

# Energy Companies and Market Reform

# Contents

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<b>Preface</b> . . . . .	.xi
<b>1 A Short History of Deregulation</b> . . . . .	1
Recent Regulatory History . . . . .	2
Enron . . . . .	8
Deregulation . . . . .	9
Notes . . . . .	13
<b>2 Corporate Self-Regulation: Form Versus Substance</b> . . . . .	19
The Monitoring Board . . . . .	20
Northeast Utilities: A Failed Competitive Strategy . . . . .	23
Cost containment . . . . .	23
Cost containment versus safety regulation . . . . .	24
Short-term earnings increase . . . . .	25
Shutdown and financial crisis . . . . .	26
Enron: Abdication of the Board . . . . .	28
Background . . . . .	28
Financial engineering . . . . .	29
The Enron board . . . . .	30
Subcommittee findings . . . . .	31
High-risk accounting . . . . .	31
Conflicts of interest . . . . .	38
Inadequate public disclosure . . . . .	43
Royal Dutch Shell Group: Management by Committee . . . . .	45
The Davis, Polk & Wardwell Report . . . . .	46
The Knight Vinke Institutional Partners Memorandum . . . . .	50
The Financial Service Authority Final Notice . . . . .	51
SEC enforcement . . . . .	53
Epilogue . . . . .	53
Observations . . . . .	54
Notes . . . . .	55

- 3 Corporate Self-Regulation: The Accountant as Gatekeeper . . . . . 67**
  - Introduction . . . . . 67
    - Auditor acquiescence . . . . . 70
    - Generally accepted accounting principles and standards . . . . . 71
    - The audit process . . . . . 72
  - CMS Energy Corp.: Revenue Inflation through Round-Trip Trading. 72
    - Background . . . . . 72
    - Auditor’s guidance. . . . . 75
    - Restatement . . . . . 76
    - Aftermath . . . . . 77
    - Accounting rules. . . . . 80
  - Enron: Mark-to-Market Accounting Writ Large . . . . . 81
    - History . . . . . 81
    - Accounting guidance . . . . . 83
    - Enron seizes the day. . . . . 85
    - Accounting rules and accounting firms . . . . . 86
  - Observations . . . . . 87
  - Notes . . . . . 88
  
- 4 FERC’s Shortfall as Market Regulator. . . . . 95**
  - Background . . . . . 95
  - FERC’s Legal Mandate . . . . . 98
  - The Filed-Rate Doctrine . . . . . 100
  - Hub-and-Spoke System . . . . . 103
  - Electric Industry Mergers . . . . . 104
  - Observations . . . . . 110
  - Notes . . . . . 111
  
- 5 The Deregulated Gas Supply Market . . . . . 117**
  - Emerging Problems. . . . . 119
  - El Paso: Affiliate Abuse and Market Manipulation. . . . . 121
    - Manipulation of the California energy market. . . . . 125
    - Settlement and aftermath. . . . . 128
  - EnronOnline: Trading Platform as Manipulation Tool . . . . . 129
    - FERC staff’s initial inquiry. . . . . 131
    - Final report . . . . . 133
  - Manipulation of Published Natural Gas Price Indexes . . . . . 136
    - Dynegy. . . . . 137

AEP . . . . .	138
Williams . . . . .	138
El Paso . . . . .	140
Other companies . . . . .	140
Epilogue . . . . .	141
Observations . . . . .	141
Notes . . . . .	142
<b>6 Implosion of the California Electricity Market—Part I . . . . .</b>	<b>147</b>
Background . . . . .	148
The Calm before the Storm. . . . .	151
Crisis Onset . . . . .	155
FERC Proceedings . . . . .	159
Notes . . . . .	164
<b>7 Implosion of the California Electricity Market—Part II. . . . .</b>	<b>169</b>
Enron’s Trading Schemes . . . . .	170
Load shift. . . . .	170
Ricochet, or megawatt laundering . . . . .	171
Fat boy, or Inc-ing load . . . . .	172
Nonfirm exports, Death Star, and wheel out . . . . .	173
Get Shorty . . . . .	175
Selling nonfirm power as firm power . . . . .	176
The Investigation Widens . . . . .	176
Withholding . . . . .	177
Submitting false load schedules . . . . .	178
Megawatt laundering . . . . .	178
Congestion games . . . . .	179
Ancillary services scams . . . . .	179
Uninstructed generation games . . . . .	179
Sharing nonpublic outage information—and collusion . . . . .	180
Root cause . . . . .	181
Refunds for Overcharges . . . . .	182
California goes to court. . . . .	184
Remedial action and settlements at FERC . . . . .	185
FERC Revisits Market-Based Rates . . . . .	187
Observations . . . . .	189
Notes . . . . .	190

