-----Original Message-----
From: James_Mietus@omb.eop.gov [mailto:James_Mietus@omb.eop.gov]
Sent: Friday, November 30, 2001 12:24 PM
To: Alexander_M_Brill@cea.eop.gov; gary.burner@do.treas.gov;
paula.farrell@do.treas.gov; peter.karpoff@hq.doe.gov;
kevin.kelly@ferc.fed.us; dan.larcamp@ferc.fed.us;
Wallace_F._Mullin@cea.eop.gov; david.reiffen@do.treas.gov;
arthur.rypinski@hq.doe.gov; Garrett_D._Soden@opd.eop.gov;
Michael_C._Toth@omb.eop.gov
Subject: Enron, Deregulation, and TVA

Of possible interest...
---------------- Forwarded by James Mietus/OMB/EOP on 11/30/2001 12:23 PM
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James Mietus
11/30/2001 12:17:36 PM

Record Type: Record

To: Richard A. Mertens/OMB/EOP

cc: Mark A. Weatherly/OMB/EOP, Marcus Peacock/OMB/EOP

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But look what's happened instead. Enron Corp., the vast energy trader at the center of the new freewheeling U.S. power markets, now faces collapse amid a blizzard of questionable financial deals. And California, the first big state to deregulate its electricity market, has watched its experiment turn into a disaster, with intermittent blackouts and retail power rates as much as 40% higher than they were a year ago.

Now, with the power industry hovering uneasily between regulation and deregulation, it faces the prospect of a market that combines the worst features of both: a return to government restrictions, mixed with volatility and price spikes as companies struggle to meet the nation's future energy needs.

Investors and lenders, spooked by the twin specters of California and Enron, have become less likely to commit capital to building new power plants, transmission lines and natural-gas pipelines. The U.S. will require big additions to its power production and distribution capacity when it emerges from the current recession -- but for now, at least, the nation's capital markets are reluctant to cough up the necessary funds.

Responding to the dramatic decline in their stock prices and the recession, energy companies are retrenching. Calpine Corp., one of the most aggressive players in the deregulated market, is waffling on previously announced plans to build billions of dollars in new power plants. Virginia-based AES Corp., which has missed its recent earnings targets, has scaled back its expansion goals and is selling some of its foreign assets. Northeast Utilities is curtailing plans to build a 30-mile underwater transmission line from Connecticut to Long Island.

Erecting Guadrails

Meanwhile, regulators are racing to place new guardrails on the U.S. power market. The federal government is trying to beef up its market-surveillance activities. And it also is trying to broker deals between states that might make interstate energy transmission faster, cheaper and easier. The power market is in "the midst of an ugly adolescence that we cannot allow to last much longer," says Nora Brownell, a member of the Federal Energy Regulatory Commission in Washington.

That's because, for the consumer, energy deregulation has been anything but good news. Unlike the deregulated telecommunications market, where fierce competition brought down prices while guaranteeing a reasonable level of reliability, the deregulated power market isn't likely to provide real benefits until it stabilizes. For now, consumers are at the mercy of wholesale forces they often can't understand and have few real options to switch between service providers.
The theory behind deregulation was that it would lead to the emergence of efficient companies that would specialize in providing electric power, carrying it over long distances or delivering it to a final customer.

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While the industry started to move in that direction, it isn't anymore. Many big power companies in the most populous states, which are the ones that also happen to be deregulated, still do a little of everything and are increasingly confused about where to place their business bets.

When it comes to electricity markets, says Frank Wolak, a Stanford University economics professor, these kinds of "hybrids don't work." But, he fears that they will be around for some time to come, especially since regulators, who once thought the markets themselves would bring about deregulation's goals, are only belatedly assuming responsibility for making sure things run smoothly.

Enron's sudden meltdown will deal a heavy blow to the broader energy marketplace that sat at the center of electricity deregulation--providing a place for utilities and power plants to buy energy they needed in a hurry, or to unload their excess supplies. The company's EnronOnline trading system, which was shut down Wednesday, accounted for a quarter of all wholesale energy trades among U.S. utilities, independent power producers and other market players.

