Testimony of Loretta Lynch
President of the California Public Utilities Commission
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Thank you for the opportunity to testify about the effect Enron had on the California electricity and natural gas markets. Enron has become emblematic of a pervasive regulatory failure in the energy markets in the United States. In a sense it has supplanted California on the front page but, as we all understand, the failure that was the California energy market and the failure that is Enron are intimately linked. I would like to comment on the linkage from the standpoint of a state regulator and to warn the members of this panel that the forces that caused the Enron debacle are still at work and must be effectively curbed at the state and federal level if we are not to see many more failures.

It is crucial that we not view Enron as an outlier or outlaw in an otherwise working market. The economic and financial structures that enabled Enron to plunder investors and consumers and ultimately its own employees need to be dismantled, much as similar structures were dismantled by the Public Utilities Act of 1935, which included both the Federal Power Act (FPA) and the Public Utilities Holding Company Act (PUHCA). This landmark statute preserved to the greatest extent possible local authority to regulate local service. It has served us well for over sixty years, until very recently.

The utility scandals of the 1920's and early 1930's involving watered stock, out-of-control prices, shady accounting and financial and consumer abuse are being reprised today. It is time to say, "Enough is enough." The

army of lobbyists for "PUHCA reform," laissez faire electricity pricing, grid federalization and the like are essentially asking you to unleash a horde of Enrons on the consumers of America. I respectfully suggest that we learn from history and the gaming and gouging that took place in the teens and twenties when I say, "Don't go there."

Consumers expect that utility service and costs will be stable and reasonable. Federal law requires that wholesale electricity prices be just and reasonable. Enron and its emulators want instability and high prices. The California experience suggests that the Enron approach is bad economics and bad policy.

Traditional regulation as practiced since the New Deal has depended on three interrelated concepts:

- Cost transparency
- Financial transparency, and
- Maintaining an appropriate nexus (a just and reasonable linkage) between cost and prices.

That system served consumers and legitimate long-term investors well. The only people it did not serve well were the energy speculators, like Insul and the cartels of the 1920s and Enron and its ilk at the turn of this century, seeking a fast buck. They have worked hard to undermine it.

Enron and its political allies, including, I'm sorry to say, politicians and regulators in California and at the Federal Energy Regulatory Commission, systematically dismantled the mechanisms for assuring these three pillars of traditional regulation. Enron pushed for the creation of a wholesale electricity market in California that would have no government or regulatory oversight of its activities in that market. Enron was active in shaping the deregulation of the California electric generation industry, both at the state Commission and at the State Legislature. Not surprisingly, with a legion of lobbyists at the Commission and before the Legislature and a business plan bent on taking advantage of deregulation and a bifurcated market, Enron got what it asked for in California. Enron then participated in the creation of wholesale market rules used by FERC and the California Independent System Operator further enabling their trading and gaming activities.

Enron itself has been active through a phalanx of organizations, and has facilitated activity by others. In California, Enron Corporation participated in numerous business ventures through its affiliates Enron Energy Services, Zond Wind Power, Enron Trade and Capital, Enron Oil and Gas, Portland General Electric, Transwestern Pipeline, The New Energy Company, and many more. Enron helped shape the policies of industry trade groups such as the Independent Energy Producers and Western Power Trading Forum and others. In addition, it spawned front groups such as the Alliance for Retail Markets (ARM) that purported to be coalitions of organizations but received the bulk of its funding from Enron. ARM and the Enron affiliates would both appear before the CPUC on electric restructuring matters, frequently represented by former high level PUC employees.

Enron was represented on the original board of the California Independent System Operator (ISO) directly and indirectly [] where it actively opposed price caps and other market power mitigation initiatives and – in an infamous episode – demonstrated the efficacy of "phantom congestion" in raising prices and then sought to prevent an antidote. After Enron demonstrated the tactic, others used it to manipulate prices "according to the rules."

The incremental creation and exploitation of loopholes and "opportunities" has been effective at least in part because FERC has been so slow to act to counteract them, once discovered. For example, it has long been known that a significant weakness in the ISO tariff is the practice of paying twice for an electric generation unit – once when it ramps up and again when it ramps down – that is inappropriately scheduled. The ISO has been attempting for nearly a year to change this feature of the tariff, only to be rebuffed by the FERC, who says simply that such a change is "premature." Meanwhile, Enron and others are exploiting this weakness for big dollars.

Enron actively sought business alliances with and takeovers of public and municipal entities. For example, it "partnered" with the City of Palm Springs to create direct access and "muni-lite" relationships with residential customers, only to leave the City program in the lurch when its attention wandered elsewhere. After Enron dumped its program without any appreciable downside to itself, others followed suit – as we learned to our

dismay last Spring when the California DWR had numerous "direct access" customers dumped back on it when FERC-deregulated wholesale prices were at their highest. California went from 16% of its overall electric load served by non-utility providers in October 2000 – the lion's share of which was Enron-provided – to 2% of all customers served by non-utility sources in June of 2001. Enron creamed off lucrative customers when prices were low then dumped those customers back on the utilities when natural gas and electricity prices rose so that it could sell its gas and electricity for the highest price – perhaps even back to the very same utility that was serving Enron's dumped customers!