- 8 Market Design** . . . . .195
  - Background . . . . .195
  - Order 2000. . . . .201
  - The Ramp-Up to Standard Market Design . . . . .203
  - Standard Market Design . . . . .204
  - Industry Reaction and FERC Response. . . . .206
  - Observations . . . . .209
  - Notes . . . . .210
  
- 9 Changing the Ground Rules**. . . . .213
  - Energy Policy Act. . . . .213
  - PUHCA Repeal . . . . .215
  - Merger Review Authority . . . . .218
  - Electricity Market Transparency, Manipulation, and Enforcement .222
    - Market transparency . . . . .222
    - Manipulation. . . . .223
    - Enforcement . . . . .225
  - Economic Dispatch, Native Load, and Locational Installed Capacity .226
  - Transmission Siting and Incentives . . . . .229
    - Transmission siting . . . . .229
    - Incentive-based transmission rates . . . . .231
    - Long-term transmission rights . . . . .232
  - Reliability . . . . .232
  - PURPA . . . . .233
  - Other Provisions. . . . .234
  - Notes . . . . .235
  
- 10 Conclusion** . . . . .243
  - The Competitive Power Market Brief . . . . .244
  - Market Design. . . . .245
  - Rethinking Electricity Restructuring . . . . .247
  - Real-World Response . . . . .249
  - A Holistic View . . . . .250
  - Notes . . . . .252
  
- Index** . . . . .255

# Preface

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This book addresses deregulation of U.S. energy markets. It illustrates the contrast between government policy choices favoring competition and the often problematic results of those choices. A central thesis is that, in network industries such as electricity and natural gas, reliance on markets must be carefully introduced and that real-world economic effects trump *a priori* theory. As the history recounted here shows, removal of price and entry constraints, without a clear understanding of the markets being deregulated, is an invitation to manipulation, rent seeking, and, ultimately, unregulated monopoly.

Energy markets are complex. At the wholesale level, bilateral contracts and auctions serve functions once performed internally by vertically integrated utilities under cost-based regulation. To avoid unintended consequences, as in California, it is essential to get markets right. Doing so requires workable market design, an iterative, bottom-up approach, and adequate underlying capacity. In the framing of policy, regulators should also assume that a variant of Murphy's law holds: If the system can be exploited, it will be exploited.

To put flesh on the bones of policy abstraction, this book includes recent case histories detailing massive failures of regulation and corporate governance. As a guide to the future, it also takes account of post-deregulation markets that work, such as PJMs. The book concludes, as two leading academics foresaw over 20 years ago, that energy industry deregulation "must involve a mixture of regulation and competition" (Joskow and Schmalensee. *Markets for Power: An Analysis of Electric Utility Deregulation*. MIT Press [1983], p. 212).

# 1 A Short History of Deregulation

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Since Enron's demise and the implosion of California's restructured electricity market in 2001, competitive energy markets have exposed huge risks, with consequences far different from those predicted. Many energy companies, investors, and consumers in the post-Enron era have suffered losses, measured in the billions, from market rigging, price spikes, rolling blackouts, massive corporate fraud, and utility bankruptcies. The stubborn persistence of market power in energy industries and widespread abuses flowing from its exercise have called forth broad remedial measures, whose efficacy nonetheless remains open to question. Citing case histories, this book shows how flawed market design, derelict corporate governance, aggressive accounting, and multiple regulatory failures have led to this result. It also evaluates the ensuing reactive reforms, identifies countervailing market-based success stories, and assesses the prospects for continued deregulation of the nation's energy markets.

In a free-enterprise economy, received wisdom dictates that competitive markets respond to customer demand by rewarding investment and innovation better than regulation. In recent decades, market-based competition has increasingly displaced command-and-control government direction as the preferred way to promote consumer welfare and reward entrepreneurial risk taking. As markets commoditized energy products, electricity and gas became

within the law to achieve its purposes.”<sup>6</sup> In so doing, they may approve, modify, or disapprove financial objectives, plans, actions, and applicable accounting principles.<sup>7</sup> Acting through specialized committees, boards also monitor corporate performance.

Board *decisions*—for example, authorization of mergers, changes in capital structure, and compensation of the chief executive officer—are subject to the business judgment rule, which assumes them to be, if not self-interested, the product of a “process that was either deliberately considered in good faith or was otherwise rational.”<sup>8</sup> Under this standard, good-faith board decisions are not open to after-the-fact objective review by a court or jury if the formalities of process have been satisfied.

