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House of Representatives

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February 25, 2002

Mr. Jeffrey Skilling
c/o Bruce Hiler, Esq.
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Dear Mr. Skilling:

Last week, I received from Enron videotapes of employee meetings. These tapes show that you were aware of a September 20, 2000, report in the *Wall Street Journal* that described how much of Enron and other energy companies' recent profits "constitute unrealized, noncash gains" that "depend on assumptions and estimates about future market factors, the details of which the companies do not provide, and which time may prove wrong."[1] The tapes also show that you dismissed this early warning of Enron's accounting problems in an employee meeting on October 3, 2000, telling employees that Enron's accounting practices are "conservatively executed" and that "[q]uite frankly, we provide more data in our annual report than anyone else in our industry and more data than anyone in any transaction-based industry. . . . We give more information than anyone else."

The October 3, 2000, videotape also shows that you told Enron employees that one of the company's goals was to "minimiz[e] the impact on Enron's balance sheet" and that to achieve this goal "[w]e are going to be bringing in partners . . . to help us leverage our capital, so that we're putting less capital per unit of revenue and profit growth for the company."

These videotapes raise questions about your actions at Enron and your testimony before the Energy and Commerce Committee on February 7, 2002. I am writing to seek additional information about these issues.

Early Warning of Enron's Accounting Problems

At the Energy and Commerce hearing, you testified that when you left Enron on August 14, 2001, you thought the company was in sound financial condition. You testified:

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[1]*Energy Traders Cite Gains, But Some Math Is Missing*, Wall Street Journal (Sept. 20, 2000).

> when I left on August 14, I thought the financial reports accurately reflected the financial condition of the company. . . . On the date I left the company on August 14, 2001, I had every reason to believe the company was financially stable.

The October 3, 2000, videotape shows, however, that you were aware ten months earlier of a September 20, 2000, article in the *Wall Street Journal* that raised serious questions about Enron's financial soundness.[2] At this time, you were the president and chief operating officer of Enron.

According to the *Wall Street Journal* article, few investors were aware that the reported profits of Enron and certain other energy companies were largely based on undisclosed assumptions and estimates about future market conditions. The problem arose from the use of so-called "mark-to-market accounting," which the *Journal* describes as "an accounting technique that allows companies to include as current earnings those profits they expect to realize from energy-related contracts and other derivative instruments in future periods, sometimes stretching over more than 20 years." Under mark-to-market accounting, changes in the value of a contract are added to or subtracted from net earnings each quarter over the life of the contract.

The *Wall Street Journal* pointed out that mark-to-market accounting can be difficult to apply to certain long-term derivative contracts, such as electricity contracts, where future market prices are difficult to determine. In such cases, "companies are allowed to base valuations on their own undisclosed estimates, assumptions and pricing models." According to the *Journal*, this problem is compounded because in their financial reports, Enron and other energy companies "only vaguely describe the methods they use to come up with" these estimates. "Ultimately they're telling you what they think the answer is, but they're not telling you how they got to that answer," said one expert quoted in the *Journal* article. "That is essentially saying 'trust me.'" The article also pointed out that if not for $747 million in unrealized gains from "risk-management activities," Enron would have reported a loss in the second quarter of 2000.

During the October 3, 2000, meeting you were asked to "respond to the *Wall Street Journal* article claiming that we booked more mark-to-market income than we had in earnings for the second quarter, and that but for mark-to-market, we would have had a loss in the second quarter." This question was asked more than a year before Enron finally acknowledged its financial problems, and you clearly had a responsibility to Enron employees and shareholders to respond accurately to the serious issues raised in the article.

You dismissed the significance of the *Wall Street Journal* article in the October 3, 2000, employee meeting, calling the article "totally, totally without merit." You said that Enron had

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[2] *Id.*

properly used mark-to-market accounting to book its profits. The *Journal's* criticism, you noted, was based on its belief that Enron did not disclose enough information about its finances.[3] You refuted this criticism, saying:

> Quite frankly, we provide more data in our annual report than anyone else in our industry and more data than anyone in any transaction-based industry. . . . <u>We give more information than anyone else</u>. To provide additional information, we would probably have to go through and give the methodology by individual book, and we have, I think, now 2,900 books around the company. You just can't do that in an annual report.

You further stated that the *Wall Street Journal* article has "absolutely no merit, no substance. . . .<u>Our accounting policies are not only appropriate, in my opinion they are conservatively executed</u>. So, we're in a strong position from an accounting basis."

