

Capital and money markets: evaluation of enron



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Background on the history of Enron:

Enron was an American Gas Company that was originally called Natural Gas Company in the early 1930's. InterNorth was a holding company that was located in Nebraska and in 1979 purchased Natural Gas Company. In 1985, Enron was born following the merger of InterNorth and Houston Natural Gas. Following the merger, in 1987 Enron discovered that oil traders in New York have overextended the companies account by \$1 billion dollars, which they were able to work it down to \$142 million. This put Enron in massive debt. For the new company to survive, Enron needed new, innovative, and strategic business plans to generate profits and improve cash flows.

In 1988 Enron opened its first overseas office in England. "Come to Jesus" was a gathering by the top heads at Enron to come up with a new strategy to get the company out of debt and make money. The plan was to pursue unregulated markets along with the continuation to pursue its current pipeline business. Kenneth Lay, the Chief Executive Officer (CEO) of Enron hired McKinsey and Company to help in the development in strategic business planning. Jeffrey Skilling was the young consultant who was assigned to this project. Skilling had a profound banking and management background which helped him create a solution to Enron's problems. Skilling stated "cash and profit woes in the gas pipeline business creates a "gas bank" in which Enron could buy gas from a network of suppliers and sell it to a network of consumers". Deregulation of the energy markets allowed companies, like Enron, to buy and sell gas and place bets on future prices. The Gas Bank program could allow buyers of natural gas to lock in long term supplies at fixed prices. Lay was intrigued by all the innovative and strategic

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plans Skilling proposed. In 1990, Lay created a new division at Enron called Enron Finance Corporation. Lay proceeded to appoint Skilling to the head of this division. Enron Finance Corporation, under Skilling, began offering financing for oil and gas producers. Kenneth Lay in 1996 promoted Skilling making him Enron's new Chief Operating Officer (COO). Skilling convinced Lay that the "gas bank" model can be used for gas as well as electric energy. Using the "gas bank" model for electric energy was a new idea and strategy to bring more revenue and profits to the company. Both Lay and Skilling traveled the country and tried to sell this concept to the heads of power companies along with top energy regulators. Enron was making news across the country for their fight to deregulate electric utilities. In 1997, Enron acquired Portland General Corporation for approximately \$2.1 billion. By the end of 1997, Enron was the largest and most powerful buyer and seller of electricity and natural gas. Since starting in 1985, revenue grew \$5 billion in the twelve years Enron has been around. Jobs number also increased dramatically from 200 to over 2,500 in the twelve years. Since Enron was so powerful and emerging, they were ready to expand their business into anything that people are willing to trade. Gas and Electric energy was not enough, they wanted to expand into water, steel, coal, paper, and the weather; whatever they can use to make money they wanted to use.

Andrew Fastow, a former student of Kellogg School of Management graduated with a Master of Business Administration degree, was one of Skilling's most prominent hires in 1990. Prior to being hired at Enron, Fastow worked at Continental Illinois Bank in Chicago dealing with leveraged

buyouts. Fastow was quickly promoted to Enron's Chief Financial Officer (CFO) in 1998. Fastow helped create a new financial structure within the company. Through off-book practices, by selling off portions of risk, the company would gain access to new capital.

All of Enron's plans were falling into place due to its broadband services (EBS) unit, a subsidiary under Enron. In 1999, the most exciting development in the financial world was due to Enron's creation of its new online trading website called Enron Online (EOL). Approximately 90% of its income resulted from trades through their online website. Every transaction through this website, Enron was a counterparty. Whether they were the buy or sell, they were a part of every single transaction. Enron tried to lure people into trading by giving away valuable information and expertise in the energy sector. This gave the community of traders and partners the confidence that Enron Online provided a safe transaction environment. Enron Online was a complete success, it handled over 335 billion dollars in trades in 2000 alone.

Overview of Enron's Operations:

Enron grew its business into three different markets: Wholesale Services, Global Services, and Energy Services. Enron offered its services to thousands of customers throughout the world.

