

**Committee Staff Investigation of the
Federal Energy Regulatory
Commission's
Oversight of Enron Corp.**

STAFF MEMORANDUM

**United States Congress
Senate
Committee on Governmental Affairs**

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STAFF MEMORANDUM

To: Committee on Governmental Affairs
Members and Staff

From: Majority Staff

Date: November 12, 2002

Subject: Committee Staff Investigation of the Federal Energy Regulatory Commission's Oversight of Enron Corp.

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INTRODUCTION

On December 2, 2001, Enron, then ranked as the nation's seventh largest company, filed for federal bankruptcy protection amid allegations of far reaching financial and other fraud. Enron's collapse left thousands of employees without jobs and with severely diminished retirement savings and erased billions of dollars of shareholder value. Perhaps most significantly, it triggered a crisis of investor confidence in U.S. financial markets – and a concomitant crisis in ratepayer and investor confidence in the energy markets. Enron's meltdown has had effects that have reverberated through the energy sector as well as other parts of the U.S. economy, and its consequences continue to be felt today.

In January 2002, the Senate Committee on Governmental Affairs undertook an investigation into the collapse of Enron. Specifically, the Committee examined a variety of public and private entities that had responsibility for overseeing or monitoring aspects of Enron's activities and protecting the public against the type of calamities that resulted. The charge was to seek to determine if these watchdogs did their jobs correctly and whether they could have done anything to prevent, or at least detect earlier, the problems that led to Enron's failure. Among the entities looked at closely by the Committee has been the Federal Energy Regulatory Commission (FERC), the government's primary energy regulator. Although Enron, at the end, was involved in an assortment of far-flung activities, at its core, Enron was an energy company, and many of its activities were subject to direct or indirect oversight by FERC.

The Committee initiated its investigation through letters sent to the FERC Chairman on February 15 and March 27, 2002, requesting information about FERC's dealings with Enron and its affiliates over the last ten years, information which FERC provided to the Committee. The Committee also made follow-up requests to FERC for further information concerning investigations, inquiries, and audits involving Enron subsidiaries and affiliates. In addition, Committee staff had a number of interviews and discussions with FERC staff, officials of other federal agencies, and non-Enron utility company employees concerning the specific matters discussed in this memo. Committee staff also reviewed thousands of documents and e-mail records from Enron and affiliated companies provided to the Committee and to its Permanent Subcommittee on Investigations in response to subpoenas to Enron.

What Committee staff for the majority found was an agency that was no match for a determined Enron and that has yet to prove that it is up to the challenge of proactively overseeing changing markets. On a number of occasions, FERC was provided with sufficient information to raise suspicions of improper activities – or had itself identified potential problems – in areas where it had regulatory responsibilities over Enron, but failed to understand the significance of the information or its implications. Over and over again, FERC displayed a striking lack of thoroughness and determination with respect to key aspects of Enron's activities – an approach seemingly embedded in its regulatory philosophy, regulations, and practices. In short, the record demonstrates a shocking absence of regulatory 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. In the end, this investigation reveals that FERC did not fulfill its

role to protect the consumer against abuses that can result if a market-based system is not adequately patrolled by those charged with doing so.

This memorandum will discuss four specific areas in which FERC failed to conduct effective oversight of Enron's activities. The first involves certain wind farms owned by Enron. In an effort to preserve these wind farms' eligibility as so-called "qualifying facilities" eligible for certain economic and regulatory benefits, Enron purported to transfer 50% ownership interests in these wind farms to third parties. At least some of the transactions, however, appear to have been sham sales. Enron, as required under FERC regulations, provided written notice to FERC of each of these sales (as well as subsequent repurchases), along with certain telling details; in some instances Enron in fact sought FERC's affirmative approval of the transactions. Nonetheless, FERC failed to make any effective inquiry – or in some cases, any inquiry at all – into these transactions, enabling Enron to receive substantial benefits for its wind farms to which it may not have been entitled.

