CORPORATE AFTERSHOCK

The Public Policy Lessons from the Collapse of Enron and Other Major Corporations

Edited by Christopher L. Culp and William A. Niskanen

CATO INSTITUTE

JOHN WILEY & SONS, INC.
CORPORATE AFTERSHOCK
CONTENTS

About the Editors vii
About the Contributors ix
Preface xvii
   Christopher L. Culp
Acknowledgments xxiii
Introduction xxvii
   William A. Niskanen
Editors’ Note xxix

PART ONE CORPORATE INNOVATION AND GOVERNANCE 1

1. Empire of the Sun: A Neo-Austrian Economic Interpretation of Enron’s Energy Business 3
   Christopher L. Culp and Steve H. Hanke
2. Corporate Accounting after Enron: Is the Cure Worse Than the Disease? 28
   Richard Bassett and Mark Storrie
3. Corporate Governance: Pre-Enron, Post-Enron 49
   Alton B. Harris and Andrea S. Kramer

PART TWO ENERGY AND DERIVATIVES MARKETS AFTER ENRON 89

4. Wholesale Electricity Markets and Products after Enron 91
   Andrea M. P. Neves
5. Regulation of Wholesale Electricity Trading after Enron 106
   Andrea S. Kramer, Paul J. Pantano Jr., and Doron F. Ezickson
6. Online Trading and Clearing after Enron 130
   John Herron
CONTENTS

7. Do Swaps Need More Regulation?  
   David Mengle  

PART THREE STRUCTURED FINANCE  AFTER ENRON  151

8. An Introduction to the Business of Structured Finance  
   Barbara T. Kavanagh  

9. Structured Commodity Finance after Enron: Uses  
   and Abuses of Prepaid Forwards and Swaps  
   Christopher L. Culp and Barbara T. Kavanagh  

10. Accounting and Disclosure Issues in Structured Finance  
    Keith A. Bockus, W. Dana Northcut, and Mark E. Zmijewski  

PART FOUR CREDIT RISK MITIGATION  AFTER ENRON  209

11. Credit Risk Management Lessons from Enron  
    Christopher L. Culp  

12. Credit Derivatives Post-Enron  
    Andrea S. Kramer and Alton B. Harris  

13. The Market for Complex Credit Risk  
    Paul Palmer  

PART FIVE REGULATING CORPORATE INNOVATION AFTER ENRON  263

14. Cowboys versus Cattle Thieves: The Role of Innovative  
    Institutions in Managing Risks along the Frontier  
    Fred L. Smith Jr.  

References  301

Index  311
ABOUT THE EDITORS

Christopher L. Culp is an adjunct professor of finance at the Graduate School of Business of the University of Chicago, where he teaches graduate-level courses on derivatives, alternative risk transfer, risk management, and investments. He also offers a graduate seminar on insurance during winter quarters as a guest professor of risk and insurance in the Institut für Finanzmanagement at Universität Bern in Switzerland. A principal at CP Risk Management LLC, Culp provides consulting services on corporate financial strategy, risk management, and capital allocation to nonfinancial and financial institutions. He also provides litigation consulting and expert testimony as a principal for Chicago Partners LLC. In addition, Culp is a senior fellow in financial regulation at the Competitive Enterprise Institute, and is a nonexecutive independent director of IDACORP, Inc., and Idaho Power Company, Inc., where he sits on the Audit and Corporate Governance Committees of both boards of directors. Culp’s latest book, Risk Transfer: Derivatives in Theory and Practice is forthcoming in the summer of 2003 from John Wiley & Sons. He is the author of two prior books, also published by Wiley—The ART of Risk Management: Alternative Risk Transfer, Capital Structure, and the Convergence of Insurance and Capital Markets (2002), and The Risk Management Process: Business Strategy and Tactics (2001)—and he co-edited Corporate Hedging in Theory and Practice: Lessons from Metallgesellschaft (Risk Books, 1999) with Merton H. Miller. He writes frequently on corporate finance, risk management, and valuation, and is co-editor for derivatives and risk management of the Financial Management Association’s online journal FMA Online. He is a member of the editorial advisory boards of the Journal of Applied Corporate Finance, the Journal of Risk Finance, and Futures Industry magazine. Culp holds a PhD in finance from the University of Chicago’s Graduate School of Business and a BA in economics (Phi Beta Kappa) from the Johns Hopkins University.