Enron's Wholesale Services (EWS) was Enron's largest business unit and responsible for all the wholesale trading and marketing operations. It was intended to market a number of wholesale products and deliver physical commodities and financial risk management services. Enron delivered more than two times the natural gas and electricity than any other competitor. The

Wholesale Services also allowed customers to have the ability to sell or buy a commodity in the terms that fit their needs. This unit of operation provided flexible networks and unique capabilities that delivered the widest and best range of solutions at predictable prices. Enron's online services offer real time pricing for over 1, 200 products giving the customer an easier way to seize and evaluate a market opportunity.

Enron's Global Services (EGS) combined all the asset-based businesses of Enron into one unit. This portfolio included several companies included in North Americas pipelines business of Enron's transportation services such as: Norther Natural gas, Florida Gas Transmission, Portland General Electric, Transwestern Pipeline, and Northern Border Partners. International companies such as: Enron Wind, Azurix and Wessex water, and EOITT Energy Corporation. This was all found through Enron's web based trading website, Enron Online. Which showed all the global commodity transaction and provided real time transaction tools and expertise information for trading.

Enron Energy Services (EES) was the retail aspect of Enron. It offered companies a more efficient way to execute their own developed energy strategies. This was the largest provider of energy services to industrial and commercial companies. In 2000 alone, Enron Energy services signed contracts valued at \$16 billion.

Timeline of Enron:

In the early 1980's, Enron argued that completion would benefit the consumers and the companies. Following this, the United States government began to lift regulations on who can produce energy and how it was sold.

Enron say this as a wakeup call to make money. It offered stable prices and was the middleman company. Did not want to offer too low or too high, Enron wanted to stay in the middle. Due to the deregulation of the energy sector, Enron turned to electricity, water, and London weather as well.

In the late 1980's, Enron started to trade futures and natural gas commodities. Future Markets are used by a consumer to get a better deal on commodity prices than they would through the open market. Enron found a way to profit from trading futures in gas contracts. Following this, Enron soon began to dominate the market for natural gas contracts. Enron, with more contracts, had more access to supplies and more customers than any of its competitors in the Energy Market. With its increasing market power, Enron could predict future prices, therefore guaranteeing future profits or losses by betting against future movements in the price of gas energy.

In the 1990s, Enron created an energy commodity business by trading commodities in unregulated markets. By doing this, they became a massive competitor in the United States energy market. Enron controlled over a quarter of the gas business market. Enron gave smaller companies the opportunity to hedge against the risk of price movements in a series of commodities. Enron also got the Securities and Exchange Commission (SEC) to approve Mark to Market Accounting. Mark to Market is an accounting method which measures the fair value of an account such as the assets and liabilities. This method is not based on the actual cost but the fair cost. Thus, Enron started using estimated profits as their actual ones.

In the Early 2000, The Dot Com Boom struck. As the Dot. Com boom prospered, it inspired Enron to create a high speed broadband telecom network. Enron wanted to create a video on demand service to customers across the world along with opening up a new network market for trading. Enron's new innovative idea for video on demand long with the soaring economy appealed to investors. Due to this, the share prices and stock of Enron shot up. It was at an all-time high, slightly over \$90 a share. Income had risen over 40% in a few years and were estimated around \$100 billion. Enron was considered one of the most admired and innovative companies in the world according to several business publications.

California Energy Crisis:

The dilemma for Enron started in 2000 when the Federal Energy Regulatory Commission (FERC) ordered an investigation to drive up electricity and energy prices in California. This was caused due to the poor deregulation of the electricity sector that Enron argued for. Enron knew it could take over California's power grid and raise the price of energy. They were able to increase the price of electricity by 800% due to all the blackouts and power outages the state witnessed on a regular basis. Enron recorded over \$400 million in earnings in 2001, which was an increase of 40% from the previous year.

The Federal Energy Regulatory Commission to drive up energy prices affected Enron. The FERC implemented an electricity price cap in California which helped eased the crisis. Enron could not charge unaffordable rates for

electricity and scam the state of California. Therefore, it caused Enron's stock to take a big hit and started the collapse of the company.

