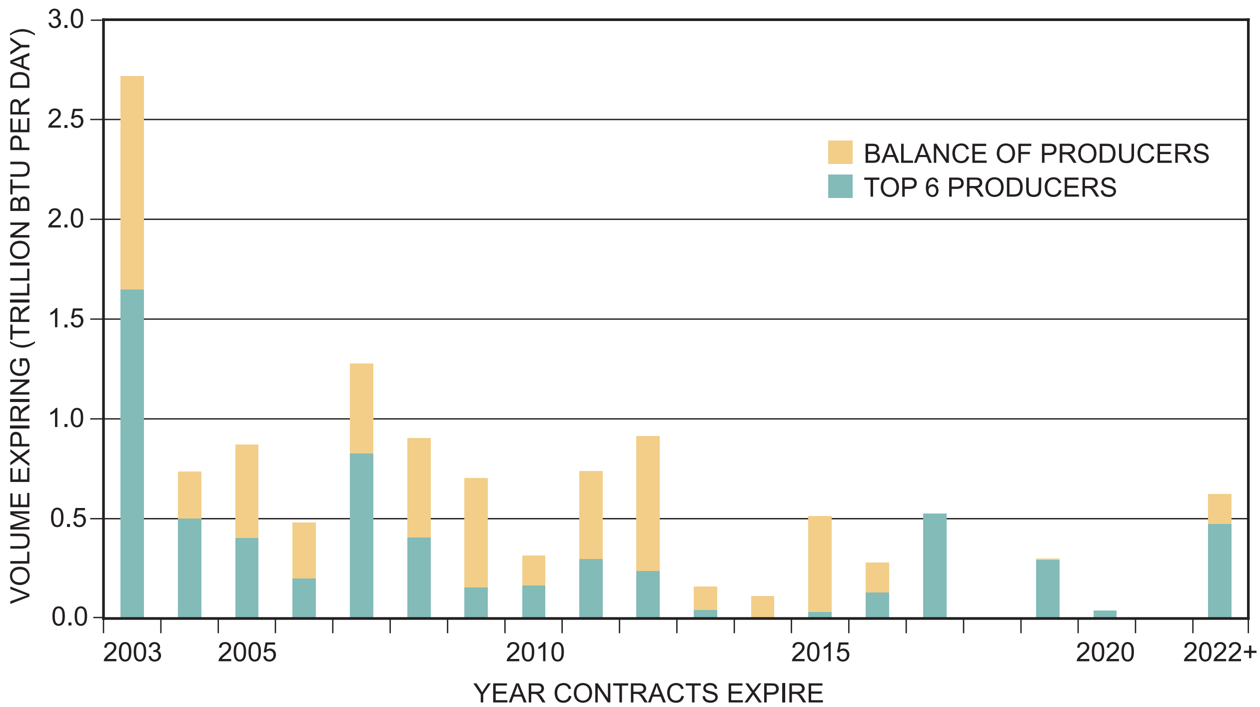


Figure T-13. Firm Contract Expiration by Year, Production Sector two northeast U.S. projects, take-away gas pipeline infrastructure will also need to be developed to link these resources to the pipeline grid. It is anticipated that LNG sellers will contract for these required infrastructure developments from the LNG terminals to major pipeline interconnects in order to ensure their supplies can reliably reach the consuming markets without hindrance or constraint, a continuation of their historical rationale.

The *LDC Sector* holds the largest amount of firm capacity of all the sectors discussed. Between 1998 and 2002, LDC firm capacity remained constant at 50 BCF/D. A key issue faced by the distribution and transmission industries in the next 5 years is the recontracting of existing LDC contracts for firm pipeline capacity as, during that period, 71% of all contracted LDC firm transportation capacity expires. This "termination window" is largely reflective of a similar picture during the gas unbundling initiative in the early 1990s, when large amounts of firm transportation were available for recontracting, but also results somewhat from more recent LDC choices to enter into shorter-term contracts. As some Public Utility Commissions (PUCs) discourage or will not support their entering into long-term contracts, the future level of longer-term LDC contracting is currently an unknown. Another principal factor that has limited LDC interest in longer-term contracts has been the advance of consumer choice programs, wherein residential and commercial customers can select their natural gas providers. Growth in these consumer choice programs is leveling off in many states, however, and in some cases retail marketers may have exited the business, causing a potential shift of consumers back to the LDC and/or the remaining marketers.

As part of the consumer competition process, states have had to specify which entity should provide service to high-risk customers or to customers whose supplier has failed to perform. Increasingly, state regulatory agencies are designating LDCs as the correct party to provide service to these customer classes, e.g. the provider of last resort (POLR). In some states, as a result of this POLR designation and the success they have had in retaining market share in spite of the advent of gas marketer competition, some LDCs are not expected to be as likely to reduce their overall firm transportation capacity requirements during the next several years. As the issue is fluid, however, LDCs facing these recontracting decisions may choose to only commit to short-term contracts to limit their exposure to continuing changes of rules and roles in their local competitive environment.

In this study, residential and commercial demand growth projections are relatively modest, at approximately 1% per annum. Consequently, LDCs are not expected to be contractors for significant new construction of firm pipeline transportation infrastructure, rather they will likely be candidates for additional storage services and related transportation capacity from storage to citygate.

3. Capacity Contracting Decisions

Market fundamentals, i.e. supply, demand, and resulting prices, will continue to signal the need for the construction of new pipeline capacity. For example, a production company which projects increasing supply volumes in an area of constrained pipeline capacity may have a need to subscribe to new capacity as a means of avoiding pipeline transportation curtailments and negative impacts to flowing gas. The ability of Cheyenne Plains to obtain contracts and move forward with additional infrastructure exiting the Rockies with a 2005 start-up, despite a belief by some that the very-recent 900 MMCF/D Kern River Expansion would provide ample capacity to transport supply away from the region, is a good example of other parties recognizing a continuing need for new pipeline infrastructure development and acting upon such.

Similarly, an LDC with increasing customer demand may have a need to solicit development of new infrastructure capacity. In both supply and market area developments, a decision to contract for new pipeline capacity may need to be considered and effected prior to the existence of an explicit price signal in the market, as many projects require years to plan, permit, and construct. Delaying expansion activities until explicit price signals materialize, or a sense of certainty can be determined, may fail to provide capacity when it is actually needed.

Besides the projection of future supply/demand constraints, a more obvious signal for pipeline transmission system development is a sustained increase in price between different geographic locations. A price differential between any two points is referred to as a locational "basis", or basis differential. Basis differentials may be higher or lower than a pipeline's maximum tariff rate, generally higher when capacity is fully utilized in an area or lower where surplus pipeline delivery capacity generally exists. The former, if sustained, may signal the need for new pipeline capacity and can create interest in pipeline expansions or new infrastructure construction. The large basis differentials between the Wyoming supply region and the Pacific Northwest, California, and Mid-Continent markets, which have recently exceeded $2.00 per MMBtu, signaled the need for new regional pipeline developments. Market participants have responded to this price signal with a commitment to long-term capacity contracts, thus leading to the expansion of Kern River Pipeline and the construction of the Cheyenne Plains and Bison pipeline systems.

Short-term basis differentials by themselves, however, are not a definitive signal of the need for infrastructure development. If there is excess supply available to a market, then market forces create significant pressure to reduce both the gas commodity cost and the price that shippers are willing to pay for transportation capacity (i.e., surplus). Given the seasonal nature of the gas market and the need to reliably serve winter peak demand, many pipeline systems are designed to have sustainable capacity above their average daily demand for much of the year. This results, then, in short-term daily pricing for transportation capacity that may be below the pipeline's maximum tariff rate for much of the year. Thus a basis differential that exists for a sustained period of time is more reflective of the value of long-term capacity contracts and is a better barometer for infrastructure investment decisions. In fact, long-term basis relationships are the principal metric utilized to determine the need to build pipeline capacity in the modeling efforts underlying this study.

For volumes of gas that producers or buyers determine they "must flow," the value of transportation can exceed the basis differential. The need for future reliable services explains why some pipeline projects can achieve the critical mass of contractual commitments necessary to support development of a greenfield system despite observed basis differentials that are less than the expected cost of transportation. Iroquois Pipeline and Maritimes and Northeast Pipeline in the northeast U.S. are examples of this type of project.

The price differential required for a project development signal to be recognized in the market is intricately tied to a convergence of many unique factors, including pipeline construction cost, the supply availability, and the expected market demand. In general, transportation cost per unit volume, both in terms of capital and operating costs, decreases as the capacity of the pipeline to be constructed increases, i.e., the economies of scale principle is applicable. For this reason there is a strong economic incentive to pursue development of a pipeline with a large capacity. However, the market frequently does not require high volume pipelines, even though they may be more economically efficient. As such, determining the project size that balances available supply and demand at rates competitive with potential shippers' alternatives is key to shipper participation, regulatory approval, and ultimate project success.

With such market forces at work, the negotiation for new capacity evolves into an ongoing discussion between producers, pipelines, and consumers, each of whom are balancing separate projections of the supply available and the growth in market demand. Not only are there cost and volume issues, but the timing of the pipeline start-up may also be a critical consideration. Usually, a number of "open seasons" or other marketing efforts are conducted by pipeline developers before a final decision is reached regarding the proper size and configuration of a pipeline project and binding agreements are signed.

For a major pipeline expansion or a new project, the maximum pipeline tariff or transportation rate is normally, but not necessarily, calculated using an annualized cost component and contract volumes. Thus, the applicable tariff rate is frequently the same in a low-demand month (April) as in a high-demand month (January). This non-varying cost for firm transport, when combined with large swings in seasonal market demand, can result in large variations in capacity utilization, citygate prices, and the realized market value of pipeline capacity.

This seasonal variability in the realized market values of pipeline capacity may increase its worth. The increased worth results from having the downside risk of holding capacity capped at the rate paid for the capacity while the upside value is not limited in today's market. Since the firm shipper has bought the right to call on the capacity at any time, the combination (capped costs, assured access, unlimited sales prices and observed price volatility) creates a potentially valuable option. Because gas prices are volatile, the same relationship holds true for monthly and daily price time intervals. In all three cases, the holder of transportation capacity has asymmetric risk with a fixed downside exposure and an uncapped but highly uncertain upside potential. Some market participants would like to "hold" this option; others would not. This option also has value in the secondary market for transportation and storage capacity that has developed. However, this opportunity is troublesome for some LDCs where regulatory barriers exist that impede them from contracting for capacity to serve their customers.

This basis volatility and associated financial exposure can increase the difficulty in obtaining a critical mass of binding agreements necessary to justify the construction of new pipeline capacity. Since each party may have its own projection of future basis value of capacity, its own view as to the "option" value of holding the capacity, and its own ideas of what other competitive options may be available, achieving the level of contractual commitments needed for project development can be time-consuming and difficult.

During the late 1990s, the difficulty in obtaining commitments from a sufficient number of parties with such diverse views was somewhat offset by the ability of shippers to purchase financial instruments, such as swaps, that provided a financial hedge for the potential basis risk associated with entering into a long-term capacity contract. For an additional fee, parties could execute financial transactions with third party entities that provided a form of insurance for all, or a portion of, its perceived forward, physical capacity position risk. Recently, however, the turmoil in the gas marketing sector has greatly reduced the availability and reliability of parties offering these "hedging instruments," thus a valuable tool which had previously assisted parties in making capacity contract decisions is no longer as readily available.

4. Timing of Responses

The response time or "lag" between the occurrence of a price signal, i.e. an increased price differential between two points, and the time at which a proposed project can gain sufficient commitments to go forward can vary significantly between one project and another. The extent of the lag will depend on the upstream supply expectations, the projections for market demand, the size of the basis differential, and the time period the basis has existed. In cases where a number of companies are in agreement that the basis is significant and lasting, the period between a project proposal and construction can be fairly short. In the case of the most recent Kern River Expansion, the developer held an open season in August 2000, filed for a FERC certificate in November 2000, made a final investment decision in March 2001, and was in commercial operations by May 2003.

One of the challenging problems in new pipeline project development is the fact that non-contracting parties on both ends of the pipeline system may ultimately benefit from new capacity construction because of the new infrastructure's impact on price and basis value. For example, all western Canadian producers benefited from the price increase that followed the development of the Alliance Pipeline, not just the producers who actually contracted for the capacity to Chicago. As is typical in a free market, there may be considerable jockeying among potential project shippers to contract for only the minimum (or no) amount of capacity while still having a pipeline project proceed. Pipelines, of course, must seek fairly large projects so that the benefits of scale can keep proposed costs and tariffs down. Since a perceived ideal position is to allow others to commit but to still be able to reap all or a portion of the benefits from a removal of a capacity constraint, gaining a critical mass of long-term commitments can be problematic for a pipeline developer. This is why some projects have multiple open-seasons, why competitive projects surface when previously announced projects appear to falter, and why some projects just don't proceed. This is typical of competitive markets at work, but can be very frustrating for pipeline developers and parties who desire to see such projects implemented. The Cheyenne Plains and Northeast ConneXion projects are both examples of projects that were marketed (and re-marketed) over the course of several years before a critical mass of shippers was finally assembled. The Cheyenne Plains system held three separate open seasons, beginning in 1999, before achieving sufficient contract commitments to justify the project in 2002.

New capacity projects can take years to develop when important consuming sectors are either inhibited or not motivated to sign long-term firm contracts. Merchant power generators, for example, may choose to not subscribe to firm contracts for all or a portion of their supply, as these important gas consumers may not believe a 24-hour, 365-day pipeline service is required, or the insurance value associated with capacity certainty is not cost-effective. Generators may also prefer, instead, to utilize released firm capacity or interruptible capacity if they perceive little financial exposure for reduced fuel reliability.

Over 128 GW of gas-fired capacity was built between 1998 and 2002; many of these facilities chose to not commit to firm pipeline transmission capacity. As such, a growing realization is that, in future years, as gas-fired generation demand increases, many combined cycle gas turbine plants may not reliably operate at their targeted annual utilization factor if additional firm pipeline capacity is not contracted. In addition, many merchant power companies are recently unable to contract for firm capacity on existing or new pipelines due to creditworthiness issues.

Another customer sector that may be disinclined to subscribe to long-term pipeline contracts is the LDC. Since LDCs have been the anchor tenants for most of the pipeline capacity constructed over the last seven decades, continuing market evolution and resultant regulatory policies may have created barriers to long-term capacity contracts that have impeded infrastructure investment. Historically, with an obligation to serve human needs customers, LDCs have maintained a level of pipeline capacity to do such. In the unbundled environment today, certain service requirements are still mandated. Where applicable, regulatory bodies must ensure that providers of last resort (POLR) or other entities providing service to human needs customers – whether gas or electricity – are allowed to make pipeline capacity commitments necessary for long-term service reliability.

Contractual commitments by various parties are critical to the expansion of the pipeline network. However, as different approaches to pipeline contracting are evolving in a changing gas marketplace, there appears to be a new paradigm evolving in contracting practices. First of all, contracts appear to be of shorter term. Second, it is becoming increasingly difficult for pipelines to contract the middle portion of a transportation path. A producer may elect to contract for pipeline capacity only as far downstream as the first unconstrained point, while some LDCs, on the other hand, may choose, or must choose, to only contract for capacity from the citygate to the nearest upstream liquid market point. These points are usually located within a market area, which may be located hundreds of miles from a supply region.

This trend creates a bifurcation in the pipeline capacity market. This "gap in the middle" is an anomaly of the current natural gas marketplace; this dilemma will affect the decisions of pipeline operators concerning the creation of new capacity and sustaining the existing capacity levels between the supply and market regions. Left to itself, the natural gas industry will find equilibrium. Clearly, however, governmental policies should not inhibit the ability of LDCs and POLRs to extend their contracts into the supply regions.

5. Financing Construction

Interstate pipelines have regulated rates of return that are reviewed and approved by the Federal Energy Regulatory Commission (FERC). The allowed rates of return on the capital employed in a project are established in large part by determining the pipeline developer's cost of capital, i.e., its costs of debt and an industry proxy group's observed cost of equity. Historically, most of the capital raised for new pipeline construction has been in the form of debt, as debt costs less than equity. Although a high debt load can increase the risk of default, in the past this risk has been offset by the revenues coming from long-term firm capacity contracts. In the current economic environment in the United States, however, debt (both existing and new) is no longer considered as attractive. Instead, the investment community has emphasized a new focus on reducing corporate debt. The natural gas pipeline industry is not immune to this type of financial pressure, thus new projects will have to be carefully analyzed and structured before additional debt is taken onto the corporate balance sheet.

The willingness of creditworthy shippers to subscribe to long-term capacity contracts has allowed a number of pipelines to be constructed utilizing project-based financing, instead of general corporate debt. Project financing allows for non-recourse debt, which does not impair the balance sheet of the parent company. This financing approach allows capital to be raised more quickly, and usually at lower cost, than issuing general corporate debt. However, the trend to shorter-term contracts by capacity holders (as discussed above) has somewhat reduced the ability of pipelines to use this method of obtaining expansion capital, as lenders want to match the lengths of contracts (with creditworthy shippers) with the proposed project's loan repayment period, which in the case of new pipelines is typically fifteen to twenty years. With a trend towards shorter-term contracts, there is a fundamental mismatch between the expectations of capacity subscribers and pipeline lenders that must be resolved if project financing is to be a primary vehicle for obtaining capital in the future.

Parties that have not traditionally owned interstate pipelines, including producers and LDC consortia, have recently shown an interest in developing such systems. The focus of producers has generally been the construction of systems to transport gas from constrained supply regions. The Alliance, Maritimes and Northeast, and Destin pipelines are good examples of this type of producer-led development. Similarly, consortia of LDCs have successfully developed short-haul pipelines within the market regions, again focusing on the de-bottlenecking of existing area constraints. Examples of LDC consortia projects include the Iroquois, Vector, and Guardian pipelines. The active involvement of producers and LDCs in the construction of new pipelines has been very beneficial to the industry, especially during the last ten-year period.

Capital-in-aid-of-construction (CIAC) has been used for years to finance laterals linking new supply and/or markets to the existing interstate network. A shipper provides the capital for construction in return for transportation services. Both parties benefit as the pipeline company is able to conserve capital while the shipper obtains the desired service. Similar to this method is a customer "self-build." In a self-build, the customer builds its own lateral to the connection with the interstate pipeline. In this case, the customer may continue to own the lateral or, with appropriate regulatory approval, they may cede ownership to the pipeline. Although both approaches facilitate the construction of laterals for segments as much as fifty miles in length, they are inadequate for the construction of larger pipeline extensions. This is because longer distances and the inclusion of multiple shippers may subject the builder to regulation by federal and/or state authorities.

D. Construction Challenges

1. Project Approval

Initial pipeline route selection and surveys are conducted by the pipeline company that is developing the project. Environmental, safety, population density, operational, and construction cost concerns are all considered in helping to determine the preliminary routing of the pipeline for further field surveys and submittal of the route to the reviewing authorities, public comment, and approval.

The project routing selection involves the review of aerial photographs, soils maps, population density surveys, and future land usage maps. The process includes the input from many diverse groups, which affect the timing of final route selection, length of the route, and ultimate cost.

Regulatory approval of pipeline proposals involves agency reviews at the federal, state and local levels. Review levels and procedures by agencies vary significantly from state-to-state with the only common review level and approach occurring at the federal agency level. Where multiple-level agency reviews exist, approval of pipeline projects can sometimes be delayed by certain lower-tiered agencies. Examples of review and approval durations range from 6 months to 42 months, depending upon the number of agency approvals and complexity of the project. FERC has been making great strides in improving the time for approval, but many times, the project is held up by some other agency even after FERC has issued a certificate. These delays in project approvals can be a significant driver of project cost increases. Also, as projects are increasingly delayed, prospective customers may begin to look for alternatives and ultimately terminate their agreements, with such withdrawals sometimes causing entire projects to collapse.

Previous discussions between the industry and the federal government on the difficulties in coordinating a pipeline project among the various federal agencies led to a Memorandum of Understanding (MOU) in 2002. This MOU established a framework for early cooperation and participation among "participating agencies" to enhance the coordination of the regulatory processes through which their environmental and historic preservation activities could occur. Review responsibilities under the National Environmental Policy Act of 1969 are met in connection with the FERC authorizations that are required to construct and operate interstate natural gas pipelines. Among the participating agencies are the U.S. Army Corps of Engineers, U.S. Forest Service, National Fisheries, Land and Minerals Management, U.S. Department of the Interior, U.S. Department of Transportation, Advisory Council on Historic Preservation, FERC, Council on Environmental Quality, and the U.S. Environmental Protection Agency.

The National Environmental Policy Act requires federal agencies to evaluate the environmental impact of major federal actions significantly affecting the quality of the human environment. The MOU encourages early involvement with the public and relevant government agencies in project development to foster a process to facilitate the timely development of needed natural gas pipeline projects. The agencies are to work together and, with applicants and other stakeholders as appropriate, identify and resolve issues as quickly as possible, attempt to build an early consensus among governmental agencies and stakeholders, and expedite the environmental permitting and review for natural gas pipeline projects.

The chair of the White House Council on Environmental Quality has stated that the new procedure will improve coordination and speed up natural gas pipelines that currently encounter years of environmental reviews by various federal agencies. The extension and full integration of this type of coordination to the state level will also be required, however, before genuine progress can be made.

Further progress could be made by developing a Joint Agency Review Process that would coordinate activities between federal, state and local agencies. A lead agency (perhaps FERC) could be assigned the authority to complete the review/approval in a timely manner, while meeting the concerns of all agencies and stakeholders. In order to be effective, this process should be the "governing" process, i.e., not to be further limited or delayed when approvals have been received to proceed from other responsible agencies. The areas of greatest concern in this regard are requirements of the U.S. Army Corps of Engineers, Coastal Zone Management Act, and Section 401 of the Clean Water Act, all of which could hinder the orderly implementation of FERC certificates. One example of this concern is the escalating use of the Coastal Zone Management Act to delay pipeline progress as exemplified by the serious delays currently experienced by the Millenium and Islander East Pipelines.

The recent FERC emphasis in the United States is to identify key stakeholders early and involve them in the process at the outset of a proposed project. An effective approval process allows third parties to become involved during designated comment periods. In these designated comment periods, external stakeholders, such as landowners or other special interest groups, are given the opportunity to voice any concerns with the pipeline route. Delays in project approval and increased costs can occur when external stakeholders come forward with significant changes in the proposed pipeline route, but this is a necessary part of the review process. FERC is required to accept and reasonably address all stakeholder comments, and thus can ask the pipeline company to research and possibly resurvey each proposed route change, involving both civil and environmental surveys, which can result in significant project delays and unanticipated cost overruns. The Joint Panel Review Process would minimize these inefficiencies, as the process should, via significant upfront participation, agree upon a route or options thereto which can uniquely be investigated.

2. Construction Issues

In addition to interventions in the approval process, delays can arise from stipulations in the approval with regard to construction issues, such as short time windows for laying pipe, work space limitations in certain areas, or mandated construction methods. The limited time periods or "construction windows" are frequently required by various state and federal agencies and can add significant costs and delays during construction of a pipeline project. Construction windows are typically imposed by environmental agencies to restrict construction activities through habitat areas or at water crossings to specific days or months of the year. These restrictions require careful planning of construction timing and implementation, and even then weather conditions or other unanticipated delays (labor, materials, etc.) during the construction window can make it difficult to complete the work during the allotted time period. If a project is delayed past the end of the construction window, then the operator may have to wait until the opening of the next window (and this could be up to a year later) to complete the project, often at substantial additional cost to the project.

