

US financial regulatory change: The case of the Californian energy crisis

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ABSTRACT

This paper is chiefly concerned with the financial regulatory change in the USA following the recent financial scandals. In particular it focuses on the Californian energy crisis in 2000–2003. The paper explores the background to the deregulation in California and its most obvious business result: Enron corporation's actions and results. Drawing from the institutional theory (Di Maggio and Powell 1983) we identify the causes of institutional pressures put on the US government to deregulate its markets in the first instance and then regulate it following the financial scandals that followed. Using Oliver's (1991) strategic responses to institutional pressures theory we trace the actions take by the US government to regulate its financial markets. The only federal (USA national government) result was the Sarbanes—Oxley law which was meant to pro-

vide corporate rules for governance. We then explore the implications of this Act and the actions taken specially to deal with Enron scandals. We conclude the paper by raising some key questions: But was it enough? And will it be enforced? What are the results for corporations and the American public?

INTRODUCTION

This paper is chiefly concerned with the financial regulatory change in the USA following the recent financial scandals. In particular it focuses on the Californian energy crisis in 2000–2003. The paper explores the background to the deregulation in California and its most obvious business result: Enron corporation's actions¹ and results.

The processes of public regulation are complex global phenomena, involving various stakeholders with diverse expectations. This is particularly the case of the Californian energy market. The energy crisis there was regional but with global implications in regulatory reform. In this paper the authors are interested in understanding the process of institutionalisation in a period where there has been a significant number of financial scandals in the USA which mirrored the California experience with Enron.²

There is a dearth of literature examining the macro regulatory context of public policy and in particular, from an institutional theory perspective. There is little

about the micro level, however. And, moreover, none that bridges the gap between the macro and micro levels. This paper also attempts to fill this gap in the literature.

The paper has three sections after this introduction. The second section identifies global pressures for change in the public sector. The third section provides a brief outline of the institutional theory framework used to explore these pressures and strategic responses by the US government to these pressures and in particular in the case of the Californian energy crisis. The final section provides some conclusions and thoughts on the effectiveness of US government's responses.

GLOBAL TRENDS IN THE REGULATIONS OF NEW PUBLIC SECTOR MANAGEMENT

During the last decade or more there have been significant changes and reforms in the global public sector. Many reforms and modernisation of utility services have taken place in the name of modernisation, efficiency, competition, transparency and accountability.³ This has resulted in a number of changes in the public sector regulatory institutions. But who is driving these regulatory changes and 'how' they are implemented are important unanswered questions.

The major changes that are taking place can be summarised as the emphasis put on to performance, results evaluation, outcomes, transparency and accountability; the shift from traditional supplier-purchaser relationship in public services provision to one based on partnership; emphasis from obtaining passive public support in the procurement process to one based on active stakeholders' involvement by providing a wider and proactive role to civic leaders and common citizen.⁴

In the USA, Public Private Partnerships (PPPs) have played a significant role in the

regulatory change of the energy markets and in particular in California. In simple terms this involves the provision of public services usually through a private sector contractor, involving building and operating in key sectors such as energy. While the PPP systems appeared to work in general in the USA, the deregulation of the California energy sector did not, despite the fact that both of the major political parties agreed to deregulate the energy market.

The PPP as an economic and political phenomenon has been supported by the US governments, in one form of public policy or another. As will be discussed later, the application of PPP is still being blamed for the failure of the financial systems and in particular the energy crisis in California. The PPP were really not partnerships. It is widely understood that the major problems lay in under-investment in infrastructure and in trying to avoid any responsibility for the public sector by relying heavily on market forces. The PPP financing has, however, financial implications for ten or more years as most agreements run for decades. It affects current generations as well as future generations of taxpayers who have to bear the future costs of services contracted by the current government. In particular, the states in the USA have few if any PPP mechanisms that monitor the use of the funds raised to finance PPP; and even further mechanisms that curb the use of business lobbying and influence on policy making. Sarbanes-Oxley, as we shall see, is a post-crisis legal resolution.

AN INSTITUTIONAL THEORY FRAMEWORK: PRESSURES FOR CHANGE AND STRATEGIC RESPONSES

This section draws from institutional theory and 'qualitative economics'⁵ in order to gain a deeper understanding of the pressures put on US government from the

socio-economic and political environments and better understand the US governments responses to these pressures.⁶ It considers institutions in a broad perspective as the shared and taken-for-granted assumptions of social actors and continually evolving through changes in rules and regulations.

It is pointed out that the tendency for organisations or governments to adopt rules and regulations from other countries and organisations is called 'isomorphism'.⁷ In a study of some of the US states to adopt international accounting standards, Carpenter and Feroz⁸ called this 'organisational imprinting'. The institutionalisation process depends on the cultural and political norms to gain 'legitimacy' and 'power relationships' rather than efficiency alone.⁹ The concept of legitimacy is complex but it is understood to be gained by political institutions when they respond and provide services in harmony with society's cultural norms and values.¹⁰

Institutional theory has three types of related pressures — coercive, mimetic and normative — operating in the institutional environment to explain the reasons of organisations adopting similar practices. Coercive isomorphism 'stems from political influence and the problem of legitimacy'. Mimetic isomorphism is 'standard responses to uncertainty' and ambiguity forcing organisations to adopt rules and regulations of other similar, more successful and/or legitimate organisations. Normative isomorphism is achieved 'primarily from professionalisation', education and (political) affiliations of bureaucrats.¹¹

Oliver¹² posits that political institutions and organisations may respond to pressures by means of acquiesce, compromise, avoid, defy and manipulate strategies. She defines an 'acquiesce' strategy as one that refers to organisations adopting recommended practices by complying with rules, regulation and acceptable norms of behaviour. According to Oliver, a 'compromise' strat-

egy is one which balances the conflicting expectations of the various interest groups through the bargaining process. Organisations may also 'avoid' complying with institutional pressures by concealing their non-compliance or completely changing their activities or may 'defy' rules, regulation and norms by dismissing, challenging or attacking them. Oliver argues that others may attempt to 'manipulate' rules, regulation and norms by attempting to shape values and criteria, and influencing or controlling the institutional processes.

