
Enron

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Spring, 2002

Class 4: Understanding Enron's Transactions II

A. Internal Understandings

1. Watkins Letter, August, 2001
 2. James A. Hecker, AA, Memo to Files re Client Accounting Inquiry, August 21, 2001
 3. Max Hendricks III, Vinson & Elkins LLP, Letter to James V. Derrick Jr., Exec. Vice President and General Counsel, Enron Corp., October 15, 2001
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Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job. I think that the valuation issues can be fixed and reported with other goodwill write-downs to occur in 2002. How do we fix the Raptor and Condor deals? They unwind in 2002 and 2003, we will have to pony up Enron stock and that won't go unnoticed.

To the layman on the street, it will look like we recognized funds flow of \$800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?

We have recognized over \$550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from \$178 mm to \$5 mm, The New Power Co by 70%, from \$20/share to \$6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for 'personal reasons' but I think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

Is there a way our accounting guru's can unwind these deals now? I have thought and thought about how to do this, but I keep bumping into one big problem – we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay back it back 2 years later. Nice try, but investors were hurt, they bought at \$70 and \$80/share looking for \$120/share and now they're at \$38 or worse. We are under too much scrutiny and there are probably one or two disgruntled 'redeployed' employees who know enough about the 'funny' accounting to get us in trouble.

What do we do? I know this question cannot be addressed in the all employee meeting, but can you give some assurances that you and Causey will sit down and take a good hard objective look at what is going to happen to Condor and Raptor in 2002 and 2003?

Summary of alleged issues:

Raptor

Entity was capitalized with LJM equity. That equity is at risk; however, the investment was completely offset by a cash fee paid to LJM. If the Raptor entities go bankrupt LJM is not affected, there is no commitment to contribute more equity.

The majority of the capitalization of the Raptor entities is some form of Enron N/P, restricted stock and stock rights.

Enron entered into several equity derivative transactions with the Raptor entities locking in our values for various equity investments we hold.

As disclosed, in 2000, we recognized \$500 million of revenue from the equity derivatives offset by market value changes in the underlying securities.

This year, with the value of our stock declining, the underlying capitalization of the Raptor entities is declining and Credit is pushing for reserves against our MTM positions.

To avoid such a write-down or reserve in Q1 2001, we 'enhanced' the capital structure of the Raptor vehicles, committing more ENE shares.

My understanding of the Q3 problem is that we must 'enhance' the vehicles by \$250 million.

I realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day. (Please review the late 90's problems of Waste Management - where AA paid \$130+ mm in litigation re: questionable accounting practices).

The overriding basic principle of accounting is that if you explain the 'accounting treatment' to a man on the street, would you influence his investing decisions? Would he sell or buy the stock based on a thorough understanding of the facts? If so, you best present it correctly and/or change the accounting.

My concern is that the footnotes don't adequately explain the transactions. If adequately explained, the investor would know that the "Entities" described in our related party footnote are thinly capitalized, the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives (unfortunately in this case, a big loss) AND Enron stock and N/P. Looking at the stock we swapped, I also don't believe any other company would have entered into the equity derivative transactions with us at the same prices or without substantial premiums from Enron. In other words, the \$500 million in revenue in 2000 would have been much lower. How much lower?

Raptor looks to be a big bet, if the underlying stocks did well, then no one would be the wiser. If Enron stock did well, the stock issuance to these entities would decline and the transactions would be less noticeable. All has gone against us. The stocks, most notably Hanover, The New Power Co., and Avici are underwater to great or lesser degrees.

I firmly believe that executive management of the company must have a clear and precise knowledge of these transactions and they must have the transactions reviewed by objective experts in the fields of securities law and accounting. I believe Ken Lay deserves the right to judge for himself what he believes the probabilities of discovery to be and the estimated damages to the company from those discoveries and decide one of two courses of action:

1. The probability of discovery is low enough and the estimated damage too great; therefore we find a way to quietly and quickly reverse, unwind, write down these positions/transactions.
2. The probability of discovery is too great, the estimated damage to the company too great; therefore, we must quantify, develop damage containment plans and disclose.

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

Summary of Raptor oddities:

1. The accounting treatment looks questionable.
 - a. Enron booked a \$500 mm gain from equity derivatives from a related party.
 - b. That related party is thinly capitalized, with no party at risk except Enron.
 - c. It appears Enron has supported an income statement gain by a contribution of its own shares.

