TESTIMONY

Before the United Sates Senate
Committee on Governmental Affairs
Thursday, January 24, 2002

Statement of
Bruce B. Henning
Director, Regulatory and Market Analysis
Energy and Environmental Analysis, Inc.

Introduction

Good morning. My name is Bruce Henning. I am Director, Regulatory and Market Analysis at Energy and Environmental Analysis, Inc. EEA is a privately owned consulting firm that provides analysis to institutional, governmental, and private sector clients in the areas of natural gas, electricity, and transportation and related environmental issues and policy. For the past 24 years, I have been an analyst of natural gas, electricity, and other energy markets. Along with my colleagues at EEA, I have conducted a number of comprehensive analyses of the North American natural gas markets, electricity markets, and energy infrastructure requirements. EEA provided the quantitative analytic support for the 1999 National Petroleum Council study, *Natural Gas: Meeting the Challenges of the Nation's Growing Natural Gas Demand*. EEA also authored the INGAA Foundation study, *Pipeline and Storage Infrastructure Requirements for a 30 Tcf Gas Market*, and performed the forecast and market analysis for the *GTI* (formerly Gas Research Institute) *Baseline Projection*. In addition, we have performed a large number of energy market analyses for private sector clients from all sectors of the energy industry including local natural gas distribution companies, natural gas producers, interstate natural gas pipeline companies, energy marketers, regulated electric utilities and independent power generation companies.

I am here today to discuss the behavior of natural gas and electricity markets in the wake of the "Chapter 11" bankruptcy of Enron. The views that I express are my own and do not reflect the views and positions of any of EEA's clients.

Enron has not been one of my clients or a client of the EEA Energy Group over the past five years. However, for the last several years, EEA has provided Enron with environmental regulatory and policy analysis, primarily tracking the development of environmental regulations and assessing the regulatory and permitting implications of different kinds of projects. Enron was also a member of the Clean Power Group, a consortium of power companies that EEA worked with on the development of multi-pollutant legislation.

Impact on Energy Consumers

Enron has been an important company in natural gas and electricity markets in the United States. Prior to the bankruptcy, Enron was the largest marketer of gas and electricity in the United States, operating in both wholesale and retail energy markets. Enron owns and operates three major interstate gas pipeline systems and has an ownership interest in a number of others. Enron has an interest in electricity generation in more than a dozen states.

The Enron failure caused some disruptions in natural gas and electricity markets, but these were relatively minor. Given the scope of Enron's activity within the gas and electricity markets, the absence of a significant disruption in energy markets is a credit to the marketplace and to the people who make the energy marketplace work. Throughout the collapse of Enron, supplies of gas and electricity have continued to be delivered to consumers. The reliability of the energy delivery system has not been compromised.

Moreover, gas and electricity prices to the retail customer have not been significantly affected by the events surrounding the Enron bankruptcy. Enron's retail gas customers generally have been able to migrate to the regulated utilities or to other energy marketers and the prices that they pay for their gas largely reflect the general market fundamentals, which are yielding substantially lower gas prices than a year ago.

Wholesale Market Impacts

Over the past two decades, the structure of the natural gas market has changed from a market that relied almost exclusively upon price regulation to a market where prices are determined by the balance of supply and demand subject to the regulatory oversight of the Federal Energy Regulatory Commission (FERC). A liquid and transparent market has developed where gas is traded on a daily basis at more than 60 locations around the nation.

Competitive wholesale electricity markets are less mature than their gas counterparts. Under the oversight of the Federal Energy Regulatory Commission (FERC) significant progress toward competitive electricity markets has occurred. Moreover, with the continuing development of FERC regulated Regional Transmission Organizations (RTOs), liquidity, transparency, and efficiency of electricity markets will likely improve further.

