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Statement of Wenonah Hauter
Before the U.S. Senate Subcommittee on Consumer Affairs, Foreign Commerce and Tourism of the Senate Committee on Commerce, Science and Transportation

Hearing on the role of Enron Corp. in manipulating electricity supplies and prices in the Western electricity market
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Good morning. Mr. Chairman and Members of the committee, my name is Wenonah Hauter. I am Director of Public Citizen's Critical Mass Energy & Environment Program. Public Citizen is a national consumer rights organization founded in 1971. As Director of the energy program since 1997, I have spearheaded Public Citizen's investigations into the problems and abuses of electricity deregulation. Due to Enron's early, active and prominent role pushing for deregulation, the company became a focus of our research.

Deregulation not only allowed Enron to become one of the most powerful corporations in the world, but it also directly led to the company's downfall. Deregulation of both energy markets and commodity trading allowed Enron to escape price regulations—a key factor in the company's meteoric, 1,750 percent increase in revenues over the past decade. Enron could not attribute its brief success, therefore, to such traditional models as incorporating innovations to improve the delivery of product at competitive prices. Rather, Enron's business model was built entirely on the premise that it could make more money speculating on electricity contracts than it could by actually producing electricity at a power plant. Central to Enron's strategy of turning electricity into a speculative commodity was removing government oversight of its trading practices and exploiting market deficiencies to allow it to manipulate prices and supply. So when FERC finally fully re-regulated the California market in June 2001, Enron's business model was soon invalid and the company bankrupt.

Enron spearheaded electricity deregulation, lobbying heavily for the transmission wheeling provisions of the Energy Policy Act of 1992 that allowed the company to gain a foothold into the wholesale market by registering as a power marketer. Weeks later, Enron embarked on its strategy to transform itself from an energy producer to an energy trader when it was the first company to petition Wendy Gramm's Commodity Futures Trading Commission asking that agency to not regulate energy trading contracts (five weeks after granting Enron the exemption in January 1993, Wendy Gramm joined the company's board at the request of Ken Lay). Enron was the first power marketer, on January 5, 1994, that the Securities and Exchange Commission exempted from the Public Utilities Holding Company Act. Enron successfully lobbied for the continued deregulation of over-the-counter energy derivatives trading when long-time Enron supporter Senator Phil Gramm helped muscle the act into law (and Gramm leads current efforts to oppose re-regulation of derivatives trading). In between, Enron spent millions of dollars influencing deregulation plans on the state level—most notably in California.

But before FERC enacted the price controls which saved California but suffocated Enron's revenue stream, the company had inflicted severe damage on west coast consumers by manipulating supplies to drive prices up. How did they do this in California, even though the company never owned any power plants in the state?

Aided by deregulation of both electricity and derivatives, Enron was able to command significant market share simply by coordinating its purchases of large volumes of short-term future electricity contracts with spot control over key transmission capacity and natural gas supplies. Because Enron was entering into these electricity and natural gas contracts in the recently deregulated over-the-counter market, Enron was in a strong position to engage in trade-based manipulation by controlling a significant chunk of the market, thereby enabling the company to predict and set short-term and spot energy prices for the Western electricity market.

While Enron played a significant role in helping to manipulate supplies and prices in California, it is important to note that the company was not alone. Indeed, the Federal Energy Regulatory Commission (FERC) has already levied fines and ordered refunds on several occasions totaling tens of millions of dollars to be paid by other energy companies, such as Dynegy, Williams, Reliant and Mirant, for their role in manipulating prices in California. More fines and investigations by FERC are forthcoming, as are separate state lawsuits. FERC has not yet issued a refund order to Enron, although one is likely imminent. But Enron's exact role in manipulating prices in California has been harder to track due to its business structure that was far more opaque than other energy firms. In contrast to other energy companies, Enron did not own any power plants or other physical infrastructure, leaving only a complex web of thousands of trades with multiple partners—including significant trading between Enron subsidiaries—leaving practically no trail for investigators to follow.

Enron worked this way in California: the company would negotiate with an owner of a power plant to purchase the electricity generated from the facility at a guaranteed price at a time very near in the future (usually the next day). Traditionally, a company's electricity market share has been measured by the number of power plants the company owns in a given market (that's why Southern California Edison, PG&E and San Diego Gas & Electric sold most of their power plants—so the utilities would not still control the wholesale market under deregulation). But power marketers represent a huge loophole: they have been free to negotiate as many wholesale energy contracts as they wish with little to no government oversight. So Enron was able to escape scrutiny and purchase enough electricity contracts in the day ahead and spot market to secure significant enough market share, where the company was in a strong position to set prices. Indeed, before the energy crisis hit the state in May 2000, Enron paid a $25,000 fine to the now-defunct California Power Exchange in May 1998 for the company's early attempts at manipulating the day-ahead wholesale electricity market. But after that, either government regulators were no longer interested in holding energy firms accountable or Enron became more sophisticated in its ability to manipulate markets, because FERC failed to intervene until it was too late.

From the scant information Enron makes available in its disclosure forms to the Securities and Exchange Commission, the Derivatives Study Center calculates that Enron claimed a $500 billion electricity and natural gas derivatives business in the months before the company declared

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bankruptcy. Of course, among the many reasons the company was forced into bankruptcy was that its executives played aggressive accounting games, utilizing so-called "mark-to-market" bookkeeping, where Enron booked much of the revenue for long-term contracts up front— providing the company with inflated revenues.

