CARL

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BOSTON

Arthur Andersen
PROFESSIONAL STANDARDS GROUP

To: John E. Stewart@ANDERSEN WO
cc:
Date: 03/04/2001 06:46 PM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron

I know you did not ask for this but I believe you should be at least have a version of what I know about this Enron "thing" from me. You may share this with anyone you deem appropriate -- we are after all partners in this Firm and should be able to have an open dialogue about issues, especially those that affect partners. In addition, it appears that I have been the subject of some conversation and no one has discussed this with me directly. So treat this as my own New York Times OpEd piece, expect we are not discussing Presidential pardons.

The Enron "thing" with me

With regard to this "thing," I believe that several points need to be made. There appears to be some sort of assertion that I have a "problem" with Rick Causey or someone at Enron that results in me having some caustic and inappropriate slant in dealing with their questions. You may recall that when I joined the PSG on December 1, 1999, Dave Duncan had requested 500-750 hours of my time on Enron specific consultation. At the time, I/we was/were told that this was cleared with the client. If in fact I had some sort of "problem," one would have though that would have surfaced at that time. The client would have vetoed such an arrangement. In fact, I was told this was sold to them. Logic would also seem to dictate that if there was some sort of "problem," I would have been removed as one of the engagement partners, much less been placed on it to begin with. Believe me, if I had some "problem," I would have never requested to have been put on the engagement given the complexity and challenges that that engagement entails. So any notion that there is some sort of long, deep seeded animosity needs to be dispelled as it simply is not true -- nor do the facts warrant it. I should also note that I have gone to great lengths to get Causey in front of standard setters. For example, I was able to get Causey to be a guest at the EITF meeting when tolling agreements were discussed because they had a vested interest in the accounting for those transactions. If I had some sort of ax to grind, I would not have even orchestrated that.

With regard to the yearend issues that apparently triggered this "thing with me," lets go through them one by one. Again, there was dialogue on process here that I was not party to but apparently I have some sort of "problem" here.

1. Blockbuster transaction -- Roger Willard and Clint Carlin approached me for about 15 minutes one afternoon to discuss two things. One, whether an interest in joint venture could be securitized and two, what are the requirements to be a joint venture. With respect to the first question, I said yes as long as it is accounted for on the equity method. We then discussed the requirements of a joint venture, including the fact that it had to be a business. The original Blockbuster transaction was simply where Enron was going to contribute this contract and the other party was going to contribute systems and expertise to deliver this product to households. I received one other question from Clint Carlin, dealing with some puts and calls. About two months later Roger Willard asked whether the equity needed to be 3% of fair value or book value. At that time I was told that they were going to have some $50 million gain on the sale of this venture interest immediately after the contract was signed and the venture was entered into. Furthermore, the other venture partner was not contributing anything. At that time, both you and I had expressed some concern about this deal. It should be noted that despite all of the turmoil over this, we (PSG) did not object to this transaction as it appeared to meet the technical requirements of Statement 125. We relied on the engagement team to address both the definition of a business and the valuation issues of immediate gain. The client's proposed accounting nonetheless was sustained. At that time, I

was aware of another securitization in which the client had provided a side agreement to guarantee the 3% residual equity at risk with the same counterparty in this transaction. Although it is not my job (which I acknowledged to the engagement team), I did suggest confirmation as an audit procedure. I believe knowledge of this did prompt us over a weekend to have the engagement team involve various levels of practice directors in this decision. In effect, this was a very risky transaction and we did not believe that the PSG should solely be in on this without others.

With respect to the infamous 4:1 test, they did not follow our advice on this. I did acknowledge several times with the engagement team that although our test is grounded in GAAP, we did make it up and it is no where to be found in the accounting literature.

2. Networks transaction -- Tom Bauer involved me on this transaction. It was similar to the one above but did involve the sale of an existing Enron business through a securitization transaction. This was probably the nth step of a series of permutations of this transaction that I had been involved in since November. The only late issue on this came after the deal had been signed. This was one of those deals where Enron contributed a business worth $100. A bank contributed cash totaling $100. The bank did this through an SPE whereby the residual equity holder contributed $3 and the debt holder contributed $97. I was asked after the deal had been signed whether that was OK. We had discussed this issue a lot within the PSG and had in fact had a client issue with the SEC along these lines. In addition, we had discussed this issue with the Enron engagement team last summer in which they documented the conclusion that the equity person would have had to contribute $6. I understand now that the gain on that transaction was $100 million. In addition, other Enron transactions had been capitalized as we have suggested.

The engagement team went back and had the equity holder contribute additional equity. The equity holder in this case was the LJM entity, a related party because the CFO is the managing equity member.