One basic question: The related party entity has lost \$500 mm in its equity derivative transactions with Enron. Who bears that loss? I can't find an equity or debt holder that bears that loss. Find out who will lose this money. Who will pay for this loss at the related party entity?

If it's Enron, from our shares, then I think we do not have a fact pattern that would look good to the SEC or investors.

2. The equity derivative transactions do not appear to be at arms length.
 - a. Enron hedged New Power, Hanover, and Avici with the related party at what now appears to be the peak of the market. New Power and Avici have fallen away significantly since. The related party was unable to lay off this risk. This fact pattern is once again very negative for Enron.
 - b. I don't think any other unrelated company would have entered into these transactions at these prices. What else is going on here? What was the compensation to the related party to induce it to enter into such transactions?
3. There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly. This alone is cause for concern.
 - a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. He complained mightily to Jeff Skilling and laid out 5 steps he thought should be taken if he was to remain as Treasurer. 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets and never addressed the 5 steps with him.
 - b. Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.
 - c. I have heard one manager level employee from the principle investments group say "I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company." The principle investments group hedged a large number of their investments with Raptor. These people know and see a lot. Many similar comments are made when you ask about these deals. Employees quote our CFO as saying that he has a handshake deal with Skilling that LJM will never lose money.

4. Can the General Counsel of Enron audit the deal trail and the money trail between Enron and LJM/Raptor and its principals? Can he look at LJM? At Raptor? If the CFO says no, isn't that a problem?

Condor and Raptor work:

1. Postpone decision on filling office of the chair, if the current decision includes CFO and/or CAO.
2. Involve Jim Derrick and Rex Rogers to hire a law firm to investigate the Condor and Raptor transactions to give Enron attorney client privilege on the work product. (Can't use V&E due to conflict – they provided some true sale opinions on some of the deals).
3. Law firm to hire one of the big 6, but not Arthur Andersen or PricewaterhouseCoopers due to their conflicts of interest: AA&Co (Enron); PWC (LJM).
4. Investigate the transactions, our accounting treatment and our future commitments to these vehicles in the form of stock, N/P, etc..
For instance: In Q3 we have a \$250 mm problem with Raptor 3 (NPW) if we don't 'enhance' the capital structure of Raptor 3 to commit more ENE shares. By the way: in Q1 we enhanced the Raptor 3 deal, committing more ENE shares to avoid a write down.
5. Develop clean up plan:
 - a. Best case: Clean up quietly if possible.
 - b. Worst case: Quantify, develop PR and IR campaigns, customer assurance plans (don't want to go the way of Salomon's trading shop), legal actions, severance actions, disclosure.
6. Personnel to quiz confidentially to determine if I'm all wet:
 - a. Jeff McMahon
 - b. Mark Koenig
 - c. Rick Buy
 - d. Greg Whalley

To put the accounting treatment in perspective I offer the following:

1. We've contributed contingent Enron equity to the Raptor entities. Since it's contingent, we have the consideration given and received at zero. We do, as Causey points out, include the shares in our fully diluted computations of shares outstanding if the current economics of the deal imply that Enron will have to issue the shares in the future. This impacts 2002 – 2004 EPS projections only.
2. We lost value in several equity investments in 2000. \$500 million of lost value. These were fair value investments, we wrote them down. However, we also booked gains from our price risk management transactions with Raptor, recording a corresponding PRM account receivable from the Raptor entities. That's a \$500 million related party transaction – it's 20% of 2000 IBIT, 51% of NI pre tax, 33% of NI after tax.
3. Credit reviews the underlying capitalization of Raptor, reviews the contingent shares and determines whether the Raptor entities will have enough capital to pay Enron its \$500 million when the equity derivatives expire.
4. The Raptor entities are technically bankrupt; the value of the contingent Enron shares equals or is just below the PRM account payable that Raptor owes Enron. Raptor's inception to date income statement is a \$500 million loss.
5. Where are the equity and debt investors that lost out? LJM is whole on a cash on cash basis. Where did the \$500 million in value come from? It came from Enron shares. Why haven't we booked the transaction as \$500 million in a promise of shares to the Raptor entity and \$500 million of value in our "Economic Interests" in these entities? Then we would have a write down of our value in the Raptor entities. We have not booked the latter, because we do not have to yet. Technically, we can wait and face the music in 2002 – 2004.
6. The related party footnote tries to explain these transactions. Don't you think that several interested companies, be they stock analysts, journalists, hedge fund managers, etc., are busy trying to discover the reason Skilling left? Don't you think their smartest people are pouring over that footnote disclosure right now? I can just hear the discussions – "It looks like they booked a \$500 million gain from this related party company and I think, from all the undecipherable ½ page on Enron's contingent contributions to this related party entity, I think the related party entity is capitalized with Enron stock." "No, no, no, you must have it all wrong, it can't be that, that's just too bad, too fraudulent, surely AA&Co wouldn't let them get away with that?" "Go back to the drawing board, it's got to be something else. But find it!" "Hey, just in case you might be right, try and find some insiders or 'redeployed' former employees to validate your theory."

