Trust, But Verify.

FERC Must Act To Ensure Transparency

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Organization of this presentation

- Looking back, especially at California
- Western Market Crisis of 2000-2001
- Post-Crisis Reforms
- FERC’s goals, budget, organization
- Current state of monitoring, compliance, enforcement
- Energy trading oversight (the “Enron loophole” and the Amaranth problem)
- Suggested FERC “fixes”
- Two final quotes

A dozen years ago, electricity dereg changed the “game” in ways we never imagined…

- In the mid-1990s, as dereg was conceived, it was sold under the banner of some dramatic claims:
  - Electricity will be treated like any other commodity
  - The “market” will rule
  - Cost will fall
  - Everything will be wonderful
- In July 1999, LeBoeuf, Lamb, Greene & MacRae opined to Enron on the legality of a proposed trading practice (Ricochet):
  - “The contemplated transaction, though questionable on business, political and social grounds, does not appear to be prohibited under current law.”
- FERC’s focus changed
  - From long-term planning to short-term efficiency
  - ISO/RTO became the favored model
  - Adopted “lack of market power” not “competitive market” standard
  - Active neglect of information gathering role

Well, Good Luck On That "Lack Of Market Power" Thing

- Electric power systems, as they now exist, and as they have always existed, possess extremely limited opportunities for effective economically competitive environments
- A very simple measure of the competitive potential of an industry, the Herfindahl-Hirschman Index, reveals the essence of the difficulty of getting true competition into the electric power industry.
- DOJ standards imply that any industry where more than 1/3 of supply comes from a single entity is "moderately concentrated" and if it's more than about three-sevenths it's "concentrated." Almost all electric power customers face moderately concentrated market environments, and most customers live in concentrated market situations.

Precursors to the Western Market Crisis of 2000-2001

- California’s price spikes in the summers of 1998 and 1999
- FERC reported on the 1998 spikes, but then ignored the recommendations related to improving access to NERC real-time supply and demand data.
- Performance and budget reviews for 1999 did not acknowledge the greater significance of that year’s price spikes
- Studies produced in late 2000 reported only that some market misbehavior may have occurred
- No meaningful investigation into causes of 2000-2001 crisis until 2002
- Enron memos and trader tapes become public knowledge courtesy of Snohomish Public Utility District
- FERC assumed voluntary compliance with its rules and regulations, never adopting the basic common-sense public policy of “trust, but verify”

Western Market Crisis of 2000-2001: Causes

- Poorly designed wholesale market in California ran on software technology that was exploited with ease
- Lack of state and federal coordination; no centralized facility for data collection and analysis
- Inadequate budgetary support for regulators from state governments and Congress
- Failure by regulators at all levels to heed early warning signs; a little too cozy with industry?
- Ineffective or no managerial oversight of trading (corporate and regulatory)
- “Look what we can get away with” mentality (gaming and gambling with other people’s money)
- No meaningful investigation by FERC into causes until 2002
- FERC’s naiveté: voluntary compliance, no “trust but verify” until after 2001, and still inadequate today
- FERC’s goal, “get parties to settle” precludes fact-based analysis and determinations
- FERC still litigating

After California and Enron's bankruptcy

- Congress: Sarbanes-Oxley
- Congress: Energy Policy Act of 2005 (EPAct 2005)
- FERC and CFTC promise to work together
  - Per EPAct 2005, FERC and CFTC have concluded "a Memorandum of Understanding on information under both the electric and gas market transparency provisions."
- FERC reforms quarterly transaction filing
- FERC reforms standards of conduct; prohibits manipulation
- Reforms of price indexes (better controls over reporting trading data)
- ISO/RTOs beef up monitoring and reporting functions

So How Has It Been Working Out?

- Mixed bag, but mostly not so well
- Some Examples Of Consequences:
  - Arguably, the NE outage of 2003
  - High prices under Texas California-like centrally administered “market”
  - Maryland auction process yields very high prices, political upset
  - Illinois auction process yields very high prices, political unrest

Are The Recent Reforms Good?

