

LEBOEUF, LAMB, GREENE & MACRAE

LLP.

A LIMITED LIABILITY PARTNERSHIP INCLUDING PROFESSIONAL CORPORATION

125 WEST 55TH STREET
NEW YORK, NY 10019-5389

Exhibit No. S-2
Schedule 3
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July 29, 1999

TO: Steven E. Levitsky
FROM: Rocio L. Olivencia
Brian S. Trackman
RE: Legality of Proposed Energy Purchase-Sale Plan

QUESTION PRESENTED

Can traders at Enron, a utility company operating in California, enter into a large purchase-sale agreement with Portland General ("Portland"), a wholly-owned subsidiary of Enron, in which: (a) Enron places an order for power with Portland; (b) Enron notifies the Independent Service Operator ("ISO"), which will then designate on a "day ahead" basis transmission pathways for the purchase, creating congestion in areas of the network and temporarily raising the price of power in the spot market; (c) Enron enters into power sales contracts with other purchasers at the new, higher price of electricity; (d) subsequently, Enron cancels its order from Portland, paying Portland only a cancellation fee; and (e) Enron realizes a substantial profit fulfilling its sales contracts entered into at the temporarily higher price? ("Contemplated Transaction")

CONCLUSION

The Contemplated Transaction, though questionable on business, political, and social grounds, does not appear to be prohibited under current law. Moreover, even if the Contemplated Transaction is illegal under current law, it is highly unlikely that any prosecution would be successful, for want of necessary evidence.

DISCUSSION

The structure of California's electric services industry has been undergoing significant changes. Utility monopolies are being dismantled in favor of a freer market structure. The California Public Utilities Commission ("CPUC") is the state agency responsible for implementing and overseeing

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utility market reform. To protect consumers and encourage greater competition in new electric services marketplace, CAPUC has issued a variety of orders. The following are most important:

- 1) Re Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation, 1995 Cal. PUC LEXIS 1034, 166 P.U.R.4th 1 (Dec. 20, 1995) ("1995 Decision")
- 2) Order Instituting Rulemaking on the Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation; Order Instituting
- 3) Investigation on the Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation, 1996 Cal. PUC LEXIS 28, 166 P.U.R.4th 1 (Jan. 20, 1996) ("1996 Order").
- 4) Order Instituting Rulemaking to Establish Standards of Conduct Governing Relationships Between Energy Utilities and Their Affiliates; Order Instituting Investigation to Establish Standards of Conduct Governing Relationships Between Energy Utilities and Their Affiliates, 1997 Cal. PUC LEXIS 1139, 183 P.U.R.4th 503 (Dec. 16, 1997) ("1997 Order").

None of the above orders expressly prohibit the Contemplated Transaction.

The 1995 Decision lays the groundwork for a disaggregated, competitive electric services market, which offers consumers a wide array of choice in how and from whom they purchase electricity. The only portion of the document that comes close to issues raised by the Contemplated Transaction deals with "congestion costs."

According to the 1995 Decision, the ISO coordinates all transmissions to ensure operational reliability and least-cost use of the system. Thus, the ISO will minimize congestion problems neutrally, not favoring any particular utility or customer. Users of the system, either individually as "direct access participants" or indirectly through the Power Exchange ("PX"), will also pay "congestion costs arising from the redispatch of the system in the face of transmission constraints." See 1995 Cal. PUC LEXIS 1034, at *101. The 1995 Decision continues, "The ISO will administer a system of transmission congestion contracts to redistribute the congestion payments and provide a set of tradeable instruments to support long-term commercial transactions across locations in the grid." See *id.*

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While it does not appear that the Contemplated Transaction would give rise to any liability, it is possible that a participant in trading congestion payment instruments, or the CAPUC itself might have a claim or be able to impose a penalty if the Contemplated Transaction were carried out and was deemed illicit market manipulation.

The 1996 Order expands upon the 1995 Order, setting forth the principle structures of the new electric services industry. The 1996 Order contains a lengthy discussion of various market power issues, both horizontal and vertical. Neither these discussions, nor those describing the PX or ISC and their functions in the new electric services market structure touch upon any arrangement like the Contemplated Transaction. Indeed, it appears that CAPUC either failed to consider such a possibility, determined that such a transaction posed no threat to the system, or believed that the new transparent spot market for electricity administered by and through the PX and ISC would prevent a party from executing a transaction like the Contemplated Transaction.

The 1997 Order, which governs conduct between "utilities" and their "affiliates" does not apply to the Contemplated Transaction because Portland is a wholly-owned subsidiary of Enron. Subsidiaries are specifically exempted from the definition of affiliate found in the 1997 Order.¹ See 1997 Cal. PUC LEXIS 1139, at *186. Even if the rules did apply, it is not clear that the Contemplated Transaction would be prohibited. Enron might still be able to place and then cancel an order for electricity through the PX, creating transmission congestion and temporarily increasing the price of power. The 1997 Order, however, contains language stating that its terms should be construed broadly in order to effect its stated goals of fostering competition by creating a common set of rules and transparent power exchange market mechanism, and of protecting consumers. See 1997 Cal. PUC LEXIS 1139, at *15, Appendix A. Thus, even if not expressly applicable to the Contemplated Transaction, if the CAPUC deemed Portland to be an affiliate of

¹ The distinction between "affiliates," "affiliated entities," and "regulated subsidiaries" is not new. CAPUC introduced the same distinction in 1993. See 1993 Cal. PUC LEXIS 80, 48 CPUC2d 163 (Feb. 3, 1993). In its decision, CAPUC ruled confirmed that affiliated entities included both affiliates and regulated subsidiaries. Regulated subsidiaries, however, did not have to meet the filing requirements for affiliates because the revenues and expenses of the subsidiary are already subject to regulation by CAPUC. CAPUC's control may be direct or indirect. In the case of Pactel and its Yellow Pages subsidiary, for example, CAPUC exercised control over the subsidiary by imputing its revenues in setting Pactel's rates. See *id.* at *7.

