ENRON and its ripple effects

Donald W. Phillips, Mark D. Saft

Donald W. Phillips In July 2000, after selling Phillips Capital Management to WestAM, Phillips became president/CEO of WestAM (US), a global, multi-asset class investment management company with offices in Chicago, New York, Houston, London, Dusseldorf and Tokyo. He is responsible for managing the U.S. operations, including strategic planning and corporate development. He is also chief investment officer of the firm's private equity investment business located in Chicago. Phillips has held executive positions with Forstmann-Leff International, Equity Institutional Investors, the Zell/Chilmark Fund, Capsure Holdings Corp, and Ameritech Corp. He has testified on pension and other benefit issues to congressional subcommittees and the Financial Accounting Standards Board.

Mark D. Saft A partner in the law firm of Holland & Hart LLP, Safty has extensive experience in finance and project development in the fields of mining, manufacturing, power generation, health care, education, transportation and water and waste treatment. He has acted as a counsel on a variety of global projects varying in size from less than $2 million to more than $1 billion. Since the 1980s, he has served as lead counsel in the development, acquisition, financing and refinancing of more than two dozen power generation facilities. Safty is the chair of Holland & Hart's Project Development and Finance Group, has been a member of the board of directors of the Denver Chamber of Commerce, and is active in a wide variety of public policy endeavors at the local, state and national levels.

The Enron collapse has given new meaning to the word "partnerships" and has brought to the fore somewhat controversial accounting procedures which helped the multinational company look more profitable than it actually was. Much has been written about the Enron debacle and there's more to come as the investigation into the practices of both Enron and its accounting firm, Arthur Andersen, moves forward.

Leading a discussion before the Global Executive Forum, Don Phillips and Mark Safty used their extensive industry expertise to shed light on the issues that led to the biggest bankruptcy in the history of the United States and now threatens the survival of one of the "Big 5" accounting firms.

GDP of Russia

The scope of Enron's operations has caused some people to wonder what Enron was really about. Its core business, said Safty, is as an exempt wholesale generator (EWG), a breed of power brokers that grew out of the Energy Policy Act of 1992 and the Public Utility Purposes and Regulatory Act of 1978, which opened the way for independent companies to build generating facilities and sell power at wholesale to the utilities.

The size of the electric industry is huge, said Safty, with "annual sales roughly equivalent to the GDP of Russia, approaching $300 billion. Right now we have about 800,000 megawatts of generating capacity in this country. Almost 250,000 as of this year are owned by independent non-utility companies that simply generate electricity and find a buyer for it." Putting these figures in perspective, Safty said, "The entire system in the State of Colorado is something on the order of 6,000 megawatts. Most of that is the Public Service Company's system."

So what was Enron? "They did build and own and operate electric generating facilities; they did market electric power, but they did other things, too," said Safty. "In the year 2000, Enron's net income was $100.4 billion. Half of that income was derived from legitimate mark-to-market accounting rules in which all the projected profits of a trade are booked as income in the quarter in which the deal is made, rather than over the life of the contract."
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"The resulting numbers are potentially open to abuse because they are based on assumptions the trader makes about what the market will look like in succeeding years. Profits can be made to appear higher by forecasting lower costs on the supply side."

Unadulterated greed

What did it take to grow Enron into the seventh largest company in the U.S.?

Said Phillips, "In the 1990s, in order to raise money, or in this case in order to convince Wall Street analysts to support your company and not question any consequence of what you did, you had to have a good story and you had to have a good storyteller. Enron had both."

It will be up to the courts to decide if Enron's partnerships skirted the law or violated the law. But there was a lack of full disclosure that raises red flags. "Many of the companies formed by the partnerships are basically undisclosed," said Phillips. "Only in time will we understand it, but the suspicion is that these undisclosed companies were Enron-related entities, the values of which were somewhat questionable, and they were sold to or bought by the various partnerships.

"There's nothing unusual about the partnerships," Phillips continued. "The unusual part is that they're sitting inside a company, and questions need to be answered such as: How did you book those fees? Who owned the carried interest? Were these undisclosed companies that have market transactions within the company?"

The structure of the partnerships allowed a lot of people - bankers, accountants, lawyers, Enron executives - to profit enormously. Phillips speculated that key employees who masterminded and ran the LJM partnerships took out $35 million dollars a year in the form of management fees plus interest plus a percentage of the original investment. "All this without putting a dime of your own money into the deal and still getting a lofty salary from Enron."

