

## C. Recent Financial History

### 1. Use of off-balance sheet entities to enhance financial performance measures<sup>92</sup>

#### Financial objectives

By the late 1990s, Enron had amassed substantial debt relating to its capital expenditures and investments in power plants, pipelines, electronic commerce, water, metals, and broadband services. Many of Enron's growth businesses required substantial upfront capital investments long before positive cash flows and earnings reasonably could be expected from those investments. These circumstances placed enormous pressure on the company's Enron 2000 financial objectives of: (1) \$1 billion of net income by the year 2000; (2) 15 percent average compound annual growth; and (3) double-digit growth in each individual fiscal year. Further, the company needed cash to service its increasing debt load.

Enron's evolving business approach also required the company to access increased lines of credit to ensure that the company had sufficient funds to settle energy contracts being traded on its online trading system. Enron experienced large fluctuations of short-term debt from quarter to quarter. These fluctuations potentially affected Enron's credit rating, which in turn affected Enron's ability to obtain low-cost financing and to attract investment. In response to this, Enron emphasized increasing its cash flow, lowering its debt, and smoothing its reported earnings to satisfy the criteria set out by credit and rating agencies.

The company developed or used a number of financing, operational, and accounting strategies to accomplish its financial objectives. These included: (1) using energy contracts called "prepays," which provided Enron a large advance payment to deliver natural gas or other energy products; (2) designing hedges to reduce the risk of long-term energy delivery products; (3) pooling energy contracts and securitizing them through bonds or other financial instruments sold to investors; and (4) making the company "asset light" by disposing of capital-intensive energy projects, such as power plants, that were traditionally associated with low returns and persistent debt on the company's books. Certain of Enron's strategies, such as its use of "accounting hedges," reportedly were designed to reduce the effect of investment value declines on Enron's financial statements, without effectively changing the economic risks relating to the asset.

Many of these strategies used special purpose entities ("SPEs") formed by Enron or Enron employees to conduct transactions with Enron and its affiliates. Instead of selling assets to, or transacting hedging transactions with, independent third parties, Enron engaged in transactions with unconsolidated, or "off-balance-sheet," SPEs that Enron did not include in its financial accounting statements.<sup>93</sup> Enron used SPEs in synthetic lease transactions (sale to an

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<sup>92</sup> The Powers Report serves as a source of information regarding the off-balance sheet transactions. See Part Three, below, for a more in-depth description of off-balance sheet entities.

<sup>93</sup> By October 2000, Enron had a total of approximately \$60 billion in assets, of which approximately \$27 billion were in Enron's unconsolidated affiliates. Use of unconsolidated entities allowed Enron to include its share of the affiliates' revenues in its income statement

SPE of an asset and a lease back of that asset); “sales” to SPEs of business assets with prearranged commitments to repurchase the assets at a specified future date; and “sales” to “hedging SPEs” of Enron stock and stock rights to provide credit support for hedging transactions.<sup>94</sup>

Enron reported for financial statement purposes gains or losses on portfolio investments on a mark-to-market basis, meaning that increases or decreases in the market value of Enron’s portfolio investments increased or decreased Enron’s financial statement earnings. Decreases in portfolio investment values adversely affected Enron’s financial statement earnings. Enron used purported hedging structures in an attempt to offset its portfolio investment losses by taking the position that the underlying portfolio investments were hedged, with Enron reporting offsetting gains on the purported hedging positions.<sup>95</sup>

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while excluding related debt from its consolidated financial statements, thereby enhancing its return on investment and certain other financial performance measures.

<sup>94</sup> Powers Report at 37. These off-balance structures and transactions were widely reported in the press and have become an issue in Enron’s bankruptcy proceedings. Enron’s unsecured creditors have attempted to obtain documents and testimony regarding 52 of Enron’s off-balance sheet affiliates: Rawhide Investors LLC; Ponderosa Assets LP; Sundance Assets LP; Zephyrus; Choctaw; Hawaii 125-0; Cerebus; Cornhusker; Nikita/EOTT; ETOL; Motown; Riverside; Service Co.; Slapshot; Marlin Water Trust; Atlantic Water Trust; Osprey Trust; Whitewing Associates LP; Whitewing Associates LLC; LJM Cayman LP; LJM2 Co-Investment LP; Condor; Raptor I; Raptor II; Raptor III; Raptor IV; Joint Energy Development Investments Limited Partnership; Osprey, Inc.; Big Doe, LLC; Braveheart; Chewco Investments, LP; Firefly; Yosemite; Big River Funding, LLC; Little River Funding, LLC; SONR #1, LLC; SONR #1 LP; SONR #2, LLC; LJM Partners, LLC; LJM Partners, LP; LJM SwapCo; LJM Swap Sub, LP; Talon, LLC; Harrier; Timberwolf; Pro[n]ghorn; Porcupine; Bobcat; Southampton Place, LP; Southampton, LP; LJM2 Capital Management, LP; and LJM2 Capital Management, LLC. Motion of Official Committee of Unsecured Creditors For Order, Under 11 U.S.C. Section 1103(c) and Fed. R. Bankr. P. 2004, For Production of Documents and Examination of Witnesses Regarding Debtors’ Off-Balance Sheet Assets and Liabilities, filed by the Official Committee of Unsecured Creditors of Enron Corp., *et. al.*, In re Enron Corp., *et. al.*, Debtor at 6 (01-16034) (Docket Entry No. 1352), *available at* <http://www.elaw4enron.com/default.asp> (last visited February 4, 2003).

