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Book Review

Second-Generation Reforms in Infrastructure Services.

Patrick González

This book contains a dozen papers, most of them previously published as working papers at the Inter-America Development Bank (IADB). The title calls for "second-generation" reforms but the main thread is an assessment of the first-generation reforms that have transformed the regulated industries (electricity, gas, communications, transportations, potable water and sewerage) first in Chile at the beginning of the eighties and then in the other Latin American countries.

The authors have inside knowledge about regulated industries in South America and this alone makes the book a good read for anybody who wants a detailed account of the deregulation experience in these countries. There will be though, I suspect, asymmetric information between the average reader and the editors with respect to the affiliation of the authors. None is given and this editorial blunder is annoying because who you are generally has something to do with what you say. Although the names of Ordover, Willig or Laffont will be familiar to most economists, few will realize that Juan A. Legisa, who writes about *Settlement of Disputes in the Power Sector in Argentina* and states that *the regulator's reactions ... have received wide approval* is really talking about himself since he has been the chief director of Argentina's main regulating body since 1997 ; or that Daniel Artana, Fernando Navajas and Santiago Urbiztondo who write about *The Regulation and Contractual Adaptation of Public Utilities in Argentina* and highlight *"imperfections" of institutional design* and *deficiencies in the privatization process* make a living out of correcting these flaws by providing regulation courses in a private institute that they founded.

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The book is divided into three parts. The first part, *Post-Privatization Disputes and Renegotiations,* provides case studies about various litigations in Argentina, Chile and Colombia written by Latin American scholars. The second part, *Promoting Competition in the Provision of Public Services: Access Arrangements to Network Industries* contains papers by Ordover and Willig (*Practical Rules for Pricing Access in Telecommunications*) and by Laffont (*Efficient Network Access Pricing Rules for Developing and Transition Economies*) who recycle standard material on access pricing in a digestible form for their managerial intended audience. The third part, *Highlights of Second-Generation Reforms in Energy Sectors in Latin America and around the World* is written mostly by Paulina Beato and Carmen Fuente, both employed at the IADB.

A recurring theme throughout the book is that the primary motivation for privatizing the utility sector in Latin American countries was to attract foreign investment. That a decentralized system supposedly yields efficiency incentives is presented as an additional bonus that would make the change from state-own utilities or local monopoly to private (usually foreign) regulated firms all the more worthwhile.

As it turned out, the capital flow went in but, in many cases, the efficiency gains where all too rare and the instances of monopolizing malpractices all too common. The authors point deficiencies in the regulatory setting put in place to ensure the competitiveness of the industry. Problems occurred because of the inability of the government or the mandated regulatory bodies to swiftly handle complex regulatory issues, to resist capture or to enforce contracts altogether. The "second-generation" reforms will supposedly address these issues granted that the pattern of reforms will be pursued in the same direction.

Notwithstanding that popular enthusiasm with privatization has cooled down considerably and that the Argentinian peso's recent debacle has left many investors shattered, this analysis is problematic because it relies on the same cause to explain the initial problem and the drawbacks associated to its candidate solution. According to the modern theory of regulation, the various possible structures, nationalization, private regulated monopoly, competitive tendering, etc, belong to the same spectrum. Where to look for an appropriate structure on that spectrum depends on concrete factors such as the technology used and the degree of competition, and more elusive factors such as the distribution of information and the capacity of the government to generate funds and to enforce contracts. Accordingly, the case can be as strong for a more traditional approach to natural monopoly. Attempts to create and foster new markets in the generation of electricity or in the retailing of long-distance calls, aims at creating marginal efficiency gains through decentralization when it is reasonably likely that these markets will operate smoothly and won't be monopolized.

Decentralization was mandatory for these countries to draw in foreign investment. But why? Why is it that the foreign funds needed to develop the infrastructures could be channeled by the private firm through decentralization but not by government ? Why is it that the Northern countries had a choice whether to jump or not on the deregulation bandwagon while the Southern countries were compelled by financial backers like the IMDB to take the train? Arguably liberalization and privatization prevented the dissipation through redistribution of funds dedicated to the growth of infrastructures. But this explanation merely emphasizes the role of (bad) corporate governance that has plagued first-generation reforms from the start.

Now if the "second-generation reforms" are successful and the problem of governance is solved in the long run, one will be lead to reevaluate the soundness of some decentralization efforts since there *are* benefits associated with a vertically integrated industry. By considering bad governance as an ancillary problem that hampers the development of markets instead of a fundamental problem that prevents these countries from contemplating the full spectrum of potential market structures, these authors are guilty of *lâcher la proie pour l'ombre.*

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Book Review

What Went Wrong at Enron

Felipe Aguerrevere

The main purpose of this book is to explain the causes of Enron's fall to bankruptcy to a wide audience. The authors discuss the management personalities, the company culture, the use of special purpose entities (SPEs) and the inconsistencies in business strategies that ultimately led to Enron's debacle.

