

Enron Was Mostly Right About One Thing: Deregulation

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Enron Corp.'s collapse and the highly publicized shortage of electric power in California during the summer of 2000 are alleged to demonstrate that deregulation of electricity has gone too far. But I believe this is a misreading of what happened, and that both episodes are really further evidence deregulation has many pitfalls.

Enron had been promoted as the type of asset-light, knowledge-intensive company that is leading the New Economy. This is why its bankruptcy surprised and angered many regulators, economists, accountants, money managers, journalists, and others who've been taken in by the blatant self-promotion of Enron. Yet the company's failure mainly reflected the pricking of a bubble created by the inflated valuations of many other high-tech companies, not just Enron.

The company had been a minor player in the gas pipeline business until it recognized the potential market for derivatives based on fluctuations in wholesale energy prices. Energy derivatives are option contracts used to hedge risk against fluctuations in electricity, natural gas, and other energy prices. Moving aggressively, it became the largest trader of electricity and gas derivatives, mainly in the over-the-counter market.

Enron had a real insight into the role of new types of securities in deregulated power markets. However, the company managed to hide from investors and regulators its bad management and possible corruption by shamelessly promoting its image. Among other dubious procedures, it booked the entire value of its trades as revenues. That artificially made it one of the largest companies in the U.S. Wall Street trading firms, for instance, only book the spread as revenues, not the whole trade. In addition, Enron overstated profits with loose and allegedly fraudulent accounting. To gain respectability, Enron generously supported community causes in Houston and hired public intellectuals with differing political views to advisory boards.

The company contributed to politicians of both parties, although more to Republicans, to encourage further and faster deregulation of electricity markets at state and federal levels, especially when it would help its own power and trading companies. These Enron political activities reinforced a common view that corporate campaign contributions are pernicious, and so encouraged Congress to try once again to reform laws dealing with these contributions.

In its defense, Enron's actions, while self-serving, were generally good for the economy as a whole. The company promoted greater competition in electric power. Enron battled against entrenched state and local electric power companies that opposed deregulation to preserve their monopolies. Enron's total expenditures on political influence were tiny compared with the potential benefits to consumers from competition in energy markets.

It is too early to assess conclusively the effects on prices and service in the relatively high-cost states such as California and Pennsylvania that partially deregulated their electricity markets. But the evidence is encouraging from nations like Australia, Great Britain, and parts of Scandinavia that moved faster to deregulate. For example, wholesale electricity prices in Australia dropped by more than one-third since deregulation began there in 1993. Consumers in Britain also reaped sizable benefits in the form of lower prices and better service. Finally, it is a testament to the new flexibility of U.S. energy markets that Enron could fail without disrupting gas or electricity supplies.

California's power crisis is considered a telling counterexample, but it mainly demonstrates that badly designed partial deregulation may be worse than doing nothing. California's retail electricity prices were kept fixed while wholesale prices were free to be determined by supply and demand. Forward contracts by retail power companies were prohibited and these companies were prevented from owning wholesale suppliers of electricity. As a result, power companies were caught in a classic profit squeeze when wholesale prices rose sharply while retail prices were not allowed to adjust upward.

To be sure, the Enron debacle indicates the need for stricter guidelines on accounting and greater Internal Revenue Service oversight. Still, stock markets have responded by punishing Enron severely for the company's transgressions, and investors have begun to look more skeptically at "new" accounting methods. In response, many companies have taken steps to make their costs and revenues more transparent.

Had states fully deregulated their electricity markets, the Enron political scandal would have been largely avoided. The company could not have gamed the system by encouraging politicians to deregulate as it favored. I conclude that flexible prices and competition are far more effective ways to improve energy markets than allowing bureaucrats and politicians to determine the speed and direction of deregulation.