Environmental agencies can also require pipeline companies to limit the width of pipeline construction rights-of-way to reduce tree clearing or other earth disturbances. Such restrictions can require hauling off of ditch spoil during pipeline installation. In some of these cases the pipeline must then be installed by stovepiping the pipeline at the location (welding one or two pipe joints at a time and then burying them as you go – a very tedious process) or by welding a portion of the pipe at a more accessible offsite location and hauling it along the right-of-way with large equipment called "side booms." These construction requirements due to work space limits will increase project costs substantially. These are, of course, further complicated and magnified, if construction windows are involved.

Mandated construction techniques often occur when pipelines have to cross water bodies, wetland areas, or major roadways. Environmental agencies, either state or federal, can order the use of special techniques, which can include horizontal directional drilling (HDD), special top-soil separation, and use of wood mats in wetland soils. Horizontal directional drilling of water crossings can prevent disturbance of plant and fishery species, but represent a risk of not completing the crossing (by failure of the drilled hole or stuck pipe during pull-back operations) and adds cost to the project. HDDs can add in the range of $200 to $1,000 per foot in additional costs to the length of pipe. In some instances additional HDDs are being required as an environmental mitigation tool, such as requiring them at small creeks and rivers where conventional crossing methods might have been used historically. Use of mats at wetland locations can add an additional $50 to $100 per foot to the pipeline costs in areas where they are used.

Environmental agencies can also require offsite "mitigation" in wetlands construction. Frequently the mitigation involves obtaining environmental credits or may involve mitigation by compensation. The purchase of property for offsite mitigation can add substantial delays and costs to the project. In many cases, the agency will not sign-off on construction approvals until the property identified for mitigation has been purchased. Delays occur since the pipeline company has to search for suitable acreage for mitigation, obtain necessary clearances for the mitigation site, and then complete the purchase of the land. With the high level of mitigation ratios (two to one is common and five to one occurs), as well as having to establish the mitigation site for long-term, pristine land use quality requirements, mitigation lands can be very expensive to purchase.

3. Post-Construction Monitoring and Operating

Development responsibilities can extend beyond the actual construction period with the increasing requirements for ongoing monitoring and repairing the pipeline corridor. Environmental agencies are now requiring pipeline companies to develop and implement a long-term monitoring program to monitor, document and correct/repair pipeline corridor restoration. Examples of current FERC and/or state standards include: a) Uplands – monitored for the first growing season and the second, if necessary, and b) Wetlands – no full width clearing; a ten-foot wide corridor over the pipeline to be maintained in an herbaceous state; and clearing only within a limited distance of the pipeline.

Inadequate or damaged pipeline corridor restoration/mitigation must be repaired or replaced to original pre-permit conditions. This ongoing monitoring and repair program can add significant costs to the project depending upon environmental sensitivity of the lands, streams and rivers crossed.

An implementation barrier involves issues related to usage of equipment such as compressors and meter regulator stations. This type of equipment must be monitored for environmental emissions such as NOx and noise. The monitoring of these levels necessitates the installation of additional monitoring equipment, sound-proofing, etc., and/or might limit the use of the equipment such as the number of run-time hours per month (or year) or prohibitions against running of the equipment at night.

4. Private Parties

Besides managing its interactions with state and federal agencies, the pipeline industry must also coordinate its relations with private parties. The FERC has conducted several seminars and prepared a document outlining their desire for more early involvement by all stakeholders in the FERC approval process. FERC encourages pipeline companies to seek out greater involvement from the various groups early in the planning process so those who are interested can participate in the decision-making process. Agencies (local, state and federal) and citizens are encouraged to get involved early and make their views known to the project sponsors. FERC's view is that earlier and more-productive involvement will lead to better project designs and less-contentious FERC and other agency processes.

At times, however, a pipeline's best efforts to negotiate rights-of-way agreements with outside parties are simply unsuccessful. In areas where there is no viable alternate route, the Congress has allowed for the use of eminent domain proceedings. Eminent domain is the legal process whereby a pipeline or utility company can obtain property rights or an easement to a route and install the pipeline on an objecting landowner's property. This process is avoided as much as possible by all pipeline and utility companies, as the cooperation by company and landowner is in everyone's best interest for both the short and long term. If the pipeline company and landowner can not agree upon a route or settlement cost for a property easement, then a federal or state court can determine and provide a lawful settlement payment amount to the landowner and thus secure the easement for the pipeline company.

A special case of where even the eminent domain principle is at issue involves the lands of First Nations people. Routing of pipelines through regions of aboriginal lands must include an extensive plan which incorporates the deep concerns that the indigenous people have for the land which the proposed pipeline will transverse. Community inclusion of the First Nation peoples in pipeline routing, environmental studies and monitoring of construction activity is standard practice. However, the complexity and detail of this overall process can upwardly impact project costs and may be a source of timing delay in getting final project and/or construction approvals.

5. Typical and Extreme Timelines

The typical project timeline for a major interstate pipeline project with an Environmental Assessment (EA) that is filed under an FERC 7 (c) certificate is normally 12 to 20 months from project initiation to the reception of the FERC authorization to construct. The typical project timeline for a FERC 7 (c) filing for a major project requiring an Environmental Impact Statement (EIS) from project initiation to FERC authorization to construct, is normally 18 to 24 months.

Once permits are obtained and land is acquired, most U.S. pipeline construction projects are typically constructed in one calendar year or construction season. In some cases, directional drills for river crossings may be completed prior to the start of cross-country pipeline work and may be a regulatory requirement to be completed before the full authorization to construct is issued by the FERC. Projects that transverse through areas with issues such as endangered species, high-population-density areas, historic artifacts, noise mitigation, and safety concerns require 6 to 18 months beyond a more typical project timeline.

6. Cost Trends

One clear trend in pipeline construction in both the United States and Canada is for the continuing escalation of costs. Costs have been increasing about 3 to 4% per year, above the projected 1.5% annual rate used in the study. Materials costs do not play a part in this escalation as they are generally aligned with the raw materials costs, which have not increased significantly in recent years. Pipeline developers are attempting to offset this trend to higher costs by using stronger steels, which allow for higher operating pressure and greater volumetric flow, as well as more efficient pipeline laying techniques. Contractors generally have become more efficient at installing pipelines by using high productivity processes such as automatic welding, but these savings have been more than offset with increased labor costs. Though the rising costs associated with new construction are somewhat of a barrier to infrastructure development, the modest nature of the overall cost increase is not expected to necessarily make required infrastructure projects uneconomic.

E. Operational Challenges for Infrastructure

If all the flows entering and exiting a pipeline were constant in nature, then it would be a relatively easy system to operate. Operators could set the compressors along the system to calculated levels and the pipeline would be “balanced” thereafter. This is called a “static” system in engineering and unfortunately it is not reflective of events in the natural gas industry.

Instead, natural gas transmission pipelines are dynamic systems with conditions constantly varying at large numbers of receipt and delivery points. Existing natural gas wells experience mechanical problems, freeze offs, and production declines that change deliveries into the system. At the same time, new gas wells are added and consumers vary their demand according to temperatures, industrial processes, and electric generation needs. The throughput capacity of a system thus varies with the amounts of gas entering and exiting the system, the pressures at each inlet and exit point, and the locations of these supply and demand points, particularly with regard to compressor stations. For traditional long-haul transmission systems, these compressor stations are installed at roughly 40 to 80 mile intervals and are used to overcome the pressure loss within the pipeline due to friction of the moving gas against the wall of the pipe.

1. Gas Delivery Variations

Within the dynamic system described above, there are three major consumption cycles that affect the transmission industry. The first is a seasonal variation of demand, from winter to summer. The second cycle is a demand variation within a season or a month. The last is the change in hourly consumption during a daily cycle.

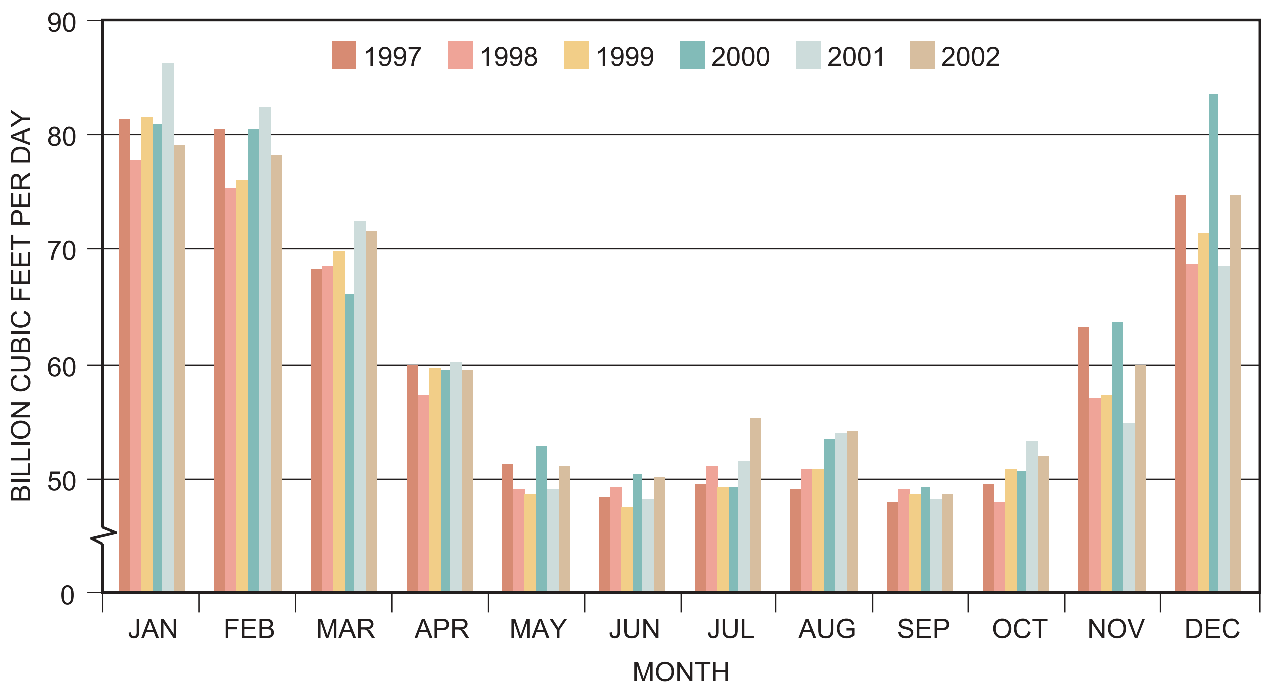
The seasonal variation exists largely due to consumption within the residential and commercial (R&C) demand segments. A large component of annual natural gas demand in the United States, approximately 36%, is for residential and commercial consumers. These consumers rely on natural gas for space heating, water heating, cooking, and other purposes. The first component, space heating, comprises approximately 70% of the R&C load, or 25% of total U.S. annual consumption of natural gas. Consumption for space heating, however, is closely tied to the winter heating season. Thus approximately 50% of natural gas consumption occurs during the five winter heating months, November through March. Figure T-14 shows the strong seasonal nature of natural gas consumption in the United States; Figure T-15 indicates the impact of residential consumption on the national total.

a. Seasonal Flow Design

Given the strong variation in seasonal demand, the industry has found it economic to use storage fields to manage the large differences between winter and summer consumption. Storage is discussed in more detail later in this chapter, but traditionally, and in large part still today, gas is injected into the storage reservoirs in summer and withdrawn in winter. This allows pipelines and wellhead production to operate at a more consistent and more efficient annual level.

As part of the industry's drive for economic efficiency, transmission lines connected to market area storage fields (in California, the Midwest, and western Mid-Atlantic) have often been constructed for different capacity levels from the supply areas to the storage fields than from the storage fields to the markets. The segment from supply to storage is typically designed based on average-day levels while that from storage to the market is based on a peak-day requirement. This design recognizes that storage withdrawals must be incremental to flowing supply and could potentially inhibit long-haul transport from the supply regions unless capacity downstream (on the market side) of storage was increased. It also allows the market to efficiently value the options between making an investment in storage and short-haul transportation versus the development of long-haul capacity directly from a supply region.

This dual capacity system on the upstream (production) and downstream (market) sides of storage has



Source: Energy Information Administration.

Figure T-14. Monthly Consumption Data

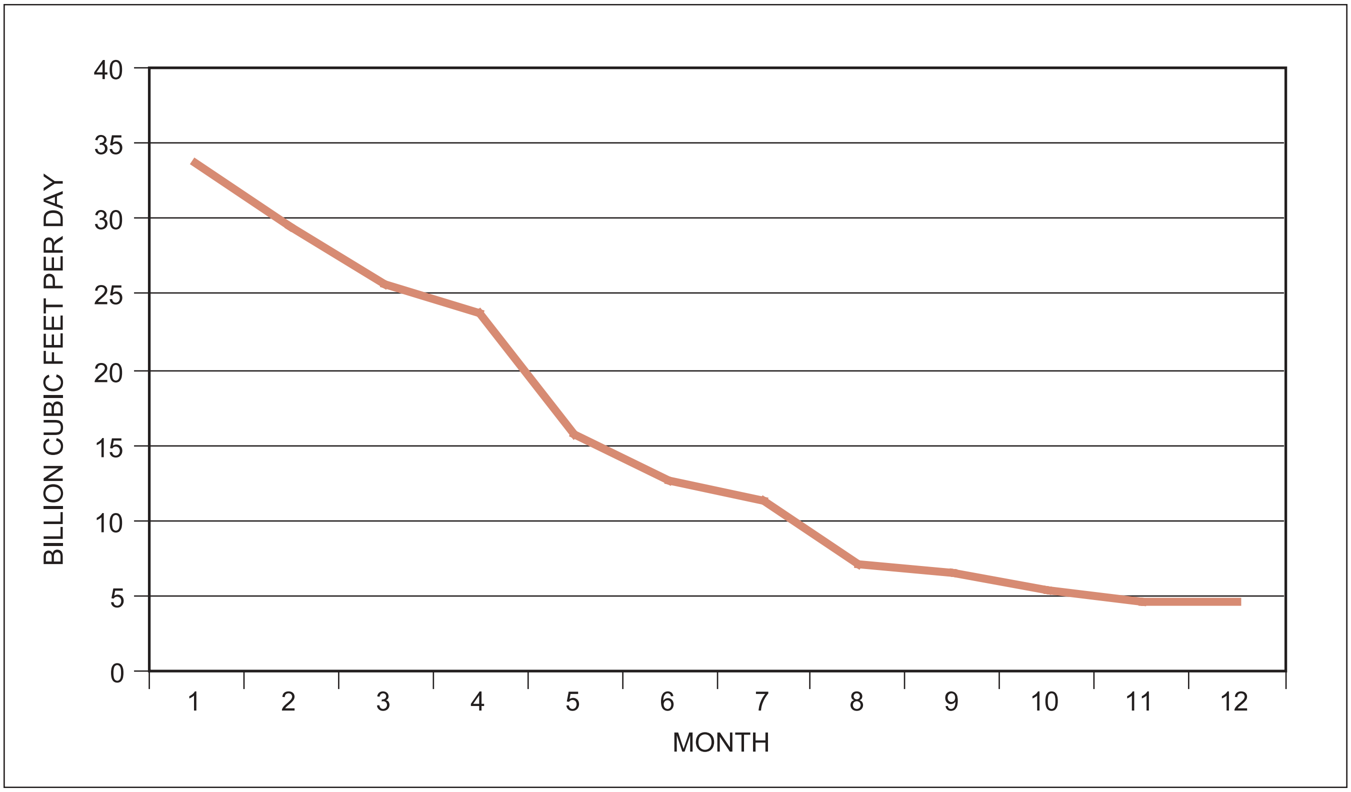


Figure T-15. U.S. Residential Demand in 2001 by Month, Sorted Highest to Lowest

worked well for many decades. The growing utilization of natural gas-fired turbines in the electric generation market is raising concerns about the effect on the summer pipeline and storage capacity usage, however. What used to be a weaker demand period for gas supply and the pipeline transmission network in the summer months is now growing rapidly stronger as gas-fired generation is used to meet air conditioning cooling demand. As summer cooling demands continue to rise over the next 25 years, the increased call on pipeline transmission capacity during the summer by electric generation will reduce the industry's ability to inject proper seasonal volumes into storage. The resulting competition for capacity on pipeline segments designed for average-day use should therefore raise overall pipeline utilization factors (actual flow/designed capacity) and associated transportation revenues. However, there may be additional expense, e.g. compressor fuel, as the pipeline and storage infrastructure must be more dynamic and more time-of-day responsive.

Pipelines are not designed for "needle" peaks in winter. Storage has not only been used to meet seasonal needs, it has also been used to meet short-term market demand. Storage allows pipelines to "draft and pack" ahead of projected demand increases, e.g. pulling in additional supplies from storage and increasing system linepack ahead of a weather front. With the serving pipeline packing-up first, LDCs and other consumers can be assured of the necessary pressures to support subsequent packing of their systems.

In the case of peak-day local markets, i.e. behind the citygate, storage may be typically required from liquefied natural gas and propane-air facilities. These types of storage are much more expensive than those used for seasonal storage but still are less costly than long-haul transmission infrastructure supporting a peak-day delivery. The demand curve moves sharply higher and almost becomes asymptotic during brief periods of high market demand. Constructing expensive transmission infrastructure that would be used for such a short time duration is not cost effective and storage alternatives, LNG and propane-air, are used instead.

Even the use of localized peaking storage does not completely shield transmission systems from the effects of a peak market demand. In these periods, pipeline customers fill their demands simultaneously with consumption need, often nominating and supplying the gas after the fact. Pipelines may thus experience high short-term drawdowns in system linepack as a result of these peak demand events and storage can subsequently help restore the linepack to acceptable levels. Alternatively, perhaps as a result of a sudden warming trend, pipelines can also experience periods where customers undertake their flowing supply. In this case, linepack increases, thus increasing system pressure, potentially to dangerous levels. In this case, pipelines must inject gas into storage, encourage customers to take their contractual quantities, or reduce supply inputs to the system.

Linepack thus operates analogously to a spring, extending out when demand is high and compressing in when demand is low. When the normal level of linepack has been substantially lowered, it may be refilled through storage withdrawals. But since storage is also heavily used during periods of peak demand, a replacement of these linepack volumes usually occurs soon after the peaking event, not during the actual period of high demand. Thus to maintain a safe pressure balance, pipelines draw upon available storage as needed to restore linepack. Due to limited ownership of equity storage (a result of the FERC-ordered unbundling in the early deregulation period of the natural gas industry) pipelines frequently have to temporarily use third-party storage resources for this limited purpose. The no-notice delivery capability and system balancing function between hourly peaks and daily demands are important system management services performed by pipelines.

b. Intra-Day Markets

One of the issues of increasing importance in the dynamics of the pipeline transmission system evolves from the intra-day market. The market demand during the course of the day can vary considerably due to residential, industrial, and electric generation consumption. Many homeowners, for instance, turn down their thermostats at night only to raise them during the day. LDCs like to "pack up" their systems prior to a cold period, anticipating higher consumption from their customers. A significant number of industrial firms have a larger demand during the daytime hours than the night hours as well. In addition, power plants may want to burn large quantities of gas for the sixteen peak hours of their operating day, while burning much smaller quantities in the overnight period.

Demand from gas turbine electric generators is a significant and growing portion of the swing in the pipeline intra-day demand. Gas turbine and CCGT plants are significantly more efficient than the natural gas or oil fired steam generators they were designed to replace, with CCGT units having a heat rate of about 7,000 MMBtu per kilowatt/hour (kWh) vs 11,000 MMBtu per kWh for steam facilities. The lower heat rate therefore provides a more efficient electricity output. Based on this superior efficiency, CCGT plants will generally be chosen to produce (or dispatch) electricity before their steam-fired plant counterparts and will also stay online longer. When comparing these CCGT units to other plants using alternate fuels, however, the comparison becomes more complex. CCGTs are, overall, more efficient than coal-fired plants but the latter are generally used as electric baseload units (first called in an electric dispatch sequence) generators due to a lower per unit cost of coal relative to natural gas. However, due to their poor performance at cycling on-and-off to follow the electric day demand profile, they must generally continue to operate even in the evening hours at a reduced rate, even though less-efficient, in order to realize the overall benefits of their lower fuel cost. Similarly, nuclear plants are generally electric baseload units because their marginal operating cost is very low, also giving them an advantage over CCGT units for baseload generation applications.

Hydro-generation has a "free" source of fuel (water) but the usage of these units varies somewhat by region. In the western United States, especially the Pacific Northwest, the water containment reservoirs are very large and the plants habitually operate as electric baseload generators. In this region, however, a low winter snowfall may reduce overall water supplies available in the subsequent summer season. This lower water availability may cause the hydro-generating electric capacity to be lowered in order to ensure that reservoirs are not decreased ahead of disciplined water management schedules. If this type of hydro-generation restriction is encountered, the electricity shortfall is typically covered by increased generation at regional gas-fired plants.

In the East, the water containment areas tend to be smaller and their usage shifts to intermediate and peaking electric operation. This region, too, may be impacted by lower than normal snowfall and rainfall.

Another regional variation occurs in the Gulf Coast where gas-fired facilities are extensively used for electric baseload generation. This region provides over

50% of the lower-48 production of natural gas supply and the short distance for pipeline transmission results in a low transportation cost. For this reason, gas-fired generation has been a preferred method in this area for many years.

Though regions differ, this use of gas fired facilities for electricity peaking can cause dramatic changes in natural gas consumption. A single 500 megawatt CCGT plant can burn 90,000 MMBtu per day or 3,800 MMBtu per hour. If a market area pipeline has a total daily delivery capacity of 1 to 2 BCF/D (Tennessee Gas Pipeline in New England or Florida Gas Transmission in South Florida, for example), then a single generation plant turned on to meet afternoon demand can raise consumption on a market area pipeline by 4-9%. The afternoon electric generation demands are thus not easily balanced due to the operating characteristics of a pipeline. The electric market has a profile driven by its electricity consumers and requires an instantaneous response while a pipeline operates best on a steady, ratable 24-hour flow. Pipeline operators, then, must deal with this growing mismatch between electric load characteristics and gas pipeline facility design using the infrastructure they have. A more flexible infrastructure would allow a more effective and more efficient response to these needs; unfortunately, capital expense would be required to accommodate such, as well as necessary filings for tariff service modifications.

It is noteworthy that the electric and natural gas transportation markets have differing cost structures. The electric generation market is priced on baseload, intermediate, peaking, thirty-minute and five-minute intervals. Most pipeline tariffs, on the other hand, are based on an expected, even 24-hour offtake. Several pipelines have offered tariff services based on a 16-hour take, such as Northern Natural Gas (NNG), Natural Gas Pipeline (NGPL) and Southern Natural Gas (SNG), and two are even experimenting with hourly charges. Thus, there is a price opportunity variance between what an electric generator is earning and what a pipeline operator receives for the hourly swing service it is providing; this is often referred to as the "spark spread". Such a price opportunity difference may serve to exacerbate the swing as generators attempt to capture as much of the "opportunity" as possible. Unfortunately, these types of actions may degrade service to other customers, so pipelines may have to notify generators to reduce their offtake.

Another type of system balancing problem occurs due to demand variation, i.e. swing. Customers are involved in a dynamic market and generally cannot specify their needs with precision. In today's pipeline transmission industry, customers nominate, confirm, and schedule their anticipated supply and pipeline transmission requirements a day before their actual usage. The day-ahead scheduling allows supply operators to direct their supply into pipelines at the proper quantities and for pipeline operators to predict the pipeline capacity and compression required to move a myriad of supply volumes to their desired delivery points.

