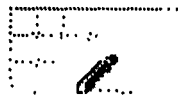


From: Rick L Carson [Rick L Carson/HOU/ECT@It-Comp]
Sent: Friday, June 09, 2000 5:12 AM
To: Stephanie McGinnis
Subject: Skilling Presentation

----- Forwarded by Rick L Carson/HOU/ECT on 06/09/2000 11:00 AM -----



Kenneth Horton@ENRON_DEVELOPMENT
06/09/2000 11:10 AM

To: Rick L Carson@ECT
cc: Lynn Bellinghausen/ENRON_DEVELOPMENT@ENRON_DEVELOPMENT
Subject: Skilling Presentation

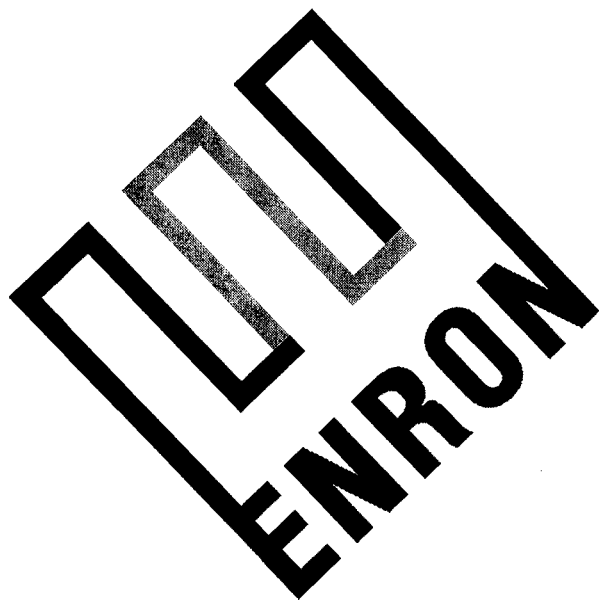
Rick,

Attached is the file with a couple of international examples (Hainan and Energovill). They can be found on pages 9 and 14. We modified the pictures slightly so that the international text would fit onto the slide.

Thank you,
Ken



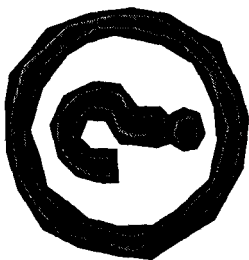
Lessons Learned
00-06-09.ppt (...)



Investment Portfolio
“Lessons Learned”

June 9, 2000

Enron Executives & Dealmakers:



Please complete the following investment survey:

YES



NO



Question No. 1

Would you invest your personal savings in a domestic fund that has expended \$1.9 billion in capital since 1997, of which 23 portfolio assets totalling \$446 million will likely be written off?

