



Winter 2009/2010 Energy Market Assessment

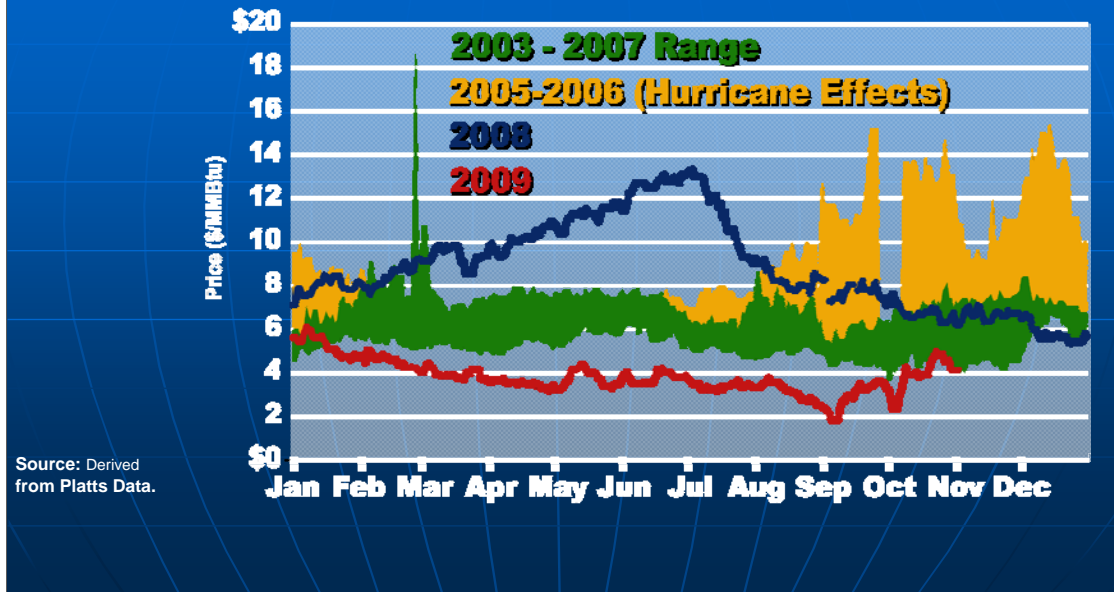
Item No. A-3
November 19, 2009

Mr. Chairman, Commissioners. Today I'm pleased to present the Office of Enforcement's Winter 2009-2010 Energy Market Assessment.

The Winter Assessment is staff's annual opportunity to share observations about natural gas, electric and other energy markets as we enter the winter.

Heading into the winter, the prospects for natural gas markets are looking better for consumers than they have in many years. Gas prices are moderate, storage is full, and supply is plentiful.

