A P P E N D I X   D

CITIGROUP CASE HISTORY

Citigroup, along with Chase was, was a major provider of prepays and financing to Enron. Beginning in December 1993, Citigroup led 14 separate prepay transactions totaling $4.8 billion for Enron. The total outstanding Citigroup prepay debt at the time of Enron's bankruptcy was $2.5 billion.[1]

The structure employed for Citigroup's prepays closely follows the structure of Chase/Mahonia transactions with Enron.[2] Citigroup created an offshore entity called Delta Energy Corporation in the Cayman Islands, which along with Enron and Citibank, would form the familiar triangle used to structure the prepays and remove price risk from the transaction.

The most prominent structural difference between the Enron/Chase transactions and the Enron/Citigroup transactions was the manner in which the later Enron/Citigroup transactions were financed. The first Enron/Citigroup transactions involved financing similar to the Enron/Chase transactions, in which the bank served as the source of funds that went through the special purpose entity, Delta, and on to Enron. Later Enron/Citibank transactions, representing $2.4 billion of the total $4.8 billion in prepay transactions between the two parties, were financed through bond offerings. "Yosemite" was the name of a series of six synthetic Enron bond offerings used to raise the $2.4 billion.[3] All of these bonds, with maturities ranging from five to seven years, remained outstanding at the time of the Enron bankruptcy.

For each of the offerings, a trust that was off-balance sheet to Enron offered credit linked obligations (notes that were linked to Enron's credit) to "Qualified Institutional Buyers."[4] By raising the funds for the prepays in this fashion, the institutional investors, rather than Citigroup, took on the risk that Enron would not or could not repay the funds. No additional credit support, such as surety bonds or letters of credit, was employed.

How the Citigroup Prepays Worked

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[1]See Appendix E for a list of all the Citigroup prepays.

[2]Citigroup's prepays involved the transfer of crude oil and natural gas. Prior to 1999, the transactions appear to have been physically settled -- the title to ownership of the commodity was transferred among the parties to the transactions. Thereafter, the transactions were all financially settled -- the funds representing the net value of each of the trades and swaps between the parties to the transaction was transferred among the parties.

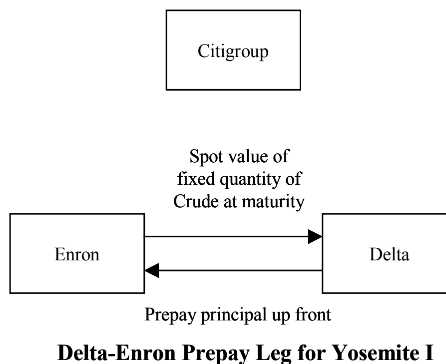
[3]They were: Yosemite I, 11/18/99, $750 mm; Yosemite II, 2/23/00, £200 mm; Yosemite III (issued as Enron CLN I–Credit Linked Note), 8/17/00, $500 mm; Yosemite IV (issued as Enron CLN II), 5/17/01, comprising 3 offerings: $500 mm; £125 mm; and 200 mm Euros.

[4]Under SEC rules, "Qualified Institutional Buyers" are entities that have sufficient resources and investment sophistication that they are deemed capable of making investment decisions without the offering material being filed with the SEC for adequate disclosure review. These are commonly called Rule 144(A) offerings.

The same basic triangle employed in the Enron/Chase prepays applied to the Enron/Citigroup transactions. For illustration purposes, a simplified prepay transaction is described with the Yosemite I Trust providing the initial funding.

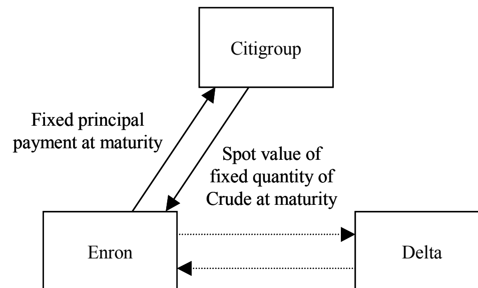
- The Yosemite I Trust loaned $800 million proceeds to Delta Energy, a Citigroup SPE.

- Delta immediately entered into a cash-settled prepaid forward contract with Enron. Delta paid Enron the $800 million up front. In return, Delta would receive the spot price value of a preset number of barrels of crude oil at maturity. The net difference between Delta's payment to Enron and the value of the crude oil owed to Delta by Enron would be settled through a cash payment.



