A P P E N D I X   B

KNOWLEDGE AND PARTICIPATION OF FINANCIAL INSTITUTIONS IN ENRON PREPAYS

The evidence reviewed by the Subcommittee staff indicates that the financial institutions that participated in Enron "prepays" understood that Enron was seeking to obtain financing from them, but wanted to obtain the financing through orchestrated, multi-party commodity (largely energy) trades rather than straight-out loans, so that the company could characterize the funds as cash flow from operations rather than cash flow from financing. Internal communications show that the financial institutions not only understood that Enron intended to engage in this deceptive accounting, they actively aided Enron in return for fees and favorable consideration in other business dealings. The evidence also indicates that these financial institutions complied with Enron's desire not to disclose its transactions to outside parties, and knowingly allowed investors, financial analysts and others to rely on Enron financial statements that the financial institutions knew or should have known were misleading.

The evidence indicates that Enron would not have been able to engage in the extent of the prepay accounting deceptions it did, involving more than $8 billion, were it not for the active participation of major financial institutions willing to go along with and even expand upon Enron's activities.

Financial Institutions Involved in Enron Prepays

Enron used "prepay" transactions to obtain more than $8 billion in financing over approximately 6 years.[1] This $8 billion figure is a conservative estimate based upon the evidence gathered by the Subcommittee to date; it is possible that the total dollar amount involved in this financing, since Enron began using it in 1992, is much larger.

Most of Enron's "prepays," both in number and dollar value, involved either JPMorgan Chase Bank ("Chase") or Citigroup.[2] Altogether, Chase and Enron engaged in at least 12 transactions from 1992 until 2001, with a combined value of more than $3.7 billion. Citigroup and Enron engaged in at least 14 transactions from 1993 until 2001, with a combined value of more than $4.8 billion. Enron also completed "prepays" with a number of other financial institutions over the last ten years including Barclays, Credit Suisse First Boston, FleetBoston, Royal Bank of Canada, Royal Bank of Scotland, and Toronto Dominion. Although the investigation was unable to determine the total value of these transactions, the evidence indicates they had a combined value in excess of $1 billion.

Financial Institution Knowledge of Accounting Deception

Internal communications and documentation at the financial institutions, Enron and Enron's accounting firm, Arthur Andersen, indicate that it was common knowledge that Enron's "prepays" were designed to manipulate Enron's financial statement by overstating cash flow from operations and understating debt.

Among the internal communications documenting the knowledge of the financial institutions are the following.

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[1]"ASF – Detail on Prepays," Enron presentation, August 2001. Bates EC 000058019.

[2]"Summary of Enron Prepays with JPMorgan Chase and Citigroup," Appendix E.

– A Chase banker wrote in a 1998 email: "Enron loves these deals as they are able to hide funded debt from their equity analysts because they (at the very least) book it as deferred rev[enue] or (better yet) bury it in their trading liabilities."[3]

– In a telephone conversation on September 20, 2001, taped in the normal course of business, three Chase employees discussed one of the Enron prepays in the following terms:

- " . . . [W]hy do they want to hedge with gas where it is now?"
- "They're not hedging, they're just, they're just, they do the back-to-back swap."
- "This is a circular deal that goes right back to them."
- "It's basically a structured finance-"
- "It's a financing?"
- "Yeah, its totally a financing, which has piece of it, they're always had on as a piece of their capital structure, so-"
- "So its amortizing. Yeah, it's amortizing debt. I get it."
- "That's exactly what it is."[4]

– A September 2000 internal email from a Citigroup employee to colleagues made these suggestions on how to explain the Yosemite prepay to potential investors: "Get into why co[mpany] does it (gets cash flow, shows up as other liab[ilities] not debt . . .) . . . i.e., [g]ives some oomph to revenues . . . . [Enron] gets money that gives them c[ash]flow but does not show up on books as big D Debt."[5]

– A 1997 Chase summary of a proposed $250 million Enron prepay, written to gain credit approval for this transaction, included the following statement: "In the past three years, Enron has utilized the prepaid sale as a mechanism to address a number of needs, including . . . sourcing funds (classified as 'Liabilities from Price Risk Management' as opposed to long term debt)."[6]