Spot Gas Prices Reach 8 Year Low

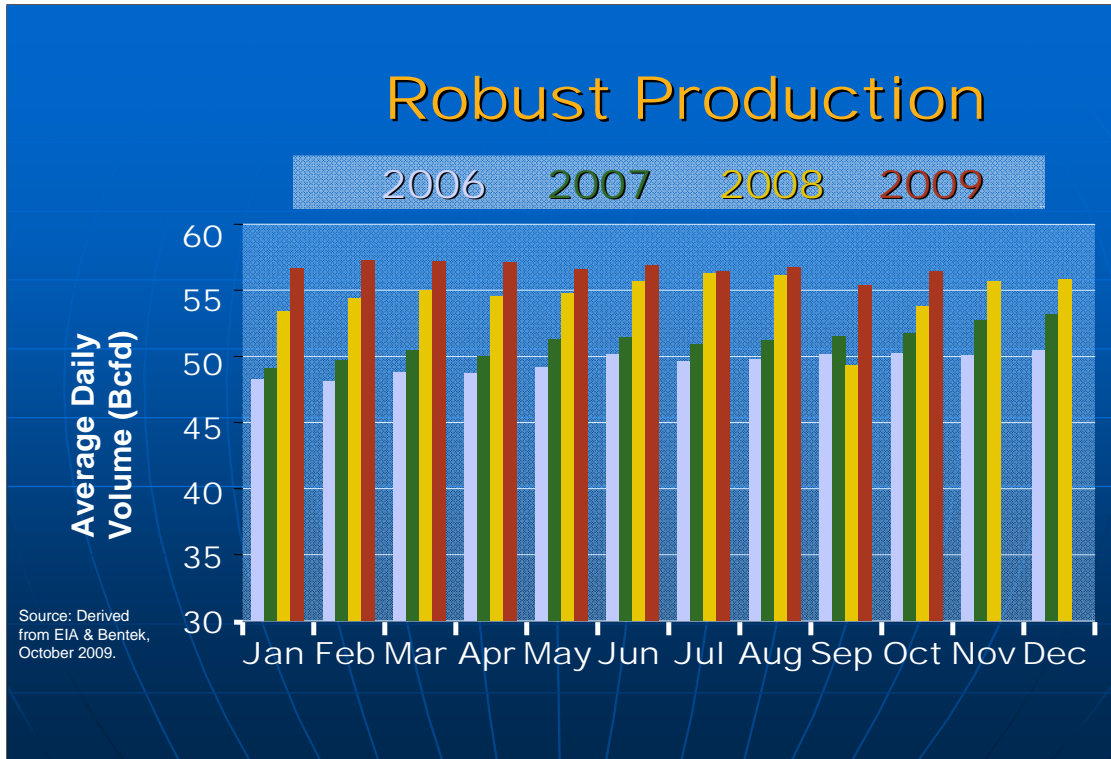


Before discussing the winter outlook, I'd like to do a quick review of the market conditions this summer that have led us to this point. This summer was exciting in that, in many parts of the country, summer gas and power prices fell to the lowest levels since 2001.

The spot price of gas at Henry Hub hit 8 year lows closing at \$1.83/MMBtu on September 4. Since then, prices have moved upward in the last two months, as technical factors and the influence of passive investment in financial markets put upward pressure on physical and financial gas prices. Nonetheless, gas prices are still the lowest we've seen in recent years.

During the summer, weather was mild over the Eastern third of the country. No hurricanes threatened gas supply. California wildfires caused few disruptions of electric generation or transmission.

Even when weather reached extremes, such as a few days in mid-August in the Northeast or in late July and mid-August in the Northwest, historical system peaks were never threatened. The only place where the system was stressed was ERCOT, where, between July 8 and July 16, load exceeded the previous peak by less than 2%. During that time, electric prices did increase, but there were no reports of reliability issues, and ERCOT did not turn to its reliability-based demand response providers for assistance.



In spite of low gas prices, gas production remains strong. During the first half of the year, production was running ahead of last year's rates.

Gas production has plateaued in 2009, but has not declined as many analysts expected at the beginning of the year. The fall-off in drilling has resulted in production declines in expensive low yield conventional gas reservoirs, but this has been offset by accelerated drilling for high yield shale gas and increased well productivity. A decline in September production was related to well shut-ins due to low prices and scheduled pipeline maintenance. The economics of shutting in shale production is less penal than that of conventional wells or coalbed methane, and many additional wells are ready to pour gas into the pipeline network, waiting for their final connection.

While the short term production picture is one of finding equilibrium after prices peaked and collapsed the last two years, the long-term story is one of abundance. In June, the Potential Gas Committee, an independent group that develops biennial assessments of gas resources, raised its estimate to over 2 quadrillion cubic feet, one-third more than its previous level and almost 100 years of gas production at current consumption levels. The large increase is almost entirely due to improvements in our ability to harvest gas from shale and get it to markets at a reasonable cost. For example, not only are we successfully getting more than double last year's supplies from the Haynesville Shale in Louisiana, but producers are also beginning to successfully tap into the mid-Bossier Shale that lies just above it. As we have indicated before, gas production is becoming more like mining and manufacturing with high probability of production from each well drilled. This environment should have profound effects on the traditional boom and bust cycle of gas production.