The inability to predict demand with precision is especially true for residential and electric generation customers. Since electric generators must meet swing requirements of residential electric customers also, the two largest sources of pipeline swing demand are closely interrelated. Most large consumers use historical data or predictive models to aid in their daily nomination requests. Reality, however, always differs from prediction and consumers are forced to use intra-day nominations and post-consumption balancing to meet their actual demand. Since each consumer's reaction to its actual market demand affects the pipeline's overall effective capacity, there is a continual effort to balance the pipeline system.

The difficulty involved in making accurate predictions of intra-day demand has caused the industry to balance accounts after the actual consumption. Customers may be forced to "take" gas and balance after the fact, i.e., a no-notice service requirement. In normal operating situations this works well since consumers taking more than their nominated demand may be largely offset by consumers taking less than their nominated volumes. For peak-day consumption, however, many (and perhaps most) consumers may be trying to take more than their nominated volumes. In this case, pipeline storage and/or peaking storage is crucial to keep pipeline systems operating.

It is worth noting that a sudden loss in demand may also cause problems for pipeline operators. If intra-day demand becomes much less than that nominated for supply, the pipeline has too much gas entering the system, which may lead to an increase in operating pressure and begin to approach unsafe operational limits. In this case, pipeline operators must inject gas into storage, request all customers attempt to take their nominated deliveries, and possibly restrict inlet supply flows.

2. Gas Supply Variations

Beyond the difficulty in balancing demand, pipelines must also deal with rapid variations in supply. Field production is itself highly variable, due to mechanical problems, processing plant interruptions, freeze offs, hurricane shutdowns, etc., and this causes pressure swings which affect pipeline capacity and throughput. Individual wells experience declines in production that can range from 2% to over 50% per year. This production decline can quickly change the pattern of inflows to a pipeline system, with new wells in a one location perhaps offsetting or replacing declines in another. The change in the pattern of supply receipt, both the locations and pressure, may significantly affect resultant pipeline capacity.

The effect of the variation in supply location on pipeline throughput capacity can be best demonstrated by the means of a simple example. Imagine a pipeline composed of the following: Supply flows in at the southern end of the pipeline at Point A, followed by a market at Point B, followed by another supply inlet at Point C, and completing with a market at Point D at the northern end of the system. If production at Point C is steadily reduced due to natural declines of the wells while Production at Point A steadily increased due to the addition of new wells, then the ability of the pipeline to deliver gas to Markets B and D may be reduced.

Transmission systems must deal with rapid changes in production, sometimes on a daily level. These changes can be caused by hurricane shut-ins when coastal and offshore production areas are threatened by violent storms, or by freeze-offs when very-cold temperatures cause water in natural gas streams to form ice, which can restrict or completely block production valves.

Because of these dynamics, which are often beyond the control of suppliers and offtakers, pipelines now offer tariffed swing services to provide customers with daily balancing mechanisms. As part of these offerings, many pipelines take on the responsibility of utilizing storage, linepack, and other mechanisms to balance any short-term mismatch in supply and demand. The pipeline is well-positioned to perform these services in a cost-efficient manner due to its ability to review and react to aggregate supply inflows and demand outflows across its entire system. The pipeline thus "sees the entire picture" of the system flow movements and is generally able to react to disruptions ahead of a serious problem.

3. Pressure and Gas Quality Issues

One of the services provided by interstate pipeline systems is the provision of pressure. In order to efficiently move gas, most pipelines in the interstate transmission grid were designed to operate at a maximum of 800 to 1,200 psi (pounds per square inch), as compared to normal atmospheric pressure of 14.7 psi. Newer pipelines have been designed to operate at pressures of 1,200 to 1,800 psi using thicker-walled pipe to withstand these higher pressures.

Customers frequently benefit from these high pressures. LDCs, for instance, use 100 to 400 psi for their distribution system mainlines. They can thus avoid the expense of compression for the portions of their system connected directly to interstate transmission facilities.

Electric generators also receive significant benefits from the provision of high-pressure gas. The new gas turbines, which comprise over 90% of electric generation plants constructed over the last four years, require pressure at 450 to 650 psi to operate efficiently. If these plants are not connected to high-pressure interstate, intrastate or LDC transmission facilities, they may have to install local compression to raise the pressure of their natural gas receipts to the required level at a substantial incremental operating and capital cost.

Besides pressure, another common factor affecting pipeline transmission customers is gas quality, sometimes called gas interchangeability. Natural gas from different supply sources can be composed of different percentages of gases that are produced in conjunction with methane. Gases without heating value, such as carbon dioxide and nitrogen, are subject to strict limits in receipt areas and gas volumes exceeding these levels can be restricted from pipeline access. Non-methane gases with heating value, such as ethane and propane, are often allowed into the transmission gas stream under looser constraints, as they are often removed from the gas stream at area processing plants. This gas quality "conditioning" involves the use of processing plants to remove high Btu content gases, such as propane and butane. The removed natural gas liquids (NGLs) are then frequently used as feedstock for the petrochemical industry. Since propane and butane are considered to have higher values as petrochemical feedstocks than heating gases, they are typically processed out of the gas streams in the supply regions.

In general, pipelines limit these non-methane gases by the heating value of the combined gases. The heating value is measured in terms of millions of British Thermal Units (Btus) where a Btu is defined as the energy required to raise the temperature of one pound of water by one degree Fahrenheit.

Due to different operating conditions, pipelines may vary their upper heating limit to different levels. In general, however, the upper limit in supply areas (1,150 Btu per cubic foot of gas) is higher than that of market regions (1,100 Btu per cubic foot of gas). Typical market area levels of Btu content range from 1,020 to 1,080 Btu per cubic foot.

One concern relative to gas quality is that different levels of Btu content per volume can lead to poor combustion characteristics. The variance in gas quality, with Btu levels either higher or lower than the level for which the burner is set, can cause poor, inefficient combustion, which increases the production of pollutants such as nitrogen oxide, carbon dioxide, and carbon monoxide. There is legitimate concern, therefore, about allowing gas with improper Btu limits to enter the pipeline system.

Poor combustion characteristics may also lower the efficiency of many gas-fired generation units, and this is an important issue for industrial firms and electric generators. When a sustained change in Btu content occurs, industrial and electric generators may be able to retune their combustion chambers adapt to the new gas quality. However, the tuning of combustion chambers and controls to a new gas quality level can be time consuming and the time spent in the tuning process may lead to a short-term loss in efficiency and/or product output. For these reasons, and more, even these large-scale consumers do not want to see rapid or continuously varying fluctuations in heat content, as that would have them constantly resetting their combustion chambers.

A second concern relative to gas quality is that potential liquid fallout from higher Btu gas degrades capacity performance and raises maintenance and safety issues. The main concern for pipelines is not strictly a varying level of heating content but the potential for liquid fallout within the pipeline system. Some of the higher-level hydrocarbon gases, pentanes and higher, will become liquids at lower pressure and temperature levels. A rapid pressure drawdown on the pipeline, perhaps due to a demand swing or a major pressure reduction at a valve, can cause this liquid fallout to occur. The presence of liquids in the pipeline can cause problems during compression, when delivering to customer facilities, and can also lead to corrosion if left to settle in low spots within the pipeline system for an extended period. Having liquids within the compressors degrades performance, as liquids are relatively incompressible as compared to gas. The degradation of performance is only part of the problem, however, as the back pressure from the liquids increases the stress on the compressor and that, in turn, can increase maintenance downtime and associated costs.

The potential for corrosion in the pipeline system is the more serious problem. Pipeline corrosion can lead to increased maintenance costs (related to attempts to locate and remove the liquids), removal of capacity from service, and, in severe cases, loss of system integrity. For this reason, pipelines need to specify within their tariffs the standards for monitoring the quality of gas volumes.

It should be clear from this discussion that the natural gas pipeline and storage industry provides more than a "commodity," as it is sometimes described. Rather, the natural gas transmission and distribution pipelines serving North America provide delivery services including the pressure, balancing, and gas quality necessary for the concurrent operation of millions of customers, from the largest industrial consumer to the flickering light of a backyard lantern. The pressure and balancing services are provided instantaneously, without direct requests from customers, and without regard to the actual time the molecules take to travel from the customers supply source.

4. Supply Challenges

a. Ethane Rejection

In the supply constrained case envisioned in this report, one potential mechanism to increase the heat (energy) content of the natural gas stream and to increase resultant delivery via the pipeline network is to reject ethane at the outlet (tailgate) of processing plants. This includes both ethane re-injection (or flashing) and lower ethane recovery during processing operations. Ethane has a higher heat content than methane, thus a gas stream with a higher level of ethane will contain more useable energy for consumers. Another favorable characteristic of ethane is that it is not subject to liquid fallout, as discussed above.

Although extensive use of ethane rejection will have to be carefully evaluated, it should be noted that ethane rejection has occurred numerous times in the past without significant problems. The previous rejections were the result of poor economics for ethane extraction, e.g. when feedstock prices for ethane dropped below the value of its equivalent heat content in the gas stream. According to published reports, ethane rejection during these past pricing periods has increased the overall heating content of the gas stream by an amount equivalent to 0.5 to 1.0 BCF/D of "regular" heat content gas. This adds appreciable energy delivery capability to the existing transmission system without requiring new pipeline infrastructure.

Given the higher prices projected for natural gas over the study period, it appears likely that it will be economic for processors to reject ethane throughout most of the analyzed period. According to reports (Oil and Gas Journal, April 21, 2003), the processing spread between NGL and natural gas prices has averaged below $0.11/gallon, less than the rate necessary for the development for new extraction plants. Since natural gas prices through 2025 are projected to average over $5.00/MMBut as compared to $3.80/MMBtu (the Henry Hub Louisiana cash price from Natural Gas Week) for the last five years, the processing spread will be even lower, thus encouraging ethane rejection.

The ability of the ethane rejection process by itself to lower overall gas prices, however, is quite low. Even if an amount equal to 1.0 BCF/D of ethane was rejected, it would be only a fraction of total U.S. projected consumption of 73 BCF/D in 2010 and 85 BCF/D in 2020.

b. LNG Imports

Liquefied natural gas (LNG) imports will be an increasing source of supply in the study. Much of the LNG produced globally has a high ethane level. Due to high shipping costs, the world LNG market has developed with a focus on achieving the highest possible heat content per volume of liquid. For this reason, ethane was left in the gas stream prior to liquefaction. Since ethane liquefies at a temperature above methane, its inclusion did not markedly change the cost or design of the upstream liquefaction facilities.

The inclusion of ethane may result in an imported gas stream with Btu content per cubic foot above 1,100, the typical U.S. market area limit. Without treatment, such as nitrogen injection, processing, or blending with low-Btu domestic production, the ethane-rich LNG could be barred from the distribution and transmission systems in market regions. Recent work done under the auspices of the Gas Technology Institute indicates that LNG with a high ethane content does not appear to cause problems at the burner tip. This study is called "Gas Interchangeability Tests" and a draft of the first part of the study has been recently released. The initial results suggest that the Btu limits in practice throughout the industry are too narrow and that alternate indices, such as the Wobbe Index, are much more prescriptive of safe combustion. It is hoped that additional studies will help the industry determine not only what is "safe" but that they will also lead to true interchangeability standards to be incorporated in the pipeline and LDC tariffs.

Additional work in this regard must be done by the industry, but the results are encouraging and suggest that high-ethane, high-Btu LNG might be delivered in market areas without requiring substantial costs for blending or processing. It is hoped that additional studies will help the industry determine not only what is operationally appropriate but that they will also lead to true interchangeability standards, to be incorporated in the pipeline and LDC tariffs.

F. Maintenance Challenges for Infrastructure

1. Pipeline Safety Legislation

Besides operational challenges, pipeline transmission operators will have to focus significant capital and attention to maintenance of their systems over the next 25 years. In 2002, Congress passed the Pipeline Safety Improvement Act, which has major ramifications for the transmission industry. Besides improving the "one call" systems used by the states and requiring enhanced operator qualifications, the Act will cause enhanced maintenance programs and actual continuing inspections of all pipelines located in population centers. According to the Act's requirements, over 50% of the riskiest pipeline segments in these regions must be "physically" inspected in the next five years. The remaining facilities must be inspected during the following five years and all pipelines must be subsequently re-inspected at less than seven-year intervals. Though currently unaddressed, recovery of these costs will be of substantial concern to pipeline operators and the level of costs is of concern to ratepayers.

The inspection requirements of the Act will impact the industry in several different ways. First, the Act will lead to a marked increase in expenditures for pipeline testing. There are three major methods that can be used in integrity testing: Inline inspection using "smart pigs"; hydrostatic testing; and external inspection. Each method will have its own set of cost factors and these will vary per pipeline and region. For instance, many major long-haul pipelines built in the World War II era were not designed or constructed to be internally inspected on a routine basis, e.g. they can not easily be tested with recently developed smart pig technology. According to a recent study, "Consumer Effects of the Anticipated Integrity Rule for High Consequence Areas" (Integrity Rule) by the Interstate Natural Gas Association of America (INGAA), 45% of the interstate grid will be difficult to test internally due to transitions in pipeline diameter, the occurrence of valves of different types and sizes, pipeline bends exceeding smart pig turning tolerance limits, etc.).

During a smart pig internal inspection, x-ray or electromagnetic detectors analyze the pipe from the inside for metal loss, cracks, and corrosion that could affect pipeline integrity. The detectors themselves are located inside of a cylinder, a "pig" that is inserted into the pipeline and pushed slowly through the system by the pressure of the natural gas. Although smart pigging has been used for a number of years to monitor pipelines, the Act will require its utilization on a much larger scale than previously.

Hydrostatic testing involves removing the pipeline from service, removing the natural gas, cleaning the pipeline of possible entrained liquids, and then filling the pipe with water under pressure. After the test is completed, the water must be removed and the pipeline dried to remove any water that could cause future corrosive damage.

The external inspection concept will require pipeline operators to remove the overfill of dirt covering the pipeline segment to be tested, which is frequently 6 feet in depth. The pipe is then inspected visually and with electromagnetic tools for cracks or corrosion. The pipeline must subsequently be reburied before being returned to full service. This method, of course, would have the maximum negative impact on landowners along the rights-of-way.

The cost of performing these tests is still being evaluated. The industry consensus, however, is that the tests will be costly. It is assumed, but not yet certain, that the FERC and other regulatory bodies will allow the cost of these tests to be included in pipeline tariffs. During periods of testing, it is clear that besides the direct cost of performing the inspection, an additional cost, or revenue loss, may occur from the reduction in throughput capacity as a result of these inspections.

The insertion of a smart pig or the excavations of a pipeline for external surveillance both reduce pipeline capacity due to pressure reductions during the inspection period. According to the Integrity Rule report from INGAA, a smart pig run in a pipeline designed for internal inspections will result in a 30% decline in throughput capacity for about three days. The capacity reduction for external inspection is 25% but the period of test climbs to 9 days. A hydrostatic test requires removal of 100% of the capacity and the process takes an average of 25 days due to the need to carefully purge the pipeline of natural gas, fill the pipeline with water, test the facility, and then dispose of water. (See Integrity Rule study, page 26.)

One effect of the increased inspections, therefore, will be temporary reduction in capacity on the lines being tested. The reduced capacity will result in an increased utilization factor for unaffected capacity and could result in a short-term increase in effective transportation rates. The result may thus be an increased short-term cost to consumers, even without the inclusion of expenses to physically perform the tests.

Many transmission laterals, however do not have an alternate line. INGAA found in the Integrity Rule study (page 12) that 85% of industrial and electric generation facilities had only a single connection. A capacity reduction or a complete removal of capacity could have an extremely harmful effect for these firms. Even if the pipeline capacity reduction is timed to occur during a period of scheduled plant maintenance, the costs can be substantial.

It appears that LDCs with multiple interstate connections will also be at economic risk from a reduction in service due to an integrity inspection. LDCs having multiple connections have sometimes designed their internal pipeline network to operate with specific pressure support from all interstate pipeline connections. Thus during periods of interstate pipeline testing, the distribution pipeline capacity and compression capabilities within the LDC system may not be adequate to maintain full service without support from localized CNG trucks, LNG peaking storage, or propane-air injection facilities. Due to its focus on the interstate system, the Integrity Rule report did not attempt to calculate any cost impacts on LDCs for situations of this type.

INGAA found that integrity inspections will add an additional $6.8 billion to interstate pipeline transmission costs under the assumption of a ten-year testing cycle. By far the largest component of these costs will be due to short-term capacity reductions on the interstate grid, which is predicted to cost $5.7 billion. Capital expenditures on infrastructure improvements are estimated as $0.6 billion while inspection costs are estimated to be $0.4 billion.

Another result of the increased integrity activity could be a pro-active decision by regulators to change historical regulatory policy to allow operators to build capacities slightly higher than current contractual commitments. The increased capacity could then be used to maintain normal throughput during periods when supplies are diverted from an alternate system due to maintenance. Since the Federal Energy Regulatory Commission (FERC), the oversight body of the interstate pipeline industry, does not routinely allow recovery of costs for capacity built without firm demand customers, this would probably require a change in current policy/approach by FERC.

2. Abandonment of Facilities

An aspect of the industry that is associated with integrity inspection and maintenance is abandonment. This term refers to the removal from service of a pipeline or its appurtenance equipment, such as valves, meters and compressors. Abandonment occurs when a pipeline (or associated equipment) becomes so aged that it is no longer economically efficient to repair it. Instead, replacement of the equipment must be performed. Or, if producing wells have declined and a pipeline connection is no longer needed, facilities may need to be abandoned even though they are in proper working condition.

Abandonment thus may or may not be linked to the creation of replacement infrastructure. It should be noted, however, that even in the case of abandonment without replacement, the industry experiences costs and the need to allocate personnel to such activities. This is due to the requirement that the abandonment of facilities must be performed in an environmentally and operationally safe manner. While this rarely requires a transmission operator to physically remove a pipeline from the ground, it may require the removal of natural gas from a line and the insertion of concrete plugs to isolate the facility.

3. Impact of Rehab and Maintenance Outages

As stated in the section on pipeline safety, maintenance procedures reduce effective throughput capacity. For this reason transmission operators traditionally schedule maintenance activities during months of weaker demand, e.g. outside of the winter and summer peak consumption periods. By performing the maintenance in a low demand period, operators strive to keep remaining available capacity above that of projected demand. If maintenance uncovers a larger than expected problem or if a simultaneous need for unscheduled maintenance occurs, then capacity can be reduced below that needed even for a weaker demand period. If this happens, then the value of the remaining pipeline capacity may quickly increase. A potential solution would be if the industry had a means of reserving capacity for maintenance reductions, then pricing peaks or volatility might be reduced. In the current industry situation, however, a pipeline has this type of spare capacity only when it is not fully contracted. This leads to a conundrum in that a "popular" pipeline is the one most difficult to schedule and perform maintenance on and can be subject to price spikes and volatility.

4. Technology

Technology development was formerly funded in part through an industry surcharge. An area of growing concern within the pipeline transmission industry is the lack of funding for industry-related research and development (R&D). Because the industry as a whole has gone through a recent period of wrenching changes, internal funds for R&D are being severely restricted.

With expiration of the natural gas surcharge, the source of funds for future technology efforts is not clear. This resulting lower spending on R&D may negatively impact the industry and its ability to implement new technology over the next 25 years.

IV. Distribution

In the natural gas industry, the distribution system is defined as that portion of the gas delivery infrastructure that delivers gas from an interconnection point with the interstate pipeline system (the "citygate") to the ultimate, end-use customer.[5] Exceptions to this general definition are common, including the increasing number of electric generation plants that receive gas directly from an interstate pipeline. However, virtually all residential, commercial and most industrial customers receive their gas from a distribution system that is owned, operated and maintained by a Local Distribution Company (LDC). LDC does not refer to the type of ownership (investor owned or municipality). Rather, LDCs in this study means the entity that distributes gas to end-use customers.

A. Overview

As a general rule, LDCs broadly categorize their services into firm and interruptible deliveries. Distribution systems are designed to meet all firm customer demands for gas even under design (colder than normal) weather conditions. The demands of customers who are served with interruptible service may or may not be met under certain conditions as defined in the LDC's delivery tariffs, potentially during design weather conditions.

Because LDCs must design their distribution systems to deliver gas even under design weather conditions, the overall capacity utilization is much lower than that of interstate pipelines. For example, a residential customer who uses gas for heating, can have a peak wintertime monthly gas consumption that is 10 or more times what the same customer's monthly gas consumption will be in the summer. The difference in gas usage is even more pronounced if peak day to minimum use days are compared. Thus, customers with fuel oil backup, such as industrial consumers or electric generators, who can interrupt their gas usage by switching to an alternate fuel, have historically allowed the LDC to use its system efficiently and reduce costs to customers. For example, if an electric generating unit needs gas in the summer, an LDC will likely have room in its distribution system simply because the residential customers (taken as a group) have a lesser need for natural gas. At the other extreme, on a cold winter day, the residential customers need much more gas. If the electric generator can switch to an alternate fuel, the residential customers will have room for the gas they need to move through the distribution system. The greatest demands on a distribution system can arise when an electric generating unit uses natural gas at the same time the residential and commercial customers experience peak usage. Meeting these demands may require the LDC to expand its facilities, exacerbating its seasonal variance in capacity utilization and potentially increasing the total overall cost to serve customers.

B. Distribution Infrastructure Investment

Distribution investment required to serve new customers can be classified into direct and indirect investments. Direct investments include the costs of new facilities needed to connect new customers to the existing system, and include mains extensions, installation of new service lines, and meters and regulators. Indirect investments include the costs of increasing system capabilities to serve additional customers, and could include main reinforcements, regulator replacement, regional debottlenecking, and improved flow design. Indirect investment costs also include expansion of computer systems, new customer call centers, and other similar investments that improve customer service and reduce operating expenditures. LDCs typically install systems sized to allow for significant customer growth, hence the need for these types of indirect investments generally cannot be linked directly to a specific new customer or group of new customers.

Construction of new facilities to meet customer demands requires the extension of gas mains and the construction of services to bring the gas into an individual home or business. The costs of both mains and services vary depending upon many factors. As shown in Table T-5, the Gas Technology Institute (GTI) has categorized the range of average costs for new construction based upon the area where the work occurs and the amount of developed versus undeveloped area.[6] Similarly, the costs to install a new service aver-

[5] This definition roughly follows the definition used to determine those segments of pipe that are regulated by the Federal Energy Regulatory Commission, i.e. transmission, and those regulated by others, i.e. distribution. Distribution regulation is typically provided by states or municipalities. This type of regulation covers pricing (rates) and terms of service. It should be noted that the Department of Transportation, which regulates the operation and safety of pipes, used a different definition.

[6] Nicholas Biederman, *Gas* "Distribution Industry Survey: Costs of Installation, Maintenance and Repair, and Operations" (September 2002), p. 6 & 35.

	Customer Density (customer per mile of main)						
	Urban	Urban	Mixed	Mixed	Suburban	Suburban	Rural
Percent of main under pavement	45-65%	65-100%	0-44%	45-64%	0-44%	45-64%	0-44%
Percent of new main installed in undeveloped areas	51%	7%	60%	78%	85%	60%	78%
Proportion of new main installed in common trench with other utilities, %	52%	32%	n/s*	32%	34%	n/s	9%
Average new main cost, $/ft	14.5	n/s*	n/s*	9.85	9.90	9.95	2.80

*n/s means there is insufficient data to determine an average value.

