

David Berick
Professional Staff Member
Governmental Affairs Committee
Testimony: "Asleep at the Switch: FERC's Oversight of Enron Corporation"
Tuesday, November 12, 2002

Introduction

Thank you, Mr. Chairman. What I will describe to you this morning, as briefly as I can, are findings from the Senate Governmental Affairs Committee's majority staff inquiry into the Federal Energy Regulatory Commission's oversight, or lack thereof, of the Enron Corporation. The findings I will highlight can be found in greater detail in the accompanying staff memo being submitted in conjunction with today's hearing.

At your direction, Mr. Chairman, in January 2002, the Committee initiated a broad investigation into the role of the federal government and private sector watchdogs in what was at the time the largest corporate bankruptcy in American history. The purpose of the investigation was to determine whether, over a period of ten years prior to Enron's collapse, federal regulators did their job correctly and took reasonable steps, consistent with their missions and mandates, to identify and if possible prevent the problems that led to Enron's implosion.

In investigating the role of FERC, the federal government's lead energy regulator, the investigation identified four specific areas of concern: Enron's sale and repurchase of certain wind farms; the activities of Enron Online, the electronic trading platform run by the company; transactions conducted between Enron and certain Enron-affiliated companies; and the well-documented California power crisis of 2000.

As you will see, the evidence in all four cases reveals a consistent pattern. In the face of Enron's tireless determination to game the system, FERC displayed a striking lack of determination to scrutinize the company's activities. And this was not simply FERC becoming another victim of Enron's misrepresentations; rather, on a number of occasions, FERC was provided with sufficient and specific information to raise suspicions of improper activities -- or had itself identified potential problems -- but failed to follow through.

In short, the record demonstrates an extraordinary lack of vigilance on FERC's part and a failure to structure the agency to meet the demands of the new, market-based system that the agency itself has championed. While we do not know with certainty whether the disclosure of any of the individual activities I will highlight here today would have prevented Enron's collapse, it seems highly likely that more proactive, aggressive action by FERC would have limited some of the abuses that appear to have occurred, raised larger questions about Enron's trading practices and other business activities, and exposed at least some of the cracks in Enron's foundation earlier. Perhaps scrutiny by a federal agency would have also jolted the Enron Board of Directors and Enron itself into acting to change direction.

At a minimum, we believe it would have alerted investors, analysts, and hopefully other regulators to look more closely at Enron.

Enron's Lobbying Efforts and FERC's Four Failures

FERC is an independent federal regulatory agency responsible for overseeing America's energy markets. As such, FERC had -- and continues to have -- jurisdiction over Enron Corporation's many energy subsidiaries and activities. There were at least 24 electric, 15 gas pipeline, and 5 oil pipeline subsidiaries or affiliates of Enron subject to FERC regulation. Not surprisingly, then, FERC had thousands of contacts with Enron over the ten-year period examined by Committee staff concerning Enron's FERC-regulated subsidiaries and affiliates.

In addition to these contacts with FERC, our investigation also uncovered evidence of an aggressive public relations and lobbying campaign that Enron undertook in 2000 and 2001 to defend its role in the California power crisis and to seek to influence the composition, policies, and practices of FERC. Through public advertising and private communications with key decision makers in Washington, Enron's campaign sought to change the debate over the California crisis. After all, Enron was heavily invested in the success of the deregulation of energy markets because it represented opportunities for Enron's energy trading and energy services businesses, as well as new market opportunities in the United States and overseas. It was important to Enron, therefore, that the California crisis not be blamed on deregulation or market systems, in general, or on the market players in a deregulated environment specifically.

Based on a review of the evidence, majority Committee staff has concluded that, among the many Enron-related questions that came before FERC in recent years, four stand out as egregious and cautionary examples of regulatory failure. In each case, despite ample opportunity and available information, FERC failed to question, much less challenge, Enron's behavior. It is likely that this passive and reactive regulatory stance enabled Enron to distort its financial condition, failed to protect energy consumers and the energy industry, and failed to prevent or mitigate the ultimate effects of the company's collapse.

First, wind farms. In January 1997, Enron acquired a number of wind farm projects that were considered "qualifying facilities," or "QF"s, under federal law, and were therefore eligible for special rate treatment -- meaning, they were allowed to charge higher rates than those otherwise generally permitted.

