Arthur Andersen
Energy

To: Carl E. Bass@ANDERSEN WO
cc: John E. Stewart@ANDERSEN WO, Benjamin S. Neuhausen@ANDERSEN WO, Patricia S. Grutzmacher@ANDERSEN WO
Date: 02/01/2000 06:19 PM
From: Debra A. Cash, Houston, 237 / 2344
Subject: Re: Enron transaction

With respect to whether the derivatives are at fair value, we will be getting a fairness opinion on the whole transaction. We would also require third party evidence of whether each derivative(the puts on the communication stock) would be at fair value at the time they are entered into.

With respect to the initial capitalization, Enron believes that the value of the puts day one (the put premium) represents the risk of the instrument for the period that it is outstanding. However, there is no similar model if the derivative is a swap. They recommend 3% of value at risk or some other probabilistic model.

Enron has currently agreed that they cannot account for the upside on ENE stock (in Carl's note 5) as P/L. They agreed that it is an equity transaction.

Our biggest issues are:

1. What does the initial capitalization of the spe have to be for Newco to be a substantive entity? (notional value or risk adjusted method)

2. What is the limitation on the MTM of the derivative (put)? Our proposal is that ENE cannot recognize income in excess of the initial capitalization of the spe plus the put premium. Under this method we would avoid recognizing income , although indirectly, on the appreciation of ENE stock.

To: Debra A. Cash@ANDERSEN WO
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Date: 02/01/2000 04:10 PM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron transaction

---------- Forwarded by Carl E. Bass on 02/01/2000 04:18 PM ----------

To: John E. Stewart@ANDERSEN WO, Benjamin S. Neuhausen@ANDERSEN WO
cc:
Date: 02/01/2000 02:31 PM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron transaction

I would like to get your thoughts on this complicated series of Enron derivatives. Ben – Deb Cash said she has already spoken to you about another variation of this transaction. I suspect I will not be the final answer here either. Enron wants to make some investments in some entities that will have high volatility. They also want to do this through an investment company.

1. LJM (SPE) forms a NEWCO and capitalizes NEWCO with 100% equity.
2. Enron's investment company (ENE Sub) purchases an investment in a third party (Third Party) and pays $100,
3. ENE Sub purchases a put option from NEWCO (assume fair value is $40). The terms of the put option are that if the value of the investment in Third Party declines below $100, NEWCO wil pay ENE Sub the shortfall. If the value rises above $100, ENE will keep the upside. The $40 premium will pay for NEWCO taking on that risk. The terms are that ENE Sub will not pay the $40 immediately, nor will NEWCO cash settle the option till the end of the option period (say 5 years).
4. Enron at the same time enters into a share settled derivative on Enron stock with NEWCO. If Enron stock price increases, Enron pays NEWCO Enron shares. If Enron stock price decreases, Enron receives Enron shares.
5. Because Enron believes that Enron stock price is going to increases in value more than Third Party value, Enron caps NEWCO's return on this arrangement as follows. If NEWCO's return achieves 25% on both the Enron stock and the put option, Enron receives from NEWCO any income that was generated off of the combined investments.
6. NEWCO is a bankrupt proof entity.

Accounting Considerations

1. I believe the initial capitalization of NEWCO should be $1.8 (3% of their total exposure defined as $100 less the $40 premium). In another structure they did last year they computed the 3% as 3% of the premium (in this case $1.2). I do not think that this really covers the total risk exposure. If they did an at the money swap I told them that it should be 3% of the total exposure, that is $100 because that is what they are exposed to. The engagement team tells me that the client has pushed back on this. I gave them the operating lease analogy. *What does a swap do to the argument that you are an investment company wanting captal appreciation and you swap all of the upside away?*
2. Once you get past that, I believe Enron would mark to market the investment in Third Party using their investment company accounting model (you could treat this as a trading security under Statment 115 and get the same answer, assuming the investment was publicly traded and Enron did not have significant influence).
3. Enron would account for the put option at fair value (both time value and intrinsic value). See below however of my concern over the substance here.
4. Absent item 5 above, the share settled derivative in Enron stock should be an equity transaction pursuant to EITF 96-13. So the fair value ofthe derivative would be recorded at the date of issuance and there would no MTM changes in subsequent periods. But you have to ask yourself why is this here. Assuming the put option is truly at fair value, NEWCO should be receiving value in the form of a premium for this transaction. The equity derivative is unneccessary. If the Third Party investment is public, it should be fairly easy to calculate the premium value to make sure that it is at "fair value." If Third Party is not public, then I think you need to get a third party quote to provide for evidence of the internal valuation. Otherwise, this equity-settled derivative does not feel right. Does Enron mark to market Item 5 above? I think you have to be careful here because you can end up recording to income return on your own stock because of the nature of how this works.

5. Example of how this could work using the assumtions above. Assume that the $40 premium's time value amortization is $20 in year 1, $10 in year 2, $$5 in years 3 and 4, respectively. Assume that the value of the Third Party stock is $90 year 1, $80 year 2, $100 year 3, $130 Year 4, and $140 year 5. Added assumtion is that Enron stock increases $6 each year.

Calculation of Enron's accounting before the contingent obligation:

Year	1	2	3	4	5
Cum Premium (40)	(20)	(10)	(5)	(5)	0
Intrinsic value change	10	10	n/a	n/a	n/a
MTM Third Party Investment	(10)	(10)	20	20	20
Enron income effect	(20)	(10)	15	15	20

Calculation of income for NEWCO

Interest on premium (assume 5%) 8	2	2	2	2	2
MTM premium 40	20	10	5	5	0
Derivative on third party equity (20)	(10)	(10)	0	0	0
Enron equity derivative 30	6	6	6	6	6
Total 58	18	8	13	13	8

Under the terms of the contingent obligation, NEWCO needs $2.25 to achieve a 25% return. Enron would receive the excess, or $55.75. Enron believe they should recognize income of $55.75 on a MTM basis over the life of which $30 is their own stock, $40 is round trip of the option premium and $8 is round trip of interest expense. You can play around with these numbers a number of different scanarios, but at the end of the day, this contingent obligation will be due Enon stock. So I would conclude that there should be no MTM on the contingent obligation and no income on its settlement for the reasons cited above.

Going back to the Enron income effect, this whole deal looks like there is no substance. The only money at risk here is $1.8 million in a bankrupt proof SPE. Al of the money here appears to be provided by Enron. So in my year 1 example where Enron receives $10 in intrinsic value from the SPE with regard to the put option, I do not think they should record an amount greater than the SPE equity of $1.8.

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John E. Stewart