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To The Files
From James A. Hecker
Date August 21, 2001
Subject Client Accounting Inquiry

Yesterday I received an ostensibly social call from Sherron Smith Watkins, a Houston office alum who works in the CFO's group at our large audit client, Enron. After some small talk about current events such as the job market and last week's CEO resignation at Enron, she asked me if I knew much about some of Enron's recent structured transactions. I told her I did not, having never worked on the Enron job, but that I had general knowledge about many of the related issues from my work on other marketing and trading clients. Although she seemed initially reluctant to get into the details with me, an Arthur Andersen audit partner, she obviously wanted a "sounding board" with whom she could discuss certain of her concerns related to a set of Enron transactions, and I told her I'd be happy to listen.

Sherron then told me she was concerned about the propriety of accounting for certain related-party transactions. The transactions in question were, based on our discussions, with an entity with a name something like "LJM", which was at the time of the transactions at least partly owned by Andy Fastow, Enron's CFO (and her current boss). She later told me that Fastow's interest in "LJM" has since been sold to Michael Copper, an Enron alum. I also understood by her tone that the potentially sensitive transactions were done within the last couple of years. Sherron seemed even more agitated about the transactions' accounting because she perceived the related footnote disclosures in the company's consolidated financial statements were difficult to understand and did not tell the "whole story".

After some investigative work since her return to Fastow's group, she reportedly had discussed some of her concerns with Enron's general counsel office (she did not name the individual). That individual had assured her that AA and Enron's external counsel (Vinson & Elkins) had reviewed the transactions' accounting and financial statement disclosures and that they were sure there was no impropriety. At that point, I mentioned to Sherron that many people inside and outside the company assume we have seen every small transaction and OK'd the accounting, which for many reasons, potentially including immateriality, is often not true. Sherron understood this, but assured me the dollars involved (approximately \$500 million) were material, even to (a company as large as) Enron. Based both on the type and size of the transactions, Sherron told me she was concerned enough about these issues that she was going to discuss them with Ken Lay, Enron's Chairman, on Wednesday, August 22, 2001.

Based on our following discussions, her perceptions and concerns were:

- In summary, Sherron couldn't understand how Enron could, with its own capital stock, repeatedly add to the collateral underlying an obligation owed to Enron from a related party without recognizing in its financial statements either a) the related Enron stock distributions or contributions to that related party or b) the high-tech investment losses such related-party obligation was supposedly protecting against.
- LJM, an investment company formerly owned at least partially by Andy Fastow (CFO of Enron), was formed to enter into various structured transactions with Enron. I understood from Sherron that one such transaction involved the hedging of certain of Enron's investments in high-tech companies. Since these high-tech investment values have declined, Enron's hedge from LJM has increased in value, thus putting LJM on the hook for a potentially large liability to Enron. Supporting this hedging arrangement, Sherron described to me that LJM was initially capitalized in large part with Enron stock, which has also significantly declined in value since yearend 2000. Well after LJM's formation, and in response to this resulting reduction in total LJM asset value, her investigative inquiries had pieced together a very troublesome scenario. She perceived that Enron was putting additional Enron stock into LJM (the exact mechanism -- sales, contributions, exchanges or otherwise -- wasn't clear from our conversation), primarily to bolster LJM's perceived ability to repay obligations that will be owed to Enron at some future date. However, according to Sherron, these additional Enron stock contributions/issuances to LJM did not appear to be recorded on Enron's books. I informed Sherron I could not comment because I was obviously unfamiliar with the facts behind both the formation and ongoing operations of LJM.
- She asserted that the Enron financial-statement disclosures related to the Fastow investment-company relationships and transactions were (putting it kindly) hard to understand and incomplete. A \$500 million gain from the LJM contract(s) was purportedly identified in interim financial disclosures. However, according to Sherron, it was not clear in the disclosures that the \$500 million gain on Enron's books from the Fastow agreement (through LJM) actually offset other losses on Enron's investments in various high-tech investments. The potential collateralization/collectibility issues behind the LJM obligation that Sherron perceived are a problem were also not spelled out. I did not attempt to confirm these disclosure assertions by pulling Enron's Form 10-K or 10-Q's (but see documentation of engagement team discussions below)
- She also asserted that, at the time of the recent sale to Mr. Copper, she had mentioned to others that LJM must have had "very limited" stockholders' equity and must have been an unsuccessful investment for its owner(s). I inferred that she thought Mr. Copper's purchase price must have been relatively small, for one or more of the following reasons: a) LJM owed so much to Enron, or b) the company had so few other assets or c) it only had assets such as Enron stock that had declined so much in value since LJM's inception. However, she also asserted that she had been told that most, if not all, of LJM's equity had been distributed to its shareholder(s) [including Fastow and CIBC, an independent banking organization unrelated to Enron] concurrently, or shortly after, its original formation.

