

# The Current State Of North American Energy Markets



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**T**here can now be no doubt that the demise of Enron has caused major damage to the energy-trading sector. The No. 1 gas and power marketer, which owned at least 30 percent of the market, doesn't just suddenly disappear without creating significant trading problems and, those energy companies that boldly declared in December 2001 that they would assume Enron's market share were premature.

The events at Enron created the financial black hole that is now consuming Dynegy, Reliant, Mirant, Williams, Aquila, Calpine and AES. It's a relentless cancer that even now is spreading to the majors. What went wrong?

## The Gold Rush

Just like the old timers chasing rumors of gold in the hills, a whole sector of the energy business abandoned sound business policy in an effort to create new unregulated markets. The idea that the first to stake a claim will find the most gold and therefore obtain the biggest reward has turned out to be false. It's much like the children's tale about the hare and tortoise except the tortoise wins when the hare, in a rush to be even faster, is caught cheating.



In today's sophisticated energy world, where all energy trading is recorded mark-to-market, real-time on NT windows-based systems, not only the energy trading desk, but the risk control group, CFO, and many others were exposed to those positions every single day. In the energy trading business, "rogue" traders and their phantom round-trip trades were actually encouraged and condoned by senior management to juice up their quarterly numbers.

Jeff Skilling's pronouncements and their acceptance, not only by Wall Street analysts, but by other energy trading companies shows that sound business thinking gave way to greed in the energy patch. This former consultant used Enron as a playground and experimental test bed for poor ideas that were gobbled up by a poorly educated and inexperienced media. In the rush to the gold, Enron became the golden goose that could not fail. Those following more conservative and cautious business models were often caught up in the frenzy to follow the lead of Enron.

## Creating The Hare Culture

The culture of the hare is one that pro-

pounds the 'star' system. Hire young bright kids with MBAs and drop them in a fiercely competitive culture where you compete for your job on a daily basis. Take your physical traders who have an encyclopedic knowledge of the nation's transportation and transmission systems and 20 years of experience and then have them report to an MBA with six months of experience of trading pork bellies for Enron. This type of culture breeds the hare. Corners are cut, rules are there to be broken or worked around and no one dares question.

Next, create an incentive program that rewards speed and profits on a quarterly basis. Hire the best and the brightest and have them consult to the best and the brightest without any knowledge base. Weed out iconoclasts and straightforward common sense folk and what you get is consensual decision-making and pronouncements about asset light, the disintegration of the energy industry, and that broadband is bigger than energy.

The point is that nothing is bigger than the energy industry. You need assets to trade. You simply need to make the stuff. And most importantly, what is actually occurring is the



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re-integration of the energy industry into a wellhead to wires seamless, vertically integrated colossus. The end result of this financial alchemy will now be an accelerated consolidation play as many competitors disappear and are subsumed by the deep pocket energy companies.

In this culture, customer relationships are forgotten in favor of electronic trades. It's not that there is anything wrong with electronic trading per se — it's just that energy is a physical business and relationships and customer knowledge are still key to the long-term success of an energy business. In a business where commodity is created and moved to be used, the savvy physical trader can make his/her company more money by having relationships in place when they are needed and through an understanding of the transportation systems and their operators.

While there will be room for electronic trading and energy merchants now and in the future, many of the want-to-be-hares forgot that assets underpin the business in the rush to follow Enron. Strangely, those that did not or could not react, the tortoises of the story, are now in much stronger positions because they own assets. And despite the problems of the energy merchant, energy is being produced, transported and delivered through the crisis without any real problems.

### Where Do We Go From Here?

What all of the headlines and media hysteria have created is a political witch-hunt by politicians who are both culpable and running for political cover. After all, Enron executed the best political hedge of all time, i.e. they gave to both political parties at both the state and federal levels.

The reality is that more regulation is coming. The Commodities Future Trade Commission (CFTC), Federal Energy Regulatory Commission (FERC), Securities & Exchange Commission (SEC), and state public utility commissions were asleep at the wheel and did not even know how to ask the right questions of energy companies. Now they will bring heavy-handed regulation, public oversight and scrutiny. They will also neither create one molecule of gas nor electron of power.

And it's not just the energy companies themselves that are impacted by all of this. What about the software vendors and all the peripheral companies that now find their markets shifting on them yet again? It wasn't just the energy merchants that

wanted energy commodity trading to be like the financial markets - so did many of the vendors bringing their Wall Street risk management methods with them.

Mark-to-market position and value at risk became the chorus of the industry - all financial innovations that make certain assumptions about holding periods and how profits are assessed. But in the world of the physical commodity, where a generation plant can go down or weather can impact loads, just exactly what does VaR tell you? At the physical end of the energy business, energy-specific risk metrics are required in addition to the financial ones.

So, we will have some more financial accountability and exposure, more movement back to the fuel adjustment clause (a passive hedge) than active risk taking and performance-based rate making, and basically a very dull supply-balancing gas and electric industry. There will be major fights at the state commission level over rate hikes just as in the past.

The dirty little secret is that the industry has had under-investment for the past decade and that those power plants built recently (the merchant power ones) particularly have to be amortized. Most people in the know think that a market-clearing price of \$40 per megawatt hour for the U.S. is in the cards. After all, we have to pay for all of those new investments in a very different financial environment of cost-of-service world although ironically it will be very similar to that model.

### Conclusion


The power crises of the past will be small potatoes to the ones in the next several years as load growth is up due to the Internet, Palm Pilot, laptop, laser printer, fax machine, and every other electric appliance in the home and office. Watch out for those summer peaks! The lack of transmission capacity will only exacerbate the problem, and mandating RTOs is a window-dressing solution. Regulators are neither creators nor entrepreneurs. They are gatekeepers and in this case, they are keeping change from the U.S. economy. Fortunately, better technology will save us in the longer term (fuel cells, microturbines, battery storage, solar, wind, and greater efficiencies).

The current state of crisis and chaos in the energy patch is not blowing over. The next wave of bad news will be the new auditors in place to replace Arthur Andersen, which had the lion's share of the business in

the energy patch. These new financial watchdogs will be overly rigorous in their accounting treatment of all energy companies. Expect more earnings restatements, off-balance sheet disclosures, and red ink in the next six to nine months.

The consolidated industry will have some new names in the mix. Global energy and utility companies with deep pockets such as RWE, Eon, GDF, EDF, Enel, and Endesa as well as the major oils such as BP, ExxonMobil, ChevronTexaco, Shell and ConocoPhillips. But the oils will stick to their knitting for the time being. They don't want to move too quickly and get caught in the political cross hairs and financial sinkhole of those "bad" trading companies. The fact is that we don't know the true financial losses out there. Enron's is at least \$100 billion, according to Stephen Cooper, their CEO.

The markets that are vibrant are oil, coal, and emissions. The oil markets are continuing to grow as they exhibit 50 percent annualized price volatility (double that of four years ago). Coal is an OTC market trading the NYMEX spec. And green trading is ready to ramp up, not only in the U.S., but the rest of the world. Following on the successful model of the seven-year-old U.S. SO<sub>2</sub> market, we will trade NO<sub>x</sub>, mercury, renewable energy credit, negawatts (energy efficiency), greenhouse gases such as CO<sub>2</sub>.

This is eventually where all of that great energy trading talent let go by Enron, Dynegy, Reliant, Allegheny, Aquila, Williams and others will settle. They know risk management and markets. They can create the green trading market. After all, everyone is allowed to fail many times, it's called risk taking, and this is the premier culture for that human phenomenon. 

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