Therefore, additional documentation is necessary to shed some light into how the company played a role in controlling supply and prices of energy in the California market. The only detailed publicly available information is contained in *Power Marketer Quarterly Reports* that Enron and other power marketers file four times a year with FERC. These disclosure forms are intended to force regulation-shy power marketers to disclose the volume and price of their trades, along with whom the trades are conducted.

But in reality, FERC does a miserable job of enforcing its disclosure requirements, as the Power Marketer Quarterly Reports are a poor excuse for government oversight. FERC allows power marketers to exclude so many crucial details about these trades that the porous disclosure forms raise more questions than they answer. Nonetheless, these disclosure forms provide enough of a window on Enron's operations to highlight significant problems.

The documents indicate that Enron's western trading operations focused entirely on the California market. This contradicts multiple public statements the company made during the California energy crisis, when company representatives argued that Enron's California operations were minimal.

Enron was making 100 percent of its west coast trades at four delivery points: COB (California-Oregon border); Path 15 (northern California); Palo Verde (California-Nevada border); and ZP26 (central California, near Bakersfield). According to many different reports, Enron was engaged in a certain amount of transmission capacity manipulation at all of these points at key times during the California energy crisis. The Nevada Public Utilities Commission has been investigating allegations that Enron was gaming the daily capacity auctions at the Palo Verde delivery point. And although Enron only had limited firm transmission rights over COB, Path 15 and ZP26, trading insiders allege that Enron was able to manipulate capacity enough to leverage its wholesale energy trading activities. By utilizing their dominance over the Palo Verde capacity (connecting CA to Nevada) with complicated spot clogging of capacity at ZP26 and Path 15, Enron's power marketing subsidiaries were better able to utilize its day ahead positions to charge inflated prices.

Enron had four registered power marketing divisions: Enron Power Marketing, Enron Energy Marketing Corp, The New Power Co, and Enron Energy Services. All were engaged in heavy trading all across the country. Because of FERC's poor regulatory requirements, however, Enron was able to hide significant details. For example, the *Quarterly Reports* for Enron Power Marketing are unintelligible; the division lumps trades conducted in every region of the country, so it is impossible to isolate their California trading operations from their New York trades.

But disclosure forms submitted by Enron Energy Services provide region-specific data that is alarming. This division, headed by President Bush's Secretary of the Army Thomas White until May 2001, was better known for its high profile retail contracts with such clients as Kaiser Permanente, Saks, Quaker Oats, JC Penny, Owens-Illinois, and U.S. Army installations. But Enron Energy Services controlled as much as 25 percent of the California wholesale market by trading electricity contracts. In the first three months of 2001—at the height of skyrocketing prices and rolling blackouts—White's division traded more than 11 million megawatts of electricity in the California market alone, making nearly 98 percent of these trades with other Enron divisions at astronomical prices—up to $2,500 a megawatt hour (the standard price at the time was less than $340 a megawatt hour). By selling power to itself at inflated prices, Enron helped skyrocket prices in California's deregulated market. Economists refer to this manipulation as *transfer pricing*.

By trading such large volumes of electricity at such high prices, White's division was able to accomplish two goals. First, trading electricity at high prices with other Enron divisions allowed the company to charge California utilities and consumers astronomical prices, thereby contributing to the Western electricity crisis. Federal and state regulators found it very difficult to trace Enron's trades, since the company had four separate divisions interacting in the wholesale and retail markets, and *with each other*. Second, engaging in transfer pricing allowed these various Enron divisions to overstate revenue and contribute to the accounting gimmickry that inflated the company's share price.

These prices were far above what other power marketers were charging at the time, and far above what Enron had been charging prior to May 2000 (when the crisis began). It is important to note that at the same time that White's Enron Energy Services division was manipulating the California energy market by charging inflated prices, Enron paid the D.C. lobbying firm Quinn Gillespie more than half a million dollars in the first 7 months of 2001 to lobby the "Executive Office of the President" on the "California electric crisis" according to the lobbying disclosure report filed with Congress on April 10, 2001. Ed Gillespie, former communications director at the RNC, was a top Bush campaign advisor and ran the U.S. Department of Commerce for the first 30 days of the Bush presidency. Enron was lobbying *against* bi-partisan efforts to re-regulate the Western electricity market by imposing price controls. And just as Enron was spending this money lobbying Congress and the White House against price controls, the Bush Administration aggressively took Enron's position. On numerous occasions, President Bush, Vice-President Cheney, their various spokespeople and cabinet officials took an aggressive stance against price controls.

At a minimum, Congress must mandate the Federal Energy Regulatory Commission to immediately investigate regulations of power marketers. Clearly, the current level of transparency allows companies to manipulate wholesale markets. If it were not for FERC's continued regulation of the Western electricity market, other power marketing firms would have incentive to pick up where Enron left off. Public Citizen urges Congress to make it clear to FERC that more scrutiny of power marketers must occur. In the meantime, it would be prudent for FERC to revoke market-based rate authority for all power marketers until a thorough investigation is concluded.