<sup>95</sup> The U.S. Government has alleged that Enron used off-balance structures for other purposes, including to receive beneficial regulatory treatment of its California wind farms under the Public Utility Holding Company Act, following Enron’s purchase of PGE. Criminal Complaint, *United States of America v. Andrew S. Fastow*, at 7 (alleging improper use of RADR special purpose entities to disguise Enron’s interests in wind farms); Complaint, *United States Securities and Exchange Commission v. Andrew S. Fastow*, at 3-5 (alleging improper use of RADR special purposes entities to achieve favorable financial benefits).

Three of Enron's off-balance sheet structures that received significant attention included the Chewco, LJM1, and LJM2 partnerships.

### **Chewco and JEDI**

In 1993, Enron and California Public Employees Retirement System ("CalPERS") entered into a joint venture investment partnership called Joint Energy Development Investments Limited Partnership ("JEDI I"), whereby each partner owned 50 percent of the venture. JEDI I was an unconsolidated entity, which meant that Enron did not include JEDI I's assets or debt in Enron's balance sheet.<sup>96</sup> JEDI I made numerous energy-related investments during the period 1993 to 1997. In late 1997, Enron wanted to approach CalPERS for a substantial cash investment in a second investment partnership to be called JEDI II. Concerned that CalPERS would not invest simultaneously in both JEDIs, Enron sought a buyer for CalPERS' interest in JEDI I. After no third party expressed interest, certain Enron employees, with the assistance of Enron, formed Chewco Investments, LP ("Chewco"), a Delaware limited partnership, to acquire and own the JEDI I interest held by CalPERS. Enron ultimately reached an agreement with CalPERS for JEDI I to redeem CalPERS' interest as a limited partner of JEDI I for \$383 million. The parties closed the transaction in November 1997 and Chewco replaced CalPERS as JEDI I's limited partner. Enron intended that Chewco be structured as an unconsolidated affiliate to achieve off-balance sheet treatment for Chewco and JEDI I following CalPERS' exit from the joint venture.<sup>97</sup>

After CalPERS ceased to be a partner of JEDI I, Enron used JEDI I as an unconsolidated affiliate to enhance or accelerate Enron's reported financial statement earnings through transactions paying Enron management fees and guaranty fees, and through JEDI I's ownership of Enron's stock or stock rights. By treating JEDI I and Chewco as unconsolidated entities after CalPERS departed from the venture, Enron reported increased net income of \$45 million (out of \$105 million total reported net income) in 1997, \$107 million (out of \$703 million reported total net income) in 1998, \$153 million (out of \$893 million reported total net income) in 1999, and \$91 million (out of \$979 million reported total net income) in 2000.<sup>98</sup>

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<sup>96</sup> Enron's investments in JEDI I were accounted for under the equity method of accounting, which meant that Enron included its net ownership interest in JEDI I in Enron's balance sheet. Enron Corp., 2000 Annual Report (2001), at 42.

<sup>97</sup> The Powers Report stated that under then applicable generally accepted accounting principles ("GAAP"), Chewco was required to satisfy two requirements for non-consolidation: (1) any control of Chewco by Enron or an Enron affiliate as a general partner had to be limited; and (2) Chewco had to have a minimum of three percent outside equity at risk. Financial Accounting Standards Board, Emerging Issues Task Force, No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions* (nullified by Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities*, an Interpretation of ARB No. 51, at Appendix D1).

<sup>98</sup> Enron Corp., Form 8-K filed with the Securities and Exchange Commission (November 8, 2001).

## LJM1, LJM2, and the Raptors

LJM Cayman, LP (“LJM1”) and LJM2 Co-Investment, LP (“LJM2”) (collectively the “LJM Partnerships”) were established by Enron employees to function as off-balance-sheet SPEs intended to transact business with Enron to improve Enron’s financial statements. The LJM transactions had the effect of boosting Enron’s reported earnings through the use of purported hedging transactions and asset transfers.

From June 1999 to June 2001, Enron entered into approximately 20 distinct purported asset sales or hedging transactions with the LJM partnerships.<sup>99</sup> In the asset sales category, Enron transferred assets to the LJM entity to remove the asset from Enron’s books. The effect in some of the transactions was that no associated risk passed from Enron, because transactions of this type generally require that the benefits and burdens of ownership pass from the transferor to the transferee.<sup>100</sup> The LJM hedges were intended to be accounting hedges, not economic hedges, designed to permit Enron to record gains on hedging positions to offset investment losses in the value of underlying portfolio investments on Enron’s financial statements.

LJM1 was organized as a limited partnership in the Cayman Islands. The first LJM1 transaction involved stock issued by Rhythms Net that Enron had purchased at the initial public offering for \$10 million and which later increased in value to over \$300 million. Enron reported the appreciation in the investment’s stock price as earnings on its financial statements, but wanted to protect its income statements from any loss if the stock price declined. In order to achieve this protection, Enron devised a strategy whereby LJM1 purportedly could provide a hedge on the Rhythms Net stock. In 1999, Enron recognized after-tax income of \$95 million from the Rhythms Net investment.