Based on our discussion, I told her she appeared to have some good questions. I emphasized that I was uninvolved in the issues of client and therefore unable to give her any definitive advice or conclusions on

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these matters, especially without knowing all the facts, which she understood. However, I encouraged her to discuss these issues with anyone in the company who could satisfy her about the accounting and disclosures related to these transactions. I told her that I admired her "stand-up" attitude and that corporate introspection about these sorts of accounting and reporting issues often was very healthy and should not be suppressed. She neither committed to update me about her discussions with Ken Lay nor requested anything further from me.

Immediately after my discussion with Sherron on August 20, I relayed the essence of her asserted concerns to Bill Swanson (ABA practice director), Dave Duncan (Enron engagement partner) and Deb Cash (a partner on several of the trading segments at Enron). On August 21, we all added Mike Odom, practice director, to the discussions, and agreed to consult with our firm's legal advisor about what actions to take in response to Sherron's discussion of potential accounting and disclosure issues with me.

Copies To:

Debra A. Cash
David B. Duncan
Michael M. Lowther
Michael C. Odom
William E. Swanson

October 15, 2001

Mr. James V. Derrick Jr.

Executive Vice President and General Counsel

Enron Corp.

1400 Smith Street

Houston, Texas 77002

Re: Preliminary Investigation of Allegations of an Anonymous Employee

Dear Jim:

You requested that Vinson & Elkins L.L.P. ("V&E") conduct an investigation into certain allegations initially made on an anonymous basis by an employee of Enron Corp. ("Enron"). Those allegations question the propriety of Enron's accounting treatment and public disclosures for certain deconsolidated entities known as Condor or Whitewing and certain transactions with a related party, LJM, and particularly transactions with LJM known as Raptor vehicles. The anonymous employee later identified herself as Sherron Watkins who met with Kenneth L. Lay, Chairman and Chief Executive Officer of Enron for approximately one hour to express her concerns and provided him with materials to supplement her initial anonymous letter. This letter constitutes our report with respect to our investigation and sets forth the scope of our review, the activities undertaken, the identification of primary concerns, and our analysis and conclusions with respect to those concerns.

1. Scope of Undertaking

In general, the scope of V&E's undertaking was to review the allegations raised by Ms. Watkins' anonymous letter and supplemental materials and to conduct an investigation to determine whether the facts she has raised warrant further independent legal or accounting review. By way of background some of the supplemental materials provided by Ms. Watkins proposed a series of steps for addressing the problems she perceived which included retention of independent legal counsel to conduct a widespread investigation and the engagement of independent auditors apparently for the purpose of analyzing transactions in detail and opining as to the propriety of the accounting treatment employed by Enron and its auditors Arthur Andersen L.L.P. ("AA"). In preliminary discussions with you, it was decided that our initial approach would not involve the second guessing of the accounting advice and treatment provided by AA, that there would be no detailed analysis of each and every transaction and that there would be no full-scale discovery style inquiry. Instead, the inquiry would be confined to a determination whether the anonymous letter and supplemental materials raised new factual information that would warrant a broader investigation.

