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## Memorandum

Date: March 31, 2002  
To: McCullough Research Clients  
From: Robert McCullough  
Subject: A History of LJM2

### Overview

Near the end of 1999, Enron established a very thin “unaffiliated” entity named “LJM” managed by Andrew Fastow, Enron’s Chief Financial Officer, that was designed to allow a series of off-balance sheet transactions with Enron. The Powers Report has identified this and its follow-on Special Purpose Entities (SPEs) as a critical issue in corporate governance and argues persuasively that they had little economic merit. The report also questions whether they should ever have been consolidated.<sup>1</sup> A careful review clearly indicates that while their consistency with Enron’s governance may have been in question, they were part of Enron’s overall financial strategy and were used to finance other major groups of SPEs including Osprey and Whitewing. Logically, these additional SPEs should also have been consolidated in 3<sup>rd</sup> Quarter of 2001 along with Swap Sub and Chewco.

The feverish ingenuity of the LJM subsidiaries and partnerships seems to reflect a race between Andrew Fastow and Arthur Andersen. There is a strong impression that Enron’s Chief Financial Officer was trying to invent solutions to traditional accounting prohibitions faster than his auditors

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<sup>1</sup>Consolidated means added together for financial reporting purposes. Unconsolidated entities would not show up in the balance sheet and income statement of the parent corporation.

could understand and apply them.<sup>2</sup>

While Andrew Fastow's involvement with LJM may well be questionable, the presence of Jeff Skilling at the October 26, 2000 LJM Annual Partner's Meeting clearly indicates the participation and concurrence of senior management.<sup>3</sup> Although the Powers Report focuses on violations of Enron's ethical code, the sheer complexity and scale of the LJM transactions indicates that Andrew Fastow was pursuing Enron's corporate goals. Simple self-dealing could have been achieved vastly more quickly and safely than the creation of the many questionable SPEs and the involvement of numerous limited partners.

LJM was an extraordinary investment opportunity. Information provided to LJM's investors appears to contain an enormously more detailed description of Enron's actual financial situation than that provided through Enron's annual reports, 10Ks, and 10Qs.<sup>4</sup> In addition, the financial opportunities available to the investors range from 12% to 2503% with an overall forecasted internal rate of return of between 51% and 69%. To quote the Powers Report:

There were several direct consequences of this failure: transactions were executed on terms that were not fair to Enron and that enriched Fastow and others; Enron engaged in transactions that had little economic substance and misstated Enron's financial results; and the disclosures Enron made to its shareholders and the public did not fully or accurately communicate relevant information.<sup>5</sup>

Our review of LJM indicates that this well may be an understatement. It is difficult to understand the financing pressures that must have existed on Enron's management to have participated in any fashion with a financing vehicle whose returns – and therefore, costs, to Enron – were so high.

In the absence of LJM and other financing mechanisms like Chewco and Whitewing, it is very likely

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<sup>2</sup>Proper financial accounting does not permit this result. To reach it, the accountants at Enron and Andersen—including the local engagement team and, apparently, Andersen's national office experts in Chicago--had to surmount numerous obstacles presented by pertinent accounting rules. Powers Report, page 129.

<sup>3</sup>October 26, 2000 LJM Annual Partner's Meeting, page 2. While the vast majority of materials used in this report are standard SEC filings and reports such as the Powers Report, this document has been obtained from Matthew Goldstein, a senior Wall Street correspondent at SmartMoney.com. A careful review of the document makes it clear that it is not simply the product of a malicious prankster. The materials show a level of detail, that if false, would require an expert insider's hand. Given the timing of the document and the level of detail, it appears to be genuine and has been treated so in this report.

<sup>4</sup>October 26, 2000 LJM Annual Partner's Meeting, page 8.

<sup>5</sup>Powers Report, page 19.

that Enron's actual operations lost money over the past five quarters.<sup>6</sup> The scale of earnings from these special transactions seemingly explains almost all of Enron's profits, bring into question the profitability and viability of Enron's trading operation.

## Hedging

After a careful reading of the Powers Report and LJM documents, the term "hedging" begins to seem very ambiguous indeed. The colloquial phrase "hedging your bets" comes from John Donne whose sermon over four hundred years ago includes the words "All your hedging in off debts/all your crafty bargains." While Enron's use of the phrase may be closer to John Donne's meaning than today's, the original sense was that a farmer would plant a hedge around his fields to protect vulnerable livestock. Today, we can purchase a hedge that will protect us from bad markets in a specific asset.

The key, however, is that we cannot hedge an investment with ourselves. The fundamental transaction involves purchasing the hedge from another party who will bear our risk for a fee. Throughout Enron's SPEs the term hedge is generally misused. Enron's "hedges" at Raptors 1, 2, and 4, were simply a vehicle for gaining the benefits from expected appreciation of Enron stock. Raptor 3's "hedge" was in the same stock that was being hedged – a sophisticated version of taking in your own washing.

## Background

On June 18, 1999, Andrew Fastow proposed a novel financing mechanism to Ken Lay and Jeff Skilling.<sup>7</sup> The concept was presented to the Board on June 28, 1999.<sup>8</sup> In the Board presentation, Fastow offered to invest \$1 million in the new SPE.

