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August 2, 1999

TO: File
FROM: John Mass
RE: Power Transaction

FACTS

Note: Some of this requires further investigation and may be more or less incorrect.

The facts contemplate a potential power transaction between two companies: "EPMI," a large power marketing concern (which is not a utility and whose only business is trading power) and PGE ("Affiliate") an electric utility regulated by the Oregon Public Utility Commission. Affiliate and EPMI are wholly-owned subsidiaries of the same ultimate parent, Enron Corp.

The parties intend to enter into a contract (for an unspecified term) providing for Affiliate to serve as the "sink" for any large power transactions (say, 400MW) entered into between EPMI and any third parties (but not Affiliate) for delivery of such 400MW from anywhere in California or Nevada to one of several standard delivery points located at the California-Oregon border ("COB"). The "sink" is the jargon used to generically refer to the party into whose "control area" (a utility electrical system providing power to end users in a specified territory) the power transmitted in connection with a power transaction "leaves the transmission system," and does not necessarily mean the ultimate buyer of the power (i.e., the "sink" could be responsible to transmit the power further along to another party or could have agreed to receive the power on another party's behalf). The "source" is the point where the power in the transaction enters the transmission system for purposes of the power contract and could be the point of interconnection with a generating plant or simply a point at which the seller takes "delivery" of the power from its seller in turn. Power flowing north (and south) from California to the Pacific Northwest generally flows on a very large 500kV transmission system known as the Pacific Northwest Intertie ("Intertie"). The Intertie is a key resource to flow power north to south from the Pacific Northwest into California during periods of peak usage in California.

Under the contract, Affiliate will receive a fee for agreeing to be obligated to serve as the sink for all power which EPMI contracts to sell to third parties who can take delivery at COB or otherwise in the Pacific Northwest. However, EPMI has no real plans to enter into any such contracts and Affiliate knows that it is unlikely to ever be called to serve as such

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sink. Rather, the sole commercial purpose of the transaction is to afford EPMI the ability to "schedule" with the California Independent System Operator ("ISO") the 400MW of power for transmission from South (California) to North (COB) on the Intertie each day or whenever it wishes to do so, even though it does not, at the time of such scheduling, have either a contract to sell the power to a third party or, at the time of the scheduling, any present intention to enter into such a contract. EPMI cannot schedule the power without providing the identity of the source and sink. The scheduling would be done simply to reserve the necessary transmission capacity with the ISO, solely on a "non-firm" or interruptible basis (that is, if the ISO needs the transmission capacity for a more important or "firm" transaction, it can "bump" EPMI from the schedule at any time) in case EPMI were to find an opportunity to enter into a favorable transaction, although, as stated, it would have no actual intention of doing so at the time of the scheduling.

The ISO is an organization in California charged with scheduling all of the power flows across the transmission system for each hour of each day in California. The ISO has a tariff on file with the Federal Energy Regulatory Commission ("FERC") which provides for the prices and terms under which parties can acquire and reserve transmission on the system ("ISO Tariff") and FERC has exclusive jurisdiction over all "wholesale" power transactions in the United States. A wholesale transaction is between two parties neither of whom is the end user of the power. "Retail" transactions are where one of the parties actually consumes the power (i.e., to keep the lights on or run machinery) and are regulated exclusively by the state PUCs.

Early in the morning of each day, all of the certificated "scheduling coordinators" in California (including EPMI) must provide their schedules for power transactions and flows to the ISO for the next day so that the ISO can "balance" the transmission system. This is necessary because, due to the physical properties of electricity and power lines, if there is an imbalance between the amount of power put into the system by generating plants and the amount of power taken out of the system by end users, the system will "crash," much like our computers but with even more annoying results. The ISO's job is to make sure this doesn't happen while treating all users of the system fairly and equally with respect to priority of their transactions. The ISO must balance the system by obtaining other power or reductions in power input into the system (or in some cases, reductions in power taken out of the system) and this power is known as "ancillary services."

