

# ENRON CORPORATION'S COLLAPSE

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HEARING  
BEFORE THE  
COMMITTEE ON  
ENERGY AND NATURAL RESOURCES  
UNITED STATES SENATE  
ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

TO RECEIVE TESTIMONY ON THE IMPACT OF THE ENRON COLLAPSE  
ON ENERGY MARKETS

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JANUARY 29, 2002



Printed for the use of the  
Committee on Energy and Natural Resources

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U.S. GOVERNMENT PRINTING OFFICE

79-753 PDF

WASHINGTON : 2002

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For sale by the Superintendent of Documents, U.S. Government Printing Office  
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800  
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# ENRON CORPORATION'S COLLAPSE

TUESDAY, JANUARY 29, 2002

U.S. SENATE,  
COMMITTEE ON ENERGY AND NATURAL RESOURCES,  
*Washington, DC.*

The committee met, pursuant to notice, at 9:30 a.m. in room SH-216, Hart Senate Office Building, Hon. Jeff Bingaman, chairman, presiding.

## OPENING STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR FROM NEW MEXICO

The CHAIRMAN. The hearing will come to order. The purpose of this hearing is to receive testimony on the impact of the Enron bankruptcy on energy markets and the interaction of Enron's activities with energy markets over a period of time. The problems of accounting misrepresentations, lost pension funds, potential tax abuses, those, of course, are the subject of other hearings which various other committees are participating in.

Irrespective of the various financial issues regarding Enron's corporate structure, the company played a significant part in the Nation's infrastructure and markets. In addition to its energy trading operations, Enron owned and operated several major interstate pipelines, including one that traversed my home State of New Mexico, and they also own the largest electric utility in the State of Oregon. The trading operations have been suspended, but the pipelines and the utility continue to operate and to provide reliable service.

Before its failure, Enron Online was the largest fiscal marketplace for energy products in the United States. I also understand Enron traded unregulated financial instruments called SWAP's, and over-the-counter instruments. The role of Enron and other energy traders in the highly volatile gas and electricity markets in California had come under increasing public and congressional scrutiny.

In 2001, the committee held four investigative hearings to evaluate the natural gas and electricity markets in California and the implications for other States in the West. In the first hearing, which we had January 31, 2001, the need for transparent markets—both with respect to pricing and capacity—was identified as one of the most pressing requirements for well-functioning electricity markets.

Enron's trading activities were different from those of a regulated exchange. Enron Online did not match buyers with sellers. It contracted with each separately, so that Enron was on the other

side of every deal. Enron provided little or no market transparency. That is, parties were not given information as to the price and volumes that were offered to others.

Market transparency is essential to efficient and competitive energy markets, both in the short term and over the long term. Over the long term, the market must signal the need for additional capacity and new fuel supplies to ensure reliable and affordable energy services. Whether adequate capacity was available or not in the West last year should have been apparent in the market before the crisis appeared. As we understand the actual events of this past fall, when Enron's financial situation became known, many parties who had been trading with Enron shifted to other fiscal markets. NYMEX, the New York Mercantile Exchange, also served as a major source of stability. In the end, it is my impression Enron's demise did not have a major impact on short-term energy markets.

The proposed energy legislation that we have introduced in the Senate as S. 1766, Senator Daschle introduced and I cosponsored the bill, tries to ensure transparency and real-time reporting of trades. The FERC has increased its oversight of individual companies. It has created a new market-monitoring function which we hope to hear about today. The States also have a critical role in ensuring adequate supply, planning, and procurements.

We look forward to hearing the testimony of the witnesses, and engaging in a thorough discussion on these issues. Senator Murkowski, why don't you go ahead with your statement.

[The prepared statements of Senators Johnson and Shelby follow:]

PREPARED STATEMENT OF HON. TIM JOHNSON, U.S. SENATOR FROM SOUTH DAKOTA

Mr. Chairman, this is an important hearing we are holding today. The demise of Enron has been well-documented and its impact is being considered in many venues, including other committees in the Senate. The scrutiny of the company is proper: Enron is a major entity of the nation's energy system and was one of the most profitable companies in the nation. The effect of Enron's fall on both its internal operations, its employees and its effect on markets needs to be examined thoroughly to determine the root of the problems and so that we can learn lessons for the future.

The Energy Committee is properly looking into the effects of this situation on the nation's energy markets. Over the last couple of years, we have seen many ups and downs in energy prices and in the wholesale energy markets, where Enron made the bulk of their profits. It seems, for the most part, that the market has responded well to the Enron's demise and picked up the slack. Fortunately, there have been no disruptions in service. But had this occurred last year when there were rolling blackouts in California and when there was poor weather, the effect could have been catastrophic.

The market also responded partially because many of Enron's contracts were above current market prices, which its competitors were rightly eager to pick up. Had the contracts been below market prices, there could have been greater disruption in the system. In addition, many other generators and trading entities, while still profitable, have seen their stock prices drop since the Enron demise. This may make it more difficult for the market to adjust to changes in the future.

I do not believe that Enron should be blamed for every issue that arises or is now present in the energy field and many of the problems with Enron are largely because of its improper accounting and financing practices rather than its trading operations. But because Enron was the largest operator in a somewhat volatile area, we need to examine closely the role of the energy trading markets and how they effect energy service. Having a robust market is good for the nation. But it is largely unregulated, at least when compared to other trading markets. I am not prepared

to say at this juncture that any changes are needed to the system but it is clear that we must take a closer look.

Moreover, it is also clear that Enron's role in the energy legislation needs to be examined. In particular, it is my hope that the Vice President and his task force will be more amenable to turning over information about the meetings that occurred and the process that led up to the issuing of its report. Reforming our energy system is an important matter and we must do so in an open manner as this committee has done in holding dozens of hearings on energy legislation. Every citizen of the nation is affected by energy services and it is important for the Administration to be as open as possible in addressing these concerns.

Thank you, Mr. Chairman, and I look forward to the testimony of the witnesses.

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PREPARED STATEMENT OF HON. RICHARD SHELBY, U.S. SENATOR FROM ALABAMA

Thank you Mr. Chairman for calling this hearing today and I wanted to thank our witnesses for being here to offer their perspective into the collapse of Enron.

Mr. Chairman, the collapse of Enron offers a very interesting story for all of those willing to invest the time and energy to investigate. I believe that the story is just beginning to unfold and in the weeks to come we will learn even more about the rise and fall of this energy giant. It is certainly unnerving to hear of the significant losses that were encountered by hundreds of Enron's stockholders and company employees. But the bright spot in all of this, as I believe we will hear today, is that our energy markets and energy consumers came out of this relatively unscathed.

Experience has taught us that we should not judge before all of the facts are before us. It is my hope that we do not pre-judge this event and rush to take legislative action before we know all of the facts. Enron received a number of exemptions to certain important laws. It is also becoming very apparent that Enron's business and accounting practices were not above board—they were not honest, they were not forthright, and most importantly they were not transparent. I believe that we must wait for all of the facts to come to light and the investigations to be completed before we begin to make legislative recommendations, if any, about the appropriate course of action to prevent another "Enron debacle".

Today's hearing is intended to focus on the impact of Enron's collapse on energy markets, but the witnesses were also asked to consider existing statutory authorities and changes proposed by S. 1766, including the repeal of the Public Utilities Holding Company Act (PUHCA). After reviewing the testimony of our witnesses, it appears that many of you have some interesting thoughts on repeal and/or reform of PUHCA and I am anxious to discuss that in more detail with each of you.

Mr. Chairman, it is no secret that I am a strong advocate of reforming the Public Utilities Holding Company Act. In my opinion, the law is antiquated, duplicative, and has outlived its usefulness. I believe, and the Securities and Exchange Commission (SEC) has suggested, that since PUHCA's inception, a comprehensive system of investor protections has been developed that obviates the need for many of the specialized provisions included in PUHCA.

Over the years, as the restructuring debate has evolved, utilities and the SEC have called for reform or repeal of PUHCA, asserting that PUHCA has achieved what it was designed to do and that in the current evolving energy marketplace, PUHCA discourages competition. In 1982 the SEC recommended to Congress that PUHCA be repealed. In a 1995 study of the regulation of public utility holding companies, the SEC called for a conditional repeal of PUHCA. And in recent testimony before the House Committee on Financial Services, Isaac C. Hunt, Jr., Commissioner of the U.S. Securities & Exchange Commission stated, ". . . because much of the regulation required by PUHCA is either duplicative of that done by other regulators or unnecessary in the current environment, the SEC continues to support repeal of PUHCA. As the SEC has testified in the past, however, we continue to believe that repeal should be accomplished in a manner that eliminates duplicative regulation while also preserving important protections for consumers of utility companies in multistate holding company systems."

Mr. Chairman, as I mentioned at the beginning of my statement, I think that it would be misguided for us to walk away from today's hearing believing that we have all of the answers. As the investigation into Enron's activities progresses and as more and more government regulators are called upon to testify in various committees of jurisdiction, I believe that a complete picture will emerge. The Securities and Exchange Commission and the Department of Justice are currently investigating Enron's collapse to determine if there were violations of existing laws. I think we should begin to make recommendations and changes to guarantee the stability and

transparency of our energy marketplace after the investigations give us a clear picture of what happened.

**STATEMENT OF HON. FRANK H. MURKOWSKI, U.S. SENATOR  
FROM ALASKA**

Senator MURKOWSKI. Thank you very much. Good morning, and let me wish all the members a belated Happy New Year.

I think it is fair to say that Enron's collapse appears to be a story of lies, deceit, shoddy accounting, corporate misconduct, cover-up, etc.

Unfortunately, Enron's employees and stockholders have been devastated by this action. We have seen a thousand people unemployed, billions lost, retirement funds wiped out. Therefore, we cannot forget that this is a business failure, not an energy market failure. I think it is important to reflect on that, because I think it is accurate. Today's hearing can be useful if we explore the impact of Enron's collapse on energy markets, on price and supply, as the title suggests. However, if the hearing is used to set the stage to speak about the need for additional Government regulations of the energy market, then we will not have a very productive hearing.

A number of committees are holding hearings on accounting. You have heard from the chairman indicating that a number of other committees are meeting as well. Commodity regulations, these are not matters of our jurisdiction or expertise.

I will focus on the subject of this hearing, the impact of Enron's collapse, and its collapse on energy markets. It is clear that energy markets are working well, despite Enron's failure. Enron was responsible for about one-quarter of the wholesale electric and natural gas markets in this country, but notwithstanding Enron's dominant position in the market. Its bankruptcy had little impact on energy markets or on price and supply. We saw that the lights stayed on and retail electric prices did not spike. Gas furnaces did not go out. Why? I think the answer is simple. Deregulated markets work. When market forces are allowed to work, when government does not micromanage the marketplace, markets match supply and demand.

Take a look at this chart. When Enron failed competing companies swooped in and immediately filled the Enron void. Consequently, no shortage or price spikes were seen, which this chart points out. You can see that the big price spike was associated with California activity, but there were no significant trends, as evident in the chart. Enron's collapse did not have any significant impact on natural gas either.

There was an effect on the stock prices of other energy companies, and certainly a chill on generation. This investment was primarily the result of concerns about credit quality and exposure to deals with Enron.

Now, compare Enron's collapse with what happened in California last summer. California is a poster child, an example of how government command and control prevents markets from working. Thus, creating shortages and price spikes. California tried to micromanage the marketplace, capped retail prices, forced divestiture of generation, required all power purchase from the stock market, prohibited utilities using long-term contracts, and made new con-

struction virtually impossible. They spent billions of taxpayer's money to pick up the pieces after they broke the market.

The results we now know. Last year, the slightest twitch in the California power market, such as; hot weather, and powerplants needing maintenance, created black-outs or price spikes. My point is, government micromanagement of the California market hurt the consumers it was trying to protect. So the story we ought to be hearing today is, deregulation benefits consumers while government market manipulation hurts consumers. I fear the story we might hear instead is that we need more Federal interference in the market, that FERC needs more authority to tinker with the market, that we cannot repeal PUHCA and instead we need super-PUHCA, that we cannot trust the free market but we can trust regulators.

I pose a question. If Enron's competitors had to go to FERC or the SEC for prior approval, how quickly could they have stepped in to replace Enron? How long would the lights have been out? Well, we do not know the answer to those questions. We can only speculate.

I look forward to hearing from today's witnesses about these issues, about the merits of Federal interference in the day-to-day operation of the market. I also look forward to the Senate creating a national energy policy that enhances domestic energy supply, makes that supply more reliable and affordable, and reduces our dependence on foreign oil. We need to foster our regulatory and investment climate, encourage new energy sources of all types. This includes: oil, natural gas, nuclear, coal, electricity and renewables, encourage construction of energy infrastructure, including transmission lines.

I think this is what the administration stands for. It is what I believe, and I know that it is what the American people expect Congress to do. We may need to deal with how corporations keep the books and how employee pension programs are operated. But let us keep corporate mismanagement in context with the operation of energy markets. I know in my banking career, the Comptroller of Currency would not allow directors to purchase stock and put it in the their own retirement business portfolios. That was a matter of simple regulation.

Let me conclude by turning to some of the politics of Enron. It appears that politics in both Houses are trying to create a political issue out of Enron's failure. Some are not particularly interested in the hard-core facts. They are not particularly interested in protecting consumers or stockholders. Just look at some of the wild claims we have seen. At one point the administration has been castigated for not helping Enron, castigated for proposing an energy policy that helps Enron. How can you have it both ways?

It is true that many elements of the administration's policy are consistent with the views of Enron. It is also true that far more elements of the Clinton administration's energy policy were consistent with the view of Enron.

Let me refer to my own experience in this area. In my time as chairman of this committee, I met with Mr. Ken Lay just once. My contact with their Washington Office was very limited. They simply



did not call, and I can see why when I read the *Washington Post* on January 13, 2002, and I quote.

At Lay's meeting with Peña on February 20, 1998, he spoke of restructuring the U.S. electric market in ways that would benefit Enron. Lay pressed the administration to propose legislation that would assert Federal authority over the national electric markets. Now, what does that mean? That means they were asking for a date certain for retail competition, and wanted FERC to preempt the States to make it happen. In other words, one size fits all.

I quote again, according to a company's version of the meeting, Lay and Peña agreed that a go-slow approach to the deregulation advocated by Senate Energy Committee Frank Murkowski was unacceptable. Peña asked Enron officials to keep the Energy Department staffers posted on developments in Congress, and solicited comments on the administration's draft of its comprehensive national energy strategy. An Enron document said Lay felt that the draft was headed in the right direction except for a few points, the document said, end of quote.

I guess we didn't see eye to eye about how best to ensure America has an affordable and reliable energy supply.

In conclusion, I think it is also true that many elements of the current Senate Leader's energy policy are straight out of the Enron playbook. It is put together without any public input, through members of the Energy Committee, which was a tragic mistake on behalf of Senator Daschle, and I think he is aware of that.

It should be pointed out that Enron has never wanted to deregulate electricity. It said it wanted to federalize electricity. Enron wanted different regulation, not deregulation. I indicated from a certain date under deregulation for everybody to come in at once for retail competition. They wanted FERC to preempt the States to make it happen, create a one-size-fits-all system that benefits national markets here such as Enron. The system would ignore local concerns and interests, and Enron wanted special provisions of particular benefit to Enron.

Unfortunately, this is reflected in the Daschle bill. Just a few examples: One, FERC authority to restructure electric power industry. Two, FERC open access on all transmission lines, including Federal. Three, uniform liability standards under FERC control; and four, transmission information disclosure that would have benefitted Enron's trading activities, special transmission access and benefits for wind generation—Enron owns a wind generator company—a renewal portfolio standard that benefits wind generation, Federal preemption of States and consumer protections. FERC is given exclusive authority over electric reliability, and Nation-wide uniform interconnection standards.

So in my opinion, as they say, those that live in glass houses should not throw stones, or those that live in glass houses perhaps should not take baths.

In any event, I look forward to hearing from today's witnesses. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Before we start, we have six witnesses here today, and before we start with their testimony I have asked Mark Seetin, who is the vice president of the New York Mercantile Exchange, to give us about a 4-minute summary of some of

the definitions that we are going to be talking about today, just as a refresher course, and then we will start with testimony.

My intent would be to have each of the witnesses testify for about 8 minutes, and then have panel members here asking questions, give each one 7 minutes to make any statements they wish, and ask whatever questions, and then we will have additional rounds as appropriate.

Mr. Seetin, why don't you go right ahead.

**STATEMENT OF MARK SEETIN, VICE PRESIDENT, NEW YORK  
MERCANTILE EXCHANGE**

Mr. SEETIN. Thank you, Mr. Chairman. I will indeed try to be brief, but as you rightly stated, the terms of art sometimes get lost in the discussions.

First of all, the risk management marketplace, particularly with energy and metals, has an regulated and unregulated side. On the regulated, are overseers, the CFTC, as Chairman Newsome represents here today, that the instruments offered are futures contracts, and options on futures contracts. On the unregulated side, in which instruments that really have much the same function as the futures side but yet are under no regulatory purview, forward contracts, over-the-counter or SWAP instruments, and over-the-counter or OTC options.

A futures contract is a binding obligation to make or take delivery of a specified quantity and quality of a commodity at a specified location and time. The key is uniformity. Every NYMEX oil contract is for 1,000 barrels with American Petroleum Institute standards, so every time you trade a NYMEX contract you know exactly what you have in that regard.

An option is a second step back from the futures contract in that it is a contract between a buyer and a seller where the buyer has the right but not the obligation that they have in the futures contract to buy or sell the underlying commodity at a fixed price over a specified period of time in exchange for a one-time premium payment. It is a little bit like a deductible insurance premium payment. If you buy insurance on your car, you take a \$500 deductible. That is quite similar to the way options operate, and you have regulated options, those that are listed on exchanges like the New York Mercantile, and options that are offered over-the-counter in the unregulated marketplace.

What is a forward contract? A forward contract is a contract in which a seller agrees to deliver a specified cash commodity to a buyer sometime in the future. In contrast to futures contracts, the terms of forward contracts are not standardized. Forward contracts are not traded on Federal exchanges.

When I was farming, I would go to the elevator and get a forward contract for 10,000 bushels of corn to be delivered in December. That was a contract between myself and the green elevator to be delivered at a forward time, not regulated.

What is an OTC or a slot contract? This is an agreement whereby a floating price is exchanged for a fixed price over a specified period. It is an unregulated financial arrangement which involves no transfer of physical energy. Both parties settle their contractual obligations by means of a transfer of cash. The agreement defines

volume duration and a fixed reference price. Differences are settled in cash over specific periods, maybe monthly, maybe quarterly, maybe over a 6-month period.

So it is an arrangement between the hedger and the provider of that OTC slot, and they say, we will use NYMEX, for example, as the base price. Every month, if your price is above, I will pay you. If the price is below the NYMEX price, you pay me. That does the same thing, in essence, as a futures contract. It allows one party to lock in the price.

What is a derivative? A financial instrument traded on and off exchange, the price of which is directly dependent on the value of one or more of the underlying securities, commodities, or other derivative instruments, or any agreed-upon pricing index, and the reason I put this last is because all of the previous instruments that we talked about are considered derivatives. Derivatives is a very encompassing term.

And with that, Mr. Chairman, I have completed, and look forward to the testimony today.

The CHAIRMAN. I think that is useful background, and a refresher for many of us. I appreciate it very much.

Let me start with Pat Wood, who is the Chairman of the Federal Energy Regulatory Commission, and who has substantial responsibility on a lot of the issues we are trying to understand here. Why don't you give us your testimony, and indicate the most important things you think we ought to be aware of as we try to move forward.

**STATEMENT OF PATRICK WOOD, III, CHAIRMAN,  
FEDERAL ENERGY REGULATORY COMMISSION**

Mr. WOOD. Thank you, Mr. Chairman. I will break my introductory remarks into two parts, what we perceive happened from the FERC, and what we have done in the general arena to, I guess, the issues that are raised by market monitoring.

Enron's collapse, just to cut to the chase, certainly as one who comes from that State, and a lot of friends of mine worked with the company and are invested in it, or were retired from it, it is a human tragedy. But I think from our perspective in this hearing today is to look at more soberly the impact on the market, that I think Senator Murkowski correctly praised as being vibrant and supportive of a lot of healthy interaction among market participants, but the collapse itself has had little perceptible impact on the commodity at wholesale of electric and gas markets in the country, which are the primary responsibility of the FERC. These energy markets adjusted quite quickly to Enron's collapse, particularly when you consider that Enron accounted for 15 to 20 percent of the trades in these aggregated markets.

Our monitoring of energy markets to date has indicated there has been no immediate damage to the energy trading in both gas or electric, or certainly in the underlying physical energy supplies. As can be expected, there has been some volatility in these markets, with the swift exit from them of trading that has impacted liquidity in the markets, and so the ranges have traded—and our staff is actually investigating that, and I will be glad to share with the committee as we get to some conclusions on that, but with few

exceptions in the physical market, very few exceptions. In fact, I just got a letter on the first one, a small company in Missouri, but people have been able to rearrange their physical deals without any impact, or perceptible impact with the underlying deals that they had executed with Enron.

On the day that it was announced that there was a formal investigation by the SEC into Enron, the commission staff began to immediately monitor the spot markets and contact market participants to evaluate what impact this significant announcement could have on the trading in the Nation's energy markets. Again, as I mentioned, the volatility increased, but as I think Senator Murkowski's aggregated chart shows, and the charts that are more closed in on 2 months that are attached on the back of my testimony, in both power and gas markets the general trends in prices due to both the weakened economy and to oversupplies of both gas in storage and of power and the rapid increase of new powerplants across the country, generally were unaffected by that. That downward trend that we saw going prior to Enron continued through the Enron collapse and continued on into what has been a very mild winter, so the weather is still primarily the key driver in these commodity prices, much as I think Chairman Newsome will mention they are for just about everything else, but that was no exception here.

At the point we began to monitor Enron Online, the online trading faction much more closely—as I mentioned in my testimony in some detail, it is a trading platform where Enron is a party and many providers can come to it as buyers or sellers—we looked at that particularly in comparison to other markets which have multiple buyers and sellers coming together to ascertain if the spreads in Enron Online and the spreads in the other markets were comparable and, in fact, throughout the entire 60-day period they were, so we are looking and continue to look at that as an issue.

To Commission staff in talking to market participants throughout this period, it became very clear that these market participants were readjusting their business deals with Enron. They were what we called flattening the books, which is to kind of be neither long nor short on the future deals that they had with each other, but to kind of basically exit Enron from the transaction and stick the market participants in a place that did not include Enron.

So the positioning that the parties did helped the calmness in the market. Certainly there was not a frenzied reaction from I think folks on our side of the fence or on your side of the fence, that time gave people the opportunity to restructure their business deals, and to basically reflect the fact that Enron may not be the party they wanted to do business with any more.

Enron is more than just an energy trader. It owns a pipeline, a set of pipelines which we regulate. Those have not filed for bankruptcy. We continue to monitor those. We set the rates for those. The safety issues for those are overseen by the Department of Transportation. Of course, safety is much focused on in light of the September 11 events, and from everything that we oversee and that we do, the pipeline industry there looks fine.

PGE, which is a large electric utility in Oregon, is also an owned subsidiary of Enron. It was announced prior to Enron's collapse

that that utility would be sold to Northwest Natural. That proceeding is pending before the FERC and other regulatory authorities, and I expect will move forward on its traditional track unaffected by the filing for bankruptcy at Enron.

The commission has done a number of things in the interim, mostly prior to the Enron events, to improve our ability to monitor markets, to oversee markets, not to re-regulate markets, but to oversee them to give buyers and sellers information that they need to ascertain what the proper price that they ought to pay for delivery of gas or delivery of power ought to be.

We have set up, as you mentioned, Senator Bingaman, a new Office of Market and Oversight and Investigation, as I have testified before the committee my intention to do so. We have, in fact, posted for the director of that office, and met with our staff to discuss how this office would work within the context of our statutory mission, and I look forward to actually some superior candidates from across the country that are interested in making markets work that want to see this continue and I have had some very, I think, attractive candidates for not only the top job but for people that want to participate in that, and I think that is a healthy transition from the whole cost of service world that we were good at to a market referee, market oversight world that I think we can be very good at.

We have the assets and facilities to do that. I expect that as we develop these things I will be visiting with the committee more if there are any issues that we need with regard to reporting requirement authority. I mentioned some certainly in regard to Senator Wyden's transparency language that we are moving forward on that effort, but I think certainly any time we ask for information we are challenged. I expect as part of asking for new information we will also quit asking for old information. I think that is what agencies need to do.

The OMB is pretty good about reminding us that we need to clear out the underbrush when the world changes, and we expect to do that, but in the new world of markets the need for information is very important. It is, to me, disclosure and not re-regulation. I think it is important to kind of keep that in balance, but we have looked at that. Staff has worked forward since September a very strong proposal about what the data needs are going to be at the commission. I look forward to moving forward on that.

We have also interestingly—and I see my time is out—have asked for comments on a number of rulemakings at the commission revising rules that have been on the books for a number of years to reflect the new market. One of them in September we put out actually asked if we should regulate or require affiliate standards of conduct to be applied to activities such as Enron Online, much as the SABRE data base was discussed during the American Airlines litigation with the Department of Justice. That is out there.

We have also asked if there should be additional accounting requirements that we have historically exempted power marketers from. If the SEC has a better solution there, and they may have published one last week, as I reference in my testimony, we certainly would not see the need to do that.

So we are moving forward on a number of fronts. I guess in closing my final, I guess, plea and concern is, this industry is one that requires a tremendous amount of capital on a daily basis to build powerplants, to build gas pipelines, to build power transmission lines, to build the local distribution companies, to put meters on pipelines and houses and businesses, and I think if I would just ask anything on behalf of the need to continue that capital flow, it is that we do keep these issues focused, as I think what I have heard in your public statement so far, that we focus on what is really the issue here, and the issue so far has not been that energy markets had anything to do with it. In fact, I would say energy markets are what saved the country from the collapse of this country being so dramatic. It is a large player. It is a big company. For it to have been digested so efficiently through the market is quite a testimony to the efficiency of the market that that company and many, many others have advocated for the better part of the decade.

I look forward to answering your questions.  
[The prepared statement of Mr. Wood follows:]

PREPARED STATEMENT OF PATRICK WOOD, III, CHAIRMAN, FEDERAL ENERGY  
REGULATORY COMMISSION

I. INTRODUCTION AND SUMMARY

Mr. Chairman and Members of the Committee: Thank you for the opportunity to testify on the implications of Enron's collapse on energy markets.

The bankruptcy of one of the largest energy providers in the country has stunned both the energy and investor communities, and many employees and retirees saw their savings accounts all but vanish.

But the collapse of Enron has not caused damage to the nation's energy trading or energy supplies. In the aftermath of Enron's collapse, prices in energy markets remained stable, trading within expected trading ranges, and, importantly, neither electric nor gas deliveries have been disrupted. The Federal Energy Regulatory Commission (Commission) has monitored the effects of Enron's collapse on energy markets and has not found any substantial spillover effects. The nation's electric and natural gas markets' resilience following the swift collapse of one of its major participants indicates a high degree of robustness and efficiency.

I disagree with those who claim that the Enron collapse sounds the death knell for competition in energy markets or justifies nationwide reimposition of traditional cost-based regulation of electricity. The facts available to date indicate that Enron's failure had little or nothing to do with whether energy commodities and their delivery to customers are monopoly regulated or competitive. Rather, Enron appears to have failed because of its questionable non-core business investments and the manner in which it reported on its financial position to its owner-investors and to the broader business community. Based on the facts as they appear now, Enron's actions would have led to the same result whether its core business focused on energy, grains, metals or books.

II. ENRON'S IMPACT ON GAS AND ELECTRIC MARKETS

Enron's collapse had little perceptible impact on the nation's commodity (wholesale) electric and gas markets, which are FERC's primary regulatory responsibility. Energy markets have adjusted quickly to Enron's collapse. The Commission's monitoring of energy markets indicates that there has been no immediate damage to energy trading or energy supplies. Although Enron transactions comprised 15 to 20 percent of wholesale energy trades, its demise has had negligible effects on trading. With a few exceptions, parties were generally able to rearrange the deals they had executed with Enron.

*Market Monitoring and Reactions*

From late October 2001, when news of a likely formal investigation of Enron and its auditors by the Securities and Exchange Commission (SEC) first became known, to early December 2001, after Enron's declaration of bankruptcy, spot market data

indicates that there was no change in natural gas or electric wholesale prices that could not be attributed to weather or other fundamentals. (See Figures 1 and 2 in the Appendix for graphs of spot market prices).<sup>\*</sup> As may be expected, Enron's swift exit from trading may have increased volatility somewhat. Our staff is currently investigating this concern more thoroughly.

Following the news of a formal SEC investigation of Enron in October 2001, Commission staff contacted market participants to learn whether any supply obligations might be in jeopardy. Staff began monitoring EnronOnline more closely, particularly any changes in the margins between the bid-ask prices on EnronOnline, as a widening of these bid-ask spreads might signal less liquidity in the market; but there was no significant change in the margin between the bid and ask prices on EnronOnline.

