Enron Jolt: Investments, Assets Generate Big Loss --- Part of Charge Tied To 2 Partnerships Interests Wall Street

By John **Emshwiller** and Rebecca Smith

Staff Reporters of The Wall Street Journal

10/17/2001

The Wall Street Journal

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Enron Corp. yesterday took a $1.01 billion charge mostly connected with write-downs of soured investments, producing a $618 million third-quarter loss. The loss highlights the risks the onetime highflier has taken in transforming itself from a pipeline company into a behemoth that trades everything from electricity to weather futures.

In addition to the size of the charge, a particular slice raises anew vexing conflict-of-interest questions. The slice is connected with a pair of limited partnerships that until recently were run by **Enron**'s chief financial officer. The company said the charge connected with the partnerships is $35 million and involves the "early termination . . . of certain structured finance arrangements."

Two years ago, the chief financial officer, Andrew S. Fastow, entered into the unusual arrangement with his employer. With the approval of the board of **Enron**, Mr. Fastow set up and ran the partnerships that stood to make him millions or more, according to partnership documents. While the company says that this arrangement was proper, some corporate-governance watchdogs have questioned whether a chief financial officer, who is responsible for overseeing the financial interests of the company, should have been involved in such a partnership that was, among other things, looking to purchase assets from **Enron**.

The two partnerships, LJM Cayman LP and the much larger LJM2 Co-Investment LP, have engaged in billions of dollars of complex hedging transactions with **Enron** involving company assets and millions of shares of **Enron** stock. It isn't clear from **Enron** filings with the Securities and Exchange Commission what **Enron** received in return for providing these assets and shares. In a number of transactions, notes receivable were provided by partnership-related entities.

Mr. Fastow's role as chief financial officer made him privy to internal asset analyses at **Enron**. An offering memorandum for the LJM2 partnership said that this dual role "should result in a steady flow of opportunities . . . to make investments at attractive prices." Mr. Fastow would find his interests "aligned" with investors because the "economics of the partnership would have significant impact on the general partner's wealth," according to this document.

In a written statement in response to questions, **Enron**, based in Houston, said "there never was any obligation for **Enron** to do any transaction with LJM. **Enron** and its Board established special review and approval processes with its senior management and external audit and legal counsel to ensure that each transaction with the LJM partnership was fair, in the best interest of **Enron** and its shareholders, and appropriately disclosed."

Mr. Fastow, through an **Enron** spokesman, declined to be interviewed.

In announcing the third-quarter loss, **Enron** said the partnership-related write-offs were part of a larger $544 million charge related to the diminished value of investments in a retail-power business, broadband telecommunications and technology. In addition, there was also a $287 million write-off resulting from its investment in Azurix Corp., a water company **Enron** spun off and then repurchased. In all, **Enron** posted a third-quarter loss of 84 cents a share, compared with a gain of 34 cents a share in the year-earlier period. Revenue rose 59% to $47.6 billion.

At 4 p.m. yesterday, **Enron**'s stock was up 67 cents a share to $33.84 in composite trading on the New York Stock Exchange, but remains far below its 52-week high of $84.88. On Monday, the day before the earnings announcement, **Enron** stock dropped by about 7%.

In an interview, **Enron**'s chairman and chief executive, Kenneth Lay, said the write-offs were designed as part of an effort to "find anything and everything that was a distraction and was causing a cloud over the company."

The quarterly loss is the latest in a series of setbacks faced by **Enron** recently after years of almost unbroken success. There have been mounting problems from expensive moves into the water and telecommunications businesses.

And there has been a steady stream of executive departures, most notably the surprise resignation in August of **Enron**'s president and chief executive, Jeffrey Skilling, who said he left for personal reasons and because of the fallen stock price.

The partnership arrangement involving Mr. Fastow, the highly regarded chief financial officer, first surfaced in an **Enron** SEC filing in 1999, but only recently has it attracted Wall Street's concern. In late July, Mr. Fastow severed his relations with the partnerships, according to a company SEC filing. Company officials said that move was partly related to questions raised by analysts and large **Enron** shareholders.

Little about the inner workings of the LJM partnerships has been disclosed to date. Private partnership documents reviewed by The Wall Street Journal indicate that **Enron** agreed to a partnership arrangement

Enron CFO's Partnership Had Millions in Profit

By Rebecca Smith and John R. **Emshwiller**
Staff Reporters of The Wall Street Journal

10/19/2001
The Wall Street Journal

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A limited partnership organized by **Enron** Corp.'s chief financial officer, Andrew S. Fastow, realized millions of dollars in profits in transactions it did with **Enron**, according to an internal partnership document.

The partnership, in some instances, benefited from renegotiating the terms of existing deals with the Houston energy company in ways that improved the partnership's financial positions or reduced its risk of losses.

Mr. Fastow, and possibly a handful of partnership associates, realized more than $7 million last year in management fees and about $4 million in capital increases on an investment of nearly $3 million in the partnership, which was set up in December 1999 principally to do business with **Enron**.

The profits from the deals were disclosed in a financial report to investors in the partnership, LJM2 Co-Investment LP, that was signed by Mr. Fastow as the general partner and dated April 30. In one case, the report indicates the partnership was able to improve profits by terminating a transaction early.

The LJM2 arrangement has become controversial for **Enron**, as shareholders and analysts have raised questions about whether it posed a conflict by putting the company's chief financial officer, who has a fiduciary duty to **Enron** shareholders, in a position of reaping financial rewards for representing LJM2 investors in business deals with **Enron**. Investors in LJM2 include Wachovia Corp., General Electric Co.'s General Electric Capital Corp. and Credit Suisse Group's Credit Suisse First Boston.

Attention has focused on Mr. Fastow's partnership activities at a tumultuous time for **Enron**, which over the past decade grew enormously by becoming the nation's biggest energy-trading company.

This year, though, it has been hit by a string of troubles, from soured business initiatives to executive departures. On Tuesday, **Enron** announced a $618 million third-quarter loss, because of a $1.01 billion write-off on investments in broadband telecommunications, retail energy services and Azurix Corp., a water company. A small chunk of that write-off, about $35 million, was attributed to ending certain LJM2-related transactions. That termination also produced a $1.2 billion reduction in **Enron** shareholder equity as the company decided to repurchase 55 million shares that had been part of LJM2 deals.

At 4 p.m. in New York Stock Exchange composite trading, **Enron** was down 9.9%, or $3.20, to $29 a share. Within the past year, the stock had topped $80 a share.

Enron officials didn't have any comment about the LJM2 partnership document. **Enron** has consistently said its dealings with LJM2 have been proper. They said the LJM2 deals, like ones done with other parties, were aimed at helping hedge against fluctuating market values of its assets and adding sources of capital.

Mr. Fastow has declined several requests for an interview about LJM2. In late July, he formally severed his ties with LJM2, as a result of what **Enron** officials said was growing unease by Wall Street analysts and major shareholders. Mr. Fastow has been finance chief of **Enron** since 1997 and has been with the firm 11 years, which included extensive work setting up and managing company investments.

Michael Kopper, a former **Enron** executive who an **Enron** spokesman said is now helping to operate LJM2, declined to comment. He also wouldn't describe his relation to LJM2.

In his April 30 report, Mr. Fastow said the partnership, which raised $394 million, had invested in several **Enron**-related deals involving power plants and other assets as well as company stock. The document said LJM2 sought a 29% internal rate of return. That was down from a 48% targeted rate of return at the end of 2000, which the document said was due in part to a decline in the value of LJM2's investment in New Power Co., an **Enron**-related energy retailer. In some transactions, LJM2 did much better than the 29% target, though this sometimes involved renegotiating individual deals.

In September 2000, the partnership invested $30 million in "Raptor III," which involved writing put options committing LJM2 to buy **Enron** stock at a set price for six months. Four months into this deal, LJM2 approached **Enron** to settle the investment early, "causing LJM2 to receive its $30 million capital invested plus $10.5 million in profit," the report said. The renegotiation was before a decline in **Enron**'s stock price, which could have forced LJM2 to buy **Enron** shares at a loss of as much as $8 each, the document indicated.

Enron Transaction Raises New Questions --- A Company Executive Ran Entity That Received $35 Million in March

By John R. **Emshwiller** Staff Reporter of The Wall Street Journal 11/05/2001

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In a transaction that raises new questions about **Enron** Corp.'s financial dealings with its management, the company in March made a $35 million purchase from an entity run by a company officer.

That payment appears to have been the last step in a complex series of transactions that allowed **Enron** to keep hundreds of millions of dollars of debt off its balance sheet for the past three years, during which the Houston-based energy-trading giant has grown rapidly. In recent weeks, **Enron**'s labyrinth of financial transactions, particularly with members of company management, has come under intense scrutiny from investors and regulators, who are seeking information about the impact of the transactions on the company and whether **Enron** adequately disclosed the deals to the public. **Enron** last week disclosed that the Securities and Exchange Commission had begun a formal investigation.

Enron officials have said repeatedly that all their actions were legal and properly disclosed. They have promised to cooperate with the SEC probe.

Enron officials wouldn't discuss the $35 million transaction. What has been learned about it was gleaned from interviews with others familiar with the matter, snippets from **Enron** SEC filings and private partnership documents. Based on these sources, the **Enron** officer involved in the transaction was Michael Kopper, a former managing director of the company's **Enron** North America unit. The entity receiving the $35 million was Chewco Investments LP. It wasn't clear from the available information what form the payment took or what, if any, gain Chewco or Mr. Kopper realized.

Mr. Kopper, who a company spokesman says left **Enron** in July, didn't return phone calls seeking comment. In the past, he has declined to be interviewed.

At **Enron**, Mr. Kopper was an associate of Andrew Fastow, the company's chief financial officer until last month. In 1999, they set up and subsequently ran a private partnership known as LJM2 Co-Investment LP, which was involved in billions of dollars of transactions with **Enron**, according to private-partnership documents and company SEC filings. Those partnership documents indicate Mr. Fastow and possibly a handful of **Enron** associates, including Mr. Kopper, made millions of dollars in fees and investment gains from LJM2.

Last month, in response to mounting controversy over the partnership dealings, **Enron** replaced Mr. Fastow as chief financial officer. Mr. Fastow hasn't responded to numerous interview requests.

Chewco is mentioned in a brief biography of Mr. Kopper that is part of a 1999 offering memorandum for the LJM2 partnership. The document said Mr. Kopper, besides being a "principal" of LJM2, "manages the general partner of Chewco, an investment fund with approximately $400 million in capital commitments that was established in 1997 to purchase from **Enron** an interest in a defined pool of **Enron** assets." The document doesn't specify what assets were purchased.

Chewco's name also appears as the debtor in a 1997 filing with the office of the Texas secretary of state. The secured party, and presumably the lender, on that debt was a limited partnership called Joint Energy Development Investments LP.

Known as JEDI, this limited partnership was created in 1993 by **Enron** and the huge California Public Employees' Retirement System to make energy-related investments. According to **Enron** SEC filings, the company and Calpers each put in $250 million and an **Enron** affiliate served as JEDI general partner and operator.

Besides bringing in outside equity, entities such as JEDI allowed **Enron** to borrow large sums for asset purchases without that debt showing up on

Enron's balance sheet. In recent years, top **Enron** officials have said publicly that keeping down debt load was vital to protecting the company's credit rating and sustaining its tremendous growth. At the end of 1995, **Enron** had $13.2 billion in assets; as of June 30, it had $63.4 billion.

Messrs. Kopper and Fastow had "extensive involvement in the organization, investment activity and operations" of JEDI, according to the 1999 LJM2 private-offering memorandum. JEDI invested $2.1 billion in 63 separate transactions, the document said. After accounting for JEDI's $500 million in equity, this indicates the partnership borrowed as much as $1.6 billion.

In 1997, Calpers sold its interest in JEDI back to **Enron** for about $375 million. At about the same time, Calpers put $500 million into a new **Enron** partnership, known as JEDI II.

At this point, **Enron** could have held on to all of JEDI, but that probably would have entailed consolidating the partnership and its debts into the company's financial statements.

That, apparently, is where Chewco came in. (Chewco got its name, says one person familiar with the matter, from the character Chewbacca in the "Star Wars" movies, where Jedi warriors also roamed.) Chewco bought from **Enron** the JEDI interest formerly held by Calpers, according to documents and interviews. It couldn't be determined what the terms of that transaction were. However, the fact that Chewco shows up as a debtor to JEDI in the Texas state filing suggests that money for the purchase was borrowed from JEDI itself.

The available information on the chain of transactions raises questions about how separate JEDI and Chewco really were from **Enron** and whether JEDI's assets and liabilities should have been folded into the company's financial statements.

In a March 2000 SEC filing, **Enron** makes a brief reference to its new JEDI partner, which **Enron** doesn't identify but presumably is Chewco. The filing said "an officer of **Enron** has invested in the limited partner of JEDI and from time to time acts as agent on behalf of the limited partner's management." While the officer isn't named, the description is similar to that given for Mr. Kopper in relation to Chewco in the LJM2 offering memorandum.

In March of this year, **Enron** moved to purchase the balance of JEDI that it didn't already own. In an SEC filing earlier this year, **Enron** said it acquired for $35 million "the limited partner's interests" in JEDI. Again, the partner wasn't named, but presumably was Chewco.

Enron consolidated JEDI's assets and liabilities into the company. The SEC filing said JEDI's holdings included 12 million shares of **Enron** stock. **Enron** said it also paid off about $620 million of JEDI "third-party debt." The third party or parties weren't named.

A Jedi's Journey

-- 1993: **Enron** and California Public Employees' Retirement System, or Calpers, form JEDI limited partnership and each commit $250 million to make energy investments.

-- 1997: **Enron** purchases Calpers' share in JEDI for about $375 million and then resells it to an entity, believed to be Chewco Investments. Chewco formed with $400 million in capital commitments and run by **Enron** officer to purchase **Enron** assets.

-- 2001: **Enron** repurchases all of JEDI and consolidates it into the company.

Trading Places: Fancy Finances Were Key to Enron's Success, And Now to Its Distress --- Impenetrable Deals Have Put Firm in Position Where It May Lose Independence --- Talks With Rival Dynegy

By Rebecca Smith and John R. **Emshwiller** Staff Reporters of The Wall Street Journal

11/08/2001 The Wall Street Journal A1 (Copyright (c) 2001, Dow Jones & Company, Inc.) When **Enron** Corp. convened its annual conference with credit analysts and bond investors in Houston last February, the energy-trading giant was soaring and looking to climb higher.

The company's stock was trading at about $80 a share, giving it a stock market value of $70 billion. Though up fourfold from three years earlier, the stock price wasn't nearly high enough, **Enron**'s new chief executive, Jeffrey Skilling, told the audience. With its dominant position in energy-trading markets and its highly touted new moves into telecommunications, **Enron** stock should be at $126 a share, Mr. Skilling argued.

All in all, a vintage performance for a company not known for being bashful. "A lot of hype. A lot of spin," recalls Todd Shipman, a Standard & Poor's analyst who attended the conference. "That was **Enron**."

Yesterday, **Enron** stock closed at $9.05 in New York Stock Exchange trading. Mr. Skilling is no longer around to promote the stock. In August, he unexpectedly resigned as chief executive after only six months in the top job. Chief financial officer Andrew Fastow was replaced last month as controversy escalated over his role in running private partnerships involved in billions of dollars of transactions with **Enron**. Kenneth Lay, **Enron**'s chief executive, has had to give up retirement plans to return to the helm.

