

PART TWO: GENERAL BACKGROUND INFORMATION

I. BACKGROUND AND METHODOLOGY

A. Background Information Relating to Joint Committee on Taxation Staff Investigation of Enron

Letter to Joint Committee on Taxation staff directing investigation of Enron

On February 15, 2002, Senators Max Baucus and Charles E. Grassley, then Chairman and Ranking Member of the Senate Committee on Finance ("Senate Finance Committee"), directed the staff of the Joint Committee on Taxation ("Joint Committee staff") to undertake a review of Enron's Federal tax returns, tax information, and any other information deemed relevant by the Joint Committee staff to assist the Senate Finance Committee in evaluating whether the Federal tax laws facilitated any of the events or transactions that preceded Enron's bankruptcy. The letter indicated that press reports had raised troubling questions about Enron, including the use of entities in tax haven countries, other special purpose entities, and questionable tax shelter arrangements. The letter stated that the Joint Committee staff should, as part of the review, examine the adequacy of present tax law, particularly in the areas of tax shelters and offshore entities.

The letter also directed the Joint Committee staff to include a review of the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, and to analyze the factors that may have contributed to any loss of benefits and the extent to which losses were experienced by different categories of employees. A copy of the letter from Senators Baucus and Grassley to Ms. Lindy L. Paull, Chief of Staff of the Joint Committee, is included in Appendix A to this Report.

Senators Baucus and Grassley directed that the Joint Committee staff conduct the Enron investigation pursuant to the authority provided to the Joint Committee under section 8022 of the Internal Revenue Code.²⁹ They asked that the Joint Committee staff transmit its findings and recommendations as soon as practicable.

²⁹ Section 8022(1)(C) of the Internal Revenue Code of 1986 (the "Code") provides that the Joint Committee will conduct such investigations with respect to the Federal tax system as the Joint Committee may deem necessary. Code section 8021 authorizes the Joint Committee to obtain and inspect tax returns and return information (as specified in sec. 6103(f)). In addition, section 8023 authorizes the Joint Committee (or the Chief of Staff of the Joint Committee), upon approval of the Chairman or Vice-Chairman, to secure tax returns, tax return information, or data directly from the Internal Revenue Service or any other executive agency for the purpose of making investigations, reports, and studies relating to internal revenue tax matters, including investigations of the Internal Revenue Service's administration of the tax laws.

Disclosure agreement

On January 30, 2002, staff of the Senate Finance Committee, Joint Committee staff, and lawyers from Skadden, Arps, Slate, Meagher & Flom LLP (“Skadden Arps”)³⁰ met to discuss whether Enron would consent to the public disclosure of its tax returns and return information in connection with a Congressional review of the role that Federal taxes may have played in the Enron bankruptcy. This meeting set in motion a series of interactions, during February of 2002, among the staff of the Senate Finance Committee, the Chief of Staff of the Joint Committee, and Skadden Arps to negotiate a disclosure agreement relating to the Joint Committee staff investigation. A representative from the Office of the Senate Legal Counsel also participated in the negotiations. The disclosure agreement was executed on March 6, 2002, by Mr. Raymond M. Bowen, Jr., Executive Vice President and Chief Financial Officer of Enron Corp., Senator Baucus, Senator Grassley, and Ms. Paull.³¹

Under the terms of the disclosure agreement, Enron agreed to provide upon request to the Senate Finance Committee and the Joint Committee copies of all Federal tax returns and related information of Enron and of affiliated and related entities not included in Enron’s consolidated returns. Enron retained the right under the disclosure agreement to elect to assert any applicable privilege or legal objection provided that such assertion would be accompanied by a document-by-document index sufficiently detailed to enable the Senate Finance Committee and the Joint Committee to evaluate the assertion.³²

³⁰ Skadden, Arps, Slate, Meagher & Flom LLP (“Skadden Arps”) represents Enron in connection with Congressional investigations and other matters.

³¹ A copy of the disclosure agreement is included in Appendix A to this Report.

³² During the course of the Joint Committee staff investigation, Enron (through its counsel Skadden Arps) did not generally raise an issue of privilege or legal objection with respect to any document requested by the Joint Committee staff. Enron made the following statement in each of the letters addressed to the Joint Committee staff: “The enclosed documents are being provided to you in accordance with the terms of the Disclosure Agreement entered into by and among the Senate Committee on Finance, the Joint Committee on Taxation and the Company as of March 7, 2002. With this production, the Company does not intend to provide a general waiver of the attorney-client, attorney work product or other applicable privileges, and does not waive those privileges as to other documents not produced here.” Enron did assert privilege in a letter to Senate Finance Committee staff dated May 8, 2002, with respect to certain matters contained in minutes of the Board of Directors from August 2001 through January 2002. Enron asserted its privilege by redacting certain portions of the minutes that Enron asserted related to (1) communications with counsel or among counsel, or involving work product of counsel, relating to discussions or handling of government and congressional investigations; and (2) communications with counsel or among counsel, or involving work product of counsel, relating to discussions or handling of litigation. In the letter, Enron stated “Other privileged material, outside these two narrow exceptions, has not been redacted in keeping with the Company’s past practice in this matter.”

The disclosure agreement required the Senate Finance Committee and the Joint Committee to seek tax returns and return information for years after 1995 from the Internal Revenue Service (“IRS”) and to request such information from Enron only to the extent either Committee was unable to obtain the information expeditiously from the IRS.

The disclosure agreement set forth the terms and conditions under which Enron agreed to the public disclosure of information collected by the Senate Finance Committee and the Joint Committee. The first part of the disclosure agreement related to Enron’s tax returns and return information.³³ In the case of Enron’s tax returns and return information, obtained by the Finance Committee or Joint Committee pursuant to section 6103,³⁴ Enron consented to disclosure only through official reports, meetings, or hearings of either the Senate Finance Committee or the Joint Committee. Any other disclosure of such information is prohibited and would violate section 6103 because it would constitute a disclosure outside the agreement. In the case of tax returns and return information of Enron for years after 1995, the Senate Finance Committee and Joint Committee further agreed to make no public disclosure before June 10, 2002.

The second part of the disclosure agreement related to all other documents and information (other than tax returns and return information obtained from the IRS). Under the disclosure agreement, the Senate Finance Committee and Joint Committee agreed that they would not disclose other nonpublic documents or information obtained from Enron, except through official reports, meetings, or hearings. In addition, the Senate Finance Committee and Joint Committee agreed that neither Committee would disclose before June 10, 2002, any such nonpublic information for years after 1995, which would be return information if it were in the possession of the IRS.

³³ Under sec. 6103 of the Internal Revenue Code of 1986 (the “Code”), the returns and return information of a taxpayer are confidential. However, a taxpayer can consent to the disclosure of information that otherwise would be subject to sec. 6103.

³⁴ Sec. 6103 only applies to returns and return information obtained from the IRS. Information provided directly by Enron, including tax returns, is not subject to sec. 6103. As noted above, the Senate Finance Committee and the Joint Committee agreed that they would first attempt to obtain tax returns and return information for years after 1995 from the IRS.

B. Methodology and Scope of Joint Committee Staff Investigation

In general

This section outlines the methodology and scope of the Joint Committee staff investigation of Enron. This Report attempts to describe the events that occurred over time at Enron both with respect to its Federal tax situation and with respect to its compensation arrangements. To understand the information and analysis that is provided in this Report, it is useful to understand the way in which the investigation was conducted.

The Joint Committee staff did not follow the Federal rules of evidence that would apply in a court proceeding in conducting its investigation. Thus, documents provided to, and reviewed by, the Joint Committee staff would not necessarily be admissible in a court of law. Similarly, with respect to interviews conducted by the Joint Committee staff, the individuals interviewed were not under oath at the time of their interviews. In some instances, the individuals made statements that would constitute hearsay in a court of law.

Enron agreed to cooperate with the Joint Committee staff investigation. Enron complied with requests for information from the Joint Committee staff through the voluntary production of documents.³⁵ The Joint Committee staff cannot represent that it was able to review all documents relating to a transaction in which Enron engaged or all information relating to other aspects of the Joint Committee investigation. During the course of the Joint Committee staff investigation, Enron was complying with document requests relating to its bankruptcy filing and other Federal investigations; thus, the company was responding to numerous document requests at the same time. In some instances, particularly with respect to executive compensation matters, Enron's recordkeeping was either abysmal or company representatives who compiled the information failed to provide relevant documentation.

Throughout this Report, specific information is provided as it was contained in documents provided by Enron or the IRS.³⁶ In many instances, the documents provided to the Joint Committee staff contained data and other information as of the time at which a transaction occurred. The Joint Committee staff could not independently verify the accuracy of this information in all cases; for purposes of this Report, the Joint Committee staff has used the information as it was provided. Furthermore, in many cases, information that may have been

³⁵ Throughout this Report, information contained in documents provided by Enron is referred to with a Bates-stamp numbering system (e.g., EC 00001234) used by Enron to identify the documents. Certain of these documents have also been included in the Appendices to this Report, as noted throughout the Report. It should be noted that Enron's counsel Skadden Arps responded to requests for information on behalf of Enron.

³⁶ Certain documents received by the Joint Committee staff in connection with the investigation are included in Appendices to this Report. Handwritten notes on these documents are not those of Joint Committee staff; in most cases, the author of the handwritten notes is not identified.

accurate when included in a document may subsequently have become inaccurate due to subsequent events such as Enron's restatement of its earnings.

Despite these limitations, the Joint Committee staff believes that its investigation provides a useful in-depth examination of some of the transactions into which Enron entered, as well as an in-depth examination of Enron's compensation structures. The information gathered enabled the Joint Committee staff to prepare a detailed discussion of specific transactions and issues to provide an insight into how large corporations might manage their tax liabilities (see Part Three of this Report, below). The discussion outlines the methods and some of the complex transactions that Enron used to manage its Federal income tax liabilities. The transactions that were reviewed by the Joint Committee staff were identified from a variety of sources, including interviews with current and former Enron employees, meetings with the IRS, and published reports relating to Enron. However, the Joint Committee staff cannot represent that this Report identifies and analyzes all transactions in which Enron engaged that might be of interest to policymakers or the IRS. The sheer volume of information relating to Enron made available to the Joint Committee staff, the fact that the issues associated with a company the size of Enron are so broad, and the difficulty faced in attempting to identify specific transactions from the face of a tax return as complex as Enron's necessarily limits the ability to identify all of the transactions in which Enron engaged.³⁷

It should be noted that this Report identifies financial accounting benefits that Enron claimed in connection with certain of its tax-motivated transactions. It was beyond the scope of the Joint Committee staff investigation to evaluate the validity of any of the claimed financial accounting benefits. Therefore, the financial benefits are presented as claimed.

The review also led the Joint Committee staff to make certain general observations about Enron that are contained in Part One of this Report, above; while these observations relate specifically to Enron, they highlight some of the systemic issues and problems facing policymakers and the IRS, especially with respect to large corporations.

The following discussion details the work done by the Joint Committee staff in connection with this investigation.