In November 1999 Andrew Fastow established LJM Cayman (LJM1). "LJM", which stands for the initials of its Andrew Fastow's wife and children, was unique in that its General Partner was also Enron's Chief Financial Officer.<sup>9</sup> LJM's limited partners were Greenwich Natwest and Credit Suisse.

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<sup>6</sup>Nonetheless, if one were to subtract from Enron's earnings the \$1.1 billion in income (including interest income) recognized from its transactions with the Raptors, Enron's pre-tax earnings for that period would have been \$429 million, a decline of 72%. Powers Report, page 99. Since the Powers Report does not consider the unwinding of Whitewing and its purchase of faltering Enron assets like Elektro, the total may well be much larger.

<sup>7</sup>Powers Report, page 68.

<sup>8</sup>Powers Report, page 69.

<sup>9</sup>Corporate Veil: Behind Enron's Fall, A Culture of Operating Outside Public's View --- Hidden Deals With Officers And Minimal Disclosure Finally Cost It Its Trust --- Chewco and JEDI Warriors, Wall Street Journal, 12/05/2001.

Andrew Fastow owned 6% of LJM Cayman and the limited partners owned the remaining 94%.<sup>10</sup> Total capitalization was \$1 million from Fastow and \$15 million from the two limited partners.

The fundamental objective of this and similar SPEs was their ability to do business with Enron “off the balance sheet.” This term does not do the arrangements justice, however. The existence of LJM did more than hide balance sheet items from investors.

When LJM purchased a share of the Cuiaba power project from Enron for \$11.3 million in September 1999, it allowed Enron to deconsolidate the natural gas supply arrangements for the plant. This, in turn, allowed Enron to recognize earnings of \$65 million dollars for sales to Cuiaba for natural gas on a mark-to-market basis.<sup>11</sup> This is in spite of the fact that the plant still does not have access to natural gas today.<sup>12</sup> After the earnings were taken, the share of Cuiaba was later repurchased by Enron. While the use of mark-to-market by Enron has been aggressive, this is a case of clear abuse – mark-to-market treatment of a transaction between different parts of Enron for a product that could not be delivered at values that cannot be verified.

It would never have been possible for even the savviest investor to have evaluated the significance of these “earnings.” For example, the 1998 10K indicates a 65% direct ownership while later financial reports simply footnote that “Enron holds varying interests in these projects.”<sup>13</sup>

The significance of Cuiaba and similar transactions is that they had a major impact on Enron’s income statement as well. The Powers Report describes the income state impact of the Raptor SPEs as:<sup>14</sup>

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<sup>10</sup>To our knowledge, LJM is a wholly-owned subsidiary of LJM Cayman, L.P. To our knowledge, Greenwich Natwest and Credit Suisse collectively own a 94% interest in LJM Cayman, L.P., and an individual owns a 6% interest. SEC Form U-57/A, 10/20/2000.

<sup>11</sup>In September 1999, Enron sold LJM1 a 13% stake in a company building a power plant in Cuiaba, Brazil. This was the first transaction between Enron and LJM1 after the Rhythms hedge. This sale, for approximately \$11.3 million, altered Enron's accounting treatment of a related gas supply contract and enabled Enron to realize \$34 million of mark-to-market income in the third quarter of 1999, and another \$31 million of mark-to-market income in the fourth quarter of 1999. In August 2001, Enron repurchased LJM1's interest in Cuiaba for \$14.4 million. Powers Report, page 135.

<sup>12</sup>11/19/2001, Electric Utility Week, page 24.

<sup>13</sup>March 18, 1999 Form 8-K. The 1999 Annual Report makes no mention of Cuiaba’s ownership at all.

<sup>14</sup>Powers Report, page 133.

	Earnings	Earnings Without Raptors	Raptors' Contribution To Earnings
3Q 2000	\$364	\$295	\$69
4Q 2000	\$286	(\$176)	\$462
1Q 2001	\$536	\$281	\$255
2Q 2001	\$530	\$490	\$40
3Q 2001	(\$210)	(\$461)	\$251
Total	\$1,506	\$429	\$1,077

For analysts, like ourselves, who are trying to determine whether Enron Wholesale Services Americas were profitable without these income statement adjustments, this is very important. The clear implication is that Enron's stated profits were mainly accounting fiction and that the trading operations were not making a significant contribution to the bottom line.

An additional major question is whether LJM should have been consolidated with Enron. Arthur Andersen has taken the position that a part of LJM, Swap Sub, should have been consolidated because it failed to meet the 3% technical standard for non-consolidation.

The Powers Report is less clear concerning consolidation of LJM1 and its follow on SPE, LJM Co-Investment L.P. (LJM2). The technical requirements that there was 3% outside equity at risk appears to have been met by both LJM1 and LJM2. At issue is whether Andrew Fastow, as an Enron officer, controlled LJM1 and LJM2. A final answer to this argument must necessarily await the detailed investigation at the SEC.

