James Kaupert

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Notes from Enron Case

From Dess, McNamara, & Eisner *Strategic Management*

- In 2001, Jeffrey Skilling was elected CEO of Enron
- Moving into deregulated energy markets
- In Sept 2000, stock price was $85-$90, by November 2001, <$1
- Various Enron individuals plead guilty to various conspiracies, and some committed suicide

From Pipelines to Commodity Trader

- Kenneth Lay named CEO of Houston Natural Gas in 1984 to avoid a takeover
- Lay merged HNG with InterNorth and others to form Enron in 1986, took company international
- Enron ranked 1st in pipelines category in 1994, and was 39th most admired company in America
- In the 90's, expanded business into other markets such as energy generation, broadband, and financial markets, while maintaining lead in pipelines
- all the leading ratings dropped after the company's decline, to last place

"Get it Done. Get it down now. Reap the rewards."

- Lay built management of mostly MBAs instead of gas/energy pros
- Enron became derivatives trading company
- creativity and human capital viewed as growth resources for the future
- Extravagance was encouraged
- stock price and Peer Review Committee (PRC) were all that mattered to the company
    - Legal dept: "We do big, complex, and risky deals without blowing up Enron"
    - employees incentivized by earnings quickly booked, without regard to long-term consequences
- high reward structure, similar to other dot-com era companies
- Every 6 months, employees provided feedback on other employees
    - lowest 15% had to be "redeployed", finding another job in the org or elsewhere
- analysts with questions on quarterly earnings calls ridiculed if details were questioned

Enron and the Capital Markets

- Skilling had been a McKinsey & Co. consultant before Enron
- Enron became market maker for natural gas in 1990, and Skilling was hired by Lay as CEO of Enron Gas Services. Andy Fastow hired as CFO under Skilling. Enron Gas Services eventually renamed as Enron Capital and Trade Resources (ECT)
- ECT did financial and risk management services for Enron and trading partners
    - asset securitization services, which made Enron's natural gas and oil groups more profitable
    - positioned Enron as market maker for various commodities

Two Critical Elements: Mark-to-Market and the SPEs

- Mark-to-Market = method to aid investors in valuing a security, based on assumptions. Used by Enron to establish prices for new commodities when reference prices didn't exist (ie: for weather)
- Special-purpose entities (SPEs) = financial mechanisms to provide flexibility for finance and risk management. Allowed Enron to move debt from its balance sheet on a continuing basis so it could keep high credit ratings
- "Outside Equity" was provided by "friends of Enron"
- Over 3000 SPEs created to keep debt off the balance sheet
- Only way to more profits was to open new commodity markets, quickly exploit them, then repeat
- Stock price soared as a result of no debt accumulating on Enron, instead being held by the SPEs
- SPEs hid debt and losses as revenue, but did not create cash flow for the company

The Investment Bank Connection

- The need for a high credit rating meant investment banks provided short-term deals that let loans look like sales revenue, allowing Enron to briefly remove unprofitable elements from balance sheet

The Enron Control System

- Significant checks existed to examine all deals by the company
- many authorizations left incomplete
- Code of Ethics waived by the board for LJM entity setup
- The board relied on two assumptions for LJM setup
    - each division would aggressively market its assets
    - Andersen's counsel on LJM deals would be independent
- Skilling did not sign many LJM transaction forms
- Stockholders and analysts found it difficult to monitor Enron's position
    - SPEs difficult to find information on
    - many proxy statements and footnotes used

- details often omitted

Three International Deals

1. Dabhol, India power plant
2. Cuiaba, Brazil gas-fired power generation plant
3. Azurix water company acquisitions

It Comes Undone

- On August 14, 2001, Skilling resigned 6 months after becoming CEO
- Nonderivatives business was losing money, profits were coming from derivatives
- Andersen noted in August 2001 that the Raptor restructurings were not properly accounted for, and needed to be revised
  - Lay announced $1.2B reduction to S/E
  - Enron consolidated SPEs back to 1997, putting the balance sheets of SPEs onto Enron's
- Class-action suit filed against Enron on behalf of shareholders in Oct 2001
- Enron hoped to merge with Dynegy, another energy competitor, but failed due to fear of what hadn't been disclosed
- Lay resigned Jan 23, 2002

The Aftershocks

Criminal Actions

- congressional hearings occurred, various people charged
  - Fastow, Sklling, Causey, Lay

The Retirement Vanishes

- Enron had been a big part of many retirement funds, especially pensions
- Enron employees were mostly invested in Enron stock, and could not sell shares until age 55
- substantial losses to pension funds of every state

The Accounting Profession

- Arthur Andersen firm stripped of ability to audit public corporations in the US, and ceased to do business
- SOX aimed at the conflict of interest between consulting and auditing

The Charity Fallout

"Enron bill" passed by US House of Representatives for disclosure of certain contributions and gifts to organizations affiliated with board members