– A 1998 Citigroup loan approval memorandum in support of a prepay known as Roosevelt states: "The prepaid forward structure will allow Enron to raise funds without classifying the proceeds from this transaction as debt (it is accounted for as 'deferred revenue'). This is a common method of raising non-debt financing among energy companies."[7]

– A June 2001 Citigroup document summarizing the accounting and tax treatment for Enron prepays states: "As we understand the accounting, the Pre-Paid creates price risk management liability, thereby receiving non-'D' debt treatment. Operating cash flow increases . . . . From a tax perspective, the Pre-Paid can be treated much like a traditional loan[.] Swap payments are deductible on the tax books, similar to loan payments."[8] A January 2000 memorandum from Enron's tax planning department makes it clear that the prepay structures are not driven by tax requirements, but by accounting considerations: "The use of a prepaid swap was not motivated by tax considerations but instead was necessary in order to report the

[3]Chase email, November 11, 1998. Bates SENATE MAH-02129.

[4]Chase audio tape, September 20, 2001.

[5]Citigroup email, "My take on how to explain ECLN," September 28, 2000. Bates CITI-SPSI 0084924.

[6]"Structuring Summary," prepared by Chase, 11/14/97. Bates JPM-1-00061.

[7]"Global Loans Approval Memorandum" for Roosevelt prepay, prepared by Citigroup, December 21, 1998.

[8]"Summary of Pre-Paid Accounting and Tax," prepared by Citigroup and attached to internal email from Citigroup employee Timothy Swanson (6/25/01). Bates CITI-SPSI 0050680.

transaction as part of [Enron's] price risk management activities rather than debt for financial accounting purposes."[9]

– In a June 2002 court filing to require certain surety bond providers to make payment on bonds related to certain Enron prepays, Chase asserts that the sureties "knew that the deals [the prepays] were part of a structured financing transaction for Enron's general corporate benefit" and that "the surety bonds were part of financing transactions in which the funds advanced by JPMorgan Chase to Mahonia were ultimately used by Enron for general corporate purposes, not to secure future sources of the oil and gas to be delivered."[10]

– Credit Suisse First Boston ("CSFB"), which participated in two Enron prepays also understood the accounting-driven nature of the transactions. Emails exchanged among CSFB employees describe a prepay transaction as an "oil-linked loan,"[11] and state that "the net effect for [Enron] is raising $150M at L[IBOR] + 75bps [basis points] for 9 months off-balance sheet. As the swap is booked in their oil swap book and not treated as debt."[12]

– One CSFB lawyer raised concerns that the Enron "prepay" was "an accounting driven transaction,"[13] and recommended vetting it through the firm's "Reputational Risk Review" process. This review raised sufficient concerns to request Enron to make six representations about the transaction, including attesting to the fact that Enron senior management was aware of the transaction and that Enron was responsible for determining its accounting treatment.[14] Enron reportedly provided verbal assurance on these matters, but declined to provide anything in writing. CSFB approved the transaction and funded the prepay.

– In 1998, Chase developed a "pitch book" to sell other companies on Enron-style prepays. The presentation describes the transactions as an "[a]lternative source of finance" and "[b]alance sheet 'friendly' " and explains that they have an "[a]ttractive accounting impact by converting funded debt to 'deferred revenue' or long-term trade payable."[15] A similar Citigroup presentation, promoting Yosemite-style prepays, boasts that the structure "[e]xpands capability to raise non-debt financing and ... improves cash flows from operations."[16]

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[9]Enron Interoffice Memorandum from Tax Planning Department, January 10, 2000. Bates EC 000037274.

[10]Amended complaint, JPMorgan Chase Bank v. Liberty Mutual Insurance Co. (USDC SDNY) Case Number 01-Civ. 11523 (JSR), paragraphs 18-19.

[11]Credit Suisse First Boston email, December 18, 2000. Bates SR 00037828.

[12]Credit Suisse First Boston email, December 8, 2000. Bates SR 00038448.

[13]Credit Suisse First Boston email, "RE: URGENT / decision required - status on Eneron (sic) oil linked loan," December 14, 2000. Bates SR 00041087.

[14]Credit Suisse First Boston, Staff Interview, July 12, 2002.

[15]Chase presentation, July 16, 1998. Bates SENATE MAH - 02604.

[16]"Credit-Linked Notes," presentation by Citibank/Salomon Smith Barney (May 2001), at 37. Bates CITI-SPSI 0041206.

