Arthur Andersen
Professional Standards Group

To: Carl E. Bass@ANDERSEN WO
cc: James F. Green@ANDERSEN WO
Date: 02/04/2000 07:45 AM
From: John E. Stewart, Chicago 33 W. Monroe, 50 / 72335
Subject: Re: Enron Derivative Transaction

I think what you are saying is that the SPE needs to be consolidated. Thus, Enron stock is treasury stock(thus not gain or loss on that) and we have a small derivative on the internet stock that protects only for $3. We should discuss it some more. You have some good points. I suggest you send this memo to Deb, Tom and Dave to reintiate the discussion.

To: John E. Stewart@ANDERSEN WO, James F. Green@ANDERSEN WO
cc:
Date: 02/04/2000 06:38 AM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron Derivative Transaction

I am still bothered with the is transaction we discussed yesterday. My understanding of the new structure is that Enron will purchase a derivative from SPE and the purchase price will be Enron stock. Assume that the value of that is $20 and the stock price of Enron stock is $2/share so Enron issues 10 shares. Presumably since they are paying an amount it is a premium for an option. In exchange, Enron will receive payments based on changes in the share price of two securities -- (1) an investment made by Enron in an internet stock ("Internet Co.") and (2) the Enron shares given to the SPE. Assume that initial investment in Internet Co. is $100. The payment is based on a formula, that is, if the SPE earns a 25% return on its initial investment, Enron receives all of the amount in excess of the return of and on the initial investment. If the return is less than 25%, the SPE keeps both its initial investment and any return up to 25%. In addition, because the SPE is also providing "protection" to Enron for Enron's investment in Internet Co., the SPE may have to give up its entire initial equity to pay Enron in the event the value of the investment in Internet Co. declines. Assume that the equity holders in the SPE put in 3% of the notional value of the Internet Co., or $3. The SPE is initially capitalized with only $3 (no debt, all equity) and it receives from Enron Enron shares valued at $20.

The initial entry made by Enron for this derivative has to be as follows:

Option	20	
Capital		20

I am bothered by two things. One, if we mark to market the receive leg of this entry, then are we not marking to market through earnings the change in value of that initial equity transaction. If the above was a share settled derivative we would have made the exact same entry and not marked to market the transaction subsequent to the initial transaction. If we mark to market, then we are receiving the appreciation on the shares we gave up.

Second, I believe this SPE is nonsubstantive. This entity is capitalized with all equity and that equity is only 3% of the ~~notional~~ amount of the risk it is providing protection for? Not to worry, because it now has these Enron shares that will increase in value. If the Internet Co. stock fails and Enron share value

increases, SPE pays Enron for the Internet Co. risk from appreciation on Enron shares. I
stock rises and Enron share value increases, SPE pays Enron based on appreciation in '
Internet Co. stock falls and Enron share value falls, SPE pays Enron $3. I do not see wl
(particularly this SPE) has any substance.

QUESTION NO. 3

What is meant in the consensus by the term EXPECTED SUBSTANTIVE RESIDUAL RISKS? Does it mean the 90 percent threshold specified in paragraph 7(d) of Statement 13?

What amount qualifies as a substantive residual equity capital investment (condition (3) of the consensus)?

RESPONSE

In these transactions, the significant elements of management and control over the leased asset generally are specified by contract when the lease is negotiated and the SPE is established. Certain of these elements of management and control raise concerns on the part of the SEC staff with respect to who possesses the risks and rewards of ownership of the leased asset. These include elements such a nonsubstantive lessor without equity at risk, a lessee who has the ability to realize all appreciation and bears substantial risk of depreciation, and a lessee who act as the construction agent and selling agent and who is at more than nominal risk. In determining if a registrant has substantive residual risks and rewards of the leased asset (condition (2) of the consensus), the SEC staff would review a transaction to determine if the lessee has these or similar elements of management and control. If the lessee would reasonably be expected to bear the substantive residual risks and receive rewards due to such elements, the SEC staff would consider condition (2) to be met. This would be a judgmental decision based on the specific facts and circumstances of each transaction, and does not involve the 90 percent determination as set forth in Statement 13.

The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards. The SEC staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3 percent is needed.

As the consensus states, the investment should be at risk with respect to the leased asset for the entire term of the lease. The investment would not be considered to be at risk, for example, if the investor were provided a letter of credit or other form of guarantee on the initial investment or return thereon. An investor note payable issued to the SPE would not qualify as an initial substantive residual equity investment at risk.

I have to ask myself why not do straight deal with Goldman? They said so themselves, it would be too expensive. If they want appreciation in their own shares, why not do an equity derivative (cash settled)? Don't want the volatility. Why is the SPE not capitalized with 97% debt? Because no bank is dumb enough to loan money whose repayment is dependent on changes in value of an internet stock. By the way, if they did so and Enron guaranteed the debt I would have the same issues.

So I think the accounting for this is as follows:

1. The SPE is non substantive. They receive no protection on the option, other than $3.
2. Any payments made on the appreciation of stock is in essence an equity transaction. They should realize no income on this. It looks like they have parked the shares there because they get it back one way or another.

John E. Stewart