Question No. 2

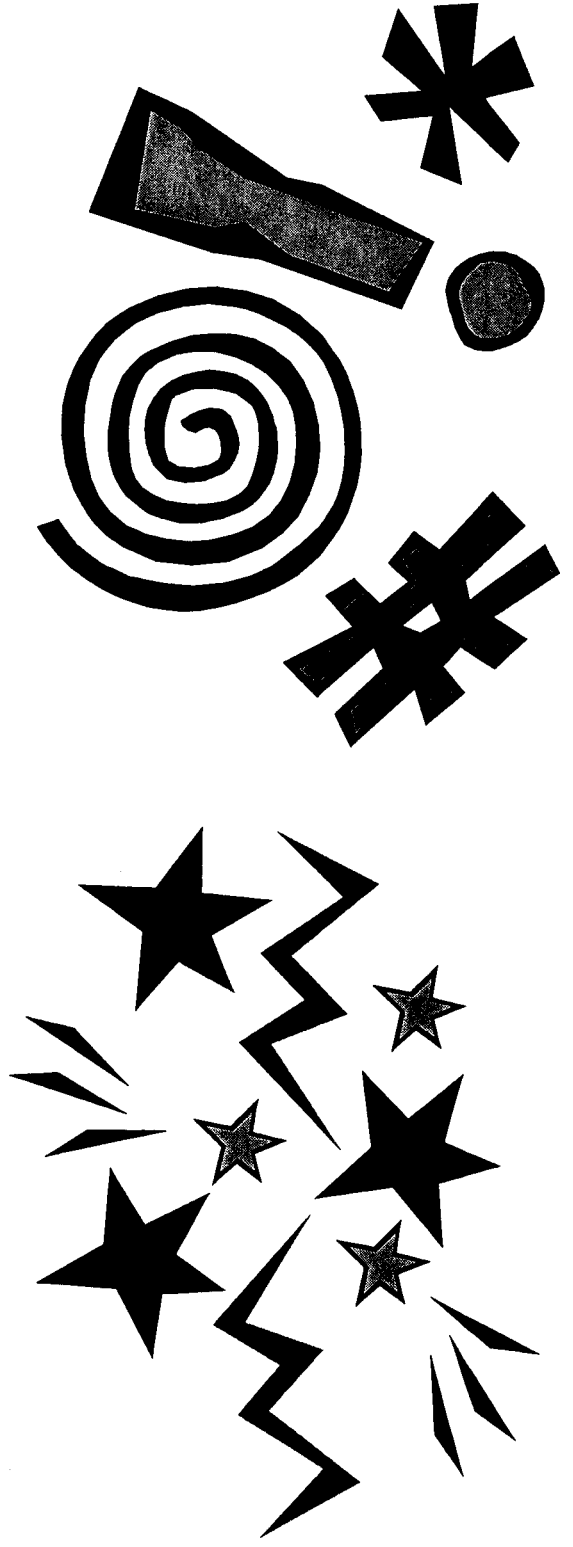
Would you recommend that your mother invest her IRA in an energy and industrial fund of 90 investments where an acceptable return is contingent on the performance of 6 key assets since the remaining 84 assets average less than a 5% IRR?

Question No. 3

Do you feel comfortable investing in a worldwide portfolio where 30% of the transactions are "troubled" or considered not meeting expectations?

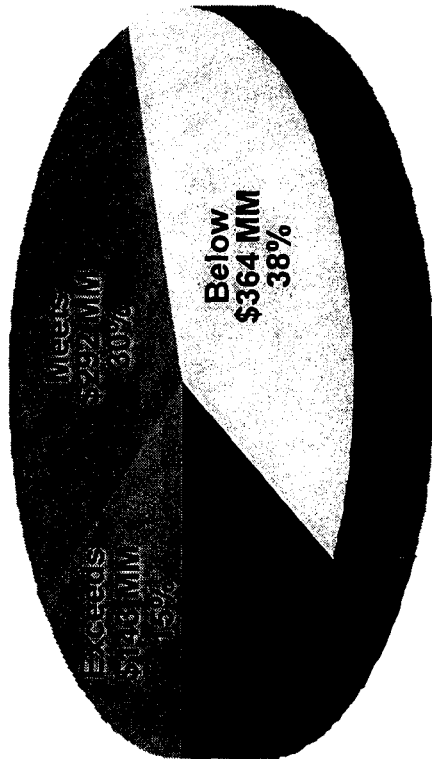
Guess What?

If you answered an emphatic “NO” to all of the previous questions you might be shocked to learn that the portfolio we are talking about is Enron’s Investment Portfolio!!!



