# Chapter 1

# The Enron Success and Failure

In 1984, Kenneth L. Lay became the Chief Executive Officer of Houston Natural Gas Corporation, a pipeline operator. Soon after he took position, his firm merged with Internorth, another pipeline company. Lay became the CEO of the merged firm, and the name of the firm was changed to Enron. As deregulation of energy became more widespread (Lay influenced the rate of change) the mission of Enron widened to include the trading of energy contracts.

Shortly after the merger with Internorth, Lay hired the consulting firm, McKinsey & Co., to help develop a business strategy for Enron. One of the consultants assigned to the Enron study was Jeffrey Skilling. Lay subsequently hired Skilling to develop new business activities for Enron. Skilling successfully launched Enron's highly profitable business of trading energy derivatives.

Andrew Fastow was hired by Enron in 1990 from Continental Illinois Bank in Chicago and was appointed Chief Financial Officer (CFO) of Enron in 1998. Fastow was thought to complement Skilling's interests and abilities. Appointing Fastow as CFO was Enron's second biggest mistake (it probably would not have been made if the first mistake of allowing the departure of Rich Kinder had not been made).

## Rich Kinder

In November 1996, Enron announced that Rich Kinder was leaving Enron. Shortly before that announcement the Enron Board of Directors (and Ken Lay) had failed to appoint Kinder as the CEO. The decision not to appoint Kinder as the President of Enron had very little to do with Kinder's acknowledged managerial abilities.

Kinder was (and is) a world-class manager, one of the few effective hands-on managers at Enron. The departure of Kinder was the most significant negative event for Enron during the 1990s. It would likely have been a different firm in 2001 if he had stayed.

When he left, Kinder bought from Enron the Liquids Pipeline Division for $40 million. With Bill Morgan and the $40 million pipeline he formed Kinder Morgan Corporation.

Kinder Morgan went public, but in 2006 Kinder and Morgan took the firm private (the corporation had a market cap of $14 billion).

In 2006, Rich Kinder was one of the world's richest persons and will be even richer when Kinder Morgan goes public again.

The $14 billion of Kinder Morgan value could possibly have been value-added to Enron if Kinder had not been rejected as CEO. Enron needed effective managers of real assets, and Kinder was among the best.

## John Wing

John Wing was another great manager (of power plants) who was shown the door by Enron in July 1991. He helped execute the original deal that created Enron and was in and out of Enron from the early-1980s to 1991. He made money for Enron with hard assets.

His biggest moneymaker for Enron was a power plant in England called Teesside. He also did many other profitable deals for Enron.

John Wing did not fit easily into the Enron management structure. He was not the type of person with whom Ken Lay felt comfortable. When Wing wanted to separate his power group from Enron and form a separate publicly owned corporation, Lay facilitated his departure from Enron.

It is interesting to conject what would have happened if Enron had financed Rich Kinder's gas pipeline company and John Wing's power company. These two entities certainly would have developed into two very interesting merchant assets.

## The Year 2001

In the year 2001, Enron was the seventh largest US Corporation (based on revenues) and possibly would have been ranked larger if the revenues of all the subsidiaries and special-purpose entities (SPEs) were factored into the calculation. It would have been ranked much lower if trading transactions were not treated as revenue. Interestingly, Enron was ranked number five in the Fortune 500 listing for 2001, published in March 2002. But no matter where we exactly rank it, Enron was a large profitable corporation before October 2001. If we consider only the available public information as of August 2001, it was a very profitable corporation.

On 17 December 2001, the Enron Corporation filed an 8-K report with the Securities and Exchange Commission (SEC). It stated that on *"December 2, 2001, Enron Corp.* (*the "Company"*) *and certain other subsidiaries of the Company* (*collectively, the "Debtors"*) *each filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code* (*the "Bankruptcy Code"*) *in the United States Bankruptcy Court for the Southern District of New York…"*

Thus, in December 2001, Enron filed for bankruptcy. How did a seemingly healthy, profitable corporation transform itself into the biggest corporate scandal of the new millennium?

The newspapers have reported extensively on the clienteles that have been harmed by the Enron collapse. These include:

Employees with 401-K plans heavily (or exclusively) invested in Enron stock;

Employees who have lost their jobs at Enron;

Employees and investors who held worthless Enron stock;

Debtholders who owned debt that had lost most of its value (including bank debt).

But, the list of those affected greatly is much longer, including:

Top management with reputations in shatters and significant reductions in wealth.

Arthur Anderson — A once highly respected public accounting firm was struggling to stay afloat and subsequently was forced to shut down operations.

Security analysts who recommended Enron stock.

Bond rating agencies who had imperfect crystal balls.

Politicians who accepted donations from Enron.

At the beginning of 2001, Enron's common stock was high compared to its earnings. How does a CEO manage a company whose stock is overvalued? Enron management chose to take actions that presented a sunny smile to the public while painful events occurred. There were some executives who, fooled by the firm's own accounting and financial tricks, actually thought things were bright.

## Five Business Segments

Enron was divided into five different specific business segments and a sixth general unit (catch-all).