The Falling and Crash of Enron:

August 14th, 2001 the Chief Executive Officer of Enron, Jeff Skilling, has resigned. Kenneth Lay, the former CEO stepped down in December of 2000 but has retaken the CEO position. Skilling stepped down shortly after the company began raising red flags and question marks due to the fraudulent accounting numbers and bad management of the company. Following this, Sherron Watkins, who was the executive for Enron's Corporate Development wrote a letter to Lay warning him of the company's irregularities that are threatening the company. This caused many investors to worry, causing them to sell off their shares of the company. Investors sold over several millions of shares which effected the stock more by another \$4 decrease. Less than eight months ago at the end of 2000, the stock was as high as \$90, but after recent news and obstacles the company is facing the stock is slightly lower than \$40 a share. Despite a majority of the investors selling off their shares and the stock dropping dramatically; Lay and Enron insist that the company will be fine and bounce back.

The worst was yet to come for Enron. In November of 2001, Enron filed documents with the SEC revising its financial statements over the past four years. The company was in debt. Dynegy, a smaller electric company and rival, announced an agreement to buy Enron for \$8 billion. Dynegy later announced that it has terminated talks with Enron on a potential merger due to the lack of Enron releasing its off balance sheet debt. In December of

2001, Enron filed for Chapter 11 bankruptcy protection and filed a law suit with Dynegy for terminating the agreement. Enron's stock has now collapsed to less than \$1 a share. Kenneth Lay resigned from chairman of the company and tried to get out before it came crashing down.

In January of 2002, Enron was approached by the United States Department of Justice. Andrew Fastow and Kenneth Lay pleaded for the 5th Amendment, which protects the individual from being forced to incriminate or expose themselves, and refused to testify. Following their actions, the United States Department of Justice on January 9th launched a full fledged criminal investigation. Enron went from one of the largest companies in the world to becoming bankrupt. As things started to unravel, employees and investors were infuriated with the senior executives for letting this go on for so long. Auditors, banks, rating agencies, analysts, and regulators all turned the other way and let this happen. The final pieces to the puzzle that brought the company crashing down were the internal policies, investment banks and advisors, the criminal activity, and poor rating and auditing. Everything here played a major role to the collapse of this, once famous and highly praised, energy company.

Enron grew into one of the largest companies in the United States, however, all of its success was based on inflated profits, money laundering, fraud, and illegal accounting practices. Several of Enron's operations and companies were losing money as well and hid these losses from the investors and shareholders through structured finance vehicles. Enron's illegal accounting techniques kept the share price high, it raised investments, and maintained

the successfulness of the company. All of these practices were to accomplish favorable financial statement results. This was not to transfer risk or achieve an economic goal. Such as Enron's deal with Blockbuster, despite the project to create Video on Demand for customers throughout the world, failed to work. Enron posted a \$110 million profit off this project.

Enron used independent partnerships where it could legally remove a loss from its balance sheet if it passed as an asset. Subsequently, the investment money flowing into these new independent companies are exhibited as profits for Enron. Therefore, Enron decreased its losses, increased its profits, and kept the debt away from its financial statements. This was to enhance the credit rating and protect the companies name within the markets they are in. Enron would set up a partnership using stocks as a funding source. The Partnership would then set up a Special Purpose Entity (SPE), ironically, Andrew Fastow a senior executive of Enron also served as the SPE's principal. Fastow received massive amounts of returns and compensation in order to help Enron in favor of the SPE's. The SPE would then agree to a contract that would pay Enron if its investment declines in value. Payments would just so happen to be made from the SPE because the investment declined. Therefore, Enron used this incoming money from the SPE and posted it as a profit on their balance sheets. Despite nobody knowing these practices were going on, besides the senior executives of Enron, the disclosures were inadequate. The Enron senior executives were making themselves richer due to these illegal and misleading actions, which is considered fraud and a conflict of interest.

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