- Yes
- Are they enough, NO
- We are still a long way from having even the basic Form 1 information of a decade ago
- Many jurisdictions have allowed utilities to hide basic power system economic data in unregulated subsidiaries
- Illinois is now suffering through the consequences of these arrangements

Illinois – Appearances Can Be Deceiving

- Power auction has all the trappings of an exercise in competitive economic forces …
- … But there are really only two participants and profound process secrecy makes auditing for market power abuse needlessly difficult

Some Observations

- Distribution utility executives claim they'll suffer ruinous downgrades of their credit ratings and likely go bankrupt without very large rate increases to cover increased power costs under deregulation/the aftermath of the power auction
- No reason to doubt their veracity because the distribution utilities ARE faced with the power costs from the auction
- The really interesting question is, what do the financials of the overarching holding companies look like?
- The auction-winning suppliers are generally subsidiaries of the same holding companies that own the distribution utilities

An Illinois Thought Experiment

- Thought experiment/policy question: holding companies normally aggregate the financial performance of the enterprises they own for tax purposes
- Should the financial risks of those enterprises also be aggregated for risk assessment/credit rating purposes?
- Have the credit risk characteristics of the holding companies changed under the new regulatory regime?
- What do we think about the possibility that the holding companies’ credit risk could be *lower* post auction compared with pre auction, regardless of the distribution of risk across owned enterprises? Think, “cash flow.”
- How can the public know the answers to these questions without basic system operating and financial data?

Newer problems

- Technology changes faster than regulation (unregulated, technologically integrated electronic trading platforms, innovative financial products; more players of all sizes; more volatility; potentially more risk)
  - Sovereignty issues and the role of central banks prevent establishing a global regulator/mediator; instead, trust the players
  - New idea being floated: “substituted compliance” (accommodating non-American exchanges by being “more or less” compliant with US regulations)
  - “Culture of secrecy” in energy trading is still pervasive
- Summer and fall 2006: Amaranth’s attempt to corner natural gas market for March and April 2007

Energy Policy Act of 2005 (EPAct 2005), Subtitle G: Market Transparency, Enforcement, and Consumer Protection

- **Sec. 1281. Electricity market transparency.**
- **Sec. 1282. False statements.**
- **Sec. 1283. Market manipulation.**
- **Sec. 1284. Enforcement.**
- Sec. 1285. Refund effective date.
- Sec. 1286. Refund authority.
- Sec. 1287. Consumer privacy and unfair trade practices.
- Sec. 1288. Authority of court to prohibit individuals from serving as officers, directors, and energy traders.
- Sec. 1289. Merger review reform.
- Sec. 1290. Relief for extraordinary violations.

These Are Great Rules, But…

- 4(b)1 still gives FERC the latitude to allow loopholes big enough for an Enron to drive through
- They contain the old fantasy of market magic, the trust that price discovery is enough to ensure competition
- They fail to be adequately specific about directing FERC to verify, to collect enough data
- Rhetorical question: can we trust FERC to systematically and consistently, through changes in administration, year after year, collect the information necessary for verification?

FERC's Organization…

- **On October 1, 1977,** the "Department of Energy Organization Act" created FERC
- **In 1999**, FERC undertook a major reorganization after its Arthur Andersen-led "FERC First Initiative."
  - Despite a new focus on markets, the division, Energy Markets, established to oversee and monitor markets within the Office of Markets, Tariffs and Rates (OMTR) inherently conflicted with FERC's new directive to "let the markets work."
  - FERC was generally uninterested in finding and resolving problems in the markets, especially those that may have been created by its new policies.
- **In 2002,** the Office of Market Oversight and Investigations (OMOI) was created.
- **In 2006,** FERC's reorganization of OMTR into the Office of Energy Markets and Reliability and its changes to OMOI resulted in a new Office of Enforcement (OE).
- Today, the Division of Energy Market Oversight (DEMO) in OE oversees "the Nation's natural gas and electric power markets and related energy and financial markets"
  - "conducts daily oversight"
  - "reports its findings and recommendations to the Commission and the public"
  - on January 18, 2007: http://ferc.gov/market-oversight/guide/guide.asp

It’s fine to have performance goals, but what about the underlying philosophy?