Commission staff also contacted counterparties and received assurances from them that they were adjusting to Enron by "shortening" their positions and not entering into longer-term arrangements with Enron. In mid-November, when it appeared that the Dynegy merger with Enron might be jeopardized, staff observed no significant change in the margin between the bid and ask prices on EnronOnline; at the same time, there was a marked increase in the volume traded on other online trading platforms, such as Dynegydirect and Intercontinental Exchange (ICE). Commission staff again contacted energy traders to determine whether major supply disruptions in wholesale markets were occurring, and was informed that Enron had "flattened its books," i.e., made its portfolio of trades neither long nor short so that it could more easily "step out" of transactions and not cause disruption. As events unfolded in late November and early December, other market participants stepped into these deals. With the exception of certain lightly-traded points, it appears that Enron's competitors have filled the void left behind by Enron.

The reason for this overall calmness in commodity prices is basic. Although Enron was a significant player in electric and gas markets—as a pipeline, as a commodity trader, as a futures contract trader, and as a market maker—there were many other players in these large, established commodity markets, and a great deal of market diversity. Once it became apparent that Enron might not be a stable counterparty, its trading partners began to systematically adjust their positions and practices in the marketplace, moving to other trading platforms and partners. A similar process occurred among the counterparties to Enron's longer-term, untraded gas and electric contracts. Thus, over only a few weeks time, the gas and electric markets systematically minimized Enron's role in the marketplace and the likelihood that a company-specific failure could significantly affect the underlying commodities. I believe the calm but vigilant reaction of the Commodities Futures Trading Commission, among others, during this period allowed time for this unwinding to take place.

The flexibility of today's energy markets allows a buyer losing its supply to replace the energy in real-time (at least briefly) through imbalance services offered by transportation providers. With more time, such as an hour or more before a supply will be lost, a buyer generally can arrange alternative supplies from a wide range of sources. Thus, the risk of a buyer having insufficient energy because of a seller's default appears to be manageable, as evidenced by the recent experience with Enron.

The more substantial risk in these circumstances is the loss of an advantageous contractual price for energy. Even this risk, however, depends on market conditions. When a seller defaults, market conditions for buying energy may be better or worse than when a buyer entered into its contract with the seller. If better, the buyer actually may benefit from not having to buy under the existing contract and instead being able to buy at lower prices elsewhere.

#### *Enron's Market Role*

Enron's role in the gas and electric markets was primarily in the trading of financial assets (commodity and futures contracts) rather than physical assets (with the exception of its natural gas pipelines, which continued operation relatively untouched by the events affecting the parent and affiliated companies). Less than 10 percent of the contracts traded in these markets involve the initial producer or final wholesale customer for the product—well over 90 percent of commodity contracts and futures are between intermediate holders who are managing risk and facilitating connections between initial producers and ultimate customers. Adjustments in the financial asset marketplace—as to the length of a contract or the identities of the counterparties—rarely affect the flow of the physical gas and electricity underlying those contracts. Thus, while the commodity markets were shortening the length of contracts and moving more trade to non-Enron partners, gas and electric deliveries continued unaffected.

<sup>\*</sup>The appendix has been retained in committee files.

Enron does control a number of natural gas pipelines, but its financial failure has had little apparent impact on their operations. But even if it had, it is worth noting that the gas and electric markets have demonstrated their ability to react to and manage around problems that could affect their ability to deliver electricity and gas. When a pipeline breaks, a compressor station fails, a transmission line collapses, or a large power plant goes off-line, the parties in the market adjust immediately to acquire other supplies and delivery routes. Having a sufficiently robust energy infrastructure makes this so. In these instances, prices may well rise and, occasionally, deliveries to retail customers may be slowed but the wholesale market reacts swiftly and minimizes the impact to wholesale and retail customers alike.

In response to the Enron crisis, Moody's has raised the credit standards for generators and traders. This has forced energy concerns to rebalance their debt-to-asset ratios, forcing many to reduce debt and cut back investments in new gas processing, pipelines and power plants. During December 2001, stock prices of several energy companies hit yearly lows. Enron's problems, in combination with the recession and reports of potential overbuilding, appear to have eroded confidence, making investors more cautious about putting money into the energy industry. This slowdown in infrastructure investment could be problematic in some regions as the economy recovers and demand for energy grows. For that reason, the Commission has accelerated its efforts to complete the transition to a more competitive wholesale power market in order to provide investment certainty.

#### *Enron and Competition*

The markets' reaction to Enron's collapse demonstrates what good, working competitive markets do best—a diverse group of market participants with adequate market information about the players and commodities act individually to produce a result that works for all. The nation's wholesale electric and gas markets showed great resilience and swift reaction time, and demonstrated that they are much stronger than any individual player in the marketplace.

Some claim that Enron's demise is due to the failure of deregulation and competition in the electric industry, of which it was one of many supporters. I strongly disagree. Wholesale competition in the gas industry has spurred gas production, encouraged pipeline construction, driven down commodity prices for the past decade and lowered retail prices accordingly. In the electric sector, wholesale competition, although it is in its infancy, has enabled the construction of thousands of megawatts of new power plant capacity across the country, resulting in lower commodity and retail electric prices in most regions, and in a cleaner generation fleet.

### III. THE COMMISSION'S REGULATION OF ENRON SUBSIDIARIES

The Commission does not regulate the parent corporation, Enron Corporation, as it does not engage in activities which are under FERC jurisdiction. FERC does regulate eleven of Enron's approximately 100 subsidiaries. Our authority, and the specific names of the Enron subsidiaries subject to our jurisdiction, are described below.

The Commission has jurisdiction over sales for resale of electric energy and transmission service provided by public utilities in interstate commerce. The Federal Power Act includes energy marketers and traditional vertically integrated electric utilities in its definition of public utilities. The Commission must ensure that the rates, terms and conditions of wholesale energy and transmission services are just, reasonable, and not unduly discriminatory or preferential. FERC also is responsible for reviewing proposed mergers, acquisitions and dispositions of jurisdictional facilities by public utilities, and must approve such transactions if they are consistent with the public interest. We also regulate the issuance of securities and the assumption of liabilities by public utilities not regulated by States.

The Commission also has jurisdiction over sales for resale of natural gas and transportation. However, FERC jurisdiction over sales for resale is limited to domestic gas sold by pipelines, local distribution companies, and their affiliates, (including energy marketers.) Consistent with Congressional intent, the Commission does not prescribe prices for these sales.

Figure 3, in the Appendix, illustrates the distinction between physical and financial assets in the energy sector and highlights the market segments of several Enron subsidiaries. It further identifies which subsidiaries and market segments fall under FERC regulation.

#### *A. Energy Marketers*

Competitive trading of energy by "marketers" generally began about two decades ago. Marketers do not usually own physical facilities, but take title to energy and re-sell it at market-based rates. Natural gas marketing began with the deregulation of the price of natural gas in 1978 and expanded with the Commission's 1992 open



access rule for natural gas pipelines, Order No. 636. In the decade since Order No. 636, natural gas marketing has developed into a large, robust activity with many marketers. The Commission lacks jurisdiction over sales of natural gas by many gas marketers. To maximize competition we have granted “blanket authorization” for those marketers under FERC jurisdiction so they do not have to file for and obtain individual approvals to sell gas at wholesale.

In the electric arena, wholesale power marketers began selling electric energy as early as 1986. The Energy Policy Act of 1992, and the Commission’s 1996 open access rule for electric transmission owners and operators, Order No. 888, further spurred the development of competitive electric power trading.

The Commission regulates the following power marketers affiliated with Enron: Enron Power Marketing Inc., Enron Sandhill Limited Partnership, Milford Power Limited Partnership, Enron Energy Services, Inc., and Enron Marketing Energy Corporation.

#### *EnronOnline*

Before its collapse, Enron was the largest marketer of natural gas and electric power. Enron’s Internet-based trading system, EnronOnline, was until recently the dominant Internet-based platform for both physical energy (electricity and natural gas products) and energy derivatives. (Derivatives are financial instruments based on the value of one or more underlying stocks, bonds, commodities, or other items. Derivatives involve the trading of rights or obligations based on the underlying product, but do not directly transfer property.) Although EnronOnline was the leading Internet-based trading platform for natural gas and electric power, it faced competition from other Internet-based trading platforms, such as Dynegydirect and Intercontinental Exchange (ICE).

Traditional exchanges, like the NYSE and the NYMEX, determine price by matching the buy and sell orders of many traders in a many-to-many trading format. In contrast, EnronOnline uses a one-to-many trading format, where an Enron affiliate is always on one side of each energy transaction, either as a seller or a buyer. The price of a commodity or derivative on EnronOnline is determined when a buyer or a seller accepts an offer or bid price posted by an Enron trader. In the wake of Enron’s downfall, the many-to-many platforms such as ICE have helped to fill the void, and create a more robust market by reflecting the bid and offer values of myriad different energy buyers and sellers.

#### *Market-based Rate Authorization*

To sell electricity at market-based rates, public utilities (including power marketers) must file an application with the Commission. The Commission grants authorization to sell power at market-based rates if the power marketer adequately demonstrates that it and its affiliates lack or have mitigated market power in the relevant markets. FERC conditions market-based rate authority on power marketers submitting quarterly reports of their purchase and sales activities and complying with certain restrictions for the protection of captive customers against affiliate abuse. There are currently 1200 electric power marketers authorized to sell energy at market-based rates.

The Commission generally grants waiver of certain regulations to power marketers which receive market-based rate authorization. For example, these marketers do not need to submit cost-of-service filings because the rates they charge are market-based. The Commission also exempts power marketers from its accounting requirements, because those requirements are designed to collect the information used in setting cost-based rates. In addition, unless others object, FERC grants power marketers’ requests for blanket approval for all future issuances of securities and assumptions of liability.

Because the Commission’s reporting and accounting requirements are designed to address a limited set of concerns, and apply only to the jurisdictional subsidiary at issue, it is unlikely that requiring power marketers to comply with these requirements could prevent a future Enron-like failure. Nevertheless, in our current rule-making proceeding on accounting rules, we have invited comments on whether the current exemptions for power marketers from such requirements remain appropriate.

#### *B. Electric Utilities*

A few years ago Enron acquired Portland General Electric (PGE), a vertically-integrated utility subsidiary of Enron that handles electricity generation, purchase, transmission, distribution and sale in eastern Oregon. PGE’s retail rates and practices are under the jurisdiction of the Oregon Public Utility Commission. PGE also sells energy to wholesale customers in the western United States. FERC has granted market-based rate authorization to PGE for certain wholesale sales. Although the

Commission waives some of its reporting requirements for power marketers, it requires continued reporting from franchised electric utilities such as PGE, so we can monitor whether its wholesale transactions are inappropriately favoring its affiliates or harming its captive customers. Although Enron's collapse has had tragic impacts upon PGE's employee retirement accounts, we have not yet seen any negative impacts on PGE's ability to meet its obligations to customers as a result of the Enron bankruptcy. I should also observe that the sale of PGE to Northwest Natural, announced prior to Enron's collapse, is pending before FERC and other regulatory bodies.

#### *C. Gas Pipeline Subsidiaries*

The Commission has limited jurisdiction over sales for resale of natural gas in interstate commerce. The Commission has jurisdiction to regulate only sales for resale of domestic gas by pipelines, local distribution companies (LDCs), and their affiliates. Consistent with the Congressional goal of allowing competition in natural gas markets, the Commission does not prescribe the prices for these sales.

The Commission has authority over the rates, terms and conditions for pipeline transportation in interstate commerce of natural gas and oil. The Commission regulates several natural gas pipeline affiliates of Enron, namely, Florida Gas Transmission, Midwestern Gas Transmission, Northern Border Pipeline Company, Transwestern Pipeline Company, and Northern Natural Gas Company.

#### *D. Transactions and Activities Not Regulated by the Commission*

The Federal Power Act does not give the Commission direct, explicit jurisdiction over purely financial transactions, such as futures contracts for electricity or natural gas. The Commission has asserted jurisdiction over such transactions only when they result in physical delivery of the energy which is the subject of the financial contract, or when such transactions or contracts affect or relate to jurisdictional services or rates (e.g., financial contracts affecting firm rights to interstate transmission capacity or the pricing of such capacity).<sup>1</sup> While Enron and its subsidiaries engaged in many electricity futures contracts and other energy-related derivatives, it does not appear that these transactions have played a significant role in Enron's demise.

### IV. FERC INITIATIVES IN ENERGY MARKETS

In response to rapidly evolving energy markets, the Commission has implemented a number of new initiatives to improve its market-monitoring abilities. The Commission's new strategic plan, adopted September 26, 2001, encompasses three major areas of activity in overseeing the energy industry:

- Infrastructure—working with others to anticipate the need for new generation and transmission facilities, determining the rules for cost recovery of new energy infrastructure, encouraging the construction of new infrastructure, and licensing or certifying hydroelectric facilities and natural gas pipelines;
- Market rules—ensuring clear, fair market rules to govern wholesale competition that benefits all participants, and assure non-discriminatory transmission access in the electric and natural gas industries;
- Market oversight and investigation—understanding markets and remedying market rule violations and abuse of market power.

This last, third strategic goal is new, and reflects the present Commission's commitment to ensuring that markets continue to work for customers. The strategic plan is available on our website at [www.ferc.gov](http://www.ferc.gov).

To give substance to this third strategic goal, the Commission is creating a new Office of Market Oversight and Investigation (MOI), which will concentrate the Commission's market-monitoring resources into one workgroup and enable the Commission to better understand and track wholesale energy markets and risk management by analyzing market data, measuring market performance, investigating compliance violations, and, where necessary, pursuing enforcement actions. MOI's work will provide an early warning system to alert the Commission of potentially negative market developments and let us act more proactively to address any problems

<sup>1</sup>In 1996, the Commission addressed the issue of whether an electricity futures contract approved for trading by the CFTC would fall under its jurisdiction, pursuant to the FPA. *New York Mercantile Exchange*, 74 FERC ¶61,311 (1996). The Commission found that the CFTC possessed exclusive jurisdiction over the trading of such futures contracts, and that the Commission would assert jurisdiction, pursuant to the FPA, only if the electricity futures contract goes to delivery, the electric energy sold under the contract will be resold in interstate commerce, and the seller is a public utility. *Id.* at 61,986.

that may arise. We are currently taking applications for the Director of this Office, who will report directly to me.

In mid-2001 the Commission created the Market Observation Resource Center (MOR) to better observe market developments and to enable us to grasp quickly the significance of changes in market conditions. MOR's computer hardware, software and subscription web services give us access to historical and real-time data about energy markets.

The Commission has launched several other initiatives within the past year to ensure vigilant and fair oversight of the changing energy markets. In July 2001, the Commission proposed in a rulemaking to amend the filing requirements for public utilities. The proposal would require all generators, public utilities and power marketers to file electronically with the Commission and post on the Internet an index of customers with a summary of the contractual terms and conditions for market-based power sales, cost-based power sales, and transmission service. These companies would also have to report transaction information for short-term and long-term market-based power sales and cost-based power sales during the most recent calendar quarter. This proposal will give the Commission and the public more complete and accessible information on jurisdictional transactions.

In September 2001, the Commission proposed in a rulemaking to revise its restrictions on the relationships between regulated transmission providers (such as Portland General Electric) and their energy affiliates, broadening the definition of an affiliate to include newer types of affiliates, such as affiliated trading platforms (e.g., EnronOnline).

Also, in September 2001, the Commission staff began a comprehensive review of the information the Commission needs to carry out its statutory obligations in the current and evolving markets in electricity and natural gas. Presently, much of the information we require relates to the historic rate-setting functions of the agency. The review so far indicates that some of this may no longer be necessary, while other information is now more essential to provide transparency in a competitive marketplace.

In December 2001, the Commission proposed in a rulemaking to update the accounting and reporting requirements for jurisdictional public utilities, natural gas companies and oil pipelines. FERC proposes to establish uniform accounting requirements and related accounts for the recognition of changes in the fair value of certain security investments, items of other comprehensive incomes, derivative instruments, and hedging activities. The proposal is aimed at improving the visibility, completeness and consistency of accounting and reporting changes for these items. It invites comments on whether entities that are currently exempted from these accounting and reporting requirements, such as power marketers, should be subject to these proposed regulations.

While I have an open mind on whether the Commission should continue to exempt power marketers from its accounting requirements, our accounting requirements are not aimed at the kind of activities allegedly undertaken by Enron. Based on our historical responsibilities, FERC's accounting requirements are focused on providing useful and accurate information for determining cost-based rates. Cost-based ratemaking encourages utilities to maximize their claimed costs and minimize their expected revenues, to justify the highest possible rates. The Commission's accounting rules and auditing are designed to ensure that utilities with cost-based rates do not overstate costs or understate revenues. On January 22, 2001, the Securities and Exchange Commission proposed additional accounting-related disclosures from a broad universe of companies, including those exempt from FERC's reporting requirements. Adoption of that proposal could eliminate the need for the FERC to alter its reporting requirements in this regard.

#### V. ADDITIONAL STATUTORY AUTHORITY

Before we can understand how to prevent another Enron-like collapse, we must first understand what internal actions and external events caused Enron to fail. That effort is now underway by this Committee and elsewhere. Then we must ask whether those actions and events can and should be prevented in the future.

Whether the Commission needs any additional statutory authority depends on the role Congress intends for the Commission. Historically, the Commission's economic regulation has focused on ensuring that energy markets deliver adequate energy at reasonable prices. The demise of Enron has had little or no effect on the supply or price of energy. Instead, Enron's collapse has primarily harmed its investors and employees. Since it appears that few of Enron's problems affected the narrow scope of wholesale energy markets, it is not clear that giving the Commission additional authority within its current scope would prevent further Enron-like problems.

To encourage greater efficiencies in the energy markets and to ensure that wholesale competition expands its ability to deliver reasonably priced, adequate energy supplies to more customers, the Commission is moving forward to complete its effort to create competitive national wholesale power markets as it did with natural gas markets in the late 1980s and early 1990s. Congress endorsed wholesale power competition in the Energy Policy Act of 1992 and further endorsement of this effort would certainly be helpful. In particular, Congress should give the Commission explicit authority to require regional transmission organizations (RTOs) where it finds RTOs to be in the public interest. RTOs will broaden regional energy markets, allowing greater market efficiencies and limiting possible discrimination in grid operations. Congress should also remove tax disincentives to transferring transmission assets to RTOs and to use of public power transmission lines.

#### *Price Transparency*

Greater price transparency will help improve the efficiency of energy markets, by providing buyers and sellers with better information about market conditions. The creation and operation of broad regional energy markets with a widely-traded set of energy products will do much to make this happen. Once RTOs over broad regional markets are established, operating under fair, clear, stable market rules, price transparency will improve significantly, even without a Congressional mandate. This has already happened to an extent in the regions now served by Independent System Operators (ISOs).

The Commission is moving forward with further transparency, as discussed above. Without question, Congressional endorsement of this effort would be helpful. Proposed Senate legislation, S. 1766, would improve market transparency through better electronic dissemination of information about trades in the energy markets and the transfer capabilities of the transmission infrastructure. These measures will help the Commission establish sound competitive wholesale markets by validating and broadening the agency's authority to compel such reporting and information dissemination. They will also help FERC and financial market regulators and players to better monitor individual companies' participation and diminish the ability of any individual player to misbehave or misrepresent in the marketplace.

I offer two cautions, however:

- First, while the transparency provisions of S. 1766 address actual trades, they do not appear to address at least two of the issues at the heart of Enron's situation—how they handled and reported the risks and valuation underlying the trades they were conducting, and how they represented the value of the trades flowing through their platforms as corporate revenue. Those are broader financial reporting and regulation issues that are outside the scope of FERC's jurisdiction.
- Second, there is a difficult balance between information that must be disclosed to make markets work and information that is commercially proprietary. It is clearly to the public benefit to implement rules that disclose more information and improve market transparency, but it is not always easy in practice to find the appropriate point between reasonable information disclosure and protection.

But these reservations do not detract from the value that a provision like Section 208 of S. 1766 may bring to the nation's energy markets, and I support adoption of an appropriate transparency provision.

#### *Creditworthiness*

The responsibility for ensuring creditworthiness of participants in wholesale energy trades lies primarily with the parties involved in those trades. Creditworthiness provisions are included in some contracts or tariffs filed at the Commission to date, and the Commission is likely to include some broad creditworthiness provisions in the standard tariffs that will be developed for all transmission providers and customers (to prevent the use of individual creditworthiness terms as discriminatory measures in narrow geographic areas or against specific players). But, market participants seem best equipped to develop sophisticated risk management measures and narrow creditworthiness concerns, and those provisions may be subject to Commission review for justness and reasonableness.

To the extent creditworthiness issues are raised before the Commission, we act expeditiously. For example, shortly after Enron declared bankruptcy, the Participants Committee of the New England Power Pool (NEPOOL) sought to implement alternative payment and financial assurance arrangements with Enron Power Marketing Inc., Enron Energy Marketing Corporation, and Enron Energy Services, Inc. Within a week of the date of filing, the Commission accepted and suspended these arrangements (subject to review of the finalized agreement), to protect NEPOOL participants while enabling the Enron subsidiaries to stay in the market and con-

tinue serving their customers. I do not think there is any need to legislatively address creditworthiness issues specific to energy markets.

*Public Utility Holding Company Act*

If Congress' policy goal is to promote wholesale energy competition and new infrastructure construction, then reform of the Public Utility Holding Company Act of 1935 (PUHCA), supplemented with increased access by the Commission and state regulators to certain books and records, will help energy customers. Energy markets have changed dramatically since enactment of PUHCA, and competition, where it exists, is often a more effective constraint on energy prices. In the 65 years since PUHCA was enacted, much greater state and federal regulation of utilities and greater competition have diminished any contribution PUHCA may make toward protecting the interests of utility customers. State and federal ratemaking proceedings, for example, are very effective in ensuring that activities of unregulated businesses do not increase regulated rates. For this reason, the provisions of S. 1766 which give broad access to a regulated company's holding company's books and records is important if PUHCA is to be repealed. But some have argued that certain provisions of PUHCA may remain valuable in protecting the interests of shareholders and employees in other regards, and I defer to others on that point.

As always, I will be happy to provide further information or answer any questions you may have and offer the services of my colleagues and staff to the Committee's efforts.

The CHAIRMAN. Well, thank you very much. Next let us hear from Mr. William M. Nugent, who is the president of the National Association of Regulatory and Utility Commissioners, as to the perspective from State commissions. Please.

**STATEMENT OF WILLIAM M. NUGENT, PRESIDENT, NATIONAL ASSOCIATION OF REGULATORY AND UTILITY COMMISSIONERS**

Mr. NUGENT. Thank you, Mr. Chairman, members of the committee. I am not only the president of NRUC, I am also a commissioner in Maine. I will present views from my perch in Maine, and where possible, that of my colleagues across the country, but I will tell you this has blown up so recently that our members have not gotten together, chewed it over, and come up with a particular policy on this.

Maine offers suggestions to FERC, or is pleased to comment on these issues, because I do not think there is any State across the country that has got a greater interest in the success of the wholesale electricity markets than does Maine.

We opened our markets to competition 2 years ago, and since that time our consumers have been directly and often immediately affected by changes in New England's wholesale electricity prices. As much as any jurisdiction we cut the ties, the regulatory tie between electricity supply and delivery by requiring utilities to completely divest themselves of generation. I have brought for the committee's work, and we can provide this to you for staff, it is a very recent annual report on electric restructuring in the State, and I also offer a blueprint which we previously provided to the FERC as to how we can move expeditiously to create a Northeast regional market.

We do this work because we believe that competition in electricity markets is likely to be fairest and most successful when transmission and distribution utilities have no reason to favor any one competitor over another. Now, the model we have chosen to open our State to competition apparently has found acceptance in the energy community. 14 energy companies are actively selling in

Maine and have won customers, including Enron, which by our estimate serves fully a quarter, an estimated 450 megawatts of Maine's load, or at least it did so prior to its recent troubles. I know that to the extent they are meeting standard offer, provider of last resort obligations, they continue to provide it as of this morning. They are doing it.

Our interest in the success of the wholesale markets is further rooted in our decision to forego artificial price-controlling devices such as price caps or long-term fixed supply contracts that insulate customers from the prices revealed in wholesale markets. Our standard offer is provided at prices that are set by competitive bid. The effect of our approach to restructuring has been dramatic. The incumbent investor-owned utilities no longer supply generation. Virtually all of Maine's generation is supplied by competitive providers, and 44 percent of our load has departed standard offering, and is served by retail suppliers, and I have the data on that to give you as well.

Our adoption of the competitive model came at a price. The prices paid by Maine consumers are, perhaps as much as any in the country, subject to the vagaries of the wholesale market and, accordingly, we have worked very hard to avoid or minimize the impacts of any events which will impair competition or unfairly injure consumers, residential or business and thus far, I am relieved to report, both Maine and New England have apparently avoided significant injury from Enron's recent financial collapse.

Most feared were threats to the reliability of supply, and to prices paid by Enron's customers. Supply continued without discernible disruption, and because of very careful management, particularly by the ISO New England and participants in the New England Power Pool, NEPOOL, there was no instability in the markets, and apparently no major financial losses. Enron's collapse did not cause a reliability problem because Enron does not own most of the generators. It does not own any of the generators in New England. The generation owners' interest remained unchanged. Run the generators and sell the output. Customers continued to want that output. Loads did not change, generators did not go anywhere, so reliability was unaffected.

And in this environment, the stressed and ultimately bankrupt Enron continued, and continues, as I mentioned a moment ago, to meet its contractual supply obligations in Maine, most, if not all of which were profitable in today's energy market. Those contracts required customers to pay a higher price than the current market price. It has been a falling energy price environment.

Nevertheless, companies who owned the generators, fearing that Enron might not pay for its power, opted out of contracts when possible and instead sold into a spot market, and new arrangements had to be found. Enron now settles each day for the trades accounted for 3 days ago, as opposed to the previous situation, which was a 30-day settlement, which the other providers continue to enjoy, a change, by the way, which was proposed on very short order in the wake of the collapse, and was approved within about 7 days by the FERC, something we very much appreciate.

Outcomes like the one in Maine and New England just experienced frequently lead to the oft-used phrase, we dodged the bullet,

and a big sigh of relief. True, the bullet did not hit us, but it was not because we were smart enough or nimble enough to escape its blow. We were simply and profoundly lucky. We are, and have been for many months, in a falling energy price market, one in which suppliers with a fixed price can profit from declining prices. Had these same set of events occurred against the backdrop of rising energy prices, suppliers would have had an extraordinary incentive to escape their obligations. Now, Maine has had some experience with that in two particular instances, and if you want to we can go into that later.

Had Enron's implosion occurred in a rising market, Maine's ratepayers could have taken a hit in excess of \$50 million, perhaps \$100 million, and remember, Maine is a State of fewer than 1.3 million people. If Enron had captured as much of the market across New England as it has in Maine, and we were in a rising energy price market, the comparable hit on ratepayers across New England could have been more than \$1 billion.

This is not to say that the markets would not have worked. Prices change because markets are functioning, and I think reliability would have been met, but the rising prices would largely reflect a more constrained supply situation and there would have been some travail for consumers.

For ratepayers there is a certain heads-you-win, tails-I-lose aspect to the energy market. If a customer signs a contract with an energy supplier, and market prices fall, the customer is stuck with paying the now higher-than-market price for its energy. This remains true even if the supplier, as Enron, goes bankrupt.

The contract is a valuable asset of the bankrupt, one which the bankruptcy court will seek to use on behalf of other creditors, but if a customer has a contract with an energy supplier, market prices rise, and the supplier for whatever reason goes bankrupt and defaults on the contract, the customers must buy new supply in the higher priced energy market and take its place in line with all the other creditors, with little hope that the protections a customer negotiated in its supply contract will provide sufficient relief.

This is not an argument for eliminating the market. It is a very deep reason why we have to ensure that we have healthy players in the market, and it goes as much to the business considerations here as to changes in market design.

I see my time is up. You have written copies of my testimony in advance. I will be happy to answer your questions as they come, Mr. Chairman. Thank you for this opportunity.

[The prepared statement of Mr. Nugent follows:]

PREPARED STATEMENT OF WILLIAM M. NUGENT, PRESIDENT, NATIONAL ASSOCIATION  
OF REGULATORY AND UTILITY COMMISSIONERS

Good morning, Mr. Chairman, members of the Committee.

Thank you for this opportunity to report to the Committee on the effects of the Enron Corporation's recent decline on the electricity market in one state (Maine) and New England. I am William M. Nugent, a commissioner on the Maine Public Utilities Commission (MPUC) and President of the National Association of Regulatory Utility Commissioners (NARUC). I will present my own views and, where possible, those of NARUC. But the Enron matter has developed so recently that our members have yet to meet and develop specific policy in response to it.