In October 1999, LJM2 was formed as a Delaware limited partnership. The first seven LJM2 transactions consisted of Enron purportedly selling poorly performing assets to LJM2, which enabled Enron to move debt off of its balance sheet and report additional earnings and cash flow from asset sales on its financial statements. One stated purpose of LJM2 was to provide a “source of private equity for Enron to manage its investment portfolio risk, funds flow,

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<sup>99</sup> The definition of a hedging transaction varies widely depending upon the purpose for which the term is used. For example, a hedging transaction for Federal income tax purposes is defined as any transaction that is entered into in the normal course of a trade or business that is properly identified as managing the risk of price changes, currency fluctuations, interest rate changes, or any other risk prescribed in regulations with respect to ordinary property or borrowings. Sec. 1221(b)(2). By contrast, a hedging transaction for financial accounting purposes is defined as a derivative that is designated as a hedge, but only to the extent that the changes in the value of the derivative are effective in offsetting changes in the fair value or cash flow of an exposure or changes in the value of net investment in a foreign operation. See Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

<sup>100</sup> Powers Report at 11-12.

and financial flexibility.”<sup>101</sup> The transactions between Enron and LJM2 that had the greatest impact on Enron’s financial statements, however, increased Enron’s earnings through the use of purported hedges. These involved four SPEs known as the “Raptors,” a series of complex transactions that began in mid-2000 and terminated in 2001.<sup>102</sup> The Raptors hedges were used by Enron to offset mounting mark-to-market losses attributable to investments otherwise reportable on Enron’s income statement.

In three of the four Raptors, an SPE was established and LJM2 provided the SPE with a \$30 million investment. LJM2’s ability to provide the hedge to Enron was created by Enron transferring its own stock or stock rights to the Raptors entity at a substantially discounted price. In these cases, Enron’s stock price needed to remain high in order for LJM2 and the Raptor entity to be able to honor the Raptors entity’s commitment to Enron pursuant to the hedge. The first Raptor (Raptor I) was formed in April 2000 and involved an SPE named Talon I, LLC (“Talon”). Enron and LJM2 established two additional Raptor structures, Raptor II and Raptor IV, that did not materially differ in structure from Raptor I.<sup>103</sup> Enron reportedly provided assurances to LJM2 that LJM2 would recoup its \$30 million investment plus an additional \$10 million profit within six months of each SPE’s establishment. The Raptors hedging transactions purportedly transferred Enron’s risk to an SPE holding Enron’s own stock and stock contracts and, therefore, did not transfer meaningful risk to an unrelated third party.<sup>104</sup>

Raptor III differed from the other Raptors in that it was intended to hedge a single Enron investment, The New Power Company (“TNPC”), rather than Enron’s investments in unaffiliated companies. Unlike the other Raptors, Raptor III held the stock of TNPC, the company whose stock it was intended to hedge, rather than Enron stock.

Throughout 2000 and into 2001, the assets of the Raptor SPEs declined in value as the value of Enron stock and stock contracts and the TNPC stock supporting the Raptor SPEs’ creditworthiness declined. By the end of December 2000, the asset and collateral values declined to the point that the Raptor SPEs had virtually no assets or capital to support their hedge obligations to Enron. In response to this, Enron structured several complex financial transactions in an attempt to provide further credit support to the Raptors entities.<sup>105</sup>

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<sup>101</sup> LJM2 Summary, materials provided by Enron. EC 000052043-44.

<sup>102</sup> Enron disclosed the first Raptor in the Form 10-Q that it filed with the Securities and Exchange Commission for the second quarter of 2000, and provided more detailed disclosures for all four Raptors in the Form 10-Q that it filed for the third quarter of 2000 and in its 2000 Form 10-K.

<sup>103</sup> Raptor II was formed in June 2000 and Raptor IV was formed in August 2000.

<sup>104</sup> Powers Report at 97-98.

<sup>105</sup> These financial arrangements included placing a “collar” (i.e., purchasing a put option at a strike price below the current market price of the security and selling a call option at a price above the current market price of the security) on the Raptor hedges in October 2000, creating a 45-day guarantee arrangement to support all four Raptor transactions in December 2000, and

In the last two quarters of 2000, Enron reported revenues of approximately \$500 million on derivative transactions with Raptor entities, which offset mark-to-market losses attributable to Enron's merchant investments, and recognized pre-tax earnings of \$532 million (including net interest income).<sup>106</sup> Enron's reported pre-tax earnings for the last two quarters of 2000 totaled \$650 million. Reported earnings from the Raptors accounted for approximately 80 percent of that total. In total, Enron reportedly used the Raptors structures to offset Enron investment losses totaling approximately \$1 billion.<sup>107</sup>

## 2. Financial performance and liquidity issues<sup>108</sup>

Enron's investment in its growing broadband business and foreign operations adversely affected Enron's liquidity position in the late 1990s and thereafter. Capital expenditures for its broadband business were expected to reach an estimated \$1.1 billion for 2000 and 2001, with broadband capital expenditures comprising 47 percent of the company's estimated 2001 total capital expenditures.<sup>109</sup> Although the Dabhol power project in India was expected to be a strong contributor to Enron's earnings, after reportedly investing \$3 billion in Dabhol, the plant was shut down in 2001. The Azurix and Wessex Water projects in the United Kingdom also faced financial and operational difficulties.<sup>110</sup> Enron's earnings performance was further adversely affected by start-up losses in its broadband business and the California energy crisis. Enron

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restructuring the Raptors in March 2001 by placing additional Enron shares at risk to support them. Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs U.S. Senate, *The Role of the Board of Directors in Enron's Collapse*, Report 107-70 (July 8, 2002) at 117.

<sup>106</sup> Powers Report at 119, 128.

<sup>107</sup> Powers Report at 132.

<sup>108</sup> For a listing of selected historical Enron financial information, see Table 3, below, Miscellaneous Financial Information, 1985-2000.