1. *Transportation and Distribution*. This segment included regulated industries (e.g., electric utility operations), interstate transmission of natural gas, and the management and operation of pipelines.
2. *Wholesale Services*. This included a large portion of Enron's trading operations, energy commodity sales and services, and financial services of wholesale customers, and the development and operation of energy-related assets (such as power plants and natural gas pipelines).
3. *Retail Energy Services (Enron Energy Services or EES)*. Sales of energy-related products (including expertise) to end-use customers (including commercial and industrial firms). On 30 June 2001, Enron had 730,000 retail customers.

4. *Broadband Services*. Construction and management of fiber-optic networks; the marketing and management of bandwidth; trading bandwith.
5. *Exploration and Production*. Exploration and production of natural gas and crude oil.
6. *The catch-all segment*. This included water and renewable energy; the supply of water and energy to end-use customers, the provision of wastewater services; construction and operation of wind-generated power projects.

The Retail Energy Services and Broadband Services were the two primary problem areas identified by the US Attorneys prosecuting Skilling and Lay.

## The Three Components

While Enron was organized into five business segments and a sixth catch-all segment, it is useful in analyzing its collapse to describe Enron as consisting of three basic components:

1. A trading unit;
2. Real assets (generating and transportation);
3. Merchant assets (ownership interests in other firms).

While the initial investment in the merchant assets was less than that in the other two components, it was transactions related to the merchant assets that contributed most significantly to Enron's collapse and to Arthur Andersen's audit difficulties.

Interestingly, the problems associated with merchant assets were created not by Enron making bad merchant asset investments, but rather by the too-clever and too-imperfect efforts to insure that gains in the value of merchant assets that had been achieved were then not lost by value decreases. The objective of hedging the gains was reasonable. The means chosen to achieve the objective by the CFO Andrew Fastow were far from reasonable.

## The Enron Hedge Fund

There was a hedge fund (ECT Investments) within Enron that invested in energy stocks. Investments were not limited to energy stocks, but the large gains were made on energy and technology stocks. The operation started small but grew to $150 million of Enron equity, and there were about $3 of debt for each dollar of equity. The fund earned annual returns of more than 20% (*Wall Street Journal*, 11 April 2002). We do not know if the profits continued after the stock market retreated in 2001.

The investing community was not at all aware of the hedge fund operations. Given the large amount of debt frequently used by hedge funds, knowledge of the existence of the fund could upset the conservative common stock investors. On the other hand, the fund offered an investment opportunity (a hedge fund) that was not normally available to investors with small amounts of capital. The hedge fund's income amounted to as much as 10% of Enron's earnings in some years.

There is no reason to conclude that the Enron hedge fund was a material contributing factor to the collapse if this fund is separate from the merchant assets that were reported.

## A Distraction

The 11 March 2002 issue of *Newsweek* contains an article titled "Enron's Dirty Laundry" in which it described "sex-drenched out-of-control corporate culture that ultimately wrecked the company". Enron's managerial culture likely contributed to the firm's collapse but in this book let us leave the subject of sex and other cultural considerations with that conclusion. For more details, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*, can be referred to. This is an excellent comprehensive investigation into the events leading to Enron's collapse. In the current book, we will focus on the accounting and finance issues that resulted in Enron's collapse.

Among the titles considered for this book was *"Enron: The Dumbest Guys in the Room"*, but to be fair, the participants were not dumb.

However, they were not the smartest, and sometimes they were too smart.

## Rush to Judgment

In the fall of 2001 and in the winter of 2002, newspapers quickly identified the fact that Enron and the system that Enron operated in were corrupt. Paul Krugman had no problem identifying Enron's corruption (*The New York Times*, 18 January 2002, p. A23).

> The Enron debacle is not just the story of a company that failed; it is the story of a system that failed. And the system didn't fail through carelessness or laziness; it was corrupted...
>
> So capitalism as we know it depends on a set of institutions — many of them provided by the government — that limit the potential for insider abuse. These institutions include modern accounting rules, independent auditors, securities and financial market regulation, and prohibitions against insider trading.
>
> The Enron affair shows that these institutions have been corrupted. None of the checks and balances that were supposed to prevent insider abuses worked; the supposedly independent players were compromised.
>
> The truth is that key institutions that underpin our economic system have been corrupted. The only question that remains is how far and how high the corruption extends.

Is "corruption" an accurate and fair description of Enron's activities?

Bob Herbert (*The New York Times,* 17 January 2002, p. A29) saw the Enron debacle as an opportunity to attack deregulation:

> The kind of madness that went on at Enron could only have flourished in the dark. Arthur Andersen was supposed to have been looking at the books, but the vast shadows cast by the ideology of deregulation allowed that

> company to escape effective scrutiny as well. So you have revolving-door abuses and pernicious financial arrangements between companies like Enron and auditors like Andersen that are similar to those between private companies.

There is also the observation of Senator Peter G. Fitzgerald of Illinois:

> Mr. Lay is perhaps the most accomplished confident man since Charles Ponzi.
>
> (*The New York Times*, 17 February 2002, p. 52)

Are the observers fair in reaching the above conclusions? Was Lay a confident man when compared to Charles Ponzi? Could Lay receive a fair trial given the press coverage?