To aid the Committee's work on restructuring the electricity industry (S. 1766 and related bills), I have brought copies of the Maine Commission's very recent 46-page

Report on Restructuring in our State. I am also providing a “Blueprint for Establishing a Northeast RTO,” suggestions as to how we believe the Federal Energy Regulatory Commission it can best aid the development of a Northeast RTO, while ensuring the efficient operation of the current markets for as long as those markets exist. Maine offered these suggestions to the FERC because Maine has an enormous stake not only in the health of the current markets but also in the further development of broader, deeper, more liquid energy markets.

No state has a greater interest in the success of the wholesale electricity markets than Maine. In the two years since we opened our retail markets to competition, Maine’s consumers have been directly and often immediately affected by changes in the wholesale prices in New England. As much as any jurisdiction, Maine cut the regulatory tie between electricity supply and delivery by requiring its utilities to completely divest themselves of generation. We did so because we believe that competition in electricity markets is likely to be fairest and most robust when the transmission and distribution utility, the T&D utility, has no reason to favor any one competitor over any other. Apparently energy companies agree; currently 14 of them have competed and won customers in Maine, including Enron, which—by our best estimates—serves fully one quarter (an estimated 450 megawatts) of Maine’s load—or at least it did so prior to its recent troubles).

Maine’s interest in the success of the wholesale electricity markets is further rooted in our decision to forego artificial price-controlling devices such as price caps or long term fixed supply contracts that insulate consumers from the prices revealed in the wholesale markets; even Maine’s Standard Offer (default or provider of last resort) supply is provided at prices that are set by competitive bid. The effect of Maine’s approach to restructuring has been dramatic:

- the incumbent investor-owned utilities no-longer supply generation service;
- virtually all of Maine’s generation is supplied by competitive suppliers, and
- 44 percent of the total electric load in Maine has departed the standard offer (the provider of last resort) and is served by retail suppliers.

Maine’s aggressive adoption of the competitive model, however, comes at a price. The prices paid by Maine’s consumers are—perhaps as much as any in the country—sensitive to the vagaries of the wholesale market. Accordingly, we have worked hard to ensure that the wholesale market reflects the economics of supply and demand, and does not provide either inadequate incentives for efficient investment or opportunities for gaming and the exercise of market power. We have tried to avoid or minimize the impact of any events which will impair competition or unfairly injure consumers—residential or business.

And, thus far, I am relieved to report, both Maine and New England have apparently avoided significant injury from Enron’s recent financial collapse. Most feared were threats to the reliability of supply and to the prices paid by Enron’s customers. Supply continued without discernible disruption. And, because of very careful management, particularly by the ISO-New England and participants in the New England Power Pool (NEPOOL), there was little instability in the markets and apparently no major financial losses.

Enron’s collapse did not cause a reliability problem because Enron does not own the generators. The generation owners’ interest remained unchanged: run their generators and sell the output. Customers continued to want that output. Loads did not change. Generators did not go anywhere. So reliability was unaffected.

And in this environment the stressed and ultimately bankrupt Enron continued—and continues—to meet its contractual supply obligations, most—if not all—of which were profitable in today’s energy market. Those contracts required customers to pay a higher price than the current market price.

Nevertheless, companies who owned the generators, fearing that Enron might not pay for its power purchases, opted out of contracts when possible and instead sold into the spot market.

NEPOOL’s old financial assurance policies allowed the organization to rescind membership in the Pool, but did not allow NEPOOL to cut off a company from trading in the energy markets in response to a situation like that posed by Enron. NEPOOL and ISO-New England’s new policy will automatically restrict a company’s trading in the pool if its credit rating falls below a certain level.

The sudden Enron disintegration impaired its ability to arrange bilateral contracts with generators. In response, Enron bought more and more from the Pool each day. When Enron declared bankruptcy, it was carrying a large, negative financial balance with the Pool (pre-bankruptcy-petition debt). There are two possible remedies for this pre-petition debt. The bonds that Enron was required to post to establish credit with the pool may cover the debt; and if not, NEPOOL has filed a claim in the bankruptcy proceeding.



Enron fought to avoid giving up its trading activities. In lieu of the 30-day settlement process accorded healthy energy trading companies, Enron negotiated a new 3-day-rolling-average payment arrangement with the Pool (administered by the ISO). Enron now maintains a 3-day cash balancing account with the ISO. At the end of each day, the ISO withdraws enough money to cover the transactions that occurred three days previously. Enron has agreed to wire-transfer to the ISO—by the end of the next day—enough money to replenish the account. In December this arrangement and term sheet were submitted to the FERC for emergency approval. The FERC promptly approved it.

There was further concern in the New England market that, because parties with bilateral contracts to supply Enron could terminate those contracts because of the bankruptcy but Enron could keep buying what it needed in the spot market, Enron's resort to the spot market could produce over-reliance on it (similar to what happened in California), sharply increasing spot-market prices. While that did not happen in this instance, it remains at least a theoretical possibility in the event of the financial collapse of another big player.

Outcomes like the one Maine and New England just experienced frequently leads to the oft-used phrase “we dodged the bullet.” True, the bullet did not hit us. But it was not because we were smart enough or nimble enough to escape its blow. We were simply and profoundly lucky.

We are, and have been for many months, in a falling energy-price market, one in which suppliers with a fixed price can profit from declining prices. Had the same set of events occurred against a backdrop of rising energy prices, suppliers would have had an extraordinary incentive to escape their obligations. (Maine has had direct experience with such circumstances.)

Had Enron's implosion occurred in a rising market, Maine's ratepayers could have taken a “hit” in excess of \$50 million, perhaps \$100 million. And, remember, Maine is a state of fewer than 1.3 million people. If Enron has captured as much of the market across New England as it has in Maine and if we were in a rising-energy-price market, the comparable “hit” for ratepayers across New England could have approached \$1 billion.

For ratepayers, there is a certain “heads you win, tails I lose” aspect to the energy market. If a customer signs a contract with an energy supplier and market prices fall, the customer is stuck with paying the now higher-than-market price for its energy. This remains true even if the supplier—as has Enron—goes bankrupt; the contract is a valuable asset of the bankrupt, one which the Bankruptcy Court will seek to use on behalf of other creditors.

But if a customer has a contract with an energy supplier, market prices rise, and the supplier (for whatever reason) goes bankrupt and defaults on the contract, the customer must buy new supply in the high-priced energy market and take its place in line with all the other creditors with little hope that the protections the customer negotiated in its supply contract will provide sufficient relief.

Maine tries to minimize such risk to the state's Standard Offer electricity customers by requiring licensed suppliers to provide evidence of their financial soundness, either by posting a substantial bond or (in the case of companies whose guaranteeing parent has a minimum credit rating of BBB+ or equivalent) by providing us a corporate guarantee that the supplier will meet its obligations.

But even if we had required and Enron had provided a bond to protect Maine's Standard Offer customers, we would have had little meaningful protection—at least sooner than the conclusion of very protracted litigation. Reportedly Enron had purchased surety bonds to guarantee billions of dollars of natural gas and crude oil to two offshore companies. Enron declared bankruptcy in November, ostensibly leaving its guarantors with the bill.

Enron's failure (perhaps amplified by large claims associated with Kmart's failure) supposedly represents one of the largest payouts ever for the surety industry, about \$2 billion, according to experts. Reportedly, it is comparable to the effect of the September 11th terrorist attacks on the property and casualty insurance industry, and the magnitude of these losses may force some bonding companies out of the surety-bond business.

As a result, bond companies likely will raise prices, require collateral, tighten underwriting standards, and cancel some policies. Thus, it could be more difficult for some companies to obtain bonds, thereby reducing the number of competitive providers and making competition less vigorous. Energy market prices may reflect these additional cost burdens.

In conclusion, well-structured, well functioning energy markets can bring substantial benefits to consumers and opportunity to ethical, well run businesses, and strengthen the U. S. economy. Benefits will be realized regardless of whether a state or states open their markets to retail competition.

The keys to a well structured, well functioning market are rules that allow all players to compete fairly, based on the underlying economics of what they bring to the competition, and on the integrity of the players. Absent the latter, competitive energy providers will not enjoy the confidence of investors (hence their financial support) or other players in the market (making it harder for them to bring valuable products to the market).

Energy providers, consumers, and investors very much need reforms that will restore confidence in markets. By themselves, states cannot protect against a incompetence or purposeful cheating by a major national company. Apart from the costs and limited effectiveness of the protections mentioned earlier (e.g., surety bonds, corporate guarantee), unscrupulous players can avoid state-designed and enforced protections by doing business only in states with the least restrictive protections. The specific reforms of this nature must be national in scope and carefully designed to balance the price of that protection—both financial and regulatory—against the value of the additional assurances received.

The CHAIRMAN. Thank you very much. Next, let us hear from Mr. Newsome, James Newsome, who is the chairman of the Commodity Futures Trading Commission.

**STATEMENT OF JAMES E. NEWSOME, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION**

Mr. NEWSOME. Thank you, Mr. Chairman, members of the committee. I appreciate the opportunity to testify on behalf of the Commodity Futures Trading Commission, and because this committee may be a little less familiar with the role of the CFTC, I have detailed in written testimony the oversight role of the CFTC and for the sake of time will abbreviate those comments this morning, but would respectfully ask that my written comments be included in the record, Mr. Chairman.

The CHAIRMAN. We will include your written comments in the record.

Mr. NEWSOME. Thank you, sir.

I would like to begin by saying, as both a regulator and a citizen, that I have great sympathy for the people who were harmed by incomplete, misleading, and inaccurate financial information. I share the concern of many that appropriate inquiries be made to ensure that investors, creditors, and others who rely on the accuracy of financial disclosures by publicly held companies can continue to do so with the fullest of confidence.

I would like to take a moment to complement Mr. Viola, to my right, his staff and members of the New York Mercantile Exchange, as well as those at the New York Board of Trade, for their remarkable reactions to the September 11 attacks. The fact that NYMEX and NYBOT were up and running within only days after the attack helped avert the possibility of further economic disruptions, and should give us all great confidence in the resilience and strength of those institutions.

I would like to share with you today the important role of the futures markets in our economy and the role of the CFTC in overseeing those markets, particularly with respect to the energy markets, and how that role changed with the passage of the Commodity Futures Modernization Act of 2000.

The commission perceives its mission as twofold, to foster transparent, competitive, and financially sound markets, and to protect market users and the public from fraud, manipulation, and abusive practices. While the stock markets provide a means of capital formation, a way for new and existing businesses to raise capital, the

futures markets provide producers, distributors, and users of commodities with a means of managing their exposure to price risk. Futures contracts based on nonagricultural fiscal commodities like metals or energy products, and on financial products such as interest rates, foreign currencies, or stock market indices, now serve the risk management needs of businesses in so many sectors of the economy that trading in these new contract areas is now many times larger than that of agricultural contracts.

Although the primary purpose of the futures markets is risk management, many futures markets also play an important price discovery role in which many businesses and investors that are not direct participants in futures nonetheless refer to the quoted prices of futures market transactions as reference points or benchmarks for other types of transactions or decisions. To fulfill its responsibilities, the commission focuses on issues of market integrity and pursues a multi-pronged approach to market oversight. We seek to protect the economic integrity of markets against price manipulation through direct market surveillance and oversight of the exchanges' surveillance efforts.

The heart of our direct surveillance is a large trader reporting system under which commodity brokers called futures commission merchants, or FCM's, and foreign brokers file daily reports with us that aggregate positions across FCM's and accounts to give a truer view of large trader presence.

Commissioners are apprised of market activity and possible problems at weekly surveillance briefings. To protect the financial integrity of the markets, our priorities are to avoid disruptions of the clearing and settling system, and to protect customer funds entrusted to FCM's. As an oversight regulator, the commission reviews the audit and financial surveillance work of the exchanges, and also monitors the health of FCM's directly. We also review clearinghouse procedures for monitoring risk and protecting customer funds.

To protect the operational integrity of the markets, the commission requires extensive record-keeping, appropriate customer disclosures, fair sales and trading practices, and training of industry professionals. The CFTC Division of Enforcement aggressively investigates and prosecutes violations of the CEA and of commission rules.

We oversee on-exchange trading of futures and options contracts based on things such as crude oil, natural gas, heating oil, propane, gasoline, and coal. The overwhelming majority of on-exchange energy transactions are executed on NYMEX. Please note that the CFTC does not regulate trading of energy on products in the cash or foreign markets, which are excluded from our jurisdiction by the Commodity Exchange Act.

Because Enron was a large trader on the NYMEX, its on-exchange activities have been regularly monitored by the CFTC. At this time, we have no indication that manipulation of any futures market was attempted by Enron. However, the rapid financial deterioration of Enron presented a separate concern for the commission. Could its positions be unwound without price volatility or reduced liquidity?

In fact, these markets proved to be quite resilient. When Enron's positions were closed out, prices did not spike up or down, nor did liquidity suffer. When Enron's financial troubles became known last fall, our staff worked closely with the NYMEX clearinghouse and the FCM's that were carrying most of its positions to monitor and manage the winding down of those positions. By adjusting margins and other appropriate measures, the clearinghouse was able to accomplish a very smooth landing while protecting the FCM's and their customers.

By mid-December, all of Enron's positions on the regulated exchanges had been liquidated. I believe this episode was an example of success for the financial controls in the on-exchange futures markets.

In 1999, the President's Working Group on Financial Markets released its report on over-the-counter derivatives, which recommended providing legal certainty for off-exchange derivatives transactions. Congress considered these recommendations and ultimately codified many of them, together with substantial reforms of the regulatory regime for exchange traded futures, in the Commodity Futures Modernization Act of 2000.

With respect to energy-based futures, the CFMA exempted two types of markets from much of the CFTC's oversight. The first is bilateral principal-to-principal trading between two eligible contract participants which includes sophisticated entities, for example, those with assets of at least \$10 million.

The second is electronic multilateral trading among eligible commercial entities, which include eligible contract participants that can also demonstrate an ability to either make or take delivery of the underlying commodity, and dealers then that regularly provide hedging services to those with such ability.

The CFTC, as part of the President's Financial Working Group, is now participating in a review of corporate disclosure issues that may yield valuable suggestions for how both industry and the Government may seek to prevent a repeat of the Enron situation. Within the commission, we are currently implementing a reorganization of the CFTC divisions that will consolidate our market oversight functions into one division to help improve an already excellent program.

Mr. Chairman, as a regulator, I believe that it is important to constantly review current policies and procedures, especially given today's dynamic marketplaces, to ensure that appropriate regulatory levels are maintained. The significance of the Enron situation and its ramifications deserve study and recommendations for improvements.

Some of those responses will come from Congress, others from regulators, and still others from industry participants. Having said this, I was a supporter of the CFMA because I sincerely believe that a one-size-fits-all approach to regulation was outdated, especially with all of the business and technological innovations that we have seen in recent history. Tailoring regulations to the nature of the participant, product, and trading facility seemed in my view to be appropriate concepts on which to define the Federal regulatory interest.

To date, I have seen no evidence to the contrary. However, we will continue to monitor the markets within our jurisdiction, and we will continue to utilize all authorities given to us by the Congress to aggressively pursue CEA violations. The commission stands ready to work with this committee, the Congress, and other regulators to find the appropriate responses.

Thank you, Mr. Chairman, for the invitation to be here, and I will be happy to answer any questions at the appropriate time.

[The prepared statement of Mr. Newsome follows:]

PREPARED STATEMENT OF JAMES E. NEWSOME, CHAIRMAN, COMMODITY FUTURES  
TRADING COMMISSION

Thank you, Chairman Bingaman, and members of the Committee. I appreciate your having given me the opportunity to testify here today on behalf of the Commodity Futures Trading Commission and to contribute to the discussion of important issues you have raised.

I would first like to say—both as a federal financial regulator and as a citizen—that I have great sympathy for those who were misinformed by incomplete and inaccurate information they may have received. I also share the concern that appropriate action be taken to ensure that investors, creditors, commercial counter parties, and others who rely on the accuracy and completeness of financial disclosures by publicly-held companies can continue to do so with the fullest confidence. I commend the Securities and Exchange Commission for having opened an investigation into these matters.

I would also like to take a moment to commend Mr. Viola and all the people at the New York Mercantile Exchange, as well as their friends and colleagues at the New York Board of Trade, for their remarkable reactions to the September 11th attacks. Their courage, tenacity, and foresight in quickly restoring market operations in the face of unprecedented challenges and terrible personal tragedies deserve the gratitude of every business, investor, and consumer because these markets can play critical roles in the U.S. and world economies. For example, the West Texas Intermediate Crude oil contract traded on NYMEX is relied upon as a price benchmark around the globe. The fact that NYMEX and NYBOT were up and running within only days of the attacks helped avert the possibility of economic disruptions across the economy and should give us all great confidence in the resilience and strength of these institutions.

With your permission, I would like to tell you a little bit about the important role of the futures markets in the U.S. economy and the role of the CFTC in overseeing those markets. I will describe how the Commission responded to the Enron situation last fall. I will also discuss our role with respect to the energy markets and how that role changed with passage of the Commodity Futures Modernization Act of 2000. Finally, I would like to offer some thoughts on how the Commission might make a contribution as we move forward.

BACKGROUND

The Commission was created by Congress in 1974 to oversee the nation's commodity futures and options markets. The Commission perceives its mission to be two-fold: to foster transparent, competitive, and financially sound markets, and, to protect market users and the public from fraud, manipulation, and abusive practices. There are important differences between the futures markets and the stock markets. While the stock markets provide a means of capital formation, a way for new and existing businesses to raise funds, the futures markets provide producers, distributors, and users of commodities with a means to manage their exposure to commodity price risk. Historically, commodity futures and options were traded on agricultural products. And while contracts based on agricultural products are traded as actively today as ever, a great many futures contracts are now based on non-agricultural physical commodities like precious metals or energy products and on financial commodities like interest rates, foreign currencies, or stock market indices. Because they serve the risk management needs of businesses in virtually every sector of the economy, the volume of trading in these financials and non-agricultural physicals is now nine times that in agricultural contracts. While farmers and ranchers continue to use futures contracts to effectively lock in the prices for their crops and herds months before they come to market, manufacturers now can also use futures contracts to plan their raw material costs and to reduce uncertainty over the prices they receive for finished products sold overseas. Mutual fund managers can use

stock index futures to protect against market volatility and effectively put a floor on portfolio losses. And electric power generators can use futures contracts to secure stable pricing for their coal and natural gas needs.

These producers, distributors, and users of commodities (whether physical or financial) are called hedgers. The futures contract positions that hedgers put on are referred to as covered positions. For example, a power generator's obligation to purchase natural gas will be covered by its ability to use that natural gas in its electricity generation. There are other participants in the futures markets who take uncovered positions in the hope of making profits rather than mitigating risks. These individuals and firms are known as speculators and they contribute to the smooth operation of a futures market by increasing its liquidity. Because the needs of different hedgers for long or short positions may not always be perfectly balanced, the presence of speculators increases market effectiveness by better ensuring that hedgers will be able to put on positions they need.

Although I have described the primary purpose of futures markets as tools for risk management, it should be noted that many futures markets play another important role in the economy, that of price discovery. Many businesses and investors that are not direct participants in the futures markets nonetheless refer to the quoted prices of futures market transactions as reference points or benchmarks for other types of transactions and decisions. This is particularly important in many agricultural markets where no other means of price discovery exists outside of the quoted futures prices but it is also true in other sectors, including many energy markets.

#### HOW THE CFTC PERFORMS ITS MISSION

In seeking to fulfill its mission to foster transparent, competitive, and financially sound markets and to protect market users and the public from fraud, manipulation, and abusive practices, the Commission focuses on issues of integrity. We seek to protect the economic integrity of the futures markets so that they may operate free from any fraud or manipulation of prices. We seek to protect the financial integrity of the futures markets so that the insolvency of a single market participant does not become a systemic problem affecting other market participants or financial institutions. We seek to protect the operational integrity of the futures markets so that transactions are executed fairly, so that proper disclosures are made to existing and prospective customers, and so that fraudulent sales practices are not tolerated.

The Commission pursues these goals through a multi-pronged approach to market oversight. We seek to protect the economic integrity of the markets against attempts at manipulation through direct market surveillance and through oversight of the surveillance efforts of the exchanges themselves. The heart of the Commission's direct market surveillance is a large-trader reporting system, under which clearing members of exchanges, commodity brokers (called futures commission merchants or FCMs), and foreign brokers electronically file daily reports with the Commission. These reports contain the futures and option positions of traders that hold positions above specific reporting levels set by CFTC regulations. Because a trader may carry futures positions through more than one FCM and because a customer may control more than one account, the Commission routinely collects information that enables its surveillance staff to aggregate information across FCMs and for related accounts.

Using these reports, the Commission's surveillance staff closely monitor the futures and option market activity of all traders whose positions are large enough to potentially impact the orderly operation of a market. For contracts which at expiration are settled through physical delivery, such as in the energy futures complex, staff carefully analyze the adequacy of potential deliverable supply. In addition, staff monitor futures and cash markets for unusual movements in price relationships, such as cash/futures basis relationships and inter-temporal futures spread relationships, which often provide early indications of a potential problem.

The Commissioners and senior staff are kept apprised of significant market events and potential problems at weekly market surveillance meetings, and on a more frequent basis when needed. At the weekly market surveillance meetings, surveillance staff brief the Commission on broad economic and financial developments and on specific market developments in futures and option markets of particular concern. At least one energy product market is usually discussed and officials of the Energy Information Administration of the Department of Energy periodically attend such meetings.

If any indications of attempted manipulation are found, the Commission's Enforcement Division investigates and prosecutes alleged violations of the CEA and Commission regulations. Subject to such actions are all individuals that are (or should be) registered with the Commission, those who engage in trading on any do-

mestic exchange, and those who improperly market commodity futures or option contracts. The Commission has available to it a variety of administrative sanctions against wrongdoers, including revocation or suspension of registration, prohibitions on futures trading, cease and desist orders, civil monetary penalties, and restitution orders. The Commission may seek federal court injunctions, restraining orders, asset freezes, receiver appointments, and disgorgement orders. If evidence of criminal activity is found, matters may be referred to state authorities or the Justice Department for prosecution of violations of not only the CEA but also state or federal criminal statutes, such as mail fraud, wire fraud, and conspiracy. Over the years, the Commission has brought numerous enforcement actions and imposed sanctions against firms and individual traders for attempting to manipulate prices, including the well-publicized cases against Sumitomo for alleged manipulation of copper prices and against the Hunt brothers for manipulation of the silver markets.

In protecting the financial integrity of the futures markets, the Commission's two main priorities are to avoid disruptions to the system for clearing and settling contract obligations and to protect the funds that customers entrust to FCMs. Clearinghouses and FCMs are the backbone of the exchange system: together, they protect against the financial difficulties of one trader from becoming a systemic problem for other traders or the market as a whole. Several aspects of the oversight framework help the Commission achieve these goals:

- (1) requiring that market participants post a performance bond, referred to as "margin," to secure their ability to fulfill obligations;
- (2) requiring participants on the losing side of trades to meet their obligations, in cash, through daily (and sometimes intraday) margin calls;
- (3) requiring that FCMs segregate customer funds from their own funds and protect these customer funds from obligations of the FCM; and
- (4) monitoring the capitalization and financial strength of intermediaries, such as FCMs and clearinghouses.

The Commission works with the exchanges and the National Futures Association (NFA) to closely monitor the financial condition of FCMs. The Commission, the exchanges, and the NFA receive various monthly, quarterly, and annual financial reports from FCMs. The exchanges and the NFA also conduct annual audits and daily financial surveillance of their respective member FCMs. Part of this financial surveillance involves looking at each FCM's exposure to losses from large customer positions that it carries and one way in which such positions are tracked is through the large trader reporting system. As an oversight regulator, the Commission primarily reviews the audit and financial surveillance work of the exchanges and the NFA but also monitors the health of FCMs directly, as necessary and appropriate. We also periodically reviews clearinghouse procedures for monitoring risks and protecting customer funds.

As with attempts at manipulation, the Commission's Enforcement Division investigates and prosecutes FCMs that are alleged to have violated financial and capitalization requirements or to have committed other supervisory and compliance failures in connection with the handling of customer business. Such cases can result in substantial remedial changes in the supervisory structures and systems of FCMs and can influence the way particular firms conduct business. This is an important part of the responsibility of the Commission to ensure that sound practices are followed by FCMs.

Protecting the operational integrity of the futures markets is also accomplished through the efforts of several divisions within the Commission. The Division of Trading and Markets promulgates requirements that mandate appropriate disclosure and customer account reporting, as well as fair sales and trading practices by registrants. Trading and Markets also seeks to maintain appropriate sales practices by screening the fitness of industry professionals and by requiring proficiency testing, continuing education, and supervision of these persons. Extensive recordkeeping of all futures transactions is also required. Trading and Markets also monitors compliance with those requirements and supervises the work of exchanges and the NFA in enforcing the requirements.

And, as with the Commission's efforts to protect the economic and financial integrity of the futures markets, the Division of Enforcement also plays an important role in deterring behavior that could compromise the operational integrity of the markets. Enforcement investigates a variety of trade and sales practice abuses that affect customers. For example, the Commission brings actions alleging unlawful trade allocations, trading ahead of customer orders, misappropriating customer trades, and non-competitive trading. The Commission also takes actions against unscrupulous commodity professionals who engage in a wide variety of fraudulent sales practices against the public.

THE CFTC'S ROLE IN THE ENERGY MARKETS AND OUR RESPONSE  
TO THE ENRON SITUATION

The Commission oversees on-exchange trading of energy-related futures and options contracts based on such things as crude oil, natural gas, heating oil, propane, gasoline, and coal. Several U.S. exchanges are designated to trade energy product futures and options, but the overwhelming majority of on-exchange transactions are executed on NYMEX, where contracts in each of the products I mentioned are actively traded. Please note that the CFTC does not regulate trading of energy products on the spot (cash) market or forward market (non-standardized contracts), which are excluded from our jurisdiction by the Commodity Exchange Act (CEA). However, the Commission can, for example, look at the spot market under our anti-manipulation oversight authority if we believe the spot market in a commodity that underlies a futures contract has been manipulated and we want to determine whether manipulation of the futures market for that commodity has been attempted.

Because Enron was a large trader of energy-based contracts traded on the NYMEX, its on-exchange activity has been monitored by our market surveillance over the years. At this time, we have no indication that manipulation of any on-exchange futures market was attempted by Enron. However, the rapid financial deterioration of Enron last year presented an additional concern about the markets: Could its on-exchange futures positions be unwound without sudden price volatility or reduced liquidity? As it turned out, although Enron had a significant presence in these markets, the company was but one of many participants in what are very large and liquid markets. When its financial difficulties became known and Enron wound down its activities, energy futures price showed remarkably little reaction: The markets for energy-related futures were not roiled and prices did not spike nor did liquidity dry up.

As would the financial difficulties of any large futures customer, Enron's difficulties also raised concerns about the ability of the FCMs that carried Enron's on-exchange futures positions to successfully close out those positions if Enron were to fail to meet margin calls. When Enron's financial troubles became known last fall, staff from our Division of Trading and Markets worked closely with the NYMEX clearinghouse and the affected FCMs to monitor and to manage the winding down of these positions. By appropriately adjusting margin requirements, the clearinghouse was able to ensure that adequate Enron funds remained on deposit at the FCMs, which both provided additional security for the FCMs and their customers and gave Enron a strong incentive to reduce its positions as quickly as possible.

The winding down of Enron's on-exchange positions was accomplished quickly and smoothly so that, by the time of Enron's bankruptcy filing, the risks to which FCMs were exposed had dropped by 80% from only a week earlier. By mid-December, all of Enron's positions on the regulated exchanges had been liquidated. (Enron also owned a small subsidiary FCM, Enron Trading Services, that carried no positions for other customers and only a very small portion of Enron's own on-exchange positions. At all times, ETS had regulatory capital several times the required level. By mid-December, ETS had transferred its customers to other FCMs.) I believe that this episode was a success for the system of financial controls in the on-exchange futures markets. There were no disruptions to the system of clearance and settlement. Enron met all its obligations. No customer lost any funds entrusted to any FCM.

HOW THE COMMODITY FUTURES MODERNIZATION ACT CHANGED THINGS

In 1999, the President's Working Group on Financial Markets—which is chaired by the Secretary of the Treasury and includes the Chairs of the Federal Reserve, Securities and Exchange Commission, and CFTC—released a report entitled "Over-the-Counter Derivatives and the Commodity Exchange Act." The report recommended changes to the CEA to, among other things, create legal certainty for off-exchange derivatives transactions, such as swaps. Congress considered these recommendations and ultimately codified many of them, together with substantial reforms of the regulatory regime for domestic exchange-trading of futures and options, in the Commodity Futures Modernization Act of 2000 (CFMA).

With respect to the energy markets, the CFMA exempts two types of markets from much of the CFTC's oversight. Such markets are described in Section 2(h) of the CEA, as amended by the CFMA. The Act defines exempt commodities as, roughly speaking, all commodities except agricultural and financial products. This category, which for the most part represents futures contracts based on metals and energy products, may be traded on the two types of markets covered by Section 2(h). The first is bilateral, principal-to-principal trading between two eligible contract



participants, which include sophisticated entities such as regulated banks or insurance companies and well-capitalized companies or individuals (for example, those with assets of at least \$10 million), among others. The second is electronic multilateral trading among eligible commercial entities, which include, among others, eligible contract participants that can also demonstrate an ability to either make or take delivery of the underlying commodity and dealers that regularly provide hedging services to those with such ability. While the Commission does not directly regulate these transactions, we do retain anti-fraud and anti-manipulation authority. The public policy issues implicated by such trading among sophisticated entities were addressed by Congress during passage of this important legislation.

