

## ENRON'S DEMISE—WERE THERE WARNING SIGNS?

As Andrew Amphlett leafed through Enron Corporation's 2000 10-K filing, he realized that he was dealing with an important milestone in corporate history. Enron wasn't just a former Fortune 500 company that had fallen from grace, but *the* financial scandal of the last three decades. The company's collapse wreaked havoc on its own employees, shareholders, suppliers, and even on the entire corporate world. Amphlett's employer, Phoenix Investments, had lost over \$25 million on Enron stock, purchased not long before Enron's stock price reached its all-time high of over \$90 per share on August 23, 2000. It was now required practice for newly employed analysts at Phoenix Investments, such as Amphlett, to prepare a brief analysis of Enron's 2000 financial statements to see what early warning signs of Enron's collapse they could uncover. Amphlett took the standard regimen of finance and accounting courses in the MBA program he had completed in 2004, but he wondered what he could uncover in a half-hour that dozens of analysts with far more resources and better access to management had failed to notice during Enron's heydays.

### Enron's Business

By the end of 2000, Enron Corporation, with revenues in excess of \$100 billion, was one of the largest energy companies in the world and was ranked seventh on the Fortune 500 list of the largest companies in the U.S. Enron, headquartered in Houston, Texas, provided products and services related to natural gas, electricity, and communications to wholesale and retail customers. Enron was principally engaged in the transportation of natural gas through pipelines to markets throughout the United States; the generation, transmission, and distribution of electricity to markets in the northwestern United States; the marketing of natural gas, electricity, and other commodities and related risk management and finance services worldwide; the development, construction, and operation of power plants, pipelines, and other energy-related assets worldwide; the delivery and management of energy commodities and capabilities to end-use retail customers in the industrial and commercial business sectors; and the development of an intelligent network platform to provide bandwidth management services and the delivery of high bandwidth communication applications.

Enron's 20,600 employees conducted the company's business in four major segments. The transportation and distribution segment included regulated industries, interstate transmission of natural gas, management and operation of pipelines, and electric utility operations. The company's wholesale services segment focused on commodity sales and services, risk management products and financial services to wholesale customers, the development, acquisition, and operation of power plants, and natural gas pipelines and other energy-related assets. The retail energy services segment conducted the company's sales of natural gas, electricity and related products directly to end-use customers, particularly in the commercial and industrial sectors, and the outsourcing of energy-related activities. The company's newest segment, broadband services, facilitated the construction and management of a nationwide fiber-optic network, the marketing and management of bandwidth, and the delivery of high-bandwidth content.

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Major highlights of Enron's business included the operation of over 23,000 miles of natural gas pipelines, the ownership and operation of Portland General Electric, a major electric utility operating in the Pacific Northwest of the U.S., a significant interest in the Dabhol Power Company, which developed and owned an electricity generating power plant south of Mumbai, State of Maharashtra, India, and 18,000 miles of fiber-optic network capacity throughout the United States.

## Company Background

Enron began as a result of InterNorth's acquisition of Houston Natural Gas for over \$2.26 billion in 1985, creating a company with a 37,000-mile network of interstate pipeline, the largest in the U.S. Under the terms of the acquisition, Kenneth L. Lay, Houston Natural Gas' chairman and chief executive, became president and chief operating officer of the new company, while Samuel F. Segnar, InterNorth's 57-year-old chairman and chief executive officer, retained his position in the new company until succeeded by Lay on January 1, 1997.<sup>1</sup> Lay recognized that deregulation of natural gas pricing and natural gas transmission tariffs created enormous opportunities for a large transmission network bringing gas to the growing markets in the southwest United States, particularly Texas and Florida.

But with the collapse of crude oil prices in the late 1980s and the exit from energy lending by major Texas banks, many small oil and gas companies were unable to finance their exploration and production programs. Traditional reserve-based loans to small operators exposed financial institutions to costly bankruptcy procedures. To participate in this type of lending, financial institutions needed expertise in traditional credit risk assessment. In the meantime, Enron hired Jeffrey Skilling, a McKinsey consultant with considerable banking experience, who developed the idea of the volumetric production payment (VPP) contract. This contract, specifically designed by Enron at considerable cost, was a claim on specific quantities of natural gas delivered over time. Enron would provide cash to the oil and gas company in exchange for a VPP contract. Enron would then have a claim on natural gas volumes. The VPP contract had the important feature that it was an *equity* claim on natural gas, and thus in the event of default, Enron would have a claim on the company's natural gas reserves which it could recover by extracting natural gas from the company's reserves.

The VPP contract required expertise in assessing natural gas reserve risk, including the quantity of available reserves and the expected costs of extraction. The natural gas volumes delivered over time could be sold in the spot market to natural gas users such as utilities and commercial businesses. In effect, Skilling created a gas bank in which Enron acted as an intermediary between natural gas producers and natural gas users. But with natural gas prices experiencing considerable volatility, many producers and users also wanted some degree of price certainty upon which to base their long-run exploration and production plans. Thus, in addition to trading in the physical side of the natural gas market, Enron provided hedging opportunities to producers and users by trading natural gas derivatives as well. With an extensive pipeline network, Enron was also able to provide natural gas transportation services, thus providing a complete portfolio of products and services run under the umbrella of Enron Gas Services. To account for contracts involving future commitments to deliver and receive natural gas, Enron pioneered the use of mark-to-market accounting in which the net unrealized profits on the offsetting long and short contracts were recognized at the inception of the contract rather than the more conventional approach of recognizing them over time as the natural gas was delivered and received. Some observers believed that this approach recognized profits prematurely and failed to fully account for the risk that counterparties to the contracts would default. Up-front profit recognition also put pressure on Enron to sustain the momentum by signing new, larger deals.<sup>2</sup>

During the 1990s, Enron grew rapidly by developing, operating, and financing infrastructure projects such as pipelines, power plants in South America, Asia, and Europe. As a consequence, Enron's stock price grew consistently, and in the late 1990s, provided investors with substantial stock returns (see Exhibit 1 for information about Enron's stock price). To further its pursuit of related businesses,

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<sup>1</sup> *The Wall Street Journal*, May 3, 1985.