Shortly after the acquisition of these wind farms, in August 1997, Enron completed its acquisition of a public utility company located in Oregon -- Portland General Electric (PGE). Under federal law, however, projects that are given special status as qualifying facilities cannot be owned by a public utility or its holding company -- meaning, more than 50 percent owned. Thus, because Enron now owned a public utility company, the wind farm projects it had purchased would no longer be eligible for QF status. In order to maintain the QF status of the wind farms, Enron found it necessary to divest itself of ownership interests in a number of these projects. In at least four cases, however, it appears

that Enron did not truly divest itself of ownership, and in fact effectively retained the risks and benefits of ownership.

FERC has the responsibility to certify that ownership requirements and other pertinent requirements for QF status are met. Critical details of these apparently sham transactions were revealed to FERC. Rather than combing through the financial facts, however, FERC failed to apply adequate scrutiny and wound up approving these transactions.

I will take the events chronologically. In 1997, Enron sold a 50 percent interest in each of three wind farm projects to a special purpose entity named RADR, allegedly set up by Enron Chief Executive Officer Andrew Fastow and his deputy, Michael Kopper. Earlier this month, Mr. Kopper pled guilty to wire fraud and conspiracy to commit money laundering based in part on a scheme he and others allegedly devised to enrich themselves and enable Enron to maintain secret control over California wind farms while appearing to maintain eligibility for QF status.

Minutes of a May 1997 meeting of the Finance Committee of Enron's Board of Directors indicate that, although the arrangement was expected to satisfy FERC's requirements for transfer of ownership, it was "not a sale for book purposes" and that Enron therefore planned to continue to recognize revenues from the projects. In addition, the minutes describe Enron's right to repurchase the projects, noting that Enron would retain a "call option to repurchase the assets in future and sell in 'non-firesale' environment" -- an indication that the company, forced to divest its interests in the wind farms quickly because of its purchase of Portland General, was using the sales to RADR to temporarily "park" the projects until it could obtain what it hoped would be more lucrative financial returns. Financially, the minutes reveal that Enron provided 97 percent of RADR's initial capital by way of a loan from one of its subsidiaries and that Enron intended to indemnify RADR against future tax, environmental, and other liabilities.

The nature of these wind farm transactions is further confirmed by a 2001 PriceWaterhouseCoopers "due diligence" report on another, related Enron transaction, which notes that, because Enron "retained all the risks and rewards associated with the projects" and retained an option to repurchase the shares, the wind farm deal was not treated as a sale and revenue from the projects were accounted for as income from joint ventures.

Information revealed to FERC in Enron's formal applications for QF status should have raised serious questions at FERC as to whether the wind farms' ownership arrangement entitled them to the special rate status. Among other things, Enron's applications stated that the company would loan RADR all the money to purchase its interest in the wind farm projects; that an Enron affiliate would indemnify the owners of RADR for certain tax liabilities; that Enron would retain an option to repurchase RADR's interest in the projects; that the land for the facilities would be leased from an Enron affiliate; and that the same Enron affiliate would receive fees for providing operation and maintenance service to the facilities.

However, despite Enron offering up all of this information, FERC appears either not to have understood or not to have tried to understand the financial arrangements described to it by Enron, and it seems that this was not out of the ordinary for FERC's review of QFs. According to the agency's staff, QF applications are generally reviewed at the staff level by engineers or others with technical expertise to determine the facility's compliance with technical requirements, but not necessarily by anyone with financial expertise.

A similar lack of meaningful scrutiny repeated itself in 2000 and 2001, when a number of wind farm projects, including the three RADR projects, were re-acquired by Enron, and FERC was once again given the opportunity to provide more than rubber stamp approval. However, in each case, Enron filed a "self-recertification" with FERC informing it of the change in ownership and asserting that the facility -- now majority or entirely owned by a utility holding company -- should maintain its eligibility for QF status. Remember, Mr. Chairman, the special QF rate status is supposed to be granted only when facilities are not controlled by a public utility or its holding company.