Overview of chronology of Joint Committee staff investigation

The Joint Committee staff began its investigation of Enron in February 2002, prior to execution of the disclosure agreement with Enron. On February 25, 2002, the Joint Committee staff made an initial document request to the IRS. In the letter to the IRS, the Joint Committee staff requested copies of all Federal tax returns (including amended returns) for Enron and other entities in which Enron had an equity interest for tax years from 1985 to the present, including supporting workpapers, and other information in the IRS' possession including, but not limited to, IRS master file information from 1985 to the present, information concerning Enron's

³⁷ In some cases, documents reviewed by the Joint Committee staff provided inconsistent information relating to certain transactions. In such cases, the Joint Committee staff attempted to develop the most reasonable description of the transaction.

involvement in tax shelter transactions, Federal tax litigation in which Enron has been involved, and information relating to Enron's involvement with specific transactions and entities. In addition, the letter requested information relating to the qualified retirement plans and compensation arrangements of Enron including, but not limited to, copies of all annual returns relating to the qualified retirement plans, copies of any IRS information relating to such plans, and information relating to nonqualified deferred compensation programs.

On February 27, 2002, the Joint Committee staff was briefed in Washington, D.C., on the history of IRS involvement with Enron by IRS personnel from the IRS National Office in Washington, D.C., and IRS personnel from Houston who were involved in the examinations of Enron's tax returns. At the same time, IRS personnel briefed Joint Committee staff on specific information contained in the Joint Committee's first document request and the logistics of transmitting this information to the IRS National Office.

The Joint Committee staff made an initial document request to Enron on March 12, 2002. This document request related to Enron's Federal tax returns and business operations and did not request information relating to the qualified pension plan and other compensation arrangements of Enron. Pursuant to the terms of the disclosure agreement, the letter requested copies of Enron's Federal tax returns for the 1985-1995 period,³⁸ as well as other information relating to Enron's business operations.

Pursuant to a request made by Enron, the Joint Committee staff met on April 23, 2002, in Washington, DC, with representatives from Skadden Arps and two employees of Enron³⁹ to discuss the Joint Committee staff's first document request and the parameters of the Joint Committee staff investigation. Enron's employees indicated that full compliance with the first Joint Committee document request would produce 3,500 to 5,000 boxes of information for the period requested. Much of the material requested was located at an off-site storage location in Houston, Texas, with a third-party contractor. The Enron employees argued that it would be too costly to produce the documentation requested by the Joint Committee staff. As a result of this meeting, the Joint Committee staff agreed to narrow the first document request in order to produce a manageable request for documentation relating to business operations of Enron relevant to the Joint Committee investigation.

On April 25, 2002, the Joint Committee staff made a first document request to Enron relating to qualified plans and compensation arrangements.

³⁸ As mentioned above, the disclosure agreement required the Joint Committee staff to attempt to secure Enron's tax returns for years after 1995 from the IRS.

³⁹ Enron employees in attendance at the meeting were Mr. Jordan H. Mintz and Mr. Edward R. Coats.

On June 7, 2002, at Enron's request, lawyers from Skadden Arps and Enron employees⁴⁰ met with Joint Committee staff to make a presentation concerning information requested by the Joint Committee staff and information on certain structured transactions and other significant transactions in which Enron engaged.⁴¹ During this presentation, the Enron employees provided an oral description, with accompanying written material, of the structured transactions that are addressed in depth in Part Three, below, of this Report.

During May, June, and July of 2002, the Joint Committee staff conducted an extensive review of documents provided by Enron and the IRS in response to the Joint Committee staff document requests.

On July 16, 2002, the Joint Committee staff interviewed Mr. Robert J. Hermann, Former Vice President and Director of Taxes, for Enron Corp.⁴²

During August through November of 2002, the Joint Committee staff conducted interviews in Houston, Texas, and Washington, D.C., of current and former Enron employees, certain members of Enron's Board of Directors, and certain outside counsel to Enron. Also during this time frame, the Joint Committee staff continued to review documents received from Enron, the IRS, the Department of Labor, the Pension Benefit Guaranty Corporation, and others in connection with the investigation.

In the course of its investigation, the Joint Committee staff received periodic briefings from the IRS with respect to the status of the IRS review of Enron's 1996 to 2001 tax returns for purposes of filing a proof of claim with the bankruptcy court.⁴³ The Joint Committee staff also received periodic briefings from the Pension Benefit Guaranty Corporation and the Department of Labor with respect to Enron's pension plans.

⁴⁰ In attendance at the meeting were Enron employees Jordan Mintz, Edward Coats, and James Ginty, lawyers from Enron's counsel (Skadden Arps and Weil Gotschal & Manges LLP), lawyers from Alston & Bird LLP (counsel for the Enron Examiner).

⁴¹ The company presentation and appendix thereto are contained in Appendix A to this Report.

⁴² The Joint Committee staff contacted Mr. Hermann after his name appeared in a May 22, 2002, Washington Post article that discussed the structured transactions in which Enron engaged. April Witt and Peter Behr, *Enron's Other Strategy: Taxes; Internal Papers Reveal How Complex Deals Boosted Profits by \$1 Billion*, The Washington Post (May 22, 2002) at A-1. The article and the interview with Mr. Hermann provided useful information for this Report. A follow-up telephone interview of Mr. Hermann took place on December 4, 2002.

⁴³ The IRS' deadline for filing a proof of claim regarding Enron's tax liabilities with the bankruptcy court is March 31, 2003. The Joint Committee staff has, in some cases, chosen not to describe or discuss certain aspects of the investigation if the staff determined that doing so could jeopardize the IRS' interests in Enron's pending bankruptcy proceedings.

Review of Enron's tax returns

The Joint Committee staff requested Enron's consolidated Federal tax returns for all years since 1985. Each of these tax returns contains thousands of pages of schedules and attachments. As noted in Table 4, below, since 1997, Enron Corp. prepared more than 1,000 Federal tax returns each year with respect to affiliated and other entities in which Enron held an interest.

Table 4.—Enron’s Federal Tax Returns*

	1997	1998	1999	2000
Total number of returns prepared for Enron consolidated tax return	274	333	502	713
Total number of returns prepared for entities filed outside of the Enron consolidated tax return**	58	164	178	190
Total number of entities/branches included in foreign information returns	628	842	1,048	1,485
Total number of entities/branches included in partnership returns	42	66	94	98
Total Number of Federal Tax Returns	1,002	1,405	1,822	2,486

Source: Enron presentation to Joint Committee staff, June 7, 2002, included in Appendix B to this Report.

* Includes pro-forma returns for check-the-box, accounting, and legal branches.

** Approximately 15-20 separate company or consolidated returns.

In addition, the Joint Committee staff was provided access by the IRS to returns of partnerships and other entities that were not legally related to Enron, but with which Enron had significant relationships. For example, in some instances, Enron may not have held an interest in a partnership engaged in a transaction with Enron; however, partners in the partnership were high-ranking Enron employees.

The proliferation of Federal tax returns prepared by Enron (note, for example, the 36 percent increase in returns from 1999 to 2000) is consistent with trends the Joint Committee staff observed with respect to the operations of the company. See, for example, the discussion in Part Three, V., below, about the increases in the numbers of off-shore entities utilized by Enron.

As Table 4, above, demonstrates, the scope of Enron’s activities, and the number of entities associated with Enron Corp., was quite large in the period before it sought bankruptcy protection. Enron Corp. and members of its consolidated group⁴⁴ also held interests in hundreds of other entities that were not themselves included in the consolidated return. For example, in Enron’s international operations, approximately 1,300 foreign entities were established, a majority of which were inactive.⁴⁵ In addition, Enron and its numerous corporate subsidiaries entered into transactions for which special-purpose entities were formed. The structured tax-motivated transactions and structured financing transactions in which Enron affiliates engaged involved the use of dozens of legal entities.⁴⁶ As a result of the broad scope of Enron’s group

⁴⁴ An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. An affiliated group means one or more chains of included corporations connected with a common parent, if stock ownership rules requiring 80-percent voting and value are met. Includible corporations do not include foreign corporations; partnerships are not included in a consolidated return. Secs. 1501 and 1504.

⁴⁵ “Enron Corp. Presentation to the Joint Committee on Taxation, June 7, 2002,” at 42.

⁴⁶ These transactions, and the entities involved in them, are described (with diagrams) in Part Three of this Report.

and the numerous consolidated and nonconsolidated entities in which Enron had an interest, the Joint Committee staff took the broad approach of examining transactions and patterns of compensatory arrangements in which Enron engaged, rather than examining Enron's structure or tax posture on an entity-by-entity basis.

In conducting its review, the Joint Committee staff did not conduct the equivalent of an IRS examination of Enron's tax returns. Rather, the staff examined certain tax-driven transactions of Enron that raised issues of tax policy and interpretation of the tax law. The staff focused on these types of transactions rather than attempting generally to examine the activities of Enron. An attempt to duplicate the type of work that the IRS performs when examining a tax return for a corporation as large and complex as Enron would have required staffing, time, and examination expertise well beyond that available to the Joint Committee staff.

The Joint Committee staff used Enron's Federal tax returns as a resource to verify information provided by the IRS and Enron. For example, the Joint Committee staff has provided a book-to-tax reconciliation for certain years, the information for which was obtained from Enron's Federal tax returns. This book-to-tax reconciliation shows how Enron's book income was translated to taxable income on its Federal tax returns.

Document requests

The Joint Committee staff made seven written document requests (including requests for information contained on other forms of media (e.g., videotapes and CD-ROMs)) to Enron during the course of its investigation. Enron responded in 16 separate letters prepared by its counsel, Skadden Arps. The document production from Enron totaled more than 100 boxes of information.

The Joint Committee staff requested documents and information from the IRS on at least six occasions. The IRS responses to these requests totaled more than 40 boxes of information.

On March 6, 2002, the Joint Committee staff requested documents and other information from the Department of Labor relating to Enron's qualified plans and other compensation arrangements within the Department of Labor's jurisdiction. Certain materials were provided to the Joint Committee staff by the Department of Labor during the summer of 2002. On October 1, 2002, a follow-up letter was sent to the Department of Labor. On October 11, 2002, the Department of Labor provided additional documents in response to the Joint Committee staff's requests.

On June 6, 2002, the Joint Committee staff met with staff of the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs with respect to the Subcommittee's investigation relating to Enron. The Joint Committee staff was afforded the opportunity to review documents the Subcommittee had collected that might be relevant to the Joint Committee staff investigation.

Interviews of individuals relevant to the Enron investigation

The Joint Committee staff considered interviews with current and former Enron employees and other individuals with connections to Enron to be an important element of its

investigation. Between July 16, 2002, and January 23, 2003, the Joint Committee staff conducted 46 interviews of individuals with information relevant to the Joint Committee staff investigation.⁴⁷ Generally, each interviewee was asked a standard set of questions based upon the individual's particular knowledge of Enron. Some of the interviews were conducted by telephone, but many were conducted in person in Houston, Texas, and Washington, D.C.

In some cases, individuals who the Joint Committee staff requested to interview were not available. Some individuals refused to cooperate with the Joint Committee staff investigation. Some individuals did not respond to repeated requests for an interview.

The Joint Committee staff who conducted the interviews took notes, but generally did not record the interviews. After each interview, the Joint Committee staff compiled their notes into a single interview record. These interview records have been used extensively in this Report to detail the activities of Enron and, in some cases, the motivation or purpose for Enron's activities.

It is important to note that the individuals interviewed by the Joint Committee staff were not under oath. To the extent individuals made statements that were inconsistent with statements made by others or with documents provided by Enron or other sources, the Joint Committee staff attempted to resolve the inconsistency through follow-up interviews or further document review. In some unresolved cases, the Joint Committee ultimately had to use its best judgment to resolve inconsistencies.