While we wait for the expert opinion of the SEC, it is possible to make a very strong argument that these entities never met the control test for avoiding consolidation. Not only does the Powers Report provide the raw materials for this argument, but the materials from the LJM Annual Meeting also provide strong evidence for consolidation.

The Powers Report argues that they cannot determine the degree of Andrew Fastow's control given our current knowledge of the structure of LJM1 and LJM2.<sup>15</sup> While correct, it neglects to recognize that in the absence of Fastow's control there was no reason for either LJM1 or LJM2 to exist.

The raison d'être of these two SPEs was the ability of a senior Enron executive to position Enron assets and financial requirements with the assistance of third party equity. In the absence of Andrew Fastow, the relationship could not have taken place. If the limited partners ousted Andrew Fastow, the connection that provided potential for profit would be severed. The bottom line is that the absence of an arm's length negotiating relationship appears critical to the success of the venture.

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<sup>15</sup>We have reviewed these issues in detail, and have concluded that there are no clear answers under relevant accounting standards. Fastow declined to speak with us about these issues. As we have noted, the limited partners of both LJM1 and LJM2, citing confidentiality provisions in the partnership agreements, declined to cooperate with our investigation by providing documents or interviews. Powers Report, page 76.

The LJM Annual Meeting documents make this very clear. The “rationale” of LJM was:

- Fund created and managed by the CFO of Enron, Andrew S . Fastow
- Focused on acquiring energy and communications assets primarily owned by Enron<sup>16</sup>

Even LJM2, the larger and more diversified of the two SPEs, only had 11% of its portfolio characterized as “Non-Enron”.<sup>17</sup>

Regardless of the fine print in the partnership agreements, LJM would lose its “rationale” if Fastow’s control was eliminated. The Fastow link was also important in that it provided a second source of value for the agreement. Page 8 of the October 26, 2000 meeting provided a detailed annual breakdown of off-balance sheet assets. Anyone equipped with this information had a far better idea of the true financial condition of Enron than the investing public. While at this point it is only speculation, this page provides evidence that the limited partners enjoyed a privileged position with Enron.<sup>18</sup> This hypothesis is supported by the presence of Jeff Skilling at the meeting – a presence that the limited partners would interpret as a demonstration of Enron’s commitment to the partnership.<sup>19</sup>

### **LJM Cayman**

LJM1 had three basic transactions with Enron. The first type of transaction was a “hedge” of Enron’s investment in Rhythms Netconnections. Stripped of the complex web of SPEs that accompanied the transaction, Enron transferred restricted Enron shares into LJM Swap Sub in exchange for a note from LJM1. LJM Swap Sub promised to reimburse Enron if the value of its Rhythms Netconnections stock fell. As the Powers Report notes, this was not a true economic hedge since it depended upon the value of Enron stock. If Enron stock declined, LJM Swap Sub would not be able to perform on its guarantee to Enron. As we have seen with the Raptors and with Whitewing, the mechanism was a

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<sup>16</sup>October 26, 2000 LJM Annual Partner’s Meeting, page 6.

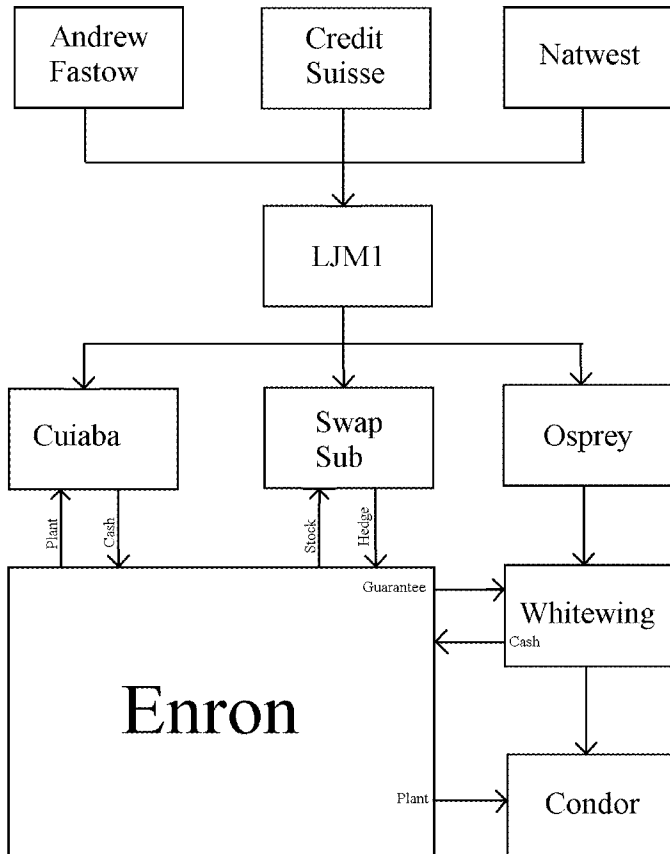
<sup>17</sup>October 26, 2000 LJM Annual Partner’s Meeting, page 22.