Institutional theory thus gives a useful lens to explore the questions of *why* governments or states adopt certain policies, rules and regulations and *how* they respond to pressures. In addition the theory explains the role of legitimacy as a survival strategy. The following sections discuss the regulatory framework in the energy sector of California, USA.

In the next section drawing from the institutional theory¹³ and micro data from qualitative economics,¹⁴ the authors identify the causes of institutional pressures put on the US government to deregulate its markets in the first instance and then explore the pressures to regulate it again following the financial scandals that followed. Using Oliver's¹⁵ strategic responses to institutional pressures theory the authors trace the actions taken by the US government mainly the introduction of the Sarbanes–Oxley law which was meant to provide corporate rules for governance.

Institutional pressures to deregulate the energy sector in California

There were many pressures put on the state of California to deregulate its energy sector. Clark and Bradshaw argue that:

'California electricity deregulation has become one of the most extensively discussed public policy failures in modern times. In spite of the analytical

attention, the enthusiasm of virtually all parties at the time that deregulation was enacted is now hard to reconstruct. It is one of those rare policy initiatives to pass unanimously by both houses of California state government. Then it went to Congress where the enabling legislation passed with the same margin: 'No significant opposition'.¹⁶

The authors document how the deregulation plan itself was formulated by the California Public Utilities Commission (CPUC) and then drafted into legislation as Assembly Bill 1890 (AB1890) in 1996. It 'built upon a very open, very public process led by the CPUC',¹⁷ though the basic theoretical premises were never questioned. The political pressures were further noticed in that the bill was adopted unanimously by both houses of the legislature, a rare show of bipartisanship but after the energy crisis started in 2000, ignored by everyone. It was signed into law by Republican Governor Pete Wilson in September 1996 and took effect in 1998. While many critics today revise their earlier arguments that there was no reason to consider deregulation because the system was not broken, in fact, there were so many pressures on the regulated electric system that some kind of change was inevitable, deregulation being just one option. And an option that was ill-founded and poorly overseen by public regulators. Instead, the new electric system was to be overseen by 'market forces'.¹⁸

There were also some economical pressures put on the US government to mimic the success of the private sector and other countries. Deregulation was first proposed by the Public Utilities Commission in 1994 after years of discussion under the influence of the presidency of Ronald Reagan (who had been Governor in California years before) and the theory of 'privatisation' espoused by Prime Minister Thatcher. It was approved by the California legislature

in August 1996. The plan had the following characteristics, and was fully endorsed by all parties in state government. Republican Governor Wilson said at the time that this 'landmark legislation' was 'A major step in our efforts to guarantee lower rates, provide customer choice and offer reliable service, so no one is literally left in the dark'.¹⁹ The elements of the deregulation plan were:

- Consumers were free to choose their electricity supply company.
- Utilities would freeze their 1996 prices at 10 per cent below previous levels for 4 years, through 2002. The rate reduction was paid for by the sale of bonds that will be repaid.
- Utilities would be reimbursed for 'stranded assets' of plants that would not be competitive, such as Diablo Canyon and high cost PURPA contracts through higher retail prices. Once stranded assets had been recovered, the price freeze would end.
- Incentives would entice utilities to sell half or more of their generation capacity to assure competition among suppliers. By May 1999 utilities had sold 17,683 MW capacity, or about 40 per cent of total generation of 55,000 MW.²⁰
- The state would set up an Independent System Operator (ISO) who would manage the high-voltage transmission grid, and the California Power Exchange (PX) that would operate the wholesale market.
- Power purchases would not be from long-term contracts but would be limited to the spot market (hour and day ahead markets). Generators would bid power to be sold in these markets, but all suppliers would be paid the price of the highest accepted bid — the Market Clearing Price.
- Renewable energy and demand side

management (conservation) were to be subsidised until 2002, at which time all technologies were to compete on the open market.

After the blackouts of 2000–2001, however, a new consensus developed that was the new energy system as seriously flawed and that deregulation is the immediate cause of the problems facing the state. During the first two years when supply was ample, utilities made money buying power on the low price spot market, and they sold their power plants for more than expected to companies interested in operating them, often headquartered out of state. They set up independent companies to own some of their assets, independent of their power distribution companies.

As Appendix A demonstrates, the sale of power plants under deregulation left the control of electrons into California in only a few power companies. Moreover the only viable market trader in the late 1990s was one company: Enron.

Corporate America: The case of Enron

Enron proves to be a good example of qualitative or personal networks for the building of business relationships in order to influence and control markets.²¹ In the US and global energy sector, Enron only recently has been uncovered for how it lobbied, took advantage and then manipulated energy markets due to deregulated energy markets.²² As Oliver²³ and Carpenter and Feroz²⁴ indicate, the response to deregulation of the energy markets by organisations was to manipulate the market conditions to their own advantage. They point out that state governments, like firms, require resources from the environment to survive. The only way government officials can politically survive is therefore to negotiate exchanges with the environment particularly during the periods of fiscal pressures. This gives other

organisations an opportunity to provide these resources so that they can exercise power over the government entities.²⁵ In the case of Enron various court cases (2002–2003) prove how Enron executives influenced public energy policy through social and business networks. Much of that influence was paid for by the Enron corporation and its executives in donations and grants to scholars and politicians. A Chair was funded, for example, at Harvard Business School from which the virtues of ‘deregulation’ and ‘privatisation’ are taught.

While all the evidence is now in, it is clear that these networks which Enron built in the social and business areas dramatically influenced political decision makers in key states and the nation’s capital. This use of networks and personal relationships was supported by money that influenced entire sectors of the economy and their markets. The behaviour of Enron and other firms is not unusual but in this case, the end result was not an open or free market but to control and dominate an entire sector. The plan almost worked.