<sup>109</sup> Enron Corp., Form 10-K filed with the Securities and Exchange Commission (April 2, 2001). Enron reported a gross margin of \$318 million from broadband services, with a \$60 million loss before interest, minority interests, and taxes, for its 2000 year. *Id.*

<sup>110</sup> Enron reported a \$326 million charge to earnings in its 2000 financial statements, reflecting Enron's portion of impairments recorded by Azurix related to assets in Argentina, and a \$287 million write-off of Azurix asset impairments in its third quarter 2001 financial statements. Enron Corp., 2000 Annual Report (2001), at 42; Press Release, Enron Corp., Enron Reports Recurring Third Quarter Earnings of \$0.43 Per Diluted Share; Reports Non-Recurring Charges of \$1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of \$1.80 for 2001 and \$2.15 for 2002; and Expands Financial Reporting (October 16, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/68-3QearningsLtr.html> (last visited January 27, 2003).

reportedly incurred in excess of \$500 million in trading losses in the California markets over the summer of 2000.

As part of its strategic plan, Enron made efforts to raise cash by selling large holdings in various businesses. In 1999, Enron Corp. and EOG established the latter as a public company independent of Enron. The 1999 EOG transaction involved the exchange by Enron of approximately 76 percent of its stock ownership of EOG for EOG's China and India operations, and generated a pre-tax financial reporting gain of \$454 million (\$345 million after-tax).<sup>111</sup> Approximately \$600 million of cash was transferred by EOG to EOGI-India, Inc., an Indian subsidiary acquired by Enron Corp. to be used by Enron to finance international activities. Also during 1999, Enron attempted to sell PGE. Enron reached agreement with Sierra Pacific Resources ("Sierra") to sell PGE to Sierra for approximately \$3 billion in cash, but the parties terminated the agreement in April 2001.<sup>112</sup>

Enron attempted to sell a large portion of its foreign assets during 2000, but these attempts also failed. One example, called Project Summer, involved Enron's attempt to sell approximately 80 percent of its non-European international businesses for \$6.08 billion in cash.<sup>113</sup> Enron believed that if consummated, Project Summer would have allowed Enron to reduce its annual dividends to be paid on its common stock, one of its financial strategies to reduce cash outflows, without raising investor concerns that the dividend cut was driven by a lack of cash.<sup>114</sup>

Investor concerns regarding Enron's financial condition began to appear in late 2000. To address these concerns, Enron President and Chief Operating Officer Jeff Skilling issued a press release on November 24, 2000, stating that "rumors of a potential profit warning are not true." On January 25, 2001, and on March 22, 2001, the company issued press releases reaffirming its confidence in "strong business prospects for 2001" and stating it was "comfortable" with estimates and previously announced targets for 2001. Enron restructured a portion of its debt in

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<sup>111</sup> Enron treated the EOG exchange transaction as a tax-free split-off under section 355 for Federal income tax purposes. *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation (June 7, 2002).

<sup>112</sup> Enron's disposition of PGE's assets, which was part of its 1998-2000 strategic plan, had been under consideration since 1997. *See* 1998-2000 Operating & Strategic Plan, Presentation to Board of Directors (December 9, 1997). EC 000046107. Enron expected to use the PGE sales proceeds to reduce debt and fund higher growth opportunities. Board Presentation: Project Granite (November 5, 1999). EC 000052176. After the aborted sale of PGE to Sierra, Enron reached agreement with Northwest Natural Gas in October 2001 to sell PGE for \$1.8 billion, including \$1.55 billion in cash, but these negotiations terminated in May 2002.

<sup>113</sup> Handout for Project Summer, Meeting of the Enron Corp. Board of Directors', August 1, 2000. EC 000043574 et. seq.

<sup>114</sup> *Id.*

February 2001 and issued \$1.9 billion face value of 20-year zero coupon notes that yielded \$1.25 billion in proceeds, most of which were used to refinance existing debt.<sup>115</sup> On April 17, 2001, Enron announced an increase in its earnings expectations for 2001. On June 19, 2001, Chief Executive Officer Skilling announced the company remained “very confident” that it would meet its previously-announced increased earnings expectations for 2001. On July 12, 2001, Mr. Skilling announced renewed confidence in achieving the 2001 earnings expectations and new increased earnings guidance for 2002.<sup>116</sup>

In general, the financial markets did not react favorably to Enron’s performance or earnings announcements during the first nine months of 2001. Enron’s stock price, which had peaked at \$90.75 per share in August 2000 and opened 2001 at \$83.13 per share, declined throughout 2001. Enron’s stock closed at \$58.10 and \$49.10 per share on March 30, 2001, and June 29, 2001, respectively. By September 28, 2001, the end of the third quarter, Enron’s stock was trading at \$27.23 per share.

At this point in time, Enron had reported financial information to the public that had portrayed Enron as a company that was increasing its revenues, net income, assets, and market capitalization. To the public, Enron appeared to have achieved the financial goals established in 1996 with its implementation of Enron 2000.

Table 5, below, provides information that illustrates Enron’s growth for the years 1985 through 2000, including its attainment of \$1 billion of net income.

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<sup>115</sup> The \$1,000 zero coupon notes were offered at an issue price of \$655.24, which represented an annual yield to maturity of 2.125 percent. The notes were convertible into Enron common stock, upon certain contingencies being satisfied, at a conversion premium. Enron was not obligated to make interest or principal payments with respect to the notes prior to their scheduled maturity of February 2021.

<sup>116</sup> The following month, in August 2001, Mr. Skilling resigned his position with Enron Corp.



