20020813-0468 Received by FERC OSEC 08/13/2002 in Docket#: PA02-2-000

EXECUTIVE SUMMARY

In this initial report, the Staff of the Federal Energy Regulatory Commission (Commission) presents to the Commission, the Congress, and the public its initial report on its investigation in Docket No. PA02-2-000 and its findings and recommendations with respect to (1) the initiation of separate proceedings to further investigate specific instances of possible inappropriate conduct by Portland General Electric Company (Portland), two other affiliates of Enron Corporation (Enron),[1] El Paso Electric Company (El Paso Electric), and Avista Corporation (Avista), and the initiation of generic reevaluations of the Commission's "simultaneous offer" rule; (2) publicly-reported California delivery point natural gas spot price data, including the use of such data in the California refund proceeding in Docket Nos. EL00-95-045 and EL00-98-042 now pending at the Commission; and (3) the impact of the Enron trading strategies (discussed in the previously released Enron memoranda[2]) on energy prices in the West.

This report reflects the views only of Commission Staff; it has not been considered by the full Commission. It is based only on the information that we have obtained and reviewed at this time; Staff continues to receive and review data including information relevant to the subjects covered in this report.

This report reflects information that was submitted to Staff under a claim of privilege pursuant to 18 C.F.R. § 388.112 (2002). Staff has made a good faith effort to ensure that none of the specifics of such material is being released to the public.

On February 13, 2002, in Docket No. PA02-2-000, the Commission directed Staff to gather information on whether any entity, including, but not limited to, any affiliate or subsidiary of Enron had manipulated short-term prices for electric energy or natural gas in the West, or otherwise exercised undue influence over wholesale electric prices in the West, since January 1, 2000, resulting in potentially unjust and unreasonable prices in

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[1]The two other Enron companies are Enron Power Marketing, Inc. and Enron Capital and Trade Resources Corporation. Portland is a traditional public utility with captive ratepayers.

[2]As we discuss in more detail below, three memoranda describing Enron's electricity trading strategies were released by Enron's Board of Directors on May 6, 2002, and made publicly available on the Commission's web site. We refer hereinafter to these strategies as the "Enron trading strategies."

long-term power sales contracts. Staff was also directed to look into other factors that may have influenced contract terms.

As part of this ongoing investigation, Staff inquired into the characteristics of publicly-reported price data, including spot prices at California delivery points that are used to calculate the mitigated market-clearing price in the refund proceeding. This area of inquiry was in part prompted by allegations that Enron's bankruptcy had triggered a substantial fall in spot prices, which allegedly was evidence that Enron had manipulated those prices. While the Commission has no jurisdiction over trade publications, once a formal investigation was initiated, Staff was then able to conduct discovery of trade publications' procedures and practices with respect to reporting natural gas spot prices.[3] The results of this inquiry are contained in this initial report.

Staff, with the assistance of outside consultants who have expertise in electric and natural gas market issues,[4] is conducting a comprehensive investigation of a variety of factors and behaviors that may have influenced electric and natural gas prices in the West during 2000-2001. This is a time- and resource-intensive investigation which involves extensive data gathering and data analysis. To date, Staff has received in excess of 70 boxes of written material and in excess of 1,200 gigabytes (GB) of electronic data. In addition, Staff is sharing information with, and otherwise coordinating with, other investigatory agencies, including the Department of Justice, the Commodity Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC).

Throughout the course of its ongoing investigation, Staff prioritized its efforts on those areas of inquiry that have the largest impact on customers, and one of those areas involves use of publicly-reported natural gas price data in calculating potential refunds in the California refund proceeding. Because of the large dollar impact and the fact that publicly-reported prices are a discrete subject readily separated from other areas of inquiry, Staff has accelerated the publication of its findings and recommendations on the use of published price data so that its findings and recommendations can be factored into the California refund proceeding. The now infamous Enron trading strategies have

[3] *See* 16 U.S.C. § 825f (1994).

[4] The outside consulting firms are Aspen Systems Corporation (Aspen Systems) and Analysis Group/Economics (AG/E). Members of AG/E active in this investigation include Edward P. Kahn and Michael Quinn. Other outside consultants include Hendrik Bessembinder, Robert S. Pindyck, and Chester S. Spatt.

adversely affected confidence in energy markets in the West. For this reason, Staff also presents its analysis and recommendations on the Enron trading strategies.

