

Testimony of S. David Freeman

**Before the Subcommittee on Consumer Affairs, Foreign Commerce and Tourism
of the Senate Committee on Commerce, Science and Transportation**

Thursday, April 11, 2002

I appreciate the opportunity to appear before this committee. I thank you for devoting your time to this issue, which, I believe, is fundamental to the future of the electric power industry as far as consumer protection is concerned.

On a personal note, I am especially pleased to be here since I served as a staff member to this Committee in 1974-76 when Chairman Hollings was really the junior Senator from South Carolina. My testimony reflects my personal views only. It is based on 40 years of experience with the electric power industry as a regulator, an official in federal and state government, and as the manager of large public utilities.

In my view the real story about Enron is not whether or not they broke the law, but about the influence they had on the lack of law enforcement by the FERC, on the rules for deregulation in California and Washington D.C. and, most importantly, their invisible role in the rip off of California consumers. Enron was by far the leading advocate for the most extreme deregulation of the electric power industry in California and they were the most active participant in the volatile market that resulted.

The fact that Enron's activities in California may have been legal is a most troublesome and lasting concern. It is all the more frightening because their profit-making role was

largely secret.

We must recognize that the so-called invisible hand of Adam Smith was Enron and their fellow gougers picking the pockets of Californians to the tune of billions of dollars. And now we are beginning to connect the dots. Prices were sky rocketing in California in late 2000 and early 2001 as a direct result of Enron's influence and participation. At the same time Enron was granted special attention to advise a new administration in Washington to oppose the price controls sorely needed to protect consumers from the enormous profits they and others were making.

All this happened despite the fact that the Federal Power Act requires that the FERC assure just and reasonable rates. Even the FERC admitted the market was not functioning properly. Enron may not have broken the law but they encouraged the new Administration to fail to enforce the law which in my view was just as bad.

It was only after Governor Davis and the California delegation repeatedly called attention to the fact that the FERC was on a sit down strike that the President appointed new Commissioners who helped Governor Davis bring that market under a measure of control. But that happened only after Californians had been overcharged at least \$9 billion.

Some may suggest that I am singling out Enron and "piling on" just because they are in trouble for other reasons. That is not true. It is important that Congress understand

that a rich and famous company can succeed in achieving terrible results for consumers. This Congress and the several states have before them serious questions inherent in the deregulation of electricity. Is the removal of controls on the price of electric power at wholesale a good idea? Does it make sense to remove the legal obligation of a utility to build or buy enough power to provide reliable electricity?

The words competition and deregulation are seductive. They sound great but the reality we found in California was quite different. A public utility industry whose books are open to public inspection, who are legally responsible for providing reasonably priced electricity, and who did just that for decades, were replaced by companies that operated in secrecy, are accountable to no one (apparently not even their shareholders or employees), could sell or withhold power as they pleased and had no obligation to build new plants.

Let us be clear about what is at stake. Having been intimately involved in what California experienced in recent years, I feel the need to convey to you the enormity of this issue. If we don't recognize why it all happened then history will surely repeat itself.

Electricity is unlike anything else in our economy. It is truly the lifeblood. Ordinary consumers and businesses alike cannot do without it for even an instant. It can't be stored by customers. Reliable, smooth electricity at a reasonable, predictable price is

an absolute necessity.

We found out in California, the hard way, that even the tiniest of shortages literally stops the economy. And without price controls, the prices shoot up to obscene levels. No one has yet suggested that in a drought we allocate water to the highest bidder (Enron did try moving into the water business) but that is exactly the scheme created in California by religious believers in the market combined with Enron's influence and persistence.

Proponents continue to talk of the potential benefits of deregulation. In California we learned who got the benefits-it was the power marketers. As for the consumers, in 1996 when deregulation was launched, the consumers were promised a 20% rate reduction by April, 2002. Instead the consumers are paying rates that are 40% higher!

Even proponents of deregulation such as the Hoover Institution Fellow and Noble Laureate Gary S. Becker concede that Enron encouraged "further and faster deregulation of electricity markets at State and Federal hands especially when it would help its own power trading companies". Mr. Becker also concedes that the collapse of Enron and California's bad experience "are further evidence deregulation has many pitfalls".

It is true that Enron did not invent deregulation. Indeed because deregulation had been carried out with airlines and telecommunication companies it had considerable momentum. But we must not forget that electricity is different from other products and

services. We can't do without it and it can't be stored.

It is important to take note that at every step of the rulemaking for deregulation in California from 1996 until today Enron, more than anyone else, used their enormous resources to urge the most extreme positions that resulted in maximum secrecy and lack of accountability. And Enron was a major participant taking advantage of the volatility in prices during the "Perfect Electrical Storm of 2001" while simultaneously waging an intensive, successful campaign that in six crucial months stopped a new Administration in Washington from doing its job of controlling prices.

