# The Enron Debacle:

## A Glimpse into Fraudulent Energy Trading

*By Professor James M. Day*

THE COLLAPSE OF ENRON revealed one of the worst corporate frauds in American history. Enron's MBAs, CPAs, lawyers, and other scoundrels were headed by Kenneth L. Lay, a Ph.D. economist who claimed he did not know what was going on. The chicanery ran the gamut from insider trading to defrauding shareholders and creditors by cooking the books, corporate officials and employees defrauding the company, and the manipulation of electric and natural gas prices. This article provides a glimpse into the trading subterfuges that raised every American's electric and gas bills.

Enron was not alone in the sham trading.[1] The combined illicit actions of Enron and other sham traders raised electric and natural gas prices to dizzying heights in California and around the nation, partly because of California's grossly flawed energy regulatory system that invited fraud. The Federal Energy Regulatory Commission (FERC), Commodity Futures Trading Commission (CFTC) and state regulatory authorities, particularly the California Energy Commission and the California Public Utilities Commission (CPUC), were no match for the sophisticated energy companies. Representative Edward J. Markey, Massachusetts Democrat, summed it up: "We're in a supersonic-speed era of electronic trading with a horse-and-buggy system to protect consumers."

Patrick Wood III, former chairman of the Public Utility Commission of Texas and FERC chairman since September 2001, stated, "Enron's trading strategies involved deliberate misrepresentations" and Enron "exploited the flaws in California's market design." Mr. Wood also admitted that FERC has "a long way to go" in matching the sophistication of the energy companies it regulates.

The issue was over-simplified by S. David Freeman, Chairman of the California Consumer Power & Conservation Financing Authority: "They can do all these sham transactions because no one's ever seen a kilowatt hour." In a way, however, Mr. Freemen is correct. Lawyers, accountants, and government regulatory officials generally lack the technological expertise not only in trading, but also in the electronic communication involved in the world of energy and its relation to electricity, oil, and natural gas. Justice William O. Douglas' dissent in Phillips Petroleum Co. v. Wisconsin admitted that the "[r]egulation of the business of producing and gathering natural gas involves considerations of which we know little and are not competent to deal."[2] Additionally, agencies lack the manpower to monitor trading and in turn react to protect the market, investors, and consumers.

### The California Energy Crisis

UNDERSTANDING THE MARKETING AND TRADING of natural gas and electricity is complex. Like most technical regulatory issues, the lawyer must work hand-in-hand with engineers and accountants whom are qualified in that particular field. If you wanted to compute the rampant fraud and collusion that occurred during California's 2000-2001 energy crisis, it would require scores of paralegals and computer whizzes experienced in trading, and an amendment to the old adage to read, "Figures never lie." In 2002, FERC obtained admissions from over a half dozen major marketers stating they provided false information to the trade press for the purpose of manipulating prices. The data, when published by the trade press, set the market prices for electricity and natural gas in many key hubs around the nation and boosted the prices to utility companies and consumers.

Before the crisis ended, former Governor Gray Davis ordered legal action filed against a number of California utilities for $8.9 billion in refunds for overcharging and price manipulation. The mishandling of the crisis and California's resultant billions in debt ultimately led to Governor Davis' recall. In December 2002, a FERC administrative law judge (ALJ) found only $1.8 billion in overcharges, a figure well below the $4 billion that California alleged was overcharged from October 2000 to June 2001. Additionally, the ALJ refused to consider the alleged $4.9 billion in overcharges that occurred prior to October 2000.

In March 2003, the FERC, which lacks power under the Federal Power Act or the Natural Gas Act to levy civil penalties, but can order refunds exceeding a "just and reasonable rate," ruled the ALJ's award was insufficient. The FERC required thirty power generators and utilities to document and justify the overcharges, in turn raising the overcharge award to $3.3 billion. The full Commission also threatened to ban several companies from trading, including BP, the British multinational petroleum giant. Additionally, in a surprise move, the FERC named the Department of Energy's Bonneville Power Administration and the Los Angeles Department of Water and Power as alleged culprits. Both mumbled that they were not conspirators, claiming that they were government non-profit agencies merely charging what everyone else was. This issue, however, will no doubt be resolved on the basis of whether the prices were just and reasonable. As the California utilities owe the power generators and marketers $3 billion in unpaid bills, the Californians will appeal the final FERC decisions ad nauseam, while awaiting the outcome of pending criminal fraud claims.

