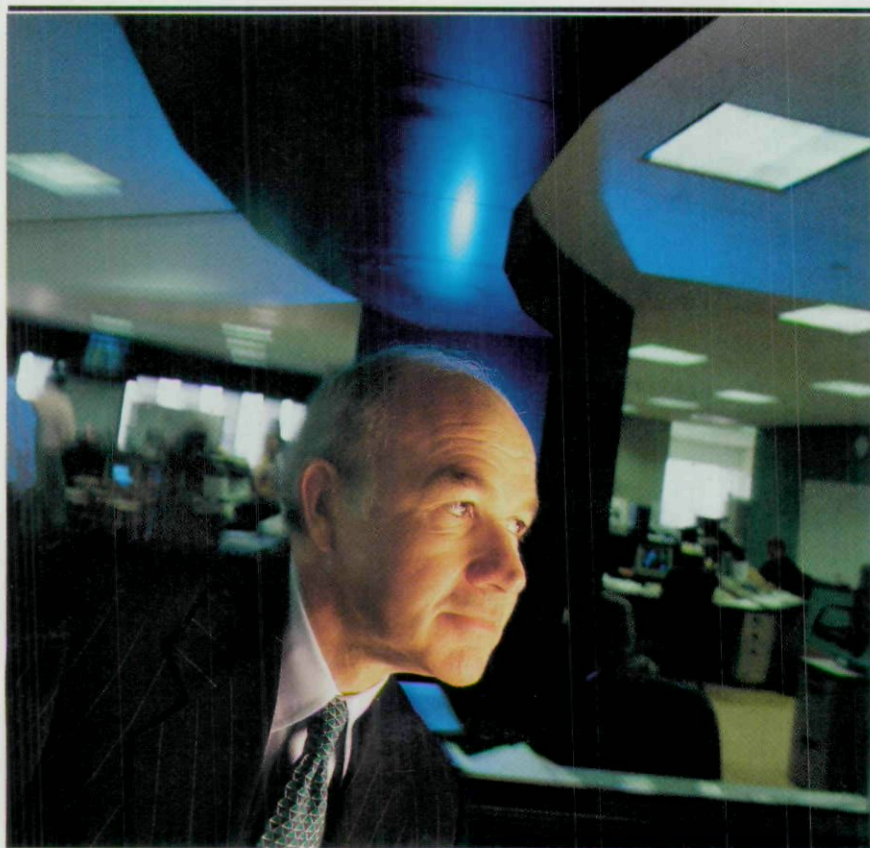
On Wall Street and in the oil patch, Ken Lay's Enron Corp. has been a smashing success. Here are some things that could go wrong.

Hidden risks

By Toni Mack



Doug Milner

Enron Corp. Chairman Kenneth Lay
Aggressive people, aggressive accounting.

ALMOST ALONE AMONG natural gas pipeline executives, Enron Corp. Chairman Kenneth Lay saw opportunity in the mid-1980s bloodbath of gas deregulation. As the safe world of protected gas markets collapsed, Lay borrowed heavily to acquire and merge four pipelines, thus creating Houston-based Enron in 1985.

And then gas prices tumbled. For a few harrowing years Enron was barely able to throw off enough cash to service its debt.

Today 51-year-old Ken Lay looks like a genius. Enron (revenues, $6.3 billion) sells or transports a fifth of the nation's gas supply; its nine gas-fired generating plants around the globe rank it the world's third-largest independent power producer. Earnings surged 20% last year to $306 million, or $2.58 a share. Another 20% rise is expected this year.

Wall Street loves Enron. Since the start of the year, the stock has jumped 34%, to an alltime high of 63½ in March. Even at a recent 55⅞, the stock is a rich three times book value and 18 times expected 1993 earnings. The S&P 500 sells for 16 times estimated 1993 earnings.

But overlooked in this euphoria are some big risks Lay is taking as he pushes Enron's profits up so fast.