Unconsidered *failure* to act, including failure to elicit information essential for effective monitoring, may also result in losses. Given boards’ underlying responsibility to see that companies function within the law, such failure is judged by a more rigorous substantive standard. Boards have an affirmative duty to inquire and must exercise a good-faith judgment that the company’s information and reporting system is adequate to ensure “that appropriate information will come to [their] attention in a timely manner.”<sup>9</sup> Failure in this respect, whether because of negligence or co-optation by a dominant chief executive, can be more damaging than a board’s questionable decisions. Board inaction may also implicitly condone ordinary course but illegal business decisions made by officers and employees “deeper in the interior of the organization.”<sup>10</sup>

The monitoring model of corporate governance contemplates an objective, process-based system that, on balance, provides little real assurance of effective oversight. If boards go through the motions of making conscientious informed judgments, neither the degree of attention actually paid nor the quality of decision reached will ordinarily be subject to substantive review. Under the business judgment rule, the primary requirement is evidence that customary procedures were followed. This has been called, at best, a “circumstantial guarantee of good governance.”<sup>11</sup> Except for



conduct. It then approved LJM2 without substantive consideration. Enron's transactions with LJM2 were nominally subject to approval by senior officers and annual review by the Audit and Compliance Committee, conflict controls later described as "poorly designed and implemented."<sup>90</sup> Over two years, Enron entered into many transactions with LJM1 and LJM2, including asset sales and complex financial deals.

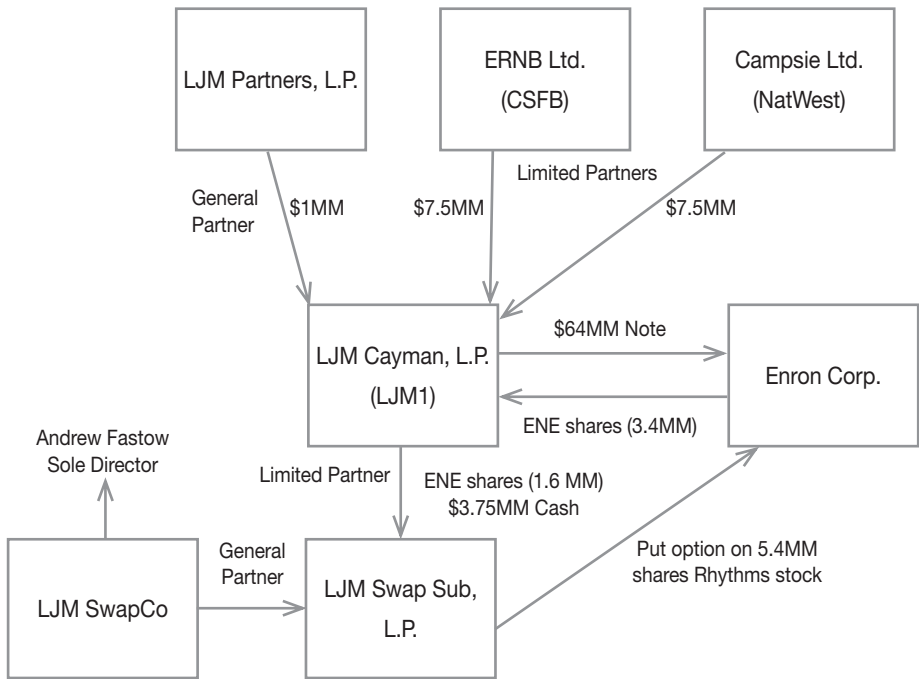


Figure 2-5. Diagram of Rhythms Transaction<sup>85</sup>

Source: Subcommittee Report, p. 81

LJM2 became an investor in and facilitator of Enron's transactions with four related SPEs called the Raptors, which served as counterparties for accounting hedges but had little or no economic substance.<sup>91</sup> With the Rhythms transaction as a blueprint, the Raptors served a similar purpose: enabling Enron to use the embedded value of its own equity to offset—and thus conceal from the market—almost \$1 billion in losses in the value of portfolio investments.<sup>92</sup> In the fourth quarter of 1999 alone, LJM2 produced \$2 billion of

Table 3–1. GAO Financial Statement Restatement Database<sup>4</sup>

<b>Category</b>	<b>Description</b>
<b>Acquisitions and mergers</b>	Restatements of acquisitions or mergers that were improperly accounted for or not accounted for at all. These include instances in which the wrong accounting method was used or losses or gains related to the acquisition were understated or overstated. This category does not include in-process research and development or restatements for mergers, acquisitions, and discontinued operations when appropriate accounting methods were employed.
<b>Cost or expense</b>	Restatements due to improper cost accounting. This category includes instances of improperly recognizing costs or expenses, improperly capitalizing expenditures, or any other number of mistakes or improprieties that led to misreported costs. It also includes restatements due to improper treatment of tax liabilities, income tax reserves, and other tax-related items.
<b>In-process research and development</b>	Restatements resulting from instances in which improper accounting methodologies were used to value in-process research and development at the time of an acquisition.
<b>Other</b>	Any restatement not covered by the listed categories. Cases included in this category include restatements due to inadequate loan-loss reserves, delinquent loans, loan write-offs, improper accounting for bad loans and restatements due to fraud, and accounting irregularities that were left unspecified.
<b>Reclassification</b>	Restatements due to improperly classified accounting items. These include restatements due to improprieties such as debt payments being classified as investments.
<b>Related-party transactions</b>	Restatements due to inadequate disclosure or improper accounting of revenues, expenses, debts, or assets involving transactions or relationships with related parties. This category includes those involving special-purpose entities.
<b>Restructuring, assets, or inventory</b>	Restatements due to asset impairment, errors relating to accounting treatment of investments, timing of asset write-downs, goodwill, restructuring activity and inventory valuation, and inventory quantity issues.
<b>Revenue recognition</b>	Restatements due to improper revenue accounting. This category includes instances in which revenue was improperly recognized, questionable revenues were recognized, or any other number of mistakes or improprieties were made that led to misreported revenue.
<b>Securities related</b>	Restatements due to improper accounting for derivatives, warrants, stock options, and other convertible securities.