Enron's methods were consistent in every venue it entered – it would try to make the rules – rules that it would then exploit for short-term advantage. After Enron shaped the California market to take maximum advantage of nonexistent government regulation and lax ISO rules, Enron turned its sights nationally. As we now know, Enron lobbied Congress to kill rules proposed by the Commodities Futures Trading Commission which would have provided at least some federal oversight of Enron's trading activities. Enron also obtained special status for its trading activities in December 2000 – at the same time it was reaping maximum profits in the California markets.

Enron continued its strategic manipulation of public processes to create business opportunities through the dismantling or modification of accepted approaches: you are seeing this approach in action today at the

FERC, where as we speak, the FERC staff is attempting to create opportunities for marketers to set prices and make markets in contravention of the FERC price mitigation order that makes marketers price takers. The incentives and rewards for such behavior are being described by others. I want to make you aware of its pervasiveness.

Every state has a regulatory body whose charter includes specifying the accounting procedures for utilities operating in its state. FERC for decades published a Uniform System of Accounts which has provided the template for state level accounting and disclosure procedures. FERC and every state have required annual reports by regulated entities in which detailed financial disclosures and disclosures of operating statistics, assets and liabilities and particularly categories of expenditures are disclosed to the public. **FERC has over the past few years at the urging of Enron and others diluted the reporting requirements, loosened the accounting rules and exempted large classes of energy sellers from making required disclosures.** FERC does not even require the same data to be filed in its quarterly reports, allowing companies like Enron to hide the true nature and extent of activities through skeletal public reporting and not be called to account by FERC. FERC does not require even these minimal quarterly reports in the natural gas area, making it virtually impossible either to track Enron's natural gas trades and activities or to link gas trading with electricity trades and actions. This makes the state regulator's job much more difficult,

because it virtually eliminates cost transparency for large segments of the energy supply sector.

In the case of Enron and many other energy supply companies the lack of cost transparency, prescriptive accounting rules and regular or detailed public reporting has undermined investor confidence in both traditional regulated utilities and in new cadre of speculator energy companies. Congress should require that the FERC ensure the primacy of promulgating and enforcing appropriate reporting and accounting procedures.

Related to the issue of cost transparency is financial transparency. Enron's use of complex corporate structures, affiliates, partnerships, asset and liabilities transfers among these entities has led to a further erosion of investor and consumer confidence and an ability to manipulate financial disclosures and, ultimately, cost and prices. The temporary monopoly positions that Enron's trading statistics suggest appear to have been accomplished at least in part through complex chains of self-dealing among affiliates of Enron and a few of Enron's compatriots.

In 1999, Enron created the first and largest electronic energy trading forum called Enron On-Line, becoming not just a customer in the market but a market maker – in both electricity and natural gas. With Enron On-Line Enron became by far the largest trader of energy – both electricity and natural gas. According to Gas Daily, Enron sold nearly double the amount of natural gas of any competitor. Enron On-Line reported over $330 billion

dollars worth of trades in 2000. That is more than the cost of all electricity produced in the United States.

How did Enron do this and what effect did it have on California? As an example, I will discuss just one period of time – the fourth quarter of 2000, as California's wholesale energy market spiraled out of control with the lifting of the wholesale price cap by FERC, at the instigation of Ken Lay, Jeff Skilling and the former conflicted California ISO board. What we find is that Enron's trading with its own affiliates was the major way that Enron did business and constituted a major factor contributing to the California energy crisis. In the fourth quarter of 2000, five Enron affiliates—Enron Energy Services, Inc., Enron Power Marketing, Inc., Enron Energy Marketing Corp., The New Power Co., and Portland General Electric Co.—bought and sold 10,167,782 MWh of electric power to and from each other, at prices as high as $1,100 MWh. These trades were not only among affiliated companies; the same individuals were managing all of these companies. These "trades" were actually sham transactions—Enron was selling the same MWs back and forth to itself, causing the price to rise with each "sale" – all under the rules that it had helped to create. The selling back and forth also created the illusion of an active, volatile market, appearing to the rest of the world as though massive trading occurring on Enron's online trading floor. By creating the excitement of a busy market place, they could entice other traders to come into their market (online). (What we would really like to know is how many of the trades Enron reported were actually *real* trades

with parties other than their affiliates.) Since Enron used accounting methods that let them book as revenue the value of every trade (not just the "profit"), they were able to create false value in their company with every affiliate trade. This was truly a Ponzi scheme.

