May 14, 2002

The Honorable Pat Wood, III
Chairman
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Dear Mr. Chairman:

The Senate Governmental Affairs Committee is conducting a broad inquiry into whether the federal agencies charged with overseeing the activities of Enron Corp. appropriately discharged their regulatory responsibilities. As you know, the Federal Energy Regulatory Commission (FERC) is among the agencies whose activities we have been reviewing.

I write to express deep concern about information revealed during the course of our investigation. As discussed further below, our inquiry to date raises serious questions about whether FERC appropriately discharged its duties to monitor and regulate energy markets, followed through on warranted reviews of Enron's energy trading business, and heeded important warning signs of problems in Enron's business activities.

Specifically, the Committee's investigation has discovered that FERC launched an internal inquiry into Enron's electronic energy trading activities in May 2001—an inquiry that asked some of the right questions about Enron's market practices, but ultimately settled for incomplete, unconvincing, or incorrect answers to those questions. Equally disappointing, FERC failed to follow up on some of the most serious concerns raised in the course of its inquiry. All this occurred at a time when internal Enron documents uncovered during the Committee's investigation show the company placed a high priority on maintaining the unregulated status of its electronic trading activities. In the end, the 2001 FERC inquiry is ultimately more noteworthy for what it overlooked than for what it scrutinized, leaving consumers unprotected.

Going forward, these events add to the numerous warning flags already flying in FERC's view. As new energy markets emerge, the nation's consumers have the right to expect their government regulatory agencies to be as aggressive in protecting and promoting their interests as energy companies are in exploiting new markets. We simply cannot accept anything less than proactive and energetic efforts by FERC to understand, monitor and, where necessary, regulate changing market developments. Our inquiry thus far suggests that FERC has yet to prove it is up to this challenge. While we cannot at this point conclude that a more proactive FERC inquiry would have sounded the alarm about Enron's shaky financial condition, a better investigation may well have exposed the cracks in Enron's foundation sooner. At a minimum, a more searching inquiry into Enron's opaque trading practices would, we hope, have led FERC to question whether it truly was discharging its duty to maintain just and reasonable energy rates.

The troubling story of FERC's 2001 inquiry into Enron Online is laid out below. I would appreciate your reviewing the information contained in this letter and providing the Committee with assurances that FERC has a plan in place to redress the institutional failures that story reveals. I intend to call FERC before the Committee to review the matters discussed in this letter, as well as other issues currently under review by Committee staff.

For the past 15 years, FERC has played a central role in transforming the wholesale natural gas and electric sectors from highly regulated systems dependent on FERC-approved cost-of-service rates to loosely regulated, highly competitive markets. This changing environment has given rise to new participants and market platforms as well as new corporate models -- such as the Enron Online trading service used by Enron Corporation -- seeking to take advantage of the new business opportunities it presented. Throughout this process, FERC has been required to play multiple roles: (1) continuing its traditional regulatory role in those cases where cost-of-service rates and regulatory approvals are still required, (2) taking on the new responsibility of leading the design and approval of untested market-oriented policies and institutional structures, and (3) maintaining throughout this period its statutory obligations to ensure that wholesale rates are just and reasonable, as required by the Natural Gas Act and the Federal Power Act and related statutes.

As evidenced by the catastrophic failure of the California electricity market, regional price spikes in both electricity and natural gas prices, and most recently the precipitous collapse of Enron – the nation's largest energy marketer – navigating the waters of this transition continues to be a complex and difficult process. It is this very complexity and difficulty that requires a new sense of vigilance on the part of FERC, the leading federal agency in this arena. While FERC has taken on such a proactive role in revising natural gas and electricity regulations to create new market-based utility practices, it has taken a decidedly reactive approach to fulfilling its obligations to ensure that rates are just and reasonable each and every day for America's businesses and consumers in these new, complex, and still evolving markets.

Despite the fact that deregulation of energy markets had opened the door for companies like Enron to create entirely new marketing models, such as Enron Online, and rapidly capture a sizable percentage of the market, it appears that FERC's efforts to understand and adjust its regulatory approach to these new entities was, and is, severely lagging. As recently released internal Enron memoranda make clear, that company sought to manipulate California's energy market and engaged in abusive trading practices during the 2000-2001 energy crisis in California and other Western states. Yet FERC apparently waited nearly two years after the first allegations of market dysfunctions arose before launching a formal inquiry into the potentially abusive actions of individual companies.

