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ENERGY MARKETS: WHEN INNOVATION BECOMES DECEPTION

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Recent activity in the U.S. electricity industry provides a case study of a dramatic failure at the intersection of the three most prominent institutions in this country's commercial life – markets, private companies and regulatory agencies. The so-called Enron memos (a pair of documents describing tactics for the firm's participation in the California electricity markets) neatly embody within just a few pages the central challenge in understanding how things went wrong. Activities described in the memos fall within three categories: 1) arbitrage that improves market efficiency; 2) "gaming" that, while perhaps consistent with the letter of applicable laws and regulations, is inconsistent with their underlying spirit; and 3) fraud. The crossing of the lines between these categories – a progressive movement from innovation to deception – is explained by several factors.

- **Competitive Instinct:** Conventional economic analysis tends to obscure the role of organizational (and human) dynamics in driving firm conduct (though this is changing with the emergence of the field of behavioral economics). Competition – as a method of commercial governance – works well partly because people like to compete. Some like it more than others.

Traders – whose job is to continually establish the best possible positions--like it a lot.

- **Money:** A strong competitive instinct at least partly explains the gaming, but not the fraud. The crossing of this line was no doubt compelled first and foremost by money. Because the California electricity markets were extremely vulnerable to the exercise of market power for extended periods, there was a great deal of money to be made by firms. Some of this was passed directly to traders in the form of multi-million dollar bonuses.

- **Corporate Controls:** What should normally be a powerful institutional force constraining personal dispositions toward misconduct instead almost certainly exacerbated them. The lack of internally imposed discipline is explained by many factors including unusually aggressive management, lack of standardized industry protocols for what often were new activities in new markets, and the lack of direct customer contact (which normally serves to activate reputational and communitarian instincts) associated with computerized trading in wholesale markets.

- **Regulatory Failure:** Normally the last line of defense, external (regulatory) oversight failed profoundly. The Federal Energy Regulatory

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Commission (and, in particular, Chairman Curt Hebert) was effectively paralyzed by an ideological belief in the beauty of free markets. The shocker was not so much any particular decision; it was a genuine unwillingness to even consider the proposition that California electricity markets were being significantly driven by market power. Forms of regulation applied by private firms such as auditors, financial analysts and ratings agencies also failed.

Economists, whose training begins with the insight that the pursuit of narrow self-interest can be made to support the greater public good, tend to reserve in their hearts a soft spot for traders and other types of speculators. We know that exploitation of a design flaw, no matter what the

intentions are behind it, provides the social benefit of highlighting the flaw.

The naturally aggressive instinct of traders can and should play a key role in driving toward efficiency the new FERC-sponsored competitive wholesale markets, which are eventually to be implemented throughout the country. And for all the obvious harm wrought by overly aggressive conduct, the recent flood of high-profile scandals has shone a bright light on pervasive and long-standing flaws in the regulatory foundation for large portions of this country's commercial life. Changes to this regulatory infrastructure, accompanied by improved corporate controls (which can and should continue to be motivated in part by well-targeted lawsuits for past misdeeds), will help ensure that future innovations do not cross the wrong kinds of lines.