Enron acquired Portland General Corporation in July 1997 and Wessex Water PLC, a British water and sewage company, in July 1998 for \$2.2 billion. In addition, Enron participated in other businesses including pulp and paper, metals, weather-related products, and broadband capacity. Enron's revenues grew from \$10.25 billion in 1985 to over \$100 billion in 2000 (see Exhibit 2 for historical financial information).

Although VPP-type contracts would generate a stream of cash flows over time as the natural gas was sold in the spot market, Enron would monetize the contracts by selling them to investors, using as conduits entities such as partnerships and corporations that were accounted for using the equity method of accounting. Under the equity method of accounting, a company shows the net investment in the entity on its balance sheet and reports only its share of the entity's profits on its income statement. Because the entity's assets and liabilities are not consolidated with the company's, the entity's debt does not appear directly on the company's balance sheet, prompting this form of financing to be referred to as off-balance sheet financing. Enron made extensive use of the equity method of accounting (see Exhibit 3 for selected items from Enron's 2000 10-K report). During the 1990s, a power struggle developed between two distinct factions: the faction represented by Rebecca Mark that wanted Enron to invest in hard assets such as power plants, and the faction represented by Jeffrey Skilling that thought Enron should become "asset-lite" by monetizing hard assets. The Skilling camp won out, and Rebecca Mark was shunted off to become Chairman and CEO of Azurix, an independent water company spun off from Enron.

Enron's rising stock price and rapid revenue growth drew accolades from Wall Street analysts, which further fueled the company's stock price growth. In April 2001, after the release of the company's 2000 10-K, SalomonSmithBarney forecasted Enron's earnings-per-share (EPS) of \$1.80 and \$2.05, respectively, for 2001 and 2002, compared to \$1.47 in 2000, and established a target share price of \$100 per share, almost 50% more than its then-current price of \$59.44.<sup>3</sup> Similarly, Credit Suisse First Boston increased its estimated 2002 EPS for Enron from \$2.20 to \$2.25, with a price target of \$110 per share.<sup>4</sup> Although Morgan Stanley Dean Witter reduced their price target to \$85 per share from \$100, it increased its estimated EPS to \$1.80 and \$2.15 for 2001 and 2002, respectively.<sup>5</sup>

## **Enron's Collapse**

On Dec. 2, 2001, Enron filed a voluntary petition for Chapter 11 reorganization with the U.S. Bankruptcy Court for the Southern District of New York. Filings for Chapter 11 reorganization were made by a total of 14 affiliated entities, including Enron North America Corp., Enron Energy Services, Enron Transportation Services, Enron Broadband, and Enron Metals & Commodity. Nonfiling entities not included were Northern Natural Gas Pipeline, Transwestern Pipeline, Florida Gas Transmission, EOTT, Portland General Electric, and numerous other international entities. On December 3, 2001, Enron arranged up to \$1,500,000,000 of debtor-in-possession (DIP) financing with Citigroup and JP Morgan Chase and secured by substantially all of the company's assets. On September 30, 2002, Enron filed a motion seeking U.S. Bankruptcy Court approval of an extension of the exclusive period during which it could file a plan of reorganization.<sup>6</sup>

During 2002, Congress conducted several House and Senate inquiries into the role played by Enron's board of directors, the company's top management, including Ken Lay, Chairman and Chief Executive Officer (CEO), Jeffrey Skilling, a former CEO, Andrew Fastow, Chief Financial Officer, and its independent accountants at Arthur Andersen. In the aftermath of the Enron scandal, Congress enacted the Sarbanes-Oxley Act in 2002 which detailed new requirements for independent directors,

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<sup>2</sup> *Forbes*, May 24, 1993.

<sup>3</sup> Enron Corporation, *SalomonSmithBarney*, April 17, 2001.

<sup>4</sup> Enron Corporation, *Credit Suisse First Boston*, April 18, 2001.

<sup>5</sup> Enron, *Morgan Stanley Dean Witter*, April 18, 2001.

<sup>6</sup> *Mergent Online*.

the establishment of a new Public Company Accounting Oversight Board to oversee and investigate the audits and auditors of public companies, mandated new roles for audit committees and independent auditors, and new internal control requirements.