<sup>18</sup>Access to Significant Proprietary Deal Flow. Enron has extensive deal origination capability that is derived from approximately 2,000 fully dedicated Enron-employed origination and monitoring professionals located around the world. The deal flow emanating from this origination infrastructure has resulted in Enron making over \$7 billion of energy-related investments in each of the last two years and holding merchant investments of over \$10 billion. As a result of Enron’s in-house deal sourcing capability as well as its leading market position in most businesses in which it operates, Enron frequently has access to investment opportunities that are not available to other investors. The Partnership expects to benefit from having the opportunity to invest in Enron-generated investment opportunities that would not be available otherwise to outside investors . LJM2 Private Placement Memorandum, page 2.

<sup>19</sup>Given the extraordinary returns some of the LJM investments were making from Enron transactions, the presence of the president of Enron seems unbelievable unless he was knowledgeable about the relationship. Any discussion of a 51% rate of return would have led to an immediate replacement of Fastow and renegotiation of the Enron transactions if Skilling was not a central part of the Enron/LJM relationship.

torturous method of speculating in Enron's own stock.

The second type of transaction was functionally identical to the larger Whitewing mechanism. Enron sold a share of the Cuiaba power plant described above. This transaction was designed to take advantage of deconsolidating existing transactions for Enron's benefit. In 2001, Enron reacquired the share of Cuiaba at a profit for LJM even though the investment was beset with engineering, environmental, and regulatory problems.



The following chart shows a very simplified “map” to LJM1's transactions:

Andrew Fastow plus two limited partners, Credit Suisse and Greenwich Natwest, contribute \$16 million to LJM1.

LJM1 enters into three major transactions with Enron and Enron affiliates: purchase of a share of Cuiaba, establish a hedge for Rhythms Netconnections, and purchase of an equity share in Osprey.

Osprey equity investors include numerous independent entities plus LJM1

Osprey and Enron invest in Whitewing. Enron provides convertible preferred stock and a guarantee. Condor purchases merchant assets from Enron, including Elektro.

The third type of transaction was an equity investment in Osprey – the “independent” partner with Enron in Whitewing. LJM's investment in Osprey – 15.3% in Osprey I and 86.7% in Osprey II – raises a clear question whether Whitewing and Condor should have been consolidated with Enron. If so, Whitewing's transactions with Enron should have been reversed in the same fashion as the Raptor transactions.<sup>20</sup>

On November 8, 2001, Enron consolidated Swap Sub. This accounting adjustment reduced earnings

<sup>20</sup>LJM2 Co-Investment L.P. and Subsidiaries Consolidated Balance Sheets, no page number.

by \$95 million in 1999 and \$8 million in 2000.<sup>21</sup> The existing accounting adjustment is nominal compared to the potential adjustment from Cuiaba (\$66 million) and vastly larger adjustments that may materialize if Whitewing was consolidated. Whitewing is owned by Enron and Osprey. Osprey, we now find, is also owned in part by an Enron controlled SPE, LJM1.

**LJM Co-Investment L.P. (LJM2)**

In October 1999, Fastow proposed a second LJM vehicle, LJM Co-Investment L.P. (LJM2). Unlike LJM1, this entity had a variety of outside investors:

- Chase Capital,
- World Air Lease,
- GE Capital,
- J.P . Morgan Capital,
- Merrill Lynch,
- C&I Partners,
- Dresdner,
- AON,
- Rho Management,
- CSFB,
- Ulysses Partners,
- Fort Wash. Private Equity,
- Morgan Stanley,
- and
- First Union Investors<sup>22</sup>

The Powers Report added several other possible limited partners to this list including:

- American Home Assurance Co.,
- Arkansas Teachers Retirement System,
- The MacArthur Foundation,
- Citicorp,
- First Union,
- and
- Deutsche Bank.<sup>23</sup>

LJM2 is considerably larger than LJM1. LJM2 was planned to have \$200 million in outside equity.

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<sup>21</sup>Powers Report, page 84.

<sup>22</sup>October 26, 2000 LJM Annual Partner's Meeting, page 4.

<sup>23</sup>Powers Report, page 73.



As before, Andrew Fastow would be the general partner.<sup>24</sup> LJM2's offering document made very attractive promises:

It explained that "[t]he Partnership expects that Enron will be the Partnership's primary source of investment opportunities" and that it "expects to benefit from having the opportunity to invest in Enron-generated investment opportunities that would not be available otherwise to outside investors." The PPM specifically noted that Fastow's "access to Enron's information pertaining to potential investments will contribute to superior returns."<sup>25</sup>

LJM2 entered into a wide variety of transactions with Enron. Some of these, Raptors 1,2, and 4 are taken from the existing model where Enron stock or guarantees were added to an existing merchant investment. Forecasted appreciation of the stock would offset possible losses in the value of the merchant investments. As with Swap Sub, the economic logic of the transaction was very weak. A fall in the price of Enron stock at the same time as a fall in the value of the merchant investment would make each of the Raptors unable to honor its "hedge".

