Testimony of
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Chairman Thompson, Senator Lieberman, distinguished committee members, and guests. On behalf of Governor Pataki and the residents of New York State, I thank you for the opportunity to testify today concerning the energy supply and price problems that New York State and the Northeast region have been experiencing since late January.

There is not another state in the union that relies on heating oil more than New York to meet its heating needs. Forty-three percent of New York's households use oil for space heating. That's 2.9 million households. Nearly 80% of those homes are concentrated in the New York City Metropolitan area, including Long Island. New York's residential sector is the largest consumer of heating oil and kerosene, or distillate fuels, in the nation. New York State accounts for 20% of the total U.S. distillate demand. As you can see from those numbers, New York's residential customers bear the brunt of any increase in heating oil prices.

As a side note, let me say here that the economic burden associated with spiraling oil prices is not confined to just heating oil. New York consumers use more than 5.6 billion gallons of gasoline, and nearly a billion gallons of diesel fuel annually, accounting for 4.5% and 2.7% respectively of national demand for these two motor fuels. The current surge in retail pump prices is significantly increasing the cost of commuting and transporting goods in New York.

Returning to heating oil issues, after a slow steady climb through the fourth quarter of 1999, home heating oil prices soared to record high levels beginning in late January. At the height of the price spike, the statewide average price for heating oil increased by more than 75 cents per gallon. On January 17, 2000, the statewide average price was $1.24; on Monday February 7th, that price was $2.02 per gallon. To put this statewide price in perspective, last year at that time, the average price for a gallon of heating oil was 91 cents. Since February 7th, we have seen this $2.02/gallon price decrease about 51 cents a gallon, but that retail price is still nearly 67% above the 90-cents-a-gallon year-ago level. (See attached chart)

As I mentioned just a minute ago, the concentration of residential heating oil customers in the State is in the New York City metropolitan area and on Long Island. In early February, heating oil prices in this region were running at about $2.25 a gallon, more than double that of a year ago.

That's critical in New York, because over the four-month winter heating season, from November through February, New York's residential, commercial, and industrial customers combined, consume, on average, 13.1 **million** gallons of distillate fuel **per day.** At its peak in January, demand hit a high of approximately 17 million gallons a day.

A small portion of that demand was for kerosene, which is an important fuel in the Northeast. Kerosene is used as a blending agent for heating oil and diesel fuel to prevent gelling and improve viscosity in low winter temperature, with a relatively small amount being used for space heating purposes. Kerosene aside, when you look at the enormous amount of daily distillate fuel use, you can begin to see the huge economic impact that we have been faced with.

Let me say that New York State has not been alone in feeling these effects. Throughout this period, we have been sharing information regarding prices, supplies, and strategies with other northeastern states through the Coalition of Northeastern Governors and the National Association of State Energy Officials on a weekly basis. This information sharing proved invaluable in helping to assess the supply and price situation throughout the Northeast.

While I don't believe there is a definable single factor that you can point to as the ultimate cause of the price spike, there were a number of market factors that contributed which bear mentioning.

From a historical perspective, we can look back at the second quarter of 1999 when crude oil prices began to rise from a low of $11 a barrel at the beginning of the year, to nearly $30 a barrel (173% increase) during the last week of January. Recently oil prices climbed to more than $34 a barrel in February although they are now hovering in the $27-28 a barrel range. Certainly, this price escalation was influenced by several factors. While domestic economic growth and economic recovery in the Pacific rim contributed, the most significant factor was production cutbacks by OPEC and non-OPEC producers that began in March 1999. This worldwide reduction of between 4 to 5 million barrels per day in crude oil production resulted in a corresponding reduction in petroleum products, which meant that the system had less slack to meet higher demand levels when the sustained cold weather snap arrived.

I just used the term "slack" to describe a market situation where additional supplies are not just sitting around waiting to be used. The petroleum industry, like other industries, has adopted "just in time re-supply" of inventories. This change in industry practice that developed over the last several years has had a large impact in New York. According to New York State Department of Environmental Conservation data, New York's total petroleum bulk storage capacity has declined by 15% and our heating oil storage capacity has declined by nearly 20% over the past five years. Additionally, over this same period, in-state storage capacity for gasoline has fallen over 17%. I understand that New York is not alone in seeing its storage capacity being reduced. There are several reasons for this decline in New York, including the high costs associated with meeting more stringent environmental regulations, increasing insurance and carrying costs to hold petroleum products, and the lack of market incentives to build and maintain new facilities.