Personal networks are often centred on basic shared philosophical norms, beliefs and concepts. Such ‘institutions’²⁶ or networks often utilise or leverage resources within a triangular relationship between government, private industry, and support institutions such as education, training, and technical assistance centres. While institutions can certainly change and even disappear or purposely disband, the initial formation of institution needs facilitation and continued support from a dispassionate outside party.

The protection of the public good is essential in various infrastructures and sectors in creating ‘civic markets’ mechanisms.²⁷ In recent months, the protection of the transportation sector must be embedded in the government. The energy crisis in California has clearly shown that

the energy sector is a public trust. The same could be argued for environment, water and telecommunications.

Social institutions can be a key component to understanding everyday business life. Thus, we see institutions not from the objectivist perspective in a structural or functional paradigm which determines the behaviour of actors, but as a broader form of exchange. Grabher²⁸ summarises networks as having four features. The first is 'reciprocity' or drawing from Peter Blau, 'actions that are contingent on rewarding reactions from others and that cease when these expected reactions are not forthcoming'.²⁹

Interaction is core or basis, then, to any exchange in business activities. Interaction, as we have seen, is far more complex in that it presumes the ability of the actors to think and reflect upon their actions. Exchange from this perspective is an 'engagement' between actors. Two or more people have established a relationship. They have engaged each other for some purpose.

THE STRATEGIC RESPONSES OF THE CALIFORNIAN STATE AND THE US GOVERNMENT

As Oliver³⁰ posits, governments and political institutions and organisations may respond to pressures by means of acquiesce, compromise, avoid, defy and manipulate strategies. According to Oliver, a 'compromise' strategy is one which balances the conflicting expectations of the various interest groups through the bargaining process.

An outline prepared by the staff for the Governor of California³¹ as they prepare to address the impact of the Enron bankruptcy on the state.³²

'The end was not unexpected, but it was still spectacular. On December 2nd Enron, once America's seventh-biggest company, filed for Chapter 11

bankruptcy. Only days earlier, its bonds had been downgraded to junk and Dynegy, a smaller energy-trading rival, had pulled out of a planned takeover. Enron is the largest company ever to go bankrupt. Disentangling the resultant mess (and lawsuits) will keep legions of lawyers employed for years to come.³³

The monetary impact in California in terms of long contracts was relatively low. For example, about \$84m in contracts was obligated by the University of California system alone. Nevertheless, the prices paid for the supply of energy to the state were controlled by 'market' companies or 'merchant firms' like Enron so that about \$9bn in additional costs for power were paid by the state to ensure power in the winter of 2000–2001.

In 2000 and the first half of 2001, Enron, among other market force suppliers, reaped enormous profits from California's deregulated energy market. Governor Davis stated in a Letter to the Federal Energy Regulatory Commission (FERC) Chairman, 'Since the summer of 2000, I have on numerous occasions demanded that the FERC investigate allegations of market manipulation by power generators and marketers, including Enron. In my testimony before the FERC on November 9, 2000, I urged the FERC to investigate and remedy California's dysfunctional electricity market. Last June I called upon the FERC to investigate and refund the detailed overpayment by California consumers and businesses.'³⁴

As Appendix D (Energy Generation Sources) indicates, the FERC did finally take action in the late spring of 2001, as Governor Davis acknowledged in a press release on 31st January, 2002, and noted the actions taken by the state and its citizens to curb the immediate energy crisis:

'I appreciate the action taken by you and your fellow FERC commissioners to

finally reinstate price caps last June. Your action, combined with California's successful conservation efforts, our construction of 11 new power plants, and long-term contracts, caused energy prices to decline.'

Subsequent reports and studies have verified the State of California's analysis of how a far more devastating energy crisis was averted over the summer of 2001 with these and other policies.³⁵ While acknowledging the role of more rain in the winter of 2001 (hence supplying more water for hydroelectric power), the fact was that the summer of 2001 was one of the 25 hottest in Californian history. The California government programmes and citizens conserved over 12 per cent throughout the summer of 2001. And the market suppliers were forced to keep prices reasonable through price caps at the state (public utility) and federal (FERC) levels. Long-term contracts further assured a constant supply of power, rather than relying upon market manipulation in the spot market.

Yet public records confirm that on 17th April, 2001, for example, then Enron CEO Kenneth Lay made eight recommendations to Vice President Cheney regarding federal energy policy. One of those recommendations was continued opposition to price caps. (A memo containing those recommendations was released the week of 20th March, 2002.) On 18th April, 2001 — the very next day — Vice-President Cheney told the *Los Angeles Times* that the White House emphatically opposed price caps. When the White House released the final report of its energy task force, seven of Enron's eight recommendations had been fully adopted by the report. But this was not unusual. Further documentation reveals that Enron staff and senior officers as well as members of its Board had tried to influence the White House during the Clinton administration and systematically pursued

its self-interests in states like California who were considering deregulation. As Kuttner notes, 'Perhaps the most damaging effect of all is the eclipse of an opposition politics. Embrace of deregulation by "pro-business" Democrats is more than a mistaken philosophical conversion.'³⁶

The White House's energy policy, as enforced by the FERC, particularly its opposition to price caps, helped to sustain the outrageous prices of the wholesale energy market. 'This prolonged California's energy crisis and continued the massive transfer of wealth from our state to out-of-state energy companies such as Enron.'³⁷

It is still unclear how much direct influence Enron had over the White House.

What is clear, however, is that the White House's energy policy was nearly a mirror image of Enron's energy policy. It is also clear that that policy was detrimental to California and the wholesale energy market throughout the West. If Enron was able to use its market power and public influence to unfairly manipulate the California energy market, then FERC must take action.³⁸

HarvardWatch³⁹ claims that among other things, the role of Enron and its funding of Harvard was an alliance to design and promote deregulation schemes that were manipulated and doomed to failure:

- 'The Harvard Electricity Policy Group (HEPG), created in 1993, is funded by Enron and has produced 1,000 reports promoting Enron's primary business need: deregulation of energy markets.'
- In 1994, two years before California passed legislation deregulating its electricity market, HEPG promoted two reports by Jeffrey Skilling offering proposals for electricity market deregulation, with a focus on California.