Lay and his protégé, Enron Gas Services Group Chairman Jeffrey Skilling, have adopted some very aggressive accounting practices. In 1991 Enron became the first and only nonfinancial public company to adopt mark-to-market accounting principles. For Enron, this means it books the discounted present value of future profits from fixed-price gas contracts as soon as the contracts are signed. It works like this:

Suppose Enron has two five-year contracts—one to sell a certain amount of gas to a utility, another to buy the same amount of gas from a producer. Netting one against the other yields a gross profit to Enron of $2.2 million. Enron then deducts shipping costs and reserves for unforeseen costs. That leaves profits of $930,000 over the life of the contracts, or $729,000 at present value after discounting at 8.7%.

This is presumably what an outside buyer would pay for that pair of contracts. So as soon as the contracts are signed, Enron takes all $729,000 into profits immediately. Under conventional historical accounting rules, Enron would spread the profits over the life of the contracts, taking into income just $186,000 per year. Enron Gas Services' Skilling says roughly half of the company's $122 million profit last year came from marking contracts to market in this manner.

What's wrong with this mark-to-market accounting? Nothing—as long as nothing major happens to impair the value of the contracts. But if something unpleasant does happen, then Enron would be forced to book losses as it wrote down the contracts.

Several factors could force such a writedown. Enron has literally billions of dollars at stake in contracts that depend on the company's suppliers, customers and financial partners living up to their obligations. What if a significant number of these other parties can't?

"That's the risk that is *the* issue," says Skilling. To protect the company, he says he requires contract counterparties to have at least triple-B credit ratings or similar credit backing. And just in case, Skilling has established a $49 million reserve for unexpected

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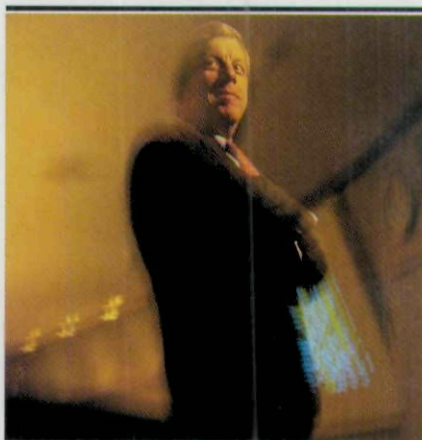
losses.

Is that enough for a $2.7 billion (revenues) gas marketing operation? Good question.

There are other risks. Enron signs contracts extending as long as 20 years. Political winds, though, are hard to predict even a few years out.

Take Clinton's proposed energy tax. What if the tax on gas were to land on middlemen like Enron? Not passing along the tax could seriously hurt Enron. Yet when FORBES asked Lay whether Enron's sales contracts allow



Doug Milner

Enron President Richard Kinder
Can Enron grow at 20% or better?

Enron to pass along such a tax, he replied that only "some" contain such protection. Enron now says "most" do.

A third risk involves Enron's ability to keep signing more and more new contracts year after year. Explains Jake Ulrich, senior vice president of Enron's biggest rival, $2.5 billion (sales) Natural Gas Clearinghouse: "If you accelerate your income, then you have to keep doing more and more deals to show the same or rising income."

Retorts Enron President Richard Kinder: "We think we can maintain a 20% or better growth rate [in gas services] each year."

So far Wall Street is putting its collective faith in Lay. As Donaldson, Lufkin & Jenrette analyst Curt Launer puts it: "You have to give them [Enron] the benefit of the doubt."

Maybe so. But given Enron's high price-to-earnings multiple, Ken Lay has no room to disappoint. ■

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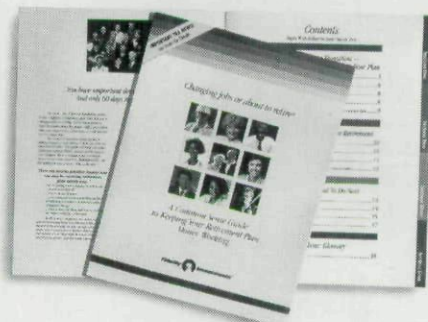

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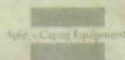

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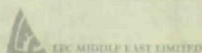

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