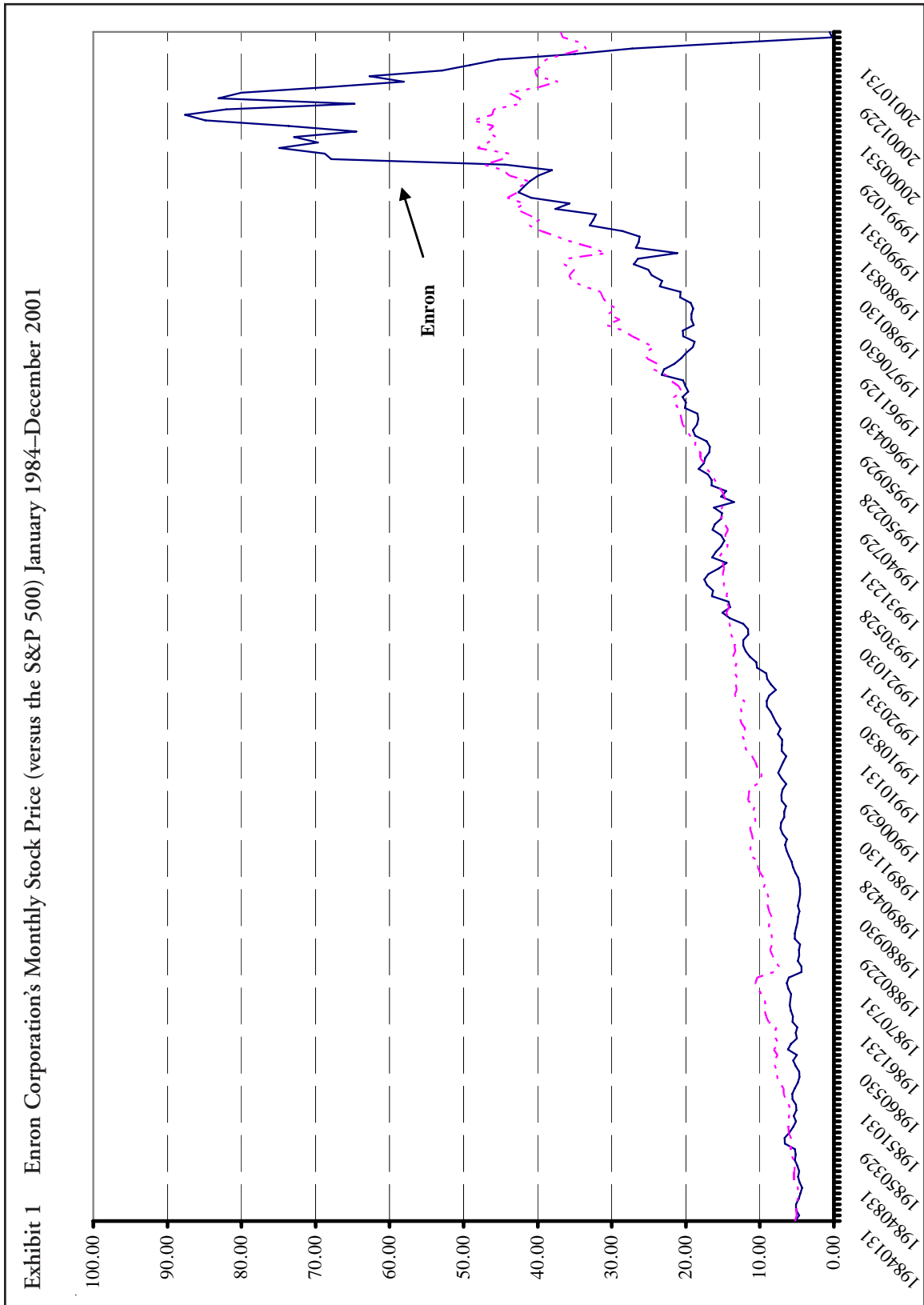
On September 10, 2003, Enron's Treasurer, Ben Glisan Jr., pleaded guilty to conspiracy, becoming the first former Enron executive to serve time in jail, with a five-year sentence. On January 14, 2004, Andrew Fastow pled guilty to conspiracy in a deal that called for a 10-year sentence and his help in the continuing investigation. Former chief accountant, Richard Causey, pleaded innocent on January 22, 2004, to a six-count indictment including conspiracy and fraud charges. Skilling was indicted on February 22, 2004, but pled not guilty to 35 counts of widespread schemes to mislead government regulators and investors about the company's earnings. On May 6, 2004, Lea Fastow, Andrew Fastow's wife, pled guilty to a reduced charge of filing a false tax form, a misdemeanor, and was sentenced to one year in a federal prison, the maximum sentence. On July 8, 2004, Enron's former CEO, Ken Lay, was indicted on 11 counts and additional charges filed by the Securities & Exchange Commission.<sup>7</sup>

### Warning Signs?

Amphlett's first pass through Enron's financial statements revealed a complex filing with many intricate footnotes, but there seemed to be few references to the infamous special purpose entities that had become synonymous with Enron's schemes to inflate its profits and stock price. The footnotes did reveal some details of Enron's investments accounted for using the equity method of accounting. Amphlett was also aware from graduate school that research studies showed some firms used accruals to boost earnings and that this was reflected in discrepancies between earnings and cash flows. For benchmarking purposes, Amphlett found that Enron's Value Line beta was 0.80 (versus 1.0 for the market) and that Enron's long-term debt rating by Moody's was a Baa1. Moody's reported that the average yield on A-rated debt was 8.07% per year, while the average yield on Baa-rated debt was 8.37% per year. At the time, the yield on 30-year Treasury Bonds was 6.055% per year, and the commonly used risk premium at the time was around 7.5% per year, although Amphlett knew that now 5% per year was viewed as the appropriate premium. Amphlett was surprised to find that Enron's shares closed at \$62.72 at the end of April 2001. Why had investors thought it was worth that much?

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<sup>7</sup> *The Wall Street Journal*, July 8, 2004.



