A.M. Tiller
10/28/99

Yosemite Financing
Confidential

1.) Two overall characterizations currently under consideration.
   a.) "Option #1." Each owner of a certificate of beneficial interest in the trust, treated as a partnership interest, is treated as owning directly its proportionate share of the assets of the trust and and having written its proportionate share of the default swap. The owners of the Certificates are Enron and the U.S. branch of a foreign bank. (Another alternative (referred to as Option #2) would have recognized Citibank as a partner as well, but Citibank is unwilling to report its participation in the transaction for any purpose, including tax, as anything other than as a swap counterparty.) As discussed below, Option #1 currently looks like the more likely characterization, but this characterization has the potential for creating [timing and/or character] mismatches.
   b.) "Option #4." The collateral asset and the default swap would be collapsed together and treated as though the trust held the debt of Enron. The Danielson language that would be necessary to treat the transaction contrary to its form has caused the accountants some discomfort and it is currently not clear that AA would agree. Based on research regarding the availability of the portfolio interest exemption (or the lack thereof), it appears that this option may not be the preferred approach. (Another alternative, referred to as Option #3, would have treated the trust as holding the debt of Citibank, but Citibank would not accept such a characterization and this characterization could potentially cause the debt to be treated as a contingent payment debt obligation.)

2.) Yosemite's characterization as a partnership and the accompanying tax consequences. Milbank is issuing a "will" level opinion in the Offering Memorandum for the Yosemite Notes, that
   a. The Notes will be treated as debt for U.S. federal income tax purposes, and
   b. The Trust will not be treated as a corporation or as a publicly traded partnership taxable as a corporation.

3.) Potential for OID on the Linked Enron Obligations ("LEOs") through an allocation of basis to the credit default swap.
   a. General rule for "investment units." If a debt obligation is issued to noteholders along with a separate property right, the combination of rights can be treated as an "investment unit" that has the potential for giving rise to original issue discount ("OID").

EC 000850764

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b. The portion of the purchase price paid by the holder which represents the FMV of the separate right must be allocated to the right, and the result of that allocation will cause the issue price of the debt obligation to be less than the price at which the debt was actually sold. Reg. section 1.1273-2(h).

c. Example: The Exchangeable Notes or ACES issued by Enron in 1995 were issued as an investment unit consisting of a debt obligation and a forward purchase contract although in the case of the ACES, the full purchase price of the notes was allocated to the debt obligation since the stated interest on the notes (6.25%) represented a yield higher than Enron's Mid-Term Borrowing Rate at the time of 5.90% thus indicating that the notes' full purchase price was attributable to the debt obligation.

d. In this case, the LEOs issued by the Yosemite Trust don't provide the noteholders with any separate property rights. Under the Indenture Agreement, the Noteholders acknowledge that Citibank is the Directing Party with respect to the Collateral for the notes under Collateral Security Agreement and the Indenture Trustee doesn't even have the right to elect to become the Directing Party with respect to an Enron Investment unless and until (1) an Indenture Event of Default has occurred, and (2) with the approval of 100% of the Noteholders of the related Series at which time the Citibank Swap immediately terminates. As a result, it doesn't appear appropriate to characterize the LEO's as being anything other than a debt instrument as opposed to an investment unit.

4.) Characterization and treatment of the credit default swap and the Enron-Citibank makewhole agreement. The swap between Yosemite and Citibank is probably best viewed as actually being two swaps: a cash flow swap and a credit default swap [although ... discuss the potential for the credit default swap to be better characterized as an option].

a.) A cash flow swap under which the Trust exchanges with Citibank the variable actual periodic receipts or yield it receives on the Enron and AAA Investments it holds and, in return, Citibank exchanges with the Trust the variable weighted average yield payable on the Notes and Certificates adjusted for .

1.) This cash flow swap doesn't qualify as a notional principal contract because not based on objective financial information. Reg. section 1.446-3(c).

2.) Query whether Enron's make-whole can be integrated with Yosemite's obligation under this cash-flow swap as a guarantee? If so, would we want to include a Danielson statement in the Enron Agreement to this effect?

