VII. PROJECT CONDOR

AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

ARTHUR ANDERSEN

NOTE – IT IS UNCLEAR WHY CHASE RECEIVED THIS LETTER OR WHY THEY SENT IT TO ENRON

Arthur Andersen LLP

1345 Avenue of the Americas
New York NY 10105-0032
Writer's Direct Dial
(212) 708-4930

September 29, 1999

Chase Securities Inc.
270 Park Avenue
New York, NY 10017

Dear Sir or Madam:

We have been engaged to report on the appropriate application of United States generally accepted accounting principles (US GAAP) to the hypothetical transaction described below. This report is being issued to Chase Securities Inc. for assistance in evaluating accounting principles for the described hypothetical transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Hypothetical Transaction:

1. Sponsor, a U.S. corporation has two wholly owned domestic corporate subsidiaries ("Sponsor Sub 1" and "Sponsor Sub 2"). Sponsor Sub 1, Sponsor Sub 2, and an unrelated third party investor (the "Investor") will form a partnership (the "Partnership"). The Partnership will be organized as a limited partnership under the Delaware Revised Uniform Limited Partnership Act.[1] Sponsor Sub 1 will be its general partner. Sponsor Sub 2 and the Investor will be its limited partners.

2. Sponsor Sub 1 will purchase $500 million of Sponsor common stock (the "Sponsor Common Stock") in the marketplace. Sponsor Sub 1 will contribute the Sponsor Common Stock to the Partnership in exchange for 97.0 percent of the Partnership's common interests (in the form of GP and LP units). Common Interests for purposes of this memo is defined as a partner's entitlement to profits or losses after the preferred return has been allocated. Sponsor Sub 2 will contribute intangibles (the "Property") with a tax basis of -0- and a fair market value of $500 million in exchange for 1.5 percent of the common LP units and a preferred LP interest that entitles Sponsor Sub 2 to an 8 percent preferred return on $500 million of its contribution. As the common interest holders, Sponsor Sub 1 and Sponsor Sub 2 (and

[1] It should also be possible for the Partnership to be organized as a limited liability company.

EC2 000037515

Investor) will, for US Federal Income Tax (FIT) purposes, be allocated all remaining profits and losses (including book gains and losses that may arise upon a distribution or revaluation of Partnership property), after allocation of the preferred returns, pro rata in accordance with their common interest holdings.

3. The Investor will contribute $500 million in cash in exchange for 1.5 percent of the common LP interests and a preferred LP interest that entitles the Investor to an 8 percent preferred return on its contribution. The Partnership will be permitted to invest the $500 million in cash contributed to it by the Investor in certain permitted investments. Furthermore, the Partnership will lease the contributed Property to the Sponsor or a Sponsor affiliate for a period of years.

4. The following sets forth the FIT assumptions and analysis:

   a. The Property contributed by Sponsor Sub 2 would be amortizable over 15-years if newly purchased by the Partnership.

   b. The Partnership will adopt the remedial method under Treas. Reg. § 1.704-3.

   c. The taxable income allocated to Sponsor Sub 2 should exceed the Section 704(b) book income allocated to such Partner by the amount of section 704(b) book amortization with respect to the contributed Property.

   d. Assuming Sponsor Sub 2 receives a cash distribution annually equal to its preferred return, it's tax basis in its Partnership interest should increase each year by the excess of taxable income over section 704(b) book income allocated to such partner.

   e. If Sponsor Sub 2 were to receive a distribution of the Property in liquidation of its interest in the Partnership, it should take a basis equal to its then existing outside tax basis in its Partnership interest.

   f. Sponsor Sub 1 should be able to receive a liquidating distribution of the Sponsor Common Stock without recognizing gain for FIT purposes. Sponsor Sub 1 should take a substituted basis in such property it receives from the Partnership in liquidation of its interest.

   g. With respect to the property which Sponsor Sub 1 receives in liquidation of its interest, Sponsor Sub 1 should be able to undertake steps to permanently eliminate any deferred FIT gain inherent in such property.

h. For purposes of this memorandum we will assume the investor will receive upon retirement from the Partnership an amount equal to its original contribution in cash. As such it can be assumed that the tax consequences to the investor associated with its residual share of income are deminimus.

Accounting Discussion:

You have asked us to address the accounting for this transaction under US GAAP in the consolidated financial statements of Sponsor. We have not been asked to address and, accordingly have not addressed, the treatment of this transaction for FIT purposes, regulatory purposes or any purposes other than treatment under US GAAP and all references to the treatment for FIT purposes are based on your analysis as described above. Accordingly, we express no opinion on the FIT consequences the transaction.

Accounting for Sponsor Sub 1, Sponsor Sub 2, and the Partnership

The rules for consolidation of subsidiaries are set forth in Accounting Research Bulletin No. 51 (ARB 51), Opinion No. 18 of the Accounting Principles Board (APB 18) and Statement No. 94 of the Financial Accounting Standards Board (SFAS 94). These rules specify that a company should generally consolidate the accounts of an investee when it has a controlling financial interest in the investee. The usual condition for a controlling financial interest is ownership of a majority voting interest. An interpretation issued by the American Institute of Certified Public Accountants generally extends the conclusions of APB 18 to partnerships. Accordingly, Sponsor would consolidate Sponsor Sub 1, Sponsor Sub 2 and the Partnership (which it controls as general partner).

Under US GAAP, the non-affiliate equity holders of a consolidated investee are treated as minority interests in the consolidated financial statements. Hence, Investor's investment in Partnership would be reflected as a minority interest in Sponsor's consolidated financial statements.

The Financial Accounting Standards Board (FASB) has issued an Exposure Draft (the ED) that would significantly revise the accounting rules for consolidated financial statements. As presently proposed, we do not believe that the ED would change our conclusions regarding the consolidation of Sponsor Sub 1, Sponsor Sub 2 or of Partnership by Sponsor.

Accordingly, all transactions among Sponsor, Sponsor Sub 1, Sponsor Sub 2 and the Partnership would eliminate in consolidation.

Purchase of the Sponsor Shares in the Market

Since Sponsor Sub 1 is a wholly-owned subsidiary of Sponsor, its purchase of the Sponsor common shares in the market place will be recorded as a purchase of treasury shares in Sponsor's consolidated financial statements (i.e. will reduce consolidated equity). The transfer of these shares to Partnership will not change this accounting since Partnership is also a consolidated entity.

Business combinations that meet all of the criteria to be accounted for using the pooling-of-interests method in accordance with APB 16 must use this method. Otherwise, APB 16 requires the use of the purchase method. Among the criteria for a pooling, are i) there must be no alterations of the equity interests of the combining companies in contemplation of the business combination and ii) the combining companies may not have aggregate tainted treasury stock, as defined, in excess of 10% of the shares being issued to effect the business combination. With certain exceptions, treasury stock that is purchased within two years preceding the date a plan of combination that is to be accounted for as a pooling is initiated, is considered to be so called "tainted treasury stock" for purposes of applying this rule (Paragraph 47d of APB 16). The shares being purchased by Sponsor Sub 1 would likely be tainted treasury shares for these purposes.

