**How Enron worked**

> Here's how Enron works. It's really quite simple.

> Ismail is a successful mule trader in Peshawar. Every year Ismail delivers

> 30 mules to the Kabul Mule Market and gets $40 per mule. This year, however,

> the Khyber Pass is full of warlord militias, so Ismail is not sure he can

> drive his mules to market without losing a mule here and there.

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> Also, the demand for mules in Kabul seems to be dropping. Maybe he'll only

> be able to sell 20 mules, or, God forbid, 15, and then be forced to feed and

> water the rest of them on a money-losing trek back home. In other words,

> it's a scary market and Ismail is worried about feeding his family. What

> Ismail needs is to limit his risk with an Enron derivatives package.

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> First he pays $2 per mule for a Khyber Pass Derivative, so that any mule

> killed or stolen by warlords will be reimbursed at the rate of $20 per

> mule-half the going market rate, but still better than taking a total loss.

> Next he buys Enron Mule Futures. For $28 per contract, he guarantees

> delivery of a mule in three months time. He takes 15 of these, figuring that

> a guaranteed $28 mule sale is better than showing up in Kabul and

> discovering that the mule buyers have been killed by stray bombs.

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> Meanwhile, at the Enron Mule Trading Desk in Houston, eagle-eyed yuppies are

> studying the worldwide mule markets and starting to have their doubts about

> those $28 delivery contracts. Mule use is dropping all over Afghanistan,

> even as the mule count is dwindling. Better resell eight of those 15

> contracts to a European commodities broker for $24 each, then make up that

> $32 loss somewhere else while cutting the company's exposure in half. But

> how to hedge the risk on the other seven?

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> Aha! A blip on the computer screen. A temporary mule shortage in southern

> Iran! With a current mule price of $42 in Tehran, Enron could offer a Linked

> Mule Swap Double Derivative tied to the gap between the price of mules

> delivered in Kabul on a given date and the price in Tehran on the same date.

> Sure, you would rather have the quick-and-clean Iran sale, instead of the

> sale in Kabul that requires trucking the mules to a foreign market. But even

> if you add in $4 per mule for transport through militia-held territory and

> averaged the markets together, you can still clear eight bucks just on the

> gap alone.

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> Enron's average price-per-future-mule is now $32.57 when you include the

> $4-per-mule loss on the mule futures dumped in Europe. But based on the

> amazing $12 Kabul/Tehran trading gap, they can easily put together a

> "delivery in either market" contract that will allow them to ask $36 per

> mule on their Mule Online Internet trading system. The first mule future

> sells instantly for $36, and the price bobs up to $36.50. Two mules go for

> $36.75, and then there's a big jump for the last three mules to $37.90.

> Enron has now off-loaded all its price-based mule futures liability for a

> profit of $31.70. But this doesn't mean they're out of the mule market in

> Central Asia. It's still two months until Ismail delivers his 30 mules, and

> Enron is on the hook for his Khyber Pass derivative insurance policy. Things

> are not looking good in that part of the world, either. The chances of a

> mule being picked off as a road-passage tax are pretty high, and the loss of

> the whole herd would be a $600 liability.

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> Quickly, the financial boys go to work, and part of that liability is resold

> to a consortium of Singapore banks, Australian mutual funds, and Saudi

> Arabian arms merchant Adnan Kashoggi, thereby reducing Enron's percentage to

> 25%, or $150 in potential liability against a $15 premium (remember the $2

> per mule paid by Ismail), and Enron also takes a brokerage fee of $20 from

> the three other partners, thereby reducing its real liability to just $120.

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> But that's still too much of a spread, so Enron continues to hedge.

> Fortunately, the company has such a diversified trading floor that Enron

> mule-market experts can walk over to the traders in the warlord-militia

> derivatives department. Sure enough, at least four tribes near the Khyber

> Pass are increasingly concerned about profit margins. There simply aren't

> enough people to rob. Things have gotten so bad, in fact, that the warlords

> are hedging against the oncoming winter by taking futures positions in

> stolen chickens, stolen humanitarian aid trucks, and Western hostages.

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> There's not a mule market yet, because the warlords have successfully

> converted many of the recalcitrant villagers into pack animals. But Enron

> knows how to MAKE markets. Quickly the numbers-crunchers go to work, and

> they soon determine that the average number of stolen mules per 100-man

> militia is 1.4 per year. That represents anywhere from $28 to $56 in lost

> mule-thievery income if the Khyber Pass is closed or inhospitable to traders

> from Pakistan. Amortizing that amount over 12 months, the warlords have an

> exposure of anywhere from $2.33 to $4.67 per month in lost pillage. Hence

> Enron announces the new Highway Robbery Derivative, in which each tribe is

> guaranteed the value of two stolen mules in each 12-month period in return

> for paying a premium of $4 per month.

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> Enron's hedge is now complete, and it is a beautiful thing to behold. The

> chances of Ismail losing a mule to a raiding party are approximately one in

> 30, or 3.33 percent. Since he's paying $60 for his derivative contract, the

> expected loss of 3.33 percent of his herd would result in a payment of only

> $20 -- a more than comfortable spread. Meanwhile, if the mule is stolen by a

> warlord holding a Highway Robbery Derivative, then the payment to the other

> side would only be $28 against premiums of $48. If Ismail simply passes

> through the Khyber Pass without incident and sells all his mules at the

> standard price, Enron pockets $60 from Ismail and $48 each from four

> warlords, in addition to the previous profit of $31.70 from that heady

> Internet mule-futures trading day and the $20 in packaging commissions. If

> each warlord steals his standard 1.4 mules per year, then Enron still owes

> six-tenths of one mule to the warlord, or about $22.20 based on a $37 sale

> price. Total expected profit, based on 5.6 stolen mules, one of which is

> stolen from Ismail: $143.20. Total profit from all Ismail-related mule

> transactions: $194.90.