Table T-5. New Pipe Construction in Different Service Areas

	Residential	Commercial	Industrial	Electric Utility
Distribution Mains ($/Foot)	$22	$22	$28	$30
Distribution Services ($/Foot)	$6	$6	$6	$6
Cost Per Meter	$250	$600	$1,500	$1,500

Table T-6. Distribution Facility Costs for New Customers in 1997

age $460 in undeveloped areas, $1,400 in developed areas, and almost $5,600 in urban areas.

However, while there is substantial variation in costs for construction in specific areas, distribution facility costs for this study were aggregated and modeled on a nation-wide average basis. Table T-6 shows the distribution facility costs for new customers in 1997, used as the baseline for projecting future LDC investment requirements. These costs include the direct costs of connecting new customers, as well as an allocation for the indirect costs.

The costs used in the NPC analysis are based on distribution system expenses from a Gas Research Institute (GRI) study of LDC cost trends[7] and are refined based on the American Gas Association (AGA) "Best Practices" review. The allocation of indirect investment costs was calibrated to reflect total national LDC investment. It should be noted these reflect smaller average size industrial and electric utility connections. It is assumed the larger industrial and electric utilities are connected directly to an interstate pipeline or that the project is funded through a customer specific charge. Table T-7 shows the footage of Mains Per New Customer assumed. Other Facilities Per New Customer assumed in this analysis are shown in Table T-8.

In addition to construction activities to expand the current distribution system, distribution systems are in a state of constant maintenance and upgrade to maintain safety, ensure system reliability and to minimize future maintenance costs. Based on AGA benchmarking information, replacement of mains ranged from 0.4 to 0.7% per year of existing installed mains among surveyed LDCs. Service replacements ranged between 0.6% and 1.3% per year among surveyed LDCs. Thus,

[7] Gas Research Institute, *Historical Cost Trends and Current Regulatory Initiatives in the Local Gas Distribution Industry,* May 1999.

Region	Residential Customers	Commercial Customers
New England	75	78
Middle Atlantic	65	70
South Atlantic	115	120
Florida	160	175
East South Central	115	140
Midwest	90	110
Upper Midwest	90	110
Central	85	110
South Central	110	120
Southwest	110	150
Mountain	85	110
West North Central	105	110
Northwest	105	110
California	50	60

Table T-7. Assumed Footage of Mains per New Customer

	Service Footage per Customer	Meters per Customer
Residential	60	1.00
Commercial	60	1.01
Industrial	200	1.70
Electric Utility	300	2.00

Table T-8. Other Facilities per New Customer

for this study, main replacements were assumed at 0.5% per year and service replacement at 0.75% per year. These rates imply service lives beyond 25 years. This matches the current projections for the lives of materials used to build new distribution facilities. As a result, in this study, main and service replacements occur only for distribution facilities installed before 2002. The facilities built in this study are not replaced during the study.

In addition, steel and cast iron pipe tend to require more maintenance and replacement. As of 2000, according to DOT RSPA reports, there was a total of 524,616 miles of steel and 24,083 miles of cast-iron greater than 4-inch diameter. The reports indicate that 11.6% of the steel pipe is bare-unprotected, 3.8% is coated-unprotected, 2.7% is bare-protected and 81.9% is coated-protected.

Given current technology, some current main replacements and upgrades can be completed by insertion of plastic piping into existing cast iron and steel pipe, which may allow for higher pressures and increased throughput. System upgrades accomplish the same results. Also, directional boring allows pipes to be installed without digging a trench.

Despite the use of cost saving techniques, main and service replacements often are significantly more costly than the construction of new facilities. Frequently, replacements occur in congested public right-of-ways where numerous other underground facilities are located. Also, replacements often occur in developed urban or suburban areas where pavement restoration and landscaping or lawn restoration is required. (By contrast, new construction often occurs in relatively undeveloped areas where these concerns are not as common. See Table T-5.) Thus, based on AGA benchmarking studies, main replacement costs were assumed to cost 50% more than construction of new mains. Similarly, replacement of services was assumed to cost 25% more than the cost of new construction. Finally, meter replacement was assumed to cost 15% more than new construction.

The total annual facility investment requirements for distribution companies are similar in the Reactive Path and Balanced Future scenarios. To accommodate the demand projected in the Balanced Future scenario, the results from the distribution analysis show that total annual facility investment requirements for distribution companies will average $5.3 billion per year (2002 dollars),[8] with a cumulative investment from 2004 through 2025 of $135 billion. This compares to average annual expenditures during the 1990s, which averaged slightly more than $4.8 billion.

However, funding for this level of expansion may be more difficult than in the 1990s because more of an LDC's cash flow in the future will be needed for other purposes, including buying higher priced gas and placing it in storage. This may result in a greater need to finance expansion of the distribution systems with external funds than was the case in the 1990s. LDC

8 Required investment reported in constant 2000 dollars.

access to capital markets will, therefore, be important but, given appropriate regulatory policy, should not be a constraint.

In determining the costs to expand the distribution system, a 1% per year increase in productivity was assumed. This significantly lowers the projected costs. Given appropriate funding for research and development (R&D), achieving increased productivity seems reasonable. Thus, it is not expected that adequacy of the distribution infrastructure will be a constraint in the future.

The improvement in overall efficiency in the residential sector in the Balanced Future reduces system throughput slightly, resulting in a modest decline in required mains reinforcement and delayed replacements. The decline in power generation demand also reduces the required investment to serve new load. This decline in investment is, however, offset by a small increase in investment to serve growth in the commercial and industrial sector load, as the lower natural gas prices in the Balanced Future scenario result in some additional growth in commercial and industrial demand.

As discussed in the Transmission section of this chapter, the United States Congress passed legislation intended to enhance the safety of "transmission" type gas pipelines[9] through stricter inspection requirements. The U.S. Department of Transportation (DOT) is currently developing the rules to implement the legislation. Companies are required to perform a baseline inspection within the first ten years of all "transmission" like pipeline located within a high consequence area (HCA). Re-inspection will be required every seven years after the initial inspection.

The AGA estimates the LDCs operate almost 22,000 miles of pipeline that is subject to this new pipeline integrity program. While the exact requirements mandated by the DOT, is not known, AGA has estimated the cost of compliance for LDCs at $2.7 billion to $4.7 billion (2002 dollars) over the next 20 years. For purposes of this study, a cost of $16,000/mile or $3.5 billion was assumed. Data on the breakdown of costs between capital investments versus maintenance expenditures is not yet available from the industry. Similarly, information on the pattern of these future expenditures was not available. Thus, for this study, it was assumed that 60% of these expenditures will be incurred in the initial ten-year period, when baseline inspections must occur. Historical annual capital expenditures in 1998 dollars can be seen in Figure T-16.

For the remainder of the study period, costs to comply with the pipeline integrity program will continue. However, since facilities needed to complete the inspections will have already been built, integrity management plans will have been written, and HCA will have been identified and mapped, it is anticipated that costs to comply with the pipeline integrity program will decline. Offsetting this decline will be the increased amount of pipe included in the pipeline integrity program as LDCs expand their systems. Thus, annual costs for LDCs to comply with pipeline integrity standards in years after 2012 were assumed to be 40% of the annual costs of the initial period. In summary, from 2004 through 2013, an annual cost of $250 million was assumed to meet the pipeline integrity standards. From 2014 through 2025, an annual cost of $100 million was assumed.

In addition to pipeline integrity costs, LDCs face increased costs to protect against security threats by terrorists. These costs cannot be readily quantified. As part of outreach, a limited number of LDCs indicated that LDCs expect some increase in costs compared to historical trends, but overall increases that are less than the costs to comply with new pipeline integrity standards. If these costs represent a 1% increase in the costs to maintain and expand the gas distribution systems, LDCs would incur new expense of $48 million per year. These costs are included here only for reference and were not included in the figures shown in this section.

C. Challenges to Building and Maintaining the Required Distribution Infrastructure

1. Provider of Last Resort/Supplier of Last Resort

As the LDC marketplace has evolved, the requirements for serving customers have continued but roles have changed. All states that have residential and commercial choice programs have addressed the provider of last resort (POLR) or supplier of last resort (SOLR) issue to some extent. The POLR/SOLR responsibility

[9] The DOT definition of "transmission" differs from the definition used by the rate setting regulators like the FERC. As a result, LDCs operate a significant amount of "transmission" pipelines from a DOT perspective.

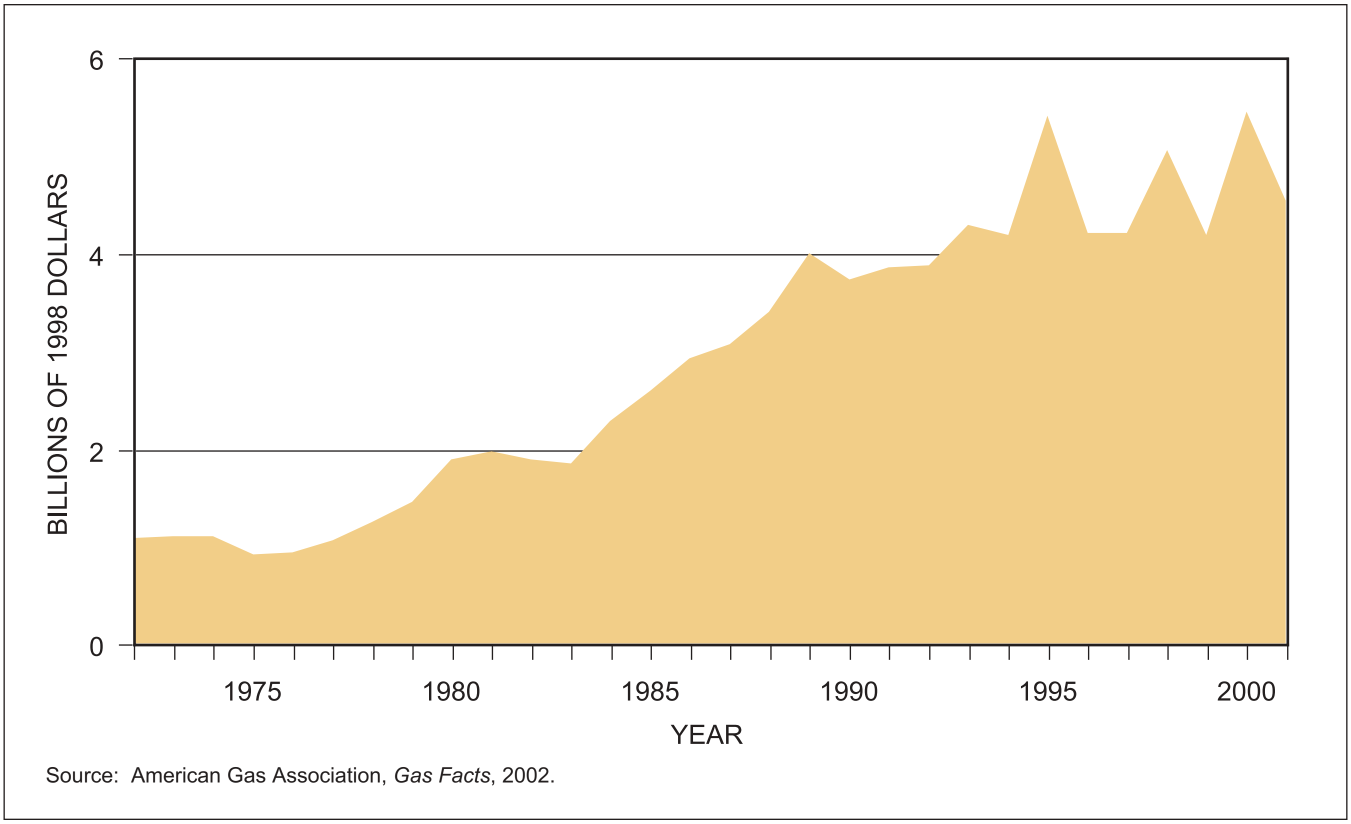


Figure T-16. Historical Investment in Distribution Infrastructure

has been defined in varying ways, but generally is the responsibility to assure that small gas consumers will not experience an interruption in the supply of natural gas to meet their needs. Thus, POLR/SOLR can include the responsibility to provide essential needs customers with gas if the customer's supplier goes bankrupt or fails to deliver gas for other reasons. POLR/SOLR responsibility always includes small volume residential gas customers (residential or commercial) and seldom, if ever, includes very large customers like electric generators.

There is debate about what entity should be a POLR/SOLR. Some states have required that the LDC assume this role, while other states have prohibited the LDC from holding the role. While these policy debates will continue, it is important to recognize that the demand for natural gas to serve residential and commercial markets will likely continue to grow. In fact, this study projects the number of residential customers served by the natural gas industry will grow from 61 million in 2003 to 81 million in 2025. This level of growth will necessitate that state and federal policy makers work with the various industry participants to assure that interstate pipeline and storage capacity is available to serve future customers. Clear definition of the responsibilities of the POLR/SOLR and appropriate commitments from policy makers to allow critical expansions are required to assure reliable service to customers.

Specifically, state regulators need to:

- Clarify the role and responsibility of the POLR/SOLR
- Define who holds that role
- Support appropriate contracting practices to assure that natural gas services and infrastructure are available to meet customer demand.

2. Siting and Permitting

The permitting and construction of new or replacement facilities is becoming more expensive as a consequence of various growth management, building code, and environmental requirements. Many of these issues have been discussed at some length in the Transmission section of this volume. It is worth noting here, however, that access to public right-of-way

(ROW) within metropolitan regions is becoming more difficult to obtain and more expensive. For example, some states and municipalities are prohibiting the installation of gas distribution facilities in a highway or street ROW. Local zoning can also impact the location of facilities and their cost. Increased costs from such items are not included in this study. However, governmental bodies need to consider the impacts (financial as well as safety and reliability) of added restrictions on the installation and maintenance of distribution facilities.

To address these and other concerns, states should also develop a mechanism to coordinate siting issues among affected state and local governmental entities, wherever multiple governmental entities have an impact on the siting of LDC facilities. Using the NARUC/IOGCC Pipeline Siting Work Group Report[10] as a framework, each state should consider, as needed, programs that might include the following type of initiatives:

- The governor establishing within the office of the governor a coordinating effort to organize and expedite the activities of all state and local natural gas permitting entities.

- States naming a lead agency that would have the authority to monitor processing schedules within existing regulatory requirements.

- The state economic development office (Commerce Department) being involved with the coordination effort and recommending actions to streamline the process.

Coordination and certainty in completing a permitting process are keys to meeting the growing need for natural gas while balancing many other key issues. Consistent government policy and rapid, predictable regulatory decisions are needed to enable timely and cost-effective system expansions.

The business environment in which LDCs operate has changed dramatically since the 1999 NPC study. Traditionally LDCs provided gas to all customers served by the distribution system. Beginning in the 1980s, large customers have had the option of purchasing their own gas and simply transporting it on the LDC's system. During the 1990s, increasing numbers of small use customers, including residential customers began to choose alternate suppliers and use the distribution system simply to transport the gas. (See Figure T-17.) Based on programs that are currently operational or announced, 99% of all electric utility customers and 96% of all industrial customers will have customer choice. Additionally, at least 72% of all commercial customers and 57% of all residential customers will also have the option to choose their gas supplier.[11] This continuing transition has changed the decision processes related to their system expansions.

3. Access to Investment Capital

Another topic of concern to LDCs arises because the reduced gas usage resulting from customer-achieved efficiency gains will lead to less gas flowing in an LDC's system and its current asset base to serve existing customers. Most LDCs have experienced this phenomena throughout the 1990s. This normally means that expansion capital will be required to attach new customers just to maintain system throughput and the associated revenue levels. Actual growth in throughput and revenue will require additional capital investment, beyond the level described, just to keep even with customers' conservation efforts. Previous expansions have largely been financed through internal cash generated from the business; however, forecasts suggest that capital markets will need to provide more of the capital required to maintain and grow the throughput and associated revenues. Accessing capital at the lowest cost in the competitive markets requires a compelling story. To achieve favorable access to capital, traditional rate designs may need to be modified or augmented to reflect the adverse impact to the financial health of LDCs caused by customers achieving the desirable goal of greater efficiency. One such example is the State of Oregon recently implementing a "conservation" tariff that encourages greater conservation by customers while mitigating the potentially adverse impacts of reductions in LDC revenue.

To serve the natural gas needs of customers through 2025 will require substantial investments by LDCs. These investments are within the range of his-

[10] Philip N. Asprodites, "Roadmap to Implementation of the Final Report of the Interstate Oil and Gas Compact Commission/National Association of Regulatory Utility Commissioners Pipeline Work Group in Louisiana" (April 2003).

[11] AGA, Policy Analysis Issues, Issue Brief 2002-02, May 7, 2002.

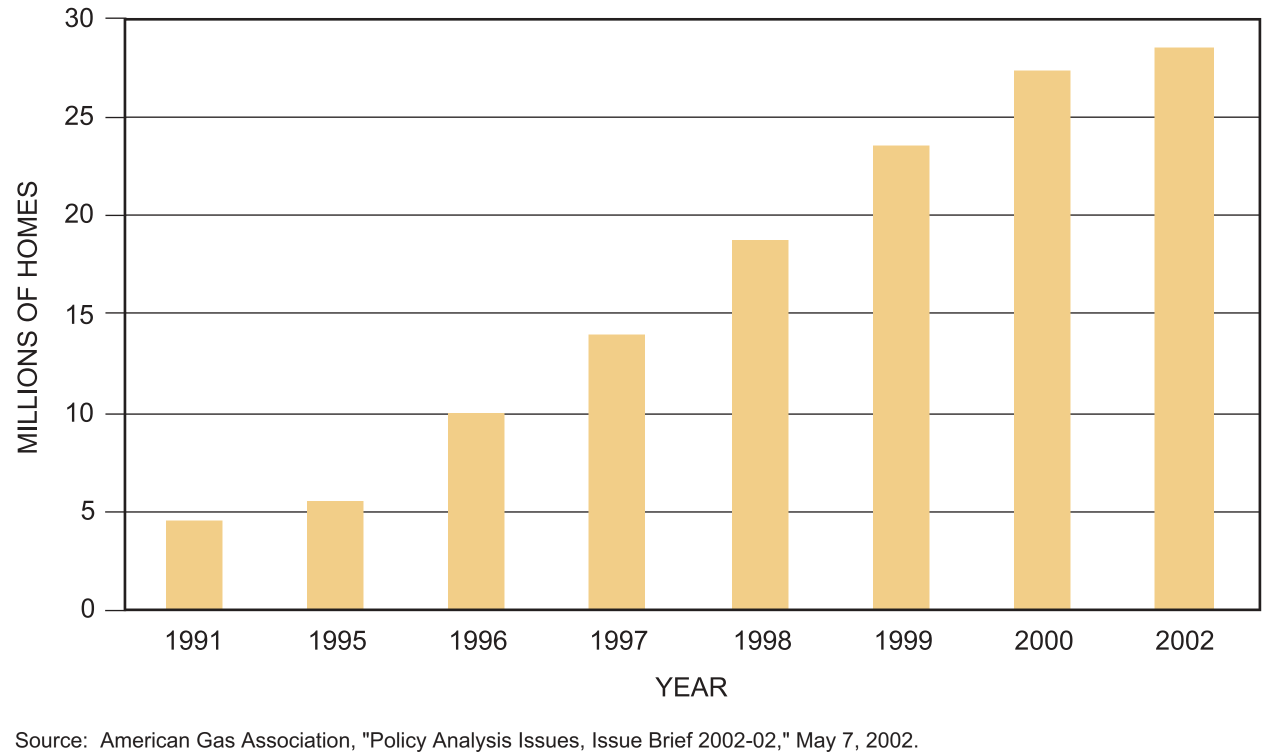


Figure T-17. Residential Customer Choice Program Announcement (Cumulative Number of Homes Eligible)

torical spending levels. However, investments of this magnitude require appropriate access to the capital markets (both debt and equity markets). Access to the capital markets will only be possible if the financial health of all parts of the gas distribution industry remain healthy.

The reliable, safe, efficient delivery of natural gas is critical to the health of the American economy. Natural gas usage, as a percentage of energy usage in the American economy, has grown steadily. Yet, LDCs are a relatively small part of the capital markets. LDC working capital needs will expand significantly at the gas prices suggested by the NPC analysis. Currently, the United States is considered to have adequate gas in storage if more than 2.5 TCF has been stored at the beginning of the heating season. The carrying cost to store this gas at $6.00/MMBtu is significantly more than the comparable costs in the $2 to $3 gas price environment often seen in the 1990s.

These types of changes, as well as changes in the broader energy market, are impacting the business risks faced by LDCs. Constant attention to the financial health of the distribution industry will allow adequate access to capital markets for all future expansions needed to serve customers.

D. Reliable Gas Service in a Changing Market

Reliability in providing gas service to customers has been the hallmark of the natural gas industry. As the natural gas marketplace changes, new demands are placed on the interstate pipeline, storage and distribution system infrastructure. Customers are demanding new services to meet their needs. In particular, electric generating customers can dramatically change the demands for gas as they follow electric load. The changes in gas requirements can occur very quickly. The issues arise whether considering the increased number of large gas-fired electric generating units or a very large increase in the amount of distributed generation in the future.

Because electricity cannot be stored, it must be produced at the moment it is used. Thus, electric generating unit requirements for natural gas can vary dramatically from hour to hour as they follow the demand for electricity. Also, the customer demand for electricity reaches a peak in the summer in many areas of the country. Thus, power plants are increasingly consuming larger amounts of gas; at the same time, distribution companies and others are attempting to fill their seasonal storage in preparation for the heating season. For example, aquifer storage fields (see detailed discussion in the Storage section) have traditionally been designed to fill in the summer and withdraw in the winter on a very specific, scheduled basis. Electric generation may require a pipeline operator to attempt multiple injections and withdrawals, greatly complicating the use of aquifer storage fields. Also, as the use of gas to generate electricity in the winter increases, further peak-day demands are placed on the natural gas infrastructure.

These concerns have been the subject of considerable discussion and debate among industry participants. Recently, INGAA,[12] AGA[13] and the APGA[14] developed a framework to discuss these issues.[15] The group's stated goal is to "ensure the continuation of the historic reliability of the natural gas industry as gas demand grows, particularly from the power generation sector." These evolving discussions among industry and government will need to continue to assure adequate, reliable, cost-effective natural gas service to all customers in the natural gas marketplace.

E. Productivity Improvements Require R&D Investments

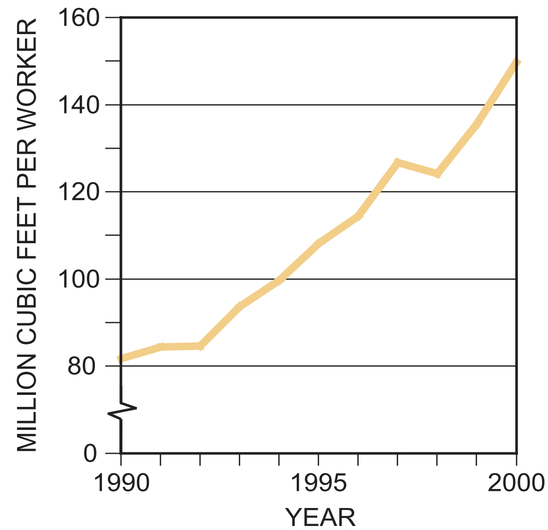
Since 1990, the productivity of distribution companies has steadily improved. This improvement resulted from: changes in the work practices resulting from continuous-improvement type programs; reductions in the workforce with judicious use of contracted labor; and implementation of new technologies affecting all aspects of construction, maintenance and operation of gas distribution systems.