2. Activities Undertaken

Our preliminary investigation included the review of selected documents provided to us by Enron and from our internal sources, interviews with key Enron and AA personnel and discussions with V&E attorneys who are familiar with legal issues addressed by Enron in connection with the subject transactions. The focus, of course, was to identify background information, disclosures and personal views with respect to the Condor/Whitewing and Raptor vehicles and Enron's relationship with LJM.

Documents reviewed in this process included excerpts of meetings of Enron's Board of Directors, including minutes of meetings of the Audit and Finance Committees of the Board, various public filings of Enron (annual reports, 10-K's, 10-Q's), documents relating to Enron's transactions with LJM, including Deal Approval Sheets and Investment Summaries, and various miscellaneous materials in the nature of presentations and memoranda. The focus of our document review was to determine whether the requisite approval of the transactions referenced in the anonymous letter had been obtained from Enron's Board and its' committees, the nature of the disclosures made with respect to the transactions and relationships questioned by the anonymous letter and supplemental materials and to provide general background information.

Interviews were also conducted with various Enron personnel based either on their connection with the transactions involving Condor/Whitewing, LJM and Raptor, or because they were identified in materials provided by Ms. Watkins as persons who might share her concerns. Those persons interviewed were; Andrew S. Fastow, Executive Vice President and Chief Financial Officer; Richard B. Causey, Executive Vice President and Chief Accounting Officer; Richard B. Buy, Executive Vice President and Chief Risk Officer; Greg Whalley, President and Chief Operating Officer (formerly Chairman of Enron Wholesale); Jeffrey McMahon, President and Chief Executive Officer, Enron Industrial Markets (formerly Treasurer of Enron); Jordan H. Mintz, Vice President and General Counsel of Enron Global Finance; Mark E. Koenig, Executive Vice President, Investor Relations; Paula A. Riekes, Managing Director, Investor Relations; and Sherron Watkins, the author of the anonymous letter and supplemental materials.

Interviews were also conducted with David B. Duncan and Debra A. Cash, both partners with AA assigned to the Enron audit engagement.

In addition to foregoing formal interviews, discussions were likewise held with Rex Rogers, Vice President and Assistant General Counsel of Enron, and Ronald I. Astin of V&E regarding general background information and the identification of specific issues relating to the matters raised by the anonymous letter and supplemental materials.

After completing interviews with all of the foregoing individuals, supplemental interviews were conducted with Andrew S. Fastow and Richard B. Causey of Enron and David B. Duncan and Debra A. Cash of AA to confirm certain information learned in the overall interview process.

As we initially discussed, we limited our interviews (with the exception of the AA partners mentioned above) to individuals still employed with Enron. Therefore, we did not interview individuals no longer with Enron mentioned in the anonymous letter or supplemental materials or any third party related to LJM.

3. Identification of Primary Concerns

Our preliminary investigation revealed four primary areas of concern expressed by Ms. Watkins' anonymous letter and supplemental materials. Accordingly, our document review and interview process focused on those areas of concern and whether the facts raised by Ms. Watkins' anonymous letter and supplemental materials presented any new information as to those matters that may warrant further independent investigation. Those areas of primary concern are as follows:

- a. the apparent conflict of interests by Mr. Fastow's ownership in LJM;

- b. the accounting treatment accorded the Condor and Raptor transactions;
and
- c. the adequacy of public disclosures of the Condor and Raptor transactions;
and
- d. the potential impact on Enron's financial statements as a result of the Condor/Whitewing and Raptor vehicles because of the decline in value of the merchant investments placed in those vehicles as well as the decline in the market price of Enron common stocks.

Our findings and conclusions with respect to each of these areas of concern are set forth separately below.

4. Conflict of Interest

Mr. Fastow actually organized two separate investment partnerships. The first, LJM-Cayman L.P. ("LJM1") was launched in June, 1999. The LJM concept appears to have been fully discussed with the Office of the Chairman and was presented to and approved by Enron's Board of Directors at a special meeting on June 28, 1999. That approval included the Board's waiver of Enron's code of ethics to permit Mr. Fastow to act as the general partner of LJM1. The primary purpose for the organization of LJM1 was to establish a non-Enron entity with which Enron could enter into a swap transaction to hedge its' investment in Rhythms Net-Communications. It was likewise recognized that LJM might negotiate to purchase additional assets in Enron's merchant portfolio. LJM raised \$16 million in outside equity, invested in a Raptor vehicle that entered into a swap for Rhythms NetCommunications and also purchased a sufficient portion of Enron's equity in the Cuiaba power plant in Brazil to allow Enron to deconsolidate that project.