In May 2001, FERC's General Counsel did initiate a related, staff-level inquiry – one into the status of electronic trading in the electric power and natural gas markets, in general, and the role played by Enron Online, in particular. A report discussing electronic trading and Enron Online's operation and the significance of its dominant share of these markets was completed on August 16, 2001.

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

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

With that observation in mind, the report asked whether financial problems at Enron would threaten the energy markets. The report answered the question in two ways. First, it concluded that Enron did not have sufficient market share to disrupt the energy market if it failed. According to the report, Enron accounted for 16 percent of gas trading and 13 percent of electric power trading in North America, with the majority of Enron's trading transacted through Enron Online. In the report's view, the energy market could continue functioning smoothly absent Enron's market share. Second, the report concluded that, in any event, the chance of Enron failing financially was remote. The report provided little support for this conclusion.

Finally, the report found that Enron Online gave a competitive advantage to Enron's own trading units by reducing their transaction costs, giving them wider access to the market, and providing them better market intelligence.

In short, though the report identified a number of areas that ought to have troubled FERC as the federal government's lead energy regulator, it found no reason for concern and no cause for action. This, I am afraid, was a critical mistake.

First, though FERC staff identified the potential risk inherent in (a) a trading model that exposed the corporation to very large financial risks, and (b) the company's dependence on its corporate credit worthiness to maintain its trading capability and to fulfill its trading commitments, staff failed to take the logical next step to thoroughly understand the significance of this finding. Instead, they conducted only a cursory analysis of Enron's financial standing, concluding that Enron was unlikely to fail as a result of overextending credit to its trading customers. This was obviously a mistake; although the scenario imagined in the report did not come to pass, in fact Enron was financially unstable, and within two months, had collapsed completely.

Second, the analysis that led to the conclusion that Enron's market share was insufficient to negatively impact the market in the event of the company's failure was far too cursory. The report based its conclusion upon limited industry-supplied data that looked only at the national picture. FERC should have based its conclusion on more thorough data from actual regional markets, where market concentration would likely have been of greater concern.

Third, while FERC concluded that it need not worry about the competitive advantage that Enron Online provided to Enron traders, Congress has received testimony that this arrangement may well have been unfair. In fact, Enron had a dominant position in the market through Enron Online, and the system gave Enron traders exclusive access to valuable information about market conditions unavailable to other participants. The extent to which Enron took improper advantage of this opportunity is unknown, but recent disclosures, contained in internal memoranda provided to FERC detailing potentially abusive Enron trading practices in 2000 and 2001 in the California and Western energy markets must lead to a review by FERC of the possible use of Enron Online by Enron's traders to facilitate such abuse.

Fourth, FERC staff failed to follow up on many of the issues raised by the report. Most troubling, given the concerns identified in the report related to Enron's financial risk, it appears that there was never any formal process established within FERC for monitoring the financial status of Enron - North America's largest energy trader - not even following the unexpected resignation of Enron CEO Jeffery Skilling on August 14. This was a key red flag that occurred just days before the final report was transmitted to FERC managers and helped persuade staff at the Securities and Exchange Commission (SEC) to begin that agency's investigation into Enron's financial condition. Even once the full magnitude of Enron's financial problems began to take shape in mid-October following Enron's restatement of earnings and public confirmation of the SEC's investigation of the company, there appears to have been no formal effort within FERC to monitor the financial condition of the company or assess possible market impacts. FERC even failed to follow the recommendation made in the August 16 report that the team that prepared it continue to monitor effectively developments at Enron Online and other electronic trading platforms. There appears to have been no effort made at the agency to ensure that this recommendation was heeded.

The significance of FERC’s failures to pay more attention to Enron’s financial condition is underscored by the agency’s reaction, late last year, to news of Enron’s collapse. When Enron's demise became evident in November 2001, FERC officials were apparently troubled enough about the potential impacts of the collapse on the energy market – the very concern dismissed in their August report – to raise these matters with representatives of the Federal Reserve, the White House National Economic Council, and Enron itself.

