ENRON ASCENDING: THE FORGOTTEN YEARS, 1984-1996

By Robert L. Bradley, Jr.

*Reviewed by Robert J. Michaels**

I. INTRODUCTION:

Few scholars have so improved our understanding of energy and its regulation as Robert L. Bradley Jr., whose thousands of published pages build on both his academic and industry experiences. He gained those experiences largely as an executive for 16 years at Enron Corporation. He was Manager of Market Planning for Transwestern Pipeline during the transitions of open access, take-or-pay, and wellhead decontrol, followed by a corporate position as policy advisor and speechwriter for CEO Kenneth Lay. *Enron Ascending* is based on public data, corporate documents, and retrospective discussions with former executives.[1] It is remarkably complete as it traces the complex paths the company followed. Readers uninterested in a particular topic may find themselves wondering why such detail, while interested specialists will be delighted. This book makes an original and major contribution to an already substantial literature.[2]

This is the third volume of a tetralogy whose basic theme Bradley calls "political capitalism," perhaps best exemplified by corporate and market developments that spanned Lay's career. Enron's CEO was right-person, right-time, right-place for natural gas, coming out of a highly regulated period, market-wise and bureaucratically competent. Corporate success would entail aggressive competition in commodities markets – and markets for political influence.

Starting from poverty, Lay understood markets by earning a doctorate in economics and teaching at the graduate level. Political skills came with six years at the Federal Power Commission, now the Federal Energy Regulatory Commission (FERC), and Interior Department during the "energy crises" of the 1970s. Those ended with removal of wellhead price controls and the transformation of interstate

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1. ROBERT L. BRADLEY JR., ENRON ASCENDING: The Forgotten Years, 1984-1996 (2018).

2. Among other works, *see* HAROLD BIERMAN, JR., ACCOUNTING/FINANCE LESSONS OF ENRON:A CASE STUDY (2008); BETHANY MCLEAN AND PETER ELKIND, THE AMAZING RISE AND SCANDALOUS FALL OF ENRON, (Revised Ed. 2013); MIMI SWARTZ AND SHARRON WATKINS, POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON (2004).

pipelines from resellers to transporters of gas. He then joined Florida Gas Company, followed his boss (Jack Bowen) to Transco Energy, and became CEO at Houston Natural Gas (HNG), turning an intrastate pipeline (beyond FERC jurisdiction) into one that might profit as gas markets emerged and grew.

The book's basic narrative starts as Enron attempts to profit by designing transactions compliant with the new rules.[3] It is there that we first encounter Bradley's comparisons between economic and political entrepreneurship, at both of which Enron excelled. Both logic and experience counsel supporting competitive markets for their efficiency. The case for political competition is often less clear-cut, but it is integral to advancing shareholder wealth under regulation. Enron's later history is marked by what economists call "agency problems" in corporate policies, allowing management to pursue goals that were in its interests but not those of shareholders. This problem was not unique to Enron, but to this day the company negatively exemplifies the importance of sound governance by shareholders in complex organizations.

II. HOW ENRON ASCENDED, AND WHY

Any strategy is the outcome of choices made under economic uncertainty. In particular, HNG under Lay had to make educated guesses about tomorrow's markets and FERC's developing policies toward them. It chose to exploit the new competitive services enabled by FERC Order 436[4] and implement them by acquiring and centralizing the operation of several regional pipelines. Alongside these organizational innovations, new FERC regulations offered additional opportunities as gas transport became market-oriented and nationwide. Other pipelines adjusted in accordance with management expectations, and Enron's choices to extend its system were those of a competitor.