## Exhibit 2 Selected Historical Data for Enron Corporation

	Dec-84	Dec-85	Dec-86	Dec-87	Dec-88	Dec-89	Dec-90	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00
<b>BALANCE SHEET ITEMS</b>																	
(In millions)																	
Cash & Equivalents	114	79	351	415	131	109	214	217	142	140	132	115	256	170	111	288	1,374
Plant, Property & Equip (Net)	3,289	6,303	4,851	6,429	6,097	6,028	6,219	6,598	6,473	6,723	6,739	6,868	7,112	9,170	10,657	10,681	11,743
Investments at Equity	140	361	496	571	455	491	516	560	636	697	1,065	1,216	1,701	2,656	4,433	5,036	5,294
Total Assets	6,122	9,596	8,484	9,529	8,695	9,105	9,849	10,424	10,664	11,504	11,966	13,239	16,137	23,422	29,350	33,381	65,503
Notes Payable	397	2,062	757	256	-	-	-	-	-	-	-	-	-	-	-	-	1,001
Long Term Debt	1,116	2,243	3,287	3,428	3,335	3,184	2,983	3,109	2,459	2,661	2,805	3,065	3,349	6,254	7,357	7,151	8,550
Total Stockholders' Equity	2,031	1,719	1,427	1,716	1,739	1,786	1,856	1,929	2,547	2,623	2,880	3,165	3,723	5,618	7,048	9,570	11,470
<b>INCOME STATEMENT ITEMS</b>																	
Sales (Net)	7,510	10,253	7,453	5,916	5,708	9,836	13,165	5,563	6,325	7,972	8,984	9,189	13,289	20,273	31,260	40,112	100,789
Operating Income Before Depreciation	866	938	702	711	695	688	787	851	981	1,076	1,157	1,050	1,164	1,390	2,266	2,113	2,808
Depreciation, Depletion, & Amortization	285	393	443	376	389	351	356	353	361	458	441	432	474	600	827	870	855
Operating Income After Depreciation	582	545	259	335	306	337	431	498	620	617	716	618	690	790	1,439	1,243	1,953
Interest Expense	146	350	452	479	433	398	395	368	327	300	282	301	286	419	616	710	876
Non-Operating Income/Expense	114	89	(10)	164	117	158	163	183	41	180	223	198	382	507	248	793	446
Special Items	(7)	(53)	C	C	175	198	67	28	112	-	15	367	178	(714)	(39)	13	121
Pretax Income	542	231	(203)	20	165	295	267	341	446	498	671	881	964	164	1,032	1,339	1,644
Income Taxes - Total	245	106	(95)	(34)	35	68	58	91	92	135	167	285	271	(90)	175	104	434
Minority Interest	-	-	-	-	-	0	7	9	18	30	51	76	109	149	154	211	231
Income Before Extraordinary Items & Discontinued Operations (EI&DO)	248	77	(156)	9	94	201	177	216	314	316	438	504	568	88	686	958	896
Extraordinary Items	-	(218)	-	-	(21)	0	-	-	(23)	-	-	-	-	-	-	-	(131)
Discontinued Operations	-	38	185	(83)	-	-	-	1	(7)	-	-	-	-	-	-	-	-
Net Income (Loss)	297	(55)	78	(29)	109	226	202	242	306	333	453	520	584	105	703	893	979
Primary - Excluding EI&DO	5.61	1.74	(3.53)	0.20	1.99	4.03	3.52	2.14	2.86	1.32	1.80	2.07	2.31	0.32	2.14	1.36	1.22
Primary - Including EI&DO	5.61	(2.33)	0.66	(1.64)	1.54	4.03	3.52	2.15	2.58	1.32	1.80	2.07	2.31	0.32	2.14	1.17	1.22
Fully Diluted - Excluding EI&DO	5.19	1.74	(3.53)	0.63	2.13	3.85	3.44	2.04	2.66	1.25	1.70	1.94	2.16	0.32	2.02	1.27	1.12
Fully Diluted - Including EI&DO	5.19	(2.33)	0.66	(0.90)	1.75	3.85	3.44	2.04	2.42	1.25	1.70	1.94	2.16	0.32	2.02	1.10	1.12

Source: COMPUSTAT; C = items combined; na = not available



Exhibit 2 Selected Historical Data for Enron Corporation (cont.)