To the extent that treasury shares reacquired within two years prior to initiation or between initiation and consummation of a pooling transaction have not been reissued or specifically reserved, an equivalent number of shares of treasury stock may be sold prior to consummation to an independent party to "cure" the presumed violation of paragraph 47d. The SEC staff agrees that so long as the treasury shares were acquired for a business purpose other than to circumvent a pooling-of-interests criterion, issuance of shares to cure the taint may occur at any time prior to consummation. Although the issuance of shares is a change in equity interest, the reissuance of the shares in the market is not a transaction that is preferential to any one shareholder group. Therefore, the taint may be cured by issuing the shares for fair value to an independent third party (assuming fair value can be established) or into the market at any time prior to consummation without violating the pooling-of-interests requirements.

The FASB has issued an exposure draft that comprehensively reconsiders the accounting standards for business combinations. This exposure draft proposes to eliminate the pooling of interests method and thus the concept of tainted treasury shares. The proposed exposure draft would be effective for transactions initiated after the issuance of a final statement (the effective date is anticipated to approximate January 1, 2001 for calendar companies). There is no way to predict whether or when this exposure draft will be adopted or what changes, if any, may be made to its provisions.

Investment by Investor

Investor's cash contribution would be recorded as a minority interest in Sponsor's consolidated financial statements. Investor would be allocated its 8% preferred dividend plus 1.5% of Partnership's net income after all preferred returns (including the preferred return to Sponsor Sub 2). These amounts would be charged against Sponsor's consolidated income statement as minority interest in earnings.

Accounting For Income Taxes

Accounting for income taxes is governed by SFAS No. 109. That Statement provides that, among other things, assets and liabilities which are recorded at different amounts for financial reporting purposes than for income tax purposes create basis differences for which a deferred tax asset or liability might be required. You have informed us that, in the transaction discussed herein, Sponsor Sub 2's tax basis in its preferred LP units will increase each year by approximately $33 until such time as Sponsor Sub 2 has a $500 basis in its preferred LP units, while Sponsor Sub 1's tax basis in its common Partnership units decreases from $500 to $0 over the life of the transaction. The resultant current tax charge and tax benefits will approximately offset in Sponsor's FIT return. Further, you have informed us that the Property can either be distributed in year 15 with its tax basis stepped up to $500 or can be distributed in any given year and be stepped up approximately by an amount equal to the product of (i) $33 and (ii) the number of tax years which have elapsed since the formation of the Partnership. Furthermore, you have informed us that the Sponsor common stock can be withdrawn from the Partnership and retired without ever resulting in a taxable gain.

SFAS No. 109 provides that deferred taxes be provided only for basis differences which qualify as temporary differences, meaning those differences between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the book carrying value of the asset or liability is recovered or settled, respectively. Further, deferred tax assets or liabilities are recorded only by the specific entity on whose books such differences reside. In other words, since the Partnership is a true tax "flow through" entity (i.e., not a taxpayer), no deferred tax asset would be provided on the books of the Partnership itself.

As the FIT dynamics of this transaction create tax basis each year available to Sponsor's consolidated group through the increase in the tax basis of Sponsor Sub 2's preferred LP units,

without such an increase for financial reporting purposes, the tax effect of the increase in basis each year would be recorded as an asset (or as a decrease to net deferred tax liability) each year with a corresponding credit to income tax expense in Sponsor's consolidated financial statements (subject to a net realization test if there is a net deferred tax asset). Further, you have informed us that Sponsor has available to it a planning strategy which, without the incurring of substantial cost, would enable it to transfer the common shares to Sponsor and retire them without incurring a tax cost. Accordingly, the decline in the tax basis of the Sponsor Sub 1's Partnership interests each year does not result in a temporary difference that would require a charge to tax expense.

Other

In situations such as these, in which the ultimate realization of the economic and financial statement benefits is dependent upon certain positions that will be taken on current and future tax returns, we believe that the financial statement benefits should be recorded only if it is probable that the pertinent tax positions will be sustained. The term "probable" is discussed in SFAS 5, *Accounting for Contingencies*, but is not numerically defined therein or elsewhere in the authoritative accounting literature. It is clear that it requires a higher degree of likelihood than the "more likely than not" standard discussed in SFAS 109 (which represents a threshold of more than 50%).

The ultimate responsibility for the decision on the appropriate application of generally accepted accounting principles for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of generally accepted accounting principles for the described hypothetical transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change. We have not been asked to address and have not addressed any tax matters relating to this transaction.

Our opinion is as of the date of this letter and we do not assume an obligation to update this opinion for subsequent changes in relevant rules or practice.

Very truly yours,

Arthur Andersen LLP

EC2 000037520

DISCUSSION MATERIAL FOR

Project Condor

April, 1999

EC2 000037482

Table of Contents

	Section
EXECUTIVE SUMMARY	I.
TRANSACTION STRUCTURE	II.
SUMMARY OF FINANCIAL IMPACTS	III.
OVERVIEW OF FINANCIAL ACCOUNTING RULES	IV.
RISKS OF THE TRANSACTION	V.

I. Executive Summary

- Transaction's purpose or goal. The transaction involves the utilization of an already existing financing structure (Project Nighthawk) into which Enron will transfer certain assets in order to free up balance sheet capacity at the Enron Corp. level (Project Daybreak). The transaction contemplates a basis step-up in fully-depreciated operating assets with a FMV of approximately $1B that are already owned by Enron back up to their FMV and the recognition of approximately $370MM in after-tax income as a result of recording a deferred tax asset for the tax benefit created by the basis step-up. In addition, it is anticipated that Enron may save as much as $5MM annually by changing or eliminating the derivatives in the current financing structure.

- The transaction will create deductions of approximately $370MM in years 2015-2032. After allowance for fees and expenses, the Transaction will generate cash flow benefits with a net present value at 7% of $72MM after-tax and a net present value at 10% of $38MM after-tax.

- Initial asset contribution. The transaction anticipates that an Enron affiliate included in Enron Corp's consolidated return would contribute fully depreciated assets (i.e., built-in gain property) with a value of approximately $1.0B to a Delaware LLC treated as a partnership for tax purposes called Whitewing Associates, LLC in exchange for a general partnership interest (calling for preferential distributions) without recognizing either taxable gain or loss. At the time of the transaction, it is anticipated that sufficient changes will have been made to the management or control of Whitewing that the entity will be treated as deconsolidated for financial accounting purposes.

- Assets leased back to Enron Affiliate. The assets contributed by Enron affiliate to Whitewing would be leased back to Enron affiliate by Whitewing.

  Partnership allocation rules. Since the newly contributed assets' book basis will differ from their tax basis, the partnership tax rules operate so as to (1) allocate the tax consequences of built-in gain property to the partner contributing the property as opposed to having those consequences shifted to another partner, and (2) eliminate those book-tax disparities over time.

B-278

EC2 000037484

I. Executive Summary

- Remedial allocation method. In this case, the partnership makes remedial and offsetting allocations of income, gain, loss, or deduction to the contributing and noncontributing partners' adjusted tax basis in their partnership interests (and not to the partners' book capital accounts). Specifically, Enron would be allocated a remedial allocation of depreciation deductions equal to the amount limited by the ceiling rule, and Enron affiliate would receive an equal and offsetting remedial allocation of taxable income.

