

# Huge bets paved way to Enron's downfall

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Behind the murky bookkeeping and the razzle-dazzle marketing, Enron Corp. offered a simple sales pitch: Our crystal ball is better than everyone else's.

That's what Ken Lay, Jeff Skilling and the rest of the company's brass meant when they touted Enron's "intellectual capital"—their stable of MBAs and traders striking deals based on everything from electricity to the weather and fiber-optic bandwidth.

Yet it wasn't just the deals that set Enron apart; it was how the company crafted them. In essence, Enron sold customers on the idea that they could lock in a price for, say, electricity for a decade or more when competitors were offering far shorter terms.

By making such long-term bets on the future price of electricity, Enron encountered massive financial risks. It's virtually impossible, experts say, to account for all the factors that whipsaw worldwide energy prices—acts of nature, acts of war and the vagaries of government regulation.

Some experts and former Enron employees say the extreme risks the company took forced it to adopt many of the controversial accounting practices that later contributed to its collapse. The greater the company's exposures, they say, the greater Enron's need to shift losses and debt off its balance sheet.

If a company wants to gauge the price of pork bellies, grain

# ENRON: Execs, board charged with assessing risk

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or natural gas, it can look at data supplied by Chicago's futures exchanges and the New York Mercantile Exchange. But when it came to the electricity trading that Enron itself pioneered, the market was so thin and new that its traders virtually invented their own numbers, former employees and outside critics say.

"This is not the Chicago Board of Trade. It's not even NY-MEX. It's Maxwell Street," said Robert McCullough, a Portland, Ore.-based analyst and former executive at Portland General Electric, one of Enron's acquisitions now caught up in its bankruptcy. "They showed some financial transactions going out 23 years, which is preposterous, of course. I call it pricing by rumor."

Such advance bets on the future price of power and other commodities became Enron's largest and most profitable business: There was Enron Energy Services to trade with power users such as big hotel chains, and Enron North America to work with power suppliers such as utilities.

In another prescient e-mail disclosed Wednesday, a former manager at EES alleged that her division "knowingly misrepresented EES's earnings" by showing a profit. "This is common knowledge among all the EES employees and is actually joked about," Margaret Ceconi wrote to Enron's board of directors last August.

Also at the center of this risk was ENA, which was once run by J. Clifford Baxter, the former Enron executive who committed suicide last week.

Why Baxter took his life re-

mains unclear; police have yet to disclose his suicide note. But this much is clear about his former division and Enron's other trading operations, former employees and analysts say: Top executives were not properly policing how much the company had at risk.

The top rung of executives and board of directors were supposed to track the combined trading bets—known as "value at risk"—and determine whether, as a whole, the firm could back them up. If not, the traders should have been told they were being too aggressive and needed to book the revenue on a hypothetical \$200 million deal, for instance, at \$50 million instead.

In Enron's case, former employees say, that was rarely done, even though Enron's top executives got constant updates of how much value at risk traders had on the line. Former Chief Financial Officer Andrew Fastow was ultimately responsible for the integrity of those "value at risk" models, experts say.

## Crystal ball gets cloudy

By April of last year, Enron was offering hints that its crystal ball had grown cloudy. The clue was buried in its 2000 annual report filed with the Securities and Exchange Commission under Footnote C of a table called "Value at Risk."

The sentence read: "In 2000, the value at risk model utilized for equity trading market risk was refined to more closely correlate with the valuation methodologies used for merchant activities." Put in plain English, the note suggested that Enron had gotten its models wrong.

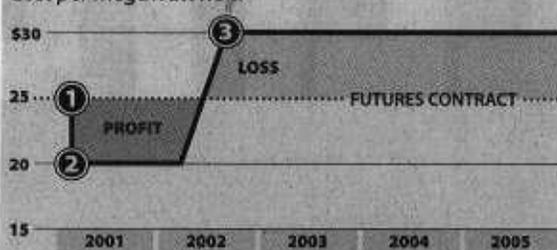
The red flag largely went unnoticed by many analysts, credit agencies and others. "Did they think this sentence was enough to warn investors that Enron [was] looking like another Long-Term Capital Management?" asked Frank Partnoy, a professor at the University of San Diego School of Law who testified before the Senate last week.

## Advance booking of profits

Analysts are examining the role of "mark-to-market" accounting in Enron's demise. The practice allows companies to book profit on the sale of a futures contract at the time the contract is signed, instead of waiting for the actual payments to arrive years later. A hypothetical example:

### HYPOTHETICAL ENERGY CONTRACT

Cost per megawatt-hour



- 1 An energy trading firm signs a contract with Business X to sell electricity at \$25 per megawatt-hour for 5 years.
- 2 Based on its own estimates of the market value of electricity, the trading firm expects to purchase the electricity for \$20 per megawatt-hour, giving it a profit of \$5 per megawatt-hour. The trading firm

Evidence of how much Enron may have artificially inflated long-term electricity rates showed up immediately after the company filed for bankruptcy on Dec. 2. The following day, the 2003 price for 1 megawatt-hour of electricity dropped from the low \$30 range to the mid-\$20s, according to McCullough.