Staff reports the following principal findings and recommendations:

With respect to the initiation of separate, company-specific proceedings and generic reevaluations:

- **Staff recommends that the Commission initiate company-specific separate proceedings, in which specific instances of possible misconduct by public utilities can be further investigated and appropriate remedies imposed. These companies are three Enron companies (Portland, Enron Power Marketing, Inc., and Enron Capital and Trade Resources Corporation), El Paso Electric, and Avista. The specific instances of possible misconduct include: violations of the companies' codes of conduct and the Commission's standards of conduct; failures to make appropriate filings under sections 203 and 205 of the Federal Power Act (FPA); violations of the Commission's open access transmission requirements; and violations of minimum operating reserve requirements.**

- **Staff recommends that the Commission reevaluate the "simultaneous offer" rule that it uses to discipline affiliate transactions to ensure that it is effective and verifiable.**

With respect to natural gas price data:

- **Historically, the spot prices for natural gas at the California delivery points highly correlate with prices at producing basins and Henry Hub. During the months of October 2000 to July 2001 – the refund period in the California refund proceeding – the correlation was abnormally low. Since that time, the high correlation has resumed.**

- **Given the abnormal correlation for this isolated period, Staff attempted to independently verify the price data to assure that they are statistically valid, reliable, and free from the effects of price manipulation.**

- **The price data published in various trade publications share a wide range of generic characteristics, that is, characteristics common to all publications,**

common to price data for both electric and natural gas products, and common to the data for both daily spot prices and forward prices. These generic characteristics – and the availability of superior alternatives – raise serious issues concerning the continued use of the published natural gas price data for California delivery points for purposes of calculating the mitigated market-clearing price in the California refund proceeding.

- **At this point in time, no independent entity, such as this Commission, can verify the published price data. This is due, in part, to the reporting firms' status as non-jurisdictional entities as well as their legitimate desire to protect the confidentiality of their sources. Without knowing the source of the raw data, there cannot be any independent verification of the price data published by any reporting firm.**

- **The trade publications reporting spot and forward prices for both electric and natural gas products at California delivery points do not employ statistically valid sampling procedures or a systematic, formal verification procedure.**

X **While Staff is continuing to investigate whether there was actual manipulation of spot gas prices, we have preliminary indications that this may have occurred. Also, market participants had the incentive to manipulate spot prices upward for natural gas at the California delivery points.**

X **Enron OnLine (EOL) was a significant source of price discovery and formation and was potentially susceptible to manipulation by market participants.**

X **Staff concludes that the reported spot prices for natural gas at California delivery points are *not* appropriate for use in computing the mitigated market-clearing price and subsequent refunds in the California refund proceeding. Staff makes no conclusions as to whether these reported prices are inappropriate for structuring contractual provisions between two sophisticated parties bargaining at arms-length.**

X **While there may be other possible alternatives, Staff has focused its analysis on two of these, and we are recommending that refunds be computed based**

on the spot prices for natural gas reported at producing area pricing points, plus an allowance for transportation to California. Spot prices at producing areas can be independently corroborated because they correlate well with prices at Henry Hub, which has a deep and liquid futures market conducted on the New York Mercantile Exchange (NYMEX), itself a CFTC-regulated organized exchange. For purposes of the California refund proceeding, Staff regards spot prices at the producing areas to be superior to spot prices at Henry Hub, because natural gas at the producing areas is actually delivered to California, while natural gas from Henry Hub is not.

- **Generators with fuel costs in excess of Staff's recommended refund formula could apply for an uplift if it is demonstrated that the fuel costs were incurred based on arms-length negotiations with non-affiliated suppliers. This option will operate as a backstop to recover costs associated with scarcity.**

With respect to the Enron trading strategies:

- **While the exact economic impact of the Enron trading strategies is difficult to determine precisely, Staff concludes that these now infamous trading strategies have adversely affected the confidence of markets far beyond their dollar impact on spot prices. Staff will continue to investigate whether the Enron trading strategies had an indirect effect on other products such as long-term physical and financial contracts.**

- **Many of the Enron trading strategies may have been attempts to manipulate prices.**

- **The Enron trading strategies also may have involved deceit, including the submission of false information, including false schedules.**

- **Enron, as a corporate entity, displayed great eagerness to experiment with all aspects of market rules and protocols in an effort to "game the system" or to provide false information.**

- **Staff recommends that the Commission require that all market-based rate tariffs include a specific prohibition against the deliberate submission of false information, or the omission of material information, whether to the Commission or to an entity such as an independent system operator, regional**

transmission organization, public utility, or market monitor. This tariff requirement should be worded broadly to cover any and all matters relevant to wholesale markets, including maintenance and outage data, bid data, price and transaction information, and load and resource data. By including these specific prohibitions, any revenues generated from transactions associated with such activities would be subject to refund under the FPA. This refund provision would be an effective means by which the Commission can better ensure that the conduct of public utilities in consistent with the public interest.

- **Staff also recommends that all market-based rate tariffs include standard provisions so that the Commission can go beyond simply refunding profits and impose penalties on violators. Staff is aware that Congress is considering expanding the Commission's currently very limited civil penalty authority, and we strongly endorse expanded civil penalty authority that applies to jurisdictional companies that violate the Commission's orders and regulations, as a means to deter the types of conduct we have encountered in this investigation.**