A financial black hole

Houston, we have a problem

HOUSTON, LONDON AND NEW YORK

The troubles of Enron, a Texan powerhouse in the energy markets, could result in a new financial crisis

JUST last year, visitors to Enron’s glittering headquarters in Houston were greeted by a giant banner that proclaimed the firm, “The world’s leading energy company”. That annoyed Enron’s smaller energy-trading rivals, many of which have offices only a stone’s throw away in Houston’s Energy Alley, but not as much as what came next—a new banner, declaring Enron “The world’s leading company”. In recent weeks, as the company has been engulfed by a financial crisis, that banner has quietly been removed.

The heady mix of audacity, ambition and arrogance revealed by the banners is as good a guide as any to Enron’s remarkable rise and fall. Forged in the 1980s by the merger of two troubled gas-pipeline firms, Enron drove the development of the sophisticated spot-and-derivatives markets in energy that it has come to dominate. Indeed, such is the scale of its operations, and its dealings with many of the world’s financial institutions, that some observers see parallels with Long-Term Capital Management (LTCM), the hedge fund that failed in 1998—and not just because seemingly brilliant financial alchemists have been humbled. Were Enron to go bust—unlikely, but in the current nervous climate, not impossible—might a crisis ensue?

Troubles in California’s politically crazed power market, an ill-advised foray into telecoms bandwidth trading and concerns about management badly dented Enron’s share price earlier this year, prompting the departure of Jeffrey Skilling, the firm’s newish chief executive, in August. Kenneth Lay, an avid free-marketeer, friend of George Bush and visionary chairman of the firm, was obliged to resume hands-on control.

This has not slowed Enron’s decline. Day by day, it seems to be sinking deeper into a financial quagmire that is largely of its own creation. Not least thanks to its lack of transparency, the firm’s credibility with the markets has eroded to the point that talk of a possible takeover or even bankruptcy is widespread.

Enron’s reputation for financial wizardry has been turned from an asset to a liability since its third-quarter results came out in mid-October, showing a $1 billion write-off on water distribution, broadband trading and other investments. Worse, disclosed only in passing by Mr Lay in a conference call with analysts, the firm suffered a $1.2 billion reduction in capital, stemming from a hedging deal with a related private-equity fund called LJM. The charge was due to Enron’s forced sale of 55m of its own shares when the partnership was unwound this summer. Almost nobody outside Enron had been aware of the terms of the deal with LJM, a “structured finance vehicle”.

Enron’s failure to offer details about the risks from other related partnerships have led many to fear the worst about its huge balance sheet. Its share plunged by 19% on October 30th alone (see chart on next page), before recovering a bit the next day.

Andrew Fastow, who was replaced as chief financial officer on October 24th, was a general partner in LJM. Jeffrey McMahon, his successor, has much to do to restore confidence. Questions abound. Were the trusts run at arm’s length? What did Mr Fastow earn from the partnership? Ominously, the Securities and Exchange Commission (SEC) has now launched a formal inquiry.

Moody’s, a rating agency, last week cut its rating on the company’s debt to barely above “junk” level. Further downgrades might unleash claims from other off-balance-sheet partnerships. Those known about, such as Atlantic Water and Marlin Water, do not seem big enough to bankrupt Enron, but speculation is rife about what other obligations might lurk secretly in other structured vehicles.

A lower credit rating could destroy Enron’s core franchise as the leading energy middleman, by scaring away customers and freezing the wholesale energy markets. That might have nasty consequences in other markets. Enron acknowledges that it is a large participant in the derivatives market, holding a portfolio with a notional value of $21 billion. Rightly or wrongly, many traders believe that figure vastly un-
states Enron’s presence. If the firms on the other side of Enron’s trades start to fear that payment is not coming, they might curb their other trading, producing a knock-on effect. Where this could end up is a subject of much conjecture.

Utilities that trade energy could be hit. So could the commodity and derivative operations of large commercial and investment banks. The ties are notably tight between Enron and J.P. Morgan Chase, according to Ventana Capital, a research firm. Not only does J.P. Morgan provide innumerable separate credit arrangements for Enron; it also has the largest derivative operation of any bank, as well as a large business trading commodities. There is “no doubt” that Enron is on the other side of many J.P. Morgan trades, says Ventana.

Were Enron to fail, Ventana thinks “it has the potential to cause a major financial crisis”, worse, in some ways, than what occurred after LTCM. That merely froze the debt markets temporarily, whereas Enron deals in the building-blocks of the American economy. Imagine gridlock in the markets for gas, timber, coal, metals, fertiliser, bandwidth or indeed any of the products Enron deals in.

As yet, this all seems unlikely. Many big traders were happy to deal with Enron this week, although at shorter maturities and with less complex structures than in the past. Trading on EnronOnline was reportedly strong. Jim Donnell of Duke Energy, a big energy trader, described “a huge dichotomy” between the collapse in confidence in Enron in the equity and credit markets and the “business as usual” attitude taken by big commodity trading firms when considering Enron as a counterparty.

Yet as questions about Enron’s credit standing spread this week, it began to have difficulty making markets in some instruments. Few firms would accept Enron’s name as guarantor of a credit derivative. In its core energy markets some big trading counterparties refused the Enron name. On the Intercontinental Exchange (ICE), two houses reportedly specified that they would not take Enron’s credit.

The biggest credit exposure appeared to be with banks, whose $3 billion of back-up lines to Enron were drawn down last week. J.P. Morgan arranged an additional $1 billion emergency credit line this week. This back-up, it is widely assumed, is needed mainly to meet margin calls triggered by the ratings downgrade.

Too big to fail?
Is Enron too big and too important to be allowed to fail? Philip Verleger, an energy economist, thinks that Enron is so central to energy markets that it could not easily be replaced. Enron’s rivals mostly disagree, unsurprisingly.

But even Enron’s worst enemies do not (yet) expect the firm to die from its current crisis. Most traders seem keen that it should live. “Nobody likes to see a wholesale trader disappear,” says one. They admire Enron’s armies of traders and their ability to do deals. EnronOnline is one of the Internet’s few success stories, assuming its huge trading volumes do indeed generate big profits, as the firm claims.

Enron’s, and the financial system’s, problems could worsen if doubts grow about its ability to meet its obligations. On the surface it is rich in assets, if not cash. But its lack of transparency leaves uncomfortable room for doubt. In June 2000, The Economist challenged Mr Lay to reply to accusations of arrogance, high-handedness and a propensity to push the limits of the law. His response was revealing. To show that such charges were baseless, he pointed to another firm unfairly maligned by critics: Drexel Burnham Lambert, an investment bank that rose from obscurity to market prominence in the junk-bond boom of the 1980s. Drexel was accused of arrogance, he groused, but it was only being “very innovative and very aggressive”. Drexel was not bailed out: Michael Milken, its star, ended up in jail, and Drexel collapsed in a heap of bad debts and ignominy.