Dynegy Corporation: Inflating Operating Cash Flow

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In 2004 three employees of Dynegy Corporation were prosecuted and served time in federal prison for complicity in Project Alpha, a $300 million gas financing and sales project that resulted in a material overstatement of operating cash flow. The project was carried out through the use of two special-purpose entities, one to achieve a tax saving and one to increase reported operating cash flow. This paper describes the cash flow part of the plan, which called for the use of ABG, a special-purpose entity that would not be included in Dynegy's consolidated financial statements. In negotiation with lenders, the conditions allowing for ABG to be excluded from consolidation were abandoned, but Dynegy failed to consolidate it nonetheless. Under the scheme, loan proceeds were in effect reported as operating proceeds. Interestingly there was no inflation of earnings or understatement of liabilities under the cash flow part of the scheme. A major factor in the motivation, design and execution of Project Alpha was the impact of mark-to-market rules on corporate financial reports.

In 2001, Dynegy Corporation of Houston, Texas, signed a series of agreements with Citibank designed to enhance reported operating cash flow by $300 million. About one year later, after the *Wall Street Journal* published an article describing the details of the agreement, named Project Alpha, the Securities and Exchange Commission opened an investigation, and Dynegy restated its 2001 financial statements. The restatement reclassified the cash flow data and a related tax benefit, resulting in a reduction of $79 million in net income. Two years after issuance of the revised financial statements, three Dynegy employees prosecuted by the Department of Justice were indicted on securities fraud charges in connection with their role in carrying out Project Alpha. Two of the employees pleaded guilty to one count each of conspiracy to commit securities fraud and received sentences of 18 months and 28 days, respectively. The third employee fought the charges in court and lost, leading to a sentence of 24 years in federal prison, later reduced on appeal to five years. The 24-year sentence was the largest in the history of white collar crime cases at the time.

In this paper we will describe the motivation for Project Alpha, the details of how it was structured, and concessions made to the financing sources that invalidated the accounting treatment and led to the fraud charges.

MOTIVATION FOR THE PROJECT

Dynegy Corporation is an energy trading company that in 2001 was operating in the shadow of Enron Corporation, its larger Houston competitor. Dynegy had not developed the kind of Byzantine use of scores of special-purpose entities (SPEs) for personal gain that characterized the frauds that brought Enron down and led to a major national reaction. That reaction culminated in the enactment of the

Sarbanes-Oxley Act of 2002 by the United States Congress. Nonetheless, in Project Alpha, Dynegy made use of three SPEs to derive a tax benefit and inflate its reported net operating cash flow. This paper will focus on the cash flow manipulation element of the plan.

The principal motivation for Project Alpha arose out of mark-to-market accounting rules. Analysts began criticizing Dynegy because of a growing disconnect between net income and net operating cash flow, a disconnect that was caused by the booking of large unrealized gains on long-term trading contracts. The booking of these gains moved into current net income the effects of future energy sales and purchases that would not generate cash for years to come. Analysts pointed out that many of those gains were based on highly subjective predictions of commodity prices, in some cases lying as many as 20 years in the future.

Traders routinely hedge their over-the-counter commodity contracts by setting up agreements for both purchase and sale, locking in prices and avoiding exposure to sometimes volatile day-to-day fluctuations in spot prices. The insistence on hedges by the financing sources in Project Alpha became a central issue in Dynegy's accounting violations.

There was intense pressure from Dynegy's management to make Alpha work because of industry-wide scrutiny of the booking of mark-to-market gains and the resultant growing gap between earnings and operating cash flow. A similar earlier attempt by the company was never brought to fruition. In addition to addressing the mark-to-market issue, Project Alpha included a tax arrangement designed to reduce federal income tax liabilities by $79 million. The resulting structure set up a monthly circular flow of funds from lenders through two special-purpose entities and a consolidated subsidiary, then back to the lenders.

STRUCTURE OF PROJECT ALPHA

Because the purpose of Project Alpha was to reduce the gap between net income and operating cash flow, it was decided to devise a system that would increase operating cash flow without increasing net income. What emerged was brilliant in its simplicity, even as it was highly suspect in its purposes. It involved using an existing partnership as a trading subsidiary, named Dynegy Marketing and Trade (DMT), and two new SPEs, named NGAI (sponsored by an outside third party) and ABG (sponsored by Citibank). NGAI was the vehicle for the transfer of tax assets from third parties to Dynegy, while ABG was the vehicle for converting loan proceeds into operating cash flows, both working through DMT.