#### SUGGESTIONS ON MOVING FORWARD

I would like to first note that the CFTC, as a member of the President's Working Group on Financial Markets, is participating in a study of corporate disclosure issues relating to auditing and accounting which may yield valuable suggestions for how both industry and the government may seek to prevent repeats of the Enron situation. Within the Commission, we have recently proposed a reorganization of the CFTC that will consolidate our market oversight functions into one division to help improve what is already an excellent program.

Mr. Chairman, as a government regulator, I believe that it is important to constantly review current policies and procedures, especially given today's dynamic marketplaces, to ensure that appropriate levels of regulation are maintained. The significance of the Enron situation and its ramifications generally deserve study and recommendations for improvements. Some of these responses will come from the Congress, while others will come from regulators, and still others will come from the industry. Having said this, I was a supporter of the CFMA because I sincerely believed that a one-size-fits-all approach to regulation was outdated, especially with all of the business and technological innovations that we have seen in recent history.

Tailoring regulations to the nature of the participant, the product, and the facility on which it is traded seemed, in my view, to be appropriate concepts on which to define a federal regulatory interest. To date, I have seen no evidence to the contrary in my agency's initial analysis of the Enron situation. However, we will continue to monitor the markets within our jurisdiction, and we will continue to utilize all authorities given to us by the Congress to aggressively pursue CEA violations.

The Commission stands ready to work with this Committee, the Congress, other regulators, and the industry to find appropriate responses. Thank you for the invitation to appear before your Committee. I will be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much. Next, let us hear from Mr. Vincent Viola, who is the chairman of the New York Mercantile Exchange. Thank you for being here.

#### **STATEMENT OF VINCENT VIOLA, CHAIRMAN, NEW YORK MERCANTILE EXCHANGE**

Mr. VIOLA. Thank you. On behalf of the members of the New York Mercantile Exchange, Mr. Chairman and members, I appreciate the opportunity to participate in this hearing. My remarks will briefly summarize our written testimony. I would like to make five principal points before the panel this morning, if I may.

NYMEX is, simply put, the largest energy marketplace in the world, and it is a federally regulated marketplace where risk management is conducted through the expertise of market surveillance and open, transparent price discovery. The critical component that makes NYMEX unique is its unique neutrality to the marketplace. The exchanges market and oversight rules identify potential problems that the exposure of the unregulated marketplace to Enron's positions may possibly have, and stepped in immediately to stabilize the marketplace from our perspective, and our marketplace's actions.

Using data and reports from the complete trading year of 2001 and to date reports for the trading year of 2002, the notional value of NYMEX energy trading volume is substantially larger than that of Enron and Enron Online. In fact, we are a factor of 5 to 1 larger in terms of notional value of the volumes traded on our marketplace as compared to Enron Online. Transparency is an important component of a truly competitive and open marketplace, but rules and procedures which forced a true competition are critical to maximizing the benefits of transparency.

While the facts to date do not indicate that the failure of Enron was related to rules or the absence of rules governing trading in energy contracts, had Congress enacted legislation supported by Enron and a number of over-the-counter market participants to remove nearly all Federal oversight from the energy markets, and platforms would have caused a market disruption that could not, I think at this point, be contemplated in terms of the end effect upon the consumer.

In addition to the openness and transparency of its trade execution operations, NYMEX's clearinghouse protects all participants against counter-party credit risks. It functions simply as a central banker for all participants in the energy marketplace, and that credit risk really is simply the risk of failure of either one of the two parties to a transaction to enact that transaction. Over-the-counter or off-exchange transactions of the type engaged in by Enron and its counter-parties do not carry this level of protection.

Enron Online was, prior to its parent's financial failure, a marketplace for the physical delivery of energy products and also for unregulated financial instruments called SWAP's, and which, as explained earlier, function as over-the-counter instruments that look and perform identically to NYMEX-regulated contracts, with several key exceptions, and I would like to point them out distinctly, if I may.

The counter-parties in an over-the-counter environment bear the credit risk of each other in a bilateral capacity. These transactions currently are not cleared. NYMEX and other forums currently plan to shortly introduce the clearing function and the anonymous central counter-party credit mechanism of clearing to these products. Pricing is not transparent to the public on a system such as Enron Online, because the system is geared and participated in by professional traders. The transactions simply are not regulated.

Typically, over-the-counter market participants utilize NYMEX as the ultimate source of the most efficient liquidity, and liquidity for the purpose of this testimony is simply defined as the difference between what someone is willing to pay or bid for a set volume of energy and what someone is willing to sell that energy for at any given instant. The energy marketplace, there is a very substantial interaction between NYMEX and the unregulated, physical and over-the-counter energy markets. The interaction was clearly apparent in the case of Enron.

I would like to share a little bit of the tactical perspective of the New York Mercantile Exchange on market structure and pricing dynamics as the Enron situation unfolded. In the early stages of Enron's difficulties in the fall of 2001, NYMEX's market surveillance and risk management staff alerted the exchange's manage-

ment of the potential problems, and immediately the exchange implemented a number of measures that are classically typical of regulated environments.

Margin requirements on natural gas contracts were immediately increased, approval was sought from—and I must personally thank the leadership of the CFTC, because we were granted immediate approval of the use of an instrument described as an exchange of futures for SWAP's, which basically this instrument allows for a participant in the cash market to migrate the exposure of that position immediately to the regulated credit mechanism of our exchange clearinghouse by simply choosing to use that instrument, so an over-the-counter unregulated instrument immediately becomes regulated, and therefore credit-protected.

The exchange policies to reduce exposure to Enron's credit risk by NYMEX traders were implemented. Indeed, as the measures were enacted we witnessed a remarkable, what we call flight to quality, quality of liquidity as market participants moved to the NYMEX, where financial performance is guaranteed as the depth and breadth of liquidity from moment to moment can be easily identified in the centralized and physical marketplace.

Based on the information available at this time, it does not appear that the failure of Enron was related to rules or the absence of rules governing trading in energy contracts. Although limited information is available concerning the volume done through the Enron system, Enron Online, SEC filings by Enron for the first two quarters of 2001 indicate that the notional value of trades on Enron Online, the electronic marketplace operated by Enron for various over-the-counter products, averaged just under \$2.8 billion per day notional value. The average daily notional value of trades on the New York Mercantile Exchange for all of the year 2001 averaged \$13 billion per day, approximately 4.6 times the daily average volume reported on Enron Online. These numbers suggest that energy companies chose NYMEX over Enron Online for a large majority of their business.

Related to the issue of Federal market oversight, I would simply like to point out the perspective of the exchange, the New York Mercantile Exchange relative to the Commodity Futures Modernization Act of 2000. NYMEX actively expressed concerns centered on a provision which appeared in both the House and Senate versions of the legislation. This provision was actively pushed by Enron, principally by Enron and other prominent participants in the over-the-counter market and would have exempted energy and metals futures contracts traded on the electronic trading platforms from nearly all regulatory oversight and thankfully, Mr. Chairman, with your and other members of this committee's very distinct efforts, there was a recognition of a serious flaw in that sort of policy perspective, and extreme deregulation was not really achieved, and I think the markets are better for it.

Quite courageously, this committee challenged Enron and others, preventing it from becoming law in its most draconian form, and I want to repeat, I think the marketplace, one of the reasons the marketplace functioned as efficiently as it did in Enron's unraveling was because of the metered and risk management perspective of the regulation.

To this day, we fail to understand the distinction, the Mercantile Exchange fails to understand the distinction between an exempt exchange doing business electronically and a physical exchange doing business in an open trading environment. The energy market conditions arising from Enron's bankruptcy could have been far different had the unwise proposal to nearly completely eliminate regulatory oversight of energy and metals futures and options contracts traded on electronic trading platforms been adopted as it was originally proposed. As it turned out, market participants availed themselves of the safety and credit enhancement provided for by the regulated marketplace.

As Congress moves forward in the examination of the complex issues arising from the bankruptcy and in consideration of how the benefits of transparency and market oversight and enhanced, open and fair competition can be extended to the broader energy marketplace, including that of electricity, where I think it is dearly needed, these lessons should be remembered as future legislation is developed and considered.

Once again, Mr. Chairman, I want to humbly thank you for the opportunity to appear, and look forward to answer any questions put forward by the panel.

[The prepared statement of Mr. Viola follows:]

PREPARED STATEMENT OF VINCENT VIOLA, CHAIRMAN, NEW YORK  
MERCANTILE EXCHANGE

Mr. Chairman, my name is Vincent Viola. I am the Chairman and Chief Executive Officer of the New York Mercantile Exchange ("NYMEX" or the "Exchange"), which is the world's largest forum for the trading and clearing of energy contracts. NYMEX is a federally chartered marketplace, fully regulated by the independent federal regulatory agency, the Commodity Futures Trading Commission ("CFTC" or the "Commission"). On behalf of the Exchange, its Board of Directors and members, I want to thank you and all the members of the committee for the opportunity to participate in today's hearing to study the impact of the collapse of Enron on the energy marketplace. As you and the members of this committee are painfully aware, the Enron bankruptcy has had a far reaching impact on employees, consumers, stockholders, regulators, elected officials, and energy market participants. The shocking swiftness with which Enron's failure occurred and the lack of transparency of the reasons for the failure are necessary topics for thorough Congressional review.

Our comments and observations today will focus primarily on the market impact and other issues, including regulatory matters, arising from the bankruptcy, and the effect it has had on the marketplace, market participants and consumers. Our remarks today will be presented in the following order:

- The Energy Marketplace—The Role of NYMEX
- NYMEX is Regulated by the Commodity Futures Trading Commission
- The Marketplace Reacted to the Enron Collapse Swiftly, and Minimal Damage Occurred
- Transparency is a Critical Component of a Competitive Marketplace
- Statutory and Regulatory Issues

THE ENERGY MARKETPLACE—THE ROLE OF NYMEX

The New York Mercantile Exchange, Inc., was established in 1872, and has grown to become the world's largest exchange for energy and precious metals. As a regulated commodity futures and options exchange, NYMEX has served as a diverse domestic and international customer base by bringing price transparency, competition and efficiency to energy markets, and provides businesses with the financial tools to deal with market uncertainty.

Although NYMEX is a marketplace for commercial participants in the energy realm to hedge risk and discover prices on large volume transactions, the benefits of this marketplace accrue to the consumers of energy who receive prices based on open and fair competition. In addition to prices being competitively arrived at, the Exchange also assures that the prices for all transactions occurring on its floor are

transparent. They are disseminated world-wide immediately upon execution via the market ticker, and are accessible real-time through a variety of market data services.

The transparency of NYMEX prices, and the integrity of its markets, makes NYMEX a visible and reliable benchmark for energy pricing which is vital to our economy. The visible and highly competitive daily transactions of energy futures and options on the exchange provide a true world reference price for each of the commodities traded. In the aftermath of the collapse of Enron, NYMEX has played a leading role in insuring against a broader financial adversity in the energy marketplace through its secure liquid market, also served once again in its role as a safe haven that we have served during other episodes of market uncertainty.

In addition to price transparency, the Exchange is used and relied upon as an open forum for hedging energy price risk. Risk shifting, in the secure liquid markets that NYMEX provides, allows commercial interests to “hedge” the risk of price fluctuations that could affect planning of their business operations, and consequently profitability, by using futures and options contracts to “lock in” energy costs. For the commercial participant, the result is a form of risk insurance against the financial adversity that can result from volatile energy prices. The primary instruments used are futures contracts and options contracts:

- A futures contract is a binding obligation to make or take delivery of a specified quantity and quality of a commodity at a specified location and time.
- An options contract is a contract which gives the holder the right, but not the obligation, to purchase or to sell the underlying futures contract at a specified price within a specified period of time in exchange for a one-time premium payment.

In addition to the openness and transparency of its trade execution operations, NYMEX’s clearinghouse protects all participants against counterparty credit risk, which is simply the risk of failure of either one of the two parties to a transaction (the buyer or the seller) to pay such funds as they become due to his counterpart as a result of the trade. Through a system of cross guaranties among the brokerage firms and banks that comprise NYMEX’s clearinghouse, credit risk is removed from each participant, because financial performance is guaranteed by the Exchange and backed by its clearing members. Customer funds are held by the Exchange and its clearing members in trust accounts which are fully segregated from the exposure and funds of the clearing firm or the Exchange itself. Over-the-Counter, or off-Exchange, transactions of the type engaged in by Enron and its counterparties do not carry this level of protection against credit exposure.

#### NYMEX IS REGULATED BY THE COMMODITY FUTURES TRADING COMMISSION

The federal government has long recognized the unique economic benefit futures trading provides for price discovery and managing price risk. In 1974, Congress created the Commodity Futures Trading Commission (“CFTC” or “the Commission”), giving it authority to regulate commodity futures and related trading in the U.S. A primary function of the CFTC is to ensure the economic utility of futures markets as hedging and price discovery vehicles—encouraging transparency, competitiveness, efficiency, and market and trade practice integrity and fairness. Regulated markets must file all terms and conditions of contracts, and contract changes, with the CFTC. The Commission also oversees registration of firms and individuals who either handle customer funds or give trading advice. It conducts and monitors rule enforcement at U.S. futures exchanges.

As part of the federal mandate, NYMEX performs many self regulatory functions, and its rule enforcement program is under the jurisdiction and watchful scrutiny of the CFTC. NYMEX expends considerable resources to maintain a compliance function, including market and financial surveillance, as well as a disciplinary process for those who might violate any of the Exchange’s rules.

#### *Unregulated Physical and Financial Markets Also Provide Risk Management*

Another component of the energy marketplace is comprised of exchanges and intermediaries not falling under the jurisdiction of the CFTC, which thus are unregulated. These markets are frequently referred to as over-the-counter (“OTC”) markets. The trading subsidiary of Enron, EnronOnline (“EOL”), was, prior to the parent’s financial failure, a marketplace for physical delivery of energy products (meaning that buyers and sellers actually intended to make or take delivery of the commodity bought or sold), and also for unregulated financial instruments called “swaps,” which are OTC instruments that look and function similarly to or identically to NYMEX’ contracts with several key exceptions:

- The counterparties bear the credit risk of each other—these transactions are not cleared;
- Pricing is not transparent to the public; and
- The transactions are not regulated.

An over-the-counter or OTC deal is a standardized or customized contract usually arranged with an intermediary such as a major bank or the trading wing of an energy company, as opposed to a standardized contract traded on a futures exchange. A swap is generally defined as an agreement whereby a floating price is exchanged for a fixed price over a specified period, thus allowing a buyer or seller of energy products to “lock in” a specific price, and avoid the risk of floating prices. The financial purpose of an OTC transaction, therefore, is usually the same as the financial purpose of a NYMEX transaction. The swap is a financial arrangement which involves no transfer of physical energy; both parties settle their contractual obligations by means of a transfer of cash. The agreement defines the volume, duration and fixed reference price (which for most contracts in the U.S. for oil or natural gas is the NYMEX price). Differences are settled in cash for specific periods—monthly, quarterly or six-monthly.

Typically, OTC market participants utilize NYMEX not only as a price reference, but also to hedge their own price exposure resulting from the swap agreements or physical contracts that they have entered into. Thus, in the energy marketplace, there is a substantial interaction between NYMEX and the physical and OTC energy markets.

THE MARKETPLACE REACTED TO THE ENRON COLLAPSE SWIFTLY,  
AND MINIMAL DAMAGE OCCURRED

In the early stages of Enron’s difficulties in the fall of 2001, some observers feared that Enron’s substantial position in the OTC marketplace could pose serious problems for a significant number of market participants. Although it is still too early to know for sure, it appears that these fears did not come to pass, although they were well-founded. Enron’s counterparties appear to have realized the risk in being paired against a company in ever-worsening condition and made alternative arrangements, including transferring positions to the NYMEX.

During that same period, NYMEX market surveillance functions, using the established tools such as large trader reporting, position limits, and position reporting, alerted staff and management to potential problems. To address issues arising from the Enron situation, the Exchange implemented a number of measures:

- Margin requirements (cash required as a guarantee of fulfillment of a futures contract) on natural gas contracts were increased.
- Approval was sought from, and granted by, the CFTC for the use of EFS (“Exchange of Futures for Swaps”) instruments for natural gas to allow market participants to migrate their positions from the OTC marketplace to NYMEX, where financial performance is guaranteed.
- Exchange policies to reduce exposure to Enron’s credit risk by NYMEX traders were implemented.

Indeed, as the measures were enacted, we witnessed a remarkable “flight to quality,” as market participants moved to the NYMEX where financial performance is guaranteed by the safety and soundness of a federally overseen clearinghouse.

TRANSPARENCY IS A CRITICAL COMPONENT OF A COMPETITIVE MARKETPLACE

Market transparency has sometimes been defined as “the ability of market participants to observe and obtain information on the trading process.” Transparency has many dimensions because a market has many kinds of participants and many types of information. In the case of Enron, concerns on transparency have ranged from corporate reports in compliance with securities law requirements, disclosure to stockholders and employees, and in the nature of the market utilized by the company’s energy trading arm. We are not inclined to comment on securities law related issues, or on corporate governance. We will direct our observations to transparency issues related to the functioning of the energy marketplace.

Mr. Chairman, through your legislative efforts and public statements, you have promoted the notion that energy markets are in need of greater transparency. More than merely paying “lip service” to the issue, you have translated your opinion into action. Specifically, H.R. 2884, the “Energy Act of 2000” (Attachment 1)\* included an important provision which you sponsored, and which directs the Secretary of Energy to study how government agencies, consumer cooperatives and others can learn

\* The attachments have been retained in committee files.

about and utilize heating oil futures to protect consumers and government budgets from energy price uncertainty. Expanding the knowledge and use of market instruments directly enhances market transparency.

Even now, the Department of Energy's Energy Information Administration ("EIA") is evaluating comments on their proposal, following an initial review by the Office of Management and Budget ("OMB"), to provide a weekly report on the volume natural gas in storage. This report, which had been done by the American Gas Association until the AGA announced that it would cease reporting in the spring of 2002, is a critical component of transparency in the natural gas marketplace. NYMEX strongly supports the EIA's efforts, but we feel it is absolutely critical that the data be released at a time when the market is open and has the largest number of participants—we have argued for a release time of 10:30 a.m. on the day of release (Thursdays). Some comments received during the OMB Review of EIA's proposal suggest that the report should be released in the late afternoon, or just prior to the weekend, so the data can be "digested," and would not cause as much volatility in the marketplace. While the intentions of those proposing after hours release may be chaste, they would have the opposite effect sought. Energy markets today trade 24 hours per day. However, the participants trading outside of the traditional "open outcry" daytime market tend to be very large and sophisticated entities. Those large entities would have a distinct advantage if the data were to be released when the most active market is closed. In essence, they would be in a position to utilize information when many market participants could not. While not exactly the same issue as "insider trading," the benefits of the natural gas survey data in enhancing energy market transparency would be greatly diminished if the data is not released during a time when the largest number of participants are active.

*Transparency Lessons Learned From the California Electricity Disaster*

The most recent, and telling, lessons on market transparency come from California. While striving to develop a competitive and transparent electricity marketplace to facilitate the implementation of California's "deregulation" legislation in the mid 1990's, the efforts of federal and state agencies overseeing the attempt failed miserably. In the name of "transparency" a government mandated monopoly market, the California Power Exchange ("PX") was created which eliminated competition and forced the market into a "spot" or day ahead marketplace which is typically the most volatile in energy markets. Making things even worse was the fact that the transmission system remained, for all intents and purposes, under the monopoly control of the utilities, thus stifling yet another avenue for competition. The fact that the PX reported prices in the name of transparency was of little use in developing a truly competitive market. When a monopoly owns a road and controls all access, price reporting, or "transparency" is of little use to the driver in need of that road. In spite of all the benefits of controlling a monopoly market, the PX filed for bankruptcy last March.

The goal of building and enhancing a transparent electricity market is a good one. However, without rules and policies which facilitate true competition—an environment where many sellers compete with each other for buyers, and non-discriminatory access to the transmission grid, "transparency" will not develop in a manner that maximizes the public good. Another potential difficulty lies in the area of committee jurisdiction. One agency with expertise and experience in competition and transparency is the CFTC. As this committee moves through the difficult legislative process, we urge that consideration be given as to how the market oversight knowledge of the CFTC might be utilized to further the goals of enhanced competition and transparency in the electricity markets.

STATUTORY AND REGULATORY ISSUES

Based upon the information available at this time, it does not appear that the failure of Enron was related to rules, or the absence of rules, governing trading in energy contracts. Until all the facts are in, we cannot say with any certainty which of several possible causes brought about the bankruptcy, but we do not believe the cause to have been the regulation or deregulation of energy trading. Based on what we now know, we are not recommending or calling for significant changes in the way the over the counter markets are regulated. However, as detailed in the following paragraphs, we still do not believe the differences in regulatory oversight between energy and metals futures contracts traded on electronic platforms, as opposed to those traded on an "open outcry" manner which resulted from legislation passed in 2000, are justified on an economic or policy basis.

Episodes like this one, where a major market participant fails, heighten the awareness that the Exchange is a safe haven, and that the benefits to doing business on a regulated marketplace hold enormous appeal, or should, to any corpora-

tion with credit or price exposure to energy. We believe that corporate boards and treasury offices should become more involved as a matter of their fiduciary obligations to their employees and shareholders to learn about the differences between regulated and unregulated marketplaces. However, we do not believe that business should be compelled to use NYMEX by virtue of a regulatory or legislative fiat.

Although limited information is available concerning the volume of business done through the Enron system, SEC filings by Enron for the first two quarters of 2001 indicate that the notional value of trades on EnronOnline (the electronic marketplace operated by Enron for various OTC products) averaged just under \$2.8 billion per day. The average daily notional value of trades on NYMEX for all of 2001 is \$13 billion, or more than 4.6 times the daily average volume reported for EnronOnline. These numbers suggest that energy companies chose NYMEX over EnronOnline for a large majority of their business. It was NYMEX, not Enron, which represented the largest forum for the trading of natural gas, crude oil, and other energy products, by a wide margin, notwithstanding (or perhaps because of) the vastly uneven regulatory schemes governing our respective conduct. It is worth pointing out that NYMEX remains solidly in business.

Recently, a number of publications have reported that the Exchange was “unhappy” with the Commodity Futures Modernization Act of 2000 (the “CFMA”). Specifically, while we were supportive of, or neutral to, much of the legislation, our major concerns centered around a provision which appeared in both the House (H.R. 4541) (Attachment 2) and Senate (S. 2697) versions of the legislation as introduced in May of 2000. This provision was actively pushed by Enron, among others, and would have exempted energy and, in the House version, metals futures contracts traded on electronic trading platforms from nearly all federal regulatory oversight.

Thankfully, Mr. Chairman, you, Senator Charles Schumer, and Senators Richard Lugar and Tom Harkin (Attachment 3) with the Senate Agriculture Committee, as well as number of members of congress including Congresswoman Carolyn Maloney, Congressmen Peter King, John Dingell, and others recognized the serious policy flaws with this extreme deregulatory measure, and quite courageously challenged Enron and others, preventing it from becoming law in its most draconian form. The final version of the legislation passed by Congress in December, 2000, (H.R. 5660) (Attachment 4), contained a modified version of the provision which added the following provisions:

- An exempt electronic exchange would be subject to anti-fraud and anti-manipulation provisions of the Commodity Exchange Act.
- Authority for the Commission to prescribe rules, if necessary to ensure timely dissemination by the electronic trading facility of price, trading volume, and other trading data should the Commission determine that the exchange performs a significant price discovery function.
- Obligate the exchange to maintain records for five years.
- An exempt electronic exchange would have to provide the Commission with access to the facility’s trading protocols and electronic access to the facility, and information relating to data entry and transaction details sufficient to enable the Commission to reconstruct trading activity on the facility conducted in reliance on the exemption.

NYMEX had opposed the exemption from its inception, and had supported its elimination from both the Senate and House versions of the CFMA. To this day, we fail to understand the distinction between an exempt exchange doing business electronically, and one doing business on an open-outcry trading floor.

The risk management/price discovery business has undergone a dramatic evolution over the last fifteen years. Many of those changes have been both the cause and the effect of legislation passed in 1992. Specifically, the growth of the over-the-counter (“OTC”) markets whether in financial or commodity swaps, Brent oil forward contracts, or other new instruments was the driving force that led to the dramatic change in commodity oversight that the 1992 amendments to the Commodity Exchange Act embodied. No longer were all futures contracts required to be executed on or subject to the rules of a contract market. For the first time, the CFTC was granted the authority to exempt from the exchange trading requirement, agreements and transactions that may otherwise have been subject to the Act. The CFTC exercised that exemptive authority shortly after the passage of the 1992 amendments, and, as a result, the growth of the over-the-counter markets greatly accelerated.

In many respects, NYMEX, as a marketplace for contracts that require physical delivery of a commodity, has been a beneficiary of the regulatory flexibility embodied in the 1992 legislation. It has fostered the growth of energy price risk management by parties that otherwise lack the ability to utilize optimally standardized



physical delivery contract because they need to manage the price risk in the commodity in a more customized manner. Regulatory flexibility has enabled these parties to structure transactions with a selected counter-party to suit their needs. To the extent that energy price risk is transferred to a willing counter-party, that party can protect itself through the use of the futures market for the generalized commodity price risk and accept the balance of the price risk (for a cost the parties agree to) or attempt to otherwise balance it off.

Congress and the CFTC must provide the flexibility to exchanges to innovate—to continue to serve the commercial needs of the community, whether oil producers, refiners, farmers, or financial institutions—free of the regulations which micro-manage, yet within a statutory framework that maintains public confidence.

In testimony presented over the past decade, NYMEX has consistently supported and advocated the need for the market oversight (position limits, large trader reporting and surveillance) that the centralized markets provide. We believe that CFTC oversight is appropriate and beneficial in areas that provide oversight and uniform standards aimed at protecting the ongoing financial integrity, market integrity and trade practice integrity of the marketplace. We believe that correct emphasis has been placed on the financial integrity and trade practice protections that the self-regulatory structure of this industry has always provided. The deepest, most liquid markets—that provide the most efficient price discovery and risk shifting—occur on the centralized market, i.e. NYMEX, where market and financial integrity oversight is a routine part of doing business.

*The Energy Marketplace Has Dealt With the Enron Bankruptcy*

Chief among the lessons to be taken from the Enron bankruptcy is the value provided by the federally chartered, regulated commodity marketplace in supplying market oversight and credit enhancement. The ability of market participants to move from largely unregulated trading platforms to the Exchange where transparency, liquidity, and market oversight are the watchwords, proved to be of critical value in avoiding broad ranging disruptions as Enron's problems became known.

The situation could have been far different had the unwise proposal to nearly completely eliminate regulatory oversight of energy and metals futures and options contracts traded on electronic trading platforms been adopted as originally proposed. As it turned out, market participants availed themselves of the safety and credit enhancement provided by the regulated marketplace. As Congress moves forward in the examination of the complex issues arising from the bankruptcy, and in consideration of how the benefits of transparency, market oversight, and enhanced competition can be extended to the broader energy marketplace, including that of electricity, these lessons should be remembered as future legislation is developed and considered.

Once again, Mr. Chairman, thank you for the opportunity to participate in this important discussion.

The CHAIRMAN. Thank you very much for your testimony.

Mr. Robert McCullough, managing partner of McCullough Research in Portland, Oregon.

**STATEMENT OF ROBERT McCULLOUGH, MANAGING PARTNER,  
McCULLOUGH RESEARCH, PORTLAND, OR**

Mr. McCULLOUGH. Thank you, Mr. Chairman, thank you, members of the committee for the opportunity to speak today. Now, I am a practitioner, a fact provider and, to be blunt, I am a tiller of the fields that are managed and regulated by the fine gentlemen who have spoken before. I am going to be very brief. The bottom line is that the Enron collapse had tremendous impacts throughout the industry. Luckily, it was not spot prices.

He really brought up the central issue, which is transparency. That is an economist term, openness, and that openness is critical to the working of a competitive market. There are three feet to the stool, financial, commercial, operational. On the financial side, the issue of blame really is not central here. We really do not care at this exact moment, in this exact panel, who is at fault, but we care critically that the Enron collapse raised the cost of capital.

For those of you who are conversant with this, it has shifted the choice of resources away from renewables towards fossil fuels, because renewables are capital-intensive. We will live with that choice for many years.

Now, how did it change the cost of capital? Simply because we do not understand the Enron statements. How do you get even the most minor understanding of the Enron statements? Well, a simple question. Who owned LJM, that led, precipitated the collapse? Well, first you need computer resources, you need a high-speed Internet connection to the SEC, you need 48 hours to download this force generation data base with real-time access, and at the end of it what you find is that on November—I am sorry, October 20, 2000, Enron stated that LJM was owned in part by Credit Suisse and Greenwich Net West.

