2003 Summer Energy Market Assessment

Staff Report by the:

Office of Market Oversight and Investigations (OMOI)

Federal Energy Regulatory Commission

As we head into the heat of summer 2003

- Market participants have taken steps toward transparent market designs and trading platforms, as open and competitive energy markets evolve.
- New power plant investments now provide higher reserve margins across much of the country.
- Market participants are addressing concerns about the quality of natural gas price reporting.
- Energy markets are rebounding from a period characterized by adverse financial conditions.

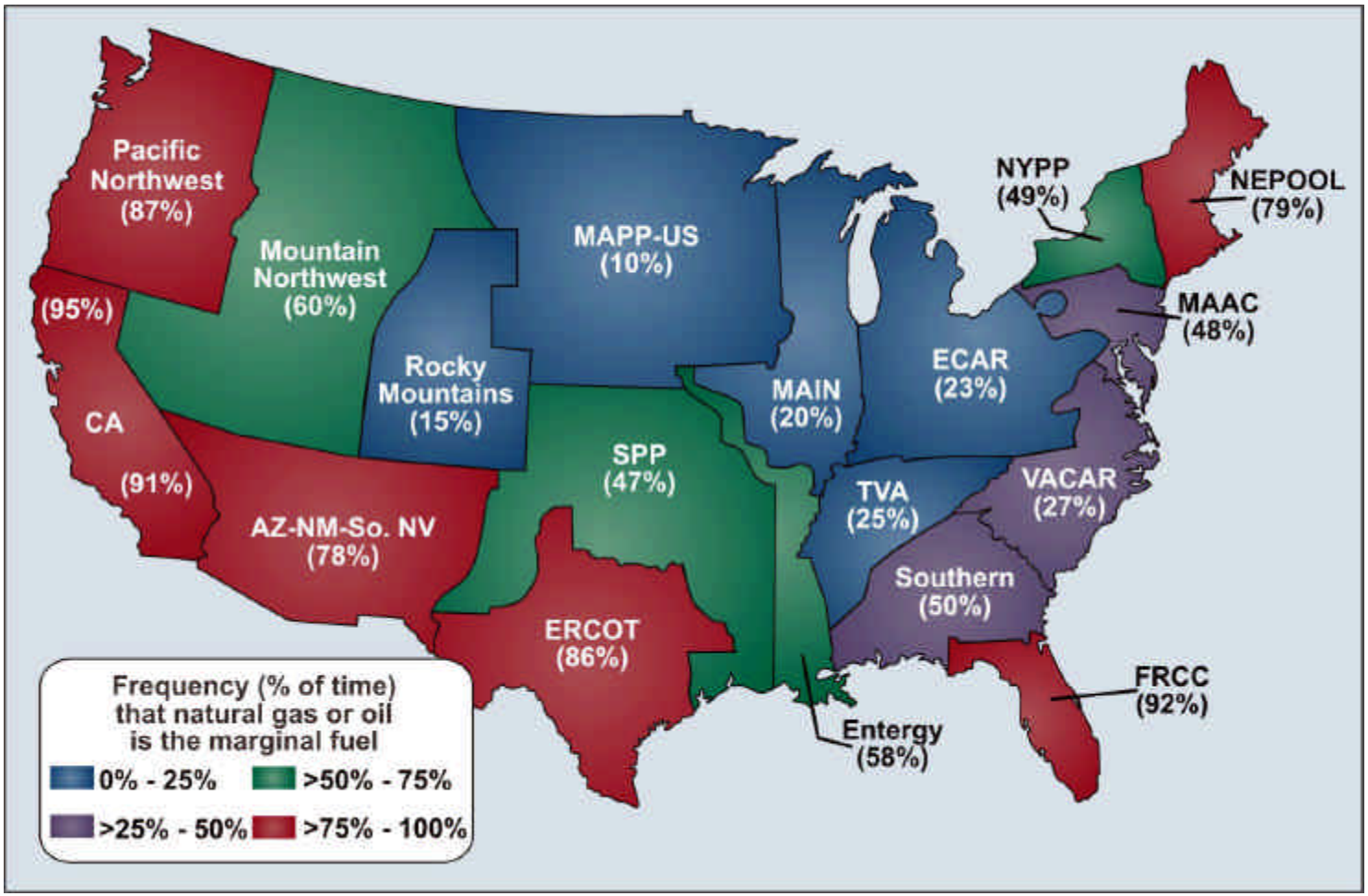
Nonetheless, there are challenges for energy markets this summer

- A tight supply-demand balance in natural gas markets is raising natural gas and electricity prices.
- Demand response, an effective tool for dampening price spikes, is missing from electricity markets.
- Financial conditions have reduced the number of companies active in energy markets, consequently limiting market liquidity and effectiveness.