Lately, the company has been offering special credit protection to increasingly nervous trading partners, including Reliant Energy Inc. and Entergy Corp. The goal: to provide assurance that **Enron** is a creditworthy partner and to prevent an exodus of customers. **Enron**'s trading operation generates 90% of the company's profits.

It looked yesterday as if the endgame might be beginning. Mr. Lay and **Enron**'s board were discussing a possible acquisition of **Enron** by its much-smaller hometown energy-trading rival, Dynegy Inc., in a stock swap valued at $7 billion to $8 billion. (See related article on page A3.)

Any merger of the two companies would probably face lengthy regulatory scrutiny, so Dynegy is also considering injecting $1.5 billion into **Enron** immediately to help stabilize the company's finances, according to people familiar with the situation. The deal would also include a significant role for oil powerhouse ChevronTexaco, which owns a 26% stake in Dynegy and would be likely to provide much of the cash for any **Enron** transaction.

Dynegy's emergence as a serious bidder for **Enron** could indicate to other interested parties that **Enron**'s problems can be solved. In fact, the collapse in **Enron**'s stock price would make it fairly easy for another large energy player to top any Dynegy offer. Royal Dutch/Shell Group is one such prominent company.

A takeover by Dynegy or any other company would almost certainly presage the departure of the 59-year-old Mr. Lay. He oversaw the transformation of **Enron** from a nondescript natural-gas pipeline company with annual revenue of under $5 billion in the late 1980s to a global energy colossus with revenue that is expected to approach $200 billion this year.

It has turned out that the formula behind that transformation contained the seeds for the company's current troubles. Executives created an ever-more-labyrinthine financial structure to support **Enron**'s explosive growth rate. Billions of dollars of debt -- which could have weakened **Enron**'s credit rating and slowed growth -- was kept off the balance sheet through tangled webs of transactions with dozens of related entities. As the financial demands became greater and the transactions more complex, **Enron** officials began creating and heading some of the entities, raising serious conflict-of-interest questions.

Neither **Enron** nor Dynegy would comment. Royal Dutch/Shell also declined to comment. Messrs. Lay, Skilling and Fastow either declined to comment or didn't return phone calls seeking interviews.

Enron officials have maintained that the markets are overreacting to a spate of bad, but nonfatal, news. On Oct. 16, the company announced a $618 million third-quarter loss and disclosed a $1.2 billion reduction of shareholder equity due in part to dealings with the Fastow-related partnerships. The company has said that its ongoing businesses are strong and it has the financial wherewithal to weather the crisis. All of its actions have been legal and properly disclosed, **Enron** has stressed.

Still, its predicament is daunting. The Securities and Exchange Commission has started a formal investigation into possible violations of federal securities law involving the Fastow-related partnerships. Several shareholder lawsuits seeking class-action status have been filed against top company officials, alleging fraud and seeking to recover some of the $20 billion in market value that **Enron** shares have lost in the past month. To address growing jitters in the energy and financial markets, **Enron** has drawn down billions of dollars of credit lines, negotiated new ones and sought a new equity infusion.

As turmoil has engulfed the company, Mr. Lay and other top **Enron** executives have kept largely out of public view -- in sharp contrast to the company's normally outspoken public persona. The one recent public-relations initiative, a conference call for analysts and big investors, turned into what even **Enron** officials concede privately was a debacle. It left company executives looking evasive and defensive rather than open and confident.

How did **Enron**, which routinely made published lists of the most-admired and innovative companies in America, fly so high and fall so fast? The answer lies in a combination of brilliance and overconfidence on a scale rarely seen in the business world.

In the process, the company helped redefine much of the energy marketplace on matters as fundamental as how power is bought and sold and how a company produces a profit from doing so. For example, the company helped create an electricity-trading market in which participants rarely take physical delivery of the commodity but instead merely tally profits or losses from transactions.

In the accounting realm, it pioneered techniques that allowed energy companies to record profits or losses on long-term contracts that hadn't yet produced any revenue. "We caught a little flak in the early 1990s from people who, I guess, thought we were pulling a fast one," **Enron**'s chief accounting officer, Richard Causey, said in an interview in August. He added that this accounting method was the most accurate way to measure energy-trading results.

Enron's audacity and success sent other energy companies scrambling to emulate it, a process that ABN Amro analyst Paul Patterson calls "**Enron** envy."

The company tested the limits of securities and accounting rules. For example, **Enron**'s SEC filings have included statements about the Fastow-related transactions that might meet the letter of disclosure laws but are so complex that even some Wall Street analysts and accounting professors have found them indecipherable.

Enron's seemingly impenetrable financial structure, hardly noticed by Wall Street in the company's heyday, is now a matter of serious concern in a suddenly skeptical investment community. "It's not easy to regain something as basic as trust," says Goldman Sachs analyst David Fleischer, a longtime **Enron** fan. In the recent conference call with **Enron** executives, Mr. Fleischer pleaded with the company to be more forthcoming about its operations -- something it has been promising to do for months.

While **Enron** employs some 20,000 people, its rise and fall can, in large measure, be traced to three men: Messrs. Lay, Skilling and Fastow. Mr. Lay joined the company in 1984 when it was still called Houston Natural Gas, a regional pipeline operator. Back then, the natural-gas industry was a largely regional business and about as exciting as watching a pipeline operate.

But Mr. Lay had big plans for his company, always preaching that natural gas was the fuel of the future. His prediction has been largely borne out when it comes to such functions as fueling electric-power plants.

He wanted to take the company beyond natural gas. **Enron** bought an electric utility in Portland, Ore., and built power plants around the world. It developed its potent energy-trading operation, which buys and sells contracts to provide electricity in the same way that contracts for wheat and pork bellies are traded. These deals were done with utilities, industrial power users and other trading firms.

To help enlarge this empire, he recruited aggressive young executives. None was brighter or more assertive than Mr. Skilling, a Harvard Business School graduate and former McKinsey & Co. consultant who joined **Enron** in 1990.

Under Messrs. Lay and Skilling, the company pushed zealously for the deregulation of energy markets -- particularly that bastion of monopoly businesses, the electric-utility industry. **Enron** officials argued that open, competitive markets could help consumers and, not coincidentally, provide huge profit opportunities in energy trading.

Mr. Skilling called the energy-trading business "a once-in-a-lifetime opportunity to establish a position to last for the next 100 years." By the late 1990s, **Enron** had evolved into primarily a trading company, rather than an owner of power plants and pipelines.

In pursuit of their deregulation goals, **Enron** officials became major players in American politics. Mr. Lay has given nearly $2 million to President Bush during his political career and is a personal friend of the president, Vice President Cheney and several members of the cabinet.

One of Mr. Skilling's early hires after joining **Enron** was Mr. Fastow, at the time a 29-year-old MBA from Northwestern's Kellogg School who had been working on leveraged buyouts and other complicated deals at Continental Bank in Chicago. Former **Enron** officials and others say that Mr. Skilling quickly became Mr. Fastow's mentor in the same way that Mr. Lay had become Mr. Skilling's.

As Mr. Skilling oversaw the building of **Enron**'s vast trading operation, Mr. Fastow saw to the financing of it. "Andy was the guy you saw when you wanted money" for a project, says one former **Enron** senior manager.

Mr. Skilling was named **Enron**'s chief operating officer in 1997. Mr. Fastow got the top finance job a year later, at the age of 36. Under Mr. Fastow, **Enron**'s finance department tripled in size, to more than 100 people.

Enron needed the added financial brainpower. As it expanded, debt and liquidity were constant concerns. What's more, the company's ambitions were roving beyond therms and kilowatts as it began to make markets in everything from water to weather.

Enron's most highly touted non-energy initiative, and Mr. Skilling's pet project, came in the area of telecommunications. The company built a coast-to-coast fiber-optic network and envisioned trading "bandwidth," or network capacity, the way it traded electricity or natural gas. **Enron** has invested several hundred million dollars so far in the project, which has produced losses of over $400 million. Yet at the February analyst meeting in Houston, Mr. Skilling unabashedly valued **Enron**'s fiber-optic business at $36 billion, according to people who were at the meeting.

But to make all of its growth dreams possible, **Enron** had to make sure that its balance sheet didn't become too laden with debt. Too much debt would lead major ratings agencies, such as Moody's Investors Service and Standard & Poor's, to lower **Enron**'s credit rating. Such downgrades could significantly increase the company's cost of borrowing and make it more difficult to finance its continued expansion.

In typically aggressive fashion, **Enron** lobbied the ratings agencies with the same vigor that it lobbied legislators. At the February meeting, Mr. Fastow urged analysts to raise **Enron**'s credit rating on long-term debt from triple-B-plus to single-A-minus. But the analysts shrugged off Mr. Fastow's entreaties. They didn't see the cash flow, earnings, or debt coverage required for such an upgrade, says one attendee.

Undeterred, Mr. Fastow said the higher rating would strengthen the company's basic finances, which could then justify the higher rating. This circular argument provoked derision among analysts, and **Enron** didn't get its `A' rating. Instead, the company was recently downgraded by the major ratings agencies as a result of its financial turmoil.

In moves that kept down its reported debt burden, **Enron** turned increasingly to off-balance-sheet transactions through limited partnerships with outside parties. In such an arrangement, **Enron** could contribute money, stock or other assets to the partnership. The partnership could then borrow large sums to purchase assets or do business deals without the debt showing up on **Enron**'s books.

While such partnership transactions had long been used in the natural-gas industry to finance deals, **Enron** took the practice to new heights of complexity. Leading that effort was Mr. Fastow and his team of young financial experts.

In recent years, **Enron** has done myriad deals with more than 30 partnerships. By far the most controversial to come to light, so far, are the ones it has done with two partnerships -- known as LJM Cayman LP and LJM2 Co-Investment LP -- which were formed and operated by Mr. Fastow. The company has said that its transactions with these partnerships were designed to hedge against fluctuating market values of company assets and energy contracts.

It isn't clear why **Enron** would allow its chief financial officer to be in a fiduciary position at partnerships that stood to profit, possibly at the company's expense, from doing deals with it. To make matters worse, private LJM partnership documents indicate that Mr. Fastow personally made millions of dollars from the partnerships -- much more than he was being paid as **Enron**'s chief financial officer.

Enron officials have repeatedly said that Mr. Fastow's actions were reviewed and approved by top management and the board of directors. However, the company has refused to answer numerous specific questions about its dealings with the partnerships. **Enron** has said that Mr. Fastow formally severed his ties with the partnerships in July in the face of rising discomfort about the arrangements on the part of analysts and major company investors.

It is nearly impossible to stitch together anything comprehensible about the partnership deals from **Enron**'s SEC filings. The only thing clear is that millions of shares of **Enron** stock and billions of dollars of assets and notes were involved in the transactions.

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Neither **Enron** nor Dynegy would comment. Royal Dutch/Shell also declined to comment. Messrs. Lay, Skilling and Fastow either declined to comment or didn't return phone calls seeking interviews.

Enron officials have maintained that the markets are overreacting to a spate of bad, but nonfatal, news. On Oct. 16, the company announced a $618 million third-quarter loss and disclosed a $1.2 billion reduction of shareholder equity due in part to dealings with the Fastow-related partnerships. The company has said that its ongoing businesses are strong and it has the financial wherewithal to weather the crisis. All of its actions have been legal and properly disclosed, **Enron** has stressed.

Still, its predicament is daunting. The Securities and Exchange Commission has started a formal investigation into possible violations of federal securities law involving the Fastow-related partnerships. Several shareholder lawsuits seeking class-action status have been filed against top company officials, alleging fraud and seeking to recover some of the $20 billion in market value that **Enron** shares have lost in the past month. To address growing jitters in the energy and financial markets, **Enron** has drawn down billions of dollars of credit lines, negotiated new ones and sought a new equity infusion.

As turmoil has engulfed the company, Mr. Lay and other top **Enron** executives have kept largely out of public view -- in sharp contrast to the company's normally outspoken public persona. The one recent public-relations initiative, a conference call for analysts and big investors, turned into what even **Enron** officials concede privately was a debacle. It left company executives looking evasive and defensive rather than open and confident.

How did **Enron**, which routinely made published lists of the most-admired and innovative companies in America, fly so high and fall so fast? The answer lies in a combination of brilliance and overconfidence on a scale rarely seen in the business world.

In the process, the company helped redefine much of the energy marketplace on matters as fundamental as how power is bought and sold and how a company produces a profit from doing so. For example, the company helped create an electricity-trading market in which participants rarely take physical delivery of the commodity but instead merely tally profits or losses from transactions.

In the accounting realm, it pioneered techniques that allowed energy companies to record profits or losses on long-term contracts that hadn't yet produced any revenue. "We caught a little flak in the early 1990s from people who, I guess, thought we were pulling a fast one," **Enron**'s chief accounting officer, Richard Causey, said in an interview in August. He added that this accounting method was the most accurate way to measure energy-trading results.

Enron's audacity and success sent other energy companies scrambling to emulate it, a process that ABN Amro analyst Paul Patterson calls "**Enron** envy."

The company tested the limits of securities and accounting rules. For example, **Enron**'s SEC filings have included statements about the Fastow-related transactions that might meet the letter of disclosure laws but are so complex that even some Wall Street analysts and accounting professors have found them indecipherable.

Enron's seemingly impenetrable financial structure, hardly noticed by Wall Street in the company's heyday, is now a matter of serious concern in a suddenly skeptical investment community. "It's not easy to regain something as basic as trust," says Goldman Sachs analyst David Fleischer, a longtime **Enron** fan. In the recent conference call with **Enron** executives, Mr. Fleischer pleaded with the company to be more forthcoming about its operations -- something it has been promising to do for months.

While **Enron** employs some 20,000 people, its rise and fall can, in large measure, be traced to three men: Messrs. Lay, Skilling and Fastow. Mr. Lay joined the company in 1984 when it was still called Houston Natural Gas, a regional pipeline operator. Back then, the natural-gas industry was a largely regional business and about as exciting as watching a pipeline operate.

But Mr. Lay had big plans for his company, always preaching that natural gas was the fuel of the future. His prediction has been largely borne out when it comes to such functions as fueling electric-power plants.

He wanted to take the company beyond natural gas. **Enron** bought an electric utility in Portland, Ore., and built power plants around the world. It developed its potent energy-trading operation, which buys and sells contracts to provide electricity in the same way that contracts for wheat and pork bellies are traded. These deals were done with utilities, industrial power users and other trading firms.

To help enlarge this empire, he recruited aggressive young executives. None was brighter or more assertive than Mr. Skilling, a Harvard Business School graduate and former McKinsey & Co. consultant who joined **Enron** in 1990.

Under Messrs. Lay and Skilling, the company pushed zealously for the deregulation of energy markets -- particularly that bastion of monopoly businesses, the electric-utility industry. **Enron** officials argued that open, competitive markets could help consumers and, not coincidentally, provide huge profit opportunities in energy trading.

Mr. Skilling called the energy-trading business "a once-in-a-lifetime opportunity to establish a position to last for the next 100 years." By the late 1990s, **Enron** had evolved into primarily a trading company, rather than an owner of power plants and pipelines.