	Dec-84	Dec-85	Dec-86	Dec-87	Dec-88	Dec-89	Dec-90	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00
<b>CASH FLOW ITEMS</b>																	
(In millions)																	
<b>INDIRECT OPERATING ACTIVITIES</b>																	
Income Before Extraordinary Items	297	166	(108)	54	130	226	202	241	336	333	453	520	584	105	703	1,024	979
Depreciation and Amortizations	288	428	407	376	389	419	458	478	462	547	532	458	474	600	827	870	855
Extraordinary Items and Disc. Operations	0	72	38	(20)	C	C	0	(0)	0	0	0	0	0	0	0	0	0
Other non-cash items	66	122	134	105	44	(127)	4	(97)	(263)	(96)	(128)	(43)	(175)	(139)	343	334	737
Working Capital Items - Change	0	0	0	(78)	(54)	(177)	272	192	(97)	(132)	(349)	(463)	92	(15)	(994)	(1,041)	300
Other Assets and Liabilities - Net Change	na	na	na	(252)	(428)	(148)	170	(23)	(144)	(183)	(4)	(487)	65	(50)	761	41	1,908
Operating Activities - Net Cash Flow	na	na	na	184	82	194	1,107	791	293	468	504	(15)	1,040	501	1,640	1,228	4,779
Investing Activities - Net Cash Flow	na	na	na	(177)	262	(135)	(567)	(599)	(7)	(639)	(604)	13	(1,230)	(2,436)	(3,965)	(3,507)	(4,264)
Financing Activities - Net Cash Flow	na	na	na	56	(599)	(63)	(435)	(184)	(339)	170	92	(16)	331	1,849	2,266	2,456	571
Cash and Cash Equivalents - Change	(120)	(35)	271	64	(255)	(3)	105	8	(52)	(1)	(8)	(17)	141	(86)	(59)	177	1,086
<b>OTHER ITEMS</b>																	
Senior Debt Rating - Monthly/S&P	. . .	BBB	BBB-	BBB-	BBB-	BBB	BBB	BBB	BBB	BBB	BBB	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+
Subordinated Debt Rating	. . .	BBB-	BB+	BB+	BB+	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB	BBB	BBB	na	na	na
Common Shareholders (# of)	33.8	32.7	30.5	28.2	30.0	26.9	27.0	26.5	25.6	27.0	26.8	25.6	11.7	58.0	58.6	58.0	58.9
Dividends (Cash) - Common	106	110	112	112	118	125	125	127	148	170	192	205	212	243	312	355	368
Employees (thousands)	10.6	11.9	7.2	6.9	6.3	6.3	7.0	7.4	7.8	7.1	7.0	6.7	26.3	15.5	17.8	17.9	20.6
Fortune Rank	na	na	na	na	na	na	na	na	na	na	129	141	94	57	27	18	7
Price - Calendar Year High	\$42.50	\$54.63	\$50.63	\$53.50	\$43.00	\$61.00	\$62.75	\$38.44	\$50.13	\$37.00	\$34.63	\$39.38	\$47.50	\$45.13	\$58.75	\$44.88	\$90.75
Price - Calendar Year Low	\$32.75	\$39.00	\$33.75	\$31.00	\$34.88	\$35.50	\$50.25	\$24.81	\$30.63	\$22.19	\$26.75	\$28.00	\$34.63	\$35.00	\$38.13	\$28.75	\$41.38
Price - Fiscal Year Close	\$42.25	\$45.00	\$39.50	\$39.13	\$36.63	\$57.63	\$54.75	\$35.00	\$46.38	\$29.00	\$30.50	\$38.13	\$43.13	\$41.56	\$57.06	\$44.38	\$83.13
Shares Outstanding at Fiscal Year End	43.88	44.66	44.40	46.84	47.36	50.34	50.45	101.22	118.59	249.10	251.68	251.24	255.12	311.25	330.88	714.53	751.63

Source: COMPUSTAT; C = items combined; na = not available

## Exhibit 3 Enron Corp.'s Financial Statements

## Consolidated Statements of Income

In Millions Except Per Share Amounts for Period Ended Dec 31, 2000	12/31/00	12/31/99	12/31/98
Revenues	--	--	--
Natural gas and other products	50,500	19,536	13,276
Electricity	33,823	15,238	13,939
Metals	9,234	--	--
Other	7,232	5,338	4,045
Total revenues	\$100,789	\$40,112	\$31,260
Costs and Expenses	--	--	--
Cost of gas, electricity, metals and other products	94,517	34,761	26,381
Operating expenses	3,184	3,045	2,473
Depreciation, depletion and amortization	855	870	827
Taxes, other than income taxes	280	193	201
Impairment of long-lived assets	--	441	--
Total costs and expenses	\$98,836	\$39,310	\$29,882
Operating Income	1,953	802	1,378
Other Income and Deductions	--	--	--
Equity in earnings of unconsolidated equity affiliates	87	309	97
Gains on sales of non-merchant assets	146	541	56
Gain on the issuance of stock by TNPC, Inc.	121	--	--
Interest income	212	162	88
Other income, net	(37)	181	(37)
Income Before Interest, Minority Interests and Income Taxes	\$2,482	\$1,995	\$1,582
Interest and related charges, net	838	656	550
Dividends on company-obligated preferred securities of subsidiaries	77	76	77
Minority interests	154	135	77
Income tax expense	434	104	175
Net income before cumulative effect of accounting changes	\$979	\$1,024	\$703
Cumulative effect of accounting changes, net of tax	--	(131)	--
Net Income	\$979	\$893	\$703
Preferred stock dividends	83	66	17
Earnings on Common Stock	896	827	686
Earnings Per Share of Common Stock	--	--	--
Basic:	--	--	--
Before cumulative effect of accounting changes	1.22	1.36	1.07
Cumulative effect of accounting changes	--	(0.19)	--
Basic earnings per share	1.22	1.17	1.07
Diluted:	--	--	--
Before cumulative effect of accounting changes	1.12	1.27	1.01
Cumulative effect of accounting changes	--	(0.17)	--
Diluted earnings per share	1.12	1.10	1.01
Average Number of Common Shares Used in Computation	--	--	--
Basic	736	705	642
Diluted	814	769	695