Let me be specific about Enron's role:

Secrecy

California created a power exchange (PX) where power could be sold and bought openly with the public knowing the price. Enron stubbornly opposed the PX, claiming power contracts should all be secret. In the middle of the crisis in January of 2001, the PX closed down and then Enron had its way.

Transmission Rights

Enron wanted only companies that owned physical rights on transmission lines to be able to reserve capacity on the lines in advance. This would allow those with deep pockets, such as Enron once had, to monopolize the transmission of electricity. They were partially successful in California. That crucial issue remains a legacy of Enron as the FERC and the DOE continue to encourage market participants in generation to own and

possibly gain control of transmission. Remember “gridlock” on the electrical highway means it becomes a heavy toll road for those for those who don’t own it but must use it.

Price caps

The battle over price caps is perhaps the most glaring example of Enron’s role in shaping the rules of deregulation in their favor. The basic idea of deregulation is that if competition is working, you don’t need price caps. In California in 2000 and beyond even the FERC has admitted that the wholesale electric power market was dysfunctional. Yet Enron was the poster child for opposing price caps.

The California ISO imposed price caps in 1999 and as the head of the city of Los Angeles power system, I supported the price caps and indeed supported lowering the caps. Those caps were effectively abolished by the FERC and prices skyrocketed beginning in 2000.

I have personal experience with the persistent nature of Enron’s lobbying efforts and attitudes. After a long phone argument with Ken Lay on the subject of price caps during which I rejected his arguments, he said to me at the end, not harshly but gleefully, that no matter what we “crazy people in California did that Enron had people working for him that could figure out a way to make money.” And they did.

All through the fall of 2000 and the first six months of 2001 as prices at wholesale were at their gouging worst, Enron was the loudest and most persistent voice opposing price caps. They were vocal and persistent at the California ISO, at the FERC, with California

public officials, the Clinton Administration, the Congress, and the Bush Administration.

It was “all Enron all the time” against price caps.

Because Enron as a trader could hide behind a curtain of secrecy no one knew the full extent of how much they profited, and we may never know. But it is now clear that as the largest trader they were profiting big time.

It is beyond dispute that Enron lobbied hard for a system that permitted them to be a huge player in California with no physical assets in the state, just the equivalent of an electronic phone book. Enron then succeeded in keeping the federal cop (FERC) off the beat while the gougers were taking our money. Analysts¹ have estimated that Enron was a party to 40% of the transactions in the California market during the height of the crisis when the big money was made. No one will ever know for sure because they had no obligation to tell.

It is worth pointing out that the decline in Enron’s fortunes coincides rather closely with California’s programs that Governor Davis and the Legislature put in place that brought prices under control. I refer to the construction of new power plants, massive conservation, long-term contracts and in June 2001 getting some controls when President Bush appointed Chairman Pat Wood and Nora Brownell to be FERC commissioners. Obviously Enron had many other problems, but it is beyond dispute that as a trader (with

¹ Robert McCullough-Testimony before the House Subcommittee on Energy and Air Quality February 13th, 2002

no power of its own to sell) Enron made money buying and selling when market prices were high, and as prices settled down so did their profits.

The open question then is whether the policies that Enron successfully engineered will be continued. That question is very real for California.

After belatedly recognizing last June that keeping a just and reasonable lid on prices was their statutory duty, those controls finally established in June 2001, are set to expire on September 30th of this year. The FERC has not found and cannot find that the wholesale market in California is competitive enough to produce just and reasonable rates. The reason is simple. The market is not competitive.

Despite California's progress, we haven't yet achieved enough of a surplus. California is still vulnerable. The serious test is whether the new Commissioners, who helped California last year, will recognize that the Federal Power Act doesn't expire on September 30th and they are duty-bound to keep the controls in place. The FERC must extend their controls until such time as they can conclude that a competitive market exists that produces just and reasonable rates. Otherwise the situation that Enron so blatantly promoted will linger on.

In California we are continuing a strong conservation effort, we are encouraging private investment in new power plants which are being added, and we are promoting

renewable energy projects as well. And we have created a California Power Authority that can step in if private companies fail to keep up with future demand.

There are some fundamental lessons to be learned from this experience:

- Electricity really is different and the system of public utilities with a duty to keep the lights on at just and reasonable rates set by regulators served this country rather well during most of the 20th century.
- Competition thrives in a surplus. But the private generators thrive in a shortage.
- It would be a mistake to assume that Enron was unique and its demise means that deregulation is “cleansed” and there are no remaining concerns

The Congress should recognize that consumers of all sizes cannot be well served by blind faith in the market. Any market for electric power generation must be combined with sufficient governmental participation to assure that the lifeblood of our society doesn't operate in ups and downs. Such volatility and shortages may be acceptable for oranges or stocks but society simply can't tolerate it for electricity.

I thank you for this opportunity to testify before a committee that brings back fond memories to me. I will be glad to try to answer any questions.