

Potential Initiatives to Restore Industry Confidence

Discussion Points
PG&E National Energy Group
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- Several perceptions are taking root in public and regulatory arenas that affect integrated energy activities
 - Information/ financial disclosure – “honesty” of trading
 - View that markets are being manipulated
 - Equity valuation – “transparency” of trading
 - View that trading activity is inflated
 - View that trading “value” is a sham
 - Capital adequacy for merchant activities – “true” cost to support merchant generation and trading
 - View that merchant activities are undercapitalized
 - View that “true” costs of merchant activities are much higher than reported, and that these activities may not be profitable
 - Value of restructuring
 - View that competitive markets are not bringing real benefits to customers, and that a return to cost-of-service regulation would be preferable
- External perceptions are very different from underlying causes
 - Informed views on the value of competitive markets are lacking
 - Information reporting is unclear and clouds the value of trading transactions
 - Market designs have been haphazard, ineffective, and are still incomplete, and many of the features of these markets encouraged or even required what appear to be illogical or even manipulative transactions
- The consequences of not reacting to incorrect perceptions may be severe
 - Poorly designed information/ disclosure requirements
 - Restriction or elimination of transactions with real value to customers
 - Credit limitations and reductions in equity value
 - Draconian price caps and market restrictions
 - Awkward and ad-hoc attempts to mimic or restore cost-of-service markets
- Multiple, loosely correlated efforts are underway within the industry to address these issues, including
 - EPSA
 - NEMA
 - Chief Risk Officers
- To be effective, we need to
 - Coordinate these efforts to avoid redundancy and mixed messages

- Channel issues to appropriate organizations for effective, ongoing management
- The attached matrix outlines
 - Common perceptions
 - Potential consequences resulting from those perceptions
 - Underlying causes creating those symptoms
 - Potential solutions addressing the underlying causes
 - Industry messages or actions designed to strengthen support for real solutions
 - Organizations that may be well placed to implement that support
 - Principal targets of our efforts
- This document is for open discussion. I encourage your feedback and recommended changes.
- We will need to ensure antitrust compliance with all actions on these issues.

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Perception	Potential Reaction	Underlying Causes	Potential Solutions	Message	Messenger	Key Targets
Energy trading is of no value to consumers and does nothing except put upward pressure on retail prices	Public has no stake in restructuring and is receptive to heavy regulation and return to rate-based supply	<ul style="list-style-type: none"> >Lack of understanding of role and value of trading. >Perception that trading is just churning the same megawatts at ever higher prices 	Broad employee, regulator, consumer and customer education program	<ul style="list-style-type: none"> >Demonstrate using concrete examples how trading reduces risk, minimizes costs and adds value to consumers >Simplified version of Salomon Primer >Simplified version of CERA "Crossroads" 	Companies? EPSA NEMA EEI	Elected officials, consumer advocates, commercial/ industrial associations (draw parallels to their businesses)
Market manipulation through "Enron" trading strategies	Regulate trading practices; explicit acceptance or preclusion of specific strategies	<ul style="list-style-type: none"> > Irrational or ineffective market design > Rules not clear 	<ul style="list-style-type: none"> > Rationalize market design; incorporate rules that provide effective incentives for desired outcome > Clarify market rules 	Integrated package: <ul style="list-style-type: none"> > Code of ethics > Discussion of critical market design issues > Summary of market design recommendations 	EPSA; NEMA; WPTF	FERC, CFTC, state PUCs, Fed and State legislators
Artificially inflated prices	Price caps	<ul style="list-style-type: none"> > Market design characteristics can artificially create price volatility > Prices need to compensate all generators for their all-in cost of operation (incl. capital) which should be expected to lead to high prices at high demand hours > If wholesale price volatility is politically unacceptable then meaningful capacity markets are required. 	<ul style="list-style-type: none"> > Education > Capacity markets > Well-designed price mitigation mechanisms 	<ul style="list-style-type: none"> > Industry recommendations to appropriate policy bodies for capacity markets and price mitigation > Education program re why in a well-constructed market wholesale spot prices should affect only a small portion of wholesale volumes, and have little or no effect on prices to ultimate consumers (and damage that price caps can do) 	EPSA	FERC, state PUCs
Trading is a sham (income based on MtM is not real; trading activity is inflated through wash trades, etc.)	Get rid of MtM, prohibit certain types of trading, limit trading to exchanges where trades are "policed"	<ul style="list-style-type: none"> > Inconsistent terminology and methods > Poor communication/ understanding of information 	<ul style="list-style-type: none"> > Standardize terminology and reporting methods through appropriate policy forums > Clarify presentation of information 	<ul style="list-style-type: none"> > Industry will develop standards > Education on why MtM is more transparent and better than other accounting methods for certain types of transactions 	NAESB	SEC (?), Fed legislators, FASB/DIG

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Companies are too highly leveraged considering credit support required for hedging and trading; credit risk is too burdensome; trading is not profitable	Companies forced to de-leverage; trading pushed to primarily exchange-based products	<ul style="list-style-type: none"> > Inconsistent terminology and methods > Poor communication/ understanding of information 	<ul style="list-style-type: none"> > Standardize terminology and reporting methods through appropriate policy forums > Clarify presentation of information 	Industry will develop standards	CROs; NAESB	Analysts, rating agencies, [legislators]
Valuation methodology - company trading positions are manipulated based on proprietary "methods"	Arbitrary standards imposed on reporting trading positions	<ul style="list-style-type: none"> > Inconsistent terminology and methods > Poor communication/ understanding of information 	<ul style="list-style-type: none"> > Standardize terminology and reporting methods through appropriate policy forums > Clarify presentation of information 	Industry will develop standards	CROs; NAESB	SEC, FASB/DIG, rating agencies, analysts
Capital adequacy [is this covered above?]						
Information/financial disclosure [is this covered above?]						
Market design and market operations are not leading to competitive outcomes or benefits to consumers.	Give up on the deregulation experiment and return to cost of service regulation.	<ul style="list-style-type: none"> > Poor market design > Inconsistent and incomplete market designs allowed to proliferate > Short-term perspective (other deregulating industries have also had these difficulties at the beginning, but show benefits now) > Mis-information by rate-based participants 	<ul style="list-style-type: none"> >Standard Market Design <ul style="list-style-type: none"> - generation dispatch rules - real-time market ops - day-ahead market ops - transmission access and service - transmission rights > Education 	<ul style="list-style-type: none"> > Support for SMD Order from FERC > Continued focus on RTO Creation and Operations > Education on history of value contribution in power and gas, fruits of deregulation in other industries 	EPSA NEMA	FERC, state PUCs, Fed and State legislators