Prior to the suspension of trading activity, Enron was the largest participant in both the wholesale gas and electric markets. Enron traded in the physical market, as well as in the important financial market for gas and electricity. The financial market involves the trading of contractual obligations that are linked to the movement of prices in the physical markets for gas and electricity. The financial markets provide a low transaction cost method for wholesale market participants to manage price volatility risk or to take positions in the markets.

Gas and electricity wholesale markets have been quite volatile, more volatile than most other commodity markets. The day-to-day demand for energy can vary substantially because of the influence of weather in a way that other commodities generally do not experience. But over time, the prices for the commodity should reflect the fundamental balance of supply and demand.

Examination of wholesale prices since September indicates that gas and electricity markets behaved reasonably well during a period where the largest market participant was in turmoil. In the gas market, the fall and early winter is a critical period. One expects volatility in gas prices and indeed gas prices were volatile. However, overall the prices continued to reflect the market fundamentals and responded to soft demand, driven by warm weather and continued weakness in industrial activity, high inventories of gas in storage, and growth in gas productive capacity that resulted from the high drilling activity throughout most of 2001.

I have included in my written testimony charts showing the prices for gas at two important locations for the gas market. For each point, one chart shows two years of market behavior and a second chart focuses on the market since September. Evaluation of this data as well as the data from more than 20 other pricing points shows that prices, while volatile, have not experienced large movements by historical standards.

Specific Effects of the Enron Bankruptcy

The Enron bankruptcy impacted market participants in a number of ways. First, Enron's electronic trading platform, Enron Online, was the largest platform in terms of volume of trades and scope of the products traded. Almost all participants used Enron Online for trades and for price discovery. When Enron Online went dark, the market lost an important source of price information as well as a low transaction cost method of trading. Fortunately, there were other sources of pricing information that is collected and available to the market and other, albeit smaller, electronic trading platforms. Market participants shifted to other sources and began to increase activity on other platforms. Some of these other trading platforms have experienced trading volume increases of 60 percent or more since the start of Enron's collapse. Within weeks, market participants had largely

adjusted to the loss of Enron Online. In addition, Enron Online or a successor may be marketed by UBS. On Friday, the U.S. Bankruptcy Judge approved the sale of Enron's trading unit, including Enron Online, to UBS. UBS may or may not become a successful player in gas and electric markets in the United States. If successful, UBS will add to liquidity and price discovery. But even without UBS, there are many sources of market transparency and liquidity to ensure the proper operation of energy markets.

The financial exposure of other parties involved in transactions with Enron is a much more complicated issue. As a general matter, companies involved in energy commodity trading work to limit the size of their exposure to any individual company, even a company that was as large as Enron. As Enron came under increasing pressure, many participants began to reduce their exposure arising from their transactions with Enron. Even so, the exposure remains large, but manageable for most companies.

Beyond that, Enron had entered into a number of longer-term contracts with buyers and sellers of gas and electricity. The status of these contracts is unclear and will be determined through the bankruptcy proceedings in the courts. It is possible that the parties that are holding contracts with Enron will find themselves back in the market when they had thought that they had hedged their future stream of production or their future energy needs. They might be worse off or they might be better off, depending upon future energy price movements, one does not know.

The loss of Enron has presented an opportunity for other energy marketing companies to capture market share. Indeed, as Enron's customers have sought to replace services obtained from Enron, other marketers have stepped in. However, the ability of these marketers to aggressively pursue market share has to be tempered with the need to insure that these companies remain financially strong.

The equity prices and bond ratings of a number of energy marketers, independent power producers, and gas pipelines have come under pressure in recent weeks. As a result, these companies have begun to take action to strengthen their balance sheets to re-establish lenders' confidence. As a part of the actions taken, many companies are reducing their capital project budgets, canceling or delaying power plant construction and delaying commitments to gas pipeline expansions.

EEA's analysis indicates that the cancellation of power plant projects does not necessarily foretell an impending electricity shortage. In our opinion, there was significantly more generation capacity proposed than was needed for the next five years. We felt it was likely that many of the generation projects would be delayed or cancelled even without the Enron bankruptcy. The Enron event precipitated the shakeout that was likely to occur in any event.