At best, "the partnerships are an example of unadulterated greed in trying to control the market, both on the buy side as well as the sell side of the transaction," said Phillips.

Last August, Jeffrey Skilling resigned as CEO and cashed in his stock options. It was suspiciously good timing because he wouldn't have been able to do so shortly afterwards when the company started falling apart. "At that time," said Phillips, "it would have been reasonable for the board of directors to call in a third party to evaluate the situation before all the guys with all the high incentives walked away.

Phillips recognizes that the board was probably lulled into a false sense of security because lawyers and Arthur Andersen auditors signed off on each and every deal. Nevertheless, "the silence of the board was deafening. And considering the proactive campaign Merrill Lynch waged selling these partnerships to institutional accounts around the world, it's hard to believe that no one in management had a clue about what was going on."

Infinite leverage

According to Forum member Richard Bard, "the genius of the Enron model was infinite leverage. The whole reason they took all this activity into partnerships and left it off the balance sheet was that it was an infinite leverage game."
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How did it work? "Enron always figured out how to have a supplier in close proximity to a buyer, so they eliminated the cost of delivery. Then they credit-enhanced the supplier with Enron credit, taking the spread between Enron's credit and the credit of some paper mill that had mediocre credit, and took that margin into their profit. So they had very competitive prices, no travel expense, a spread on interest, and the Enron guarantee.

Then they basically kept spooling off this debt and leverage into partnerships to make this an infinite game that would never end. They took some risks in their forward contracts, but when you start having enough percentage of the world's market, you know you've ultimately got a buyer. They didn't really care what it was they were trading. When the global recession starts to hit, the buyers stop buying, the suppliers can't supply, and all of a sudden Enron is forced out," said Bard. The leverage wasn't illegal, but it wasn't disclosed in a way that promoted understanding of Enron's dealings.

"So it was a control game, it was a finance game, it was a spread game, and as recently as a year ago, it was thought to be brilliant.

"There were certainly indicators early on that could have been looked at, and this game should have been called a couple of years ago. It might have saved the company."

Safty added, "These partnerships were given very high credit ratings and support by the credit rating industry and the analytical industry because the partnerships were also funded with significant amounts of debt which were off the balance sheet of the parent, Enron. Essentially, it was not true nonrecourse off-balance-sheet debt; it was debt backed by the guarantee of the parent company stock.

Impacts

Arthur Andersen, it is believed by many, is guilty of muddying up Enron's true financial picture and thus facilitating the company's questionable actions. But proving wrongdoing in a court of law will be difficult. Phillips is bothered that the government is going after the entire Arthur Andersen organization rather than the handful of people who may be guilty. "There are about 30,000 Andersen employees in the United States. Why have all these employees dislocated? Indict the people who were involved, don't indict the corporation."

"Globally," said a Forum guest, "there were 65,000-70,000 Arthur Andersen people. The meltdown started over a month ago and the organization is decimated."

The impacts of the Enron collapse spread out in many directions, starting with Enron employees who lost their jobs; shareholders who saw their investments shrink to a fraction of their previous value; energy purchasers whose contracts were not delivered on; and insurance and financial institutions and other creditors who are holding the bag for $11 billion of unsecured debt - the amount outstanding when the company went down.

There have been some less obvious ripple effects, which Safty outlined.

- Electric purchasing rating agencies. "They were criticized for what they didn't know and didn't say. Now they're hypercritical of every company in the energy industry and some very solid companies with real assets have been downgraded and their stock prices have plummeted."
- Deregulation of the electric energy industry. "Deregulation was stalled before Enron and it now faces an even more difficult path because of Enron."
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- The accounting industry. "The entire universe of SEC regulation of companies is in turmoil. And within the energy industry there is massive confusion about what consolidation and reorganization should go forward because nobody knows what the model will be."

Safty talked about a major impact he sees coming regarding foreign companies entering the U.S. market. "Currently, the percentage of the electric industry in this country that is foreign owned is relatively small. Five years from now, 30 percent or more of the power industry in the U.S. could be owned by European investors," he said. "The reason is that all of the energy companies in this country that have been devastated by Enron have their assets on the market, and many of the buyers are going to come from Europe."

"This is neither good nor bad," he added. "It's just a statement of impact."

Even with the facts on the table, it's hard to grasp the extent to which this company fumbled and brought down others with it. One Forum guest had a philosophical view of the conditions that produced Enron. "We were entering into a world where earnings didn't matter; sales didn't matter; only the promise mattered."