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Volume 1 Issue 9: Enron: the end of endless possibilities

So many possibilities, but who could have predicted that one possibility would trigger an avalanche for the company, the energy industry, and the corporate world?

Confessions of an Enron executive

If "Enron" was a fictitious company, Lynn Brewer's "House of Cards" would be the perfect script for a Hollywood blockbuster like "Wallstreet" or even a television series like "Dallas." Instead, "Enron" was a real company, and this book is non-fiction. So why did the publishers HarperCollins, who had originally agreed a six-figure deal with the author, reject the final manuscript?

You can read about Brewer's discovery of fraud, corruption, incompetence, scandalous behaviour, unethical practices at Enron, while she worked there as Lynn Morgan (her maiden name). She started as a (natural gas) contracts administrator, transferred to Rebecca Mark's water world Azurix, and then worked for Enron Broadband in her last position as Senior Competitive Intelligence Specialist in the Portland office.

Then you will see why people loved and hated Enron at the same time. You either worked for Enron, got a great package (including stock options) and great career prospects, or you didn't. Lured by the promise, she accepted a position there, only to be told by her boss that her mission was to sack two of the three people reporting to her.

The picture Brewer paints of Enron is political: back-stabbing, selfish, greedy, power-hungry individuals succumbing themselves readily to the seven cardinal sins. As the saying goes, "you either beat them or join them." Newcomers get golden-handcuffed by the stock options. Greed breeds greed.

If everybody else does it and gets away with it, could it be wrong? It becomes a question of economics vs ethics. How dare you question something that makes money for the company? Brewer soon learns that the company makes money by a) covering up the real truth with a web of complexity so great that no one bothers to unravel it, b) getting the deal done at whatever cost (because your bonus is booked to the deal being made), c) covering up for each other, and d) intimidating and being intimidated.

To understand what happened at Enron, it's not enough to just follow the news. The devil is in the nitty gritty details of energy contracts, the conversations of Enron employees, and Brewer's fascinating, frank, if not shocking, account of her three years at Enron. She takes you inside the minds of the traders, the household names of Jeff Skilling, Rebecca Carter, Ken Rice, amongst others, and into the culture of Enron.

Loopholes or illegality

New York Times October 20, 2002 news analysis entitled "A Powerful, Flawed Witness Against Enron" concludes, "Moreover, many traders, Mr. Belden included, seem to have thought that such manipulations were simply clever methods of taking advantage of poor rules, rather than illegality."

This is an interesting debate. It's a basic principle of economics that rational individuals act to serve their self-interests and incentives. One of these is to find loopholes in the rules and take advantage of them. If the people who make the rules are not smart enough to spot the loopholes, could the individual be blamed for exploiting the loopholes?

Many academics have found that electricity markets are very susceptible to gaming. "Gaming" refers to the economic phenomenon of maximising value whenever there are more than two people transacting with each other. "Gaming is the act of exercising market power to reap large profits. Gaming differs from arbitrage in that the former arises from persistent opportunities rather than a temporary advantage created by inefficiencies in the market."

So if the rules aren't good enough, and individuals, as rational decision makers, identify the loopholes and "game" the system to make profit for themselves, could this be wrong?

Similarly, if a trader's mission is to make as much money for himself and the company, he will find and exercise trading strategies to do so. If an electricity trader follows company rules and market rules, making lots of money, but causing blackouts in the State of California, is he to blame?

But what about corporate ethics? Where does that come into the picture?

Rapid downward spiral

It's the speed of the collapse that's the most amazing, one observer remarked in December 2001.

There are two things that would speed up a downward spiral:

1- a trading company that stops trading: when nothing happens, everything negative starts to happen. Money has to be constantly moving for business to stay afloat.

2- loss of confidence and credibility: people stop trading with you, and you get back to point one.

It wasn't very long ago, that as children, we learned to climb the ladder to slide down the slide. It was hard work climbing up. Sliding down was easy and fast.

So it's hard work building a business and dead easy to lose it.