In pursuit of their deregulation goals, **Enron** officials became major players in American politics. Mr. Lay has given nearly $2 million to President Bush during his political career and is a personal friend of the president, Vice President Cheney and several members of the cabinet.

One of Mr. Skilling's early hires after joining **Enron** was Mr. Fastow, at the time a 29-year-old MBA from Northwestern's Kellogg School who had been working on leveraged buyouts and other complicated deals at Continental Bank in Chicago. Former **Enron** officials and others say that Mr. Skilling quickly became Mr. Fastow's mentor in the same way that Mr. Lay had become Mr. Skilling's.

As Mr. Skilling oversaw the building of **Enron**'s vast trading operation, Mr. Fastow saw to the financing of it. "Andy was the guy you saw when you wanted money" for a project, says one former **Enron** senior manager.

Mr. Skilling was named **Enron**'s chief operating officer in 1997. Mr. Fastow got the top finance job a year later, at the age of 36. Under Mr. Fastow, **Enron**'s finance department tripled in size, to more than 100 people.

Enron needed the added financial brainpower. As it expanded, debt and liquidity were constant concerns. What's more, the company's ambitions were roving beyond therms and kilowatts as it began to make markets in everything from water to weather.

Enron's most highly touted non-energy initiative, and Mr. Skilling's pet project, came in the area of telecommunications. The company built a coast-to-coast fiber-optic network and envisioned trading "bandwidth," or network capacity, the way it traded electricity or natural gas. **Enron** has invested several hundred million dollars so far in the project, which has produced losses of over $400 million. Yet at the February analyst meeting in Houston, Mr. Skilling unabashedly valued **Enron**'s fiber-optic business at $36 billion, according to people who were at the meeting.

But to make all of its growth dreams possible, **Enron** had to make sure that its balance sheet didn't become too laden with debt. Too much debt would lead major ratings agencies, such as Moody's Investors Service and Standard & Poor's, to lower **Enron**'s credit rating. Such downgrades could significantly increase the company's cost of borrowing and make it more difficult to finance its continued expansion.

In typically aggressive fashion, **Enron** lobbied the ratings agencies with the same vigor that it lobbied legislators. At the February meeting, Mr. Fastow urged analysts to raise **Enron**'s credit rating on long-term debt from triple-B-plus to single-A-minus. But the analysts shrugged off Mr. Fastow's entreaties. They didn't see the cash flow, earnings, or debt coverage required for such an upgrade, says one attendee.

Undeterred, Mr. Fastow said the higher rating would strengthen the company's basic finances, which could then justify the higher rating. This circular argument provoked derision among analysts, and **Enron** didn't get its `A' rating. Instead, the company was recently downgraded by the major ratings agencies as a result of its financial turmoil.

In moves that kept down its reported debt burden, **Enron** turned increasingly to off-balance-sheet transactions through limited partnerships with outside parties. In such an arrangement, **Enron** could contribute money, stock or other assets to the partnership. The partnership could then borrow large sums to purchase assets or do business deals without the debt showing up on **Enron**'s books.

While such partnership transactions had long been used in the natural-gas industry to finance deals, **Enron** took the practice to new heights of complexity. Leading that effort was Mr. Fastow and his team of young financial experts.

In recent years, **Enron** has done myriad deals with more than 30 partnerships. By far the most controversial to come to light, so far, are the ones it has done with two partnerships -- known as LJM Cayman LP and LJM2 Co-Investment LP -- which were formed and operated by Mr. Fastow. The company has said that its transactions with these partnerships were designed to hedge against fluctuating market values of company assets and energy contracts.

It isn't clear why **Enron** would allow its chief financial officer to be in a fiduciary position at partnerships that stood to profit, possibly at the company's expense, from doing deals with it. To make matters worse, private LJM partnership documents indicate that Mr. Fastow personally made millions of dollars from the partnerships -- much more than he was being paid as **Enron**'s chief financial officer.

Enron officials have repeatedly said that Mr. Fastow's actions were reviewed and approved by top management and the board of directors. However, the company has refused to answer numerous specific questions about its dealings with the partnerships. **Enron** has said that Mr. Fastow formally severed his ties with the partnerships in July in the face of rising discomfort about the arrangements on the part of analysts and major company investors.

It is nearly impossible to stitch together anything comprehensible about the partnership deals from **Enron**'s SEC filings. The only thing clear is that millions of shares of **Enron** stock and billions of dollars of assets and notes were involved in the transactions.

Running on Empty: Enron Faces Collapse As Credit, Stock Dive And Dynegy Bolts --- Energy-Trading Giant's Fate Could Reshape Industry, Bring Tighter Regulation --- Price Quotes Suddenly Gone

By **Rebecca Smith** and John R. Emshwiller Staff Reporters of The Wall Street Journal 11/29/2001

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Enron Corp., the once-mighty energy trader at the center of the nation's vast deregulated market for electricity and natural gas, wobbled on the brink of collapse yesterday after credit-rating agencies downgraded its debt to junk status.

Following the ratings announcements -- which force Enron to accelerate repayment of billions of dollars of debt from cash it doesn't have -- its smaller cross-town rival in Houston, Dynegy Inc., called off a planned merger. The $9 billion all-stock deal had been aimed at rescuing Enron after questions about a series of financial transactions involving company insiders shook investors and sent Enron's stock plunging. Dynegy yesterday accused Enron of "misrepresentations" -- an allegation Enron denied and is expected to contest in court.

In a day that brought a series of devastating rapid-fire blows to Enron, its energy-trading business -- the nation's biggest, having handled $1 trillion in transactions since

November 1999 -- shut down for two and a half hours. Soon after the downgrade announcements, price quotes on Enron's widely used online trading system went blank, as one trader after another at the company's Houston headquarters walked away.

Enron's breathtaking fall will reshape the U.S. energy business, casting doubt on the belief that gas and electricity markets should be lightly regulated, with their management largely left to freewheeling traders. The fiercest industry proponent of free markets, Enron was vilified by California officials earlier this year, when the state's deregulated market careened off course. California's largest utilities lurched toward insolvency, leaving the state saddled with billions of dollars of debt.

With no access to credit and its only potential savior on the fly, it now appears that Enron may well be joining PG&E Corp.'s Pacific Gas and Electric unit in U.S. bankruptcy court. That would be a striking irony, since Enron once was regarded as being in the vanguard of a new way of doing business that would relegate old-line utilities like Pacific Gas and Electric to second-class status.

On its books, Enron has assets worth $62 billion. But investors have little confidence in that number or in the company's accounting of its sizeable liabilities. Enron has recently been adjusting its financial figures, and many of its dealings are still poorly understood by outsiders. A week ago, the company said it had about $1.6 billion in cash -- a surprise to many analysts who thought it had $1 billion more than that.

The bottom line: Enron doesn't appear to have enough profitable assets to survive in its current form.

Under Chairman and Chief Executive Kenneth Lay, the company embarked on a revolutionary transformation, moving away from the business of running hard energy assets, such as power plants, and into the field of buying and selling contracts for energy. The crown jewel sought by Dynegy wasn't Enron's handful of power plants and pipelines around the globe, but its EnronOnline trading system.

Since its start in November 1999, the system had become the dominant forum for U.S. electricity and natural-gas trading. As Enron's problems mounted in recent weeks, other trading firms began limiting their exposure to the company, causing its trading volume -- and hence, cash flow -- to dry up.

The sudden decline of Enron's once-potent trading business is one big reason Standard & Poors Ratings Group, Moody's Investors Service Inc. and Fitch Inc. pulled the trigger yesterday. Noting that the Dynegy merger probably wouldn't go through, S&P also said Enron's woes in recent weeks had caused "significant damage" to its trading and marketing operations. The company's market capitalization has fallen from a peak of about $70 billion in 2000 to less than $1 billion.

S&P said that a voluntary filing by Enron under Chapter 11 of the U.S. Bankruptcy Code is "a distinct possibility." Chapter 11 gives a company protection from its creditors while it reorganizes.

Unwilling to concede defeat, Enron's chief financial officer, Jeff McMahon, said the firm is "reviewing all our options" but isn't contemplating liquidation.

Enron's stock and bond prices fell hard yesterday. Its shares, which had been hovering at about $4 as Dynegy and Enron worked to resuscitate the deal, closed at 61 cents in New York Stock Exchange composite trading. Enron's benchmark bonds fell to 20 cents on the dollar, down from their already-depressed level of 50 cents. Dynegy shares fell $4.92, to close at $35.97 in NYSE trading.

Enron, which has 21,000 employees, was dropped from the S&P 500 Index after the markets closed yesterday.

The company's crash is likely to push regulators to keep a closer eye on such asset-light energy traders that have reported huge profits while generating relatively little cash from operations. The Federal Energy Regulatory Commission is considering applying tougher rules to wholesale-energy markets, while other regulators will look more closely at accounting practices used by trading firms. "If you don't have the Ten Commandments, it's hard to find a sinner," said Nora Brownell, a Republican FERC commissioner.

It was Enron's habit of opening new markets, using imaginative financial structures and employing aggressive accounting methods that first brought it great success -- and then contributed to its downfall. Enron became a bold player in everything from commodities, such as electricity, to exotic financial instruments, such as "weather derivatives," a form of insurance used to cover weather-related losses.

The company made much of its profit by buying and selling energy many times over, capturing the difference between buyers' bids and sellers' offers. Unlike a traditional commodities exchange, open to all, natural gas and electricity are traded privately, with many transactions involving just two players.

The company also borrowed heavily, sometimes recording the debt on separate operations off Enron's balance sheets, meaning that debt wasn't immediately apparent to many investors. Enron poured a lot of this money into building its new markets. Wall Street analysts and, in private, some company executives now say the company also priced some of the assets it kept on its books at inflated levels. The company repeatedly has said its accounting has been entirely proper.

By last year, Enron was in the middle of about one quarter of the electricity and natural-gas deals done by energy producers, traders and utilities. It had big operations as far afield as Bolivia and India, and it had a seemingly unstoppable ability to produce ever-higher quarterly earnings. Fortune magazine called it the most innovative company in America and ranked it No. 7 on the Fortune 500. With annual revenue of $100 billion, Enron had eclipsed International Business Machines Corp. and AT&T Corp.

Enron came unglued last month, after it disclosed a big quarterly loss and The Wall Street Journal reported that the company's chief financial officer and other executives had profited personally from partnerships that Enron used to move assets on and off its books. These profits apparently came at the expense of the company and its shareholders. The Journal also reported that the company was forced to shrink its equity base by $1.2 billion. The Securities and Exchange Commission launched an investigation.

Previously, even though Enron's practices had worried some regulators, the Bush administration had kept its distance. Over the last decade, the company and its chairman, Mr. Lay, have been Mr. Bush's biggest financial backers, donating nearly $2 million to his campaigns. Before the company's recent problems came to light, Mr. Lay enjoyed unusually good access to top administration officials, including Vice President Dick Cheney, who earlier this year drafted a new national energy plan that seemed to lean heavily on Mr. Lay's suggestions.

More recently, the White House hasn't stepped forward to defend Mr. Lay or Enron. And few members of the energy-trading fraternity, who have always seen Enron as sharp-elbowed, did anything to help the company.

Dynegy saw an opportunity, though, to acquire the company against which it had always been compared. Dynegy Chairman Chuck Watson agreed to buy Enron in an all-stock transaction that valued the firm at $9 billion, a pittance compared with its $70 billion peak market value.

But Enron's stock price fell further after more disclosures that future profits weren't likely to be as strong as expected and volume started to dry up at the company's trading desk. Dynegy sought to renegotiate the price downwards.

Executives of the two companies had huddled since Sunday, first in Westchester County, N.Y., and then in Houston, trying to come up with a formula that would allow Enron to survive until a merger could be completed. The talks fell apart when it became clear that even a proposed additional $1 billion investment from Dynegy and bankers J.P. Morgan Chase & Co. and Citigroup Inc.'s Citibank wouldn't be enough to see it through regulatory and shareholder approvals.

The disintegration of the Dynegy-Enron deal is a blow to the two huge banks, which were the leading cheerleaders and financiers behind the transaction. They had invested hundreds of millions of dollars to help get the deal done. Not only will the failure tarnish their status as merger-and-acquisition advisors, but they will also be on the hook, along with some 800 other creditors, in trying to recover several hundred million dollars in unsecured loans to Enron. J.P. Morgan shares were down $2.30, to $37.50, while Citigroup shares were down $2.75, to $47.80, in NYSE composite trading.

The breakdown of the talks will probably produce litigation. Dynegy used $1.5 billion of funding provided by its part-owner, ChevronTexaco Corp., to help provide liquidity to Enron. As a result of the collapse of the merger agreement, Dynegy said it planned to claim the collateral on that investment -- all of the preferred stock of an Enron subsidiary, Northern

Natural Gas, which owns 16,500 miles of interstate natural-gas pipelines between Texas and the Great Lakes.

Enron isn't likely to let that go without a fight. Neither Dynegy's Mr. Watson nor the company's president, Steve Bergstrom, attended the Westchester meeting. Mr. Watson was at the Mexican resort of Cabo San Lucas. As Enron's Mr. Lay flew back to Texas on Monday, believing he had an agreement to preserve the merger, he received a phone call saying that Mr. Watson wasn't happy with the terms. Enron executives asserted that they didn't breach any of the covenants of the merger agreement and didn't make any material misrepresentations to Dynegy.

Mr. Watson said he told Mr. Lay in a phone conversation early Wednesday that the deal was off. "I told him I was very disappointed we couldn't put this together," said Mr. Watson. "We part as friends," he added.

Mr. Watson said, "We worked our butts off to make this thing work." But he said Enron's "sharp deterioration" couldn't be ignored. "I wasn't about to put our balance sheet in jeopardy," he said.

Natural gas prices on the New York Mercantile Exchange surged about 25 cents yesterday morning on the Enron news, above $3 per million British thermal units, then dipped back into negative territory because of other factors.

Another big worry for Enron is keeping its bankers at bay. Enron's fall isn't expected to rattle credit markets in the fashion of the 1998 collapse of another financial high-flyer, hedge-fund Long Term Capital Management. But Enron has an estimated $13 billion in debt on its balance sheet and a further $7 billion in off-balance-sheet financings. It may be on the hook for additional debt in connection with four dozen investment partnerships.

Bankers and regulators said the risk of Enron's debt problems having a broader impact is limited by the fact that many lenders to the firm have syndicated the debt, spreading smaller chunks of it among many institutions.

Still, the credit downgrade brings immediate pressure. An estimated $3.9 billion of liabilities associated with two of those investment partnerships now will be triggered for repayment. Analysts estimate that even with the recent cash infusion from Dynegy and Enron's decision last month to draw down its remaining available credit lines, the company has less than $2 billion in available cash.

So far, it doesn't appear that Enron has started negotiations with lenders over a "prepackaged" bankruptcy-reorganization plan that could limit litigation. The company has hired Weil Gotshal & Manges, a New York-based law firm well-known for its bankruptcy practice. Yesterday, Enron engaged investment bankers with the Blackstone Group to come up with a restructuring plan.

As soon as word came yesterday that the Dynegy deal had fallen apart, a "war room" staffed by lawyers was set up on Enron's massive trading floor in Houston, with the goal of trying to stop suppliers and customers from trying to get out of pending contracts. Other traders struggled to meet Enron's delivery obligations.