Table 5.-Miscellaneous Financial Information, 1985 to 2000

Year	Revenues of [billions of dollars]	Operating income [millions of dollars]	Net income per books [millions of dollars]	Total assets [billions of dollars]	Year-end common stock price per share (split-adjusted) <sup>1</sup>	Market capitalization [billions of dollars] <sup>2</sup>
1985	\$16.4	\$234	\$-79	\$12.1	\$5.63	\$2.0
1986	9.3	-158	557	10.1	4.94	1.8
1987	8.5	330	-29	9.4	4.89	1.8
1988	8.3	295	109	8.7	4.58	1.7
1989	9.8	337	226	9.1	7.20	2.9
1990	5.3 <sup>3</sup>	434	202	9.8	6.84	2.8
1991	5.7	498	232	10.1	8.75	3.5
1992	6.4	614	306	10.3	11.59	6.1
1993	8.0	631	333	11.5	14.50	8.5
1994	9.0	716	453	12.0	15.25	7.6
1995	9.2	618	520	13.2	19.06	9.6
1996	13.3	690	584	16.1	21.56	11.3
1997	20.3	15	105 <sup>4</sup>	22.6	20.78	12.9
1998	31.3	1,378	703	29.4	28.53	18.9
1999	40.1	802	893	33.4	44.38	33.4
2000	100.8	1,953	979	65.5	83.13	62.5

Notes: (1) This column shows Enron's stock price on a split-adjusted basis, not on an historical actual price basis. For example, Enron's per share actual stock price on December 31, 1985, was \$45.00, which converts to a \$5.63 split-adjusted price to account for the three 2-1 stock splits since then. Enron Corp. did a 2-for-1 stock split during each of 1991, 1993, and 1999; (2) The figures for 1985 through 1992 are based on end of year market prices and outstanding share information. The figures for 1993 through 2000 are as reported in the company's Form 10-K filings for the relevant year, which reflect market price and outstanding shares at a point in between the relevant year end and the date the Form 10-K was filed. These figures do not take into account the value of preferred stock issued and outstanding during these periods; (3) The revenue figures for 1990 and subsequent years reflect the 1993 divestiture of EOTT, which caused the company's revenues to be restated downward for 1990 and thereafter; (4) After a \$463 million non-recurring charge relating to J-block gas contracts.

Source: Compiled by the Joint Committee staff from Enron's annual reports and Forms 10-K filed with the Securities and Exchange Commission. Split-adjusted stock prices are as reported in the Historical Market Data Center<sup>TM</sup> from Dow Jones & Company, Inc.

### 3. Accounting irregularities, adjustments, and non-recurring charges to earnings for financial reporting periods 1997 to 2001

Certain of the company's accounting practices came under scrutiny when an Enron employee warned Enron management "that we will implode in a wave of accounting scandals."<sup>117</sup> In August 2001, Ms. Sherron Watkins, Vice President for Corporate Development, sent a memorandum to Mr. Lay raising numerous areas of concern regarding accounting issues with respect to the Raptor, LJM, and Condor transactions,<sup>118</sup> including the disclosure of related party transactions and equity derivative transactions. The memorandum also outlined some solutions, including retaining the services of a law firm (other than Enron's general counsel, Vinson & Elkins) to investigate these transactions, and retaining the services of an accounting firm (other than Enron's auditors, Arthur Andersen).

In October 2001, at Enron's request, Vinson & Elkins conducted an investigation into the issues presented in Ms. Watkins' memo by addressing the following areas of concern: (1) the apparent conflict of interest involving Mr. Fastow's ownership in the LJM partnerships; (2) the accounting treatment accorded the Condor and Raptor structures in Enron's financial statements; (3) the adequacy of public disclosures of the Condor and Raptor transactions; and (4) the potential impact on Enron's financial statements of the Condor/Whitewing and Raptor vehicles. Each issue was given separate consideration and Vinson & Elkins' findings were consistent with the company's overall approach. Vinson & Elkins concluded that "facts disclosed through our preliminary investigation do not, in our judgment, warrant a further widespread investigation by independent counsel and auditors."<sup>119</sup>

On October 16, 2001, Enron announced its first quarterly loss in four years when it reported a net loss of \$618 million for the quarter ended September 30, 2001, after taking into account after-tax non-recurring charges of \$1.01 billion.<sup>120</sup> The non-recurring charges consisted of a \$287 million write-off of asset impairments relating to Azurix Corp., Enron's U.K. water company, for its planned dispositions of its North American and certain South American service-

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<sup>117</sup> Ms. Watkins memo to Mr. Lay (August 2001). See <http://www.news.findlaw.com/hdocs/docs/enron/empltr2lay82001.pdf>.

<sup>118</sup> The Raptor, LJM, and Condor transactions are discussed in greater detail in Part Three of this Report.

<sup>119</sup> Letter from Mr. Max Hendrick II of Vinson & Elkins to Mr. James V. Derrick, Jr. of Enron Corp., dated October 15, 2001. E68562. <http://news.findlaw.com/hdocs/docs/enron/veeron101051ltr.pdf> As discussed in Part Three of the Report, Vinson & Elkins also participated as an advisor in the Condor structured transaction.

<sup>120</sup> The Form 10-Q filed by the company with the Securities and Exchange Commission reported the loss at \$644 million. Previously, Enron had not reported a net loss since the second quarter of 1997.

related businesses;<sup>121</sup> a \$180 million charge associated with the restructuring of Enron's broadband businesses; and a \$544 million loss principally relating to "Enron's interest in The New Power Company, broadband and technology investments, and early termination during the third quarter of certain structured finance arrangements with a previously disclosed entity."<sup>122</sup> At the same time, Enron announced that it was making a \$1.2 billion reduction to shareholders' equity. Information disclosed in the company's Securities and Exchange Commission filings explained that the \$544 million charge related in large part to a pre-tax charge of \$710 million associated with the termination of the Raptors special purpose entities, and that the \$1.2 billion equity reduction was required to correct Enron's improperly recording an investment in the Raptors partnerships as an asset rather than as a reduction to equity.<sup>123</sup>