The second investment partnership – LJM2 Co-Investment, L.P. ("LJM2") – was organized in October, 1999. At an October 11, 1999 meeting of the Finance Committee of the Board of Directors Enron's activities with LJM1 were reviewed and the proposal for transacting business with LJM2 was discussed and approved. The Board of Directors at its' meeting on October 12, 1999 waived Enron's code of ethics to permit Mr. Fastow to serve as a general partner of LJM2 and establish guidelines for Enron's transactions of business with LJM2. Those included: (i) no obligation to do transactions between Enron and LJM2; (ii) the Chief Accounting and Risk Officers would review, and where appropriate, approve transactions with LJM2; (iii) there would be an annual review by the Board's Audit Committee of completed transactions or recommendations as appropriate; and (iv) there would be an annual review as to the application of the Company's code of ethics to assure that such transactions would not adversely affect the best interests of the Company.

The LJM2 partnership raised \$349 million in equity from investors ranging from commercial and investment banks, insurance companies, public and private pension funds, and high net worth individuals. LJM2 has engaged in approximately 21 separate transactions with Enron.

Pursuant to the Board's guidelines, special procedures were adopted and utilized for the transaction of business with LJM. Those procedures included the preparation of a special LJM2 Deal Approval Sheet ("DASH") that would be prepared for every Enron/LJM2 transaction generally describing the nature of the commercial transaction and the relevant economics. Approval was also required by a variety of senior level commercial, technical and commercial support profes-

sionals. DASH was supplemented by an LJM approval process checklist testing for compliance with Board directives for transactions with LJM2, including questions addressing the following:

- Alternative sales options and counter-parties,
- determination that the transaction was conducted at arm's length,
- disclosure obligations, and
- review of the transaction by Enron's Office of the Chairman, Chief Accounting Officer and Risk Officer.

As part of these procedures, it also appeared that several additional controls were adhered to. These included LJM senior management professionals never negotiating on behalf of Enron; Enron professionals negotiating with LJM reporting to senior Enron professionals other than Mr. Fastow; Enron Global Finance commercial, legal and accounting monitoring of compliance with procedures and controls for regular updates for Chief Accounting and Risk Officers, and internal and outside counsel regularly consulted regarding disclosure obligations and review of any such disclosures.

Based on our review of the LJM Deal Approval Sheets and accompanying checklist, it appears that the approval procedures were generally adhered to. Transactions were uniformly approved by legal, technical and commercial professionals as well as the Chief Accounting and Risk Officers. In most instances, there was no approval signature for the Office of the Chairman except for several significant transactions. It also appeared that the LJM transactions were reviewed by the Audit Committee on an annual basis. At the February 7, 2000 meeting of the Audit Committee all LJM transactions occurring prior to that date were reviewed. A review of all the LJM transactions during the following year was made at the February 12, 2001 meetings of both the Audit and Finance Committees.

Based on our interviews with various Enron representatives, and notwithstanding the foregoing guidelines and procedures that were adopted concerns were expressed about the awkwardness in LJM's operating within Enron and two potential conflicts of interest. The awkwardness arose from the fact that LJM's professionals, primarily individuals reporting to Mr. Fastow and Michael Koppers were also Enron employees who occupied Enron space and worked among Enron employees. Transactions were negotiated between Enron employees acting from [illegible in document] other Enron employees acting for LJM. Within Enron there appeared to be an air of secrecy regarding the LJM partnerships and suspicion that those Enron employees acting for LJM were receiving special or additional compensation. Although there was a Services Agreement between Enron and LJM pursuant to which LJM compensated Enron for the services of Enron personnel and use of Enron's facilities, this fact did not quell the awkwardness of the Enron employees "wearing two hats." Much of this awkwardness should be eliminated on a going-forward basis, however, by reason of Mr. Fastow's sale of his ownership interests in LJM effective July 31, 2001 to Mr. Koppers (who resigned from Enron prior to the transaction) and the complete separation of LJM's employees and facilities from Enron.

