STATEMENT OF HERBERT S. WINOKUR, JR.

Before the Permanent Subcommittee on Investigations
Committee on Governmental Affairs
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Chairman Levin, Senator Collins, and Members of the Subcommittee. Good morning, and thank you for the opportunity to address the Subcommittee.

My name is Herbert S. Winokur, Jr. I currently am a member of the Board of Directors of Enron Corporation. I have served as the Chairman of the Finance Committee of the Board of Directors of Enron. I have been a member of the Board since the mid-1980s. I volunteered for and served as a member of the Board's Special Investigations Committee (the "Powers Committee") to attempt to understand what happened at Enron.

I. INTRODUCTION

I appreciate the opportunity today to talk with the members of this Subcommittee about the involvement of Enron's directors in the related party transactions that have received so much attention, and about our oversight of Enron more generally. My colleagues will address issues related to accounting of and internal controls regarding these transactions, management compensation, and other matters concerning the directors. Attached as an appendix to this statement are excerpts from Enron's Board of Directors' meeting minutes that document some of my comments in the following paragraphs.

I will discuss shortly the basis on which the Board approved and sought to control the LJM transactions. But, in my opinion, one of the principal causes of Enron's failure was the loss of lender and investor confidence that resulted from the three significant restatements to Enron's financial statements presented in October and November 2001. Two related to earnings restatements for four and two years, respectively, and the third a significant reduction in shareholder equity. The first two derived from inadequate outside equity capitalization (to permit deconsolidation) in two special purpose entities of $6 million and $25 million respectively. The third derived from a presentation change from grossing up certain assets and liabilities to netting them. While a related party was involved in each transaction, the related party aspect does not appear to have been a factor in any of the accounting errors.

In none of these three restatements did the Board – or its Audit Committee – have any prior knowledge (except immediately prior to their disclosures) of the errors which were required to be corrected. In each case, Enron's management had approved the financial statement presentations and, as appropriate, Arthur Andersen had certified or reviewed the presentations. How and why these errors occurred are the subjects of several government investigations. As I said above, I believe that the loss of investor confidence in Enron and its management that resulted from these accounting restatements was a significant contributing factor to Enron's downfall.

With that in mind, I would like to turn to a general discussion of three areas.

- The first is to describe how the Enron Board of Directors and the Finance Committee went about discharging its obligations.
- The second summarizes the specific circumstances in which we approved the LJM structures and the controls we put in place to ensure that these transactions remained in the best interests of the Company.
- Finally, I will address certain of the hedging transactions that the Board approved and that have come under so much criticism.

II. DISCUSSION

A. The Board of Directors and the Finance Committee of Enron

Enron's Board of Directors was composed of 12 independent directors and two inside directors, Kenneth Lay and Jeffrey Skilling. As a Board, we worked to help move Enron into a new business environment characterized by increased globalization of investment, increased sophistication in the capital markets, and rapid regulatory and technological change. This new business environment required us to make certain business decisions that, at the time, made sound economic sense: undertaking initiatives in power and water deregulation, entering into developing markets abroad, and building an extensive broadband network. Enron's expansions were hailed in the media as innovative and brilliant. Over the decade of the 1990's, Enron became the dominant company in providing electricity and gas to customers around the

world.

To some extent, as now has been learned, by early 2001 Enron's reach had exceeded its grasp. Business decisions that made sense at the time, such as the building of an extensive broadband network, or Enron's entry into developing energy markets abroad, did not work out. Other broadband companies, such as Level 3 and Qwest, have experienced severe declines in the price of their stock as the demand for bandwidth dried up. Global Crossing, another broadband company, is—like Enron—in bankruptcy. Our initiatives in power and water deregulation abroad were also less productive than we believed they would be. Other similar companies such as AES and Dynegy also have seen significant declines in their stock prices.

I raise this to make an important point. Enron, as a company, took a number of business and financial risks. These risks were disclosed by Enron. They were also recognized by the analysts and rating agencies who followed the company. To suggest otherwise is to ignore the disclosed and well-publicized facts about Enron and its business strategy.

