Ethical Egoism: A Guiding Principle of the Market Economy?
—A Case Study of Enron Collapse—

Eiji FURUYAMA*1

Synopsis

In the capitalist market economy savings, which seek capital gain and dividend, are channeled to business enterprises, which need financial resources for business creation and expansion. Capital markets play a key role in this circulation of financial resources. Investor’s decision depends on the information that is publicly available and it is theoretically assumed that business enterprises publicly disclose full and complete information of their present and future value. In actuality, however, the financial disclosure is not always full and complete. It might intentionally hide information implying risk for investors. When ENRON boasted “tremendous opportunities for growth” in the 2000 annual report, it was already known to the insiders that their overseas ventures in the U.K., Azurix project and the Dabhol power plant in India had caused the corporation an enormous loss. EnronCredit.com, which was launched in February 2000, was a financial disaster and Blockbuster 20-year deal to provide video-on-demand service to consumers over high speed Internet lines announced in July 2000 and incorporated in their financial statement as part of revenue and income existed only on book and never realized. All such negative information was hidden from the eye of investors and the Enron’s stock price hit an all-time high of US$90.56 in August 2000.

ENRON was deceiving capital markets and investors. Among those factors which tempted the corporation into deception the following three factors were of particular importance: (1) availability of sophisticated financial techniques that could disguise loss from the financial statement, (2) an excessive emphasis on mark-to-market accounting that led the corporation to an obsession with the stock prices, and (3) personnel evaluation system called PRC (Performance Review Committee), adopted by ENRON spurred employees to an endless competition to enhance their sales record.

ENRON created special purposes entities (SPE) one after another, in which the accumulating loss was disguised. One year and two months after the ENRON stock price had hit an all-time high, the SEC began a probe of the corporation’s management of the SPE’s. When it was revealed that the SEC started investigating the financial practice of ENRON, its stock fell to US$20.65. Arthur Andersen, public accounting firm that audited ENRON, began shredding Enron-related documents. Dynegy, the second largest energy trader next to ENRON announced a deal to purchase ENRON. However, as major credit rating agencies downgraded Enron’s bonds to junk status, Dynegy terminated its deal to buy ENRON. ENRON stock price plunged into US$0.61. On December 2, 2001 ENRON filed for Chapter 11 bankruptcy protection. The court assessed the Enron’s debt at US$63 billion and its disposable asset at US$12 billion.

Ethical egoism would function as a guiding principle of business behavior in the market economy if and only if it is supported with a correct knowledge basis. Contrary thereto was the case of Enron.

Key words: Ethical Egoism, Enron, Corporate scandal, mark-to-market accounting, corporate governance

*1 Faculty of Human Cultural Sciences and Business Administration, Nihonbashi Gakkan University
1. Democracy, Trust and Securities Market

In one of the best seller books in 1992, *The End of History and the Last Man* (1992 Free Press) Francis Fukuyama attempts to answer a Kantian question regarding the possibility to describe a universal history of mankind. Broadly, Fukuyama’s thesis can be divided into two aspects. One is an empirical argument, in which he points out that the number of liberal democracies increased from only three in 1790 (United States, Switzerland and France) to 36 in 1960 and then to 61 in 1990. The other is a philosophical argument taken from Hegel and Hobbes, in which he sees history as the dialectic between two classes, i.e., master and slave. The thesis, which is master, and antithesis, which is slave, are merged and lifted up to a synthesis, where both can live in peace together, putting a period to the primordial battle of the fundamental tension between man’s pride or desire for recognition and his fear of violent death, which forces him to accept a life of slavery in return for peace and security. Socially this synthesis, according to Fukuyama, has been realized only in a political system adopting the parliamentary democracy.

Fukuyama’s thesis was often misinterpreted as he claimed that the history ended in 1989, when the Berlin Wall was fallen down or 1991, when the Soviet Union was dissolved as a sovereign state. This misinterpretation was partially due to the fact that the book was published in 1992 and also due to that the book was so superbly titled that many people misunderstood the message having a look only at the book title without reading the content. Fukuyama argues that history ended in 1789 with the French Revolution, which initiated the parliamentary democracy. Since then it was getting more and more obvious that no other political system was superior to the parliamentary democracy, politically, economically as well as ethically. In this argument is also expressed Fukuyama’s confidence in the American democracy, which came out of the American Revolution, a cousin of the French Revolution.

Fukuyama analyses in his next book Trust (1995 Free Press) the key factors, which promise the democracy a high economic prosperity. Trust is essential for those who trade and the most rudimentary form of trust is the one resting on kinship. Kinship-based trust is, however, limited in its extension. Fukuyama comes up with an idea that the culture of trust as the source of spontaneous sociability allows business enterprises to grow beyond family into professionally managed organizations. Fukuyama tests his thesis by comparing successful cases of economy one another and presents a rather unorthodox list of “high-trust societies”, which are the US, Germany, and Japan and “low-trust societies”, which are Italy, France, Korea, and Taiwan.

“Why is it necessary to turn to a cultural characteristic like spontaneous sociability to explain the existence of large-scale corporations in an economy, or prosperity more generally? Wasn’t the modern system of contract and commercial law invented precisely to get around the need for business associations to trust one another as family members do? Advanced industrialized societies have created

† This is a full text of the paper read by the author at the Eighth International Conference of ISINI (International Society for Intercommunication of New Ideas), which was held at Wageningen, the Netherlands, August 24-27, 2005.
comprehensive legal frameworks for economic organization and a wide variety of juridical forms, from individual proprietorships to large, publicly traded multinational enterprises. Most economists would add rational individual self-interest to this stew to explain how modern organizations arise. Don't business based on strong family ties and unstated moral obligations degenerate into nepotism, cronyism, and generally bad business decision making? Indeed, isn't the very essence of modern economic life the replacement of informal moral obligations with formal, transparent legal ones?“ (ibid, p.149)