The first area of potential conflict of interest voiced by several individuals was the risk that undue pressure may be placed on Enron professionals who were negotiating with LJM because those individuals would ultimately have their performance evaluated for compensation purposes by Mr. Fastow in his capacity as

Chief Financial Officer. In particular, Jeffrey McMahon noted that while he was Treasurer of Enron he discussed this conflict directly with Mr. Fastow and Jeffrey Skilling and that the conflict was not resolved prior to his acceptance of a new position within Enron. Mr. McMahon stated, however, that he was aware of no transaction where Enron suffered economic harm as a result of this potential conflict.

The second potential conflict of interest identified by several individuals was that investors in LJM may have perceived that their investment was required to establish or maintain other business relationships with Enron. Although no investors in LJM were interviewed, both Mr. Fastow and Mr. McMahon stated unequivocally that they told potential investors that there was no tie-in between LJM investments and Enron business. Moreover, Mr. Fastow stated that Merrill Lynch was paid a fee for marketing LJM partnership interests and that a number of investors, such as private and public pension funds and high net worth individuals had no business relationship with Enron.

In summary, none of the individuals interviewed could identify any transaction between Enron and LJM that was not reasonable from Enron's standpoint or that was contrary to Enron's best interests. Conversely, the individuals interviewed were virtually uniform in stating that LJM provided a convenient alternative equity partner with flexibility that permitted Enron to close transactions that otherwise could not have been accomplished. Moreover, both the awkwardness and potential for conflict of interest should be eliminated on a going-forward basis as a result of Mr. Fastow's divestment of his ownership interest in the LJM partnerships.

5. Accounting Issues

As stated at the onset, the decision was made early in our preliminary investigation not to engage an independent accounting firm to second guess the accounting advice and audit treatment provided by AA. Based on interviews with representatives of AA and Mr. Causey, all material facts of the Condor/Whitewing and Raptor vehicles, as well as other transactions involving LJM, appeared to have been disclosed to and reviewed by AA. In this regard, AA reviewed the LJM solicitation materials and partnership agreement to assure that certain safeguards were provided that would permit LJM to be a source of third party equity in transactions conducted with Enron. AA likewise reviewed specific transactions between Enron and LJM to assure that LJM had sufficient equity in the transaction to justify the accounting and audit principles being applied.

The relationship between Enron and AA was an open one and, according to Mr. Causey, Enron consults AA early and often on accounting and audit issues as they arise. AA concurs with this statement, but points out that in certain of its accounting and audit treatments, it must rely on Enron's statement of the business purpose for specific transactions and Enron's valuation of assets placed in the Condor/Whitewing and Raptor structures.

Enron and AA representatives both acknowledge that the accounting treatment on the Condor/Whitewing and Raptor transactions is creative and aggressive, but no one has reason to believe that it is inappropriate from a technical standpoint. In this regard, AA consulted with its senior technical experts in its Chicago office regarding the technical accounting treatment on the Condor/Whitewing and Raptor transactions, and the AA partners on the Enron account consulted with AA's

senior practice committee in Houston on other aspects of the transactions. Enron may also take comfort from AA's audit opinion and report to the Audit Committee which implicitly approves the transactions involving Condor/Whitewing and Raptor structures in the context of the approval of Enron's financial statements.

Following our initial interview with AA representatives you agreed with us that it was desirable and appropriate to provide them with Ms. Watkins' anonymous letter and supplemental materials so that AA could comment directly on specific allegations contained in those materials. AA identified two allegations in particular that, if accurate, would affect their accounting and audit treatment. Those allegations were, in effect: (i) There was a handshake deal between Mr. Skilling and Mr. Fastow that LJM would never lose money on any transaction with Enron; and (ii) LJM received a cash fee in the Raptor transactions that completely recouped its investment and profit.

Mr. Fastow adamantly denies any agreement with Mr. Skilling or anyone else that LJM would never lose money in transactions with Enron and he recognized that such an agreement would defeat the accounting treatment that was the very objective for the formation of LJM. Mr. Causey is unaware of any such agreement and has seen no evidence of it.