The trading system's shutdown came in the wake of disclosures that Enron's directors and top officers approved a series of partnerships that moved debts off the company's balance sheet. In several cases, those partnerships enriched company officers but later produced huge losses for Enron.

That kind of "balance-sheet abuse" says Goldman Sachs analyst Jonathan Raleigh, might now "reduce overall liquidity and cause lenders to tighten credit standards" for the entire energy-trading industry. The result could be the kind of supply squeezes that led to six days of blackouts in California earlier this year.

California's supply problems didn't spread beyond the Pacific Northwest--but that's largely because of the sharp economic downturn. As spot-market power prices in California shot up to an average of $317 per megawatt in December 2000 from $32 per megawatt hour the preceding April, energy companies were making enormous amounts of money. Investors drove up the price of the companies' stocks, with Enron at one point trading at 60 times its projected next year's earnings. New funding was flooding in from debt and equity markets. Under pressure from regulators worried about a repeat of the California debacle, energy companies got busy building power plants, drawing up plans to fix the nation's antiquated electric-transmission systems and plotting new natural-gas pipelines.

But that golden moment for the industry turned out to be short-lived. Early this year, federal energy regulators placed caps on the wholesale price of power sold in the western U.S. as California's two main investor-owned utilities were pushed to the brink of insolvency. Then, in the spring, natural-gas and electricity prices collapsed around the country as the economy suddenly slowed to a crawl. Even before Enron got into trouble, the big energy companies began to see their stock prices sink, and investors began to cast a more critical eye on their expansion plans in the wake of the California chaos and the resulting multibillion-dollar electricity payment crisis.

One of the first signs that a sea change was under way came a few months ago when demand for power-generation turbines began to soften. Because there are only three domestic suppliers of such multimillion-dollar engines, the most expensive pieces of machinery used by commercial electricity producers, the machines must be ordered well in advance of their deployment.

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At the root of the problem is a lack of capital and earnings. While energy companies routinely beat their own bullish quarterly profit estimates last year, many of them have lately indicated that they will miss earnings projections. With electricity and natural-gas prices down, energy sales tend to be less profitable. Hence, investors haven't been willing to pay the same price-earnings multiples for energy stocks.

Bankers, meanwhile, want convincing evidence that future power prices will be high enough to justify new projects. That's far from guaranteed in deregulated markets. In fact, national electricity prices, which hit a 52-week peak of $216 per megawatt, now are being quoted at $23.45 per megawatt, according to the Mirant National Power Index.

To give some idea of how radically the landscape has shifted, take the case of power conglomerate UtiliCorp United Inc., of Kansas City, Mo. In April, taking advantage of the general enthusiasm toward deregulated markets, it spun off its Aquila Inc. trading unit at a price of $24 a share, raising $480 million. "We saw an opportunity to crystalize the value" of the trading company, says UtiliCorp President Bob Green.

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But that won't help consumers unless new power plants and transmission lines come online in time for the economy's resurgence and new rules are put in place that guarantee a more transparent market. The latter won't be an easy task, because power trading is done on a variety of public and private exchanges, with traders darting in and out to take advantage of price discrepancies.

Lately, there's been growing evidence that some power companies have found lucrative ways to exploit this system -- at consumers' expense. Their tactics include manipulating wholesale electricity auctions, taking juice from transmission systems when they aren't supposed to and denying weaker competitors access to transmission lines. Regulators believe that this behavior has contributed to supply glitches and inflated prices.

Under its new chairman, Pat Wood, the FERC has been pressing companies to

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Sent: Friday, November 30, 2001 12:24 PM
To: Alexander_M_Brill@CEA.EOP.GOV; Gary.Burner@DO.TREAS.GOV;
paula.Farrell@DO.TREAS.GOV; Peter.Karpoff@HQ.DOE.GOV;
Kevin.Kelly@FERC.FED.US; Dan.Larcamp@FERC.FED.US;
Wallace_P_Hullin@CEA.EOP.GOV; David.Reiffen@DO.TREAS.GOV;
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California's supply problems didn't spread beyond the Pacific Northwest -- but that's largely because of the sharp economic downturn. As spot-market power prices in California shot up to an average of $317 per megawatt in December 2000 from $32 per megawatt hour the preceding April, energy companies were making enormous amounts of money. Investors drove up the price of the companies' stocks, with Enron at one point trading at 60 times its projected next year's earnings. New funding was flooding in from debt and equity markets. Under pressure from regulators worried about a repeat of the California debacle, energy companies got busy building power plants, drawing up plans to fix the nation's antiquated electric-transmission systems and plotting new natural-gas pipelines.