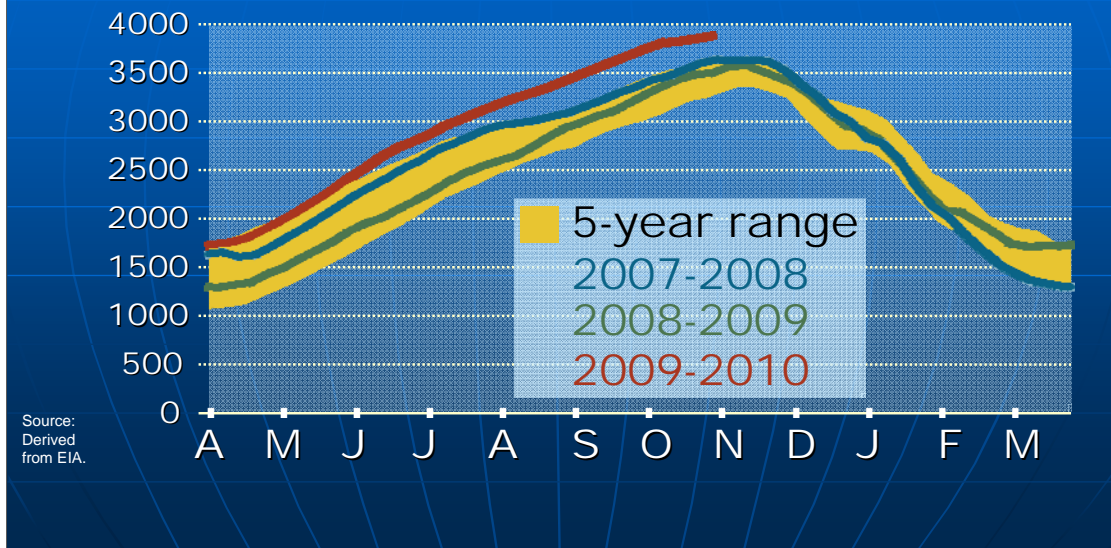
Continues on next page

Continued from previous page

In addition to domestic production, we have *averaged* 1.2 Bcfd of LNG into the natural gas system in 2009. Although this is 19% higher than last year, it is considerably below the predictions of earlier this year. Plentiful domestic gas supplies, rebounding demand in Europe and Asia, and extended supply outages in Algeria, Nigeria and Norway have moderated demand for additional tanker loads on our shores.

I will also note that one key source of supply has declined; net Canadian pipeline imports are down 15%, largely displaced by domestic supply and LNG.

Record Breaking Gas Storage

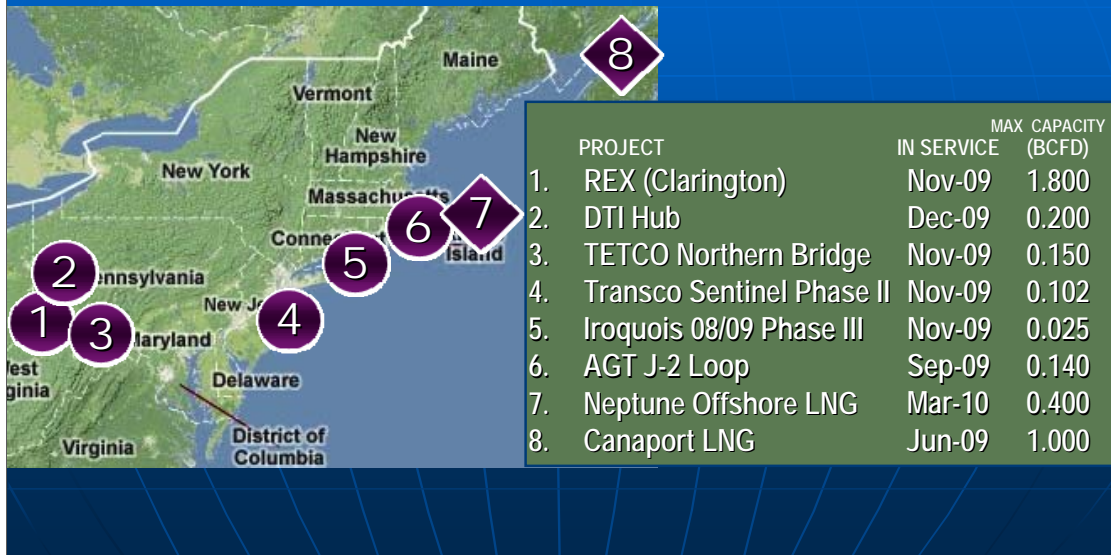


With production outpacing demand, gas has to go into storage. This year, we breezed past previous years' highs. At the traditional close of the injection season, October 31, there was 3,788 Bcf of gas in storage, 7% more than any time in the past. New storage capacity, 186 Bcf, has been opened over the past 2 years. But, even with this new capacity, US storage fields are 98% full.

Storage is so full that pipelines have imposed limits on the amount of gas that can be injected into storage and in some instances have asked interruptible capacity holders to make withdrawals.

Gas is not the only energy source with record high inventories. US power sector coal stockpiles have also broken all records, with 198 million tons or 73 day of stocks available.

