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Speech Transcript

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Thank you Dennis and Jim for inviting me here today. I joined Enron in July of 2000, so was a short timer who showed up for the peak and rode it down. I didn't participate in the upside, but really got to experience the downside! From late August through the bankruptcy of December 2nd, I worked in Public Affairs, helping Ken Lay, the Chairman, and Mark Frevert, the Vice-Chairman, with outside energy-industry speeches and public appearances. By the third-quarter earnings release of October 16, Enron was in damage-control mode and traditional speechwriting ceased. I then did what I could to help the other groups on our floor, which included Government Affairs, Marketing Communications, and Public Relations. Backing up a little, I want to thank all of today's presenters. I really enjoyed all of the papers, found them very interesting, and identified some areas where Enron might offer a case study.

Enron fell into the new economy. It wasn't a dot-com. It was formed in the mid-1980s from a dramatic regulatory shock, namely deregulation and "open access" requirements within the U.S. natural gas industry. By government fiat, Enron was given transportation access to the existing natural gas pipelines of the incumbents, and was able to develop a trading operation that engaged in the merchant function of buying and selling natural gas. Under this new system, the transportation service was unbundled from the natural gas commodity itself, whereas traditionally they had been bundled as a single service. In the 1990s, U.S. electric power underwent a similar

deregulatory change, and Enron aggressively entered those merchant markets. In the natural gas and power markets, Enron “piggybacked” on earlier sunk-cost investments of the incumbents, using the existing pipeline and electricity infrastructures.

As Professor Economides mentioned in his presentation, Enron was the counterparty on one side of every trade that it processed. As such, Enron was able to collect vast amounts of real-time data about energy markets, which it used in trading for its own book. Enron traders mined proprietary data to find arbitrage opportunities, and in early years profited substantially by arbitraging very inefficient natural gas and power markets. As those markets became more efficient, arbitrage opportunities became fewer and less profitable. As Dynegy, Tradespark, Intercontinental Exchange and other trading platforms entered the market, trading margins declined.

By the late 1990s, Jeff Skilling, the former CEO of Enron, began to tout Enron as a “new economy” company. He described Enron as a “post-Fordist” disaggregator of traditional value chains. In his public speeches he often used a Ford analogy, describing how Henry Ford’s early plants would make everything used in the automobile, from tires to windshield glass. Ford controlled rubber plantations to supply the rubber for their tires, forests where they derived wood for dashboards, steel mills to supply the sheet metal, and so on. In this very rigid vertical chain, resulting in a finished automobile, the Ford Motor Company owned or controlled all components of the manufacturing process. Over time, these vertically integrated chains disaggregated, with component outsourcing and just-in-time manufacturing creating dramatic improvements in efficiency by introducing flexibility to the system. Skilling envisioned Enron’s trading platform as

breaking up traditional, rigid value chains, introducing flexibility and creating similar efficiencies while producing benefits for Enron. Enron was quite successful with this strategy in the power and natural gas industries. But, as mentioned earlier, barriers to entry in those markets had been removed by open access requirements under deregulation, which wasn't true in other industries Enron tried to enter.

In late 1999, Enron introduced EnronOnline. I wasn't working for Enron at the time, but followed the company closely because it related to my academic research. I remember Jeff Skilling, President and COO, saying that the Internet was not a disruptive technology for Enron. The Internet simply allowed them to increase their trading volumes by supplanting fax and telephone trading with Internet trading. That was the story early on, and I think he was correct. Between 1999 and 2000 the trading volumes more than doubled, with Enron's revenue, which reflected trading volumes, reaching roughly \$100 billion in 2000, placing it number seven on the Fortune 500. Also in 2000, Skilling began to change his tune about the Internet as a disruptive technology. He wanted to expand the market-making business model developed for power and natural gas into other industries, including steel and pulp and paper. He began to think in terms of disaggregating those vertically integrated value chains using the Internet, despite the lack of open access mandates as with power and natural gas. He then embraced the Internet as a disruptive technology, which was typical of Jeff Skilling. He tended to tap into whatever "new economy" theme was prevalent in the marketplace at any given time; and, at that time, the stock market was rewarding companies that engaged in new-economy storytelling. Enron's attempted foray into broadband trading, where a broadband capacity glut predetermined failure, is one example.

