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STOEL RIVES LLP

MEMORANDUM

December 6, 2000

TO: RICHARD SANDERS

FROM: CHRISTIAN YODER AND STEPHEN HALL

RE: Traders' Strategies in the California Wholesale Power Markets/ ISO Sanctions

CONFIDENTIAL: ATTORNEY/CLIENT PRIVILEGE/ATTORNEY WORK PRODUCT

This memorandum analyzes certain trading strategies that Enron's traders are using in the California wholesale energy markets. Section A explains two popular strategies used by the traders, "inc-ing" load and relieving congestion. Section B describes and analyzes other strategies used by Enron's traders, some of which are variations on "inc-ing" load or relieving congestion. Section C discusses the sanction provisions of the California Independent System Operator ("ISO") tariff.

A. The Big Picture

1. "Inc-ing" Load Into The Real Time Market

One of the most fundamental strategies used by the traders is referred to as "'inc-ing' load into the real time market." According to one trader, this is the 'oldest trick in the book' and, according to several of the traders, it is now being used by other market participants.

To understand this strategy, it is important to understand a little about the ISO's real-time market.[1] One responsibility of the ISO is to balance generation (supply) and loads (demand) on the California transmission system. During its real-time energy balancing function the ISO pays/charges market participants for increasing/decreasing their generation. The ISO pays/charges market participants under two schemes: "instructed deviations" and "uninstructed deviations." Instructed deviations occur when the ISO selects supplemental energy bids from generators offering to supply energy to the market in real time in response to ISO instructions. Market participants that increase their generation in response to instructions ("instructed deviation") from the ISO are paid the "inc" price. Market participants that increase their

[1] The "real-time" energy market is also known as the imbalance energy market. The imbalance energy market can be further subdivided into the (1) supplemental energy or instructed deviation market and (2) the ex post market or uninstructed deviation market.

generation without an instruction from the ISO (an "uninstructed deviation") are paid the ex post "dec" price. In real-time, the ISO issues instructions and publishes ex post prices at ten-minute intervals.

"'Inc-ing load' into the real-time market" is a strategy that enables Enron to send excess generation to the imbalance energy market as an uninstructed deviation. To participate in the imbalance energy market it is necessary to have at least 1 MW of load. The reason for this is that a generator cannot schedule energy onto the grid without having a corresponding load. The ISO requires scheduling coordinators to submit balanced schedules; i.e., generation must equal load. So, if load must equal generation, how can Enron end up with excess generation in the real-time market?

The answer is to artificially increase ("inc") the load on the schedule submitted to the ISO. Then, in real-time, Enron sends the generation it scheduled, but does not take as much load as scheduled. The ISO's meters record that Enron did not draw as much load, leaving it with an excess amount of generation. The ISO gives Enron credit for the excess generation and pays Enron the dec price multiplied by the number of excess megawatts. An example will demonstrate this. Enron will submit a day-ahead schedule showing 1000 MW of generation scheduled for delivery to Enron Energy Services ("EES"). The ISO receives the schedule, which says "1000 MW of generation" and "1000 MW of load." The ISO sees that the schedule balances and, assuming there is no congestion, schedules transmission for this transaction. In real-time, Enron sends 1000 MW of generation, but Enron Energy Services only draws 500 MW. The ISO's meters show that Enron made a net contribution to the grid of 500 MW, and so the ISO pays Enron 500 times the dec price.

The traders are able to anticipate when the dec price will be favorable by comparing the ISO's forecasts with their own. When the traders believe that the ISO's forecast underestimates the expected load, they will inc load into the real time market because they know that the market will be short, causing a favorable movement in real-time ex post prices. Of course, the much-criticized strategy of California's investor-owned utilities ("IOUs") of underscheduling load in the day-ahead market has contributed to the real-time market being short. The traders have learned to build such underscheduling into their models, as well.

Two other points bear mentioning. Although Enron may have been the first to use this strategy, others have picked up on it, too. I am told this can be shown by looking at the ISO's real-time metering, which shows that an excess amount of generation, over and above Enron's contribution, is making it to the imbalance market as an uninstructed deviation. Second, Enron has performed this service for certain other customers for which it acts as scheduling coordinator. The customers using this service are companies such as Powerex and Puget Sound Energy ("PSE"), that have generation to sell, but no native California load. Because Enron has native California load through EES, it is able to submit a schedule incorporating the generation of a generator like Powerex or PSE and balance the schedule with "dummied-up" load from EES.

Interestingly, this strategy appears to benefit the reliability of the ISO's grid. It is well known the California IOUs have systematically underscheduled their load in the PX's Day-

Ahead market. By underscheduling their load into the Day-Ahead market, the IOUs have caused the ISO to have to call on energy in real time in order to keep the transmission system in balance. In other words, the transmission grid is short energy. By deliberately overscheduling load, Enron has been offsetting the ISO's real time energy deficit by supplying extra energy that the ISO needs. Also, it should be noted that in the ex post market Enron is a "price taker," meaning that they are not submitting bids or offers, but are just being paid the value of the energy that the ISO needs. If the ISO did not need the energy, the dec price would quickly drop to $0. So, the fact that Enron was getting paid for this energy shows that the ISO needed the energy to balance the transmission system and offset the IOU's underscheduling (if those parties own Firm Transmission Rights ("FTR") over the path).

2. Relieving Congestion

The second strategy used by Enron's traders is to relieve system-wide congestion in the real-time market, which congestion was created by Enron's traders in the PX's Day Ahead Market. In order to relieve transmission congestion (i.e., the energy scheduled for delivery exceeds the capacity of the transmission path), the ISO makes payments to parties that either schedule transmission in the opposite direction ("counterflow payments") or that simply reduce their generation/load schedule.

Many of the strategies used by the traders involve structuring trades so that Enron gets paid the congestion charge. Because the congestion charges have been as high as $750/MW, it can often be profitable to sell power at a loss simply to be able to collect the congestion payment.

B. Representative Trading Strategies

The strategies listed below are examples of actual strategies used by the traders, many of which utilize the two basic principles described above. In some cases, the strategies are identified by the nicknames that the traders have assigned to them. In some cases, i.e., "Fat Boy," Enron's traders have used these nicknames with traders from other companies to identify these strategies.

1. Export of California Power

   a. As a result of the price caps in the PX and ISO (currently $250), Enron has been able to take advantage of arbitrage opportunities by buying energy at the PX for export outside California. For example, yesterday (December 5, 2000), prices at Mid-C peaked at $1200, while California was capped at $250. Thus, traders could buy power at $250 and sell it for $1200.

   b. This strategy appears not to present any problems, other than a public relations risk arising from the fact that such exports may have contributed to California's declaration of a Stage 2 Emergency yesterday.

2. "Non-firm Export"

a. The goal is to get paid for sending energy in the opposite direction as the constrained path (counterflow congestion payment). Under the ISO's tariff, scheduling coordinators that schedule energy in the opposite direction of the congestion on a constrained path get paid the congestion charges, which are charged to scheduling coordinators scheduling energy in the direction of the constraint. At times, the value of the congestion payments can be greater than the value of the energy itself.

b. This strategy is accomplished by scheduling non-firm energy for delivery from SP-15 or NP-15 to a control area outside California. This energy must be scheduled three hours before delivery. After two hours, Enron gets paid the counterflow charges. A trader then cuts the non-firm power. Once the non-firm power is cut, the congestion resumes.

c. The ISO posted notice in early August prohibiting this practice. Enron's traders stopped this practice immediately following the ISO's posting.

d. The ISO objected to the fact that the generators were cutting the non-firm energy. The ISO would not object to this transaction if the energy was eventually exported.

Apparently, the ISO has heavily documented Enron's use of this strategy. Therefore, this strategy is the more likely than most to receive attention from the ISO.

2. "Death Star"

a. This strategy earns money by scheduling transmission in the opposite direction of congestion; i.e., schedule transmission north in the summertime and south in the winter, and then collecting the congestion payments. No energy, however, is actually put onto the grid or taken off.

b. For example, Enron would first import non-firm energy at Lake Mead for export to the California-Oregon border ("COB"). Because the energy is traveling in the opposite direction of a constrained line, Enron gets paid for the counterflow. Enron also avoids paying ancillary service charges for this export because the energy is non-firm, and the ISO tariff does not require the purchase of ancillary services for non-firm energy.

c. Second, Enron buys transmission from COB to Lake Mead at tariff rates to serve the import. The transmission line from COB to Lake Mead is outside of the ISO's control area, so the ISO is unaware that the same energy being exported from Lake Mead is simultaneously being imported into Lake Mead. Similarly, because the COB to Lake Mead line is outside the ISO's control area, Enron is not subject to payment of congestion charges because transmission charges for the COB to Lake Mead line are assessed based on imbedded costs.

d. The ISO probably cannot readily detect this practice because the ISO only sees what is happening inside its control area, so it only sees half of the picture.

e. The net effect of these transactions is that Enron gets paid for moving energy to relieve congestion without actually moving any energy or relieving any congestion.

3. "Load Shift"

a. This strategy is applied to the Day-Ahead and the real-time markets.

b. Enron shifts load from a congested zone to a less congested zone, thereby earning payments for reducing congestion, i.e., not using our FTRs on a constrained path.

c. This strategy requires that Enron have FTRs connecting the two zones.

d. A trader will overschedule load in one zone, i.e., SP-15, and underschedule load in another zone, i.e., NP-15.

Such scheduling will often raise the congestion price in the zone where load was overscheduled.

The trader will then "shift" the overscheduled "load" to the other zone, and get paid for the unused FTRs. The ISO pays the congestion charge (if there is one) to market participants that do not use their FTRs. The effect of this action is to create the appearance of congestion through the deliberate overstatement of loads, which causes the ISO to charge congestion charges to supply scheduled for delivery in the congested zone. Then, by reverting back to its true load in the respective zones, Enron is deemed to have relieved congestion, and gets paid by the ISO for so doing.

e. One concern here is that by knowingly increasing the congestion costs, Enron is effectively increasing the costs to all market participants in the real time market.

f. Following this strategy has produced profits of approximately $30 million for FY 2000.

4. "Get Shorty"

a. Under this strategy, Enron sells ancillary services in the Day-ahead market.

b. Then, the next day, in the real-time market, a trader "zeroes out" the ancillary services, i.e., cancels the commitment and buys ancillary services in the real-time market to cover its position.

c. The profit is made by shorting the ancillary services, i.e., sell high and buy back at a lower price.

d. One concern here is that the traders are applying this strategy without having the ancillary services on standby. The traders are careful, however, to be sure to buy services right at 9:00 a.m. so that Enron is not actually called upon to provide ancillary services. However, once, by accident, a trader inadvertently failed to cover, and the ISO called on those ancillary services.

e. This strategy might be characterized as "paper trading," because the seller does not actually have the ancillary services to sell. FERC recently denied Morgan Stanley's request to paper trade on the New York ISO.