But that golden moment for the industry turned out to be short-lived. Early this year, federal energy regulators placed caps on the wholesale price of power sold in the western U.S. as California's two main investor-owned utilities were pushed to the brink of insolvency. Then, in the spring, natural-gas and electricity prices collapsed around the country as the economy suddenly slowed to a crawl. Even before Enron got into trouble, the big energy companies began to see their stock prices sink, and investors began to cast a more critical eye on their expansion plans in the wake of the California chaos and the resulting multibillion-dollar electricity payment crisis.

One of the first signs that a sea change was under way came a few months ago when demand for power-generation turbines began to soften. Because there are only three domestic suppliers of such multimillion-dollar engines, the most expensive pieces of machinery used by commercial electricity producers, the machines must be ordered well in advance of their deployment.

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At the root of the problem is a lack of capital and earnings. While energy companies routinely beat their own bullish quarterly profit estimates last year, many of them have lately indicated that they will miss earnings projections. With electricity and natural-gas prices down, energy sales tend to be less profitable. Hence, investors haven't been willing to pay the same price-earnings multiples for energy stocks.

Bankers, meanwhile, want convincing evidence that future power prices will be high enough to justify new projects. That's far from guaranteed in deregulated markets. In fact, national electricity prices, which hit a $2-a-week peak of $216 per megawatt-kilowatt, are now being quoted at $23.45 per megawatt, according to the Mirant National Power Index.

To give some idea of how radically the landscape has shifted, take the case of power conglomerate UtiliCorp United Inc., of Kansas City, Mo. In April, taking advantage of the general enthusiasm toward deregulated markets, it spun off its Aquila Inc. trading unit at a price of $24 a share, raising $480 million. "We saw an opportunity to crystallize the value" of the trading company, says UtiliCorp President Bob Green.

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But that won't help consumers unless new power plants and transmission lines come online in time for the economy's resurgence and new rules are put in place that guarantee a more transparent market. The latter won't be an easy task, because power trading is done on a variety of public and private exchanges, with traders darting in and out to take advantage of price discrepancies.

Lately, there's been growing evidence that some power companies have found lucrative ways to exploit this system -- at consumers' expense. Their tactics include manipulating wholesale electricity auctions, taking juice from transmission systems when they aren't supposed to and denying weaker competitors access to transmission lines. Regulators believe that this behavior has contributed to supply glitches and inflated prices.

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Still, even a more aggressive FERC hasn't been able to solve some lingering problems. A good example is the continued existence of one of the nation's worst transmission bottlenecks. Known as "Path 15," the line interconnects the populous southern part of California with more abundant energy resources in the north. The Department of Energy has pledged to help expand Path 15, which was implicated as a key cause of the blackouts in California earlier this year.

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-----Original Message-----
From: James Mietus@omb.eop.gov [mailto:James_Mietus@omb.eop.gov]
Sent: Friday, November 30, 2001 12:24 PM
To: Alexander M. Brill@cea.eop.gov; gary.burner@do.treas.gov;
paula.farrell@do.treas.gov; peter.karpoff@hq.doe.gov;
kevin.kelly@ferc.fed.us; dan.larcamp@ferc.fed.us;
Wallace P. Mullin@cea.eop.gov; david.reiffen@do.treas.gov;
arthur.rypinski@hq.doe.gov; Garrett_D._Soden@opd.eop.gov;
Michael_C._Toth@omb.eop.gov
Subject: Enron, Deregulation, and TVA

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_____________ Forwarded by James Mietus/OMB/EOP on 11/30/2001 12:23 PM
_____________

James Mietus
11/30/2001 12:17:36 PM

Record Type: Record

To: Richard A. Mertens/OMB/EOP

cc: Mark A. Weatherly/OMB/EOP/EOP, Marcus Peacock/OMB/EOP/EOP

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But look what's happened instead. Enron Corp., the vast energy trader at the center of the new freewheeling U.S. power markets, now faces collapse amid a blizzard of questionable financial deals. And California, the first big state to deregulate its electricity market, has watched its experiment turn into a disaster, with intermittent blackouts and retail power rates as much as 40% higher than they were a year ago.