3. "Raptor" derivative transactions -- Enron has entered into a series of complicated derivatives with a related party (the CFO) in which this related party CFO writes options to Enron to protect Enron's investments in various internet businesses. The capital for the SPE is derived from Enron cash settled derivatives that are European in that they cash settle at the end of the derivative life. I will honestly admit that I have a jaded view of these transactions and "dragged my feet" initially. This was in part due to an impairment test that Deb Cash had devised to keep these transactions honest. The yearend issues dealt with the impairment test. The engagement team had asked whether these various SPEs could be cross collateralized so that losses in one entity could offset losses in another. I told them that as long as they were truly cross collateralized that seemed OK. The problem I was told was that the CFO had no reason to inject a loss on one vehicle. The client's proposal was that the vehicles be cross collateralized but if the there was a loss in one vehicle, the CFO had the option to remove the cross collateralization any time he chose to. Based on how the impairment test was devised, I did not see any way that this worked. In effect, it was heads I win, tails you lose. The engagement team appeared to be split on this -- two partners had a problem with the client's proposed accounting and one did not. In the end, however, the engagement team agreed with me as did the Practice Director. It was decided by them to "fix" this feature before the release of the financial statements. One thing to note was I was told that the client never agreed to the impairment test to begin with. So the real issue that I thought had been addressed and resolved had never been resolved with the client.

One problem I had with Raptor was that the original structure was one in which the PSG was not consulted on. In that transaction, the SPE had at risk only a nominal amount of equity (less than the 3% residual at risk of the notional value of an internet investment). Furthermore the SPE was in a bankrupt entity so any loss on the derivative could not be funded by the SPE. I understood that there was a $100 million loss on an internet investment that otherwise should have been reported absent the derivative. At no time was PSG consulted on the original structure -- we did attempt to make sure the subsequent structures were adequately capitalized.

Those are the yearend issues. In total they represent about $150 million plus of income or avoided losses at yearend -- and all involved the Practice Director. At no time did I ever have communication with the client on these issues. All of my communications were solely with the engagement team. You can understand then as to how I am perplexed as to how the client even knows I was consulted on with respect to these issues and how they believe I am too caustic and cynical with respect to their transactions (see below).

The only other issue that came up post yearend but affected 2000 was the Azurix impairment. I was consulted on an impairment issue at the Azurix level. I told the engagement team that their facts were a little shaky but if they could prove them then they had a position. It was not, however, without risk. At the time, Azurix was going through a "going private" transaction. The client wanted to record an impairment in the fourth quarter. I was also consulted on the impairment issue at the Enron level of its investment in Azurix. You had told them about 6-9 moths ago that 6-9 months was a good indicator of whether an impairment was permanent with respect to that investment. I had repeated that advice post yearend but by then the investment was under water for about 18 months. I told the engagement partner that it was judgment -- not really PSG's call. I was told by him that "he had never communicated the original advice to the client and therefore he could not go in and do so now." I was led to believe that he went to his Practice Director. Again, not really our call.

<u>Process</u>
Apparently, part of the process issue stems from the client knowing all that goes on within our walls on our discussions with respect to their issues. I believe that when we are either having discussions or have reached a decision, the FIRM has done so. The PSG only gives advice. The engagement partners and practice directors then reach a decision based on that advice as well as other considerations, but it is the FIRM that does so. We should not be communicating with the client that so and so said this and I could not get this past so and so in the PSG. I learned that lesson the hard way when I was senior working for Gary Goolsby about 17 years ago. I have first hand experience on this because at a recent EITF meeting some lower level Enron employee who was with some else from Enron introduced herself to me by saying she had heard my name alot -- "so you are the one that will not let us do something." I have been on calls where the EA has interrupted the call saying that so and so was waiting for an answer from me on this that or the other. In fact, the client called during a meeting on the Raptor derivative transactions between me, the Practice Director, and the engagement team. One of the partners told the EA that interrupted us that "they were still meeting with Carl."

I have also noted a trend on this engagement that the question is usually couched along the lines "will the PSG support this?" When a call starts out that way, it is my experience that the partner is struggling with the question and what the client wants to do. But lately managers have been posing their questions that way.

Let me propose an alternative. The engagement team should prepare a memo documenting all aspects of the transaction as well as the research that supports a conclusion or the conflicting research that leads to the grayness. All too often (in fact, without exception), it has lately been a call from a manager with a flowchart and we then have to slug through it to find the real issues. For example, within the past week the client proposed placing a contract into a "joint venture." An interest in the joint venture would then be sold for a $20-40 million gain. The parties to the joint venture were the same parties to the contract. There were no customers (the customer was the other "venturer"), no process, no business. In fact the press release was clear that a contract was entered into. There is no mention of a joint venture. In effect, nothing was accomplished in this transaction except a sale of future revenues. The engagement partner agreed with my view and in fact had the same view. She was seeking concurrence. I was told they booked the transaction any way and that we will propose a PAJE.

Once we conclude on something, or render some advice, the engagement team should deliver that advice or conclusion as if it was their own. It is after all the engagement team's responsibility to sign the opinion -- not ours.