Appendix A to this Report contains a list of individuals the Joint Committee staff interviewed and their relationship to Enron. The document in Appendix A also contains a listing of certain individuals who did not agree to the Joint Committee staff's request for an interview.

Joint Committee staff travel

Joint Committee staff made four trips to Houston, Texas in connection with its investigation (during March, August, and September of 2002). During these trips, the Joint Committee staff met with IRS personnel from Houston and Dallas and interviewed current and former Enron employees.

Other investigations and sources of information

The Joint Committee staff reviewed publicly available information relating to Enron, including information made available by the Securities and Exchange Commission; the Department of Labor; the Pension Benefit Guaranty Corporation; the Senate Committee on Health, Education, Labor, and Pensions; the Senate Committee on Governmental Affairs; the Senate Committee on Energy and Commerce; the Senate Committee on Commerce, Science and Transportation; the Senate Committee on Banking, Housing, and Urban Affairs; the House Committee on Financial Services; the House Committee on Energy and Commerce; the House Committee on Education and the Workforce; and the U.S. Bankruptcy Court for the Southern District of New York.

⁴⁷ The Joint Committee staff sent more than 48 letters to potential interviewees and their counsel and made numerous telephone calls in its attempts to schedule interviews.

The Joint Committee staff reviewed media reports relating to Enron's activities for information relevant to the Joint Committee staff investigation.

Outside advisors

The Joint Committee staff reviewed tax opinions and other documentation regarding the tax advice provided by Enron's outside advisors with respect to many of the transactions within the scope of the investigation.⁴⁸ Although the Joint Committee staff reviewed such opinions and advice for purposes of analyzing the transactions, the Joint Committee staff did not examine the propriety of this advice under present standards of professional conduct or similar rules relating to Federal tax practice, or for purposes of determining whether there may have been violations of tax statutes relating to tax return preparers or tax advisors.

⁴⁸ Many of the tax opinion letters reviewed by the Joint Committee staff are included in Appendix C to this Report.

II. HISTORY OF THE COMPANY

A. Background

Enron Corp. is a Houston-based energy and commodities trading holding company currently under Federal bankruptcy reorganization protection.⁴⁹ Through approximately 3,500 domestic and foreign subsidiaries and affiliates, Enron conducted business in diverse markets and industries, including wholesale merchant and commodity market businesses, the

⁴⁹ Enron Corp., an Oregon corporation, and thirteen of its affiliates filed voluntary petitions for Chapter 11 bankruptcy reorganization protection on December 2, 2001, in the United States Bankruptcy Court, Southern District of New York. Simultaneously with the filings, the companies collectively filed a motion requesting entry of an order jointly administering and consolidating for administrative purposes only these Chapter 11 cases. Additional affiliated entities were consolidated with the proceeding subsequent to the original filings.

As of February 8, 2003, Enron reported that the following 79 Enron companies have filed voluntary petitions for Chapter 11 reorganization: Artemis Associates, LLC; BAM Leasing Company; Clinton Energy Management Services, Inc.; EBF LLC; Calypso Pipeline, LLC; EES Service Holdings, Inc.; EESO Merchant Investments, Inc.; EFS Construction Management Services, Inc.; ENA Asset Holdings, L.P.; ENA Upstream Company LLC; Enron Broadband Services, Inc.; Enron Broadband Services, L.P.; Enron Capital & Trade Resources International Corp.; Enron Communications Leasing Corp.; Enron Corp.; Enron Energy Information Solutions, Inc.; Enron Energy Marketing Corp.; Enron Energy Services Inc.; Enron Energy Services L.L.C.; Enron Energy Services North America, Inc.; Enron Energy Services Operations, Inc.; Enron Engineering & Construction Company; Enron Engineering & Operational Services Company; Enron Expat Services, Inc.; Enron Federal Solutions, Inc.; Enron Freight Markets Corp.; Enron Fuels International, Inc.; Enron Gas Liquids, Inc.; Enron Global LNG LLC; Enron Global Markets LLC; Enron India Holdings Ltd.; Enron Industrial Markets LLC; Enron International Fuel Management Company; Enron Liquid Fuels, Inc.; Enron LNG Marketing LLC; Enron LNG Shipping Company; Enron Management, Inc.; Enron Mauritius Company; Enron Metals & Commodity Corp.; Enron Methanol Company; Enron Natural Gas Marketing Corp.; Enron Net Works L.L.C.; Enron North America Corp.; Enron Power & Industrial Construction Company; Enron Power Marketing, Inc.; Enron Processing Properties, Inc.; Enron Property & Services Corp.; Enron Reserve Acquisition Corp.; Enron Transportation Services Company; Enron Ventures Corp.; Enron Wind Constructors Corp.; Enron Wind Corp.; Enron Wind Development LLC; Enron Wind Energy Systems Corp.; Enron Wind Maintenance Corp.; Enron Wind Systems, Inc.; E Power Holdings Corp.; EREC Subsidiary I, LLC; EREC Subsidiary II, LLC; EREC Subsidiary III, LLC; EREC Subsidiary IV, LLC; EREC Subsidiary V, LLC; Garden State Paper Company, LLC; Intratex Gas Company; LINGTEC Constructors, L.P.; National Energy Production Corporation; NEPCO Power Procurement Company; NEPCO Services International, Inc.; Offshore Power Production CV; Operation Energy Corp.; PBOG Corp.; Palm Beach Development Company, L.L.C.; San Juan Gas Company, Inc.; Smith Street Land Company; Tenant Services, Inc.; The New Energy Trading Company; Zond Minnesota Construction Company LLC; Zond Pacific, LLC; and ZWHC LLC.

management of retail customer (end-use) energy services, the operation of gas transmission systems, and the management of energy-related assets and broadband services.

Enron's roots can be traced to a domestic natural gas pipeline company formed in 1930. For the next 30 years, the company remained a domestic natural gas pipeline company. In the 1960s, Enron began a series of changes that diversified the company into other energy markets. Major expansion of the company's operations occurred in the late 1980s and early 1990s as the company moved from being a domestic company to a global provider of energy products. In the mid and late 1990s, further expansion of Enron's activities continued, including a shift from a company based in physical energy assets to a provider of broader services, such as risk management, communications, and financial services.

By the time it filed for bankruptcy protection, Enron had been transformed from a domestic natural gas pipeline company into a global provider and trader of: (1) energy resources and commodities (including electricity, crude oil, physical natural gas, liquefied natural gas, wind power, and air emissions credits); (2) financial and risk management services (including hedging, weather, energy price, and foreign exchange risk management); and (3) electronic commerce (including trading in bandwidth capacity, operating a global Internet-based transaction system for trading in wholesale and retail energy and other commodities, and providing movies and other entertainment on demand). Enron also expanded into non-energy resource businesses such as global metals trading and water resources. Much of Enron's business strategy attempted to take advantage of market opportunities in increasingly deregulated energy markets, including natural gas and electricity, or in lesser regulated markets, such as energy commodities trading and electronic commerce.

Enron has been recognized as a leading innovator⁵⁰ and employer.⁵¹ Enron's market capitalization reportedly increased from approximately \$2 billion in the mid-1980s to

⁵⁰ Enron was named the "Most Innovative Company in America" for six consecutive years by Fortune magazine, and also ranked among the top five companies in Fortune's categories of quality of management, quality of products and services, and employee talent in the 2001 rankings. Press Release, Enron Corp., Enron Named Most Innovative for Sixth Year (February 6, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/15-MostInnovative-02-06-01-LTR.html> (last visited January 22, 2003).

⁵¹ At the time it filed for bankruptcy, Enron employed approximately 25,000 employees worldwide. Affidavit of Jeffrey McMahon Pursuant to Local Bankruptcy Rule 1007-2 at 5, In re Enron Corp., et. al., Debtors (No. 01-16034 (Docket Entry No. 3)), available at <http://www.elaw4enron.com/default.asp> (last visited January 27, 2003). Enron was named to Fortune magazine's list of "100 Best Companies to Work For in America" for 1998 (73rd), 1999 (24th), and 2000 (22nd). Press Release, Enron Corp., Enron Named #22 of "100 Best Companies to Work for in America" (December 18, 2000), at <http://www.enron.com/corp/pressroom/releases/2000/ene/111-FortuneBestCo.html> (last visited January 22, 2003); Press Release, Enron Corp., Enron Named One of "100 Best Companies to Work for in America" (December 21, 1999), at <http://www.enron.com/corp/pressroom/releases/1999/ene/fortune.html> (last visited January 22, 2003).

approximately \$70 billion in early 2001.⁵² Enron reported consolidated revenues of \$101 billion for 2000, and ranked seventh on the Fortune 500 list of the country's largest companies for 2001.⁵³ As of December 31, 2000, the company had approximately 58,920 shareholders of record with respect to its outstanding shares of common stock.⁵⁴ Enron's bankruptcy filing was the largest corporate bankruptcy in U.S. history prior to the July 21, 2002, filing by Worldcom, Inc.⁵⁵

⁵² Enron reported in 2001 that during the 15-year period that Mr. Kenneth L. Lay was Chief Executive Officer of the company (1986 to 2001), its market capitalization increased from \$2 billion to \$70 billion. Press Release, Enron Corp., Enron Announces Skilling Resignation; Lay Assumes President and CEO Duties (August 14, 2001), at <http://enron.com/corp/pressroom/releases/2001/ene/58-ENE-SkillingResignation-08-14-01-LTR.html> (last visited January 22, 2003).

⁵³ <http://www.fortune.com/fortune/fortune500> (last visited January 22, 2003). Enron moved up to fifth place on the Fortune 500 list for 2002, and was sixth on Fortune's 2002 Global 500, which lists the world's largest corporations. *Id.*

⁵⁴ Affidavit of Jeffrey McMahon Pursuant to Local Bankruptcy Rule 1007-2 at 6, In re Enron Corp., et. al., Debtors (No. 01-16034 (Docket Entry No. 3)), at <http://www.elaw4enron.com/default.asp> (last visited January 27, 2003).

⁵⁵ http://www.bankruptcydata.com/Research/15_Largest.htm (last visited January 22, 2003).

B. History of Business Operations

1. Formative years and the 1985 acquisition of Houston Natural Gas

The company that became Enron Corp. was incorporated as Northern Natural Gas Company, a Delaware corporation, on April 25, 1930. The company changed its name to InterNorth, Inc. ("InterNorth") in 1980, and then to Enron Corp. in April 1986.⁵⁶

During the company's first thirty years of existence its only business was transporting and marketing natural gas. During the 1960s, it diversified its operations to include natural gas liquids, petrochemicals, and exploration and production of natural gas and oils. Its revenues and assets increased steadily during the 1970s and early 1980s. The company underwent major expansion in the 1980s when it acquired Belco Petroleum Company (an oil and gas exploration and production company) in 1983, Chemplex Company (a manufacturer of olefins, high- and low-density polyethylene and adhesives) in 1984, and Houston Natural Gas Corporation ("HNG") on July 1, 1985. The HNG acquisition was a major contributing factor to the company's ultimate transformation from a regional natural gas pipeline to a global provider and trader of energy and other products.