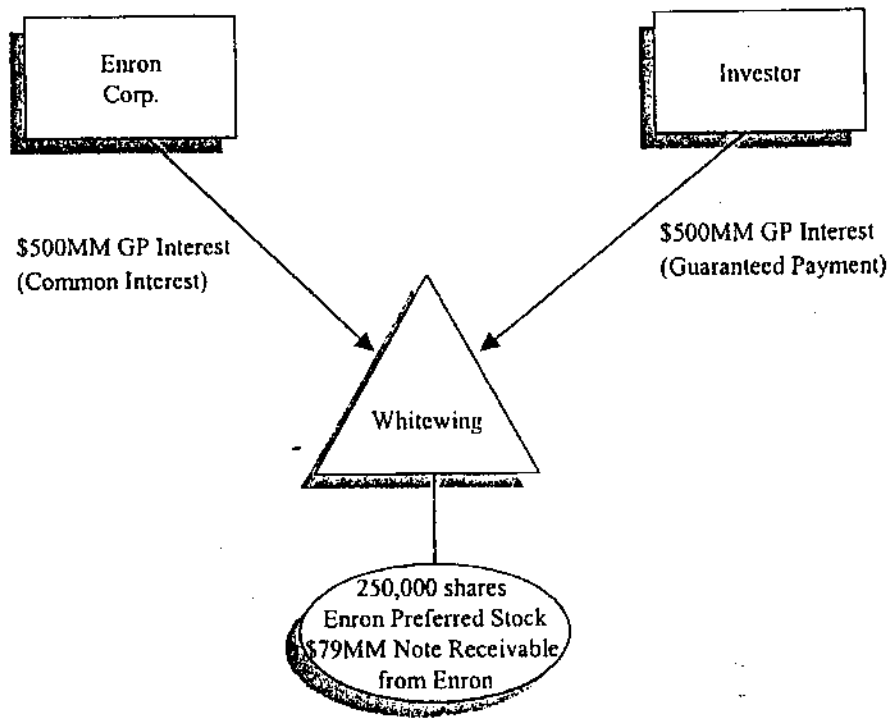
- Basis Step-Up. The remedial allocations each year will increase Enron affiliate's basis in his partnership interest and reduce Enron's basis in its partnership interest. Over the tax depreciable life of the asset contributed by Enron affiliate to Whitewing, Enron affiliate's basis in its partnership interest will increase from $-0- to $1B.

- Basis Step-Up Carries Over to Distributed Assets. When Whitewing distributes the property to Enron affiliate in liquidation of Enron affiliate's interest in the partnership, Enron affiliate will have a basis in the property equal to the $1B basis Enron affiliate had in its partnership interest.

- Enron's Basis Reduction. At the same time that Enron affiliate's basis is being increased by a combination of both operating income and remedial allocations of taxable income (net of cash distributions), Enron Corp's basis in its partnership interest will be reduced by the same amount. Since Enron Corp's current basis in Whitewing is only slightly in excess of $500MM, Enron Corp. will need to acquire the outside investor's $500MM interest in order to provide Enron Corp. with the basis necessary for offset by the remedial allocation rules and cash distributions.

II. Transaction Structure

1. Current Structure (Project Nighthawk)



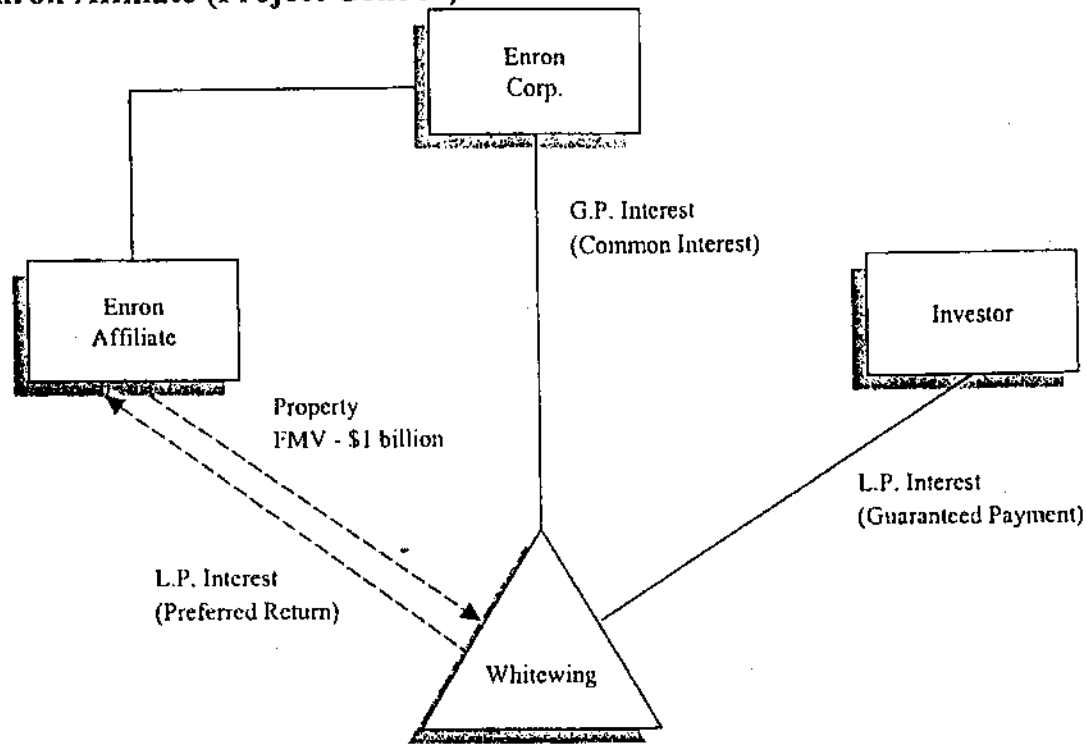
- This illustration provides a simplified illustration of the financing structure put in place in late 1997.
- The 250,000 shares of Enron preferred stock are convertible into an aggregate number of 25MM common shares with a total fair market value of over $1.5B (assuming a FMV of $60/share).
- The current structure is scheduled to terminate, if not before, on the structure's fifth anniversary, December 29, 2002.