Now, the critical issue there is, how can an investor possibly invest in these markets without knowing who the central owners of these vast enterprises are? This is a logical question. Because that information is not available, the financial markets are not transparent, the cost of capital will be higher. The change will end up in the resources we are served by in years to come, and certainly by consumers.

Next, let us talk about the impact on commercial businessmen, trading. A simple fact of the matter is, we have very little information on commercial arrangements. Some of the new institutions, like the California ISO, are very, very secretive. They were lobbied from the beginning by players in that market to set commercial data availability rules that were very restrictive. You required the intervention of the regulatory commissions of all the Western States, the Governor's office of many of the major utilities simply to find out which resources were running in 2000 and 2001 in California.

We still have very little understanding about who dominates many of these hubs. We have very little information about the critical long-term forward markets. The chairman of FERC is entirely correct, we did not see a lot of spot price changes, but we were appalled to find that at the moment of Enron's bankruptcy the 2003 and 2004 forward prices in the critical hubs in the Pacific Northwest changed, were reduced downward by 30 percent.

We cannot explain that coincidence, because the data is not available. Moreover, it is not simply a question of one trader making money and another trader losing money. Those are prices that directly impact consumers.

The Bonneville Power Administration across this period was forced into a major rate increase. They had very unpleasant financial results. Preliminary review of what data is available in the case that Enron may possibly be the largest single commercial partner for the Bonneville Power Administration. Again, that will be sorted out in days to come. The bottom line is that we need much more commercial information available.

My firm and my clients have fought efforts at FERC and the North American Electric Reliability Council and at the EIA to make less information available. That is the wrong path.

Now let us get to the most important issue. It is actually system operations. When all is said and done, we are a wealthy country.

We can afford the tremendous bills we saw out of the California market fiasco. It was not pleasant. Two of our major industrial clients went bankrupt, one major utility is bankrupt, but reliability is not something you can fix later on by moving around money.

In the winter of 2000, 2001, the lack of system operations information from California led to a major policy error. The Secretary of Energy, doing the best he could—and this is not an error on his part. It is an error on the policymaking part—decided to direct all of the utilities in the Northwest to draw down that scarce storage battery, the Columbia River, to keep the lights on in California. I do not think he could have made any other decision, but we know from the research done by the Northwest Regional Planning Council that he brought us within 20 percent of long-term interruptions in the Northwest.

We are not talking an hour a day, we are talking homes and stores and churches, factories being without lights for 8, 16 hours at a time for weeks. The bottom line there is, we needed that operational data. We still need it. We still, by the way, do not have an easy flow of it.

Our firm actually receives that data from the Oregon Public Utility Commission. It then passes it back to California State authorities like the AG's office and the California Public Utility Commission. That is how makeshift that information flow is.

The bottom line, gentlemen, is that transparency, openness is a far better tool than regulation. If we know what is going on, we know what we need to fix. At that point, the excellent job of the regulators can focus in on the actual problems. Before that, we are trying to operate competitive markets in the dark, and unfortunately I am not kidding. We came close, in the winter of 2000-01, to actually running the largest single integrated electric system in the world in the dark.

Thank you very much.

[The prepared statement of Mr. McCullough follows:]

PREPARED STATEMENT OF ROBERT MCCULLOUGH, MANAGING PARTNER,  
MCCULLOUGH RESEARCH, PORTLAND, OR

Mr. Chairman and Members of the Committee:

Good morning. Thank you for this opportunity to speak on the need for transparency in energy markets.

I would like to start by telling a short historical tale with enormous relevance to today's situation. Seventy years ago a pioneering electric and natural gas firm collapsed. The bankruptcy, the largest one in U.S. history at the time, destroyed the retirement savings of millions of Americans. Thankfully, due to the primitive technology of the time, interconnections between systems were rare and the collapse had few operational implications—the lights stayed on.

As everyone in this room is aware, I am speaking of the Insull Trust. Sam Insull, Edison's secretary, had built a huge empire known for its lack of transparency. Even given the weak financial reporting standards of the time, Insull's structure was shrouded in secrecy. Ownership relationships were so tangled that it took twenty years to untangle the web of interlocking directors and pyramided debt and equity financings.

The collapse of the Insull Trust created an enormous public outcry. Reforms directly traceable to the collapse are the genesis of our current regulatory structure—the SEC, the Federal Energy Regulatory Commission, and a variety of other mechanisms like the Public Utilities Holding Company Act. Even the North American Electric Reliability Council likely owes its existence to the tangled industry structure bequeathed to us by Sam Insull.

Seventy years later we are re-enacting the same drama with Enron. Not only are the financial details frighteningly similar, but we are realizing that our regulatory

framework has failed to protect investors and consumers from exactly the same abuses.

In a sense we are lucky that the two largest collapses in U.S. history have occurred in firms that had little operational significance. Our situation would have been far worse off if Enron had actually achieved the level of hegemony over retail markets that they often boasted about. In practice, both failures ended up hurting investors more than consumers. We need to recognize that this will not always be the case if reforms are not enacted.

The common theme between these two disasters is transparency. Transparency is an academic's name for openness. In everyday English it simply means the ability of investors, traders, and operators to understand what is going on in the electric and gas industry. Unique in the economy, our energy infrastructure is central to the health of society on an instantaneous basis. Failures in electricity and gas open the specter of the lights actually going out in large areas of North America. Transparency allows policy makers, regulators, investors, entrepreneurs, and consumers to make intelligent and well founded decisions about their energy supply. A refrain we hear often repeated is that competitive markets don't operate very well in the dark. If we fail to set the right policies, we may actually get to experience this first hand.

Transparency is critical in three different, but closely related, arenas.

#### FINANCIAL TRANSPARENCY

The first of these is financial. Both Enron and Insull were characterized by a bewildering corporate structure and very sketchy financial reporting. Insull pioneered abuses in interlocking directorates, pyramided securities, and self-dealing. As the weeks pass after Enron's Chapter 11, we are hearing exactly the same allegations.

One of the ironies of the Enron debacle is that if Representative Sam Rayburn, one of the authors of the 1935 Public Utilities Holding Company Act, had had his way, Enron would have been a registered utility holding company. The stringent reporting and regulatory requirements would very likely have allowed us to avoid Enron's implosion. Every arcane financial transaction would have been on the record. Every major decision (and most minor ones) would have been subject to SEC review.

Now we all know that PUHCA is complex, difficult to apply, and technologically outmoded. In practice, applying PUHCA has been like gardening with a chainsaw—possibly effective but difficult to control. I am not proposing that we can easily rehabilitate this tool today. The key is that the detailed reporting required under PUHCA would have provided the transparency that the investors desperately needed to protect themselves from Enron's hidden risks.

The investor—even those aided by sophisticated Wall Street analysts—simply did not have the data to make an informed choice. Our detailed dissection of just one of Enron's Special Purpose Entities (SPEs) required massive computer resources, many years of experience on the ground in the industry, and thousands of hours of professional effort.

Whitewing, the asset holder that supported the investments at Enron and Osprey, is now worth no more than \$2 billion dollars against a book value of \$4.7 billion. No matter how creative the bankruptcy court is in the unraveling of Enron's Chapter 11, investors will lose \$2.7 billion dollars from just this one SPE.

The required reforms are straightforward. Off-balance sheet financing does not mean stealth financing. Whitewing's income and balance sheets needed to be part of the reports available to investors. Massive, billion dollar shifts were frequently made in Whitewing's structure and only reported with a line or two in Enron's 10Qs and 10Ks.

Equally dangerous was Enron's use of mark-to-market revenue and earnings accounting. Enron apparently calculated the proceeds from multi-year transactions based on values from forward markets that are thin at best and non-existent at worst. One industry pundit called depending on forward markets in electricity as pricing by rumor. If mark-to-market is used, the assumptions behind the calculations must be open for review.

#### COMMERCIAL TRANSPARENCY

Commercial transparency is also a problem. FERC's previous chairman, Curt Hebert, recently appeared before this committee and stated that "In today's competitive markets, however, confidentiality of price and customer information can be critical to a utility's success." One of the lessons of the California market failure and Enron's collapse is that he cannot have been more wrong.

One of the ironies of the California crisis is that the theoretical pursuit of transparency through the establishment of centralized markets at the California ISO and Power Exchange led to the filing of a tariff at FERC that made almost all commercial information secret. The logic is that commercial data availability would make gaming the centralized markets easier and, therefore, in order to protect the competitive process, government must intervene to suppress the distribution of market data.

In practice, the secrecy enforced by the ISO has made their markets completely opaque. Another irony is that in the course of the many investigations currently under way as well as numerous FERC cases, all commercial information is now readily available to market interests. Only policy makers, the press, and consumers do not have access to market data.

Restriction of market information weakened the negotiating position of consumers and made high prices far more likely in these markets.

Even today, weak reporting of marketers to FERC and restrictive information rules by ISOs make concentration and abuse in market hubs difficult to monitor. Enron, for example, doesn't include market hub information in their quarterly marketing report to FERC, even though many other marketers do. Our only way to know the degree of market dominance Enron had achieved at certain hubs is to "reverse engineer" reports from marketers who do report such data in order to calculate Enron's share of transactions. In doing so, we now know that Enron had achieved a share of greater than 30% of transactions at the California-Oregon Border.

The relevance of such information is critical. On December 3rd, Enron went into Chapter 11. At the same time, forward markets on the West Coast fell by 30%. No other changes in operations, hydroelectric supply, or fossil fuel prices took place at that time. The clear implication is that Enron may have been using its market dominance to "set" forward prices.

The negative impacts of these policies are not only felt by consumers. Bonneville Power, an agency of the Energy Department, posted \$337 million in losses last year—losses that reflect a cost in the short term to the U.S. Treasury. One possible reason is the large degree of transactions between Enron and Bonneville during this period.

Transparency, simply put, requires open information for consumers and policy makers. In the absence of open information market failures are easily disguised and corrective measures are painfully delayed.

#### OPERATIONAL TRANSPARENCY

The third area where transparency is critical involves system operations. Market-ers have been lobbying FERC, NERC, and the Energy Information Administration to restrict information in the name of competition.

While their arguments seem specious to long time market participants such as myself, their energetic advocacy often disguises the weakness of their arguments. Where system operations are concerned, granting their demands may well be catastrophic.

NERC and the regional reliability councils were established in response to the massive blackout along the eastern seaboard in November 1965. The idea was to promote reliability by coordinating information between parties. All information was open to the public and accessible to policy makers.

Until 2000, the system worked very well. In 2000, the system foundered. California emergencies, we now generally believe, had a strong component of market failure. In December of 2000, our utility clients on the West Coast simply did not know whether that the emergencies were true or not.

When the California crisis started, on May 22nd, 2000, the question of whether the high California prices were due to withholding by California generators or a real capacity shortage was of critical importance to the neighboring systems. Upon investigation, we found that the California ISO had effectively classified all of their operating information. We were unable to understand why the California ISO's official reports to the Western System Coordination Council showed a healthy surplus—15%—but they were declaring capacity emergencies every few days. A critical issue was whether the major thermal units in California were actually being dispatched. The California ISO was distributing this information to the WSCC, which in turn was making it available to market participants within California. Access, even by WSCC members, outside this small group was energetically opposed by marketers and the California ISO. When we finally raised this issue publicly in October of 2000 and gained access for Pacific Northwest utilities, the regulatory Commissions in Oregon and California, and a variety of California state agencies such as the

California Energy Commission and the California Oversight Board, the California ISO responded the following day by ceasing to provide this information, citing, in part, access to information by Oregon state regulators.

How did commercial transparency create this 180 degree reversal of public policy? The answer comes from a lack of understanding about competitive markets and the importance of information to consumers. The fundamental fact that the ISO overlooked is that freedom of information makes markets more efficient. The ISO had no real way of judging whether they were actually facing a capacity shortage or a problem in their markets once they had forestalled open debate by classifying virtually all operational information.

Today, we know that plant operations in 2000 among the five major generators only averaged 50%. Comparable resources—by age, fuel, and size—operated at over 90% in surrounding states over the same period. In passing, the historical average availability for comparable equipment, by age, fuel, and size is 84%.

As an historical aside, FERC gradually came to understand the importance of this data and established a “must offer” rule for the California generators as part of their repair package at the California ISO. This rule, combined with a price ceiling, returned the California market to competitive levels. It also appears to have reduced thermal plant outages from 50% to 10% in a matter of weeks.

The lack of reliable operational information brought the system very close to disaster. The hydroelectric reservoirs in British Columbia, Oregon, and Washington are finite. Water stored in these reservoirs are the last insurance policy against system collapse. If the California emergencies really reflected a capacity shortage rather than a market failure, it would have been critical to maintain this insurance policy.

As it turned out, the Secretary of Energy, on the basis of insufficient information, directed the U.S. systems to draw down this insurance policy in order to serve everyday loads in California. If winter weather in British Columbia, Oregon, and Washington had turned harsh, blackouts of substantial duration might well have resulted.

The fault was not with the Secretary of Energy. The fault was in an ISO tariff that restricted the information available to policy makers.

In the absence of data, we cannot have an informed debate. In the absence of an informed debate, we can and often do make the wrong decisions.

The first two forms of transparency discussed above, financial and commercial, only affect dollars—losses to investors and overcharges to consumers. The loss of transparency in the area of system operations was vastly more critical. We came close to shutting off light and heat to millions of consumers in January and February 2000—only a year ago—because we drew down our reserves several months too early.

The right policy direction is to guarantee transparency to investors, consumers, and operators. The result of the collapse of the Insull Trust in 1932 was to make information available to policy makers and the public. The implications of the Enron collapse of 2001 is that we have allowed the resolve of our parents and grandparents to dissipate.

If we fail, and the evidence from the Enron debacle is that we are failing, we may really get the chance to explore competitive markets in the dark.

Thank you.

The CHAIRMAN. Thank you very much.

Our final witness this morning is Dr. Lawrence Makovich, who is the senior director and co-head of the Northern American Energy Group in Cambridge, Massachusetts. Dr. Makovich, thank you for being here.

**STATEMENT OF DR. LAWRENCE J. MAKOVICH, SENIOR DIRECTOR AND CO-HEAD, NORTH AMERICAN ENERGY GROUP, CAMBRIDGE, MA**

Dr. MAKOVICH. Thank you. The collapse of Enron, America’s largest electricity trader on the heels of the California power shortage creates a crisis of confidence in deregulation of power markets. Therefore, it is quite important to ask this question, what was the impact of this company’s collapse on power markets across the United States?

Now, to answer this question we must realize that power markets are a set of interconnected markets. There are regional spot markets for energy, there are ancillary service markets, energy futures markets, forward markets, capacity markets, and retail power markets. The impacts of Enron's collapse range from negligible to significant across these markets.

In the spot markets, Enron's collapse had little impact on spot markets. An examination of the daily spot market prices over the past year show no discernible impacts on electric energy prices on critical dates surrounding the Enron collapse, including December 2, when they declared bankruptcy. Therefore, Enron's collapse did not distort the price signals that determine the efficient utilization of powerplants in regional markets across the country.

In ancillary service markets, Enron's collapse did not significantly collapse these markets that involve transactions for commodities like voltage support, reactive power, and spinning reserves. Enron's collapse did not close down critical energy supply infrastructure, did not threaten electric reliability, nor increase the likelihood of brownouts and blackouts.

In futures markets, it is important to realize that the spot markets, the volatility we see there is telling us the power business is a very risky energy transformation business. As a result, it is very important that this business has futures and forward markets that are structured to work well to provide necessary risk management, and of course the most significant impact derives from Enron's position as America's largest power trader.

Enron's bankruptcy forced many power contracts to unravel at a significant cost to Enron counter-parties. Similar nonperformance problems surfaced during the 1998 defaults by bankrupt traders and bankers in the Midwest power markets and during the California power crisis that required counter-parties to write off hundreds of millions of dollars. Such write-offs are necessary again in the wake of Enron's collapse. Consequently, many Enron counter-parties may suffer value declines in capital markets, at least for some period of time.

However, there is an important caveat. Although Enron's collapse forced market players to scramble to replace contracts to mitigate risk exposures, the collapse occurred with enough warning to avoid a shock to energy futures prices.

Some of this stability is due to the futures exchanges themselves. These exchanges are run by neutral third party entities such as the NYMEX that were in a position to intervene for Enron's non-performance and maintain market liquidity.

Enron's collapse did affect forward power markets. The forward power markets involve nonstandardized bilateral contracts for power delivery in the future, usually of a longer term than the monthly futures contract. However, unlike futures markets, no neutral third party entity organizes these markets. As a result, Enron filled this void in power markets by being a market maker in forward power markets.

To do this, Enron set up a many-to-one trading platform, Enron Online, to facilitate these transactions. To make it attractive, Enron provided market liquidity by ensuring continuous transactions as an intermediary. This was one of the major reasons why

Enron operated as a buyer and seller in roughly one-quarter of all electric trading activity.

Enron's collapse suggests that it was a mistake to allow a significant market buyer or seller to be the market maker without any oversight. As a market maker, Enron created information asymmetry by providing all buyers to buy from Enron and all sellers to sell from Enron. As a result, even though Enron aided the market by providing more price information liquidity, Enron was also in a position to be consistently among the first to know about most forward market transactions.

In the extreme, information asymmetry becomes insider trading, and such flaw has a potential to destroy confidence in the market. However, even well short of that situation, lesser information asymmetries can also create potential problems. To see this, imagine the temptations facing a market maker/player to take large speculative positions in forward markets, believing that their information advantage will allow reversal of the position ahead of others if the market moves against them. Such information asymmetry puts other market players at a disadvantage, and even puts investors in a position of being the last to know about the speculative position of trading companies they own.

An information advantage market maker/player has the potential to create a destabilizing trader collapse if the information advantage is not perfect, and eventually results in a big, wrong, inescapable bet. Allowing the largest buyer and seller in the market to be the market maker without oversight is also a mistake, because such conditions create dangerous incentives when a market maker also tries to function as the objective arbiter of forward power prices.

This potential problem arises when the market maker/player uses mark-to-market accounting for their forward power positions and, as a result, they are not indifferent to the forward power price. Clearly a dangerous incentive arises, because the market maker/player has either a net long or a net short position, and has the incentive to shade reported forward prices to increase reported earnings. Therefore, oversight is essential when a major market player is clearly not indifferent to the forward price, and yet fills the role of objective arbiter of forward prices.

Enron's collapse may have a positive impact on capacity markets. Capacity markets involve the trading of dispatchable megawatts to ensure long-run supply and demand balance in power markets. Enron was an influential stakeholder in power market design, and an opponent of capacity markets. Enron believed that forward markets alone could keep supply and demand in balance in power markets over the long run. As a result, Enron's demise may help build the consensus that forward power markets alone cannot fulfill this function, and capacity markets are needed.

Such capacity markets are a common element in the power markets that evolved from tight power pools, the ones that seem to be working better right now, and it is part of the reforms suggested in the California market design to include these going forward.

In retail markets, Enron's collapse does contribute to a crisis of confidence in power market deregulation. That significantly impacts State legislation and implementation of retail market reform.



The well-publicized collapse of Enron on the heels of the California crisis is slowing or reversing the move from regulation and towards the market by overshadowing the positive evidence and lessons from the evolving power markets that are working in several regions in the United States.

In conclusion, Enron's collapse had significant impacts on some power markets, but does not threaten the U.S. power system in the near term. Enron's collapse does create this crisis of confidence. Of course, it will take a year or more to find out if the problems of lack of oversight, distorted market player/maker incentives, or asymmetry of information played a role in Enron's demise, or whether the collapse was primarily driven by quite different factors connected to partnerships and debt. Nevertheless, such a daunting investigative task simply highlights the need for greater oversight and transparency in forward power markets as part of the ongoing structure of power markets.

Thank you.

[The prepared statement of Mr. Makovich follows:]

PREPARED STATEMENT OF DR. LAWRENCE J. MAKOVICH, SENIOR DIRECTOR AND  
CO-HEAD, NORTH AMERICAN ENERGY GROUP, CAMBRIDGE, MA

IMPLICATIONS FOR ENERGY MARKETS OF THE ENRON COLLAPSE

The collapse of Enron—America's largest electricity trader—on the heels of the California power shortage creates a crisis of confidence in the deregulation of power markets. The regional power markets across the United States are a set of interconnected markets—spot energy markets, ancillary service markets, energy futures markets, forward power markets, capacity markets, and retail power markets. The impacts of Enron's collapse on these evolving power markets ranges from negligible to significant. Few impacts are found in the spot, ancillary service, futures and capacity markets. Significant impacts are found in forward power markets in the short run and retail markets in the long run.

*Electric Energy Spot Markets*

Enron's collapse had little impact on spot energy markets—the trading of megawatt-hours in real time. An examination of daily spot market prices over the past year shows no discernable impacts on electric energy prices on critical dates surrounding the Enron collapse—including around December 2 when Enron declared bankruptcy. Therefore, Enron's collapse did not distort the price signals that determine the efficient utilization of power plants in regional markets across the country.

*Power Ancillary Service Markets*

Enron's collapse did not significantly impact ancillary service markets that involve transactions for commodities including voltage support, reactive power, and spinning reserves. These markets are necessary because buyers and sellers of power cannot simply contract for power flows without confronting thermal, voltage and stability constraints of moving power through a network of high voltage lines. Physics dictates that power flows along the path of least resistance and not along the contract paths dictated by market transactions. As a result, simple bid and offer negotiations cannot determine supply nor can they clear fast enough to balance electric supply and demand reliably in real time. Thus, power markets involve rules and institutions to create markets or contract terms to provide these commodities. Enron's collapse did not close down critical energy supply infrastructure and thus did not threaten electric reliability nor increase the likelihood of brownouts or blackouts.

*Power Futures Markets*

The power business is a risky energy transformation business. Thus, futures and forward power markets are necessary to provide risk management. For example, energy futures markets involve trading of standardized power contracts for energy delivery at future dates. Such a futures contract allows a buyer to purchase electric energy at a fixed price ahead of the delivery date. As such it provides a hedge against high spot energy prices in the future. The counterparty to this purchase is typically a power supplier who runs the opposite risk of low spot energy prices. Power suppliers face this risk because they typically commit to multi-month con-

tracts for fuel supply and thus face the risk that future power prices may be too low to cover locked in fuel costs and quantities. Thus, a futures transaction brings together parties with opposite risk exposures to mitigate their risk. The futures exchanges are set up around liquid spot trading hubs because although few futures contracts involve physical delivery, such physical delivery has to be possible in order for the hedging activity to take place. A settlement of the futures contract occurs based upon the difference between the futures contract price and the actual spot price of electricity on the due date.

The most significant impact derives from Enron's position as America's largest power trader. Enron's bankruptcy forced many power contracts to unravel—at a significant cost to Enron's counterparties. Similar nonperformance problems surfaced during the 1998 defaults by bankrupt traders and brokers in the Midwest power markets and during the California power crisis that required counterparties to write-offs hundreds of millions of dollars. Such write-offs are necessary again in the wake of Enron's collapse. Consequently, many Enron counterparties may suffer value declines in capital markets, at least for some period of time.

However, there is an important caveat: Although Enron's collapse forced market players to scramble to replace contracts to mitigate risk exposures, the collapse occurred with enough warning to avoid a shock to energy futures prices. Some of this stability is due to the futures exchanges themselves. These exchanges are run by neutral third party entities such as the NYMEX that were in a position to intervene for Enron's nonperformance and maintain market liquidity.

#### *Power Forward Markets*

Enron's collapse affected forward power markets. Forward power markets involve non-standardized bi-lateral contracts for power delivery in the future usually of a longer term than the monthly futures market contract. Such contracts are necessary because the standardized contracts of power futures markets are appropriate to manage some but not all of the risk in the power business. However, unlike futures markets, no neutral third party entity organizes these markets. As a result, Enron filled this void in power market by being a market maker in forward power markets.

As a market maker, Enron set up a many-to-one trading platform—Enron Online—to facilitate transactions. To make it attractive, Enron provided market liquidity by insuring continuous transactions as an intermediary. This was one of the major reasons why Enron operated as a buyer or seller in roughly one quarter of all electric trading activity. Enron's rapid collapse put pressure on forward market players to scramble and adjust their contract positions as Enron collapsed. As a result, other power traders were able to expand activity and fill the void left by Enron's collapse.

Other traders have filled in for Enron in forward markets. Enron's collapse suggests that it was a mistake to allow a significant market buyer or seller to be a market maker without oversight. As a market maker, Enron created information asymmetry by requiring all buyers to buy from Enron and all sellers to sell to Enron. As a result, even though Enron aided the market by providing more price information and liquidity, Enron was also in a position to consistently be among the first to know about most forward power markets transactions. As a result, this critical enabling software in forward power markets did not maximize market transparency concerning interactions between buyers and sellers but instead, Enron-Online may have allowed the company to gain an advantaged information position. Of course, this remains to be examined as the investigation into Enron goes on, however, such information asymmetries can create a serious market flaw.

In the extreme, information asymmetry becomes insider trading and such a flaw has the potential to destroy confidence in a market. However, even well short of that situation, lesser information asymmetries can also create potential problems. To see this, imagine the temptations facing a market maker/player to take large speculative positions in forward power markets believing that their information advantage will allow reversal of the position ahead of others if the market moves against them. Such information asymmetry puts other market players at a disadvantage and even puts investors in a position of being the last to know about the speculative positions of the trading companies they own. An information advantaged market maker/player has the potential to create a destabilizing trader collapse if the information advantage is not perfect and eventually results in a big, wrong, inescapable bet.

Allowing the largest buyer and seller in a market to be a market maker without oversight is also a mistake because such conditions creates dangerous incentives when a market maker/player also tries to function as an objective arbiter of forward power prices. This potential problem arises when the market maker/player uses

mark-to-market accounting for their forward power positions and as a result, are not indifferent to forward power prices.

To see this flaw in allowing a major player to also be the market maker without oversight, suppose a market maker/player buys power under a ten-year contract from a supplier. The market maker uses this transaction, along with other similar transactions that it acts as an intermediary for, to establish the forward power price curve at that time. This requires the application of some judgment because these transactions are not standardized. As time passes, other transactions occur that provide the basis for the market maker to reset the forward price curve. If the forward price curve increases then the value to the power buyer of the ten-year power sales contract at the fixed price increases. On the other hand, if the forward price curve decreases then the value to the power buyer of the ten-year power purchase contract declines.

Mark-to-market accounting allows the buyer to record this change in contract value as current period earnings. Clearly, a dangerous incentive arises because the market maker/player that has either a net long (purchases exceed sales) or net short position (sales exceed purchases) has the incentive to shade reported forward prices to increase its own reported earnings. Therefore, oversight is essential when a major market player is clearly not indifferent to the forward price and yet fills the role of objective arbiter of forward power prices.

#### *Power Capacity Markets*

Enron's collapse may have a positive impact on capacity markets. Capacity markets involve the trading of dispatchable megawatts to insure the long run supply and demand balance in power markets. Enron was an influential stakeholder involved in power market design and an opponent of capacity markets. Enron believed that forward market contracts would keep supply and demand in balance in power markets over the long run. As a result, Enron's demise may help build a consensus that forward markets cannot fulfill this function and capacity markets are needed. Such capacity markets are a common element in the power markets that evolved from tight power pools and the reforms in the California market design include a plan to create capacity markets.

#### *Retail Power Markets*

Enron's collapse contributes to a crisis in confidence in power market deregulation that significantly impacts state legislation and implementation of retail energy market reform. The problem is that retail markets are linked to wholesale markets and power markets cover large multi-state regions. Thus, seven years into power industry deregulation, less than half of the electricity customers in the US have choice of power suppliers and only a small fraction of demand is linked to market price signals. This loss of momentum in power deregulation perpetuates a volatile mix of uncoordinated markets and regulation into the future.

The well-publicized collapse of Enron is slowing or reversing the move from regulation and toward the market in power industry restructuring by overshadowing the positive evidence and lessons from evolving power markets that are working in several US regional markets.

#### CONCLUSION

Enron's collapse had significant impacts on some power markets but does not threaten the US power system in the near term. Enron's collapse on the heels of the California power crisis does create a crisis of confidence that may affect the course of industry restructuring in the long run. Of course, it will take a year or more to find out if the problems of a lack of oversight, distorted market player/maker incentives or asymmetry of information played a role in Enron's demise—or whether the collapse was primarily driven by quite different factors, connected to partnerships and debt. Nevertheless, such a daunting investigative task simply highlights the need for greater oversight in forward power markets as part of the ongoing structure of power markets.

The CHAIRMAN. Thank you very much. I think all of this testimony has been very useful. Let me just start. We will do 7-minute rounds here.

Let me just start with the question that occurred during your testimony, Dr. Makovich. You indicate that you believe that allowing the largest buyer and seller in the market to be a market maker without oversight is a mistake. What kind of oversight do

you think is required, and who should perform that oversight, and what, in addition to just oversight, are we talking about?