Some Statistics

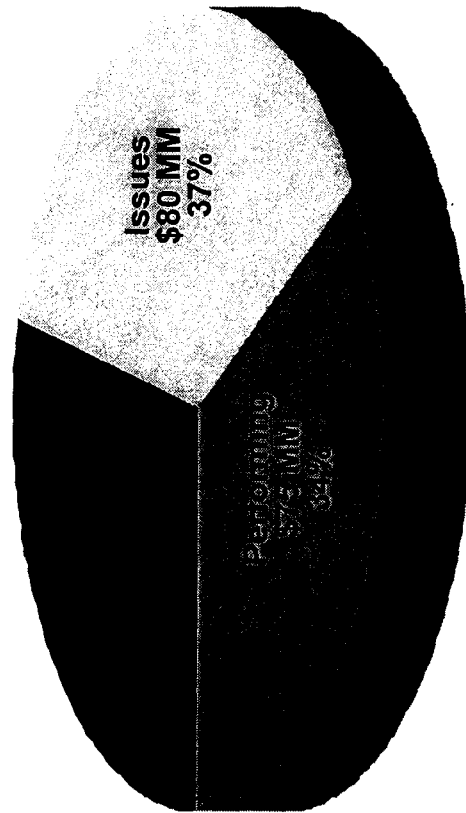
ENRON NORTH AMERICA – MERCHANT PORTFOLIO



EQUITY PORTFOLIO PERFORMANCE

Cost Basis \$1.0 Bn

CONCLUSION: 55% of originally expended capital is not meeting expectations



DEBT PORTFOLIO PERFORMANCE

Cost Basis \$0.2 Bn

CONCLUSION: 66% of portfolio debt has issues or is not performing

Some More Statistics

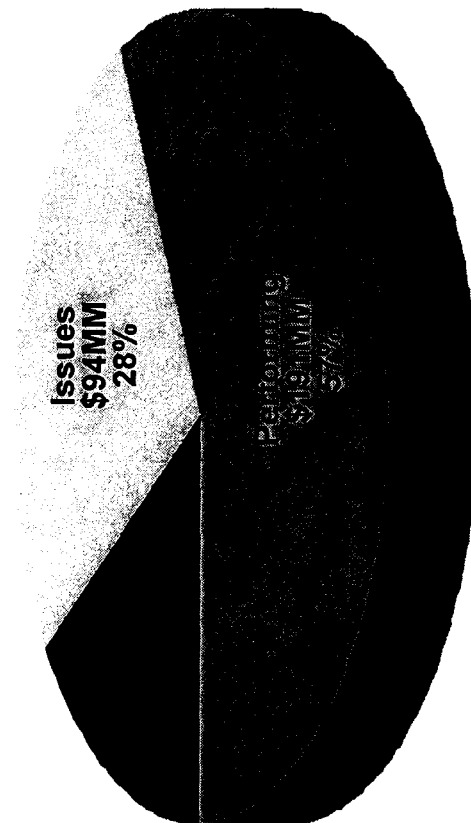
ENRON INTERNATIONAL REGIONS – MERCHANT & STRATEGIC PORTFOLIO



EQUITY PORTFOLIO PERFORMANCE

Cost Basis \$4.3 Bn

CONCLUSION: 22% of originally expended capital is not meeting expectations



DEBT PORTFOLIO PERFORMANCE

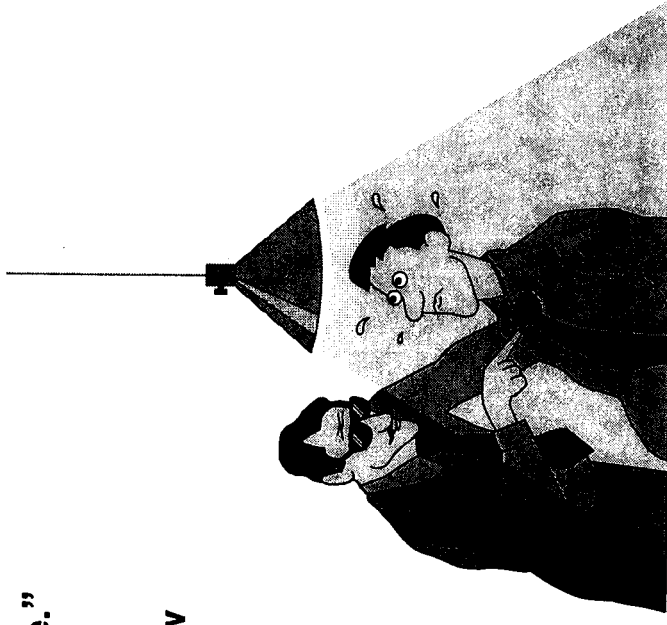
Cost Basis \$0.3 Bn

CONCLUSION: 43% of portfolio debt has issues or is not performing

Is there an overall problem with our deal culture?