That being said, the decline in bond ratings and equity prices for many companies will increase the cost of capital for many needed infrastructure projects. This increase will have an effect on energy markets for a number of years and if confidence is not re-established in the relative near-term, the financial fallout of the Enron bankruptcy will become more troublesome. This country will need considerable amounts of capital investment in gas pipeline, gas distribution, electricity generation and transmission, and gas and oil exploration and development over the next 10 to 20 years. The planning, permitting, investment, and construction of these projects will be a challenge and will require a financially healthy energy industry.

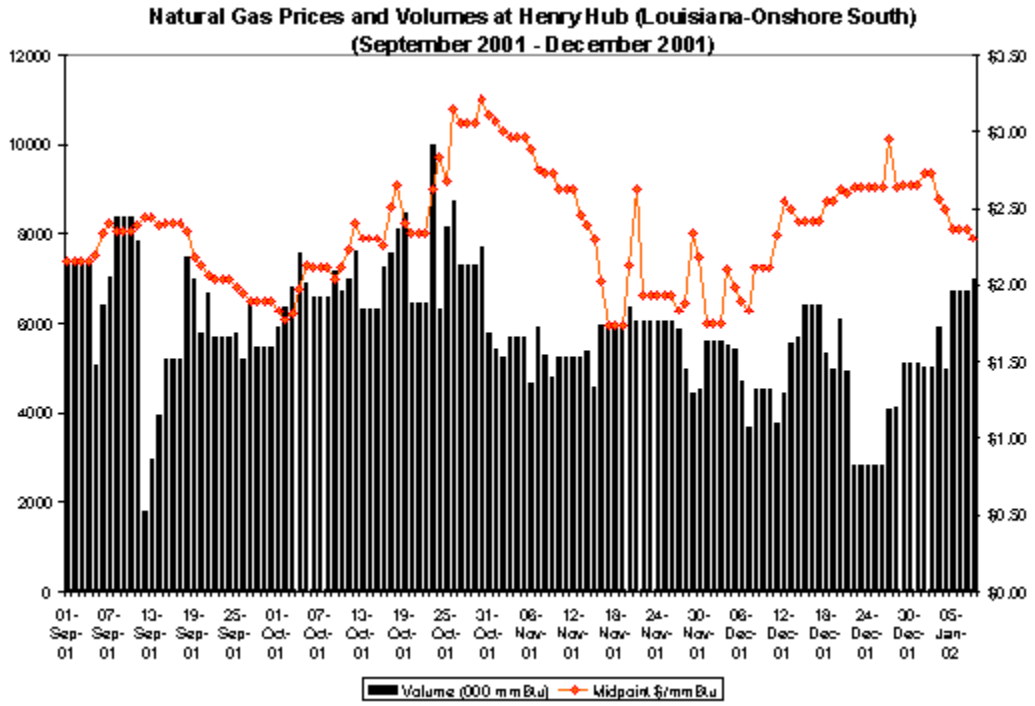