William A. Niskanen, an economist, has served as chairman of the Cato Institute since 1985, following experience in academy, government, industry,
and other policy institutes. He joined Cato after serving as a member and acting chairman of the Council of Economic Advisers under President Reagan. His prior experience in the government included serving as an assistant director of the Office of Management and Budget under George Schultz and as director of special studies in the office of Secretary of Defense Robert McNamara. As a professor of economics, Niskanen taught at the University of California at Berkeley and Los Angeles. He also organized and directed a program to teach economics and systems analysis techniques to military officers. His first position out of graduate school was as a defense analyst at the Rand Corporation, and he later served as a division director at the Institute for Defense Analyses. In the late 1970s, he was the director of economics at the Ford Motor Company. Niskanen has a BA from Harvard and an MA and PhD in economics from the University of Chicago. His professional specialties have been public finance and public choice. He is the author of the following books: Bureaucracy and Representative Government; Reaganomics; Going Digital!; Policy Analysis and Public Choice, a fifth book that will be published later this year, and many articles. His primary reward as a co-editor of this book, he relates, is continuing a lifelong learning experience with new issues and techniques.
ABOUT THE CONTRIBUTORS

Richard Bassett is the cofounder and managing director of Risktoolz, an international corporate finance consulting and software firm (www.risktoolz.com). Bassett's career in finance has included working in the merchant banking division of Security Pacific Bank in London and New York, where he was a registered securities dealer in the institutional bond and equity markets. He was managing director of Alcar Europe as well as managing director of Corporate Performance Systems worldwide. Bassett has led assignments that include: more than 35 M&A transactions with a cumulative value in excess of $60 billion; development of a corporate credit system for a major U.S. bank involving credit evaluation in 85 countries and the attendant problems in reconciling, or not, competing accounting practices; developing a series of strategic planning systems for global corporations, often involving hundreds of participants in scores of countries; worked extensively in developing optimal capital structure programs for large, diverse, multinational firms; and has been a pioneer in the introduction and establishment of shareholder value programs working with more than 100 companies since 1987. Prior to his finance career, Bassett worked as a ministerial assistant for the Minister of Fisheries and Oceans, Minister of Health, and the Cabinet Secretariat, in the governments of Canada and British Columbia. Bassett completed his undergraduate degree at the University of Victoria, Canada, and earned an MBA through a combined program at Boston College in the United States and Insead in France.

Keith A. Bockus is a principal at Chicago Partners LLC and at CP Risk Management LLC. Chicago Partners provides a multidisciplinary approach to consulting services on matters of economics, finance, accounting, and technology. Through its subsidiary, CP Risk Management, the firm offers specific consulting services for measuring and managing financial risks. Bockus specializes in microeconomics and financial analysis. He has consulted on various risk management matters, with a
particular concentration of clients in the banking and energy sectors. He also consults in various commercial litigation matters and testifies on damages issues. Bockus is also active in Chicago Partners’ forensic accounting practice. He holds MBA and PhD degrees from the University of Chicago Graduate School of Business, and a BA in economics (Phi Beta Kappa) from the Johns Hopkins University. Previously he worked as an information technology consultant to various U.S. government agencies.