We know now that the *Wall Street Journal* article was right. As one former Enron employee has recently said, Enron's use of mark-to-market accounting techniques resembled "a license to print money."[4] Other observers have called Enron's financial statements "virtually indecipherable,"[5] "gobbledygook,"[6] and "nearly impenetrable."[7] Given the prescient accuracy of the *Journal*'s reporting, it is hard to understand your statements on October 3, 2000, that the report was "totally, totally without merit."

In fact, there appear to be few scenarios that explain your statements on October 3, 2000. One possible scenario is that you thought what you said was true, in which case the *Wall Street Journal* reporter -- who tried to piece together the puzzle of Enron's practices in the dark, with incomplete parts, and without knowing what the puzzle was supposed to look like -- was able to gain a better understanding of Enron's financial condition than you had.

For this scenario to be plausible, the following would have had to happen. The *Wall Street Journal* article was printed on September 20. You read and evaluated it. As president and

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[3] *Id.*

[4] *Fuzzy Rules of Accounting and Enron*, New York Times (Jan. 30, 2002) (quoting Glenn Dickson, a former manager in Enron's energy services unit).

[5] *Enron Was Open Book That No One Could Read*, Miami Herald (Jan. 27, 2002).

[6] James Chanos quoted in *Enron Was Open Book That No One Could Read*, Miami Herald (Jan. 27, 2002)

[7] *Is Enron Overpriced?* Fortune (Mar. 5, 2001).

COO, you didn't need to surmount any of the obstacles the reporter faced. You had every relevant document at your disposal, as well as an insider's understanding of Enron's financial blueprint. Notwithstanding those advantages, you somehow missed all the relevant information and concluded the story was "totally without merit." Since there is now no disagreement that the story was accurate, this scenario suggests a staggering level of negligence and incompetence.

A second scenario is that you and others realized the reporter had accurately identified a major flaw in Enron's accounting practices, and you simply intentionally misled Enron's thousands of employees with false statements.

Since either of these scenarios is damning, I want to give you an opportunity to provide any other explanation that I might not have considered.

Minimizing Balance Sheet Impacts

During the same meeting, you also discussed Enron Net Works, which at that time was a new division designed, in your words, to create "additional growth opportunity." One of the points you emphasized was the importance of minimizing the impact on Enron's balance sheet. You stated:

> We're going to move quickly and we're going to do it in a way that minimizes the impact on Enron's balance sheet. We are going to be bringing in partners and typically people who may have had operations in some of these businesses before to help us leverage our capital, so that we're putting less capital per unit of revenue and profit growth for the company.

Many of the financial problems that led to Enron's collapse involved using "partners" to "minimize the impact on Enron's balance sheet." Through the use of partnerships, Enron moved debt off its balance sheet and attracted investment from outside sources that allowed Enron to leverage its stock. As a result of its accounting activities relating to these partnerships, Enron also apparently significantly inflated its earnings and masked its liabilities in its public filings. On November 8, 2001, Enron revised its financial statements to account for $586 million in losses over the previous five years relating to partnerships.

In your testimony before the Energy and Commerce Committee, you tried to distance yourself from these financial arrangements. You stated: "While I was at Enron, I was not aware of any inappropriate financing arrangements, designed to conceal liabilities, or overstate earnings." Your October 3, 2000, remarks raise questions about this testimony. One possible reading of your October 3, 2000, statements is that you were endorsing exactly the kind of off-balance-sheet partnerships that contributed to Enron's downfall.

There may, however, be a more innocuous explanation for your comments. It could be that you were simply articulating an obvious and defensible financial principle to your employees, and the similarity to the actual practices Enron used for its balance sheets is an unfortunate coincidence. While this may seem unlikely to some given what is now known about Enron's practices, I don't want to reach any conclusions about your statements without additional information from you.

Conclusion

The October 3, 2000, videotape raises important questions about your knowledge of Enron's financial problems and your role in promoting Enron's efforts to "minimize the impact" on Enron's balance sheet. I urge you to respond to the issues raised in this letter by March 18, 2002.

Sincerely,

Henry A. Waxman
Ranking Minority Member

cc: The Honorable Ernest F. Hollings
Chairman, Senate Committee on Commerce, Science, and Transportation

The Honorable John McCain
Ranking Minority Member, Senate Committee on Commerce, Science, and Transportation

The Honorable W.J. (Billy) Tauzin
Chairman, House Energy and Commerce Committee

The Honorable John D. Dingell
Ranking Minority Member, House Energy and Commerce Committee