Both Mr. Fastow and Mr. Causey acknowledge that LJM was to receive a cash fee for its management of the Raptor vehicles in an amount not to exceed \$250,000.00 annually for each company, for a total of \$1,000,000.00 for the four entities. AA was aware of Enron's payment of these fees as well as other organizational costs of the Raptor entities, but these fees fall far short of recouping LJM's investment in the Raptor entities. Both Mr. Fastow and Mr. Causey were quick to point out, however, that in each Raptor vehicle the first transaction was a "put" of Enron shares which was settled favorably to LJM prior to maturity, and as a result thereof, distributions were made to LJM in amounts equal to or greater than its initial investment in those Raptor vehicles. AA is aware of these transactions and is comfortable that, by reason of the applicable special purpose entity accounting rules, the transactions do not undermine LJM's equity investment in the Raptor vehicles.

When questioned about her basis for these two allegations in her anonymous letter and supplemental materials, Ms. Watkins acknowledged that she had no personal, first-hand knowledge of either allegation. Both were based solely on rumors that she heard during the two months she was working in Enron Global Finance, and she was uncertain about any details of the alleged cash fee allegation. Notwithstanding the lack of any solid basis for the allegations we think it is likely that AA will seek some kind of assurance from Enron and perhaps from Messrs. Fastow and Causey that no such agreement or cash fee payment occurred.

6. Adequacy of Disclosures

Notwithstanding the expression of concern in Ms. Watkins' anonymous letter and supporting materials regarding the adequacy of Enron's disclosures as to the Condor/Whitewing and Raptor vehicles (which, to a large extent, reflect her opinion) AA is comfortable with the disclosure in the footnotes to the financials describing the Condor/Whitewing and Raptor structures and other relationships and transactions with LJM. AA points out that the transactions involving Condor/Whitewing are disclosed in aggregate terms in the unconsolidated equity af-

filiates footnote and that the transactions with LJM, including the Raptor transactions, are disclosed in aggregate terms in the related party transactions footnote to the financials.

The concern with adequacy of disclosures is that one can always argue in hindsight that disclosures contained in proxy solicitations, management's discussion and analysis and financial footnotes could be more detailed. In this regard, it is our understanding that Enron's practice is to provide its financial statements and disclosure materials to V&E with a relatively short time frame within which to respond with comments.

7. Potential Bad Cosmetics

Concern was frequently expressed that the transactions involving Condor/Whitewing and Raptor could be portrayed very poorly if subjected to a Wall Street Journal expose or class action lawsuit. Factors pointed to in support of these concerns included (i) the use of Enron stock to provide equity necessary to do transaction with Condor/Whitewing and Raptor; (ii) recognizing earnings through derivative transactions with Raptor when it could be argued that there was no true "third party" involved in those transactions; (iii) because both merchant investment value and Enron stock have fallen, the Raptor entities may not be able to satisfy their obligations to Enron, thus raising the question "Who ultimately bears this loss?"; (iv) the apparent conflict of interest issue raises questions as to the valuation of assets sold to or that were the subject of transactions with Raptor and the timing of those transactions, (generally at a point when the valuation was at a historical high point).

8. Conclusions

Based on the findings and conclusions set forth with respect to each of the four areas of primary concern discussed above, the facts disclosed through our preliminary investigation do not, in our judgment, warrant a further widespread investigation by independent counsel and auditors.

Our preliminary investigation, however, leaves us with concern that, because of the bad cosmetics involving the LJM entities and Raptor transactions, coupled with the poor performance of the merchant investment assets placed in those vehicles and the decline in the value of Enron stock, there is a serious risk of adverse publicity and litigation. It also appears that because of the inquiries and issues raised by Ms. Watkins, AA will want additional assurances that Enron had no agreement with LJM, that LJM would not lose money or transactions with Enron and that Enron paid no fees to LJM in excess of those previously disclosed to AA. Finally, we believe that some response should be provided to Ms. Watkins to assure her that her concerns were thoroughly reviewed, analyzed, and although found not to raise new or undisclosed information, were given serious consideration.

We have previously reported verbally to Mr. Lay and you regarding our investigation and conclusions and, at your request, have reported the same information to Robert K. Jaedicke in his capacity of Chairman of the Audit Committee of Enron's Board of Directors. At Dr. Jaedicke's request, we gave a verbal summary of our review and conclusions to the full Audit Committee. Should you desire to discuss any aspect of this written report or any other details regarding our review of this matter, please do not hesitate to contact us at your convenience.

Very truly yours,

Vinson & Elkins L.L.P.
Max Hendricks III