"That raises the specter that the thin forward markets were being affected by Enron in order to protect their accounting results," McCullough said. "If they could show the right numbers to Arthur Andersen, they could then use that to justify their [accounting] calculations. ... If the market is thin enough, you can almost create your own prices."

A closer look at Enron's trading operations—the company's major revenue generator that wowed Wall Street—helps explain how Enron muted those warning signals and eventually paid the price when those signals got too loud to ignore.

One of the central problems, former employees and analysts now say, is that Enron hid losses or shifted them to other parts of the company rather than acknowledge to investors and oth-

ers that its crystal ball wasn't quite as clear as advertised.

"We would go further out on the futures contracts than anybody else would. ... So you could pretty much make up your own numbers," said Mike Boutcher, a former Enron employee who worked closely with its traders as he designed products to help power users ensure against outages. "We believed we had the right people who could guess 10 years out. Apparently we were wrong."

But it took years for those bad bets to catch up with Enron, thanks in large part to the off-the-books partnerships that hid losses from investors and whose disclosure pointed the company toward disaster.

"You have your chips on the table. Do you let it ride, or do you pull your chips off and accept your loss?" Boutcher said. "Accepting the loss is not something Wall Street would tolerate. So at some point someone had to say, 'Let it ride—or find a way through these special financing vehicles to take those losses and move them off the corporate books.'"

In fact, a small number of analysts following Enron raised

counts this \$5 profit in earnings for the current quarter (the quarter in which the contract was signed) even though payment has not been made.

3 Years go by and electricity costs go up—for example, a lack of rain causes hydroelectric plants to reduce production, lowering supply—and the trading firm must actually pay \$30 per megawatt-hour to the electricity producer.

Because of its contract with Business X, however, the trading firm must continue to sell the electricity at \$25 per megawatt-hour, resulting in a loss of \$5 per megawatt-hour.

To offset this loss, the trading firm must continue to sell more futures contracts to maintain net earnings.

With these new contracts, the trading firm experiences the same price problems, creating an even larger real deficit, even though its earnings continue to look good.

### MARK TO MARKET AND ENERGY COMMODITIES

Mark-to-market accounting is practiced by traders of all kinds of commodities. However, electricity and other energy derivatives aren't as commonly traded as more traditional commodities such as grain and pork bellies; prices can therefore be more easily manipulated. Under mark-to-market accounting, these manipulated prices can inflate a company's earnings.

Sources: Robert McCullough, McCullough Research; Pearl Street Inc.

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just those points in the last couple of years as their peers were heavily promoting its stock. The few skeptics insisted that Enron traders were inflating long-term energy prices in order to boost earnings.

Inevitably, even Enron's crystal ball couldn't defy any number of variables that might mess up the numbers built into their long-range deals—regulatory changes, community opposition to new power plants—not to mention the volatile nature of energy demand.

### 'New way of operating'

Long-term contracts are actually nothing new in the electricity business. Utilities with monopolies often entered into long-term contracts to purchase electricity, some for as long as 20 years and sometimes using derivatives contracts.

What made Enron different is that it "created not so much a new market, but a new way of operating in the market, with their sophisticated computer programs and their extremely aggressive sense of what an acceptable deal might be, said Arthur O'Donnell, associate editor of the California Energy Markets newsletter in San Francisco.

Individual traders had every reason to keep the game going. They earned bonuses based on the projected value of the deals they struck, former employees said, so they often boosted those figures even if it meant Enron was on the hook for more money than might be good for the firm.

The traders were in effect "peons" who "wouldn't have a

clue" what the company's overall value at risk was, McCullough said. For "the estimates of what the price would be in the years to come, the guys on top were the ones who were setting the overall price structure."

On Tuesday, McCullough gave the Senate Energy and Natural Resources Committee a little history lesson, noting that the Enron drama has a clear historical precedent.

Commonwealth Edison's own Sam Insull, once Thomas Edison's personal secretary, sought to protect his market share in the 1920s by setting up a trust that purchased the company's own stock. When the stock market crashed and the Great Depression struck, Insull's vast holdings in electricity imploded in the largest bankruptcy in U.S. history at the time.

Destroying the retirement savings of millions of Americans, the Insull Trust debacle helped prompt creation of today's regulatory structure, McCullough noted, from the SEC to the Federal Energy Regulatory Commission.

"The right policy direction is to guarantee transparency to investors, consumers and operators. The result of the collapse of the Insull Trust in 1932 was to make information available to policymakers and the public," McCullough told the senators. "The implication of the Enron collapse of 2001 is that we have allowed the resolve of our parents and grandparents to dissipate."

McRoberts reported this story from Houston and Garza from Washington.