[12] INGAA (Interstate Natural Gas Association of America) represents interstate pipelines.

[13] AGA (American Gas Association) represents investor-owned local distribution companies.

[14] APGA (American Public Gas Association) represents publicly owned natural gas local distribution companies.

[15] March 7, 2003, Letter to The Honorable Patrick H. Wood, III, Chairman of FERC from David N. Parker, President and CEO of the AGA.



Sources: Energy Information Administration, *Historical Natural Gas Annual, 1930 Through 2000,* DOE/EIA-E-0110(00), December 2001, Table 3, "Natural Gas Consumption in the United States, 1930-2000"; American Gas Association, *Gas Facts*, various editions.

Figure T-18. Gas Delivered per Worker

A measure of productivity in LDC operations is gas delivered per LDC employee. With an average drop in staffing levels of 4% per year since 1990, Figure T-18 demonstrates the increased amount of gas delivered per distribution company employee, primarily as a result of implementation of new technologies. Much of this technology came from research and its correlated product and skill-set developments. However, expenditures for gas research have declined in the last five years, driven in large part by the reduction in funds collected through the FERC-mandated gas distribution surcharge. The collections of these funds will be completely eliminated by the end of 2004.

As noted above, these reductions were in part achieved by using contracted labor, i.e. outsourcing. Some future levels of reductions in the workforce are likely. However, the ability to continue work force reductions at these historical rates through the study period without degrading customer service and safety is unlikely.

In the 1999 NPC Natural Gas Study, an annual 1% productivity assumption was used. For comparison to other studies, in its 2001 Baseline Projection the Gas Research Institute projected a 2.1% decrease in the cost of distributing a unit of gas. (See Figure T-19.)

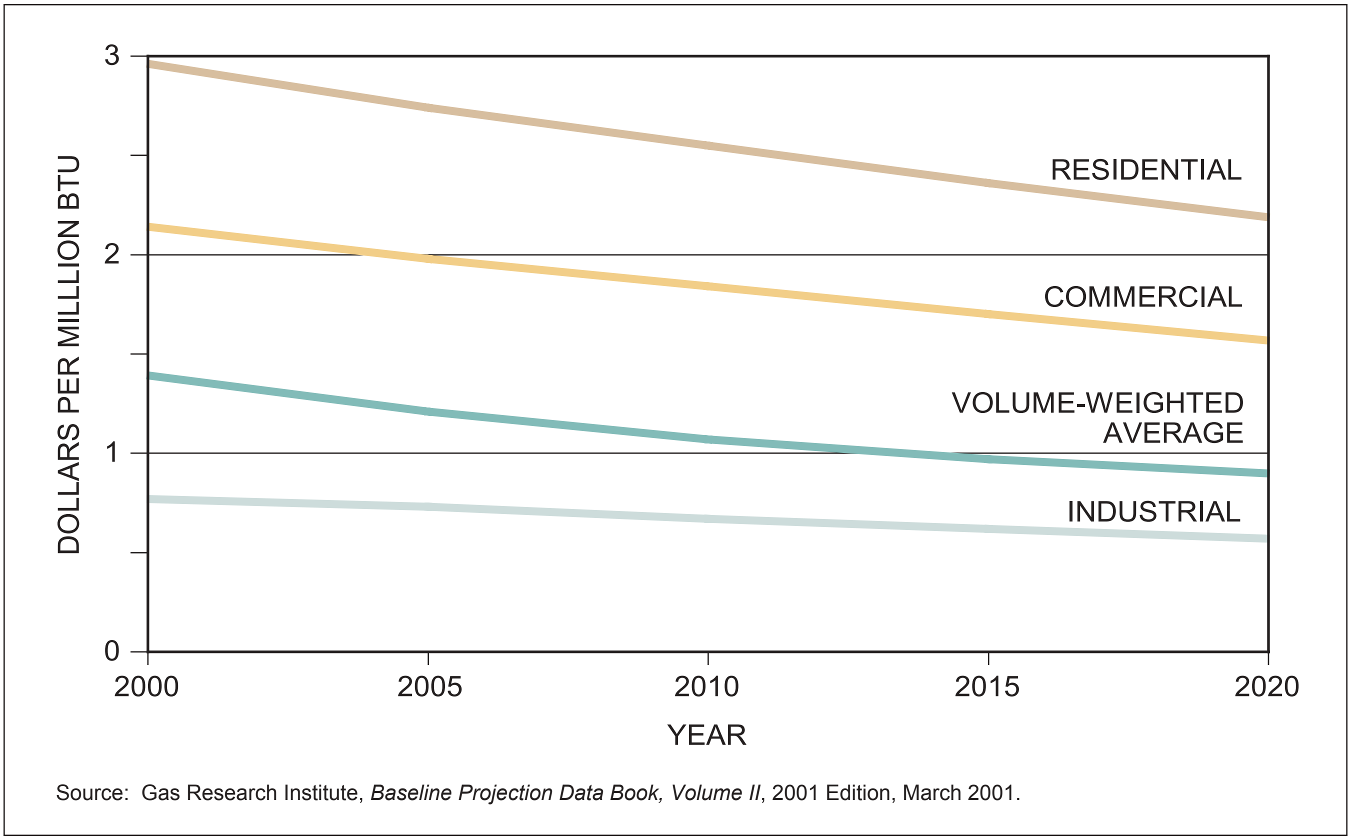


Figure T-19. Gas Distribution Costs (1999$)

It is reasonable to assume that half of this savings would result from enhanced technology and half from business practice improvements. Given the workforce reductions of the last ten years, the rate of further reductions is problematic. Thus, a 1% gain in productivity is likely a reasonable assumption for this study, but only if technological advances can be supported. Such a gain would result in reduced customer costs of $300 to $400 million per year, over the costs of the previous year. Offsetting some of this improvement, however, will be the costs of implementing the pipeline safety requirements and integrity rules previously discussed.

The need for research is as strong now as in the past. The ability to monitor and maintain the existing distribution infrastructure continues. With the level of expansion projected to meet the new demands shown in this study, new and even more environmentally sensitive and lower-cost construction techniques are needed. Better technologies for locating existing underground facilities will enhance the safety and operation of existing facilities[16] and reduce the costs of new construction. Improved operation of existing facilities with increased flexibility and throughput will reduce costs. Research and development have provided and must continue to provide the new techniques and technologies to reduce costs and increase both the safety and reliability of distribution systems.

Many LDCs believe government funding of research remains a critical need. In addition to state- and federal-sponsored R&D, many LDCs participate in and fund R&D. However, some distribution companies may operate under regulatory frameworks that discourage R&D. In such situations, LDC shareholders, finding themselves at risk to benefit, may be reluctant to support investment in the research and development that is needed to continue these productivity enhancements into the future. While funding for gas research must be assured, the funding must be provided by those who benefit from the research. Given the inability of LDC shareholders to benefit from R&D investments in operations, the intervention of government

[16] "Third party damage," where someone other than an LDC hits the distribution pipe, is the leading cause of damage to the distribution system.

will be required. State regulatory commissions should consider removing any barriers to LDCs' participation in collaborative research. Similarly, DOE funding of gas utilization technology research must continue and, if possible, expand.

F. Distributed Generation

In its broadest sense, distributed generation (DG) is the production of electricity near the place where the electricity is used, often on the customer's premises. DG can use many energy forms to produce electricity, including wind, solar and natural gas. In analyzing the impacts on the gas distribution system, however, only natural gas units will be considered. It is important to recognize that in recent years, large DG units have tended to be connected directly to pipelines. Thus, only smaller DG units will likely be served directly from a local distribution system. For purposes of this discussion, small DG will mean units that will produce 20 megawatts at peak, or less.

DG can be used in settings where a high level of electric reliability is required or where a heat recovery opportunity exists that greatly enhances the efficiency of the DG application. Customer interest in installing DG is growing and has moved into the mainstream of energy planning. Considerable research is being focused on the development of distributed generation. Added research is critical.

In addition, policy makers and standards organizations are assessing steps that will facilitate the increased use of DG. For example, the Federal Regulatory Energy Commission (FERC) has initiated an advance rulemaking notice to determine the interconnection requirements for DG units.[17] The National Association of Regulatory Utility Commissioners has developed Model Interconnection Procedures.[18] While not yet consensus standards, these do provide a basis for policy debate. Also, the State of New York has developed interconnection standards for small DG units.[19] The Institute of Electrical and Electronics Engineers (IEEE) recently developed standards for DG interconnections. The IEEE standard (P1547) establishes minimum technical and performance standards for interconnecting DG up to 10 megawatts. Development of these types of standards to resolve technical and business practice issues is moving forward and will need to continue if DG is to play a major role.

An increase in DG penetration in the marketplace will not dramatically impact the supply, demand or transmission assumptions of this study. Electrical demand for the nation is not going to change simply because of changes in the manner in which the electrical demand is met. Thus, to the extent that DG usage increases beyond the model assumptions, electricity generation in other electrical power plants will be reduced. To the extent that DG is operated as baseload facilities, there may also be additional displacement of baseload sources, including coal or nuclear generation.

However, the differences, when considered on a North American scale, are minor. In this study, DG penetration on the distribution system as a whole was not significant. Should DG become more prevalent, LDCs will be required to transport more gas through their systems. If DG installations occur in areas where gas demand has declined because of conservation, efficiencies, or business relocations, only minimal changes in distribution infrastructure may be needed. In areas where gas usage is already approaching infrastructure design limits, there may be an increase in cost by requiring larger sized pipes, higher pressures or both. The following comparisons will help to gain a feel for the impacts of these potential increases in DG usage. These assume an installation in the Great Lakes Region:

- A moderate size commercial establishment (e.g. a drugstore) with a 30 KW DG unit will increase gas consumption by the equivalent of approximately 25 residential homes.

- A 120-room hotel with a swimming pool and a 60 KW DG unit will increase gas consumption by the equivalent of approximately 50 residential homes.

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[17] Advanced Notice of Proposed Rulemaking, August 16, 2002, RM02-12-000 Standardization of Small Generator Interconnection Agreements and Procedures.

[18] Small Generation Resource Interconnection Procedures for Resources No Larger than 20 Megawatts.

[19] Standardized Interconnection Requirements and Application Process for New Distributed Generators 300 kVA or Less, or Farm Waste Generators 400 kW or less, Connected in Parallel with Radial Distribution Lines, New York State Public Service Commission, Revised March 20, 2003.

- A 3 KW DG unit installed in a single residential home will increase gas consumption by the equivalent of approximately 3 average residential homes.

Thus, while extensive modeling of DG within the NPC study did not occur, it is important that policy makers continue to provide opportunities for customers to receive the advantages of DG, while balancing issues like reliable service and cost. DG can provide advantages in reliability, energy efficiency and environmental impacts, when encouraged by appropriate public policies. With DG development in its infancy, industry and government must work together to define its role and potential contribution to the future. This includes dialogs with respect to:

- Appropriate tax policy including tax credits and depreciation
- Resolving lingering interconnection issues between the DG unit and the electric grid to assure safety and reliability
- Research funding to further develop DG technologies

Businesses should encourage the expansion and installation of distributed generation through their support in:

- Resolving technical issues regarding the safety, reliability and interconnectability of DG units
- Educating consumers on the advantages and limitations of DG
- Funding of initiatives to bring DG technologies into the market.

V. Storage

The ability to effectively store and retrieve large quantities of natural gas has been a key factor in the growth and development of the natural gas industry. At its most basic level, the storage function allows for the generally asynchronous supply and demand functions to be efficiently matched. Perhaps the most obvious example of this functionality involves satisfying the highly seasonal demand for natural gas for space heating purposes in the residential and commercial sectors during the wintertime. Indeed, without the ability to build gas inventories in storage prior to the high-demand winter period; it is unlikely that natural gas would have become such a dominant space-heating fuel in these sectors. Without storage, the wintertime surge in demand would require that production be accelerated greatly for the winter season, then throttled back as temperature-driven demand waned. Huge amounts of pipeline capacity would have to be available to transport the gas to market areas, much of which would then be vastly underutilized at other times of the year. Thus, a major function of storage is to augment supply to satisfy seasonal demand increases.

A second major function of storage is the operational function of load balancing, usually associated with pipeline operations. In essence, the function of load balancing is operating the system in such a way that receipts of gas into the system roughly equal deliveries of gas from the system, within certain operating tolerances. Thus, interconnections to storage give the pipeline operator a place to inject excess gas when more is being received by the pipeline than delivered, as well as an incremental source for withdrawal of gas when more is being delivered to customers than is received by the pipeline.

A third major function for storage, which has gradually grown in prominence, is the rapid cycling or turnover of working gas storage inventory. This has been driven both by the deregulation of natural gas wellhead prices and transportation infrastructure, and also by changes in the electricity-generating industry. Further, this function involves the physical capabilities of certain types of storage facilities and is most often associated with salt cavern storage facilities because of the ability to inject gas into and withdraw gas from these facilities at very fast rates relative to their storage capacities (see "Characteristics of Major Storage Types," later in this section). This function gives the holder of this type of storage capacity significant flexibility. Operationally, it enables the industry to accommodate the frequent load fluctuations characteristic of natural-gas fired electricity generating facilities, which have comprised the bulk of newly-installed generating capacity as the electric industry deregulates. This function also supports a wide variety of market-based uses, where the purpose of its use is primarily to obtain a profit as opposed to operational uses. Essentially, this function enables participants to profit from changes in gas prices over short time intervals, taking advantage of periods of high volatility in gas markets.

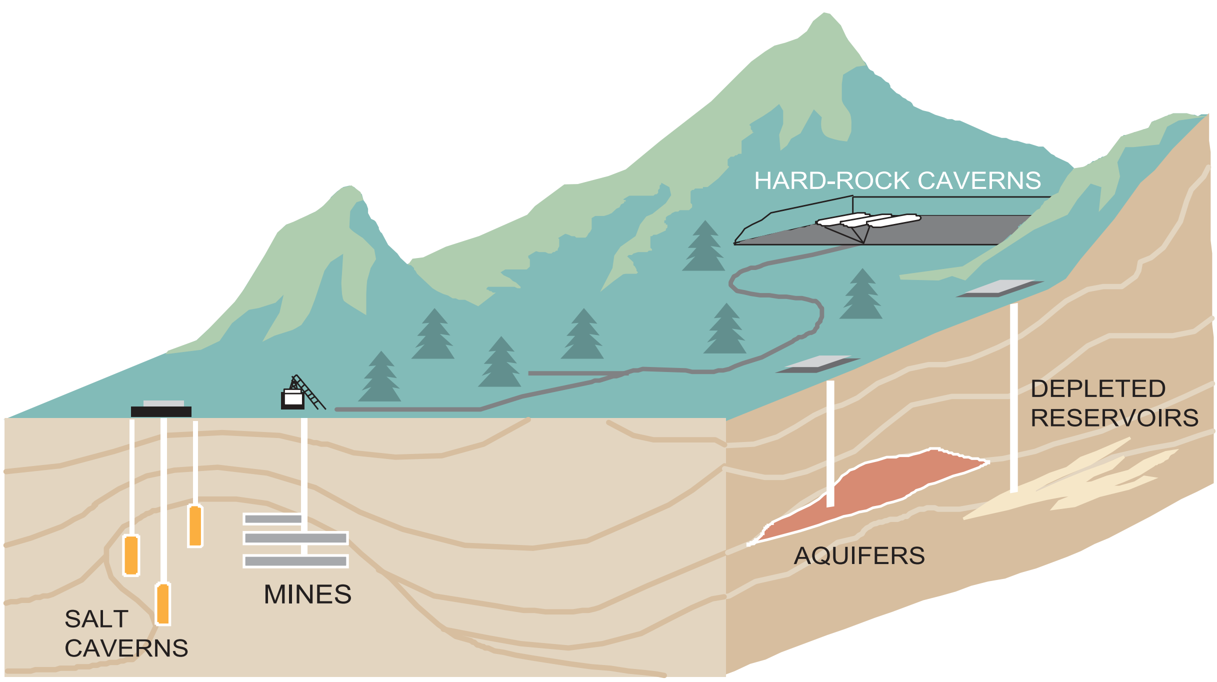
A. Overview

Natural gas may be stored in a number of different ways (see Figure T-20). It is most commonly held in inventory underground under pressure, in three types of facilities. These are depleted oil and/or gas reservoirs, aquifers, and caverns developed in salt formations. Several reconditioned mines are also in use as gas storage facilities.

Each type has its own physical characteristics (porosity, permeability, retention capability) and economics (site preparation costs, deliverability rates, cycling capability), which govern its suitability to particular applications. Two of the most important characteristics of an underground storage reservoir are its capability to hold natural gas for future use and the rate at which gas inventory can be injected and withdrawn – its deliverability rate. The distribution of storage facilities varies regionally by type within the U.S. lower-48 and Canada, as can be seen in Table T-9.

It is important to note that while this data indicates total working gas capacity of over 4.5 TCF, the largest amount of inventory actually cycled in any year has been 2.9 TCF, and evidence suggests that storage capacity may be incapable, for a variety of reasons, of cycling more than that volume without extreme seasonal price variability.

In addition to the three primary storage types, industry participants also have a number of other options to satisfy the temporary spikes in demand generated by end users – such as a surge in demand for space heating during an unusually cold period, or a sudden requirement for an electric utility to bring online a natural gas-fired generator – that can exceed the ability of traditional storage to handle. These storage options usually involve storing liquefied natural gas (LNG), compressed natural gas (CNG), or liquefied petroleum gas (usually propane) in above-ground storage tanks, and have the capability to deliver natural gas or a propane-air mix into the local distribution system when required. These facilities are generally capable of relatively high deliverability but for short durations. (Commonly used storage terminology is defined in the box entitled "Common Terms of Storage Measurement.")



Source: PB - KBB, Inc.

Figure T-20. Types of Underground Natural Gas Storage Facilities

Region/State	Depleted Gas/Oil Fields: Number of Sites	Depleted Gas/Oil Fields: Working Gas Capacity (BCF)	Aquifer Storage: Number of Sites	Aquifer Storage: Working Gas Capacity (BCF)	Salt Cavern Storage: Number of Sites	Salt Cavern Storage: Working Gas Capacity (BCF)	Total: Number of Sites	Total: Working Gas Capacity (BCF)	Percent of Working Gas Capacity
Consuming East	242	1,722	34	354	4	5	280	2,081	46
Consuming West	31	606	6	38	0	0	37	644	14
Producing	74	1,087	*	*	24	138	98	1,226	27
Total U.S. Lower-48	**346**	**3,414**	**41**	**393**	**28**	**143**	**415**	**3,951**	**87**
Canada	11	598	0	0	1	4	12	602	13
Total North America	**357**	**4,012**	**41**	**393**	**29**	**147**	**427**	**4,553**	**100**

*Any aquifer facilities in this region have been counted as depleted gas/oil fields to preserve data confidentiality.

Notes: Regions are those used by the EIA in its Weekly Underground Storage Survey. BCF = billion cubic feet.

Table T-9. Regional Distribution of Storage Facilities and Working Gas Capacity

1. Characteristics of Major Storage Types

The following are brief descriptions of the characteristics of each of the major storage types. Depleted oil/gas reservoir storage facilities are the most widely distributed geographically. Aquifer facilities are found primarily in the Midwest, while most salt cavern storage has been developed in the salt formations along or near the Gulf of Mexico in Texas, Louisiana, and Mississippi.

a. Depleted Oil and Gas Reservoirs

Most existing gas storage in the United States is held in depleted natural gas or oil fields. Conversion of a field from production to storage may take advantage of existing wells, gathering systems, and pipeline connections. The geology and producing characteristics of a depleted field are also well known due to its previous production history. All oil and gas reservoirs share similar characteristics in that they are composed of rock with enough porosity so that hydrocarbons can accumulate in the pores in the rock, and they have a less permeable layer of rock above the hydrocarbon-bearing stratum. Operators thus use the pressure of the stored gas and, in some cases water infiltration pressure, to drive withdrawal operations.

Cycling in this type of facility (number of times a year the total working gas volume may be injected/withdrawn per year) is relatively low, and daily deliverability rates are dependent on the degree of rock porosity and permeability. These facilities are usually designed for one injection and withdrawal cycle per year, and often for only one cycle. Daily deliverability rates from depleted fields vary widely because of differences in the surface facilities (such as compressors), base gas levels, and the fluid flow characteristics of each reservoir. Retention capability, which is the degree to which stored gas is contained within the boundaries of the reservoir area, is the highest of the three principal types of underground storage. Depleted field storage is also the least expensive to develop, operate, and maintain. However, base gas costs, for providing a minimum reservoir pressure, can be quite significant.

Common Terms of Storage Measurement

There are several volumetric measures used to quantify the fundamental characteristics of an underground storage facility and the gas contained within it. For some of these measures, it is important to distinguish between the characteristic of a facility such as its *capacity*, and the characteristic of the gas within the facility such as the actual *inventory level* or the actual rate at which gas is injected or withdrawn. These measures are as follows:

Total gas storage capacity is the maximum volume of gas that can be stored in an underground storage facility by design and is determined by the physical characteristics of the reservoir and installed equipment.

Total gas in storage is the volume of storage in the underground facility at a particular time.

Base gas (or **cushion gas**) is the volume of gas intended as permanent inventory in a storage reservoir to maintain adequate pressure and deliverability rates throughout the withdrawal season. For depleted field and aquifer storage facilities, base gas typically occupies one-half or more of total storage capacity, with the remaining capacity available to store working gas.

Working gas capacity refers to total gas storage capacity minus base gas.

Working gas is the volume of gas in the reservoir above the level of base gas. Working gas is available to the marketplace.

Deliverability is most often expressed as a measure of the amount of gas that can be delivered (withdrawn) from a storage facility on a daily basis. Also referred to as the deliverability rate, withdrawal rate, or withdrawal capacity, deliverability is usually expressed in terms of millions of cubic feet per day (MMCF/D). Occasionally, deliverability is expressed in terms of equivalent heat content of the gas withdrawn from the facility, most often in dekatherms per day (a therm is roughly equivalent to 100 cubic feet of natural gas; a dekatherm is the equivalent of about one thousand cubic feet, or 1 MCF). The deliverability of a given storage facility is variable, and depends on factors such as the amount of gas in the reservoir at any particular time, the pressure within the reservoir, compression capability available to the reservoir, the configuration and capabilities of surface facilities associated with the reservoir, and other factors. In general, a facility's deliverability rate varies directly with the total amount of gas in the reservoir: it is at its highest when the reservoir is most full and declines as working gas is withdrawn.

Injection capacity (or **rate**) is the complement of the deliverability or withdrawal rate – it is the amount of gas that can be injected into a storage facility on a daily basis. As with deliverability, injection capacity is usually expressed in MMCF/D, although dekatherms per day is also used. The injection capacity of a storage facility is also variable, and is dependent on factors comparable to those that determine deliverability. By contrast, the injection rate varies inversely with the total amount of gas in storage: it is at its lowest when the reservoir is most full and increases as working gas is withdrawn.

