STATEMENT

Asleep at the Switch:

Chairman Joe Lieberman

Tuesday, November 12, 2002

Today we continue a series of Senate Governmental Affairs Committee hearings on what federal and private sector watchdogs did and did not do to expose and prevent the unethical and probably illegal behavior of Enron Corporation in the months and years leading up to the company's collapse. Our goal from the beginning of this investigation last January has been to determine whether federal agencies and others responsible for safeguarding our markets did all they could to prevent this economic catastrophe from occurring so that we can act now to prevent another such catastrophe from occurring again.

Today we focus on the role of an agency that had direct regulatory responsibility over Enron's energy business, the Federal Energy Regulatory Commission. The majority staff of this Committee has completed an exhaustive investigation into FERC's role, and in my judgment what they have found is an embarrassing and unacceptable story of governmental failure. Again and again, FERC failed to ask critical questions about Enron's business practices—questions that might have exposed the fissures in Enron's fiscal foundation sooner and spared investors, employees, and consumers some of the pain they have endured. Or in the few cases when they did ask the pertinent questions, the people at FERC settled for incomplete or incorrect answers.

The Committee's investigation has found the most egregious examples of lax FERC oversight in four areas: one, the company's treatment of certain wind farms and the special rate status for them which Enron tried to preserve; two, the operation of Enron Online—Enron's electronic trading platform—which it now appears Enron may have leveraged to its unfair advantage against customers in the marketplace; three, the handling of transactions between Enron and its affiliated companies; and four, Enron's actions during the West Coast energy crisis last year, which raised electricity prices in California, Oregon, Washington, and other Western states by billions of dollars, and which have come under fresh scrutiny because of the guilty plea last month by former Enron energy trader Timothy Belden.

In these four cases, FERC's oversight ranged from naive at best, to negligent at worst.

First, the agency more often than not trusted Enron's assertions rather than questioning them.

Indeed, in some cases it failed to pursue questions even when Enron offered sufficient and specific evidence of potential abuses in documents submitted directly to the agency.

For example, when Enron applied to obtain a special, beneficial rate status on a number of wind farms that it had acquired, and in those applications included many details that should have raised red flags at FERC, the agency failed to subject that application to anything but a superficial review. Enron itself was not, under the regulations, permitted to own the windfarms—but FERC was told, among other things, that Enron was providing the financing to the new "owner" of the projects, that Enron would retain a right to repurchase the projects, and that Enron would indemnify the new "owner" for tax liabilities

incurred when it was repurchased. Despite FERC knowing all this, the agency approved the ownership arrangement and the special rate status was granted.

Then, when Enron sought to have the special rate status extended, it submitted a "self-recertification," which—like all such self-certifications FERC receives—the agency never reviewed at all. It simply filed the application away and allowed Enron to claim the special status. Only now, after this Committee's investigation raised questions about FERC's handling of these transactions, has FERC opened an investigation into Enron's original claims.

The government did not create, empower, and fund FERC so that it could be a filing cabinet. We created it to protect consumers, ensure just and reasonable energy rates, and create a level playing field for all businesses and utilities—a role that is more crucial than ever in newly deregulated markets.

Second, the agency failed to anticipate or prepare for changes in the energy markets, which are among the most volatile and rapidly evolving sectors of our economy.

Americans expect our lead regulatory agencies, which we depend upon to keep the economy fair and efficient, to anticipate major trends and stay on top of where the economic markets they monitor are headed.

Despite questions about whether FERC had the authority to regulate Enron Online and other electronic trading platforms—which had grown into a powerful force by the year 2000 and were expected to dominate energy trading within a few more years—FERC failed to even complete the jurisdictional memo that would have been the starting point for any long-term public policy strategy about how to handle this transformation.

Third, FERC reacted belatedly to many serious offenses, letting possible market abuses go uncorrected and unchallenged for many months.

Too often, in place of effective oversight, the agency offered timid hindsight. For instance, in November 2000 a FERC staff investigation into the causes of the California energy crisis concluded that power sellers had the potential to manipulate the power market. After coming to that obvious conclusion—which cried out for follow-up—it took over a year for FERC to launch an investigation into the market behavior of individual companies during the California energy crisis—and that was only after Enron's collapse.