At the time of the 1985 acquisition of HNG, InterNorth was a publicly traded regional interstate natural gas pipeline company based in Omaha, Nebraska. As of December 31, 1984, InterNorth had approximately 35,000 miles of natural gas pipeline, \$6.1 billion of total assets, 10,551 employees, and \$7.5 billion of revenues during fiscal year 1984.⁵⁷ Its natural gas operations were sold to purchasers at various points in the upper Midwest, as well as in the production area States of Texas, New Mexico, Louisiana, Oklahoma, Kansas, Colorado, Montana, and Wyoming. Following the Federal deregulation of natural gas markets commenced by the Federal Energy Regulatory Commission ("FERC") in 1985,⁵⁸ InterNorth sought to expand its presence in the domestic natural gas industry by acquiring HNG. HNG was a publicly traded intrastate natural gas pipeline company that had three large but separate pipeline systems based in Texas, Florida, and California.⁵⁹ HNG had approximately 14,000 miles of natural gas pipeline, 3,100 employees, and \$3.9 billion of assets as of December 31, 1984. InterNorth and

⁵⁶ Enron Corp. reincorporated as an Oregon corporation in 1997.

⁵⁷ InterNorth's operating revenues were derived from the transmission and distribution of natural gas at wholesale and retail (38 percent); the acquisition, production, transportation, and marketing of natural gas liquids and petroleum products (52 percent); the exploration and production of natural gas and oil (5 percent); and the production and marketing of plastic resins and films, petrochemicals, and antifreeze (5 percent).

⁵⁸ Various FERC orders mandated a fundamental restructuring of interstate pipeline sales and transportation services, and further enhanced competition in the natural gas industry by assuring comparability of pipeline sales and services offered by competitors.

⁵⁹ HNG had been an intrastate natural gas pipeline company operating primarily in Texas until 1984 when it acquired interstate pipeline systems based in Florida and California.

HNG reported market capitalization of \$2.1 billion and \$1.4 billion, respectively, as of March 1985.

InterNorth acquired HNG pursuant to a stock acquisition in which InterNorth paid HNG shareholders \$2.4 billion cash for all of HNG's stock. For financial reporting purposes, the InterNorth/HNG transaction was reported as the acquisition by InterNorth of HNG, effective June 1, 1985, under the purchase method of accounting. For Federal income tax purposes, the transaction was reported as a taxable purchase by InterNorth of HNG's stock, and HNG and its affiliates were included in InterNorth's consolidated Federal income tax return beginning in calendar year 1985.

The combination of InterNorth's and HNG's pipeline systems formed the largest natural gas pipeline system in the United States, approximately 37,000 miles in length, and the first nationwide natural gas pipeline network in the United States. HNG's Houston pipeline served as the hub of the company's network and major interstate pipelines, and created a pipeline system that extended from the borders of Mexico to Canada, and from Florida to the Arizona-California border. The combined company's major businesses included: (1) gathering and wholesale marketing of natural gas through its pipeline system (approximately 63 percent of the company's assets); (2) exploration and production of natural gas and crude oil (approximately 25 percent of the company's assets); (3) production, purchase, transportation, marketing and trading of natural gas liquids, crude oil, and refined petroleum products (approximately five percent of the company's assets); and (4) the manufacture and marketing of polyolefin plastic resins and related products (approximately five percent of the company's assets).⁶⁰

Although HNG was the smaller of the two combined companies, its officers and directors took over management control soon after the acquisition.⁶¹ The combined company first operated under the name HNG InterNorth. HNG's Chairman and Chief Executive Officer, Mr. Kenneth Lay, became the Chairman of the Board and Chief Executive Officer of HNG InterNorth in February 1986.⁶² By the end of 1986, a majority of Enron Corp.'s officers and directors were former officers and directors of HNG, the acquired company.

⁶⁰ At the time of the HNG acquisition, InterNorth was the eighth largest producer of polyolefin resins in the world.

⁶¹ This was contemplated in the agreement between InterNorth and HNG. Pursuant to section 6.12 of the Agreement and Plan of Merger between the companies, InterNorth agreed and covenanted to cause its Chairman and Chief Executive Officer to remain in those positions until January 1, 1987, at which time Mr. Lay would assume those positions, and increase the InterNorth board size to permit ten directors to be selected by HNG's board or by Mr. Lay. The Chairman and Chief Executive Officer of InterNorth at the time of the acquisition left the company in November 1985.

⁶² Mr. Lay became Chairman and Chief Executive Officer of HNG in June 1984. He served in these capacities with HNG InterNorth and Enron Corp. until February 2001, at which time Mr. Jeffrey K. Skilling was promoted to Chief Executive Officer of the company. Mr. Skilling resigned from Enron in August 2001, and Mr. Lay once again became Chief Executive

2. Transition from natural gas company to diversified energy company: 1986-1995

During 1986 to 1995, Enron began its transformation from a domestic natural gas company to a global provider of energy products. Immediately following the HNG acquisition, Enron implemented a program of selective asset divestitures. Asset dispositions included certain pipelines that were required to be sold as a condition to regulatory approval of the HNG acquisition, retail natural gas operations, the petrochemicals business segment, and other smaller operations.⁶³

At the end of 1986, Enron was predominantly a domestic business, with the company's foreign assets and foreign operating revenues comprising 10 percent and eight percent, respectively, of the company's worldwide totals.⁶⁴ The company had oil and gas reserves in the United States and Canada, most of which were held in its subsidiary, Enron Oil & Gas Company ("EOG").⁶⁵

By the late 1980s, however, Enron's business began to change. Enron became involved in buying and selling energy commodities, as well as exploring, developing, and transmitting natural gas and liquid energy products. During 1987, Enron discontinued its speculative oil and petroleum products trading operations conducted by Enron Oil Corp. in New York due to losses incurred as a result of unauthorized trading activities. In 1989, Enron began entering into long-term fixed priced energy contracts, and trading natural gas commodities through the use of forward contracts and other instruments.

As recently as 1990, Enron viewed itself as a natural gas company. In its Annual Report released in early 1990, Enron stated, "Enron enters the 1990s with a focused business strategy, a strong set of values and a vision to become the premier integrated natural gas company in the world. Enron's business is natural gas, from the reservoir to the burner tip ..."⁶⁶

Officer. Mr. Lay remained Enron's Chairman of the Board and Chief Executive Officer until he resigned from those positions in January 2002. Mr. Lay resigned as an Enron director in February 2002.

⁶³ The divestitures and associated layoffs of employees reduced the company's total workforce from 8,800 employees in 1985 to 7,200 employees at the end of 1986.

⁶⁴ See Table 5, Miscellaneous Foreign and Domestic Financial Information for Enron, 1991 to 2000.

⁶⁵ As of December 31, 1989, EOG's reserves were 91 percent natural gas and predominantly domestic (91 percent located in the United States and nine percent located in Canada).

⁶⁶ Enron Corp., 1989 Annual Report, at 6 (1990). For the year ended December 31, 1989, Enron's consolidated group of companies derived approximately 35 percent of its revenues from natural gas operations, 63 percent from liquid fuels operations (including liquid natural gas, gas liquids, and crude oil), and 2 percent from exploration and production. *Id.* at 1.

In the early 1990s, Enron increased its natural gas trading and financing activities through its subsidiaries, Enron Gas Marketing, Inc., Enron Finance Corp., and Enron Gas Services.⁶⁷ During the period 1992-1994, Enron disposed of a substantial portion of its liquid pipeline assets, including the Northern Border Pipeline in 1993, and its substantial Enron Oil Trading & Transportation Company ("EOTT") crude oil and trading operations in 1994, by transferring those assets to unconsolidated partnerships such as Enron Liquid Pipelines, LP, Northern Border Partners, LP, and EOTT Energy Partners, LP.⁶⁸ Enron's disposition of EOTT was so significant that it caused Enron to restate certain of its financial statements, beginning with those included in its 1993 Annual Report.⁶⁹

In 1994, Enron began purchasing and selling electricity after Enron's power marketing subsidiary obtained a no-action letter from the Securities and Exchange Commission exempting its power marketing activities from regulation as an electric utility under the Public Utility Holding Company Act.⁷⁰

In the 5-year period, 1991 through 1995, Enron's annual revenues (restated after taking into account the divestiture of EOTT) increased from \$5.7 billion to \$9.2 billion. Enron's total assets were \$13.2 billion as of December 31, 1995.

⁶⁷ In 1992, Enron adopted the mark-to-market method of accounting for financial statement purposes for its trading operations. See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation (June 7, 2002).

⁶⁸ Enron Liquid Pipelines, LP, Northern Border Partners, LP, and EOTT Energy L.P. were classified as master limited partnerships. Enron reported to the Joint Committee staff that the master limited partnership prospectus informed investors of the intent to register the aforementioned as tax shelters under sec. 6111(c). See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation (June 7, 2002).

⁶⁹ EOTT's operations had accounted for revenues of \$8.2 billion, \$7.7 billion, and \$6.4 billion of Enron's consolidated revenues for 1991, 1992, and 1993, respectively. Enron Corp., Form 10-K for Fiscal Year Ended December 31, 1993 (note 3 to the consolidated income statement). Enron's reported revenues decreased from \$13.5 billion in 1991 to \$6.3 billion in 1992, with revenues from liquid fuels (including EOTT) decreasing from \$9.9 billion to \$2.0 billion for those years. Enron Corp., Form 10-K for Fiscal Year Ended December 31, 1991 (1992), at 23-24; Enron Corp., Form 10-K for Fiscal Year Ended December 31, 1992 (1993), at 20-21. Based on these reported amounts, the EOTT divestiture decreased Enron's reported consolidated revenues by approximately 55 percent and 44 percent for 1992 and 1993, respectively. *Id.* See also Enron Corp., 1992 Annual Report (1993), at 42, 51 (disclosing proposed spinoff of EOTT and reporting EOTT's activities as discontinued operations).

⁷⁰ Congressional Research Service, Financial Oversight of Enron: *The SEC and Private-Sector Watchdogs, Report of the Staff to the Senate Committee on Governmental Affairs*, at 47-51 (October 8, 2002).

During the early 1990s, Enron also increased its foreign presence principally through the development, acquisition, promotion, and operation of natural gas and power projects and the marketing of natural gas liquids. A consortium that included Enron acquired a southern Argentina pipeline system in 1992 to establish Enron's first presence in South America. In April 1993, Enron made its first substantial investment in the European energy markets when it began its Teesside operations, a combined cycle gas turbine power plant in the United Kingdom. In 1994, Enron formed Enron Global Power and Pipelines to develop energy projects in developing nations. By 1995, Enron's international activities included power plants or projects in Germany, Guatemala, and the Philippines, its pipeline system in Argentina, retail gas and propane sales in the Caribbean basin, and natural gas liquids processing at Teesside. By the close of 1995, Enron's foreign assets and revenues accounted for approximately 14 percent and 11 percent of total worldwide assets and revenues, respectively.

3. Transformation to a marketing and logistics company: 1996-2001

The period 1996-2001 involved four significant company-wide themes: (1) expansion into increasingly deregulated domestic energy markets such as natural gas and electricity; (2) movement into global markets such as power plants, water, and metals; (3) transformation from a physical assets company to a provider of risk management, communications, financial, and energy services; and (4) a focus on attaining financial and operational objectives established in January 1996. Enron promoted itself as an innovator and a company for the changing economy, describing itself as having "metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people."⁷¹ The company's Chief Executive Officers during this period, Messrs. Lay and Skilling, oversaw the company's transformation.

