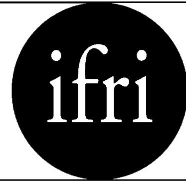

Le Centre Français sur les Etats-Unis
(CFE)

Séminaire du 15 mai 2002 : Après ENRON, quelles régulations ?

Panel 2 Is energy deregulation guilty?

Remarks by Pierre Lepetit, senior research fellow, French Center on the United States

According to authorities (FERC, CFTC, EIA) and operators on the U.S. energy market, the Enron collapse wouldn't have had a major impact on energy market either on quantity delivered or on prices. The closing out of Enron's positions was accomplished quickly and smoothly. No customer lost any funds entrusted to any brokers. To be short "market works". Enron paid a severe price.

Nonetheless Enron's collapse contributes to a crisis in confidence in power market deregulation that significantly impacts state legislation and implementation of retail energy market reform (as Peter mentioned previously US states have deferred or cancelled plans for retail competition in the past 18 months and several European leaders didn't hesitate using the Enron argument for delaying further liberalization).

As Enron blazed the trail in new market it appears that no single regulatory authority had a clear overview on Enron. Enron was an exempt holding company under the Public Utility Holding Company Act of 1935; Enron as a market-based rate operator was given a waiver of certain accounting regulations by FERC; FERC has no direct, explicit jurisdiction over purely financial transactions such as futures contracts for electricity or natural gas; the Commodity Future Trading Commission does not regulate trading of energy products on spot markets or forward markets, bilateral trading and electronic multilateral trading between two eligible contracts participants.

Information available to date allows us to think that Enron tried

- to free itself from the market rules with the derivatives instruments
- and to benefit from a flawed deregulation in California.

1. Enron collapse underlines the lack of oversight on <u>forward power markets</u>.

Unlike future markets, no neutral third party entity organizes the forward power markets. As a market maker, Enron set up a many-to-one trading platform – Enron On line.

Even though Enron provided price information and market liquidity by insuring continuous transactions as an intermediary, it seems that it was a mistake to allow a significant market buyer or seller to be a market maker without oversight for at least two reasons:

- <u>An information asymmetry</u> created by requiring all buyers to buy from Enron and all sellers to sell to Enron. It is a serious market flaw for it allows the market maker to benefit of an unfair advantage vis-à-vis other market players.
- <u>An incentive to shade reported forward prices to increase its own reported earnings.</u> Mark-to-market accounting allows the buyer to record the change in contract value as current period earnings.

Neither the Federal Energy Regulatory Commission nor the Commodity Future Trading Commission have jurisdiction on energy financial transactions. Both declared two months ago before the Congress that they had no indication that manipulation of any on-exchange futures market was attempted by Enron and that these transactions (on futures markets) have played a significant role in Enron's demise. This opinion was supported by Chairman Alan Greenspan. This has to be confirmed but the problem is not on the futures market (one-to-one) but on the forward markets (many-to-one) and the electronic trading.

Not only the Commodity Exchange Act excluded forward markets from the jurisdiction of the CFTC but the 2000 Commodity Futures Modernization Act (CFMA) excluded also electronic multilateral trading with the consent of the CFTC Chairman who declared in a recent Congress hearing that "a one-size-fits-all approach to regulation was outdated, particularly in the light of important advances in technology within the financial services industry". And the attempt by Senator Dianne Feinstein (CA) to subject trade energy derivatives to the same requirements as other exchanges last April was strongly opposed by derivatives dealers, bankers and energy traders arguing that again regulation would plunge OTC derivatives into a cloud of legal uncertainty and that it would wreak havoc on the electronic trading platforms that are flourishing in the energy markets.

A growing number of information shows that Enron was purposely engaged in "earning manufacturing business" (creation of artificial overstated earnings which were unrealized gains). For example in 2000, a reporter of the Wall Street Journal found that for the whole year unrealized trading gains accounted for more than half of the company's originally reported pretax profits. When their derivative strategies started to go sour it seems that Enron removed the contracts from its financial statements and hid them in special entities created for that purpose.

Thus it would be unlike that Enron had not benefited from the opportunity offered by the lack of oversight on the forward markets. The question is no to discuss the fact that swaps have enhanced economic efficiency but to check whether corporate governance and market self discipline are sufficient to guarantee that customers can have confidence in the derivatives markets and more broadly in the energy markets and that deregulation delivers on its promises.

2. **Enron had the ability to affect prices at least in California and there is growing evidence that it did it.**

According to FERC's quarterly marketing reports Enron's sales in California were nearly 30% of the market by the fourth quarter of 2000. Such a market share is sufficient to exercise price leadership (cf example of PG&E before 1998). Since the Western System Power Pool had published in 2000 a data base showing the hourly plant operations of many of the plants of the west coast, any market participants would be able to easily adjust their operations to accentuate the California ISO's problems during an hour when demand was high.

Some evidences begin to appear that Enron and several other power suppliers (Reliant, Dynegy and CMS energy) did manipulate the California market and even the Texas market.

Testifying in April to a subcommittee of the Senate Commerce Committee Loretta Lynch, President of the California Public Utilities Commission, said the PUC had determined that five subsidiaries traded large volumes of electricity contracts among themselves. Because Enron booked as revenue the value of each trade, the transactions allowed the company "to create false value" and because Enron reported the trades on its online trading system, se said, they created an artificially high benchmark price for other companies buying and selling power.

Documents released by Enron last week show that traders used strategies code-named "Fat Boy", "Ricochet", "Get Shorty", "Load Shift" and "Death Star" to increase Enron's profits from

trading power in the state – techniques that added to electricity costs and congestion on transmission lines.

It is too early to say whether these trades were legal or only exploited weaknesses in the California market regulation. The line between price manipulation and exploiting legitimate market opportunities was thin particularly in California's nascent and flawed electricity trading market. As far as we learn it appears that power trading was much less profitable than the companies has told investors and that these companies used questionable accounting practices and artificial trades to inflate their revenues and their earnings.

To conclude, considering what we know it would be hazardous to say that Enron had no impact on energy markets. Indeed markets were able to adjust smoothly and Enron is paying a huge price for its behavior. But the regulations must be smarter than the market participants. As a FERC Commissionner, William Masey, said last week: " Solid market rules that prohibit abusive behavior are critical, and regulators cannot be naïve about this". The critical question is how to avoid that a market participant acquire a power on the market.

Moreover additional authority should be given to regulators and state authorities to achieve a national open and competitive transmission grid which are essential to reduce regional or local market power.