Enron's liquidity position deteriorated as it attempted to deal with the fallout from its adverse earnings announcements. On October 25, 2001, Enron drew down on approximately \$3 billion of its available bank lines to repay outstanding and expiring commercial paper obligations and provide immediate cash liquidity. Just a few days later, on October 31, 2001, Enron announced its Board of Directors had appointed a special investigative committee to be chaired by Mr. William C. Powers, Dean of the University of Texas Law School, to examine and take actions with respect to the off-balance sheet transactions between Enron and related parties, including, as appropriate, making reports to the Securities and Exchange Commission.<sup>124</sup>

The financial markets continued to react negatively to Enron's situation, and Enron's stock dropped to \$13.90 per share on October 31, 2001. On November 8, 2001, Enron announced that it was restating its financial statements for the periods 1997 through 2000 and the

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<sup>121</sup> This was in addition to a \$326 million charge reflecting Enron's portion of impairments recorded by Azurix related to assets in Argentina that was reflected in Enron's 2000 financial statements.

<sup>122</sup> Press Release, Enron Corp., Enron Reports Recurring Third Quarter Earnings of \$0.43 Per Diluted Share; Reports Non-Recurring Charges of \$1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of \$1.80 for 2001 and \$2.15 for 2002; and Expands Financial Reporting (October 16, 2001), *available at* <http://www.enron.com/corp/pressroom/releases/2001/ene/68-3QearningsLtr.html> (last visited October 28, 2002).

<sup>123</sup> The explanatory information was contained in a Form 8-K filed on November 8, 2001, and in the company's third quarter 2001 Form 10-Q filed on November 19, 2001. The accounting errors pertaining to the \$1.2 billion restatement of equity were made in the second quarter of 2000 and in the first quarter of 2001.

<sup>124</sup> The three-month investigation culminated in the February 2002 release of the Powers Report. According to Mr. Powers' testimony before the House Committee on Finance Services, the report would be a "helpful starting point for the necessary further investigations by Congressional Committees, by the Securities and Exchange Commission, and by the Department of Justice." *See* Testimony of William C. Powers, Jr., Chairman of the Special Investigative Committee of the Board of Directors of Enron Corporation, Before the House Committee on Financial Services (February 4, 2002).

first two quarters of 2001 to reflect the retroactive consolidation of certain investments that Enron previously had reported as off-balance sheet entities. These entities included: (1) JEDI I and Chewco, each of which should have been consolidated beginning in November 1997; and (2) a wholly-owned subsidiary of LJM1 that engaged in the Rhythms Net hedging transactions that should have been consolidated beginning in 1999. Enron announced that earnings for the periods 1997 through the second quarter of 2001 were adjusted downward by a total of \$569 million, with \$396 million attributable to JEDI I and Chewco, and \$103 million attributable to the LJM1 subsidiary.<sup>125</sup> Enron filed a Form 10-Q quarterly report with the Securities and Exchange Commission on November 19, 2001, that included detailed information regarding these restatements. The Form 10-Q restatements varied slightly from those announced earlier by Enron in the November 8, 2001, press release.

Table 6, below, summarizes the restatements as set forth in Enron's November 19, 2001, Form 10-Q.

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<sup>125</sup> Enron reported these adjustments in a Form 8-K filed with the Securities and Exchange Commission on November 8, 2001. Enron also decreased its third quarter 2001 earnings by \$17 million at the same time.

**Table 6.—November 19, 2001, Form 10-Q Accounting Restatements for Enron**  
 [Millions of Dollars]

Accounting period	Net income as initially reported	Net income as restated	Adjustment to net income	Chewco and JEDI I portion	LJMI portion	Other	Raptors equity adjustment (non-P&L)
1997	\$105	\$26	\$-79	\$-28	\$0	\$-51	\$0
1998	703	564	-139	-133	0	-6	0
1999	893	635	-258	-153	-95	-10	0
2000	979	842	-137	-91	-8	-38	-172
1Q 2001	425	460	35	6	0	29	-1000
2Q 2001	404	409	5	0	0	5	-1000
<b>Totals</b>	<b>3,509</b>	<b>2,936</b>	<b>-573</b>	<b>-399</b>	<b>-103</b>	<b>-71</b>	<b>N/A</b>

Note: N/A = not applicable.

Source: Compiled by the Joint Committee staff from Enron's Form 10-Q filed with the Securities and Exchange Commission on November 19, 2001.

Prior to Enron's October and November announcements of its third quarter earnings loss and its earnings restatements, Enron had reported shareholders' equity of \$11.7 billion as of June 30, 2001, in its second quarter 2001 Form 10-Q filed with the Securities and Exchange Commission on August 14, 2001. The aggregate effect of the charges to third quarter 2001 earnings and equity adjustments reported on October 16, 2001, and the restatements announced in November 2001, was a decrease in Enron's net income for the periods 1997 through 2001 of approximately \$1.7 billion. This included \$399 million relating to JEDI I and Chewco, \$103 million relating to LJM1, \$710 million relating to LJM2 and the Raptors entities, \$287 million relating to Azurix, and \$180 million relating to the broadband businesses.<sup>126</sup> Enron's equity diminished from the \$11.7 billion it had reported as of June 30, 2001, to \$9.6 billion it reported as of September 30, 2001.<sup>127</sup>

Enron's stock price, which had moved slightly upward in early October 2001, plummeted during the weeks following its announcement of its third quarter loss on October 16, 2001. Its per share price dropped from \$34.30 on October 16 to \$13.90 at the close of trading on October 31, 2001.

