EVERYONE'S A WINNER

It's all too easy to look back now with the gift of hindsight, and be the armchair expert. What's more difficult is to see things within their context at the time. Over the years, I have come to see Andy Fastow not as the embodiment of pure evil that so many people would have you believe. He was a human being, with frailties, one of which was that he was very greedy. But then most of us would probably plead guilty to that one, given the opportunity, and certainly the decisions that led me to invest in Southampton can be ascribed only to vanity or greed. Take your pick, really.

I don't think there is any doubt, even in his own mind, that Andy stepped across the line at some stage into criminality, even if he didn't realize it at the time. His testimony that he lied to Causey about where the $30 million was going was proof enough of fraud, and I suspect he would accept that. Likewise, he and Kopper had been lining their own pockets at Enron's expense for some years prior to the SwapSub deal.

But once you understand what happened with the SwapSub unwind, you perhaps get a little glimpse into the mind of a somewhat tortured genius. His greed was perhaps the product of marrying the heiress to a billion dollar estate, or maybe his envy of those that he saw as less able than himself at Enron who had amassed huge piles of the company's stock simply by dint of having been around for longer than him, and were consequently now rich beyond the dreams of avarice as a result of what maybe he saw as at least partially his efforts.

In any event, what follows is what I believe to be the definitive version of what happened over a very short period in March 2000. There is no doubt whatsoever that Fastow moved the pieces around the board. But my best guess is that he didn't think he was robbing Enron at all. I think he thought he was helping them out of a hole, and that $30 million was a small price for them to pay, particularly since none of it was going to go through their earnings statement. After all, Fastow needed SwapSub to be seen as a 'win' for Enron, because LJM2 was already up and running, and Fastow wanted to use the SwapSub model for some much larger and more aggressive transactions with Enron.

Andy recognized that Enron had got themselves in a pickle by overstating the value of the RhythmsNet derivatives on the balance sheet at year end 1999. These were the contracts with SwapSub, under which SwapSub promised to pay Enron if the share price of RhythmsNet collapsed. In short, the lower the RhythmsNet share price, the greater the value of the promise to pay.

The problem was that SwapSub could only pay to the extent of its assets, which were just over three million Enron shares, and as at year end 1999 these had an open market value of about $140 million, even ignoring the impact of the stock restriction, which would have further reduced their 'fair' value. So SwapSub's ability to pay on its derivative contracts as at year end 1999 should have been limited to $140 million at most. But Enron had the RhythmsNet contracts in their books as an asset with a value of $222 million.

Contrary to popular belief, it was Enron's decision to unwind SwapSub, not Fastow's initiative, and it was based on this problem, which was of their own making. Enron's specialist risk group had analysed the position in early 2000, and recognized that the ability of SwapSub to make good on its obligations was suspect, and consequently it was likely that Enron was going to have to take a significant writedown in its accounts come the quarter end in March.

When the Enron stock price went through the roof in late January 2000, therefore, Causey saw the opportunity to cash in the chips, and approached Fastow at the end of February with a view to unwinding the deal. Fastow, being a very smart guy, saw the problem that Enron had, and identified an opportunity for profit from solving it.

On a strictly 'fair' market basis, SwapSub's liabilities (the RhythmsNet derivatives) were probably in the region of $180 to $190 million in early March 2000, although of course the value was constantly moving. Its assets at the same time (the Enron shares) were worth around $200 million because of the huge jump in the price of the Enron stock after the January 20th announcement of Enron Broadband, but when the stock restriction was applied, this fell to about $160 million. So on a 'fair' market basis, SwapSub had negative value, meaning that if Enron just took back the Enron stock and ripped up the derivatives, it would have to record their value at just $160 million (the 'fair' value of the assets), resulting in a loss of $62 million against the year-end valuation of $222 million.

Disaster.

Fastow had a much better idea, which came in several parts. First, why not just ignore the stock restriction altogether, meaning that SwapSub's assets would be worth $200 million, rather than $160 million, and thus have more than enough value to cover the value of the derivatives? But even that would still produce a loss of $42 million for Enron if the derivatives were just given their fair value of $180 million, while the partners of LJM would walk away with a profit of $20 million.

So Fastow persuaded Causey to ignore the *actual* valuation of the RhythmsNet derivatives, and instead focus on an *implied* value. Instead of looking at what the value ought to be, let's decide what we *want* the value to be, and engineer it so that it is so. The higher the value of the derivative contracts on unwind, the lower the loss that Enron would have to take.

His plan was ingenious. Ignore the stock restriction, and at the date of unwind, pump up the Enron stock price, thus maximizing the value of SwapSub's assets. Deduct Fastow's $30 million price from the value of the assets, and whatever was left could be attributed to the RhythmsNet derivatives value. The higher the Enron stock price, the more earnings he would create, because the smaller the loss on the derivatives value.