Northeast Infrastructure Build Out



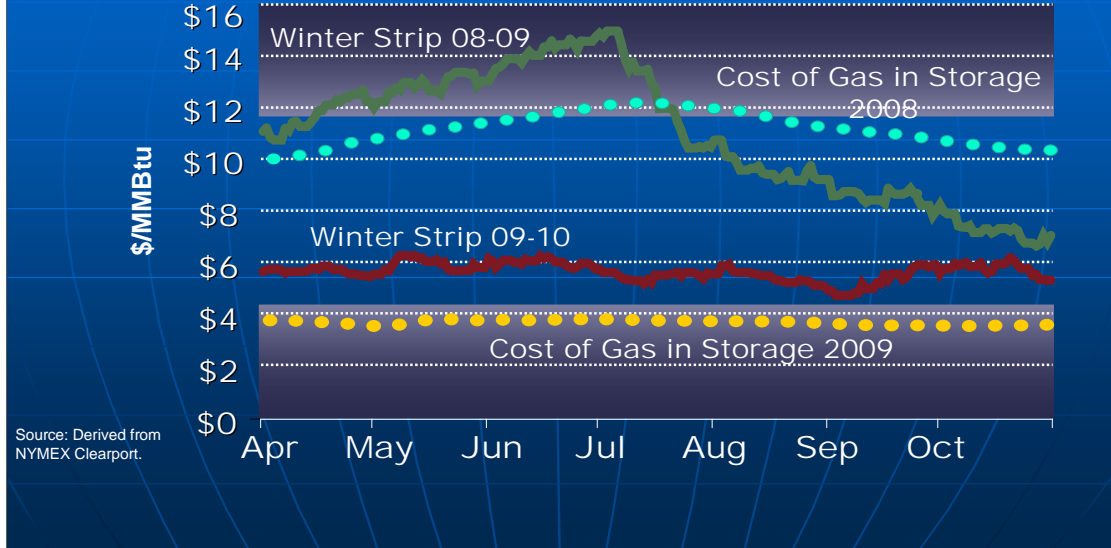
Northeast and Midwest markets will benefit from new infrastructure this winter that provide greater options for sourcing and transporting gas. East Coast and Midwestern consumers traditionally relied on the Gulf Coast and Canadian imports for gas supply. Through new pipelines and LNG terminals they now have access to supplies from the Rockies, and expanded access to gas from Appalachia, and global LNG.

With 3.8 Bcfd of new Northeastern pipeline capacity and LNG supply, we should see lower basis and price volatility this winter. Last year, the Northeast added 1.7 Bcfd, and we saw significantly less price volatility even though *the winter was colder than normal* and demand was slightly up.

1.8 Bcfd of the new gas service is attributable to the extension of the Rockies Express Pipeline (Number 1 on the map), which is beginning service to Clarington, Ohio this month. When REX reached Lebanon Ohio, last spring, natural gas from the Rockies gained greater access to eastern markets, lowering prices to East Coast consumers and raising prices for Rockies producers. The price difference between the Rockies and Appalachia has declined from as much as \$1.80 per MMBtu before REX East entered service to 30-35 cents in August. Early indications in forward prices indicate that the prices will converge further when REX is completed. Eastern and western US gas market are becoming coupled.

I would also note that not all pipeline expansions have occurred in the Northeast. New pipeline capacity has been added to bring new sources of shale gas in Texas and Louisiana to the market. This pipeline capacity has had the market effect of breaking down long standing price differences between market hubs in the two states and reducing dependence on gas from the Gulf of Mexico that can be disrupted in the event of a hurricane.