The ISO tariff does provide for situations where a scheduling coordinator sells ancillary services in the day ahead market, and then reduces them in the day-of market. Under these circumstances, the tariff simply requires that the scheduling coordinator replace the capacity in the hour-ahead market. ISO Tariff, SBP 5.3, *Buy Back of Ancillary Services.*

f. The ISO tariff requires that schedules and bids for ancillary services identify the specific generating unit or system unit, or in the case of external imports, the selling entity. As a consequence, in order to short the ancillary services it is necessary to submit false information that purports to identify the source of the ancillary services.

5. "Wheel Out"

a. This strategy is used when the interties are set to zero, i.e., completely constrained.

b. First, knowing that the intertie is completely constrained, Enron schedules a transmission flow through the system. By so doing, Enron earns the congestion charge. Second, because the line's capacity is set to "0," the traders know that any power scheduled to go through the inter-tie will, in fact be cut. Therefore, Enron earns the congestion counterflow payment without having to actually send energy through the intertie.

c. As a rule, the traders have learned that money can be made through congestion charges when a transmission line is out of service because the ISO will never schedule an energy delivery because the intertie is constrained.

6. "Fat Boy"

a. This strategy is described above in section A (1).

7. "Ricochet"

a. Enron buys energy from the PX in the Day Of market, and schedules it for export. The energy is sent out of California to another party, which charges a small fee per MW, and then Enron buys it back to sell the energy to the ISO real-time market.

b. The effect of this strategy on market prices and supply is complex. First, it is clear that Enron's intent under this strategy is solely to arbitrage the spread between the PX and the ISO, and not to serve load or meet contractual obligations. Second, Ricochet may increase the Market Clearing Price by increasing the demand for energy. (Increasing the MCP does not directly benefit Enron because it is *buying* energy from the PX, but it certainly affects other buyers, who must pay the same, higher price.) Third, Ricochet appears to have a neutral effect on supply, because it is returning the exported energy as an import. Fourth, the parties that pay Enron for supplying energy to the real time ex post market are the parties that underscheduled, or underestimated their load, i.e., the IOUs.

8. Selling Non-firm Energy as Firm Energy

a. The traders commonly sell non-firm energy to the PX as "firm." "Firm energy," in this context, means that the energy includes ancillary services. The result is that the ISO pays EPMI for ancillary services that Enron claims it is providing, but does not in fact provide.

b. The traders claim that "everybody does this," especially for imports from the Pacific Northwest into California.

c. At least one complaint was filed with the ISO regarding Enron's practice of doing this. Apparently, Arizona Public Service sold non-firm energy to Enron, which turned around and sold the energy to the ISO as firm. APS cut the energy flow, and then called the ISO and told the ISO what Enron had done.

9. Scheduling Energy To Collect the Congestion Charge II

a. In order to collect the congestion charges, the traders may schedule a counterflow even if they do not have any excess generation. In real time, the ISO will see that Enron did deliver the energy it promised, so it will charge Enron the inc price for each MW Enron was short. The ISO, however, still pays Enron the congestion charge. Obviously a loophole, which the ISO could close by simply failing to pay congestion charges to entities that failed to deliver the energy.

b. This strategy is profitable whenever the congestion charge is sufficiently greater than the price cap. In other words, since the ex post is capped at $250, whenever the congestion charge is greater than $250 it is profitable to schedule counterflows, collect the congestion charge, pay the ex post, and keep the difference.

C. ISO Tariff

The ISO tariff prohibits "gaming," which it defines as follows:

> "Gaming," or taking unfair advantage of the rules and procedures set forth in the PX or ISO Tariffs, Protocols or Activity Rules, or of transmission constraints in period in which exist substantial Congestion, to the detriment of the efficiency of, and of consumers in, the ISO Markets. "Gaming" may also include taking undue advantage of other conditions that may affect the availability of transmission and generation capacity, such as loop flow, facility outages, level of hydropower output or seasonal limits on energy imports from out-of-state, or actions or behaviors that may otherwise render the system and the ISO Markets vulnerable to price manipulation to the detriment of their efficiency." ISO Market Monitoring and Information Protocol ("MMIP"), Section 2.1.3.

The ISO tariff also prohibits "anomalous market behavior," which includes "unusual trades or transactions"; "pricing and bidding patterns that are inconsistent with prevailing supply and demand conditions"; and "unusual activity or circumstances relating to imports from or exports to other markets or exchanges." MMIP, Section 2.1.1 et seq.

Should it discover such activities, the ISO tariff provides that the ISO may take the following action:

1. Publicize such activities or behavior and its recommendations thereof, "*in whatever medium it believes most appropriate.*" MMIP, Section 2.3.2 (emphasis added).

2. The Market Surveillance Unit may recommend actions, including fines and suspensions, against specific entities in order to deter such activities or behavior. MMIP, Section 2.3.2.

3. With respect to allegations of gaming, the ISO may order ADR procedures to determine if a particular practice is better characterized as improper gaming or "legitimate aggressive competition." MMIP, Section 2.3.3.

4. In cases of "serious abuse requiring expeditious investigation or action" the Market Surveillance Unit shall refer a matter to the appropriate regulatory or antitrust enforcement agency. MMIP, Section 3.3.4.

5. Any Market Participant or interested entity may file a complaint with the Market Surveillance Unit. Following such complaint, the Market Surveillance Unit may "carry out any investigation that it considers appropriate as to the concern raised." MMIP, Section 3.3.5.

6. The ISO Governing Board may impose "such sanctions or penalties as it believes necessary and as are permitted under the ISO Tariff and related protocols approved by FERC; or it may refer the matter to such regulatory or antitrust agency as it sees fit to recommend the imposition of sanctions and penalties." MMIP, Section 7.3.

MEMORANDUM

Brobeck
ATTORNEYS AT LAW

TO: **Richard Sanders**

FROM: **Gary Fergus**
Jean Frizzell (Gibbs & Bruns LLP)

SUBJECT: Status Report on Further Investigation and Analysis of EPMI Trading Strategies

DATE:

CC: **Tim Belden**
Michael Kirby
Barrett Reasoner

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As part of our preparation for the various investigations and litigation actually and potentially facing EPMI in connection with the California energy market, Jean Frizzell, Barrett Reasoner, Mike Kirby and Gary Fergus spent several full days over the past few months at EPMI for the purpose of learning and understanding more about the data, methodology, the various strategies used by the traders and the implementation of those strategies. This is a highly complicated subject matter and all of us are still learning.

We used as our starting point the Preliminary Memorandum dated December 8, 2000, which we understand was prepared as the first step in educating you and outside counsel about EPMI trading practices. The Preliminary Memorandum was written by Steve Hall, an associate on loan from the Stoel Rives law firm, and co-authored by Christian Yoder, the in-house counsel at EPMI. Over the course of the past month, we have spent a fair amount of time with a number of traders. In some instances, we met the same traders more than once to try and understand the various practices. On January 11th, we spent another full day with Tim Belden, chief trader for EPMI in Portland going over the strategies that have been identified. Here is our summary of the status of our further investigation and present analysis of the EPMI trading practices:

Overview

The California energy market during calendar year 2000 was an incredibly complex and dynamic environment. Weather, supply shortages, physical limits and market volatility contributed to this environment. During the past month, we have had several outside law firm lawyers, each with varying degrees of experience with California electricity market, work together with the EPMI traders to understand the market and the practices. From time to time, the understanding of and interpretation by the lawyers interviewing the same traders about the market and the trading practices were inconsistent. When that happened, we would go back to the traders to try and gain a common understanding of the particular market and trading strategy. At this point in the process, we realize that there are very few clearly defined trading strategies. Depending upon the particular circumstances of the day, trading strategies were modified and applied in response to EPMI's portfolio, market conditions, the individual trader's understanding of them, and the individual trader's preferences within a larger overall framework. In part, this is because trading is done 7 days a week for many different schedules (e.g. PX day ahead, PX day of, ISO hour ahead, ISO real time etc

EPMI is only one of many market participants. We do not have nearly enough information to gain a good understanding of all of the impacts other participants, and whatever their strategies might have been, had on the market. For these reasons, you should consider this a work in progress, rather than the definitive analysis of EPMI trading practices. We may learn that some of the conclusions we have reached will later turn out to be inaccurate. In fact, we learned during this process that some of the information contained in the Preliminary Memorandum, which resulted in some erroneous assumptions and conclusions, cannot be supported by the facts and evidence which are now known. In other instances, some statements in the Preliminary Memorandum understandably mixed trading strategies and schedules. In order to minimize the risk of confusing matters further, we have taken the additional step of having Tim Belden review this memorandum to see if we have accurately described the trading practices and to see whether he can spot any flaws in our analysis. We tried to follow the same format of the Preliminary Memorandum for easy cross reference.

"Incing" Load into the Real Time Market

"Incing" was a slang name (short for "increasing") for a trading strategy used in response to the independently owned utilities (IOU) well known and documented strategy of significantly underestimating their load in the PX day ahead market. This practice by the utilities apparently occurred almost daily. Because the IOU's purchased their power through the PX day ahead market, the PX thus became their scheduling coordinator; the ISO's resulting schedules understated the load for the next day. The IOU practice of underestimating load artificially lowered the PX day ahead market clearing price. Incing served to partially counteract the reliability issues caused by this practice and, from the California consumer's perspective, appears to have been preferable to the alternative of selling outside of California. In addition, incing may have increased the actual guaranteed available supply of power in the California market depending upon the shape of the demand curve. Incing reduced demand in the ISO market, therefore reduced the ex post price and potentially lowered the overall cost to California consumers. When incing, EPMI was a price taker in the ISO ex post market.

Death Star

Death Star was a slang name for a strategy that addressed congestion between northern and southern California. During certain periods, there are transmission limits between northern California and southern California on path 15 and path 26. It appears that the source of the congestion may have been the consistent underestimating of load by PG&E – the same underestimating referred to above. Because the demand was artificially lower in Northern California, it appears supply was trying to move to southern California. By using a combination of ISO approved scheduled counterflows and alternative non-ISO transmission lines, EPMI increased the transfer capability between the regions, reduced congestion, and utilized underused pathways to increase the overall supply of electricity in southern California. By virtue of using multiple transmission paths, EPMI took on financial risks, including having the transmission line derated, assessment of additional congestion charges, and liability for take or pay transmission charges on alternative transmission lines to execute the strategy.

Contrary to certain statements in the Preliminary Memorandum, congestion was relieved and energy did flow through otherwise underutilized paths.