Two problems emerged at this point. First of all, as a matter of policy FERC never reviewed the RADR self-certifications, and to this day still never reviews self-certifications, for QF status -- no matter what the applications may say unless an outside party raises an objection. Instead, FERC simply files the form away, as it did in the case of RADR. Another case where Enron took advantage of the weaknesses inherent in this self-certification system occurred in November 1998 when Enron self-certified a new ownership arrangement for another wind farm project known as Cabazon. In this case, Enron self-certified that it had transferred 50% ownership in the project to a non-profit organization, The Nature Conservancy, within the meaning of FERC's QF ownership requirements. In fact, Enron did not actually transfer an ownership interest, only a right to 50% of the net profits -- a condition which did not actually meet the FERC ownership test. Indeed, The Nature Conservancy did not consider itself to have any ownership interest in the Cabazon project. However, because this ownership change was the subject of a self-certification, it was not reviewed or contested by FERC.

Second, Enron took advantage of a regulatory black hole between FERC and the Securities and Exchange Commission. Enron told FERC in its self-recertification application that it was eligible to own the wind farms because it had applied to the SEC requesting a special exemption under the Public Utility Holding Company Act, which would permit it to retain QF status for the wind farms. And it did have such an exemption request pending at the SEC. That application remained pending, however, for two and a half years. In fact, the SEC is only now considering its merits.

Meanwhile, from the moment the application was on file at the SEC, for FERC's purposes it was deemed to have been approved. The two agencies never communicated with each other about the substance of the application. Instead, FERC's practice was -- and still is -- to treat a company's "good faith" application to the SEC alone as sufficient for the company to qualify for this exception. Enron got the benefits of the QF status and retains them to this day.

Mr. Chairman, imagine two outfielders, each hoping the other will claim a pop ball, only to let it drop right between them. This is the net result of the regulatory black hole between FERC and the SEC.

The second area in which FERC failed to adequately scrutinize Enron's activities was Enron Online.

In 1999, Enron Corporation played a lead role in a fundamental shift in the way natural gas and electric power were traded in America, by creating Enron Online, an Internet-based trading platform for natural gas and electric power. Online energy trading became a significant portion of the energy trading market: in 2001, it was estimated to account for approximately 38 percent of natural gas and 17 percent of electric power marketed in the U.S. Until Enron's bankruptcy, Enron Online was widely acknowledged to be the leading platform for such trading. Enron, in turn, lauded itself for its trading capabilities and rapidly expanded the range of commodities it traded – from paper to broadband communications capacity.

The public policy implications of this fast-emerging energy trading method interested FERC -- at least up to a point. In May 2001, FERC's General Counsel initiated a staff-level inquiry into the status of electronic trading in the electric power and natural gas markets, in general, and the role played by Enron Online, in particular. FERC staff were asked to evaluate Enron Online's dominant position in electronic trading in the energy industries and to determine whether that position might be exploited to manipulate prices and otherwise contort the energy market. A report discussing these matters was completed on August 16, 2001.

The report found that, unlike some online trading platforms which operate as third-party, "many-to-many" exchanges matching willing buyers and sellers, Enron Online appears to have operated as a proprietary extension of Enron's trading units, including entities regulated by FERC. In other words, in this so-called "one-to-many" exchange, an Enron trader was a party, either as a buyer or seller, to every trade on Enron Online. Therefore, only Enron would know valuable information about the actual volumes and prices transacted on its trading platform -- and, of course, how the prices charged in any particular transaction were set or how they compared to those charged in other, similar transactions.

The report also observed that Enron Online simply served as a trading platform for other Enron subsidiaries, shouldering no financial risk on its own. In other words, the financial risk of all the trades conducted through Enron Online remained with these other subsidiaries and, since Enron's traders were a party to every trade, this risk was substantial. This also meant the solvency of Enron as a whole was important to the viability of Enron Online and to Enron's trading activity.

With that observation in mind, the report asked whether financial problems at Enron would threaten the energy markets. The report answered the question in two ways. First, it concluded that Enron did not have sufficient market share to disrupt the energy market if it failed. As we describe in our memorandum, this conclusion was based on a cursory analysis of the entire North American energy market rather than a more thorough attempt to

scrutinize individual regional markets -- which would have yielded a much more complex and much more troubling picture. Second, the report concluded that, in any event, the chance of Enron failing financially was remote. The report provided little support for this conclusion, and has obviously been disproved over the last year.

Finally, the report found that Enron Online gave a competitive advantage to Enron's own trading units by reducing their transaction costs, giving them wider access to the market, and providing them better market intelligence, but concluded that there was no reason for concern. This conclusion also appeared the result of wishful thinking; there is now evidence, described in a recent FERC staff report, that Enron in fact likely exploited this advantage to manipulate prices, particularly in California and the Western markets.

