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Ken Lay's Junk Bond Ride Up on the Natural Gas Express

A popular notion as to why Enron failed is that its leaders didn't "stick to their knitting." When Ken Lay joined Houston Natural Gas (the firm that would grow to become Enron) as its chief executive officer (CEO) in 1984, the company was an undistinguished utility whose business focused on moving natural gas through the pipelines that were its major assets, extending thousands of miles across the United States. Over time, Enron became a trading giant that would play a major role in every new market that came along, luring away some of Wall Street's top talent in the process. But in the late 1980s and early 1990s, the deregulating natural gas and electricity markets would be its bread and butter both as an energy company and as a Wall Street type trading firm. While there can be no question that Enron's hubris caused it to eventually overextend itself, entering markets where it had no business being, its initial inclination to expand was a sound business decision.

From the beginning, Enron was different from other companies. Most successful companies trace their roots to a powerful innovator and the products that grew out of his or her innovation. Thomas Edison's lightbulb ultimately became the General Electric Company. Bill Gates's brilliant marketing of a personal computer operating system laid the foundation for Microsoft. In contrast, Enron was based on an idea. While Ken Lay, Enron's founder, did not think of the idea that fueled Enron's growth, he embraced and advocated it with the fervor that one might expect from the son of a Baptist minister from rural Missouri. The idea that drove Ken Lay and fueled Enron was that of the power of the free market system.

Ken Lay's background was quite unlike that of a typical corporate chieftain, most of whom have formal training in engineering and/or management. All of Ken Lay's degrees, including his Ph.D. from the University of Houston, were in economics. Among the many positions he held before he settled down at Enron was a job teaching economics as an assistant professor at George Washington University. Ken Lay could easily have ended up writing policy papers at a conservative think tank or as a pundit on a cable news network, but instead he became head of one of the largest (and for a time one of the most respected) companies in the United States.

In the 1980s, the world's image of Texas businessmen was shaped by the television show *Dallas*, which centered on the chicanery of Texas oil baron J. R. Ewing. The fictional J. R., played to perfection by Larry Hagman, epitomized what many people saw to be the evils of the market system. He sold a dirty product, crude oil, and employed even dirtier means to get his way. J. R. Ewing's behavior went far beyond that of a typical capitalist to that of an out-and-out anarchist. To him, the rules of the market were meant to be broken whenever it was convenient. In contrast, Ken Lay dealt in a relatively clean product, natural gas.

Until demand for energy started to outstrip supply in the 1960s, oilmen found natural gas to be a nuisance. Crude oil and natural gas were often discovered together, and oilmen would have to burn the gas off in large flares in order to extract the oil. Fortunately for the blue skies of Texas, natural gas, unlike oil and other fossil fuels, burns very cleanly. Still, the growth in the big cities of Texas and California, as well as other sprawling metropolitan areas that relied on the automobile for transportation, led to a growing pollution problem that by the 1960s could no longer be ignored. With other alternative energy sources still on the drawing board, environmentalists embraced natural gas as the only fossil fuel to provide a clean alternative to petroleum products.

HOUSTON'S J. R. OF NATURAL GAS

Before we explore where Ken Lay's crusade for natural gas ultimately led him, it is worth noting that Ken Lay and J. R.

Ewing did have many things in common. Lay was not known for tolerating rivals, even if they had been close business associates for some time. At Enron, for example, the vice chairman's position was known by many Enron senior executives as the "ejector seat." Those who had been ejected from this number two position, or jumped out themselves, included executives such as Richard Kinder, Rebecca Mark, Cliff Baxter, and Joseph Sutton, all of whom held the vice chairman's role in title or function. It seemed that the faster Enron grew, the sooner it would need a new vice chairman. Furthermore, like J. R., Ken Lay exerted political influence and deal-making savvy to have the rules changed in ways that worked in his and Enron's favor. Lay's transformation of Houston National Gas into Enron, and his ability to remain in the driver's seat, would certainly have earned one of J. R. Ewing's trademark grins.