DMT was to be consolidated into Dynegy's financial statements, while ABG and NGAI were not. (See Exhibit 1.)

Citibank was originally engaged to sell natural gas to ABG, but as the transaction was being arranged, the bank assembled a group of lenders, including Deutschebank and Credit Suisse First Boston, to provide funding. Once the original structure was expanded to include a syndicate of lenders, Dynegy's desire for a trading transaction became blurred with the syndicate's desire for a low-risk investment (essentially a loan). This, in turn, led to the issues that ultimately invalidated the intended accounting treatment.

The project was to work in two phases over five years. Phase 1 would cover the nine months remaining in 2001, and phase 2 would cover the following 51 months. Up front, the newly created NGAI was to receive $300 million in borrowed funds which it would immediately invest as equity in DMT (Exhibit 1). NGAI's equity would constitute a 99-percent, nine-month term ownership interest in DMT, with Dynegy contributing the remaining one percent as general partner. This was the vehicle for the transfer of the tax benefit from a third party to Dynegy. DMT would immediately lend the $300 million (illustrative dollar amounts are approximate and rounded) to Dynegy, which would repay it as needed after the first nine months had passed.

Meanwhile the financing sources would also transfer $35 million as an equity investment (later understood to be a loan) in newly created ABG. (Exhibit 2) ABG would use the $35 million to buy natural gas in the market and sell it to DMT at a deep discount (for approximately $1 million). DMT would immediately sell the gas to customers at market for a $34 million cash gross profit. It would then send to NGAI the $34 million plus $1 million received from Dynegy as debt service on the $300 million loan. This transfer would begin the redemption of NGAI's partnership interest in DMT. NGAI would use the $35 million to begin repaying the lenders, who would then transfer $34 million to ABG for the next month's round of transactions.

After nine months of these transactions, extending to the end of 2001, NGAI would cease to exist, its holding in DMT now liquidated and its $300 million loan paid off. At the same time, DMT would have accumulated $306 million in gross profit and operating cash flow. (See Exhibit 5 for summary journal entries). The purpose of Project Alpha was achieved: $306 million in net financing receipts were shown on the Statement of Cash Flows as net operating proceeds.

Now the 5-year contract would enter the second phase, consisting of 51 months in which the gas sales from ABG to DMT would be made at a premium over the market, reversing the effect of phase 1. (Exhibit 3) This meant ABG would have 51 months of $7 million in guaranteed positive operating cash flow and related profits while DMT was committed to mirror-image negative cash flow and negative profits. This was the vehicle for repayment of the $306 million that the syndicate invested in ABG during 2001 in the form of the monthly $34 million transfers. Funding to finance DMT's losing transactions would come from Dynegy as it paid back the $300 million loan from DMT made at the inception of the project.

At the end of 2001 DMT and ABG would have mirror image mark-to-market loss and gain on the 51 remaining months of the contract. The contract would have been worth close to zero at the inception of the project on April 1, but the first nine months exhausted the part that favored DMT, leaving the 51-month part that favored ABG remaining in force. DMT, therefore, would record $34 million mark-to-market losses monthly until the end of the fiscal year, while ABG recorded mark-to-market gains. By the end of the nine months these would accumulate to approximately $306 million. Then in the ensuing 51 months the gain and loss would be gradually reversed as DMT paid premium prices to ABG, accumulating to $357 million at the end of the 5-year contract.

In summary, for the nine months of year one DMT, consolidated into Dynegy, would record $306 million in gross profit offset by $306 million in mark-to-market losses that would in turn create a $306 million liability. In addition it would show $306 million in operating cash flow. At the same time ABG would record the mirror-image items: $306 million in negative gross profit, $306 million of negative operating cash flow, $306 million in mark-to-market gains, receipt of $306 million in investment proceeds, a $306 million liability to the lenders, and a $306 million long-term asset from DMT. Interestingly, this fraudulent scheme, while it altered internal elements of net income, neither overstated net income nor understated liabilities. The only bottom-line numbers misstated were operating cash flows and financing cash flows on the Statement of Cash Flows.