5.) Citibank Swap.

a.) Tax uncertainty. In a 1997 article in The Tax Lawyer, Milbank Tweed partner, Bruce Kayle (who just happens to also be tax counsel for Citibank in this transaction) describes in some detail the uncertain tax treatment of a variety of transactions which Bruce describes generically as credit derivatives. 50 The Tax Lawyer. Will the Real Lender Please Stand Up? The Federal Income Tax

EC 000850765

Treatment of Credit Derivative Transactions, 569-615 (Spring 1997). It is Bruce's premise that the tax uncertainly for these transactions doesn't pose a substantial risk for market participants who are banks or dealers but that these tax risks should be a serious consideration for other market participants.

b.) Three characterizations. Bruce's article indicates that the Citibank swap which is nominally documented as a swap (with an ISDA Master, a Schedule, and Confirmation) could actually be treated as one of three things for tax purposes, a credit default swap, an option, or a guarantee, each with distinct tax consequences.

c.) Characterization as a credit default swap.

1.) Notional principal contract. Although a credit default swap could generally be expected to qualify as a notional principal contract ("NPC"), this swap would not so qualify because it is not based on objective financial information. Because of the absence of guidance for swaps that don't qualify as NPCs, this discussion continues to focus on the factors, pro and con, for NPC treatment.

A.) Enron is expected to pay Citi's fee over the term of the swap at an annualized rate of 12.5 basis points per year for a total annual fee of $10M. Multiple payments support support swap treatment at least at a cosmetic level.

B.) There are technical questions about whether payments under a credit default swap really fit the definition of an NPC as set out in Reg. section 1.446-3(c).

C.) Bruce asks if a swap has provisions that make it sufficiently close to other arrangements such as an option or a guarantee, whether it should be allowed to be treated as an NPC to the extent that there are substantively different tax results to the counterparties.

2.) Timing. The discussion below is based on the premise that the credit default swap were treated as an NPC which it is not.

A. If Citibank's payment [in the event of a Enron Investment default] were characterized as a periodic payment, Citi would have a deduction and Yosemite would have income in the period in which the payment was made.

B. If Citibank's payment were treated as a non-periodic payment, the timing would probably be the same. Non-periodic payments are supposed to be spread out and taken into account over the periods to which they relate. Where a default is not imminent or threatened, Bruce concludes that an effort to quantify and allocate the Yosemite entity's payment would be an arbitrary exercise and recognition of this fact would cause one to conclude that the period the payment is made is the period to which it relates.

C. If Citibank chooses cash settlement, Yosemite would have to sell the underlying obligation and recognize the corresponding loss to avoid accelerating income.

EC 000850766

D. If Citibank chooses physical settlement, Yosemite should recognize the loss on the receipt of the substituted investment.

E. If Yosemite sold an Enron Investment prior to default and if the reference obligation were actively traded personal property, the loss on the Enron Investment could be deferred under the straddle rules. As a result, we should guard against Enron Investments that would qualify as actively traded personal property or ensure that they are not sold by Yosemite.

3.) Character.

A. Since the Trust can be expected to recognize a capital loss on the default of the Enron Investment, Yosemite will want to say that Section 1234A applies to make Citi's payment under the swap capital in character.

1.) The NPCs rules that are believed to accord ordinary character to periodic payments generally are inapplicable here.

2.) There is a concern about finding a satisfactory distinction for purposes of saying that a Citi payment under the swap is capital, but Enron's payment of Citi's fee is ordinary.

3.) Exposure. The biggest risk of this characterization appears to be the potential for the payment of Citi's fee to be treated as capital rather than ordinary. [If Yosemite is treated as having made this payment, capital losses will be allocated to the Certificateholders over the term of the deal that will not offset the ordinary certificate yield allocated to them. As a result, they will recognize capital gain on the conclusion of the transaction when their interests in Yosemite are redeemed.] Although there are also concerns about timing as well since the swap won't qualify as an NPC, it would seem the Service would have more difficulty making the case that another timing methodology would be more appropriate.

c.) Characterization as an option. Bruce's article notes that the absence of multiple payments being required of either party under a swap might put NPC characterization in jeopardy and justify a position that the contract is better characterized as an option. Bruce notes, however, that there is no reason why an option could not call for its premium to be paid in installments.