Social/Process Issues

- ❖ Earnings pressure at Enron causes deals to be done “at any price.”
- ❖ Commercial personnel are rewarded for deals closed now not how deals perform in the long term.
- ❖ Deals are negotiated by originators inexperienced in banking and finance.
- ❖ Deal originators/advocates have been left in charge of portfolio management with disastrous results.
- ❖ The raising of legitimate deal concerns by review personnel has not been encouraged by dealmakers or Senior Management; in fact, there has been a “shoot the messenger” mentality.
- ❖ We have invested heavily in industries where we clearly have little experience or a defined strategy.



What do “bad” deals have in common?

COMMON THREADS

- ☛ Marginal assets
- ☛ Weak or dishonest counterparty management
- ☛ Passive/lenient asset management by Enron
- ☛ Failure to understand the industry; its markets, technology and construction risks
- ☛ Underpriced capital
(i.e. equity risk for debt returns)
- ☛ Failure to understand or consider the counterparty's liquidity situation
- ☛ Limited rights in the event of a distress situation
- ☛ Investing in commodity play when markets are at their peak

DEAL EXAMPLES

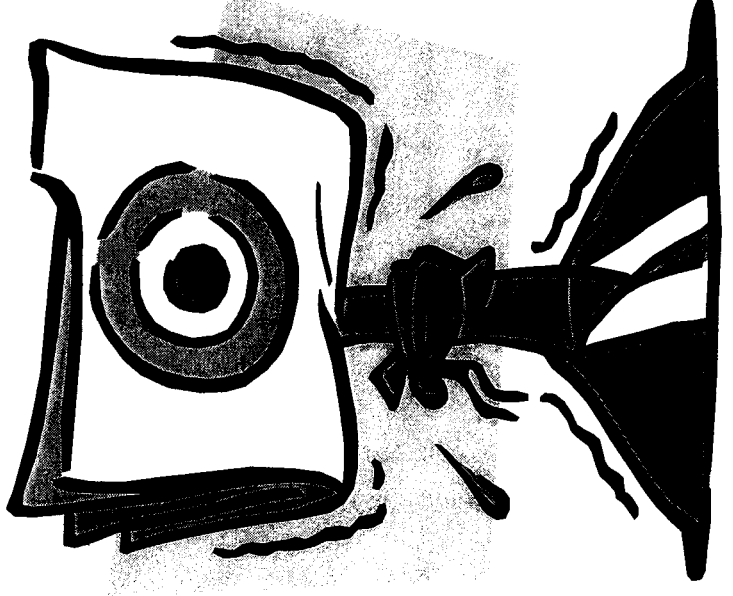
- Meridian I, Lewis Energy, CGAS
- Noram, Kafus, Energovill, Japro
- Ecogas, Lyco, Gasco, Adrian
- Qualitech, Citadel, Crown, Kafus
- Hughes Rawls, Earl Burke, Repap
- Costilla, Carrizo, Repap
- Carrizo, Costilla, Inland, Hainan
- Elektro, Queen Sand, Brigham

Discussion of Common Threads

Marginal Assets

As a "lender of last resort", Enron is brought many deals that have been turned down by banks or other investor groups. Often these deals involve assets that have not been performing but supposedly with our client's "expertise" and Enron money can be turned into "stars"

Meridian Ventures I was a Limited Partnership that Enron formed with Meridian Exploration Company of Pittsburgh, Pennsylvania to recover additional crude oil reserves from the Bonanza Unit in Cochran County, Texas by forming a waterflood unit. At least two previous owners of the Bonanza Unit had tried unsuccessfully to waterflood the property but Meridian was confident that they knew why previous efforts failed. Unfortunately, they weren't any smarter than the previous guys and the entire investment was written off!!!