The securities market is a place where the characteristics of the high-trust societies are most typically exhibited. In the capitalist economy savings, which seek earnings in forms of interests, capital gain or dividend, are channeled to business enterprises, which need financial resources for business creation and expansion. Securities markets play a key role in this circulation of financial resources. Investment in securities is a form of fund transfer, i.e., from the investors to the sponsors, who issue the securities. Lending is another form of fund transfer. However, in terms of the degree of risk bearing there is a fundamental difference between investments in securities and lending. A lender's risk is low when it is covered with a concomitant amount of collateral. A lender may not be required to trust the borrower a hundred percent if his fund transfer is covered with the collateral offered by the borrower. However, investors' decision-making to transfer his fund to another rests much on his unilateral trust in the sponsor, who issues the securities. The investment decision-making is based on the information that is publicly available and it is theoretically assumed and almost taken for granted, especially in a high-trust society, that business enterprises publicly disclose full and complete information of their present and future value. In actuality, however, the financial disclosure is not always full and complete. It might intentionally hide information implying risk for investors.

2. Securities Market Deceived

In its annual report of 2000 Enron announced that the corporation had built unique and strong business with tremendous opportunities for growth in the business of wholesale as well as retail energy services, broadband services, and transportation services. It further stated that their market opportunities would triple over the coming five years. Such a boastful announcement appeared to be substantiated through the Enron and subsidiaries consolidated income statement, which reported the total revenues of US$101 billion, US$2.5 billion income (before interest and income taxes) and the net income of US$979 million. In the 500 Largest U.S. Corporation by Fortune Enron ranked ahead of IBM and was placed 7th, only one rank below CITIGROUP, whose revenues were US$112 billion.

When Enron boasted “tremendous opportunities for growth" in the 2000 annual report, it was already known to the insiders that their overseas ventures such as Azurix project in the UK, and the Dabhol power plant in India had caused the corporation an enormous financial loss. EnronCredit.com, which was launched in February 2000, was a financial disaster and Blockbuster 20-year deal to provide video-on-demand service to consumers over high speed Internet lines announced in July 2000 and incorporated in their financial statement as part of revenue and income existed only on book and was never realized. All such negative information was intentionally hidden and those inves-
tors who blindly trusted window-dressed financial reports kept purchasing Enron's stock to bring its price to an all-time high of US$90.56 in August 2000.¹

In order to maintain higher prices for its stock, Enron kept deceiving securities market by artfully concealing the loss from the eyes of investors. Among those factors which prompted the deception the following three factors were of particular importance: (1) availability of sophisticated financial techniques that could be abused to disguise loss from the financial statement, (2) an excessive emphasis on mark-to-market accounting that led the corporation to an obsession with the stock prices, and (3) personnel evaluation system called PRC (Performance Review Committee), adopted by the corporation spurred employees to an endless competition to enhance their sales record even at the risk of committing unethical practices.

Enron created special purposes entities (SPE) one after another, in which the accumulating loss was disguised. One year and two months after its stock price had hit an all-time high, the SEC began a probe of the corporation's management of the SPE's. When it was revealed that the SEC started investigating the financial practice of Enron, its stock fell to US$20.65. Arthur Andersen, public accounting firm that audited Enron, began shredding Enron-related documents. Dynegy, the second largest energy trader next to Enron, announced a deal to purchase Enron. However, as major credit rating agencies downgraded Enron's bonds to a junk status, Dynegy terminated its deal to buy Enron. Its stock price plunged into US$0.61. On December 2, 2001 Enron filed for Chapter 11 bankruptcy protection. The court assessed the Enron's debt at US$63 billion and its disposable asset at US$12 billion.

The Enron collapse was scandalous as it involved accounting irregularities, debt camouflage, and breach of fiduciary duty. It was not only scandalous, but also grossly suspected as constituting such crimes as fraud, conspiracy, insider trading, and obstructions of justice.²

The sudden and dishonorable implosion of a large corporation was as shocking as the September 11 terrorist attack, both taking place in the first year of the new century. The two incidents severely shook the confidence in a high-trust society.

3. The Birth of Enron

Had it not been for constant and accelerated social, economic and political trends of deregulations, Enron would not have been born. In the recent decades in the US, UK, and other countries the financial, transportation and telecommunication sectors have been extensively deregulated. In spite of early criticisms that deregulations would lower the quality of services and increase risks for customers, the results of deregulations of those industries have been in general and on the average favorable, enhancing efficiency of resource allocation, redistributing monopoly rents, and resulting in lower cost for consumers. The late comer in this series of deregulation was the energy sector, which started toward the late 1970's and the early 1980's. The man who was to be the founder of Enron was an economist with a job experience at the Federal Power Commission, the precursor to the Federal Energy Regulatory Commission (FERC). He was also teaching microeconomics, macroeconomics and government-business relations at the graduate course of the George Washington University in Washington DC. An economist started his business career in the energy industry precisely when the tide
of deregulation was making into that industry. Kenneth Lee Lay, the founder of Enron, was born to a rural family in Tyrone, Missouri in 1942. His father was a minister of Southern Baptist church but had to hold other jobs besides ministry in order to support his family with three children. Ken was in the middle and already helping family financially with part-time job such as delivering newspapers when he was still nine years old. The parents were strongly education-minded and when Lay was at sophomore year of a local high school, they moved to Columbia, the site of the University of Missouri. Lay was a brilliant high school boy. Assisted with scholarship grants, loans and money raised through his part-time jobs, Lay was able to attend the University of Missouri at Columbia. He was elected as the president of fraternity Theta Beta Pi when he was in junior year. While attending undergraduate courses Lay showed keen interest in economics and upon recommendation of Professor Pinkney Walker he continued his study in economics at the graduate school of the university. Lay obtained M.A. in economics in one year. He started the career as a corporate economist with Humble Oil, which later became a part of Exxon, in Houston. The young economist was much attracted to the energy industry, especially by the industry’s highly capital intensive nature. He is said to have told one writer: "It required a lot of long-range planning and interface with government and regulatory bodies, which also tended to fit into my economics training."^4^ The war in Viet Nam escalated and expecting to be drafted, he joined the Navy in 1967 as a supply officer. Thanks to the high level of his education Lay was able to attend Naval Officer Candidate School in Rhode Island and soon accepted to Pentagon as an economist. He served for three years as the Assistant Secretary of the Navy for Financial Management. During this service Lay made a research on the economic impact of defense spending, on which he wrote a Ph.D. dissertation to be presented to the University of Houston. After his discharge from the Navy in 1971 he found a job with the Federal Power Commission, which later became the Federal Energy Regulatory Commission or FERC, one of the key players in the US energy deregulation. At the Power Commission he was an assistant to his former M.A. thesis supervisor, Pinkney Walker, who was then head of the Commission quitting the University of Missouri.^5^ Lay was promoted to deputy under-secretary for energy of the U.S. Department of the Interior. In Washington he also taught the graduate courses of the George Washington University in micro- and macro-economic theories as well as government-business relations.