In 1996, Enron introduced "Enron 2000," a plan that represented the company's commitment to achieving three specific financial objectives: (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.⁷² Enron 2000 was introduced and described in the company's year-end earnings release issued to analysts, media, shareholders, and employees, and was communicated to stock analysts and management personnel at separate meetings.⁷³ In announcing Enron's 1996 earnings per share, Mr. Lay, chairman and chief executive officer of Enron, was quoted in an Enron press release as saying, "Enron achieved its earnings and operational goals in 1996, the

⁷¹ Enron Corp., 2000 Annual Report, at 9 (2001).

⁷² Presentation to Enron Corp. Board of Directors' Meeting, December 9, 1997 (describing the history regarding introduction of Enron 2000 and its importance as the standard against which the company's actual financial performance was to be measured). EC 000046072.

⁷³ Enron Corp., 1996 Performance Review (January 17, 1997). EC 000103501.

first year of our Enron 2000 initiative to reach net income in excess of \$1 billion and achieve a minimum double digit growth in annual earnings per share."⁷⁴

Enron restructured its worldwide operations in January 1997. The restructured company: (1) consolidated its international activities into Enron International (consisting of Enron Development Corporation, Enron Joint Venture Management, Enron Americas, and Enron Global Power and Pipelines); (2) established the Enron Gas Pipeline Group, which was responsible for all of Enron's North American pipeline companies; (3) established Enron Ventures Corp. to manage its international and domestic engineering and construction activities; (4) formed Enron Renewable Energy Corp. to conduct wind energy projects; (5) formed Enron Capital Management to encompass Enron's treasury and corporate risk management functions; and (6) continued Enron Capital & Trade Resources, which was later renamed Enron North America Corp.

Enron's shift during this period from physical assets to services businesses was evidenced by its growth in reported risk management assets (from \$0.5 billion in 1992 to \$21 billion in 2000) relative to net plant, property, and equipment (from \$6.5 billion to \$11.7 billion during the same period). By March 2000, Enron was the sixth largest energy company in the world, with its businesses divided into three core areas: (1) wholesale services, including the marketing and delivery of physical commodities and financial risk management services; (2) retail energy services business, including providing integrated energy and facility management outsourcing solutions to commercial and industrial consumers worldwide; and (3) global services, including asset-based businesses such as pipelines, engineering businesses, and international power, pipeline, and distribution operations. Enron entered into contracts for physical delivery of energy products, as well as financial contracts related to trading its wholesale commodity products, including commodities contracts, forward contracts, swap agreements, securities contracts, caps, floors, collars, futures contracts, repurchase agreements, and options.

Enron's reported consolidated revenues increased from \$13 billion in 1996 to \$101 billion in 2000. During the same period, Enron's reported total assets increased from \$16.1 billion to \$65.5 billion.⁷⁵

Natural gas and electricity in the United States

At the beginning of 1996, Enron operated the second largest natural gas transmission system in the world. Throughout the 1990s Enron also increased its power marketing activities, which consisted of selling power at market-based rates. Shortly after announcing its January 1997 worldwide restructuring, Enron formed Risk Management & Trading Corp. to "manage trading books" for various Enron entities. Soon thereafter, Enron formed Enron Energy Services

⁷⁴ Press Release, Enron Corp., Enron Reports 12 Percent Increase in 1996 Earnings Per Share, to \$2.31 Per Share (January 21, 1997) at <http://www.enron.com/corp/pressroom/releases/1997/12per.html> (last visited January 26, 2003).

⁷⁵ The asset and revenue figures were reported in the company's financial statements prior to charges and restatements announced and made in October and November 2001.

to sell energy and advisory services, such as long-term energy management, to large consumers.⁷⁶

In early 1997, Enron took steps to increase its electricity development and production in the northwestern United States when it announced a strategic energy alliance with Northern California Power Agency, pursuant to which Enron would provide a comprehensive package of services, including the sale of natural gas and financial and risk management products. This event reportedly marked the first alliance of its kind following California's deregulation of the electric power industry. In July 1997, Enron acquired Portland General Corporation ("PGC"), an electric utility holding company, and Portland General Electric ("PGE"), its affiliated electric utility with approximately 685,000 residential and commercial retail customers in Oregon. Enron's acquisition of PGE and PGC was effected by a \$1.9 billion stock swap in which Enron issued 50.5 million shares of Enron stock to PGC shareholders in exchange for 49.6 million shares of PGC stock. Enron also consolidated \$1.1 billion of PGE's debt, making the total acquisition price approximately \$3 billion.⁷⁷ Enron considered PGE to be its platform to enter the deregulated California electricity market.⁷⁸ In October 1997, Enron entered the California electricity market by offering consumers two weeks of free electricity and utility rates guaranteed for at least two years.

Enron's acquisition of PGE raised certain regulatory issues under the Public Utility Holding Company Act that caused Enron to change its corporate domicile from Delaware to Oregon. When Enron acquired ownership of all of the outstanding voting securities of PGE, an Oregon public utility, Enron became a public utility holding company within the meaning of the Public Utility Holding Company Act. The Public Utility Holding Company Act provided a limited "intrastate exemption" from certain regulatory provisions if the holding company (Enron Corp.) and its subsidiary utility (PGE) were domiciled within the same State. Concomitant with the PGE acquisition, Enron Corp. reincorporated in Oregon, reissued its capital stock without par

⁷⁶ As identified in Enron press releases, these long-term energy management customers ultimately included, among others: The Chase Manhattan Corporation, IBM, Quebecor, Starwood Hotels and Resorts, Compaq, Simon Properties, Sonoco, Owens-Illinois, Quaker Oats, Eli Lilly, JCPenney, and Saks Incorporated. See Press Release, Enron Corp., Enron and Chase Manhattan Bank Sign Long-Term Energy Management Agreement (February 2, 2000), at <http://www.enron.com/corp/pressroom/releases/2000/cne/chase.html> (last visited February 11, 2003); and Press Release, Enron Corp., Enron Reports Record First Quarter Recurring Earnings of \$0.47 per Diluted Share; Increases Earnings Expectations for 2001 (April 17, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/enc/ENE-Q1-01-LTR.html> (last visited February 11, 2003).

⁷⁷ The PGE acquisition was reported under the purchase method of accounting for financial reporting purposes. For Federal income tax purposes, Enron treated the acquisition of the stock of PGE and its affiliates as a tax-free reorganization pursuant to section 368(a)(1)(A) when PGC was merged with and into Enron.

⁷⁸ Enron Corp., Form U-1, Application-Declaration Under The Public Utility Holding Company Act of 1935, filed with the Securities and Exchange Commission (February 28, 2002).

value, and ceased to be a Delaware corporation, in order to place Enron Corp. and PGE within this intrastate exemption.

By 1999, Enron had become the largest merchant of power and gas in North America. Enron's gas pipeline group owned interests in four interstate pipelines, operated 32,000 miles of pipelines in 21 states, and transported approximately 15 percent of the U.S. natural gas demand.

Foreign markets

During 1996 to 1998, Enron commenced marketing electricity and natural gas, delivering energy and other physical commodities, and providing financial and risk management services around the world. Construction of the combined cycle power plant project in Dabhol, India began in 1996.⁷⁹ Years 1998 and 1999 brought further expansion into foreign markets, with Enron making a substantial equity investment in Elektro, a Brazilian electricity transmission system. In total, Enron's foreign net proved reserves of natural gas and liquids had increased as a portion of worldwide net proved reserves from four percent and 13 percent, respectively, at the end of 1985, to 45 percent and 65 percent, respectively, at the end of 1998.⁸⁰ Enron entered the water business in July 1998 when it acquired Wessex Water Plc, a major U.K. water company. The 1998 acquisition of Wessex Water for \$2.2 billion, and the formation of a new water company, Azurix Corp. ("Azurix"), was effected to allow Enron to own and operate strategic water and wastewater assets, such as local distribution systems and treatment facilities, and to develop related infrastructure. Azurix pursued water projects in Europe, Latin America, and Asia.

During 2000, Enron opened a Tokyo office to pursue opportunities in Japan's energy, commodity, and financial sectors, with an initial focus on activities such as risk management, multi-commodity market making, electronic commerce, and merchant asset development. In May 2000, Enron entered the metals markets by acquiring MG plc, an independent international metals market-making business, for approximately \$2 billion.

Enron's total international investment ultimately exceeded \$7 billion, including more than \$3 billion in Latin America, \$1 billion in India, and \$2.9 billion in Britain. It owned or operated electric power plants or transmission systems in the United Kingdom, Germany, Turkey, Guatemala, the Philippines, the Dominican Republic, and off the coast of China, and operated one or more of its businesses in approximately 20 countries and territories, including Central America and the Caribbean (Panama, Guatemala, Nicaragua, Puerto Rico, the Dominican Republic, and Jamaica), South America (Colombia, Venezuela, Argentina, Brazil, and Bolivia),

⁷⁹ The Dabhol project became the subject of extensive litigation between Enron and the State of Maharashtra, India, regarding energy prices charged by Enron.

⁸⁰ "Net proved reserves" is a measure of energy reserves that have been proved to a high degree of certainty, based on studies performed by engineers.

Europe (Poland, Italy, and Turkey), and Asia Pacific (People's Republic of China, Guam, and the Phillipines).⁸¹

Enron used foreign subsidiaries and offshore entities to hold its investments throughout the world. Enron located more than 140 subsidiaries in the Netherlands alone, including subsidiaries for its broadband and wind energy units, and formed numerous subsidiaries in low-tax jurisdictions such as the Cayman Islands and Bermuda.⁸² By the end of 2001, Enron's worldwide ownership structure included approximately 1,300 different foreign entities, with over 400 entities formed in the Cayman Islands.⁸³ Much of Enron's reported foreign earnings remained offshore, as Enron's reported undistributed earnings from foreign subsidiaries increased from \$185 million in 1993 to \$1.8 billion in 2000.

By the end of 2000, Enron was reported to be the sixth largest energy company in the world, with its foreign revenues accounting for approximately 23 percent of its total reported worldwide revenues.

Communications businesses

Much of Enron's activity during the late 1990s involved expansion into the communications and financial services businesses by taking advantage of emerging technologies such as the Internet and other forms of electronic commerce.⁸⁴ Enron formed businesses designed to facilitate the trading and transacting of business by others, and to sell technological and communications capacity as a commodity.

One of Enron's major business strategies during the late 1990s was the creation of an online energy trading business that bought and sold contracts to deliver energy products such as natural gas, oil, and electricity. In November 1999, Enron created EnronOnline, a global Internet-based transaction system for wholesale energy and other commodities. EnronOnline allowed participants to view commodity prices in real time and directly transact with Enron over

⁸¹ See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002). The assets held in the various international investments ranged from pipelines, power plants, electricity, gas processing, gas compressions, and gas distributions. *Id.* See also Enron website, factsheet Enron Global Services - International. See <http://www.enron.com/corp/pressroom/factsheets/egs/egsi.html>.

⁸² For example, Enron Oil & Gas India, Ltd., which conducted upstream oil and gas activities in India, was a Cayman Islands corporation with a registered office in Grand Cayman.

⁸³ See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002). Approximately 250 entities were associated with active operations. *Id.* See Part Three of this Report for a detailed discussion of Enron's use of foreign entities.