As anyone from the Northeast can tell you, winter is fickle. This past December saw record temperatures roll in, but not record cold temperatures, they were record mild temperatures that continued into early January. When the extreme cold weather arrived in the middle of January we experienced a sharp increase in demand by all sectors simultaneously. For the two-week period ending January 29, the temperature was 56% colder than last year at that time, and 18% colder than normal. This spike in demand was critical because, following on the heels of extremely mild December weather, sufficient supplies were not available. The latest available data indicates that this has not been a harsh winter. October 1, 1999 through March 18, 2000 data shows that temperatures have been 9% warmer than normal, and one percent warmer than last year.

The combination of increased demand and insufficient supplies created greater competition among buyers, including interruptible natural gas customers and electric generators, that served to drive already high prices higher. An interruptible gas customer is generally a large fuel user who contracts for below-market natural gas prices throughout the year in exchange for switching to an alternative fuel when the utility needs gas capacity or when the temperature reaches a designated degree number.

However, some believe that interruptible natural gas customers and electric generators were major contributors to the sharp increase in demand and the corresponding higher prices for petroleum products. We are looking into this situation in New York to see what effect interruptible gas customers and electric generators had on the supply and price of petroleum products. Early indications are that an additional 3.4 million gallons a day of distillate fuel were consumed by traditional customers. Another incremental 1 million gallons a day was consumed by interruptibles; 720,000 gallons used by electric generators, and 320,000 gallons used by tariff customers, those switched by a temperature trigger. Demand by these customers occurred at the same time that supplies were dwindling and prices were sky-rocketing.

The competition for product that occurred during the cold snap, and the fact that competition was driven in part by low regional supply stocks throughout the entire winter season, leads me to another major market force that has played an important role: refinery utilization.

New York does not have any refineries within the State. We rely on refineries in New Jersey, Pennsylvania, the Gulf Coast, and overseas to meet our product needs. National refinery utilization rates dropped to about 84% in early February, and have only rebounded to 90% by mid-March. At the end of December, refineries were operating at 89.7% of capacity. A year ago, when the oil markets were calm, the comparable utilization rate was 94%. Heating oil production on a national basis was down 16% from a year ago in early February. On the East Coast, heating oil production was down 46% from year-ago levels at the beginning of February. While refinery utilization began to rise in late February in response to increased pressure, questions still remain as to why there was low utilization when the demand for heating oil was so robust.

Switching concerns for a moment, today domestic gasoline output approximates 7.9 million barrels a day. That's about 5% more than last March, but national inventories remain lower than a year ago.

These refining patterns raise questions both nationally and regionally. Before the January cold snap, national heating oil stocks were nearly 30% lower compared to last year, and Middle Atlantic States' (NY, NJ, Delaware, Pennsylvania) heating oil inventories were 16% lower than a year earlier. By the third week in January, these heating oil reserves had shrunk to nearly 15 million barrels, or 50% less than a year ago and below any comparable level of the past seven years. At the same time however, diesel fuel production on a national level increased more than 7% and on the East Coast by more than 23%.

Today, gasoline stocks nationally are down 12% from a year ago levels, but in the Middle Atlantic states inventories are 20% lower than last year. The result is that the price of unleaded regular in New York has escalated 17 cents a gallon in recent weeks from $1.43 at the end of January, to $1.60 in mid-March. The current statewide average gasoline price exceeds the previous all time high of $1.51 gallon established in early December 1990, during the Persian Gulf War.

Caught up in all of these market forces were the consumers. Everyone from residential heating customers to hospitals, public health and safety agencies, trucking firms, small businesses, large fuel oil dealers, and the motoring public are feeling the effects of these price increases. Particularly hard hit during that period, and still looking for relief from high diesel fuel prices is the trucking industry. There are reports that the average retail price of a gallon of diesel fuel rose over 63% in the Northeast from $1.35 in early January to $2.06 during the latter half of the month and reached the $2.29 to $2.69 range by the first week of February. Trucking companies have been unable to absorb these astronomical price hikes and we are now seeing these higher costs passed along to customers. Following the retail chain downward, these customers are then forced to raise the prices of the goods they sell to households and other commercial businesses, creating a major economic impact that is still rippling through the region's economy.

While some predictions were made about possible price increases due to known factors like the OPEC cutbacks, the sudden and dramatic price increases we saw were way outside the expected norm.

Take for example, the fact that the average price difference between a gallon of #2 heating oil and crude oil over the past year hovered around 52 cents per gallon. For the month of February, the price differential equaled $1.01, 49 cents over the historical price spread. While that number has dropped to 74 cents during the past three weeks, it's still 22 cents over the normal price spread. (See attached chart)

Needless to say, Governor Pataki is concerned about the economic consequences of this unprecedented rise in petroleum prices and the effects on New York's citizens, particularly our elderly, working poor, and low-income consumers. I will discuss the economic impact in further detail later in my testimony. Certainly at the onset, New York's first concern was with public health and safety issues.