Armed with good knowledge of theories in economics and experience-based insights into the energy industry and government-industry relationships Lay joined a natural gas utility Florida Gas in 1973 as vice president. In 1981 president of Florida Gas, Jack Bowen, moved to Transco, which was a Houston-based pipeline company supplying gas to the New York-New Jersey area. Bowen scouted Lay from Florida Gas to put him in the position of president and COO of Transco.

The majority of U.S. natural gas wells are drilled in five major regions: Texas, Louisiana, Gulf Coast, West Texas and New Mexico. Other wells are scattered in a huge area stretching from Kansas to Oklahoma and the Rocky Mountains, and there is also a considerable number of gas wells in Alberta, Canada. End users of natural gas are divided into two categories, household and industries. More than 60
percent of natural gas production are consumed as factory fuels, fuels for electric power generation and organic chemicals materials. In order to supply gas from the processing plants located near the wells, which are concentrated in a certain regions, to end users, which are scattered all over the continent, a vast network of pipelines sprawl all over the continent, stretching to 280,000 miles (100 times more than the distance between Los Angeles and New York!).

Gas management is not an easy job. Transportation of gas is far more difficult than oil, which is liquid and can be stored in barrels or tanks and transported by vehicles, trains or ships. For gas transportation through pipelines compressors are used to raise the pressure of gas in the pipelines. High-pressured explosive gas is an extremely dangerous stuff and therefore, the operation has to be carefully monitored. The industry was tightly regulated by the government. Gas producers must drill and pump gas in accordance with the regulations and sell gas at the prices set by the federal government. Under such strict governmental controls there was no competition and consequently, not market in the natural gas industry. The contracts between suppliers and users were take-or-pay, which meant that the buyer would still pay some amount even if the product or service was not provided.

By the time Lay was at Transco, the situations of energy regulation were going to change toward the direction of deregulation. In the background of this change there was a shortage of natural gas supply. While gas demand was steadily increasing, there was no incentive to increase on the part of suppliers since prices were regulated. Consequently, there was a gas supply shortage. In 1978 the government started to remove its price control of natural gas. This meant that natural gas producers could set the sales prices at their wells. On the other hand, many pipeline companies would sign long-term contracts to purchase gas from producers in order to avoid supply shortage in future. The 1978 deregulation worked well and gas production increased. However, shortly after gas production increase, a recession set in and gas demand dropped to press the prices down from US$6 per 1000ft$^3$ to US$3 per 1000ft$^3$. In 1980's there was even a market satiation in the gas supply.

Lay was an economist and learned a lot through practicing the gas business management during the late 1970's and early 1980's. It was a rare and invaluable opportunity for him to test his own economic theory hypotheses and receive the feedback coming from the real economy. Fully equipped with theories and practices of energy economics and government-business relations, Lay moved from Transco to Houston Natural Gas, another pipeline company, in 1984. He finally assumed the position of chairman and chief executive officer at Houston Natural Gas or HNG. When Lay joined HNG, the company had just narrowly survived a takeover attempt by one of the competitors, Coastal Corp.

At HNG Lay continued to pursue the spot market of natural gas, but at the same time he had a vision to create a gas sales consortium. In 1984 he organized Transco and four other pipeline companies, Morgan Stanley and law firm Akin Gump Strauss, Hauer & Feld LLP to create a natural gas clearing house. The clearing house to stabilize spot market was so successful that Morgan Stanley took over the control of the house in 1985 to make it an independent gas marketing firm. The late 1980's were the stormy period for gas companies as
take-over and M&A were rampant in the industry. In such a period HNG was more offensive than defensive under the leadership of Lay. It spent US$1.2 billion to buy out Transwestern Pipeline and Florida Gas Transmission. By purchasing those two pipeline systems, HNG expanded its network from Oklahoma and West Texas to California and to the entire area in Florida. HNG doubled its pipeline network mileage. It was not a local pipeline company in Texas anymore. It became one of the largest pipeline companies in the United States. Its customer base was so diversified, extending from household utilities to electric power plants and gas chemical companies. The majority of big M&A by HNG was financed through debt. The increased debt enhanced HNG’s immunity against takeover attempt by rival firms. After all such set-up had been completed at HNG, a second wave of energy deregulation was announced in 1985. The order came from FERC, where Lay worked from 1971 to 73, to the effect that local utilities could buy gas from the producers and pay the pipeline companies just for transporting the gas. Separation of gas trading and gas transportation also meant that government controls would remain in the pipeline mainly for safety reasons while gas trading was then left to the hands of free market.

Lay was an economist and must have grasped that the second wave of deregulation would provide a tremendous business opportunity with HNG. The pipeline industry is a natural monopoly like railway business because of its huge investment in the pipeline network and could enjoy monopoly rent under free market. However, since it is regulated by the government and cannot charge higher rates for their gas transport services, its monopoly rent would remain residual. On the other hand gas trading is deregulated and would function freely in a competitive market. If a firm holds a control of two companies, i.e., gas trading and gas transport, the residual monopoly rent in the gas transport would be realized in the gas trading division or at least it would function as a competitive edge. This vision further prompted Lay to enhance the degree of monopoly of the pipeline network of HNG and this was the motive to merge HNG with InterNorth, a much larger pipeline company than HNG, based in Omaha, Nebraska. In May 1985 the two companies released news that InterNorth would buy Houston Natural Gas for US$2.3 billion or US$70 per share while the HNG stock was traded for US$46.88 per share on Wednesday, May 1, 1985, two days earlier than the date of merger.

