

FERC's Office of Market Oversight and Investigations

November 4, 2002
Electric Utility Consultants, Inc.
RTO Conference
Washington, D.C.

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Morgan Lewis
COUNSELORS AT LAW

SEC Fines Dynegy \$3 Million in Probe of Deals

By PETER BEHR
Washington Post Staff Writer

SEC Enforcement Director Stephen M. Cutler said the \$3 million fine was based on Dynegy's failure to fully cooperate with the agency in its initial investigation. The SEC indicated the fine could have been more had the company not begun assisting the inquiry.



FILE PHOTO BY CRAIG HARTLEY — BLOOMBERG NEWS

Dynegy's headquarters building in Houston. The energy-trading firm settled SEC charges it defrauded investors by inflating its earnings.

Dynegy Inc. was fined \$3 million by the SEC yesterday for overstating its cash flow. The \$300 million overstatement of the company's cash flow, according to the SEC, resulted from a complex energy deal called Project Alpha. In its public financial statements, Dynegy initially accounted for the cash as the front end of a multiyear energy trade.

"In reality, the \$300 million was a loan masquerading as operating cash flow," the SEC said yesterday. "As a result, Dynegy investors were deceived," said Harold F. Degenhardt, head of the SEC's Fort Worth office.

Dynegy also received a \$79 million tax benefit by claiming large financial losses on the initial energy trades in the Alpha transaction, the SEC said.

The company, which settled the SEC charges without admitting or denying the agency's findings, overstated its cash flow from operations by 37 percent and its net income by 12 percent last year, the SEC said.

Project Alpha's funds came from Citigroup, which also arranged similar disputed energy transactions with Enron that should have been declared as loans, according to a Senate subcommittee.

Degenhardt said the SEC continues to investigate individuals and "third parties" involved in the Dynegy transactions.

Dynegy previously announced that it will restate earnings for 2001 and 2002 after correcting the accounting treatment of Project Alpha and the round-trip trades.

Energy trading has all but disappeared since Enron's bankruptcy filing last year as investors have fled from Dynegy and other Enron competitors. Dynegy shares closed at \$1.20 yesterday, up 3 cents but far below their 52-week high of \$46.94, reached last November during the company's failed attempt to acquire Enron.

The stock losses and trading investigations prompted key Dynegy leaders. Founder and chief executive Charles L. Watson resigned in May, followed the next month by Chief Financial Officer Robert D. Doty Jr.

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The Washington Post: September 25, 2002

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Dynegy to Stop Trading Energy; President Bergstrom Resigns

By REBECCA SMITH

Dynegy Inc. said it will discontinue its primary business of energy trading and that its president and chief operating officer, Steve Bergstrom, has resigned.

Dynegy said it will now focus on making its remaining electricity-generation and distribution operations more profitable. The Houston company, once an energy-industry highflier, is laboring to avoid a bankruptcy-court filing as its stock price has plunged. In 4 p.m. New York Stock Exchange composite trading, Dynegy slumped 27 cents, or 25%, to 81 cents. The stock's 52-week high was \$47.20.

Mr. Bergstrom's resignation follows the departures last May of Chuck Watson, who was the company's founder, chairman and CEO, and in June of its chief financial officer, Rob Doty. Dynegy said the company will continue to be led by interim CEO Dan Dienstbier while its board searches for a permanent replacement. Dynegy is also expected to announce significant job cuts in coming weeks.

The moves show how difficult it has been for Dynegy to adjust to the drastic changes in the electric and natural-gas sector that began a year ago today when former industry leader Enron Corp. reported earnings that showed it had been inflating profits and hiding debt through a series of off-balance-sheet maneuvers. Since then, the sector has been wracked by questions about its accounting practices, falling stock values and a collapse in wholesale electricity prices and trading volumes.

Some analysts said Dynegy's decision to halt its trading operations will do little to mend the company, although it will free up about \$500 million of the \$1.2 billion in cash it posted as collateral to back its trading positions. Thomas E. Capps, chairman and CEO of Dominion Resources, of Richmond, Va., said the announcement came as no surprise since "Dynegy's credit is so bad that no one will trade with them."

