Opening Statement of Rick Caplan

Before the Senate Permanent Subcommittee on Investigations

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Thank you Mr. Chairman and Members of the Committee.

My name is Rick Caplan. I am a Managing Director of Citigroup's Corporate and Investment Bank and co-head of the North American Credit Derivatives Group, one of several business groups at Citi that structures transactions for sophisticated corporate clients. I began working in the derivatives business at Citibank in 1997, and I first became involved in structuring certain transactions for Enron in 1999.

A prepaid swap transaction – the transaction you have invited us to talk about today – is a form of structured finance. Structured financings have been used over the past several decades by virtually all sophisticated companies as a way of raising money. Just as companies always consider the tax, legal, and accounting consequences of every transaction they enter into and attempt to structure those transactions so as to achieve the most favorable results, the same is true when companies seek to finance themselves. Often times, the most efficient and effective form of financing for a company is not a straight loan, but a structured finance transaction that, in addition to generating liquidity, can address these other business considerations.

Most large public companies use many different forms of structured financing. In each instance, they choose the form of financing that best addresses their unique business and capital needs. While many structured financings have the same economic impact as a loan, they often are treated differently for accounting purposes. Such transactions are commonplace in corporate America and play an integral role in our capital markets.

There are many examples of loan-like transactions that have different accounting treatments. These include, among many others, financing tools that support much of this nation's trading in fixed income securities (such as repurchase agreements – "repos" – and reverse repos), widely-used insurance products (such as guaranteed investment contracts and finite insurance), equipment trust certificates widely used in the airline industry, and common project finance strategies (such as synthetic leases). Like many clients, Enron retained Citibank to arrange various types of financings – ranging from simple revolving credit facilities to more sophisticated structured financings, such as asset securitizations, synthetic leases, and prepaid transactions.

As this Committee is aware, Enron was the 7th ranked company in the Fortune 500 and was a company of great prestige and high standing, which made extensive use of structured finance. Indeed, from 1995 through 2001, Fortune Magazine selected Enron as the "Most Innovative Company in America."

And in 1999, Enron's CFO, Andrew Fastow, was awarded CFO Magazine's "Excellence Award for Capital Structure Management," based on the "unique financing techniques" he pioneered.

For all of Enron's innovation and sophistication, the prepaid swap transactions we are discussing today were hardly a unique financing technique. Prepaid swap transactions – and similar commodity-based financings – had been widely used in the power and energy industry since the 1970s. Prepaids have been an efficient way for energy traders to extract some of the embedded cash value of their long-term trading contracts, particularly since those contracts cannot be readily sold or assigned.

In essence, a prepaid swap contract involves an up-front cash payment by one party in return for an obligation by another party to deliver a commodity (or the cash value of that commodity) at some point in the future. In the prepaids engaged in by Citibank with Enron, Enron received cash up-front, in exchange for Enron's obligation to deliver, at some point in the future, a specific quantity of gas or oil or its financial equivalent.

The prepaids provided Enron with an ability to raise cash against certain long-term assets which, as we understood it, helped Enron address a "disconnect" between the revenue and cash flow in its trading book.

Enron, like all other trading companies, applied "mark-to-market" accounting to its trading activities. Under mark-to-market accounting, Enron was required immediately to record as revenue the present value of all its long-term commodity contracts, even though it would not receive the actual cash flow related to such revenue until a later time. Enron's financial statements therefore showed substantial revenue, without corresponding cash flow.

Enron told Citibank that, because of the way auditors – including its auditors, Arthur Andersen – accounted for prepaids, Enron could use prepaids to bring its cash flow in line with its revenues. As Enron explained, because prepaids were comprised of commodity trades executed in Enron's trading book, Enron's financial obligations on these trades would be recorded in its trading book as a trading liability – called "price risk management liability" – and the cash generated by these trades would be recorded in its trading book as "cash flow from operations."

Enron assured Citibank that its accounting treatment of prepaids had been fully vetted by Arthur Andersen, which, at the time, was one of this nation's leading accounting firms. The accounting position we understood Enron was taking, on the advice of Arthur Andersen, seemed reasonable based on our understanding of the then-existing accounting rules and guidelines. I should add that Citibank did not advise Enron – nor would it advise any client – as to the appropriate accounting treatment of any transaction. Indeed, it is the firm's policy to inform clients that Citibank is not giving accounting advice and to direct clients to consult with their independent auditors on the appropriate accounting treatment for any transaction.

Some have suggested that prepaids are "off balance sheet" or that the liabilities that Enron incurred as a result of these financings somehow were "disguised" or "hidden." That simply is not true. Enron's obligations on these financings were clearly reflected as liabilities on Enron's balance sheet and denominated as "price risk management liability." A "price risk management liability" is a liability, plain and simple, that must be satisfied every bit as much as "debt." Thus, while not recorded as debt, prepaid liabilities were clearly obligations of the company and visible as such to investors.

There also has been a suggestion that Enron somehow was able to generate extra cash flow by using prepaids instead of loans. That also is not accurate. The overall cash flow for Enron would be exactly the same whether Enron used prepaids or entered into a bank loan. In the case of prepaids, which are contracts transacted in Enron's trading book, Enron booked the cash it received on these contracts as "cash from operations" – not as "cash from financing." We understood that Arthur Andersen had fully vetted, and blessed, this accounting treatment as well.

Another point I would like to address is the confusion that has arisen between prepaids and credit-linked notes. There is no necessary linkage between the two. Prepaids exist without credit-linked notes; credit-linked notes exist without prepaids.

A credit-linked note is simply a security through which an investor takes on the credit risk of a particular company without actually purchasing a bond issued by that company. Credit-linked notes are well-recognized financial instruments, widely issued and traded each year.

Citi structured Enron credit-linked notes – called Yosemite and the ECLNs. These instruments were sold to the largest, and most sophisticated, institutional investors in several Rule 144A offerings. Citi promised investors that the credit-linked notes would perform similarly to straight Enron bonds – and they have. In the case of the Yosemite transactions, the proceeds of these credit-linked notes offerings happened to be used – on day-one – to fund prepaid transactions, but could have been used to fund alternative obligations over time. There is no inherent connection between credit-linked notes and prepaids.

As with every offering that Salomon Smith Barney brings to market, the Enron credit-linked notes (and the underlying prepaid financings) were fully vetted and reviewed. The firm's stringent internal control processes are designed to safeguard Citi's reputation for integrity through careful screening of potential transactions. The credit-linked notes and the underlying prepaid financings were approved only after undergoing this screening process.

I believe that our conduct in arranging the prepaids (and in selling Enron credit-linked notes) was entirely appropriate. We arranged these financings for what appeared at the time to be one of America's best and most admired companies. We used a financing structure that had been commonly employed in the energy and power industry for many years. And we relied on the fact that Enron's accounting treatment of these transactions was blessed by one of the nation's leading accounting firms and seemed reasonable under the then-existing accounting rules and guidelines.

Thank you Mr. Chairman and members of the Committee, and I look forward to answering whatever questions you may have.