As a result of the merger HNG/InterNorth was US$12.1 billion worth in assets, with 15,000 employees and the second largest pipeline network in the United States. Samuel Segnar, the chairman and CEO of InterNorth, assumed the CEO of the merged company. It was agreed that Segnar would remain in that position until 1987 and then be succeeded by Lay. The new company was re-named as Enron and its headquarters were moved from Omaha to Houston.

4. Growth of Enron

Enron started with a shaky financial foundation. Debt was a real concern for the newly born company. HNG had already been deeply in debt when it had purchased Transwestern Pipeline and Florida Gas Transmission. Immediately after the merger Enron had to lay off 1000 employees and further 500 to save US$70 million per year. In 1987 Enron issued US$585 12-year debentures and paid off a part of the long-term
debtor with the revenue from the debenture sales and yet the balance of the long-term debt at the end of 1987 was as high as US$3.4 billion.

Enron sold off redundant assets and peripheral business to trim down the company essentially to pipeline services. It owned 37,000 miles of pipeline network nationwide, occupying 13% share in the market. Enron had a separate, unregulated unit of gas trading and the unit which transported gas for government-approved fees. Enron also possessed gas processing plants, which drilled and extracted methane, ethane, and propane gas. Step by step Enron achieved the grand vision of Kenneth Lay to alter the residual monopoly rent of the gas transportation unit to profits of the gas trading unit. In 1987 Enron registered US$5.9 billion revenue and earned US$53.7 million ordinary profit before tax, which was yet as low as 3% of the revenue. The primary objectives of Enron were yet further rationalization of operation, slimming-down of employment structure and strengthening of the financial basis. Richard Kinder, who was a fraternity brother of Lay at the University of Missouri, joined Enron as Vice Chairman. He also held a title called General Counsel and Chief of Staff. Kinder actually acted as the Chief Operating Officer, but he did not hold that title as Mick Seidl, who was originally from Florida Gas, a good friend of Lay and a former academic like Lay, was the COO of Enron till 1989. Seidl was a slow decision maker and more interested in the glamorous status of a company executive than hard work of making profits for the company. Richard Kinder was just the opposite. He was a tough and demanding business administrator. He was a quick decision maker and always interested in making profits. Under his management all the staffs and employees had to work so hard that the ends were necessarily met. From 1989 Kinder was the COO of Enron and in 1996 he left Enron as he felt uncomfortable with Jeff Skilling's "asset light" business model. The sales and net profits of Enron during Kinder's administration were as follows:

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<th>1990</th>
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<td>Sales</td>
<td>5,300</td>
<td>5,700</td>
<td>13,300</td>
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<td>Net Profits</td>
<td>202</td>
<td>232</td>
<td>584</td>
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Source: Enron Annual Report

In the late 1980’s the whole natural gas industry faced one single problem: it was a problem of interaction between sellers and buyers of natural gas. Natural gas used to be traded under the government control at the prices set by the government and the contracts between sellers and buyers were mostly on a long-term basis. After deregulation, however, the deals were made more and more on a spot basis. Price settlement for one month supply of gas, for example, was done in a frantic few days at the end of every month. Spot market prices were volatile and fluctuated depending on weather. Such uncertainty of natural gas market discouraged some users to switch from gas back to oil and coal.

Enron was trying to convince the industry to move back to long-term contracts like those days when the industry was regulated by the government, except for the prices which were to be negotiated between sellers and buyers instead of being set by the government. Enron established a new division called Enron Gas Marketing for such purposes of gas marketing. It made a long-term sales contract with the customers and purchased gas on a spot basis from the gas producers. The system was welcome to the gas users, but it increased risks on the part of Enron. Then the idea of "Gas Bank"
was introduced by Jeff Skilling, a McKinsey consultant, who later became CEO of Enron Gas Marketing. The idea of gas bank is as follows. Gas producers make contract with Enron to sell their gas to Enron, which is a bank and producers are depositors so to speak. Customers who buy gas from Enron are borrowers. The bank or Enron will obtain profits, which result from difference between the price at which it acquires the gas and the price at which it sells the gas to the customers, just as a bank earns the spread between interests it charges on borrowers and interests it pays depositors. In the beginning the system did not work as designed. When the gas market was weak, suppliers were willing to sell gas at the contracted prices to Enron, but when the market was strong, they tended to renegotiate their sales prices. Skilling solved this problem by changing Enron’s payment method. Instead of paying the gas suppliers on a delivery basis, Enron then would pay cash in return for a long-term contract. Not all of gas producers were financially strong and Enron provided loan with such financially weak suppliers so that they were contractually and also financially bound to extract, process, and deliver gas exclusively to Enron.

The gas bank finally began to work. More and more customers and producers were signing long term contracts. Enron was a pioneer among the gas traders which had introduced a system of long term contracts to give more stability to the post-deregulation gas market. Skilling’s innovation went one step further. While the long term contracts were more and more standardized in terms of price and delivery conditions, the contract itself could be traded. That sort of business had long since been practiced in the oil market, namely, oil future market. Natural gas, which was once strictly regulated by the federal government, finally became one of those commodities, which were traded in a commodity market.

5. Failure of Enron

If Enron had stayed as a gas trader and limited its activities to the US natural gas market, the Enron scandal would not have taken place. Lay was convinced that deregulation would open new business chances. He envisioned that the next industry that would be deregulated after natural gas would be the electric power. In the 1980’s, the electricity supply industry was undergoing a rapid change. For a long time the industry had been remarkably stable and served the public well. A significant feature in these changes was an attempt to introduce competition among generators and distributors to create electricity “market”. A free market, it was so argued, would reduce cost just as in case of transportation and telecommunication.