Load Shift

Load shift is a general term used to describe a variety of scheduling practices and trading strategies in the day ahead and hour ahead markets. One variation of load shifting involved scheduling ISO approved counterflows in the ISO day ahead market, ISO hour ahead market or both. Generally speaking, as an alternative to purchasing power in the north, EPMI purchased power in the south and counterflowed that power to the north. Such transactions had the effect of providing congestion relief in the ISO day ahead market or the ISO hour ahead markets. These transactions placed EPMI at financial risk for the differences in price between the regions.

Another category of load shifting involves shifting the load on paths for which EPMI purchased firm transmission rights. This category was briefly discussed in the Preliminary Memorandum. We have learned more about this load shifting strategy since the Preliminary Memoranda was written. As the result of several in depth interviews with the traders and review of the public market surveillance reports available to the public and all market participants, it is apparent that the assumptions and conclusions contained in the Preliminary Memorandum were inaccurate. First, in hindsight, it now appears likely that the load shifting strategy, without knowing the impact of other market factors, sometimes may have reduced the prices in the north while leaving prices in the south unchanged or minimally impacted. Second, it appears that the estimate of profits from this load shifting strategy in the Preliminary Memorandum was vastly overstated and indeed confused. It would appear that the source of the confusion may have been that the Preliminary Memorandum reported the total profit attributable to the EPMI firm transmission rights on path 26, as reflected in ISO public documents, as opposed to any calculation of the profit of this particular strategy.

Get Shorty

"Get Shorty" was the slang name for a trading strategy involving the provision of ancillary services in the PX day ahead and ISO hour ahead markets. EPMI committed to providing the ancillary services in the PX day ahead market and covered its position by purchasing those services in the ISO hour ahead market. Accordingly, EPMI actually purchased the services

necessary to provide ancillary services if called upon to do so. In fact, the ISO regularly called upon EPMI for ancillary services that were provided. Based upon the information we have so far, there was only one incident where EPMI failed to cover its position. In that single instance, EPMI promptly offered to, and ultimately did, return the payment received for the ancillary services that were not provided. Accordingly, the strategy did not impact the reliability of the grid. This strategy, however, did place EPMI at financial risk. On a number of occasions, it appears the cost to cover exceeded the amount received in the day ahead market and EPMI provided services to the ISO at a loss.

The Preliminary Memorandum incorrectly assumed that the information provided to the ISO was inaccurate. It now appears that, consistent with daily ISO practices, that EPMI did not specify the source of the ancillary services at the time of sale.

Ricochet

"Ricochet" was the slang term for a trading strategy that existed because EPMI was not permitted to make adjustment bids in SC to SC (scheduling coordinator) trades due to limitations in the ISO software systems. Ricochet served the dual purpose of allowing for adjustment bids and opening up market options for EPMI including the supplemental and bilateral markets. By using this strategy, EPMI was at financial risk if the PX price exceeded either the supplemental or bilateral market price. Furthermore, the ISO software limitation forced EPMI to incur additional costs, export charges, ancillary services on exports and line losses on imports.

Ricochet appears not to have been a strategy that was used to a significant extent when compared to EPMI's overall portfolio. It appears that other market participants with control areas adjacent to California and access to extremely flexible generation resources may have relied more extensively on this strategy.

At the present time, EPMI faces its own software limitations in implementing ISO approved adjustment bids in SC to SC transactions.

Non-Firm Export

This was a trading practice that involved scheduling counterflows three hours ahead of the time energy would flow. The scheduled counterflow had the likely effect of reducing the congestion charge on the scheduled path. Under this strategy, EPMI qualified for the congestion relief payment two hours before the scheduled flow. Ultimately, EPMI did not flow the power. Based upon the information we have, this practice does not appear to have had any demonstrable impact on either the PX price or the ISO ex post price. However, in August 2000, the ISO directed that the practice be discontinued. The EPMI traders with whom we spoke confirmed that EPMI has complied with that mandate.

Selling Non Firm Energy as Firm Energy

This was a trading strategy that was occasionally used in southern California to allow for the import of power that would otherwise not be available. The net effect of this practice, in conjunction with other market factors, was to increase the overall supply with no apparent impact on PX price. EPMI was subjected to financial risk in that if the non-firm power was cut,

EPMI would have to cover the energy cut by purchasing that power in the ISO market at the ex post price.

At this time, it appears that the net result of this practice was to bring additional supply into California.

Scheduling Energy to Collect the Congestion Charge II
The net effect of this strategy was to schedule counterflow thereby reducing congestion in hour ahead market. This was a high risk strategy because EPMI was exposed to the ex post market price that could exceed the congestion price. This strategy could have potentially lowered the congestion charge depending upon a wide variety of other market factors.

STOEL RIVES LLP

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To understand this strategy, it is important to understand a little about the ISO's real-time market.[1] One responsibility of the ISO is to balance generation (supply) and loads (demand) on the California transmission system. During its real-time energy balancing function the ISO pays/charges market participants for increasing/decreasing their generation. The ISO pays/charges market participants under two schemes: "instructed deviations" and "uninstructed deviations." Instructed deviations occur when the ISO selects supplemental energy bids from generators offering to supply energy to the market in real time in response to ISO instructions. Market participants that increase their generation in response to instructions ("instructed deviation") from the ISO are paid the "inc" price. Market participants that increase their

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The answer is to artificially increase ("inc") the load on the schedule submitted to the ISO. Then, in real-time, Enron sends the generation it scheduled, but does not take as much load as scheduled. The ISO's meters record that Enron did not draw as much load, leaving it with an excess amount of generation. The ISO gives Enron credit for the excess generation and pays Enron the dec price multiplied by the number of excess megawatts. An example will demonstrate this. Enron will submit a day-ahead schedule showing 1000 MW of generation scheduled for delivery to Enron Energy Services ("EES"). The ISO receives the schedule, which says "1000 MW of generation" and "1000 MW of load." The ISO sees that the schedule balances and, assuming there is no congestion, schedules transmission for this transaction. In real-time, Enron sends 1000 MW of generation, but Enron Energy Services only draws 500 MW. The ISO's meters show that Enron made a net contribution to the grid of 500 MW, and so the ISO pays Enron 500 times the dec price.

The traders are able to anticipate when the dec price will be favorable by comparing the ISO's forecasts with their own. When the traders believe that the ISO's forecast underestimates the expected load, they will inc load into the real time market because they know that the market will be short, causing a favorable movement in real-time ex post prices. Of course, the much-criticized strategy of California's investor-owned utilities ("IOUs") of underscheduling load in the day-ahead market has contributed to the real-time market being short. The traders have learned to build such underscheduling into their models, as well.

Two other points bear mentioning. Although Enron may have been the first to use this strategy, others have picked up on it, too. I am told this can be shown by looking at the ISO's real-time metering, which shows that an excess amount of generation, over and above Enron's contribution, is making it to the imbalance market as an uninstructed deviation. Second, Enron has performed this service for certain other customers for which it acts as scheduling coordinator. The customers using this service are companies such as Powerex and Puget Sound Energy ("PSE"), that have generation to sell, but no native California load. Because Enron has native California load through EES, it is able to submit a schedule incorporating the generation of a generator like Powerex or PSE and balance the schedule with "dummied-up" load from EES.

Interestingly, this strategy appears to benefit the reliability of the ISO's grid. It is well known the California IOUs have systematically underscheduled their load in the PX's Day-

Ahead market. By underscheduling their load into the Day-Ahead market, the IOUs have caused the ISO to have to call on energy in real time in order to keep the transmission system in balance. In other words, the transmission grid is short energy. By deliberately overscheduling load, Enron has been offsetting the ISO's real time energy deficit by supplying extra energy that the ISO needs. Also, it should be noted that in the ex post market Enron is a "price taker," meaning that they are not submitting bids or offers, but are just being paid the value of the energy that the ISO needs. If the ISO did not need the energy, the dec price would quickly drop to $0. So, the fact that Enron was getting paid for this energy shows that the ISO needed the energy to balance the transmission system and offset the IOU's underscheduling (if those parties own Firm Transmission Rights ("FTR") over the path).

2. Relieving Congestion

The second strategy used by Enron's traders is to relieve system-wide congestion in the real-time market, which congestion was created by Enron's traders in the PX's Day Ahead Market. In order to relieve transmission congestion (i.e., the energy scheduled for delivery exceeds the capacity of the transmission path), the ISO makes payments to parties that either schedule transmission in the opposite direction ("counterflow payments") or that simply reduce their generation/load schedule.

Many of the strategies used by the traders involve structuring trades so that Enron gets paid the congestion charge. Because the congestion charges have been as high as $750/MW, it can often be profitable to sell power at a loss simply to be able to collect the congestion payment.

B. Representative Trading Strategies

The strategies listed below are examples of actual strategies used by the traders, many of which utilize the two basic principles described above. In some cases, the strategies are identified by the nicknames that the traders have assigned to them. In some cases, i.e., "Fat Boy," Enron's traders have used these nicknames with traders from other companies to identify these strategies.

1. Export of California Power

NO! 250?

a. As a result of the price caps in the PX and ISO (currently $250), Enron has been able to take advantage of arbitrage opportunities by buying energy at the PX for export outside California. For example, yesterday (December 5, 2000), prices at Mid-C peaked at $1200, while California was capped at $250. Thus, traders could buy power at $250 and sell it for $1200.

b. This strategy appears not to present any problems, other than a public relations risk arising from the fact that such exports may have contributed to California's declaration of a Stage 2 Emergency yesterday.

2. "Non-firm Export"

a. The goal is to get paid for sending energy in the opposite direction as the constrained path (counterflow congestion payment). Under the ISO's tariff, scheduling coordinators that schedule energy in the opposite direction of the congestion on a constrained path get paid the congestion charges, which are charged to scheduling coordinators scheduling energy in the direction of the constraint. At times, the value of the congestion payments can be greater than the value of the energy itself.

b. This strategy is accomplished by scheduling non-firm energy for delivery from SP-15 or NP-15 to a control area outside California. This energy must be scheduled three hours before delivery. After two hours, Enron gets paid the counterflow charges. A trader then cuts the non-firm power. Once the non-firm power is cut, the congestion resumes.

c. The ISO posted notice in early August prohibiting this practice. Enron's traders stopped this practice immediately following the ISO's posting.

d. The ISO objected to the fact that the generators were cutting the non-firm energy. The ISO would not object to this transaction if the energy was eventually exported.

Apparently, the ISO has heavily documented Enron's use of this strategy. Therefore, this strategy is the more likely than most to receive attention from the ISO.