Discussion of Common Threads

Weak or Dishonest Counterparty Management

Often we deal with small entrepreneurial types that are technically oriented but don't have the management experience to properly run a larger entity. Typically these people have not had the funds nor the inclination to spend their money on a professional staff. Occasionally, Enron has encountered a partner that is of questionable integrity. One such example follows:

Enron through its EnSerCo affiliate loaned \$15.5 million to Noram, Inc. for the refurbishment of a jackup drilling rig in storage in Brazil. The background investigation of Noram's CEO, a Norwegian born promoter, indicated an association in the 1980's with an individual that was involved in numerous lawsuits for questionable oil and gas fund raising activities. The Deal Team questioned the CEO about the association, which he dismissed as a casual acquaintance. The deal was then approved and funded but unfortunately the drilling rig market hit bottom in early 1999 and Enron had to foreclose on the rig when Noram defaulted. The CEO has since used his international connections to improperly move other collateral property out of the U.S. into jurisdictions unfavorable for Enron's recovery. We should have gone with the old adage, "Where there's smoke, there's fire!"

Another example includes Energovill, a Hungarian company purchased in 1998. In 1999, Enron dismissed most of the senior management of Energovill, following the discovery of a \$690,000 tax liability incurred prior to Enron's acquisition, which had not been revealed. Energovill's problems were compounded by the over-reliance on a single individual sponsoring the deal internally and who subsequently left the company, as well as the underestimation of the costs of integrating a business into the "Enron structure."

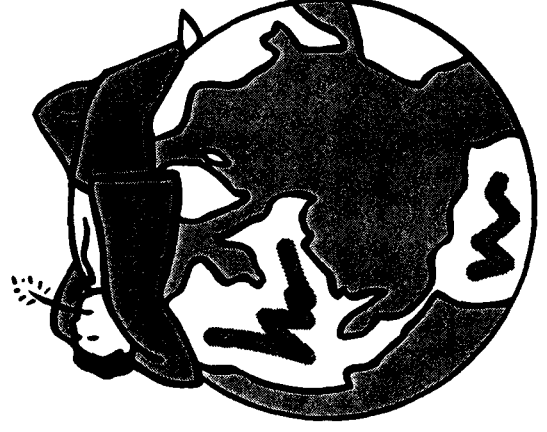


Discussion of Common Threads

Passive / lenient asset management by Enron

There are several reasons that it is difficult for a deal originator to be an effective post-deal asset manager. The first constraint is time: effective asset management is time intensive which takes away from new deal development. Secondly, since most successful deal originators have established social relationships with clients, it is a difficult, if not impossible transition to make from being a "friend" to a hard nosed lender or investor demanding performance. Lastly, human nature makes it difficult to admit defeat. When a deal goes sour, the reaction of some deal originators is to put more money in to try to save the deal or "hide the ball" until things get so bad that they "blow up". One such deal is chronicled below:

Ecogas is a landfill gas company in which Enron acquired an 85% interest in 1999. When the deal was approved it was recognized that considerable external project financing was necessary for viability and a tentative financing commitment from a recognized financial institution was in place at closing. Subsequent to closing, the financing commitment fell through and for five months the deal team failed to notify Enron's senior management of the situation. It was only when the liquidity situation at the company got so severe that lawsuits were being filed by vendors, that the full facts were disclosed.



Discussion of Common Threads

Failure to understand industry, its markets, technology and construction risks

Enron has invested in a number of new (to Enron) industries where is is now clear that we did not have the level of knowledge of the market and technical risk necessary to make an intelligent investment decision. In many of these investments our only product marketing and technical evaluation was a review of the consultant reports provided by the counterparty.