One of the responsibilities of Enron's Finance Committee was to review regularly the Company's financial ratios and liquidity. At the Finance Committee meetings, Enron management routinely presented us with Enron's actual and projected financial ratios and near-term liquidity, a report on meetings and discussions with the credit rating agencies, and an analysis of Enron's borrowing costs relative to those of its competitors, which informed us of the market's contemporaneous view of Enron. Between meetings, we also received reports on Enron from Wall Street equity and debt analysts, including their detailed financial projections.

For example, during the February 12, 2001 Finance Committee meeting, we were told that "the Company's total liquidity was over $8.3 billion." We were also told that "there had not been any change in the Company's ratings by the rating agencies but noted that the Company was working on being upgraded to 'positive outlook' by Standard & Poors." We regarded this as a good report on the financial health of the Company. Based on the Powers Report, we have since learned, however, that during this time period, management (without Board knowledge or approval) was working to restructure the Raptor vehicles by inserting $800 million in additional equity capital. Neither the Finance Committee nor the Board was told of those efforts. The Raptor structures, in fact, never appeared on a list of the top 25 credit exposures that was presented regularly to the Finance Committee. I do not know why we were not told of the credit concerns about the Raptors. The procedures we had put in place to receive reports on significant credit exposures should have revealed this issue to us, but the required report was never made. The improper accounting related to the Raptor restructuring was one of the matters that were addressed in the October/November 2001 restatement.

The picture presented by management at the August 13, 2001 Board meeting was no different. Recurring net income for the second quarter and the six-month period was reported to be higher than plan and the prior year's levels. Debt to equity capital ratio was 46% at the end of June, about the same as the prior year, and was expected to be 42.7% by year-end.

B. Special Controls for the LJM Partnerships

I will now focus on the Finance Committee's involvement in the approval and oversight of the LJM partnerships.

The press and others have reported repeatedly that Enron's Board "waived the Code of Conduct" when it permitted Enron's Chief Financial Officer, Andrew Fastow, to serve as general partner of LJM1 and LJM2. The Board did not.

For many years before the LJM matters were brought to the Board, Enron maintained a Code of Conduct for its employees, which required each employee to certify in writing annually as to his or her compliance.

Enron's Code of Conduct permits the Chief Executive Officer to make a determination that an officer's investment does not present a conflict of interest. The Code of Conduct provides as follows:

> "The Chairman of the Board and Chief Executive Officer of Enron Corp. shall consider carefully the summary of relevant facts, and if he concludes that there appears to be *no probability of any conflict of interest* arising out of the proposed investment the officer or employee shall be so notified and may then make the proposed investment in full reliance upon the findings of the Chairman of the Board and Chief Executive Officer of Enron Corp." (emphasis added)

As the Board minutes of June 28, 1999 state, when LJM1 was approved, the Board adopted and ratified the determination by the Office of the Chairman "that participation of Andrew S. Fastow as managing partner/manager of the [LJM] partnership will not adversely affect the interests of the Company." This Board action followed a presentation describing the business purpose of LJM1 and the significant financial benefits therefrom to Enron. The Board was told that PricewaterhouseCoopers "would be rendering a fairness opinion" and that Mr. Fastow would have "no direct

pecuniary interest in the Company's stock" which provided credit support to the partnership. This transaction was disclosed in Enron's June 30, 1999 and in succeeding Form 10-Qs and 10-Ks, including the related party aspect. Arthur Andersen reviewed the transaction as part of its review of the June 30, 1999 10-Q.

At the October 10, 1999 Finance Committee meeting and the Board meeting on October 11, Mr. Fastow presented an update on the financial benefits from LJM1, and recommended, to obtain quick, flexible equity to Enron with reduced transaction costs, that he be permitted to organize LJM2, a new fund with outside investors (and him as managing partner) to be an "additional, optional source of private equity." He proposed that the Chief Accounting Officer review and approve all transactions with LJM2. The Committee, upon questioning, learned that Arthur Andersen was "fine with" the partnership structure, and that LJM2's limited partners -- expected to be institutional investors -- would be able to remove Mr. Fastow without cause. The Finance Committee augmented these controls by requiring that the Chief Risk Officer also review and approve all transactions and that the Board's Audit and Compliance Committee review all transactions annually and make any recommendations it deemed appropriate. Thereafter, upon management's recommendation, and after mandating additional controls, the Board ratified the Office of the Chairman's determination that Mr. Fastow's participation "will not adversely affect the interest of the Company." LJM2 was disclosed as a related party transaction in Enron's 1999 and 2000 Forms 10-K and the 2000 Proxy Statement.

