MEMORANDUM

December 17, 2001

TO: David M. Becker, General Counsel

FROM: Robert K. Herdman, Chief Accountant RKH
David B.H. Martin, Director, Division of Corporation Finance DM

RE: Correspondence from Chairman W.J. "Billy" Tauzin and Chairman James C. Greenwood

In correspondence addressed to Chairman Pitt dated December 7, 2001, Congressman W.J. "Billy" Tauzin, Chairman of the House Committee on Energy and Commerce, and Congressman James C. Greenwood, Chairman of the Subcommittee on Oversight and Investigations, have asked that the Commission respond to three questions related to the Committee's and Subcommittee's consideration of issues related to Enron Corporation.

The three questions presented in the letter from Chairman Tauzin and Chairman Greenwood are set forth below in bold italics, and each question is followed by the staff's response.

1. For the period beginning January 1997 until the SEC began its formal inquiry into Enron, did the SEC review any of the 10Qs or 10Ks filed by Enron? If so, identify the filings reviewed and provide a brief description of the review.

During the period in question, the Division of Corporation Finance examined the Form 10-K of Enron Corp. for the year ended December 31, 1997 and all Forms 10-Q and Forms 8-K, filed between March 13, 1998 and March 5, 1999. These filings were examined in connection with the Division's review of an initial public offering registration statement of notes filed by two related parties, Enron International CPO, LP and Enron International CPO, Inc. The registration statement for the offering subsequently was withdrawn. The Division's comment letters and the related filings are included in the documents accompanying this memorandum.

The Commission's Division of Corporation Finance has primary responsibility for overseeing disclosures by public companies. The Division's role in the review process is to use reasonable means to encourage public companies to make full and fair disclosure to investors of all material information. The Division of Corporation Finance does not independently audit the operations of public companies nor does it approve a security or transaction.

2. Please explain how Enron or any other commercial entity can include in current earnings unrealized gains on its derivatives portfolio. What guidance do accounting rules provide for the valuation of energy derivatives in a portfolio?

As a very general rule, under generally accepted accounting principles ("GAAP"), when a company intends to sell or trade an instrument or contract in the market place (as opposed to accepting delivery of items under the instrument or contract), changes in the market value of that instrument or contract are included in the company's earnings. This generally applies whether the instrument is a derivative or a commodities contract.

Because of recent press reports concerning Enron's accounting for energy contracts that it intended to trade ("energy trading contracts"), it may be helpful to the Committee to describe how companies can include changes in unrealized gains on their energy trading contracts in earnings.

Entities commonly enter into contracts for the purchase and sale of energy commodities. Historically, most energy contracts were settled by physical delivery. However, in recent years companies have entered into energy contracts, at rapidly increasing rates, to speculate on market movements, to conduct hedging transactions, or otherwise to generate gains from market price differences. Because these contracts can be complex, the rules for these contracts can be complex as well.

GAAP defines energy trading contracts as those "energy contracts entered into with the objective of generating profits on or exposure to shifts in market prices." As noted above, inherent in that definition is an evaluation of an entity's intent in entering into an energy contract. GAAP provides a set of indicators to consider when determining whether an operation's energy contracts are entered into for trading purposes.

If an energy contract is determined to be an energy trading contract, GAAP requires that the energy trading contract be marked to market. In other words, the contract would be measured at fair value, determined as of the balance sheet date, and the gains and losses from changes in the value of that contract are to be included in earnings. GAAP requires that the amount from these changes in value that are included in earnings be disclosed either in the financial statements or in the footnotes to the financial statements.

Consistent with GAAP for financial instruments such as debt and equity securities and derivatives, GAAP does not specify how to compute fair value for energy trading contracts, other than that it should be done on an individual contract basis. Instead, GAAP provides a general principle, stating that fair value is the amount at which a contract could be bought or sold in a current transaction with willing parties, that is, other than in a forced or liquidation sale.

Pursuant to GAAP, a quoted market price in active markets is considered the best evidence of fair value and shall be used as the basis for the measurement, when available. If a quoted market price is not available, GAAP requires companies to estimate fair value based on the best information available in the circumstances. As quoted market prices may not exist for many energy trading contracts, companies must consider prices for similar energy contracts and the results of valuation techniques. When valuation techniques or models are used, the best information for companies to consider includes recent spot prices and forward prices. An energy price curve is constructed by compiling forward prices of what the energy commodity is expected to be one to five years in the future. Specifically, observable forward prices are generally available up to three years into the future, and broker-dealer prices are often available four to five years into the future. As a result, similar energy contracts with similar durations of five years or less have observable fair values within a narrow range.