2. "Death Star"

a. This strategy earns money by scheduling transmission in the opposite direction of congestion; i.e., schedule transmission north in the summertime and south in the winter, and then collecting the congestion payments. No energy, however, is actually put onto the grid or taken off.

b. For example, Enron would first import non-firm energy at Lake Mead for export to the California-Oregon border ("COB"). Because the energy is traveling in the opposite direction of a constrained line, Enron gets paid for the counterflow. Enron also avoids paying ancillary service charges for this export because the energy is non-firm, and the ISO tariff does not require the purchase of ancillary services for non-firm energy.

c. Second, Enron buys transmission from COB to Lake Mead at tariff rates to serve the import. The transmission line from COB to Lake Mead is outside of the ISO's control area, so the ISO is unaware that the same energy being exported from Lake Mead is simultaneously being imported into Lake Mead. Similarly, because the COB to Lake Mead line is outside the ISO's control area, Enron is not subject to payment of congestion charges because transmission charges for the COB to Lake Mead line are assessed based on imbedded costs.

d. The ISO probably cannot readily detect this practice because the ISO only sees what is happening inside its control area, so it only sees half of the picture.

e. The net effect of these transactions is that Enron gets paid for moving energy to relieve congestion without actually moving any energy or relieving any congestion.

3. "Load Shift"

a. This strategy is applied to the Day-Ahead and the real-time markets.

b. Enron shifts load from a congested zone to a less congested zone, thereby earning payments for reducing congestion, i.e., not using our FTRs on a constrained path.

c. This strategy requires that Enron have FTRs connecting the two zones.

d. A trader will overschedule load in one zone, i.e., SP-15, and underschedule load in another zone, i.e., NP-15.

Such scheduling will often raise the congestion price in the zone where load was overscheduled.

The trader will then "shift" the overscheduled "load" to the other zone, and get paid for the unused FTRs. The ISO pays the congestion charge (if there is one) to market participants that do not use their FTRs. The effect of this action is to create the appearance of congestion through the deliberate overstatement of loads, which causes the ISO to charge congestion charges to supply scheduled for delivery in the congested zone. Then, by reverting back to its true load in the respective zones, Enron is deemed to have relieved congestion, and gets paid by the ISO for so doing.

e. One concern here is that by knowingly increasing the congestion costs, Enron is effectively increasing the costs to all market participants in the real time market.

f. Following this strategy has produced profits of approximately $30 million for FY 2000.

4. "Get Shorty"

a. Under this strategy, Enron sells ancillary services in the Day-ahead market.

b. Then, the next day, in the real-time market, a trader "zeroes out" the ancillary services, i.e., cancels the commitment and buys ancillary services in the real-time market to cover its position.

c. The profit is made by shorting the ancillary services, i.e., sell high and buy back at a lower price.

d. One concern here is that the traders are applying this strategy without having the ancillary services on standby. The traders are careful, however, to be sure to buy services right at 9:00 a.m. so that Enron is not actually called upon to provide ancillary services. However, once, by accident, a trader inadvertently failed to cover, and the ISO called on those ancillary services.

e. This strategy might be characterized as "paper trading," because the seller does not actually have the ancillary services to sell. FERC recently denied Morgan Stanley's request to paper trade on the New York ISO.

The ISO tariff does provide for situations where a scheduling coordinator sells ancillary services in the day ahead market, and then reduces them in the day-of market. Under these circumstances, the tariff simply requires that the scheduling coordinator replace the capacity in the hour-ahead market. ISO Tariff, SBP 5.3, *Buy Back of Ancillary Services.*

f. The ISO tariff requires that schedules and bids for ancillary services identify the specific generating unit or system unit, or in the case of external imports, the selling entity. As a consequence, in order to short the ancillary services it is necessary to submit false information that purports to identify the source of the ancillary services.

5. "Wheel Out"

a. This strategy is used when the interties are set to zero, i.e., completely constrained.

b. First, knowing that the intertie is completely constrained, Enron schedules a transmission flow through the system. By so doing, Enron earns the congestion charge.. Second, because the line's capacity is set to "0," the traders know that any power scheduled to go through the inter-tie will, in fact be cut. Therefore, Enron earns the congestion counterflow payment without having to actually send energy through the intertie.

c. As a rule, the traders have learned that money can be made through congestion charges when a transmission line is out of service because the ISO will never schedule an energy delivery because the intertie is constrained.

6. "Fat Boy"

a. This strategy is described above in section A (1).

7. "Ricochet"

a. Enron buys energy from the PX in the Day Of market, and schedules it for export. The energy is sent out of California to another party, which charges a small fee per MW, and then Enron buys it back to sell the energy to the ISO real-time market.

b. The effect of this strategy on market prices and supply is complex. First, it is clear that Enron's intent under this strategy is solely to arbitrage the spread between the PX and the ISO, and not to serve load or meet contractual obligations. Second, Ricochet may increase the Market Clearing Price by increasing the demand for energy. (Increasing the MCP does not directly benefit Enron because it is *buying* energy from the PX, but it certainly affects other buyers, who must pay the same, higher price.) Third, Ricochet appears to have a neutral effect on supply, because it is returning the exported energy as an import. Fourth, the parties that pay Enron for supplying energy to the real time ex post market are the parties that underscheduled, or underestimated their load, i.e., the IOUs.

8. Selling Non-firm Energy as Firm Energy

a. The traders commonly sell non-firm energy to the PX as "firm." "Firm energy," in this context, means that the energy includes ancillary services. The result is that the ISO pays EPMI for ancillary services that Enron claims it is providing, but does not in fact provide.

b. The traders claim that "everybody does this," especially for imports from the Pacific Northwest into California.

c. At least one complaint was filed with the ISO regarding Enron's practice of doing this. Apparently, Arizona Public Service sold non-firm energy to Enron, which turned around and sold the energy to the ISO as firm. APS cut the energy flow, and then called the ISO and told the ISO what Enron had done.

9. Scheduling Energy To Collect the Congestion Charge II

a. In order to collect the congestion charges, the traders may schedule a counterflow even if they do not have any excess generation. In real time, the ISO will see that Enron did deliver the energy it promised, so it will charge Enron the inc price for each MW Enron was short. The ISO, however, still pays Enron the congestion charge. Obviously a loophole, which the ISO could close by simply failing to pay congestion charges to entities that failed to deliver the energy.

b. This strategy is profitable whenever the congestion charge is sufficiently greater than the price cap. In other words, since the ex post is capped at $250, whenever the congestion charge is greater than $250 it is profitable to schedule counterflows, collect the congestion charge, pay the ex post, and keep the difference.

C. ISO Tariff

The ISO tariff prohibits "gaming," which it defines as follows:

> "Gaming," or taking unfair advantage of the rules and procedures set forth in the PX or ISO Tariffs, Protocols or Activity Rules, or of transmission constraints in period in which exist substantial Congestion, to the detriment of the efficiency of, and of consumers in, the ISO Markets. "Gaming" may also include taking undue advantage of other conditions that may affect the availability of transmission and generation capacity, such as loop flow, facility outages, level of hydropower output or seasonal limits on energy imports from out-of-state, or actions or behaviors that may otherwise render the system and the ISO Markets vulnerable to price manipulation to the detriment of their efficiency." ISO Market Monitoring and Information Protocol ("MMIP"), Section 2.1.3.

The ISO tariff also prohibits "anomalous market behavior," which includes "unusual trades or transactions"; "pricing and bidding patterns that are inconsistent with prevailing supply and demand conditions"; and "unusual activity or circumstances relating to imports from or exports to other markets or exchanges." MMIP, Section 2.1.1 et seq.

Should it discover such activities, the ISO tariff provides that the ISO may take the following action:

1. Publicize such activities or behavior and its recommendations thereof, "*in whatever medium it believes most appropriate.*" MMIP, Section 2.3.2 (emphasis added).

2. The Market Surveillance Unit may recommend actions, including fines and suspensions, against specific entities in order to deter such activities or behavior. MMIP, Section 2.3.2.

3. With respect to allegations of gaming, the ISO may order ADR procedures to determine if a particular practice is better characterized as improper gaming or "legitimate aggressive competition." MMIP, Section 2.3.3.

4. In cases of "serious abuse requiring expeditious investigation or action" the Market Surveillance Unit shall refer a matter to the appropriate regulatory or antitrust enforcement agency. MMIP, Section 3.3.4.

5. Any Market Participant or interested entity may file a complaint with the Market Surveillance Unit. Following such complaint, the Market Surveillance Unit may "carry out any investigation that it considers appropriate as to the concern raised." MMIP, Section 3.3.5.

6. The ISO Governing Board may impose "such sanctions or penalties as it believes necessary and as are permitted under the ISO Tariff and related protocols approved by FERC; or it may refer the matter to such regulatory or antitrust agency as it sees fit to recommend the imposition of sanctions and penalties." MMIP, Section 7.3.

Arthur Andersen
E&P and IPP's

To: David B. Duncan@ANDERSEN WO, Thomas H. Bauer@ANDERSEN WO
cc:
Date: 02/06/2001 08:24 AM
From: Michael D. Jones, Houston , 2541
Subject: Enron retention meeting

Dave, I was not sure whether you were planning on documenting the meeting yesterday. My significant notes were as follows (these were not very detailed, but I was not sure how detailed you wanted to get, assuming that you were going to document the meeting). Let me know if you want me to take a stab at it first (if so we should probably get together for a few minutes to discuss your documentation ideas.:

Attendees:
By Phone: Samek, Swanson, Jeneaux, Jonas, Kutsenda, Stewart
In Houston: Bennett, Goddard, Goolsby, Odom, Lowther, Duncan, Bauer, Jones

Significant discussion was held regarding the related party transactions with LJM including the materiality of such amounts to Enron's income statement and the amount retained "off balance sheet". The discussion focused on Fastow's conflicts of interest in his capacity as CFO and the LJM fund manager, the amount of earnings that Fastow receives for his services and participation in LJM, the disclosures of the transactions in the financial footnotes, Enron's BOD's views regarding the transactions and our and management's communication of such transactions to the BOD and our testing of such transactions to ensure that we fully understand the economics and substance of the transactions.

The question was raised as whether the BOD gets any competing bids when the company executes transactions with LJM. DBD replied that he did not believe so, but explained thier transaction approval process generally and specifically related to LJM transactions.

A significant discussion was also held regarding Enron's MTM earnings and the fact that it was "intelligent gambling". We discussed Enron's risk management activities including authority limits, valuation and position monitoring.

We discussed Enron's reliance on its current credit rating to maintain itself as a high credit rated transaction party.

We discussed Enron's dependence on transaction execution to meet financial objectives, the fact that Enron often is creating industries and markets and transactions for which there are no specific rules which requires significant judgement and that Enron is aggressive in its tranaction structuring. We discussed consultation among the engagement team, with Houston management, practice management and the PSG to ensure that we are not making decisions in isolation.

Ultimately the conclusion was reached to retain Enron as a client citing that it appeared that we had the appropriate people and processes in place to serve Enron and manage our engagement risks. We discussed whether there would be a perceived independence issue solely considering our level of fees. We discussed that the concerns should not be on the magnitude of fees but on the nature of fees. We arbitrarily discussed that it would not be unforseeable that fees could reach a $100 million per year amount considering the multi-disciplinary services being provided. Such amount did not trouble the

participants as long as the nature of the services was not an issue.