The Raptors were in the nature of a pure gamble, where investors were guaranteed their investment in weak assets with an infusion of Enron stock or the promise of Enron stock. As Sherron Watkins wisely noted in her letter to Ken Lay:

Raptor looks to be a big bet, if the underlying stocks did well, then no one would be the wiser. If Enron Stock did well the stock issuance to these entities would decline and the transactions would be less noticeable. All has gone against us.<sup>26</sup>

There is no question that her characterization was correct. The Powers Report clearly indicated that this mechanism was little more than a speculation in Enron's own stock.<sup>27</sup>

Raptor 3 took this concept even further. Raptor 3's logic is so attenuated that it is surprising that it passed even the most cursory review. Raptor 3 was designed to hedge Enron's investment in The

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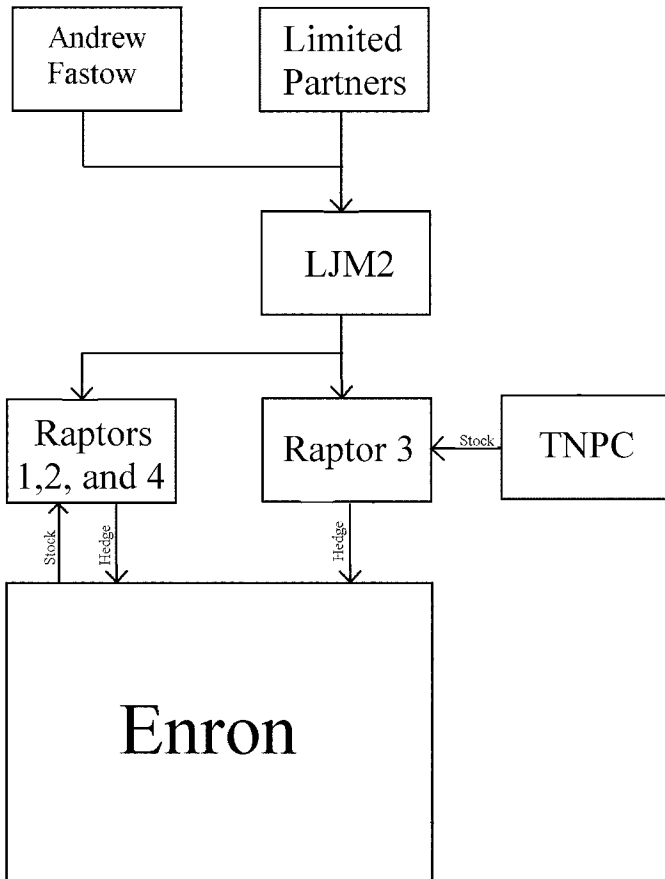
<sup>24</sup>Powers Report, page 71.

<sup>25</sup>Powers Report, page 72.

<sup>26</sup>Watkins letter, page 3.

<sup>27</sup>In three of the four Raptors, the vehicle's financial ability to hedge was created by Enron's transferring its own stock (or contracts to receive Enron stock) to the entity, at a discount to the market price. This "accounting" hedge would work, and the Raptors would be able to "pay" Enron on the hedge, as long as Enron's stock price remained strong, and especially if it increased. Thus, the Raptors were designed to make use of forecasted future growth of Enron's stock price to shield Enron's income statement from reflecting future losses incurred on merchant investments. This strategy of using Enron's own stock to offset losses runs counter to a basic principle of accounting and financial reporting: except under limited circumstances, a business may not recognize gains due to the increase in the value of its capital stock on its income statement. Powers Report, page 97.

New Power Company (TNPC). TNPC asset for honoring the hedge to Enron was TNPC stock. If TNPC stock fell, as it did, Enron would be paid for its losses from the TNPC stock held by Raptor 3. In effect, the survivors of a sinking ship would be rescued by other survivors on the same sinking ship. While this may have been persuasive at the time, it is hard to see how it survived any management or Board review.



LJM2 had a much wider set of limited partners reflecting its larger base.

Raptors 1, 2, and 4 involved different hedges using Enron’s own stock.

Raptor 3 attempted to hedge Enron’s investment in TNPC using TNPC’s stock.

The four Raptors slid into insolvency as Enron and TNPC stock declined in price. After a rescue in the first quarter of 2001 when even more Enron stock was pledged to support the “hedge”, Enron decided to terminate the Raptors.

While the logic of the Raptors appears tenuous, the rate of return promised to LJM2 investors was not. The Powers Report indicates that the returns reported to the LJM2 investors were “193%, 278%, 2500%, and a projected 125%, respectively.”<sup>28</sup> While these returns are outlandish by any normal standards, they were only moderate by LJM2 standards. The Coyote and Yosemite investments showed an infinite internal rate of return – a mathematical anomaly that occurs when returns are

<sup>28</sup>Powers Report, page 128.