Conclusion

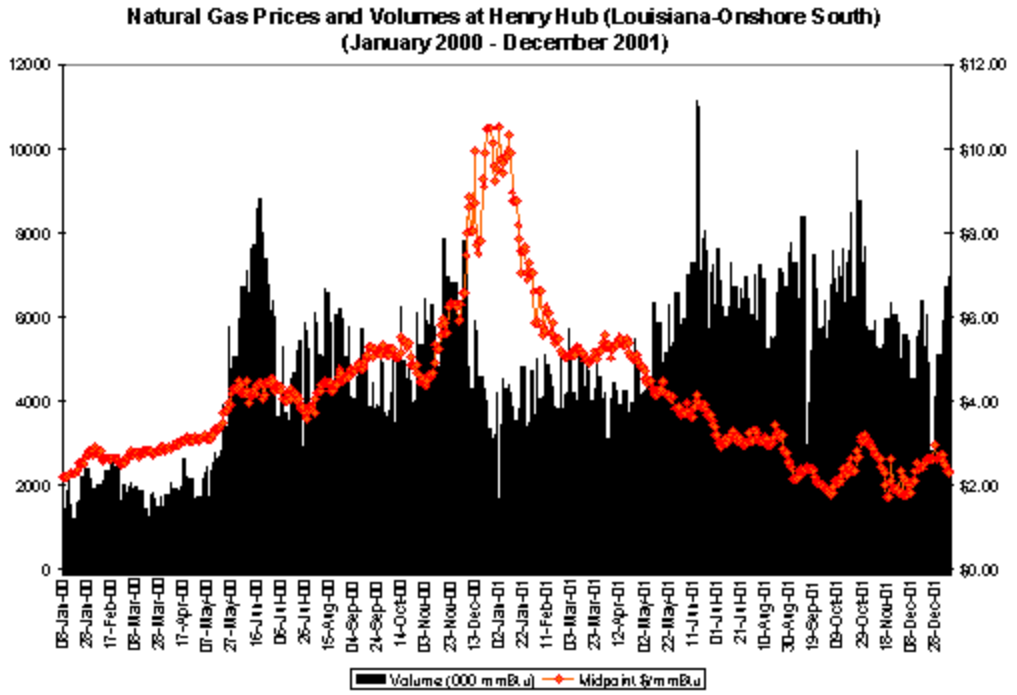
The events surrounding the bankruptcy of Enron have been tragic for thousands of Enron employees and investors and raise a number of serious questions regarding corporate accounting and disclosure of corporate information. All of us that work in the field of energy know individuals who have been hurt tremendously and have seen the personal pain of the people involved.

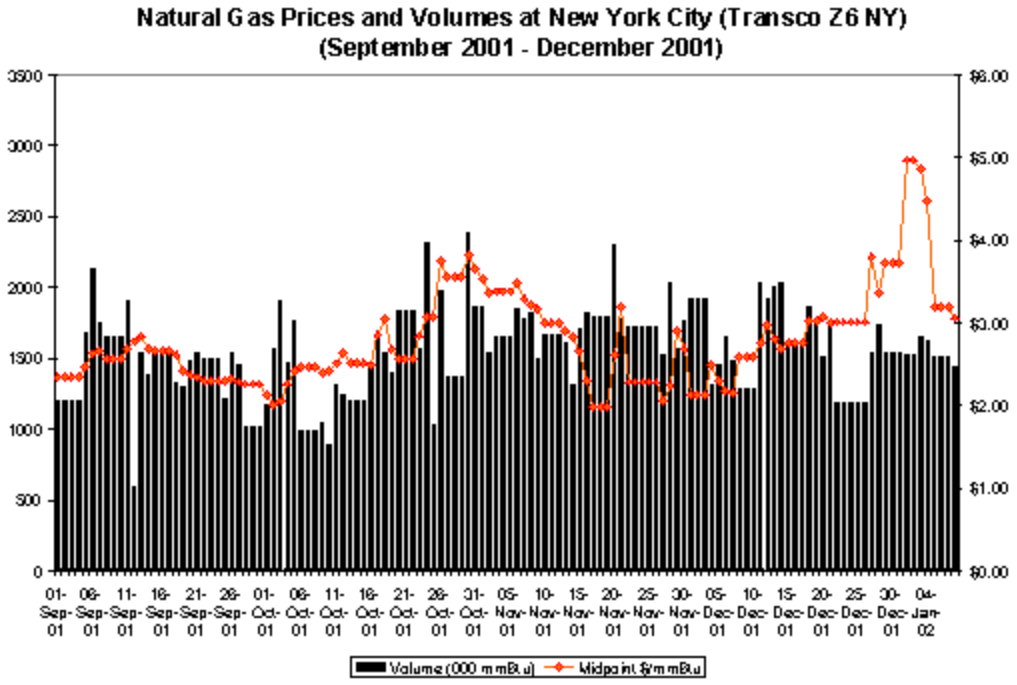
But from the relatively narrow perspective of energy markets, the performance in the last several months has shown an ability to respond to a major disruption in the market without an interruption of the delivery of energy to consumers and without a significant increase in consumer prices. The