**Doron F. Ezickson** is a partner in the Trial Department in McDermott, Will & Emery’s Boston office. He is partner-in-charge of the Boston office, co-chair of the firm’s Energy Practice Group and serves on the firm’s Management and Executive Committees. His energy practice involves a wide array of federal and state regulatory issues and litigation relating to the development and operation of the wholesale and retail electric markets. From 1991 to 1993, Ezickson worked for Massachusetts Governor William F. Weld, as deputy chief of staff/chief of operations and as assistant chief of staff. His responsibilities included management of the governor’s office operations, coordination of Cabinet activities, and policy development and implementation. Ezickson is also the former executive director of the Massachusetts Office of International Trade and Investment. Ezickson received his bachelor’s degree in Asian studies from Dartmouth College in 1981. He graduated magna cum laude in 1985 from Boston University School of Law, where he was an articles editor for the *Boston University Law Review*. Ezickson then served as a law clerk for the DC Circuit of the U.S. Court of Appeals. Ezickson is admitted to practice in Massachusetts; Washington, DC; and Pennsylvania.

**Steve H. Hanke** is a professor of applied economics and co-director of the Institute for Applied Economics and the Study of Business Enterprise at the Johns Hopkins University in Baltimore. He is also a senior fellow at the Cato Institute in Washington, DC, and a principal at Chicago Partners LLC in Chicago. In addition to writing a regular column in *Forbes* magazine, he is a contributing editor at *Forbes Global* magazine, *Central Banking*, and the *International Economy*. A distinguished associate of the International Atlantic Economic Society, Hanke was named by *World Trade* magazine as one of the 25 most influential people in the world in 1998.

**Alton B. Harris** is a founding partner of Ungaretti & Harris and heads the firm’s Financial Practices Group. He concentrates his practice in the areas of corporate finance and financial regulation, focusing particularly on the federal regulation of financial institutions and financial products and services. He was named by the *National Law Journal* as one of the 50
outstanding securities lawyers in the United States. Harris graduated from Harvard College and Harvard Law School. He is an adjunct professor of law at Northwestern University Law School where he teaches courses on the regulation of derivative products and the financial markets. He served as a consultant to the Reporter for the American Law Institute’s Federal Securities Code. He was a member of the Legal Advisory Board of the National Association of Securities Dealers. He is a member of the American Law Institute and the Committee on Securities Regulation of the American Bar Association. He is a life trustee of the American Bar Foundation.

John Herron is internationally recognized as a global expert and a leading entrepreneur in the financial markets. He was previously the CEO, founder, and developer of the Australian Derivatives Exchange (ADX), which was a pioneer among electronic exchanges. Herron’s vision of a competitive and efficient financial industry within a global market led him to Chicago, where he assisted in the establishment of Fair Market Associates (FMA), an industry consulting group. He is also a contributor to numerous financial market publications, and has recently been appointed as a nonexecutive director to 4DTrading, a U.K. financial software company. Prior to establishing ADX, Herron held senior banking positions within the Australian financial markets for over 15 years. He has lectured extensively at the Securities Institute of Australia and several universities. Herron holds a bachelor of economics, a bachelor of arts, and a master of commerce from the University of Sydney in Australia.

Barbara T. Kavanagh is a principal at CP Risk Management LLC, Chicago, Illinois. She has many years of experience as a risk management consultant working with major corporations and financial institutions all over the world. Her work has focused on trading markets, cash and derivative financial instruments, and structured finance and securitization for nearly 15 years. Prior to her current position, she was the senior credit officer in ABN AMRO’s investment bank in North America, a risk management consultant with KPMG and Ernst & Young, and worked for many years within the Federal Reserve. During her career inside the Federal Reserve, she was involved in a number of public policy making matters, including those relating to trading markets, structured finance and securitization, and trade clearing, payments, and settlements systems.