"The utilities are all calling and want to make sure that the customers still want to take our gas, and the suppliers are wondering if we will pay for their gas," said one Enron trader. "We are going to have to be very innovative."

In the short term, there are fears that Enron's crippled state will, in the words of Merrill Lynch analyst Steve Fleischman, cast a "cloud of uncertainty" over all of the energy traders that do business with Enron. Other big traders, such as El Paso Corp., Mirant Co., Entergy Inc. and Duke Energy Corp., were busy yesterday, trying to calculate what exposure they still have to Enron.

In recent weeks, many of those companies, including Dynegy itself, have been cutting back on their trades with EnronOnline, fearing the company would fail. They have shifted their business to the rival Intercontinental Exchange and other trading systems. Most big energy-trading companies saw their stocks fall yesterday.

Some predict the energy-trading business will now shrink, with no clear successor to Enron's throne. They point out that stocks of competitors haven't moved up in anticipation of seizing market share from Enron. If anything, Enron's demise as a major trader will reduce the number of transactions possible -- not only for energy products, but also for such commodities as metals and pulp and paper.

Alexei Barrionuevo contributed to this article.

Shock Waves: Enron's Swoon Leaves A Grand Experiment In a State of Disarray --- Electricity Policy May Be Left To Lurch Between Poles Of Regulation, Free Rein --- Recession Is Powerful Factor

By **Rebecca Smith** Staff Reporter of The Wall Street Journal 11/30/2001

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It was one of the great fantasies of American business: a deregulated market that would send cheaper and more reliable supplies of electricity coursing into homes and offices across the nation.

But look what's happened instead. Enron Corp., the vast energy trader at the center of the new freewheeling U.S. power markets, now faces collapse amid a blizzard of questionable financial deals. And California, the first big state to deregulate its electricity market, has watched its experiment turn into a disaster, with intermittent blackouts and retail power rates as much as 40% higher than they were a year ago.

Now, with the power industry hovering uneasily between regulation and deregulation, it faces the prospect of a market that combines the worst features of both: a return to government restrictions, mixed with volatility and price spikes as companies struggle to meet the nation's future energy needs.

Investors and lenders, spooked by the twin specters of California and Enron, have become less likely to commit capital to building new power plants, transmission lines and natural-gas pipelines. The U.S. will require big additions to its power production and distribution capacity when it emerges from the current recession -- but for now, at least, the nation's capital markets are reluctant to cough up the necessary funds.

Responding to the dramatic decline in their stock prices and the recession, energy companies are retrenching. Calpine Corp., one of the most aggressive players in the deregulated market, is waffling on previously announced plans to build billions of dollars in new power plants. Virginia-based AES Corp., which has missed its recent earnings targets, has scaled back its expansion goals and is selling some of its foreign assets. Northeast Utilities is curtailing plans to build a 30-mile undersea transmission line from Connecticut to Long Island.

Meanwhile, regulators are racing to place new guardrails on the U.S. power market. The federal government is trying to beef up its market-surveillance activities. And it also is trying to broker deals between states that might make interstate energy transmission faster, cheaper and easier.

The power market is in "the midst of an ugly adolescence that we cannot allow to last much longer," says Nora Brownell, a member of the Federal Energy Regulatory Commission in Washington.

That's because, for the consumer, energy deregulation has been anything but good news. Unlike the deregulated telecommunications market, where fierce competition brought down prices while guaranteeing a reasonable level of reliability, the deregulated power market isn't likely to provide real benefits until it stabilizes. For now, consumers are at the mercy of wholesale forces they often can't understand and have few real options to switch between service providers.

The theory behind deregulation was that it would lead to the emergence of efficient companies that would specialize in providing electric power, carrying it over long distances or delivering it to a final customer.

While the industry started to move in that direction, it isn't anymore. Many big power companies in the most populous states, which are the ones that also happen to be deregulated, still do a little of everything and are increasingly confused about where to place their business bets.

When it comes to electricity markets, says Frank Wolak, a Stanford University economics professor, these kinds of "hybrids don't work." But, he fears that they will be around for some time to come, especially since regulators, who once thought the markets themselves would bring about deregulation's goals, are only belatedly assuming responsibility for making sure things run smoothly.

Enron's sudden meltdown will deal a heavy blow to the broader energy marketplace that sat at the center of electricity deregulation -- providing a place for utilities and power plants to buy energy they needed in a hurry, or to unload their excess supplies. The company's EnronOnline trading system, which was shut down Wednesday, accounted for a quarter of all wholesale energy trades among U.S. utilities, independent power producers and other market players.

The trading system's shutdown came in the wake of disclosures that Enron's directors and top officers approved a series of partnerships that moved debts off the company's balance sheet. In several cases, those partnerships enriched company officers but later produced huge losses for Enron.

That kind of "balance-sheet abuse" says Goldman Sachs analyst Jonathan Raleigh, might now "reduce overall liquidity and cause lenders to tighten credit standards" for the entire energy-trading industry. The result could be the kind of supply squeezes that led to six days of blackouts in California earlier this year.

California's supply problems didn't spread beyond the Pacific Northwest -- but that's largely because of the sharp economic downturn. As spot-market power prices in California shot up to an average of $317 per megawatt in December 2000 from $32 per megawatt hour the preceding April, energy companies were making enormous amounts of money. Investors drove up the price of the companies' stocks, with Enron at one point trading at 60 times its projected next year's earnings. New funding was flooding in from debt and equity markets. Under pressure from regulators worried about a repeat of the California debacle, energy companies got busy building power plants, drawing up plans to fix the nation's antiquated electric-transmission systems and plotting new natural-gas pipelines.

But that golden moment for the industry turned out to be short-lived. Early this year, federal energy regulators placed caps on the wholesale price of power sold in the western U.S. as California's two main investor-owned utilities were pushed to the brink of insolvency. Then, in the spring, natural-gas and electricity prices collapsed around the country as the economy suddenly slowed to a crawl. Even before Enron got into trouble, the big energy companies began to see their stock prices sink, and investors began to cast a more critical eye on their expansion plans in the wake of the California chaos and the resulting multibillion-dollar electricity payment crisis.

One of the first signs that a sea change was under way came a few months ago when demand for power-generation turbines began to soften. Because there are only three domestic suppliers of such multimillion-dollar engines, the most expensive pieces of machinery used by commercial electricity producers, the machines must be ordered well in advance of their deployment.

A year ago, says David Sokol, chief executive of Iowa-based utility owner Mid-American Energy Holdings Co., "you had to pay a premium to get a turbine." Companies with lots of turbines on order, such as San Jose, Calif.-based Calpine, boasted that they would clean up in newly deregulated markets such as the West, the Northeast and New York, where electricity supplies back then were tight. "But now," Mr. Sokol says, "I know of at least 100 [turbines] that are for sale. People want you to take their place in line."

While most energy companies are pressing ahead with projects they have started, they have grown cautious about breaking ground on new ones. Just a few months ago Calpine boldly claimed it would have 70,000 megawatts of generating capacity -- the equivalent of 35 to 45 big power plants -- in operation by 2005. Now it's backing away from that assertion. The company currently has only a fraction of that capacity, 11,000 megawatts.

At the root of the problem is a lack of capital and earnings. While energy companies routinely beat their own bullish quarterly profit estimates last year, many of them have lately indicated that they will miss earnings projections. With electricity and natural-gas prices down, energy sales tend to be less profitable. Hence, investors haven't been willing to pay the same price-earnings multiples for energy stocks.

Bankers, meanwhile, want convincing evidence that future power prices will be high enough to justify new projects. That's far from guaranteed in deregulated markets. In fact, national electricity prices, which hit a 52-week peak of $216 per megawatt, now are being quoted at $23.45 per megawatt, according to the Mirant National Power Index.

To give some idea of how radically the landscape has shifted, take the case of power conglomerate UtiliCorp United Inc., of Kansas City, Mo. In April, taking advantage of the general enthusiasm toward deregulated markets, it spun off its Aquila Inc. trading unit at a price of $24 a share, raising $480 million. "We saw an opportunity to crystalize the value" of the trading company, says UtiliCorp President Bob Green.

Aquila's stock soared to $35 before it began slipping at the end of May. Since then, it has tumbled by half. Today, with a price/earnings ratio of eight -- less than most utilities -- the "equity markets are closed" to Aquila, Mr. Green says.

Now, UtiliCorp, which mainly owns regulated utilities, is planning to buy back all the publicly traded Aquila shares. It hopes that by taking shelter under UtiliCorp's umbrella, Aquila will be able to benefit enough from its parent's strong credit rating and healthy balance sheet to keep trading and buying more power plants.

In other words, the regulated utilities, once considered homely wallflowers, are looking more alluring these days as trading firms, such as Aquila and Enron, have fallen from favor. That could portend a reduction in the huge trading volumes, and accompanying price volatility, that marked the early stages of energy deregulation.

But that won't help consumers unless new power plants and transmission lines come online in time for the economy's resurgence and new rules are put in place that guarantee a more transparent market. The latter won't be an easy task, because power trading is done on a variety of public and private exchanges, with traders darting in and out to take advantage of price discrepancies.

Lately, there's been growing evidence that some power companies have found lucrative ways to exploit this system -- at consumers' expense. Their tactics include manipulating wholesale electricity auctions, taking juice from transmission systems when they aren't supposed to and denying weaker competitors access to transmission lines. Regulators believe that this behavior has contributed to supply glitches and inflated prices.

Under its new chairman, Pat Wood, the FERC has been pressing companies to take steps it believes will create power markets that are less susceptible to such shenanigans. Chief among them is for utilities to surrender control of their high-voltage power lines to independent operators that would give all market participants fair access and will operate spot markets for power.

Earlier this month, the commission told three of the nation's big integrated utilities -- American Electric Power Co., Entergy Corp. and Southern Co. -- that until they relinquish control of their power lines to an independent operator, FERC may intervene to limit the prices they charge wholesale customers. At least one of the three is appealing the FERC mandate.

The commission has also stepped up efforts to settle pesky but important technical issues, such as how independent power producers can hook up new plants to the lines of nearby utilities and how transmission services can best be priced.

Still, even a more aggressive FERC hasn't been able to solve some lingering problems. A good example is the continued existence of one of the nation's worst transmission bottlenecks. Known as "Path 15," the line interconnects the populous southern part of California with more abundant energy resources in the north. The Department of Energy has pledged to help expand Path 15, which was implicated as a key cause of the blackouts in California earlier this year.

But actually getting the work done may require PG&E Corp.'s Pacific Gas & Electric unit, which owns the 90-mile stretch of line, to get approval for the expansion from the state Public Utilities Commission. But Pacific Gas, which placed itself under the protection of the federal bankruptcy courts amid the California power crisis, is at loggerheads with the PUC. The upshot is that there may be significant delays in upgrading Path 15. The implication: when the economy cranks back up, so too will the possibility of more supply shortages and higher prices, says Terry Winter, chief executive of California's Independent System Operator, which operates the state's electricity grid.

Corporate Veil: Behind Enron's Fall, A Culture of Operating Outside Public's View --- Hidden Deals With Officers And Minimal Disclosure Finally Cost It Its Trust --- Chewco and JEDI Warriors

By John R. **Emshwiller** and Rebecca Smith

Staff Reporters of The Wall Street Journal 12/05/2001 The Wall Street Journal A1

HOUSTON -- Around the beginning of October, Enron Corp. executives visited credit-rating-agency officials for talks about the company's third-quarter results. Those results contained what turned out to be a bombshell.

Enron mentioned in the talks that shareholders' equity, the difference between the company's assets and its liabilities, would be reduced by $1.2 billion because of transactions with certain partnerships, says a person familiar with the matter. Some of the credit analysts, regarding this as so significant it needed to be disclosed, privately urged Enron to report it to the Securities and Exchange Commission, this person says.

But Enron didn't do so, nor did the company explain it in its nine-page earnings announcement in mid-October. The only public inkling came during an earnings-report conference call, in a reference by the company chairman so fleeting that some analysts say they missed it.

It was vintage Enron: minimal disclosure of financial information that, in retrospect, was central to understanding the complex company. Only a few months ago, Enron was wowing Wall Street with its growth and innovation, racking up large, steady earnings gains as it pioneered the global trading of everything from power to weather contracts. But virtually unseen until the end was an Enron culture that contained the seeds of its collapse, a culture of highly questionable financial engineering, misstated earnings and persistent efforts to keep investors in the dark.

Senior Enron executives flouted elementary conflict-of-interest standards. The company hired legions of lawyers and accountants to help it meet the letter of federal securities laws while trampling on the intent of those laws. It became adept at giving technically correct answers rather than simply honest ones.

One senior Wall Street official recalls recently asking Enron officials whether the company had retained bankruptcy counsel. He was told no. He later found out that while Enron hadn't formally retained such representation, it had met with bankruptcy lawyers. "If you don't ask the absolute right question, you don't get the right answer," he says. "Enron does that a lot."

Yet public trust, above all, was what Enron had to have, in order to conduct its business as a trader and party to thousands of contracts. Once doubts began to seep into the public realm, thanks partly to that mysterious hit to equity and Enron's waffling about what it meant, other suspicious Enron moves began to emerge.

The company had transactions with certain partnerships that were run by its own officers -- but treated by Enron as separate. It offered only murky and fragmented information about these partnerships. One partnership, whose existence Enron didn't reveal for four years, was part of an arrangement that inflated earnings by several hundred million dollars during that period.

And the company's debt level was much higher than it revealed, thanks to the partnerships, which allowed Enron to keep some debt off its books. Meanwhile, executives made repeated public assurances that Enron's finances and business operations were healthy, only to have those statements refuted by subsequent revelations. Ultimately, these disclosures created a crisis at Enron, sending its stock plunging and its partners and clients fleeing.

While Enron has acknowledged that a loss of investors' confidence was at the root of its woes, company officials have consistently defended their actions as legal and proper. An Enron spokesman reiterated yesterday that the company made every effort to put out accurate information. When something was found to be inaccurate, Enron took prompt steps to correct it, the spokesman said.

On Sunday, Enron filed for bankruptcy-law protection in New York federal court -- the biggest such filing ever. It simultaneously filed a multibillion-dollar suit against a company that last week backed out of a rescue pact, rival Dynegy Inc. Enron's stock, which touched $90 a share last year, closed yesterday on the New York Stock Exchange at 87 cents.

Top officials now are the targets of some two dozen shareholder suits. They face a formal SEC investigation, a Justice Department criminal probe and congressional inquiries. The company, now struggling to avoid liquidation, has tapped existing credit facilities and lined up fresh capital exceeding $7 billion in recent weeks, and is looking for more.

Not every detail of this tangled tale has yet been fully unraveled. It's still not clear whether concealment and financial engineering were a central strategy at Enron for years, or just a last desperate resort when earnings were falling short. Questions also still surround the sudden midsummer resignation of Chief Executive Jeffrey Skilling, whose role in Enron's collapse remains uncertain.

What is clear, though, is that rarely in the annals of American business has an enterprise so mighty and so highly regarded fallen so far so fast.

Led by its chairman, Kenneth Lay, Enron during the 1990s morphed from a nondescript gas-pipeline company into the nation's biggest energy trader, matching utilities, power suppliers and other investors in a vast unregulated marketplace. It gradually turned into a trading juggernaut that increasingly disdained long-term ownership of hard assets.