In addition to the above discussions were held to varying degrees on each page of the presentation materials.

Take away To Do's:
Inquire as to whether Andy Fastow and / or LJM would be viewed as an "affiliate" from an SEC perspective which would require looking through the transactions and treating them as within the consolidated group.
Suggest that a special committee of the BOD be established to review the fairness of LJM transactions (or alternative comfort that the transactions are fair to Enron, e.g., competitive bidding)
Why did Andy not select AA as auditors, including when PWC was replaced with KPMG. Discussions concluded that we would likely not want to be LJM's financial advisors given potential conflicts of interest with Enron.
Focus on Enron preparing thier own documentation and conclusions to issues and transactions.
AA to focus on timely documentation of final transaction structures to ensure consensus is reached on the final structure.

David B. Duncan

From: PGE News
To: ALL PGE EMPLOYEES
Date: 8/14/01 2:54PM
Subject: Jeff Skilling resigns as CEO of Enron

PGE News ..... August 14, 2001

Jeff Skilling resigns as CEO of Enron

Enron today announced that President and CEO Jeff Skilling has resigned, effective immediately, and that the Enron Board of Directors has asked Ken Lay to resume his role as Chairman and CEO.

"Stan Horton called this afternoon to inform me of Jeff's decision to step down for personal reasons," says PGE CEO and President Peggy Fowler. Horton, CEO of Enron Transportation, is Fowler's executive connection to the Enron team. "He wanted to let me know that Mr. Skilling's departure will not in any way impact Enron's ongoing strategy for success and we should expect no near-term dramatic organizational changes."

"Clearly, Enron will continue to focus on increasing the company's stock value," Fowler added. "PGE can help in this effort by remaining committed to our Scorecard goals and operational excellence."

Below is the letter Ken Lay is sending to Enron employees this afternoon announcing the decision:

To: Enron Employees Worldwide
From: Ken Lay

It is with regret that I have to announce that Jeff Skilling is leaving Enron. Today, the Board of Directors accepted his resignation as President and CEO of Enron. Jeff is resigning for personal reasons and his decision is voluntary. I regret his decision, but I accept and understand it. I have worked closely with Jeff for more than 15 years, including 11 here at Enron, and have had few, if any, professional relationships that I value more. I am pleased to say that he has agreed to enter into a consulting arrangement with the company to advise me and the Board of Directors.

Now it's time to look forward.

With Jeff leaving, the Board has asked me to resume the responsibilities of President and CEO in addition to my role as Chairman of the Board. I have agreed. I want to assure you that I have never felt better about the prospects for the company. All of you know that our stock price has suffered substantially over the last few months. One of my top priorities will be to restore a significant amount of the stock value we have lost as soon as possible. Our performance has never been stronger; our business model has never been more robust; our growth has never been more certain; and most importantly, we have never had a better nor deeper pool of talent throughout the company. We have the finest organization in American business today. Together, we will make Enron the world's leading company.

CC: Kathy & George Wyatt; Kathy Wyatt

Ken Lay <ken.lay@enron.com> on 08/27/2001 08:36:38 PM

To: <[redacted]@enron.com>
cc:

Subject: 2001 Special Stock Option Grant

As promised, I want to update you on the Special Stock Option Grant that I announced at the all-employee meeting.

You have been awarded a stock grant as follows:

Special Stock Option Grant
Grant Date: August 21, 2001
Grant Price: $36.88
Vesting: Options are 100 percent vested on date of grant
Number of options: Based on 5 percent of an employee's annualized base salary as of August 13, 2001 and a theoretical stock option value of $15. You will be notified of the actual number of stock options awarded to you.
Option Term: Five years
The terms and provisions of this grant are subject to the applicable 1991 or 1994 Enron Corp. Stock Plan, as will be referenced in the stock award agreement.

Employees who are eligible to participate in this special program will receive award details in the next several weeks. More information about this grant will be available on the HR web site http://hrweb.enron.com.

As I mentioned at the employee meeting, one of my highest priorities is to restore investor confidence in Enron. This should result in a significantly higher stock price. I hope this grant lets you know how valued you are to Enron. I ask your continued help and support as we work together to achieve this goal. Again, on behalf of the Enron Board and myself, thanks for everything you are doing to make Enron the great company it is. And stay tuned for regular updates from me about what is happening around Enron.

Ken

Remarks of Joseph F. Berardino
Managing Partner – Chief Executive Officer, Andersen

U.S. House of Representatives
Committee on Financial Services
December 12, 2001

Chairman Oxley, Congressman LaFalce, Chairman Baker, Congressman Kanjorski, Chairwoman Kelly, Congressman Gutierrez, Members of the Committee.

I am here today because faith in our firm and in the integrity of the capital market system has been shaken. There is some explaining to do.

What happened at Enron is a tragedy on many levels. We are acutely aware of the impact this has had on investors. We also recognize the pain this business failure has caused for Enron's employees and others.

Many questions about Enron's failure need to be answered, and some involve accounting and auditing matters. I will do my best today to address those.

I ask that you keep in mind that the relevant auditing and accounting issues are extraordinarily complex and part of a much bigger picture. None of us here yet knows all the facts. Today's hearing is an important step in enlightening all of us. I am certain that together we will get to the facts.

If there is one thing you take away from my testimony, I hope it is this: Andersen will not hide from its responsibilities. That's why I'm here today. The public's confidence is of paramount importance. If my firm has made errors in judgment, we will acknowledge them. We will make the changes needed to restore confidence.

Today, I want to address two issues that go to the heart of concerns about our role as Enron's auditor.

First, did we do our job? I want to explain what we knew and when we knew it on several key issues, keeping in mind that our own review – like yours – is still under way.

Second, did we act with integrity? I want to discuss the $52 million in fees we received and respond to concerns that have been raised.

I also want to talk about what I believe are some of the lessons we can already learn from Enron – for our firm, for the accounting profession, and for all participants in the financial reporting system.

Let me start by telling you what we know about three particular accounting and reporting issues:

- the restatements caused by the consolidation of two Special Purpose Entities, known as SPEs, and the recording of previously "passed" adjustments as a required byproduct of the restatement;

- a $1.2 billion reclassification in the presentation of shareholders' equity during 2001 – of which $172 million was misclassified in the audited 2000 financial statement, and;

- the company's disclosures about its off-balance-sheet transactions and related financial activities.

I want to emphasize that my remarks are based on the information that is currently available. We have made our best efforts to be complete and accurate in describing what we know. But our review, like the work of the SEC, this Committee, Enron's board, and others, is not yet complete. It is always possible that new information could be developed that would change current understanding of events or uncover new events.

Consolidation of Special Purpose Entities

Let me begin with the Special Purpose Entities. SPEs are financing vehicles that permit companies, like Enron, to, among other things, access capital or to increase leverage without adding debt to their balance sheet. Wall Street has helped companies raise billions of dollars with these structured financings, which are well known to analysts and sophisticated investors.

Two SPEs were involved in Enron's recent restatement announcement. On one, the smaller of them, we made a professional judgment about the appropriate accounting treatment that turned out to be wrong. On the one with the larger impact, it would appear that our audit team was not provided critical information. We are trying to determine what happened and why.

Let's begin with the larger SPE, an entity called Chewco. What happened with Chewco accounted for about 80 percent of the SPE-related restatement.

In 1993, Enron and the California Pubic Employees Retirement System (Calpers) formed a 50/50 partnership they called Joint Energy Development Investments Limited, or JEDI for short. Among other factors, the fact that Enron did not control more than 50 percent of JEDI meant that

that partnership's financial statements could not be consolidated with Enron's financial statements under the accounting rules. In 1997, Chewco bought out Calpers' interest in JEDI. Enron sponsored Chewco's creation as an SPE and had investments in Chewco.

The rules behind what happened are complex, but can be boiled down to this. The accounting rules dictate, among other things, that unrelated parties must have residual equity equal to at least 3 percent of the fair value of an SPE's assets in order for the SPE to qualify for non-consolidation. However, there is no prohibition against company employees also being involved as investors, provided that various tests were met, including the 3 percent test.

In 1997, we performed audit procedures on the Chewco transaction. The information provided to our auditors showed that approximately $11.4 million in Chewco had come from a large international financial institution unrelated to Enron. That equity met the 3 percent residual equity test. However, we recently learned that Enron had arranged a separate agreement with that institution under which cash collateral was provided for half of the residual equity.

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What happened?

Very significantly, at the time of our 1997 procedures, the company did not reveal that it had this agreement with the financial institution. With this separate agreement, the bank had only one-half of the necessary equity at risk. As a result, Chewco's financial statements since 1997 were required to be consolidated with JEDI's which, in a domino effect, then had to be consolidated in Enron's financial statements.

It is not clear why the relevant information was not provided to us. We are still looking into that. On November 2, 2001, we notified Enron's audit committee of possible illegal acts within the company, as required under Section 10A of the Securities and Exchange Act.

Now, about the second SPE structure; specifically, a subsidiary of the entity known as LJM1. This transaction was responsible for about 20 percent -- or $100 million -- of Enron's recent SPE-related restatement.

In retrospect, we believe LJM1's subsidiary should have been consolidated. I am here today to tell you candidly that this was the result of an error in judgment. Essentially, this is what happened:

After our initial review of LJM1 in 1999, Enron decided to create a subsidiary within LJM1, informally referred to as Swap Sub. As a result of this change, the 3 percent test for residual equity had to be met not only by LJM1, but also by LJM1's subsidiary, Swap Sub.

In evaluating the 3 percent residual equity level required to qualify for non-consolidation, there were some complex issues concerning the valuation of various assets and liabilities. When we reviewed this transaction again in October 2001, we determined that our team's initial judgment that the 3 percent test was met was in error. We promptly told Enron to correct it.

We are still looking into the facts. But given what we know now, this appears to have been the result of a reasonable effort, made in good faith.

Adjustments previously not made to Enron's 1997 financial statement

As a result of the restatement for the SPEs, Enron was required to address proposed adjustments to its financial statements that were not made during the periods subject to restatement. Questions have been raised about certain of these "passed adjustments." Let me address that issue next.

As part of the audit process, the auditor proposes adjustments to the company's financial statements based on its interpretation of Generally Accepted Accounting Principles (GAAP). A company's decision to decline to make proposed adjustments does not mean that there has been an intentional effort to misstate. If the auditor believes that the company's actions result in either an intentional error or a material misstatement, it may not sign the audit opinion.

Often, there is a timing issue to consider. These adjustments typically are proposed by the auditor at the conclusion of the audit work – usually one or two months after the close of the year-end. Some companies, like Enron, choose to book those adjustments in the year after the auditor identifies them, when they are immaterial.