– Enron itself was clear about the purpose of its "prepays." A presentation prepared by Enron's accounting department for an internal educational seminar states: "Why does Enron enter into Prepays? Off balance sheet financing (i.e. generate cash without increasing debt load)."[17]

– Andersen was equally clear. "Enron is continuing to pursue various structures to get cash in the door without accounting for it as debt."[18]

Financial Institution Actions to Assist Enron's Accounting Deception

The participants in Enron's "prepays" were not only aware that the transactions were driven by Enron's desire to manipulate its financial statements, the financial institutions actively aided Enron in designing and implementing financial structures that created and maintained the fiction that the transactions were trades rather than loans.

– To help Enron create an appearance of independent trades in each "prepay," both Chase and Citigroup included as one of the participants an offshore shell corporation that appeared to be an independent entity but, in reality, was established and controlled by the respective bank. The two offshore entities are Mahonia Ltd.[19] and Delta Energy Corp., which were created and controlled by Chase and Citigroup, respectively. Since these entities apparently had no employees, no office, and no independent business operations, each bank provided the legal advice, paperwork, and financial support necessary for its affiliated offshore shell to participate in the trades. Without an independent third party, the trades that canceled each other out and allowed the prepay to function as a loan would not have been possible.

– When Andersen raised questions about the independence of Mahonia and Delta and requested a letter from each representing that it was an independent operational business apart from the bank and Enron, personnel at the associated banks complied. A taped telephone conversation on September 13, 2001, among Chase and Enron employees discussing the Andersen request shows that they were well aware that they were contributing to a fiction that Mahonia was independent from Chase:

-"You're talking about the rep letter from Mahonia . . . saying, you know, it has the right to do transactions like this. . . .Before what we've done is just really looked at the actual charter, and you've got the information, but now Andersen is pushing back and saying, hey, we need to have a specific rep letter that a representative of Mahonia signed that reps a certain point"
-"Which is, yeah, separate from Chase. It doesn't have Chase showing up anywhere on the fax letterhead or anything along those lines, a separate fax number, et cetera. . . ."
-"That goes to the same point you were raising earlier, Jeff, that from your side, you also want to make sure that Mahonia seems independent."[20]

– In one recent Enron prepay, a May 2001 internal Citibank memorandum suggested adding a minimal charge of one penny to the price spread to make it seem "a little more like a true trade." The memorandum states: "[The spread offers a more real transaction, the penny is in fact diminutive and figures to be an incremental 1 [basis point] on the whole transaction . . . . I highlighted the 1 penny spread to Kelly after I sent an initial script . . . . I told her that the charge makes the prepaid structure a little more like a true

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[17]"What are Prepays?", presentation prepared by Enron accounting department for internal educational seminar, undated. Bates EC 001594740.

[18]Internal Andersen email, December 16, 1998. Bates AASCGA 1132-1.

[19] Other Chase-controlled entities such as Mahonia natural Gas Limited and Stoneville Aegean were sometimes used in place of or in addition to Mahonia, Ltd.

[20]Chase audio tape, September 13, 2001.

trade, whereas a written floor and a purchased cap cannot be executed at the same level – good for both parties from an auditing/regulatory perspective."[21]

– To help Enron characterize prepay funds as coming from energy trades, several of the financial institutions were careful not to include requirements or descriptive language in the prepay documentation that would disclose the true nature of the transaction. For example, when drafting documents for its prepay with Enron, CSFB instructed its lawyers: "very important for them [Enron] is that the docs are as standard as possible and DO NOT include any representations on accounting driven transactions."[22]

– A 1999 Citigroup memo discussing Enron's repayment of a portion of a prepay states: "The paperwork cannot reflect their [Enron's] agreement to repay the $190 mm as it would unfavorably alter the accounting . . . ."[23] Citigroup memos reveal that Enron had agreed to repay the $190 million in two payments by dates certain, prior to the delivery dates for crude oil indicated in the energy trading documentation, but putting that agreement in writing would have caused the transaction to be classified as debt. As a result, Citibank accepted an unwritten "agreement" from Enron that it would repay the $190 million by the agreed date.[24] All of these actions made it easier for Enron to execute its "prepays" and claim they were the proceeds of energy trades rather than loans.

