

**Testimony of California Public Utilities Commission President Loretta M. Lynch  
Before the U.S. Senate Commerce, Science & Transportation Committee  
March 15, 2002**

Mr. Chairman, Senators, thank you for the opportunity to discuss the Enron memos and what must be done to stop the further plundering of the California economy. Thirteen months ago I testified before Mr. Burton's House Committee on Government Reform in April 2001. I said at that time in my prepared testimony:

FERC's failure to enforce the law – to require that wholesale electric rates be just and reasonable – has created an untenable situation. California faces an unbounded wholesale price risk and a dysfunctional market, characterized by pervasive market power of the sellers to demand and receive unconscionable prices and profits. Under these circumstances, no one – not the utilities, not the banks, not the state, not the ratepayers – will accept and fund an unlimited risk. California is literally being plundered, with the full knowledge and consent of the FERC.

It took FERC another two months to impose west-wide market controls and returned to California to a semblance of normalcy with its June 19, 2001 order, an order that FERC announced will expire in just over four months on September 30, 2002. Senators, we are all at the beginning of understanding what really happened in California. You cannot permit FERC to let these basic consumer protections expire until a comprehensive scheme of enforcement of the just and reasonable electricity pricing requirements has not only been established but has also been proven to work.

With the publication of the Enron memos, none of us can hide from a basic truth: the California energy crisis has never been about supply or demand or any other set of economic fundamentals. It has been about a complete lack of appropriate enforcement, and lax or nonexistent federal regulation. The Enron memos describe some of the means by which California was plundered. It is now past time to assess how devastating FERC's failure to enforce the law has been to California's economy and to California's families.

We now know that the regime of so-called "market-based rates" approved by FERC has been simply a way of permitting sellers to avoid the just and reasonable price requirements of the Federal Power Act. By refusing to state their prices in advance through a public filing at FERC, sellers are placed in a position to commit deception or fraud. The Enron memos are a catalog of the misrepresentations that may be used to defeat the just and reasonable legal requirement – misrepresent load, misrepresent powerplant deliveries, misrepresent power destinations, misrepresent transmission line loadings.

The new disclosures about the prevalence of "round-trip" trading among the affiliates of a handful of huge energy merchants in order to create false impressions of large volumes and high prices that drive indices are additional evidence that the market-based rate regime extracts unconscionable prices from California's consumers far in excess of what the just and reasonable

standard would permit.

The sellers protest that they were merely following the rules. That lie can now be put to rest. The Enron memos demonstrate that the FERC-enforced ISO tariffs were broken, as loosely as those tariffs were written; that the scofflaws were pursuing “trading strategies” designed to defeat the just and reasonable standard as a matter of corporate policy. Laws were bent, to be certain. But laws were also broken, as slides 1-4 show.

### **FERC’s Failure to Investigate or Act**

These practices are not news to FERC. FERC was warned that these kinds of practices were occurring. California has been complaining to the FERC about just these kinds of behaviors, since at least September 2000. Governor Davis and I and key California legislative leaders called on FERC to investigate these kinds of behaviors as early as August and September of 2000 and the CPUC offered to partner with FERC in the investigation. FERC never responded. California has been complaining to both the Clinton and the Bush Administration FERC for over 20 months now about the kinds of practices detailed in the Enron memos to no avail. Slide 5 details FERC’s inaction. The CPUC offered on numerous occasions in the Summer and Fall of 2000 to cooperate with the FERC staff in pursuing the investigation that led to the December 15, 2000 order. We were rebuffed. Indeed, subpoenas that we asked FERC to enforce in November 2000 are still unenforced. Our offers to

the new FERC to jointly investigate California's market failures and seller behaviors have similarly not been accepted.

In order to maximize the value of these strategies to the sellers, price caps had to be eliminated without change to any other structural element of grid management, which FERC did on December 8, 2000. FERC took this, and its subsequent action on December 15, 2000, on the basis of explicit findings that the types of misrepresentations and malfeasance described in the memos were not taking place. Either the FERC was misled by seller interests in the course of its investigation or it deliberately ignored without comment evidence in its possession that illegal acts were possibly taking place. Enron did do its best to mislead the FERC in its filings during this period, as slides 6 and 7 demonstrate.