- **FERC is fixated on ISO/RTO models**
  - Even before 2000, theorists tried to invent fixes and “tweaks” to encourage long-term investment
  - Current examples: LICAP/FCM in New England; the RPM fight in PJM
  - Long-term transmission rights?
  - Seams issues unresolved
- **FERC promotes competitive markets *and* monitors them**
  - FERC has opened Docket No. AD06-11-000 (“Price Transparency”) and “may issue rules to increase transparency in electric and gas markets”
  - FERC relies on its market power screens for detection (but what if a company passes the “screen tests” yet still has market power?)
- **FERC also “enforces”**
  - FERC is not sufficiently removed to function as a dispassionate evaluator
  - In reviewing mergers & acquisitions, is bigger always best?
- **FERC’s 2007 Conference on Competition In Wholesale Power Markets” more of the same**
  - Omits “lower prices” as a primary objective of federal deregulation efforts

Reform FERC's monitoring

- FERC has more staff assigned to market monitoring than any of the ISOs
  - But "more staff" does not necessarily result in more/better *independent* monitoring
  - Who defines the "quality" of FERC's monitoring?
  - When will FERC monitor auctions?
  - Limited resources: FERC cannot monitor the nation's markets and analyze the details

- FERC has opened Docket No. AD05-17-000 ("Electric Energy Market Competition"), creating "a five-member inter-agency task force ("Electric Energy Market Competition Task Force"), of employees from DOJ, FERC, FTC, DOE, Ag [who] shall submit to Congress a final report on competition within wholesale and retail markets for electric energy in the U.S."

- FERC issued Order 668 requiring greater transparency by RTOs

Reform FERC's data collection, analysis and reporting

- **FERC utilizes far less data than the ISOs**
  - DEMO's quarterly transaction data is exactly the same as the reports filed by all of the investor-owned utilities/marketers that sell electricity
  - In other words, FERC relies on the same data available to any financial analyst
  - At a minimum, it is a month old
  - Reflects only the sales side of the deals
  - Does not include transactions by public power entities
  - **DEMO does not have access to** NERC's real-time supply and demand data
  - DEMO Does not monitor bidding behavior of wholesale auction players
  - Lack of access to good data is sometimes a problem
  - Inadequate or lagging software technology at FERC?
- **FERC had not managed to publish more than one "State of the Markets" report every two years**
  - Not understanding how to use/interpret the data it does have to maximum advantage
  - Can FERC always recognize market "anomalies" in time?
- **Last week it issued an abbreviated report (59 pp), explaining:**
  - "…the annual *State of the Markets Report* will now consist of a summary of significant national electric and natural gas market developments over the previous year. Regional detail will be provided, and updated more regularly, within the Web pages themselves."

Reform FERC's enforcement and penalties

- Under EPAct 2005, FERC opened Docket No. RM06-3-000, in which it "may prescribe such rules as it determines necessary and appropriate" under the electric and gas market manipulation provisions which make unlawful any manipulative device or contrivance (as those terms are used in the Securities and Exchange Act of 1934)"
  - Order No. 670 ("Anti-Manipulation/Anti-Fraud") January 2006

- Under EPAct 2005, FERC flexed its muscles for the first time (January 18, 2007)
  - Four civil penalties against Entergy, NRG, PacifiCorp, SCANA *(but they self-reported their violations of FERC's rules)*
  - One against Northwestern Energy Corporation *(but it was "ratted out" by another utility)*

- Too much effort spent on enforcement for too little return?

CFTC oversees Designated Contract Markets (DCM), i.e., futures markets

- Commodity Exchange Act (section 5)
- Following 3 years of study, CFTC issued “Acceptable Practices” on July 7, 2006 for comment
- Final acceptable practices for Section 5(d)(15) (“Core Principle 15”) 1 of the Commodity Exchange Act issued February 1, 2007 with 2-year phase-in requires DCMs to
  - Have “35% public director standard” (reduced from 50%)
    - “Public directors are persons who have no ‘material relationship’ with their DCM”
  - Establish regulatory oversight committees composed only of public directors
  - Disciplinary panels” must include at least 1 “public person”; must keep “thorough minutes”