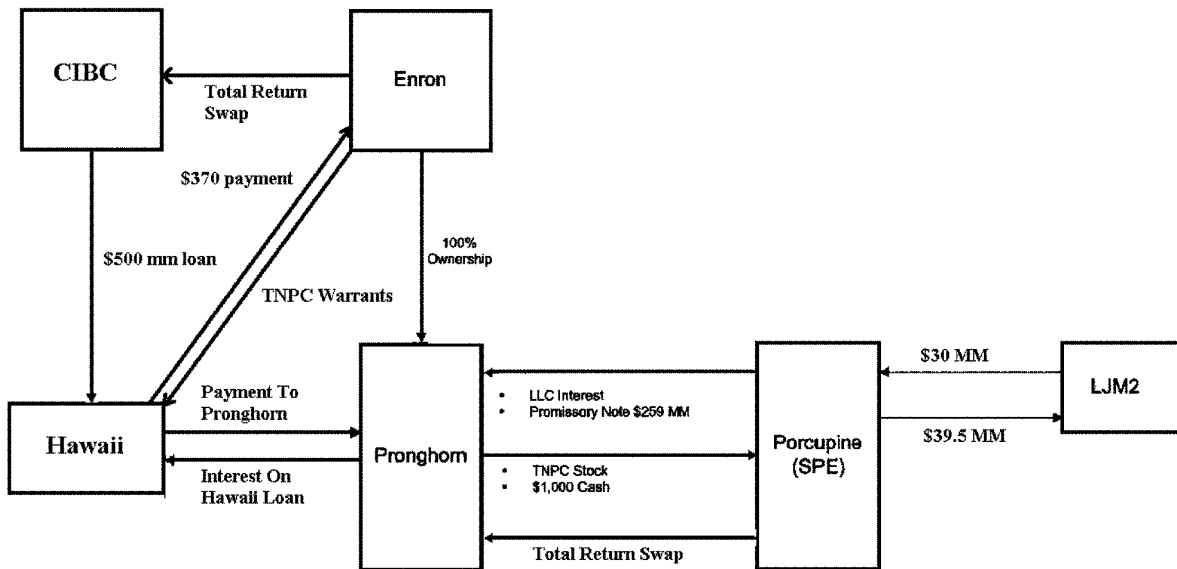
projected with no initial investment.<sup>29</sup>

### Raptor III

The origin of Raptor III was in the TNPC IPO. Enron was eager to sell its share in TNPC, but was unwilling place unrestricted shares into the market for fear of depressing the fragile share price. Enron’s solution was to create a mystifying next of SPEs designed to purchase the assets that would meet Arthur Anderson’s critical review. The structure became so complex and unconvincing that it eventually started a conflict between Arthur Anderson’s partners.

The first step was the creation of Hawaii I 125-0. Hawaii I 125-0 borrowed \$500 million from CIBC. The assets in Hawaii clearly would not support the loan from CIBC so Enron was forced to provide a guarantee of the entity. Given TNPC’s weak business prospects, this put Enron back where it had started. It was able to declare a significant profit – \$370 – but it knew that it was exposed to considerable risks.

Unable to find an entity that would cover the guarantee, Enron proceeded to create one – at some cost – at LJM2.



Overall, the detailed breakdown of cashflows projected the internal rate of return on all investments to be 51%. The “Activity Summary” indicated a 69% per annum internal rate of return.<sup>30</sup> While these

<sup>29</sup>October 26, 2000 LJM Annual Partner's Meeting, page 28.

<sup>30</sup>October 26, 2000 LJM Annual Partner's Meeting, page 18.

returns were purely hypothetical and were based on an optimistic 15% per year appreciation in the price of Enron stock until January 1, 2003, they also reflected a return completely above market.<sup>31</sup> This level of return was only supportable in a financial climate where Enron could afford to pay real earnings to third parties in return for cooperation in adding illusory earnings to their own income statement.

While the returns summarized above are projects, a detailed summary of changes to partners' capital is contained in LJM2 Co-Investment, L.P. and subsidiaries, Consolidated Statement of Changes in Partners' Capital.

	Limited Partners	General Partner	Total Partners
Partners' capital at December 31, 1999	16,503,579	265,659	16,769,238
Capital contributions	241,208,451	2,662,364	243,870,815
Distributions	-111,354,232	-2,593,693	-113,947,925
Increase in partners' capital from operations	18,563,133	6,544,583	25,107,716
Partners' capital at December 31, 2000	164,920,928	6,878,913	171,799,841
Distributions	-115,825,564	-5,778,460	-121,604,324
Withholding tax	-138,411		-138,411
Increase in partners' capital from operations	17,827,159	5,635,637	23,462,796
Partners' capital at September 30, 2001	66,783,812	6,739,090	73,522,902
Annual Internal Rate of Return (MR Estimate)	43.06%	8,870.54%	58.27%

We calculated the annual internal rate of return by assuming that contributions and distributions were spread evenly across the months and should be viewed as an approximation only. The significance of this calculation is that the partners were seemingly receiving returns comparable to the projections in the October 26, 2000 meeting.

The amazing thing about the Raptors was not the potential for self-dealing that formed the theme of the Powers Report, but the feverish ingenuity that seems to have seized Andrew Fastow and his team. As quoted above, the Powers Report describes this as a contest between the participants and accounting restrictions. It is the hallmark of intense negotiations that complexities upon complexities are added to simple transactions in order to meet the objections of each of the parties. The four Raptors each had different financial and accounting details. The sense we draw from this is less a collaboration, but a race where Andrew Fastow and his team invented new solutions to surmount each obstacle raised by outside auditors, legal counsel, and the limited partners. Simple self dealing would not have required a fraction of the creativity shown in the creation and the maintenance of these financial structures. Even the name, "raptor", brings forth the image of a fast moving dinosaur attempting to outwit its human antagonists.