Futures market participants expect natural gas prices to remain above those of 1990s

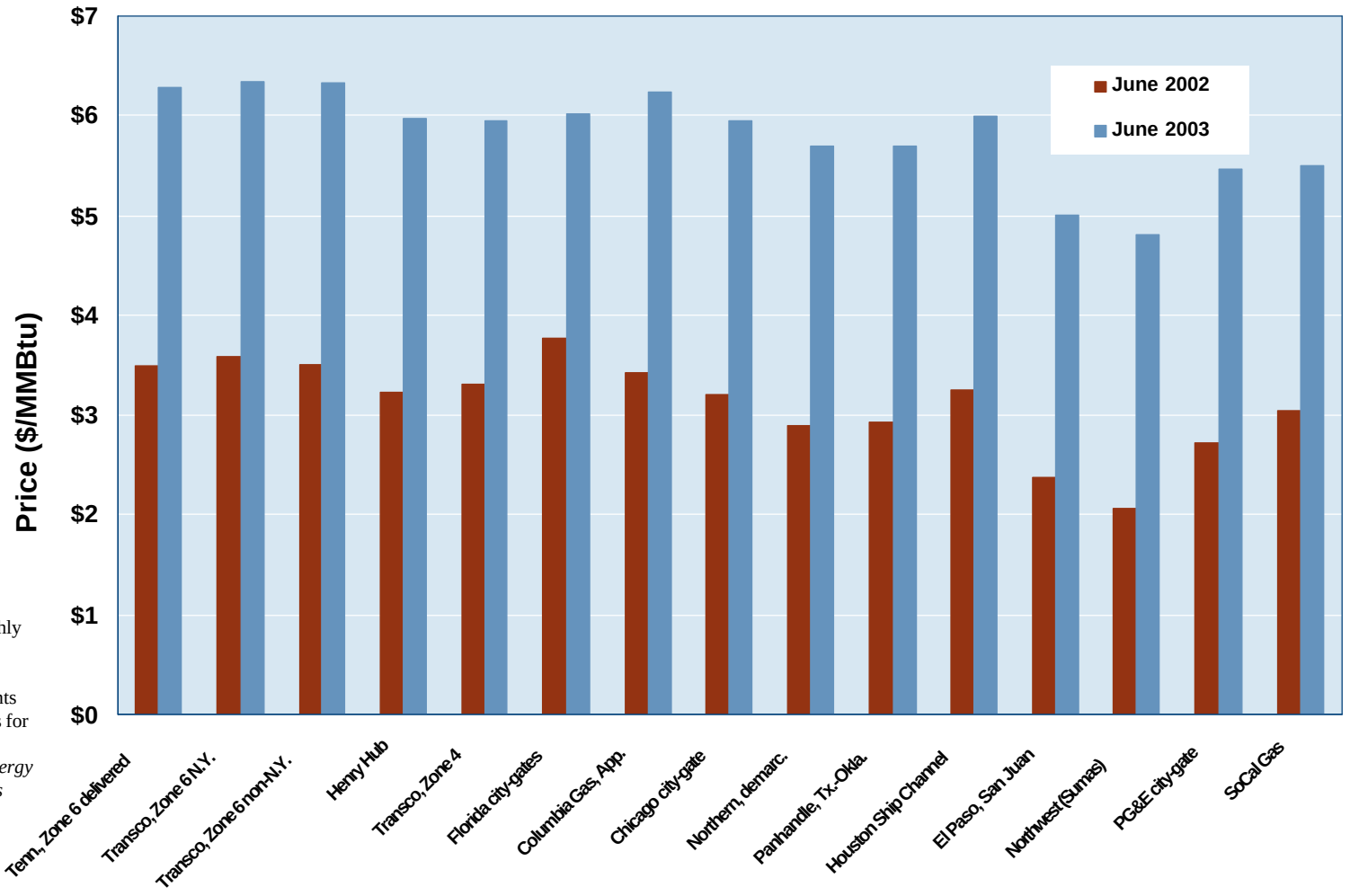
Source: Historical data are Nymex settlement prices from GASdat. Futures prices are Nymex settlement prices on May 29, 2003.