Questions have been raised about $51 million in adjustments not made in 1997 when Enron reported net income totaling $105 million. Some have asked how adjustments representing almost half of reported net income could have been deemed to be immaterial.

Auditing standards and SEC guidance say both qualitative and quantitative factors need to be considered in determining whether something is material. The Supreme Court has described this approach as the "total mix" of information that auditors must consider.

In 1997, Enron had taken large nonrecurring charges. When the company decided to pass these proposed adjustments, our audit team had to determine whether the company's decision had a material impact on the financial statements. The question was whether the team should only use reported income of $105 million, or should it also consider adjusted earnings before items that affect comparability – what accountants call "normalized" income?

We looked at "the total mix" and, in our judgment, on a quantitative basis, the passed adjustments were deemed not to be material, amounting to less than 8 percent of normalized earnings. Normalized income was deemed appropriate in light of the fact that the company had reported net income of $584 million one year earlier, in 1996, $520 million in 1995 and $453 million in 1994.

It is also important to remind you that the restatement analysis presented in Enron's recent 8-K filing was not audited. When Enron's audited restatement is issued, the $51 million in adjustments presented in 1997 will be reduced for the effect of adjustments proposed in 1996, which were recorded in 1997.

Reclassification of $1.2 billion of shareholders' equity

Now let me turn to the issue of shareholders' equity. Shareholders' equity was incorrectly presented on Enron's balance sheet last year and in two unaudited quarters this year.

Auditors do not test every transaction and they are not expected to. To do so would be impractical and would be prohibitively expensive. EnronOnline alone handled over 500,000 transactions last year.

Auditing standards require an audit scope sufficient to provide reasonable – not absolute -- assurance that any material errors will be identified. This testing is based on a cost-effective and proven technique known as sampling. If appropriate accounting is found in a properly chosen sample, this generally provides reasonable assurance that the accounting for the whole population of transactions has been done in accordance with GAAP and is free of material misstatement.

Shareholders' equity was initially overstated last year for a transaction with a balance sheet effect of $172 million. This amount was recorded as an asset, but should have been presented as a reduction in shareholders' equity. That amount, $172 million, was less than one third of one percent of Enron's total assets and approximately 1.5 percent of shareholders' equity of $11.5 billion. It was a very small item relative to total assets and equity and had no impact on earnings or cash flow. Accordingly, the transaction fell below the scope of our audit.

In the first quarter of this year, Enron accounted for several more transactions in a similar way, increasing the size of the incorrect presentation of shareholders' equity by about $828 million.

The quarterly financial statements of public companies are not subject to an audit, and we did not conduct an audit of Enron's quarterly reports. Consistent with the applicable standards, our work primarily was a limited review of the company's unaudited financial statements.

In the third quarter, Enron closed out the transactions that included the $172 million and the $828 million equity amounts, and we and Enron reviewed the associated accounting. This review included third-quarter impacts on the profit and loss statement and on the balance sheet. This is when the erroneous presentation of shareholders' equity came into focus.

We had discussed the proper accounting treatment for similar types of transactions with Enron's accounting staff, and therefore, the scope of our work on the year 2000 audit and this year's quarterly reviews did not anticipate this sort of error. When we informed the company of the error, the company made the necessary changes in its financial statements.

Questions about disclosure

Questions have been raised about the sufficiency of Enron's disclosures, especially about unconsolidated entities. I ask you to keep in mind that the company disclosed in its financial statements that it was using a number of unconsolidated structured financing vehicles. Unconsolidated means, by definition, that the assets and liabilities of these entities were not recorded in Enron's financial statements. However, in certain circumstances, footnote disclosures are required.

With that disclaimer, let me offer one man's view of what investors were told. Enron had hundreds of structured finance transactions. Some were simple; others, very complex. The company did not disclose the details of every transaction, which is acceptable under GAAP, but it did disclose those involving related parties and unconsolidated equity affiliates.

- JEDI and other entities are listed in footnote nine of Enron's 2000 annual report.

- LJM1 and LJM2, involving the company's former CFO, both were described in the 1999 and 2000 annual reports and described more fully in its annual proxy statements.

In footnote 11 to the 2000 annual report, Enron also disclosed under the heading "Derivative Instruments" that it had derivative instruments on 12 million shares of its common stock with JEDI and 22.5 million with related parties.

Some people say we should have required the company to make more disclosures about contingencies, such as accelerated debt payments, associated with a possible decline in the value of Enron's stock or changes in the company's credit rating.

I ask you to keep in mind that the company's shares were coming off near record levels when we completed our audit for 2000. No one could have anticipated the sudden, rapid decline we

witnessed in this stock and its credit ratings, and accounting rules don't require a company to disclose remote contingencies.

That said, we continue to believe investors would be better served if our accounting rules were changed to reflect the risks and rewards of transactions such as SPEs, not just who controls them. Putting more of the assets and liabilities that are at risk on the balance sheet would do more than additional disclosure ever could. We have advocated changes in these accounting rules since 1982.

I offer an additional observation about Enron's disclosures. Press reports indicate that some who analyzed the company's public disclosures came to the conclusion that perceptions about the company – and thus the market's valuation of Enron – were not supported by what was in the company's public filings.

Fees paid to Andersen

Some are questioning whether the size of our fees, $52 million, and the fact that we were paid $27 million for services other than the Enron audit, may have compromised our independence at Enron. I understand that the size of fees might raise questions, and I think our profession must be sensitive to that perception.

With that in mind, I think it would be helpful for the Committee to have a deeper understanding of the nature of the work we did for Enron, and how the fees for that work were reported.

As a starting point, it is important to recognize that Enron was a big, complex company. Enron had $100 billion in sales last year. It operated 25,000 miles of interstate pipeline and an 18,000-mile global fiber optic network. Enron did business in many countries. Its EnronOnline trading system was the world's largest web-based eCommerce system and handled more than half a million transactions last year – for 1,200 products. Enron was the seventh largest company on the Fortune 500.

This was not a simple company. It was not a simple company to audit. In addition to its operations and trading, Enron, as we know, engaged in sophisticated financial transactions. Not a few, but hundreds. Assets worldwide totaled $65 billion, both before and after Enron adjusted for the restatements

Given this complexity, it should not surprise anyone that the fees paid to our firm for Enron's audit were substantial. The $25 million we were paid for Enron's audit last year is comparable to the amounts that General Electric and Citigroup, two sophisticated financial services providers,

paid for their audits. It is slightly more than the audit fees paid by two others -- JPMorgan Chase and Merrill Lynch.

Because of the way the fee categories for new proxy statement disclosures on auditor fees were defined, many services traditionally provided by auditors – and in many cases *only* provided by auditors – now are classified as "Other." Regrettably, without knowledge of the underlying facts, this leads some to believe that such fees are for "consulting" services.

In fact, $2.4 million of the $27 million in "Other" fees reported by Enron last year related to work we did on registration statements and comfort letters. This is work only a company's audit firm can do.

Another $3.5 million was for tax work, which has never even been mentioned as a conflict with audit work. Audit firms almost always do tax work for clients.

Another $3.2 million of the "Other" fees Enron paid us last year related to a review of the controls associated with a new accounting system – a service highly relevant to the auditor's understanding of the company's financial reporting system. Another Big Five firm installed that financial accounting system -- for about $30 million.

Finally, $4 million of the fees listed as having been paid to Andersen were, in fact, paid to Andersen Consulting, now known as Accenture. As most of you know, our firms formally separated last August and had been operating as independent businesses for some time. Nevertheless, the rules said Enron had to report any fees it paid to Andersen Consulting as having been paid to its audit firm.

If you take all these factors into account, the total fees that Arthur Andersen received from Enron last year amounted to $47.5 million. And of this, about $34.2 million, or 72 percent, was audit-related and tax work. Total fees for other services paid to our firm amounted to $13.3 million. This was for several projects, none of which was for systems implementation or for more than $3 million.

Some may still assert that even $13 million of consulting work is too much – that it weakens the backbone of the auditor. There is a fundamental issue here. Whether it's consulting work or audit work, the reality is that auditors are paid by their clients. For our system to work, you and the investing public must have confidence that the fees we are paid, regardless of the nature of our work, will not weaken our willingness to do what is right and in the best interest of the investors as represented by the audit committee and the board.

I do not believe the fees we received compromised our independence. Obviously, some will disagree. And I have to deal with the reality of that perception. I am acutely aware that our firm must restore the public's trust. I do not have all the answers today. But I can assure you that we are carefully assessing this issue and will take the steps necessary to reassure you and the public that our backbone is firm and our judgment is clear.

Lessons for the Future

When a calamity happens, it is absolutely appropriate to ask what everyone involved could have done to prevent it. By asking the other witnesses and me to testify today, the committee is working hard, in good faith, to understand the issues involved and to help prevent a recurrence with another company.

I believe that there is a crisis of confidence in my profession. This is deeply troubling to me, as I believe it is a concern for all of the profession's leaders and, indeed, all of our professionals. Real change will be required to regain the public's trust.

Andersen will have to change, and we are working hard to identify the changes that we should make.

The accounting profession will have to reform itself. Our system of regulation and discipline will have to be improved. I discussed some of the issues that the profession faces in an op-ed in the *Wall Street Journal* last week, which is attached to my testimony.

Other participants in the financial reporting system will have to do things differently as well – companies, boards, audit committees, analysts, investment bankers, credit analysts, and others.

We all must work together to give investors more meaningful, relevant and timely, information.

But our work starts with our firm. We are committed to making the changes needed to restore confidence.

A day does not go by without new information being made available, and I would observe that all of us here today -- and many others who are not here -- have a responsibility to seek out and evaluate the facts and take needed action. My firm, and I personally as its CEO, will continue to do our part. I hope that my participation today has been helpful to your efforts.

Thank you.

OFFICE OF THE VICE PRESIDENT

WASHINGTON

January 3, 2002

The Honorable Henry A. Waxman
House of Representatives
Washington, D.C. 20515

Dear Representative Waxman:

This is in response to your inquiry by letter of December 4, 2001 about meetings between the Vice President or the former National Energy Policy Development Group's ("Group") support staff and representatives of the Enron Corporation during the preparation of the National Energy Policy that was published on May 17, 2001. The Enron Corporation announced on December 2, 2001 that Enron and certain of its subsidiaries had filed voluntary petitions for reorganization under Chapter 11 of Title 11 of the U.S. Code in the U.S. Bankruptcy Court for the Southern District of New York. Your letter stated that you viewed it as appropriate to ask whether Enron had communicated "information about its precarious financial position" in any meetings.

Enron did not communicate information about its financial position in any of the meetings with the Vice President or with the National Energy Policy Development Group's support staff. These meetings are described below.