These measures for any given storage facility are not necessarily absolute and are subject to change or interpretation. For example, in practice, a storage facility may be able to exceed certificated total capacity in some circumstances by exceeding certain operational parameters. Additionally, the distinction between base gas and working gas is to some extent arbitrary; so gas within a facility is sometimes reclassified from one category to the other. Further, storage facilities can withdraw base gas for supply to market during times of particularly heavy demand, although by definition, this gas is not intended for that use.

b. Aquifers

Aquifers, which originally contained water, may be suitable for gas storage purposes if certain geologic criteria are met. In the United States, aquifers that are used for gas storage are found primarily in the Midwest. There are several reasons why an aquifer is the least desirable type of underground storage, many of which contribute to making aquifer storage more expensive to develop and maintain than depleted reservoir storage. It is typically not as expensive to develop as salt formation storage, however.

First, it takes about twice as long to develop an aquifer storage site compared with an average depleted gas or oil field. Unlike a depleted site, the geology of an aquifer site is unknown beforehand. As a result, seismic testing must be performed to determine its geologic profile. Important also are such characteristics as the confinement area of the reservoir, the location and type of the "cap" rock ceiling barrier, existing reservoir pressure, and the porosity and permeability of the reservoir rock. The potential gas capacity of the reservoir is also unknown and can only be determined as the site is developed.

Second, all new facilities must be installed, including wells, pipelines, dehydration facilities, and compressor operations. Aquifer storage sites also may require additional facilities relative to the average depleted field site, such as greater compression for injection purposes (to push back the water), or more extensive dehydration facilities to "dry out" the gas upon withdrawal.

Third, no native gas is present in an aquifer formation. Thus, base or cushion gas must be acquired and injected into the reservoir to build and maintain deliverability pressure. Once in operation, aquifer reservoirs have one potential advantage over depleted field storage. Because of the additional support of an aquifer's water (pressure) drive, in most instances, higher sustained deliverability rates than gas or oil reservoirs can be designed and attained. Aquifer formations have certain operational characteristics that distinguish them from other storage types. Injection and withdrawal activities generally are required to conform to a disciplined schedule to avoid damage to the reservoirs or loss of gas. Therefore, aquifers only cycle once per year.

These limitations have important market implications, because operations at these facilities can't respond significantly to price changes or demand fluctuations. Thus, aquifer storage is more suitable for seasonal use and not suitable for multiple cycling and rapid response to changing needs, supply fluctuations, or sudden price arbitrage opportunities.

c. Salt Caverns

There are two basic types of geologic formations in which cavern structures used to store natural gas are developed: salt domes and bedded salts. Both are created by injecting water (leaching) into a salt formation and shaping a cavern. Caverns created in salt domes are large caverns as they are constructed within very thick salt formations. Salt domes can be miles in diameter, 30,000 feet in height, and can be as shallow as several hundreds of feet below the surface. Storage caverns developed in salt domes are often shaped roughly like a thick carrot: relatively "tall" and narrow.

While the salt dome itself might extend thousands of feet into the earth, storage caverns in salt domes are generally limited to depths shallower than 6,000 feet. This is because, at extreme depths, as temperature and pressure increases, salt is ductile and will creep or flow, which can become a major consideration in cavern construction possibly leading to excessive cavern closure/degradation over time. Hence, the optimum size of a storage cavern in a salt dome must be established with this in mind.

A bedded salt storage cavern, on the other hand, is generally developed from a much thinner salt formation (hundreds of feet or less). As a result, the height-to-width ratio of the leached cavern in a bedded deposit is much less than for a cavern in a salt dome. The depth of bedded salt formations is highly variable in North America. Some bedded salt formations are as shallow as a few hundred feet while others are many thousands of feet deep. Bedded salt formations also contain much higher amounts of insoluble particles (shale and anhydrite rock) than salt dome formations. These materials remain in the reservoir after the leaching process and can impact the eventual capacity of the cavern. In addition, because the height/width ratio is low, the cavern roof can be less stable than in a domal cavern. As a result of these as well as other factors, bedded salt storage development and operation can be more expensive than that of salt dome storage.

Because salt cavern storage facilities are essentially high-pressure storage vessels akin to underground tanks, their injection and withdrawal rates are very high and base gas requirements low. Their resulting ability to cycle working gas inventory numerous times during a year makes them ideal for meeting large demand swings.

d. LNG Storage

Liquefied natural gas (LNG) is natural gas that has been cooled to approximately minus 260 degrees Fahrenheit for storage as a liquid. LNG storage accounts for a very small portion of the overall natural gas storage capability in the United States as LNG working gas storage capacity is just over 2% of the overall capacity.[20] However, LNG storage facilities have relatively high deliverability rates that allow operators to deliver an amount equal to up to 14% of all underground storage. LNG storage can be grouped in two general categories: peak-shaving storage and marine terminals. Each of these categories has specific characteristics and utilization benefits.

Traditionally, LNG storage facilities in the United States were constructed solely for use by local utilities but more recently they have been developed to provide input into interstate pipelines. Peak-shaving LNG facilities fulfill an important role in supplying natural gas to customers. Unlike marine terminals which cycle their inventory, peak-shaving LNG storage is usually filled and held in the cold, liquid state for an extended period of time to supply natural gas only during peak demand periods. Peak-shaving LNG storage is often located in areas where it is not feasible or economical to access more traditional storage or pipeline infrastructure.

Peak-shaving LNG storage has two main positive attributes: its high deliverability capability as compared to more traditional storage and its flexibility with respect to where the storage can be located. However, peak-shaving LNG storage is more costly on the basis of dollars per million cubic feet of storage capacity, when compared to traditional storage.

Marine import terminals receive LNG shipments and have on-site storage. The LNG is stored in aboveground storage tanks until it can be regasified and injected into the pipeline grid. Additionally, the LNG can be stored until it is trucked, in liquid state, directly to customers. Marine terminals are typically equipped with enough storage space to accommodate LNG receipts from one to two LNG tankers. The principal operation of an import terminal is not for gas storage, but rather for receiving the water-borne LNG imports and then promptly regasifying LNG for shipment via pipelines to customers.[21] Marine terminal storage may also provide some peak-shaving storage services; however, that is not its principal function.

LNG marine terminal operators work to achieve a stable offtake rate. Terminal planning typically aims for a regular arrival of tankers, with adequate on-site storage to adapt to slight variations in shipping schedule. Delays in tanker receipts can be accommodated by drawing stocks from on-site storage; similarly, early arrival of shipments leads to some buildup in stocks. Operators must balance ship arrivals and inventory to ensure their ability to meet contractual requirements, so falling below certain operational thresholds is perceived as undesirable. However, there tends to be some flexibility in operations that might allow increased flows during periods of peak demand to help mitigate the market stress. In the forecast analyses herein, it is assumed that current and future LNG marine terminal operators can increase their overall sendout from each facility to 120% of normal flow rates for up to 3 days. This higher rate of drawdown must be followed by subsequent refill to restore on-hand stocks to optimal conditions. Operators will attempt to refill such stocks as promptly as possible.

e. Propane-Air

Propane-air storage is another method by which gas utilities and industrial customers meet demand during the coldest days of the year. Propane is stored in aboveground tanks or underground caverns (usually granite) until needed. Because it vaporizes relatively easily, propane can enter the gas pipeline distribution systems with little difficulty. However, as a gas, propane is heavier and has a higher energy density than methane, which is the largest component of natural gas. While propane contains about 2,520 Btu per cubic foot, natural gas contains approximately 1,000 Btu per cubic foot. As a result, these plants blend propane with air to produce a gas that has a burning characteristic similar to natural gas. Generally, a propane-air mixture containing 1,400 Btu per cubic foot has burning characteristics similar to natural gas. Some industrial consumers who utilize interruptible service on pipelines may use propane-air as a back-up fuel capability when their gas

[20] Source: Energy Information Administration, *U.S. LNG Markets and Uses*, January 2003.

[21] Ibid.

capability is "interrupted" by their utility. Similar to LNG plants, propane-air systems also provide utilities an opportunity to meet peak demands without reserving pipeline capacity that would rarely be needed. Although propane-air systems are common as a cheap alternative to pipeline capacity, there have been concerns over several failures for the propane to properly vaporize on especially cold days in the Midwest.

f. Compressed Natural Gas

Utilities across the country also may compress natural gas for local storage, although this technology is used to a much lesser extent than propane-air and LNG. Natural gas, which is transported on interstate pipelines at a pressure anywhere from 600 to 1,500 pounds per square inch, is compressed to approximately 3,000 pounds per square inch for storage in large cylinders. These compressed natural gas (CNG) cylinders, ranging 30-50 feet in length and approximately 20-inches in diameter, can be used as a form of peak shaving, but are more often used for vehicular fuel.

The cylinders are also often trucked to system locations to provide standby service where gas utilities are repairing gas distribution lines and don't want to interrupt service to local consumers. Although CNG continues to grow as a vehicular fuel, compression of natural gas for peak-shaving operations is expensive in comparison to LNG and propane-air because of its relatively low energy density.

2. Geographic Distribution of Storage Assets in the United States

The locations of the active underground natural gas storage facilities in the U.S. lower-48 and Canada are displayed in Table T-10. The regional grouping of states in Table T-9 was developed by the American Gas Association for use in its now-discontinued weekly underground natural gas storage report. (The Energy Information Administration has adopted the same regional breakout for its weekly survey and report of underground natural gas storage inventories.) A summary of the numbers of storage facilities and estimated working gas capacities by type of facility and region is also presented in Table T-9.

B. Historical Background and Statistics

In 1915, natural gas was first successfully stored underground in Welland County, Ontario, Canada. Several wells in a partially depleted gas field were reconditioned. Subsequently, gas was injected into the reservoir and withdrawn the following winter. In the United States, in 1916, Iroquois Gas Company placed the Zoar field, south of Buffalo, New York, into opera-

U.S. LOWER-48

New England	Mid-Atlantic	South Atlantic	East North Central	East South Central	West North Central	West South Central	Mountain	Pacific
ME	NJ	MD	MI	KY	ND	OK	MT	WA
VT	NY	DC	WI	TN	SD	TX	ID	OR
NH	PA	WV	OH	MS	MN	AR	WY	CA
MA		VA	IL	AL	NE	LA	NV	
CT		NC	IN		IA		UT, CO	
RI		SC			KA		AZ, NM	
		GA			MO			
		FL						

CANADA

Eastern Canada	Western Canada
Quebec	Manitoba
Ontario	Saskatchewan
	Alberta
	British Columbia

Table T-10. Locations of North American Storage Facilities tion as a storage site. In 1919, the Central Kentucky Natural Gas Company repressurized the depleted Menifee gas field in Kentucky. By 1930, nine storage reservoirs in six different states were in operation with a total capacity of about 18 billion cubic feet (BCF). Before 1950, essentially all gas storage was in partially or fully depleted gas reservoirs.

In some areas of the country, particularly the Midwest, there were no suitable depleted gas/oil fields available for potential conversion to storage fields. As a result, the concept of using an aquifer formation for storage was tested and developed. Although the testing was done in the 1930s, it was not until the early 1950s that firms began to develop aquifers for natural gas storage.

Most of the nation's storage sites were developed between 1955 and the early 1980s. During this period, U.S. storage capacity increased over fourfold, from about 2.1 trillion cubic feet (TCF) in 1955 to 8 TCF in 1985.[22] The need for underground storage grew as consumption of natural gas increased significantly. The mix and requirements of consumers also changed as demand shifted toward the more weather-sensitive residential and commercial markets. Furthermore, in the mid- and late-1970s, the interstate market encountered supply and demand imbalance situations during several exceptionally cold winters, and as a result service curtailments were imposed.

The demonstrated inability of the industry to meet large and sudden increases in demand for natural gas during the winter months in some areas helped stimulate the planning and construction of new storage. Regulators and industry saw increased storage development as necessary to avoid a repeat of such occurrences and also to satisfy expected increases in gas demand during the 1980s. Since the mid-1980s, total storage capacity has remained at approximately 8 TCF, even with the recent surge in new storage development as some new sites have been added but some have also been abandoned. However, the daily deliverability from storage has increased.

The volatile gas market during the late 1980s set in motion certain events that heightened interest in new storage facility development. Interest in new storage resurged as regulatory changes under FERC Orders 436 and 636 forced more competition into the marketplace. Storage became increasingly important as all pipeline services were unbundled and customers had to make their own storage arrangements. These changes led to increased interest in development of storage sites that would provide greater deliverability and more access to working gas capacity. Between 1992 and 2002, deliverability from storage increased by 29%, from approximately 65 BCF/D to 83 BCF/D.

C. Results from the Study Regarding Capacity Utilization

1. Changes in Storage Capacity

The reference case (Reactive Path scenario) analysis projects an increased demand for North American storage capacity of close to 1 TCF over the 22-year study period, relative to the demands on storage in the 1999-2002 period, which averaged 2.3 TCF per year. Recognizing that the base period (1999-2002) was characterized by relatively light demand on storage due to generally warm winters, it is estimated that the current storage infrastructure is sufficient to satisfy an increased average annual demand of approximately 300 BCF, leaving 700 BCF of demand that will need to be met by development of new capacity. As much as 150 BCF of this new capacity could be required in the very near term if there were a return to winter weather patterns closer to historical normal levels. As only 109 BCF of storage additions are projected to occur by 2005 (based on projects currently announced), most of any such near term demand increase will need to be met through more efficient use of existing capacity, and measures to increase capacity and deliverability at existing facilities.

By 2015, total cumulative storage capacity additions will need to have approached 400 BCF, and by 2025, 700 BCF, to accommodate growth in the total gas market. While many of the best resources for gas storage (based on location and geology) have been developed, this rate of growth in the infrastructure is considered achievable provided that favorable market conditions exist to finance the additions. Conventional storage is expected to account for over 80% of the projected additions and high deliverability peak shaving the remainder. The states or provinces included in each region are identified in Table T-10.

When discussing the adequacy of storage infrastructure, it must be kept in mind that demands on storage

[22] Refers to total storage capacity rather than usable capacity.

vary greatly, from year to year, depending on weather, and that even if the projected growth in capacity is achieved there will likely be winters when the system is unable to fully supply gas withdrawal requirements without some significant short-term reduction in gas demand, whether price induced or otherwise. A winter of significantly colder than normal winter weather can increase demand for storage capacity by as much as 25% relative to a normal year. It has been many years since North American storage capacity has been tested by such a winter and it is very likely that current storage capacity would be severely challenged to meet such demand, with potential for even greater price spikes and demand destruction than what was experienced in 2001 and 2003.

Storage additions for the U.S. lower-48 were evaluated on the basis of nodes within the nine census regions, while additions for Canada were split between nodes in eastern and western Canada.

In the U.S. lower-48, the need for near-term storage additions is greatest in the Pacific, East South Central, South Atlantic, West South Central, and Mid-Atlantic regions. Near-term storage additions for the Mountain region are projected to grow modestly. No near-term storage additions are projected for the West North Central or New England regions.

Projected additions to peak shaving and conventional North American storage over the 2005-2025 period are 550 BCF. Nearly 80 BCF of the projected additions are for high deliverability peak shaving storage facilities, with lower-48 additions accounting for 90% of this requirement. All regions of North America will require some new high deliverability peak shaving storage. The need for this type of storage will be greatest in the South and Mid-Atlantic regions, collectively accounting for over 30% of the projected growth in peaking storage, driven primarily by growth in the residential and commercial sectors. Peak shaving growth in the West South Central and Pacific regions are projected to grow at 9 BCF each. Eastern Canada will experience the need for peak shaving additions as well; additions in this region are projected to be over 8 BCF.

Projected additions to conventional storage during 2005-2025 are largely concentrated in the lower-48 market area. Three regions in particular, East North Central, Mid-Atlantic, and South Atlantic, are projected to experience significant storage growth amounting to about two-thirds of the projected overall storage additions. Combined storage growth in these three regions is projected to be about 320 BCF, with the greatest additions to the East North Central at approximately 111 BCF (10% increase over current), followed by nearly 109 BCF (44% increase over current) and 99 BCF (23% increase over current) to the Mid-Atlantic and South Atlantic, respectively.

This increase in storage will require additional pipeline capacity to reach the market centers, particularly for storage developed to serve the Mid-Atlantic and Northeast markets, which lack suitable reservoirs for storage development within the region. Instead, the new storage capacity will have to be developed in the western portions of Pennsylvania and New York and eastern Ohio. This will result in the construction of incremental pipeline capacity of approximately 2 BCF/D from these storage sites to the coastal market centers, which include New York City, Boston, and Philadelphia.

The Mountain region is projected to require nearly 55 BCF of additional storage (17% growth), and the West North Central a proximal 37 BCF (22% growth) of new storage capacity. Eastern Canada is projected to see growth of about 40 BCF, or about a 20% increase relative to current storage capacity.

2. Changes in Storage/Withdrawal Patterns

Annual average North American daily loads adjusted for storage are projected to grow 19 BCF/D from 71 BCF/D to 90 BCF/D from 2005-2025 (Figure T-21). This growth will impact storage injection and withdrawal patterns in certain regions more than others, though in general, seasonal withdrawals will increase in response to growth in the residential and commercial sectors, and to some extent growth in power generation. In contrast, growth in the Industrial sector during this same period is projected to be virtually flat with likely no impact on storage usage patterns. Injection patterns will be impacted more due to growth in power generation than anything else.

Daily loads during the 10 highest demand days of the year are projected to increase from approximately 101 BCF/D to over 126 BCF/D during the study period, while loads during the 60 highest demand days are projected to grow from 92 BCF/D to 116 BCF/D. Storage plays a critical role in satisfying incremental load during peak use periods. The highest load periods occur during the heating season and storage withdrawals typically satisfy over 50% of the daily North

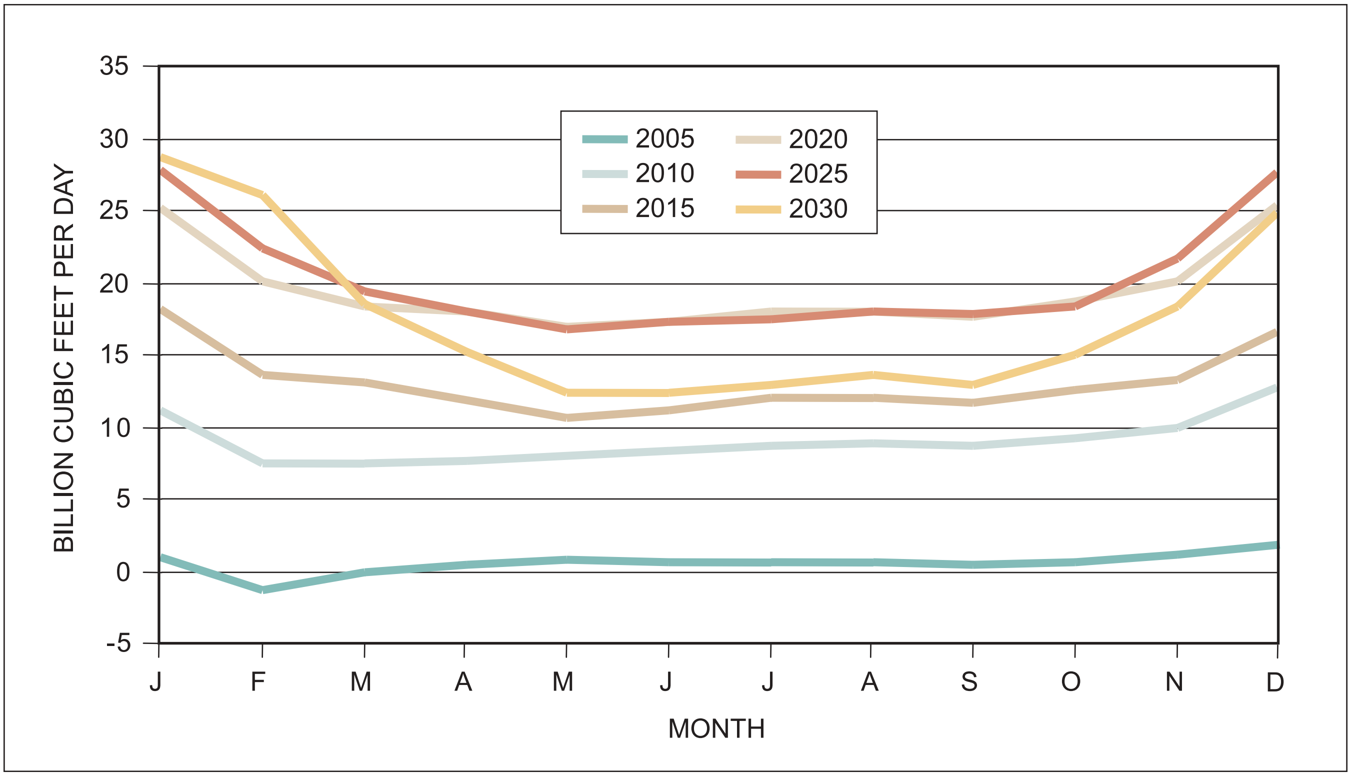


Figure T-21. Growth in Monthly Gas Demand (from Base Year 2003)

American load during the highest demand days of the heating season. Two regions in particular stand out in this regard: in the East North Central region, the reference case projects demand during the 60 highest demand days of the year will be over 2.4 times the average daily load. A similar projection is evident for the West North Central where demand during the 60 highest demand days of the year is nearly twice that of the average daily demand. Under such circumstances, storage is ideally suited to satisfy these incremental seasonal loads, which are predominantly driven by space heating requirements in the residential and commercial sector.

Loads associated with the residential/commercial sectors are highly temperature sensitive, and thus, significantly impact winter withdrawals, and will continue to do so. North American growth in these two consumption sectors is projected at 18% and 52% respectively. The impact of this growth will result in greater utilization of existing storage capacity – i.e. withdrawing a larger percentage of working gas capacity than has been experienced in recent years – and create the need for new storage facilities on a regional basis.

As previously noted, overall growth in the natural gas market is expected to require the addition of approximately 400 BCF of new storage working gas capacity by 2015 to meet the needs of a year of normal weather. However, actual annual storage injections and withdrawals have been highly variable in the past, due primarily to variability in weather, and in particular the magnitude of winter heating degree days. The potential impact on demand for storage due to future weather variability was assessed by reference to the weather sensitivity cases developed by the Demand Task Group. Those cases mapped actual historical data for heating degree days and cooling degree days by census region for the period 1977 through 1999 onto the forecast period, varying the timing of the coldest year data (1978-79).