Natural gas-fired generation frequently sets the regional wholesale electric price



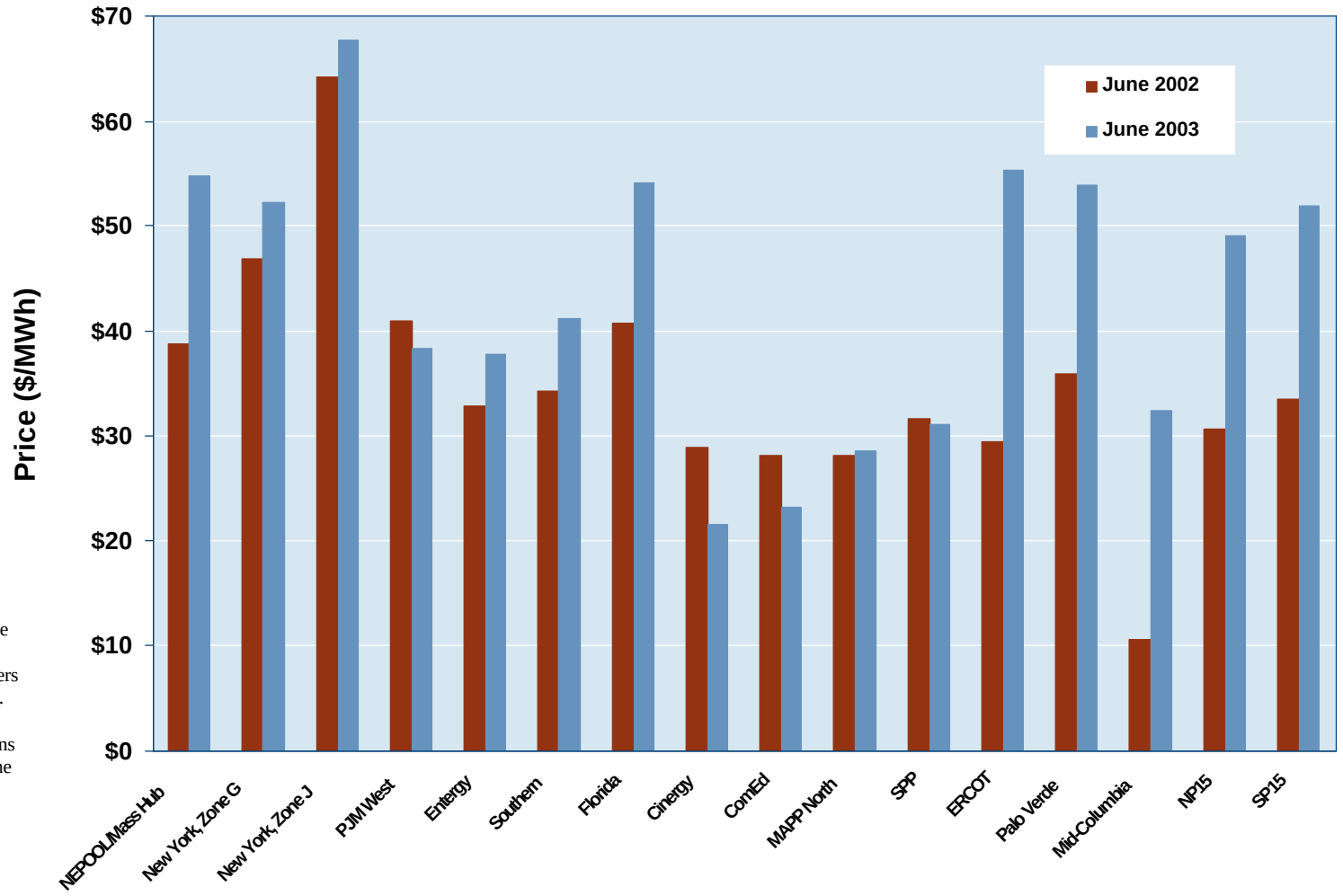
Note: Percent of time natural gas or oil is projected to be on the margin in 2003.
Source: Cambridge Energy Research Associates (CERA), April 30, 2003.