B-280

EC2 000037486

II. Transaction Structure

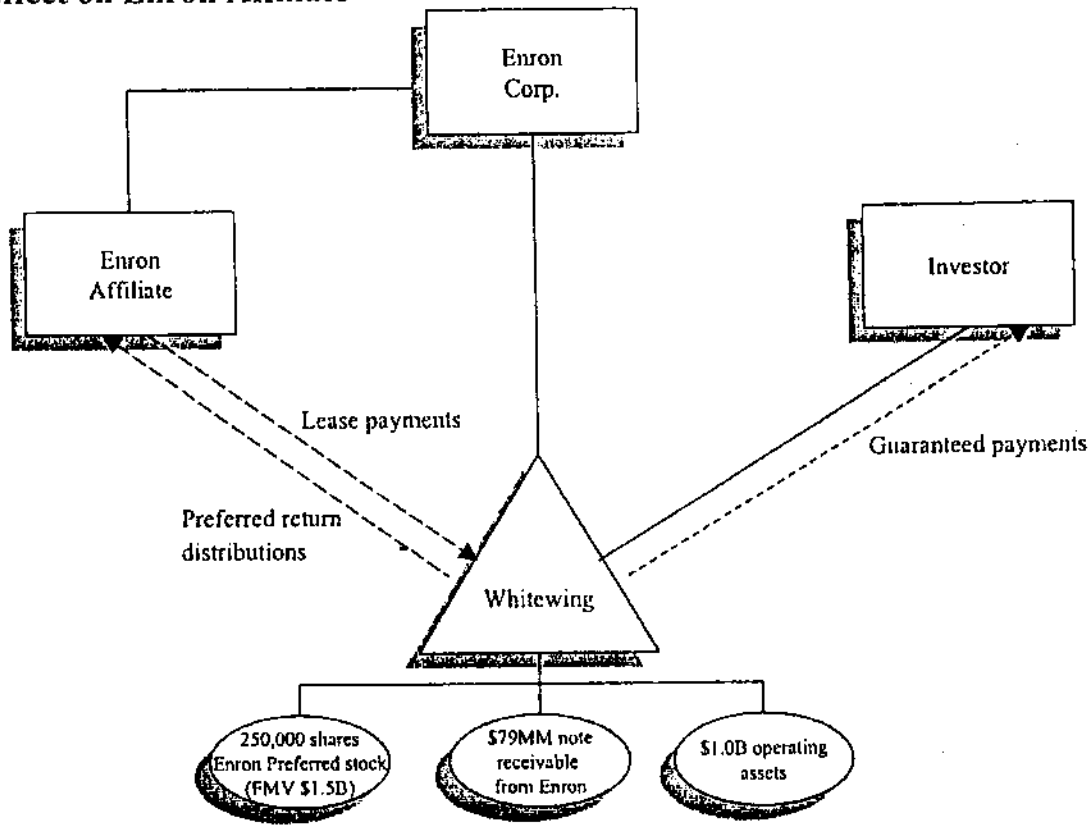
2. Admission of Enron Affiliate (Project Condor)



- Enron Affiliate makes a contribution to Whitewing of fully-depreciated assets with a FMV of approximately $1B in exchange for a partnership interest which provides a preferred return.
- The assets are subject to lease by Whitewing back to Enron Affiliate over a period of 16 years, equal to the depreciable life of newly purchased assets of that type.
- Over the term of the structure, Enron would be allocated a remedial allocation of depreciation deductions which will reduce, over a 16 year period, the basis in its partnership interest to zero. Enron affiliate would be allocated an equal and offsetting remedial allocation of taxable income which will increase, over the 16 year period, the basis in its partnership interest to $1.0B.

II. Transaction Structure

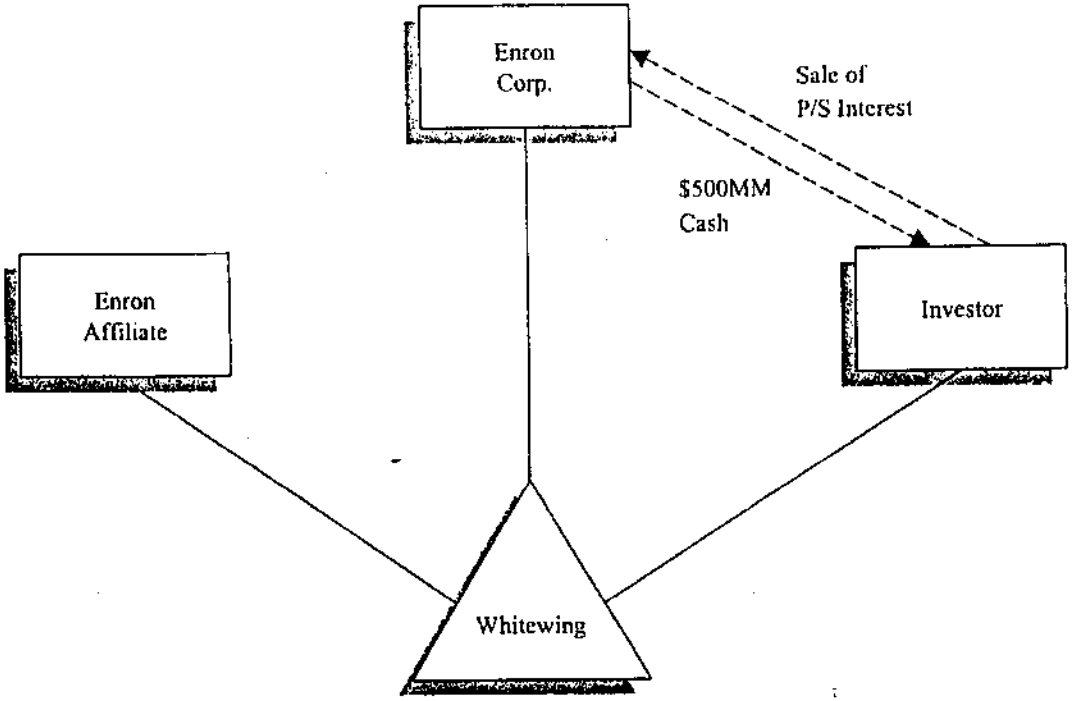
3. Transaction's Effect on Enron Affiliate



Over the 16 year period of the structure, Enron affiliate would make lease payments to Whitewing for the use of the operating assets.

II. Transaction Structure

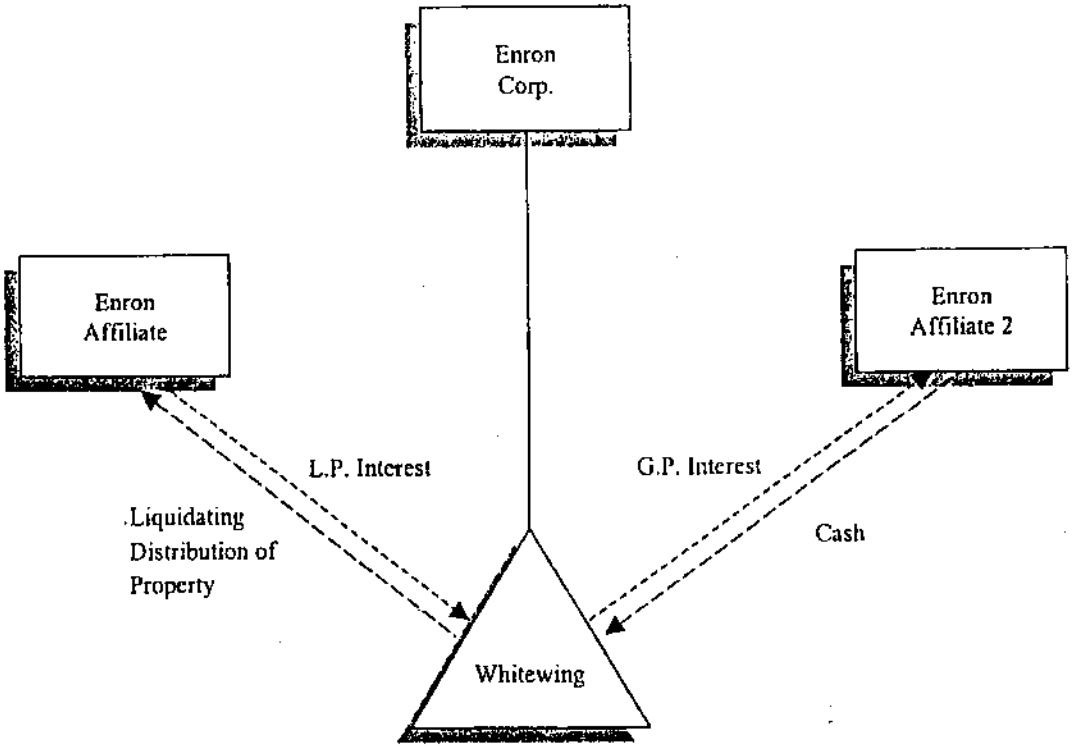
4. Purchase of Investor Interest



- At a point sometime during the term of the structure before Enron takes cash distributions that reduce its capital account to zero, Enron would acquire the investor's partnership interest in Whitewing.