THE ACCOUNTING TREATMENT

Using these SPEs and transactions, Dynegy hoped to achieve its goal of boosting operating cash flow while not increasing net income. This required that DMT be consolidated into Dynegy's financial statements while ABG was not (Exhibits 2 and 6). For this to be allowable under generally accepted accounting principles (EITF 90-15), ABG had to show the characteristics of an independent entity. This required that at least 3 percent of its capitalization—$9 million—be in the form of at-risk equity investment.

Guidance from Arthur Andersen, Dynegy's audit firm, was that the 3 percent threshold would be met if one New York Mercantile Exchange contract in ABG's portfolio was unhedged. (Each NYMEX gas contract covers 10 billion BTUs.) The independent equity investors in ABG became concerned about the exposure this unhedged risk posed. In addition, the lending syndicate became concerned that in a worst case scenario ABG would not have the funds to liquidate the investment over the 51 months after 2001, and they began to demand that the risk be hedged or the deal terminated. In last-minute negotiations, the independent equity investor hedged the 10 billion BTUs outside the structure of the transaction, directly with Citibank. This hedge was not disclosed to the auditors because the result would have been that ABG should have been consolidated. Dynegy did not perform this consolidation, and thus committed fraud.

Consolidating ABG (see Exhibit 4 and 6) would undo everything Dynegy was trying to achieve with Project Alpha. The transactions between DMT and ABG are represented in journal entry form in Figure 5. They would be treated as internal in the consolidated financial statements and thus eliminated from those financial statements, while the $300 million influx of cash would now have to be reported in the financing section of the cash flow statement as a loan or equity investment rather than in the operating section. DMT's mark-to-market loss—a key element of the plan—would be eliminated against ABG's mark-to-market gain (Exhibit 4 and 6). Neither net income nor net operating cash flow ($315 million cash in and $315 million cash out) would be significantly affected, and thus the income-to-operating-cash gap on the cash flow statement would not be reduced.

The $300 million liability would still be there at the end of 2001, in the form of an obligation to remit to the lenders the profit from the premium prices over the ensuing 51 months. At the start of the process the liability was shown on NGAI's books directly to the lenders. As NGAI's equity in DMT was liquidated during 2001 and it paid off its loan, the liability would progressively grow in DMT's books as it recorded its mark-to-market losses. At the same time a $306 million asset would grow on the lenders' books as they put $34 million monthly into ABG to finance its bargain-basement sales of gas to DMT.

THE NEGOTIATIONS

In April 2001, Dynegy sent a team of seven employees to New York along with multiple representatives from outside law firms and banks plus one Arthur Andersen tax representative to negotiate with Citibank to set up Project Alpha. It was expected to take a week to reach final agreement, but the sessions dragged on for six weeks. It became increasingly evident to Dynegy's negotiating team that Citibank had sold the plan to investors as a financing deal rather than a physical gas deal. As a result those investors were insisting on hedging all of the gas contracts, including the 3 percent Arthur Andersen had said must remain unhedged to justify not consolidating ABG.

After four weeks of increasingly acrimonious negotiations, Dynegy relented, agreeing to hedge the 3 percent. As a result it should have consolidated ABG and NGAI, but it did not do so in its published 2001 financial statements.