**Note:** Excluded are announcements involving stock splits and changes in accounting principles, as well as other financial statement restatements that were not made to correct mistakes in the application of accounting standards.

Source: GAO-03-395R, January 17, 2003, p. 6

*Accounting Concepts No. 2*, FASB (1980), app. B, ¶ 160: “The quality of reliability, and, in particular of representational faithfulness, leaves no room for accounting representations that subordinate substance to form.”

<sup>22</sup> Schillit. *Financial Shenanigans* (1993), p. x.

<sup>23</sup> See *Evidential Matter, Statement on Auditing Standards No. 31*, AU § 326.01. American Institute of Certified Public Accountants (1980), SAS 31.

<sup>24</sup> See *Auditing Accounting Estimates, Statement of Auditing Standards No. 57*, AU § 342.10. American Institute of Certified Public Accountants (1989).

<sup>25</sup> Baker and Hayes. “Reflecting Form over Substance: The Case of Enron Corp.” *Critical Perspectives on Accounting*, 15: 767, 771–82 (2004).

<sup>26</sup> *St. Denis*, p. 22.

<sup>27</sup> See *Statement on Audit Standards No. 82*, AU § 316.17. American Institute of Certified Public Accountants (1997); 15 *U.S. Code* § 78b [§ 10A(b)].

<sup>28</sup> *In the Matter of CMS Energy Corp., Securities Act Release No. 8403* (March 17, 2004) (hereafter *Securities Act Release No. 8403*), p 2.

<sup>29</sup> *Ibid.*, n. 5.

<sup>30</sup> *Ibid.*, p. 2.

<sup>31</sup> Public Citizen. *The Public Utility Holding Company Act and the Protection of Energy Consumers: An Examination of the Corporate Records of the Top Companies Pushing for PUHCA Repeal* (September 2002), p. 11.

<sup>32</sup> CMS annual report (2001), p. 1.

<sup>33</sup> *Securities Act Release No. 8403*, p. 5.

<sup>34</sup> *Ibid.*, p. 5.

<sup>35</sup> *Ibid.*

<sup>36</sup> *Ibid.*

<sup>37</sup> *Ibid.*, pp. 5–6.

<sup>38</sup> *Ibid.*, p. 6.

suppliers, and users on equal terms.<sup>2</sup> Industrial and commercial users, among others, could then buy gas directly from producers and marketers for shipment on interstate pipelines. Pipeline companies eventually unbundled their transportation, storage, and sales services, and shippers created a secondary capacity market by releasing to other shippers unneeded pipeline transportation capacity, on either a temporary or a permanent basis.<sup>3</sup>

As a result of these initiatives, producers today sell natural gas at wholesale to consumers, market intermediaries, and resellers free of federal government price control pursuant to contract or on the spot market at a specific location for the price prevailing at that time and place. Wholesale prices are set by supply and demand in the marketplace, subject only to FERC review to ensure that the prices are just and reasonable. Buyers and sellers also arrange to transport gas to market, with the buyer typically paying the pipeline for transportation and any required ancillary services en route, such as storage.<sup>4</sup>

A pipeline may deliver gas directly to consumers located along its right-of-way or at the city gate to a local distribution company, regulated as an intrastate utility, which redelivers the gas to residential, commercial, and industrial users. In the case of residential customers, the local distribution company purchases gas for resale. For commercial and industrial customers, however, it usually delivers gas they have purchased directly from remote producers and acts as a transporter only.<sup>5</sup>

Deregulation of the wholesale gas industry has led to proliferation of market centers or distribution hubs, associated geographically with central pipeline interconnections, where individuals and companies come together to buy and sell natural gas on the spot market. In 1990, as a further market adaptation, futures contracts for natural gas delivered at the Henry Hub, a distribution center in Louisiana, were first traded on NYMEX. Since then, NYMEX has also created contracts for trading natural gas at other hubs, with prices determined at the Henry Hub.<sup>6</sup>