⁸⁴ See, e.g., Enron Corp., 1998 Annual Report, at 21 (1999); Enron Corp, 2000 Annual Report, at 3 (2001).

the Internet free of commission.⁸⁵ In May 2000, together with IBM and America Online, Enron formed New Power Company to market power and natural gas over the Internet to homes and businesses. In May 2001, Enron reported that approximately 60 percent of all Enron transactions were being conducted online, with a 75 percent reduction in the cost of processing transactions.

Another significant event during this period was the creation of Enron Broadband Services, the purpose of which was to buy and sell Internet access as a commodity.⁸⁶ As part of this effort, Enron launched broadband steering media services and the trading of bandwidth as a commodity,⁸⁷ and built what Enron called the first all-Internet Protocol backbone in the United States (named the Enron Intelligent Network, or EIN). Enron also invested \$10 million to acquire 5.4 million shares of Rhythms NetConnections, Inc. ("Rhythms Net"), a privately-held Internet service provider for businesses using digital subscriber line technology.⁸⁸ Enron later extended its Enron Intelligent Network broadband business to Europe through an agreement with British Telecommunications PLC.

Enron also entered various other financial and services markets through a variety of venues, including: (1) Enroncredit.Com, a real-time credit department for business-to-business

⁸⁵ Enron Online commenced trading in November 1999. It reportedly generated transactions involving \$857 million of notional dollar value in its first two weeks, \$336 billion of notional value through 548,000 executed transactions during 2000, and \$590 billion of notional value by the time EnronOnline reported its one millionth transaction on May 23, 2001. 1999 Performance Review, EC 000101574; Enron Corp., 2000 Annual Report, at 3 (2001); Press Release, Enron Corp., Enron Completes One Million Transactions on EnronOnline (May 23, 2001), at <http://www.enron.com/corp/pressroom/releases/001/ene/45-MillionthTransaction-LTR-5-23-01.html> (last visited January 22, 2003).

⁸⁶ This opportunity stemmed from the PGE acquisition. Enron acquired PGE's communications business, which Enron reported to be the basis for Enron Broadband Services, in the PGE merger. Enron Corp., 1999 Annual Report, at 23 (2000).

⁸⁷ This was accomplished through an Enron subsidiary, Enron Communications, Inc., which announced its first forward trade of bandwidth on December 2, 1999. The seller in the transaction was Global Crossing Services. Press Release, Enron Corp., Enron Communications Announces First Commodity Bandwidth Trade (December 2, 1999), at <http://www.enron.com/corp/pressroom/releases/1999/ene/bandwidth.html> (last visited January 22, 2003).

⁸⁸ Enron's initial Rhythms Net investment of \$10 million reportedly grew to approximately \$300 million, though Enron was prohibited from selling any of the shares before the end of 1999 because of a lock-up commitment it undertook when it acquired the shares. Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., dated February 1, 2002 ("Powers Report"), at 77. As described below, Enron entered into a purported hedging transaction with a newly formed special purpose entity in an attempt to hedge against a decrease in Rhythms Net stock values while Enron was required to hold the shares.

customers;⁸⁹ (2) a 20-year exclusive relationship with Blockbuster Inc. to provide movies on demand to households via the Internet;⁹⁰ (3) commodity transactions involving weather derivative products; and (4) online emissions allowance auctions.⁹¹

⁸⁹ EnronCredit.com was described by Enron as being the first global online credit department to provide live credit prices and information regarding hedging credit exposure instantly over the Internet, and allowed customers to transact in bankruptcy swaps via EnronOnline.

⁹⁰ The Enron/Blockbuster movie-on-demand relationship, announced in July 2000, was terminated in March 2001.

⁹¹ Enron's first online emissions allowance auction was conducted March 2000 and involved sulfur dioxide.

C. Recent Financial History

1. Use of off-balance sheet entities to enhance financial performance measures⁹²

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.⁹³ Enron used SPEs in synthetic lease transactions (sale to an

⁹² 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.

⁹³ 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.⁹⁴

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.⁹⁵

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

⁹⁴ 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).

⁹⁵ 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.⁹⁶ 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.⁹⁷

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 2000.⁹⁸

⁹⁶ 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.

⁹⁷ 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).

⁹⁸ 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.⁹⁹ 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.¹⁰⁰ 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,

⁹⁹ 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*.

¹⁰⁰ Powers Report at 11-12.

and financial flexibility.”¹⁰¹ 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 2001.¹⁰² 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.¹⁰³ 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.¹⁰⁴

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.¹⁰⁵

¹⁰¹ LJM2 Summary, materials provided by Enron. EC 000052043-44.

¹⁰² 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.

¹⁰³ Raptor II was formed in June 2000 and Raptor IV was formed in August 2000.

¹⁰⁴ Powers Report at 97-98.

¹⁰⁵ 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).¹⁰⁶ 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.¹⁰⁷

2. Financial performance and liquidity issues¹⁰⁸

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.¹⁰⁹ 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.¹¹⁰ Enron's earnings performance was further adversely affected by start-up losses in its broadband business and the California energy crisis. Enron

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.

¹⁰⁶ Powers Report at 119, 128.

¹⁰⁷ Powers Report at 132.

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

¹⁰⁹ 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.*

¹¹⁰ 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).¹¹¹ 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 2001.¹¹²

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.¹¹³ 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.¹¹⁴

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

¹¹¹ 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).

¹¹² 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.

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

¹¹⁴ *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.¹¹⁵ 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 2002.¹¹⁶

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.

¹¹⁵ 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.

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

Table 5.—Miscellaneous Financial Information, 1985 to 2000

Year	Revenues [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) ¹	Market capitalization [billions of dollars] ²
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 ³	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 ⁴	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 CenterTM 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."¹¹⁷ 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,¹¹⁸ 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."¹¹⁹

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.¹²⁰ 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-

¹¹⁷ Ms. Watkins memo to Mr. Lay (August 2001). See <http://www.news.findlaw.com/hdocs/docs/enron/emplr2lay82001.pdf>.

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

¹¹⁹ 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.

¹²⁰ 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;¹²¹ 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."¹²² 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.¹²³

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.¹²⁴

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

¹²¹ 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.

¹²² 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).

¹²³ 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.

¹²⁴ 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.¹²⁵ 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.

¹²⁵ 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
Totals	3,509	2,936	-573	-399	-103	-71	N/A

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.¹²⁶ 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, 2001.¹²⁷

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.¹²⁸

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.¹²⁹ As part of the negotiations, Dynegy (through Chevron

¹²⁶ 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.

¹²⁷ 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).

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

¹²⁹ 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.¹³⁰

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, 2001.¹³¹ 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.¹³² Within the next several days, numerous other

¹³⁰ 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.

¹³¹ 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).

¹³² 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.¹³³ In its bankruptcy filing, Enron Corp. (separately, not including any affiliates) listed its assets at \$24.8 billion and liabilities at \$13.1 billion.¹³⁴ 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.¹³⁵

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.¹³⁶ 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.¹³⁷ 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.

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

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

¹³⁴ 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.

¹³⁵ 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.

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

¹³⁷ 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,¹³⁸ 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.¹³⁹

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.¹⁴⁰ 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.¹⁴¹

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

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

¹⁴⁰ 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.

¹⁴¹ 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.”¹⁴² Enron presently reports assets of \$47.3 billion, including 9,000 miles of pipeline, and 14,000 employees.¹⁴³

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.

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

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

D. Enron's Federal Income Tax Position

1. Enron's consolidated Federal income tax filings

Enron Corp. is a calendar year taxpayer that uses the accrual basis method of accounting for Federal income tax purposes. Enron Corp. files consolidated Federal income tax returns in which it reports the consolidated taxable income of its affiliated group within the meaning of section 1504(a).¹⁴⁴ Enron reported 346 entities as members of its affiliated group in its 2000 tax return.¹⁴⁵ Enron's consolidated group also includes numerous single member limited liability companies that Enron treats as disregarded entities for Federal income tax purposes.¹⁴⁶

The IRS master file account information pertaining to Enron Corp. as of January 8, 2003, shows that Enron filed Federal income tax returns for each of its taxable years from 1988 through 2001. Enron filed its Federal income tax return for its 2001 taxable year in September 2002.¹⁴⁷ Enron's tax return for calendar year 2002 is not due until March 17, 2003.

Mr. Robert J. Hermann signed Enron's Federal income tax returns for the years 1985 through 2000 in his capacity as an officer of the company.¹⁴⁸ Mr. Jordan H. Mintz signed

¹⁴⁴ In general, an affiliated group is defined for this purpose to mean one or more chains of corporations connected through stock ownership with a common parent if the common parent owns, directly or indirectly, at least 80 percent of the total voting power and value of the stock of such corporations. Certain corporations, including tax-exempt corporations, life insurance companies, foreign corporations, section 936 corporations (regarding the Puerto Rico and possessions tax credit), regulated investment companies, real estate investment trusts, domestic international sales corporations, and S corporations, generally are not eligible to be included in an affiliated group. Sec. 1504(b).

¹⁴⁵ Form 1120, Enron Corp., 2000 (Form 851 Affiliations Schedule).

¹⁴⁶ Enron North America, Corp. (a subsidiary of Enron Corp.) alone reported in excess of 100 such entities. *See* Diagram of Enron North America - Disregarded entities. EC2 000025345. Under the Treasury Department's "check-the-box" entity classification regulations issued in December 1996, a domestic entity (other than a corporation and certain other ineligible entities) with a single owner is disregarded as an entity separate from its owner for Federal income tax purposes unless such entity elects to be treated as an association taxable as a corporation. Treas. Reg. secs. 301.7701-3(b)(1)(ii) and 301.7701-2(c)(2). Such a disregarded entity is treated as a branch or division of its sole owner for Federal income tax purposes.

¹⁴⁷ Enron filed documents with the Federal bankruptcy court which state that PGE has ceased to join in the filing of Enron's consolidated Federal income tax returns as a result of a May 7, 2001, transaction that caused PGE to cease to qualify as a member of Enron's affiliated group. Docket No. 8232, paragraph 27.

¹⁴⁸ Mr. Hermann signed the returns as "Vice-President, Tax" for the tax years through 1995, as "VP & General Tax Counsel" for the tax years 1996 through 1998, and as "Managing Director and General Tax Counsel" for the tax years 1999 and 2000.

Enron's Federal income tax return for the 2001 taxable year as Enron's Managing Director and General Tax Counsel.

Table 7, below, provides a reconciliation of Enron's consolidated financial statement net income and Enron's consolidated taxable income for 1996 through 2000. The information contained in the table is based on Enron's tax returns as filed without regard to audit adjustments.¹⁴⁹ In addition, the information contained in the table is based on Enron's financial statements as initially reported, without regard to earnings restatements as announced on November 19, 2001.¹⁵⁰

¹⁴⁹ The IRS examination of tax years 1996 through 2000 is ongoing.

¹⁵⁰ See Table 6, above, November 19, 2001, Form 10-Q Accounting Restatements for Enron, for a detailed listing of Enron's restatements. It is impossible to fully assess Enron's book to tax differences prior to determination of Enron's ultimate tax liability, which is under review by the bankruptcy court, and without a restatement of Enron's financial statements for these periods to reflect generally accepted accounting principles.