A wide range of fair value estimates may result, however, if the duration of an energy contract exceeds five years. Forward prices beyond the fifth year must be estimated, so the assumed rate of volatility has an important role in the assignment of fair value. Generally, prices are less volatile in the long run than in the short run. However, the current accounting guidance is not specific as to the application of fair value methods, so the assumed volatility of energy prices may vary, potentially leading to a wider range of assessed fair values.

As noted above, determining the appropriate accounting for energy trading contracts can be complex. For example, under GAAP, they may be considered derivative instruments. Under GAAP, instruments or other contracts that meet the definition of a derivative instrument are included in the scope of Financial Accounting Standards Board Statement No. 133, *Accounting for Derivatives and Hedging Activities* (Statement 133). Statement 133 requires an entity to recognize all derivative instruments at fair value on its balance sheet. If the derivative does not meet the criteria in Statement 133 for hedge accounting,[1] the gain or loss resulting from its changes in value is recognized currently in earnings. These are unrealized gains or losses in the sense that the derivative contract has not yet been settled.

3. Under what circumstances do accounting guidelines allow for the non-consolidation of special purpose entities from the sponsoring company's financial statements?

An SPE is an entity created by a sponsor to carry out a specified purpose or activity, such as to consummate a specific transaction or series of transactions with a narrowly defined purpose. SPEs are commonly used as financing vehicles in which assets are sold to a trust or similar entity in exchange for cash or other assets funded by debt issued by the trust. SPEs can provide a lower cost of financing and can create tax advantages.

GAAP requires consolidation of majority-owned subsidiaries (that is, the parent owns more than 50% of the subsidiary's voting stock) unless the majority owner does not control the subsidiary due to voting agreements, management contracts, or other restrictions. Under GAAP, consolidation of an SPE is generally expected when an entity has a controlling financial interest in the SPE.

Very generally, GAAP also provides that even if a sponsor of an SPE does not own a majority of the SPE's voting securities, it still must evaluate whether or not to consolidate the SPE. This is true even in those cases in which the sponsor does not hold an equity interest in

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1 For the limited purpose of this discussion, hedging accounting may be considered to provide for the gains and losses on certain assets and liabilities to be recognized in the financial statements in the same period as losses and gains on the related derivative instrument.

the SPE. In those circumstances, the SPE should not be consolidated only when all of the following conditions are met:

1) The owner of the majority of the SPE's voting securities is an independent third party who makes a substantive equity capital investment that is at risk during the entire term of the transaction;
2) The owner of the majority of the SPE's voting securities has control of the SPE; and
3) The substantive risks and rewards of the assets or debt of the SPE do not rest with the sponsor.[2]

If the above conditions are not met, the assets, liabilities, results of operations, and cash flows of the SPE should be consolidated in the sponsor's financial statements.

As previously described, in order for the SPE's sponsor not to consolidate the SPE, an independent third party must make a substantive equity capital investment that will be "at risk." In practice, in order to be considered "substantive," an investment should, at a minimum, equal 3% of the fair value of the assets owned by the SPE.

The accounting literature also provides consolidation guidance for specific types of transactions involving SPEs. In some cases, an SPE may hold title to assets and lease them to companies. In those circumstances, the accounting literature indicates that the lessee (the company) is required to consolidate the SPE lessor when certain criteria are met.[3] The consolidation criteria for SPEs used in leasing transactions follow the general criteria outlined above.

In addition, different accounting rules have been developed for certain types of SPE transactions used in securitizations of financial assets (such as credit card or other types of receivables). Under that guidance, very generally, SPEs that are permitted only to perform very limited functions, including holding title to assets, collecting cash on those assets, issuing debt, and repaying the debt, are not consolidated. The rules for these types of SPEs are complex, given the general complexity in the securitization market.

The FASB has had, for many years, a project on its agenda to provide more comprehensive accounting guidance for both consolidation of SPEs and for consolidation of other types of entities. The FASB currently is considering comments that it received on an exposure draft of a potential accounting standard that it issued in 1999. The Commission, as noted in its 2000 Annual Report to Congress, has urged the FASB to continue their efforts to provide consolidation guidance concerning SPEs. The FASB recently announced its intention to concentrate on developing guidance for dealing with several consolidation issues

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2 Emerging Issues Task Force (EITF) Topic No. D-14, *Transactions involving Special-Purpose Entities.*

3 EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions,* and EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.*

encountered in present practice, including issues related to SPEs. We will continue to urge the FASB to address SPE consolidation issues to increase financial statement transparency.

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The Office of the Chief Accountant and Division of Corporation Finance would be pleased to discuss these issues at your convenience.