XI. PROJECT NOLy

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Interoffice Memorandum

To: Robert J. Herman

From: Stephen H. Douglas

Department: ENA Tax

Subject: Synthetic Mark-to-Market Program (Project NOLly)

Date: August 29, 2001

Summarized below are the steps set forth on the attached diagram (the results of such steps referred to as the "Transaction") and the general tax consequences thereof. In short, the Transaction permits ENA to economically segregate the "in-the-money" portion (that is, the gain portion) of its financially settled trading contracts (i.e., futures, swaps and options) entered into in connection with its commodities trading business ("Financial Contracts") and to monitor the performance of such trading position (and, derivatively, the performance of the trading groups that effected such position). The segregation of the in-the-money portion of the Financial Contracts in the manner described will result in ENA's recognition of considerable taxable income during the 2000 tax year, which income will be offset by taxable loss in subsequent tax years upon the liquidation of the Chiricahua entities (described below). The amount of taxable income resulting from the Transaction will approximate that which would result if ENA had affirmatively elected mark-to-market treatment for tax purposes for the portion of its Financial Contracts involved in the Transaction. The Transaction will not result in negative accounting consequences for ENA because the tax gain resulting at the outset of the transaction will be offset with subsequently recognized tax losses in an equal amount (described in greater detail below).

Initially, and by way of background, ENA transacts a significant amount of physically settled commodities transactions and hedges such transactions as necessary by entering into Financial Contracts with unrelated parties based on commodities of the type traded by ENA ("3rd Party Financial Contracts"). The economic position underpinning 3rd Party Financial Contracts is, in turn, aggregated in Risk Management & Trading Corp., a wholly owned Delaware incorporated subsidiary of ENA ("RMT"), pursuant to a monthly master swap contract (the "Monthly Swap") where such positions are aggregated with similar Financial Contracts written by RMT to Enron affiliates ("Affiliate Financial Contracts"). The Monthly Swap conveys to RMT all of the economic consequences related to ENA's 3rd Party Financial Contracts with the exception of the credit risk of the ENA counterparty (that is, ENA remits to RMT that which ENA's counterparty is required to pay to ENA regardless of whether such counterparty makes payment to ENA).[1] Alternatively, RMT generally enters into Affiliate Financial Contracts directly with Enron affiliates rather than having such contracts entered into by ENA and subsequently placed in RMT (as is done with 3rd Party Financial Contracts) in order to eliminate the need to have such contracts then placed in RMT under the Monthly Swap. Ultimately, the above described arrangements result in an efficient manner to aggregate ENA's Financial Contracts for state franchise tax purposes (a topic beyond the scope of this memorandum) and permits the efficient monitoring of ENA's aggregate Financial Contract trading position (i.e., the aggregation of all Financial Contracts in a single entity permits easy calculation of a net trading position that would be much more difficult to effect were such positions entered into separately by the

[1] ENA is not required to notify its counterparties of the economic transfer of their positions to RMT because of the retention of credit risk.

many Enron affiliates). As described, however, the 3rd Party Financial Contracts and Affiliate Financial Contracts are aggregated and the performance of 3rd Party Financial Contracts is difficult to discern separately from the performance of Affiliate Financial Contracts. The Transaction is designed to segregate the performance of a portion (i.e., that portion which is in-the-money) of the 3rd Party Financial Contracts and permit easy monitoring of such position by ENA.

STEP ONE: As previously described, ENA transacts a significant volume of 3rd Party Financial Contracts each month and economically places such positions in RMT via the Monthly Swap. For tax purposes, this results in a reduction (or increase, depending on the directionality of the net trading position transferred under the Monthly Swap) of ENA's income (or loss) and an increase in RMT's loss (or income), respectively. The Monthly Swap does not, however, result in a transfer of the 3rd Party Financial Contracts to RMT for tax purposes.

STEP TWO: To segregate the in-the-money portion of the 3rd Party Financial Contracts from the broader pool of Financial Contracts held in RMT, RMT will enter into a separate Financial Contract (the "RMT Financial Contract") with Chiricahua LLC, a newly formed wholly-owned by RMT (directly and indirectly) Delaware limited liability company ("Chiricahua") characterized as a partnership for tax purposes. The RMT Financial Contract will be "off-market" (or, otherwise said, it will be in-the-money) in favor of Chiricahua because it will aggregate in Chiricahua the in-the-money portion of RMT's 3rd Party Financial Contracts. The creation of the RMT Financial Contract will be recharacterized for tax purposes as RMT entering into an at-market swap with Chiricahua (that is, a swap that is not in-the-money to Chiricahua) and a contribution to Chiricahua by RMT of an RMT debt obligation in an amount equal to the in-the-money portion of the RMT Financial Contract (such RMT debt referred to as the "Tax Loan"). Consequently, RMT will possess an interest in Chiricahua with no tax basis (by application of the rule that a partner does not receive tax basis for the contribution of a note to a partnership until such time as payments are made on the note) and will otherwise be obligated to contribute an amount to Chiricahua equal to the balance of the Tax Loan. RMT will acquire basis in its interest in Chiricahua as payments on the Tax Loan are made (or deemed made, as the case may be).