Bradley largely approves of Enron's political adroitness in liberalizing FERC regulation, but is far more critical of the company's advocacy of oil tariffs and pricing CO_2 to penalize coal. But what is a company to do in the mixed economy with rent-seeking opportunities? Even free-market economist Milton Friedman spoke to fiduciary responsibility to grasp political opportunities (although he did not like the policies). Bradley's contrasts between economics and politics are problematic. He attempts to distinguish productive outcomes from market choices with wasteful rent seeking that he sees as inherent in political competition. The distinction is not as useful in Enron's case as it might be in other markets. The managers of a regulated firm cannot possibly choose policies independently of politics. Any policy (including a conscious choice of inaction) will reallocate economic resources and change the fortunes of market participants, and illogical choices may breach the firm's duty to shareholders. Since the 1950s, regulation

3. BRADLEY, *supra* note 1.

4. A discussion of the relevant legislation and FERC orders appears in ROBERT MICHAELS, "THE NEW AGE OF NATURAL GAS: HOW THE REGULATORS BROUGHT COMPETITION, 16 Regulation, (Winter 1993), 68-79; Order No. 436-A, FERC Stats. & Regs. Regulations Preambles 1982-1985 ¶ 30,675 (1985).

under the Natural Gas Act had fostered and rewarded inefficient conduct. FERC Order 436 and successors produced efficiencies that enriched Enron, its customers, and some of its competitors. We can never know the actual extent of the benefits created directly and indirectly by Enron's political activities, but Bradley's recounting makes clear that the company's regulatory interventions did not reduce them.

In particular, the competition that emerged in the 1990s expanded the choices available to both consumers and competitors. Those choices were not the restrictions and foreclosures of a classical horizontal monopoly. Likewise, real competitive markets are poorly described by price-taking producers and unchanging institutions. A more realistic description is one of rivalrous innovation (*e.g.*, opening a store in an underserved area) which if successful will yield both consumer benefits and supernormal profits that will be eroded by the entry of competitors. Incumbent sellers are not without defenses to restrict entry or raise rivals' costs, but Enron's record of political action against competitors is sparse. It was part of a short-lived and unsuccessful coalition to tax imported oil during the 1980s, which if successful would have benefitted both Enron and similarly situated competitors. After acquiring wind power generator Zond in 1997, it successfully lobbied the Texas legislature to impose a renewable generation requirement on utilities. The benefits of that requirement are difficult to trace and other wind generators could in any case compete with Enron for quotas. Given its market success at the time, a management decision to deemphasize Enron's political activity may have been reasonable.

A fuller accounting of Enron's fall awaits Bradley's final volume, but *Enron Ascending* suggests a major role for governance failures that facilitated the survival of practices that outsiders would have difficulty detecting. Its top management understood the value of predictable share prices to the extent that it used unorthodox accounting policies to raise current earnings. Specifically, its choice of "mark-to-market" (MTM) accounting allowed it to immediately record all expected future revenues from a multi-year project. Using MTM can be informative for shareholders and analysts if comparable markets exist, but here Enron was asserting that it could accurately price long-term transactions that had few if any precedents even in the short term. The particulars of Enron surely delayed recognition that its finances were not as they seemed. Broad reasons included (1) management's encouragement to shareholding by employees that dulled incentives to seek out information; (2) higher level employees in particular received larger and sooner rewards under MTM; (3) valuation was difficult because with or without MTM the company operated in many corners of the energy industry, often ones without deep markets. Perhaps most importantly Enron's credibility rested on unorthodox relations between its management, its Board of Directors' Audit Committee, and its outside auditors at the ultimately bankrupted Arthur Andersen. Markets would eventually confront Enron's accounting, but it took time for pessimistic hedge funds such as Kynikos to invest in large and long-lived short positions that would pay off as the truth diffused.

III. CONFLICTS AND CONSEQUENCES

In business schools, Enron is already a graphic example of conflicts inherent in corporate governance, but Bradley treats it as almost unique. Looking past the wreckage, economists and other experts might praise its entrepreneurial culture, but Bradley points to strategic deceit and imprudence from its very first year to conclude that Enron was a "contra capitalist" company. To Bradley, this means that its intellectual sources included modern "philosophies, business fads, and a socioeconomic system" that "worked against best practices, as classically defined."[5] For better or worse, Enron developed as it did, and Bradley does not provide the alternative of an economically efficient organization that could have survived in competition with companies that worked with the dual uncertainties of markets and politics.

