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FERC 2006 State of the Energy Markets Report

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Last month, the Federal Energy Regulatory Commission (FERC) issued their annual discussion of the state of the energy markets in the United States. This year's report represents a change from those in the past, in that previously the FERC had issued three detailed reports, which were usually produced well after the fact. This year's version provides a comprehensive look at the U.S. energy market place, but more or less summarizes the commission's views. They still provide a lot of detail, but for the most part, the minutia of the regional energy market data is now covered in supplemental reports.

The 2006 report is reflective of the issues and developments that the FERC is viewing as their top priorities. Broadly stated, the FERC has identified three areas that they view as being those that command their greatest attention at this point: 1) Promote development of a strong energy infrastructure, 2) Support competitive markets, and 3) Prevent market manipulation.¹ In line with these priorities, the FERC report discusses, in detail, four areas that they view are reflective of the current long-term market issues, in addition to a generalized discussion of the natural gas and power markets.

Infrastructure Issues

The first area on which they focus is "Infrastructure Outages and Their Effects on Energy Markets." In this section of the report, they cover four specific instances of what they believe the market itself has identified as infrastructural weaknesses, including rail outages that impact coal fuel supplies, damage as the result of hurricanes, western pipeline capacity constraints, and a review of the New York City and Long Island electric supply situation. The FERC noted that with each incident of disruption or weakness, the market signaled the event with higher prices, and with the exception of the NYC/Long Island example, these price events expanded on a regional basis and created price imbalances that affected other areas of the broader market.

Interdependency of Energy Markets

The second area of focus in the report is titled "Increasing Interdependence Among Energy Markets." The FERC notes that "In 2005 and 2006, U.S. physical energy markets became more integrated, both among themselves and with global energy markets." They specifically identified a growing influence between natural gas and power markets, natural gas and crude markets, and the global changes in the LNG markets.

In their discussion of the natural gas and power markets, they note that a lack of coordination between the operational management of the two markets has led to problems during market stresses, including some generators selling their fuel supplies off during periods of high gas prices and relatively low power prices, loss of

base-load generation requiring increased gas fuel burn to bring up replacement generation (and leading to natural gas price spikes), and instances where natural gas was unavailable for fuel supplies due to differing nomination deadlines between the markets. The FERC responded by requiring RTOs and ISOs to propose changes to their scheduling and compensation practices to better coordinate with the gas markets. They also issued a notice of proposed rulemaking to incorporate, by reference, proposals to add another intraday gas nom cycle with bumping rights, change the RTO's scheduling timelines to ensure the power markets clear during the gas nomination cycles, and require that generators have adequate fuel if they are bidding into the day-ahead power markets.

Regarding the linkage for the natural gas markets and crude, the FERC noted that in 2006, coming out of the hurricane season of 2005, the markets appeared to discount high storage levels and keep market prices higher than would have been expected, apparently out of fear of a cold winter and lower production volumes. They also believe that world oil prices played a role in keeping gas prices consistently higher than storage levels would indicate, as crude prices and gas prices tracked at levels reflective of periods of lower storage volume. This was despite lower LNG imports in 2005 and 2006. The FERC noted that when gas prices did start to fall during the year, gas started displacing fuel oil in fuel switching capable facilities. This was particularly evident in the New York area where, starting in March 2006 and continuing for several months, natural gas fell below residual fuel oil and led to significant fuel switching. As the report pointed out, the Energy Information Agency reported that in 2006, less than half as much fuel oil was burned for generation as compared to 2005, while gas usage increased 5 percent over the same period.²

Despite lower imports of LNG into the US markets in 2005 and 2006, the report makes clear that the FERC continues to view LNG as a significant source of energy for the states in the near future, as investment in import facilities continue at high levels, with new projects under construction and new approvals having been granted. However, they note that the United States is competing with increasing demand from Europe and Asia, the U.S. market is going to be more and more influenced by the prices commanded in these markets; markets that are more heavily reliant on LNG for natural gas supplies.

Electric Demand Response

The FERC notes that in 2006, demand response programs were effective at load shaving in periods of constraint, in some cases reducing peak day load by as much as 6 percent, helping to unburden the system during these key periods. The FERC believes that the invocation of these demand response programs helped to ameliorate the impact of shortages on the physical markets, even though they note the demand response programs were not invoked for market management purposes. Among the programs they noted as having good effect were calls for voluntary use reduction and programs that compensated users for allowing interruptible service.

Growing Influence of Futures and Financial Energy Markets

As the volume of speculators in the futures and financial markets grew with new entrants from hedge funds and financial institutions, their impacts on the physical markets became a significant concern. The FERC discusses this relationship in some depth in their report, but noted despite the vocal concerns of public officials, they

believe that speculators are playing a necessary role in the market. While acknowledging that financial energy market speculation is undoubtedly impacting physical gas prices, particularly those linked to Henry Hub (and primarily basis deals for gulf coast and northeast deliveries), without speculators in the market willing to assume futures risk, there would not be a liquid market for physical producers looking to lay off that risk.

In their executive summary, the FERC acknowledges that as the futures and financial markets continue to grow and evolve, it may inevitable that they will exert more and more influence on the physical markets, providing that those non-physical markets are sufficiently robust and transparent. Taken as a whole, it would appear the FERC is recommending a laissez-faire stance toward these markets.

Summary

The FERC report should be required reading for anyone involved in the energy markets. Given the commission's mandates and authorities, it provides a good insight into their priorities for the coming years and potential adjustments that they may make to address energy market imbalances. Many times, those that interact with the FERC are doing so on what are very technical questions, primary around tariffs and rules. It's easy to forget the potential the FERC has to make structural changes that can affect virtually every player in the space.

To download a copy of the report, go to the FERC website at www.ferc.gov/market-oversight/st-mkt-ovr/st-mkt-ovr.asp.

¹ FERC Website, www.ferc.gov/about/top-priorities.asp

² EIA, *Monthly Flash Estimate of Electric Power Data*, Dec. 21, 2006



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