II. Transaction Structure

5. Liquidation of Enron Affiliate's Interest



- After 16 years have passed, Whitewing would distribute the assets originally contributed by Enron Affiliate in a liquidating distribution in exchange for Enron Affiliate's interest in Whitewing.
- If Enron wanted Whitewing to maintain its status as a partnership, a second Enron Affiliate could contribute cash (or other property) to Whitewing in exchange for a partnership interest prior to, or simultaneously with, the liquidating distribution to the first Enron affiliate.

B-284

EC2 000037490

III. Summary of Financial Impacts

Project Condor

Summary Projections of Cash Flow and Accounting Earnings

	Cash Position		nnual Accounting Earning
Years	Tax Deduction for Depreciation	Total Annual Cash Position	After-tax Earnings
1999	$ -0-	$ -0-	$ 18,500,000
2000	-0-	-0-	35,150,000
2001	-0-	-0-	31,635,000
2002	-0-	-0-	28,490,000
2003	-0-	-0-	25,641,000
2004	-0-	-0-	23,051,000
2005	-0-	-0-	21,830,000
2006	-0-	-0-	21,830,000
2007	-0-	-0-	21,867,000
2008	-0-	-0-	21,830,000
2009	-0-	-0-	21,867,000
2010-2014	-0-	-0-	98,309,000
2015-2019	139,416,000	139,416,000	-0-
2020-2024	110,408,000	110,408,000	-0-
2025-2032	120,176,000	120,176,000	-0-
	$ 370,000,000	$ 370,000,000	$ 370,000,000

Assumptions:

1. Transaction occurs June 30, 1999.
2. Effective tax rate of 37%.

IV. Overview of Financial Accounting Rules

- The initial accounting entry recorded by Enron affiliate at the outset of the transaction should be as follows:

Investment in Whitewing	[book basis]		
		Investment in Asset	[book basis]

- Each year over a period of 16 years, remedial allocations of income to Enron affiliate results in a deduction to Enron for which a current tax benefit would be recorded as follows.

Year 1, assuming a $50M remedial allocation

Current tax liability	16,300,000		
		Current tax expense	16,300,000

Year 2, assuming a $95M remedial allocation

Current tax liability	32,950,000		
		Current tax expense	32,950,000

B-286

EC2 000037492

V. Risks of the Transaction

Specific Risks	Mitigating Factors
• Business purpose - A transaction must have a business purpose separate and apart from the creation of tax benefits to be assured that it will be sustained on audit.	• Contribution of assets to Whitewing provides additional balance sheet capacity to Enron • New funding raised by Whitewing can be used to make additional equity investments • Recapitalization of Whitewing will allow for the change or elimination of expensive derivatives in the original structure • Whitewing is an "old and cold" entity formed to be a fundraising vehicle and accomplish certain financial reporting and rating agency goals
• Clinton administration's fiscal year 2000 budget proposal tax provisions - The budget proposal includes provisions that tighten the standards applicable to so-called "corporate tax shelters" and attempt to restrict the shifting of basis from non-depreciable assets to depreciable assets for partnership liquidating distributions.	• The budget proposal excludes from the definition of "corporate tax shelter" those transactions where the sought-after tax benefit is clearly contemplated by the applicable provision. This carve-out should be applicable to the sanctioned use of the remedial allocation method. • The budget proposal relating to partnership liquidating distributions has the curious effect of potentially turning an ordinary depreciation deduction that would be recognized over time into an immediate capital loss. Also, one can potentially structure around the provision. • Preliminary information indicates that the partnership provisions in the budget proposal are not expected to receive much in the way of Congressional support.
• Risk of a change in law - A change in law could deny Enron affiliate the sought-after basis step-up	• Transaction can be unwound at any time. • Benefits achieved would be proportional to the time the structure was outstanding. • Complications of an "unwind" are minimized since the transaction occurs mainly between two Enron entities.

Project Condor

Purchase of equity interest to increase Enron Corp's basis in Whitewing. Steven had envisioned that Enron would purchase the outside investor's (equity's) interest about 4-5 years into or mid-way through the life of the partnership. Enron Corp's basis has to be sufficient to absorb the cash distributions during the term of the partnership because cash distributions in excess of Enron's basis will give rise to capital gain. The problem is that buying the equity interest will cause a deconsolidation of the partnership. In response to this problem, Steven suggests that Enron could wait until just before it wants to take its cash out of the partnership [or even until the partnership is liquidated] before acquiring the investor interest.

For example, during the first 7 years or so, Enron Corp. would take its cash distributions until its basis is reduced to zero. From that point forward until the [pipeline assets] are distributed to Enron affiliate, the same money would be distributed to Enron by the partnership but only in the form of a loan. After the [pipeline assets] are distributed to Enron affiliate, the $30M in annual dividend income coming into the partnership would increase Enron Corp's basis sufficiently to allow the distribution of the current income. When the structure has been in place over the [15-20] year depreciable life of the [pipeline assets] and Whitewing is ready to be deconsolidated, Enron Corp. would purchase the outside investor's interest and [reduce the deficit in its book basis or capital account to bring it up to zero].

Enron's election not to use either the full or partial purchase option. Presumably, the new partnership agreement for Whitewing will also not contain a right on the part of Enron elect a full or partial purchase option. Steven, in fact, seemed to indicate that the partnership might operate in 5 year increments. This intuitively makes sense based on the time horizon of most lenders, but it complicates things.

Since the benefits of the transaction would be much reduced if the partnership were terminated only 5 years into the structure, Steven suggests that the partnership agreement provide for a doomsday scenario that would occur is the outside investor required the partnership's liquidation. In this case, the partnership agreement would provide that the partnership's assets could be distributed in kind to either the partners or to persons designated by the partners in accordance with their positive capital accounts. The partnership would have to accumulate cash sufficient to repay the investor [or obtain a loan from Enron?]. The partnership would then transfer the Enron common stock and [pipeline assets] subject to lease to a new partnership. Under Section 708(a), this new partnership would be considered a continuation of the old partnership [on the assumption that because of the introduction of Enron affiliate as a partner,

EC 000850644

the outside investor would no longer have an interest constituting 50% or more of the total interest in partnership capital and profits under section 708(b)(1)(B)].