A fuller understanding of Enron requires examination of what the non-Enrons were doing in these markets, most importantly how they competed with some success against Enron's questionable strategies. Over the 1980s and 1990s, competition arrived in the industry. Possibly the best measure of competitiveness is the record of market performance after Enron collapsed, and by that measure hardly anything happened. The new markets and regulations were robust and liquid enough to take an immense bankruptcy in stride with gains and losses falling where they might. To put Enron in perspective we need to learn more about the fortunes of its competitors and customers.

There are good reasons to favor competition over politicization, but Bradley's case for the former needs to be better delineated. Enron, he says, was the "least capitalistic megacompany in modern US history,"[6] which is a statement that contains too many undefined terms. An assertion that Enron sought federal regulation may not be factually correct. If the company operated in interstate markets, it could not possibly have avoided seeking federal regulation or at least changes in existing rules. Likewise, he sees Enron as a problem for "anyone who believes in the highly regulated economy."[7] Today it is impossible to disbelieve in that economy as a factual matter, so where is the problem?

Bradley largely associates Enron's fall with the overambition of its founder and always CEO, Ken Lay. There is much that is positive in the Enron story; into the 1990s, it was at the forefront of hydrocarbon transport, marketing, and finance. On the horizon were potentially growing markets in which Enron had already developed some competency, including renewable power, electricity retailing and energy services, carbon trading, and environmental services, all of which Bradley claims were either infeasible and/or never profitable.[8]

To analyze the wisdom of Enron's choices by looking backward does not improve our understanding. It is better to ask what a rational management would have chosen using only the facts available at the decision point, and here Enron's

5. BRADLEY, *supra* note 1, at 671. The details appear in several chapters of Volume I.
6. *Id.* at xiv.
7. BRADLEY, *supra* note 1, at Front Matter.
8. *Id.* at 6 – 8.

choices were plausible.[9] In a situation of market and technological uncertainty, we can expect some failures. Bradley, however, attributes Enron's difficulties to managerial hubris aggravated by inexperience in mainstream energy markets. Lay, he avers, was not an engineer, lacked background in accounting and finance (but held an economics Ph.D.), and never "clawed his way up the corporate ladder, much less built a company from scratch."[10] Instead, he complemented his Ph.D with human capital acquired in regulatory agencies and pipeline management, perhaps an ideal skill set at the time. His understanding of politics took him a long way, along with most of a once-moribund gas industry.

The importance of politics in today's markets virtually requires that a publicly held corporation have a "social responsibility" strategy. Looking at Enron's renewable power experience, it remains unclear whether Lay was walking the walk or just talking the talk. (Enron quietly got into coal in 1997, which became a notable profit center at the end.) It hardly matters. To profit over the long term from a range of changes in energy markets and environmental policy, Enron had to participate in a heterogeneous coalition that simultaneously exploited its gas-related assets (a "bridge fuel") and threw some support to politically active advocates for renewables.

For energy lawyers and students of energy regulation, *Enron Ascending* may be the best (or least-worst) way to revisit or learn about the minutiae of natural gas and electricity regulation in the 1980s and 1990s. For students of corporate governance, Enron remains a classical case study of decision-making under market and political opportunity from which worldviews about capitalism will inevitably clash.

Bradley attempts to draw a broader picture of Enron and these ventures by claiming that "Capitalism did not fail. The mixed economy failed."[11] What needs exploring is how his vision could have succeeded in today's unavoidably political world. It is one of many summary discussions that this reviewer hopes to see in the final volume. In the last analysis, the financial markets did get to the bottom of Enron, but before they did, the company would revolutionize the nation's energy future.

9. In some situations, Enron exited lines of business when the numbers did not pan out. It was, for example, unable to design a profitable template for retail power sales in California under the state's irrational regulatory regime. It dropped out of that market, which in fact never developed.

10. ROBERT BRADLEY JR., CAPITALISM AT WORK: BUSINESS, GOVERNMENT, AND ENERGY (2008), 2-3.

11. BRADLEY, *supra* note 1, at xiv.