Philosophy 104, Business Ethics, Queens College, Spring 2007
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Lecture Notes, February 9

I. Enron, legality, and morality

In our last class, I mentioned some of the criminal convictions of Enron executives.
Our concern, in this course, is with ethical behavior.
Of course, there is a difference between illegal behavior and immoral behavior.
One way to describe the difference is to say that the law is what remains of ethics when politics has taken its toll.
That description is not exactly right, but it hints at something right.
We want our laws to be good ones, and we hope that they are.
If the laws are good, then it will be immoral to break the law.
When we talk about ethical behavior in business, often we mean just legal behavior.
If the laws are not good, one still might want to obey the law, for practical reasons.
So, the first test for ethical behavior in business, given that the laws are good, is whether one has obeyed the law.

We may also wonder whether certain actions violate the spirit of the law.
When we talk about the spirit of the law, if the laws are good ones, we are talking about ethics.
So, the second test for ethical behavior in business is whether one has been good, where the law is silent.
Since our time is limited, we will follow the time-honored tradition of business ethics and focus on legality.

II. Enron background

Enron had started as a natural gas company named Houston Natural Gas (HNG).
Traditional natural gas companies were a staid group.
Drilling and exploration (energy production) were always risky, and so the industry had significant volatility.
But, utilities and pipeline companies, like HNG, were very conservative.
There was lots of governmental regulation, which mean little room for creative management.
Energy company executives commanded high salaries.
The culture was Texan and masculine: steaks and scotch and strippers.

In the early 1980s, the natural gas industry was in trouble.
During the energy crisis of the 1970s, the government wanted to stimulate production to respond to a shortage of gas.
The federal government thus raised the regulated price that gas producers had to be paid for some types of natural gas.
In order to prevent future shortages, pipeline companies like HNG signed long-term take-or-pay contracts, which ensured them all of the gas that a producer could supply.
But, this raised the price of gas.
And, many industrial customers switched to cheaper oil and coal.

The government would not let the gas companies out of their take-or-pay contracts, and many of them went bankrupt.

Lay had come to HNG in 1984.
He had been born to a poor family, and was bright and innovative, and self-made.
He earned a Ph.D. in economics, and had a short career as an academic.
He switched to government for a few years, and then to several jobs as an energy company executive.
At Transco, his last job before coming to HNG, he developed a spot market for natural gas which replaced the wasteful take-or-pay contracts, and allowed producers to sell directly to customers.
He lobbied for, and got, the necessary deregulation.
He worked to create a new kind of energy company in the wake of deregulation.
And to work on more deregulation.

Lay brought in Skilling to work on gas trading, in 1988.
Skilling had come from Harvard and McKinsey, and he brought their arrogant attitude with him.
The Smartest Guys in the Room, does a better job than Eichenwald on his personality, pp 28 and 31.
But, see *Conspiracy*, p 27-8, for the Harvard interview story.
Specifically, he brought the idea that Enron should be an asset-light strategy.
He helped change Enron from a gas company to a trading company.
By the late 1990s, Enron functioned in many ways more like a bank than a traditional energy company.
The deregulation of natural gas meant that there were ways to profit on energy trading.

III. The Gas Bank

Deregulation had made natural gas customers skittish.
When prices were set, a company could predict what they would have to pay for their power.
With deregulation, prices could spike.
Enron was able to attract customers by signing them to long-term contracts, which fixed their costs.
Then, Enron worked on attracting gas producers.
Producers didn't mind the potential for price spiking, which would bring higher profits.
But producers tended to lack capital, since exploration was risky.

Enron found a niche for itself by supplying capital to facilitate exploration in return for locking in prices.
Enron would be successful if they could lock in prices with producers, overall, which were lower than the ones they were charging retail.
The bank analogy, then, equated producers with depositors and customers with borrowers.
Enron made money from the difference.
But, really, this structure just made Enron like any other middleman, buying wholesale and selling at a markup.

The real innovations came in part when Enron realized that they didn't even have to deliver the gas.
They could act as an insurance agency on the price.
That is, they could write contracts fixing the price for retail customers.
If the gas were delivered at a cheaper rate, Enron would earn the difference.
If the gas were more expensive, Enron would have to pay the difference.
Now, Enron was set to be more of a speculator.