Second, the memo will look at an investigation that FERC staff conducted in May 2001 into the operations of Enron Online, Enron's electronic trading platform used to buy and sell electricity and natural gas. The inquiry included questions about the competitive advantage that this trading operation gave Enron traders and whether that advantage could lead to abusive practices in the market; in connection with this inquiry, FERC staff also looked at questions concerning Enron's financial viability. FERC staff asked some of the right questions about Enron's electronic trading activities and finances, but ultimately settled for incomplete, unconvincing, or incorrect answers to those questions. Equally troubling, FERC failed to follow up on some of the most serious concerns raised in the course of its inquiry – concerns that have since been borne out. A critical legal memorandum regarding the basic question of whether FERC had jurisdiction over such trading platforms as Enron Online – which were expected to become the dominant way to trade both electricity and natural gas – was started but left to languish until Chairman Lieberman raised questions about it in a May 15, 2002 letter to FERC Chairman Wood. All this occurred at a time when Enron internal documents uncovered during the Committee's investigation show that the company placed a high priority on maintaining the unregulated status of Enron Online.

Third, the memo will examine questionable transactions between Enron and its FERC-regulated affiliated companies. In particular, shortly before Enron declared bankruptcy, it borrowed approximately \$1 billion through two of its pipeline subsidiaries, securing the loans with the pipelines' assets. When Enron went bankrupt, the pipeline companies – and potentially their ratepayers – were left to repay the loans. In addition, there is evidence suggesting that Enron may have used its public utility affiliate, Portland General Electric (PGE), to engage in the questionable export and reimportation of electricity from California during the Western energy crisis of 2000-2001 and disguised these prohibited interaffiliate transactions. Although FERC has now opened investigations into both matters, before Enron's collapse it had been unprepared and unwilling to act against suspect interaffiliate transactions either because the Commission's rules were inadequate or because it was not able to effectively monitor whether companies were complying with the rules.

The fourth area involves the abusive trading practices that, according to recently released documents, Enron traders engaged in during the California energy crisis. FERC waited nearly two years after the first allegations of market abuse by individual companies arose before launching a formal inquiry into the potentially abusive actions of individual companies. This was despite the fact that FERC was provided with information raising concerns about the exercise of market power in California as early as 1998. Not until February 2002 did FERC pursue evidence that suggested that companies like Enron were manipulating the market. This failure to look at the behavior of individual companies came while Enron, deeply concerned about the effect the Western energy crisis could have on the course of deregulation and on its business, engaged in an extensive public relations and lobbying campaign to influence FERC's actions in the California market.

In addition to examining these areas of failed oversight, the memo will look at the efforts the Commission has undertaken recently to more effectively oversee the contemporary energy markets. Committee staff has serious concerns about whether, as currently constructed, such efforts are likely to result in the proactive, aggressive agency that is needed to protect consumers.

* * *

While we do not know with certainty whether the disclosure of any of the individual activities to be highlighted at the hearing would have prevented Enron's collapse, it seems highly likely that more vigilant, 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 unearthed at least some of the cracks in Enron's foundation earlier. Perhaps scrutiny by a federal agency would have 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.

I. FERC: BACKGROUND

FERC is an independent, five-member regulatory commission within the Department of Energy. It was created in 1977 as a successor to the Federal Power Commission, which had been established in 1935 by the Federal Power Act. FERC regulates the interstate transmission and wholesale sale of electricity and natural gas, while state and local governments regulate retail sales and intrastate transmission. FERC also licenses hydroelectric projects and regulates the transmission of oil by interstate pipelines.

Over the past 25 years, FERC has overseen a fundamental change in the energy industry from a set of highly regulated monopolies to a system increasingly based on market competition. The regulatory framework as it has evolved and is administered by FERC in three areas that constituted a substantial portion of Enron's energy business – electricity, natural gas, and oil – is, very briefly, as follows: