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FERC's Wood: Contracts Could Be Voided if Enron Manipulated Markets

By NGI Staff Reports on January 30, 2002 at 5:00 a.m.

If investigators find that Enron Corp. manipulated forward electricity markets, FERC Chairman Patrick Wood told a Senate hearing Tuesday that possibly the courts or state or federal regulators could void some of the high-priced, long-term power contracts on the West Coast.

Responding to concerted questioning by Sens. Diane Feinstein (D-CA) and Maria Cantrell (D-WA) about the long-term contracts signed by western utilities, Wood said that if it could be proved the high prices "were the result of market power and rather than true scarcity," then there could be a forced renegotiation. Wood said the Commission could consider doing a Section 206 investigation on the contracts.

In other hearing developments, Robert McCullough of McCullough Research in Portland, OR, -- emphasizing the great need for more information and transparency in the market -- said that had Enron not been exempted from the Public Utility Holding Company Act (PUHCA), it would have been required to report the controversial off-balance sheet partnerships that ultimately led to its collapse and bankruptcy. Startled by this disclosure, Sen. Ron Wyden (D-OR) called for the Senate panel to "look very carefully" at the laws that allowed for Enron's exemption.

Dr. Lawrence J. Makovich, senior director and co-head of North American Energy Group in Cambridge, MA, said the Enron debacle showed that it was a mistake to let a major "market player" be a "market maker" through its unregulated on-line trading activities, particularly in the forward energy market. At its worst, it increased Enron's opportunity to engage insider trading, putting its competitors at a huge disadvantage.

Makovich said that the fact that the forward market dropped 30% on Dec. 3, the day Enron declared bankruptcy, is a strong indication the company was propping up the market. McCullough said the public needs to know "Enron's position in these markets, whether Enron did have a large share of the forward contracts. There is so much information we just don't have."

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These were just a few of the disclosures that arose during the Senate Energy and Natural Resources Committee hearing that explored the impact of the Enron collapse on energy consumers and markets. All who testified drove home the need for more market transparency and reporting requirements.

"...[T]ransparency, openness is a far better tool than regulation," McCullough said. Wood noted this was especially "critical" in the power markets, which he said were "a lot thinner." The cry for more transparency, however, should not be confused with "more government interference" in energy markets, cautioned Sen. Frank Murkowski (R-AK). He believes any attempt by the federal government to "micro-manage" the energy markets would be disastrous.

But Committee Chairman Jeff Bingaman (D-NM) thinks new laws may be needed to require full disclosure of energy transactions by private energy companies. Feinstein echoed these sentiments, and questioned whether the still-remaining on-line energy platforms, operated by Dynegy Corp. and Williams Cos., should be subject to federal oversight.

"Now that Enron is out of the on-line energy trading business, companies like Dynegy and Williams have stepped in to fill the void. There's no transparency...this could all happen again," Feinstein said. The Intercontinental Exchange or ICE was exempted from these criticisms since it is a multi-party exchange.

She believes that price manipulation by EnronOnline was responsible for the high natural gas prices that ultimately led to the spikes in electric prices in California last year. EnronOnline controlled 50-57% of the gas trades in the southern half of the state, she said, admitting the figure was based on anecdotal evidence. But because it engaged in unregulated bilateral trading, "nobody except Enron knew the prices that were being bid."

McCullough pointed out that if you have an open pit outcry, "you can check how deep the market is; you can tell if there's only one person in the pit. With EnronOnline there was no way of knowing what the prices represented." He thanked Wood for requiring quarterly market reports, which provide some information. And the energy companies aren't the only ones keeping secrets, he said, advising that it has been extremely hard to get any information out of the Cal-ISO. "There's very little information on who dominates most of these hubs."

The physical energy markets and the futures markets got a clean bill of health in the wake of the Enron collapse. Although there was "some volatility" in energy prices, FERC's Wood said that overall there was "little perceptible impact" on the market. He noted, however, that he was concerned about Wall Street's "overreaction to other peoples' [financial] books," and energy companies' limited access to the capital markets.

James E. Newsome, chairman of the Commodity Futures Trading Commission, reported that "when Enron's positions closed out, prices did not spike up or down, nor did liquidity suffer."

Moreover, "at this time, we have no indication that manipulation of [the energy] futures market was attempted by Enron," Vincent Viola, chairman of the New York Mercantile Exchange (Nymex), told the Senate committee. Nor, he added, was there any evidence that certain "rules or the absence of rules" related to the trading of energy futures contracts contributed to Enron's demise.

Viola estimated that the notional value of trades on EnronOnline was about $2.8 billion per day in 2001, compared to $13 billion per day on Nymex. These numbers suggest that energy companies chose Nymex to conduct most of their trading activities because the exchange is overseen by federal regulators, he said.

Viola noted that Nymex "actively expressed concerns" a few years ago when Enron favored exempting all energy and metal futures contracts traded on electronic platforms from federal oversight. Congress rejected the idea, he said, adding that the "markets are better for it." To this day, he said Nymex fails to understand the distinction between an exempt exchange doing business electronically and a physical exchange.

North American Energy's Makovich believes a shock to futures energy prices was avoided because the Enron collapse occurred with "enough warning," allowing customers to reduce their financial exposure. But, he added, the market for forward electricity contracts -- which are non-standardized, unregulated bilateral contracts -- wasn't as fortunate.

Unlike the futures market, there is no neutral third-party entity that organizes these contracts, said Makovich, who added that EnronOnline filled this void in the power market by being a "market maker" in the forward markets. As a result, "Enron was...in the position to be consistently among the first to know about most forward market transactions." The lesson to be learned from the Enron failure, he believes, is "it was a mistake to allow a significant market buyer or seller to be [a] market maker without any oversight."

In addition, Makovich said the Enron collapse has led to a "crisis of confidence" in the retail energy markets that could stunt market reforms. He believes it could even cast a shadow on the already-deregulated energy markets that are working. That would be the wrong reaction, said Sen. Murkowski. "The lights stayed on and retail [energy] prices did not spike" in the wake of Enron, he noted, and he credited this to deregulated markets. Wood agreed with the senator, noting that it would be wrong to think that Enron's failure "sounds the death knell for competition."

William Nugent, a Maine regulator and president of the National Association of Regulatory Utility Commissioners, said his state "dodged the bullet" following Enron's failure, but it wasn't because

Maine is so market-savvy. Rather, "we were simply and profoundly lucky" that the collapse occurred in a down market.

If it had occurred during a rising market, Nugent estimated that Maine alone would have suffered a hit of $50-100 million, while New England's losses would have been in the billions of dollars.

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