More innovatively, Enron started to trade the contracts, since they were a reliable flow of future income.
By locking customers into contracts, their withdrawals looked a lot more like loans, which would be paid back by the gas producers, than purchases.

The innovations of the gas bank and the consequent energy trading seem harmless from an ethical perspective.
Energy trading continues to this day.
Indeed, in Enron's final days, only its core businesses, the gas pipelines and energy trading, were profitable.
For a long time, the energy traders supported the rest of the over-extended company and all its bad investments and businesses.
Enron probably would not have been able to rise to such a bloated state had it not been for its creative financing.
So, on one hand the idea of the gas bank is harmless.
But, it seems like it was the first step to a terrible end.
Enron's main trouble arose from its use of special purpose entities, SPEs.

IV. SPEs

The gas bank was Enron's model for its core business, and it was Skilling's big idea.
Enron served as a middleman between gas producers and utilities which distributed to retail customers.
Later, Enron attempted its own retail business.
Enron's retail gas division was just one of many unsuccessful ventures.
Skilling's idea was to sign utilities to long-term contracts which were balanced by the long-term contracts Enron set with producers in exchange for loans to be used for exploration.
Further, once the long-term contracts were signed, Enron could use the contracts as trade commodities.
Thus, Enron's trading operation, its major innovation, was begun.

Enron first started using SPEs to keep the debt and risk from gas production off of Enron's books.
The methods used are just like those in bank securitization, when a bank will bundle loans and sell them to independent investors.
Cactus, the first SPE, was an essential part of the gas bank.
Cactus was funded by both Enron and independent investors (especially GE) in 1991.
It bought gas production payments (i.e. gas) in exchange for loans to the producers.
Then, it sold the gas to Enron.
The key to its utility was that any risk associated with production was no longer part of Enron's accounting.
t was part of the so-called independent entity, Cactus.

There are GAAP rules for the independence of an SPE from its main investor.

1. The entity must have at least a three percent ownership which is not part of the main company.
2. The entity must be independently controlled.
3. The entity must have a real financial liability.

In the case of Cactus, the three rules were met, in large part due to investments from GE.

A problem with the SPEs, though arose from the accounting.
The accounting rules on the retail side were different than those on the production side.
Skilling proposed to solve the problem by replacing traditional oil-and-gas accounting with mark-to-market accounting.

V. Mark to market accounting

Mark-to-market accounting allows a company to declare future profits now.
Consider a farmer.
In spring, the farmer has no income.
So, the farmer appears poor.
But, the farmer may have lots of assets, the crops that are planted and growing.
With mark-to-market, the value of the farm can be measured by the expected profits earned at harvest.

Mark-to-market accounting is thus not an ethical problem in itself.
But, it did lead to pressure on the company, creating an atmosphere ripe for ethical problems.
On mark-to-market, Enron would declare all its profits from a contract when that contract was signed.
When they signed a long-term (say ten- or twenty-year) contract, they booked huge profits.
If traditional accounting were used, those profits would recur throughout the life of the contract.
So, there was great incentive to sign big contracts, since it meant huge profits for the company right now.
Of course, if you were a dealmaker for Enron and you were able to make a deal for a big contract, you would get a big bonus, as well.

VI. The PRC

Bonuses at Enron were determined in large part by the Performance Review Committee (PRC).
At the twice-annual PRC, all managers would get a say in the bonuses of all employees.
That is, an employee's bonus was not merely determined by those in his/her department.
All employees were ranked in categories from one to five.
The numbers of rankings at each level were predetermined, so that you could only move up if some one else moved down.
Ten percent of employees had to be ranked as fives, which meant they were to be fired if they did not improve in the next PRC.
Some employees called the PRC "rank and yank."
Skilling developed the PRC in order to encourage people to work creatively, to expand their jobs.
But, the PRC created a vicious, highly competitive environment.
The fact that all managers had a say in any employee's bonus was intended to minimize nepotism.
But, it merely meant that managers were making secret pacts before the PRC meetings, alliances to support each other's workers.