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Enron - a possibility, though highly unlikely - and not a subsidiary, the 1997 Order would present legal risk to Enron.

In addition to the aforementioned CAPUC orders, California has a number of statutes prohibiting unfair competition and fraudulent business practices. Although these statutes do not specifically target utility companies, they may be broad enough to apply to the Contemplated Transaction.

California's Unfair Competition Act (the "Act"), found under Section 17200 of the Business and Professions Code, prohibits unfair competition. As used in the chapter, unfair competition means "any unlawful, unfair or fraudulent business act or practice." Cal. Bus. & Prof. Code § 17200.

The unlawful practices prohibited by Section 17200 include any practices forbidden by law, "be it civil or criminal, federal, state, or municipal, statutory, regulatory, or court-made." Saunders v. Superior Court, 27 Cal. App. 4th 832, 838 (1994). In essence, Section 17200 borrows violations of other laws and makes them independently actionable under the Act.

The section's "unfairness" prong refers to any practice whose harm to the victim outweighs its benefits. In determining unfairness, the court employs a balancing test. On one hand it examines the practice's impact on the alleged victim and on the other, the justifications and motives of the alleged wrongdoer. Klein v. Earth Elements, Inc., 59 Cal. App. 4th 965, 969 (1997). This portion of the statute is interpreted broadly. An action will arise when a business practice "offends an established public policy or when the practice is immoral, unethical, oppressive, unscrupulous, or substantially injurious to consumers." Wolfe v. State Farm Fire & Casualty Insurance Co., 46 Cal. App. 4th 554, 561 (1996). The section's intentional broadness allows the court "maximum discretion to prohibit new schemes to defraud." Podolsky v. First Healthcare Corp., 50 Cal. App. 4th 632, 647 (1996).

The section's use of "fraudulent" does not refer to the common law tort of fraud. A plaintiff bringing an action pursuant to Section 17200 need only show that members of the public are likely to be deceived. In order to deter such practices, the court may impose liability and civil penalties without proof of reliance, deception or injury. People v. Dollar Rent-A-Car Systems, Inc., 211 Cal. App. 4th 119, 131 (1989).

Section 17204 of the Act grants the Attorney General, district attorneys and city attorneys exclusivity in pursuing actions under Section 17200. Cal. Bus. & Prof. Code § 17204. Such actions for relief may be initiated upon complaint of the people of California or upon the complaint of any "board, officer, person, corporation or association or by any person acting for the interests of itself, its members or the general

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public." Saunders at 839. Pursuant to Section 17204, one does need to bring an action on one's own behalf in order to have standing to sue. Thus, a private plaintiff who has suffered no injury at all may sue to obtain relief for others. Stop Youth Addiction, Inc. v. Lucky Stores, Inc., 17 Cal. 4th 553, 561 (1998).

Section 17203 of the Act sets forth the remedies available under the Act. Cal. Bus. & Prof. Code § 17204. Any party found liable pursuant to Section 17200 may be enjoined from initiating or continuing the unfair practice. The court may also order restitution of any money or property which may have been acquired by means of unfair competition.

Enron's liability pursuant to the Act will rest largely on the availability of evidence surrounding the Contemplated Transaction. If there is proof that Enron manipulated the system so as to increase its profits, there will be greater likelihood that Enron will be liable under the Act.

California also has a number of statutes codifying the elements of deceit and fraud. Section 1572 of California's Civil Code, for example, establishes the elements required for actual fraud. Cal. Civ. Code § 1572. Actual fraud, as defined by the section, occurs when a party to a contract, with intent to deceive another party or induce him to enter into the contract:

- 1) suggests false information with knowledge of its falsity;
- 2) asserts false information without knowledge of its falsity but unwarranted by the information available to that person;
- 3) suppresses that which is true;
- 4) makes a promise without any intention of performing it; or
- 5) acts in any other manner fitted to deceive.

A victim of fraud, who experienced an actual injury, may sue the wrongdoer for damages. Punitive damages may also be granted in an action for fraud. See id.

Section 1709 of the Civil Code establishes the term for a similar cause of action: fraudulent deceit. Cal. Civ. Code § 1709. Pursuant to this section a party who willfully deceives another with intent to induce it to alter its position to its detriment is liable for any damages the deceived party may have suffered.

California's definition of deceit is identical to its meaning of actual fraud. Cal. Civ. Code § 1710. Thus, the two claims are often brought in conjunction with each other.

In addition to these statutory claims, suits for fraud and deceit often include a number of more general tort claims, such as common law fraud and misrepresentation. Like the statutory claims, however, these common law causes of action require an element of intent. As with conviction under the Act, liability under the fraud and deceit statutes and common law theories will depend largely on the availability of relevant evidence.

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