IMPLICATIONS FOR GAAP

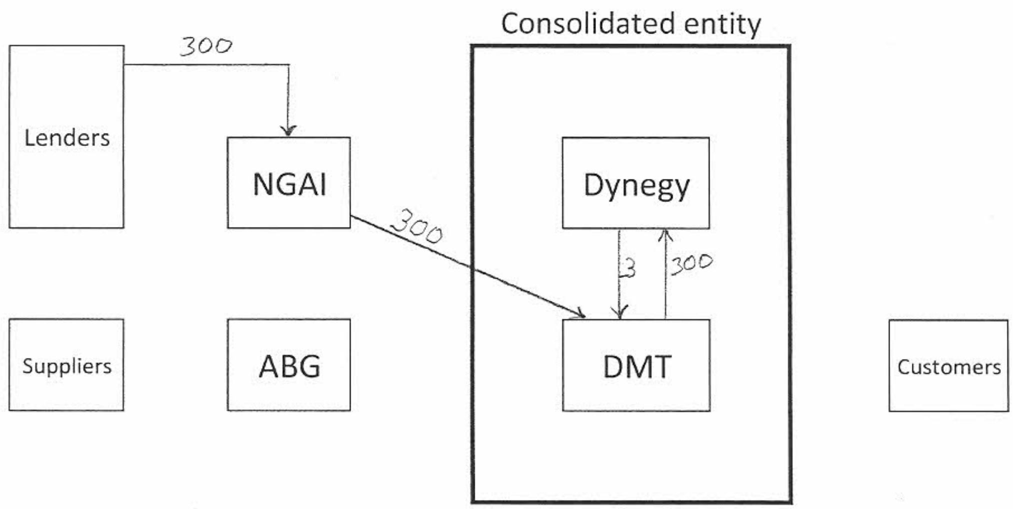
After the scandals at Enron and Dynegy there was criticism that the 3 percent rule was too lenient and needed to be expanded to 10 percent, which the Financial Accounting Standards Board did in 2003 when it issued Interpretation 46(R). However there is a certain irony in the fact that the 3 percent threshold worked just as had been intended. Dynegy (like Enron) failed to tempt investors to put money at risk in their SPEs as required under the rule. While 3 percent sounds like a trivial amount, in projects as large as Enron's and Dynegy's it means a large amount of money has to be put at risk -- $9 million in the case of Dynegy's $300 million Project Alpha. Clearly investors did not see ABG as an independent business, and so demanded that the entire amount be hedged. Citibank therefore was unable to provide the financing as originally planned. The problem was not that 3 percent was too low a bar, but rather that the companies failed to follow the rule. Raising the bar to 10 percent would seem to be primarily a symbolic move, though perhaps it would discourage companies from initiating schemes like Project Alpha.

Accountants cannot make something from nothing, nor can they make things vanish into thin air. Rather, they can move things around. In the case of Project Alpha, the plan was to increase Dynegy's 2001 operating cash flow. True to form, however, this was to lead inevitably to a future opposite effect. Moving cash flow around in 2001 through the sales between ABG and DMT meant that there would be a future reversal, in this case over the next 51 months, in which Dynegy's operating cash flow would be reduced as the investors were repaid. The result would have been to worsen the cash flow-to-net income gap in those 51 months, increasing the pressures that were the original incentive for the plan. Not surprisingly Dynegy's management began taking steps to deal with this. The plan was to set up Alpha 2, a $600 million deal, twice as big as Alpha 1. Alpha 2 never came to fruition, however, as it was aborted along with the desired accounting treatment of Alpha 1 when the SEC started its inquiry in the spring of 2002.

AFTERMATH

In the spring of 2002 Dynegy was forced to restate its 2001 financial statements to consolidate NGAI and ABG (Exhibits 4 and 6). This erased the desired effects of Project Alpha, including the tax benefit obtained through NGAI. The result was a $79 million reduction in net income and a $306 million reduction in operating cash flow. The company eventually paid a fine of $3 million under an agreement with the SEC, and, as noted above, three of its employees who were on the negotiating team served time in federal prison on securities fraud charges. In addition Dynegy's CFO paid $376,000 in fines, disgorgement and interest in a settlement with the SEC.