In short, though the FERC report identified a number of areas that could have and should have raised concerns with federal government's lead energy regulator, it found no reason for concern and no cause for action. Quite simply, FERC's review was too cursory, settled for incomplete answers, drew the wrong conclusions, and the agency ultimately failed to follow up on the warning signs it did raise. These were critical mistakes.

Another very troubling facet of the August 2001 report is that it was not distributed to any of FERC's commissioners prior to, or during, Enron's collapse to inform their decision-making with regard to this event, and it is unclear at what point any of the information contained in the report may have been provided to the Commission. Thus, a report that might have served as a warning wound up being little more than a footnote in the story of Enron's collapse.

Finally, FERC initially did not even bother to address a critical but unresolved question - namely, to what extent FERC and the Commodity Futures Trading Commission, both of which have some regulatory responsibility for energy trading, had jurisdiction over such electronic trading platforms. This was despite the fact that Enron Online and similar systems were at the time expected to become the dominant way in which both electricity and natural gas were traded. A FERC legal memorandum analyzing FERC's jurisdiction over online trading, including Enron Online, was to have been prepared in August 2001. That memorandum was not completed until July 2002 -- after Chairman Lieberman raised questions about it -- creating another regulatory black hole, and leaving any thorough scrutiny of Enron Online and other electronic trading platforms to languish.

One final footnote about the 2001 Enron Online inquiry is that it also examined the issue of how pricing information from Enron Online might distort published market price indices, such as those reported by trade publications like *Natural Gas Intelligence* and *Gas Daily*. The FERC staff report noted that such indices were comprised of anecdotal, unconfirmed information and that information provided from a source such as Enron Online could be subject to manipulation. At the time the staff was examining this issue, the Commission was promulgating its order on refunds for the California market, which included a methodology for determining baseline electricity generation costs tied to these published prices indices. The concerns expressed by the Enron Online inquiry staff concerning these indices were never communicated to the Commissioners considering the refund issue, nor was other relevant information compiled by the Office of the Chief Accountant concerning electric generation costs in the California market. The significance

of these failures is highlighted by the FERC staff's August 2002 report on its ongoing Enron investigation which found that published price indices in the California market were unreliable and may have been distorted or even manipulated by data from Enron Online. The 2002 report recommends that, as a result, the Commission modify its California refund methodology.

Mr. Chairman, our third area of review was Enron's affiliated transactions.

Whenever a company conducts transactions among its own affiliates there may be cause for concern about fair dealing. One concern is that where one affiliate has captive ratepayers, a one-sided deal may impose financial burdens on those ratepayers. Another concern is that one affiliate will treat another with favoritism at the expense of other companies or in ways detrimental to the market as a whole.

Based on our review of the evidence, we have concluded that existing regulatory rules and tools, in the hands of a passive FERC, proved inadequate to deter Enron, as the company now appears to have engaged in a number of inappropriate interaffiliate transactions.

Just one example are the loans two of Enron's natural gas pipeline subsidiaries obtained for their parent company in November 2001. As Enron struggled to avoid bankruptcy, the company announced that JP Morgan Chase & Co. and Citigroup, Inc. had committed to loan it a total of \$1 billion. But the loans were actually made to two of Enron's FERC-regulated, interstate pipeline subsidiaries -- Northern Natural Gas Company and Transwestern Pipeline Company -- and were secured by the assets of those pipeline companies. The vast majority of these loan proceeds were subsequently transferred to Enron in the form of unsecured loans from the pipelines to their parent company. After Enron declared bankruptcy a few weeks later, it made no payments on these loans, and the pipeline companies, which did not file for bankruptcy, were left to pay off the entire amount of the obligations to the banks -- a matter of concern because ordinarily such costs would be passed on to shippers who use the pipelines, and ultimately to natural gas customers.

In this case and others, FERC is now investigating potential wrongdoing concerning Enron's interaffiliate transactions and seeking to strengthen some of the relevant accounting rules. However, it is troubling that the agency failed to address the broader policy question earlier. As key parts of the energy markets have been deregulated under FERC's watch and at FERC's urging, the issue of transactions among a company's affiliates have taken on increased importance. Until Enron's collapse, however, FERC failed to adequately identify such transactions as significant problems that warranted Commission action -- or where it did, as in the case of transactions between marketing affiliates and traditional utilities, FERC's regulations proved inadequate. Thus, this turns out to be another area in which FERC did too little, too late. The agency did not adequately anticipate problems in the market it was instrumental in constructing.

