

**Testimony of Gerald A. Norlander**  
**Executive Director**  
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**Before the**  
**Committee on Energy and Air Quality**  
**United States House of Representatives**  
**The Effect of the Enron Bankruptcy**  
**on**  
**The Functioning of Energy Markets**  
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## **Summary of Testimony of Gerald Norlander**

The impact of Enron and its bankruptcy on the energy markets requires further scrutiny and assessment. Congress should reconsider key assumptions about markets and consumer benefit upon which the stalled movement for electricity industry restructuring had been premised.

Consumers were given the impression that the electricity industry restructuring model urged by Enron would offer at least as good or better service at a better price than traditional cost based regulation. Now consumers are being told prices must be destabilized and raised before future competition will lower them. The Enron lesson is that restructuring is not a value proposition for the ordinary consumer. Congress must do more to assure universal service, consumer protection, and affordability.

Wholesale energy prices may not have been significantly affected by the Enron bankruptcy. The claim that Western wholesale electricity prices dropped due to the absence of Enron should be further investigated. If Enron was a major force in stabilizing energy prices in the forward markets, it remains unclear whether future electricity and natural gas prices will become more volatile, and whether the wholesale markets will now be characterized by more frequent periods of boom and bust. Some Enron retail contracts are cancelled, adversely affecting consumers.

The Enron bankruptcy has been followed by major financial setbacks for other electricity market participants. This could lead to a slowdown in building planned generating facilities; further mergers and consolidation; and ultimately a reduction in the number of electricity suppliers. The combination of fewer plants built and fewer suppliers may raise additional market power issues.

The larger question for Congress is whether there can be confidence that federally approved wholesale markets and market-based rate mechanisms are free from gaming or manipulation. Enron is currently under investigation to determine whether it and others manipulated markets to drive California energy prices up to unprecedented levels in 2000 and 2001. Market-based rates established in federally approved spot markets, and off-market contracts colored by those markets, should yield results for consumers as good or better than traditional cost based regulation, to satisfy the public's demand for reasonable rates. Too heavy reliance was prematurely placed on federally approved spot markets in California and New York which were flawed in design, vulnerable to market power, and without effective remedies, with resulting great harm to consumers.

The goal of restructuring was to achieve efficient prices and results better than traditional regulation. Mathematical analysis has shown, and economics laboratory simulations of market behavior confirm, that many more participants are needed before spot auction markets, and bilateral markets informed by the spot prices, can be competitive. Accordingly, generators should be required to file their cost data to permit detection and analysis of strategic bidding behavior, and to provide the necessary information upon which prompt and effective market power remedies can be based.

### **Testimony of Gerald A. Norlander**

I am Gerald Norlander, Executive Director of the Public Utility Law Project. Thank you for inviting me to testify on the effect of Enron on energy markets, and for the opportunity to suggest remedial measures. PULP is a nonprofit organization, created by community organizations during the 1970's energy crisis, to represent the interests of low income utility consumers. We focus our efforts on matters affecting universal service, consumer protection, and affordability. Our website is: [www.pulp.tc](http://www.pulp.tc)

I am also Chairman of the Electricity Committee of the National Association of State Utility Consumer Advocates (NASUCA). NASUCA is an association of state utility consumer advocates from 43 states, and has several members from nonprofit organizations such as PULP.

We did not have time before today's hearings to develop specific NASUCA positions on the impact of Enron on energy markets, and so my remarks today are on behalf of PULP. In the course of my testimony, however, I will mention the NASUCA resolution on the problem of market power in the energy markets.

The hasty rush to restructure the electric industry is now characterized by higher rates for consumers in California and New York City, which experienced 43% bill increases in the Summer of 2000. Last year, I pointed out in an article that the electricity restructuring "Juggernaut" had already ground to a halt, and observed that the legendary Juggernauts of India crushed overzealous worshipers. I argued that much more attention must be given to consumer concerns such as rate stability and predictability, universal service, consumer protection, and affordability. The halt or slowdown of restructuring in the states had already occurred well before the collapse of Enron, but restructuring adherents had still urged staying the course. Consumers were promised that even if rate decreases were not in sight, after a period of higher rates, competition would lower them at some unspecified future date. Customers were exhorted to "let go" and trust the market and that the trust would grow with experience. That panglossian optimism evaporated with the fall of Enron. Paraphrasing a great Texan, Willie Nelson, the New York Times titled a recent article reviewing New York's restructuring experience "Turn Out the Lights, The Party's Over."