Use of assets temporarily. The use of Whitewing as a entity to cycle assets in and out of is not a good idea because of the disguised sale rules. Steven seemed to agree that we should get the appropriate asset(s) into the structure at the same time we lever up Whitewing. I'm still not clear, I guess, on Ben's rationale here. He indicated that Jeff McMahon wants to sell some assets out of the Rawhide structure, and Ben wants to scale back the transaction because from his standpoint, it is not efficient to tie up assets of this value given the amount borrowed. That makes sense. What is still unclear to me is why moving them into this structure is a good idea unless they would serve as additional collateral and Ben doesn't seem to be treating them this way based on the put option he has designed. (See below for more on this issue)

Use of the current Enron building. [For federal income tax purposes, the Enron building is treated as owned by Enron Leasing Partners, LP. ("Leasing Partners"), a Delaware limited partnership of which a 97% LP interest is owned by Organizational Partner, Inc. or "OPI," a 1% GP interest is owned by Enron Property Management Corp., and a 2 LP interest is owned by an unrelated institutional investor. Leasing Partners received the rights (and assumed the obligations) under the lease from OPI as a partnership contribution in exchange for an LP interest.... Ben will want to know why he can't use the Enron building in Project Condor...]

Leverage as business purpose. If pipeline assets are contributed to Whitewing, we should get credit for them from a business perspective and to support leverage as our business purpose. Specifically, the put option should be reduced for the value of the assets. Steven wonders why we even need the put option at all. See below for more.

Put options. It is more awkward for the bank with the put agreements with Enron and Whitewing to also be the lender to Whitewing. We may be able to get there, but this is an awkward arrangement. What is the cost of the option versus the value of the tax deduction on the interest over the period of the debt that is being put at risk. ("Quick and dirty" example: $1B x 8% x 35% x 5 years = $140M)

Confirm with Ben that the reason he wants both banks to be the same is because the cost of the put is reduced when only one bank rather than two have Enron credit exposure. In terms of quantifying the cost of the put, confirm with Ben how far the first bank's credit exposure extends. For example, if Enron's stock is worth zero, is the first bank on the hook for the full $1.5B?

Steven asks why do we need the put option. The partnership agreement could provide that if the value of the underlying property has a value of less than $1B, Enron or Enron affiliate could be obligated to make capital improvements or sell the property. This would

EC 000850645

result in liquidation of the partnership, but in this case, we could lose the sought-after benefit any way. Why? The partnership rules require that the distribution of proceeds in liquidation be in accordance with the partners' capital accounts. If the value of the property has fallen below $1B but Enron affiliate's capital account still equals $1B, the partnership will have an obligation to distribute cash (or stock) to make up the difference.

General partnership anti-abuse rules.

Remedial allocation anti-abuse rules. In McKee's partnership treatise, the authors state that the choice of the remedial allocation method is subject to the anti-abuse rule of Reg. section 1.704-3(a)(10). [see legislative history also cited] Steven says, however, that our application of the remedial allocation method should not run afoul of the rule and, in fact, follows it to the letter. The rule provides that an allocation method (or combination of methods) is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain (or loss) among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. In this case, the tax consequences are not being "shifted" but are instead being allocated to the partner whose contribution of property had the built-in gain.

Depreciation anti-churning rules. Bob Hermann has asked the question of whether the depreciation anti-churning rules apply. Essentially, Steven Klig hadn't focused on these rules and we both plan to study them further. My quick research thus far indicates that the MACRS and ACRS anti-abuse rules are intended to disallow a taxpayer from applying these accelerated accounting rules to property originally placed in service prior to the effective dates for these rules.

EC 000850646

Interoffice Memorandum

To:

From: AnnMarie Tiller

Department: Corporate Tax Department

Subject: Whitewing Associates, Proposed Restructuring of

Date: February 26, 1999

Confidential: Attorney-Client Privilege

Per your request, I have provided a summary below of the tax issues relating to a three-pronged proposal regarding the restructuring of Whitewing Associates, LLC to:

1.) remove Enron's "cash-out" option to persuade the rating agencies to give Enron some portion of equity credit for the transaction;
2.) effect a book deconsolidation of the Whitewing so as to treat Nighthawk's interest in Whitewing under the equity method for financial accounting purposes rather than as minority interest; and/or
3.) restructure the transaction to refinance Whitewing by replacing Nighthawk with [new equity of $250M and new lenders of $1B that would allow Nighthawk to be repaid its $500M and allow Enron to take $250M in new funds out of the structure, leaving Enron and Equity each with $250M in equity holdings. What would the $500M in new Whitewing liquidity be used for? – This scenario would appear to run afoul of Notice 94-48. Left Ben Glisan a VMX on 2/26/99.]

Background

EC 000850731

Whitewing Associates, LLC ("Whitewing") came into existence as part of a leveraged equity financing transaction put into place in late 1997. The advantages of the initial transaction from Enron's perspective included the following:

- The ability to raise the $500M in new capital from the issuance of $1B in newly issued convertible preferred stock of Enron Corp.;
- The newly issued Enron Corp. preferred stock was purchased by Whitewing, a newly-formed entity, treated as a partnership for tax purposes, which Enron controls;
- Enron retained much of the upside and downside potential in its stock held by Whitewing;
- The transaction does not [or at least did not] have any earnings per share ("EPS") impact since the transaction permits Enron to report the shares held by the partnership as treasury shares;
- Enron deducts 100% of the guaranteed payment made by Whitewing to the outside investor, a special purpose entity, called Nighthawk Investors, LLC ("Nighthawk"), as Enron's distributive share of this partnership item;
- Nighthawk's interest in Whitewing is reflected for financial accounting purposes as minority interst in the financial statements;
- The transaction was designed with the hope that it would receive some degree of equity credit from the rating agencies.

Rating Agency Issue. Because the rating agencies have failed to-date to give Enron any degree of equity credit for the transaction, Enron management has for some time considered what structural changes could be made to

eliminate what the rating agencies apparently view as Enron's "cash out" option. Under the transaction documents that have now been drafted and exchanged with the outside investor, lender, and surety provider in the structure, Enron proposes to elect to (1) to settle the underperformance option of Enron stock with a physical (stock) rather than a cash settletment; and (2) to deny itself the right to voluntarily exercise the full or partial purchase option under the purchase option agreement to redeem the interest of the outside investor.

Deconsolidation. A proposal has recently been made to restructure the transaction to accomplish the balance sheet objective of deconsolidating Whitewing so that Nighthawk's interest will no longer be treated as minority interest but will instead be treated under the equity method for book purposes. Arthur Andersen has indicated tentative approval for a non-redemptive transaction, i.e., a transaction that would not require the distribution of either either the Enron demand notes or Enron preferred stock held by Whitewing. The general categories of action steps AA has identified to accomplish the short-term goal of deconsolidating Whitewing include the following:

1.) The Whitewing LLC Agreement must be amended to provide Nighthawk with some additional management rights;
2.) Whitewing may have to distribute some portion of its assets - either the $79M Enron demand note or Enron preferred stock with a similar value - to reflect a more even 50/50 split of the partners' interests; and
3.) If some portion of Enron stock is removed from the structure, Enron may have to write a share settled put option [for the benefit of Citibank] to protect against the additional price risk to which Citibank would then be subject.
4.) [Do any of the other derivative contracts need to be unwound?]
5.) [Anything else?]

[Restructuring. A longer term goal that may be pursued on [a parallel track/or later in the year] is a review of the structure to determine whether certain additional benefits could be achieved from a replacement of some of the Enron preferred stock held by Whitewing with another income generating asset(s) of the same value ....]

Conclusion

[Because of the importance of the $79M demand note from a purely business perspective, there is a a business question of whether it makes sense to distribute Enron preferred stock out of the partnership rather than the Enron demand note. From a tax perspective, however, neither the distribution of the stock or the notes should result in the recognition of taxable income. Revisions of the Whitewing LLC Agreement to provide Nighthawk with additional management rights are beneficial to our characterization of Whitewing as a partnership for tax purposes.]

necessity for reserves against the tax deductions [given the changes to the structure and how it is being highlighted in Board Minutes, etc....]