- HEPG provided Enron a conduit to government officials overseeing regulatory policy. At least two members of the Federal Energy Regulatory Commission (FERC) worked with HEPG, and one of them, Judith Cardell, went on to do research for Enron and testify to the FERC on Enron's behalf.
- HEPG has held nearly 30 conferences throughout the country on energy deregulation for industry insiders. It is known that Enron executives attended and presented at these conferences, but HEPG will not release full information on attendance.
- HEPG and Enron collaborated to design and promote electricity deregulation schemes in Texas, New England, Montana, and Brazil.
- The results of these deregulation schemes were disastrous for consumers and workers.'

Peterson⁴⁰ reports on over 100,000 pages of actual transcribed discussions among Enron employees as they 'conspired to shout down a healthy plant as blackouts rolled across California in early 2001'. This was *not* as many economists noted a 'perfect storm'. In short, the blackouts were not caused by natural forces as storms are. These were man-made and even pre-dated the emergency blackouts. For example, one Enron trader identified only as Bill called it "a good plan" to shut down a small Las Vegas power plant on Jan. 17, 2001, under the guise of "checkin' a switch on the steam turbine".'

The names of the trades through these records and court testimony are now well known to the public. But the traders even called California 'Grandma Millie' and chanted 'bum baby bum' as they gloated about the inflated costs of power in the state. The market manipulation was possible because Enron either owned the power plants or controlled the market. Hence as

one Enron employee, Rich from Las Vegas, informed Bill in reference to a 52-megawatt plant was out of service for several hours while over half a million homes and businesses in North-Central California experienced rolling blackouts: 'we want you guys to get a little creative ... and come up with a reason to go down'.⁴¹

The shutdown, Bill added, was 'supposed to be, ah, you know, kinda one of those things'. In an effort to cooperate, Rich responded: 'OK, so we're just comin' down for some maintenance, like a forced outage type thing?' 'I think that's a good plan, Rich,' Bill said. '... I knew I could count on you.'

Further data and records reveal even more corruption of markets by many Enron employees. FERC noted afterwards that Enron owed the state over \$1.3bn. Bankruptcy and corporate protection of senior employees, however, meant that the state and its citizens would never see any of those funds returned.

CBS broadcast excerpts from the tapes on 8th June, 2004. In one tape, an employee says, 'You gotta think the economy is going to *** get crushed, man. This is like a recession waiting to *** happen.'

The tapes show Enron tried to bring California to its knees. Elsewhere on the tapes, another employee says, 'This is where California breaks.' 'Yeah, it sure does man,' says another. And they proposed to do that by exporting energy out of the state so the company could drive up prices even more.

'What we need to do is to help in the cause of, ah, downfall of California,' an employee is heard saying on the tapes. 'You guys need to pull your megawatts out of California on a daily basis.' 'They're on the ropes today,' says another employee. 'I exported like a *** 400 megs.' 'Wow,' says another employee, '*** em, right!'

Traders can be heard manipulating the market, using now-infamous schemes with names like death star, ricochet and fat boy. One employee is heard asking, ‘You want to do some fat boys or, or whatever, man, you know, take advantage of it.’

In fat boy, Enron traders used fake power sales to hide megawatts, shrinking the supply of energy and driving up prices. They also used the oldest trick in the book: lies. ‘It’s called lies. It’s all how well you can weave these lies together, Shari, alright, so,’ an employee is heard saying. The other employee says, ‘I feel like I’m being corrupted now.’ The first employee adds, ‘No, this is marketing.’ ‘OK.’

The tapes could affect dozens of cases already filed against the company by California Attorney General Bill Lockyer. ‘If these are ever heard by a jury, they’re going get strung up,’ said Lockyer. Here is a checklist⁴² of the several icons that collapsed with the fall of Enron:

‘*A pension double standard.* Enron’s retirement plan was heavily invested in its own stock. Executives cashed out over a billion dollars, while ordinary employees were locked in. Janice Farmer, who retired with \$700,000 in Enron, told a Senate hearing last week that she is left with a \$63 monthly Social Security check.

Bogus accounting. Since the Great Depression, the one form of regulation that even Wall Street has supported is the regulation of stock trades and corporate accounting ... (when) once asked an ultra-Chicago economist if there was any regulatory agency that he endorsed. “The SEC,” he said instantly, explaining that capitalism itself depends on honest information. Enron’s entire game was to make its business plan so complex that neither investors nor regulators nor even its own auditors could penetrate it. While its core energy business made money (at the expense of

consumers), it had speculative off-the-books subsidiaries. These borrowed heavily to make risky investments and eventually took the whole company down.

The business press. Enron’s breathless cheerleaders included not only its own insiders and stock touts but also a business press that pronounced it the epitome of the new economy. It surely was that — epitomizing all the smoke and mirrors. In the wake of its collapse, Enron’s former sycophants have turned on it, with *Forbes* and *Fortune* running scathing denunciations. *BusinessWeek* asked giddy Enron boosters what they thought now. (Gary Hamel, chairman of Strategos, before the collapse: “Enron isn’t in the business of eking the last penny out of a dying business but of continuously creating radical new business concepts with huge upside.” After: “Do I feel like an idiot? No, but if I misread this company in some way, I was one of a hell of a lot of people.”) Well, yes. The one holdout among the business press is, of course, *The Wall Street Journal*, still trying to blame the debacle on regulators (*editorial note: add the Economist*).

Deregulation generally. Enron’s collapse impeaches the conceit that a market economy can be efficiently self-policing. Enron fleeced consumers by manipulating prices of electricity and gas; it fleeced investors and its own employees. Tycoons do this because they can. Enron should signal a whole new era of re-regulation — of everything from electricity to pensions to accounting standards. And it is another warning that Social Security pensioners cannot trust Wall Street.’

