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Electricity Regulation: The Mess We're In, How We Got There, And the Road Out

FACS Seminar
Washington, DC
January 27, 2003

Marsh & McLennan Companies

How Markets Work[SM]

We're In A Mess

1. California
2. Collapse of Power Marketing: Enron, Dynegy, Aquila, et. al.
3. Collapse of Independent Generation Companies: AES, Mirant, Calpine, Williams
4. Different regulatory/deregulatory schemes in every state
5. Disputes over the feasibility of competitive:

   a) Generation

   b) Transmission Systems

How We Got There

Recognition that regulation didn't work particularly well

- **Nuclear disallowances**
- **Large price differences between neighboring utilities**
- **Politics, politics, politics**

Siren Call of Competition: Trucking, Airlines, Pipelines, Telecommunications

Changes in the structure of optimal provision: the Combined Cycle Combustion Turbine

What Was Wrong with Our Deregulatory Vision?

- Inordinate distrust of utilities
- Inappropriate focus on retail competition
- Bad analogies
- Discrepant visions from regulatory entities with overlapping authority
- Half-measures
- Unwillingness to accept the rough-and-tumble of competition
- Unwillingness to let prices go up
- Inordinate focus on market power

A Way Out

- **Allow the FERC Standardized Market Design paradigm to work. This does not mean not to criticize parts of the plan… only that jurisdictional challenges should be quashed.**
- **Provide certainty to generators. Nothing will be built until people know how they will be paid. Remove as much discretion as possible from the procedure to determine prices**
- **Focus on wholesale competition. Retail competition can be delayed … possibly forever. This should also allay fears of state regulators.**
- **Streamline approval processes for new generation in supply-constrained areas**
- **Make someone bear the costs.. It doesn't have to be the end-user, but it ought to be an arms-length deal, e.g. New Jersey**
- **Pray for cool weather and lots of rain**

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Houston, We Have A Problem: A Contrarian View of Enron

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What Was Enron, Anyway?

- A Pipeline Company
- An Energy Trading Company
- A Bunch of “Rocket Scientists”
- A Dot.Com
- A Hedge Fund
- A House of Cards
- Whatever You Wanted It To Be

What Do You Get When You Cross Don Corleone with an Enron Financial Statement?

An Offer You Can't Understand

The Possible Culprits

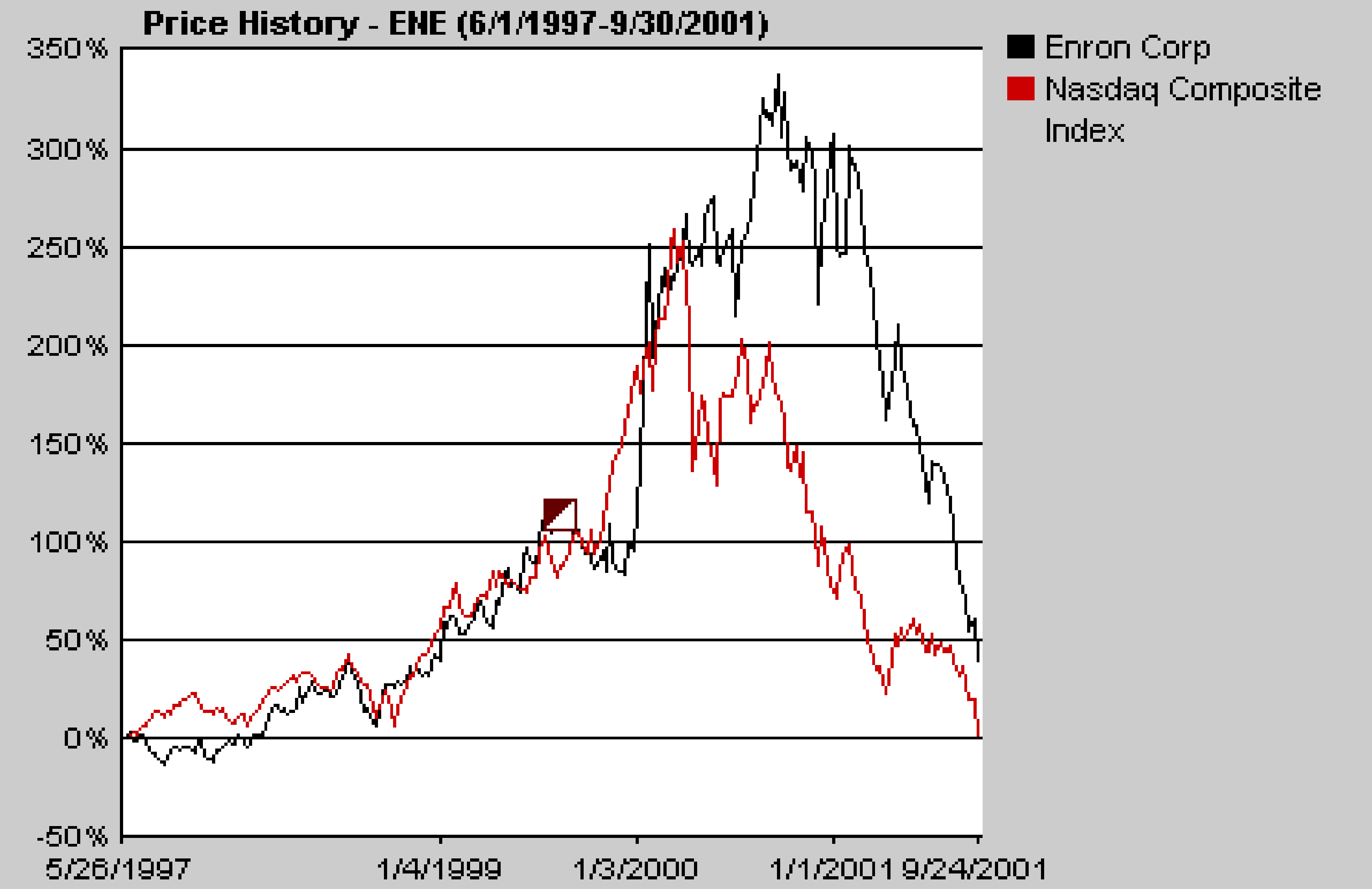
1. Enron Management in their Role As Managers on Behalf of Enron Stockholders
2. Enron Managers in their Role As Managers on Behalf of Enron Managers
3. Arthur Andersen, LLP
4. Vinson and Elkins, LLP
5. Moody's and Standard & Poor's
6. Investment Analysts
7. The Investors Who Relied On The Investment Analysts or Enron Management or Andersen

My View, Part 1

On the collapse:

- Enron was a company which refused to tell analysts, and even their own shareholders, what they did for a living
- Amazingly, analysts recommended the stock anyway, and, slightly less amazingly, investors bought the stock anyway.
- Whatever happened to *caveat emptor?*
- I’ve studied most of what’s been published about their collapse, and I still have no idea of anything they did wrong, other than certain technical rules involving outside capital

Enron and NASDAQ



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My View, Part 2

On Enron's effects in California

- Trivial as far as the "smoking gun" memos go
- FERC agrees with me
- The California ISO agrees with me
- Probably, on net, favorable
- A pure example of politics trumping fact

The real scandal: early access to the rules which were skewed to their benefit. A common problem