Quoting Governor Pataki, "New York is no stranger to adversity" and thankfully so. During the past few years New York has seen nature's forces take a toll on our State with floods, ice storms, and other natural disasters. Those crisis situations have helped the State refine its emergency response capabilities and this most recent threat to the health and safety of our residents was no different.

From our first contact with industry officials about impending home heating oil shortages, the State's emergency response was initiated. Governor Pataki directed NYSERDA, the State Emergency Management Office, the Public Service Commission, and the Consumer Protection Board to establish an around-the-clock coordinated effort. Telephone hotlines were established immediately to handle emergency calls for shelter or heating assistance and to report suspected instances of price gouging. State officials began contacting county energy emergency coordinators across the State to assess their local situation. Daily contact with the U.S. Coast Guard was established. The Coast Guard is responsible for ice-breaking activities in New York harbor and the 150 miles northward to upstate markets on the Hudson River to ensure delivery of available fuel supplies. Daily calls were also placed to dealers to assess supply problems and price trends. Heating oil distributors were also supplied with emergency contact information for their customers in the event they experienced a shortfall in supply.

The Governor also took action on a number of regulatory fronts to help overcome some of the supply and resupply problems that New York encountered. These included:

* Directing the State Public Service Commission to work with New York's utilities to voluntarily keep their interruptible natural gas customers on natural gas rather than switch to fuel oil;

* Directing the State Department of Taxation and Finance to issue temporary interstate certificates to in-state heating oil distributors and trucking companies to allow them to import heating oil;

* The State Department of Environmental Conservation in conjunction with NYSERDA granted one-week waivers to allow New York City municipal facilities to use slightly higher sulfur content fuel oil to meet their heating needs;

* The Governor also asked the State Consumer Protection Board and NYSERDA to investigate the causes of the current shortage and recommend measures to prevent a re-occurrence.

Besides initiating a comprehensive State action plan to help our residents, Governor Pataki was also active on the national level. Early on, Governor Pataki asked the Clinton Administration for an immediate investigation into the factors that drove the price increases and supply shortages. He also asked at that time for additional Low-Income Home Energy Assistance Program (LIHEAP) emergency aid to be released as well.

The Federal LIHEAP program is extremely important to New York because we have more than 1.4 million eligible households within the State. This year, 500,000 to 600,000 households will be served by the program. When Governor Pataki requested federal assistance, funds were critically needed to help New York's struggling families meet the rising cost of fuel. In response, the Department of Health and Human Services released $45 million in emergency LIHEAP funds to 10 Northeastern states. New York did very poorly in that initial allocation. I'm pleased to say that, in the ensuing two emergency allocation rounds, New York fared much better.

Besides easing the financial burden on those eligible for LIHEAP assistance, the heating oil price problem extended beyond low-income households to families and small commercial customers who have had trouble meeting their oil cost obligations. To address that issue, Governor Pataki has taken action to increase the Home Energy Assistance Program eligibility levels in New York to 60% of the State's median income from the current 150% of poverty level.

The estimated impact this heating season on New York's economy will be about $650 million dollars higher than last year. About $450 million of that increase will be borne by New York's heating oil customers. A family that typically uses 900 gallons of fuel oil during the winter heating season will pay an additional $350 dollars this year. If you were unfortunate enough to have received a 225-gallon delivery during February, you paid about $216 dollars more than a year ago at that time.

These additional costs are now causing a ripple effect among the states' fuel oil dealers who, in many instances, had customers that could not make full payment for deliveries. This, in turn, created cash-flow and bank line-of-credit problems, which is causing concern about the increased potential for personal and corporate bankruptcies that could weaken the oil distribution systems. A recent survey by NYSERDA and the NYS Consumer Protection Board found that dealers are extremely concerned about their receivables. One dealer stated, " We experienced extra borrowing to cover the purchase of higher priced oil and to cover the increase in accounts receivable. We also expect a large volume of customers who will never pay us, which will result in increases to our yearly bad debt expense." While some assistance may be available from the Small Business Administration, we are hearing that a quicker means to make funds available to dealers is desperately needed.

Why did we find ourselves in this position, and what actions need to be taken so that we don't have a re-occurrence down the road?

First, let me say that I was pleased to see that many of the steps that the Pataki administration took in New York, were incorporated into the Administration's actions that were announced on February 10th when a second round of LIHEAP funds were released. Hopefully those actions will now be put in place as part of a federal action plan for the future so that nobody is caught off guard if it should happen again.

Certainly in the short term, we need to use our influence with the OPEC and non-OPEC cartel producers to increase production. This is critical. Cartel control of production has created the perception of a shortage which is a major factor in driving these price increases. This situation created calls in some areas for Government to allocate fuels. That would be extremely difficult, and someplace I hope we never have to go. We must take whatever steps are necessary to protect our energy security and the public's health and safety.

