The basic premise behind Enron's strategy is to create markets for goods and services that were traditionally transacted through legacy distribution channels with complex sales forces and long-term contracts. Enron entered into these markets not only as a broker and trader, but often also as a market maker, holding positions for long periods. In some cases Enron made strategic investments in key physical assets, Enron created an ability to complete the markets. This also gave Enron an ability to add risk management features to its products and differentiate from the commodity product of its competitors. For instance, Enron took positions on the physical and knowledge assets (such as logistics, risk management, and back office capabilities) to provide high-margin structured products to customers via eCommerce platforms.

Jeff Skilling, who was at the helm of Enron during the heady days of the 1990s, saw Enron providing the means for asset-heavy companies to breakup into efficient units keeping only the risks for which they had a comparative advantage. The markets would be used to transfer all other risks. As the market maker, Enron would pick up a handsome bid-ask spread. Management guru, Gary Hamel, coined the term “market operating system” (MOS) to describe Enron’s business model.

Critical to successfully implementing this strategy requires a solid credit rating and an ability to accurately measure and coordinate transactions in multiple markets. This is particularly difficult when some markets are well organized (e.g., have traded spot and futures) while others involve a multitude of one-of contracts, often requiring additional efforts to secure the underlying physical assets. Although Enron found attractive profit opportunities by serving as a market maker, in doing so, Enron had to bear several new types of risk (for example, credit risk and liquidity risk). Enron took pride in doing managing these risks and became Wall Street’s poster boy for innovative risk management. In fact, then CEO Jeff Skilling often pointed to this as a key competency of Enron.

The importance of good credit for an operation like Enron's cannot be overstated. Their ability to execute a contract with forward delivery obligations relies on being able to convince the counter party of ones ability to honor and service the contract during its entire life. In the earliest days Enron did so by creating asset backed subsidiaries -- like the Cactus fund for securitizing natural gas. As it became successful, Enron was able to use their own balance sheet instead of tying up marketable assets such as Treasury securities. As the stock market capitalized Enron’s potential future value (at its peak, Enron’s price-to-earnings ratio was in the range of Internet firms), Enron was able to achieve very high leverage on its asset base.
The complexity of Enron's business model made their balance sheet opaque to the markets. But growing earnings and the aura it achieved in both financial and business communities, made other market participants see Enron as an excellent credit risk. [Enron’s management team was ranked as number one in Fortune’s list of companies, ahead even the much touted management team at GE.]

I believe the root of their problems has a lot to do with growing too fast, into market areas where Enron did not have a comparative advantage either in complementary physical assets or knowledge. In the process Enron lost its ability to keep track of all the risks and often took on large positions and faced unforeseen risks. For example, Enron did not have deep expertise in markets like telecommunications bandwidth, water, steel, paper pulp, semiconductor chips, or advertising, to name some of their recent forays.

It is as if Enron’s phenomenal success created such hubris in the top management that they began disregarding the much touted risk management discipline. In particular, Enron made two big bets over the last few years: Bandwidth services and Enron Online (and its associated “Net Work” ventures).

In setting up the bandwidth business they took large positions that couldn't be hedged out -- they have a big long position on intercontinental fiber capacity of which a large amount is still dark and will remain that way given the economic slowdown. Many of the illiquid markets required holding large open positions for long periods. In effect, they began speculating on things for which they had no comparative advantage. Even if they were smart long-term positions, Enron faced large liquidity risks, much like LTCM.

Enron Online is simply a convenient trading vehicle for commodities that were traditionally transacted via intermediated markets. Enron began playing the role of a market maker to jump-start some of the thinly traded markets. Again, this called for taking and holding large positions. Given the economic downturn any long positions they had are likely to have hurt them. In any case, the revenues of Enron Online depend on trading volume. But costs were mostly fixed (information technology and people cost of the trading organization). This exacerbated Enron's exposure to general economic activity.

In order to maintain the foundation of their top-notch credit rating Enron focused intensely on maintaining a solid balance sheet. Quarter after quarter Enron produced very high growth in earnings. (Although, in the past few years, their margins narrowed substantially. Hence, they were carrying very large volumes to generate the revenue base needed to continue earnings growth.)

What brought about such a precipitous fall is the actions Enron took to camouflage their true earnings. They hid behind an array of accounting loop holes by creating asset swaps with related-party partnerships. In mid-October Enron announced that it had overstated its earnings by nearly $1.2 billion as part of such a related-party transaction. Although details of these partnership ventures are as yet unknown, they would presumably have the following flavor: Enron sells bad (non-performing) assets to wholly owned third parties. The asset purchases
financed by loans from Enron, would be reflected at full value in Enron’s balance sheet. The partnership’s accounts would not be consolidated with Enron. These revelations were a fatal blow to Enron’s reputation. Its reputation was critical to Enron’s ability to trade and be a market maker.

The original motivation for such special purpose entities (SPEs) is to transfer risks away from a company’s balance sheet to a set of investors having a comparative advantage to bear such risks. In the case of Enron, it appears that financing of the SPEs were backed by Enron’s equity with further protection provided by topping-up clauses in case Enron equity fell below a threshold. In effect, Enron was able to use equity disguised as debt. The natural question then is, “how much of the problems are due to the lack of transparency, not only to the public but also to the various institutions lending to the SPEs?” It is also clear that the various parties (auditors, board of directors) who are expected to perform oversight, monitoring and due diligence failed.

Does what happened at Enron spell the end to Enron’s business model? I think not. The model is sound but implementing it requires much management discipline. The entrepreneurial culture at Enron was well suited to strategically experiment with this new model. Its many successes forever changed the landscape of several industries. As is common in history, the model will be fine-tuned by followers.