Dr. MAKOVICH. By the term oversight I am not suggesting micro-management of these markets. What I am talking about here are the kind of very standard disclosure requirements on positions, the kind of transparency in market prices that a many-to-many exchange that provides, that provides no one with an advantage, advanced information advantage, so this really is about transparency and reporting requirements. It does not mean that forward contracts have to be public knowledge, but we do need some third party entity.

Now, whether that is NYMEX expanding their business into this area, that can analyze these contracts and publish the necessary information for these markets to know where they are on a real-time basis.

The CHAIRMAN. Let me ask Mr. Newsome, do you agree that the additional oversight or openness that both Mr. McCullough and Dr. Makovich talks about is required, and if so, how do we get to it?

Mr. NEWSOME. Well, I think that transparency and disclosure are kind of like talking about apple pie and mom. Everyone is in favor of that.

But I think as we look back over the last couple of years, there has been a very full debate and airing of the issues. When Congress was determining the Commodities Futures Modernization Act, that is certainly an area that was looked at.

I think based upon debate that took place during that time period, because of the type of trading there, Congress certainly did not choose to require at that time that those markets disclose, and I think it bears out some difference.

In the energy exemption there are basically two levels. The bilateral level of eligible contract participants, there is no requirement there for disclosure, because it is one entity doing business with another single entity without any multilateral type competition.

The CHAIRMAN. Does anybody else have a point of view on this? Mr. McCullough, I gathered from your testimony you believed that it was a mistake for Congress to exempt these trading activities in energy commodities from these requirements for disclosure.

Mr. MCCULLOUGH. This has been like a mechanic who just pulled his head out from the guts of a car, to say what you should do to fix all cars in the future. We do not really have very deep and liquid electric markets. We do not really understand the price as well. Our only discovery in 2003-04 electric prices in the largest electric market in the world is through surveys conducted by the press. This is a very weak tool upon which to base the planning for an entire half of the North American continent, and we have even weaker tools in some of the other areas.

The CHAIRMAN. Mr. McCullough, just reading from an article that was in the *Energy Daily* this morning—where you are quoted or referred to as saying that Enron could have been driven to more and larger long-term deals in order to generate increasing amounts of market-to-market paper profits needed to hide its losses on earlier short-term deals that other money-losing operations—the thrust of the article as I understand is your suspicion at least, your belief that there is a possible manipulation that was taking place

on these forward contracts that we have not yet become aware of. Is that an accurate statement? Would you want to elaborate on that?

Mr. McCULLOUGH. Yes, sir. What we have is such a thin market that Enron Online taking a position in these forward markets could easily have become the basis for the mark-to-market accounting. In a sense, the value of Enron's financial statement would have become the chicken and the egg.

Now, we have had some clarification of that hypothesis recently in the *Tribune*, and the *Houston Chronicle*, I believe, where we have traders off the record saying that their deals did not seem to pencil out, but they were directed to go on ahead. If so, that would be highly consistent with this outcome. The problem is more than simply losing the investors in Enron money. The problem is that those forward market disturbances might become the basis of power purchasing for utilities like Seattle City Light, or Governor Gray in California, in which case we might be talking about distortions that will take years to work out.

The CHAIRMAN. I think my time is up.

Senator Thomas.

Senator THOMAS. Thank you, Mr. Chairman. I would like my statement, along with Senator Domenici's statement, to be put in the record.

The CHAIRMAN. We will include that statement in the record.

[The prepared statements of Senators Thomas and Domenici follow:]

PREPARED STATEMENT OF HON. CRAIG THOMAS, U.S. SENATOR FROM WYOMING

Thank you, Mr. Chairman, for holding this hearing. To say the demise of Enron was a shock to all of us is an understatement. I was deeply disappointed at the collapse of this energy giant and equally concerned when the actions of the company's top management came to light.

However, as the Senate Energy Committee, we are not here today to discuss the demise of Enron, but whether or not its collapse has had affects on the energy market. Ironically, what happened to the company is unrelated to Enron's trading business—that is the side of the company associated with deregulation. Unfortunately, some will try to link what happened to Enron to the electricity restructuring debate, the natural gas markets and maybe even the overall energy debate. Enron's problems were less about energy and more about poor investments and unconventional, for lack of a better term, accounting practices.

Fortunately, market participants were sophisticated enough to fill in the blanks and energy markets have not been significantly affected. Both the wholesale electric and natural gas markets continue to function smoothly. Sadly, for many shareholders, Enron's collapse has had severe implications on the capital markets in this sector. Since the company's demise, there was a huge collapse in investor confidence and many companies have seen enormous losses with respect to stock prices.

I hope we learn from this hearing that Enron's collapse, though a tragedy for the company and its employees, has had no real impact on energy markets. The company's failure should not influence the energy legislation that this committee or, in our case, this Congress, might pass in the future but, should influence the securities legislation we might pass down the road. What has happened at Enron should not influence the debate regarding energy policy, but make us raise serious concerns over corporate accounting and disclosure of corporate information.

I look forward to hearing from the witnesses.

PREPARED STATEMENT OF HON. PETE V. DOMENICI, U.S. SENATOR  
FROM NEW MEXICO

Mr. Chairman, I understand that this hearing was called, and I quote from the briefing memorandum prepared by your staff, to probe the "impact of the Enron bankruptcy on energy markets."

As more and more details emerge about the demise of Enron, and its effects on employees and shareholders, there can be no question that we must learn a great deal from this collapse and strengthen our financial and reporting policies so this can't happen again. The impact of this fiasco on the retirement plans of countless employees is also an extremely serious situation. The federal government may need to implement new policies to ensure that this kind of debacle can not, again, destroy the future plans of so many dedicated employees.

From the briefing materials prepared by your staff, Mr. Chairman, I note the conclusion that the demise of Enron had, and I quote, "little impact on energy markets." Analysis of the Republican staff confirms the same fact. Testimony from the Chairman of FERC states that "the collapse of Enron has not caused damage to the nation's energy trading or energy supplies."

So, Mr. Chairman, while we have much to learn from the collapse of Enron from regulatory and financial transparency and securities and retirement plan perspectives, it appears that the simple answer to your goal for this hearing, as stated by your staff, is that the Enron collapse had little impact on energy markets.

Some would argue that the collapse of Enron presents an argument against deregulation of electricity markets. I do not agree, any more than I would agree that the recent fiasco in the California energy markets is an indictment of deregulation.

I think it's far too early to judge the success of electricity deregulation, but it's also far too early to condemn it as a failure. The California situation arose from some ridiculous constraints on market prices and costs—a rational analysis of their approach to deregulation would have easily shown it that it was an over-constrained attempt to manipulate the market. It was anything but an attempt to apply free market principles to the electricity sector.

Several states are in the midst of much more successful deregulation ventures. We need to give them time to develop their approaches and evaluate lessons learned from their experiences. Above all, we need to be sure that the federal government does not overly constrain the ability of states to deregulate. I think it's safe to bet that states, after studying the California problems, will also be careful to ensure that a true market economy thrives in their state if they choose to pursue deregulation.

America built its economic engine by providing free and open markets, with a transparent financial system to allow evaluation by consumers and shareholders. We have prospered tremendously from allowing the free market system to work. Deregulation may be a boon for consumers, but only if it's done in the context of a free market system with full respect for the rights of individual states.

Before closing, Mr. Chairman, I also want to note that some are arguing that Congress should delay action on a comprehensive energy bill while all the lessons of the Enron situation are analyzed. I've already noted my support for learning all we can from this situation and applying those lessons to improved federal controls. But I want to state that the Enron situation absolutely should not be used as still another excuse to delay action with serious and credible debate on an energy bill.

As President Bush has noted on many occasions, energy security is part of national security and it is a vital component of homeland defense. Where we can take actions to lessen our dependence on foreign energy producers, especially those from unstable parts of the globe, we should be doing so. I hope such discussions will be part of a floor debate on an energy bill, since the most unfortunate decision was made by the Senate leader to strip this Committee from its jurisdiction over this bill.

In closing, in the rush to study the Enron collapse, Congress is launching hearing after hearing. Many of those hearings may uncover critical new opportunities to improve federal systems, but I don't think that will be the outcome of this hearing. Instead, Mr. Chairman, I suggest that we allow states to continue to experiment with deregulation of electricity markets, while benefiting from the experiences of other states.

Senator THOMAS. Let me follow up on your last comment there. I guess you said Enron's deals would set the price. I do not quite understand that. You have generators, you have a price, you know

what the price is. If you have transmission to move it, why would Enron's deal set the price?

Mr. McCULLOUGH. Mr. Senator, the problem is that we have a very deep short-term market. The hourly market is huge. The long-term market is bilateral. There are only a few players out there. Recently, we put together a long-term deal for a large Northwest industrial, a huge smokestack industry. There were only four bidders, so Enron simply being a player in that has enormous ability to swing those forward markets, and because they are not regulated they are in an organized market like NYMEX. We only find out what those bids are.

Senator THOMAS. But if you had a regulated market you would not be doing that.

Mr. McCULLOUGH. I meant regulated in the sense that we would have CFTC or NYMEX oversight, or NYMEX acting as the home for that market, and so what happens is, we only find out by a survey and, in fact, we are pricing by rumor, and when we discovered that plan's energy trader, one of the leading journals in the nuts and bolts side of the business, showed this major shift in forward prices on the day of their bankruptcy, that came as quite a shock to us.

Senator THOMAS. I guess it is a little hard, the uncertainty of futures is true in most any commodity, and so that is up to the buyer to make that judgment, it seems to me.

But Mr. Wood, you covered a lot of things. Just in a word or two, what would you suggest as a result of this be done by the Congress, or by the FERC, or have you gotten to the point that you are ready to say?

Mr. WOOD. I think watching this whole event unfold, it is clear that there is a lot going on here, other than the issues that these bright people—and I am honored to be in their midst, quite frankly. I have learned more here than I have in probably the last 4 months in my job, just listening to these smart guys talk, but there is a lot more going on in this story, and I would just suggest, as I mentioned at the end of my opening remarks, that there is some wisdom to be had from listening, and I know there are a number of other committees looking at this. Before you see what the Enron deal can teach us, what is interesting is there are some broader stories here, and some of which, a lot of which were going on before the Enron event happened regarding, I know, the issue on price transparency.

Certainly, I know Commissioner Brownell and I talked about that at our confirmation hearing before you all back in May, I guess it was. Transparency for markets is critical. The gas markets—we have talked a lot about the power markets, but not so much about the gas. They have been around about 10 years longer. They are much more deep, they are much more liquid. The forwards go a lot farther out into the future. They are a lot more competitive.

Enron Online was one-fourth or one-fifth of that market, so people felt they were getting a raw deal from Enron Online. They have got plenty of other alternatives to go to to do forward trading. The power markets are a lot thinner.

And I am sorry, you asked me to do it in a word or two. I guess a word or two, I think steady as she goes on opening up the power markets. Congress has been supportive of the commission's efforts to do that thoughtfully and do that assertively to get the power markets to a health and depth and liquidity that the gas markets are.

Senator THOMAS. You have all talked about transparency. The question is, how do we do that? Does Congress need to do that, or can you do that?

Mr. WOOD. As I mentioned in my testimony, Senator Thomas, we have started on that effort at the commission. I think we will get—as pointed out here by Dr. Makovich, we will get, I guess, the traditional push back from folks that do not want certain information to be disclosed into the market. Enron was always good about arguing that, about how much they did not want out there in the public marketplace for information, and I expect that others will fill their shoes and then we will have to deal with that.

Senator THOMAS. There has been some increase in generation capacity, but that has been one of the problems, is the uncertainty, I think, of investment in generation. What do you think this Enron thing has as an impact on that, any of you?

Mr. WOOD. Moody's did change after one of the accounting issues came up with regard to the Enron story. Moody's did really go after, and I believe the others have joined them, go after what the reporting requirements are for all of the other people who, unlike Enron, are very asset-heavy. But I mentioned in my testimony I am a bit worried about the overreaction to other people's books that the Enron story precipitated and what that might do to the availability of capital in the short run with the generators, particularly people building powerplants, putting it on the ground, putting cleaner plants in place than the ones they are replacing.

Senator THOMAS. What is your reaction, any of you, to transmission? It seems to me if you are going to have market generators you have to move power, and obviously if you want to have a marketplace in the generation area you have to have more transmission, do you not?

Mr. WOOD. Amen to that.

Mr. NUGENT. Senator, I think you clearly need more transmission to make the market flow and function better. I will say that solution seemed to be coming forward. Some have not even been presented yet to us, but therefore strengthening the capacity over certain routes, seeking some novel new routes to markets, and there are some cost pressures that are building that may overcome some opposition to transmission in certain areas.

I think particularly of southwest Connecticut, for example, where there is a real difficulty in getting power into that area. I would say that these are not easy things to solve. They balance a lot of issues in the environmental area or in the acceptability in neighborhoods. We are working to solve those as they come forward.

Senator THOMAS. Would you think that an interstate grid with RTO's off of it would be the direction we ought to be moving?

Mr. NUGENT. Well, Maine has voiced its support of that, and the question is how to get from here to there, but stronger ties among that to enable trading are important.



Senator THOMAS. Doctor, I do not know where you are with the resistance to doing away with PUHCA, but are there not a lot of things that still remain of service in more than one State if PUHCA was removed?

Dr. MAKOVICH. Well, the holding company act is really designed to prohibit very large, multi-State ownership in this business, and the question of sizing this business today is a little bit different. What we do have is large, multi-State transmission networks that really define these markets, so the real question is, is anybody too big within any one of these regional power markets that you are worried about them having undue influence?

It is actually an advantage for companies actually to stabilize their earnings. If we do allow them to diversify across several of these regional power markets we do not want companies that have all their eggs in one basket, so that when you get a boom-and-bust cycle in power prices we get tremendous variation in their earnings, so the question of size really now I think needs to focus on making sure the markets are not dominated, these regional markets, and actually it is probably a good thing if we have companies that can diversify the risk of these power markets across regions.

Senator THOMAS. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Wood, I appreciate you noting that I have been trying to lift the cloak of secrecy surrounding energy markets for a long time. I think the public ought to be able to obtain basic information about what is going on out there, and I want to emphasize, we are just talking about basic business information. We are talking about transmission capability, generating capacity, plant outages. That is what we ought to be getting out. That is what is in the bill that I introduced, the bipartisan bill with Senator Burns, and we are going to stay with this until it gets done.

Now, the testimony today indicates that following Enron's bankruptcy, forward markets, the forward energy markets on the west coast dropped by 30 percent. That was testimony, I believe from Mr. McCullough. Does that suggest that by keeping secret key information, that Enron was able to artificially inflate the west coast prices by 30 percent?

Mr. WOOD. Again, I think we have heard the very nonliquid markets, there are not many trades that are that far out. You remove one guy from it and there is going to be a big change.

Now, the drop, I am not sure I could drop all the point and say that the drop in those prices automatically means there was some untoward activity by Enron when there is not that many places in the market in the first place, but it certainly is worth following up on.

Senator WYDEN. My concern is, there were no other changes on the west coast, no changes in hydro supply, fossil fuel prices. People were in the dark, and I am not sure that the country can conclude that Enron was not manipulating the energy markets on the west coast.

Mr. WOOD. The time frame you are talking about, Senator Wyden, was when?

Senator WYDEN. Right at the time of the filing on December 3, Enron went into chapter 11, at the same time, forward markets on the west coast fell by 30 percent, no other changes occurred, and I want to be clear about that—because you have said that it really does not seem to have been any dramatic price ramifications as a result of what was going on in Enron and, of course, people did not have the information. I am not sure that it is possible for the country to conclude that Enron was not manipulating the market with their energy trading to the detriment of my constituents and Senator Feinstein's constituents and others.

Mr. WOOD. I think that is fair. I would like to say that what I focused on in my testimony were the markets we do watch, which are the physical markets that are the real exchange of power, and not these markets that were referred to, the forward markets, which are not regulated anywhere, so I wanted to make sure my testimony was clear on that.

Senator WYDEN. I think your point is fair as well. I would like you to follow that up.

Mr. WOOD. I would be glad to.

Senator WYDEN. Because, given that situation, that certainly raises questions about whether Enron was manipulating the west coast market, our constituents. You have got three west coast members here who have a lot of folks hurting, and I would like you to get back to us on that.

Mr. WOOD. I will do that.

Senator WYDEN. Thank you.

Mr. McCullough, a question for you. In your prepared testimony, you said, and I believe you are the first witness now to say to the Congress that if the Public Utility Holding Company Act had been enforced it could have been used to avoid a portion of this horrible debacle for our constituents. How did it happen that Enron was not regulated under the Public Utility Holding Company Act?

Mr. MCCULLOUGH. I can certainly imagine the FEC was unwilling to donate massive resources, or even knew how to donate the resources in a very changed market, but if we were under registered utility rules, every one of those SPE special purpose entities would have had to have been reported to the SEC. They would have been public. We would have known that there were \$4.7 billion at risk in White Wing, and certainly anyone who lives in Portland knows hundreds of people who have lost their life savings, and so it sounds pretty credible to me at the moment. That law was written for the Insull Trust 17 years ago, and I think it is possible the rules and regs could be regulated.

Senator WYDEN. Was Enron granted an exemption from the Public Utility Holding Company Act?

Mr. MCCULLOUGH. Yes, sir.

Senator WYDEN. They were granted an exemption, and when was that that they were granted an exemption?

Mr. MCCULLOUGH. I am sorry, I do not have that information.

Senator WYDEN. Were there public hearings? I guess I am a little incredulous. You told us now that they were actually granted an exemption from the Public Utilities Holding Companies Act. Were there public hearings, or is there any record on this point?

Mr. McCULLOUGH. I am not an expert on SEC activities, but it is my understanding that it was a letter as opposed to a full hearing.

Senator WYDEN. Mr. Chairman, I would like to insert into the record at this point a letter from a number of consumer groups raising questions about the exemption that Mr. McCullough has talked about, and again, this was the first time I had ever heard about this, but I think this is another area that when we have a chance to review the documents and to look at this, it is important.

I do not have any further questions, Mr. Chairman.

The CHAIRMAN. Thank you very much. Just to clarify, I am informed, and the witnesses can contradict me if I am wrong here, but there is a regulation that the Securities and Exchange Commission issued sometime ago, 17 CFR 250.2, which essentially says that unless otherwise required by the commission, a holding company, which is a subsidiary of a registered holding company, need file only the initial statement, and essentially Enron took advantage of that regulation to just file a statement when they acquired the Portland utility to say that they were not covered. I believe that is the way it occurred.

Senator WYDEN. My understanding is, and this is what I would like to have clarified, Mr. Chairman, is apparently there are some reports that there was a subsequent March 1997 exemption—and I guess we will have to take a look whether that is the PUHCA statute or the Investment Company Act statute, and I think you were talking about them receiving an exemption, is that right?

Mr. McCULLOUGH. Yes, sir. I apologize for not being an SEC expert, but it is my understanding the SEC did not pursue Enron under the PUHCA rules.

Senator WYDEN. Mr. Chairman, I want to be clear. Again, this is an area I have heard about for the first time, and I think we ought to look very carefully at both the Investment Company Act of 1940 and the PUHCA statute and review them both, because, given the fact that this has not been talked about, and apparently there has been an exemption from one of these statutes that might have protected my constituents and people on the west coast, I would like us to look at that.

Senator THOMAS. Mr. Chairman, I asked that question a little while ago. Based upon the fact that you operate on one State, apparently there is an exemption, at least a statutory exemption, so that is probably where we need to look.

The CHAIRMAN. We will try to get this clarified. This is a good line of inquiry, and we need to understand it better.

Senator Feinstein.

Senator FEINSTEIN. Thanks very much, Mr. Chairman.

Mr. Chairman, earlier I handed you a letter asking that we hold a follow-up hearing to learn more about Enron's online transactions, and how they affected California and the Western energy market from May 2000 to June 2001. I believe, Mr. Chairman, that this is a Pandora's Box, and that it must be opened.

I would like to begin my comments with some quotes from yesterday's *Los Angeles Times*, and I quote: "the entire electric restructuring agenda on a national level was an Enron agenda," said State Senator Steve Peece, who led the legislature's effort in 1996, Cali-

ifornia legislature, to shape deregulation. They had such control and influence over Federal regulators that in turn put California in a place where we had no choice.

This is sort of a follow-up of what Senator Wyden just made very clear. The PUC under pressure set out in 1993 to overhaul its 80-year-old system of regulating the monopolies of Pacific Gas & Electric, Southern California Edison, and San Diego Gas & Electric.

The fact that Skilling was in PUC meetings was an indication of how important we thought this was, said David Parquet, an Enron vice president who has been with the company in California since 1993. Most of the ones that would later come to dominate the California market, Reliant, Duke, and Mirant, for example, did not hire lobbyists or begin giving campaign contributions until after 1997, when they bought the powerplants that PG&E, Edison, and San Diego Gas & Electric were forced to auction under deregulation.

Enron did spend a lot of money on this, said Robert Michaels, an economics professor at Cal State Fullerton, who has worked as a consultant for the firm. Enron was essentially the only company, other than the utilities, that had the resources and motivation to send lawyers and experts to thousands of working groups and hearings. Enron was very, very insistent on what came to be called the market separation rule, said Paul Joskow, a Massachusetts Institute of Technology economist who worked for Edison as a consultant. Those of us who participated warned the commission that there were significant potential dangers there.

Mike Florio, senior attorney with the Utility Reform Network and a member of the board that Overseas Cal-ISO, said he is convinced that a more integrated approach would have spared California the worst of the soaring prices that lasted from June 2000 to 2001. With the ISO and the power exchange being separate, he said, none of the market monitors could see the whole picture, so it was possible for people to play games much more easily without being detected.

Now, this is important, and I want to go now into the online aspects of the Enron business, because two companies have taken up that online trading with no transparency, and a third has taken up that online trading with transparency, namely, Intercontinental Exchange with transparency, Dynergy and Williams with no transparency.

Let me make this point. In 1999, the entire cost of electricity for the State of California was \$7 billion. In 2000, it was \$27 billion, and in 2001, it was \$26.7 billion. This was a massive transfer of wealth from California's investor-owned utilities from consumers to a handful of energy companies, and this is just the electricity portion of it.

Let us take a quick look at spot prices for natural gas, which everyone knows drives the price of electricity. This is November 2000. The red are spot gas prices in southern California, the blue spot gas prices in northern California. It goes right up to here, and this narrow black line is the benchmark for the rest of the United States.

Ladies and gentlemen, you clearly see what has happened. We are told by analysts that Enron Online may have controlled up to 50 to 70 percent of the trading market for natural gas deliveries

into southern California, 50 to 70 percent. There was no price transparency. There was no regulatory oversight because Enron's trades were bilateral, and natural gas prices drive up electricity prices.

Keep in mind that many of the generators had gas contracts and did not buy on the spot market on the graph, but they used spot market prices to justify the higher electricity prices, and this is why I think this is so critical, that we look very deeply into this.

On December 12, 2000, the spot price of natural gas delivered to the southern California border was \$59.12 a decatherm. Well, it was \$10.12 a decatherm in nearby San Juan, New Mexico. Know that it costs less than \$1 to deliver the gas from San Juan to the California border. On December 12, there was \$48 a decatherm unaccounted for. As you can see from the graph, the problem lasted well into the springtime.

To keep this in perspective, today's gas price average is \$1.91 for most of the country, and \$2.05 for California, so there is a lot of money unaccounted for, while at the same time Enron and other energy marketers are announcing record profits during that quarter.

These exorbitant gas prices helped drive up electricity prices in California to more than 10 times higher than they should have been, and we still do not know why the price of natural gas was so much higher in California than in neighboring States. Again, Enron Online, I am told, could have controlled 50 to 70 percent of the natural gas trades in southern California, and all this time, because Enron Online was engaged in bilateral trading, nobody except Enron knew the prices that were being bid.

Last January, I introduced legislation to ensure there would be at least transparency in the delivery of natural gas. I am pleased with Senator Wyden and Senator Bingaman's interest in this subject and the fact that there is a transparency in the Democratic energy bill introduced by Senator Daschle in November. Now that Enron is out of the online energy trading business and companies like Dynergy and Williams have stepped in to fill the void, there is no transparency, if there was not the cap and the intervention, finally, by the FERC, this could all happen again.

I am really starting to believe that Congress needs to ensure that a regulatory agency is willing to step up to the plate and protect consumers from a repeat crisis. Energy deregulation proponents argue that deregulation benefits consumers by increasing their choices and lowering their prices. You would have a hard time finding a California consumer that believes that today, so FERC indeed has a lot of work to do, and I want to begin by asking Mr. Wood this question.

The CHAIRMAN. Senator Feinstein, you have run out of time. Why don't we go ahead to Senator Cantwell.

Let me just advise we are told there will be a vote here in just a few minute, so we will hear from Senator Cantwell, and then we may adjourn for a short period to go vote and come back and continue.

Senator CANTWELL. Thank you, Mr. Chairman, and I think I will enter a longer statement into the record, if I may.

[The prepared statement of Senator Cantwell follows:]

PREPARED STATEMENT OF HON. MARIA CANTWELL, U.S. SENATOR  
FROM WASHINGTON

I. INTRODUCTION

Thank you, Chairman Bingaman, for holding this important hearing on the implications of the Enron bankruptcy for our nation's energy markets.

It is our duty as policymakers to take a close look at the factors that contributed to this company's collapse.

We have an obligation to shine a light on what one Enron executive last year called a "regulatory black hole," a vortex consisting of lax oversight, loophole ridden accounting practices and potentially criminal acts on the part of corporate executives. A black hole that Enron itself was proud to help create. After all, it was central to Enron's business strategy.

Mr. Chairman, as the Senate prepares to debate an energy bill, I must add that I am deeply troubled by the Bush Administration's refusal to turn over the records of its energy policy task force to the General Accounting Office.

At a time when Enron's collapse has illustrated in graphic detail the need for transparency in our nation's energy policy, the Administration's refusal to turn over those records smacks of insensitivity toward the many Americans whose lives have been touched by this debacle, if not outright obstructionism.

Enron's bankruptcy has touched the lives of hundreds of thousands in our country.

The effects are being felt most directly and most painfully by the families of Enron's rank and file employees—many of whom lost not just their jobs but their retirement savings.

II. WASHINGTON STATE IMPACTS

Even the residents of Washington state, who may seem far from the epicenter of this scandal, are feeling its impacts.

- Already the Washington Attorney General has filed suit on behalf of the State Investment Board, seeking to recoup more than \$100 million in lost shareholder value.
- A 64-year-old construction firm that employs 600 in Bothell, Washington—purchased by Enron in 1997—was left in limbo when its assets were swept into Enron's central cash management system and locked up in the bankruptcy proceeding.
- A Washington-based insurance company has reported a \$20 million loss—a 10 cents per share earnings hit—as a result of its Enron bond holdings.
- And a number of our utilities—among them Seattle City Light, which has already experienced an almost 50 percent rate increase over the past year due to the Western energy crisis—are owed money by Enron.

Viewed within the sweeping, multi-billion dollar collapse of this company, these losses may seem small. But I assure my colleagues that they make a difference to Washington state retirees, investors and utility ratepayers—many of whom have already been affected by recession, the tragic events of September 11 and this past year's chaos in Western energy markets.

For many of my state's residents—who have seen double-digit power rate increases over the past year—the first questions that comes to mind in view of Enron's collapse is, quite simply: Where did all of our money go?

My initial response to this question might be: down the regulatory black hole that Enron helped create, along with the retirement savings of many working families and a good deal of investors' confidence in the integrity of our financial markets.

To be sure, this is a question to which the Senate will demand a more complete answer during the course of its ongoing investigation into the factors that contributed to Enron's downward spiral.

III. MARKET TRANSPARENCY

And while we are still in the process of unwinding Enron's complex web of corporate shell games, I believe a lesson extracted from the financial debacle is equally relevant to this Committee's hearing today. That is, much as the disintegration has pointed to a need for greater coherence and consistency in corporate accounting practices, it has underscored the need for transparency in our nation's energy markets.

We will hear testimony today that Enron's collapse has caused almost surprisingly little disruption in wholesale energy markets.

But I believe there remain a number of unanswered questions—brought into sharp relief for me by the Western energy crisis—that it is the duty of this Committee to examine.

In particular, I think it is a great relief that the collapse of such a dominant trader as Enron—which handled up to 25 percent of our nation's wholesale energy transactions—had such a small impact on both energy supply and price.

But the question foremost in my mind remains:

What if Enron's collapse had occurred in the midst of the Western power crisis, when chaos in the markets reigned, rolling blackouts had become a fact of life in California and appeared imminent in the Northwest, due to a drought of historic proportions?

While energy in the West is now plentiful and prices remain low—due in part to recession, mild, wet weather and loss of load, not to mention jobs in energy intensive industries—how would the market have responded when energy ran \$3,000 per megawatt and utilities were scouring for all possible sources of generation?

Mr. Chairman, while I'm glad that the impacts to energy consumers have been negligible thus far, my fear is that no one really knows the answer to this question. And the reason, in my view, is a troubling lack of transparency in our nation's energy markets the very same lack of transparency that has many energy analysts, regulators and consumers scratching their heads over the seemingly incongruous set of factors that gave rise to the past year's Western energy crisis.