Discussion

EC 000850732

1.) Rating Agency Issue. If Enron elects not to exercise either its Partial or Full Purchse Options under the Purchase Option Agreement, Enron will severely restrict at least its contractual ability to decide the manner and timing for unwinding the structure. Assuming Enron goes forward with this election, an unwind must take one of the following forms: (a) newly negotiated purchase option by Enron and Nighthawk outside the original transaction documents; (b) a transfer by Nighthawk of its Class B

Interest to a third party under Section 10.2(b) (which requires Enron's consent); (c) liquidation provisions... .

[Since Nighthaw is supposed to receive a distribution of cash under Section 12.5 of the PartnershipAgreement and since the partnership is scheduled to liquidate in [2002] under Section [___], the result of this change is that Nighthawk can force a liquidation of the partnership and a sale of the preferred stock. Outside counsel has indicated that Reg. section 1.337(d)-3 should probably not pose a threat to such a sale and that the regulation can be expected to be repealed, but we may have Texas franchise tax issues to face in the event of a sale of the stock to the public wherein we could not identify what ....[Mitigant – Citibank is motivated to work with Enron to unwind the transaction in the manner in which is most beneficial to Enron...]
will probably be deleted by the and the fact that the, Nighthawk can effectively force a liquidation of the partnership in

Enron's election to settle the underperformance put with stock should not make it easier for the IRS to assert the application of section 163(l). Section 12.5 of the Joint Venture Agreement requires that Citibank be paid in cash which would require that stock be sold by the JV to raise the funds to pay Citibank. And, as discussed further below, the IRS has recently issued a PLR that indicates such a sale should qualify for nonrecognition of gain (and loss) treatment under section 1032. See TAM 9822002 (5/29/98

Distribution of Enron Demand Note. Ignoring the important role the $79M amount has from a business perspective as the "Termination Premium Reserve" for the transaction, there should not be any tax consequence of distributing the Enron Demand Note if that is deemed necessary to accomplish deconsolidation.. First, both the contribution and the distribution of the Note should probably be ignored as merely transitory. See Reg. section 1.704-1(b)(2)(iv)(d)(2) provides that a partner's capital account is only increased for a promissory note contributed to a partnership by the partner making the note when the partner makes principal payments on the note (or when there is a taxable disposition of the note by the partnership. Second, even if the distribution of the Note is treated as a partnership distribution, there should be no cancellation of indebtedness consequences to Enron Corp. If a partnership loans money to a partner and the partner's indebtedness is subsequently canceled, Reg. section 1.731-1(c)(2) provides that the obligor partner will be deemed to have received a distribution of money or property at the time of cancellation. As a result, Whitewing will be generally insulated from gain or loss under Section 731(b), and Enron Corp. will not recognize gain or loss under Section 731(a)(1) unless the amount of money distributed to it exceeds the basis of its partnership interest (or the distribution was a liquidating distribution and loss was recognized under Section 731(a)(2)).

If the distribution of the loan were treated as a cash distribution, it is possible that the Service could allege that the distribution is part of a disguised sale under section 707(a)(2)(B) and Reg. section 1.707-3. If so, there should still not be any potential for Enron Corp. to recognize a tax gain. Reg. section 1.707-3(a)(2) provides that any deemed sale is considered to take place on the date that the partnership is considered the owner of the initial transfer of property. In this case then, the deeemed sale, if any, would be deeemed to have taken place on the creation of the structure when the basis of the Enron preferred stock held by the partnership equaled its fair market value. As a result, any "sale" deemed to have taken place should not give rise to any gain to Enron. To the extent that the Service alleged that the deemed sale was subject to disclosure on Form 8275 (since the transfers were made within a two-year period), the response should be that it was too late since the form is supposed to be filed for the taxable year of the transfer which, now given this recharacterization, would have been back in 1997. Reg. sections 1.707-3(c)(2) and –8

EC 000850733

Debt vs. Equity – Management Rights. Whitewing has two partners: (1) Enron Corp. which made an approximately $579M cash contribution for a 98.5% common interest in the partnership, and (2) Nighthawk

which made a $500M contribution in exchange for a guaranteed payment interest and a 1.5% common interest in the partnership. Currently, Nighthawk does not have any right to participate in the management or control of Whitewing except with respect to certain extraordinary matters. *See* Whitewing LLC Agreement, Sections 3.3 and 4.3.

2.) In concluding initially that Whitewing should be treated as a partnership and that Enron's and Nighthawk's interests should be treated as partnership interests, weight was given to the following factors:

a.) Intent of the parties to treat Whitewing as a partnership;

b.) Treatment for regulatory, rating agency, and financial accounting purposes. The intent of the parties was to treat Nighthawk's interest as minority interest for all reporting purposes.

c.) Upside potential and downside risk. Nighthawk is entitled to 1.5% of the gain and losses on the preferred stock held by Whitewing.

d.) Subordination to other creditors. As an equity holder in the partnership, Nighthawk's interest is subordinated to all creditors of Whitewing.

e.) Participation in management. Nighthawk has limited management rights regarding the operations of Whitewing. Without the consent of Nighthwk, Whitewing cannot, among other things, (i) enter into any transaction of merger or consolidation; (ii) liquidate, wind up or dissolve itself, or commence a voluntary case, action or proceeding under any bankruptcy or insolvency laws except as specifically provided for in the LLC Agreement; or (iii) convey, sell, lease, transfer or otherwise dispose of, in one transaction or a series of transactions, any portion of Whitewing's property except as specifically provided for in the LLC Agreement. *See* Whitewing LLC Agreement, Section 4.3.

f.) Absence of a fixed maturity date (other than the scheduled partnership termination date of 5 years).

If additional management powers are necessary for purposes of deconsolidating Whitewing for GAAP accounting purposes, such changes should be helpful for purposes of supporting the partnership characterization of Whitewing.

3.) **Distribution of Enron Stock**. If Enron stock must be removed from Whitewing to accomplish either of the short- or long-term objectives, several tax issues must be considered:

a. **Reg. section 1.337(d)-3**. To the extent that the balance sheet fix requires a distribution of some portion of the Enron preferred stock held by Whitewing back to Enron, Enron runs the risk of being required to treat the transaction as a redemption or exchange of the stock for a portion of Enron's partnership interest with a value equal to the stock distributed. In effect, Enron would have gain to recognize approximately equal to the appreciation in the Enron stock since the transaction was closed on December 30, 1997. [Number of shares x ($65/share - $40/share)]

The regulations are intended to restrict a company from using a partnership to circumvent the repeal of the General Utilitites doctrine. In this case, however, the perceived abuse sought to be addressed is not present. The stock is intended to distributed solely to Enron Corp. which would have a zero basis in its own stock anyway and Enron would be able to sell the stock again without the recognition of gain (or loss) under section 1032. The problem is that the proposed regulations currently contain no carve-out for non-abusive transactions and their effective date, when and if they are ever finalized, is retroactive back to March 9, 1989. It was, in fact, this issue which had caused the tax folks working on setting up the initial structure to conclude that the preferred stock held by Whitewing might have to remain outstanding indefinitely unless and until Treasury could be convinced to carve out non-abusive transactions from the regulation's coverage.