Moving far beyond energy, Enron pioneered hundreds of different types of trading contracts, ranging from commodities such as water to exotic new financial instruments. The company assembled an immense pool of financial and trading talent among its 21,000 employees.

As Enron concentrated on trading of complex instruments, it came to resemble a vast financial-services empire, handling billions of dollars of other people's money. But to analysts and investors seeking to understand it, Enron wasn't very informative. Officials could be dismissive of inquiries, even rude. Closely questioned during a conference call last spring, Mr. Skilling called one company critic an "a--h---."

Many Wall Street analysts admitted to not fully understanding chunks of Enron, a company that had 3,500 subsidiaries and affiliates spread across the globe. During the booming 1990s, as Enron delivered plump earnings and stock gains, this didn't matter. Investors "were scared not to be in it," says Paul Patterson, an analyst at ABN Amro.

The confluence of events that changed perceptions began in August with the sudden resignation of Mr. Skilling.

The former McKinsey & Co. consultant, who is 48, had become president in 1997. Last February he became CEO as well. Remaining chairman was his mentor, Mr. Lay, a friend and financial backer of President Bush and Vice President Cheney. In the early days of the Bush administration, Mr. Lay, who is 59, had been widely expected to take a cabinet post.

Messrs. Lay and Skilling made a formidable team. The courtly and amiable Mr. Lay had wide-ranging experience in government, academia and business, and his opinion was frequently sought in the energy world. Mr. Skilling, a Harvard M.B.A., was a brash, fiery figure who spoke rapidly and peppered his conversations with financial jargon.

Without warning, Mr. Skilling resigned on Aug. 14. He initially cited "personal reasons." But in an interview the next day he said his own frustration over Enron's weakening share price -- then about $43 -- played a major role in his decision. "I don't think I would have felt the pressure to leave if the stock price had stayed up," he said.

The abrupt departure forced Mr. Lay to retake the reins. He was reassuring to the public. "I can honestly say the company is in the strongest shape it's ever been in," Mr. Lay said at the time. He also promised that in the future, Enron would be more open and accessible to investors. Mr. Lay acknowledged that the company had "lost some credibility" with investors.

The day of the announcement, Enron filed its report with the SEC for the three months ended June 30. Tucked in the 36-page document were several paragraphs describing deals involving hundreds of millions of dollars between Enron and unnamed partnerships headed by and partly owned by an unnamed "senior officer" of the company. The filing added that the officer had sold his partnership interests in July and "no longer has any management responsibilities for these entities."

But it wasn't Mr. Skilling who ran the two partnerships, known as LJM Cayman LP and LJM2 Co-Investment LP. It was Chief Financial Officer Andrew S. Fastow, a Skilling protege who was still very much with the company. The "LJM" came from the first initials of Mr. Fastow's wife and two sons. A company spokesman said the dealings between Enron and Mr. Fastow's partnerships were perfectly proper and had been done to help Enron protect its assets against fluctuating market prices.

The partnerships had been around for two years and appeared in Enron SEC filings during that time. But the manner in which they were disclosed, with different pieces of information appearing in different filings, made it difficult to learn such basics as which senior executive was running the partnerships.

Worse, there was no way from the available information to understand just what the partnerships were doing or what impact they had on Enron's finances. Some stock and credit analysts say they had never heard about the LJMs until they read about them in the newspapers in recent weeks.

Mr. Fastow's LJM dealings were, however, well-known within Enron and a magnet for criticism. Part of LJM's activities involved buying Enron assets, and some officials balked at doing deals that could enrich a senior executive at the company's expense, say people familiar with the matter. At least two senior officials complained internally about the potential conflicts of interest. The concerns were turned aside by top management, say the people familiar with the events.

The anger might have been greater had those who complained known the extent of Mr. Fastow's financial gains from LJM. Internal partnership documents show that the CFO made millions of dollars a year from LJM, far more than his corporate compensation.

One private document for LJM2's successful effort to raise nearly $400 million boasted of "preferred access" to Enron deals and said that Mr. Fastow's economic interests would be "aligned" with the partners'. Late last year, Mr. Fastow and Enron were laying plans for a $1 billion LJM3 fund, though it never came to fruition. Enron later estimated that Mr. Fastow made more than $30 million from the LJM partnerships.

Mr. Fastow has declined repeated requests to be interviewed. His attorney points to Enron statements saying that all of the company's dealings with the partnerships were proper and thoroughly vetted by the board and top management.

In September, Enron faced questions from The Wall Street Journal about the partnerships. According to a person familiar with the matter, there were sharp internal disagreements over whether to make top officials available for interviews. This person says that at one point, Mr. Fastow shouted that he saw no "upside" to talking.

Then came Enron's Oct. 16 report of its third-quarter earnings. Although a $1 billion write-off for telecommunications and other ventures produced a big net loss, the company trumpeted a 26% increase in "recurring earnings" due to "very strong results" of its "core" businesses. The stock posted a gain for the day.

The news release contained a cryptic reference to a charge relating to the "early termination . . . of certain structured finance arrangements with a previously disclosed entity." This seemed to be Enron code for LJM. In response to questions, the company said the LJM-related charge was $35 million.

Mr. Lay himself tried to put the LJM matter to rest. "I don't think we need to say anything more about that," he said in an interview at the time.

Later, however, an Enron SEC filing on Nov. 8 disclosed that the actual charge related to LJM dealings was $462 million. The $35 million figure represented cash paid to LJM in the termination, company officials now said, with the other hundreds of millions reflecting declines in the value of Enron assets held by LJM-related entities.

"It was not our intent to mislead," said Mr. Lay's chief of staff, Steve Kean, in mid-November.

On Oct. 17, the Journal revealed some of the partnerships' inner workings, their dealings with Enron and the fact that Mr. Fastow stood to make millions from his participation. Shortly afterward, Enron's stock began tumbling.

That same day, word of the $1.2 billion reduction in shareholders' equity started rippling through Wall Street. On Oct. 18, the Journal reported for the first time that the equity reduction stemmed from transactions related to the LJM partnerships.

During the earlier discussions with credit-rating agencies, Enron had attributed the equity reduction to an "accounting error," says the person familiar with those discussions. However, in an Oct. 17 interview with the Journal, Enron Chief Accounting Officer Rick Causey didn't mention an accounting error. He said that as part of its dealing with the partnerships, Enron had put up 62 million of its own shares. In return, it gained a $1.2 billion note receivable from the partnerships. When the arrangements were terminated, he explained, Enron simply canceled the note and retired the stock. The retirement of so many shares accounted for a $1.2 billion reduction in shareholders' equity.

A spokesman added that Enron didn't see this as a material transaction that needed to be publicly disclosed. The spokesman yesterday said that he had been told by company officials at the time that it was "a balance-sheet issue" and didn't need to be included in the third-quarter earnings discussion.

However, in a Nov. 8 SEC filing, Enron declared that the equity reduction was largely due to an accounting error -- one that required the company to restate prior-year financial reports.

The SEC within a few days started an informal inquiry. It soon grew into a formal investigation, which meant the agency had power to subpoena witnesses and documents. At the same time, credit-rating agencies were beginning to put Enron on review for possible downgrade.

That was worrisome. Keeping an investment-grade rating was vital for the health of the trading operation, which produced more than 90% of Enron's third-quarter operating earnings. Moreover, a fall to "junk" status would trigger accelerated repayment of billions of dollars of obligations.

In an effort to stanch the bleeding and restore confidence, Mr. Lay and other top officials, including Mr. Fastow, held a conference call on Oct. 23. Sparring with analysts and investors, the executives seemed defensive and even hostile at times. Mr. Lay wouldn't let Mr. Fastow answer questions about the partnerships, but expressed his "highest faith and confidence" in his chief financial officer.

The next day, the company announced Mr. Fastow was no longer Enron's CFO. Mr. Lay said the about-face was necessary to "restore investor confidence."

After the conference call, Enron top brass retreated from the public arena. Behind the scenes, Enron was frantically looking for a rescue strategy, approaching both competitors such as Dynegy and wealthy investors such as Warren Buffett for a cash infusion. So intense was the quest that one Enron attorney, a member of the Weil, Gotshal & Manges law firm, flew from Dallas to Houston for a planned two-hour meeting and didn't get back for two weeks.

Dynegy was intrigued by the notion of taking over a company that was five times its size and had long overshadowed it. Dynegy President Steve Bergstrom, an Enron alumnus, had a scheduled social lunch with an old friend, Stan Horton, who runs Enron's pipeline business. Mr. Horton asked if he could bring Enron Vice Chairman Mark Frevert and President Greg Whalley. In a private room at Houston's Plaza Club, Mr. Whalley popped the question: Would Dynegy be interested in buying Enron? "I was flabbergasted," says Mr. Bergstrom. "We were like the little kid on the block to them." He remembers thinking, "They're in worse trouble than I thought."

Mr. Bergstrom suggested having Mr. Lay call Dynegy Chairman and founder Chuck Watson, and within hours the two talked. Then they met face to face and privately Oct. 27 at Mr. Lay's home in Houston's exclusive River Oaks neighborhood, hammering out major points of a deal.

Dynegy's biggest shareholder, ChevronTexaco Corp., approved a $2.5 billion investment in Dynegy that Dynegy would use to give Enron a cash infusion. The first $1.5 billion would come right away and the rest at the closing. J.P. Morgan Chase & Co. and Citibank arranged a further $1 billion of credit, so that on Nov. 9, the two sides were able to announce a $9 billion all-stock betrothal. Mr. Lay, deflecting questions about Enron's woes, said the combination "is all about the future."

But amid the optimistic talk, new bombshells were exploding at Enron. Its Nov. 8 SEC filing disclosed for the first time company dealings with an entity called Chewco Investments LP. Just four days before the filing, the company had refused requests by The Wall Street Journal to discuss the entity or even acknowledge its existence.

As it turned out, Enron had plenty of reason to be sensitive about Chewco, named for the "Star Wars" character Chewbacca. Chewco had been set up in late 1997 during a rocky period for Enron, when the company was missing its quarterly earnings targets and losing a bit of its Wall Street credibility. Prudential Securities analyst Carol Coale recalls a meeting with Mr. Skilling during this period when, she says, he promised "some strong earnings growth" in the coming quarters.

Now it's known that between 1997 and the end of last year, Enron's dealings with Chewco and a related partnership known as JEDI (for Joint Energy Development

Investments) kept hundreds of millions of dollars of debt off Enron's books. Moreover, business deals with the partnerships also allowed Enron to book $390 million in net income, roughly 13% of reported profits for the period, according to the Nov. 8 SEC filing.

Although Enron treated Chewco as an independent third party, there were lots of indications to the contrary. Chewco was managed by Michael Kopper, an Enron officer who later helped Mr. Fastow run the LJM partnerships. Early Chewco funding of $383 million came almost entirely via Enron through loans it arranged or guaranteed.

In its Nov. 8 filing, Enron said that Chewco and JEDI should never have been treated as separate parties. Retroactively folding them back into Enron was the principal cause of a restatement that slashed Enron earnings for the prior four years by $586 million, or 20%. The company said its financial statements for those years could no longer be relied upon.

These disclosures further rocked an already-shaken investment community. If Enron officials knowingly created and controlled Chewco as a sham third party to boost profits, they could be in violation of federal fraud statutes, says Jacob Frenkel, a former SEC attorney and federal prosecutor. At the very least, says Ronald Barone, head of Standard & Poor's energy and utility group, Chewco represented "financial engineering on the razor's edge."

Mr. Kopper, who last summer left Enron to run the LJM operation, declines to be interviewed. According to Enron, he bought out Mr. Fastow's partnership interests. A recent visit to LJM's offices, across the street from Enron's Houston headquarters, found no one willing to talk.

During the years in which Enron was issuing earnings statements it now says were incorrect, Mr. Lay, Mr. Skilling and other top executives of Enron sold hundreds of millions of dollars in Enron stock. Partly as a result, they and others face a raft of shareholder suits. Some Enron traders complained angrily at a company meeting last month about $62 million in severance the Dynegy deal would bring Mr. Lay. After a day of giving out conflicting signals, Mr. Lay announced he wouldn't take the severance.

Revelations about Chewco and LJM fueled concern about other surprises that might be hidden in dozens of other partnerships with which Enron did business. One problem: Millions of shares of Enron stock provided the underpinnings for at least some of those partnerships.

As Enron's stock price fell, the stability of those structures was threatened, says one Enron insider, who speculates that Mr. Skilling's decision to resign might have been influenced by this development. "When he saw the stock price falling, I think he knew a crisis was coming," this person says.

Mr. Skilling won't talk about Chewco or anything else having to do with Enron. On a recent morning, outside his newly built mansion in Houston's River Oaks neighborhood, Mr. Skilling reiterated his desire to be left alone but didn't seem angry about being approached. "I understand it's a big story," he said in a soft voice.

On Nov. 19, Enron revealed more bad news. In another SEC filing, it said it could be forced to take a further $700 million pretax hit to earnings because of a plunge in the value of assets at yet another investment partnership. In addition, Enron said its declining credit rating had triggered $690 million in accelerated payments to investors.

Trading partners began to back away. The stock plunged anew, falling to about $5 a share by Thanksgiving.

Dynegy executives say the Nov. 19 filing was pivotal in changing their thinking about the merger. Enron appeared to be burning through cash at a frightening rate, says Mr. Bergstrom, Dynegy's president, and it kept coming up with unpleasant surprises. "I think they knew more than they were telling," he says. Enron spokesman Mark Palmer replies that "if they had done their due diligence, they would have known about" Enron's condition.

The companies made one last stab at saving the deal over the Thanksgiving weekend, huddling at a resort in Westchester County, N.Y.

They slashed the deal's price to $4.17 billion. But in an ominous sign for Enron, neither of Dynegy's top two executives attended. And the revised deal was never made final. Analysts estimated that at least $4 billion more cash was needed to bolster trading partners' confidence, and no one was willing to put up that kind of money.

A week ago, Enron's world caved in. Standard & Poor's, tired of waiting for the negotiations to produce a new rescue of Enron, dropped its credit rating below investment grade.

Other rating agencies followed. Later the same day, Dynegy formally called off the acquisition, and Enron traders walked away from their screens. About 4,000 Enron employees already have been laid off, with $4,500 in severance pay.

Many face an further hit as retirement accounts, heavy with Enron shares they weren't allowed to sell, are decimated. After the collapse of the merger, some of the 7,500 headquarters employees headed to Houston bars to blow off steam.

One took the time to remove Dynegy's stock symbol and stock price from the electronic tote board in the Enron lobby. Left behind was Enron's stock price, by then measured in dimes, and the constantly replaying message at the bottom of the board: "Enron . . . . endless possibilities."