The deregulation process in electricity was slow and there were and still are strong opinions that it should not be left to the hands of free market, because the stability of its supply is so vital to people's life. Furthermore, there are many technical difficulties in trading electricity in a market, because it cannot be stored and vastly lacks the flexibility to adjust supply capacity in response to the change in demand.

The UK was an earlier starter of electricity deregulation. The industry was privatized and power generation was separated from power distribution. With one of the private power generation companies in the UK, National Power and another British company, ICI Chemicals, Enron decided to build a natural gas powered electric generating company. The site for a new power plant was Teeside in northern England, where ICI Chemicals had a factory and
its capacity was estimated 1,875-megawatt. The project was signed in 1990 and the plant was completed in 1993. The power generation project itself was not a failure for Enron, but its deal with the so-called J-Block in the North Sea oil field proved to be a fiasco.

Enron committed to supply the Teeside plant 300 million ft$^3$ of gas per day from two new fields under the North Sea. Enron agreed to buy natural gas from the J-Block under a long term contract and the J-Block supplier, Phillips Petroleum agreed to supply 260 million ft$^3$ per day. The contract was a take-or-pay. This contract later became a cause of huge financial loss to Enron.

Teeside was just a start of Enron's international business, which was led and promoted by Rebecca Mark. She was involved in one of the most controversial overseas projects conducted by Enron. The State Electricity Board of India was suffering from financial loss due to their poor management of power systems. India was then opening up its power market to foreign investors. In 1993 Enron proposed to build a gas-powered electric plant in Dabhol, about 100 miles from Mumbai (Bombay), the capital of Maharashtra, the second most populous state in India. Two other US firms joined the project: General Electric and Bechtel Engineering. The share of participation was 80% for Enron and 10% each for General Electric and Bechtel. The total planned capacity was 2,015-megawatts divided into two phases and the project required US$2.9 billion. The first phase would provide 695 megawatts, fueled with naphtha and the second phase with 1,320 megawatts fueled with liquefied natural gas or LNG. From the beginning there was a resistance to this project on the local side and it was rumored that Enron bribed the Congress Party of India, which took US$13 million. Enron vehemently denied this rumor. Another difficulty was how to finance the project. The Indian partner insisted that the International Bank for Reconstruction and Development (IBRD) should be invited to provide a low interest long term loan. In 1993 the IBRD examined the project, but turned it down as the bank concluded that the project was not economically feasible. The IBRD was critical about the plan to supply fuel for the second phase with liquefied natural gas. LNG is the only alternative means of gas transportation when pipeline cannot be used. Enron proposed to supply LNG from Qatar to Dabhol, but the IBRD judged that though it would be technically possible, the idea would not be viable in terms of cost.

The Dabhol project was a showcase for the US Government as it seemed to prove the competitiveness of American energy industries. The then U.S. Secretary of Commerce Ron Brown visited India, accompanied by Lay, to participate in the contract signing ceremony. In spite of the IBRD's refusal, the U.S. Export-Import Bank provided US$298 million loan and the Overseas Private Investment Corp provided US$100 million loan. From other financial sources Enron managed to arrange the loan to build up US$643 million to finance the project and the first phase construction started.

Soon after the signing of the contract there was a political change on the part of the local partner. In the election of March 1995 an alliance of Bharatiya Janata Party or BJP and Shiv Sena won and the Congress Party, which promoted the project with Enron, lost. The alliance of BJP and Shiv Sena was largely based on the anti-Enron campaign. The project was viewed by those who opposed it that the foreign capital was intending to exploit people in India.
by forcing them to buy higher priced electricity. It was known to them that in the contract Maharashtra was supposed to buy electricity from Dabhol at 8 US cents per KWH while the then prevailing rate was 5.6 US cents per KWH. In May 1995 a crowd of several hundred people protested the project and they threw rocks and stones to the workers in the project site. The project was suspended and the Indian partner wanted to cancel the contract. The case was brought to the arbitration in London. While the construction of the phase one was being suspended, interest accrued from the loans at the rate of US$250,000 per day.

While Enron was struggling in India, another blow came from Teesside. Enron contracted with Phillips Petroleum to buy gas from its J-Block oil well and the contract was a take-or-pay. Enron thought that the natural gas prices would tend to rise on a long term basis. In actuality, however, the gas price in 1995 was almost half compared to the price in 1992, when Enron contracted the J-Block. Enron intended to cancel the contract, but after several litigious talks with Phillips Petroleum, Enron made a one-time cash payment of US$440 million in 1997 and it affected the second-quarter results.

The above description is a sort of post-mortem examination of the Enron's failed overseas ventures. How, then, were these projects officially reported to the investors?

"The Dabhol power project in the state of Maharashtra is the cornerstone of Enron's activities in India and is expected to be a strong contributor to Enron's earnings in 1999 and beyond. Upon achieving full commercial operation in 2001, 2,450 megawatts facility, which will include India's first-ever liquefied natural gas (LNG) terminal and regasification facility, will be the largest independent power project in the World. The Dabhol LNG terminal will create opportunities for Enron to build a natural gas pipeline and supply gas to other energy and industrial customers along India's west coast, where the current gas supplies are short. In early 1999, the first 825 megawatts of the Dabhol facility began commercial operation and the remaining 1,624 megawatts moved into the construction stage. Electricity from the Dabhol facility is being sold through a 20-year power purchase agreement that Dabhol Company holds with the Maharashtra State Electricity Board. In addition to the Dabhol project and related activities, Enron is pursuing other power and gas projects across India."  