Throughout the country, natural gas prices have doubled since last summer



Note: Prices shown are the monthly average actual mid-point prices. June 2003 numbers include data through June 18 only. Price points selected are representative points for the regions of the United States analyzed in the *2003 Summer Energy Market Assessment.* Source: *Gas Daily*.

Depending on the role of natural gas in the region, some regions' electricity prices have increased



Note: Prices shown are the average actual on-peak day-ahead load-weighted prices. June 2003 numbers include data through June 18 only. Price points selected are representative points for the regions of the United States analyzed in the *2003 Summer Energy Market Assessment*. Source: *Megawatt Daily*.

To address high natural gas prices market participants are taking action

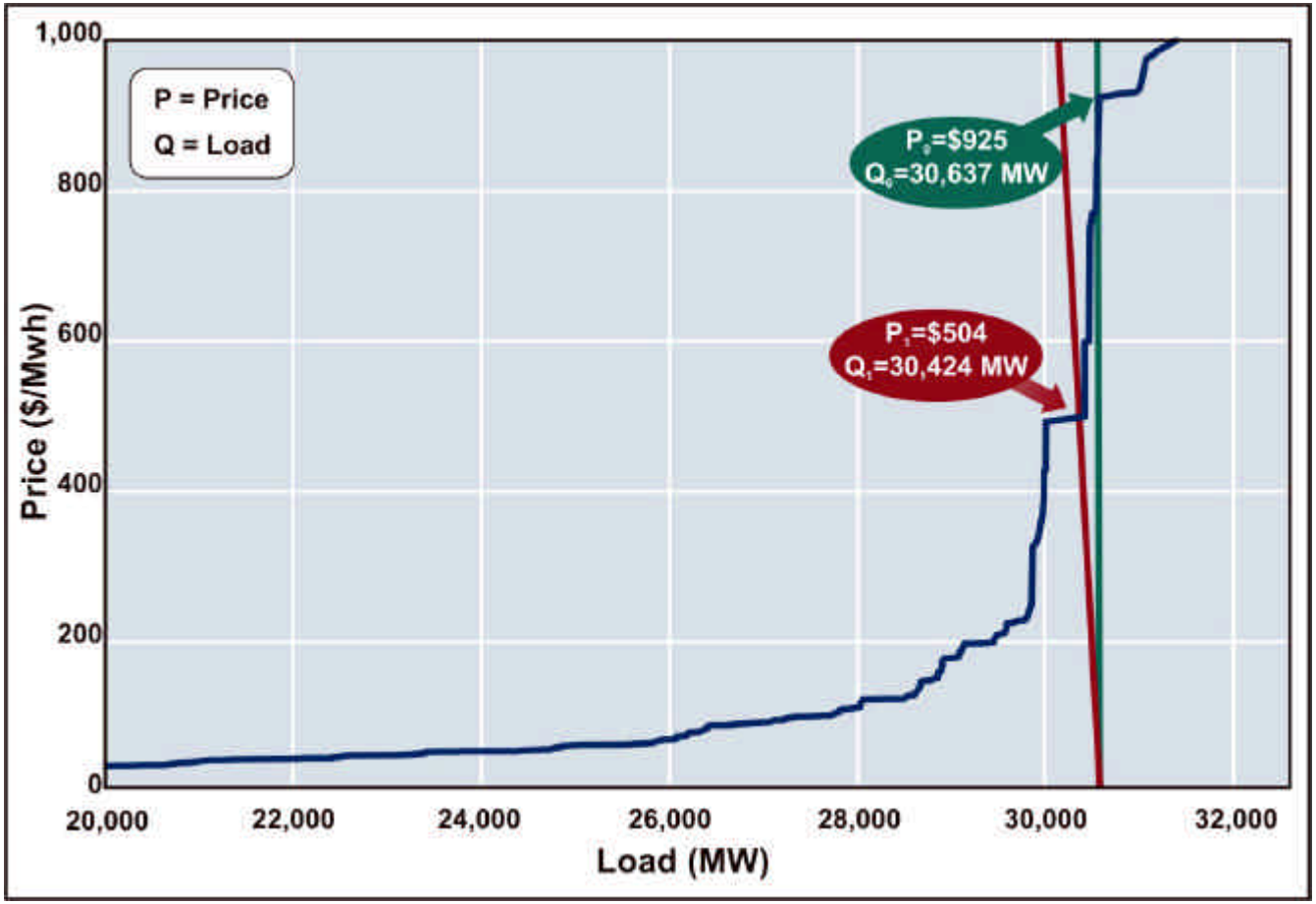
Industry Actions

- More drilling is occurring in response to prices.
- Industry is seeking access to new supply sources.
- Competitive pressures could displace some inefficient natural gas-fired generators with new, efficient natural gas-fired units.

Commission Actions

- Expediting new certificates for pipeline capacity, including out of the Rockies
- Enhanced Certificate Streamlining Initiative
- Revised LNG terminal policy
- Regional Infrastructure Conferences

Small reductions in demand can lower spot market electricity prices significantly for all customers



Source: Confidential bid data and illustrative demand curves.

Demand response has many benefits for customers

Demand response in electricity markets:

- reduces peak prices
- moderates price volatility
- reduces peak loads, reduces congestion and improves local reliability
- reduces supplier market power
- moderates long-term price levels by lowering spot market prices

Demand response will play a limited role this summer

- Demand response participation identified in organized electricity markets was low in 2002.
  - 0% in CAISO
  - 0% in ISO-NE
  - 3% in NYISO
  - 3% in PJM
- Outside organized markets, reliable demand response data are not available.

To address the lack of demand response market participants are taking action

Industry Actions

- Some regions are promoting demand response aggressively to help meet reliability needs this summer, such as in New York and Connecticut.
- ISO-NE revised its tariff to provide more price certainty to customers.
- NYISO has tied activation of demand response to prices in the spot market.