## The Activities of Kenneth L. Lay

The 4 February 2002 issue of *Newsweek* had an article on Lay. For the purposes of this book, the pictures accompanying the text are most significant since they give us some insight how he spent his time as the top manager of Enron.

a. Lay with George and Barbara Bush at an economic summit.
b. Lay with Phil and Wendy Gramm (at the 1992 Republican Convention). Phil was a US Senator.
c. Lay golfing with Bill Clinton, Gerald Ford, and Jack Nicholas.
d. Lay with George W. Bush.
e. Lay with Clyde Drexler and Rudy Tomjanovich (one-time basketball luminaries).
f. Lay receiving an award from the Wildlife Conservation Society.
g. Lay with Mikhail Gorbachev.
h. Lay on vacation.

While these pictures prove little, they do indicate that Lay took his public relations responsibilities seriously. There is little evidence to date (including the 2006 trial) that he was a "confident man" when compared to Charles Ponzi. There is some evidence to show that he did not pay attention to the details of the management, because of which he failed to perform properly as CEO. This is particularly valid since the "details" of Enron were material and affected its very existence.

## The Path of the Enron Stock Price

In August 2000, the Enron common stock sold in excess of $90 per share. In January and February 2001 it was still sold in excess of $80. This was a P/E of 66 based on trailing basic earnings per share of $1.22 for 2000.

By August 2001 the stock price had fallen to below $40. Even after the earnings and stock equity revisions were announced on October 16 and 17, the stock still sold for $20 (as late as October 23).

By November 30, the stock price was $0.26 per share and on 15 January 2002, the stock was suspended from trading on the New York Stock Exchange.

## The Indictment

The Grand Jury indictment of Skilling and Lay included the following (p. 3, Section 5).

> 5. As detailed below, defendants KENNETH L. LAY ("LAY"), JEFFREY K. SKILLING ("SKILLING"), and their conspirators, engaged in a wide-ranging scheme to deceive the investing public, including Enron's shareholders, the SEC, and others (use "Victims"), about the true performance of Enron's businesses by: (a) manipulating Enron's publicly reported financial results; and (b) making public statements and representations about Enron's financial performance and results that were false and misleading in that they did not fairly and accurately reflect Enron's actual financial condition and performance, and they omitted to disclose facts necessary to make those statements and representations fair and accurate.

The indictment concluded that the conspiracy's objectives included (paragraph 17).

- Reporting recurring earnings that falsely appeared to grow smoothly by approximately 15 to 20 percent annually and thus create the illusion that Enron met or exceeded the published expectations of securities analysts forecasting Enron's reported earnings-per-share and other results;
- Touting falsely the success of Enron's business units;
- Concealing large losses, "write-downs," and other negative information concerning its business units;
- Masking the true magnitude of debt and other obligations required to keep the company's varied and often unsuccessful business ventures afloat;
- Deceiving credit rating agencies in order to maintain an investment-grade credit rating; and
- Artificially inflating the share price of Enron's stock, including attempting to stem the decline of Enron's share price in 2001.

If true, these are bad actions, but none of the above, by themselves, are likely to cause the bankruptcy of a healthy corporation. But Enron was to a large extent a trading corporation, and the bad press in the fall of 2001 led to the loss of its trading partners and financing.

## Conclusions

This book will investigate the factors leading to Enron's collapse and try to separate out the significant from the less significant. We shall see that there were real factors contributing to the collapse and that there were intangibles that eroded the market's faith in Enron's accounting and business practices, and created the "run on the bank" that was described by Jeffrey Skilling (ex-CEO of Enron).

The objective of Chapters 2 and 3 is to establish that there were no sufficient reasons for a casual reader of Enron's published financial statements to conclude that this was a financially distressed corporation. Chapter 4 starts the explanation of the fall.

The book will also review elements of the 2006 Skilling–Lay trial. The objective is not to determine the innocence or guilt of the two men. Rather, it is to dissect the accusations and testimony so that some of the fluff can be cast aside, and it can be better determined whether the Skilling–Lay trial was fair or not. The two men should not have been convicted because investors lost money when Enron collapsed, but the bankruptcy of Enron looms large as a primary factor in their convictions. At least there is reason to think that the Judge and the US Attorneys thought it was very important.

The position of this book's author is that Enron (Skilling and Lay) could have presented more and better financial information to the public. But the US Attorneys also distorted the facts and arguments during the Skilling–Lay 2006 trial at a level that was comparable to the accounting distortions of Enron. The US Attorneys "knew" Skilling and Lay were guilty and used strategies to gain convictions, given their guilt.

It is interesting to note that four of the most significant events leading to Enron's bankruptcy did not give rise to immediate accounting entries. These events were (1) hiring of Fastow; (2) departure of Kinder and Wing from Enron; (3) giving of Marks a relatively free hand to make international investments; (4) shift of mark to marketing accounting.

## Reference

McLean, B and P Elkind (2003). *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*. New York, NY: Portfolio (the Penguin Group).