Nevertheless *The Economist*⁴³ and economists in general continue the same theme today is it did when the Enron bankruptcy began:

‘The company’s opaque accounting makes it hard even now to understand why it got into trouble, and whether the

cause was bad luck or worse. The close links between Enron's chairman, Kenneth Lay, and George Bush will keep the affair in the political limelight. And Enron's staff, whose retirement fund was, at the company's urging, mostly invested in Enron shares that they, unlike the company's bosses, were then unable to sell, deserve public sympathy. But if America's capital markets are to stay the cynosure of the world, some quick lessons need to be drawn.'

The bottom line to the neoclassical economic community who unflagging support market power, content that 'proper' deregulation or privatisation will sort out the Enron's and other companies. Some will survive and others will disappear. Business as usual is the economic creed. Or as *The Economist* concludes one article, 'In the drama of capitalism, bankruptcy plays an essential part — until the next boom'.⁴⁴ In the Enron case, however, the culprit is the accounting firm that ventured from its traditional and honourable function in the audits to the consulting role now seen in all accountancy firms. As *The Economist* wrongly puts it:

'The most important concern auditing. Enron has restated its profits for the past five years, chopping \$600m off its earlier numbers. The company's auditor was Andersen, now a target of many lawsuits. Last year Enron paid Andersen a fat audit fee of \$25m; it also paid the firm \$27m for consulting services.'⁴⁵

The Economist goes on to cite other wrongdoing by Andersen. That was December 2001, just after the Enron bankruptcy. Since then a number of firms have confessed to questionable accounting practices and a number of accounting firms have owned up to their use of 'liberal accounting methods'. Certainly *The Economist* is

correct in saying that 'After Enron, the SEC should do what its former chairman, Arthur Levitt, has long urged: ban accounting firms from doing consulting work for their audit clients. Accounting rules also need updating.'⁴⁶ Nevertheless, what is lost in this spurious debate is the core issue of de-regulation itself.

'Last are regulatory lessons.' according to the Economist.

'There is a risk of turning any bankruptcy into an excuse for massive new regulation. Some have argued that energy is too important to be left to markets of the sort that Enron pioneered; or that, since it was engaged in financial speculation, Enron should have been regulated like a bank. Neither conclusion is justified. Energy deregulation has brought huge benefits in lower prices and more secure supplies: energy trading will continue to grow regardless of Enron's collapse. Nor would it be wise to subject all companies with financial arms to stifling bank regulation. Enron's energy exchange was, however, explicitly exempted from oversight by financial regulators: that should be changed.'⁴⁷

There has yet to be any evidence supporting these claims from *The Economist* or economist proponents of de-regulation anywhere in the world. In the end, the best lessons of all will come from the mere fact of Enron's bankruptcy. *The Economist* again argues that:

'The first is the regulation of auditors. For years the profession has insisted that self-regulation and peer review are the right way to maintain standards. Yet Enron has shown that this is no longer enough.

Second is the urgent need to eliminate conflicts of interest in accounting firms. Andersen collected audit fees of \$25m from

Enron, its second-biggest client, last year, but it earned even more for consulting and other work.

Lastly come America's accounting standards. GAAP standards used to be thought the most rigorous in the world. Yet under British standards (sic), Enron would not have been able to overstate its profits by so much. And, once again, although Enron may have been egregious, it is not a lone offender.

The Enron scandal shows that America can no longer take the pre-eminence of its accounting for granted. That is a far bigger concern than any number of congressional investigations'.⁴⁸

The deep or underlying structure about what really happened to Enron can be seen after the collapse of Enron. Eichenwald⁴⁹ gives a good detailed account. And the Associated Press reported:⁵⁰

Aug. 22 — Finance executive Sherron Watkins meets privately with Lay to discuss concerns of finance and accounting fraud that could ruin the company, after submitting an anonymous memo that said, 'I am incredibly nervous that we will implode in a wave of accounting scandals.'

Oct. 16 — Enron reports a \$638 million third-quarter loss and discloses a \$1.2 billion reduction in shareholder equity, partly related to partnerships run by Fastow that hid huge amounts of debt as well as writedowns in money-losing broadband and water trading ventures.

Oct. 24 — Enron ousts Fastow.

Nov. 8 — Enron files documents with SEC revising its financial statements for past five years to account for \$586 million in losses.

Nov. 28 — Enron stock plunges below \$1 and questions about its finances mount.

Dec. 2 — Enron files bankruptcy protection.

Dec. 3 — Thousands of workers laid off.

2002:

Jan. 9 — Justice Department confirms it has begun a criminal investigation of Enron.

Jan. 23 — Lay resigns as chairman and CEO.

Feb. 4 — Lay resigns from the board.

March 14 — Former Enron auditor Arthur Andersen LLP indicted for destroying Enron-related documents.

June 15 — Andersen convicted of obstruction.

Aug. 21 — Former top Fastow aide Michael Kopper pleads guilty to money laundering and conspiracy, the first ex-Enron executive to strike a deal with prosecutors. He identifies a string of partnerships designed to falsely portray Enron as financially healthy while enriching him, Fastow and others.

Aug. 27 — Enron begins seeking buyers for its domestic natural gas pipelines, Pacific Northwest utility Portland General Electric and a collection of international assets in 14 countries, mostly in Latin America.

Oct. 16 — Andersen sentenced to probation and fined \$500,000; firm was already banned from auditing public companies and had only a few hundred employees left after its conviction.

Oct. 31 — Fastow indicted on 78 charges of conspiracy, fraud, money laundering and other counts.

2003:

March 12 — Indictment unsealed against two former Enron Broadband executives on charges of faking \$111 million in earnings from a failed video-on-demand deal with Blockbuster.

March 19 — Enron announces plan to emerge from bankruptcy as two separate companies — one domestic, the other international — to emerge from bankruptcy rather than sell them at lowball prices. The domestic company would be named CrossCountry Energy

Corp., and the international company is Prisma Energy International Inc.

May 1 — Andrew Fastow's wife, Lea, and seven former executives charged. Lea Fastow accused of participating in some of husband's deals.