If he could somehow get the value of the Enron stock to $252 million, unrestricted, then even after deducting the $30 million which would be paid to Southampton, Enron would be able to show an implied value of $222 million on the derivatives, and thus no loss on the trade. The magic was that other than for the $30 million, no cash would change hands, and none of the shares would actually need to be sold in the market. Enron would just take them back into its Treasury stock. All that would then be at risk would be the price of the RhythmsNet shares that Enron would hold unhedged on its balance sheet until the Quarter end at 31st March. And he had a plan for those, too.

It was totally upside down. Utterly wrong. But for Enron it was compelling. Pay nothing, do it properly, and take a loss of maybe $60 million to earnings. The $40 million 'gain' on the Enron stock from the stock restriction discount would be reflected only in Enron's capital account, not its earnings statement. Worthless. No cash spent, but a big loss.

Or play it Andy's way, pay $30 million cash, and maybe record no loss at all. The $30 million would never go through Enron's earnings statement, since it was in effect a payment to purchase some of its own stock, which was a strictly capital account transaction.

Everybody won.

Rick Causey would tell the investigators after the fact that he couldn't recall why he hadn't insisted that the transaction be unwound using the restricted value of the Enron stock. Since even Enron's auditors didn't pick up on it, I guess he was hardly going to blow the whistle on himself.

It was truly ingenious. But the trade needed assistance both from the inside and outside. Someone somewhere ensured that Enron's risk management group never got to look at the unwind, which under normal circumstances, according to Jeff McMahon, they should always have done.

For Causey, Enron employees Bob Butts and Mike DeVille were charged with getting the trade done. DeVille later testified to the Powers' investigators that he had been made aware that Fastow wanted LJM (in fact it was Southampton, but he did not know this) to walk away with $30 million, and that he thought Fastow was 'making a killing', but that his job was to assess whether the deal was fair to Enron, and in his view it was.

It would appear that the agreement as to the $30 million price was made between Fastow and Causey as early as 10th March, which was three days after GNW had agreed to sell its stake in SwapSub for $1 million, and several days before Fastow entered into negotiations with CSFB. By the time Fastow started those negotiations, therefore, he knew exactly what he had to play with, and what he needed to do.

Having fixed the price at $30 million, Fastow then needed the deal to close with the Enron share price as high as possible, since the value of the trade would be struck by reference to the Enron stock price on the date of the legal agreement. Thereafter, Enron would have an unhedged position in the RhythmsNet stock, and this too would need to be managed.

Enron was now in the situation that it was at risk of its own share price falling, and thereby reducing the amount of value in the deal. To eliminate this risk, Fastow got Enron to write him a Put Option, giving SwapSub the ability to sell its shares to Enron at a price of $71.31, the closing price of the Enron stock on 7th March, and just 30c per share shy of Enron's all time high stock price of 21st January, the day after it reinvented itself as a tech stock.

The market value of such an option for Fastow and LJM would be measured in millions of dollars, but because of the way the SwapSub transaction was about to work, it was actually more valuable to Enron than Fastow! They needed to be seen to buy their own shares back from LJM at the highest possible price, because the higher the price they nominally paid, the higher the implied value of the Rhythms derivatives, and the smaller their loss. Mel Brooks would have been proud.

On 22nd March 2000, Enron signed the agreement to pay $30 million to unwind the SwapSub transaction, ripping up the derivative contracts and taking back just over three million shares of its own stock. Enron's share price that day closed at an all time high of $75.0625, up nearly five per cent on the day and over fifteen per cent higher than the price just a week previously.

On the day of the unwind, over 5 million Enron shares were traded on the stock exchange, some three million more than the normal market volume. Coincidence? Perhaps; but I'm not a great believer in them. Not least because the share price fell heavily the following day, after the deal had been struck, and when it no longer mattered to Enron. The earnings had already been crystallized.

Since Enron would not take physical delivery of the SwapSub stock for another month, someone was out there buying the stock heavily in the market, pushing up the price. But who? Perhaps the New York Stock Exchange knows the answer. Certainly I don't, although I have my strong suspicions.

For Andy Fastow and Enron it was certainly a good day. At an unrestricted price of over $75 a share, SwapSub's total assets were valued at approximately $237 million, meaning that after deducting the $30 million that Enron was going to pay, the derivatives could be given an implied value of $207.5 million, a loss of just $14 million against year-end figures. The put option that Enron had given Fastow had not been needed.