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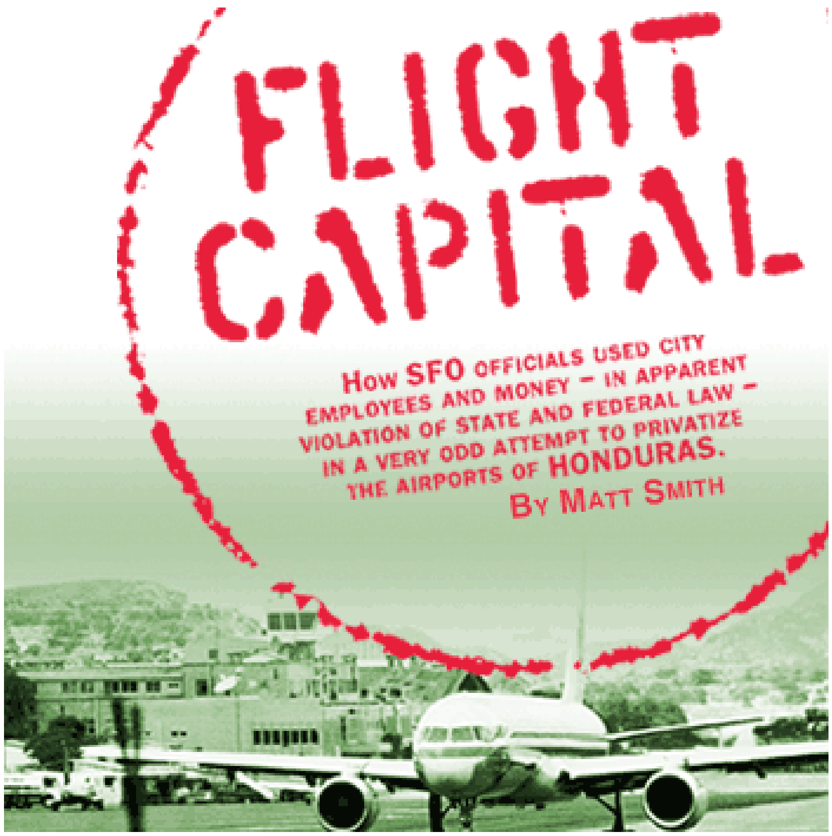
Flight Capital

How SFO officials used city employees and money -- in apparent violation of state and federal law -- in a very odd attempt to privatize the airports of Honduras

BY MATT SMITH



Control tower at Toncontín International Airport in Tegucigalpa, Honduras.

Jorge Arturo Pineda, a laconic, ruddy-faced investigator with Honduras' federal Attorney General's Office, sits in front of Docucentro, a photocopy shop in Tegucigalpa, the capital of Honduras, staring at the crumbled asphalt at the edge of Boulevard Morazán. "It's dirty here," Pineda observes. "Everything's really, really dirty."

He isn't talking about the street.

Today, one of Pineda's co-workers resigned angrily upon determining that a former boss in the AG's Office would not be prosecuted on allegations of stealing $5 million from his own political party. Yesterday the attorney general himself announced that 14 prominent government embezzlement cases had been derailed by corrupt judicial officials.

For a century, corruption's been a ubiquitous part of Honduran life. It will remain so, Pineda says, and nothing a pencil-pushing attorney general's investigator does will change the situation.

For this reason, Pineda and his sidekick, Walter Hernández, a literature-quoting lawyer also employed by the Attorney General's Office, have agreed to spend this, their workday afternoon, at Docucentro helping me photocopy binders full of government files on an unusual plan to privatize the country's airports. Pineda had lobbied the attorney general, that I might gain access to the binders; Hernández came along to ensure that Pineda would have no trouble getting the files past a lobby guard.

Just once, Pineda and Hernández told me time and again during my recent visit to Tegucigalpa, they'd like to get their hands on government officials who had abused the public trust. Now, as the copy machines at Docucentro churn out page after page of copies -- pages containing names such as San Francisco Mayor Willie Brown, San Francisco International Airport Director John Martin, SFO Deputy Director John Costas, SFO Special Assistant Leonardo Villarroel Fermin Jr., and city Treasurer Susan Leal -- I assure them that this time, they did.

Later that evening, Daniel Rivera, the lawyer who had resigned in disgust earlier in the day from the AG's Office, joins Hernández, Pineda, and me to help celebrate our afternoon's enterprise. "There are two types of corrupt people," says Rivera, portentously raising his brown bottle of Salva Vida beer. "There are those who lack imagination -- corruption falls in their lap and they don't know what else to do. And then there are those who are corrupt *because* of imagination; their force of will is consumed by conjuring ways to steal.

"It's the imaginative ones who scare me."

The files spirited from the Honduras Attorney General's Office, when combined with a variety of other documents and a series of interviews conducted in San Francisco and Tegucigalpa over the past four months, detail the activities of a group of SFO bureaucrats who can truly be said to have shown expansive imagination.

In 1997, at the suggestion of SFO executives Martin and Costas, the San Francisco Board of Supervisors approved the creation of a private, for-profit corporation that would have a single shareholder -- the City and County of San Francisco -- and would carry out foreign airport consulting projects. This authorization included one infusion of taxpayer funds, a $10,000 chunk of start-up capital from the city's General Fund. From that time forward, the bureaucrats insisted, the company would be self-funding. The basic notion: This new firm would win contracts at airports around the globe, earning enough money to expand and to repatriate, at some point, profits to the city. The corporation's books and activities would be kept secret from most city officials, and the city would not be allowed to intervene in the company's activities. By shielding the city from knowledge of the corporation's actions, the logic went, San Francisco would be protected from liability.

Costas and his co-workers took the idea and ran wild, ignoring the promises that the firm, SFO Enterprises LLC, would support itself and turning it into a vacuum that sucked city time and money into a private money sack. Over time, SFO officials diverted at least $900,000 in city funds to the benefit of SFO Enterprises without obtaining specific permission from the Board of Supervisors, in apparent violation of the state laws on official misconduct and federal law on the use of airport money.

SFO Enterprises attempted to win contracts all over the world, and SFO officials spent tens of thousands of city dollars traveling to Paris and Rome for airport-privatization conferences, and to Peru to discuss business deals. In the end, Costas and his cohorts apparently won only one major deal, an agreement, in the year 2000, on the privatization of the international airports of Honduras. In attempts to implement that agreement, Costas and his underlings inappropriately used city employees, costing the city -- and saving SFO Enterprises -- hundreds of thousands of dollars in personnel costs. Working on behalf of Costas, Airport Special Assistant Leo Fermin obtained a highly unusual $40,000 city cash advance to buy a car and rent an apartment in Tegucigalpa. Because it was funded in large part by the city, the Honduran "success" may also have exposed the city to millions of dollars of potential civil liability. And during the Honduras operation, airport money was clearly used for the benefit of the private firm, potentially exposing the city to federal anti-diversion penalties that could restrict future access to federal funds. **NEXT »**

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Control tower at Toncontín International Airport in Tegucigalpa, Honduras.

Costas, Fermin, and other airport bureaucrats were able to make these diversions under the gaze of city officials expressly tasked with protecting the San Francisco treasury.

City Treasurer Susan Leal was, until recently, a director of SFO Enterprises. To this day, Leal defends Costas' operation, claiming it is a sound investment for

this week in News

Feature
The Perfect Crime
For 20 years, South American thieves have been stealing millions of dollars in gems and jewelry from traveling salespeople in San Francisco. And no one -- not the cops, jewelers, or insurance companies -- has the slightest idea how to stop them.

Mecklin
Whore vs. Bore
Californians have refused public campaign financing, and we've gotten what we deserve: a governor's race between a fund-raising slut and a clueless rich guy

the city despite documentation to the contrary.

Deputy City Attorney Mara Rosales served as corporate secretary for SFO Enterprises while simultaneously holding down her city job. As a result, the City Attorney's Office appears to have actively enabled a type of misconduct -- the diversion of public resources to private benefit -- that it is ordinarily expected, even required, to advise against.

Deputy City Attorney Nathan Ballard says his office does not believe Rosales' dual roles conflict. The office asked for a state attorney general's opinion on exactly this matter in 1998, he says. The response: no conflict.

"We view the city's concerns to be the same [as SFO Enterprises']. Their interests are the same. The city owns the for-profit corporation in its entirety, and the city is the beneficiary of all the corporation's profits," Ballard says.

Rosales insists that the city received top-notch legal advice from her.

"There has been no laundering, if you will -- no washing of money, as you say it. There has been no violation of federal law; there has been no violation of the City Charter," Rosales offers. "If you follow the paper trail, with the agreements between the entities, they are arm's-length agreements."

By "agreements," Rosales appears to be making reference to a letter from Airport Deputy Director John Costas to his boss, Airport Director John Martin, saying SFO Enterprises Inc. planned to pay back part of the airport resources it had used. It is dated March 12, 2001, more than three years after Costas and Martin had begun to oversee the diversion of funds from the airport into this private corporation -- a corporation they had jointly promoted.

The Office of the Mayor, at the time held by Willie Brown, was listed as the sole shareholder of SFO Enterprises, and therefore Brown was in a position to monitor the debacle. But he contended through a spokesman that he had no information about the company, its activities, or the activities of the people charged to run it.

The City Controller's Office, the ultimate overseer of San Francisco's purse strings, appears to have approved unusual funding requests wholesale, glossing over inappropriate travel expenses and authorizing legal bills that included payments for obviously nonlegal spending. The $40,000 cash advance that was to be used on a Tegucigalpa car and apartment, for example, was "verbally approved by Remy Nelly of the Controller's Office," according to an internal memo.

City Controller Edward Harrington says the diversion of airport funds to SFO Enterprises appeared to be a lawful use of city funds, because the airport's budget included funding for an International Services Division, and this division was related to SFO Enterprises Inc. "My recollection was that it was anticipated, or at least discussed, that there would need to be some upfront spending to be done. There was discussion that there was going to need to be trips. Clearly the airport has advanced money to the corporation, at least on a cash basis," says

Harrington. "We asked questions, and it seemed to fit within the pattern of how it was originally proposed, and so we approved it."

On Monday, Assistant Deputy Airport Director Mike McCarron said San Francisco International Airport management would not be available to comment on this story. **NEXT »**

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By Luis Elvir

The Tegucigalpa airport terminal displays the logo of InterAirports, the consortium that won the Honduran airport privatization contract.

San Francisco's Honduran adventure finds its beginnings in November 1996, when Airport Director John Martin and SFO Deputy Director John Costas founded a unit at the airport called the International Services Division. It had the express purpose of earning profits for San Francisco by selling consulting services to foreign airports. Judging from memos, meeting minutes, and other documents, the logic of the new division went something like this: As an entity that generates nearly $300 million in annual revenues, the San Francisco International Airport is the equivalent of a major corporation; the bureaucrats who collect fees from airlines, run the parking lots, etc., are therefore close facsimiles of major international business executives. And, by way of a final leap of logic, the expertise of these bureaucrats could be profitably leveraged in the management of foreign, for-profit airports.

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Night Crawler
Making Scents
An afternoon with Mandy Aftel and the ineffable magic of natural perfume

Bay View
Miracle at the KK Cafe
Peanut milk can strengthen AIDS patients, heal gums, soothe chronic skin diseases, and prevent baldness, or so it is said. And it's found only one place on Earth.

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We went to the largest stamp collectors' convention in California. And found something to write about.

Letters
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With Costas as its director, the International Services Division participated in consortia that bid on the privatization of airports in Santiago, Chile, and Perth, Australia. The groups that included SFO lost both contracts, but the Costas group did earn a $380,000 fee, paid by other members of the losing Perth consortium. Thus emboldened, in 1997 Costas and Martin urged San Francisco's city fathers to allow them to turn the new division into a private, for-profit, city-owned corporation. Such an entity would be unfettered by public access laws that govern -- and, supposedly, hamper -- city agencies, Costas argued.

"A private for-profit corporation will provide for rapid response necessary in a competitive business environment," Costas wrote in a 1997 memo to the city budget analyst. "Through a private, for-profit corporation that separates public assets and funds from the private enterprise, the necessity for multiple layers of approvals and extended processes can be eliminated and more timely decisions can be made."

More specifically, the corporation would be able to avoid the "extended process" of responding to public information requests. Private corporations aren't subject to laws guaranteeing public access to information about government entities -- even when the corporations are owned by the government. By having the ability to keep its operations secret from the public, this new corporation would not be forced to reveal trade secrets, airport officials said. Indeed, secrecy was described by proponents as one of the main benefits to forming the new, private corporation.

Another touted benefit of Costas' operation dealt with federal laws that prohibit municipalities from looting the budgets of their city-owned airports toward other municipal ends. Like other major airports, SFO receives millions of dollars annually in federal subsidies. According to federal law, all revenues generated by an airport -- airline landing fees, federal grants, bond funds, etc. -- should stay at the airport.

If Costas and his subordinates at the International Services Division were to turn out to be entrepreneurial wizards in the field of international infrastructure privatization, federal law would prohibit the city from using any profits for non-airport activities. And a violation of these laws could ultimately lead federal regulators to deprive the airport of federal funds; airports all over the country are routinely sued and penalized for this sort of fund diversion.

Costas suggested to city officials that his new private firm could create the bureaucratic version of a miracle: He would turn the airport into a cash cow that drained its milk into the city's General Fund -- without violating federal law. Despite the unlikeliness of the spectacle -- after all, an airport bureaucrat was promoting the idea of moving money from the airport into the city's General Fund, rather than vice versa -- the Board of Supervisors, then dominated by appointees and allies of Mayor Brown, bought Costas' idea.

There were catches, though, small print on the back of the box, if you will. The new corporation simply, absolutely, positively could not use airport funds.

Melba Yee, a deputy city attorney who works at the airport, came up with the following explanation in an official memo: "If structured as a separate legal entity with its own source of funds separate from the monies generated from ongoing airport activities, this line of business could produce a long-term source of revenue which lawfully could be provided to the general fund. ... Under this structure, no airport revenues would be used for the corporation, nor would revenues from the corporation be used to operate the airport."

In proposing their new private corporation to city officials, Costas and airport director John Martin were likewise charming in their scrupulousness. Martin, for his part, insisted that the city specifically allocate $10,000 for start-up funding of the corporation, rather than obtaining this money from the budget of the airport itself, because use of airport money "would be considered improper revenue diversion and thus violate federal regulations," a 1997 budget analyst's memo quoted Martin as saying.

Costas, for his part, told the budget analyst that "all costs incurred by the corporation would be funded by the revenues to be realized by the corporation," according to the budget analyst's memo. **NEXT »**

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By Luis Elvir

A plane lands at Aeropuerto Toncontin

Keeping the new corporation's accounts separate from the city's was important for reasons beyond obeying federal law, Deputy City Attorney Yee opined. Maintaining a fire wall between city funds and the accounts of the newly formed private corporation was also essential to protecting the city from civil liability under California law. "As long as the city acts

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solely as a shareholder, the corporate formalities are observed ... and the corporation is properly capitalized for the business in which it engages, the protection of the city as a shareholder will be preserved. If, on the other hand, the city intervenes in the day-to-day affairs of the corporation or ignores the separate legal identity of the corporation, then the city may lose the protection that is otherwise provided by California law."

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In other words, according to the City Attorney's Office, the Budget Analyst's Office, and the airport bureaucrats who were the proposed private corporation's main protagonists, the city's venture into international private entrepreneurship possessed a third rail: If it were somehow to become a conduit for diverting city funds beyond the initial $10,000 investment, San Francisco would run the risk of violating federal law and/or exposing itself to the huge financial liability connected to running international airports.