Instead of joining with California to get to the bottom of the market manipulation and fix the loose or nonexistent market rules, FERC has done its best to put off in depth investigations, refused to work with the state on investigating these problems jointly and by manipulating their own administrative processes, has refused to allow California to present its case to a neutral judge in a federal court.

### **FERC Fights Judicial Review of its California Orders**

The attached timeline in slide 8 shows how it is that 18 months and many billions of dollars after FERC first decided the issues, California is still

not able to obtain judicial review. Slide 8 is just one example of how California has been stymied in its efforts to challenge FERC's decisions that caused the California energy market to careen out of control. FERC began relaxing what little price cap controls California had in place with the publication of its draft ruling November 1, 2000. California immediately protested by objecting and filing administrative briefs in front of FERC as we were required to do.

To date, that draft ruling, the December 8<sup>th</sup> emergency action and FERC's December 15<sup>th</sup> complete elimination of price caps continue to be stuck in FERC. See Slide 9. FERC has opposed California's attempts to get California's complaints about FERC's lack of process, lack of evidence supporting the elimination of price caps and lack of evidence demonstrating that FERC's lax regulations would prevent market power and gaming in front of any federal court through arcane procedural moves that use the FERC's rehearing process to defeat federal court jurisdiction.

Given this record of delay, Congress needs to ensure that the courts enforce the Federal Power Act's existing provision which provides that if FERC has not acted on a petition for rehearing within 30 days, it is deemed denied and the parties may proceed to the appellate court. FERC currently evades this provision by issuing non substantive "tolling" orders, hindering judicial review.

## **The Effects of FERC's Failure to Enforce - A Market Unbounded**

It is critical to set the lack of FERC action in Fall 2000 and 2001 against the broader context of what was occurring in the CA market. Slide 10 compares natural gas prices nationally against those in CA. As is demonstrated, CA natural gas prices spiked to over eight times the price of natural gas nationally. The chart also shows California's attempts to stop the manipulation. Within a month after I was appointed President of the CA Commission the CPUC filed an action against El Paso and its subsidiaries for illegally manipulating California's natural gas markets. We knew then that El Paso had perfected using its affiliates and its market power to illegally create artificial shortages and to drive up the price of natural gas. FERC refused even to grant CA a hearing to present its evidence for over a year after the filing date – and throughout the huge run-up in natural gas prices during the winter of 2000-01.

But the natural gas facts turn much more sinister when overlaid against what was happening at FERC concerning electricity regulation. The sellers had been complaining for months by November 2000 that rising natural gas prices meant that the price caps would not allow them to function profitably. FERC took those assertions at face value. Natural gas prices spiked just before CA ISO Executive Director Terry Winter ran to the FERC on December 8<sup>th</sup>, 2000 claiming that CA's price caps must be eliminated.

FERC relied on what we now know to be false shortages in early December, 2000, shortages Enron admits in its December 6<sup>th</sup> memo having partially caused, and on high natural gas prices, prices about which FERC had California's complaint on which it was sitting, to justify blowing out the only protection CA had against the gouging that was occurring. The Enron memos show us exactly why FERC's enabling actions were so devastating.

FERC failed to investigate in the early fall, failed to allow CA to present its evidence of natural gas manipulation, failed to accept CA's offers to work together; failed to enforce the CPUC's subpoenas for basic information from the sellers and their scheduling coordinator representatives, but saw fit in four hours to remove the price caps. And FERC continues to this day to fight California's efforts to challenge their actions in a neutral venue – a federal court.

Chart 12 shows what happened to wholesale electricity prices when FERC removed the price caps. California's prices spun out of control, quadrupling in a matter of days, and the utilities, which were bleeding up until that time, began to hemorrhage rapidly. California again and again called upon FERC to act. We at the PUC swung into action and began emergency rate relief proceedings the next week, culminating in a multi-billion dollar retail price increase on January 4<sup>th</sup>, 2001, within a month of FERC's elimination of wholesale prices.

## **Enron and the Sellers' Ability to Manipulate the Market to Influence Governmental Decisions**

Emboldened by FERC's inaction, the sellers increased their audacious practices. The week after the PUC instituted emergency retail price increases, as prices rose and supplies tightened, stage two emergencies were called in CA on January 9<sup>th</sup>, 10<sup>th</sup> and 11<sup>th</sup>, although peak demand on those days only reached normal low mid-winter levels. Meetings occurred in Washington D.C. on January 9<sup>th</sup> and 10<sup>th</sup> with California elected officials, energy officials, sellers and Clinton Administration officials at which no agreement was reached.