Skilling positioned Enron as a company that would change the world by commoditizing and financializing all manner of things, with EnronOnline as the global trading platform for these new commodities. When he took over as CEO from Ken Lay in late 2000, the vision for the company changed from being the “world’s leading energy company” to being the “world’s leading company.” As mentioned earlier, the power and natural gas markets were opened to Enron and others through deregulation. Those markets were nascent and quite different from more mature markets--like steel and pulp and paper--not undergoing a deregulatory shock. Skilling wanted to use the trading platform and business model that Enron had established for the energy markets and apply it to these other industries, breaking up traditional value chains, introducing flexibility, and extracting value for Enron. The idea was to create fungible, liquid commodities out of different grades of pulp, steel, and so on. The hope was that by posting these product offerings on EnronOnline, enough liquidity would eventually develop to support a profitable, in-house trading operation. Enron even extended the market-making paradigm to the freight and advertising industries. But it found that if there isn’t a liquid market already established, creating physical liquidity in new commodities requires an enormous balance sheet, enormous sunk costs, and enormous access to capital. Enron even tied up capital purchasing steel inventories and pulp and paper mills, to ensure a steady source of commodity supply. Enron became severely over-leveraged, essentially betting the farm on the idea of disaggregating and then virtually integrating traditional value chains using the Internet as a virtual network. Enron began to hide losses and move debt off the balance sheet, as it attempted to protect its credit rating and maintain the confidence of counterparties and other stakeholders.

In the energy industry, according to Enron, it was no longer necessary to own physical

networks of pipelines, power plants, and electricity transmission grids. It was only necessary that Enron traders have access to the sources and sinks embedded in those physical networks. Enron bet that it could use the virtual-network characteristics of the Internet to create similar trading opportunities in other industries, and invested huge sums in attempting to develop these trading strategies and platforms. Enron underestimated its cost of capital, and as the financial markets became more aware of Enron's increasing debt leverage, its cost of capital climbed. The more EnronOnline grew in terms of volumes and product offerings, the greater the working-capital requirements. Growing the trading platform actually fueled Enron's demise, because it simply could not feed the beast long enough to create sufficient liquidity and turn the elusive corner of profitability. With insufficient liquidity, there were insufficient arbitrage opportunities in these new markets, and no money to be made from trading.

When Enron imploded, the energy trading markets immediately corrected with very little impact, and the void that Enron left was filled by others. This supports the contention that EnronOnline did not benefit from network effects. Enron had a 30% market share in energy commodities not because of network effects, but because it was willing to be the financial market maker. It was willing to accept financial risks that no one else would accept, and post offerings others were not willing to post. Enron's large market share stemmed from Enron's access to capital and its irrationally high risk-tolerance. What Enron received in exchange for its risk-taking was greater volume. More volume meant more proprietary data, which meant more arbitrage opportunity for Enron's trading book. Enron also needed volatility, because it was naturally long volatility. The greater the price volatility for energy commodities, the more arbitrage opportunities there were. As the power and gas markets became more mature, volatility and

arbitrage opportunities declined, resulting in declining margins.

The other commodities markets that Enron tried to create were not coming to fruition as quickly as hoped, and eventually Enron ran out of capital. The accounting irregularities of the last couple of years may have been meant to conceal Enron's declining financial position long enough to reach positive operating cash flows from trading in new commodities, including broadband. Enron ran out of time, and made a lot of bad bets along the way. Unfortunately, the market steadily rewarded Enron even as it increasingly made huge bets that would eventually lead to its implosion. Lack of transparency and the market exuberance for new-economy stocks fueled the Enron bubble, and contributed to irrational risk taking within Enron. I'd now be happy to answer any questions.