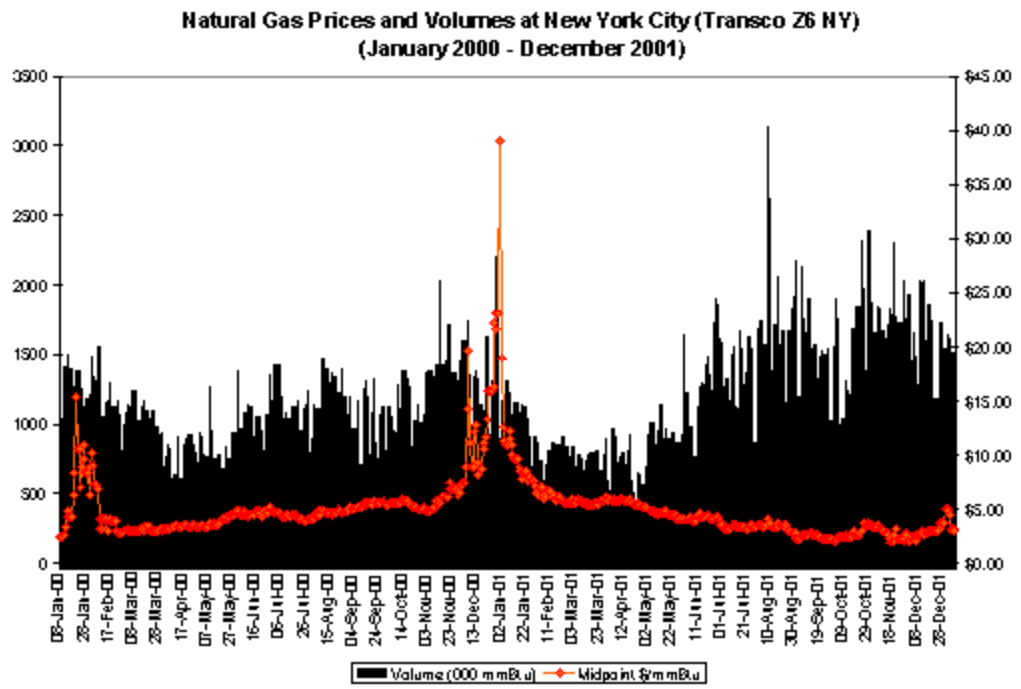
events challenged the men and women in energy companies to meet their commitments to the consumer. The structure of gas and electric markets forged by federal and state regulators in accordance with the federal and state laws performed well in the face of an event that had never been seriously contemplated.

I would like to thank the Committee for the opportunity to express my views and I would be happy to answer any question that I can.




Natural Gas Prices and Volumes at Henry Hub (Louisiana-Onshore South)
(January 2000 - December 2001)
12000
10000
8000
6000
4000
2000
0
$12.00
$10.00
$8.00
$6.00
$4.00
$2.00
$0.00
Volume (000 mmBtu)
Midpoint $/mmBtu


Natural Gas Prices and Volumes at New York City (Transco Z6 NY)
(September 2001 - December 2001)
3500
3000
2500
2000
1500
1000
500
0
$6.00
$5.00
$4.00
$3.00
$2.00
$1.00
$0.00
Volume (000 mmBtu)
Midpoint $/mmBtu



Data Source for Charts: *Natural Gas Daily*

Committee Members | Subcommittees | Hearings | Key Legislation | Jurisdiction
Press Statements | Current Issues | Video of Select Hearings | Sites of Interest