1.) Bruce observes that there is suprisingly little guidance regarding the essential elements that cause an economic relationship to be treated as an option for tax purposes.

2.) Timing. Yosemite's would neither deduct or amortize the payments to Citibank of its fee. Instead, Yosemite would offset these payments against any payment it actually received from Citibank under the credit default swap or it would recognize a loss

EC 000850767

at the expiration of the swap if Citibank were never required to make a payment.

3.) Character.

A.) Since the underlying obligation is a capital assets to Yosemite, Yosemite would have a capital loss equal to the aggregate payments it makes to Citi if the swap expires without any default. Section 1234.

B.) Citi's payment to Yosemite should be capital under Section 1234A.

4.) Exposure. As in the case of characterization of the swap as an NPC, it appears that the biggest risk is treatment of Yosemite's payment of Citi's fee as capital.

d.) Characterization as a guarantee.

1.) Bruce observes that just as there is no real guidance about what are the fundamental elements of an option for tax purposes, there is no real guidance about the fundamental elements of a guarantee.

A.) First fundamental element - is the requirement of a payment on the nonperformance by the primary obligor which is present in the credit default swap.

B.) A second fundamental element is that the payment by the "guarantor" must bear some relationship to the nonperformance by the primary obligor.

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5.)Characterization of the Make-Whole Agreement and "Magic Note."

a.) The "Magic Note" or other contractual agreement that is intended to make the Yosemite trust whole for any differential between the amount received by the Trust and ded to serve the function previously served by the Periodic Payments under the latest draft of the Enron Agreement or make-whole agreement. In other words, if the Scheduled Interest Receipts received by the Trust and transferred to Citi under the Citibank Swap are insufficient to pay interest on the Yosemite Notes and yield on the Certificates (Citi's obligation under the Citibank Swap), then Enron makes up the difference. Mark Spradling says that the Magic Note will have a $25M principal amount and a maturity date of four days prior to the maturity of the Notes [open issue – which tranche or will there be a separate Magic Note for each tranche?]

b.) The Enron Magic Note resembles a

EC 000850768

6.) Withholding on payments from Yosemite to U.S. branch of foreign bank.

a.) Any payments by Yosemite to the U.S. branch of a foreign bank will be subject to withholding.

1.) Non-ECI. If Yosemite income is non-effectively connected FDAP income or other income subject to withholding that is included in the foreign partner's distributive share of partnership income, the payments will be subject to withholding under Section 1442.

2.) ECI. Alternatively, if Yosemite income is effectively connected to a U.S. trade or business, any income allocable to the U.S. branch of the foreign bank will be subject to withholding under Section 1446. Withholding under either provision applies regardless of whether the distributive share of the foreign partner's income is actually distributed or not.

b.) Withholding on Non-ECI. With respect to the timing of withholding on non-ECI, Rev. Rul. 89-17, 1989-1 C.B. 289 provides that since a partner's undistributed distributive share of partnership FDAP income is deemed distributed on the last day of the partnership's taxable year, a partnership must withhold and pay the tax by the date on which the Schedule K or K-1 is sent to the foreign partners.

c.) Withholding on ECI. Yosemite must withhold at a rate of 35% in the case of its corporate partner, the foreign bank. The tax must be paid in quarterly estimated tax payments based on a computation of the foreign partner's allocable share of ECI and reported on Form 8813, Partnership Withholding Tax Payments (Section 1446). In addition, Yosemite must file an annual return on Form 8804, Annual Return for Partnership Withholding Tax (Section 1446) and a copy of Form 8805, Foreign Partner's Information Statement of Section 1446 Withholding, must be attached to the Form 8804 and also supplied to the foreign bank. The amount of the withholding tax paid by Yosemite on behalf of the foreign bank is allowed as a credit to the bank toward its U.S. income tax liability. In order to claim the credit, the bank must attach the Form 8805 furnished by Yosemite to its U.S. income tax return.