The results of the weather sensitivity analysis indicate that annual demand for storage capacity should be expected to be highly variable if year-to-year weather variability is comparable to the historical period. Figure T-22 illustrates this annual variability in demand for storage under three of the weather sensitivities, relative to the base case which assumes normal weather in every year. It indicates that in the event of a significantly colder than normal winter in the near

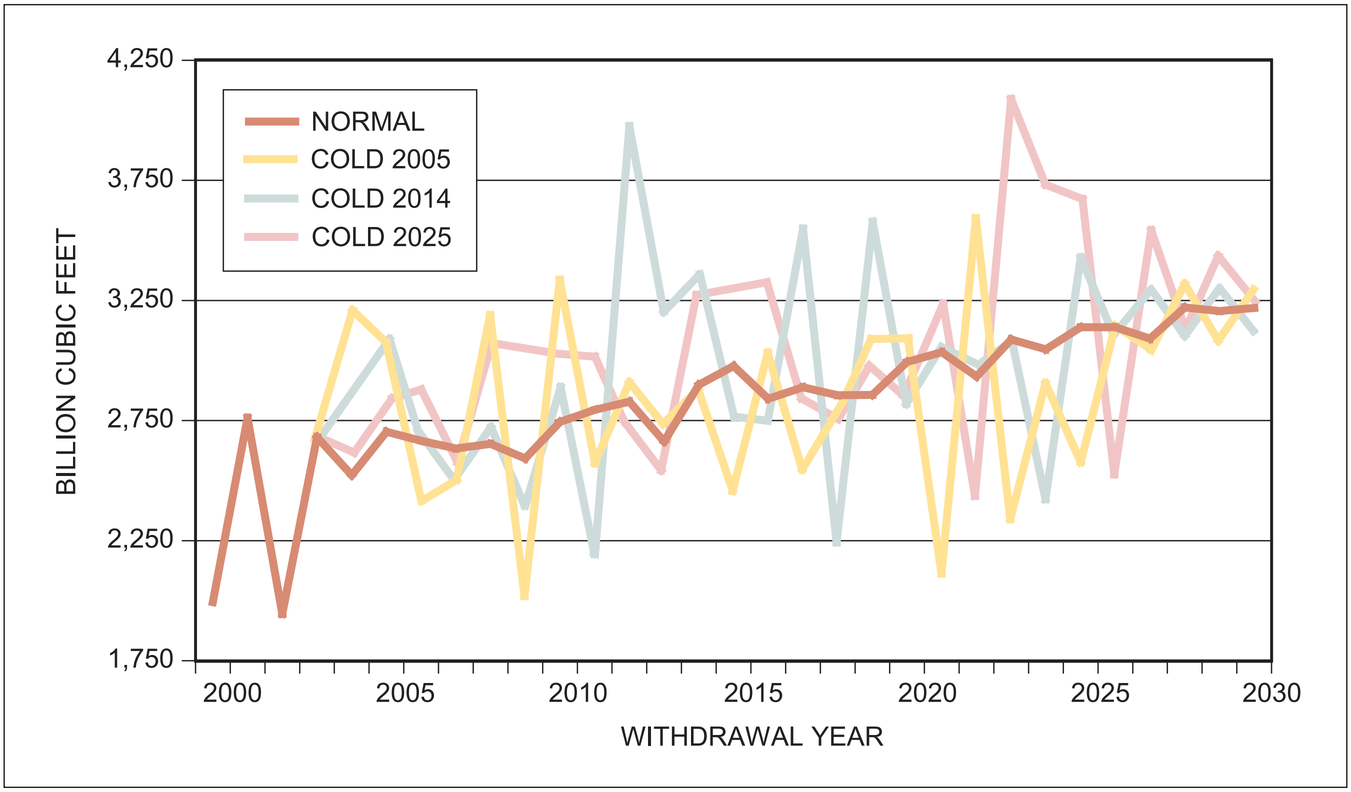


Figure T-22. Total North American Storage Demand in the Balanced Future Scenario – Normal vs. Cold Weather

term, demand for storage could be as high as 3.2 TCF, as compared to maximum annual net storage injections and withdrawals to date of 2.9 TCF. Peaks in demand for storage could be more extreme in the event that such a colder than normal winter occurs in later years, due to the combined effect of the weather and the growing weather sensitivity of gas demand during the forecast period.

The ability of existing U.S. and Canadian storage infrastructure to achieve total summer injections or total winter withdrawals of more than 2.9 TCF per year has not been demonstrated, and years in which more than 2.6 TCF to 2.7 TCF have been injected and withdrawn have tended to be characterized by high levels of gas price volatility. Winter peak gas demands in excess of the current infrastructure's capability would likely result in increased gas price peaks, seasonal fuel switching and seasonal demand destruction.

Natural gas demand has always been seasonal, but a recent phenomenon is that, due to increased gas-fired generation implemented around the continent, a new summer season peak is also developing. Other than the industrial load, which has traditionally been steady on a daily and seasonal basis, the other major demand sectors (residential, commercial, and electric generation) are weather sensitive and have a high degree of variability. Demand in North America is projected to grow by 19% between 2003 and 2015, whereas industrial demand is projected to grow by only 3%. This would mean that the stable industrial demand sector is becoming a smaller percentage of total demand. This effect is more pronounced in the United States, where industrial demand is projected to decline by 6% from 2005 to 2015.

Demand for power generation, which will make up the majority of projected demand growth, is highly variable on an hourly, daily, and monthly basis. As can be seen in Figures T-23 (historical 1997) and T-24 (projected 2025), power generation not only increases the number and magnitude of winter demand peaks, but it also creates a secondary demand peak in the summer. It also creates an hourly demand profile that is even more pronounced than that of a traditional residential/commercial load profile. The growing summer peak shortens the summer season gas storage injection period, primarily allowing for injections only in the off-peak electric demand hours of the day and

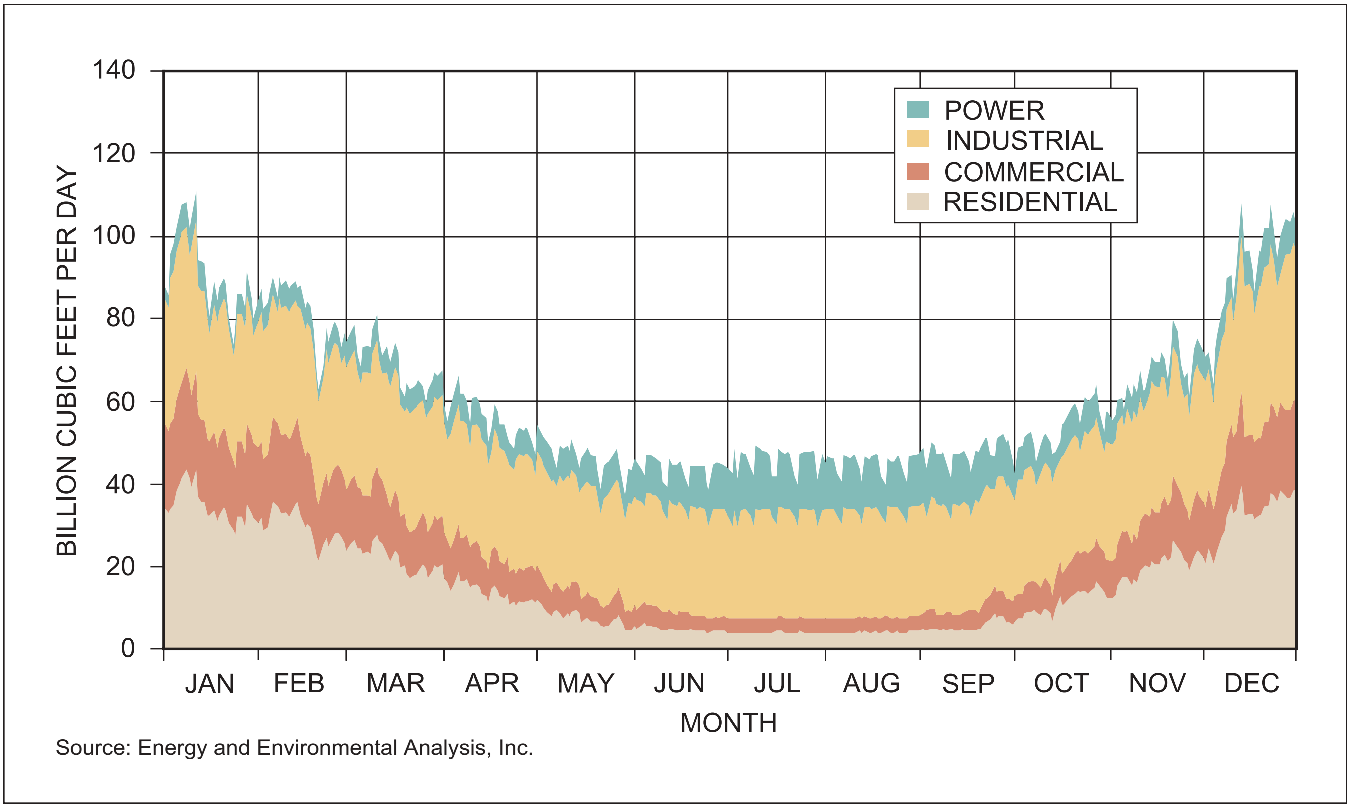


Figure T-23. 1997 Daily Loads for the United States and Canada

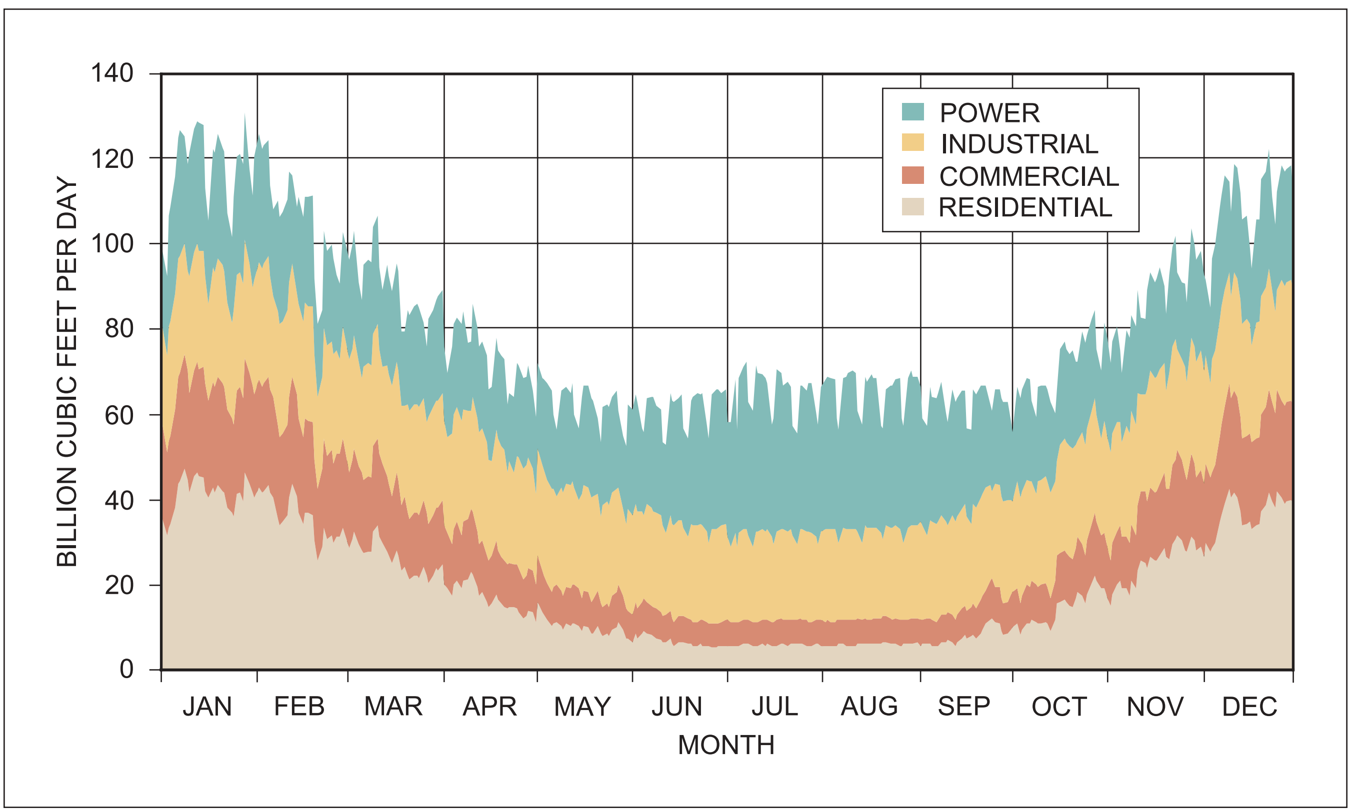


Figure T-24. 2025 Daily Loads for the United States and Canada thus requiring more volume to be injected into the shoulder (historically lower demand) months of April through June and September through October.

The Reactive Path scenario projects the Mid-Atlantic, South Atlantic, and to a lesser extent, the West North Central regions will experience the greatest growth in this summer peak, though in each case, loads during the summer peak remain significantly less than those associated with the winter months. Thus, as gas-fired generation facilities are added to the infrastructure, supply dedicated to serving this market will compete with supply intended for storage injections.

In order to satisfy storage refill requirements, greater injections into storage during the shoulder months of April, May, September, and October will likely be necessary to completely refill storage by the beginning of the winter season. In a supply constrained environment, this "time-compression" of the storage injection season will place upward pressure on summer prices as gas consumed in the power generation sector competes with gas intended for storage.

3. Required/Assumed Infrastructure Additions (Costs)

Projected near-term (2003-2005) demand for seasonal storage could grow by as much as 450 BCF, relative to the requirements of 1999-2002, with most of that increased demand being due to an assumption of a return to more normal weather. As much as 300 BCF of that demand growth may be accommodated by the existing infrastructure. Based on announced projects, it is expected that storage capacity will grow by only 109 BCF by 2005. Additions to working storage capacity in the lower-48 amount to 69 BCF, and consist of projects previously announced to the market. Any remaining incremental near-term demand for storage will need to be met by more efficient utilization of existing capacity and short-term enhancements to the capacity and deliverability of existing facilities. There is a significant risk that any near-term return to more normal weather patterns could not be met by the existing infrastructure without some increase in seasonal gas price variability and volatility. The Pacific region will experience the largest near-term growth at over 29 BCF. The announced projects involving capacity expansion of existing reservoirs at an estimated cost of $1 billion. Over 34 BCF of the near-term storage additions will be high deliverability salt cavern facilities located in the Mid-Atlantic, South Atlantic, West South Central, and Mountain regions, with a total estimated development cost of $211 million.

A mix of new salt cavern storage capacity and depleted reservoir storage projects in the Mountain and East North Central regions make up the remaining 4 BCF in the U.S. lower-48. The total cost associated with these additions is $38 million. Near-term additions to Canadian storage amount to 40 BCF, all of which are located in Western Canada and involve new development in depleted reservoirs. The estimated cost associated with these additions is $100 million.

Projected North American storage infrastructure additions over the 2005-2025 period are approximately 550 BCF, 80 BCF of which will consist of high deliverability salt cavern facilities. In total, future North American storage infrastructure additions over the study period carry an estimated cost of nearly $5 billion.

On a regional basis, the development of 111 BCF of additional depleted reservoir and aquifer storage capacity is projected in the East North Central at an estimated cost of $905 million. Conventional storage additions to the Mid-Atlantic region are forecast at 141 BCF, all of which will likely entail the conversion of depleted reservoirs, at an estimated cost of $1.3 billion.

Growth of conventional storage in the South Atlantic is projected at about 99 BCF, with an estimated development cost of $804 million. The Mountain region is projected to need almost 55 BCF of additional conventional storage with attendant development costs of $468 million.

The remaining additions to the lower-48 storage capacity are projected at almost 87 BCF, at a total estimated cost of $1.07 billion. Projected additions to Canadian storage capacity are 56 BCF, including over 8 BCF of high deliverability storage. All but about 2 BCF of these additions are projected for Eastern Canada. The total estimated cost of storage additions in Canada is $260 million. Table T-11 shows the capacity additions and estimated costs in more detail.

It should be noted that these regional capacity addition estimates are based on model results that may not adequately reflect geological and other factors which favor construction of capacity in some regions relative to others. In particular, it is likely that more of this required capacity will be built in the

Region Number	Region Name	Announced 2003-2005	2003-2005 Est. Cost (MM$)	Additions (BCF) 2005-2025	2005-2025 Est. Cost (MM$)
1	New England	-	-	32.1	382
2	Middle Atlantic	5.0	47	108.9	914
3	East North Central	0.9	8	111.4	905
4	West North Central	-	-	36.9	332
5	South Atlantic	7.6	72	98.5	804
6	East South Central	16.0	149	6.0	227
7	West South Central	6.6	62	9.2	282
8	Mountain	3.2	30	54.3	468
9	Pacific	29.3	274	35.1	225
	Total U.S. Lower-48	**68.6**	**642**	**492.4**	**4,539**
10	Canada East	-	-	54.3	250
11	Canada West	40.0	100	1.8	10
	Total Canada	**40.0**	**100**	**56.1**	**260**
	Total North America	**108.6**	**742**	**548.5**	**4,799**

Notes: MM$ = millions of dollars. BCF = billion cubic feet.

Table T-11. Projected Storage Capacity Additions and Costs by Region

major producing regions of the United States and Canada, and less in the market regions than is indicated in the discussion above.

D. Market Needs for Storage

The natural gas storage infrastructure must maintain its ability to serve its traditional markets while developing the capacity to meet new demands on the pipeline system. The traditional markets serve the historical needs of both the gas consuming region markets and the gas producing region markets.

The traditional role of storage in the consuming region has been for seasonal time-shifting of volume from summer availability to winter usage and peak-day deliverability for residential and commercial customers served through regulated LDCs. Seasonal time-shifting of supply refers to the use of storage assets to preposition gas as close to these seasonal end users as possible. Withdrawals of working gas in storage during the heating season augment pipeline supply, which alone would be insufficient to meet the increased wintertime demand. The critical nature of this role was reinforced by the experience of the 2002-2003 heating season – one with widespread and persistently frigid temperatures that caused the industry to withdraw working gas down to record low levels. Related to seasonal shifting, a key role for storage is to meet peak-day demand requirements. On the highest demand days, storage provides the bulk of gas sendout for at least some LDCs.

The traditional role of storage in the producing region has been for seasonal time-shifting by producers of gas. This role has been increasingly filled by gas marketers who, hoping to capture price advantage, use the storage capacity to buy during periods of oversupply while selling in periods of undersupply.

Over the past several years, as electric generators have installed more and more gas-fired generation assets, a secondary peak is developing in the summer months related to space cooling requirements. This new source of demand is altering the traditional seasonal demand for gas and increasing the daily demand for gas deliverability. Figure T-25 illustrates the large surge in demand during the heating seasons, and the developing secondary summer surge in demand. Although not as pronounced as the winter peaks, the secondary peaks occur during the refill season and compete for supplies that otherwise might be available for storage injection. The increased use of natural gas for electric generation is increasing the load management challenge for pipelines and storage operators on a daily and even intra-day basis.

Therefore, the operation and utilization of storage is evolving, and the industry faces the growing challenge of refilling inventory for traditional heating season requirements in competition with a growing summer demand surge while also managing the ever more frequent fluctuations in demand load.

E. The Outlook for Storage

Market dynamics have created a growing need for multiple cycle storage facilities. In recent years there have been several occasions when winter/summer seasonal price spreads have declined to such low levels that seasonal storage of gas for price arbitrage purposes has been uneconomic. However, the operational need to store gas to balance winter and summer demand with relatively flat gas supplies has remained. In addition, the gas market's fluctuation on a day-to-day, week-to-week and month-to-month basis demands quick turnaround of storage inventories. With credit concerns, i.e., cash flow, becoming an issue for many gas traders and marketers, storing gas without access to it for 6-8 months can be a risky proposition.

Electric generation demand in summer will compete with storage injection requirements during the summer cooling season. This issue has been in place for a number of years. Most multiple cycle storage operators are familiar with the double dipping of inventories due to cooling load in the summer and heating load in the winter. This is the effect of summer season generation demand on the pipeline infrastructure, and this effect continues to strengthen. If the pipeline infrastructure is strained due to peak summer loads, scheduled storage refills can be interrupted. As this phenomenon increases, there will be more and more of these refill interruptions. For those storage facilities with rigid refill requirements, this can become a serious problem. Less rigid requirements will have to be considered, which might require more horsepower installation, more wells, or reductions in the level of working gas available from year-to-year.

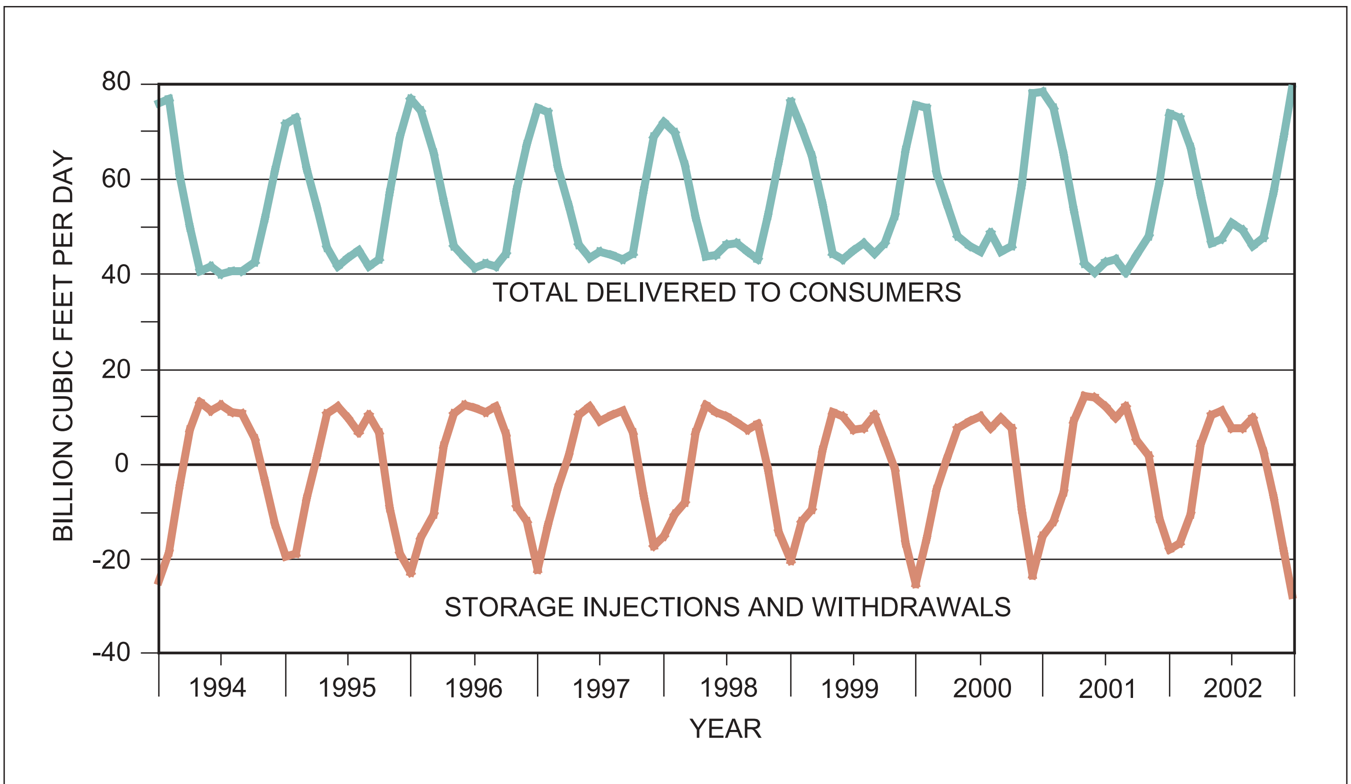


Figure T-25. Deliveries to Consumers and Storage Injections/Withdrawals, 1994 to 2002

F. Challenges to Building and Maintaining the Required Storage Infrastructure

1. Access Limitations

The difficulty of siting storage facilities can be attributed to the need to find a site with the appropriate combination of geological features, pipeline proximity, and the ability to obtain land, rights, and permitting. Once a geologically suitable site is found at an acceptable location with respect to the natural gas pipeline infrastructure, the ability to obtain permitting, land, and development rights becomes critical. The primary access limitations on developing storage capacity are the difficulties in dealing with multiple governmental entities, limitations on emissions, and limitations on storage reservoir operating pressures.