Mr. Bergstrom, who couldn't be reached for comment, was a driving force behind Dynegy's energy-trading business. He has been with the company 17 years.

The fact that Dynegy is leaving the trading business, rather than selling its portfolio of contracts, also shows how tough things have become in a sector that two years ago was riding high amid euphoria about the fat profits to be had in newly deregulated electricity markets. Dynegy, like many other firms, now holds contracts to purchase electricity at prices that are above today's rock-bottom levels.

Dynegy's difficulties started last November when it tried to buy larger rival Enron. The deal collapsed, and Enron soon sought bankruptcy-court protection, triggering investor fears that the whole sector was troubled. Dynegy's problems were compounded by disclosures about its use of disguised bank loans to make its trading business look healthier. It also disclosed it had used so-called round-trip trades, in which one company sells and immediately buys back the same amount of energy at the same price, a ploy that appears to boost its trading business.

The Wall Street Journal: October 17, 2002

Office of Market Oversight and Investigations

- In February 2002, FERC announced that it will establish the OMOI to oversee and assess the operations of the Nation's gas, oil pipeline and electricity markets.
- FERC has asked for increased budget authority of \$7 million to hire 50 FTE in order to build its investigations capability.
- 90 out of a likely 120 staff on board. FERC has also hired consultants to aid investigations.

Office of Market Oversight and Investigations

- William Hederman appointed Director of OMOI. Hederman comes to FERC from LECG, an energy and finance consulting group.
- Dennis O'Keefe named Deputy Director, Investigations and Enforcement. Prior to joining OMOI, O'Keefe served 20 years with the CFTC, including 16 years as assistant director of the Enforcement Division.

What will OMOI do?

- Identify and remedy problems concerning market structure.
 - *FERC will perform twice-yearly Seasonal Market Assessments.*
- Investigate and remedy individual market participant behavior.
 - *FERC intends to devise remedies that include mitigation, prohibitions and penalties.*

Why OMOI?

- FERC trying to restructure the industry but also attempting to restructure itself as well.
 - **Industry restructuring through:**
 - Formation of RTOs with a standard market design
 - *Pro Forma* Generator Interconnection Agreement and new open access tariff.
 - **FERC restructuring through:**
 - investigations of markets through OMOI and MMUs

GAO Report

- In June 2002, the General Accounting Office (GAO) issued its analysis of FERC's ability to oversee energy markets.
- GAO Report's Principal Findings:
 - FERC has not yet defined and implemented an effective regulatory and oversight approach.
 - FERC faces significant human capital and organizational structure challenges.

The OMOI Model

- FERC has acknowledged that OMOI will conduct investigations “of the sort that are routine at agencies such as the CFTC.”
- CFTC model based upon the SEC model.
- Basic investigation: Informal at first, *i.e.* call and a follow-up letter. If SEC does not sense that the company is cooperating, it becomes a formal investigation.