- States are working to implement new demand response tariffs or improve existing ones, such as in California and Florida.

Commission Actions

- FERC has proposed market design rules that allow demand resources to participate on an equal footing with supply resources in wholesale markets.
- FERC requires market monitors to report on demand response in annual reports and monitors electric markets to ensure that demand resources are treated fairly.
- FERC has approved revisions to demand response tariffs in ISO-NE, NYISO and PJM.
- FERC is creating standard interconnection rules for small generation.
- Along with DOE, the Commission is conducting analysis of distributed generation and its effect on electricity market prices and reliability.

Financial conditions have dampened energy market liquidity

- Current financial conditions have forced market participants to exit trading, reducing the liquidity of physical and financial energy markets and, consequently, their effectiveness.
- Longer-term implications of the lack of liquidity include reductions in available capital for infrastructure investments and storage injection.
- Current financial conditions highlight the need to ensure that the conditions of nonregulated affiliates do not harm regulated utility customers.

To address financial conditions, market participants are taking action

Industry Actions

- Restructuring to improve financial conditions and remain competitive in the longer-term
- Using innovative techniques to increase effectiveness, such as credit clearing

Commission Actions

- Enhanced oversight of corporate financial management to protect regulated customers. For example, review of Section 203 and 204 policies and adoption of an interim rule for "Regulation of Cash Management Practices"
- Proposed additional quarterly financial reporting
- Continued oversight of credit standards for pipelines and electric transmission owners
- Work to implement the wholesale market platform
- Continuing work to bring closure to western market issues, providing regulatory certainty to market participants

Further information on OMOI's *2003 Summer Energy Market Assessment*

- This presentation will be available following the meeting on www.ferc.gov.
- The complete *2003 Summer Energy Market Assessment*, including Regional Assessments, will be available in the next several weeks from www.ferc.gov.
- Please contact Lisa Carter (Lisa.Carter@ferc.gov) or Jolanka Fisher (Jolanka.Fisher@ferc.gov) with any questions.