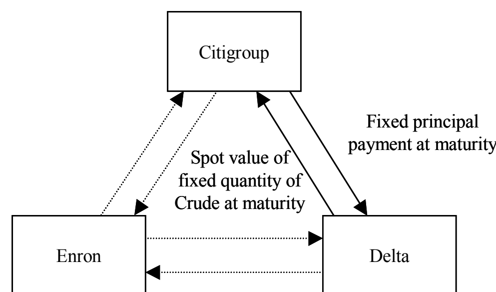
Delta-Enron Prepay Leg for Yosemite I

- At the same time, Enron and Citigroup entered into a hedging transaction.[5] In a cash-settled swap, Enron would receive the spot value of the same fixed amount of crude as in the Enron-Delta transaction at maturity, while Citigroup would receive a fixed value of $800 million at maturity.



Enron-Citigroup Commodity Swap (Hedge)

- Meanwhile, Citigroup and Delta entered into a hedging transaction. In a cash-settled swap, Citigroup would receive the spot value of the same fixed amount of crude as in the Enron-Delta and Citigroup-Enron transaction at maturity, while Delta would receive the fixed value of $800 million at maturity.



Citigroup-Delta Commodity Swap (Hedge)

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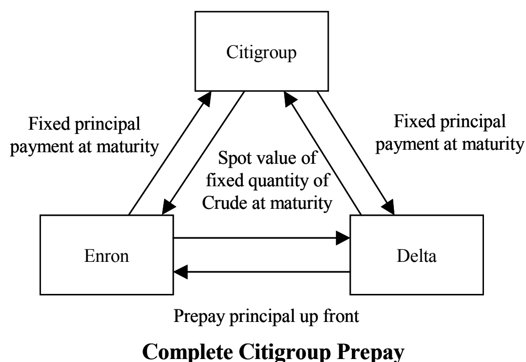
[5]A hedging transaction is a transaction established to limit or eliminate the risk a party bears in another transaction. In this case, Enron has price risk in its transaction with Delta - i.e., the $800 million it receives from Delta might be less than the cost of the spot price of the oil that it owes to Delta. Similarly, Citibank has price risk from the transaction that it enters into with Delta as part of the series of transactions involved in this prepay transaction - the spot value of the oil it receives from Delta may be less than the $800 million it pays up front to Delta.

In this arrangement, the spot value of the crude oil that each party owes and receives cancel each other out. Thus, the net effect is that the only transfer of funds is the transfer of $800 million from Enron to Citigroup and back to Delta, from which it originated.[6]



Complete Citigroup Prepay

In effect, Enron receives $800 million at the beginning of the transaction and repays the principal to Delta (via Citibank) at maturity. Every six months an interest payment, the spot value of a certain fixed volume of oil, is returned to Delta by Enron. Swaps in place on the Enron/Citibank and Citibank/Delta legs ensure a fixed interest payment of $29 million being paid to Delta every six months, an effective rate of 7.25%. The risk retained by Citibank and Delta is the same as if they loaned money to Enron. The effect of the transaction is like a loan, but it is not accounted as such in Enron's financial statements.

Citigroup and Enron also introduced a series of caps and floors on the payments made in each leg of the transaction.[7] These floors and caps ensured that no party paid or received more or

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[6]Another way to look at the structure is to look at the net cash payments at maturity for each leg. The Enron-Delta leg pays the spot value of the fixed number of barrels back to Delta upon maturity. This value may be more or less than $800 million. If it is more than $800 million, the swaps in the other trading legs effectively "refund" the spread to Enron via Citigroup. If the Enron-Delta payment at maturity is less than $800 million, the swaps in the other trading legs effectively provide a "make-whole" payment paid by Enron to Delta via Citigroup such that Delta's payments from both legs total $800 million. Price risk is eliminated. The net result is that $800 million of principal is routed directly and indirectly from Enron to Delta upon maturity.

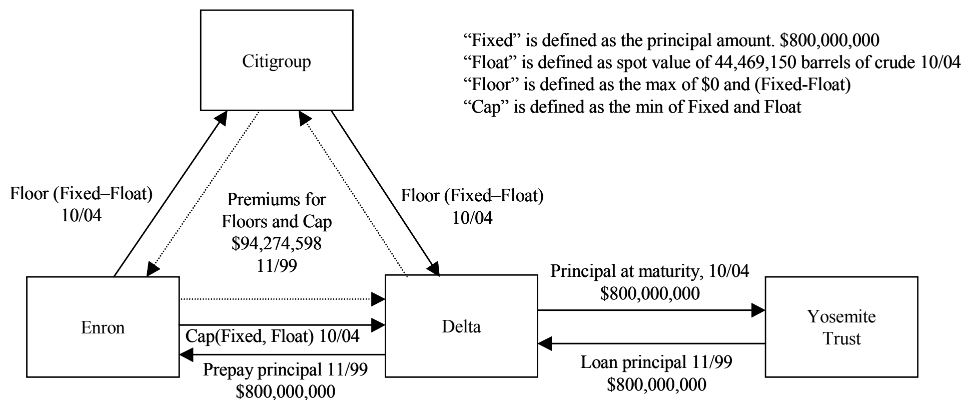
[7]The purpose of the floor/cap arrangement was to eliminate excess pre-settlement risk (PSR) on the principal. The problem addressed arises from the case where the spot value of the oil at maturity is greater than the fixed amount of $800 million. Under this circumstance, the cash in excess of $800 million that needs to be in transit during settlement represents additional risk for the parties depending on how the legs settle.