Another troubling facet of the August 2001 report is that it was apparently not distributed to you or to any commissioners prior to, or during, Enron's collapse to inform your decision-making, and it is unclear at what point any of the information contained in the report may have been provided to you or other commissioners. In other words, a report that might have served as a warning wound up being little more than a footnote in the story of Enron's collapse.

Even though FERC initiated this report examining Enron Online and other electronic trading platforms – suggesting some level of concern within the agency about their growing influence – and found that, in fact, the use of online trading platforms and their trading volume were expected to grow dramatically, the agency has fallen far short of giving these mechanisms the scrutiny they deserve.

In fact, an important task related to the Enron Online inquiry -- the preparation of a comprehensive legal memorandum analyzing FERC's jurisdiction over online trading, including Enron Online -- was begun, but never completed. This, in my mind, is akin to the Food and Drug Administration (FDA) utterly failing to scrutinize the development of a major new class of drugs, so this effort should be quickly resurrected and completed. Completion of such a memo is also needed to clarify the jurisdictional boundaries between FERC and the Commodity Futures Trading Commission (CFTC) regarding energy trading activities and products, including online trading, and to better define the two agencies' respective market monitoring responsibilities in these developing markets. I also urge FERC to include examination of the role of electronic trading in its ongoing investigation into manipulation of the Western electric and natural gas markets.

These trading platforms are precisely the sort of emerging market institutions that one would expect FERC to anticipate, to understand, to monitor and to address as the federal government's lead regulatory agency as the natural gas and electricity sectors transition to open, competitive markets.

To date, the Committee's investigation has shown that many institutional watchdogs failed completely in their obligations to alert the public to the precariousness of Enron's business. The American people have every right to expect that federal regulatory agencies they fund with their tax dollars will act only on behalf of the public interest. It is therefore of great concern to me that FERC, having identified the specific red flag of Enron's credit and financial exposure and its potential risk to U.S. energy markets, not only concluded that such a failure was unlikely, but apparently took little action to ensure that this conclusion remained valid in the face of significant new developments – developments that prompted a sister agency to initiate first informal, and later, formal investigations. FERC's job is not simply to promote market changes, but to anticipate and monitor new developments and problems, and to protect the consumer against abuse. That latter role seems to have been neglected.

In order to further the Committee's inquiry, please provide answers to the following questions no later than May 28 , 2002:

1) Has the Commission reviewed the August 16, 2001 report and the circumstances leading up to and following it? Do the Commissioners believe they received the information contained in the report in a timely manner? If the Commissioners did not receive the information in a timely manner, what steps will you take as Chairman to ensure that relevant staff investigations and work products are provided to the Commissioners?

2) What conclusions has the Commission reached regarding the way staff handled the August 16 report and the follow-up anticipated by that report?

3) In light of the fact that we now know the August 16 report's conclusion regarding Enron's financial condition has been proven false, has FERC reevaluated its policies or approach to conducting financial evaluations? Does FERC have adequate statutory and regulatory authority to ascertain the financial condition of regulated entities and parent corporations, such as Enron?

Does FERC have adequate requirements to ensure the creditworthiness of energy marketers?

4) Why did FERC apparently fail to implement the recommendation in the August 16, 2001 report to direct the inquiry team to continue to monitor Enron Online and other trading operations? What plans does FERC have for monitoring the development and operation of online trading platforms, as recommended by the August 16, 2001 report, including plans to coordinate such activities with CFTC?

5) Given the finding that Enron's trading model entailed significant financial risk, why did FERC take no formal action to monitor the financial status of Enron after the August 16 report, especially given changing circumstances?

6) Records provided by FERC show that there were interagency meetings with CFTC and with the SEC to discuss electronic exchanges, data collection, and market monitoring activities at the same time the inquiry that produced the August 16 report was underway. At the same time, FERC was also conducting an investigation into energy prices in the Northwest and a proceeding to determine whether the citizens of California were entitled to refunds from marketers like Enron. Were these apparently interrelated efforts coordinated?

7) Why was the legal analysis of the jurisdictional issues surrounding online trading abandoned? Does FERC intend to complete the legal analysis of the jurisdictional issues surrounding online trading originally initiated as part of the Enron Online inquiry and identified in the August 16, 2001 report? If so, when?

Thank you in advance for your cooperation.

Sincerely,

Joseph I. Lieberman
Chairman