LJM2 also participated in the purchase of Enron merchant assets. Nowa Sarzyna, a power plant

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<sup>31</sup>October 26, 2000 LJM Annual Partner's Meeting, page 33.

located in Poland, was sold to LJM2 as a temporary expedient.<sup>32</sup> As with Cuiaba, the Nowa Sarzyna project could not have been analyzed by the most dedicated investor. When Enron could not find an interested buyer for the troubled project, the plant was sold to Whitewing. In the end, Enron recorded a \$16 million dollar gain for the sale. LJM2 received a 25% return on its investment and Whitewing owned a troubled asset whose value was guaranteed by Enron stockholders.

Nowa Sarzyna represents a direct example where LJM2 received an excellent return for its role in moving an Enron asset through two theoretically independent entities in order to add earnings to the Enron income statement. Since the ultimate owner of the plant was backstopped by Enron, no economic purpose other than the accounting benefits was served by Nowa Sarzyna's transit through Enron's SPEs.

### **Sherron Watkins**

In August of 2001, Vinson and Elkins, Enron outside counsel, concluded that

Based on the findings and conclusions set forth with respect to each of the four areas of primary concern discussed above, the facts disclosed through our preliminary investigation do not in our judgment warrant a further widespread investigation by independent counsel and auditors.<sup>33</sup>

The Powers Report is somewhat more positive, but hardly a ringing endorsement:

With the benefit of hindsight, and the information set out in this Report, Watkins was right about several of the important concerns she raised. On certain points, she was right about the problem, but had the underlying facts wrong. In other areas, particularly her views about the public perception of the transactions, her predictions were strikingly accurate. Overall, her letter provided a road map to a number of the troubling issues presented by the Raptors.<sup>34</sup>

The central importance of the Watkins letter was not the keen understanding she showed concerning the abuses in LJM and Whitewing, but the fact that she was not part of the team that was working on these SPEs. Watkins knowledge of the transactions gleaned from everyday access within Enron gives a strong sense that these arrangements were not secret from either senior staff or management.

The following chronology reflects Jeff Skilling's involvement with LJM as documented in the Powers Report.

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<sup>32</sup>Powers Report, page 140.

<sup>33</sup>October 15, 2001 Vinson and Elkins review of Sherron Watkins letter, page 8.

<sup>34</sup>Powers Report, page 176.

April 5, 1999	Third Amended and Restated Limited Partnership Agreement <sup>35</sup>
June 18, 1999	Fastow proposes LJM to Lay and Skilling
June 28, 1999	Skilling introduces Fastow's presentation to the Enron Board
September 23, 1999	LJM2 invests in Osprey Trust Certificates
September 30, 1999	LJM1 pays \$11.3 for a 13% interest in EPE
October 11, 1999	Finance Committee discussion of LJM2
October 13, 1999	LJM2 PPM
October 18, 1999	Fastow presentation to the Board including Lay and Skilling on LJM2
October 20, 1999	LJM2 is formed
December 14, 2000	LJM2 sells Osprey Trust Certificates to Chewco
December 15, 1999	LJM2 PPM Addendum
December 17, 1999	LJM1 repays \$64 million note plus interest
December 21, 1999	LJM2 purchases 75% of a company that owns Nowa Sarzyna
December 22, 1999	Formation of ENA CLO
December 20, 1999	Whitewing loans LJM2 \$38.5 million
December 20, 1999	LJM1 loans LJM2 \$20 million
December 22, 1999	LJM2 invests \$32.5 million in ENA CLO
December 22, 1999	LJM2 gets a line of credit of \$65,000,000 from Chase Manhattan
December 28, 1999	LJM2 invests in Bob West Treasure
December 29, 1999	LJM2 purchases 90% of MEGS
December 29, 1999	LJM2 purchases Yosemite certificates
December 30, 1999	Condor purchases Yosemite certificates
December 31, 1999	LJM2 review by Arthur Anderson
February 1, 2000	Carl Bass memo produces limiting Enron income to equity investment by LJM2
February 28, 2000	Condor loans \$35 million to LJM2
March, 2000	McMahon complaint to Skilling
March 28, 2000	Arthur Andersen review of Raptor
May 1, 2000	Raptor presentation to Board with Fastow, Skilling, and Lay in attendance
May 12, 2000	LJM2 Approval Sheet for Blue Dog <sup>36</sup>

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<sup>35</sup>Amendment to the Third Amended and Restated Limited Partnership Agreement of Ljm2 Co-investment, L.P.