It was an irony that Enron bankrupted before the project "achieve full commercial operation in 2001." In 1994 Enron bundled together all its overseas ventures into one limited partnership called Enron Global Power Pipeline (EGPP). Enron retained 52% of EGPP, investing its own stock, and the remaining 48% stake was sold in the securities market. The offering of EGPP shares raised US$200 million cash for Enron, which transferred all its overseas projects, assets as well as debts, to EGPP. It meant that the investors in EGPP paid cash to purchase huge debts of Enron. Economic journalism was partially responsible in misleading the investors. It projected an image that Enron has shaken up the sleepy gas pipeline and power business by aggressively embracing risk and continually remaking itself. One article referred to the stocks of EGPP as a good buy, to which Wall Street had not paid enough attention yet.  

The facts about Dabhol and the J-Block were known to economic journalism. However, their report was editorialized and biased that Enron, which was a dynamic and innovative company, would eventually overcome such difficulties.

Enron established subsidiaries one after
another, such as Enron Capital & Trade Resources (ECT), Enron Communications, EnronCredit.com, Enron Development Corp., Enron Energy Services, Enron Renewable Energy Corp. and so forth. The financial results of all those subsidiaries had to be reflected in the consolidated profit and loss statement and the balance sheet of Enron Corp. During the late 1990’s Enron moved into new business areas. During the period from 1996 to 1998, about 60% of Enron’s earnings were generated from business which Enron had not been engaged ten years earlier. Such a rapid growth required huge initial capital investments, which were not expected to generate earnings or cash flow on a short run and that would place an immediate pressure on Enron’s balance sheet. In order to fund the new investment, Enron resorted to a financial practice, which could raise fund without affecting their consolidated balance sheet, no matter how many subsidiaries Enron would establish for new business. That was the establishment of special purpose entities (SPE’s). SPE is approved by Financial Accounting Standards Board (FASB) and its original idea was to isolate risk by setting up an independent legal entity that would own one asset, such as credit card receivables. If the credit card company gets bankrupted, the legal entity would suffer from a total loss. Otherwise it would earn income on a certain percentage of the credit card receivables. However, if the sponsor itself sets up an SPE, what would constitute “independence” of an SPE? The rule said that if more than 3 percent capital of the SPE comes from an independent party, it is regarded as an SPE and it does not need to be reflected in a consolidated financial statement of the parent company. This is what accountants call “non-consolidation equity requirement of SPE”. “Don’t search for the logic behind the 3 percent threshold. There isn’t any.”

The Enron’s practice of SPE management was highly complicated involving mesh-like re-financing and re-investment. The following is a simplified version of JEDI case. JEDI, which stands for Joint Energy Development Investment, was established in 1993 with joint participation of the California Public Employees Retirement System (CalPERS), which paid up with cash US$250 million and Enron, which invested US$250 million worth of its own stock. By 1997, JEDI had invested its entire fund here and there and Enron needed CalPERS to invest in a second similar fund. CalPERS insisted to sell the stakes of JEDI to someone else before establishing a second JEDI. The two parties agreed that the stake of CalPERS was then worth US$380 million, which represented a 22 percent annual return for CalPERS. Enron had to find an entity, which would pay US$380 million in cash. An SPE called Chewco was established. An Enron employee, Michael Kopper, was the founder of Chewco, but he personally possessed only US$125,000, which he paid in Chewco. Barclays, a British bank, provided Chewco US$240 million with a guarantee given by Enron. Then, JEDI advanced Chewco US$132 million under a revolving credit arrangement and the remaining US$11.4 million came from Barclays, structured in such a way as to be recorded as a loan on Barclay’s books and as equity by Chewco. Chewco was perfectly in compliance with the 3 percent rule, except that Michael Kopper was an Enron employee, who was not an entirely independent entity. The stakes of CalPERS in JEDI were transferred to Chewco and US$380 million was paid to CalPERS.
6. Evaluation of Enron

What was Enron, after all? For a decade from its establishment till 1996 Enron was a gas trader and its corporate value rested on the activities to contribute value added to the society through services associated with production and distribution of natural gas. Since 1996 Enron was transformed into a corporation selling valueless paper, in which it was written "your dreams would be realized." In that respect it was a phenomenon similar in its nature to the Mississippi Bubble, the South Sea Bubble and the Dutch tulip mania. It was a sophisticated Ponzi Schemes, directed and staged by a smart guy with MBA on the scripts written by an economics Ph.D., half academic and half bureaucratic. Paul M. Healy and Krishna G. Palepu estimate the market capitalization of Enron at US$60 billion on a basis of Enron's stock, which was priced at US$83.13 on December 31, 2000. This amount more or less corresponds to the total debt at the bankruptcy, which was US$63 billion. Suppose that the majority of those who have invested in Enron and lost money and those who have gained money through Enron-associated activities are both US residents, the loss equals to the gain and it was a zero-sum game in the US macro-economy. Individually, of course, there must have been asset transfer from the unlucky to the lucky. The unluckiest among them were those Enron employees, who held majority of their 401K fund in the Enron stocks.

The next question is: Did Enron commit a fraud against investors? In July 2000 Enron signed a 20-year agreement with Blockbuster Video to introduce entertainment on demand. Enron set up pilot projects in the cities of Portland, Seattle and Salt Lake City and tested the system with about twenty pilot customers. On a basis of this pilot project Enron estimated profits of more than US$110 million from the Blockbuster agreement. Income was estimated from this figure as the present value of net future cash flows and entered in the book. Blockbuster Video was not realized beyond the pilot with a few dozen customers in the three cities. It was a fraud to enter an unrealized contract as if it had been realized. However, the book had been audited by a certified public accountant before it was published. Furthermore, in view of the wide-spread mark-to-market accounting practice, it was not a total fraud like the Ponzi scheme, which guaranteed investors a 40% return in 90 days by buying and selling of international mail coupons. Though it proved to be wrong, Enron entered its book "future sales". In a securities market "future" is always traded. Investors' decision-making is derived from their trust in the financial report released by the sponsors. The sponsors are expected to report as openly as possible. No matter how openly the sponsor tries to report, however, the information asymmetry in the Akerlof-Stiglitz sense would remain.

We now turn to the ethical aspects of Enron. Enron had Code of Ethics, published in July 2000. A part of it states as follows.

