

Senate Democratic Policy Committee Hearing

“Lessons from Enron: An Oversight Hearing on Gas Prices and Energy Trading”

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I am honored to be invited to appear before you and to express a few perspectives on energy market issues of the recent past, present and near future. I applaud this Committee for asking the questions that bring us here today. United States energy markets are critical to the welfare of our nation and its people and those markets are showing some very troubling characteristics.

I am the Director of a state agency that was created in 1996 and charged with monitoring the performance of wholesale electricity and gas markets serving Californians and trying to protect their interests in the relevant federal regulatory forums, primarily before the FERC. Trying to understand the forces at work in those markets has been an exercise of increasing complexity. I would say that in 1998, with considerable investigative effort and very little collaborative assistance from federal regulators, we could “see” perhaps 70% of the important trading in and around these markets and believed we had an 80-90% understanding of what forces were setting prices. Today, I would say that we can “see” something like 25% of the important trading and I am not confident that we can really determine what and who are setting prices much of the time.

Some Lessons from the 2000-2001 Western Market Failure

In a one year period starting in mid-2000, California and other western states saw a spectacular wholesale electricity market failure, in the midst of which came serious interrelated abuses in the wholesale natural gas market. Before any refunds, these events cost Californians about 30 billion dollars in increased energy prices. Consumers in neighboring states experienced similarly dramatic costs for which I do not have a summation. One factor that has often been cited as a cause of the electricity market failure is a “flawed market design”, especially the high reliance on the spot market for physical energy. On the many occasions when people have argued that the problem was caused by bad market design (usually implying that it was thus the market’s fault rather than the sellers’ fault) the same people rarely remind the world what they had argued for when the market was being crafted.

When the California market design was being drawn up, wholesale energy sellers, and Enron most loudly among them, argued strongly and successfully for a structure in which no one would see the totality of the market. Information on forward trading would not be available to those who monitored the day-ahead market. Neither forward nor day-ahead trading information would be available to those who monitored the real-time market. Information on derivative and hedge trades would not be available to anyone trying to monitor the energy markets. Some of the same traders who blamed over-reliance on spot energy scheduling in 2001 previously argued for a

market in which all electric energy would be physically procured in the spot market and forward transactions would be in the form of financial hedge instruments only.

As the California crisis was unfolding, we struggled to get data from many sources to put together a full picture of what entities were doing. At times, behavior that looked like it was intended to move prices seemed to make no sense because it wouldn't make money in the energy market for the company involved (based on the sum of their buying and selling). That behavior suddenly looked like rational manipulation when we got an insight into that entity's positions in futures or derivatives that would change value based on energy price movements.

I am reminded of a statement that was made to me by a senior officer of Enron not long before the Western energy crisis – at a time when Enron was still at its most brash. He told me that Enron was then a counterparty to over half-a-trillion dollars of energy financial hedges and that we could never hope to understand forward energy markets without knowing what those positions were. Of course, he had no interest in our being able to understand those hedges but only in discouraging us from trying to make judgments about energy futures pricing. The number he stated may have been entirely false, I do not really know. But I do find continuing validity in the claim he made that one can't really figure out what's going on in physical energy trading without a general knowledge of what's out there in derivatives.

There is one other point I would like to make in recalling the California crisis. Enron was bold, outspoken and devious. Enron was not alone. It is easy to blame the “dead guy”. I take no solace in the thought that Enron is gone and so we are now safe. Enron became famous in part for some colorfully-named gaming strategies. Enron was not the first to be observed using most of these strategies. Enron was a big player in some types of abuses and a relatively small player in some other abuses. Enron was dominant in some functions, such as Enron Online. In its demise, something will fill the vacuum and someone will be in a position where they could abuse markets if the structures and rules allow it to happen.

Some thoughts about where we are now.

At the present time, neither bulk electricity markets nor wholesale natural gas markets are very transparent. Some trades are reported in publicly available data, many are not. There is no single regulator that appears to have access to the range of information that would be needed to fully understand either of these markets or the interrelationship between them. Prices in each of these markets remain volatile. Prices in each of these markets have seen significant and extended deviations from following traditional production cost curves. Major movement in these markets appears to be driven by speculation as often as by any direct change in traditional “fundamentals” of production cost, supply and demand.

As the members of this Committee know well, there were major swings in wholesale gas markets following last year's Gulf Coast hurricanes. My agency attempted to evaluate some of this trading after our State Legislature raised questions concerning gas market competitiveness. The exercise was an interesting and frustrating one. We could not see nearly as much information as we wanted, particularly with respect to futures trading. We were unable to tell whether the trading information we could see was representative of the large amount that we could not. From what we could evaluate, it was evident that prices and trading positions were being significantly influenced by speculative trades, probably more so than by trading between

traditional producers and consumers. Some movements appeared to correlate more closely to movements in other commodities than to changes in gas fundamentals. This may have been a consequence of trading by multi-commodity hedging interests.

I am careful about when I suggest that markets are being manipulated or running unfairly to consumer interests. I will not say those things here. I will offer the opinion that electricity and gas and other energy markets are acting in ways different than they have in the past. They are producing volatile and often very high prices, they are not correlating well to traditional fundamentals. The markets for the physical commodities seem to be substantially influenced by trading in related derivatives. The markets are not very transparent to consumer protection institutions such as mine or to regulators themselves it seems. I do not think any federal regulator has clear enough access to information to ensure that it has a complete picture. I think this is a very important subject for the Congress to consider. Thank you.