– When due to Enron's growing debt levels, Citigroup credit analysts became reluctant to extend Enron additional financing through new "prepays," Citigroup worked with Enron to design and establish the Yosemite structures which, instead of relying on bank financing, obtained funds under Rule 144(A) offerings from qualified investors. Citigroup underwrote four Yosemite offerings which produced sufficient funds for half a dozen Enron prepays worth a total of $2.4 billion. Citigroup even participated as an equity owner in the trusts that were a key element in these structures.

Financial Institution Actions to Keep Prepays Secret

In addition to helping Enron design and execute multiple "prepay" transactions, the financial institutions complied with Enron requests to restrict disclosure of the nature and extent of its prepay activities. By design and intent, the "prepays" structured by Enron and the financial institutions made it impossible for investors, analysts, and other financial institutions to uncover the true level of Enron's indebtedness.

– Enron hid from investors and financial analysts the extent and nature of its "prepay" activities. In its financial statements, Enron included the money it received from "prepay" transactions on its balance sheet in a line item known as "Price Risk Management," burying the proceeds within a much larger figure, about $20 billion in 2000, representing the company's overall trading liabilities. This $20 billion did not separately identify funds derived from "prepay" transactions; in fact, Enron's financial statements never explicitly addressed Enron's "prepay" activity at all, despite its growing role in the company's finances. At one point Arthur Andersen auditors recommended to Enron Chief Accounting Officer Rick Causey that Enron provide more complete disclosure on its prepay transactions, but Mr. Causey declined to do so.[25] The financial institutions that participated in Enron's "prepays" also kept quiet about what they knew.

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[21]Citigroup email, May 9, 2001. Bates CITI-SPSI 0053452.

[22]Credit Suisse First Boston email, December 15, 2000. Bates SR 00037769.

[23]Citigroup email, "Enron/Roosevelt Update," April 22, 1999. Bates CITI-SPSI 0068751.

[24]Citigroup email, "Enron/Consent to Amendment to Roosevelt Transaction," April 27, 1999. Bates CITI-SPSI 0046833.

[25] Arthur Andersen, Staff Interview, July 19, 2002.

Most of Enron's "prepays" were transacted with Chase and Citigroup; neither disclosed information publicly about the extent of Enron's prepay activity, even in documentation associated with the Yosemite Rule 144(A) offerings. Financial analysts that closely followed Enron, including analysts with major credit rating agencies, told the Subcommittee staff that they had been completely unaware of Enron's prepay activities prior to its bankruptcy.

– Citigroup provided a major boost to Enron's prepay secrecy when it worked on the design of the Yosemite structures. These structures offered investments in Enron-related matters and did not reveal to investors the specific investments into which their funds were being placed. The trusts and the lack of information on specific investments functioned as a "black box," in the words of Enron, to prevent investors and others from knowing that the Yosemite proceeds were being used to fund Enron prepays. An Enron presentation touting the advantages of using the Yosemite proceeds for prepays states that the Yosemite structure "provides for a unique 'black box' feature which provides considerable flexibility" and that the "[b]lack box allows Enron the ability to provide a permanent take-out feature for highly structure[d] transactions in the capital markets while limiting disclosure of prepay to Citibank." The presentation warns: "[T]he use of prepays as a monetization tool is a sensitive topic for both the rating agencies and banks/institutional investors. The ability to continue minimizing disclosure will likely be compromised if transactions continue to be syndicated."[26]

– On one occasion, when a Yosemite investor learned about Delta Energy Corporation and contacted Enron for additional information, Enron personnel reacted strongly to stop further disclosure. Enron immediately sent a series of emails to Citigroup which stated: "[A]pparently an investor spoke to someone at citi and received info on delta. This person . . . is now calling us asking about delta now. We need to shut this down."[27] "By the way – not blaming you guys just trying to figure out how to shut it down."[28] Citigroup declined to provide any additional information to the investor.