On February 14th, Governor Pataki called on the Federal Department of Energy to immediately release oil from the Strategic Petroleum Reserve (SPR). Secretary Richardson heard the same message from elected officials from all over the Northeast on February 16th at the Northeast Heating summit held in Boston. There was a consensus that moving SPR oil from Gulf Coast salt domes into the market would signal that United States citizens will not be held hostage to the whims of oil-producing nations. If we took that significant step then to expand available oil supplies, world oil prices would already have started to decline, and the oil-producing nations would have been encouraged to come to the table with greater levels of oil production.

Also, releasing SPR oil now will prevent a repeat of the tight supply conditions that disrupted the heating season from extending to gasoline and diesel fuel availability as we approach the spring and summer driving season. I'm concerned that we have yet to see any results from the Administration's "Oil Diplomacy Strategy" as we enter the summer driving season. Had we released these supplies in February, this oil would be in the marketplace now.

Another important step the Federal government can take to help New York and other New England states is to ensure that adequate funding is in place for Coast Guard icebreakers that work to keep New York's waterways clear for the movement of petroleum products and other commerce. We are hearing rumors that by next winter services may be cut back by the Federal Department of Transportation, the parent agency of the Coast Guard. Should the number of Coast Guard icebreakers be reduced, it would definitely imperil health and safety. Part of this winter's crisis was attributable to resupply difficulties, and if not for the Coast Guard's commitment to ensure that these critical vessels continue to work to keep our waterways open, we would have been much worse off than we were. There is truly no other mode of transportation available other than barges to deliver the quantity of fuel necessary to supply the New York market, and parts of Vermont and Massachusetts that are supplied from New York terminals.

Another area of critical importance is for the federal government to do a better job of working with the states with respect to planning and responding to emergencies. Within the Department of Energy, the Energy Information Administration does a professional job of collecting data and disseminating it to the states, but there is an obvious disconnect in-house. That information needs to be used by the Department to work with major oil suppliers and refiners in advance of crisis situations to make the necessary course corrections. Government cannot allow supply disruptions to occur that threaten the public health and safety of our citizens. The Department of Energy needs to play a much more pro-active role then it did. We are pleased that the Department of Energy now believes that energy emergency planning is an essential government function.

An important step that we are looking at in New York State is better fuel diversity. Looking at the factors that came together to create the current situation, it's apparent that we need to take a close look at expanding natural gas pipeline capacity in the State and in the Northeast. The Federal Energy Regulatory

Commission can play an important role in helping states like New York with expediting certification and approval of new and expanded pipeline capacity into the Northeast.

As a matter of public trust, the Federal Government must do a thorough investigation to determine if oil markets were manipulated and profits were made on people's misery. People in New York and throughout the Northeast want to understand what happened to their hard-earned dollars. We believe they need an answer. In New York, Governor Pataki has directed the State Consumer Protection Board to vigorously investigate any reports of price gouging involving anyone or any business taking advantage of this severe, extreme weather by demanding sky-high prices for basic necessities, including the fuels we use to heat our homes. However, a full-scale Federal investigation is warranted and needed.

Last, but certainly not least, I would be remiss if I did not comment on the need to diversify our sources of energy supplies. We must redouble efforts to develop domestic oil reserves, renewable energy resources, alternative-fuel technology, and to promote energy efficiency.

We must increase domestic oil production if we have any hope in the future of lessening our dependence on foreign oil and ensuring our energy security. Perhaps you don't think of New York when you think of natural gas and oil production, but we do have a vibrant research and development program in place that is funding research to demonstrate increased natural gas production and enhanced oil recovery technology. Working with groups like the Independent Oil and Gas Association and the New York State Oil Producers Association, we are experimenting with new mapping programs and horizontal drilling techniques on Appalachian natural gas and oil reserves. We must look for every opportunity to increase domestic production, but states can't do it alone. It will take a commitment on the part of Congress and the Department of Energy to join the states as partners in this effort.

In addition to encouraging domestic production, we must also increase funding for energy efficiency initiatives. At NYSERDA we also fund a wide-range of R&D initiatives to improve the efficiency of oil heating equipment.

Currently, the DOE has a $6 billion budget, but only a nominal amount of that is dedicated energy-efficiency funding. New York State has increased funding four-fold for R&D and energy efficiency as part of our transition to competition. We have tremendous potential, and situations like the one that has happened in the Northeast should serve as the lighting rod to spur us to action, ensuring that we have a secure energy future for our children and their children.

Once again, on behalf of Governor Pataki and the citizens of New York, I want to thank you Chairman Thompson for the opportunity to testify today. I would be more than happy to answer any questions you may have.