There was a third crucial reason for keeping taxpayer resources away from the new corporation that went unmentioned in Costas' 1997 sales pitch to the Board of Supervisors: Unless the firm's accounts were kept unerringly separate from the city's, it would be impossible to determine whether the city was making or losing money on its new venture -- particularly because details of the operation of the new venture were to be kept secret from city officials.

In the world of private corporations the city contemplated entering in 1997, the ability to keep a strict accounting of a company's bottom line is the hub from which all other decisions emanate: which business opportunities to pursue, whether to retain or fire the company's chief executive, whether it is financially wise to continue or discontinue a business enterprise. Unless the city scrupulously divorced its accounts from those of this new enterprise, it ran the risk of creating a financial black hole. Unless the accounts were kept separate, public officials assigned to the new corporation -- such as Costas, who was the corporation's chief executive, and Fermin, the corporation's chief financial officer -- would be able to spend hundreds of thousands of taxpayer dollars without telling anybody how they used it.

During the first three years of the life of SFO Enterprises, public records show, that kind of misappropriation seems to have been accomplished, over and over.

Aeropuerto Toncontín in Tegucigalpa, Honduras, is the only airport in the world where motorists must stop at a traffic signal to await passing planes. Out-of-towners sometimes run the light. Locals rarely do; such is the terror of seeing car windows darkened by the belly of an airliner.

Aeropuerto Toncontín is considered by pilots who have landed there to be the world's keenest skills test. At 5,046 feet, the runway is approximately half the length of runways at SFO; it is surrounded by six mountain peaks; in making landings, pilots are forced to execute a tight U-turn before skimming their wings along a gully of mountainside residential dwellings. Aeropuerto Toncontín may be the only airport in the world whose main terminal clock was six hours slow the morning of Aug. 11, 2001. It's surely the only airport where a private security guard held a gun to the head of a customs official in July, leading the government to shut down customs for two days. ("It was a question of them not recognizing the legitimate authority of the government," says a very irritated Jorge Yllescas Oliva, director of Honduras' version of the Internal Revenue Service. "The guard was very arrogant. He placed the gun right here," he adds, motioning to his forehead.)

Welcome to the capital of Honduras, bastion of surreal superlatives, a city rife with corruption, grinding poverty, and decrepit infrastructure, home to SFO Enterprises' sole publicly acknowledged line of business.

San Francisco became part of the consortium granted the right to privatize Honduras' four international airports -- located in the cities of Tegucigalpa, San Pedro Sula, La Ceiba, and Roatán -- only after failing elsewhere around the globe. SFO managers had traveled the world in hopes of winning airport privatization concessions, using city money, living on city paychecks, boasting of their authority as San Francisco city officials, while actually working on behalf of SFO Enterprises, which was very specifically set up *not* to be part of the city government. In essence, a two-sided deception was under way: In San Francisco, everyone was pretending that SFO Enterprises was entirely separate from the airport and the city. Overseas, airport bureaucrats were presenting themselves as city officials, and glossing over or minimizing the difference between the city of San Francisco, which has tens of billions of dollars in assets, and SFO Enterprises, which was worth $10,000.

"When they won the concession, we had the idea that experts from the airport in San Francisco were going to come and improve our airport, and that they were going to invest $125 million. I had understood that InterAirports SA [the consortium that won the privatization contract] was the same thing as the San Francisco International Airport. We know that's a prestigious institution, so we figured that was great. We figured it was a stroke of good fortune that the San Francisco airport would run our airports," says Juliette Handal, president of the Honduran Private Enterprise Council, a national Chamber of Commerce.

(Judging from documents pertaining to an earlier privatization effort, Costas and his subordinates may have done more, at least once, than simply leave an impression that the city was backing their efforts. In Panama, a notarized document lists the San Francisco International Airport -- which, legally speaking, is the same as the City and County of San Francisco -- as a 10 percent equity partner in Airport Management Group Inc., a corporation created to bid on the privatization of a Panamanian airport. The city's business partners: two Panamanian banks.) **NEXT »**

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By Luis Elvir

Inside the terminal at Aeropuerto Toncontin

As Costas' team squandered hundreds of thousands of city dollars on losing privatization proposals, it became clear that the new corporation needed to hire outside experts. In some respects, at least, this reality undermined the logic behind the creation of SFO Enterprises. The company was created, after all, to exploit S.F. government expertise in

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the area of international airport management. But Costas hired Alex Seid, who, according to *Aviation Week*, had been director of project development for the Massachusetts Port Authority, which had also set up a division to pursue private airport consulting work. However, like others who worked for SFO Enterprises, Seid was hired as a city of San Francisco employee, and he traveled on a city government expense account -- while pursuing a private corporation's business.

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To pursue the Honduran privatization contract, Seid helped assemble a consortium of international airport-industry players. The consortium offered an astoundingly high bid to win a privatization contract for Honduras' international airports. The consortium, called InterAirports SA, told Honduran reporters it would invest $120 million to improve airport facilities over 20 years. The consortium also included Servicio Littoral Pacífico SA, a Peruvian warehousing and shipping company known as Serlipsa; Swissport SA, an international firm that provides airport ramp services; Pacific Architects and Engineers, an L.A.-based contractor that, among other things, managed CIA infrastructure during the Nicaraguan Contra war; Calmaquip Engineering Inc., a Miami-based contractor; and Honduran partners CIC and Interoceánica.

According to a contract I obtained between SFO Honduras SA -- the corporate shell created as a subsidiary to SFO Enterprises for purposes of the airport privatization project -- and its consortium partners, other members of the group agreed to pay SFO Honduras a $750,000-per-year fee to provide "operation and management services" for the consortium.

The consortium took over the airport in October and (as reported in a previous column, "Flying Blind," March 28) proceeded to earn the ire of the Honduran business community by immediately jacking up the fees importers pay for processing their goods through customs. But fee hikes were the least of SFO Enterprises' problems.

SFO Enterprises had a problem that many new businesses face -- undercapitalization. SFOE (as it is often called in government documents) did not have a source of start-up funding beyond the pitifully insufficient $10,000 voted by the San Francisco Board of Supervisors. Fees from consortium members would not cover required spending for years. To solve the cash-flow problem, SFO bureaucrats embarked on a truly brazen series of maneuvers.

The simplest, yet most costly, portion of these maneuvers involved the unauthorized use of city personnel and travel expenses. City files are now packed with expense vouchers that airport officials, who are city employees, submitted for work conducted on behalf of SFO Enterprises. These officials spent city money to educate themselves in the ways of international airport privatization -- while boasting during conference round-table discussions of plans for their new private corporation.

In July 1999, for example, the city paid about $5,000 for Fermin to attend the fourth annual Latin American Airport Privatization Development Summit in Miami, a sum that does not include Fermin's salary and benefits during this time. The city paid for John Costas to attend a similar conference in Paris the following year. Martin, likewise, attended a similar conference, at city expense, in Rome. City employees were regularly reimbursed thousands of dollars for travel to Honduras. A Nov. 28, 2000, city travel-advance check made out to Gerardo Fries in the amount of $3,035 is typical of dozens of such SFO Enterprises- related city cash requests made from 1997 through 2001.

Airport officials were selective in providing accounting documentation, making it difficult to assess the full amount of city money that was spent. But judging from the privatization contracts city officials attempted to win around the world, combined with the level of spending reflected in bills, checks, and receipts I was able to view, it's apparent that these officials spent more than a million dollars on SFO Enterprises' behalf.

As helpful as city travel advances were to SFO Enterprises, they did not provide the kind of walking-around money necessary to run a foreign business operation. Costas and Fermin turned to the giant San Francisco-based law firm Morrison & Foerster LLP, which does around $1 million each year in legal work for San Francisco International Airport. Legal billing statements often contain line items that refer to expenses or (in this case) disbursements; these billings usually seek repayment for sundry office expenses such as photocopying fees, messenger services, and the like. But on legal bills submitted to the airport by Morrison & Foerster and another law firm, Felipe Danzilo y Asociados in Tegucigalpa, "disbursements" could total thousands of dollars, and involve a lot more than copying and delivery.

For example, a Morrison & Foerster bill dated Oct. 11, 2000, seeks city reimbursement of $13,986 to "set up office for SFO Honduras," the SFO Enterprises subsidiary in Honduras. Morrison & Foerster submitted dozens of bills with Honduras-related disbursements; the payments total well into the six figures. Such disbursements through law firms appear to have been used to pay SFO Enterprises' on-the-ground expenses in Honduras for several months. (An attorney with Morrison & Foerster specializing in aviation law refused to comment for this story, referring information requests to the airport.)

Legal bills weren't the only method of washing airport money into Honduras. In one case, mentioned previously, Fermin took the odd step of requesting a city cash advance of $40,000, to be made out to airport employee Steven Zehr; according to records at the City Controller's Office, Fermin said the money was needed right away to rent an apartment and to buy a car in Honduras. The Controller's Office approved this highly unusual request. **NEXT »**

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By Luis Elvir

The Tegucigalpa firm of Danzilo y Asociadas, which SFO officials used to route money to Honduras.

According to now-retired Controller's Office Accounting Operations Manager Harold Guetersloh, Fermin did not provide an accounting of how the $40,000 had been spent for several months, despite repeated requests from the Controller's Office that he do so. Finally in April, six months later, after I began requesting city documents on SFO

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Enterprises' finances, the airport's International Services Division returned the $40,000 to the city, using a different check than the one originally issued. The airport officials hadn't needed the $40,000 after all, was the explanation Guetersloh says he was offered. Other documents, however, say SFO employees began using a Tegucigalpa apartment not long after the $40,000 cash advance.

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In the end, documents obtained from the city controller and SFO make it clear that airport officials diverted, at minimum, hundreds of thousands of city resources into SFO Enterprises, a private, for-profit corporation.

When a scenario similar to the SFO Enterprises situation was described to Sandra Michiokau, a spokeswoman for the state attorney general, she declined comment, but referred me to state law saying that a public official may not, without authority of law, appropriate public funds "to his own use, or to the use of another."

As Costas and Fermin solved their Honduran cash problem by diverting city funds, they faced a crisis in the area of human resources. For reasons not entirely clear, Costas had a difficult time keeping managers on board. Though Seid did not speak Spanish, officials at the Honduran Public Utilities Commission and elsewhere say the former Boston airport official forged a relatively smooth working relationship with the consortium partners, government officials, the press, and the Honduran business community. Seid left early this spring, to be replaced by Steven Zehr, who had previously worked for the Hong Kong Airport Authority. According to people who worked with him in Honduras, Zehr's brief tenure as manager of Honduras' airports proved a disaster.

Zehr's term lasted a couple of months, and Gerardo Fries, another airport official, was apparently sent down briefly as manager. "They'd send somebody for a couple of weeks, and then they'd disappear," says Tania Pagoada, an official with the Superintendencia de Concesiones y Licencia, Honduras' version of a public utilities commission. "Managers would come and go. It was hard to tell what was going on."

Earlier this year, consortium partners finally managed to hire Johnny Morales, who had previously directed operations at the airport in Santiago, Chile, which had been privatized by a consortium led by the Vancouver International Airport.

Despite the malfunctioning terminal clock, the security guard's gun to the head of a customs official, and a just-resolved cargo-fee dispute between Honduran business leaders and InterAirports SA, Morales seems to be performing competently. InterAirports SA has complied with requirements to submit detailed plans for airport improvements to be built during the next two years -- the terminal will be remodeled; the parking lot will be widened; a flight information screen will be installed. Work is on schedule to complete new training manuals, safety manuals and procedures, security procedures, and the like, Morales says, and his claims are backed up by Public Utilities Commission Director José Gilberto Aquino.

Pedro Emilio Banegas, an account executive for infrastructure finance with the Central American Bank for Economic Integration, tells me that his organization -- a regional nonprofit financing institution similar in structure to the World Bank -- may loan InterAirports SA half of the $60 million it has committed to investing in Honduras during the coming years. The rest may come from the International Finance Corp., a division of the World Bank, and the Inter American Development Bank, another regional nonprofit lending institution.

So if the SFO consortium's implied promise to invest $120 million in Honduras over 20 years may have been an exaggeration, airport improvements are likely to go ahead just the same.

Oddly, San Francisco is almost nowhere to be seen in the Honduran operation. The contract between SFO Enterprises' subsidiary, SFO Honduras, and the InterAirports consortium stipulates that San Francisco would be responsible for developing airport operational standards and procedures, drafting plans, conducting environmental assessments, and creating safety, security, and management manuals. But according to Morales and Public Utilities Commission officials who regularly meet with consortium members, SFO Honduras is not doing any of these things. Private consultants are. Morales says SFO officials are "reviewing" finished work done by the consultants, but Morales hires the consultants and supervises their work.

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By Luis Elvir

The Tegucigalpa airport terminal displays the logo of InterAirports, the consortium that won the Honduran airport privatization contract.

These days, San Francisco International Airport officials rarely book rooms at the luxurious Princess Hotel in Tegucigalpa, traverse the city streets in a new car, or hold meetings at the InterAirports SA office at Aeropuerto Toncontín. San Francisco airport officials have essentially vacated Honduras, leaving the task of running the privatization of Honduran

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airports to their other consortium partners. The director hired by the consortium says the project is on track, but there are compelling reasons to seek a full accounting of why Martin, Costas, and Fermin were allowed to divert city government money into a private corporation, under the noses of the city treasurer and employees of the city attorney and city controller.

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In convincing supervisors to approve the creation of SFO Enterprises four years ago, airport officials warned the city of the clear legal strictures against mingling airport funds with the soon-to-be-created for-profit corporation. In retrospect, Airport Director John Martin's insistence that the city provide the corporation's $10,000 start-up stake seems prescient. Federal law indeed prohibits the diversion of airport funds for non-airport uses. Now it must be seen whether the federal government will penalize SFO for the use of hundreds of thousands of airport dollars on an international privatization program.

I asked Airport Director John Martin to account for airport money that had been diverted into SFO Enterprises, the private corporation. In response, he gave me computer printouts describing an "agreement" under which SFO

Enterprises would repay the airport $565,088.92 over seven years at 5.464 percent interest, for the private corporation's expenses paid for by the city during fiscal year 1999-2000.

The document gave every appearance of having been ginned up specifically in response to my public records request: It was a photocopied computer printout dated March 12, weeks after I had begun inquiring about SFO's activities in Honduras. Martin did not provide me with any initial "agreement" to borrow the money in the first place. He provided no "agreement" about how SFO Enterprises would repay the city money diverted into the service of this private company during fiscal years 1997-1998, 1998-1999, or 2000-2001. When I requested accounting related to this supposed "loan," Martin gave me printouts, dated April 18, which had been check-marked with a pencil before being photocopied, listing travel and other expenses that had benefited SFO Enterprises. Like the first one, this documentation was dated after I began inquiring about SFO Enterprises and more than three years after the airport began diverting money into the private corporation.

Rosales rejects the idea that the fund transfers' unusually scant, late, and informal documentation might have been prepared specifically for purposes of satisfying a public information request.

"I hate to break it to you, but we don't go around jimmying things up; we don't react to people's requests for information," says Rosales. "I can assure you that those agreements were in the works. The only reason those weren't consummated was that the legal review was so extensive about the thing. It's because we have so many lawyers looking at the thing that it took forever to put them in the final form. This SFOE thing is new; it's cutting edge. It means the lawyers get crazy about dotting every "I' 10,000 times. You may laugh, but that's what happens. We're pretty busy around here. The SFO Enterprises idea doesn't come out of people at the San Francisco International Airport not having anything to do."