## Exhibit 3 Enron Corp.'s Financial Statements (cont.)

**Consolidated Balance Sheet****In Millions for Period Ended Dec 31, 2000**

	12/31/00	12/31/99
<b>Current Assets</b>	--	--
Cash and cash equivalents	1,374	288
Trade receivables (net of allowance for doubtful accounts of \$133 and \$40,	10,396	3,030
Other receivables	1,874	518
Assets from price risk management activities	12,018	2,205
Inventories	953	598
Deposits	2,433	81
Other	1,333	535
<b>Total current assets</b>	<u>\$30,381</u>	<u>\$7,255</u>
<b>Investments and Other Assets</b>	--	--
Investments in and advances to unconsolidated equity affiliates	5,294	5,036
Assets from price risk management activities	8,988	2,929
Goodwill	3,638	2,799
Other	5,459	4,681
<b>Total investments and other assets</b>	<u>\$23,379</u>	<u>\$15,445</u>
<b>Property, Plant and Equipment, at cost</b>	--	--
Natural gas transmission	6,916	6,948
Electric generation and distribution	4,766	3,552
Fiber optic network and equipment	839	379
Construction in progress	682	1,120
Other	2,256	1,913
	<u>\$15,459</u>	<u>\$13,912</u>
Less accumulated depreciation, depletion and amortization	3,716	3,231
<b>Property, plant and equipment, net</b>	<u>\$11,743</u>	<u>\$10,681</u>
<b>Total Assets</b>	<u><u>65,503</u></u>	<u><u>33,381</u></u>
<b>Current Liabilities</b>	--	--
Accounts payable	9,777	2,154
Liabilities from price risk management activities	10,495	1,836
Short-term debt	1,679	1,001
Customers' deposits	4,277	44
Other	2,178	1,724
<b>Total current liabilities</b>	<u>\$28,406</u>	<u>\$6,759</u>
<b>Long-Term Debt</b>	8,550	7,151
<b>Deferred Credits and Other Liabilities</b>	--	--
Deferred income taxes	1,644	1,894
Liabilities from price risk management activities	9,423	2,990
Other	2,692	1,587
<b>Total deferred credits and other liabilities</b>	<u>\$13,759</u>	<u>\$6,471</u>
<b>Commitments and Contingencies (Notes 13, 14 and 15)</b>	--	--
<b>Minority Interests</b>	2,414	2,430
<b>Company-Obligated Preferred Securities of Subsidiaries</b>	904	1,000
<b>Shareholders' Equity</b>	--	--
Second preferred stock, cumulative, no par value, 1,370,000 shares authorized,	124	130
Mandatorily Convertible Junior Preferred Stock, Series B, no par value, 250,000	1,000	1,000
Common stock, no par value, 1,200,000,000 shares authorized, 752,205,112 shares	8,348	6,637
Retained earnings	3,226	2,698
Accumulated other comprehensive income	(1,048)	(741)
Common stock held in treasury, 577,066 shares and 1,337,714 shares, respectively	(32)	(49)
Restricted stock and other	(148)	(105)
<b>Total shareholders' equity</b>	<u>\$11,470</u>	<u>\$9,570</u>
<b>Total Liabilities and Shareholders' Equity</b>	<u><u>65,503</u></u>	<u><u>33,381</u></u>

## Exhibit 3 Enron Corp.'s Financial Statements (cont.)

<b>Consolidated Statements of Cash Flows</b>			
<b>In Millions for Period Ended Dec 31, 2000</b>	<b>12/31/00</b>	<b>12/31/99</b>	<b>12/31/98</b>
Cash Flows From Operating Activities	--	--	--
Reconciliation of net income to net cash provided by operating activities	--	--	--
Net income	979	893	703
Cumulative effect of accounting changes	--	131	--
Depreciation, depletion and amortization	855	870	827
Impairment of long-lived assets (including equity investments)	326	441	--
Deferred income taxes	207	21	87
Gains on sales of non-merchant assets	(146)	(541)	(82)
Changes in components of working capital	1,769	(1,000)	(233)
Net assets from price risk management activities	(763)	(395)	350
Merchant assets and investments:	--	--	--
Realized gains on sales	(104)	(756)	(628)
Proceeds from sales	1,838	2,217	1,434
Additions and unrealized gains	(1,295)	(827)	(721)
Other operating activities	\$1,113	\$174	\$(97)
<i>Net Cash Provided by Operating Activities</i>	4,779	1,228	1,640
Cash Flows From Investing Activities	--	--	--
Capital expenditures	(2,381)	(2,363)	(1,905)
Equity investments	(933)	(722)	(1,659)
Proceeds from sales of non-merchant assets	494	294	239
Acquisition of subsidiary stock	(485)	--	(180)
Business acquisitions, net of cash acquired (see Note 2)	(777)	(311)	(104)
Other investing activities	(182)	(405)	(356)
<i>Net Cash Used in Investing Activities</i>	\$(4,264)	\$(3,507)	\$(3,965)
Cash Flows From Financing Activities	--	--	--
Issuance of long-term debt	3,994	1,776	1,903
Repayment of long-term debt	(2,337)	(1,837)	(870)
Net increase (decrease) in short-term borrowings	(1,595)	1,565	(158)
Net issuance (redemption) of company-obligated preferred securities of subsidiaries	(96)	--	8
Issuance of common stock	307	852	867
Issuance of subsidiary equity	500	568	828
Dividends paid	(523)	(467)	(414)
Net disposition of treasury stock	327	139	13
Other financing activities	(6)	(140)	89
<i>Net Cash Provided by Financing Activities</i>	\$571	\$2,456	\$2,266
Increase (Decrease) in Cash and Cash Equivalents	1,086	177	(59)
Cash and Cash Equivalents, Beginning of Year	288	111	170
Cash and Cash Equivalents, End of Year	1,374	288	111
Changes in Components of Working Capital	--	--	--
Receivables	(8,203)	(662)	(1,055)
Inventories	1,336	(133)	(372)
Payables	7,167	(246)	433
Other	1,469	41	761
Total	1,769	(1,000)	(233)

**Exhibit 4 Selected Information from Enron's 2000 10-K****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Net income includes the following:

(In millions)	2000	1999	1998
After-tax results before items impacting comparability	\$1,266	\$957	\$698
Items impacting comparability: (a)			
Charge to reflect impairment by Azurix	-326	-	-
Gain on TNPC, Inc. (The New Power Company), net	39	-	-
Gains on sales of subsidiary stock	-	345	45
MTBE-related charges	-	-278	-40
Cumulative effect of accounting changes	-	<u>-131</u>	<u>-</u>
Net income	\$979	\$893	\$703

(a) Tax affected at 35%, except where a specific tax rate applied.