Winter Forward Prices Much Lower than 2008

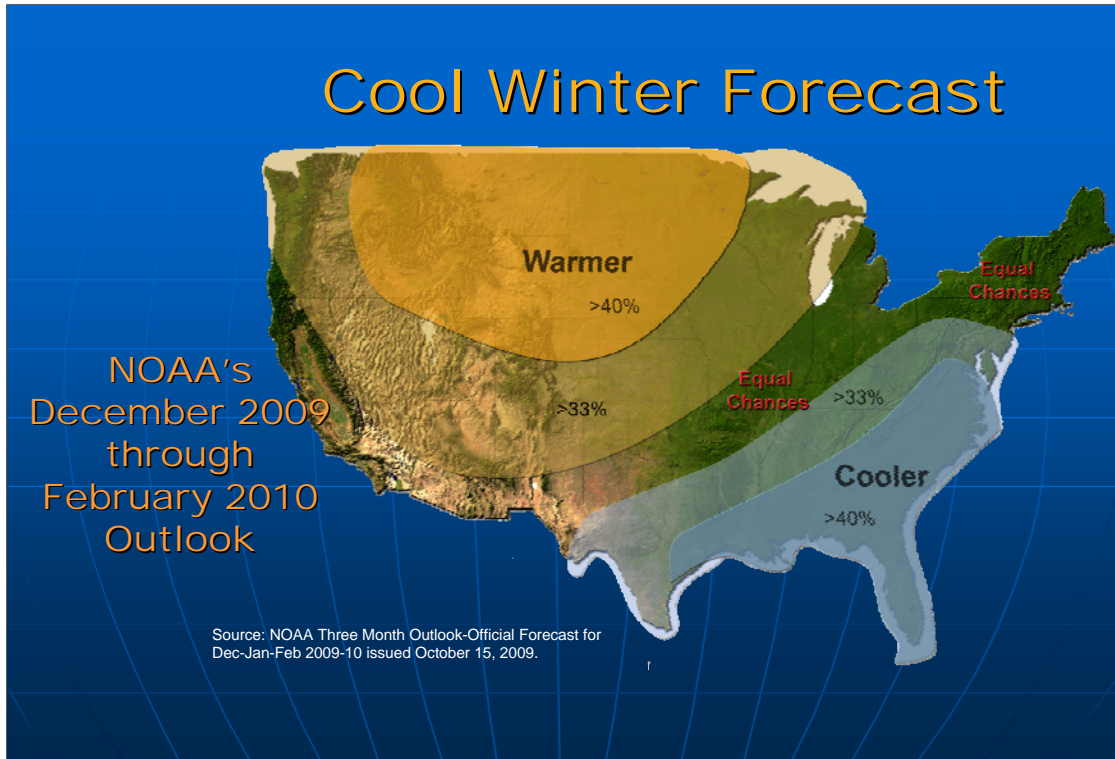


The robust outlook for production, the lack of hurricane-related supply disruptions during the summer, competitive prices for LNG on the global market, storage crammed to capacity and new pipeline capacity all contribute to an outlook for moderate gas prices to consumers this winter. At the end of October, I could have purchased a fixed price supply of gas for the winter for \$5.12 at Henry Hub. Last year, the same supply would have cost \$7.15. Unlike the spot price of gas, the winter price has remained steady most of the year.

Let me make two points clear right now.

First, when severe weather occurs this winter, the price of gas will spike. However, all things being equal, those spikes are likely to be less severe than they otherwise would have been.

Second, gas that has already been purchased by LDCs for this winter was bought at spring and summer prices. Nothing that happens this winter will change that. We estimate the price, on average, of gas put into storage this year was around \$3.45/MMBtu, compared to \$9.84/MMBtu last year.



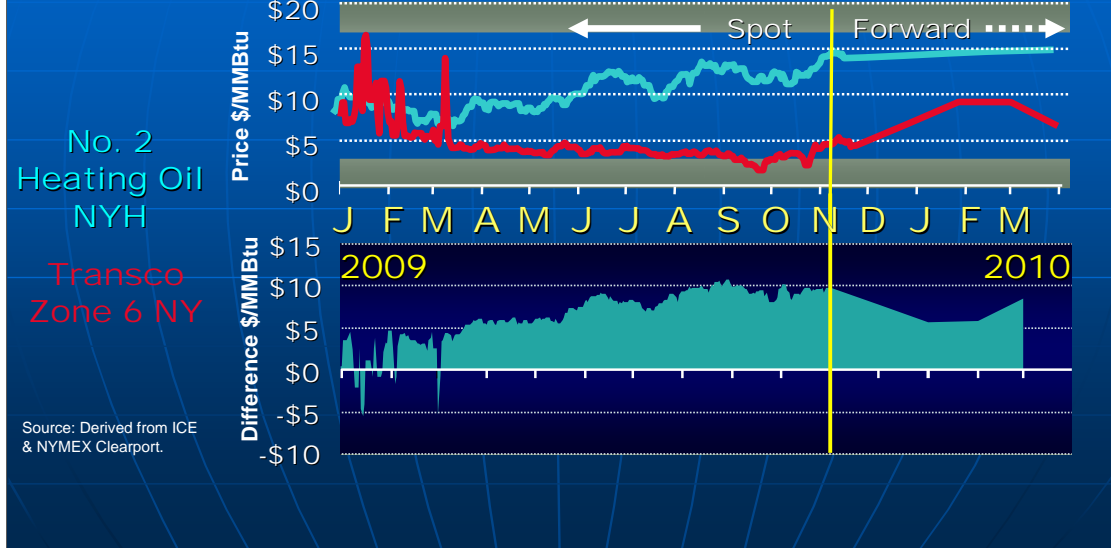
As always, weather is the key wildcard going into the winter. This chart shows NOAA's outlook for the coming winter.