Table 7.—Enron Corp. and Subsidiaries: Reconciliation of Financial Statement Income to Taxable Income 1996-2000
[millions of dollars]

	1996	1997	1998	1999	2000
Net Income Reported in Consolidated Financial Income Statement ¹	584	105	703	893	979
Less Net Income from Entities not Included in Consolidated Tax Return					
Domestic Corporations ²	-96	-189	-149	-152	-345
Foreign Corporations ³	-232	-44	-521	-1,110	-1,722
Partnerships ⁴	-145	-211	-319	-638	-6,899
	-473	-444	-989	-1,900	-8,966
Plus Net Income from:					
Intercompany Elimination Made for Books but not for Tax	1,322	1,300	1,884	3,997	13,625
Entities not Controlled for Financial Accounting Included for Tax ⁵	0	0	14	122	258
	1,322	1,300	1,898	4,119	13,883
Book Income Reported on Consolidated Tax Return	1,433	961	1,612	3,112	5,896
Significant Book to Tax Adjustments ⁶					
Federal Income Taxes	159	-35	45	-128	193
Net Partnership Adjustments	-107	-122	-109	-338	-481
Net Mark to Market Adjustments	-118	118	-333	-906	-537
Constructive Sale (section 1259)	0	0	0	0	5,566
Structures Treated as Debt for Tax not for Book (e.g., equity or minority interest)	-2	-24	-3	-12	-149
Company Owned Life Insurance Adjustment	-19	-24	-27	-35	-20
Stock Options Deduction	-113	-9	-92	-382	-1,560
Depreciation Differences	-67	-65	-57	-124	-154
Equity Earnings Reversal Per Tax Return	-1,183	-1,023	-1,688	-2,868	-5,516
All Other Book to Tax Differences	-293	-281	-101	223	-137
Taxable Income Reported on Consolidated Tax Return	-310	-504	-753	-1,458	3,101

Notes:

(1) As originally reported. (2) Corporations not meeting 80 percent vote and value test (sec. 1504(a)(2)). The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (3) Foreign corporations are not eligible for inclusion in consolidated tax return (sec. 1504(b)(3)). (4) Partnerships are required to file separate Federal income tax returns. The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (5) Disregarded entities for tax purposes (Treas. reg. sec. 301.7701-3) not included in consolidated financial statements. The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (6) Amounts as reported in Enron presentation to the Joint Committee staff, June 7, 2002. Appendix B contains this presentation. In addition, Appendix A contains further details of Enron's book to tax adjustments as reported in the tax return.

2. Interaction between Enron and the Internal Revenue Service

Selected information regarding Enron's tax department

Prior to the 1985 acquisition of HNG by InterNorth, HNG had a tax department with 24 employees, and InterNorth had approximately 55 tax department members. The 1985 HNG/InterNorth combination created a combined tax department with approximately 80 employees, led by Mr. Hermann, who had served as HNG's Vice President of Corporate Taxes.¹⁵¹ The size of the Enron tax department decreased in the late 1980s as a result of recommendations by external management consultants that the company's tax department should be reduced to about 40 employees.

Enron's tax department went through significant expansion and reorganization during the 1990s. Beginning in 1989 or 1990, when Enron's business was moving beyond physical assets into financial products, Enron's tax department began "managing" Enron's tax liability, rather than merely preparing a tax return to report income resulting from Enron's operations. During the late 1980s Enron had been reporting net operating losses for Federal income tax purposes, resulting in a cumulative reported net operating loss carryover of approximately \$404 million available from its 1990 taxable year.¹⁵² Enron had "tight sands" tax credits, however, that Enron could utilize only if it had taxable income that generated a Federal income tax liability. It became advantageous for Enron to begin reporting positive taxable income for Federal income tax purposes, rather than net operating losses, to ensure full utilization of the tight sands tax credits. In its 1990 annual report letter to its shareholders and customers, Enron reported that the tight sands tax credits, combined with a Texas severance tax exemption, could be worth more than \$100 million to Enron on a present value basis.¹⁵³ For 1991, Enron reported Federal taxable income of \$167.5 million after fully utilizing its \$404 million net operating loss carryover from 1990.¹⁵⁴ Enron also reported that its tight sands tax credits amounted to \$17 million in 1991 and could exceed \$40 million in 1992.¹⁵⁵ By this time, Enron recognized the importance of Federal income tax benefits, such as the tight sands tax credits, as a means of favorably affecting income

¹⁵¹ The information regarding Enron's tax department was obtained during the course of interviews conducted by the Joint Committee staff.

¹⁵² Enron reported a consolidated net operating loss carryover of \$403 million, available until 2003, in its notes to its 1990 annual report. Enron Corp., 1990 Annual Report, at 47 (1991). The actual amount of the carryover reported on Enron's 1991 tax return was \$404 million.

¹⁵³ Enron Corp., 1990 Annual Report, at 6 (1991). The letter stated the successful move to longer term contracts and "the supportive role Enron Oil & Gas played in the passage of tight sands legislation were significant accomplishments in 1990." *Id.*

¹⁵⁴ Enron Corp., 1991 Annual Report, at 43 (1992).

¹⁵⁵ *Id.* at 3. Enron stated that the "positive impact of the tight gas sand tax credit, continued emphasis on cost control and net revenue from other marketing activities should allow EOG earnings to continue to improve despite low natural gas prices." *Id.*

for financial reporting purposes.¹⁵⁶ From the period 1991 through 1995, Enron claimed tight sands tax credits of approximately \$150 million.¹⁵⁷

In 1991, Enron also started expanding into international business ventures. In order to win bids on international ventures, the tax department provided tax planning methods involving the establishment of offshore companies to reduce U.S. tax on income from the ventures.¹⁵⁸ This led to staffing increases in the international tax area in Enron's tax department personnel and in other areas as well, causing the staff to approximately double in size from the late 1980s to 1996. Enron's tax department grew from a staff of 83 in 1996 to 253 in 2000.¹⁵⁹ The majority of these employees were located in Houston, although a few were in Portland, Oregon, and others were in Enron's office in London, England. By the end of 2001, however, the tax department had decreased to 183 employees. By 2002, the Enron tax department had further declined to 117 employees.

During the second half of the 1990s, the Enron tax department was divided into 12 separate and distinct functions. These functions included: Managing Director/General Tax Counsel; Planning; Reporting & Analysis; Tax Systems; Structured Transactions; Audits; Sales and Use Tax; Ad Valorem Tax; Administrative; Azurix; PGE - Portland; and London.¹⁶⁰ At the beginning of 2001, Enron's tax department was organized into several groups, generally with a vice president in charge who reported to Mr. Hermann. These groups included: Corporate Reporting and Analysis; Corporate - International; Corporate - Tax Planning; Enron North

¹⁵⁶ Enron was able to reduce its income tax expense (and increase its financial statement net income) by the amount of its tight sands tax credits. *See e.g.*, Enron Corp., 1993 Annual Report (1994), at 52, n.3. Enron reported that it utilized tight sand tax credits of approximately \$42.5 million in 1992, and that it expected to utilize approximately \$50 million of the credit in 1993. Enron Corp., 1992 Annual Report, at 31 (1993). Enron reported it would continue to support a possible extension of the credit qualification period beyond 1992, and that it would continue to benefit from the credit after 1992 because it applied to previously qualified production through 2002. Enron Corp., 1992 Annual Report 31 (1993).

¹⁵⁷ *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

¹⁵⁸ These offshore structures are discussed in more detail in Part Five.C., below, of this Report.

¹⁵⁹ *See* Appendix B, Enron Corp. Tax Department Summary Headcount Analysis, Enron Corp. Presentation to the Joint Committee on Taxation (June 7, 2002), at 8.

¹⁶⁰ *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

America; Enron Energy Services; Europe; Enron Broadband Services; Gas Pipeline Group; Audits; and Structured Transactions.¹⁶¹

Enron's tax department was proactive. Over time the tax department generated benefits for Enron that equaled, or eventually far outstripped, the budgeted cost of the tax department itself. The benefits generated by Enron's tax department included financial earnings as well as tax savings.¹⁶²

Enron's tax department obtained the services of external tax advisors for general tax advice that included: tax return preparation, transfer pricing documentation, State tax issues, tax audit support, and Federal tax consulting.¹⁶³ Enron estimated that it paid \$14 million in external U.S. tax advisor fees in connection with such advice during the late 1990s.¹⁶⁴

During the period 1997 through 2000, Enron prepared more than 1,000 Federal tax returns for each year with respect to its affiliated and related entities.¹⁶⁵ From 1997 to 2000, the total number of Federal tax returns prepared by the department increased from 1,002 to 2,486.¹⁶⁶ Similarly, the total number of State income and franchise tax returns prepared by the department increased during this period from 622 to 1,422.¹⁶⁷

Enron's tax department prepared an annual report measuring the total tax savings generated by the department. The tax department transmitted the report to Enron's Board of Directors each December, before the Board approved the bonus pool for employees. In the late 1990s, the pay and bonuses of the tax department personnel were determined, like those of other Enron employees, on a ranking system with different levels. The base pay and bonus for any particular individual in the tax department were not specifically dependent on the tax savings

¹⁶¹ Appendix B, Tax Department Organization As Of January 1, 2001, Enron Corp. Presentation to the Joint Committee on Taxation (June 7, 2002), at 7; a description of the Structured Transactions Group is included in Part Three. A of this Report.

¹⁶² These benefits are described in more detail with respect to the structured transactions described in Part Three.A., below, of this Report.

¹⁶³ See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

¹⁶⁴ *Id.* These estimates do not include external tax advisor fees paid with respect to Enron's structured transactions.

¹⁶⁵ See Part Two, Background and Methodology. See also Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

¹⁶⁶ *Id.*

¹⁶⁷ See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

generated by that individual. A general discussion of Enron employee compensation is described in more detail in Part Four of this Report.

IRS examination of Enron tax returns

From 1990 to the present, the IRS conducted four examinations of Enron's Federal income tax returns. The examinations were divided into four audit cycles as follows: (1) taxable years 1983 through 1987; (2) taxable years 1988 through 1991; (3) taxable years 1992 through 1994; and (4) taxable years 1995 through 2001. The first three audit cycles were closed by the IRS in 1993, 1996, and 1998, respectively.¹⁶⁸ The net agreed deficiencies with respect to these examination cycles totaled \$4.3 million. The audit cycle for 1995 through 2001 is currently under examination by the IRS.¹⁶⁹

Each of the IRS's examinations of Enron's tax returns was coordinated through a team manager and a team coordinator. The IRS team generally included revenue agents, economists, engineers, and specialists in financial products, international examinations, and computer audits.¹⁷⁰ Each IRS team that examined Enron's 1985 through 1987 and 1988 through 1991 audit cycles consisted of 11 individuals. The IRS team size increased to 13 individuals for the 1992 through 1994 audit cycle, and to 27 individuals for the 1995 through 2001 audit cycle. The team manager for the last three audit cycles was the same IRS employee. The IRS assigned a different revenue agent as the team coordinator for each of the four audit cycles.

The IRS reported certain audit adjustment information to the Joint Committee staff. According to those reports, the adjustments to taxable income made by the IRS audit teams for Enron's taxable years 1988 through 1995 were as follows: -\$18.8 million for 1988, -\$27.3 million for 1989, -\$11.7 million for 1990, \$19.7 million for 1991, \$101.6 million for 1992, \$85.9 million for 1993, and \$211.8 million for 1994. The total net adjustments made by the IRS audit teams for taxable years 1988 through 1994 increased Enron's taxable income by \$361.2 million.