Diluted earnings per share of common stock were as follows:

	2000	1999	1998
Diluted earnings per share (a):			
After-tax results before items impacting comparability	\$1.47	\$1.18	\$1.00
Items impacting comparability:			
Charge to reflect impairment by Azurix	-0.40	-	-
Gain on The New Power Company, net	0.05	-	-
Gains on sales of subsidiary stock	-	0.45	0.07
MTBE-related charges	-	-0.36	-0.06
Cumulative effect of accounting changes	-	<u>-0.17</u>	<u>-</u>
Diluted earnings per share	\$1.12	\$1.10	\$1.01

(a) Restated to reflect the two-for-one stock split effective August 13, 1999.

**CAPITALIZATION**

Enron is a party to certain financial contracts which contain provisions for early settlement in the event of a significant market price decline in which Enron's common stock falls below certain levels (prices ranging from \$28.20 to \$55.00 per share) or if the credit ratings for Enron's unsecured, senior long-term debt obligations fall below investment grade. The impact of this early settlement could include the issuance of additional shares of Enron common stock.

Enron's senior unsecured long-term debt is currently rated BBB+ by Standard & Poor's Corporation and Fitch IBCA and Baa1 by Moody's Investor Service. Enron's continued investment grade status is critical to the success of its wholesale businesses as well as its ability to maintain adequate liquidity. Enron's management believes it will be able to maintain its credit rating.

**1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Investments in Unconsolidated Affiliates.** Investments in unconsolidated affiliates are accounted for by the equity method, except for certain investments resulting from Enron's merchant investment activities which are included at market value in "Other Investments" in the Consolidated Balance Sheet. See Notes 4 and 9. Where acquired assets are accounted for under the equity method based on temporary control, earnings or losses are recognized only for the portion of the investment to be retained.

## 4 MERCHANT ACTIVITIES

An analysis of the composition of Enron's merchant investments and energy assets at December 31, 2000 and 1999 is as follows:

(In millions)	December 31,	
	2000	1999
Merchant investments (a)		
Energy	\$137	\$516
Energy-intensive industries	63	218
Technology-related	99	11
Other	<u>302</u>	<u>341</u>
	601	1,086
Merchant assets (b)		
Independent power plants	53	152
Natural gas transportation	36	35
	<u>89</u>	<u>187</u>
Total	\$690	\$1,273

(a) Investments are recorded at fair value in "Other Assets" with changes in fair value reflected in "Other Revenues."

(b) Amounts represent Enron's investment in unconsolidated equity affiliates with operating earnings reflected in "Equity in Earnings of Unconsolidated Equity Affiliates."

Enron provides capital primarily to energy and technology-related businesses seeking debt or equity financing. The merchant investments made by Enron and certain of its unconsolidated affiliates (see Note 9) are carried at fair value and include public and private equity, government securities with maturities of more than 90 days, debt and interests in limited partnerships. The valuation methodologies utilize market values of publicly-traded securities, independent appraisals and cash flow analyses. Also included in Enron's wholesale business are investments in merchant assets such as power plants and natural gas pipelines, primarily held through equity method investments. Some of these assets were developed, constructed and operated by Enron. The merchant assets are not expected to be long-term, integrated components of Enron's energy networks.

For the years ended December 31, 2000, 1999 and 1998, respectively, pre-tax gains from sales of merchant assets and investments totaling \$104 million, \$756 million and \$628 million are included in "Other Revenues," and proceeds were \$1,838 million, \$2,217 million and \$1,434 million.

## 9 UNCONSOLIDATED EQUITY AFFILIATES

Enron's investment in and advances to unconsolidated affiliates which are accounted for by the equity method is as follows:

(In millions)	Net Voting Interest (a)	December 31,	
		2000	1999
Azurix Corp.	34%	\$325	\$762
Bridgeline Holdings	40%	229	-
Citrus Corp.	50%	530	480
Dabhol Power Company	50%	693	466
Joint Energy Development Investments L.P. (JEDI)(b)	50%	399	211
Joint Energy Development Investments II L.P. (JEDI II)(b)	50%	220	162
SK - Enron Co. Ltd.	50%	258	269
Transportadora de Gas del Sur S.A.	35%	479	452
Whitewing Associates, L.P.(b)	50%	558	662
Other (c)		<u>1,603</u>	<u>1,572</u>
		\$5,294(c)	\$5,036(c)

(a) Certain investments have income sharing ratios which differ from Enron's voting interests.

- (b) JEDI and JEDI II account for their investments at fair value. Whitewing accounts for certain of its investments at fair value. These affiliates held fair value investments totaling \$1,823 million and \$1,128 million, respectively, at December 31, 2000 and 1999.
- (c) At December 31, 2000 and 1999, the unamortized excess of Enron's investment in unconsolidated affiliates was \$182 million and \$179 million, respectively, which is being amortized over the expected lives of the investments.