EC 000850734

Notwithstanding the regulation and its retroactive date, Steven Klig of Deloitte & Touche, has an off the record discussions with the folks at Treasury regarding this regulation and they have indicated that the regulation will never be finalized. Steven believes that even it the regulation were ultimately finalized, it would take a different form and

b. **Disguised sale**. [Open. Presumably, the analysis would be similar to that above regarding the distribution of the Enron demand note....]

c. **Section 1032**. If Enron were intending to issue additional equity anyway, Enron could consider selling that equity into the market directly out of the partnership. There has been ongoing concern about whether a sale of this sort by a partnership holding stock of its corporate partner would qualify for nonrecognition of gain (and loss) treatment under section 1032. The conclusion that nonrecognition treatment is indeed appropriate was bolstered in a recently issued Taxpayer Advice Memorandum (TAM 9822002 (5/29/98)) wherein the IRS concluded that a partnership should be treated as an aggregate of its partners for purposes of applying section 1032. (The gain allocated to a corporate partner as its distributive share of gain realized by the partnership from the transfer of stock to the other partner (in exchange for the other partner's contribution of an operating business to the partnership – an exchange which the Service separately concluded was subject to the the disguised sale rules) did not have to be recognized by the corporate partner because the partnership was treated as the aggregate of its partners.) However, since a TAM cannot be cited as precedent, this approach is not without risk. [There is also a Texas franchise tax issue to the extent that stock is sold out of the partnership to the the public since some portion of the holders will be deeemed Texas persons....]

4.) **Dividends Received Deduction**. While Enron common stock is the only asset held by Whitewing, Enron will claim the 100% dividends received deduction under section 243(a) for its distributive share of the dividend income recognized by the partnership on the common stock. If in connection with the long-term goal, other assets are substituted for some portion of the stock held by Whitewing, then Whitewing will have income some portion of which will presumably be allocated to Enron which will offset the Enron's distributive share of the partnership's deduction for the guaranteed payment. Presumably, this income will be the type that would have been recognized in taxable income anyway by some member of Enron's consolidated group.

5.) Notice 94-48. One of the distinctions drawn between Notice 94-48 and Enron's 1997 transaction was the thinly capitalized nature of the partnership in the Notice versus the 100% overcollateralization of Whitewing. Whitewing is capitalized with $1B in Enron preferred stock and certain additional assets which together secure Nighthawk's $500M interest in the partnership. The additional assets held by the partnership include (1) $79M used to establish the Termination Premium Reserve (and that while Enron retained a certain [credit rating status] is loaned to Enron in exchange for a interest-bearing demand note), (2) Enron's obligation to fund a Preferred Payment Reserve on the event of [.....], (3) the insurance contract purchased by Nighthawk from AMBAC, and (4) the put options purchased by the lenders.

It is the $79M demand note that Enron now proposes to distribute or forgive for purposes of establishing a more even 50/50 split of the partners' interests in Whitewing. [Assuming one get resolve the legal or business issue of obtaining Nighthawk's agreement to eliminate this credit support, the removal of this amount would presumably not affect the Whitewing's overall collaterization to too large an extent.]

6.) **and other issues of these changes**.....[Open]

EC 000850735

- The transaction involves the interplay of the partnership distributive share rules of Section 704(b) and the nonrecognition rules of Section 1032 applicable to corporate taxpayers on the receipt of consideration for their own stock. If built-in gain property is involved rather than full cost property, the transaction also relies upon the rule of remedial allocation rules of Section 704(c). The transaction is possible because the partnership, Whitewing Associates, LLC, is capitalized with Enron common stock.

EC 000850647

Nighthawk Restructuring Summary

Structure:

- Based on the Project Nighthawk structure already in place
- Contribution by Enron affiliate to Whitewing of $1B of leased assets in return for preferred partnership interest subordinate to Nighthawk's current interest
- Assets may be built-in gain (i.e., fully depreciated) property or full cost property, depending on what is available
- Effect of remedial allocations under partnership tax rules results in Enron affiliate's basis in the partnership climbing to $1B over the term of the transaction (or it would stay the same if full cost property is used), while Enron's basis in the partnership decreases to zero.
- When the leased assets are distributed at the end of the transaction (e.g., 15 to 20 years), the tax basis of the property will be stepped up to $1B, the amount of Enron affiliate's tax basis in its partnership interest in Whitewing. Section 732(b).
- Enron affiliate's tax basis will be used by Enron affiliate in the form of future depreciation or loss on the sale of the property.

Benefits:

- The increase in tax basis in Enron affiliate's interest in its partnership interest (and in the assets that will be distributed on liquidation) is approximately $1B that represents a future tax benefit of $350M.
- The tax liability of Enron and Enron affiliate from the transaction is approximately $310.7M (35% x [$1,367,760B less $480,000,000 DRD].
- Enron should, therefore, be able to create a deferred tax asset of $39.3M as a credit to income [$350M future tax benefit less the $310.7M tax payment].
- Change in law risk is mitigated with an unwind possible at any time with proportional benefit equal to time the structure is outstanding

Issues:

- Effect of restructuring and addition of the leased assets on current rating agency treatment?
  - Best answer is an enhanced rating or no effect.
  - What is the likelihood of a reduction (or maybe that isn't possible)?
- Additional leverage from addition of leased assets? Business issue.
- Business purpose
  - Potential (but fairly unlikely) agreement by guaranteed payment investor to reduce guaranteed return to which it is otherwise entitled
  - Potential to eliminate the expensive structured derivative contracts in the current structure if lease has a "hell or high water" provision causing the investor to hold a quasi-debt instrument.
  - Potential to leverage up structure with additional collateral?
  - Others? Business people can potentially help here.

EC 000850800

- Assumption of risk of enactment of Reg. section 1.337(d)-3 if assets are appreciated
  - Worst case scenario is immediate gain recognition
  - Acceptance of risk represents a judgment call for company.
  - Use of full cost property (as opposed to built-in gain/fully depreciated property) avoids risk but may not have such property.
  - Mitigants include current NOL posture. AMT? Capital gain management?
  - Not an active regulatory project. Not expected to be enacted because other provisions prevent the result the IRS sought to achieve.
- Other deals:
  - D&T has two deals ongoing, one for a pharmaceutical company and one for a "conservative" oil and gas company. One is a $500M transaction and one $1B transaction.
  - Only a handful planned
  - Not aware of anyone else with the technology although bits and pieces are in deals he has seen.
- Clinton Administration Fiscal 2000 Budget Proposals
  - Corporate tax shelter and partnership provisions
  - Bill Archer
  - Concern over how Treasury wields broad powers granted to it
- Effect on current structure
  - Reduces exposure to Notice 94-48
  - Potentially eliminates need for expensive derivatives in system – insurance contract backstopped by S&P put and underperformance put. [Is this cost incorporated into the guaranteed payment made by Whitewing each calendar quarter?]
  - [Nighthawk's right to liquidate the partnership in 3 ½ years is not a good fact. We believe Citibank won't penalize us too much but what about Harch Capital Management?]
  - [Management rights given to Nighthawk for purposes of deconsolidation may also pose a problem if Whitewing holds an operating asset]

EC 000850801