<sup>36</sup>LJM2 will enter into a Letter of Agreement with General Electric Company to acquire the rights to purchase two PG7121EA Gas Turbine Generator Sets. LJM2 will appoint EECC as its Agent to negotiate the Purchase Agreement and EECC will enter an Option agreement with LJM2 to acquire LJM2's rights to purchase the two Gas Turbine Generator Sets. In consideration of LJM2's role in facilitating this transaction. EECC will pay LJM2 a non-refundable option payment of \$846,378. In consideration for EECC acting as Agent for LJM2 in negotiating this transaction. LJM2 will pay EECC a pro-rated Agency Fee of \$100,000 for each six months the Agency agreement is in effect . In the event that EECC fails to complete negotiation of the Purchase Agreement by May 31 . 2000 and the letter agreement is terminated by either party . EECC shall pay LJM2 as liquidated damages all amounts paid by LJM2 to GE under the Letter Agreement including the \$2.000.000 initial payment. EECC will also reimburse LJM2 for the amount of the Agency fee payable by LJM2 and for all transaction costs incurred by LJM2 as a result of such failure.

July 7, 2000	Option Fee - Coyote Springs
July 10, 2000	TNPC Investment
July 12, 2000	Osprey Trust investment
August 3, 2000	LJM2 additional investment in Raptor I
August 3, 2000	LJM2 \$41,000,000 from Raptor I
August 7, 2000	Skilling informs Board that Raptor II had been approved in June
September 11, 2000	LJM2 investment in Raptor IV
September 22, 2000	Additional investment in Raptor II
September 22, 2000	LJM2 receives \$41,000,000 from Raptor II
October 5, 2000	Raptor III distribution from Raptor III
October 6, 2000	Skilling present at Board meeting where additional LJM controls were discussed
October 10, 2000	LJM2 invests in OA Investments <sup>37</sup>
October 26, 2000	Skilling attends LJM Annual Partnership Meeting
November 9, 2000	Arthur Andersen analysis of Raptor III
November 11, 2000	Blue Dog option investment fee
November 17, 2000	Final payment on Whitewing loan
December 11, 2000	LJM2 investment in JGB Trust (Avici)
December 11, 2000	LJM2 investment in LAB Trust (Catalytica)
December 15, 2000	Blue Dog option exercised
December 22, 2000	Investment in Fishtail <sup>38,39</sup>

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The Purchase Agreement is substantially complete, however, and it is definitely expected that it will be executed by May 31, 2000.

EECC will have the option to acquire the turbines until November 10, 2000. It is anticipated that by that date EECC will identify a profitable power project opportunity within Enron or with a third party in which to utilize the turbines and will exercise its option to purchase the turbines from LJM2 although there is no obligation for EECC to exercise such option.

LJM Approval Sheet, page 20.

<sup>37</sup>On October 10, 2000, LJM2 invested \$6.5 million in OA Investments, a leveraged vehicle formed by DLJ that purchased \$50 million of new certificates in Osprey Trust, which is an indirect owner of approximately \$1.06 billion of Enron's merchant assets. The \$6.5 million investment will earn a current yield of 25.5%, and repayment of capital is primarily dependent on the sale of Enron stock and the sale of the assets in the merchant portfolio. In addition, Osprey equity holders are entitled to a 1.5% upside sharing in the value of the Trust. The current value of this sharing to LJM2 for this investment is \$5.0 million.

<sup>38</sup>Brenner showed Causey the LJM approval sheet for Fishtail that showed that Barry Schnapper, who reported to Fastow, negotiated the transaction on behalf of Enron. Causey said this was an interesting deal. Fishtail involved Pulp and Paper, a separate business unit. Bill Brown was a finance person who reported to Mintz. There was an understanding that a corporate finance person would help out here and there on deals. In that context, Schnapper must have helped on the Fishtail deal. Schnapper's involvement did not necessarily surprise him. The finance group worked with lots of people on lots of deals. Their involvement in the LJti4 deals did not totally contravene what Causey presented to the Committee. Causey did not go back through all of the LJM deals and review the LJM approval sheets. Mintz created the format, and Causey thought and still does think that they are a

December 28, 2000	Sale of Backbone
January 23, 2001	Raptor IV distribution of \$40.5 million
February 12, 2001	Skilling becomes CEO
March, 2001	Skilling signs Raptor IV LJM2 approval sheet
March 3, 2001	Carl Bass defence against “thing” with Enron
March 12, 2001	Sale of LAB Trust (Catalytica)
March 12, 2001	Carl Bass removed from Enron account
March 26, 2001	Raptor restructure
May 17, 2001	LJM2 sells ENA CLO
July 2001	Kopper buys Fastow’s interest in LJM2
August 14, 2001	Skilling Resigns
August 15, 2001	LJM2 sells Cuiaba
September 28, 2001	Unwind of Raptor
October 24, 2001	Fastow fired

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fair representation of what was going on . Causey did not see the involvement of the corporate finance people as a key point. The whole process involved other people and business units that did not think the corporate finance function was a key factor in making the deal work. Causey was sure that there were discussions with the Finance Committee about the supplemental controls, but he did not remember what was discussed .

March 26, 2002 Additional Interviews, page 13.

<sup>39</sup> December	\$8(3)	Investment in Fishtail	Purchase of equity in an SPE that would receive preferred economics of Enron's pulp and paper trading business
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Power’s Report, page 147.