#### **4. Illiquidity and failed merger attempts during November 2001**

Enron's stock continued its downward slide during early November, closing at \$8.41 per share on November 8, 2001, the day it announced its earnings restatements for 1997 through 2001. The company's debt structure had become increasingly difficult to support as the company's weakening credit ratings and declining stock price triggered defaults under various debt covenants. Enron debt coming due in the fourth quarter of 2001 reportedly had increased from less than \$1 billion dollars to \$2.8 billion, as Enron's cash on hand reportedly had decreased from \$3 billion dollars to \$1.2 billion.<sup>128</sup>

On November 9, 2001, Enron announced that it had reached agreement to be acquired by Dynegy, Inc. ("Dynegy"), a global provider of energy and communications services, in a \$9 billion stock-for-stock acquisition.<sup>129</sup> As part of the negotiations, Dynegy (through Chevron

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<sup>126</sup> The \$1.2 billion Raptors equity adjustment made during third quarter 2001 did not involve an earnings restatement because the prior erroneous entries had not been reflected in the company's income statements.

<sup>127</sup> Enron Corp., Form 10-Q for the Fiscal Quarter Ended September 30, 2001 filed with the Securities and Exchange Commission, at 6 (November 19, 2001).

<sup>128</sup> Wendy Zellner & Stephanie Anderson Forest, *The Fall of Enron*, Business Week (December 17, 2001).

<sup>129</sup> Enron later reported in its bankruptcy filings that Dynegy had agreed to pay approximately \$9 billion in Dynegy stock and assume approximately \$13 billion in Enron debt. Motion Of The Debtors Pursuant To Rule 1015(B) Of The Federal Rules Of Bankruptcy Procedure For Joint Administration Of Cases, In re Enron Corp. et.al., Debtors (No. 01-16034) Docket Entry No. 2), at 6, at <http://www.elaw4enron.com/default.asp> (last visited February 5, 2003).

Texaco Corporation, which owned approximately 27 percent of the combined common stock of Dynegy), provided Enron a \$1.5 billion cash infusion in exchange for a preferred stock interest in Enron's subsidiary, Northern Natural Gas Company, and certain option rights to acquire Northern Natural Gas Company in the event the merger terminated.<sup>130</sup>

Enron's announcement of the ongoing Dynegy merger negotiations temporarily bolstered Enron's stock price. Enron's stock price increased slightly to \$9.06 per share by the close of business on November 19, 2001, the day Enron provided detailed information to the Securities and Exchange Commission regarding its 1997 through 2001 earnings restatements. On November 20, 2001, however, Enron warned that continuing credit worries, reduced asset values, and reduced trading activity could weaken fourth quarter 2001 earnings. Enron's stock price fell to \$6.99 that day, and to \$4.11 by the close of trading on November 27, 2001.

Enron's financial condition continued to deteriorate, and the Dynegy merger agreement unraveled on November 28, 2001. That same day, Enron shut down EnronOnline, and various ratings agencies downgraded Enron's long-term debt to "below investment grade" (i.e., junk bond) status. Enron announced it had temporarily suspended all payments other than those necessary to maintain its core operations, and that it was evaluating and exploring options to protect its core energy businesses. Enron's stock fell from \$4.11 to \$0.61 per share on November 28, and closed at \$0.26 per share on November 30, 2001. Enron was on the brink of bankruptcy.

## **5. Bankruptcy reorganization and present condition**

Enron Corp. and thirteen of its affiliates filed voluntary petitions for Chapter 11 bankruptcy reorganization protection on December 2, 2001.<sup>131</sup> On the same date, Enron filed suit against Dynegy, alleging Dynegy had wrongfully terminated its proposed merger with Enron and sought damages of at least \$10 billion.<sup>132</sup> Within the next several days, numerous other

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<sup>130</sup> Dynegy exercised its option rights to acquire Northern Natural Gas Company when the merger negotiations terminated. Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (August 19, 2002), at Exhibit 99.1.

<sup>131</sup> The affiliates included, among others, Enron North America Corp., the wholesale energy trading business; Enron Energy Services, Inc., the retail energy marketing operations; Enron Transportation Services Company, the holding company for pipeline operations; and Enron Broadband Services, Inc., the bandwidth trading operation. Excluded from the bankruptcy filing were Northern Natural Gas Pipeline, Transwestern Pipeline, Florida Gas Transmission, EOTT, PGE, and numerous Enron International entities. Press Release, Enron Corp., Enron Files Voluntary Petitions for Chapter 11 Reorganization; Sues Dynegy for Breach of Contract, Seeking Damages of at Least \$10 Billion (December 2, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/PressRelease11-12-02-01letterhead.html> (last visited October 28, 2002).

<sup>132</sup> Press Release, Enron Corp., Enron Files Voluntary Petitions for Chapter 11 Reorganization; Sues Dynegy for Breach of Contract, Seeking Damages of at Least \$10 Billion

Enron affiliates filed petitions to be included in the consolidated bankruptcy proceeding.<sup>133</sup> In its bankruptcy filing, Enron Corp. (separately, not including any affiliates) listed its assets at \$24.8 billion and liabilities at \$13.1 billion.<sup>134</sup> The combined listed assets of Enron Corp. and its thirteen affiliates that initially filed for reorganization protection totalled \$63.4 billion. Enron and certain of its consolidated debtors continue to operate businesses and manage properties as debtors in possession pursuant to the Federal Bankruptcy Code.<sup>135</sup>

On January 15, 2002, the New York Stock Exchange suspended trading of Enron stock and moved to delist the company's shares from the exchange.<sup>136</sup> On January 17, 2002, Enron discharged Arthur Andersen, its auditor. On February 2, 2002, the Powers Report was delivered to the Enron Corp. Board of Directors. On February 12, 2002, the company announced that the total claims of its creditors exceeded the fair market value of its assets and that it did not expect equity interest holders to receive any interest in the reorganized company.<sup>137</sup> In March 2002, the U.S. Trustee in the bankruptcy proceeding appointed an Employment-Related Issues Committee to investigate issues relating to current and former employees of Enron. On May 24, 2002, the bankruptcy court for the Southern District of New York approved the appointment of Neal Batson, as the Examiner for Enron Corp.

