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Re-regulation of Energy Industry Solution for Protecting Consumers, Shareholders from Another Enron-Style Fraud

America has painfully learned what happens when deregulation is applied to electricity and other energy commodities with inelastic supply and demand, high capital costs and prohibitively expensive transaction costs. The combination of deregulated state wholesale electricity markets, federal deregulation of commodity exchanges and the gutting of federal regulatory oversight has removed accountability and transparency from the energy sector, allowing corporations like Enron to manipulate price and supply of electricity and natural gas through the exercise of significant market power. California's recent energy crisis and Enron's bankruptcy would have been impossible under a regulated system.

Deregulation not only allowed Enron to become one of the most powerful corporations in the world but also directly led to the company's downfall. Deregulation of both energy markets and commodity trading allowed Enron to escape price regulations — a key factor in the company's meteoric, 1,750 percent increase in revenues over the past decade. Enron cannot attribute its success, therefore, to such traditional models as incorporating innovations to improve the delivery of product at competitive prices. Rather, Enron's business model was built entirely on the premise that it could make more money speculating on electricity contracts than it could by actually producing electricity at a power plant. Central to Enron's strategy of turning electricity into a speculative commodity was removing government oversight of its trading practices and exploiting market deficiencies to allow it to manipulate prices and supply. So when federal regulators implemented price controls for the California market in June 2001, Enron's business model was soon invalid and the company bankrupt.

But lawmakers should have seen it coming. Public Citizen has always argued that characteristics unique to the electricity industry inhibit true competition — leaving regulation of energy firms necessary to protect consumers. These attributes (inelastic supply and demand, high capital costs and prohibitively expensive transaction costs), well-known to engineers and economists for decades, were glossed over by Enron as they paid off politicians at the federal and state level. As a result of these characteristics, true competition has not materialized in wholesale electricity markets.

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There are three basic steps Congress and the President can take to restore accountability to our nation's energy markets and protect consumers from corporate manipulation of supplies and prices:

1. **Strengthen the regulatory and enforcement power of the Securities and Exchange Commission (SEC) by extending jurisdiction over power marketers.** The SEC enforces the **Public Utility Holding Company Act of 1935 (PUHCA)**, which protects consumers by regulating multi-state utility companies. The law was originally enacted in response to the corporate abuses by utility holding companies. These abuses contributed greatly to the stock market crash of 1929, leaving ratepayers with bankrupt utilities and higher rates. But PUHCA has lost much of its teeth over the decades, mostly in response to deregulation. For example, deregulation of electricity markets allowed a new type of corporation, power marketers, to buy and sell electricity. Rather than owning power plants like traditional utilities, deregulation allowed power marketers to trade electricity in the wholesale market through commodity exchanges and contracts. Enron pushed a gaping hole in SEC jurisdiction when the company won a ruling from the commission on Jan. 5, 1994, that exempted power marketers like Enron from PUHCA regulation. As a result, power marketers like Enron were free to command significant market share in deregulated markets because PUHCA's restrictions did not apply to power marketers. **Therefore, Congress must extend regulations by ordering the SEC to classify power marketers as "facilities" under PUHCA.**
2. **Congress must re-regulate the trading of energy futures.** Practically in the dead of night, Senator Phil Gramm (R-Texas) helped push through S. 3283, the "Commodity Futures Modernization Act of 2000" on December 15, 2000. Sections 103 and 106 of this legislation deregulated the trading of energy futures, which allowed companies like Enron to bypass regulated trading forums like the New York Mercantile Exchange and operate an unregulated power auction that trades electricity, natural gas and other energy commodities in huge volumes without reporting details of its activities to government regulators. As a result, Enron's unregulated energy trading subsidiary enhanced the company's ability to manipulate supply to drive the price of electricity higher. **Therefore, Congress must order the Commodity Futures Trading Commission to regulate energy derivative contracts and close unregulated power auctions by repealing sections 103 and 106 of the "Commodity Futures Modernization Act of 2000."**
3. **Congress must amend the Federal Power Act, forcing the Federal Energy Regulatory Commission (FERC) to revoke market-based rates and order cost-based pricing in all wholesale electricity markets.** In light of the failure of deregulation to deliver lower prices due to the lack of wholesale competition, the market-based rates FERC allows unregulated power companies and marketers to charge monopoly-priced rates that price-gouge utilities and consumers. Therefore, Congress must amend the rules FERC follows through the Federal Power Act and annul the market-based rate certification for all wholesale power companies, re-regulating the market by imposing cost-of-service based rates. So-called cost-based rates allow power companies to pass through 100 percent of their costs plus a regulated rate of return (FERC would certify that the costs were legitimate by securing access to the company's books).