"At Enron, we treat others as we expect to be treated ourselves. We believe in respect for the rights of all individuals and are committed to promoting and environment characterized by dignity and mutual respect for employees, customers, contractors, suppliers, partners, community members and representatives of all levels of Government."

In actuality, however, the company managed to anger virtually all of its big customers. The word was out that:"Don't do business with Enron. They'll steal your wallet when you aren't
looking."  

As to the personality of Kenneth Lay there are more favorable descriptions than hostile. He was the preacher's son and with all the social pressures that role demanded, he strove from childhood to be flawless in the eyes of God.

"Just about everyone who met Lay for the first time liked him, from world leaders to the ministers from Houston’s poorest neighborhoods. A very rich man as early as the mid-eighties, he always able to convey, at least from a distance, that he was a man of simple tastes and good works. His dark eyes were unusually soulful, though they could turn as hard as onyx, and he had the oversized, enveloping hands of a farm boy, which he had been. He also possessed the politician's gift—or the habit of the minister's son, which he also was—remembering not just your name but the name of your sister, and the ability to collect when she had recovered from her last heart surgery."  

Lay, however, was very optimistic and looked always at the better sides and believed that things would always be better than they were. Because of this optimistic personality Lay might have developed unhealthy capacity for self-delusion and he tended to deceive himself about harsh truth he did not want to face. He might have allowed Andrew Fastow to practice dubious accounting techniques of setting up innumerable SPE’s to solve shortage of cash flows caused by an execution of his recklessly optimistic business visions.  

Both Jeffrey Skilling and Andrew Fastow were typical MBA’s who climbed up the ladder of company executives in a relatively short period. Both were immature in their philosophy of life and believers of cheap libertarianism. Skilling obtained MBA at Harvard and Fastow at North Western. Before he was scouted by Skilling, he was a senior director at Continental Bank in Chicago. His job was to help clients to reduce their debts through offering stocks, bonds and other securities. He had a good experience and also expertise in that field of financing, and it was precisely what Enron was looking for. Furthermore, he had been married to a daughter of Weingarten, a famous rich family in Texas. Fastow already pleaded guilty and now awaits sentencing. He stated to prosecutors in his January 2004 plea bargain as follows.

"While CFO, I and other members of Enron’s senior management fraudulently manipulated Enron’s publicly reported financial results. Our purpose was to mislead investors and others about the true financial position of Enron and, consequently, to inflate artificially the price of Enron’s stock and maintain fraudulently Enron’s credit rating. I also engaged in schemes to enrich myself and others at the expense of Enron’s shareholders and in violation of my duty of honest services to those shareholders."

Probably, Fastow was cynical and lacked sense of justice. No business ethics course might have been offered at the MBA course of North Western University!

Finally, Jeffrey Skilling. Contrary to the case of Kenneth Lay there are very few favorable descriptions about this man. He is described as arrogant, intimidating, and very smart. On March 2, 2002 he appeared on CNN's Larry King Live and said:

"Larry, I spent probably most of my professional life helping to build Enron Corp. I don't think there was anyone that was as shocked by the collapse of the company as I was."

One of a very few favorable comments about Jeffrey Skilling is by Kenneth Lay:

"I have worked with Jeff more than 15 years, including 11 here at Enron, and have had few, if any, professional relationships that I value
7. Conclusion

Securities markets are vitally important for a market economy so far as marketed articles are worth being securitized such as stock, debentures, and governmental bonds. Such asset as real estate might also be worth being securitized. However, there would be no economic or commercial meaning in securitizing "band widths" of telecommunication. With an advancement of computer technology an increasing number of band widths can be supplied and there will be no "shortage" of band widths. Electricity will never become a commodity like oil since it cannot be stored. It will never become a branded consumer product like Coca-Cola, even if it is bought by consumers in a retail market. There is no business model, which can solve problems of the peak supply cost of electricity in a free market.

Among business people, ethical egoism would be a most widely accepted moral principle. It claims that for a moral action it is necessary to maximize one's self-interest. Instead of "maximization" it can also be stated that one should achieve a certain level of profits or welfare. Ethical egoism, when it is advocated by such philosophers as Ayn Rand and Friedlich Nietzsche, may give an impression that it is fundamentally different from such traditional moral principles as Kantian deontology and Benthamian utilitarianism; those traditional principles place some weight on the interests of others. Well examined, however, ethical egoism is not so much different from deontology and utilitarianism in terms of its relationships to interests of others. Each person needs the cooperation of others to obtain offering such as friendship. If one acts with no weight to others at all, others will not cooperate with him. Suppose that one breaks his promise to others, because to do so is his self-interest. If such a case happens, others will not accept his promise anymore. Therefore, he must do his best to keep his promise with weight to others.

The principle "we treat others as we expect to be treated ourselves" can also find a comfortable place in ethical egoism.

Ethical egoism, if interpreted correctly, can function as an effective guiding principle of business people.

References:

1) In March 5, 2001 issue of Fortune, Bethany McLean warned that the Enron stock was overpriced. She points out that Enron's return on equity was 13% and its return on invested capital was only 7% calculated on a basis of its balance sheet of 2000. The article further points out that while Enron pretends to be a "hard" company producing natural gas and electricity, it keeps selling off its "iron and steel" assets under a pseudo-new-theory term "assets light management". McLean published together with Peter Elkind The Smartest Guy in the Room (2003 Fortune), one of the most authoritative histories of the amazing rise and scandalous fall of Enron. A film was made on a basis of this book and released in the U.S. in April, 2005.