Dream job come true

She heard the name from afar. Curious about them, she researched the company at length. They were pioneers, innovators in the idea of treating energy like currency. Some of its philosophy sounded very attractive: using flexibility to deal with uncertainty.

There was a Euromoney story about their exploits in India. The magazine cover had a big Texan cowboy and a wiry Indian man - clearly the cowboy was winning the rodeo.

A career magazine featured a Stanford MBA graduate who spoke positively about his experiences with the company. His career progression was competitive but rapid. And there seemed like endless possibilities.

So she called the personnel office to find out how she could apply for a job. She wrote to the MBA, who was now a director in the firm's European office. She also responded to a newspaper advertisement by a recruitment firm for the company.

Three ways of trying to get in - surely this sent the message to the company how keen and serious she was about her desire to work for them.

Twelve interviews later, she got the job. And off to Houston, she went.

Make the deal, restructure later

In the commercial departments, there existed great pressure to make a deal. Deal makers were the stars in this hunter-rather-than-gatherer culture. Their annual bonuses depended on the size of the deal booked.

Whether the deal was good in the long term was not the deal maker's concern. For, by that time, he would have moved to another department.

The company culture of rotating people from department to department ensured that they were always mentally challenged. It also allowed different people to work together and to cross-fertilise ideas generated in one area to another.

If a deal did go sour, it was possible to restructure it by calling in a group of analysts to model it and lawyers to renegotiate it. By magic, the deal was suddenly profitable again. And more people made money, that is, the people on the renegotiation team earned their annual bonus.

While it may seem strange that you could always "make good" a deal gone sour, the secret was that each time a new deal was made or restructured, it was good publicity for the company.

The very lucky ones, those that worked long and hard on big deals, got rewarded in other ways too. The company flew the UK team to the Cayman Islands for a long weekend. This further signalled to analysts and dealmakers alike to go after the big deals.

Options translated

The high turnover of deal entry clerks posed a big hiring problem for the trading floor. Deal input was a manual, repetitive, and therefore tedious activity. However, the deal input supervisor refused to take on non-college graduates without A levels in mathematics.

The supervisor explained that most deals were very complex and required knowledge of options.

Options are derivative instruments, which are financial products whose value (price) depend on something else (also called underlyings). To understand derivatives, you need to have studied calculus. But not just basic college level calculus. The valuation of options requires an understanding of stochastic calculus.

Coincidentally graduates with good understanding of such mathematics also came with high ambition and great expectations. They got frustrated with entering trades. The smart ones spent their time networking with traders, effectively collecting options.

Strictly defined, an option is the right but not the obligation to purchase or sell the underlying product. Translated, an option gives you access. So the more people that know how good you are and what you're after, the more opportunity you have for advancement or transfer -- the more likely you'll get what you want.

Understanding options is a fundamental requirement of the trading business. Applying them to one's career aspirations means collecting options and exercising them at the right time. Translation: good office politics.

The more options you have (the more people you know, the more skills you have), the more valuable you are. The more valuable each option is (the right kinds of people, the right kinds of skills), the more valuable you are.

Eventually the deal supervisor figured out that knowledge of options was actually detrimental to her goal of keeping the recruits she trained. So she lowered her entry standards and accepted a college graduate who only had an O level in mathematics. And he was the one who stayed.

"Endron"

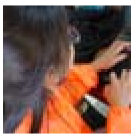
In 1996, the company conducted market research and found that most people had never heard of their name. One video showed a London cabdriver responding with "oh, I've heard of it. Is it from the song - En - run - run, Do - run - run?" Others thought it was a flower.

For its retail power campaign, branding was very important. So they spent money creating an image of trust for residential buyers.

Eventually, the marketing campaign paid off. By then, various business school case studies had been written about the company's innovative financial engineering. And certainly within the energy industry, the name was synonymous with success and overachievement.

Ironically, in a matter of weeks, without a multi-million dollar ad campaign, the company became a household name for its rapid demise.

Moral of the story? Sometimes it's easier to be infamous.



Editor