The Star Wars theme discussed in the preface gives a good context to the full story. Enron created a variety of SPEs not only to disguise its true financial condition, but also to channel wealth to a small group of its executives. These SPEs were not like the financing vehicles widely used by corporations. The example of movie studios that need to borrow money for making and distributing their films is used to illustrate how SPEs work. In essence, an SPE is a separate company whose only purpose is to borrow money for few months to get films into theatres. The loan is paid off from the box office receipts from the movie.

Chapter 1 describes the origins of Enron and introduces Ken Lay and his business philosophy. He believed fervently in the power of free markets and this was the idea that fueled Enron.

Chapter 2 presents an early case of hidden losses at Enron. In 1987 Enron Oil lost a lot of money betting on the future price of oil. Enron management apparently enlisted their accountants to cover up the true amount of these losses. This chapter also explains and illustrates with examples the concepts of mark-to-market accounting and securitization.

Chapter 3 Introduces Jeffrey Skilling and Enron Gas Services (EGS). After the natural gas market was deregulated in the United States, prices, which had been

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relatively fixed when the market was regulated, fluctuated wildly. It became desirable for consumers of natural gas to purchase gas ahead of time at predetermined price for future delivery. Producers were also willing to enter into long-term contracts that fixed the price of natural gas rather than be at the mercy of the daily price fluctuations. Skilling sensed a market opportunity. His vision was to create a "gas bank" that would serve as an intermediary between buyers and sellers, allowing both to shed their unwanted risks. The following quote from the book summarizes the success of EGS. "Much of Enron's reputation as a world-class innovator comes from the creation of the gas bank and Enron's later efforts to duplicate that success in related markets, most notably electric power." This chapter also explains how Enron used an accounting process known as mark-to-model to value its natural gas contracts and the incentives to manipulate the models used to its advantage. It is worth noting that Enron first got into the SPE business in connection with its gas bank.

Chapter 4 describes Enron's corporate culture and shows how the methods used in evaluating its employees created an environment where most were afraid to express their opinions or to question unethical and potentially illegal business practices. This chapter also introduces former Enron CFO Andrew Fastow.

Chapter 5 explains the two conflicting strategies at Enron. Jeffrey Skilling's "asset lite" strategy consisted in making profits by creating markets in as many goods as possible using the success of EGS as its model. This required that Enron had the creditworthiness to do business with counterparties in the financial market. However, the other strategy, to invest in large-scale assets in energy and telecommunications, required that Enron assume more debt to finance these investments. A large debt made Enron a poor choice for a trading counterparty by financial market standards.

Chapter 6 presents the evolution of EnronOnline, which made the trading of commodity contracts as easy as point and click. It displayed, side by side, buy and sell prices for different products. Enron was the counterparty to all transactions. Enron ended up making markets in 1,800 different commodities and contracts. Enron's expansion showed a tendency to enter markets in which it had little expertise. This placed Enron at the mercy of more knowledgeable insiders.

Chapter 7 describes the problems that Enron faced in building the market for broadband communications. Unlike other markets that it had created before, where little initial competition gave rise to significant profits in the beginning, in the market for broadband, Enron not only faced competition from several other energy companies who wished to cash in on the internet mania, but also from the big telecom companies that were getting financing from the same banks that funded Enron. In the end Enron's broadband adventure ended up being, like the title of the chapter, a costly mistake.

Chapter 8 explains the problems that Enron had with its international expansion, in particular, water companies in Britain and Argentina and electric power in India. The chapter also presents Rebecca Mark and the conflicts between her strategy of accumulation of hard assets and Skilling's asset-lite strategy. In the end Skilling triumphed and was named CEO. The chapter ends with a quote by Professor Harold Bierman of Cornell University that summarizes how, in many cases, Enron would do deals for the sake of doing them, but without doing the homework necessary to ensure their success. "It is not clear how buying a water company enables a corporation to trade water contracts on a worldwide basis."

Chapter 9 presents disclosure problems that led to the restating of Enron's financial results in October of 2001 to reflect the deteriorating conditions of many of its businesses, especially the broadband communication business. The chapter also highlights the events leading to Skilling's resignation in August of 2001 and the failed attempt to be acquired by rival Dynegy. After the Dynegy deal fell apart, Enron filed for Chapter 11 protection from its creditors on December 2, 2001.

Chapter 10 presents several key post-bankruptcy events. It starts with the letter that Sherron Watkins anonymously sent to Ken Lay in August of 2001 warning him about potential accounting scandals. Then it goes into the role of Arthur Andersen in Enron's accounting problems, the Congressional investigations and the Powers report, which provides an inside look at how Enron's SPEs worked.

The book, like Enron, ends with Chapter 11.

I enjoyed reading this book, and I recommend it to those who are looking for a concise account of the events that led to the fall of Enron. For those that have been following the news in the past months the book can be valuable as an outline of the Enron saga. I found the examples used to illustrate terminology such as SPEs, mark-to-market, sham trading, securitization and commodity swaps, very useful in providing a basic understanding of concepts that appear complicated to explain to the average person.

What Went Wrong at Enron
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