### **The Pre-Bankruptcy Impact of Enron on Energy Markets**

Enron was a major driving force in an effort throughout the country to restructure regulation of wholesale and retail electricity prices, replacing cost-based regulation with market mechanisms widely assumed to yield better results. The key element of the model was the creation of volatile wholesale spot markets under federal, not state, control.

Once the spot markets were established, Enron offered respite from the price volatility they introduced, through long term energy contracts and financial derivatives at Enron Online. Enron claimed to be able to hedge energy prices either through contracts or energy market derivatives that would protect wholesale buyers from future market price volatility. Similarly, in the retail markets, it was assumed that Enron and other marketers would smooth out the volatility that had been introduced by the old utilities, which in the past had striven to make rate changes glacially.

Enron avidly supported wholesale spot markets with high volatility and without upper limits on price sellers could demand, and participated in the spot and bilateral wholesale markets in New York and other states as a buyer and a seller. In addition, in some states, Enron affiliates sold energy and energy services to retail consumers.

Enron generally called for states to introduce retail competition, and to begin passing through of wholesale spot market prices to retail consumers who had not yet left the incumbent utility provider. Under the model, the utility would sell its power plants and cease efforts to hedge forward prices for its remaining retail customers. Competitive interstate energy companies, including Enron affiliates, would then offer retail consumers respite from the volatile pricing if they preferred predictable, stable rates.

Electricity spot markets, so critical to Enron's strategies, were created, with varying degrees of attention to:

- Reliability - the challenge of mirroring additional market transactions in an already complex electricity grid that was not physically designed for that purpose,
- Cost - is it worth enormous expense to modify the electric grid in transmission constrained areas - ostensibly so more sellers can compete in presently constrained areas - when at the end of the day, as wider geographic scope is created, market power may be maintained by reducing the number of sellers, through merger and consolidation?
- Market design - did market rules ensure efficient pricing and adequate information?
- Market power - could the new markets be "gamed" by bidders?
- Remedies - are regulatory tools sufficient to protect the public from market failure, exploitation, and results inferior to traditional regulation?
- All of the federally approved spot markets created to date have been found to be vulnerable to the exercise of market power.

#### The Post-Bankruptcy Impact of the Enron Bankruptcy

It is probably too soon to assess the full impact of the Enron bankruptcy on energy markets. The information needed to determine the full impact of the demise of Enron is not publicly available. Some reports suggest that wholesale energy prices, to date, may not have been significantly affected by the Enron bankruptcy. The market role of the special purpose entities and partnerships created by Enron is unclear. The first "JEDI" partnership with the California Public Employees Retirement System apparently was a party to some energy transactions. It is possible that partnerships or special purpose entities were the ultimate counterparties of some of Enron's wholesale energy market-making activities. If so, the question arises whether there are some still-outstanding forward contracts held by Enron or the partnerships, and whether those will be honored. There is no answer without access to the books of the partnerships, which apparently are not in bankruptcy. Some parties with contracts for energy to be provided by Enron may have "unwound" their positions, and may fortuitously have found substitute supplies at low cost from other sources in the energy markets, which are currently characterized by surplus and low prices. Some Enron contracts may still be fulfilled in vestigial operations now taken over by a successor. It has been claimed that Western wholesale electricity prices actually dropped due to the demise of Enron. Further investigation is needed.

Enron retail energy services contracts are reported to be cancelled, adversely affecting some consumers who had long term contracts that will not be fulfilled:

- The guaranteed prices and energy-bill predictability that Enron offered have evaporated along with the energy-trading giant's profits. Amid the rubble of Enron's bankruptcy, some of Chicago's most prominent corporate and civic names are now moving to find a replacement for Enron, who had sold them contracts worth hundreds of

millions of dollars stretching over several years or more."