Andrea S. Kramer is a partner in the law firm of McDermott, Will & Emery, in its Chicago office. She is the head of the firm’s Financial Products, Trading, and Derivatives Group. Kramer focuses her practice on
xii ABOUT THE CONTRIBUTORS

tax and regulatory counseling and defense, legislative consulting, regulatory advice, documentation of customized and OTC financial products, risk management policies and procedures, and bankruptcy and creditors’ rights issues. She advises clients on the design, trading, and risk management applications of highly complex and rapidly evolving OTC products, such as securitized assets, electricity derivatives, emission allowances, weather derivatives, equity swaps, credit derivatives, contingent debt instruments, and hybrid products. Kramer devotes a substantial amount of time to representing taxpayers in contested tax matters. She is a frequent contributor to trade and professional journals, having written over 100 articles and publications on derivative financial products. She is the author of Financial Products: Taxation, Regulation, and Design (Panel Publishers, 3rd ed., 2000) a three-volume, 3,600-page treatise that is kept current with annual supplements. As the leading treatise on financial products law, it has been cited by the courts and commentators on several occasions. She is also co-editor-in-chief of the quarterly CCH Journal of Taxation of Financial Products. A frequent speaker at conferences and workshops, Kramer has presented close to 200 speeches and full-day workshops on trading activities and financial products. She has developed and conducts full-day training courses on the documentation and negotiation of swap transactions, financial product tax issues, and foreign currency tax issues.

David Mengle is head of research for the International Swaps and Derivatives Association, with responsibility for education and survey activities. He also teaches courses in economics and risk management at the Fordham University Graduate School of Business. Prior to joining ISDA in November 2001, Mengle worked in the Derivatives Strategies Group at J.P. Morgan in New York. During that time, he was active in ISDA educational and policy initiatives. Before that, he was a research economist with the Federal Reserve Bank of Richmond, specializing in bank regulation, payment system risk, and market value accounting. Mengle holds a BA from the Citadel and a PhD in economics from the University of California, Los Angeles.

Andrea M. P. Neves is a principal at Chicago Partners LLC and CP Risk Management LLC, where she provides economic consulting services in the areas of financial risk, derivatives valuation, and market mechanisms. She focuses on asset pricing issues arising from volatile market activity. She also provides expert witness testimony in these areas for litigation and arbitration resolution. Her typical clients include multinational corporations, investment banks, broker/dealers, asset managers, and derivatives
exchanges. Neves has worked extensively with electric utilities and power marketers on the crises that have affected the wholesale electricity trading markets in the United States over the recent years. Some of her most rewarding projects have been helping such clients incorporate risk management for a trading operation into an overall financial risk management strategy and framework. Neves also teaches a course in financial risk management in the executive education program at the University of Chicago’s Graduate School of Business, and she has authored numerous publications in financial journals. Neves received her BS in Physics from Mary Washington College, a MS in Physics from Texas A&M University, and a MA in Economics with an emphasis in finance from Virginia Polytechnic Institute in Northern Virginia.

**W. Dana Northcut** is a principal of Chicago Partners LLC, a consulting firm that specializes in the application of economic theory to a variety of legal and regulatory issues. He consults in the areas of accounting, finance, and valuation and has testified on damages issues. He is also adjunct associate professor of accounting at the University of Chicago Graduate School of Business where he regularly teaches accounting and financial analysis. Northcut has held other academic teaching and research positions and has professional experience as a Certified Public Accountant.

**Paul Palmer** is the CEO of Capital Credit, a merchant bank and asset management boutique that focuses on complex credit risk. He is former president of Enhance Structured Products at Asset Guaranty/Enhance Financial Services Group where he was responsible for creating credit risk transfer products for financial institutions and industrial companies globally. Palmer has created several innovative asset-backed structures for domestic and international clients, including the first-ever supply bond for an emerging market future flow securitization, the first-ever insured check remittance securitization, and the first synthetic capital product for stock and commodities exchanges. Palmer spent eight years with Asset Guaranty and was a member of the Board of Directors of Asset Guaranty Insurance and Enhance Reinsurance Companies. Prior to that, he was at American International Group where he worked in the financial product development and lending areas. Palmer has underwritten and managed over $30 billion in credit risk transfer exposures from global financial institutions. He has a BA in economics from the City College of the City University of New York, and has completed executive management courses at Stanford and Tuck business schools. Palmer’s work in the credit risk management arena was recognized by *Risk* magazine in January 1999.