The final area in which Committee staff reviewed FERC's oversight of Enron Corporation regards the company's role in the California energy crisis.

As you will recall, severe energy shortages in California began in the spring of 2000, about two years after the state's energy deregulation plan was put into place. The state's

investor-owned utilities blamed the crisis for the crisis on power sellers and marketers who, they said, were unfairly manipulating the system to gin up profits. The power marketers, on the other hand, claimed that flaws in the actual structure of the new California system were the chief culprit for the crisis.

FERC, which as far back as 1998 had received reports from energy experts in California raising concerns about the exercise of market power, began a staff investigation into the causes of the California crisis in the summer of 2000. The investigation reached what might be considered a curious conclusion: that power sellers had the potential to manipulate the power market, but that there was no evidence to indicate whether an individual company engaged in actual market abuse. The report concluded that identifying individual cases of market abuse would require further investigation.

Despite this initial report clearly articulating the potential for market abuse, it would take a full 15 months -- until February 2002, after Enron had collapsed -- for FERC to order a formal staff investigation into the market behavior of individual companies. Even as FERC was avoiding the question of what individual companies were doing, Enron itself initiated an internal investigation into its own trading practices in California, in October 2000. That investigation would ultimately result in memoranda asking some searching questions about a range of strategies that Enron traders used -- such as the so-called "Get Shorty," "Death Star," "Fat Boy," and "Ricochet" trading strategies -- and discussing the "sanction provisions of the California Independent System Operator (ISO) tariff." Unfortunately, the company appears to have been more concerned about its own behavior than the government's lead regulator.

As stated earlier, FERC itself would not begin to investigate these practices until more than a year later, after Enron's collapse. In August of 2002, that investigation produced an interim report describing the manipulative trading practices that Enron's traders had allegedly engaged in. Those findings have further prompted three formal FERC investigations into the behavior of individual companies, including Enron, in the crisis.

More details about what FERC may have found had it been more vigilant were revealed earlier this month, when Timothy Belden -- who headed Enron's Western trading desk -- pled guilty to a charge of conspiracy to commit wire fraud, based on allegations that he and others at Enron engaged in trading strategies designed to manipulate energy prices in the California market from 1998 to 2001.

Of course, accountability is important. However, the majority Committee staff believes that the rules and regulations of a federal agency such as FERC cannot effectively deter unreasonable market action if the agency fails to hold market participants accountable in the near term. It should not have taken Enron's collapse to finally trigger FERC's investigation of the role of individual companies in the California energy crisis.

Conclusion

In conclusion, Mr. Chairman, all four stories convey the same message: The Federal Energy Regulatory Commission was a poor match for Enron's tireless efforts to subvert the spirit - if not the letter - of the regulatory system. FERC's failure cannot be attributed simply to Enron's aggressive public relations and lobbying campaigns or the deviousness of

its methods. In many cases, the Commission had specific and sufficient information that should have raised suspicions about improper behavior on Enron's part. In other cases, FERC recognized potential problems, but through poor management, internal communications disconnects, or sheer lack of will, never followed its suspicions through to their logical ends.

Even after Enron declared bankruptcy, FERC dragged its feet and failed to step into the breach, reinforcing a pattern of performing too little too late.

To be fair, FERC has taken some tentative steps to remedy an unacceptable state of affairs such as creating a new office of market oversight and investigation. But simply rearranging its bureaucracy is not the answer. FERC must work in concert with other regulatory agencies; it must request and be given sufficient resources to monitor the marketplace; and it must be cognizant of what goes on under its own roof. But most importantly, FERC must completely reorient itself to a changed and increasingly complex regulatory environment - an environment that FERC itself has fostered, but failed to adapt to.

Had FERC proven more aggressive on any one of the fronts I have described in my testimony today, it might have unearthed Enron's abuses sooner, perhaps mitigating the company's collapse, protecting consumers from untold hardships, and competitors from Enron's alleged market manipulations. Instead, through a striking lack of vigilance, I think it's fair to say that FERC abdicated its core responsibilities as a federal regulator of the energy markets.

I hope that the information I have presented today will inspire a higher standard in the future.

Thank you. I look forward to your questions.