Now, with the power industry hovering uneasily between regulation and deregulation, it faces the prospect of a market that combines the worst features of both: a return to government restrictions, mixed with volatility and price spikes as companies struggle to meet the nation's future energy needs.

Investors and lenders, spooked by the twin specters of California and Enron, have become less likely to commit capital to building new power plants, transmission lines and natural-gas pipelines. The U.S. will require big additions to its power production and distribution capacity when it emerges from the current recession -- but for now, at least, the nation's capital markets are reluctant to cough up the necessary funds.

Responding to the dramatic decline in their stock prices and the recession, energy companies are retrenching. Calpine Corp., one of the most aggressive players in the deregulated market, is waffling on previously announced plans to build billions of dollars in new power plants. Virginia-based AES Corp., which has missed its recent earnings targets, has scaled back its expansion goals and is selling some of its foreign assets. Northeast Utilities is curtailing plans to build a 30-mile undersea transmission line from Connecticut to Long Island.

Erecting guardrails

Meanwhile, regulators are racing to place new guardrails on the U.S. power market. The federal government is trying to beef up its market-surveillance activities. And it also is trying to broker deals between states that might make interstate energy transmission faster, cheaper and easier. The power market is "in the midst of an ugly adolescence that we cannot allow to last much longer," says Nora Brownell, a member of the Federal Energy Regulatory Commission in Washington.

That's because, for the consumer, energy deregulation has been anything but good news. Unlike the deregulated telecommunications market, where fierce competition brought down prices while guaranteeing a reasonable level of reliability, the deregulated power market isn't likely to provide real benefits until it stabilizes. For now, consumers are at the mercy of wholesale forces they often can't understand and have few real options to switch between service providers.
The theory behind deregulation was that it would lead to the emergence of efficient companies that would specialize in providing electric power, carrying it over long distances or delivering it to a final customer.

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Other markets have a harder time of it and give their advocates fits, like the high-potential kid with behavioral problems. Electricity seems to fit in this category. California and Enron are symptomatic of the struggle underway as the market labors to develop.

Where you stand determines what you see.

Deregulation fans will see Enron and its aftermath as regrettable but predictable, given the fact that laws are confusing and reforms are incomplete. The obvious solution: Let FERC, states and competitors work out the needed reforms and institutions ASAP.

Critics of deregulation of course will see this Rorschach test quite differently -- risky business, doomed from the start, the result from irrational adherence to ideology, a victory of theory over common sense.

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But look what's happened instead. Enron Corp., the vast energy trader at the center of the new freewheeling U.S. power markets, now faces collapse amid a blizzard of questionable financial deals. And California, the first big state to deregulate its electricity market, has watched its experiment turn into a disaster, with intermittent blackouts and retail power rates as much as 40% higher than they were a year ago.

Now, with the power industry hovering uneasily between regulation and deregulation, it faces the prospect of a market that combines the worst features of both: a return to government restrictions, mixed with volatility and price spikes as companies struggle to meet the nation's future energy needs.

Investors and lenders, spooked by the twin specters of California and Enron, have become less likely to commit capital to building new power plants, transmission lines and natural-gas pipelines. The U.S. will require big additions to its power production and distribution capacity when it emerges from the current recession -- but for now, at least, the nation's capital markets are reluctant to cough up the necessary funds.

Responding to the dramatic decline in their stock prices and the recession, energy companies are retrenching. Calpine Corp., one of the most aggressive players in the deregulated market, is waffling on previously announced plans to build billions of dollars in new power plants. Virginia-based AES Corp., which has missed its recent earnings targets, has scaled back its expansion goals and is selling some of its foreign assets. Northeast Utilities is curtailing plans to build a three-mile underwater transmission line from Connecticut to Long Island.

Erecting Guardrails

Meanwhile, regulators are racing to place new guardrails on the U.S. power market. The federal government is trying to beef up its market-surveillance activities. And it also is trying to broker deals between states that might make interstate energy transmission faster, cheaper and easier.