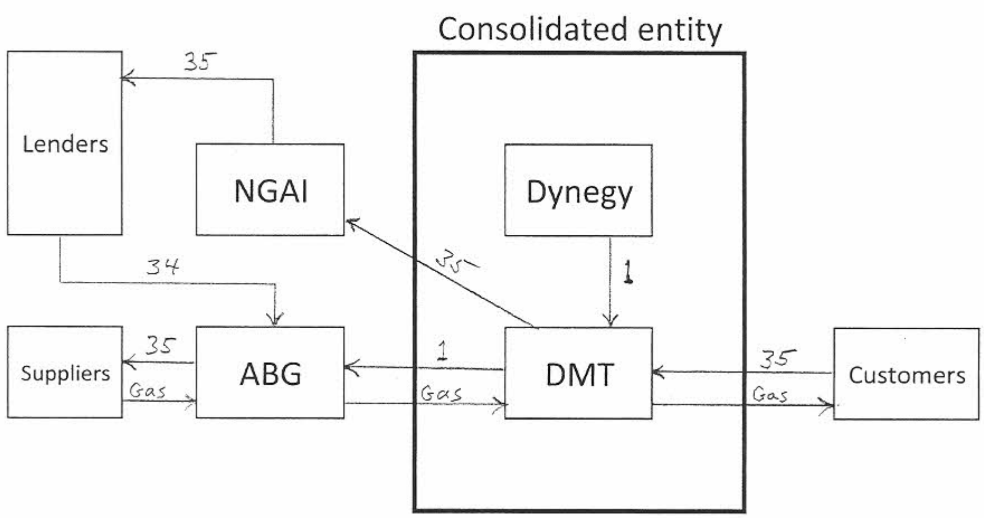
Exhibit 1



Capitalizaton of NGAI and DMT

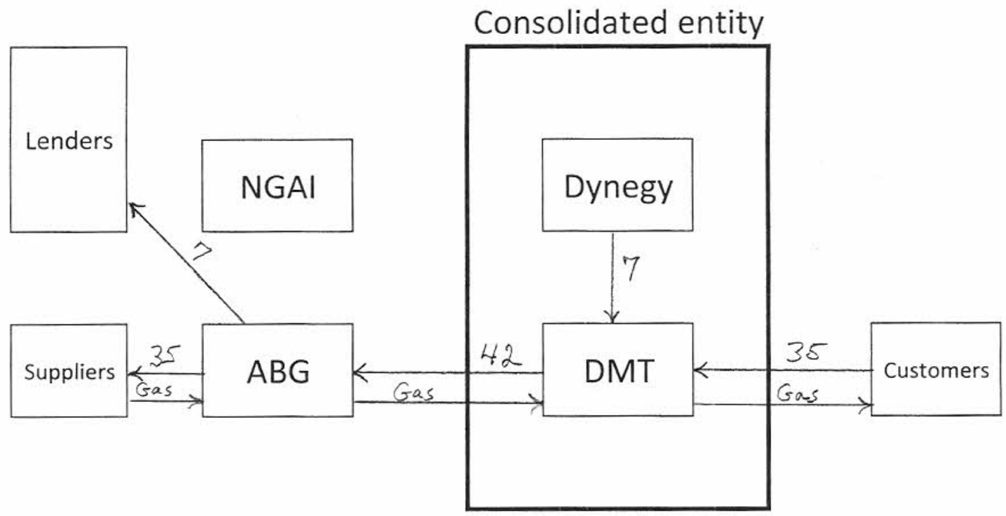
Dollars in millions

Exhibit 2



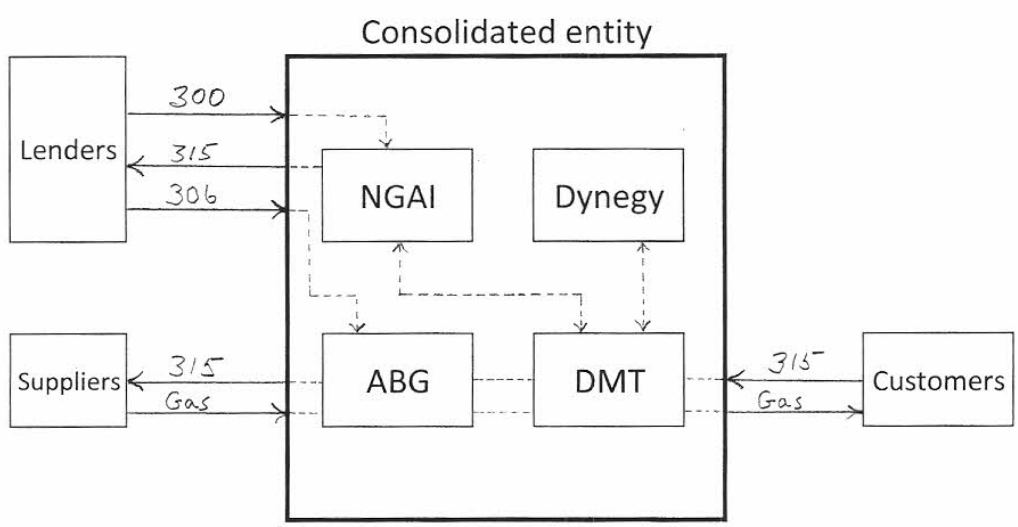
Monthly gas payments and liquidation of NGAI, 2001