Qualitech Steel was a start up steel mill in which Enron invested approximately \$50 million. The success of this venture was tied to the mill's ability to produce steel of a particular high quality level which was never achieved. The company then lost their intended customers and had to compete (unsuccessfully) in the low grade, low margin steel market. The Company filed for Chapter 11 in March of 1999. It appears that Enron will lose our entire investment as a result of failure to recognize the technological risks inherent in the deal.



Discussion of Common Threads

Underpriced Capital (i.e. equity risk for debt returns)

Underpricing capital can be a result of faulty analytics or the desire of the dealmaker to cultivate a business relationship with a counterparty by doing the first deal as a "loss leader". Unfortunately, in many instances the follow-on business never comes. In the oil and gas finance areas, we have seen many transactions where equity, (in fact, very risky equity in the form of drilling and exploration projects) was priced at debt like returns. A painful lesson follows:

Hughes Rawls, LLC was a drilling partnership managed a Mississippi based E & P company in which Enron was a participant. After making an initial equity investment of \$12.5 million, Enron agreed to lend up to \$20 million to the LLC to fund a drilling obligation in the Gulf of Mexico under a farmout agreement with Chevron. The established interest rate on the loan was 10% and the borrowing base was established at 120% of proved reserves. The drilling turned out to be much riskier than anticipated and a number of wells had cost overruns. It now appears that Enron will write off nearly \$8.0 million on this loan.

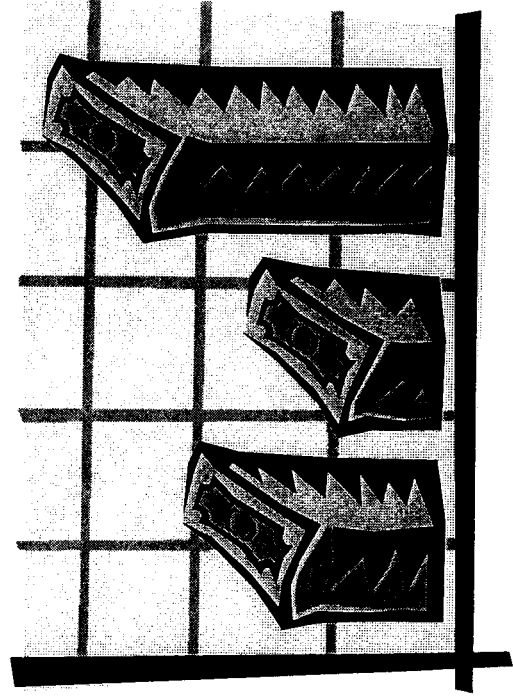


Discussion of Common Threads

Failure to understand or consider the counterparty's liquidity situation

Obviously, most of our finance business customers have liquidity issues or they would not be seeking our capital in the first place. Often the true extent of their cash flow problems are either not identified, understated by the customer or ignored by the dealmaker. Unfortunately, once we make that initial advance we are in a bit of a "Catch 22" situation, torn between trying to save our original investment by providing the company liquidity and not wanting to put more money in a deal that is experiencing problems. The importance of a full understanding of the counterparty's cash flow situation cannot be underestimated.

Costilla Energy is a Midland, Texas based oil and gas company. In 1998, Enron invested \$50 million in a preferred stock issue. At the time of our investment, Costilla's debt exceeded the value of its reserves and the company had a \$13 million working capital deficit. Costilla actually needed far more than our \$50 million to pay creditors and to execute their business plan which included a major acquisition from Pioneer. When commodity prices crashed in late 1998, the Company's financial condition became hopeless and they are now in bankruptcy with no hope for any Enron recovery.



Discussion of Common Threads

Limited rights in the event of a distress situation

A study of a number of deals that have become "troubled" indicates that legal documentation to provide Enron with rights in the event of a distress situation were lacking. It appears that some of these rights were traded away by dealmakers. Others were missed entirely or were ambiguous because pro-forma compliance certificates were not included showing how covenant calculations should be made.