The Yosemite structures place a cap on the cash payment at maturity from Enron back to Delta. The cap is set to the fixed amount, namely $800 million in the case of Yosemite I. There is no longer any need for additional cash to refund the excess payment to Enron via Citigroup should the spot value of the crude exceed $800 million. To complete the structure, floors along the path from Enron to Delta via Citigroup block payments in the reverse direction for the high spot value case.

Therefore, if the spot value paid by Enron to Delta at maturity is less than the fixed value, just as before, the swap/floor still effectively provides a make-whole payment from Enron to Delta via Citigroup such that Delta's payments

less than the original $800 million paid by Delta. The floor/cap arrangement was considered proprietary "prepay technology" by Citigroup, not to be revealed to other financial institutions.[8]

To ensure that each leg of the triangle appears as a true trading contract, there is also an up-front premium payment made in each leg to cover the value of the cap or floor derivatives in each leg. Since the price of each derivative ($94 million for Yosemite I) is identical for each of the legs and flows in the same direction around the triangle, no net payment accrues to any party. The net effect, however, is that the $800 million up-front prepay from Delta to Enron is reduced to $706 million, and an additional "premium payment" flows from Delta to Enron via Citigroup. Enron still receives the same $800 million up-front.



Yosemite I Principal Payments

Upon close-out of the trading legs, Delta repays the $800 million principal to the trust, which then pays back the bondholders.

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from both legs total $800 million. If the spot value at maturity is greater than or equal to the fixed value, then a payment of the fixed value is made by Enron directly to Delta. No payments are made on the other legs. In either case, price risk is eliminated, but now the total amount of cash in transit prior to settlement is never more than the fixed value, namely $800 million in the case of Yosemite I.

[8]Citigroup email, "RE: Yosemite II (Europe)," November 16, 1999. Bates CITI-SPSI 003361.

Ownership and Control of Delta

Similar to the Enron-Chase prepays, all but one of the Citibank-Enron prepays involved an SPE, Delta Energy Corporation, which was incorporated in the Cayman Islands in 1993 at the request of Citigroup.[9] Its purpose was to be a third party to the prepay transactions. None of the individuals interviewed from Enron and Citigroup, however, indicated to the Subcommittee that Delta was anything other than an SPE established for the sole purpose of entering into contracts to effect prepays.

Although Delta appears, technically, to be a legally separate entity from Citigroup, as with Mahonia, the facts surrounding its creation, operation and control prove otherwise. Delta is a non-substantive entity established for the benefit of Citigroup.

- Delta was established by Citigroup.[10]
- There is no indication that Delta has a physical office or staff, or that it has the personnel or physical facilities to engage in oil and gas trading.
- Delta only participated in prepay transactions that also included Citigroup.[11]
- Delta was capitalized with only $1,000. It could not have participated in trading activity of the size of the Yosemite deals without receiving financing from Citigroup or Yosemite Securities Trust.[12]

Citigroup controls Delta

- For each transaction, Citigroup and Enron prepared a set of completed documents for Delta.[13]

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[9]Delta was originally administered by Givens Hall Bank and Trust, Ltd. in the Cayman Islands and is now administered by Schroder Cayman Bank and Trust Company, Ltd. Schroder was acquired by Salomon Smith Barney, a subsidiary of Citigroup, in January 2000. As of September 10, 2001, Delta's parent company was Grand Commodities Corporation, also of the Cayman Islands. It is represented by Maples and Calder, Cayman Islands Attorneys at Law. Bates CITI-SPSI 0103726.

[10]Citigroup email, "RE: A couple more questions," August 31, 2000. Bates CITI-SPSI 0046024.

[11]September 3, 1999 Citigroup email implies that Citigroup is Delta's only business partner. Bates CITI-SPSI 0036322.

[12]Bates CITI-SPSI 0046605 and CITI-SPSI 0046542.

