CASE STUDY - ENRON SCANDAL

The role financial instruments played in the downfall of Enron

As often happens with buccaneering entrepreneurs, Enron got a case of hubris. It figured if it could trade energy, it could trade anything, anywhere, in the new virtual marketplace, Newsprint, Television advertising time, Insurance risk, High-speed data transmission. All of these were converted into contracts -- called derivatives -- that were sold to investors. Enron poured billions into these trading ventures, and some failed. It turned out Enron was good at inventing businesses, but terrible at the tedious work of running them, judging by some appalling internal management audits discovered by The Times's Kurt Eichenwald. For a time, Enron swept its failures into creative hiding places, but ultimately the truth came out, confidence in the company collapsed and you now have a feeding frenzy.

To keep its mystique alive and its stock price growing, it set up partnerships where it could bury its losses, or generate imaginary revenues. Here's one of the more audacious examples, pieced together by The Wall Street Journal: Enron invested a bunch of money in a joint venture with Blockbuster to rent out movies online. The deal flopped eight months later. But in the meantime Enron had secretly set up a partnership with a Canadian bank. The bank essentially lent Enron $115 million in exchange for Enron's profits from the movie venture over its first 10 years. The Blockbuster deal never made a penny, but Enron counted the Canadian loan as a nice, fat profit.

The broader market effects resulting from the rise and fall of Enron

The market for wheeled energy is electrical energy generated by one entity and transmitted through high capacity lines to an eventual purchaser, which is not necessarily the adjacent power system; electrical energy can be “wheeled” through several interconnected operators. So in theory a Quebec hydro utility could sell electricity to Nebraska. That market predated Enron and survives, with some new safeguards against gaming the system.

Enron could game the markets because they had informational advantages and Jeffrey Skilling thought like a Finance Guy, not as an engineer. They played the energy markets like a stock market, creating false demand to boost marginal prices, then bidding on account to further gas the price of marginal megawatts (the unit of trade). Frantic and befuddled system operators, who might be trying to handle a temporary surge in demand, saw prices as high as 10x what they were accustomed to. Having created the buying panic, Enron wheeled, through market options, apparent supply. They then let the artificial market crisis subside and exercised options (puts) that allowed them to force sale of higher priced megawatts. Or, alternatively, they played calls, filling contracts executed as prices were rising quickly with megawatts they could purchase cheaply as markets re-equilibrated. In one case, they created a false demand in Southern California and "solved" it with supply purchased in Northern California.

This is all classic stock market manipulation, and much of it is illegal. In any case, Wall Street guys see through these tactics and usually only dumb money gets hurt. But with Enron, it was rate payers who footed the bills and citizens who faced brownouts. The system now is back to being handled by technocrats, engineers and long term contractual agreements that specify ranges of "allowed" pricing. These reforms were essentially a codification of the informal system of mutual supply that existed before the private power markets allowed manipulation of the marginal price of a megawatt.

You might expect the answer that Sarbanes-Oxley reforms were a consequence of Enron, and I agree the negative publicity helped the passage of that set of reforms, and directly addressed the attempted defense of Skilling (I didn't know what was happening) by specifying the signatures of the CEO and CFO on the financial statements. But I doubt those reforms will have long run impact since the smart money has simply gone to private placements and private equity arrangements which are much less troubled by So, or indeed by any reporting requirements. The consequence is that the number of publicly listed US firms has been dropping while private equity has enjoyed great growth.

In terms of larger set of markets, very little has changed. Enron was a great scam not just because it manipulated a market system; but rather because it portrayed itself as having tapped - in some mysterious fashion- the power of free markets. This allowed them to tell a story that Wall Street believed and which the Street in turn sold to millions. The big payoff was the monetization of Enron employees through stock appreciation. They were encouraged to plow the maximum they could into the stock, and that seemed to be a guaranteed rocket to the moon. Until eventually some simple questions about profitability could not be answered and some child remarked the Emperor had no clothes. At the end, they were selling liabilities to subsidiaries who booked them as assets. But they were not an anomaly, nor did the national publicity stop others.

Essentially, Finance has the means of creating new asset classes and, as long as enough people accept them, they can become collaterizable assets. This means they can secure loans that are made in real cash. If their acceptance continues, they propagate throughout the financial systems, falsely boosting apparent wealth without adding real value.

Recommendations of risk mitigation techniques that could have been applied to minimize Enron's risk profile

The problem at Enron appears to be how it managed risks in the implementation of its projects. It appears that "Enron always bragged that it was state of the art in risk management, but here's a company that didn't really do its risk-management homework. Deals were approved that had "poor profit and loss projections," resulting in "unprofitable contracts."" Because of risk management failures, Enron apparently made bad business deals. Examining Enron produces conflicting stories. The whole industry was using off-the-books vehicles and Enron's were the most sophisticated. Enron could innovate in capital management because it combined its sophistication with that of the leading law and accounting firms in that field." On the other hand, Enron was an uncontrolled mess where highflyers cared nothing for the consequences of the transactions that yielded them bonuses. At Enron, projects emerged that were implemented without basic operational controls. Risk management was Enron's claim to fame, as well as its weakest link.

A basic lesson from Enron's downfall is that the more reliable corporate internal controls are, the less there is a need for intrusive auditing. The task for redesigned corporations, and the law to the extent it is able, is to govern these work councils by improving internal risk management controls. To do so, risk management groups need to be understood.

Following are the points:

- The first was management, which could have adopted better accounting practices. Unfortunately, once management has bought into the belief that the function of a corporation is to reward upper management, rather than to maximize the profit of the company's owners (i.e., the shareholders), it is unlikely that they will behave with total propriety. This is made worse by the group dynamic of peer pressure, where otherwise honest people will do things that in retrospect should not have been done.

- The second group that might have stepped in was the independent auditors. However, the independent auditors made much more money from consulting than they did from the audit, and we suspect there was a great deal of internal pressure to preserve the revenue stream, rather than endanger it through petty propriety. In a word, they were not independent. While we like to think that these actions were atypical (other partners in the firm seem astonished that those involved would have done what they did.

- The third group was Congress, in its role as regulator. In 2000, Arthur Levitt, then chairman of the Securities and Exchange Commission, proposed an SEC rule that would bar accountants from also acting as consultants, because he felt it created a conflict of interest. That proposal was rejected after 46 members of Congress called or wrote personal letters to Levitt questioning the proposed rule and some lawmakers reportedly threatened to withdraw funding from the SEC.

Source- Internet Blogs, Articles, Research Papers