The effect of these trades was to increase the wholesale price of electricity in the California market. These transactions, which Enron was engaging in with itself, caused wholesale prices to rise both because they directly influenced various price indices and because the prices reported on Enron's Internet-based trading site, EnronOnline, became the benchmark for wholesale bids into the PX and ISO.

These purchases and sales between affiliates were only possible because there was no regulation of this market; there were no rules imposed by the CFTC or the FERC to prohibit sham transactions between affiliated entities. Moreover, the CA ISO and PX had little ability and no appetite to discipline Enron in the market.

In addition to trading among themselves, a number of these affiliates were scheduling coordinators (SCs) with the ISO. SCs serve as the link between retail buyers, generators and the ISO. SCs have access to electricity market information from many sources not generally available to average investors and are in a position to manipulate the market. For example, SCs can game the market by scheduling non-firm power to cover their needs, forcing the ISO to buy reserve power in the spot market to back the SC. As

a market maker Enron also had the ability to influence the bids and costs of other Coordinators as well.

The consequences of this and similar activities by Enron's imitators – the sons of Enron – were devastating. The huge volumes of internal trades created volatility in the market from which Enron profited. Enron could create transmission congestion through meaningless trades with itself, and then get paid to eliminate that congestion or re-route electricity within California. Enron's internal trading could affect accepted market indices, thereby increasing the prices paid to generators and suppliers that are tied to those indices.

Enron could also use the rules and their internal trading to commit power that was made in California out of the state, thereby artificially creating the appearance of shortages of electricity generated in California that could only be remedied through "imports." This is a practice known as "megawatt laundering," and is a pervasive feature of the west-wide electricity market. It is the reason that mitigation measures must be West-wide. Experts have estimated that exports quadrupled from California from 1999 to 2000. Enron's moving of California-generated power out of state – through internal and other trades -- raised prices and contributed to blackouts that were in fact unnecessary. At the times of the blackouts that California experienced, there was never any physical, real world shortage of generation capacity in California.

While Enron's failed ventures and accounting practices may have brought them to financial ruin, its energy trading enterprise was exorbitantly profitable – accounting for over 90% of Enron's overall revenues in 2000. The gravy train did not stop nor did the underlying systemic problems become apparent until the FERC put a stop to it on June 19th, 2001, with its historic action that brought order, temporarily, to California's market. FERC imposed price caps that conservatively estimated costs of generating electricity in California, setting the effective price first at $92/mwh and modified it upward slightly. It set a "must-offer" order that required sellers to sell to creditworthy California buyers, reducing the ability to game prices by withholding power, although ISO management actions have reduced the effectiveness of this requirement. And it prevented those who were not generating power from setting the price throughout the market, preventing those like Enron who traded the same power over and over internally or with others solely to drive the price up by the time it was sold to the utilities, to the ISO or to the state. FERC intends to terminate these key and critical protections on September 30th unless there is a clear signal from this Congress to keep these basic, minimal boundaries on California's market until FERC can assure you and the people and businesses of California that the transgressions of Enron and others will not re-occur.

We know from bitter experience in California that more regulation is needed. Specifically, to fix this market Congress needs to ensure that:

- **Market participants should not also be market makers.**
- **Exemptions for online and electronic trading under the Commodity Futures Modernization Act of 2000 must be curtailed to improve reporting and oversight.**
- **All energy traders should be regulated as a utility subject to control by FERC.**
- **Clear, detailed transaction reporting for natural gas and electricity trades must be required and enforced on at least a quarterly basis.**
- **Statutory affiliate rules are necessary to limit the proliferation of related trading entities that skew and game the market, gouging consumers – or outlaw these trades and interrelationships outright.**
- **FERC should be directed to strengthen its role in providing accountability and disclosure of costs and finances of energy sellers.**
- **FERC must update its systems and its ability to keep up with the games. For example, the FERC database needs to be updated, streamlined and made truly accessible to regulators and the general public.**

As I conclude these remarks I am mindful that my role as a regulator doesn't end in the energy arena. Congress also has a real opportunity now to help insulate telecommunications consumers from these same types of accounting and reporting schemes executed so effectively by Enron and other energy companies. With cross-country mergers, bankruptcies, high technology affiliates and other changes rampant in the telecommunications industry, Congress and the Federal Communications Commission must ensure that the FCC strengthens uniform national reporting requirements for telecommunication companies and their affiliates about costs, profits, revenues and service quality. Instead, the FCC is leaning away from requiring such national reporting just at a time when we need more information to monitor our information infrastructure. This data is critical to the states' ability to meaningfully protect telecommunications consumers, from basic service to broadband, from the kinds of manipulation I've discussed today.

At the turn of the twenty first century, the nation needs again to strengthen its regulation of energy companies – which have morphed into even more complex entities – selling more complicated and risky products than what the nation experienced in the 1920s and 30s. Congress must keep it simple, keep it clear and keep regulation and enforcement strong – unlike the conditions California and the nation face today.