The OMOI Model

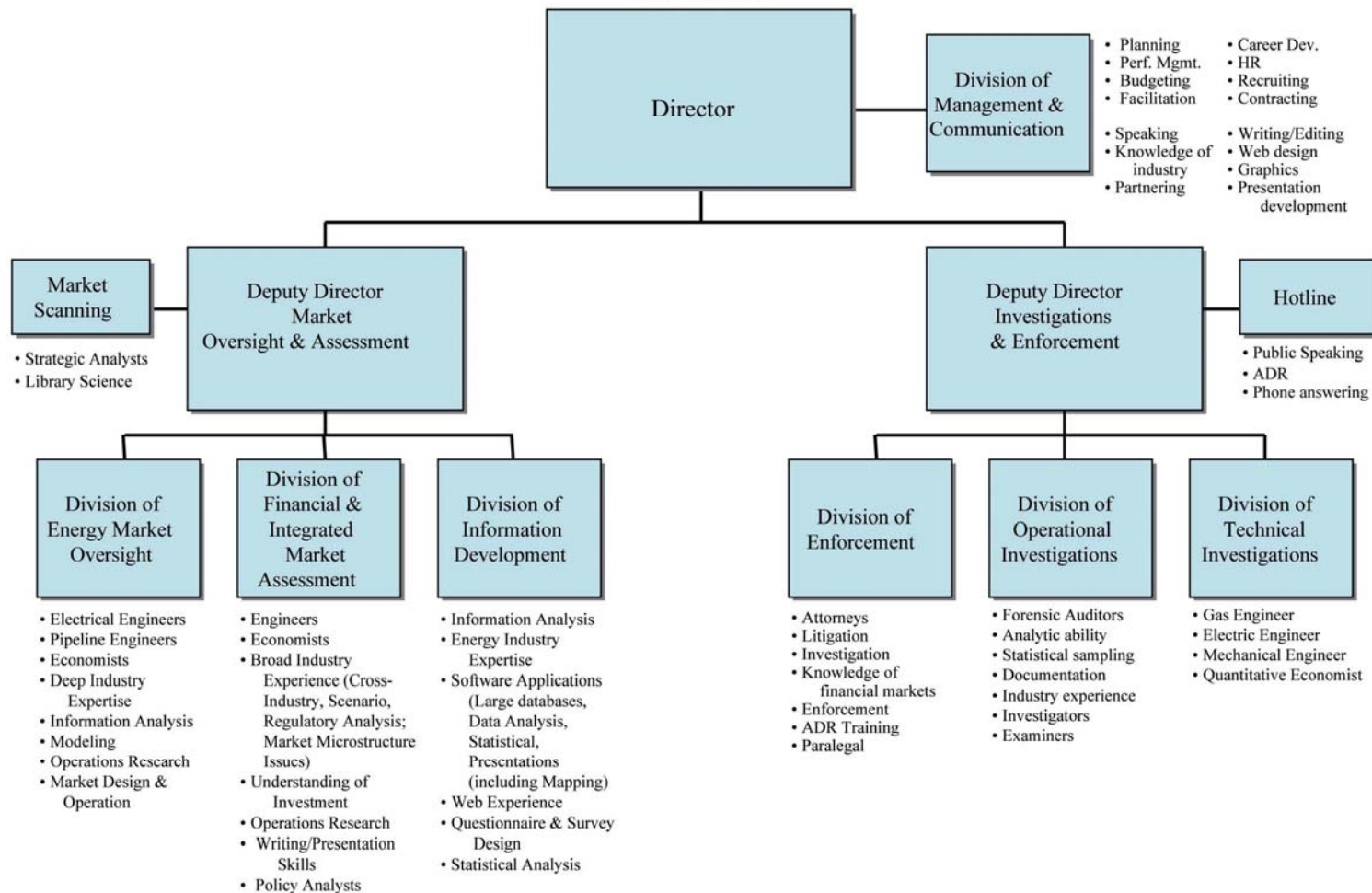
- If the abuse is on-going, SEC will conduct an abbreviated investigation in order to secure enough information so that it can go to court and get a restraining order.
- FERC intends to follow a similar model.
- Chairman Wood established similar market oversight division in Texas. Currently, that group is investigating market manipulation in the Texas retail markets.

OMOI Centers of Activity

- OMOI will consist of three centers of activity:
 - An oversight and assessment group made up of economists and engineers to analyze markets.
 - An investigations and enforcement section made up of primarily attorneys and auditors.
 - A management and communications division that will coordinate with state regulators, consumer groups and market monitors.

OMOI Organization Chart

- Skillsets -



Examples of OMOI Enforcement Actions

- OMOI currently working with the market monitor of an ISO to address a case of market power.
- Hederman would not name the ISO or the company but said that both were in advanced discussions trying to reach a settlement.

Examples of OMOI Enforcement Actions

- Hederman: "Somebody who was charging prices that we would not view as just and reasonable is probably going to make a refund. The company in question didn't appear to have been trying to manipulate the market but took advantage of what appeared to be a good opportunity to them."

Restructuring Today, August 14, 2002

- What is the legal authority for this?