d.) Indemnities for timing mismatches. Counsel for Citibank implied that he thought at least some of Yosemite's income would be ECI and that a timing mismatch could occur between the quarterly estimated tax withholding dates and the date on which the bank would otherwise owe the tax, thus presumably justifying an indemnity for this timing difference. [Does this make sense? If the foreign bank is already a U.S. taxpayer (and presumably it will be), it will be obligated to make estimated tax payments anyway. Why should an estimated tax payment be a justification for an indemnity based on timing?]

e.) Potential for Yosemite to Generate ECI. [Open]

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EC 000850769

6.) The tax treatment of Delta and Enron North America ("ENA") under the lower-tier swaps.

a.) Delta's treatment under its two swaps with ENA and Citibank.

1.) The notional principal contract ("NPC") periodic payments received by Delta from Citibank and paid by Delta to ENA based on the spot price of oil should offset one another or wash. It is generally understood that such periodic payments are ordinary in character.

2.) Delta's receipt of 8% quarterly [interest] payment annually should constitute ordinary income to Delta. This income should be offset by a similarly sized will be offset with a deduction for "interest" paid on the Delta Notes, but the Cayman Islands doesn't assess any tax on income anyway.

3.) Receives $800M at 10/2006.

4.) Embedded option contracts

A.) If both option contracts are treated as embedded, the prepaid premiums paid for each will be amortized using the "level payment mehtod" of Reg. section 1.446-3(f)(2)(iii)(A). Reg. section 1.446-3(f)(2)(v)(A).

B.) If the the option contract Delta sells is treated as embedded but the option contract it purchases is treated as a separate contract ... [plus describe basis for such a position...]

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b.) ENA's treatment under its two swaps with Delta and Citibank.

1.) Offsetting floating rate periodic payments

2.) Payment of 8% periodic payments annually.

3.) Receipt of $800M in prepaid amount either recognized in income over the life of the contract under Reg. section 1.446-3(f) OR entirely treated as receipt of a loan under Reg. section 1.446-3(g).

4.) Repayment of $800M at 10/2006 treated as a deduction.

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7.) Whether Delta is a CFC and the tax effects of such a characterization

a. Initially, Delta is deemed to be owned 50/50 by U.S. (Enron) and foreign entities (U.S. branch of a foreign bank) after applying the constructive ownership rules of Section 318(a)(2)(A) which look through Yosemite to its partners for purposes of applying the stock ownership rules of Section 957. Enron and the U.S. branch are expected to each contribute 50% ($37.5 M of the total capitalization of the trust). With this equilibrium, Delta might not be a CFC. If, however, Enron pays the various fees and expenses associated with the transaction (which is expected), Enron will probably be deemed to make a partnership contribution for those amounts and, as a result, Delta could potentially become a CFC EXCEPT for the fact that Enron should not be a

EC 000850770

U.S. shareholder because the Delta Notes are intended to be non-voting. Section 951(b).

b. If Delta is or were to become a CFC AND if the Delta Notes were treated as voting stock,
   1.) Delta's income from the notional principal contracts to which it is a counterparty would constitute foreign personal holding company income under Section 954(c)(1)(F), and
   2.) The stock of Delta is used as security for the and thus would constitute a pledge for the obligation of a U.S. person for purposes of Section 956(d) and Reg. section 1.956-2(c).

c. The business team has confirmed that the Delta Notes are intended to be non-voting.