In assessing the proposal to create a private consulting corporation, Deputy City Attorney Melba Yee accurately raised the question of potential liability to the city. As long as the accounts were kept separate, she said, the city would be safe. Accounts weren't kept separate, and by Yee's logic, the city is now not safe from liability relating to SFO Enterprises' airport privatization venture. Instead, our city government faces the prospect of being liable for airport safety in a country with some of the most dangerous airports in the world. Aside from Tegucigalpa's mountainous approach and short runway, there's Roatán, an isolated tropical island with limited firefighting or medical facilities.

Now it must be determined whether there is some way to limit or eliminate the city's new liability load.

But these issues take a back seat to possible violations of California criminal law, which explicitly prohibits public officials from giving money to private entities without authorization, and without getting value in return.

I have no evidence that Costas, Martin, Fermin, Rosales, or any of the public officials involved in SFO Enterprises used this corporation for their own financial benefit.

But a troubling fact remains: Because SFO Enterprises is a private corporation whose activities and records are secret to the public, it is all but impossible for me, most elected officials, and members of the public to monitor the activities of the corporation, its officers, or its employees. If the corporation's assets were ever used to benefit a public official, or anyone else, inappropriately, there would be little if any way for the malfeasance to be discovered.

At its inception, SFO Enterprises had a sole owner, the city of San Francisco, and airport officials suggested the city would reap profits from the private company's activities. But the city had no right to audit the books of the private company to see if profits were being made. The city had no ability to object if new owners came on board. It was clear from the beginning that the private firm had *no obligation whatsoever* to repatriate profits to the city. And because it is a private corporation, SFO Enterprises does not have to provide its records, or open its books, to journalists or the general public.

If this kind of arrangement, in which city resources are used in a private company distinct from the city government, is legal, a host of public officials might decide to be as enterprising as the bureaucrats at San Francisco International Airport.

Chiefs of police across the state might set up private security firms whose books are out of the reach of public disclosure laws. They might order police to spend days and weeks working for the private firms, and they might fudge their accounting so that it becomes unclear where city employee time ended and private corporate gain began.

City treasurers from here to San Diego might set up private accounting firms -- arguing that the firms would make those cities bundles of money -- and then keep the books secret and make extensive use of city employee time and expertise.

If prosecutors don't take action when laws prohibiting this kind of thing are violated, our government will wind up tangled in sweetheart deals, and smiley-faced embezzlements, and front companies, all protected by an impenetrable veil of secrecy. And when that happens, we will have created an American version of Honduras, right here in San Francisco.

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Flying Blind

Are San Francisco International Airport managers running Honduras' airports? If so, why?

BY MATT SMITH

Fred Harper

Shipping bra and panty material to Honduras used to be a simple matter. You'd land one of your ABX Air DC8-63F cargo craft on the tarmac of the *Aeropuerto Internacional Ramon Villeda Morales* outside of Tegucigalpa, cart a few 450-cubic-inch containers to your nearby red-and-white warehouse, wait for a

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He's Gotta Have It
Local filmmaker Caveh Zahedi's career was waylaid by his addiction to prostitution and porn. Today, his sexual compulsions could be the source of his comeback.

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Beetle Mania
The intense joy of mounting a worthy bug in proper fashion

Bay View
A Black and White Issue
A lawsuit alleging racism at

customs agent, then ship the material over to the Maidenform factory. Once the bras and panties were manufactured, you'd follow the same simple procedure with the finished product, only in reverse.

Amtrak's Oakland yard has made it to the Supreme Court -- and could affect discrimination cases nationwide

Postscript
Dying to Know
As a young doctor's tragic fate makes clear, a lack of information about hepatitis B has put many Asian-American lives at risk

Dog Bites
House of Race Cards
Willie Brown to S.F.: You're racist. Racist racist racist racist racist racist. Biased, too.

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No more. Ever since an outfit called SFO Honduras LLC won the right to privatize the airport, everything seems to have run amok. For one, facilities fees have gone sky high. And the delays? Don't even *ask* about the delays.

"Everything takes forever," says Mercedes, a clerk at the Tegucigalpa offices of Antillas Air, a cargo company that does most of its work with Caribbean *maquiladora* textile manufacturers. "Now we've got to haul cargo from the old customs facility, near where we land, to a new one. It's a narrow dirt road, and it's dangerous; one runs the risk of having cargo hijacked, and it definitely slows down the operation."

By now you're probably asking yourself, "Why in the hell is a San Francisco newspaper columnist writing about potential panty hijackings in Honduras?" If you are, I share your pain. I felt that exact same "what in the hell are we doing here?" sensation when I learned recently that an outfit describing itself as a division of the San Francisco International Airport had just won the right to privatize the airports of Honduras. It was similar to the "you've got to be kidding" feeling I had when I learned that this very same outfit -- which appears to be run out of the offices of San Francisco International Airport -- is bidding on airport privatization contracts in the Sultanate of Oman, a traditional monarchy bordering Saudi Arabia; in Panama, a banking capital just north of Colombia; and in Jamaica, a place where, I'm told, people smoke a lot of marijuana, which may be for the good. Readers may need a few tokes by the time I'm done explaining why the good name of San Francisco's airport is being used to delay lingerie deliveries in Honduras.

It's a tale that involves possible misuse of the name of San Francisco International Airport, a trademark potentially worth millions. It's a tale of Third World business deals set up in a way so convoluted and with such a high degree of secrecy that they create at least the appearance, or the possibility, of profiteering by public-payroll airport employees. It's a tale of a mysterious private corporation, supposedly set up to enrich the city of San Francisco's General Fund, but with no clear indication that it has given, or will ever give, the city a dime. It's the tale of perhaps the most unusual business arrangement you've ever heard of, one that begs, no, *implores* the question: *¿Qué chingados hacemos en Tegucigalpa?*[1]

As with any Latin American surrealist work, to understand the present of SFO Honduras LLC, it's necessary to travel to the past, in this case, the past back to July 1997. Then, the San Francisco Board of Supervisors approved legislation, carried by Barbara Kaufman, creating an untoward, private, for-profit California corporation, to be called SFO International Services, that would supposedly generate money for the city government's General Fund by doing consulting work for foreign airports.

The fact that our city's airport might do international consulting work wasn't in and of itself unheard-of. An airport-privatization fervor had gripped the Third World during the late 1990s, much in the manner that a craze for privatizing banks, roadways, and telecommunications, electrical, and sewage utilities had enveloped developing nations during the prior half-decade. The airport privatizations were being handled in most cases by consortia involving publicly owned airports in cities such as London, Vancouver, and Madrid.

The boys at SFO wanted in on the action, so in 1996 they tried their hand, bidding as a governmental entity on an airport privatization program in Peru. They lost, but didn't merely chalk the loss up to experience. Instead they did a truly cagey thing, and blamed their failure on the airport's status as a city agency. They told the Board of Supervisors that they could never compete against public agencies such as Heathrow Airport and VCR airport in Vancouver unless they were allowed to keep their business completely secret, something a public agency is legally prohibited from doing. (That other public airports seemed to be winning these contracts handily despite their governmental status went unmentioned.)

So the board, remarkably, approved the creation of a private corporation with no guarantee that the new entity would provide a dime of profit to the city. According to bylaws approved by the Board of Supervisors, SFO International Services Inc. would be structured in such a way that neither the Board of Supervisors nor anybody else outside the firm could gain access to information about the firm's activities or management. The only outside entity with formal access to such information would be the Office of the Mayor.

SFO International Services was presumably set up to earn money for the city's General Fund -- at least that's what supervisors were told. But according to the new corporation's bylaws, the city would get money only "if the [firm's] Board of Directors declares a dividend for shareholders." In short, the supes set up a secretive corporation with a board of directors who would give money to the city if and when they met -- in secret -- and decided to do so.

The resolution was approved by Supervisors Kaufman, Amos Brown, Leslie Katz, Susan Leal, Jose Medina, Gavin Newsom, Mabel Teng, Michael Yaki, and Leland Yee, with only Tom Ammiano and Sue Bierman opposed. And that, apparently, is the last the city would ever hear of SFO International Services Inc. -- until last October, when unusual notices began appearing in the Honduran press. They described how a consortium "led by San Francisco International Airport" had placed an astoundingly high bid to win a 20-year privatization contract for Honduras' four international airports. The bidding (shown on national television to counter Honduras' reputation for corruption) resulted in a contract in which a consortium called SFO Honduras LLC/(Interairports) would invest $120 million to improve airport facilities during the next 20 years. The consortium also includes Servicio Littoral Pacifico SA, a Peruvian warehousing and shipping company known as Serlipsa; Swissport SA, an international firm that provides airport ramp services; Pacific Architects and Engineers, an L.A.-based contractor that, among other things, provides grounds and facilities maintenance at U.S. military air bases; Calmaquip Engineering Inc., a Miami-based contractor that, according to the *Broward Daily Business Review*, has been supplying Latin American airports with technology since the late 1950s; and Honduran partners CIC and Interoceanica.

While an airport privatization industry insider tells me that San Francisco's airport has assumed no financial risk as part of the Honduras deal, and is part of the consortium strictly on a fee basis, Serapio Umanzor, editor for investigative projects at the Tegucigalpa daily newspaper *La Prensa*, tells me consortium partners encouraged the widely held impression that it is really San Francisco's airport that now owns the right to run Honduras' airports. *La Prensa* itself said, "The winning concessionaire is affiliated with San Francisco International Airport, the seventh largest in the world."

Which is odd, because the corporation was set up specifically to *have absolutely no formal relationship* with San Francisco International Airport.[2]

Which oddness got me to wondering -- which wondering in turn got me to checking -- and as it happens, I could find no corporation in the files of the California Secretary of State with the name SFO International Services Inc., or anything similar. Was SFO International Services set up in the Cayman Islands? Or Panama? Or some other country with strict banking secrecy laws and airports that need First World help? Who knew?

Even though SFO International Services did not show up in searches of the California Secretary of State's corporation records and the Nexis database of corporate information, the business newsletter *Caribbean Update*, in a brief article announcing "investment opportunities" in Honduras' airport privatization, lists the contact for the Honduras airport project as Alex L. Seid, manager, International Services, San Francisco International Airport. Seid's address is listed as a San Francisco International Airport post office box; his phone number, an SFO switchboard number.

I called Ron Wilson, SFO's public information officer, who did nothing to suggest that Honduras' privatization work isn't being run out of the airport's offices.

So I then asked Mr. Wilson some basic questions -- such as where SFO International Services is registered as a corporation; who its board members are; and whether it has so far produced any revenues for the city's General

Fund -- the kind of basic information that a flack for any *normal* corporation could answer without hesitation. I asked whether airport employees doing work for SFO International Services are required to take time off from their regular SFO jobs. I asked why SFO managers have participated in the privatization of Honduras' airports, and on what basis the decision would be made to repatriate profits from the Honduras privatization to the city's General Fund. I asked why SFO International Services is bidding on airports in Jamaica, Panama, and Oman.

Mr. Wilson told me to submit my questions in writing. I did this Thursday, explaining that I had a Monday deadline. He said he had to refer my questions to a Mr. John Costas, who is in charge of the Honduras "program" and who couldn't get back to me until the next day. Friday Wilson sent me an e-mail.

"Unfortunately John Costas has gone home sick again this afternoon. He has apparently completed his response, and it is being reviewed by appropriate staff. We will not be able to convey the response to you before Monday March 26th," the e-mail said.

And on Monday, Mr. Wilson said there would be no answers until Tuesday.

I put the same set of written questions to Mayor Willie Brown's press officer. Brown's office, which had, after all, been named as a shareholder of SFO International Services Inc., would presumably know what the company was up to. But Brown's press office likewise failed to answer my questions by the end of Monday.

Perhaps Mr. Costas will someday explain why activities presumably done on behalf of a private corporation are being carried out from the offices of a city agency. Perhaps he will tell me where SFO International Services is registered, who its officers and directors are, and who will receive the $120 million in contracts SFO Honduras LLC will be handing out over the next two decades.

Perhaps this Honduran airport deal is all perfectly on the up and up, and completely in line with the interests of the people of San Francisco. Maybe SFO International Services isn't a profiteering vehicle that channels money to airport and city government insiders. Or is it that the airport itself won the contract in Honduras, rather than the private corporation set up specifically to pursue such opportunities?

Until the elusive Mr. Costas decides to speak up, I guess we simply won't know.

There's a reason why ordinary companies -- that's to say, companies that aren't strange, secret, quasi-private entities like SFO International Services -- take great pains to avoid having their good names associated with business deals they do not control. If a valuable corporate name is sullied, millions, even billions, of dollars of public goodwill can be lost, resulting in the massive diminishment of future sales. In the modern business world, a good corporate name can be the most valuable thing any entity owns.

That's why it would be too bad if SFO's Third World privatization deals were to go sour, and San Francisco were to become known as the city that screws over developing countries, just to make a buck.

In the case of Honduras, that may be precisely what is happening.

SFO Honduras LLC placed a bid for the right to privatize the country's airports that was so high -- 39.7 percent of gross revenues, or twice the rate economists predicted the airport sale would generate -- that this entity has been forced to charge increased fees for the use of customs warehousing and processing facilities. And these high fees may end up hurting the local economy.

Serapio Umanzor, the *La Prensa* editor, tells me there's been an outcry in the local business community over high customs fees the new airport has been charging. Indeed, according to Connie Gorospe, president of Antillas Air-Worldwide, which handles much of the country's *maquiladora* cargo, the rates the airport charges to allow merchandise to pass its customs bays have been raised thirteenfold. Worse, shippers such as Antillas are no longer allowed to use their own warehouses; they must pay steep SFO Honduras LLC fees to warehouse their cargo for the few minutes between unloading and inspection. The new warehouse that shippers must use is, as it happens, in a most inconvenient location, about a mile away from the airport's main landing strip, and connected by a poorly maintained road that's not even passable by truck.

"We have to use a tractor hauling little carts," says Gorospe, who adds that the increased shipping costs and delays have so far driven 20 percent of his *maquiladora* manufacturers to other countries. "They can't afford this surcharge -- a lot of them have moved out of the country. The big guys have production going on in different countries. They've taken a lot of production out of Honduras and taken it to their other facilities."

Whether or not one likes the international textile business, the fact is that Central American countries such as Honduras have staked their economic futures on it. So the SFO Honduras LLC *maquiladora* purge "has affected the finances of a lot of Hondurans," says Mercedes, the Tegucigalpa cargo clerk.

Do the people of San Francisco really, *really* want to be in the business of torching Third World economies for a few General Fund bucks we may never, ever see?

And do we really want the boys at the airport to continue running their public-private, developing-country, airport-privatization shop with absolutely zero public oversight, as has been the case so far?

Isn't it, perchance, time we pulled SFO International Services Inc.'s britches down, to see what we might find?

***1** "What the hell are we doing in Tegucigalpa?"*

***2** Quoting from a memorandum by City Attorney Louise Renne: "To the extent that international consulting services are provided by a division of the San Francisco International Airport, the City itself could be potentially liable for successful claims arising from international services activities. Therefore, one purpose of the corporate form is to protect the city from such liability."*

sfweekly.com | originally published: March 28, 2001

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