Sept. 10 — Glisan pleads guilty to one count of conspiracy to commit securities and wire fraud and is immediately sentenced to five years in prison. Later begins cooperating with prosecutors.

Sept. 17 — Indictments unsealed against three former Merrill Lynch bankers for their roles in the Nigerian barge deal.

Nov. 18 — Enron announces deal to sell Portland General to an investment group backed by Texas Pacific Group for \$1.25 billion in cash and \$1.1 billion in assumed debt.

2004:

Jan. 14 — Andrew Fastow pleads guilty to conspiracy in a deal that called for a 10-year sentence and his help in the continuing investigation. Lea Fastow pleads guilty to filing false tax forms in a deal that calls for a five-month sentence and a year of supervised release.

Jan. 22 — Former top Enron accountant Richard Causey pleads innocent to conspiracy and fraud charges for allegedly being 'a principal architect' of widespread schemes to mislead investors in the scandal-ridden energy company.

Feb. 19 — A 42-count indictment against Jeffrey Skilling and Causey is unsealed, charging Skilling with 35 counts of conspiracy, fraud and insider trading, and Causey with 31 counts. Skilling pleads innocent.

April 7 — Lea Fastow withdraws a plea agreement after a federal judge balks at a sentencing deal.

May 6 — Lea Fastow pleads guilty to a reduced charge of filing a false tax form, a misdemeanor, and is sentenced to one year in a federal prison, the maximum sentence.

May 21 — Enron announces offer of \$2.2 billion from Texas billionaire and Coastal Corp. founder Oscar Wyatt Jr. to buy CrossCountry; offer includes \$430 million in assumed debt.

June 24 — Enron announces competing \$2.3 billion bid for CrossCountry from Southern Union Co. and GE Commercial Finance Energy Financial Services; includes \$430 million in assumed debt.

July 7 — Sealed indictment against Lay handed up.

July 8 — Lay surrenders to FBI. Indictment unsealed, accusing him of participating in a conspiracy to manipulate Enron's quarterly financial results, making false and misleading public statements about the company's financial performance and omitting facts necessary to make financial statements accurate and fair. Lay pleads innocent.

July 15 — U.S. Bankruptcy Judge Arthur Gonzalez confirms Enron's reorganization plan.

The Economist,⁵¹ *Fortune* magazine,⁵² other international business journals and most economists worldwide come to the same conclusion: Enron was a case of bad accounting (or at least mixing accounting and consulting) rather than a mistake to deregulate public good markets like energy. The culprit here is the mythology of neoclassical economics that fosters and encourages market forces to manipulate.

One issue that the Enron case has clearly demonstrated is how important 'knowing' people can be. That is, close friendships can be useful for political influence. In academic terms, this has been called 'networks'.⁵³

The manipulation of markets by firms is rooted in the notion that the firm acts and behaves, as we have seen above in the Enron case, in its own self-interests. In this case, the firm involved and subjected its accounting firm to do its bidding. Indivi-

duals communicating in an interactive or face-to-face manner, where the relations consist of concrete meetings between members in the firm, conduct all business.

In the end, five people were convicted. Thousands of people lost their jobs. What is worse is that tens of thousands lost their savings and retirement. The senior staff, while found guilty, only suffered personal financial loss. None served time in jail. Ken Lay was tried but to this day, never confessed to any guilt. Much like Enron has been seen in other organisations, while guilty of omission and ignorance, corporate leaders claim innocence. Yet that plea must be challenged as in any organisation.

Does the leadership hold ultimate responsibility? Moreover, do leaders lead by example? If Lay and others pushed for higher profits for the shareholders and executives, at any cost, then the employees under them would do anything to gain those profits and be heralded as heroes. This is not corporate governance. Nor is it an example of 'market forces'. It is pure and simple greed and illegal.

SOME CONCLUDING THOUGHTS

Understanding institutions, such as the examples like Enron and others who 'bought' influence and manipulated markets, illustrates a far more deeper understanding of business, how it worked and did not work. More importantly these deep structures and the rules by which the actors operated are the key to business actions and can be used in the transformational model to be more predictive. Soon legal cases will document these rules, name the actors and set new rules, hopefully, for the future behaviour of corporate America. As in the energy crisis in California, the deep structural rules within regional communities were far more accurate than what it appeared to happen at the surface of events leading to regulations.

When we look at organisations, especially the larger, older, famous ones, they seem *solid*, they seem *permanent*, and they seem *orderly*. This is, after all, why they are called organisations. Images of organisations as solid, permanent, orderly entities run through many textbooks. But they only tell half the story. They obscure the other half: the chaos which looms behind the order, surfacing from time to time, such as when computer systems break down, when products are sent to the wrong destination or when bookings are made for the wrong dates. They also obscure the immense human efforts and energies, which go into keeping organisations solid and orderly.

A 'civic core'⁵⁴ must be at the heart of any public sector transformation in order to eliminate and assure that the public good is being the basic concerns of public officials for everyone in a community, state, region or nation. The role of government is just that: a social contract. It means forming organisational mechanisms that oversee and monitor the public good. In the end if the public good is not the prime focus and concern of governmental institutions, cultures and their institutional infrastructures will fail. Leaving water, waste, energy or for that matter education, telecom and transportation to business interests only will replicate future crises such as those experienced in California — and now elsewhere.

ACKNOWLEDGMENTS

We wish to acknowledge helpful comments provided by our colleagues and in particular by Michael Fast of Alborg University and Iqbal Khadaroo of Queen's University Belfast.