#### V. CONCLUSION

As the Senate prepares to consider comprehensive energy legislation, I think it is imperative we keep in mind one of our primary goals: fostering reliable and efficient markets, which require accurate and timely information for participants, regulators and, ultimately, the consumers themselves. I again thank you Mr. Chairman for holding this important hearing on the lessons we can learn from Enron's collapse.

Senator CANTWELL. But Mr. McCullough, I appreciate your testimony this morning. Also, I find some of the comments and statements very disturbing as to what it means to Northwest citizens who were far more concerned about this energy crisis before the events in December, because they had actually seen the effects of high energy prices, and even though we have started to recover from what has been a drought, we still have people in the Puget Sound area and various parts of the State who are paying 50 percent rate increase in their electricity rates, and to think that perhaps, that that 50 percent rise in electricity might have been caused by some of these forward contracts is a very disturbing concept.

I am not shooting the messenger. I appreciate your comments, but when you say that no other charges in operation and hydroelectric supply took place at this time, there is clear implication that Enron may have been using its market dominance to set forward prices. This, to Northwest consumers, seems to be what they have been thinking all along, that where there is smoke there is fire, and in this particular case they have been gouged.

My first question is, how do we get more information on the forward contracts? How does this committee obtain more information on the forward contracts, and what do you think the implications are for those forward contracts today, given the structure of the bankruptcy? Will some of these entities still have to live up to those forward contracts if, in fact, energy is delivered?

Mr. MCCULLOUGH. Well, the second question is the easiest. Yes, Northwest utilities' industrial customers will have to live by the deals they made, and they are stuck with these higher prices for years to come. We know that each of the utilities buys a portfolio. Bonneville, City Light, Portland General, Puget Sound Energy, all

have had exposure to those market changes, and they have all had cost.

The first question is harder. To the degree that utilities really operate in forward markets, this is a very critical issue. We have had debates in front of FERC about whether markets should be viewed as hourly or daily or monthly. To an extent, an hourly market is like the neighborhood bodega. You go down once in a while to buy some milk, but most of us actually buy our food at Safeway or even Cosco. We buy in the future, not simply the present.

So forward markets are very, very important to us. Our industrial and utility clients are far more likely to be in the monthly/yearly markets than they are in the hourly markets, and so any information the committee can provide, both on the current Enron crisis and hopefully through their leadership into changing of the rules that will give us transparency in those forward markets is going to be absolutely critical.

It requires an enormous amount of work to discover that Enron had a 30 to 50 percent position in the critical mid-Columbia market. It is not easy in the moment. The only good information we have is from FERC's quarterly marketing reports, and thank you, Mr. Chairman, for having those, because that is all we have, and we really do need to know who is carrying the simple positions so we can judge whether they are fair markets and fair prices.

Senator CANTWELL. Mr. McCullough, do you believe those markets, an entity should have to live by those forward markets, if, indeed, Enron is found to have been manipulating the market?

Mr. MCCULLOUGH. I am an economist rather than a lawyer. Contracts are pretty sacred to economists even when they are wrongful. Certainly the Attorney General and his fellow Attorneys General up and down the coast have been looking into that question, and if they find wrongful behavior, I suspect then we could find some protection for the customers in the coastal States, California through Washington.

Senator CANTWELL. Thank you. Mr. Wood, do you have a response to that question? Do you think utilities, if Enron has been found to be manipulating the forward contracts, do you think that utilities should have to live and be stuck with those prices?

Mr. WOOD. I think a court could probably make the call, or the State commissions could determine that there are sufficient facts to void—in general, it is hard to conclude yes or no, but I think that a court is pretty good at saying that is a voidable contract and therefore we should not be required to be paid. That is what we use courts for.

I think there is also, depending on the jurisdiction and the ability of our commission or State commission to do the same.

Senator CANTWELL. Mr. Wood, I have been enthusiastic about your appointment to FERC. I think I even told one of the local newspapers that this is exactly what the FERC needs, is the new energy and smarts of Patrick Wood.

I have a question, though, because obviously part of this going through my constituents' mind and I think the general public's is just this right to know, on SEC filings and corporate earnings reports, on campaign finance disclosures, on even public policy documents, and I guess my question is, since FERC is this quasi-judi-



cial entity and there is some sort of firewall, you do have communications with the administration, I am sure, on their energy policies, and you do have some communications, or I would assume—and this is probably proceeding prior to you taking over as chairman.

You do have some communication with, obviously, these various entities like Enron. Would FERC make those documents available to the public, your communications either between the administration on energy policy and your communications, or potential communications that may have occurred prior to your being the chair of FERC, related to Enron?

Mr. WOOD. I would be glad to, Senator, as I think I have been asked for the press for the latter, particularly. I think much to everyone's surprise besides mine, because I can tell you Enron has not been in to see me or my staff at all since I have been here, and plenty of other people have, but that is a pretty short list, but I would be glad to give you what we have had.

Senator CANTWELL. But your communication with the administration, or prior to your taking over, because obviously that is new, but the FERC's communication to the administration in the early part of the year on energy policy. Again, while my constituents were saying, we are getting gouged, and yet there was not disclosure. There was not real disclosure on the formation of what the energy policy was by the administration. Those kinds of communications between FERC and the administration on that energy policy, would those communications be available?

Mr. WOOD. I would be glad to look into that, if any exist. I know from my experience in the State government there was a pretty clear definition up front about the distinction between an independent agency as opposed to an executive agency, and the administration, so I will look into what exists before I came, but I do not believe there has been anything since I came there.

Senator CANTWELL. Well, we appreciate FERC's willingness to make documents public.

Mr. WOOD. We are a public agency, answerable to the Congress. Thank you.

The CHAIRMAN. With that, we have this vote that has already started. Why don't we take a 15-minute break and vote.

Senator SCHUMER. Mr. Chairman, I just have one question. Can I get that question in?

The CHAIRMAN. We will go ahead and defer to Senator Schumer for that question.

Senator SCHUMER. Thanks, Mr. Chairman. I would ask my statement be read into the record. I know we are trying to get over to the vote.

[The prepared statement of Senator Schumer follows:]

PREPARED STATEMENT OF HON. CHARLES E. SCHUMER, U.S. SENATOR  
FROM NEW YORK

Good morning. I would like to begin by thanking the Chairman for holding these hearings, which I feel are part of this committee's significant and necessary role in evaluating the performance of post-Enron energy markets.

Within the scope of the energy market, the collapse of Enron has demonstrated the damage and dysfunction that can result from a lack of transparency and oversight, and how a transparent market can be a stabilizing and steadying force. In this case, we have a market that had been dominated by Enron, in which participants and observers were unable to gain a clear and total picture of the markets within which they operated, markets that by and large existed outside of adequate oversight.

During the debate regarding the CFMA, I was greatly concerned about the similar effects that granting electronic trading facilities an exclusion from CFTC oversight would have had on the market, and fought hard against such an exclusion. Exempting electronic trading facilities from CFTC oversight would have resulted in regulatory arbitrage, essentially meaning that all trading commodities would be exempt from CFTC oversight. There would have been no anti-market manipulation rules, among others, to protect the markets. Those of us who were concerned about the ramifications of an ETF exemption fought that provision and won.

Today, as a result of Enron's collapse, what we're seeing is exactly the opposite of regulatory arbitrage. We are seeing a flight to quality. The stable, transparent markets have absorbed the market share that Enron had enjoyed without missing a beat. The fact that the largest energy trader in the United States could undergo a rapid collapse without disrupting supplies or creating price shocks is a testament to the strength of U.S. markets. However, it also demonstrates the importance of regulation in ensuring the integrity of our markets.

Although the markets have performed admirably, we cannot afford to simply breathe a sigh of relief that in the short term the energy markets have been able to move on. We have a responsibility to fully evaluate the long-term implications of the Enron collapse on the future performance, and on how government fulfills its regulatory role. Today's hearing should serve an important role in guiding the Senate as we move toward considering comprehensive energy legislation that includes significant regulatory reforms.

Contained in S. 1766 is the repeal of Public Utility Holding Company Act. In order to fill the void, a number of the regulatory procedures established under PUCHA, including merger authority and guaranteed access to books and records are passed to FERC and State regulators. We need to explore the question of whether or not these transfers or authority are adequate, or whether, and in what fashion they need to be augmented. We also need to explore where opportunities may exist for state regulators to work in concert with FERC to create a safe and stable climate for deregulation.

In my estimation, the most significant contribution we can make toward the long term well-being of America's energy markets, and as a result, America's prosperity, is to create a regulatory climate that will allow open markets to function with transparency and security for all participants.

Senator SCHUMER. I would just ask, as some of you know, I was particularly interested in the attempt to totally deregulate electronic trading facilities, and was heavily involved in trying to stop that from happening when it happened, and so I guess what I would ask the witnesses, and particularly Mr. Newsome and Mr. Viola, who is here along with Mr. Seetin, is this.

Do you think that in general since the Enron problems there has been a flight to quality to large and more transparent markets in electronic trading, or do we have to worry about the fractionalization of the markets, and people going into little corners and trading into nontransparent platforms and, related, what actions need to be taken to prevent a chain reaction of little mini-Enrons if the potential for such—and does the potential for such reaction exist?

I guess Mr. Newsome first, then Mr. Viola.

Mr. NEWSOME. Thank you, Senator. As we spoke about a little earlier, obviously there was a full airing and debate by Congress as they deliberated the Commodity Futures Modernization Act. I think that debate was certainly warranted, and very useful information, and a proper regulatory regime came from that debate.

As we look at the CFMA, as we look at the flight to quality and protection, one of the things that was included in the CFMA that has not been discussed here is the allowing of clearing four these OTC instruments. That is an area that I know that NYMEX is planning to move into, and I certainly think there is a lot of positives that can come from that, because when you get the credit controls that you currently have on exchange offered and utilized off-exchange, that is something that could give all of us more comfort, and so I think there are already some things in that act that currently are not being utilized, that because it is such a new act, it is just being implemented. I think market participants are starting to move in that direction and will offer some controls.

Senator SCHUMER. So you have a little more confidence than you would have before the act?

Mr. NEWSOME. Yes, sir.

Senator SCHUMER. Mr. Viola.

Mr. VIOLA. Senator Schumer, I think clearly the last minute efforts at sort of not having complete deregulation and exemption occur in the CFMA helped greatly in keeping markets stable through what would have been a very much more disruptive period, and I think that has to be made very clear. The efforts on behalf of this committee were instrumental in keeping market structure and price dynamics stable in the unraveling of Enron.

I think a flight to quality is being experienced in the regulated environments. The players do not want to fractionalize, they want to converge on the central counter-party risk and anonymous clearing function of the regulated exchanges like NYMEX. The point that we at NYMEX want to repeat is that the standard for regulation should be the same between an electronic platform and open auction outcry public forum where the trades are physically executed by traders. That is the one point we want to make.

In the one study that we have done, and observed the one migration from a pit environment to an electronic environment—that was the German bond market that moved to a completely electronic environment—we see that beyond the first one or two months, the first quarter of trading, the market does fractionalize, and it clearly becomes opaque, and it becomes a broker-dealer market. There is not that centralized liquidity you have in the public forum of a trading pit, and even though people may seem to think electronic media creates efficiency because it is digitized and quicker, in fact it starts to fractionalize liquidity.

So those are the points I think from an exchange standpoint. There is going to be a convergence. There will be over-the-counter clearing provided by exchanges like the NYMEX and the Intercontinental Exchange, but clearly the standard for regulation should be converged to the same.

Senator SCHUMER. Thank you, Mr. Chairman. I appreciate that.

The CHAIRMAN. You are certainly welcome. We will take a 15-minute break, and then have a second round.

[Recess.]

The CHAIRMAN. Let me ask everyone to take their seat. We will start the hearing again.

Let me ask a few additional questions, and I know Senator Feinstein has got additional questions. I do not know if other members will return or not to ask questions, but we will try to do 5-minute rounds at this point just so that we can get through as many questions as possible.

Let me try to paraphrase what I think I am hearing as a result of some of the testimony and the questions of Senators also, and that is a concern that Enron was the major player in many of these forward contracts, or markets for electricity in particular, but also natural gas, and that as the major player they had the ability to set the price, or substantially impact the price that those markets would require people to pay if they wanted to enter into those forward contracts.

And then the implication is that perhaps either individual traders or someone in the company might have artificially inflated those prices or required higher prices than the market otherwise was requiring in order to gain the profit from that, presumably, but that the effect of this might have been to cause California and some of the other entities that were in these long-term markets, these forward markets, to lock themselves in at much higher prices than they otherwise would have had to.

Is that a fair paraphrase of what you believe might have occurred, or did occur, Mr. McCullough.

Mr. MCCULLOUGH. Yes, Senator.

The CHAIRMAN. Is there anybody else who has a point of view on whether or not this did occur, or might have occurred, or does this sound like an implausible scenario, based upon other factors?

Yes, Dr. Makovich.

Dr. MAKOVICH. I think what I have testified to is that you do not want to put somebody in the position, because the forward market is not very liquid and is nonstandardized, you do not want to put them in a position where they have to add judgment to say, well, here is what the forward price is, and also then have that impact their earnings.

Now, the question about, was there manipulation, for a trader, depending upon their position, whether they are in a net short or net long position, they can benefit from having prices move down as well as having prices move up, so it is not clear what Enron's position would have been in the Northwest, whether they would have actually benefitted from a drop in price.

What we did see last year across the United States is all forward power markets dropped significantly about mid-point in the year, and you saw that very clearly in the futures strip, which does go out for about a year or so into the future.

If the forward markets are thin, then it takes a while for the forward markets to reflect that as well. The liquidity of the futures market is that much greater, and so there was just a general downward movement in forward pricing across all power markets in the United States last year.

The CHAIRMAN. So what you are basically saying is, you think there may not have been an incentive for Enron to artificially inflate the price in the forward markets.

Dr. MAKOVICH. Because of their position and because of disclosure. We do not know what their position was. If they are short or long, they can benefit by the price going up or down, and so the testimony is, we do not want to put people in the position of having to have a judgment to say, here is where the market is, and that affect the valuation of those positions in the future.

The CHAIRMAN. Let me ask one other question. This is about the online trading issue.

Mr. Viola, you have raised this issue, saying that you do not think there is a justification for a different standard for electronic trading versus trading in the pit. What is the current state of law on that, or the current state of law with regard to oversight and regulation of online trading, and what do you believe that law should be?

Mr. VIOLA. Well, I think to reduce my answer to as simple a statement as possible, the current state is that the standards of compliance and disclosure and position reporting, those three principal areas are less onerous for an electronic trading platform that is exempt, as applied to the compliance disclosure and oversight standard for a pit-traded environment, and I think that those two standards need to converge so that the liquidity provided in a physical environment can be competitive from a structural standpoint, market structure standpoint.

The CHAIRMAN. Mr. Newsome, do you have an opinion on that?

Mr. NEWSOME. Yes, sir. I think there are some differences, and those differences are why the CFMA looked at a different regulatory scheme versus regulating both the open outcry and the electronic systems exactly the same.

When you look at different tiers of regulations, it is based upon several criteria, and one difference in that criteria is real time audit trail that is available to a regulator through an electronic system which is not available to a regulator through an open outcry system in which you have to put together that audit trail through a manual method.

Another difference was the types of traders who are using the system. If you operate in an open outcry system, then basically you have access to both sophisticated and retail types of traders. Obviously, in a market in which you have retail trade, there is a higher need for regulation. If you are operating in a market in which there are solely sophisticated operators, the intent was felt that there was a less regulatory need there than there was with retail participation, and so I think there are some reasonings of why there is a difference between regulation at the two levels.

The CHAIRMAN. And the assumption that you have there is that there will be less sophisticated traders involved in pit trading than there will be in online trading?

Mr. NEWSOME. No. There is an opportunity to—even if an electronic system wanted to open up to a retail customer base, then they would have to assume a higher level of regulatory responsibility. The exchange in a pit-trader system has an opportunity to op-

erate in a less-regulated environment if it wants to limit its market base only to those sophisticated customers.

At this point the CFMA, most of the exchange-traded contracts had decided to stay at the highest-regulated level because of having access to the full customer base, so there is a flexibility to the market participants who have different levels of regulation, depending upon what customer base that they want to operate with and what type of system they want to utilize.

The CHAIRMAN. So in your view the key distinction is not between being online and being physically trading in the pit. The distinction is how sophisticated the people are who have access to the market to trade.

Mr. NEWSOME. Correct.

The CHAIRMAN. Let me call on Senator Feinstein.

Senator FEINSTEIN. Thanks very much, Mr. Chairman.

Mr. McCullough, I mentioned in my statement that analysts had told us that Enron controlled about 50 to 70 percent of the gas trades that went into California. Would you agree with that number?

Mr. McCULLOUGH. Yes, Senator, with the caveat that since we have no open discovery on Enron Online, it is purely anecdotal.

Senator FEINSTEIN. Thank you, and you also say in your written remarks that on December 3, when Enron went into Chapter 11, at the same time forward markets on the west coast fell by 30 percent, and then you say, unlike what Mr. Makovich just said, no other changes in operations, hydroelectric supply or fossil fuel prices took place at that time. The clear implication is that Enron may have been using its market dominance to set forward prices.

Mr. McCULLOUGH. Yes, Senator. Let me clarify. I do not believe Dr. Makovich and I were disagreeing. We had two major west coast shifts. He completely correctly described the mid-year shift that occurred throughout the markets, but the shift I am referring to is actually a December 3 shift, not December 2, because I remember that was a Sunday, was it not, but actually on the trading days we had that dramatic shift, and that was in addition to the price shifts that Dr. Makovich was describing.

Senator FEINSTEIN. Thank you, Mr. McCullough. That would indicate to me, Mr. Wood, that there was, in fact, a distorted market, and I would like to ask you to take a look at California's bilateral electricity contracts. If, in fact, Enron transactions have distorted that market, and Governor Davis signed those contracts, there is a good argument that those generators should be forced to renegotiate those contracts, so I am making that request of your commission.

Mr. WOOD. Yes, ma'am. We will do that. I think it would actually be, we have not—encouraged I guess is a strong word, but we have answered when the California commission has attempted to kind of get at these issues, that they could certainly file at the commission a formal complaint so that we can bring the full tools of discovery, and I shared that with President Lynch, and I am not sure what their status is on doing that.

Senator FEINSTEIN. Has such a complaint been filed?

Mr. WOOD. Not from California. One has been from Nevada.

Senator FEINSTEIN. Well, I will see that one gets filed, then.

Let me ask you this question. My understanding is that at the break you related to the press that you did not think Enron was responsible for California's natural gas spikes. If it was not Enron, the only two main suspects would be El Paso and/or SEMPRA through southern California gas. I would like to ask what went wrong. I would like very much to get your view.

Mr. WOOD. The question that was asked related to the short-term markets, which I have been kind of differentiating on today because we do not have, as was pointed out here today, focus on the long-term markets, particularly on gas, which are quite competitive, although the fact you raised about the 50 to 70 percent certainly raised my eyebrows. That is a pretty high number for one to assume that it is competitive.

So with that caveat, which we will look into, because it certainly is something we are supposed to look into, there are two other players. One of those is certainly subject to the pending complaint you and I visited about in this forum before, and we did just reopen the record in El Paso and attempt to fully flush out the record and understand what happened on capacity on that key pipeline going into the State.

I am not saying they did something right or did something wrong, but just making sure we understand fully what the facts are there, so I am a little reluctant to opine on that, but I would be happy to once we do get a record back from our judge.

Senator FEINSTEIN. But you are prepared to give me your assurance that you are going to look into this?

Mr. WOOD. Yes, ma'am.

Now, as to December, we have got a jurisdictional issue between us and the State. Once the runs get to the State, California is not unique, but certainly there are only a very few States where the State commission takes over the regulation of the natural gas and the physical facilities of a pipeline, once it gets to the State borders, and we have visited with you all about that before, but there is a bit of—I would call it not a dislocation, but a difference as to how regulatory treatment of the line that we regulate coming into California and the line that the CPUC regulates, which takes over from that point to get to the generator plant, or get to the final customer.

That jurisdictional line has been certainly something we have worked through informally with the commission to try to get around these issues.

I do know that they took some actions in the recent months to change what many have identified as being a tariff problem, that people could not buy power all the way through from, say, Utah to a point on the coast, and now I think the commission has addressed that at the State level, so that should help.

Senator FEINSTEIN. I do not want to use all my time. I have got one very important question.

Mr. WOOD. But certainly on the El Paso one I will answer when it is appropriate, and we will find out what we can about SEMPRA and talk to you about that.

Senator FEINSTEIN. Does FERC have the authority to regulate online trading presently?

Mr. WOOD. We in September, before this all came up, put out revisions to our standards of conduct which are kind of code words for, if you have got a regulated company and a competitive company under the same umbrella, we want to make sure that the regulated company does not do something to benefit its competitive cousin to the detriment of somebody else out there in the market.

Senator FEINSTEIN. Is the answer yes?

Mr. WOOD. We asked the question on online, should we go forward and treat online as though it were a pipeline company, so that is out there. We would not have asked it if we did not think we could answer yes, so the answer is yes.

Senator FEINSTEIN. Very interesting.

Second question. Do you have the expertise to do it?

Mr. WOOD. Honestly, no. That is why I mentioned a moment ago I put out the job announcement for director of this new office, and then a number of new people coming on it. The Congress was kind enough to give the Commission additional funds and positions to use for the enforcement and investigation purpose, and I fully intend to utilize those.

Senator FEINSTEIN. If you went along those lines, since energy trades can change hands dozens of times, do you think that FERC should be able to regulate all energy trading platforms all over the counter, energy trades? How would you see that?

Mr. WOOD. If the Congress wants us to do that, Senator, we will do that. I would aver that there might be a more expert agency to do that, but whatever you all want us to do is what we do.

Senator FEINSTEIN. Well, let me ask, my understanding is that the CFTC does not want that responsibility. Is that correct?

Mr. NEWSOME. Well, I do not think the CFTC has ever made that determination of whether they wanted it or did not want it.

Senator FEINSTEIN. Then that is not correct, so are you open to it, and would you have the expertise to do it?

Mr. NEWSOME. Well, certainly we are open to whatever the Congress chooses for us to do. I think if the Congress decides that there needs to be more regulatory oversight into that area, I think the CFTC would be a proper place to look for that regulatory oversight.

Senator FEINSTEIN. Mr. Wood, how do you feel about that?

Mr. WOOD. I would concur.

Senator FEINSTEIN. So your preference would be that any regulatory authority be vested with the CFTC rather than FERC?

Mr. WOOD. I differentiate between the physical market, which is where we have expertise, and then the financial trading market, which again is used to handle risk of the physical market. If we make sure the physical market works well, and that those are transparent and open and known and liquid, then the rest of the transactions that Jim and his group work with work much more effectively, and I think are subject to whatever oversight is appropriate for that activity.

Senator FEINSTEIN. Thanks very much.

The CHAIRMAN. Senator Cantwell.

Senator CANTWELL. Thanks, Mr. Chairman. I would like to follow up on a couple of my earlier points, and the point Senator Feinstein has been making, and obviously, Mr. Chairman, I think we



should think about what information this committee does seek to further shed light on these forward contracts, but Mr. Wood, I wanted to ask a question.

I believe that the Supreme Court has previously found that FERC has the authority to negate bilateral contracts if it finds that the terms or conditions of those contracts are unjust or unreasonable, and I know that your comment earlier, when I asked the question, was about the court, and I know we are talking about what we are going to do moving forward, and what is the proper authority, but would you use the authority, your authority in this case if we find that these contracts signed during the height of this crisis show that they were manipulating the forward markets?

I do not think I have to again emphasize how important this is to my State, given the fact that there are many entities—and again, I am not 100 percent clear, but I think some of the contracts that Enron might have had with individual businesses might have had an escape clause so they got out of that payment, but I do not think the utilities, again the ratepayers of those utilities are going to get out of those increases and forward contracts.

Mr. WOOD. And I did mention earlier—I am sorry if I mumbled it—but that the court or a commission, whether it be us or a State commission, would have similar authority, and yes, ma'am, we have that under section 206 of the Federal Power Act, that authority to look at those contracts.

I guess my only caution would be if those contracts did reflect a true scarcity price that reflected the lack of or the reduction of hydropower and relative more expensive fossil fuel—

Senator CANTWELL. But I think the point is being made—

Mr. WOOD. If it is market-power related, then I think that is a different type of hearing than just one of true scarcity. I think that is the only difficult thing I would put out there for you to understand before these cases would come to the commission, if they do, that that is probably the line of inquiry. If it would be as a result of market power, then you would go one route. If it is the result of scarcity, then you probably would be more uninclined to reform those contracts.

Senator CANTWELL. But again, my constituents are asking who is this FERC entity, as they were getting gouged for higher prices, and what are they going to do to mitigate this impact, and yes we had a drought, but going out and buying on the spot market at a time when the partial deregulation caused all sorts of problems, now they are hearing maybe these forward contracts are unjust, what is FERC going to do to investigate those forward contracts in a manner that will give us some answers that I think the public deserves to have.

Mr. WOOD. Well, as you know, as we talked about, I think the first time we met, there is a pending complaint about a number of contracts under this section 206 before the commission. I believe it is finishing up briefing at this point, and has had a judge's opinion on it.

Senator CANTWELL. Do you think Mr. McCullough's point that things that—I mean, because that investigation started and is researching information back to December 1999, and now we are talking about isolating—and I have queried FERC before on these

forward contracts, and whether they should be rolled into this investigation, and oftentimes people have responded yes, it is of interest, but not a clear commitment that these forward contracts should be investigated in the detail that I think this morning's hearing is saying that they should.

Mr. WOOD. Are you requesting that the Commission do a section 206 investigation in the long-term contracts?

Senator CANTWELL. Yes. I think I would like to know what documents you are going to seek that would clarify whether, in fact, this 20 or 30 percent increase that happened during this time period is because of manipulation by Enron. I think the public—again, ratepayers in my State are paying a 50-percent increase in our utility rates and want to know.

Mr. WOOD. And we will get them an answer that answers it one way or another, and I will commit to doing that for you, Senator.

Senator CANTWELL. Thank you.

Mr. McCullough, do you have any other input on what documents we might be seeking, or that FERC should be seeking or this committee should be seeking that would help shed light on this?

Mr. MCCULLOUGH. Yes, Senator. Very clearly, we do need to know Enron's position in these markets, as Senator Feinstein has said. FERC apparently—and it is anecdotal. When I say that, it does not mean it is not true. It means we cannot tell for sure if Enron did have a 30 to 50 percent share of these markets, which appears to be the current anecdotal evidence, in electricity, then they have a tremendous ability to shift those prices.

So I think it is important for these forward positions to become public, and it is very important as well in terms of the financial investigations to know what these forward positions were, because again in market-to-market they were being used as the center point of Enron's valuation, so I think throughout the entire nexus, we are very interested in this specific question.

Senator CANTWELL. Again, Mr. Chairman, obviously Senator Feinstein has asked for more hearings and clarification, and I support that. I think it is critically important that we understand it, and again the difference is between how some individual businesses in this bankruptcy may be getting out of these forward contracts, and yet utilities, which ratepayers are impacted by, may not be.

The CHAIRMAN. Let me ask, to just clarify for my own understanding, there is a difference between forward contracts and long-term firm power contracts, and the contracts that consumers are currently having to pay under, and that utilities in California are having to pay under, are these long-term firm power contracts, as I understand it.

Now, the concern here that Mr. McCullough has raised and others have raised is that these forward contracts—which are unregulated and which are really a hedging device to hedge against risk as you go forward into the future—the prices of these forward contracts were artificially inflated, and the artificial prices there were affecting in adverse ways one of the prices that people entered into with long-term power contracts. Is that a correct understanding of what we are talking about here?

Mr. McCULLOUGH. Yes, Mr. Chairman. If I could describe it very simply, we do not have a book, a Bible we can open and see the future. When Governor Gray's team made these long-term contracts, when my clients or utilities and industries in the Northwest make these long-term contracts, they do it by the simplest possible way. They pick up the phone and they ask the vendors—and Enron was a very important vendor—what the prices are in 2003, 2004, 2005, and in Governor Gray's case, all the way out to 2010. Then once they have that price discovery, then they will actually sit down and sign that long-term contract.

If the evidence we have from this very narrow test at the beginning of December, which was designed to avoid issues on hydro or drought, because it was so short that we just saw this one event, and we could see the sudden reaction, if those affected everyone's perceptions on long-term prices, then we might in fact have had a serious distortion that would show up all the way through the power prices in Seattle and San Francisco and San Diego, even beyond our authorities in Edmonton, Alberta, and all the way down to Tijuana. This could have affected the markets throughout the entire West Coast for long-term contracts.

The CHAIRMAN. So that these forward contracts, those are the contracts the price of which dropped 30 percent on 3 December, the forward contracts.

Mr. McCULLOUGH. Correct.