When Lay took the reins of Houston Natural Gas in 1984, he faced an enormous problem. Houston Natural Gas was a relatively small company, and Wall Street was in the midst of a mergers and acquisitions binge in which the little fish were becoming an endangered species with so many big fish eager to swallow them up. Indeed, Kenneth Lay came to the attention of the board of directors of Houston Natural Gas when the company was in the process of fending off a hostile takeover bid from Coastal Corp. He was quickly able to double the size of the company by acquiring two other natural-gas companies, Florida Gas and Transwestern Pipeline. Lay's next move was to team up with InterNorth, a similar company based in Omaha, Nebraska, whose pipelines were a natural fit with Lay's. Though InterNorth saw itself as acquiring Houston Natural Gas, Lay pitched it to his people as a merger. Sure enough, it took only a year for him to wrest control of the new company, which was now called Enron, from its CEO, Samuel Segnar. By itself, the new name was a signal of the company's ambition, given its resemblance to that of Exxon, the energy giant where Ken Lay had started his career in 1965 when the Houston division was known as Humble Oil.

In the process of creating Enron, Ken Lay had to fight off a bid by Irwin Jacobs, the renowned corporate raider, to take over the company. Jacobs had accumulated a substantial stake in InterNorth before the merger, and Enron got rid of him by buying back this stake at a substantial premium. Jacobs' tactic of mounting a threat to take over a company for the purpose of selling the shares back to it at a huge profit, something Gordon Gekko did in the 1987 movie *Wall Street*, was popularly known as "greenmail."

Ken Lay could only save Enron from the clutches of Irwin Jacobs by using $230 million in excess funds in the employee pension fund to buy stock and by borrowing the money to pay him off. To get this money, Ken enlisted the aid of Michael Milken, Wall Street's junk bond king who operated out of the Beverly Hills branch of Drexel Burnham Lambert. Until Milken came along, Drexel was a second-rate New York investment bank. It then quickly gained prominence as the premier issuer of junk bonds before collapsing in 1990 as the result of a scandal that would ultimately send Michael Milken to prison.

Like Ken Lay, Michael Milken was an idea man. His big idea came from research that he conducted as a student at the Wharton School of Finance. He found that corporate bonds that the ratings agencies did not consider worthy of gaining their seal of approval in the form of an investment-grade rating, which came to be known as junk bonds, were a great investment. Financial markets tended to avoid such bonds, so their prices were usually much lower than their true value. If Milken's reasoning had stopped there, that insight alone could have made him quite wealthy, but he took things another step further and became filthy rich as a result.

The bonds that Milken studied were mostly "fallen angels." These bonds were investment grade when they were issued but over time had fallen out of favor with the agencies (led by Standard & Poor's and Moody's Investors Service) that rate them. Usually these downgrades were the result of business setbacks that drained a company's financial resources and raised the possibility that it might eventually default on its bond payments. The main reason that the price of a bond that fell into disgrace could plunge to bargain levels was that large investment managers, especially those who managed pension funds, were legally bound to hold only investment-grade bonds. In general, the companies that had the financial strength to issue bonds were large companies, leaving smaller companies out of the financial markets and at the mercy of banks.

Michael Milken, though sheer force of will and hard work, created a new financial market in which smaller companies could issue junk bonds and investors could buy them, making both sides better off and generating huge fees for Milken and his Drexel Burnham brethren that had no precedent on Wall Street. Milken not only helped companies to issue junk bonds, he increased their value to investors by maintaining an active secondary market for them after they were issued. (Unlike stocks, only a tiny fraction of all bonds are traded on public exchanges.) The main problem with junk-bond financing is that investment bankers, lacking the regulatory oversight of their less well compensated counterparts at commercial banks, in the heat of competition could make one bad deal after another. Such deals would overload the issuing company with debt to the point where one wrong move could drive it into bankruptcy. The investors in the junk bonds would suffer as well because the value of their investment would be reduced to whatever they could salvage in bankruptcy court, which often was pennies on the dollar. In the short run, the deal makers would profit from their huge fees, but as bankruptcies increased, which they did in the early 1990s, they would become the lepers of Wall Street for several years.

