could be at the center of all this—and wasn't that always the plan?—it stood to make a ton of money.

Without question, natural-gas trading was more complicated than other kinds of commodities trading. Unlike wheat or soybeans—or crude oil, for that matter—natural gas flowed continuously, 24 hours a day. Different hubs in North America, such as Chicago's City Gate or the Katy Interconnect near Houston, had their own pricing variations. There were transportation contracts, which were different from contracts guaranteeing price. There were capacity contracts, which reserved space on pipelines. And different users had different needs: power plants wanted long-term supplies; industrial users wanted more gas in good economic times and less in tougher times; utilities wanted seasonal gas, that is, they wanted more gas in the winter, when their customers had to heat their homes. Some customers were willing to pay a premium price to ensure the transportation of the gas; others might decide to pay less and contract with someone else for the transportation. There was an almost infinite number of moving pieces.

Skilling reveled in the complexity of the natural-gas market he was creating. He had one of his ready-made analogies so that everyone could see it the way he saw it. A natural gas contract was a little like a cow, he used to say. A cow doesn't just have one kind of meat; it has all sorts of different meats, from sirloin to hamburger. And people are willing to pay different prices for the part that they want. In the same way you could divide a gas contract into many different parts and sell them to people with different needs.

In fact, some of the people you traded with might not even be in the natural-gas business at all. To be a player in this new business, you just needed to understand the price of natural gas and the concept of risk. In the coming years, Wall Street firms piled into the business, but Enron always had a huge advantage. Its immense network of physical assets, its ability to tie all the moving pieces together and provide physical delivery of the gas itself, and its long history in the gas business gave it insights its Wall Street competitors could never match. These, alas, were lessons Enron would one day forget.

But that was still in the future. For now there was tremendous excitement in Skilling's group about what they were doing, and they brought to it a missionary zeal. Early employees in Skilling's division would always recall those days as pure magic—a time when anything seemed possible and much of what they did turned to gold. Skilling himself was down-to-earth, accessible, and open to argument in a way he wasn't later. "In the early days, we were printing money," Cliff Baxter later recalled. "We saw things no one else could see." Amanda Martin, another former executive, added, "In the beginning, it was brilliant, we were riding a train, we were proselytizing. We were the apostles. *We were right.*"

It wasn't long before a skeptical industry began to agree. In the spring of 1990, the New York Mercantile Exchange began trading natural-gas futures, though very limited ones, dealing only with gas delivered to a key hub in Louisiana. But

Enron's fast-growing trading desk was handling other, more complicated trades, and Skilling knew that he needed some of Wall Street's expertise in pricing and managing the risk associated with derivatives. To get that expertise, he cut a deal with Bankers Trust, which was one of the leaders on Wall Street in derivatives trading. It was a sweet deal for Bankers Trust: in return for sharing its smarts, it would get a third of the profits. Too sweet, in fact; it wasn't long before the Enron crowd and the Bankers Trust crowd began bickering.

Still, it was exhilarating to see natural-gas trading start to work, to see this intellectually pure idea take hold in the real world in much the way Skilling had envisioned it. "This was the most creative period. It fundamentally changed the industry," says one former executive. Then he adds sadly, "What happened later is where it all went wrong."

Even before joining Enron, Skilling had made a very strange demand. His new business, he told Lay, had to use a different type of accounting from the one ordinarily used by the natural-gas industry. Rather than using historical-cost accounting like everyone else, he wanted Enron Finance be able to use what's known as mark-to-market accounting. This was so important to him—"a lay-my-body-across-the-tracks issue," he later called it—that he actually told Lay he would not join Enron and build his new division unless he could use mark-to-market accounting.

Because much of what happened at Enron can be traced to the decision to use mark-to-market accounting, it's important to take a moment to understand it. Suppose you've booked an asset and a liability on your balance sheet, for instance, a ten-year contract to supply natural gas to a utility in Duluth. Under conventional accounting, the value on your books continues to reflect your initial assumptions over the life of the deal, even if the underlying economics change. Using the concept of marking-to-market, however, you're forced to adjust the values on your balance sheet on a regular basis, to reflect fluctuations in the marketplace or anything else that might change the values. That's the first big difference. Here's the second. When you use conventional accounting, you book the revenues and profits that flow from the contract as they come through the door. But under the mark-to-market method, *you can book the entire estimated value for all ten years on the day you sign the contract.* Changes in that value show up as additional income—or losses—in subsequent periods.