The CHAIRMAN. And that drop in your view is evidence that those forward contracts were artificially high prior to December 3, and many of these long-term fixed contracts, power contracts that California and others were entering into, may well have been artificially high as a result.

Mr. McCULLOUGH. Yes, Mr. Chairman. The Governor Gray contracts were higher than the cost of building a new powerplant. They were very, very high at the time, but they were the only contracts apparently his team were able to negotiate. We did not know whether that was scarcity—we do not even have the data today to know whether it was scarcity or market failure. Most of us presume it was market failure, because the crisis has dissipated.

But where we are now is, we see this sudden single test, this experiment with this sudden change, and it really does give us some reason to doubt whether or not that forward market was deep enough to get the right economic answers.

The CHAIRMAN. So if, in fact, these forward contracts had as big an impact as we are here speculating on the price of long-term fixed contracts, then the obvious question is, why are forward contracts in this unregulated column on that chart that Mr. Seetin put up earlier, why are forward contracts not in some way or another regulated so that people have a better sense of where they are and how they can be justified.

Mr. McCULLOUGH. Yes, Senator. Now, I am not a person who opposes markets. I am a price theory economist, but at the very least we need to have discovery. We need to have open pit outcry that enables us to check how deep the market is, and we need to find out if there is only one person in the pit, if there is only one person in the pit that we know to proceed with caution. We do not have that information in front of us today.

The CHAIRMAN. We are halfway through another vote here. Let me just ask Senator Feinstein, Senator Cantwell, did you want us to do another round and come back after this vote, or do you have a final question we can finish up with?

Senator CANTWELL. I think, Mr. Chairman, we can submit any further questions.

Senator FEINSTEIN. I would like to submit some in writing.

The CHAIRMAN. We will submit some additional questions in writing. We thank you all very much. I think it has been a very useful hearing, and we will adjourn the hearing.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]



## APPENDIXES

### APPENDIX I

#### Responses to Additional Questions

U.S. COMMODITY FUTURES TRADING COMMISSION,  
*Washington, DC, February 8, 2002.*

Hon. JEFF BINGAMAN,  
*Chairman, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.*

DEAR CHAIRMAN BINGAMAN: Thank you for the opportunity to appear before the Committee on Energy and Natural Resources on January 29. Enclosed please find my response to the extra questions supplied by Senator Feinstein as a follow-up to the hearing.

Sincerely,

JAMES E. NEWSOME,  
*Chairman.*

#### RESPONSES TO QUESTIONS FROM SENATOR FEINSTEIN

*Question.* Can you explain why energy transactions, and specifically Enron's bilateral energy trades are exempted from CFTC regulation?

*Answer.* The Commodity Futures Modernization Act of 2000 (CFMA) was signed into law by President Clinton on December 21, 2000. It amended the Commodity Exchange Act (the Act or CEA) to, among other things, provide legal certainty for over-the-counter (OTC) derivatives products. The CFMA added to the CEA a new exemption in Section 2(h)(1) for some types of bilateral transactions between sophisticated parties in certain non-agricultural and non-financial commodities, including energy products. Other types of bilateral energy trades are beyond the scope of our regulatory authority under the Act by virtue of the statutory exclusions of forward contracts in Section 1a(19) and swap transactions in Section 2(g).

*Question.* I suspect that Enron On-line didn't just happen to fall through the cracks, so what was the rationale for this exemption? Do you think this was a mistake?

*Answer.* Congress enacted the CFMA after a number of hearings were conducted by our House and Senate oversight committees (in the context of reauthorizing the CFTC) that covered issues related to evolving markets. I believe Congress appropriately recognized that OTC derivatives markets, which provide valuable risk management tools to commercial counterparties and other sophisticated users throughout the economy, do not necessarily require the same level of regulation as markets that serve retail participants.

*Question.* I understand that the CFTC investigated Enron On-line and concluded that there was no market manipulation. Did you have all the information you needed to make this determination? How much more information would you have had if Enron was performing multi-lateral rather than bilateral trading?

*Answer.* The Commission has not initiated a formal investigation of Enron On-line. However, the CFTC's market surveillance staff regularly monitors the regulated futures and options markets, including those for exchange-traded energy contracts, to identify activities or price relationships that might indicate attempted manipulation or other threats to the orderly operation of these markets. We receive daily reports of large trader positions. Commissioners and senior staff are kept apprised of significant market events or potential problems at weekly surveillance meetings. Staff from the Energy Information Administration of the Department of Energy are invited to participate when energy markets are on the agenda. Thus,

because Enron was often a large trader of energy-based contracts on the New York Mercantile Exchange (NYMEX), its on-exchange trading activities were monitored by our market surveillance staff and we have no indication that Enron ever attempted to manipulate any on-exchange futures or option market.

If an electronic trading facility operates multilaterally pursuant to Section 2(h)(3) of the CEA, the CFTC has authority under Section 2(h)(4) to prescribe rules to ensure the timely dissemination by the facility of price, trading volume, and other trading data where the CFTC determines that such facility serves a significant price discovery function for transactions in the underlying cash market. The Act does not provide the CFTC this authority with respect to bilateral transactions entered into pursuant to Section 2(h)(1).

*Question.* What regulations governed the hedging instruments that Enron sold? Some have alleged that Enron sold hedge funds which rewarded Enron when gas prices were high and volatile? Can you respond to these claims?

*Answer.* If by hedging instruments, you refer to futures or options traded by Enron on the NYMEX or another regulated exchange—which, like other derivative instruments, can serve risk management (hedging) purposes—then Enron’s positions would be subject to a full range of CFTC regulations, including the large trader reporting requirements discussed above. If, however, you are referring to transactions which may be conducted over-the-counter under the CFMA amendments of the Act, then the exemptions and exclusions discussed above would apply.

Hedge funds, on the other hand, are a form of pooled investment vehicle, which typically cater only to sophisticated investors. Some hedge funds, if they participate on a regulated futures exchange, must register with the CFTC as commodity pool operators. We are not aware of Enron having ever marketed interests in any hedge fund, commodity pool, or other pooled investment vehicle.

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FEDERAL ENERGY REGULATORY COMMISSION,  
Washington, DC, February 14, 2002.

Hon. JEFF BINGAMAN,  
*Chairman, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.*

DEAR MR. CHAIRMAN: Thank you for your January 31, 2002 letter enclosing questions from Senator Richard C. Shelby and Senator Gordon H. Smith for the record of your Committee’s January 29 hearing on the impact of Enron collapse on energy markets.

I have enclosed my responses to Senator Shelby’s and Senator Smith’s questions. If you need additional information, please do not hesitate to let me know.

Best regards,

PAT WOOD, III,  
*Chairman.*

[Enclosures]

#### RESPONSES TO QUESTIONS FROM SENATOR SHELBY

*Question 1.* Chairman Wood, in your testimony you state that:

“Enron appears to have failed because of its questionable non-core business investments and the manner in which it reported on its financial position to its owner-investors and to the broader business community. Based on the facts as they appear now, Enron’s actions would have led to the same result whether its core business focused on energy, grains, metals, or books.”

This leads me to believe that regardless of the level of regulation imposed upon Enron, you believe that they would have failed, is this the case?

Mr. McCullough makes the argument that had Enron been a registered holding company all of this may well have been avoided, do you agree with this assessment?

*Answer.* The full details of Enron’s accounting practices are not yet clear. Until further information is available, I cannot say whether additional regulation, or what types of additional regulation, might have prevented Enron’s collapse. The excerpt quoted from my testimony was intended to mean that Enron’s problems did not depend on the fact that Enron’s core business is in the energy industry. The accounting principles at issue appear to apply to all domestic companies, and are not unique to the energy industry. In response to Mr. McCullough’s assertion, I believe that until we have a comprehensive understanding of the facts, it would be premature to judge whether Enron’s collapse may have been averted if Enron had been a registered holding company.

*Question 2.* Chairman Wood, in your statement you mention that in “December of 2001, the Commission proposed a rulemaking to update the accounting and reporting requirements for jurisdictional public utilities, natural gas companies and oil pipelines.”

Could you please explain to the Committee, the current accounting and reporting requirements for these entities, and if you could detail the differences in those requirements for registered holding companies and non-registered holding companies?

Answer. The Commission’s current accounting requirements for jurisdictional public utilities, natural gas companies, and oil pipelines are encompassed in the Commission’s Uniform System of Accounts, 18 CFR Parts 101, 201 and 352 (2001). The Uniform System of Accounts generally requires these jurisdictional entities to establish and maintain a systematic and complete accounting for all of their costs. The Uniform System of Accounts is aimed primarily at ensuring that the Commission has reliable and comprehensive information to verify that cost-based rates are just and reasonable.

The Commission has established a number of reporting requirements for jurisdictional companies. The most important one is that public utilities, natural gas companies and oil pipeline companies must file an annual report, which generally contains a balance sheet, a statement of income, a statement of retained earnings and a statement of cash flows—all kept in accordance with the Uniform System of Accounts.

Marketers typically would be exempt from these accounting and reporting requirements, since the requirements are intended to elicit cost information and are not relevant to the market-based rates allowed for marketers. However, power marketers must file quarterly reports concerning their recent power transactions.

The Commission’s accounting and reporting requirements do not vary based on whether the company is or is not part of a registered holding company. Although the Commission in certain circumstances imposes restrictions on public utilities that are part of registered holding companies, with respect to pricing for non-power goods and services, the basic accounting and reporting requirements applicable to a jurisdictional company are not affected by whether or not that company is owned by a registered holding company. Public utilities in holding companies must abide by the Commission’s accounting requirements as well as those of the Securities and Exchange Commission.

*Question 3.* Chairman Wood, continuing along those lines, it is my understanding from the minimal account of information that we now have that Enron may have violated the rules of the Financial Accounting Standards Board—essentially, they may have violated existing accounting rules. In your opinion, would these new accounting and reporting requirements that FERC is proposing provide an extra layer of protection for consumers and investors?

Answer. No. The Commission’s proposed accounting and reporting requirements are intended to make accounting for jurisdictional energy companies more consistent with existing accounting requirements for non-jurisdictional companies. The Commission’s proposal would not have prevented Enron’s apparent noncompliance with existing accounting requirements or standards.

The proposed accounting and reporting requirements would establish uniform accounting requirements and related accounts to recognize changes in the fair value of certain security investments, items of other comprehensive income, derivative instruments, and hedging activities, consistent with certain Financial Accounting Standards Board protocols. The new accounting requirements would apply to those public utilities, natural gas companies and oil pipelines required to comply with the Commission’s Uniform System of Accounts. For these companies, the proposed rules are intended to improve the accuracy and completeness of the accounting information available to the Commission, customers and others.

As noted above, power marketers are not required to comply with the Uniform System of Accounts. Thus, the proposed new requirements would not apply to power marketers. However, the Commission did ask for comments on whether the exemption of power marketers from the existing and proposed accounting requirements remains appropriate. These comments are due to be filed by March 11, 2002. The Commission will evaluate this issue carefully after receiving all of the comments.

#### RESPONSES TO QUESTIONS FROM SENATOR GORDON SMITH

*Question 1.* The Pacific Northwest wholesale generation and transmission system provides reliable, low-cost electric service to consumers in the region. The predominant cause of transmission constraints is not service for regional loads, but marketers and others wheeling power out of and through the region. What problems would



you be solving for electricity consumers in the Northwest by mandating an RTO and national market standards?

Answer. In my view, all uses of the transmission grid are equally valid. With most Load Serving Entities (LSEs) dependent on some amount of generation remote from their loads, I cannot conclude that regional exports rather than native load are the cause of transmission constraints. In general, RTOs will achieve greater efficiencies in power markets and limit opportunities for discrimination in grid operations. They will promote greater competition in regional wholesale markets, which will benefit customers by lowering delivered electricity rates. RTOs will also conduct regional transmission planning, expedite reasonable cost grid expansions, and eliminate transmission rate pancaking. A standard market design would help remove barriers to regional trade and facilitate regional coordination in performing key industry functions.

I recognize that the electric infrastructure in each region of the country has unique operational characteristics and needs. As the Commission continues developing RTOs and market design, I will remain mindful of the need for balance between the efficiencies of a seamless national market and regional flexibility.

To this end, the Commission has provided a number of opportunities for representatives from each region of tire industry to express their interests and concerns on these issues, either in writing or in public meetings. The Commission will continue its extensive outreach efforts as we adopt and implement new policies and requirements on RTOs and market design. The Commission is also preparing cost-benefit studies to ensure that any actions we may require on these issues are in fact likely to benefit customers. I assure you that whatever policies and requirements the Commission ultimately adopts will be based on our goal of producing additional savings for customers.

*Question 2.* Given that FERC still regulates wholesale power and transmission, what are the limitations of market-based solutions to ensuring adequate power generation and adequate transmission infrastructure?

Answer. Market-based solutions are an important step to ensure the adequacy of our electrical infrastructure. Investors will not provide the capital needed by the electric industry unless they believe they will be compensated adequately compared to other investment opportunities. Thus, a good market structure with some assurance of sound rulemaking and revenue recovery is essential to assure that new generation and transmission are built.

However, as you suggest, market-based solutions are not sufficient, by themselves, to ensure development of needed infrastructure. Siting issues often can delay or prevent such development. Of course, we must meet our need for energy infrastructure without unduly impairing our Nation's environmental assets. However, siting problems are sometimes driven by the fact that the benefits of proposed infrastructure would go to one state or region while the costs (economic or environmental) would go to another. We must find ways to ensure that everyone's interests are considered adequately and that the benefits and burdens of development are distributed as fairly as possible. The Western states, through the Western Governors Association and the Committee on Regional Electric Power Cooperation, have recognized the importance of sound Western energy infrastructure expansion and are developing methods of cooperation to better handle these siting issues across states. Here too, having an RTO-led regional planning process would help achieve regional infrastructure solutions.

*Question 3.* My constituents rely on their long-term Bonneville contracts to move federal generation from its source to their loads. How are those rights going to be accommodated and protected in an RTO?

Answer. Bonneville is not a public utility and thus the contracts under which it provides service are not subject to the Commission's direct jurisdiction under sections 205 and 206 of the Federal Power Act. The same concerns you express, however, have been expressed by and on behalf of public utilities. In that context, two key issues raised in the Commission's rulemaking on market design are: (1) whether an RTO transmission tariff should apply to bundled retail transmission; and (2) whether existing transmission contracts (e.g., contracts in effect before formation of an RTO) should be grandfathered. In the Commission's Order No. 888, the Commission did not assert jurisdiction over bundled retail transmission. That issue is now pending before the U.S. Supreme Court. Also in Order No. 888, and in the formation of certain Independent System Operators, the Commission grandfathered existing transmission contracts. However, grandfathering existing contracts may not be the most efficient approach to RTO formation. We have received a number of constructive suggestions on these points in our standard market design proceedings and will carefully consider the interests of all affected parties before making any decision on these issues in our pending rulemaking.

## APPENDIX II

### Additional Material Submitted for the Record

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CONSUMERS FOR FAIR COMPETITION,  
*Washington, DC, January 25, 2002.*

Hon. JEFF BINGAMAN,  
*Chairman, Committee on Energy and Natural Resources, Dirksen Senate Office  
Building, Washington, DC.*

DEAR CHAIRMAN BINGAMAN: For years, the Securities and Exchange Commission (SEC), private utilities and others have argued that the Public Utility Holding Company Act (PUHCA) was a redundant, anachronistic law.

As detailed in the attached paper, the financial collapse of Enron underscores the continued importance of regulating the conduct, financing and structure of utility companies to facilitate effective regulation, protect consumers and investors and support fair competition. Absent receipt of an SEC staff “no action” letter, Enron would have qualified under PUHCA as a registered holding company. Such a determination would have resulted in significant restrictions on Enron’s broadband and foreign utility investments, as well as inter-affiliate transactions, and required SEC pre-approval of Enron securities issuances and direct oversight of books and records.

Effective administration of PUHCA could have prevented, minimized or provided “early warning” of the events that precipitated Enron’s collapse.

Enron’s corporate empire, according to recent reports, includes roughly 5,800 affiliates and subsidiaries—including 821 located offshore. Simply providing limited access for the Federal Energy Regulatory Commission and state utility regulators to review holding company books and records, as provided in S. 1766, is clearly inadequate to safeguard consumers and investors and prevent the corporate and accounting shell-game employed by Enron to disguise the true nature of its investments, financial condition and affiliate relations. Yet, with repeal of PUHCA, every utility company in the country—companies vested with responsibility for provision of an essential service—could mimic the corporate structure employed by Enron, thereby shielding itself from effective regulatory scrutiny and exposing consumers and investors to significant risks.

Consumer for Fair Competition—an ad hoc coalition of consumer representatives, public power organizations, industrial customers and small businesses—believe Congress should strengthen, not weaken, the nation’s laws that protect consumers and investors and promote fair competition. We urge you to delete repeal of the Public Utility Holding Company Act from your pending legislation unless adequate, additional protections are provided.

Sincerely,

MARTY KANNER,  
*Coalition Coordinator.*

#### COLLAPSE OF ENRON HIGHLIGHTS THE NEED TO STRENGTHEN, NOT WEAKEN, THE NATION’S ELECTRICITY LAWS

The sudden and dramatic financial collapse of Enron, the world’s largest electricity and natural gas trader, highlights the need to strengthen, not weaken, the nation’s electricity laws to ensure that consumers and investors are protected and fair competition advanced.

On December 12, 2001, testimony before the House Energy and Air Quality Subcommittee, SEC Commissioner Isaac Hunt outlined the abuses that led to passage of the Public Utility Holding Company Act of 1935 (PUHCA): “inadequate disclosure of the financial position and earning power of holding companies, unsound accounting practices, excessive debt issuances and abusive affiliate transactions.” Commissioner Hunt asserted that enhanced and expanded regulation by the SEC and the

states—as well as changes in the accounting profession—rendered the protections found in PUHCA “duplicative and unnecessary.”

The Enron collapse underscores the failure of the remaining fabric of regulatory oversight to uncover the abuses that starkly parallel those that led to enactment of PUHCA. Repeal of federal statutes, such as PUHCA, removes important tools that could be used to prevent future, similar collapses in the energy industry and associated investor and consumer harm.

PUHCA is intended to regulate the structure, financing and operations of utility holding companies to prevent complicated corporate structures, affiliate transactions and consolidations that prevent effective regulation and cause investor or consumer abuse. Following is a summary of key provisions of PUHCA and their implications in the Enron debacle:

1. Utility ownership restriction. If a company owns one operating utility, it is precluded from purchasing another unless the acquired utility can be physically and operationally integrated with the original utility. In addition, if the resulting acquisition creates a multi-state utility, then the holding company must become a “registered” holding company under PUHCA, with additional restrictions on financing and diversification. The effect of this restriction was to limit Enron to owning a single operating utility—Portland General Electric. Had additional, non-integrated utility acquisitions been allowed, the consumer impact of Enron’s collapse could have been significantly magnified. PUHCA repeal would allow a small number of companies to acquire a large number of utilities, not for reasons of economic and physical integration but for reasons of cash flow. This trend toward concentrated utility ownership will magnify the harm to energy consumers from the financial failure of any one of these companies. Recently, a federal court held that the SEC erred in approving a merger between two large utilities because their systems were not integrated. This shows the need for more vigorous regulatory oversight—not less.

2. Finance and Accounting. PUHCA requires registered holding companies to secure SEC approval prior to the issuance of stock and provides for SEC—not just private accounting firm—auditing of company books and records. Had Enron been a registered holding company, and PUHCA been effectively administered, these requirements could have prevented or provided “early warning” of Enron’s use of stock as collateral and payment to a variety of limited partnerships.

3. Diversification restrictions. PUHCA is supposed to limit each registered holding company holdings to a single integrated utility system, plus only those businesses that are “necessary or incidental” to that system. In short, holding companies must stick to their core business, and operate it efficiently. One of the primary contributing factors in Enron’s collapse was its diversification into broadband, water utilities and foreign utility investments. Had the SEC effectively administered PUHCA, Enron would have been classified as a registered holding company<sup>1</sup> and its investments in broadband would have fallen under the 1996 Telecommunications Act restrictions requiring prior state commission approval, investment disclosure requirements and access to books and records, capitalization, and pledging of utility assets.<sup>2</sup> In addition, Enron’s investments in foreign ventures would have faced tighter restrictions. Repealing PUHCA will remove the restrictions on holding company diversification and conditions on holding company investment in telecommunications and foreign utility. This action could potentially lead to other utilities making risky investments that lead to financial ruin.

4. Affiliate transactions. PUHCA stipulates terms for financial and commercial transactions between affiliates that, if properly enforced, should prevent corporate shell games that hide the true financial condition of a company. PUHCA repeal will remove one check on complicated corporate structures that could hide similarly looming catastrophes. Because of the increasingly multi-state nature of such transactions, additional statutory protections are needed.

5. Restrictions on consolidation. In the wake of Enron’s collapse, numerous other “merchant” power companies have had their credit downgraded and seen stock prices plummet. This financial situation, by weakening smaller newcomers, is likely to lead to increased consolidation, as healthier incumbent market participants ac-

<sup>1</sup>The Federal Energy Regulatory Commission (FERC) determined that Enron’s electricity trading operations qualified Enron as a “public utility”. As noted in a January 21, 2001, *Wall Street Journal* article, the SEC staff issued a “no action letter” in January 1994, determining that Enron’s energy marketing and brokering activities did not constitute “facilities” within the mean of an electric or gas utility that would require Enron to become a registered holding company. Had the SEC staff made the same determination as the FERC, Enron would have become a registered holding company under PUHCA with the associated restrictions.

<sup>2</sup>By restricting the pledging of utility assets, captive ratepayers would not be at risk for failed diversification ventures, and those ventures could be more limited in scope to do the absence of collateral.

quire their weaker competitors. While such consolidation may be financially beneficial to the acquiring and acquired companies—it will certainly reduce the number of market participants and reduce competition. PUHCA requires that any proposed merger produce economic and operational efficiencies and be in the public interest. Rather than utilizing this “net benefits” test, FERC policies call for approval of any merger that does not cause obvious harm. Repealing PUHCA will lower the standard for utility mergers and acquisitions and lead to increased consolidation and reduced competition in the industry.

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STATEMENT FOR THE RECORD OF THE AMERICAN PUBLIC POWER ASSOCIATION BEFORE  
THE SENATE ENERGY AND NATURAL RESOURCES COMMITTEE HEARING ON THE IMPACT  
OF THE ENRON COLLAPSE ON ENERGY MARKETS

The American Public Power Association (APPA) is pleased to submit testimony to the Committee on the impact the collapse of Enron has had upon energy markets and the defects and regulatory deficiencies in energy markets that led to the collapse. APPA represents the interests of more than 2,000 publicly owned electric utility systems across the country, serving approximately 40 million citizens. APPA member utilities include state public power agencies and municipal electric utilities that serve some of the nation’s largest cities. However, the vast majority of these publicly owned electric utilities serve small and medium-sized communities in 49 states, all but Hawaii. In fact, 75 percent of our members are located in cities with populations of 10,000 people or less. Further, most publicly owned utilities are not generation self-sufficient but depend on wholesale power purchases to meet the retail loads of the communities they serve.

When Enron filed for Chapter 11 bankruptcy protection on December 2, 2001, it became the largest bankruptcy in U.S. history. Enron’s collapse has affected thousands of Enron employees, many of whom lost their life savings as well as their jobs. Enron stockholders lost countless millions as Enron stock rapidly crumbled from approximately \$90 a share to less than a dollar per share this year. In Texas, the Teachers Retirement System and Employees Retirement System lost a combined \$59.7 million as a result of investments in Enron stock. In addition, banks that loaned Enron money may not be repaid, causing instability among lending institutions.

The collapse of Enron has consequences for energy markets as well. Independent power producers nationwide have seen their stock prices drop as a result of weakened investor confidence. The negative investor sentiment lingering from the Enron debacle has eroded the price of Calpine Corporation stock, the country’s largest independent power producer, to a one-year low.

Appropriately, the Department of Labor, the Securities and Exchange Commission and the Department of Justice have launched investigations into Enron’s collapse. In addition, numerous congressional committees have stated their intent to hold hearings on issues related to Enron.

We believe it is particularly appropriate for this committee to examine Enron’s collapse because of the serious implications this event has for the electric utility industry and electric industry restructuring legislative initiatives. We commend Chairman Bingaman and members of the Committee for holding this hearing today. Information that comes to light as a result of this hearing, as well as other ongoing investigations, could help shape electricity legislation and protect consumers, as well as investors, from the questionable practices that caused Enron’s bankruptcy.

Unfortunately, the Enron debacle is more than a case of greed and accounting failures. The collapse of Enron represents a colossal regulatory failure.

In 1935, the Public Utility Holding Company Act (PUHCA) was enacted to regulate the structure, financing and operations of utility holding companies to prevent complicated corporate structures, affiliate transactions and consolidations that prevent effective regulation and cause abuse of investors or consumers. PUHCA directs the Securities and Exchange Commission (SEC) to regulate the activities of large, multi-state electric or gas utility holding companies and to limit their diversification into non-utility businesses. In fact, PUHCA was created to prevent precisely the kind of utility holding company structure—with nearly 1,000 affiliates—that Enron became.

Under PUHCA, the SEC enforces: special accounting requirements; limits on utility mergers and expansion; and tough restrictions on affiliate relationships. To date, 35 companies are regulated by the SEC under PUHCA. It is interesting to note that despite arguments PUHCA is perceived by companies as a major problem, the number of companies choosing to be regulated under PUHCA by the SEC has doubled over the past 10 years.

Enron was clearly intent on avoiding regulation under PUHCA. In 1993, Enron obtained a “no-action letter” or waiver from the SEC exempting their wholesale power-selling unit, Enron Power Marketing Inc., from registering under PUHCA. Some have argued that the SEC would have been within its authority to require Enron Power Marketing Inc. to register under PUHCA and that the SEC issued the waiver without addressing the legal issues in the application. Conversely, when faced with a similar decision the Federal Energy Regulatory Commission (FERC) determined that Enron’s electricity trading operations qualified Enron as a “public utility.”

Had the SEC applied the same criteria, Enron would have become a registered holding company under PUHCA with the associated restrictions. Restrictions that would have been in place had Enron been a registered holding company include: SEC approval prior to the issuance of stock; SEC auditing of books and records; limits on diversification; and terms for financial and commercial transactions between affiliates. The restrictions, had they been appropriately administered, could have prevented, or provided “early warning” of, Enron’s collapse. Appropriately, the SEC is now reviewing the 1993 staff ruling to award the waiver; however, this will provide little comfort to the Enron employees and shareholders who suffered great personal and financial loss.

Further evidence of the lengths Enron would go in order to avoid PUHCA regulation can be found in Enron’s 1997 acquisition of Portland General Electric (PGE), a deal specifically structured to avoid placing Enron under the strictures of PUHCA. In fact, in a July 1996 article in *The Electricity Daily* Ken Lay, Enron’s CEO at the time, stated in reference to the PGE deal and their efforts to avoid PUHCA regulation “. . . clearly there are {PUHCA} constraints in other deals. We think the Act should be repealed.” Ironically, had these constraints not been in place, additional, non-integrated utility acquisitions would have been allowed and the consumer impact of Enron’s collapse would have been significantly magnified.

Ultimately, the repeal of PUHCA will allow a small number of companies to acquire a large number of utilities, not for reasons of economic and physical integration but for reasons of cash flow. This trend towards concentrated utility ownership will magnify the harm to consumers from the financial failure of any one of these companies.

In addition to the waiver from PUHCA, Enron was able to obtain a SEC exemption from the Investment Company Act of 1940. This waiver allowed Enron to shift the debt of their foreign operations off their books and permitted Enron executives to invest in partnerships affiliated with the company.

Clearly, having regulations in place is not enough—these regulations must be strictly enforced in order to be effective. At least in terms of PUHCA, a deficiency in SEC enforcement contributed to the Enron debacle. This enforcement deficiency may be related to the SEC’s belief that PUHCA should be repealed or the fact that there are currently proposals pending in Congress that would repeal PUHCA.

Ironically, it was a similar deficiency in enforcement, at FERC in this instance, which prolonged and contributed to the energy crisis in the West. In California and throughout the West, we believe that FERC was so focused on promoting competition that it completely lost sight of its obligation under the Federal Power Act to permit only just and reasonable wholesale rates and its responsibility to ensure that consumers are protected from abuses of market power. Rather than relying upon assumed competition to regulate wholesale electricity markets, FERC should have taken immediate steps to control electricity prices in the West.

Over the next several months much information will be gleaned and many lessons will be learned from the hearings and investigations in the Enron collapse. Congress should proceed cautiously on comprehensive restructuring legislation until such time that those lessons can be assimilated into legislation. Proceeding on comprehensive electricity legislation without the benefit of information that comes to light as a result these hearings and investigations ultimately is likely to cause more harm than good. In order to better protect consumers, shareholders and the integrity of energy markets from similar “Enron” collapses in the future, Congress should undertake an examination of current laws and regulations on the books and ensure that those laws and regulations are being adequately enforced. Further, Congress should consider, when appropriate, strengthening existing law as a means of closing potentially exploitable loopholes.