

ARTHUR ANDERSEN

To: The Files

From: Dave Duncan
Deb Cash
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Date: December 31, 1999

Subject: LJMII Partnership Structure

Background

We were informed by a senior officer of Enron (CFO) that he saw a unique opportunity to match various capital providers wanting to diversify into sectors in which he had experience with needs Enron and other companies like Enron had for high degrees of third party equity capital. In effect, he wanted to form his own private equity fund similar to others he had observed in the market place which made sizable private investments and whose participants included sophisticated investors. He had explored this notion with other members of Enron's upper management who indicated a willingness for him to develop this idea. He further indicated that both he and they hoped that he could accomplish this and remain with the Company. While he and the Company planned to consider and address the obvious Corporate Governance and Fiduciary responsibility issues, we were asked by he and other members of Enron management to review the entity as it was developed to determine whether necessary features existed which would enable Enron to do transactions with the entity that would result in third party accounting recognition. Our deliberations with respect to such entity are described below.

Structure

On December 20, 1999, a private investment company, LJMII Co-Investment L.P. ("LJMII") was created for the purpose of acquiring or investing in primarily energy-related or communications-related businesses or activities.

LJMII was capitalized at formation with \$55 million of equity and \$63 million of debt capital. As indicated in the attached diagram (Diagram 1), the equity holders are comprised of a senior officer of Enron (2% ownership and General Partner) and various third party investors (98% ownership). The composition of the 98% third party investor ownership, which were 51 entities in total, are as follows: Financial Institutions (37%), Pension Funds (22%), Independents (19%), Insurance Co. (10%), Other funds (8%) and Foundations (4%). A portion of the debt was provided by an entity that is wholly owned by a joint venture in which Enron is a co-owner, and the remaining debt was provided by a third party bank.

Since LJMII planned to transact at least initially with Enron, we determined that we should view LJMII as an Enron sponsored SPE. We informed Enron that, at some point, we might reconsider our view of LJMII as an SPE and that such reconsideration would be based on the number of third party transactions and the size of those transactions to the operations of the entity as a whole. Since we considered LJMII to be an SPE, we informed Enron and LJMII that we would subject LJMII to the capital and control tests set forth in EITF 90-15 and Topic D-14 before any transactions between the two entities could be given accounting recognition for Enron. Additionally, because of the significant senior officer involvement we needed to determine that 1) the senior officer did not control the partnership and 2) certain criteria existed to provide assurance that all transactions executed between Enron and LJMII involved the input of the outside investors to preclude the appearance of self dealing.

Issues

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1. Is the minimum SPE capitalization requirement met to support nonconsolidation?
2. Does the control structure support nonconsolidation of the entity for Enron Corp. as a result of the related party relationship?
3. What are the necessary disclosures?

Issue 1

EITF 90-15 requires SPE structures to be capitalized with at least 3% third party residual equity. As a result of the senior officer equity ownership (which we determined should not be given any credit when determining whether sufficient capital existed when evaluating potential transactions with Enron), we determined that the required amount of equity would need to be 3.02% as opposed to the normal 3% (to effectively discount for the proportionate share of the officer's ownership). The balance sheet of LJMII consists of \$55 million of funded equity capital and \$63 million of debt. Total funded third party equity of LJMII is \$54 million, as indicated on the attached diagram. As this represented approximately 45% of the total capitalization, we determined that the SPE capital threshold was met with respect to any transaction LJMII may undertake directly with Enron.

Issue 2

Topic D-14 states that the SEC staff believes that for nonconsolidation by the sponsor to be appropriate, the majority owner of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE and has substantive risks and rewards of ownership of the assets of the SPE. The \$54 million of LJMII equity that was contributed by third party investors represents a substantive capital investment. As indicated, a senior officer of Enron serves as the GP of LJMII and is therefore in control of day-to-day operations of the partnership. To overcome the presumption of control by the GP (and by association, Enron) for purposes of consolidation, we noted that the Partnership Agreement included the provision that the GP can be removed without cause with the recommendation of two-thirds of the AC and a vote of Limited Partners (LP) that represents 75% of the total LP interests. With respect to the inclusion of criteria to ensure LP involvement in transactions with Enron, we noted that an Advisory Committee ("AC") existed with specific duties outlined in the partnership agreement. These duties included, among other things, reviewing and approving all transactions between LJMII and Enron or any of its subsidiaries above certain thresholds. We determined that transactions below the thresholds would probably not be material to Enron, but we informed management we would have to review such situations on a case-by-case basis. We noted that the AC consists of representatives of the limited partners, all of whom we noted were independent from Enron (2 pension fund representatives, 4 financial institution members, 1 independent and 1 insurance company). Although we noted that the AC members are appointed by the GP, we noted that all other LP had the right to remove any AC member without cause with the consent of 75% of the LP's. We concluded that these provisions were sufficient to overcome the presumption that the GP (and by association Enron) controls and that nonconsolidation of LJMII is therefore appropriate. We informed the client that, while the removal of the GP without cause feature generally was sufficient to overcome a presumption of control by the GP, an important consideration was the reasonableness of the ability of the LP's to do so. We noted that the existing feature (two-thirds of AC and 75% of the LP's) was at the very upper limit of what may be acceptable. We encouraged them to request LJMII to lower these thresholds before any material transactions were consummated.

Issue 3

Since the GP of LJMII is a related party, as transactions are entered into with Enron or its affiliates,

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certain disclosures will be required. We informed the client that the existence of LJMII will need to be disclosed, including the related party that serves as the GP of the partnership, as well as the purpose of the entity. The nature of transactions executed with Enron and Enron affiliates must also be disclosed as well as any associated gains or losses. We will review the filings and other issuances of financial statements to ensure all appropriate disclosure requirements are met.

Conclusion

We concurred with Enron that the necessary capitalization and control features had been met for nonconsolidation of LJMII and that recognition could be given to transactions with LJMII as a third party.

We informed management that this conclusion would need to be reviewed as transactions occurred and that we would need to address the audit evidence we would require (particularly with respect to the valuation of transactions between the two entities) on a case-by-case basis as they occurred.

We discussed these issues with Carl Bass and John Stewart of the Professional Standards Group, who concurred with our conclusions. We also reviewed the formation of this entity and our conclusions with Mike Odom, Practice Director, Bill Swanson, ABA Head, and Mike Lowther, concurring partner.

Additional Note

In addition to the technical accounting issues, we also considered Enron corporate governance issues related to these transactions. We discussed with Enron management (other than the senior officer involved) their planned activities to ensure such issues had been considered. We determined that Enron was receiving advice from internal and external counsel regarding the acceptability of the transactions and planned to disclose the formation of the entity and any contemplated transactions between the entity and Enron with the Finance Committee of the Board of Directors of Enron prior to their completion. In connection with our procedures, we confirmed that all of the above occurred. We also ensured that the Audit Committee was made aware of the entity and related transactions.