STEP THREE: Finally, to facilitate monitoring the performance of the RMT Financial Contract (and, derivatively, the in-the-money portion of the 3rd Party Financial Contracts), RMT will enter into a total return swap (the "TRS") with Tularosa LLC, a newly formed wholly-owned by ENA (directly and indirectly) Delaware limited liability company ("Tularosa") characterized as a partnership for tax purposes, whereby Tularosa will pay (at a mutually agreed upon time) RMT the in-the-money amount inherent in the RMT Financial Contract on the day it is entered into and in return for which RMT will pay (upon conclusion of the TRS) Tularosa the total return associated with its interest in RMT Newco. The TRS is net settled by RMT and Tularosa on the settlement date of the TRS. In this manner, ENA will be able to monitor the performance of the in-the-money portion of its 3rd Party Financial Contracts since such performance will be reflected in the amount of net payment ultimately paid (if the performance is negative) or received (if such performance is positive) by ENA (through Tularosa) in settlement of the TRS. As a consequence of RMT entering into the TRS, RMT will recognize for tax purposes the entire in-the-money amount of the RMT Financial Contract and will acquire tax basis in its interest in Chiricahua in such amount. Finally, as RMT settles its position with Chiricahua under the RMT Financial Contract, RMT will be treated as making payments on the Tax Loan and will acquire additional tax basis in its Chiricahua interest (essentially, assuming that the RMT Financial Contract ultimately settles for an amount equal to the in-the-money portion of such contract on the day such contract is written, RMT will possess tax basis in its Chiricahua interest that is approximately twice the amount of gain recognized upon RMT entering into the TRS). As discussed in greater detail in Step Four, upon liquidation of Chiricahua by RMT, RMT will recognize a tax loss

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equal to the amount by which its tax basis in Chiricahua exceeds the payments made by RMT on the Tax Loan (in essence, RMT will recognize a tax loss equal to the amount of gain recognized upon entering into the TRS).

STEP FOUR: The liquidation of Chiricahua, as described in Step Three, will, without more, result in the recognition of a tax loss by RMT equal to the positive difference between the tax basis that RMT possesses in its Chiricahua interest and the amount of money received from Chiricahua by RMT upon such liquidation. The amount of such recognized loss will equal the amount of income recognized in Step Three upon execution of the TRS. This results under the general rule that a partner only recognizes tax loss upon the liquidation of a partnership in the event that such partner only receives money, certain accounts receivables or inventory (which property is hereby referred to as "qualified property") upon liquidation and the value of qualified property received is less than such partner's tax basis in its partnership interest. Alternatively, if property other than qualified property ("nonqualified property") is distributed in liquidation of a partnership, tax loss is preserved in the distributed nonqualified property by allocating tax basis not otherwise allocable to qualified property to the distributed nonqualified property despite the tax basis allocated to nonqualified property exceeding such property's fair market value. In the instant case, Chiricahua's sole asset will, without more, consist of money received from settlements under the RMT Financial Contract. In turn, RMT will possess tax basis in its Chiricahua interest equal to the amount recognized as a result of the TRS (described in Step Three) plus settlement amounts paid under the RMT Financial Contract during the term of such contract (such settlement amounts increasing RMT's basis in Chiricahua because they are viewed as payments on the Tax Loan by RMT to Chiricahua). RMT will thus possess a tax basis in Chiricahua that exceeds the amount of cash received by Chiricahua upon settlement under the RMT Financial Contract (which cash will constitute, without more, Chiricahua's sole asset upon liquidation) equal to the amount of income recognized upon execution of the TRS. Accordingly, liquidation of Chiricahua by RMT will result in the recognition of a tax loss by RMT equal to the amount of income recognized upon execution of the TRS since RMT will receive money from Chiricahua that is less than RMT's tax basis in Chiricahua in an amount equal to the income recognized by RMT upon execution of the TRS. Finally, without more, the loss resulting from liquidation of RMT Newco in this fashion will constitute capital loss. Alternatively, however, in the event that Chiricahua distributes nonqualified property in liquidation, such property would be allocated tax basis in accordance with the fair market value of all such distributed nonqualified property in an amount equal to the difference between RMT's tax basis in Chiricahua and the value of qualified property received (i.e., an amount equal to the income recognized upon execution of the TRS). In this manner, the tax loss otherwise recognized by RMT upon liquidation of Chiricahua would be preserved in the nonqualified property distributed upon liquidation. In turn, upon disposition of the nonqualified property by RMT, RMT would recognize a tax loss equal to the amount received from such disposition and the tax basis of such property, the character of which loss would be determined by the character of the nonqualified property disposed of in the hands of RMT (i.e., ordinary if such property were ordinary to RMT).