The outlook is for below average temperatures in the Mid-Atlantic and Southeast, with an equal chance of temperatures being colder or warmer than usual in the Northeast, Ohio Valley and California. Warmer than normal temperatures are forecast for the West outside of California. Other weather forecasts are predicting much colder than normal temperatures and snowy conditions after the new year for the eastern seaboard.

Once again, colder-than-normal weather brings spikes in demand and prices, but we expect the price spikes to be moderated by the availability of gas from production, LNG and storage and new pipeline and storage capacity.

The South and West are forecast to be wetter than average, with normal precipitation levels along the East Coast and in the Midwest. Drier than normal conditions are forecast in the Pacific Northwest and the Ohio Valley.

The Spread between Oil and Gas Has Widened



Source: Derived from ICE & NYMEX Clearport.

Another wildcard for gas prices this winter is the widening spread between the prices of gas and oil. Last December, oil and gas prices reached parity. In the last nine months, oil prices recovered while gas prices fell; in September oil was 5 times the price of gas. In forward contracts, this spread has narrowed going into winter, but not sufficiently to erase the clear advantage gas has over oil.

Traditionally, the price of oil has acted as a release valve to hold down the spot price of gas. If gas prices got too high, demand would decline as larger users switched to oil. Environmental regulations, local reliability rules and new plant construction has made the switchover effect less pronounced. Nevertheless, it still exists.

As the current price differential moves deeper into winter, gas prices would need to rise steeply to create incentives to switch. The forward prices indicate some expectation of that possibility. This price relationship, then, will help to determine not only how much oil fired generation is used this winter, but also will help determine gas and electricity prices as it gets colder.

Winter (Jan-Feb) On-Peak Forward Prices 2009 vs. 2010

Location	2009 Price (\$/MWh)	2010 Price (\$/MWh)	% Change
New York City	\$108.50	\$86.18	-21%
Massachusetts Hub	\$86.24	\$70.53	-18%
PJM Western Hub	\$68.50	\$59.31	-13%
Northwest (Mid C)	\$55.37	\$50.99	-8%
Southern California (SP-15)	\$60.56	\$53.43	-12%
Palo Verde*	\$52.95	\$49.25	-7%
Midwest ISO (Cinergy)	\$56.25	\$42.74	-24%
	(\$/MMBtu)	(\$/MMBtu)	% Change
Henry Hub (Gas)	\$6.80	\$5.64	-17%

Sources: Winter is defined here as January and February. Palo Verde price and change is for the first quarter instead of Jan-Feb. Forward on-peak electric and natural gas data is from ICE as of 10/26/09 and is compared to the same forward packages from last Jan-Feb as of 10/24/08.

I will now turn to the outlook for winter electric prices.

Forward winter electric prices range from 7% to 24% lower than winter forward prices at this time last year. These declines mostly follow forward natural gas prices. Another contributing factor is likely expectations for electricity consumption. According to data from the Energy Information Administration (EIA), for the first six months of the year, electricity sales to retail customers were down 5% from the previous year. In the Midwest, where the price decrease is the greatest, the MISO market monitor has also identified the increased availability of wind power as a key factor for the decline.

Regionally, electric prices are highest in the Northeast, consistent with the Northeast typically having the highest winter gas prices. The West coast has traditionally benefited from lower natural gas prices than the East coast. Changing conditions have changed this price relationship. This year, the REX pipeline has resulted in a significant improvement in gas prices in the Rockies relative to the rest of the country. Also, the price of gas from western Canada has moved upward due to declining gas production and the declining dollar. These relatively higher western gas prices are reflected in the gas forwards for January and February.



Winter 2009/2010 Energy Market Assessment

Item No. A-3
November 19, 2009