While under bankruptcy reorganization protection, the company has attempted to sell its non-core assets (primarily global assets and broadband services segments), restructure to protect its core businesses (wholesale gas and power, coal, retail businesses in North America and Europe, and natural gas pipeline businesses), and settle litigation and other claims.

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(December 2, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/PressRelease11-12-02-01letterhead.html> (last visited January 22, 2003).

<sup>133</sup> In November 2001, Enron Europe, the company's European energy-trading arm, filed for creditor protection under the laws of the United Kingdom.

<sup>134</sup> The company reported that this total debts figure, as reported in the corporation's voluntary petition for bankruptcy reorganization, did not reflect off-balance sheet and contingent obligations.

<sup>135</sup> A total of 75 Enron companies are reported as Enron bankruptcy debtors in the most recent Monthly Operating Report filed with the Securities and Exchange Commission and the bankruptcy court. Enron Corp., Form 8-K filed with the Securities and Exchange Commission, at 4-9 (January 9, 2003). As of February 8, 2003, Enron reported that 79 Enron companies have filed voluntary petitions for Chapter 11 reorganization.

<sup>136</sup> Enron's stock fell to \$0.26 per share on November 30, 2001, just prior to its bankruptcy filing.

<sup>137</sup> In Forms 8-K filed by the company with the Securities and Exchange Commission on and after February 12, 2002, the company has stated it "believes the existing equity of the company has and will have no value and that any plan ... confirmed by the bankruptcy court will not provide the company's existing equity holders with any recovery."



Major business asset dispositions completed during Enron's bankruptcy reorganization include: (1) the February 2002 sale and licensing of certain North American gas and electric power trading assets, including EnronOnline; (2) the sale of Enron Oil & Gas India, Ltd.; (3) the sale of various wind energy assets and holdings; (4) the sale of its domestic and European metals businesses; and (5) the May 2002 sale by Azurix Corp. of Wessex Water Ltd. On August 27, 2002, Enron commenced its auction of 12 major assets, including PGE,<sup>138</sup> several power plants, and its interests in the Transwestern, Florida Gas Transmission, and Northern Plains pipelines. On October 10, 2002, the bankruptcy court approved the sale of the newly constructed headquarters building, Enron Center South.<sup>139</sup>

On August 15, 2002, Enron and Dynegy announced settlement of their dispute regarding the termination of merger discussions in late 2001. Pursuant to the settlement, Enron received \$25 million cash and agreed to forego claims regarding Dynegy's exercise of its option to acquire Northern Natural Gas Company relating to Dynegy's \$1.5 billion equity infusion made during November 2001.

Enron filed with the bankruptcy court its Statement of Financial Affairs ("Statement"), which provides certain financial and other information regarding the company as of the bankruptcy filing date. Among other things, the Statement reported that Enron and its affiliates paid senior management \$309.9 million in salary, bonuses, long-term incentives, deferred payments, loan advances, expense reimbursements, director's fees, and other payments during the year preceding the bankruptcy filing.<sup>140</sup> The company has filed Monthly Operating Statements for the periods of December 2001 through October 2002 with the bankruptcy court, and with the Securities and Exchange Commission as attachments to Form 8-K filings. These statements are unaudited and do not contain a balance sheet. The company has certified to the Securities and Exchange Commission that it does not have an independent auditor, it believes that retention of an independent auditor is not feasible, and it does not intend to provide audited financial statements for the fiscal year ended December 31, 2001, or any subsequent unaudited quarterly financial statements.<sup>141</sup>

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<sup>138</sup> Enron's earlier agreement to sell PGE to Northwest Natural Gas Company terminated in May 2002.

<sup>139</sup> Enron had commenced construction of this structure, a 40-story, 1.2 million square feet office headquarters in downtown Houston, Texas, in 1999.

<sup>140</sup> Statement of Financial Affairs, Exhibit 3b.2 (list of all insider payments made within one year immediately preceding the commencement of the bankruptcy case). These same insiders also received \$434.5 million of compensatory stock value during this period relating to exercised Enron stock options and Enron restricted stock, measured at the time of the exercise of the option or the lapsing of the stock's restrictions.

<sup>141</sup> Enron Corp., Form 8-K filed with the Securities and Exchange Commission (August 13, 2002). The company has stated, however, that if a comprehensive review of accounting adjustments, including asset impairments and writedowns, related to previously reported financial information, were conducted, and a consolidated balance sheet as of December 31,

Enron now describes itself as being “in the midst of restructuring its business with the hope of emerging from bankruptcy as a strong and viable, albeit smaller, company.”<sup>142</sup> Enron presently reports assets of \$47.3 billion, including 9,000 miles of pipeline, and 14,000 employees.<sup>143</sup>

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2001, were prepared in accordance with GAAP, an estimated \$14 billion writedown of assets would be required. Monthly Operating Statement for the Period December 2 to 31, 2001, filed with the Securities and Exchange Commission on April 22, 2002. The same report stated an additional downward adjustment of \$8 billion to \$10 billion relating to price risk management assets as of December 31, 2001, could also be required in such a case.

<sup>142</sup> <http://www.enron.com/corp/> (last visited January 22, 2003).

<sup>143</sup> <http://www.enron.com/corp/pressroom/factsheets/company.html> (last visited February 8, 2003).