As the money that could be made from junk bonds increased, so did the tendency to violate securities laws. The biggest offender was Ivan Boesky, whose "greed is good" attitude and insider-trading activity inspired the creation of the Gordon Gekko character in *Wall Street*. Milken had close ties to Boesky, and those ties ultimately got Milken a prison sentence as part of a plea bargain. While Milken maintains his innocence, his poor judgment in picking his business partners in the process of building his empire led to his downfall regardless of whether he truly committed a crime.

A MOUNTAIN OF DEBT

Ken Lay, who kept in contact with Michael Milken years after Milken was released from prison, clearly viewed him as a kind of role model. Making a new market, as Milken did with junk bonds, could be the road to fantastic wealth. Unfortunately, Ken Lay failed to heed the lessons of Milken's failure. He often rubbed elbows with this controversial figure in finance, including a private meeting in May 2001 that was purportedly held to drum up support for Lay's solution to California's energy crisis. To say the least, Milken was a strange but visible guest to this secretive meeting, which included luminaries such as Arnold Schwarzenegger and Richard Riordan, the mayor of Los Angeles. These were lessons that Lay would end up experiencing for himself in his own way.

With control of Enron secured by a mountain of debt obtained with Milken's assistance, Ken Lay faced an enormous challenge to Enron's future. He believed fervently in free markets, but the market for natural gas was about as far from free as you could find in the United States.

The problem began with the Arab oil embargo in 1973, when the Nixon administration imposed wage and price controls in a failed effort to keep inflation manageable. Most wage and price controls were removed as their futility became apparent and were replaced by such laughable efforts as the WIN (Whip Inflation Now) button campaign of the Ford administration. Energy prices, however, remained under federal control.

Like Forrest Gump, who magically appeared in the background at critical points in history, Ken Lay left Houston for a while during the early 1970s to work in the federal energy bureaucracy and rose to the position of deputy undersecretary of energy at the Interior Department. As one of the few avid proponents of free markets at the time, he attracted some attention by his arguments for the deregulation of natural gas. It would be nearly a decade before serious efforts at deregulating the industry would make it into law.

ENRON RIDES DEREGULATION WAVE

As Enron was being born in 1985, the Reagan administration was in the process of dismantling the price regulation that had inhibited the growth of the natural gas industry. While both the Reagan and Bush administrations strongly backed deregulation, the enabling legislation would have to go through a Congress controlled by Democrats. Although it took several bills and lots of lobbying, by the time Bill Clinton took office in 1993 deregulation of natural gas at the federal level had run its course. What regulation remained was largely at the state level.

In the process of freeing Enron from the shackles of federal regulation, Ken Lay came to master another of J. R. Ewing's specialties—political hobnobbing. Indeed, as Enron grew, the charming Mr. Lay became its "outside man," leaving the day-to-day internal operation of the company to his underlings. Lay combined considerable charm, homespun roots, and economic expertise in a way that made him a natural to make the case for policies that would benefit Enron.

Lay and others at Enron contributed lavish amounts to politicians and the "soft money" institutions that helped fund them. He was a constant presence not only in both Bush administrations, but in the intervening Clinton administration as well. Because natural gas was seen as friendly to the environment, Lay was embraced by failed presidential candidate Al Gore, who supported the Kyoto Accords that his opponent George W. Bush and many other Republicans found unacceptable. Lay played both sides of the aisle so completely that when the matter of Enron came up for Congressional hearings in 2002, there were few key committee members who had not received campaign money from Enron.

Kenneth Lay's mastery of politics both inside his company in Houston and with the federal government in Washington was not enough to make the business successful. Like other companies burdened with junk bond interest payments to make, Enron had to either grow quickly or die. Enron came into existence with a natural-gas pipeline system that already spanned much of the United States, so further growth in that area was limited. However, deregulation of energy markets was creating new markets, new opportunities, and new temptations.