- The Enron bankruptcy has been followed by major financial setbacks for other market participants. This could lead to more mergers, a consequent reduction in the number of electricity suppliers, and a slowdown in the building of new generating facilities. If there is an insufficient number of sellers to make markets competitive, this could have serious future policy impacts.

If, as Enron asserted, it was stabilizing energy prices in the forward markets, it remains unclear whether future electricity and natural gas prices will become more volatile, and whether the wholesale markets will be characterized by more frequent periods of boom and bust. Such volatility could cause new problems down the road for both business and residential consumers.

The majority of states that have not restructured their electric industries as urged by Enron are now even more reluctant to accept on faith that if they allow their utilities to sell off their generating plants, "the market" participants like Enron and generators like Mirant and Reliant will actually provide the future supply and price stability needed. Similarly, consumers may have even less appetite to risk the major rate instability and price increases experienced in California and New York, for relatively little in the way of promised savings.

The larger question for Congress is whether the public can have confidence that federally approved wholesale markets and market-based rates are free from strategic bidding, gaming or manipulation. Market-based rates established in or influenced by federally approved spot markets must yield results as good or better than traditional cost based regulation to satisfy the existing statutory command to establish reasonable rates.

At Enron's urgings, heavy reliance was prematurely placed on some markets flawed in design, vulnerable to market power, and without effective remedies. Enron is currently under state and federal investigation to determine whether it and others manipulated the markets to drive California ISO energy prices up to unprecedented levels in 2000 and 2001. Congress should lend its powers to see that this issue is cleared up.

The theoretical goal of the spot markets is that competing generators will bid to sell their output at their marginal running costs, recovering their investment and earning a fair return to the extent their plant is more efficient than the least efficient unit called to run at any particular time. A major flaw detected in the spot market models, however, is that strategic bidding ("gaming") can readily occur, even at non-peak times by sellers who do not have a large market share. Despite this, markets are being approved with too few sellers using obsolete or inapplicable screens to test for anti-trust compliance.

Mathematical analysis and game theory has shown that many participants are needed before spot auction markets, and the bilateral markets informed by spot prices, can possibly be competitive. Characteristics of electricity and the repetitive nature of the auctions permit participants to establish a Nash equilibrium mutually benefitting the players, (without overt cartel price-fixing or anti-trust conspiracy), through strategic bidding. This is not limited to the most extreme bidding behaviors noticed at times of peak system demand. Recent economics laboratory simulations of electricity spot market auction bidding behavior found that rates could be driven 50% above cost, with or without price-caps, confirming the need for many more sellers, and the inadequacy of federal agency policies that still rely on traditional notions about what constitutes a sufficient number of participants and maximum market share.

The Committee has requested suggestions regarding information disclosure and for making markets more transparent. States that have not yet restructured, and customers throughout the nation, can have no confidence that proposed new federal markets would be better than

traditional regulation if there is no information upon which to measure the difference, and no fallback price readily available when the markets fail to yield reasonable rates. NASUCA in its Resolution 2001-01 urged "cost-based price regulation and/or other appropriate means of mitigation in any wholesale market where rates are not demonstrably and reliably just and reasonable." Similarly, PULP has urged that generators file their running costs as a routine matter. This information disclosure will facilitate prompt analysis of bidding behavior in the markets and provide the necessary information upon which remedies can be based.

### **Conclusion**

Five years ago consumers were given the impression that the electric industry restructuring urged by Enron would offer at least as good or better service at a better price than traditional cost based regulation.

A year ago, after California, they were told to be patient, they "may have to pay higher prices, before they pay less," but to "let go," it was only "a matter of trusting the free market and trusting free-market entrepreneurs. Trust grows with experience."

After Enron, the lesson is that restructuring, while it may be beneficial to some industry stakeholders, does not appear to be a value proposition for the ordinary consumer.

Before going any further to restructure the electric industry, Congress needs to do more to assure universal service, consumer protection, and affordability of energy for ordinary energy consumers.

Thank you for the opportunity to present this testimony. I look forward to any questions from the Committee.