The inconsistency in requirements for FERC and state facility certifications increases the time and cost to develop storage facilities. Proving necessity, i.e., market need, and tailoring implementation plans for minimization of environmental impact are two areas that can have widely varying meanings depending on the approval entity involved. When two or more entities must be satisfied, the complexity involved in satisfying all parties increases exponentially.

It is estimated that existing storage facilities can be expanded to increase capacity by as much as 5%. However, modification of an existing storage field can prove to be as difficult, if not more difficult, than new development. Two examples of this are regulations that limit emissions and regulations that limit the maximum pressure in a storage reservoir.

Limitations on air emissions effectively restrict the amount of compression that can be used to support injection and/or withdrawal activities in a storage facility. Since the ability to inject gas into a reservoir is dependent on the facility's compression capacity, injection capacity is a common limiting factor on the effective capacity, or the ability to cycle a storage field. As a result, many storage operators in emissions-controlled regions limit injection rates to 50% of withdrawal rates. This is particularly evident in the Rockies, California, and the Northeast regions. Operating existing fields more efficiently is often more cost-effective and environmentally sound than new facility development.

In a similar manner, the ability to increase the operating pressure in a storage reservoir can improve the efficiency of existing assets. States generally limit the maximum pressure in a reservoir to the discovery pressure of the reservoir. The ability to safely delta pressure (increase) a reservoir can substantially and cost-efficiently expand the capacity and deliverability of the existing reservoir.

2. Limited Nature of Suitable Geologic Sites

Any access restrictions can have an even greater impact when the limited number of sites is considered. Depleted reservoirs, aquifers suitable for storage, and salt formations are all of limited extent in North America. Any target storage formation must first be reasonably close to a major pipeline before practical storage development can be considered. This initial and obvious requirement limits many suitable geologic formations from consideration for storage development. Very few states have suitable depleted reservoirs, aquifers, and salt formations available for practical storage development. The mere presence of a candidate geologic formation for storage cavern development may not be sufficient to warrant practical storage development. For example, even though there are extensive bedded salt deposits in the Northeast United States, storage cavern development has been difficult to justify economically in the Northeast because there are few options for disposing (or otherwise utilizing) the massive salt brine volumes that naturally result from salt cavern development.

3. Costs to Create Storage Infrastructure

Deregulation of the interstate pipelines under FERC Order 636 has had a significant impact on the availability of cost data associated with new storage projects. Prior to Order 636, new storage developments and expansions to existing interstate storage facilities were typically approved by the FERC under traditional cost of service rate treatment. Costs associated with new storage and storage expansions were contained in the Exhibit K portion of an organization's application to FERC. As such, storage development cost data were considered in the public domain and were readily available for review and analysis.

Order 636 afforded some storage operators and developers alike with the option to seek authority to develop new storage facilities under the concept of market-based rates wherein the applicant is not required to submit development cost data. This option is open to developers who can demonstrate the absence of what is referred to as market power, i.e. that competitive alternatives either exist within the nearby market or could be developed by someone else under a similar rate structure.

The assumptions used in this study concerning costs associated with expanding existing storage facilities and development of new facilities were based upon a review of FERC filings dating back to 1994. The review revealed that costs associated with expanding existing depleted reservoir and aquifer storage facilities do remain available in FERC documents since most expansions over the past 8 years have been performed under existing rate structures (cost-of-service rate structure). Most new storage developments on the other hand have been filed under the market-based-rates option, and thus, review of development cost data for these facilities is very limited.

No single source of cost data for expansion of intrastate storage facilities exists; thus, expansion costs for intrastate facilities are not reflected herein, though costs should conform to those of similar interstate expansions. A total of seven applications were listed on the FERC website, six of which included cost data. These applications were reviewed and the cost data contained in them used to establish average costs associated with enhancing existing storage facilities. Data and cost information for one Canadian project was supplied by the operator and is included here for purposes of establishing development cost data. Table T-12 lists all of the projects and summarizes the additional facilities, increase in storage capacity, and/or deliverability for which FERC or comparable regulatory approval was sought.

These data indicate expansion costs ranged from a low of $0.17 million per BCF to a high of $9.10 million per BCF over an eight-year period, with the average cost being approximately $2.5 million per BCF of incremental capacity. For purposes of this exercise, we've assumed this average cost is reasonable and typical of the costs associated with expansions to both inter- and intrastate storage facilities.

Costs associated with expansions of salt cavern storage facilities were not available on the FERC website. Estimates based on industry experience range from approximately $2-3 million per BCF, depending on where in the country the expansion occurs.

Docket No.	Filed Date	Company	Field Name	State	Capacity Increase (BCF)	Total Project Cost ($MM)	Enhanced Storage Cost ($MM/BCF)
Depleted Reservoirs							
CP02-409-000	7/17/2002	ANR Storage	Excelsior 6	MI	4.0	4.4	1.10
CP01-67-000	1/17/2001	SouthWest Gas Co.	Howell	MI	1.3	3.9	3.12
CP98-546-000	5/13/1998	Columbia	Ripley	WV	0.8	7.3	9.10
CP98-637-000	6/26/1998	Columbia	Glady	WV	0.7	0.1	0.17
CP96-213-000	2/28/1996	Columbia	Various	Various	16.8	53.3	3.17
CP95-62-000	11/4/1994	Columbia	Crawford	OH	8.2	8.4	1.03
CP02-391-000	6/24/2002	Natural Gas Pipeline	North Lansing	TX	10.7	31.1	2.90
	10/1/2002	Intragaz	St. Flavian	Quebec	2.9	3.2	1.10
				Total	45.4	111.7	
						Average Cost	**2.46**

Notes: MM$ = millions of dollars. BCF = billion cubic feet.

Table T-12. Summary of Storage Expansion Costs – Regulated Facilities

For those few projects that have been developed under intra-state authority, there is no central repository for cost data and access to such data at the state level is limited. For purposes of this exercise, we have assumed an average cost for development of new depleted reservoir and aquifer storage of $2 million per BCF of working gas capacity based on industry experience.

4. Impacts of Price and Basis Risk on Infrastructure Development

Historically, a principal function of the North American gas storage infrastructure has been that of balancing highly seasonal and weather-sensitive fluctuations in demand, with relatively flat year-round supply. The principal alternatives to storage generally rely on significant gas price variability and volatility to force a supply/demand balance: during times of excess supply, i.e., the gas price must fall low enough to induce producers to shut in gas production, and/or during times of excess demand the price must rise high enough to force short-term demand destruction.

In an environment in which gas supply remains increasingly challenged to keep pace with growing demands for natural gas, it is to be expected that producers will have an incentive to maintain gas production at near maximum capability at all times, as has generally been the case in recent years. The principal alternative to the short-term balancing role of gas storage in the future, then, is likely to be some form of forced demand destruction, through the price mechanism or otherwise. The adequacy of storage capacity, then, is increasingly important to supporting a market that can continue to grow while providing reasonable assurances of supply and acceptable levels of gas price volatility.

The seasonal balancing requirements of the North American gas market are expected to grow at a rate approximately equal to the overall rate of growth in total gas consumption. This total balancing requirement (defined as the total amount of gas that would need to be injected into storage during the April to October injection season and withdrawn during the November to March withdrawal season to allow average daily gas production to remain constant) has averaged approximately 2.3 TCF during the period 1999-2002, a level consistent with actual annual storage injections and withdrawals during that period, a period of generally warmer than normal winters on average.

A return to "normal" weather, combined with continued gas market growth, would see this annual balancing requirement grow by 15% to 20% by 2005, to approximately 2.7 TCF. Beyond 2005, the balancing requirement is expected to grow consistent with overall demand growth such that total balancing requirements fluctuate around 10% of total annual demand.

The continued strong growth in demand for seasonal balancing is primarily a function of projections of very strong growth in gas demand for power generation. This includes requirements of electrical consumers, which is sensitive to both actual summer and winter weather, as well as the traditional winter residential and commercial heating demand. Industrial demand, on the other hand, which tends to be more evenly distributed throughout the seasons, will show little total growth. The overall effect of these trends will be relatively higher future growth/needs in the winter months than in overall annual demand. Due to this incremental growth in gas-fired power generation, there is also a continuation of recent trends towards a secondary summer peak in demand, albeit modest in comparison to the continuing growth in the winter peak.

Despite the fact that, on average, the past four years have experienced relatively moderate seasonal balancing requirements due to somewhat warmer than normal winters, seasonal gas price variability and volatililty have been significant. An objective of avoiding even greater price variability and volatility in the future would suggest that storage working gas capacity may need to grow by as much as an additional 250 BCF between 2005 and 2015, and an additional 300 BCF between 2015 and 2025. Gas storage capacity growth to meet these targets will require an adequate resource base of further storage development opportunities and market incentives that encourage investment in expansion of existing facilities and development of new facilities.

5. Market Signals and Financial Requirements

The capital investments that would be required to add 700 BCF of additional working gas capacity by 2015 are significant, yet small relative to the potential capital requirements in other sectors of the natural gas industry. A more significant issue with regard to financing storage capacity growth is whether there will be adequate market signals to encourage such investment.

Storage development costs vary significantly from region to region and by facility type. Expansions of existing facilities have the potential to add approximately 200 BCF of incremental capacity at an average cost in the range of $5 million per BCF of working gas, while new projects will require $5 million to $10 million per BCF. Total financial requirements of adding 700 BCF of working gas capacity by 2025 are likely to be in the range of $4 to $6 billion.

Similar to pipeline transmission capacity, contracting practices for natural gas storage capacity are currently undergoing significant change, and it is not yet apparent how the market requirement for increased capacity will be translated into contractual arrangements to underpin investments. Generally speaking, storage customers can be classified into two broad categories: those who contract for capacity for its value in capturing time period gas price arbitrage margins (summer/winter price differentials; spot versus future month differentials etc.) and those who contract for capacity to meet their operational and reliability requirements without regard to price arbitrage opportunities. Traditionally, LDCs have held a large proportion of total storage capacity and have tended to operate with relatively price-insensitive storage injection and withdrawal targets, using storage capacity as a vital asset in satisfying their obligation to meet winter peak demands. Until recently, the fastest growing segment of storage customers was the energy marketing companies who were primarily focused on price arbitrage opportunities. Over the last 18 months, however, there has been a noticeable retreat from gas storage contracting by energy marketing companies, due in no small part to the financial difficulties of this segment. Thus the entities that will contract for the necessary storage facilities to meet future growth needs remain uncertain.

Also, market and regulatory trends of recent years have caused LDCs to become less active in contracting for long-term gas storage capacity. The introduction of customer choice programs and the uncertainties regarding the LDC's role as "supplier of last resort" (as discussed in the Distribution section of this report) have presented difficulties for LDCs in forecasting their future contractual requirements for gas supply, pipeline capacity, and storage capacity. At the same time, in the recent past there was a strong movement towards LDC reliance on energy marketing companies to manage their contracted LDC storage capacity, often through short-term asset optimization arrangements between LDCs and marketers.

Coupled with market conditions that were characterized by relatively small summer/winter spreads throughout the first five months of 2003, these trends have resulted in what is currently described by storage developers as a "very soft market" for the development of new gas storage capacity, notwithstanding the positive longer-term fundamentals as echoed herein.

In order for gas storage capacity development to meet anticipated future demands, storage developers feel they must see a revitalization of demand for multi-year gas storage contracts through some combination of customers such as LDCs and others with firm obligations to serve seasonal and peak-day market requirements for critical needs customers, and/or the emergence of a business sector which is capable of performing this role while also in pursuit of price arbitrage opportunities.

6. Development Lag

There is an extensive delay between project initiation and completion. Although development time lags vary significantly by region and by type of storage, on average it is expected that there will be a lag of 3 years or more between project identification and completion. Assuming favorable market conditions, as discussed in the previous section, this development lag should not pose a significant problem for the 550 BCF of capacity that would need to be added between 2005 and 2025. However, it does mean that any portion of the potential increase of 400 BCF in demand for storage prior to 2005 that can not be met by increased utilization and enhancements of existing facilities, is almost certainly going to result in increased gas price variability and volatility during that period. As previously discussed, this potential near-term increase in demand for storage will be very dependent on weather, and is based on an assumption of a return to more normal weather patterns, relative to recent years of warmer than normal winters.

7. Technological Impacts

New technologies for gas storage performance are continually being investigated by the industry and industry support agencies. For example, the Gas

Technology Institute (GTI), the United States Department of Energy (USDOE) National Energy Technology Laboratory (NETL), and the Solution Mining Research Institute (SMRI) all fund ongoing research and development activities in gas storage performance improvements. Many specific examples of gas storage performance improvement are noted on the cited agency websites. Two examples of gas storage improvements and research are briefly described below. Many others are being pursued through active research efforts.

a. Horizontal Injection/Withdrawal Wells

Horizontal gas storage wells have the potential to significantly improve the injection and withdrawal performance and the efficiency of existing and newly developed gas storage reservoirs. Based on the results of a 1991 study funded by the Gas Research Institute,[23] in excess of 70% of the storage capacity in the United States and Canada is associated with reservoirs that are considered good to excellent candidates for horizontal wells based on their petrophysical characteristics. Properly applied, this technology can enhance gas deliverability, recovery of working gas from poorly-drained regions of a reservoir, increase the amount of gas available to cycle by reducing reservoir working pressure, and reduce environmental impact.

While there are a number of considerations that come into play in determining whether horizontal wells may enhance storage reservoir performance, some rules of thumb may be applied. Generally speaking, the technology is best suited for relatively thin, homogeneous reservoirs, and reservoirs which exhibit natural fracturing. Horizontal wells tend to be more effective in thinner formations because the incremental increase in wellbore-reservoir contact area is much larger than for relatively thick formations.

Vertical and horizontal permeability, which are measures of the ease with which gas flows through porous rock, are extremely important as well. Vertical permeability is a key parameter in horizontal wells in that it controls gas flows in the reservoir from above and below the wellbore. In particular, the ratio of horizontal to vertical permeability has a dramatic impact on horizontal well deliverability. All else being equal, a horizontal to vertical permeability ratio less than 1.0 indicates reservoir properties may be ideal for horizontal gas storage well applications.

In low and high permeability gas storage reservoirs alike, horizontal wells can significantly improve deliverability and drainage. In low permeability reservoirs (< 1 millidarcy), it may be difficult for a single vertical well to efficiently drain a large area. For example, in storage reservoirs with permeability ranging from 0.1 – 0.01 millidarcies, a single vertical well located on 40 acre spacing would not be capable of efficiently draining that area within the timeframe of a typical storage withdrawal cycle (120-150 days); several vertical wells would be necessary.

Conversely, a properly completed horizontal well could adequately drain a 40-acre tract. In high permeability reservoirs, vertically completed wells experience near-wellbore turbulence due to increasing flow velocity as gas flow converges on the near-wellbore area. This near-wellbore turbulence is inversely proportional to the length of the interval open to the storage formation and results in additional pressure loss that impacts deliverability. Horizontal wells are much less prone to this effect because a significantly larger interval is typically open to the storage formation.

Deployment of horizontal well technology in the gas storage industry has increased steadily since the early 1990s. While there is no known repository for industry statistics, a random survey of a number of major storage operators suggests that application of this technology is well developed. Discussions with a number of operators indicate that horizontal gas storage well deliverability often ranges from 6-10 times that of conventional vertical wells in the same reservoirs. A few operators reported that they have successfully implemented horizontal well in-fill drilling programs to convert base gas to working gas, thereby increasing the percentage of total inventory which can be cycled; increases in cyclable capacity ranged from approximately 8-15%.

Several operators also reported that horizontal wells have provided access to previously under-drained regions of storage reservoirs because surface access restrictions prohibited the drilling of conventional vertical wells (in one instance, the under-drained region was beneath a major wetland where conventional surface access was not possible). One operator reported a significant reduction in horsepower utilization and

[23] Gas Research Institute, *Critical Performance Parameters for Horizontal Well Applications in Gas Storage Reservoirs,* June 1993.

fuel savings as a result of plugging many older vertical wells and replacing them with branched horizontal wells. Even though costs for horizontal wells were reported to range from 2-3 times the cost of conventional vertical wells, the economics still favored horizontal well deployment.

As the existing storage infrastructure ages and replacement of wells becomes a necessity, it is highly likely that storage operators will turn increasingly to horizontal wells to maintain or improve deliverability, working gas capacity, and efficiency. Horizontal drilling technology lends itself well to locating several storage wells on a single pad at the surface. This type of design affords the added benefit of simplifying and significantly reducing the extent of gathering system piping.

b. Lined Rock Cavern Storage

As noted previously, high deliverability storage (possible with salt caverns for example) cannot be developed in many areas of the United States with practical capital expenditures. The Northeast and many parts of the Southeast are not suitable for conventional salt cavern development. Another option for high deliverability storage in these regions is Lined Rock Cavern (LRC) storage. The LRC technology is being pursued in Sweden where a pilot scale facility soon will be in operation. Application of the LRC technology initiates with the excavation of a shallow cavern in a "hard rock" formation. A "lining" of concrete and a very thin steel shell is then installed that allows the cavern to sustain very high gas pressures. The gas pressures in the LRC facility can be far in excess of the gas pressures that would be possible in an unlined cavern, but still must be below the pressure that would "lift" the overlying rock formation or otherwise cause enough rock formation movement to damage the thin steel lining.

The LRC technology has been reviewed by Department of Energy's National Energy Technology Laboratory and was found to be economically impractical in the U.S. Northeast primarily because of the high labor cost associated with excavation and tunneling in the United States. It is nonetheless possible that this technology might eventually be modified so as to be financially attractive in areas of the United States in which other types of high deliverability storage cannot be developed.

VI. Comparison to Other Transportation Outlooks

An assessment of recent pipeline projects indicates that North American inter-regional pipeline capacity grew by 11.4 BCF/D from 1999 to 2002. This capacity growth exceeded the prediction of 8.7 BCF/D made in the 1999 NPC study. Most of the difference occurred in the Southeast and the Rocky Mountains. The growth in the Southeast was related to greater than expected market expansion (market pull), while the Rocky Mountain growth was in response to increased supply deliverability (supply push). The estimated average annual cost of these expansions was approximately $6.1 billion.[24] This compares to a 1990s average expenditure for the United States and Canada of $2.5 billion.[25]

The cost of pipeline construction per mile in the early to mid-1990s increased at an annual rate of 1.5% per year. Costs grew more rapidly from 1998 to 2000, averaging over 11% per year. Costs declined somewhat after the construction peak in 2000 because a smaller number of active projects led to lower prices for pipe, materials, and construction crews. However, despite the recent decline in construction activity, the growth rate in cost per mile increased by 3.1% per year from 1993 through 2002, which is twice the rate projected in the 1999 NPC Study. The primary factors leading to larger than projected cost increases were higher expenses for right-of-way and labor.

Peak construction years for transmission pipelines in this study occur when Arctic pipelines are under construction (2008-2013). The overall construction estimates are lower than those that were projected in the 1999 NPC study, principally because of:

- Lower natural gas demand
- Lower production estimates from mature production regions
- Significantly higher imports of liquefied natural gas (LNG) directly into East and West Coast markets
- Utilization of existing pipeline infrastructure to transport gas from growing production regions.

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[24] The INGAA Foundation, Inc., *Pipeline and Storage Infrastructure for a 30 Tcf Market – An Updated Assessment*, 2002.

[25] Ibid.

VII. Transmission, Distribution, and Storage Recommendations

Sustain and Enhance Natural Gas Infrastructure

Although the United States and Canada have an extensive pipeline, storage, and distribution network, additional infrastructure and increased maintenance will be required to meet the future needs of the natural gas market. The recommended actions listed below are required to ensure efficient pipeline, storage, and distribution systems:

- **Federal and state regulators should provide regulatory certainty by maintaining a consistent cost recovery and contracting environment wherein the roles and rules are clearly identified and not changing.** Regulators must recognize that aging infrastructure will need to be continuously maintained and upgraded to meet increasing throughput demand over the study period. They must also recognize that large investments will be required for the constructions of new infrastructure. To make the kinds of investments that will be required, operators and customers need a stable investment climate and distinguishable risk/reward opportunities. Changes to underlying regulatory policy, after long-term investments are made, increase regulatory and investment risk for both the investor and customers.

- **Complete permit reviews of major infrastructure projects within a one-year period utilizing a "Joint Agency Review Process." Projects that connect incremental supply and eliminate market imbalances should be the highest priority and expedited.** Where available supply is constrained, FERC should expedite timely infrastructure project approvals that will help mitigate the current supply demand imbalance. Longer term, new project reviews should be expedited via continuing enhancement and increased participation in a Joint Agency Review Process, similar to that which FERC has utilized recently. A Joint Agency Review Process would require up-front involvement by all interested/concerned parties including appropriate jurisdictional agencies allowing the decision process to proceed to approval and implementation more accurately, more timely, and at lower overall cost. The final FERC record should resolve all conflicts. The areas of greatest concern in this regard are requirements of the U.S. Army Corps of Engineers, Coastal Zone Management Act, and Section 401 of the Clean Water Act, all of which could hinder the orderly implementation of FERC certificates. This process must also assure that a project, which has used and successfully exited this process, may proceed per the direction received and will not be delayed by non-participating parties or other external regulatory standards or processes. This suggestion is a more-specific rendering of the 1999 NPC study's fifth recommendation: "Streamline processes that impact gas development." The NPC supports legislation that accomplishes the "Joint Agency Review Process" as described above. Regulators at federal, state, and local levels, with cooperation of all participating parties, should establish processes and timelines that would complete the regulatory review and approval process within 12 months of filing.

- **Regulatory policies should address the barriers to long-term, firm contracts for entities providing service to human needs customers.** Many LDCs will not enter into long-term contracts in today's market out of fear that regulators may subsequently deem them imprudent in the future. Similarly, power producers, especially those that provide peaking service, are reluctant to contract for firm pipeline service because charges for firm service cannot be economically justified in power sales. As discussed in Finding 9 in the Summary volume of this report, this practice is impairing the investment in infrastructure. The result is that regulatory practices that limit long-term contracts (prudence reviews and ratemaking) inhibit efficient markets and discourage the development and enhancement of pipeline infrastructure. The regulatory process must allow markets to transmit the correct price signals and enable market participants to respond appropriately. Regulators should encourage, at all levels of regulation, policies that endorse the principles of reliability and availability of the natural gas commodity. All regulatory bodies should recognize the importance of long-term, firm capacity contracts for entities providing service to human needs customers and remove impediments for parties to enter into such contracts.

- **FERC should allow operators to configure transportation and storage infrastructure and related tariff services to meet changing market demand profiles.** At the interstate level, FERC should continue to allow and expand flexibility in tariff rate and service offerings and continue to allow market-based rates for storage service where markets are shown to be competitive so that all parties can more accurately value services and make prudent contracting decisions. To ensure that existing and future transmission, distribution, and storage facilities can be adapted to meet the significantly varying load profiles of increased gas-fired generation, FERC and state regulators need to allow and encourage operators to optimize existing and proposed pipeline and storage facilities. In some cases, this will require a significantly more flexible facilities design based upon peak hourly flow requirements, and/or a modification to existing facilities to provide for optimizing storage injections in off-peak hours or in shoulder months.

- **Regulators should encourage collaborative research into more efficient and less expensive infrastructure options.** Funding for collaborative industry research and development is in the process of switching from a national tariff surcharge-funded basis to voluntary funding. Because of the benefits of reduced costs, system reliability, integrity, safety, and performance, DOE should continue funding for collaborative research. Regulators need to encourage and remove impediments regarding cost recovery of prudently incurred R&D by the operators to fund necessary collaborative research.