FERC's New MBR Condition

*"If you don't make it illegal, you can't
prosecute it."*

Richard O'Neill,
FERC Office of Economic Policy

FERC's MBR Condition

Securities Regulation - Rule 10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- a. To employ any device, scheme, or artifice to defraud,
- b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

FERC's MBR Condition

- FERC's Proposed MBR Condition:

As a condition of obtaining and retaining market-based rate authority, the seller is prohibited from engaging in anticompetitive behavior or the exercise of market power. The seller's market-based rate authority is subject to refunds or other remedies as may be appropriate to address any anticompetitive behavior or exercise of market power.

FERC's MBR Condition

- What will be deemed illegal behavior?
 - Illegal behavior will be determined after the fact.
 - The condition outlaws anticompetitive behavior and the exercise of market power without specifying what that entails.
 - This is FERC's version of the SEC's Rule 10b-5 – a catchall provision, although one that targets less specific behavior than 10b-5.

Investigation of Western Market Manipulation

- Genesis of the high-profile activities by FERC: the "Enron memos"
 - These were privileged communications.
 - Memos simplified (perhaps oversimplified) complicated trading strategies, with catchy, easy to remember and descriptive nicknames.
 - *E.g.*, "Death Star," "Get Shorty," "Fat Boy," "Ricochet."

Investigation of Western Market Manipulation

- Strategies described ranged from the clearly legal to what sounds like textbook fraud.
- Some of the laws that the press and politicians have cited as being potentially implicated included wire fraud, false statements to the government, RICO, antitrust, state criminal fraud, state civil business practices laws, and (for public companies) the securities laws.

Investigation of Western Market Manipulation

- In addition to FERC, a variety of enforcement, regulatory, and legislative bodies at both the state and federal level have gotten involved.
- Some include a federal grand jury, the CFTC, the SEC, the U.S. Senate, state PUCs (in particular the Texas PUC), the California legislature, and the California Attorney General.
- The possibility of private civil litigation has also been raised and remains a possibility.

Investigation of Western Market Manipulation

- These are serious matters for energy companies.
- What defines "success"?
 - No further inquiries, penalties, or adverse publicity.
 - Investigator is also initial decision-maker: cooperation and credibility are important.
 - Government investigators are interested in making a case. They are not your friends.
 - Not letting the response become the "story." *See, e.g. Arthur Andersen, Watergate.*

Investigation of Western Market Manipulation

- The basics of a threshold response protocol:
 - Freeze electronic and hard copy document destruction with an appropriately drafted bulletin to employees.
 - Also, confirm and understand information system procedures.
 - Focus first on collection of documents and data.

Investigation of Western Market Manipulation

- Protect communications with attorney-client and work product protections.
- Assign company point person.
- Consider early retention and involvement of counsel (this itself can buy credibility, just like with an SEC, DOJ, or other analogous investigation).

Investigation of Western Market Manipulation

- Dynamics and challenges of the response:
 - Collection of documents and materials. Create an auditable and reconstructable paper trail.
 - Interviews. Protect with attorney-client privilege, memorialize, make clear purpose and roles.

Investigation of Western Market Manipulation

- Preparation of written responses to FERC. Again, credibility: what will other parties disclose? Important to strike the right balance between appropriate vs. over-qualification of responses.
- Post-response. It is not safe to assume that you can rest easy after the response is submitted.

Investigation of Western Market Manipulation

- Summary:
 - FERC's investigation of western market manipulation reflects many trends and characteristics of future enforcement activity that we are likely to see.
 - We are also likely to see these trends and characteristics in more limited company-specific investigations by FERC.
 - Recognize the risks presented by the new enforcement landscape and be prepared to respond accordingly.

Conclusion

- FERC has begun the process of transforming itself into a proactive vs. reactive agency.
- The old way of doing business will give way to the new enforcement model: RTO MMUs working in conjunction with OMOI.

Conclusion

- Process is similar to SEC enforcement model with NASD acting as the first line of defense against potential market abuse and the SEC acting as the ultimate oversight authority.
- Always be sensitive to the broader implications for the company of a FERC investigation.