All power to be put into the system in California, is required to be "sold" through the California Power Exchange ("PX"), which basically acts as a market clearinghouse to set the prices and availability of power in California, except for certain ancillary services which the ISO can acquire directly from any party having them available for sale. Just like the ISO, early in the morning of each day, all parties who have power to sell into the system must "bid" the power into the PX, showing the amounts, hours and prices at which they are willing to sell. The ISO tells the PX how much power will be needed and for what hours, based upon the "day ahead" schedules filed by the scheduling coordinators, and the PX selects the parties

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to provide the power based upon their bids, going from lowest to highest (the price, I think, for everyone for a particular hour is the highest price that the PX reaches in order to satisfy the demand). (This is simplified to a considerable degree for our purposes.) With respect to ancillary services however, particularly for large, urgent transactions, the PX is not used and the ISO must pay whatever the market may be in order to preserve the balance of the system.

Power transactions, however, are constantly changing due to weather conditions and many other factors; therefore, it is necessary for the ISO to constantly adjust its schedules as each day and hour approach. The scheduling coordinators are required to update their schedules to reflect changes in their transactions and this often takes place in the "hour ahead" time frame, since the likely ultimate demand in a particular hour cannot finally be known until very close to the real time thereof. Thus, in our transaction, EPMI will file an "hour ahead" schedule releasing the non-firm transmission capacity it previously scheduled for its 400MW moving south to north over the Intertie when it files its schedule for the hour preceding the hour when that transaction otherwise would have begun.

Whenever this happens, there is created an imbalance in the system because the ISO was planning for this 400MW to be input into the system at the source (somewhere in California) and to be taken out of the system at COB by the sink, Affiliate and had arranged to balance the system accordingly. When a relatively small amount of power is involved, it is easy for the ISO to obtain the ancillary services necessary to manage this imbalance. However, if a very large amount is involved, such as our 400MW, it is more difficult for the ISO to obtain the ancillary services, especially at times of peak usage, because all of the generators are already committed and running full tilt and there is very little time in which to act. At such times, the laws of supply and demand operate to give a party that has power available a premium price. EPMI plans to have power available to take advantage of this opportunity which it will, in effect, to some degree have created. The result will be that the ultimate parties buying power in California to balance their systems and serve their end users (the utilities) will pay the ISO more for such power than they otherwise might have done had the 400MW not been scheduled and withdrawn.

EPMI and Affiliate believe this arrangement, while admittedly unusual, is lawful under the ISO Tariff because the ISO Tariff, apparently (I will be looking at this) does not require a transaction to have been already entered into as a prerequisite for having your scheduling coordinator schedule the amount of power for the transaction on a non-firm or interruptible basis, which is inexpensive because it can freely be bumped. This, EPMI believes it is acceptable under the ISO Tariff to schedule transmission for power that you know you are unlikely to need, or even that you know you will not need.

EPMI believes this represents a window of opportunity or "loophole" in the design of the new competitive marketplace in California which can be exploited to make a profit when the ISO has to "scramble" at the last minute to obtain ancillary services necessary to balance

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the system when the 400 MW non-firm schedule is withdrawn at the last minute. Because this market is new and developing, various parties have been able to exploit other such loopholes and make large profits as a result, but, insofar as we are aware, none of those transactions has involved a contract or agreement between two parties (or affiliates) but only a single party "gaming" the system by, say, the way in which it structures its bids for power to the PX. Many of these parties, particularly the utilities or very large generators, have information unavailable to the rest of the market that enable them, in EPMI's view, to manipulate the process to varying degrees that would not work if the market were fully informed.

The response so far of the entities charged with making this market work - the PX, the ISO and several market surveillance or compliance committees - has largely been to conduct investigations and make reports to the California regulatory authorities and FERC and then to file a revised ISO Tariff seeking to close the loopholes and make the market more efficient. EPMI feels that if this is likely to be the only response to the proposed transaction, then it would be foolish not to exploit the loophole to make a profit for its shareholders until the loophole is closed. However, if EPMI or Affiliate could be exposed to substantial damages or fines or other penalties, whether criminal or civil, then it will not enter into the proposed transaction. Affiliate has asked us to advise it on this question and whether it should agree to serve as the sink for the proposed transaction.

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