The power market is in "the midst of an ugly adolescence that we cannot allow to last much longer," says Nora Brownell, a member of the Federal Energy Regulatory Commission in Washington.

That's because, for the consumer, energy deregulation has been anything but good news. Unlike the deregulated telecommunications market, where fierce competition brought down prices while guaranteeing a reasonable level of reliability, the deregulated power market isn't likely to provide real benefits until it stabilizes. For now, consumers are at the mercy of wholesale forces they often can't understand and have few real options to switch between service providers.

The theory behind deregulation was that it would lead to the emergence of efficient companies that would specialize in providing electric power, carrying it over long distances or delivering it to a final customer.

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Enron's sudden meltdown will deal a heavy blow to the broader energy marketplace that sat at the center of electricity deregulation -- providing a place for utilities and power plants to buy energy they needed in a hurry, or to unload their excess supplies. The company's EnronOnline trading system, which was shut down Wednesday, accounted for a quarter of all wholesale energy trades among U.S. utilities, independent power producers and other market players.

The trading system's shutdown came in the wake of disclosures that Enron's directors and top officers approved a series of partnerships that moved debts off the company's balance sheet. In several cases, those partnerships enriched company officers but later produced huge losses for Enron.

That kind of "balance-sheet abuse" says Goldman Sachs analyst Jonathan Raleigh, might now "reduce overall liquidity and cause lenders to tighten credit standards" for the entire energy-trading industry. The result could be the kind of supply squeezes that led to six days of blackouts in California earlier this year.

California's supply problems didn't spread beyond the Pacific Northwest -- but that's largely because of the sharp economic downturn. As spot-market power prices in California shot up to an average of $317 per megawatt in December 2000 from $32 per megawatt hour the preceding April, energy companies were making enormous amounts of money. Investors drove up the price of the companies' stocks, with Enron at one point trading at 60 times its projected next year's earnings. New funding was flooding in from debt and equity markets. Under pressure from regulators worried about a repeat of the California debacle, energy companies got busy building power plants, drawing up plans to fix the nation's antiquated electric-transmission systems and plotting new natural-gas pipelines.

But that golden moment for the industry turned out to be short-lived. Early this year, federal energy regulators placed caps on the wholesale price of power sold in the western U.S. as California's two main investor-owned utilities were pushed to the brink of insolvency. Then, in the spring, natural-gas and electricity prices collapsed around the country as the economy suddenly slowed to a crawl. Even before Enron got into trouble, the big energy companies began to see their stock prices sink, and investors began to cast a more critical eye on their expansion plans in the wake of the California chaos and the resulting multibillion-dollar electricity payment crisis.

One of the first signs that a sea change was under way came a few months ago when demand for power-generation turbines began to soften. Because there are only three domestic suppliers of such multimillion-dollar engines, the most expensive pieces of machinery used by commercial electricity producers, the machines must be ordered well in advance of their deployment.

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At the root of the problem is a lack of capital and earnings. While energy companies routinely beat their own bullish quarterly profit estimates last year, many of them have lately indicated that they will miss earnings projections. With electricity and natural-gas prices down, energy sales tend to be less profitable. Hence, investors haven't been willing to pay the same price-earnings multiples for energy stocks.

Bankers, meanwhile, want convincing evidence that future power prices will be high enough to justify new projects. That's far from guaranteed in deregulated markets. In fact, national electricity prices, which hit a $2-week peak of $2.16 per megawatt, now are being quoted at $2.45 per megawatt, according to the Mirant National Power Index.

To give some idea of how radically the landscape has shifted, take the case of power conglomerate UtiliCorp United Inc., of Kansas City, Mo. In April, taking advantage of the general enthusiasm toward deregulated markets, it spun off its Aquila Inc. trading unit at a price of $2.4 a share, raising $480 million. "We saw an opportunity to crystallize the value" of the trading company, says UtiliCorp President Bob Green.

Aquila's stock soared to $35 before it began slipping at the end of May. Since then, it has tumbled by half. Today, with a price/earnings ratio of eight -- less than most utilities -- the "equity markets are closed" to Aquila, Mr. Green says.

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