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- 'A chronology of Enron Corp.:
- 1985 — Houston Natural Gas merges with InterNorth to form Enron.
- 1989 — Enron begins trading natural gas commodities.
- 1990 — Founder and chairman Kenneth Lay hires Jeffrey Skilling to lead the company's effort to focus on commodities trading in the deregulated markets. Over the years, the company becomes the largest natural gas merchant in North America and the United Kingdom.
- December 2000 — Enron announces that president and chief operating officer Jeffrey Skilling will take over as chief executive from Kenneth Lay in February. Lay will remain as chairman. Stock hits 52-week high of \$84.87.
- 1997 — Skilling named president and chief operating officer of Enron. Andrew S. Fastow creates his first partnership designed to kept debt off Enron's balance sheet, a first step toward similar financial moves to hide debt and inflate profits that lead to Enron's downfall.
- March 1998 — Fastow named chief financial officer.
- August 2000 — Enron shares reach high of \$90.
- December 2000 — Enron announces Skilling will take over as chief executive in February. Shares hit 52-week high of \$84.87 on Dec. 28.
- Aug. 14 2001 — Skilling resigns after six months; Lay named CEO again.
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APPENDIX

Summary of Sarbanes–Oxley (www.Sarbanes-Oxley.com)

The Sarbanes–Oxley Act was signed into law on 30th July, 2002, and introduced highly significant legislative changes to financial practice and corporate governance regulation. It introduced stringent new rules with the stated objective: 'to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws'.

It also introduced a number of deadlines, the prime ones being:

- Most public companies must meet the financial reporting and certification mandates for any end of year financial statements filed after June 15th 2004
- smaller companies and foreign companies must meet these mandates for any statements filed after 15th April 2005

The Act is actually named after its main architects, Senator Paul Sarbanes and Representative Michael Oxley, and of course followed a series of very high profile scandals, such as Enron. It is also intended to 'deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders' (Quote: President Bush).

The Sarbanes–Oxley Act itself is organised into eleven titles, although ss. 302, 404, 401, 409, 802 and 906 are the most significant with respect to compliance (Sarbanes–Oxley s. 404 seems to cause most concern) and internal control. In addition, the Act also created a public company accounting board.

Perhaps one of the most remarkable aspects of this legislation, however, relates to its profile. It is very much in the public and media arena. The focus is certainly intense in this respect, creating yet another clear motivation for compliance. There is simply no escaping it!

Directory launched and initial FAQ published

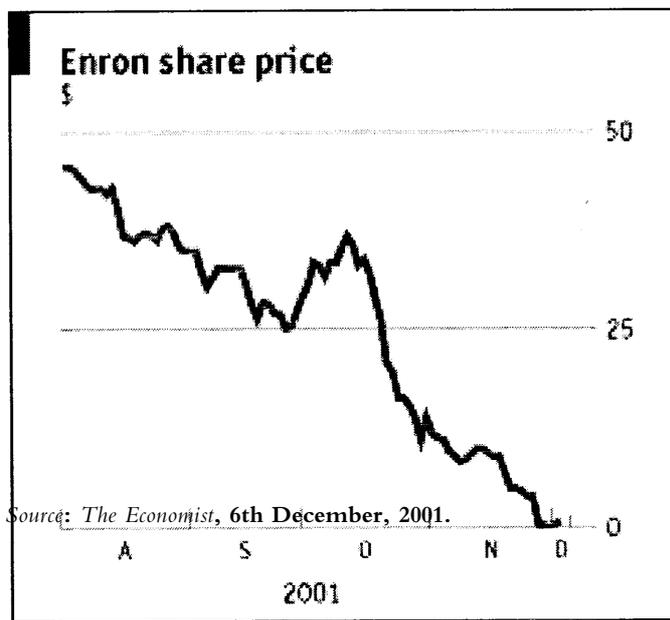
The Directory of Sarbanes–Oxley Act service providers has now been opened. This will include links to a wide range of lawyers, legal bodies, consultants and others offering services and solutions with respect to the act. It can be viewed directly here

Also, a first, basic, overview 'Frequently Asked Questions' has been published in the FAQ section (see left-hand panel). Other more comprehensive FAQs will be added in due course.

APPENDIX A: ENRON SHARE VALUE

Lessons must be learnt from America's largest corporate bankruptcy

Figure 1 Enron share value



APPENDIX B: ENRON CORPORATE RESULTS

As of 14th June, 2005, 11:14 p.m.

- J.P. Morgan, June 2005: The investment bank agreed to pay \$2.2bn to settle a class-action lawsuit filed by investors of Enron, topping a \$2bn settlement reached by Citigroup.
- Citigroup, June 2005: Financial-services behemoth's \$2bn settlement over the sale of stock and bonds before the energy company's collapse more than doubles all previous Enron-related settlements combined.
- Enron directors, January 2005: Ten former Enron directors agree to pay \$13m from their pockets as part of a \$168m settlement of a suit brought by shareholders whose investments were wiped out.
- Lehman Brothers, November 2004: Investment bank agrees to pay \$222.5m to investors over Lehman's participation in the sale of Enron notes shortly before the company's bankruptcy proceedings.
- Bank of America, July 2004: Bank agrees to pay \$69m to investors who had billions of dollars in losses related to Enron's collapse.

- Canadian Imperial Bank of Commerce, December 2003: Bank agrees to pay \$80m over SEC civil charges that some CIBC employees helped Enron manipulate its financial statements.
- Citigroup, J.P. Morgan, July 2003: Banks agree to pay a total of \$305m and change their vetting process for financial deals over actions related to loans and trades the firms' made with Enron and Dynegy.
- Merrill Lynch, February 2003: The first financial services firm to settle with regulators, Merrill agrees to pay \$80m to resolve civil charges that it aided Enron in fraudulently overstating earnings.
- Andersen Worldwide, August 2002: Parent of Arthur Andersen LLP, Enron's chief auditor, agrees to pay \$60m to settle lawsuits related to the company's collapse.

APPENDIX C: ENRON-ANDERSEN TIMELINE

31st May, 2005, 3:29 p.m.

Associated Press, WSJ.com research

2000

December 2000: Enron announces president and chief operating officer Jeffrey Skilling will take over as chief executive from Kenneth Lay the next February. Lay will remain as chairman. Stock hits 52-week high of \$84.87.

2001

August 2001: Skilling resigns after six months; Lay is named CEO again.