As the Vice President mentioned in his interview on the *Frontline* program on May 17, 2001, the Vice President met with Mr. Kenneth L. Lay, chairman and chief executive officer of the Enron Corporation. The meeting occurred on April 17, 2001 and lasted for about a half-hour. They discussed energy policy matters, including the energy crisis in California, and did not discuss information concerning the financial position of the Enron Corporation.

The National Energy Policy Development Group, which existed from January 29, 2001 to September 30, 2001, had a support staff. As you may recall from my letter to you of May 4, 2001, individuals on the Group support staff met, prior to issuance of the National Energy Policy, with many individuals to gather information relevant to the Group's work. The Group's support staff held such meetings with a broad representation of people potentially affected by the Group's work, including individuals involved with companies or industries (e.g., in the electricity, telecommunications, coal mining, petroleum, gas, refining, bioenergy, solar energy, nuclear energy, pipeline, railroad and automobile manufacturing sectors); environmental, wildlife, and marine advocacy; State and local utility regulation and energy management; research and teaching at universities; research and analysis at policy organizations (i.e., think-tanks); energy consumers, including consumption by businesses and individuals; major labor unions; and many Members of Congress or their staffs.

Included among those with whom the Group's support staff met were representatives of the Enron Corporation. The Executive Director of the support staff met on February 22 and March 7, 2001 with Enron representatives and reports that they discussed energy policy matters and did not discuss information concerning the financial position of the Enron Corporation. On April 9, 2001, Group support staff held a meeting with about two dozen representatives of various utilities, which was known to include an Enron representative and which did not involve discussion concerning the financial position of the Enron Corporation.

Two additional meetings occurred after publication of the National Energy Policy, one of which was after the termination of the Group. The Deputy Executive Director of the support staff met on August 7, 2001 with officials of an Enron German subsidiary and reports that they discussed energy policy matters and did not discuss information concerning the financial position of the Enron Corporation. An employee on the Vice President's staff, who previously was the Executive Director of the Group's support staff, met on October 10, 2001 with Enron representatives and reports that they discussed energy policy matters and did not discuss information concerning the financial position of the Enron Corporation.

To summarize, as the above information reflects, during the period that the National Energy Policy was in formulation, the Vice President had only one meeting with Mr. Lay, which was the meeting that the Vice President mentioned on television in May. During the same period, the National Energy Policy Development Group's support staff, which had meetings with a broad range of individuals involved in energy matters, had two meetings with Enron representatives, plus a meeting with utility representatives that included an Enron representative. Also described above were two staff-level meetings that occurred well after issuance of the National Energy Policy. None of these meetings included discussion of the financial position of the Enron Corporation.

I note for your information that the Vice President and Mr. Lay of Enron Corporation both served on a panel on June 24, 2001 at the American Enterprise Institute World Forum in Beaver Creek, Colorado. The panel was widely attended and addressed energy matters. There was no discussion of information concerning the financial position of Enron Corporation.

Your letter mentioned a number of Federal officials not employed by the Office of the Vice President. To the extent you wish to inquire about their official activities, I would respectfully refer you to their employing departments, agencies or offices.

The information above is provided to you as a matter of comity between the legislative and executive branches, with due regard for the constitutional separation of powers, and reserving all legal authorities and privileges that may apply. It is our hope that submission of the information will help you avoid the waste of time and taxpayer funds on unnecessary inquiries.

Sincerely,

David S. Addington

David S. Addington
Counsel to the Vice President

ONE HUNDRED SEVENTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON GOVERNMENT REFORM

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WASHINGTON, DC 20515–6143

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January 10, 2002

The Honorable John Ashcroft
Attorney General
U.S. Department of Justice
950 Pennsylvania Avenue, NW
Washington, D.C. 20530

Dear Attorney General Ashcroft:

According to press reports, the Justice Department's criminal division in Washington, D.C., has opened an investigation of Enron Corporation. This is a significant step in ensuring that the very serious allegations of fraud and self-dealing that have been leveled against the company and its officers and directors are thoroughly investigated and, if appropriate, prosecuted. The Department's investigation can help to shed light on the mysterious events surrounding the sudden collapse of the seventh-largest company in the country.

As welcome as the Department of Justice's involvement is, it raises an awkward question regarding your own personal background with Enron. As you know, during your last election campaign in 2000, Enron was one of your largest contributors. In total, you received $55,000 from Enron's PAC and Kenneth Lay, the CEO of Enron. On October 31, 2000, just one week before the election, Mr. Lay himself gave $25,000 to the "Ashcroft Victory Committee." The amount of Mr. Lay's contribution was many times greater than the maximum allowable contribution by individuals to federal candidates, which is just $2,000, and it appears to have been given in a manner that many campaign finance experts believe thwarted the intent of election laws.[1]

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[1]According to FEC filings, the Ashcroft Victory Committee was "a joint fundraising committee of Ashcroft 2000 and the National Republican Senatorial Committee" that "maintains both federal and nonfederal accounts." Letter from Beth Lyndon, Treasurer, Ashcroft Victory Committee to Kenneth A. Davis, Reports Analyst, Federal Elections Commission (Apr. 27, 2000). The public interest group Common Cause has written that this unusually structured committee was "designed to raise illegal 'soft money' into [your] campaign" and succeeded in raising money that exceeded federal contribution limits. Letter from Scott Harshbarger, President, Common Cause, and Fred Wertheimer, President, Democracy 21 to Sen. Patrick Leahy (Jan. 16, 2001).

There have also been reports that Mr. Lay hosted a fundraiser for you in 1998, when you were running for the Republican presidential nomination,[2] and that Mr. Lay has been a contributor to your campaigns since 1994, when you first ran for U.S. Senate.[3]

At this time, I am not writing to recommend a specific course of action for you, but rather to seek your thoughts about the impact of your previous association with Enron. The Justice Department's Manual for U.S. Attorneys provides that "[w]here there is the appearance of a conflict of interest, the United States Attorney should consider a recusal."[4] I am interested in your views on whether your previous connections with Enron would pose either a "conflict of interest" or an "appearance of a conflict of interest" that would warrant a recusal. I would also like to know whether you are considering other measures to ensure the impartiality of the Enron investigation.

In the past, when conflict-of-interest concerns were raised regarding Enron, the White House Counsel's Office summarily dismissed the issue and refused to provide relevant information. For example, the White House Counsel's Office has consistently denied my repeated requests to provide details about the contacts that Karl Rove, Senior Advisor to the President, had with Mr. Lay while Mr. Rove held over $60,000 of Enron stock.

I hope that you will take a different approach. The Enron collapse is a scandal of significant proportions. It clearly warrants thorough investigation by the Justice Department and congressional committees. At a minimum, I would hope that you would immediately fully disclose your past background and contacts with Enron and seriously consider whether it is appropriate for you to be involved in the criminal investigation of Enron.

Sincerely,

Henry A. Waxman
Ranking Minority Member

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[2] *Local Elections Can Alter Number of Votes in Congressional Runoffs*, Houston Chronicle (Apr. 19, 1998).

[3] According to the FEC records, Mr. Lay gave you $1,000 during your 1994 campaign for Senate. In total, the FEC records indicate that you have received over $60,000 from Mr. Lay or other Enron sources during your campaigns for federal office.

[4] U.S. Attorney's Manual at 3-2.170.

ONE HUNDRED SEVENTH CONGRESS

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January 11, 2002

The Honorable Paul H. O'Neill
Secretary of the Treasury
15th St. & Pennsylvania Ave., NW
Washington, DC 20220

The Honorable Donald L. Evans
Secretary of Commerce
14th St. & Constitution Ave., NW
Washington, DC 20230

Dear Secretary O'Neill and Secretary Evans:

I am writing to request information about your communications with Enron Chairman Kenneth L. Lay and possibly other Enron officials or representatives prior to the company's bankruptcy filing. The purpose of the request is to determine why the Administration apparently did nothing to mitigate the harm of the Enron bankruptcy to thousands of its employees and shareholders. I am also interested in knowing why it has taken so long to learn that two Cabinet Secretaries had early warning of Enron's impending bankruptcy.

News accounts of January 11, 2002, indicate that Secretary O'Neill received calls from Mr. Lay on October 28 and November 8.[1] In one or both of these calls, Mr. Lay reportedly informed Secretary O'Neill that he was concerned that Enron might not be able to meet its financial obligations and that the results could be similar to those that occurred when Long-Term Capital Management went bankrupt. Mr. Lay reportedly also had a conversation on October 29 with Secretary Evans. In this conversation, Mr. Lay apparently stated "that he was having problems with his bond rating and he was worried about its impact on the energy sector," and

[1] *Enron Asked for Help from Cabinet Officials*, Washington Post (Jan. 11, 2002); *Enron Contacted 2 Cabinet Officers before Collapsing*, N.Y. Times (Jan. 11, 2002).

that "he would welcome any support the Secretary thinks appropriate."[2] In addition, Enron President Lawrence "Greg" Whalley reportedly telephoned the Treasury Undersecretary for domestic finance, Peter Fisher, six or eight times in late October and early November.[3]

White House Press Secretary Ari Fleischer stated that as a result of your conversations with Mr. Lay, Secretary O'Neill asked Undersecretary Fisher to explore whether the "financial condition of Enron could have similar implications as Long Term Capital."[4] According to Mr. Fleischer, you decided to do nothing.[5] Mr. Fleischer stated:

> [T]he government...took a look at this from a substantive matter, from when Mr. Lay made those phone calls, and decided the appropriate step was not to intervene or take any action....This was done based on judgment of the Cabinet Secretaries and the merits, and they decided properly and wisely so, in the President's opinion, that the government should not have intervened in any way after Mr. Lay made the phone call to Secretary Evans."[6]

On December 2, Enron filed for bankruptcy. Approximately 4,000 Enron employees have been laid off, and an additional 3,500 have been placed on leave.[7] Many Enron employees have lost virtually their entire retirement accounts, which were heavily tied up in Enron stock. Numerous other investors, including many retirement plans around the country, have lost millions of dollars.

Mr. Lay's discussions with the two of you took place squarely within a lock-down period, when an estimated 12,000 participants in Enron's 401(k) plan were prevented from accessing

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[2]*Enron's Lay Sought Cabinet Officials' Help*, Wall Street Journal (Jan. 11, 2002); *Enron Chairman Warned Bush Officials on Collapse*, N.Y. Times (Jan. 10, 2002).

[3]*Enron Asked Treasury for Credit Aid*, Associated Press (Jan. 11, 2002).

[4]White House Press Briefing (Jan. 10, 2002).

[5]*Id.*

[6]*Id.*

[7]*Labor Opens ERISA Investigation of Enron Assistance to Dislocated Workers*, U.S. News and World Report (Dec. 5, 2001).

their retirement accounts and selling their plummeting Enron stock.[8] If Mr. Fleischer's representations are accurate, it would appear that no one in the Bush Administration acted on the knowledge of Enron's rapidly declining financial condition to help employees whose retirement plan collectively lost an estimated $1 billion.[9] The life savings of many Enron employees simply evaporated during this period. Moreover, based on the scant information that this Administration has provided to date, it appears that no one bothered even to ask whether any remedies, administrative or legislative, were available to help the Enron employees frozen out of their retirement accounts.