Fastow wasn't finished there, however. In one of the internal LJM spreadsheets, there was a calculation of the target price that RhythmsNet shares needed to reach at the quarter end in order to leave Enron in a no-profit no-loss position on the entire deal as against its year-end 1999 figures. The calculations were done assuming that the value of the SwapSub Enron stock was $71.31 a share, indicating that this spreadsheet was done after the put option was granted and before the 22nd March.

At that price, the Rhythms derivatives would have an implied value of $195 million, giving a loss of $27 million against the year-end value, which would need to be offset by a profit on Enron's physical holding of RhythmsNet shares. The result was that the RhythmsNet stock price needed to be at no less than $36 a share come 31st March, to create a profit of $27 million on Enron's shareholding of 5.4 million RhythmsNet shares against their value at year end 1999, when their price had been $31 a share.

On 23rd March 2000, in an internal memorandum, the Enron business unit that owned the RhythmsNet shares was instructed to start selling them as and when possible, at a sale price of no less than $36, with all trades to be executed through Merrill Lynch. They would be disappointed. At no stage did the share price get that high over the coming week. On 30th March, RhythmsNet shares closed at a price of $29.5.

The following day, however, over twice the normal daily volume of Rhythms shares were traded, and the stock price rose nearly twenty five per cent to close the quarter at $36.812. Like with the Enron stock on 22nd March, there was a mystery buyer in the market, pushing up the stock price at a very fortuitous time.

In a separate spreadsheet done after the quarter end, all of the closing figures were recorded, showing that Enron had made a net gain in earnings, quarter on quarter, of over $15 million. The loss of $14 million on the derivatives had been offset by a gain of nearly $30 million on the rise in value of the RhythmsNet shares.

It was a triumph. Pure fantasy, of course, but in the weird and wonderful world of US accounting, it did the trick, if only for the purpose of quarter end reporting.

RhythmsNet shares never came close to reaching $36 again. In common with many tech stocks after March 2000, they started a long, slow road to oblivion. By the end of April, they were at just above $20 a share. By the end of December (when CSFB had predicted the price would be at $48 for the purposes of justifying their sales price of $10 million), the stock was at about $1 a share.

That Enron lost a lot of money liquidating their stake in RhythmsNet after 31st March is undoubted. But you could hardly blame Fastow for this. Getting rid of the stake, and unwinding the SwapSub hedge, was not his idea - it was Causey's. From the perspective of Andy Fastow, Causey had got them into a hole, and Andy had dug them out of it. If earnings statements are the measure of success, I suspect Andy thought that $30 million was a small price to pay for the rabbit he pulled out of the hat.

It would have been better for everyone if SwapSub had been a financial disaster for Enron, because it would have been a relatively small one, and they could have moved on, and the story might have had a very different ending.

Better still, if they had instead agree to implement the structure proposed in our supposedly fraudulent presentation of 22nd February, instead of unwinding SwapSub, Enron would have been able to keep its hedge in place for a further two years, and then walk away with about $220 million in cash when RhythmsNet went bust.

Instead, buoyed by its perceived success, SwapSub was to become the template for the much more complicated 'Raptors' in LJM2, which would play no small role in bringing down the company some twenty months later. These infamous transactions would be brilliantly caricatured in Lucy

Prebble's 2009 stage play *Enron*, where they were portrayed as velociraptors growling menacingly around Andy Fastow's office.

Enron kept digging holes by making bad business investments. A technology stock here. A Brazilian power plant there. Some spurious water business somewhere, perhaps. Fastow presumably saw himself as having to keep digging the morons in the business units out of their holes through his own efforts, and he was damned if he wasn't going to get paid for it. Between the bad business decisions and Fastow's ever more desperate attempts to provide hedges for them, Enron built a giant edifice which was predicated almost entirely on its own share price continuing on its upwards trajectory.

Vince Kaminsky, who worked in Enron's Risk group, and wrote papers on derivatives pricing, told the Powers inquiry in late 2001 that he had thought the concept of LJM and SwapSub, which he had derided in June 1999 before the transaction was done, was stupid but not illegal. The Raptors, by contrast, he described as both stupid and illegal. He and his group had been kept well away from these transactions until it was all way too late, and Enron was imploding.

When Jeff McMahon put the key piece into the middle of the jigsaw, so that finally we understood what had happened between Causey and Fastow, and why, other pieces of the jigsaw began also to fall into place, and as ever, some of them looked pretty unpleasant. Some key questions still remained unanswered, though.

Who, most notably, was buying all the Enron and RhythmsNet shares in the market on 22nd March and 31st March, and why were they doing it? My suspicions immediately fell on CSFB, of course. Part of me really wanted to prove that they were up to their necks in the whole murky adventure. Part of me was terrified to contemplate it.