For the 1995 through 1999, the IRS issued 854 information document requests to Enron through March 5, 2002. Some of the information or materials requested included or involved: planning materials, partnership filings and returns, phantom stock deductions, other deductions, balance sheets, reorganization materials, affiliates' receivables, commodity derivatives and commodity physical positions, employee status, company policies, and general information. As of March 5, 2002, Enron had completed its responses to 830 requests. The outstanding requests involved related party transactions, potentially abusive tax shelters, development costs,

¹⁶⁸ Internal Enron management documents reported that Enron had "successfully concluded the audit of the 1989-1991 tax returns, sustaining the deductibility of Net Operating Loss carry forward, which allowed recognition of \$10 MM in tax benefit during third quarter 1995." 1995 Performance Review. EC 000102767.

¹⁶⁹ The Joint Committee staff understands that the IRS examination of Enron's 1995 taxable year is complete and that proposed adjustments have been made with respect to 1995.

¹⁷⁰ The IRS team for the 1995 through 2001 audit cycle also included specialists in employee plans and a specialist in excise taxes.

partnership income/loss, trading in the context of financial deals, capital gains, political contributions, and certain self-audit adjustments. The IRS expects to propose or make adjustments to one or more of the years in the open audit cycle, which could affect Enron's tax liability for such years.

Enron's overall working relationship with the IRS was described by Mr. Hermann as "professional" and "good" from the mid-1980s through the mid-1990s.¹⁷¹ Mr. Hermann reported that Enron's expansion into international markets in the mid-1990s complicated the IRS's development of an audit plan and audit team to examine the tax implications of this growth, resulted in the IRS exploring irrelevant issues, and caused the working relationship between the IRS and Enron to deteriorate.¹⁷² During IRS briefings, the Joint Committee staff was told that the relationship between Enron and the IRS became strained in the later years.

Enron's involvement in the coordinated industry case program

The IRS uses a coordinated industry case program¹⁷³ ("CIP") to coordinate the examination of large and highly diversified taxpayers. Pursuant to the CIP, over 1,600 of the largest corporate taxpayers are audited on an ongoing basis for a period of one or more years. If a taxpayer is chosen for the CIP, the taxpayer and all of their effectively controlled entities are included in the case. Unrelated entities may also be included in the case if they are associated

¹⁷¹ Joint Committee staff interview.

¹⁷² *Id.*

¹⁷³ The CIP was created to centralize control of large cases and obtain uniformity and consistency in management. *See* Internal Revenue Manual Ch. 4.45.3.1 (Primary Control—Overview). CIP cases generally are selected based on factors that potentially indicate a high level of tax complexity. Such factors include the taxpayer's gross assets (usually starting at \$500 million), gross receipts (usually starting at \$1 billion), the number of entities involved, the number of separate and distinct major industries the taxpayer is involved in, and the specialized staff-related resources required to conduct the audit. Each of these factors is considered for a specific taxpayer and if certain thresholds are met the case qualifies as a CIP case. Usually, once a corporation qualifies as a CIP case it will remain in the program even if there may be a change in its circumstances. *See* Internal Revenue Manual Ch. 4.45.2.1 (Case Selection--Identification of Cases). Irrespective of whether a case exceeds the required threshold, a case may be included in the program if it is determined to be sufficiently complex and would likely benefit from using the team approach of the CIP. Likewise, cases meeting the thresholds may be excluded from the examination under the CIP. *See* Internal Revenue Manual Exhibit 4.45.2-1 (Criteria for the identification of Coordinated Industry Program cases).

Audit-related work in CIP cases is carried out by a team of revenue agents and other specialist members (such as international tax specialists, employment and excise tax specialists, economists, and engineers) who are responsible for reviewing and analyzing the tax liabilities of the corporate taxpayer in their respective area of specialization over a period of approximately 26 months. *See* Internal Revenue Manual Ch. 4.45.7.1 (Examination Cycle).

with the taxpayer in activities that have significant tax consequences. In 2001, over 400 cases and 3,700 returns were closed after being examined under the CIP.¹⁷⁴ Enron has been a CIP program participant since January 1989.

3. Enron's Federal income tax payments

Enron filed Federal income tax returns for 1996 through 2001 that reported a tax liability (before payments and credits) only for its 2000 and 2001 taxable years. These returns report that Enron paid no Federal income taxes with respect to taxable years 1996 through 1999.¹⁷⁵ Enron's taxable year 2000 Federal income tax return reported a tax liability of \$63.2 million, tax payments and other credits of \$70.1 million, and an overpayment of \$6.9 million. Enron's taxable year 2001 Federal income tax return reported a total tax of \$13,331, but a refund due to Enron of \$20,428.¹⁷⁶

Table 8, below, contains selected information regarding the company's taxable years 1986 through 2001, based on Enron's consolidated Federal income tax returns as filed without regard to audit adjustments.¹⁷⁷

¹⁷⁴ These returns related to a number of different taxable years. See Department of Treasury, Program Performance Report for FY2001, at <http://www.ustreas.gov/gpra/2001rpt.pdf>.

¹⁷⁵ This is consistent with the IRS master file account information pertaining to Enron Corp. as of January 8, 2003.

There have been conflicting accounts regarding whether Enron paid Federal income taxes during its profitable years. For example, a January 17, 2002, analysis of Enron's financial documents by Citizens for Tax Justice concluded that Enron received a net tax rebate of \$381 million for the five-year period 1996 to 2000, even though it had U.S. profits before Federal income taxes of \$1.785 billion for the same period. <http://www.ctj.org/html/enron.htm>. The Congressional Research Service, however, concluded that Enron paid U.S. Federal taxes during 1996 through 2000. Congressional Research Service, Report for Congress: *Enron and Taxes*, No. RS21149 (February 12, 2002).

¹⁷⁶ Although Enron made no Federal income tax payments with respect to its 2001 taxable year, Enron's 2001 return reported a credit for Federal tax on fuels of \$33,759, which exceeded the reported tax due of \$13,331 and created the reported refund of \$20,428.

¹⁷⁷ These figures do not include taxes paid by related entities that were not included in Enron's consolidated group. For example, EOG was not included in Enron's consolidated Federal income tax return for those periods in which Enron owned less than 80 percent of EOG, and the figures do not include any taxes paid by EOG during such period. See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

**Table 8.—Selected Information Relating to Enron's U.S. Federal Taxes for 1986-2001,
Per Original or Amended Returns**
[millions of dollars]

Year	Regular income tax	Alternative minimum tax	Other taxes	Nonrefundable credits	Total tax	Tax payments	Refundable credits	Tax due or overpaid
1986	0	0	1.4	0	1.4	1.3	0	0.1
1987	0	0	0.6	0	0.6	0.6	0	0
1988	0	0	0	0	0	11.0	0	-11.0
1989	0	1.2	0.1	0	1.3	2.0	0	-0.7
1990	0	31.4	0.4	0	31.8	41.4	0	-9.6
1991	56.9	90.4	0.8	-30.1	118.0	124.0	0	-6.0
1992	68.2	0	0.3	-12.4	56.1	60.0	0	-3.9
1993	78.7	0	0.3	-29.2	49.8	56.0	0	-6.2
1994	62.5	0	0.2	-23.7	39.0	44.0	0	-5.0
1995	56.7	0	0.2	-26.5	30.4	21.6	0	8.8
1996	0	0	0	0	0	0	0	0
1997	0	0	0	0	0	0	0.1	-0.1
1998	0	0	0	0	0	0	0	0
1999	0	0	0	0	0	0	0	0
2000	21.3	41.9	0	0	63.2	70.0	0.1	-6.9
2001	0	0	0	0	0 ¹	0	0	0
Totals	344.3	164.9	4.3	-121.9	391.6	431.9	0.2	-40.5

Notes: (1) Enron reported tax for 2001 of \$13,331, tax credits of \$33,759, with a refund due of \$20,428.

Source: Forms 1120, Enron Corp., 1986-2001.

4. Enron's reported present Federal income tax position

Enron reported net operating losses (before net operating loss carryovers) for each of its taxable years 1996 through 1999. Enron did not seek to carry back those net operating losses to receive a refund of income taxes paid in earlier years. Instead, Enron carried forward these net operating losses (\$3.1 billion) into 2000.¹⁷⁸ The net operating losses for 1996 through 1999 prevented Enron from obtaining closure for Federal income tax audit purposes with respect to those years.¹⁷⁹ As a result, Enron adopted a strategy to pay tax for 2000 to close out the audit for 1996 through 1999. Late in 2000, Enron entered into a number of transactions intended to generate taxable income in 2000 that would absorb the entire \$3.1 billion net operating loss carryover to that year.¹⁸⁰ In its 2000 Federal income tax return, Enron reported \$3.1 billion of taxable income (before its net operating loss deduction), which Enron offset with its reported net operating loss carryover from 1999 to 2000 of approximately the same amount. The following year, 2001, Enron recognized losses from closing out the transactions that had generated taxable income in 2000. This resulted in a net operating loss of \$4.6 billion on Enron's 2001 Federal income tax return.¹⁸¹

5. Federal income tax claims in Enron's bankruptcy proceeding

Enron Corp. and each of its affiliates included in the consolidated bankruptcy proceeding that filed a Statement of Financial Affairs with the bankruptcy court (except one company, Enron LNG Shipping Company) listed the IRS as a creditor holding an unsecured claim, with the total

¹⁷⁸ The \$3.1 billion net operating loss carryover (as reported in Enron's 1999 return) consisted of \$337.5 million from 1996, \$503.5 million from 1997, \$752.8 million from 1998, and \$1.4 million from 1999. The 1996 loss amount of \$337.5 million differs slightly from the \$310.2 million reported on Enron's 1996 return. Enron reported its consolidated alternative minimum tax net operating loss carryover from 1999 to 2000 as \$2.9 billion.

¹⁷⁹ A net operating loss carryover from a year closed under the generally applicable limitations provisions of Section 6501 may be examined for purposes of adjusting the net operating loss deduction allowable in a subsequent open year. Rev. Rul. 56-285, 1956-1 C.B. 134; Rev. Rul. 65-96, 1965-1 C.B. 126. This rule has the effect of keeping open Enron's taxable years for which it had reported unexpired net operating losses (1996 through 1999), for these limited purposes, beyond the generally applicable limitations periods.

¹⁸⁰ These transactions were part of the Project NOLy transaction that is described in Part Three of this Report, which by itself generated \$5.5 billion of the taxable income that Enron reported in its 2000 tax return. A member of Enron's tax department described the transactions "as generating income [to] close tax years". In that person's words, "we needed a statute and so in the year 2000 we managed our taxable income to pay \$60 million in tax so that we'd have a statute and use up the \$3 billion NOL we had." Joint Committee staff interview.

¹⁸¹ The intent of Project NOLy was to generate sufficient income in taxable year 2000 to use the company's \$3.1 billion net operating loss carryover, and reverse the income recognized by Enron the following year (in 2001).

amount of the claim being unknown. Enron Corp. listed as an asset a Federal income tax refund of \$63.2 million in its Statement of Financial Affairs, Schedule B, filed with the bankruptcy court on June 17, 2002. On August 1, 2002, the bankruptcy court ordered that the IRS has until March 31, 2003, to file proofs of claim or interests against any of the Enron entities that are part of the consolidated bankruptcy proceeding. Under that order, the IRS may seek an extension of the deadline for filing its proof of claim beyond March 31, 2003.