Enron's equity in earnings (losses) of unconsolidated equity affiliates is as follows:

(In millions)	December 31,		
	<u>2000</u>	<u>1999</u>	<u>1998</u>
Azurix Corp.(a)	(\$428)	\$23	\$6
Citrus Corp.	50	25	23
Dabhol Power Company	51	30	-
Joint Energy Development Investments L.P.	197	11	(45)
Joint Energy Development Investments II, L.P.	58	92	(4)
TNPEC, Inc. (The New Power Company)	(60)	-	-
Transportadora de Gas del Sur S.A.	38	32	36
Whitewing Associates, L.P.	58	9	-
Other	123	87	81
	<u>\$87</u>	<u>\$309</u>	<u>\$97</u>

- (a) During the fourth quarter of 2000, Azurix Corp. (Azurix) impaired the carrying value of its Argentine assets, resulting in a charge of approximately \$470 million. Enron's portion of the charge was \$326 million.

Summarized combined financial information of Enron's unconsolidated affiliates is presented below:

(In millions)	December 31,	
	2000	1999
Balance sheet		
Current assets(a)	\$5,884	\$3,168
Property, plant and equipment, net	14,786	14,356
Other noncurrent assets	13,485	9,459
Current liabilities(a)	4,739	4,401
Long-term debt(a)	9,717	8,486
Other noncurrent liabilities	<u>6,148</u>	<u>2,402</u>
Owners' equity	<u>\$13,551</u>	<u>\$11,694</u>

- (a)Includes \$410 million and \$327 million receivable from Enron and \$302 million and \$84 million payable to Enron at December 31, 2000 and 1999, respectively.

(In millions)	December 31,		
	2000	1999	1998
Income statement(a)			
Operating revenues	\$15,903	\$11,568	\$8,508
Operating expenses	14,710	9,449	7,244
Net income	586	1,857	142
Distributions paid to Enron	137	482	87

- (a) Enron recognized revenues from transactions with unconsolidated equity affiliates of \$510 million in 2000, \$674 million in 1999 and \$563 million in 1998.

In 2000 and 1999, Enron sold approximately \$632 million and \$192 million, respectively, of merchant investments and other assets to Whitewing. Enron recognized no gains or losses in connection with these transactions. Additionally, in 2000, ECT Merchant Investments Corp., a wholly owned Enron subsidiary, contributed two pools of merchant investments to a limited partnership that is a subsidiary of Enron. Subsequent to the contributions, the partnership issued partnership interests representing 100% of the beneficial, economic interests in the two asset pools, and such interests were sold for a total of \$545 million to

a limited liability company that is a subsidiary of Whitewing. See Note 3. These entities are separate legal entities from Enron and have separate assets and liabilities. In 2000 and 1999, the Related Party, as described in Note 16, contributed \$33 million and \$15 million, respectively, of equity to Whitewing. In 2000, Whitewing contributed \$7.1 million to a partnership formed by Enron, Whitewing and a third party. Subsequently, Enron sold a portion of its interest in the partnership through a securitization. See Note 3.

In 2000, The New Power Company sold warrants convertible into common stock of The New Power Company for \$50 million to the Related Party (described in Note 16). From time to time, Enron has entered into various administrative service, management, construction, supply and operating agreements with its unconsolidated equity affiliates. Enron's management believes that its existing agreements and transactions are reasonable compared to those which could have been obtained from third parties.

#### 16 RELATED PARTY TRANSACTIONS

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly-formed entities (the Entities) assets valued at approximately \$1.2 billion, including \$150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately \$309 million, including a \$50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, \$309 million in notes receivable, of which \$259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of \$1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of \$172.6 million is invested in Enron demand notes. In addition, Enron paid \$123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron \$10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

In 2000, Enron entered into derivative transactions with the Entities with a combined notional amount of approximately \$2.1 billion to hedge certain merchant investments and other assets. Enron's notes receivable balance was reduced by \$36 million as a result of premiums owed on derivative transactions. Enron recognized revenues of approximately \$500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments and price risk management activities. In addition, Enron recognized \$44.5 million and \$14.1 million of interest income and interest expense, respectively, on the notes receivable from and payable to the Entities.

In 1999, Enron entered into a series of transactions involving a third party and the Related Party. The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) the Related Party received 6.8 million shares of Enron common stock subject to certain restrictions and (iii) Enron received a note receivable, which was repaid in December 1999, and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, the Related Party agreed that the senior officer of Enron would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. In 2000, Enron and the Related Party entered into an agreement to terminate certain financial instruments that had been entered into during 1999. In connection with this agreement, Enron received approximately 3.1 million shares of Enron common stock held by the Related Party. A put option, which was originally entered into in the first quarter of 2000 and gave the Related Party the right to sell shares of Enron common stock to Enron at a strike price of \$71.31 per share, was terminated under this agreement. In return, Enron paid approximately \$26.8 million to the Related Party.

In 2000, Enron sold a portion of its dark fiber inventory to the Related Party in exchange for \$30 million cash and a \$70 million note receivable that was subsequently repaid. Enron recognized gross margin of \$67 million on the sale. In 2000, the Related Party acquired, through securitizations, approximately \$35 million of merchant investments from Enron. In addition, Enron and the Related Party formed partnerships in which Enron contributed cash and assets and the Related Party contributed \$17.5 million in cash. Subsequently, Enron sold a portion of its interests in the partnerships through securitizations. See Note 3. Also, Enron contributed a put option to a trust in which the Related Party and Whitewing hold equity and debt interests. At December 31, 2000, the fair value of the put option was a \$36 million loss to Enron.

In 1999, the Related Party acquired approximately \$371 million, merchant assets and investments and other assets from Enron. Enron recognized pre-tax gains of approximately \$16 million related to these transactions. The Related Party also entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately \$34 million.