Exhibit 3



Cash flows after 2001

Exhibit 4



Annualized Restatement of 2001 transactions

(Dotted lines represent cash flows eliminated in the consolidation)

Exhibit 5

Planned entries in DMT Supply LP (Amounts approximate)

At the start:

Cash	303M	
Equity – NGAI		300M
Equity – Dynegy		3M
Initial capitalization of DMT		
Advance to Dynegy	300M	
Cash		300M
Loan from DMT to Dynegy		

Monthly for nine months:

Gas	1M	
Cash		1M
Discounted gas purchases from ABG		
Cash	35M	
Sales revenue		35M
Sale to outside customers at market		
Cost of goods sold	1M	
Gas		1M
Cost of sales to outside customers		
Cash	1M	
Interest revenue		1M
Interest from Dynegy on intercompany loan		
Equity – NGAI	35M	
Cash		35M
Ratable retirement of NGAI's equity in DMT		

End of fiscal year:

Loss on fwd contract	306M	
Forward gas contract to ABG		306M
Value of contract marked to market as activity of the first nine months, favorable to DMT, is liquidated		

At year end NGAI is now out of the picture, and the payments to/from it are classed as financing cash flows (via equity). The loan to Dynegy and the interest payments coming back are eliminated in the consolidation process. At year end, the forward contract now has negative value because it obligates DMT Supply to buy gas at above-market prices for the coming 51 months. The amount is enough to repay the investors/lenders who ratably put $306 million into ABG to finance its first nine months of below-market sale of gas to DMT. Dynegy's consolidated income statement will show the gross profit on DMT's gas sales, but that will be offset by the loss on the forward contract so net income will not be increased by much if any in year 1. But the cash flows for the purchase and sale of the gas by DMT will be classed as operating, thus narrowing the gap between earnings and operating cash flow by $306 million. In the first nine months, 99 percent of actual cash flows will be paid to equity investors through NGAI due to their 99 percent interest, and the equity will reduce ratably until it is eliminated at year end.

At year end an approximately $306 million mark-to-market loss (plus related payable) is recorded, which will be an addition on the statement of cash flows in the reconciliation of net income to net operating cash flows. And ABG, having supposedly independent investors with $9 million or so of their money at risk, does not have to be consolidated.

Entries in ABG Gas Supply (Amounts approximate)

<u>Monthly for nine months:</u>

Cash	34M	
Payable to lenders		34M
Cash from investors		
Gas inventory	35M	
Cash		35M
Purchase of gas @ market		
Cash	1M	
Sales		1M
Sale of gas to DMT		
Cost of goods sold	35M	
Gas inventory		35M
Cost of sales to DMT		

<u>End of fiscal year:</u>

Forward gas contract to DMT	306M	
Gain on forward contract		306M
Mark to market of contract as activity of the first nine months, favorable to DMT, is liquidated		
Sales	9M	
Equity	297M	
CGS		306M
Yearend closing entry		

Exhibit 6

Elimination entries in consolidation process as reported (ABG not consolidated)

Payable to DMT	300M	
Receivable from Dynegy		300M
Elimination of intercompany loan		
Interest revenue	9M	
Interest expense		9M
Elimination of intercompany expense and revenue, Dynegy and DMT		
Equity—Dynegy	*3M*	
Investment in DMT		*3M*
Elimination of Dynegy's holding of DMT equity		

Additional elimination entries in restatement ordered by SEC as ABG is consolidated

Sales Revenue	35M	
Cost of goods sold		35M
Elimination of sales from ABG to DMT		
Gain on forward contract	*306M*	
Loss on forward contract		*306M*
Elimination of mark-to-market gain (ABG) and loss (DMT)		
Forward gas contract to ABG	*306M*	
Forward gas contract to DMT		*306M*
Elimination of intercompany contract		