Another round of meetings was called, this time for Los Angeles. On Saturday, January 13<sup>th</sup>, 2001 we gathered in Governor Davis' offices to discuss the CA electricity crisis further. At that meeting, as the sellers pushed Governor Davis and legislative leaders to guarantee payment for power at any price and pushed to change CA law, my contemporaneous notes of that meeting reflect Ken Lay, CEO of Enron stating the following: "if there is NOT a plan that is resolved this weekend, the supplies will dry up. You saw that last Thursday." Keith Bailey, CEO of Williams followed: "If we don't have a deal/public statement re: the law." Lay was referencing the Stage Two power emergencies CA had just experienced.

Later in that meeting, as Lay pressed for legislative changes, he stated: "It gets more & more difficult every day starting Monday morning until the

comprehensive solution happens & is shown.” And lo and behold, that is exactly what happened. Slide 13 graphically depicts what was occurring during these key meetings and during key governmental decisions. That next week, as the CA Legislature debated whether to change California law to allow the State to step in and buy outrageously-priced power for the utilities, California experienced Stage Three emergencies on Tuesday, January 16<sup>th</sup>, necessitating turning off interruptible customers and water project power; CA experienced a **blackout** of power on Wednesday January 17<sup>th</sup>, in hindsight as “motivation” for the CA elected officials to do what the sellers demanded. An emergency purchasing bill, SB 7x, was introduced on Thursday January 18<sup>th</sup> as CA experienced its second January blackout, back to back with the first. Within 48 hours after introduction, that bill was passed and signed, prompted in no small part by the back to back blackouts occurring during deliberations about this change in law.

The rest of that week, on January 19<sup>th</sup> through the 21<sup>st</sup>, CA experienced Stage Three emergencies and had to drop nonfirm electric load as the state began purchasing power at the exorbitant rates demanded by the sellers.

In retrospect and with the admissions in the Enron memos it is obvious that the sellers could and did hold CA hostage to their demands. Thus, the state’s intervention into the power buying business was forged by a crisis of the sellers’ own making. And FERC was nowhere to help.

During this time, FERC was busily granting market price authority for scores of the major power sellers, however. Slides 14-15 detail all the applications and reapplications for market-based pricing authority that FERC has granted since the December Enron memos were written. Those memos alone show the market was broken, that illegal and unethical market power abounded. FERC should have determined, on the basis of sound evidence, that the market was truly competitive – namely that it worked without gaming – before it granted any market based authority. Additional applications for market based pricing authority are still pending at FERC. In the face of the pervasive unethical and illegal behavior, admitted by Enron, FERC should revoke all market-based pricing authority and should grant no further market based pricing authority until it can assure this Congress and this nation that the market works to provide California with just and reasonable wholesale electricity rates as required by federal law.

### **Summary of Needed Action**

FERC must assure this Congress and this nation that it can perform its job and get to the bottom of this pervasive fraud. Until it completes a thorough investigation, in which the evidence it obtains is open to the state of California and to the public, Congress should ensure that the following protections are taken (slide 16):

- The regime of market based rates as it presently functions at FERC must be fundamentally overhauled,
- West-wide market price caps, “must-offer” orders and anti-Enron pricing protections

- (collectively often called “market mitigation measures”) must remain in place so that creative minds cannot find new forms of manipulation for taking the money of California businesses and families.
- FERC should be required to finalize its orders so that CA can finally have its day in court and Congress should require the courts to enforce the “deemed denied” provision to FERC’s rehearing process;
  - FERC must revoke the market based pricing authority that rests on false and fraudulent assumptions of competitive markets that simply do not exist in California.
  - FERC must give Californians their money back – both for past market manipulation in 2000 and 2001 and for future excessive long term contract prices paid because California was forced to negotiate long term contracts at excessive prices just in order to keep the lights on last year.
  - In those FERC refund proceedings, CA should have access to all the data and documents FERC obtains in its investigation into the sellers’ activities.

Thank you for your courtesy.