The question, of course, is why was Skilling so adamant about an accounting method, of all things? He could list several reasons. One rationale in particular spoke volumes about the way Skilling viewed business. He'd never let go of the consultant's conceit that the idea was all and the idea, therefore, should be the thing that was rewarded. He felt that a business should be able to declare profits at the moment of the creative act that would earn those profits. Otherwise businessmen were mere coupon clippers, reaping the benefit of innovation that had been devised in the past by other, greater men. Taken to its absurd extreme, this

line of thinking suggests that General Motors should book all the future profits of a new model automobile at the moment the car is designed, long before a single vehicle rolls off the assembly line to be sold to customers. Over time this radical notion of value came to define the way Enron presented itself to the world, justifying the booking of millions in profits on a business before it had generated a penny in actual revenues. In Skilling's head, the idea, the *vision*, not the mundane reality, was always the critical thing.

Skilling also insisted that mark-to-market accounting gave a truer reading of a company's financial reality than the more common historical-cost accounting. "There's no way around it," he would tell people. "It reflects the true economic value." To him this wasn't even a debatable issue. His favorite example was the S&L crisis (which was still in full swoon at the time Skilling joined Enron). Historical-cost accounting allowed S&Ls to keep loans that had collapsed in value on their books at wildly inflated prices, which in turn allowed them to hide the true state of their finances. By contrast, Wall Street firms, which have to use mark-to-market accounting to value their portfolios, take hits when, say, the stock market collapses because they have to mark the value of their assets to the current market price. Mark-to-market accounting, in fact, is an important component in ensuring the "transparency" of portfolio values. Because portfolio managers are forced to mark their holdings to market every day, their investors know precisely how much they've made—or lost.

What's also true, though, as we now know from painful experience, is that any accounting method is susceptible to abuse. And the natural-gas business at this critical moment in its history was ripe for mark-to-market accounting abuse. Why? Because the value of a natural gas contract cannot be determined with the same precision that one can determine the price of a share of stock. Sure, you can gauge today's natural gas price precisely, and with the growth in NYMEX futures contracts, there is even a market price for gas, say, 12 months in the future. But natural-gas contracts might have durations of 10, even 20 years. And who could say with any certainty what the price of gas was going to be 10 years from now at a hub like the Chicago City Gate? Yet to book all that revenue and profit up front, as mark-to-market accounting required, somebody at Enron had to estimate the price of gas 20 years hence. Even well-intentioned estimates might turn out to be completely wrong.

And of course there would also be times when those estimates weren't so well-intentioned, times when somebody needed a little extra income to make the earnings Enron promised Wall Street or get paid a big bonus or stash earnings away for a rainy day. Indeed, over the years, Enron extended mark-to-market accounting well beyond natural gas to other areas where the "value" was even more subjective—and abuse even more tempting.

There are two other potential problems with mark-to-market accounting. The first is the mismatch between profits and cash. Just because a company can book twenty years' worth of revenues and profits in one fell swoop doesn't mean it actually has the money in hand. On the contrary: even if everything happens precisely as predicted, the money rolls in quarter after quarter, year after year, for the duration of the contract. And so with mark-to-market accounting, there is often a large discrepancy between the profits the company is reporting to its shareholders and the cash it has on hand to run the business. Sure enough, Enron's financial filings soon included this phrase: "recognized, but unrealized, income." In other words, Enron had booked the earnings, but it didn't yet have the cash. If the estimated value is correct, then over the life of the contract, the cash should equal the earnings, but the longer the term of the contract, the bigger the initial mismatch. And of course, you can't run a business on paper profits—at least, not forever.

The most dangerous problem of all is the very thing that makes mark-to-market accounting seem so seductive in the first place: growth. When the initial deals are cut and all the potential profits are immediately posted, a company using mark-to-market accounting appears to be growing rapidly. Wall Street analysts applaud, and the stock rockets upward. But how do you keep that growth rate up? True, you're still receiving the cash from past contracts. But you can't count it in your profits, because you've booked it already. It's as if you have to begin every quarter fresh. If you did one deal last quarter, in order to show growth you have do two the next and four the quarter after that and eight after that and on and on. And if you're promising Wall Street that your earnings will increase at a 15 percent annual clip, well, soon enough you're on a treadmill that becomes faster and steeper as the company gets bigger.