## Wash Transactions

THE MOST POPULAR SLIGHT-OF-HAND TRANSACTIONS were the "wash" or "round-trip" electricity trades between power generators, marketers, and traders. In effect, wash transactions involve the selling and buying back of identical quantities of electricity at the same price. Why sell and then buy back electricity at neither profit nor loss? When caught, one of the culprits, CMS Energy, claimed it did it so inflate its gross revenue by $5.2 billion in two years, amounting to 23 percent of its revenues. CMS Energy claimed it was a small company and wanted to appear like a big-time trader, which sounds logical. However, as this process might attract new business and puff up its stock value, the Securities and Exchange Commission (SEC) looks upon it with a jaundiced eye. The practice also falls within the jurisdiction of the CFTC (even though it is a cash transaction) if the wash could or tend to affect the price of a commodity. The bright line rule is whether the intent in making a wash sale was not to make a bona fide trading transaction.[3]

Loretta Lynch, president of the CPUC, offered several reasons for Enron's involvement in wash trades. She claimed that four Enron affiliates traded 10 million megawatt hours of electricity at ever-increasing rates during December 2000 in order to create a volatile market and raise the market price. In 2001, the FERC identified 24 electric marketers and generators and 15 gas pipeline producers and marketers that were Enron affiliates, and estimated Enron was involved as a buyer or seller in 38 percent of the natural gas and 17 percent of the electric power marketed in the United States. This is not to say that Enron was the sole purchaser or buyer in the transactions. In many cases, Enron was just another trader in the "daisy chain" of transactions that increased prices. Additionally, as natural gas is a primary fuel for producing electricity, increasing gas costs had a synergistic effect in raising electricity prices.

Revelations about Enron's first known cover up of wash transactions, fraud, and losses occurred in 1987, one year after Kenneth Lay took over as chairman and CEO. Lay consolidated a series of gas pipeline companies, creating one company with the name Enron. Traders in Enron's New York office were discovered to have overstated their trading volume to inflate their division's revenues, boost the company's trading prominence, and increase their personal commissions on nonexistent sales. Lay failed to report the crime to Enron's board of directors or to the SEC. Lay needed to show Wall Street analysts revenue in order to demonstrate that Enron's market was growing. As the greedy traders continued using wash trades to fill their wallets, several of Enron's trading partners became suspicious of the excessive trading volumes. Out of concern that the wash trades may be discovered, causing trading partners to demand that Enron cover its positions with cash that the company could not afford, Lay fired the traders and reported an $85 million loss. This reported loss, however, was a lie. The actual loss was instead $142 million, not $85 million. Why did Lay lie? By underreporting the loss, Lay could still report a profit.

Lay's claim that he knew nothing about Enron employees' illegal actions during his tenure as CEO is difficult to believe. Early on in Enron's venture into trading, approximately 75 Enron employees participated in setting up a phony trading floor at Enron's Houston headquarters. This was done to give visiting Wall Street analysts the impression that Enron was doing a booming trading business. It was a joke and common knowledge around the headquarters that some of the computers they pretended to use to impress the analysts were not even hooked up!

## Trading Tricks

INTERNAL MEMOS FROM ENRON, obtained through discovery during the California litigation, described in detail Enron's trading schemes, each labeled with cute names (see below). Used as instructions, the names of the friendly traders necessary to complete the schemes are missing. These are of course only allegations, which Enron "vigorously denies." The company claims that the memos were misinterpreted. Opinions outside of Enron regarding the memos vary from lawyers agreeing that the transactions will be difficult to prove in court, traders claiming they are simply an arbitrage means that have been used for years, and many prosecutors asking why they were written if they were not followed.

### "Ricochet"

Under this scheme, Enron purchases cheap power in California controlled by price caps and sells it to a "friendly" out-of-state buyer, who in turn sells it back at a higher price not subject to price caps. Enron then "ships" it back to California at an uncontrolled higher price. (In many cases, the "friendly" transactions were physically impossible, instead serving as mere "paper trades.")