The “Enron loophole”…

- US Senator Feinstein: “Energy Markets Improvement Act” (2005)
  - Provides information about availability and market price of wholesale electric energy and transmission services and protecting consumers and competitive markets from false of misleading information and from the adverse effects of potential collusion or other anticompetitive behaviors
  - Prohibits round trip trading
  - Prohibits market manipulation
  - Addresses over-the-counter transactions and electronic trading facilities for energy commodities

- US Senator Feinstein: “Oil and Gas Traders Oversight Act” (2006; 2007)
  - CFTC oversight over electronic trading platforms for oil and gas
  - Traders must keep extensive records and to report large market positions
  - Traders in the US must report on their activities in non-US exchanges

The “Enron loophole,” con’t.

- US Representative Stupak: “Prevent Unfair Manipulation of Prices Act” (2006; 2007)
  - Covers energy transactions executed or traded on an electronic trading facility
  - Provide information, maintain records for at least 5 years after the date of a transaction, including large trading positions
  - Prohibits fraudulent transactions
  - Establishes criminal and civil penalties

Is there such a thing as too much transparency? The Department of Justice thinks so.

- "Given that electricity and related markets may have characteristics that make them susceptible to coordination, the Commission in general should beware of increasing transparency by mandating rapid disclosure of highly-detailed, firm-or transaction-specific information. In particular, the Commission should be particularly wary of mandating disclosure of such information in spot markets for electricity and forward markets for standard block electricity products, both of which have many of the characteristics that may render a market susceptible to coordination."
  - Department of Justice to FERC (Docket No. AD06-11-000)

- DOJ suggests…
  - Aggregation and/or
  - "Masking" (disguising) a transaction's names and details from the competition
  - "Lagging" information, i.e., releasing the details later

Learning from Amaranth

- "…I believe the energy markets are more transparent, informative and free of the widespread manipulation and speculative behavior than ever. To the extent that abuse occurred, the efforts of the CFTC and FERC have effectively corrected it without resorting to a whole new volley of regulatory mandates."
  - Sharon Brown-Hruska, CFTC commissioner, **January 25, 2006**

- "Hedge fund Amaranth Advisors LLC said Monday that it has suffered heavy losses related to its investments in natural gas, and it could report a year-to-date decline in the fund of more than 35% when it finishes unwinding its positions."
  - Dow Jones News Service, **September 18, 2006**

- Amaranth's losses from betting on natural gas futures contracts between March and April 2007 totaled $6.5 billion; traders call the two months (the end of the heating season) the "widow-maker"

- Amaranth "had huge positions on ICE and in other off-NYMEX instruments to keep its big bets out of sight of regulators."
  - Platts Commodity News, **January 30, 2007**

- The CFTC asked the Intercontinental Exchange to provide it with large-trader data and other information
  - nothing as of **January 31, 2007**

- The Government Accountability Office will issue a report on enforcement and compliance within the SEC
  - Expected by **June 2007**

- **On February 10**, the Group of 7 ordered its Financial Stability Forum to update a 2000 report on hedge funds.

Final words…

- “The Energy Policy Act of 2005 permanently changed the Commission. It outlawed market manipulation in power and gas markets, gave us responsibility to assure reliability of the electric grid, and gave us meaningful enforcement tools that we badly needed. Congress entrusted the Commission with substantial civil penalty authority, and we are using that penalty authority firmly and fairly to sanction wrongdoing and to encourage compliance. We are now an enforcement agency capable of very effective oversight, and are dedicated to becoming a preeminent enforcement agency.”
  - Joseph Kelliher, FY 2008 Congressional Performance Budget Request, p. 66

- “Markets are meant to be greedy, not fair. Efficient, not sufficient. They’re very good at short-term allocation of scarce resources, but that’s all they’re good at. They were never meant to tell you how much is enough or how to fulfill the higher purpose of a human being.”
  - Amory Lovins, January 22, 2007 (although he was speaking about energy efficiency, we would do well to heed his words)

- And, not to belabor the point – well, yes, let’s belabor it: "Doveriai no proveriai"
  - Russian proverb (Trust but verify)