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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. Marketers 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.