8.) Whether Delta is a PFIC and the tax effects of such a characterization.

a.) Delta can be expected to meet either or both of the income and asset tests for qualification as a passive foreign investment company or "PFIC" since all of its assets and income, at least initially, are expected to be foreign personal holding company income under Section 956(c)(1)(F).

b.) For purposes of determining if the stock of a PFIC is owned by a U.S. person, the attribution rules of Section 1298(a)(3) provide that stock owned directly or indirectly by a partnership is treated as owned by its partners. As a result, Enron will be a U.S. person with respect to Delta. Although one would think a similar look-through concept would apply to the foreign bank which holds its interest through a U.S. branch, Section 1298(a)(1)(B) indicates otherwise since it appears that one is expected to stop the attribution process once one reaches a U.S. person (except to the extent otherwise provided in regulations of which there currently appear to be none).

c.) [Discuss need to make a QEF election ...]

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9.) Withholding on payments from ENA (a U.S. entity) to Delta (a foreign entity). *See separate memorandum by Brent Vasconcellos dated 10/27/99.*

10.) The overall effect of the Citibank/foreign bank total return swap on the characterization of the transaction.

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11.) Tax treatment and structuring of transaction fees and expenses

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12.) Texas franchise tax

a.) Per discussion with V&E partner, Jim Penny, on 10/27/99, the Texas Comptroller has issued a ruling stating that derivative financial products,

EC 000850771

regardless of the index on which they are based, are treated as intangibles. As such, the payments exchanged under such contracts should be sourced under the location of the payor rule.

1. Corporations and LLCs. For corporations and LLC payors, their location for purposes of this rule is determined by the state of their formation.
2. National banks. For a national bank like Citibank, N.A., its location for purposes of this rule is determined by the location of its principal office (which in this case is probably New York).
3. Trusts. For a trust like Yosemite, its location for purposes of this rule is determined by its principal place of business. In this case, we will want to take the appropriate steps to ensure that Yosemite's principal place of business is in Delaware by, for example, having Wilmington Trust Company handle its day-to-day operations and the hiring the services of a non-Texas office of a public accounting firm to handle the preparation of the Yosemite's tax return and other tax filings as well as any required financial reports.

b.) Trusts are non-taxable entities for Texas franchise tax purposes.

1. Grantor trusts. Jim indicates that the Comptroller is somewhat perplexed about how to treat grantor trusts, but we had already concluded that we probably couldn't treat Yosemite as a grantor trust anyway.
2. Qualification as a foreign LLC. Jim Penny said that he understands that Texas does not provide limitation of liability protection to foreign trusts like Yosemite and so people will sometimes qualify a foreign trust as a foreign LLC to provide it with that protection. The quid pro quo is that LLC status makes the entity a taxable entity for Texas franchise tax purposes and requires the filing of a Texas franchise tax report.

c.) Based on the formalistic approach adopted by the Comptroller in analyzing transactions, Jim indicated that even if we adopted a substance-over-form analysis for federal tax purposes (i.e., collapsing the structure and taking the position that Yosemite holds the debt of Enron), he thought there was a good chance that the Comptroller would still treat the various swaps as swaps and apply the beneficial location of the payor rule. Although we did not discuss the issue with Jim, a characterization of what Yosemite holds as debt of Enron would seem to still allow the application of the location of the payor rule for the sourcing of interest payments as well.

Yosemite Financing Structure
Open Questions

* Financing Amounts
  - Economics of deal presumably require the amounts raised from sale of Notes and Certificates to all be invested in the Delta Notes and become a part of the notional on the underlying prepaid swaps
  - What is the size of the Yosemite Notes offering – the latest OM still contained blanks?
  - What is the size of the certificates offering – is it still an Enron/non-Enron split of 49%/50%, at least before the payment of expenses?

- Delta Energy Corp.
  - Who holds the beneficial interest in the Cayman Islands charitable trust that apparently holds the only equity in Delta?
  - Has Delta been checked open or closed?
  - Will AA get its representation and warranty that Delta holds "other assets" or will Delta require additional equity to avoid SPV status for accounting purposes?
- Enron Agreement
  - Do we have a more recent iteration than the version dated 9/15/99?

- Citibank Swap
  - Confirm that it is intended that Citibank receive periodic payments for its role as counterparty under this swap.
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