

Observations on Enron

It didn't make the headlines when Enron collapsed. It didn't have the human interest stories of financial ruin associated with the loss of jobs and pensions. It lacked political drama and there was no need to debate legislative and regulatory action because it wasn't associated with investor protection, fraudulent accounting or inadequate corporate governance. It was only a story about market architecture that ended the same way others ended. However, its effect on risk management and the efficiency of energy markets may prove to be profound.

Two totally different market architectures were competing for the order flow in the energy and power sectors when Enron met its demise.

In one of them, purportedly invented in modern times, there is a dominant principal (buyer or seller) for a wide variety of energy and power products and their derivatives. That dominant economic actor provides liquidity in hundreds of products to thousands of participants. In the case of Enron, the principal appeared to have a virtually endless capacity to extend credit in all of these markets and to all of the participants. It appeared to be infinitely scalable in new products because the dominant player's corporate culture fostered innovation.

In the alternative market architecture, which has emerged over many centuries, there is either a significant number of bilateral trades in an over-the-counter (OTC) market or a centralised multilateral market. Principals, or their agents (brokers), consummate transactions relying on the creditworthiness of their counterparties. The creation of an independent clearing service occurred when the supply of credit could not satisfy the demand for credit. Increases in the capacity for credit were limited by the totality of capital of the individual participants and/or their clearing corporations.

The scalability of new products in the bilateral market depends on the creativity of the individual buyer or seller. In the multilateral market new products' scalability depends on the innovative capacity of all buyers or sellers exercising their creative skills through trade associations or exchanges.

EnronOnline embodied the first type of market architecture. It was a dominant principal in the energy and power markets and their derivatives. It was commonly accepted by a significant part of the investment community that the company could dominate several existing and new markets. Enron came from relative obscurity to be the seventh largest corporation in the US in terms of

sales. Its model seemed to be infinitely scalable with no credit constraints and a boundless ability to innovate. The proof lay in its market power in markets as diverse as natural gas, weather derivatives and bandwidth. The company's ability also seemed boundless because of the emergence of the internet – a key facilitating technology of the 1990s.

Enron's sudden demise was a surprise to all of us except for a few very wise short sellers. In retrospect, a simple study of a few commodity and capital markets would have revealed that this type of market architecture generally has a short life. Variants of this story occurred in both the grain markets and the bond markets during the 20th century.

While the halcyon days of Enron captured huge amounts of attention, the second type of market architecture quietly proceeded to grow, transform and mature into a deep market that is effectively filling the gap left by Enron's collapse.

Both the New York Mercantile Exchange and the International Petroleum Exchange (IPE) – traditional examples of the multilateral,

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voice-brokered format – experienced substantial volume growth during the 1990s. The OTC markets continue to thrive and are being transformed by the introduction of new approaches to trading. In the latter part of the decade, the industry experienced a move towards electronic marketplaces. The Atlanta-based Intercontinental Exchange (ICE) and Tradepark are two examples of this new trend. At ICE, the number of participating firms and users soared by more than 400% last year, while the number of trades it executed grew 15-fold. With the acquisition of the IPE, ICE added a broad range of exchange-traded energy-based futures and options markets to its extensive roster of energy and metals-based OTC derivatives markets. Last year, ICE also signed an agreement to offer optional clearing services through the London Clearing House. These recent events indicate



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a move towards a 'fusion' of these two types of OTC/multilateral markets.

Though some may have feared that the collapse of a dominant player like Enron would have caused massive disruption to the market(s), this was not the case. After the firm's demise its business was seamlessly transferred to other markets, as evidenced by the huge increase in deal flow at the ICE. Despite the fact that Enron's collapse could have caused major disruption to the energy markets, this smooth transition during the busy winter trading season was barely noticed by the media. With the exception of a 15 February article in *The Economist*, it was not a headline story.

What lessons can we learn from a brief look at history when the dominant actor no longer exists? First, the collapse of the dominant player can cause financial ruin for its counterparties (in addition to its creditors, employees and community) and may introduce systemic problems that cause economy-wide damage. However, it is also a time when its market shares are divided among other participants. To the extent that trading migrates to public exchanges, market participants will benefit from more transparent prices and the steady flow of data on volume and open positions. The self-regulating markets may again enjoy expanded benefits from the market confidence provided by their systems of rules, checks and balances and exposure to external inspection. The results are greater profitability for the survivors and more efficient markets. This ultimately leads to lower transactions costs. Improved efficiency in these markets will help ensure economically rational allocation of energy resources.

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