Oct. 16: Enron reports \$638 million third-quarter loss and discloses \$1.2 billion reduction in the value of shareholders' stake in the company, partly related to a web of partnerships run by chief financial officer Andrew Fastow that had helped the company inflate profits and hide debt.

Nov. 8: Enron revises financial statements for previous five years to account for \$586 million in losses.

Nov. 28: Enron stock plunges below \$1 as questions about its finances mount.

Dec. 2: Enron files for Chapter 11 bankruptcy protection, the largest in U.S. history at the time.

2002

Jan. 9, 2002: Justice Department confirms it has begun a criminal investigation.

Jan. 23: Lay resigns as chairman and CEO.

March 14: Former Enron auditor Arthur Andersen is indicted for destroying Enron-related documents.

June 15: Andersen is convicted of obstruction. (See full trial recap.)

Oct. 16: Andersen is sentenced to probation and fined \$500,000; firm was already banned from auditing public companies and had only a few hundred employees left after its conviction.

2005

April 27, 2005: Several Supreme Court justices express open disdain during oral arguments for the sweeping theory the Justice Department used to secure the criminal conviction of Andersen. In the trial, the jury had focused on an Andersen attorney's advice to implement a 'document retention' policy – which actually called for destroying tons of paper records just ahead of an expected Securities and Exchange Commission probe – to show that Andersen had 'corruptly' persuaded others to impede an 'official proceeding.'

May 31: The Supreme Court overturns the conviction of Andersen for destroying documents related to its Enron account before the energy giant's collapse. In a unanimous opinion, justices say the former Big Five accounting firm's June 2002 conviction was improper because the jury instructions at trial were too vague and broad for jurors to determine correctly whether Andersen had obstructed justice.

APPENDIX D: ENRON EXECUTIVES LEGAL STATUS

Enron's Lay not charged, not off hook; investigators reviewing stock trades, finances
Carrie Johnson, *Washington Post*, Friday, 20th February, 2004

A Widening Net

With the indictment of Jeffrey K. Skilling, the former president of Enron, most of the company's former top executives have now been indicted or pleaded guilty to various financial crimes. A number of lower-level executives have also been swept up in the investigation.

CORPORATE EXECUTIVES	FORMER POSITION	STATUS	ACCUSATION
Jeffrey K. Skilling	Chief executive	<i>Indicted</i>	Conspired to manipulate Enron's financial statements
Richard A. Causey	Chief accounting officer	<i>Indicted</i>	Conspired with Mr. Fastow to manipulate Enron's financial statements
Andrew S. Fastow	Chief financial officer	<i>Pleaded guilty</i>	Created partnerships to hide Enron's debt and enriched himself in deals between the partnerships and Enron
Lea Fastow	Assistant treasurer	<i>Pleaded guilty</i>	Aided her husband in hiding kickbacks related to the partnerships
Ben F. Glisan Jr.	Treasurer	<i>Pleaded guilty</i>	Manipulated Enron's financial statements to aid Mr. Fastow in the conspiracy
David W. Delainey	Chief executive, energy divisions	<i>Pleaded guilty</i>	Sold stock when he knew Enron's financial statements were false
Michael J. Kopper	Finance executive	<i>Pleaded guilty</i>	Aided Mr. Fastow in his conspiracy
Lawrence M. Lawyer	Finance executive	<i>Pleaded guilty</i>	Evaded taxes by failing to report income from one of the Fastow partnerships
Dan Boyle	Finance executive	<i>Indicted</i>	Helped disguise a loan by Merrill Lynch as a sale of power barges in Nigeria
Sheila K. Kahane	Accountant	<i>Indicted</i>	Helped disguise the Nigerian barge deal

EXECUTIVES AT ENRON'S BROADBAND DIVISION

Joseph M. Hirko	Chief executive	<i>Indicted</i>	Intentionally misled investors about the division's prospects and performance to drive up Enron's stock price and then sold stock knowing that its value was inflated. All have been charged with insider trading, fraud and conspiracy
Kenneth D. Rice	Chief executive	<i>Indicted</i>	
Kevin A. Howard	Chief financial officer	<i>Indicted</i>	
Kevin P. Hannon	Chief operating officer	<i>Indicted</i>	
Rex Shelby	Senior vice president	<i>Indicted</i>	
F. Scott Yeager	Senior vice president	<i>Indicted</i>	
Michael W. Krautz	Accounting director	<i>Indicted</i>	

ENERGY TRADERS

Timothy N. Belden	Managing director	<i>Pleaded guilty</i>	Manipulated the California energy market during the energy crisis in 2000 and 2001 to drive up prices and reap profits for Enron
Jeffrey S. Richter	Senior trader	<i>Pleaded guilty</i>	
John M. Forney	Senior trader	<i>Indicted</i>	

APPENDIX E: LEGAL AND CIVIC RESULTS OF ENRON

No business as usual after 'perfect storm' of Enron scandal

Gregg Fields, *Knight Ridder Newspapers*

10 results of Enron

1. The rise of Spitzer: New York Attorney General Eliot Spitzer cracked down on the brokerage and mutual-fund industries.
2. And the fall of Pitt: Securities and Exchange Commission Harvey Pitt resigned amid charges that he was too close to the accounting industry.
3. The demise of Arthur Andersen: The venerable accounting firm, Enron's auditor, closed after it was convicted of obstructing justice.
4. Sarbanes-Oxley Act: The law requires greater accountability on the part of executives and boards.
5. The brokerage firewall: Tougher separations between financial firms' stock trading and analysis operations were mandated.
6. Greater shareholder rights: 401(k) plans now give shareholders more leeway to sell company stock.
7. Unchained giants: Pension funds have become more aggressive in pushing for changes.
8. Deregulation rethought: Utility deregulation lost its popularity after Enron's abuses in California came to light.
9. No more big paycheck: Richard Grasso left the New York Stock Exchange following repeated controversy over his \$187.5 million pay package.
10. No more big paycheck II: New accounting rules would require companies to treat stock options as an expense; options packages have become more scarce.