2) As of June 2005 a total of 33 criminal charges are brought forward. Among them 2 in prison, 13 awaiting sentencing, 5 jury-convicted, 1 acquitted, 1 awaiting decision on retrial, 5 on trial, 3 awaiting trial, and 3 are fighting extradition. As of October 5, 2005 ex-Chairman Ken Lay and ex-CEO Jeff Skilling are scheduled to be tried, along with former Chief Accounting Officer Richard Causey, Jan. 17, 2006. Afterward, Lay will be tried on charges involving his personal banking. ( Houston Chronicle special report on Enron http://www.chron.com/content/chronicle/special/01/enron/index.html)

3) There are two publications by Pinkney Walker: Economics of income distribution (1962 Lucas
4) Fox, Loren, ENRON the Rise and Fall (2003, Wiley & Sons) p.8

6) A standard unit of energy is BTU or British thermal unit. BTU is the amount of heat required to increase the temperature of a pint of water by one degree Fahrenheit. A wooden kitchen match produces approximately 1 BTU. MBTU stands for one million BTU and often used as a standard unit of natural gas measurement. One cubic feet (1ft³) of natural gas produces approximately 1 MBTU. Therefore, as the unit of natural gas. MBTU is occasionally expressed as MMBTU, which is intended to represent a thousand thousand BTUs.

8) International Brotherhood of Electrical Workers-AFL-CIO-CLC is constantly campaigning against electricity deregulation. Refer, for example, the following site: http://www.ibew.org/stories/01journal/0107/canadaderegulation.htm

9) She joined Enron in 1982, became executive vice president of Enron Power Corp. in 1986, chairman and CEO of Enron Development Corp. in 1991, chairman and CEO of Enron International in 1996 and vice chairman of Enron Corp. in 1998. She was named to Fortune’s “50 most power women in American Business” in 1998 and 1999 and Independent Energy Executive of the year in 1994. She is a graduate of Baylor University. She took a leave from Enron while she was still rising the corporate ladder and attended Harvard University to obtain a degree in MBA.

11) Fortune, April 3, 1995, p.136
12) An article by Harry Hurt III in the August 5, 1996 issue of Fortune is an example.
14) It was named after the Star Wars character Chewbacca. Most of the SPE’s established by Andrew Fastow carried the names of the Star War characters. Peter C. Fusaro and Ross M. Miller analyse Fastow’s obsession with the Star War and its relationship to his financial crimes in What went wrong at ENRON (Wiley, 2002).

17) http://www.themokinggun.com/enron/enron-ethics1.html
18) A statement by longtime Enron executive Amanda Martin quoted in McLean, Bethany and Elkind, Peter, op., cit., p.107
20) http://www.chron.com/content/chronicle/special/01/enron/index.html
21) ibid.
22) ibid.
23) The hero of Ayn Rand’s novel, John Galt, states: “I swear by my life and my love of it that I will never live for the sake of another man, nor ask another man to live for mine.” (a quote from Atlas Shrugged by Ayn Rand)
倫理的利己主義: それは市場経済の指導理念たらうるか?

－エンロン崩壊の研究－

古山 英二

Synopsis邦訳

資本主義市場経済においては、キャピタルゲインと配当を求める貯蔵は、事業の創造と拡大の為に資金を求める企業に向けて還流される。このような金融資源の循環において中心的役割を演じるのが資本市場である。投資家達の決断は公開情報に依存し、そうした公開情報は当該企業の現在ならびに将来の価値を包み隠さず公表しているが理論的には考えられている。しかしながら、公表されている財務情報が、企業に関する完全な情報を含んでいるとは限らない。それは、投資家にとってのリスクを示唆するような情報を意図的に隠蔽しているかもしれない。エンロンが2000年の年次報告で“驚異的な成長の機会”を自慢に発表したとき、同社が進めていた英国におけるアブリック事業やインドにおけるダブホール発電所事業が、同社に多大な損失をもたらしていることを同社の幹部達は既に知っていた。2000年2月に発足したエンロンクレディットは財務的に大失敗であった。ブロックバスター社との間で結ばれた高速光ケーブルによるビデオ・オン・デマンド事業は、2000年7月に発表され、2000年の売り上げと利益に計上されていたが、実際には帳簿上のの存在であった。そのようなネガティブな情報は投資家の目から一時隠され、エンロンの株価は2000年8月US$90.56という空前の高値をつけた。

エンロンは資本市場と投資家達を欺き続けた。エンロンをしてそのような欺瞞に走らせた幾つかの要因のうち特に重要なものは次の三つであろう。即ち、(1) 財務諸表から損失を隠蔽する複雑かつ巧妙な財務上の技術が存在したこと、(2) 時価評価会計（mark-to-market accounting）に拘泥するあまり、自社株の高値維持の執念に取られ過度にしたことが、及び(3) “業績評価委員会”が主導する人事評価方式が、従業員を阻害のない売り上げ拡大競争に追い込むことがそれである。

エンロンは“特定目的法人”（SPE=Special Purpose Entity）を次から次へと設立し、損失の隠蔽を行った。エンロン株が最高値を記録してから1年後に、米国の証券取引委員会（SEC）はエンロンのSPE業務に関する調査を開始すると発表した。SECがエンロンの財務関連業務に就き調査を開始したことが公表されるや、エンロン株はUS$20.65に下落した。エンロンの財務諸表を監査していた監査法人アーサー・アンデルセン（Arthur Andersen）はエンロン関連の書類を一斉にシュレッダーにかけ始めたことが報道された。全米第2のエネルギー企業であるダイナジー（Dynegy）は、エンロン買収計画を発表したが、エンロンの信用査定がジャンクボンド扱いに格下げされたことを理由に買収計画を白紙に戻した。この発表があった直後に、エンロン株はUS$0.61に暴落、2001年12月2日エンロンは米国破産法第11条に基づき破産後の財産保全申請をニューヨーク地裁に申請した。裁判所の査定は、同社の負債総額630億ドルに対し処分可能資産総額は120億ドルに過ぎないことを明らかにした。

倫理的利己主義が市場経済における経営倫理の規範として正当な役割を果たしうるのは、それが正しい知識ベースに裏づけされている場合のみに限られる。エンロン経営者達の知識ベースが不適切であったが故に、倫理的利己主義は企業不祥事の推進役に堕した。

キーワード：

・エンロン
・企業不祥事
・時価評価会計
・企業統治

*1 日本橋学館大学 人文経営学部

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