Despite the potential dangers Skilling had little difficulty convincing Kinder, Lay, and Enron's board to see things his way. On May 17, 1991, some 11 months after Skilling joined Enron, the audit committee of Enron's board approved the use of mark-to-market accounting for Skilling's new business. Now all he had to do was persuade the Securities and Exchange Commission. As it turns out, that wasn't much more difficult. In a letter dated June 11, 1991, Enron asked the SEC not to object to Enron's new choice of accounting methodology. Among Enron's arguments was that "as a trader" Skilling's new business "creates value and completes its earnings process when the transactions are finalized" and that "other commodity trading businesses which are analogous" used mark-to-market accounting. Enron included a missive from its accountants at Arthur Andersen stating that mark-to-market accounting was indeed preferable.

Over the next six months, at least eight letters were exchanged between the agency and the company, and two meetings between Skilling and other Enron representatives and the SEC staff took place. A review of the correspondence shows that the SEC was focused on a key issue: how would Enron estimate price? The agency even suggested that Enron consider some additional disclosure to investors in its financial filings until it got a better sense of the reliability of its estimates. Enron resisted, asserting that mark-to-market earnings would be calculated based on "known spreads and balanced positions" and that its numbers

would not be "significantly dependent on subjective elements." At which point, the SEC essentially caved.

On January 30, 1992, the SEC told Enron that it would not object to the use of mark-to-market accounting beginning that year. On getting the word, Skilling was ecstatic. He quickly gathered his troops in the conference room of the thirty-first floor, where his group had its offices. To celebrate, he brought in champagne: champagne to toast an accounting change! By 2 P.M., most of Skilling's staff, which numbered around 50, were reveling in the celebration.

And then Enron did something quite telling. Less than two weeks later, on February 11, Enron sent the SEC a letter informing them that it had decided that the "most appropriate period" for the adoption of mark-to-market accounting was not 1992 after all. Rather, Enron wrote the agency that it planned to apply mark-to-market accounting to the year that had just ended: 1991. Since Enron had not yet filed its financial statements for 1991, it could now do so using the new accounting methodology. Enron said the impact on earnings was "not material." In the big picture, that was true: Enron reported $242 million in earnings that year. But earlier in the year Skilling's division had estimated that its mark-to-market earnings for 1991 transactions would be about $25 million. That number, assuming it held up, amounted to half the profits in Skilling's new division.

There was one last lingering issue: Bankers Trust. Practically from the moment Skilling brought Bankers Trust in, he regretted it. He hated the way the New York bankers treated the Texans like rubes. He hated even more the fact that he had agreed to give such a large percentage of Enron's trading profits to Bankers Trust, especially once he decided that his team didn't really need the bank's expertise in derivatives. He and his group could learn how to do it themselves—indeed, they *were* learning how to do it themselves.

Bankers Trust felt the same way about Enron: why did they need to be in partnership with these guys when they could run their own trading operation and keep *all* the profits? They were contemptuous of the Enron traders and too arrogant to hide it. They would openly complain that they were working with neophytes. Meetings soon deteriorated into pitched battles about who was assuming what risk and how much each of the partners should be compensated.

Finally, in June 1991, Bankers Trust decided to pull out of the deal. In retrospect, it was a foolish move, given the extent to which Enron soon dominated the natural-gas trading business—and the sweet deal Bankers Trust had extracted from Skilling. And the Bankers Trust executives only compounded their mistake by the way they went about their departure. They did it in the dead of night, without ever informing anyone at Enron, and as they walked out the door they pulled a dirty trick. Knowing the bank was going to walk away from Enron, one of its executives called in a junior employee named Kevin Hannon and ordered him to delete all the files containing the trading information. Over one summer weekend, Hannon did just that. He then jumped on a plane and flew back to New York.

On Monday morning an Enron executive named Lou Pai came running up to Skilling. "Those fuckers," he yelled. "They erased all the tapes!"

"Who?" asked a surprised Skilling.

"BT," replied Pai. "They're gone!" It was a crisis but not a protracted one. An Enron employee worked around the clock for the next month to rebuild the files, and the Enron trading desk was in the black by July. Never again did Jeff Skilling involve an outside party in his trading operation. "This is *our* business," he thought. And it was.