An example of this ambiguity was Carrizo Oil and Gas where Enron's rights were contingent, in part, on Carrizo failing a cash flow test relating to the Company's ability to pay dividends. The definition of cash flow was very ambiguous, there were no defined terms or pro forma exhibits that clarified the calculation. The Company disputed Enron's interpretation and we were put at a disadvantage in our settlement negotiation.

Another example is the Hainan Meinan Power Company. Hainan was established to own, operate, and manage a 154MW power plant on an island south of China. The investment premise was based on a rapidly growing economy, but China controlled the province's over-heated growth, eliminating generation requirements. Additionally, difficulties with one of Enron's partners in the \$174 MM deal essentially forced Enron into buying out the other's share in order to create a small amount of hope of saving or resolving the deal.

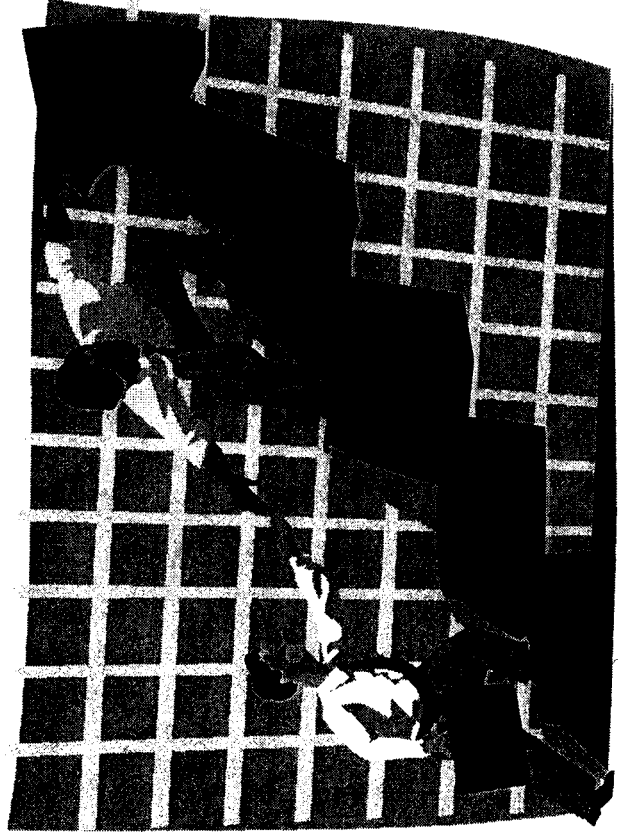


Discussion of Common Threads

Investing in commodity play when markets are at their peak

Enron as an investor has tended to rush into "hot" markets. Unfortunately, on a number of occasions, we have invested at the peak in a number of markets that are essentially commodity plays. This occurred in the U.S. in 1998 where many oil and gas investments were made at the peak of the market and when commodity prices collapsed, so did the stock prices and credit worthiness of the companies in our portfolio.

Additional examples are the Brazilian assets, Elektro, CEG and Gaspart where our initial investments appear to have been made near the top of the market which has since declined substantially.



Changes Made to Date



- ▶ *More complete due diligence*
- ▶ *Standardized terms for legal documents*
- ▶ *Some separation of deal origination and asset management achieved*
- ▶ *RAC makes independent recommendation on DASH*
- ▶ *Improved portfolio reporting and early identification of problem assets.*

Recommendations

- ⌘ Review staffing of deal origination functions to ensure that adequate financial, industry and negotiating experience is in place.
- ⌘ Compensation package for deal originators should be changed to more directly reflect long term deal performance.
- ⌘ Senior Management should require that every deal up for approval be presented in an open forum with both pros and cons of the deal presented.
- ⌘ Every deal involving technology or operational risk must have an independent engineering review
- ⌘ Deals should only be developed using current market input and terms to provide third party corroboration and the ability to syndicate.
- ⌘ Completely separate deal origination and asset management.
- ⌘ Implement deal “milestones” tracked through the compliance system including detail construction costs and progress monitoring.