FERC's response, to be blunt, emphasized the word "late" in "regulate"—very late.

That is unacceptable. Energy consumers on the West Coast should have had the federal government on their side during the energy crisis in 2000—not six months or a year later. And the companies who may have tried to manipulate the market, or may be thinking about doing it in the future, need to understand that FERC will be a sharp and sophisticated watchdog—not a listless and lackadaisical bystander.

Remember: FERC is the regulatory agency that, alongside Enron and others, led the charge toward widespread deregulation of the energy business. So it is particularly ironic and irresponsible that FERC exhibited no vigilance to ensure that everyone obeyed rules of fair play in the deregulated marketplace the agency itself had helped to create.

Oftentimes, FERC seemed to view itself not as a regulator but as a facilitator—not as a market cop, but as a market cheerleader, which left consumers without protection.

FERC's failure here is akin to raising the speed limit on our highways without putting any state troopers on the road to catch reckless drivers. When market players are given unprecedented latitude in a previously regulated market, there simply must be effective checks and balances. No matter how passionately we believe in capitalism as the best system for economic growth and opportunity, the invisible hand cannot do it all. Markets have no conscience. To ensure markets of integrity, as well as efficiency, as well as profit, that invisible hand needs to be assisted by the firm hand of government oversight in the name of ethics.

Fourth, FERC made no effort to address the gaps, flaws and inadequacies in the regulatory structure that allowed Enron's most questionable business practices to go without scrutiny.

For example, Enron had applied to the SEC requesting a special exception to the Public Utility Holding Company Act. Under FERC's rules, simply requesting such an exception allowed Enron to repurchase a number of its wind farms while maintaining their special rate status—status that would otherwise not have been available to a utility holding company such as Enron—and apparently allowed it to earn tens of millions of dollars above what it would otherwise have earned from these projects.

For more than two and a half years, the SEC sat on that application without reviewing it. Did anyone at FERC pick up the phone and ask the SEC about the status of these applications? Did the two lead regulatory agencies—FERC and the SEC—ever talk to each other about these applications? The sad answer is, "No."

It's frustrating enough when major market abuses escape government regulation because perpetrators are crafty enough to fly under the government radar. But it's infuriating when big blips are right there on the screen and the people manning the stations don't bother to open their eyes. FERC and the SEC had the opportunity—indeed, the duty—to reconcile this regulatory blind spot to make sure that no companies could exploit it. But the agencies languished. They let the blind spot linger. And consumers paid the price.

Fifth, FERC all too often relied on shortcuts and cursory analysis of the markets to come to overly optimistic conclusions about the potential effects of market manipulation.

An internal FERC staff report into the Enron Online trading platform, released in August 2001, asked whether the possibility of financial problems at Enron could threaten the energy markets. Its answer—"no"—was based on incomplete and unrealistic assessments. First, FERC looked at the entire North American energy market rather than individual, regional markets. Second, the report concluded that the chance of Enron failing financially was, in any event, remote. And though the same report recognized the competitive advantage Enron Online gave to Enron's own trading units, it ultimately concluded that these advantages presented no cause for concern. FERC's staff itself later found this conclusion to be wrong.

FERC's slipshod analysis is especially indefensible because Enron was not simply another player in our energy markets. By the time of its collapse, Enron had grown to become the seventh largest company in the nation—the largest electricity and natural gas trading company—and a company that made no secret of its ambitions to grow even larger.

In addition to the specific questions at stake with Enron, and any other corrupt company that may seek to follow in its path, there is a broader policy question at

stake here. Can deregulated markets be left to police themselves, or does government need to become more vigilant in ferreting out abuses than it has been? The results of this investigation answer that question definitively: unregulated and unprotected energy markets are a recipe for disaster for consumers and businesses that need to buy energy.

This is about more than assigning blame for the past. It's about learning lessons for the future. This country consumes more and more energy all the time. The American people need energy markets that serve them fairly, transparently, and efficiently—in every sector and in every region.

Our economy cannot function without power. And our federal regulators, on whom the people depend for protection, cannot protect those markets if they systematically fail to exercise the powers we give them to do their job.

Senator Thompson?