– Enron's prepay secrecy was so successful that, while each financial institution involved in an Enron prepay had inside knowledge of that particular transaction, it appears that no financial institution – even Chase or Citigroup – knew the total number and dollar value of all of the "prepays" engaged in by Enron. For example, an October 2001 exchange of emails at Chase had this to say after the bank learned, to its surprise, that Enron had $5 billion in prepays outstanding, an amount that was much greater than Chase had expected:

-"$5B in prepays!!!!!!!!!"
-"shutup and delete this email."[29]

– In September 1999, in response to internal concerns regarding the complexity, reliability and completeness of Enron's audited financial statements, a Salomon Smith Barney ("SSB") senior banker led a review of Enron's capitalization. The report[30] was presented to Citigroup's Investment Grade Debt Commitment Committee, which is charged with approving commitments of the bank's capital to investment grade debt financings. The report included information on Enron's capitalization taken from Enron's audited financial statements, analyses conducted by Moody's and an analysis based on SSB's knowledge of the company.

[26]Enron presentation on Yosemite. Bates ECa000196339, 41.

[27]Citigroup email, November 14, 2001. Bates ECp000097038.

[28]Citigroup email, November 14, 2001. Bates ECp000097037.

[29]Chase emails, October 24, 2001. Bates SENATE MAH 00645.

[30]Salomon Smith Barney presentation, "Capitalization". September 20, 1999. Bates CITI-SPSI 0031094 - 98.

The internal SSB analysis reported a level of indebtedness which included prepays and was higher than what was reported in Enron's financial statements and in Moody's analysis of Enron.[31] In Enron's financial statements, the prepay number was not shown as debt but was buried in Price Risk Management Liabilities and not disclosed separately from Enron's other trading liabilities. There would be no way for an institution other than Enron, the bank involved, or Enron's auditor to know how much in prepay transactions was outstanding.[32]

Clearly, Citigroup had better insight into Enron's true financial condition than most other actors, acknowledging that "there is no question that Enron cashflow has become more dependent on Price Risk Management (prepay) activities."[33] It is safe to conclude that analysts and investors also would have been interested in evaluating these outstanding Enron commitments; in the case of so-called prepays, that analysis was impossible for outsiders.

In advance of Enron-linked securities offerings in 2000 and 2001 (the Yosemite and ECLN offerings), Citigroup prepared additional internal Enron credit analyses, using the same methodology employed in the first analysis. In all instances, the level of indebtedness was significantly higher than what was reported in Enron's financial statements.[34] The aggregate amount of debt related to prepays increased from $750 million in the September 1999 SSB internal analysis to more than $2.2 billion in the April 2001 analysis. This $2.2 billion includes Yosemite I, Yosemite II and ECLN I proceeds, which were used to fund new prepay transactions. Only Enron and Citigroup knew the use of Yosemite I and II and ECLN I proceeds, given the "blind" nature of these trusts. Citigroup included this information in its internal analysis of Enron, increasing Enron's publicly disclosed debt levels by the amount of the Yosemite and ECLN offerings, as well as the $750 million attributed to prepays in SSB's initial internal analysis. This fact raises questions regarding Citigroup's representation of Enron's financial condition in the offerings for Yosemite and ECLN securities.

Incentives for Financial Institutions to Support Enron's Accounting Deceptions

There are many possible explanations for why major financial institutions were willing to go along with and even expand upon Enron's "prepay" activities. One obvious incentive was the fees paid by Enron which provided lucrative business deals to a number of financial institutions on Wall Street and elsewhere. (Citigroup earned approximately $167 million from 1997 through 2001.]

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[31]Representatives of Citigroup pointed out that some structures included in their analysis were already counted, at least in part, in the Moody's analysis, therefore indebtedness linked to these structures may have been double-counted in the initial SSB internal analysis. These items included $1.5 billion from Condor, $550 million from Marlin; $500 million from Margaux and $450 million from Firefly. Bates CITI-SPSI 0031097.

[32]Not even Citigroup knew how much Enron had outstanding in prepay transactions. Yet, the firm viewed prepays as an important component of Enron's capital commitments, as reflected by Citigroup's inclusion of prepays in the analysis. In explaining why Citigroup decided to include the prepay number in the capitalization analysis, while it did not include any other trading liabilities, the SSB banker who oversaw the first analysis told Subcommittee staff that, "We knew the number was there, and it has cash flow that has already been spoken for associated with it." Staff Interview, July 16, 2002.

[33]Citigroup email, "Enron Credit Approval," April 18, 2001. Bates CITI-SPSI 0085843.

