Enron and the Future of Capitalism

Christopher Culp and Steve Hanke of the Cato Institute have published a very interesting policy analysis of Enron and the reasons for its failure. Their point is that business failure based on management error in applying sound business principles should not be punished, and that Enron's failure was the consequence of its deviation from an originally successful business model. The fraud and other misconduct was simply a misguided and inappropriate attempt to save the company for which the company and the individuals involved should be punished. While I agree with them on this point, there is another, more important lesson to be learned from Enron – the increasing importance of an understanding of commodity pricing theory in a global economy. There is a link to the document below.

While interesting, this is not easy reading. But, with rare exceptions, the principles Culp and Hanke discuss will have to be mastered by most enterprises in our economy. To date, corporate management has been able to get by with only a passing familiarity with neo-classical economic theory. Globalization of the economy and increasing commoditization of most goods and services will require much more than a passing familiarity with neo-Austrian economic theory, the principles that both made Enron successful and that, when ignored, led to its downfall.

Culp and Hanke do not clearly explain commodity pricing, and an understanding of the consequences of dealing in a commodity would be helpful to an understanding of their analysis of Enron. Basically, the price of all commodities trends toward the marginal cost of the lowest cost, or most efficient, producer. Since the marginal cost is the cost of producing an additional unit of output, the seller with the lowest fixed costs is often the one with the lowest marginal costs, because competitors' marginal costs have higher fixed cost components. I would also suggest that, for similar reasons, sellers with the lowest weighted average cost of capital are likely to have the lowest marginal costs, provided they are not burdened by excessive fixed costs.

Although commodity prices trend toward the marginal cost of the lowest cost producer, prices do not ever get to that level because of market frictions such as supply chain bottlenecks, government regulation, artificial barriers to entry, taxes and – most importantly for Enron and most other commodity companies – asymmetric information.

Jeff Skilling recognized that increasing sales in a commodity market where prices are continuing to fall would not be a successful, long-term business model. He looked at the problem of selling in a commodity market and concluded that to make money the firm had to efficiently exploit market frictions and profit from the difference between the current price and the anticipated future price in ways that brought value to customers.

So, initially Enron embarked on a strategy of acquiring control, if not ownership, of supply chain assets in the energy business and offered customers economic solutions to their energy cost problems. This was done by establishing and growing a derivatives and trading business. Enron prospered because it understood the energy business very well and had market frictions, particularly asymmetric information, working in its favor. Its capital investments were low, a strategy referred to as "Asset Lite", and this enabled the company to earn high returns on invested capital (much of which was initially debt capital).

It then made two mistakes. First, it made substantial up-front capital investments in new commodity markets (like water utilities) in anticipation of changing conditions that would cause those markets to ultimately fit the energy business model. Second, it entered the electricity and broadband data markets, where it offered no economic value because it had no market frictions or – since it did not understand the underlying businesses – asymmetric information to exploit.

The accounting and financial reporting improprieties were incidental. They were desperate attempts to save a firm that was destined to fail eventually. The lesson of Enron's failure is not found in these shenanigans. Enron teaches that in commodity markets deviating from sound business models based on neo-Austrian pricing theory is fatal.

Increasingly, most goods and services are becoming commodities. The rear guard action of most companies against commoditization is why intellectual property has become so important. A product can only maintain a price significantly in excess of marginal cost by minimizing competition with effective intellectual property protection. What most companies have failed to recognize is that, with the exceptions of composition of matter patents and brand equity based on trademarks, intellectual property protection is almost never effective.

The current cohort of CEOs and CFOs who base their strategies on short books with small words and titles beginning with phrases like "Four Winning Strategies…" and "Seven Simple Rules…" are in for a very rude awakening. Without an understanding of commodity pricing theory and a strategy to exploit market frictions in a way that adds value, their companies will not succeed.