### "Fat Boy"

Enron traders speculate whether California utilities have underestimated the next day's electricity demand with the California Independent System Operator (CISCO). Enron is correct the vast majority of the time, since utilities will attempt to hold down the price by lowering projected demand, especially when California placed caps on consumer prices, possibly forcing utilities to purchase wholesale power at a price in excess of the retail price. Enron schedules to ship more power over the grid than its customers require, a violation of the rules many traders ignore. When demand exceeds the utilities' estimates, Enron sells its "extra" power on the spot market at many times the original price.

Enron's defense is that it merely overestimated its requirements and the utilities underestimated the demand. Enron delivered the electricity when needed and avoided one of seven blackouts and 38 curtailments of electricity which

occurred in California during the first five months of 2001. Hence, Enron serviced the consumers.

### "Get Shorty"

For a fee, Enron agrees to provide CISCO with standby generation and transmission services the following day, if and when needed. Enron plans to purchase the services if requested, contrary to the agreement that requires it to identify the standby sources. Enron purchases the rights and services early the next day when prices are cheaper, and submits a false statement of the source.

### "Load Shift"

Enron deliberately overestimates the power demand in Northern California to create a fear of transmission congestion, and raises the price in the north. At the same time, it underestimates the demand in Southern California. Enron then earns a fee to shift the load to the south from the north in order to alleviate the self-inflicted congestion.

This is a variation of the old "inc-ing" marketing ploy (short for load increasing) to earn fees for not sending power that was never intended to be sent over the lines in the first place.

### "Death Star"

Enron schedules to import electricity on California's southern border and transport it to Northern California. As the transmission lines are often booked – Californians do not like nasty transmission lines and will not permit them to be built in their neighborhood, regardless of the need for more lines – Enron receives a fee to transmit the electricity from another direction and relieve the congestion.

## Conclusion

IN OCTOBER 2002, Timothy N. Belden, Enron's chief trader on the West Coast, pled guilty to one count of conspiracy to commit wire fraud to drive up California's electricity prices. As part of the plea bargain, the 35-year-old agreed to testify against Enron's corporate officers and turn over $2.1 million in salary and bonuses he earned in 2001, representing the portion tied to fraud. Incidentally, Belden earned $5.5 million in salary and bonuses in 2001. Thus, the question becomes what else did he do for the $3.4 million balance he received that the feds do not know about?

Belden faces up to five years in prison and a $250,000 fine. If I were the judge at sentencing, I would ask Belden, an electronics engineer, "Why did you schedule to send 2,900 megawatts of power over a 1,500 megawatt line?" Although physically impossible, the correct answer is that it was worth the risk. CISCO fined Belden $25,000 for causing the congestion, which Enron gladly paid. The price jumped 70 percent, and the soon to be bankrupt Pacific Gas & Electric Co. was charged an extra $5.5 million that day because of a blatant scam that CISCO should have stopped immediately. A second question might be, "Did you receive a bonus for the $570 million for electricity sold to Pacific Gas & Electric, who filed for bankruptcy and may never pay?"

In early 2003, the Houston Chronicle reported that Enron's legal fees would reach $1 billion for its bankruptcy and the defense of 23,000 separate claims totaling $400 billion out of Enron's estimated net assets of $15,000 billion. I believe Enron's fees will exceed $1 billion and the civil and criminal cases will drag on for years. The old saying that crime does not pay will not apply to all of Enron's employees – the facts are too complex and proof of the fraud is too difficult. BLB

*Professor Day teaches Oil & Gas Law, the Regulation of Energy, and International Petroleum Transactions at the Washington College of Law and practiced in the fields for over thirty-seven years. His third book, Oilmen & Other Scoundrels, was published in June 2004. It includes a chapter "Enronians & Other Scoundrels," from which this chapter is taken.*


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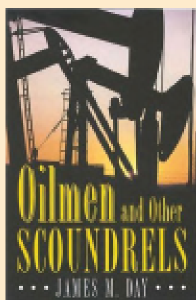


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## ENDNOTES: *Professor James M. Day*

[1] To name a few: American Electric Power, Calpine Corp., CMS Energy, Duke Power, Dynegy, El Paso Corp., Mirant Corp., Reliant Resources, and Williams Energy.

[2] Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, 690 (1954) (Douglas, J., dissenting).

[3] *See* Stoller v. Commodity Futures Trading Comm'n, 834 F.2d 262 (2d Cir. 1987).