[34]November 1999 analysis: SSB estimate of Enron debt was 38% higher than debt reported in Enron's financial statements. Bates CITI-SPSI 0005184. August 2000 analysis: SSB estimate of Enron debt was 40 - 53% higher than debt reported in Enron's financial statements. Bates CITI-SPSI 0007241. April 2001: SSB estimate of Enron debt was 57 - 92% higher than debt reported in Enron's financial statements. Bates CITI-SPSI 0008756.

In addition, in some cases, Enron explicitly pressured some financial institutions to participate in particular "prepay" transactions, as a favor and inducement for Enron to channel additional business their way. A series of Citigroup emails illustrates this issue.

– A September 2001 Citigroup email states: "Spoke with Ben Glisan, [Enron Treasurer], re our turn down of the $200mm prepaid bridge request. . . . He was calm and did not threaten loss of any specific business. . . . [T]his turndown was major disappointment and perhaps a first from Citi but we still have significant capital committed and Enron recognizes that. . . . Expect will continue to work on existing deals with us but intend to spread the business. . . . Told him that we intended to work even harder on the relationship etc. More to come; I have call with Fastow today."[35]

– An October Citigroup email a few days later states: "Spoke with Fastow . . . . CP rollover was clear financial need in a difficult time while the prepaid was an accounting need in a difficult time and we differentiated between the two. Talked about need for continuing dialog particularly our appetite for additional Enron paper during the quarter."[36]

– A Citigroup email exchange[37] a week later states:

-"Last week, we were informed by enron that we had not been selected to arrange either project X (monetize contract values in their price risk book) or project popeye . . . . Each are potentially precedent-setting and lucrative deals. . . . Also: chase and csfb did provide prepays at the end of the last quarter - csfb replacing us when we rejected the 20mm request. . . ."
-"With respect to Brazos I specifically visited with Glisan several weeks ago before the $200mm request was on the table saying that we had some issues with Brazos such that we would prefer not to participate but I wanted feedback from him as to how important it was to them and that we would have to look at it as a 'trust me, Enron relationship deal'. He said he would prefer not to do 'trust me' deals and he would get back to me. He has not. Also at same meeting questioned him on what he had 'scheduled' for us for remainder of year. . . . . We still have the existing $250mm prepaid to deal with for which they still 'owe' us one for having provided the $250mm originally."

CSFB emails show similar concerns, as well as actions by Enron to encourage the financial institution to participate in a "prepay." A CSFB email exchange[38] in September states:

- "Please remind me as to who at Enron originally asked for this deal and why we agreed to do it (and most importantly what did CSFB get from it besides being nice guys once again)."
- "We agreed to do the deal [a prepay] as it was a special request/favor from Ben [Glisan]. Not sure if we got anything specific other than a relationship building chip."

In the case of Citigroup, another motivation in setting up the Yosemite and CLN structures was to lower its own exposure to Enron. A Citigroup memorandum states, "these prepays [Roosevelt and Truman] will be repaid with the proceeds from the Yosemite, ...eliminating the obligor exception." Instead, credit exposure for all the Yosemites and CLNs was transferred to the bondholders.[39]

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[35]Citigroup email, September 26, 2001. Bates CITI-SPSI 0085837.

[36]Citigroup email, October 1, 2001. Bates CITI-SPSI 0085836.

[37]Citigroup emails, October 8, 2001. Bates CITI-SPSI 0085833-34.

[38]CSFB emails, September 17, 2001. Bates SR 00037828.

[39] Global Loans Approval Memorandum, Citigroup, October 19, 1999. Bates CITI-SPSI 0002996.

After several years of participating in Enron "prepays," both Chase and Citigroup found another reason to go along. Both began attempting to sell the product to other companies. Chase informed the Subcommittee that it entered into Enron-style prepays with seven companies apart from Enron.[40] Citigroup indicated that it shopped the idea to 14 companies apart from Enron, successfully selling it to at least three.[41]

This evidence suggests that Enron is not the only company obtaining loans disguised as energy trades and recording cash flows from operations instead of from financing. Major financial institutions are knowingly assisting and even promoting such transactions, which would not be possible without their willingness to provide the funds, supporting paperwork, and a sham offshore trading partner.

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[40]Chase correspondence with the Subcommittee, July 18, 2002.

[41]Citigroup correspondence with Subcommittee, July 17, 2002.