Testimony of
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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). 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.

<u>Enron's market role</u>

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.

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 rulemaking 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).[1] 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

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[1] 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.

infrastructure, encouraging the construction of new infrastructure, and licensing or certificating 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.

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 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.

<u>Price Transparency</u>

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.

<u>Creditworthiness</u>

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 continue 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.