Updates given to the Finance Committee about the LJM transactions were positive. At the May 1, 2000 Finance Committee meeting, prior to a discussion of the proposed "Raptor" hedging transaction, Mr. Fastow reported that "he had hired individuals to manage the investment vehicles [LJM1 and LJM2] and that he personally was devoting approximately three hours a week to the investment vehicles." We were also told that LJM2's investments had a "projected rate of return of 17.95%." Mr. Causey, the Chief Accounting Officer, told the Finance Committee that "Arthur Andersen, LLP had spent considerable time analyzing . . . the governance structure of LJM2 and was comfortable . . . ." We now know from the Powers Committee report that the LJM2 investors were receiving much higher returns.

The minutes of the October 6, 2000 Finance Committee show that the Finance Committee continued to focus on Mr. Fastow's dual role. Mr. Fastow described to the Committee six of the mechanisms that "*had been put in place* to mitigate any potential conflicts," (emphasis added) one of which was that "Messrs. Buy, Causey and Skilling approve all transactions between the Company and the LJM funds." A second was that Mr. Fastow maintained his fiduciary duty to Enron. In addition to the controls that Mr. Fastow described, the Committee instructed management that Mr. Fastow's compensation be reviewed by the Board's Compensation and Management Development Committee and that transactions between the Company and the LJM funds be reviewed quarterly by the Finance Committee in addition to the annual review by the Audit Committee.

The Finance Committee received its first quarterly, and the Audit and Compliance Committee received its second annual, report on the related party transactions with LJM on February 12, 2001 from the Chief Accounting Officer. Arthur Andersen was present at the Audit Committee meeting when these matters were discussed. Mr. Causey discussed the "Board-established guidelines for transacting with LJM." He then reviewed compliance with the Board guidelines, informing them that "The Company has adopted the following procedures and controls in response to the Board's direction," and listed them. Finally, he reviewed with the Committees the "Checklist review complemented by the adoption of additional controls." Mr. Causey informed the Finance Committee that the controls "had been discussed with the Audit and Compliance Committee, and commented that the process was working effectively."

The preceding, I submit, illustrates that the Board applied Enron's Code of Conduct when it ratified management's recommendation regarding LJM1 and LJM2, and added substantial additional controls to ensure that all of the Enron/LJM transactions would be in the best interests of the company. The record also indicates that the directors regularly monitored the LJM transactions and management's involvement. We asked for and repeatedly received reports which informed us that the controls were working and that there were no concerns raised either by management or our outside auditors.

C. Enron's Use of Off Balance Sheet Financing, Hedges and Forward Contracts

Enron has been criticized for its use of what are widely accepted and well-established off balance sheet financing or special purpose vehicles to raise debt and equity. This practice is common and permitted by the accounting rules (if structured correctly). Many large and well-known companies use off-balance sheet financing routinely. Leasing companies and reinsurance companies exist to provide off balance sheet financing to their customers. Enron's extensive use of off-balance sheet financing was widely known and well publicized.

The Board has also been criticized for authorizing hedge transactions that made use of Enron stock for credit

support. Let me address that criticism.

Enron had within its portfolio certain highly volatile investments, such as restricted stock of Rhythms NetConnection, a high technology company. Enron was required to use mark to market accounting on its "merchant" investments. That combination of volatile investments and mark to market accounting had the potential to create instability and unpredictability in the Company's income statement. Putting in place hedges to mitigate and stabilize those risks made good business sense. In fact, companies have been sued by their shareholders because they failed to put in place hedges on significant and volatile investments.

The Board was presented by management with a plan to hedge these investments with an under-utilized asset. We were told that Enron had significant unrealized value in forward contracts previously issued on its own stock. These forward contracts were written by Enron in order to hedge the expense of Enron's stock-based incentive compensation plan. In simple terms, Enron wrote forward contracts to purchase its stock in the future at present prices to protect itself against the risk that its stock would appreciate in value and thus make its incentive compensation plan more expensive. I understand this to be a common business practice.