In fact, some senior Administration officials have publicly expressed surprising indifference to the fate of Enron employees and shareholders. Secretary O'Neill stated this morning that "while Enron may be important, . . . in the world that I live in, with hundreds of other things going on, this is just another piece of business."[10] The President's chief economic advisor, Larry Lindsey, called the Enron debacle a "tribute to American capitalism."[11]

In addition, accounts of your early conversations with Mr. Lay raise concerns about whether advance notice of Enron's desperate financial condition was taken into account as the Administration formulated positions on important matters of public policy. For example, throughout the month of November, you continued to advocate for retroactive repeal of the alternative minimum tax.[12] This legislation would have had dramatic implications for Enron, as it would have given the company a government-funded infusion of $254 million.[13]

Given the magnitude of the financial harm caused by Enron's collapse, and the close ties

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[8]*Fair Shares? Why Company Stock is a Burden for Many,* Wall Street Journal (Nov. 27, 2001).

[9]*See Enron Employees Enraged Over Losses,* Business Insurance (Dec. 10, 2001).

[10]Transcript of Good Morning America (Jan. 11, 2002).

[11]*Interview with Lawrence Lindsey*, Fox News Sunday Roundtable (Jan. 6, 2002).

[12]*See Deal Breaker*, New Republic (Nov. 29, 2001); *U.S. Panel Says that Recession Officially Began in March*, Business Day (Nov. 28, 2001); *Economic Aid Stalled Amid Recession*, Newsday (Nov. 27, 2001); U.S. Department of the Treasury, *O'Neill Urges Senate to Act Quickly on a Bipartisan Economic Stimulus Bill* (Nov. 8, 2001) (press release).

[13]Citizens for Tax Justice, *House GOP "Stimulus" Bill Offers 16 Large, Low-Tax Corporations $7.4 Billion in Instant Tax Rebates* (Oct. 16, 2001, updated Oct. 26, 2001).

between the company and the Bush Administration, the public deserves to know what Administration officials knew and when they knew it about the situation of Enron and its employees. Therefore, I request that the two of you individually respond to the following questions:

(1) Please provide details regarding your conversations with Mr. Lay of October 28, October 29, and November 8. Please provide any written or electronic materials held by your Department that relate to this question.

(2) Please provide details regarding Undersecretary Fisher's conversations with Mr. Whalley in October and November. Please provide any written or electronic materials held by your Department that relate to this question.

(3) Did you, any other person in your Department, or to your knowledge any other official in the Administration have any other communications with Mr. Lay or any other Enron officials or representatives in 2001, beyond those referred to in questions 1 and 2? If so, please provide names, dates, form of communication, and information exchanged or matters discussed.

(4) Upon receiving the information regarding Enron's financial situation in October, did you convey information about Enron's financial condition to any person, apart from Undersecretary Fisher? If so, please provide the names, dates, form of communication, and the information exchanged, including copies of any written or electronic materials.

(5) Did you, any other person in your Department, or to your knowledge any other official in the Administration convey this information to any person within the Vice President's office or any of the advisors to the President? If so, please provide the names, dates, form of communication, and the information exchanged, including copies of any written or electronic materials.

(6) Please provide details about Undersecretary Fisher's review. For example, over what time period did Undersecretary Fisher explore the financial implications of a potential Enron bankruptcy? What was the scope of the exploration? Did the Department of the Treasury or the Department of Commerce examine the impact of Enron's potential bankruptcy on the employees of the corporation? On the shareholders of the corporation? On other creditors of the corporation? What were your respective departments's conclusions regarding the impacts of an Enron bankruptcy on each of these groups? On the energy sector? On the financial sector? On the economy at large? Please provide any written or electronic materials held by your respective departments that relate to any of these questions.

(7) How did Undersecretary Fisher conduct this investigation? Did he or his staff communicate with any Enron officials or representatives? If so, please indicate names, dates, form of communications, and information exchanged. Did he or his staff communicate with Enron's auditors or any financial backers? Did he or his staff communicate with any financial experts outside of the Commerce or Treasury Departments? Did he or his staff communicate with any others within the Administration? Please provide any written or electronic materials held by your respective departments that relate to any of these questions.

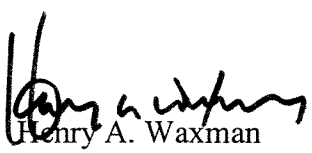
(8) At the time that you decided to take no action, had you considered the potential impacts of an Enron bankruptcy on its employees? Did you make any attempt to obtain information about the impact of such a bankruptcy on the employees?

(9) The Bush Administration continued to advocate for retroactive repeal of the corporate alternative minimum tax throughout the month of November, when repeal could have had a significant impact on Enron's financial situation. Did any Enron official or representative ask you, any other person in your Department, or to your knowledge any other official in the Administration, to support this legislation? Were you aware that Enron favored adoption of this legislation?

(10) Why did it take so long for the public to learn about your contacts with Enron prior to its bankruptcy filing?

I want to make clear that I believe it is inappropriate to make any ethical allegations against you or any other Administration official at this time. I think it is essential, however, that these questions be answered so that there is a clear public accounting of this matter. We all owe that to the thousands of families that are facing financial ruin from the Enron bankruptcy, and I hope that it will be possible for you to provide the answers I'm seeking by January 18, 2002.

Sincerely,



Henry A. Waxman
Ranking Minority Member

January 12, 2002

Mr. Kenneth L. Lay
Chairman
Enron Corporation
1400 Smith St.
Houston, TX 77002

Dear Mr. Lay:

Since December 4, 2001, my staff has been investigating the collapse of Enron Corporation. An important component of this investigation is reaching out to current and former employees who might have relevant information. I have done this through the establishment of an Internet tip line, as well as through other means.

As a result of this investigation, I have obtained some e-mails that you purportedly sent out to Enron employees about Enron's financial condition and stock price in August 2001. Copies of these e-mails are enclosed. If it is true that you sent these e-mails, then it appears that you misled your employees into believing that Enron was prospering and that its stock price would rise:

- In an e-mail apparently sent to all employees on August 14, 2001, the day that Jeffrey Skilling resigned as CEO, you stated: "**I want to assure you that I have never felt better about the prospects for the company.** All of you know that our stock price has suffered substantially over the last few months. One of my top priorities will be to restore a significant amount of the stock value we have lost as soon as possible." You concluded: "**Our performance has never been stronger; our business model has never been more robust; our growth has never been more certain**. . . . **We have the finest organization in American business today.**"[1]

- In an e-mail on August 27, 2001, to employees who received a grant of stock options, you apparently said that "one of my highest priorities is to restore investor confidence in

[1]E-mail from Ken Lay to Enron Employees Worldwide (Aug. 14, 2001) (emphasis added).

Enron. **This should result in a significantly higher stock price.**"[2]

By the time of the second e-mail, when the stock price was $37, you had already sold $40 million of Enron stock during 2001 and over $100 million since October 1998.[3] The price of Enron stock eventually fell to a low of 26 cents a share on November 30, 2001.

If these e-mails are genuine, your pronouncements about Enron's financial condition and stock price stand in stark contrast to what is now known about Enron's precarious situation. They also stand in stark contrast to the statements you made to Secretary of the Treasury Paul H. O'Neill nine weeks later about Enron's dire financial condition. At a minimum, they create the appearance that you misled Enron employees about the value of their investments in Enron and the security of their jobs. If this were accurate, it would be a gross betrayal of your employees' trust, as well as possibly illegal conduct.

Clearly, the statements in these e-mail messages require further investigation. For this reason, I request that you:

(1) Please verify whether you sent the enclosed e-mails;

(2) If the e-mails are genuine, please explain whether you were aware when you sent them of Enron's financial vulnerabilities. If you were not aware of this, please explain whether this was because Jeffrey Skilling or other executives withheld that information from you;

(3) Please provide me with all records of internal Enron communications, including e-mails and videotapes, between August 14, 2001, and December 2, 2001, assessing the value of Enron's stock price or Enron's financial condition; and

(4) Please provide me with copies of all public statements by Enron executives between August 14, 2001, and December 2, 2001, regarding the value of Enron's stock price or Enron's financial condition.

I would also like to know about your decision to prevent participants in Enron's 401(k) plan from accessing their retirement accounts and selling their plummeting Enron stock. For this reason, I request that you provide all information relating to Enron's decision to establish the 401(k) lock-down. According to the *Wall Street Journal*, this lock-down began on October 17,

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[2]E-mail from Ken Lay to Unnamed Employee (Aug. 27, 2001) (emphasis added).

[3]Class Action Complaint for Violations of the Federal Securities Laws, *Amalgamated Bank, et al., v. Kenneth Lay, et al.* (S.D. Tex. 2000).

2001, the day after Enron first revealed its financial difficulties.[4]

Finally, I would like you to explain why, after you allegedly sent the e-mails and subsequently spoke to Secretary O'Neill -- and as the company's stock continued to fall -- you still sought a $60-million severance package from Enron. As you will remember, when Enron employees objected to this, you proposed reducing your package to $40 million.[5] When Enron employees objected to that proposal, you finally decided in mid-November not to accept this compensation.[6]

I think it is essential that this information be provided so that there is a clear public accounting of this matter. We all owe that to the thousands of families that are facing financial ruin from the Enron bankruptcy. Accordingly, I would appreciate your providing this information by the close of business, January 18, 2002.

Sincerely,

Henry A. Waxman
Ranking Minority Member

Attachments

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[4]*Fair Shares? Why Company Stock is a Burden for Many*, Wall Street Journal (Nov. 27, 2001).

[5]*Enron CEO Says No to $60.6 Million*, Washington Post (Nov. 14, 2001).

[6]*See id.; Lay To Forgo $60M Severance,* Gas Daily (Nov. 15, 2001); *Enron Chief Nixes $60 Million; Lay Decides Against Accepting Severance Package*, San Antonio Express-News (Nov. 14, 2001).

To: David B. Duncan@ANDERSEN WO
CC:
BCC:
Date: 10/12/2001 08:56 AM
From: Michael C. Odom
Subject: Document retention policy
Attachments:

More help.

---------- Forwarded by Michael C. Odom on 10/12/2001 10:55 AM

To: Michael C. Odom@ANDERSEN WO
cc:
Date: 10/12/2001 10:53 AM
From: Nancy A Temple, Chicago 33 W. Monroe, 50 / 11234
Subject: Document retention policy

Mike-
It might be useful to consider reminding the engagement team of our documentation and retention policy. It will be helpful to make sure that we have complied with the policy. Let me know if you have any questions.

Nancy

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