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Surplus of Electricity Supplies May Persist at Least Until 2005

By REBECCA SMITH
Staff Reporter of THE WALL STREET JOURNAL

A surplus of electric power across much of the nation has turned into a glut that isn't expected to ease until 2005 or 2006.

The energy surfeit has slashed wholesale power prices and put the thumbscrews on companies that embarked on costly power plant projects in recent years. Indeed, if all the power plants proposed or under construction were to be completed, some regions would have twice as much excess capacity in a couple of years as is necessary to meet reliability standards.

Consumers won't immediately derive the full benefit of today's depressed prices, although they could over time see electricity bills gradually decline. That is because utilities generally purchase power through long-term contracts that fluctuate less than spot-market prices.

Some companies are canceling or slowing projects. **Calpine** Corp. Tuesday said it is canceling equipment orders and slashing $3.4 billion from its construction budget for 2003-2005.

"We're in a particularly complicated period in the history of this industry," says Michael Carter, senior energy analyst at Platt's, a division of **McGraw-Hill** Cos. "There's a glut today. But there's also fear that if too many plants get canceled, it could tip us back toward shortage in a few years."

Still, industry experts say it will be several years before today's surpluses are worked down. The situation underscores how quickly energy markets can pivot. Two years ago, California was suffering electricity blackouts and supplies were tightening in the Northeast, Texas and other regions. This sparked a construction boom in generating capacity in 2001 and 2002, just as the economy slowed and demand growth slackened. Spot power markets also lost much of their volatility as big consumers such as California moved more of their electricity purchases to long-term contracts.

Electricity prices vary sharply from region to region and day to day. But power prices in general have dropped significantly from levels seen two years ago.

For the foreseeable future, prices look depressed. **Duke Energy** Corp., for example, says it has sold its entire expected output for 2003 at an average price of $51 per megawatt hour. It has agreed to sell electricity, in 2004 and 2005, for average prices of $44 and $39 per megawatt hour, respectively. Amid low prices, it is holding back some capacity "for when the market turns," says Robert Brace, Duke's chief financial officer.

According to Platt's, the reserve margin -- the amount of capacity beyond what is needed to satisfy peak

demand -- hit 31% in the 11-state Western region at the end of last year and could hit 56% of total capacity by 2006 if current projects under construction are completed. In the Northeast, reserves of 29% could hit 45%. The Southeast, excluding Florida, would see reserves shoot to 52% from 30%.

Fears that this overcapacity will further crush prices, coupled with tighter credit conditions imposed by banks on the industry, are prompting a reaction. According to research by Energy Ventures Analysis Inc., Arlington, Va., through the course of 2002 the number of new megawatts of capacity expected to come on line in 2003 and 2004 dropped by about 30% and 60%, respectively, from what had been previously planned.

AES Corp., Arlington, Va., said last month it was terminating a 1,100-megawatt power project in Redlands, Calif., which was the biggest generating plant under construction in the state, in order to conserve cash. AES took a charge of nearly $400 million for canceling this project and another in Florida.

John Rowe, chairman of Chicago-based **Exelon** Corp., says he expects to see a "modest recovery" in prices in 2005. But he cautions, "My crystal ball is more quartz than crystal, really."

Exelon bought plants with more than 4,000 megawatts of New England generating capacity from Sithe Energies Inc. in mid-2000. Mr. Rowe says if he had known in 2000 what he knows now, "we would not have done the Sithe deal on the terms we did. The only silver lining is we should be able to make serious money in 2006 and 2007."

A new fear is emerging on the part of public officials that the industry may be overreacting in canceling plants, which could tip some regions back into a tight supply in a few years' time. That would be good for companies that want higher prices, but bad for consumers. For example, if only 10% of plants under construction and 20% of those under advanced development got cut in the West, energy margins in 2006 would remain roughly as they are today, Platt's says. If the economy picked up substantially, supplies could tighten more than is healthy.

Write to Rebecca Smith at rebecca.smith@wsj.com[1]

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(1) mailto:rebecca.smith@wsj.com

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