Management wanted, appropriately, to use that unrealized value most effectively for the benefit of the shareholders. It informed the Board that the proposed transaction was the best way to do so. We were informed at the same time that the transaction would be the subject of a fairness opinion by PriceWaterhouse Coopers. We were also aware that Arthur Andersen would be reviewing the transaction in connection with its review of the June 30, 1999 10Q and had no reason to believe, either at the time we approved the transaction or at any subsequent time, that Arthur Andersen was troubled by the transaction or its accounting treatment.

We believed that the Raptor I transaction, which was presented to the Finance Committee on May 1, 2000, was quite similar structurally to the original LJM hedge transaction. By that time, Arthur Andersen had certified the 1999 10K, and our inside and outside attorneys had, we believed, approved the disclosure. The minutes disclose that during that meeting, Mr. Causey "stated that Arthur Andersen LLP; had spent considerable time analyzing the [Raptor] structure and the governance structure of LJM2 and was comfortable with the proposed transaction."

The use of forwards on Enron stock in Rhythms Net and the Raptor transactions was disclosed in Enron's public filings, in disclosures that we believed had been reviewed and approved by both Arthur Andersen and Vinson & Elkins, our regular outside securities counsel.

The transactions that were presented to us—and many were not—were presented as valid economic hedges of Enron's risks, using the gains in the Enron stock forward positions. I want to make clear that I never understood, and was not told, that the business purpose of entering into the LJM transactions was to create fictitious earnings. Quite the contrary, I was told that the LJM transactions were being undertaken to hedge the risks and volatility of our assets, and to assist Enron in obtaining additional third-party debt and equity capital on favorable terms to Enron shareholders to support the company's growth.

III. CONCLUSION

What happened at Enron has been described as a systemic failure. I see it instead as a cautionary reminder of the limits of a director's role. We served as directors of what was a large and complex corporation. A director's role, by its nature, is a part-time job. It also was necessarily defined by the nature of Enron's enterprise—which was worldwide in scope, employed more than 20,000 people, and engaged in a vast array of trading and global development activities.

By force of necessity, we could not know personally all of the employees. As we now know, key managers and employees whom we thought we knew proved to disappoint us significantly. And outside advisors, whom we believed to be critical components of an effective oversight role, failed in their duties.

Take, for example, the Raptor restructure. As has been disclosed in the press, on February 5, 2001, Arthur Andersen held an internal meeting in which it expressed significant concern about the credit capacity of the Raptor vehicles and the quality of the earnings being attributed to them. Just one week later, however, with full knowledge of the Raptor credit problems, Arthur Andersen assured the Audit Committee that Enron would receive a clean audit opinion on its financials. Andersen also told the Audit Committee that there were no material weaknesses in Enron's internal controls—even though one week earlier its auditors had discussed, but not shared with the Board, the fact that the controls imposed by the Board for these related party transactions were not being followed.

Had the Raptor restructure been presented to the Board, I believe the Board might well have chosen the alternative - to shut down the Raptors - which also would have by definition avoided the accounting error related to issuance of new equity which accounted for the bulk of the $1.2 billion reduction in shareholders' equity we took in October. I find the failure of management to come forward in this mater to be particularly tragic.

Arthur Andersen's failure to disclose its concerns to the Board, as well as management's marked disregard for the

required internal controls and lack of candor with respect to information owed to us, deprived the Board—and deprived me—of the ability to deal proactively with this problem. We cannot, I submit, be criticized for failing to address or remedy problems that were concealed from us.

Three months ago, days after release of the Powers' Report, I appeared before a House Subcommittee. At that time, I was deeply disturbed and disappointed with what I had read. I also squarely disagreed with certain conclusions in the Report, especially about the directors' judgment and oversight, which disagreement I expressed during my testimony. Even with the benefit of a few more months to review these issues, I remain resolute in my belief that we directors were diligent and dedicated to our charge. Based upon the recommendations, advice, and information we received from management and our advisors, we acted in good faith and attempted to pursue the best interests of Enron and its shareholders. I deeply wish, however, that at least one person—management, employee, or outside advisory - had come forward to the Board with his or her concerns when we could have addressed them.

I am prepared to respond to any questions from the Subcommittee.

Thank you.