[13]Citigroup, Staff Interview, June 24, 2002.

- When third parties needed to communicate or negotiate with Delta, they directed all inquiries through Citigroup.[14,15]

- Delta's outside attorneys seek authorizations from Citigroup instead of from Delta directly.[16]

- Delta's expenses associated with prepay transactions were reimbursed by Citigroup.[17,18]

- Delta's Citigroup bank account is controlled by Citicorp.[19]

- Delta's Administrator is Schroder Cayman Bank and Trust Company, Ltd, a subsidiary of Citigroup since January, 2000.[20]

Further evidence indicates that contracts between Enron, Citigroup and Delta did not achieve the de-linkage requirements set forth by Arthur Andersen.[21]

- Yosemite had cross-termination provisions that were designed to collapse the entire prepay structure in the event of a party's default.[22]

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[14]Memo from Maples and Calder to Citigroup asks Citigroup to look into fees not paid by Enron to Maples and Calder related to Delta, September 10, 2001. Bates CITI-SPSI 0103726.

[15]Enron email to Citigroup to discuss representations that Delta needs to make to Arthur Andersen, June 22, 2001. Bates CITI-SPSI 0050675.

[16]Memo from Maples and Calder. They would like to disclose information about Delta and ask Citigroup "if you would confirm whether it is acceptable to you for this information to be provided." November 2, 1999. Bates CITI-SPSI 0046604.

[17]Fax from Bank of Bermuda (Cayman) Limited to Citigroup asking to be paid fees for work done related to Delta. Bates CITI-SPSI 0103717.

[18]May 16, 1999 fax to Citicorp Securities Inc. acknowledging that Delta fees were paid. Bates CITI-SPSI 0046893.

[19]Citigroup memos,"We will not be obtaining any documentation because of the internal nature of the account," September 27, 1994. Bates CITI-SPSI 0032825 and CITI-SPSI 0032830.

[20]Memo from Maples and Calder to Citigroup, September 10, 2001. Bates CITI-SPSI 0103726.

[21]Bates CITI-SPSI 0103943.

[22]See, for example, December 22, 1999, Citibank/Delta Swap Confirmation, p. 8, Bates CITI-SPSI 0003606. In his interview with Subcommittee staff, a Citigroup Vice President who signed many of the swap agreements, confirmed that the goal of these clauses was to collapse all three legs of the transaction simultaneously. Note: Swap Confirmation agreements for all three parties to the prepay (including the Enron-Delta leg) were drafted by the same attorneys for Citigroup, Milbank, Tweed, Hadley & McCloy.

- As a result of a provision associated with the Yosemite trust, Citigroup effectively had a lien on Delta's right, title, and interest in Delta's agreements with Enron.[23]

- Another provision of the Citigroup-Delta leg precludes Delta from making any changes in the Enron-Delta leg without the consent of Citigroup.[24]

- Citigroup emails after Enron bankruptcy show an operational concern for terminating the agreements on the same day.[25,26]

Finally, as with Mahonia in the Chase prepays, Delta did not have sufficient price risk in its transactions to justify accounting for them as trades.

- Citigroup paid Delta a fixed fee for serving as a party to the prepay transaction.[27]

- Delta never profited from or lost on price fluctuation in the commodities traded in the prepay transactions. Commodities prices were not a factor in profitability to Delta.[28]

- Values for legs of the Yosemite prepay were calculated based on borrowing rates instead of commodities prices.[29]

- Delta contracts designed to terminate simultaneously with other contracts to avoid price risk.[30]

Yosemite

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[23]Enron/Delta Swap Confirmation, December 22, 1999, p. 8, Bates CITI-SPSI 0003580.

[24]Citibank/Delta Swap Confirmation, December 22, 1999, p. 8, Bates CITI-SPSI 0003606.

[25]Citigroup email addressing the need to terminate the floating legs of a prepay transaction between Delta and Enron simultaneously, November 13, 2001. Bates CITI-SPSI 0068679.

[26]Citigroup email, December 2, 2001. Bates CITI-SPSI 0091839.

[27]From transaction documents, this amount, typically $5,000, was taken from the initial proceeds of each financing. Delta Fee document, Bates CITI-SPSI 0103719.

[28]Ibid.

[29]An Enron/Citigroup presentation for Yosemite prepay shows the prepay calculated in terms of LIBOR. Bates CITI-SPSI 0103942.

[30]Citigroup email, September 3, 1999. Bates CITI-SPSI 0036322.

Citigroup (then Citicorp) had been working with Enron on various financial transactions since 1989. The relationship earned Citigroup a total of $167 million in fees and interest income from 1997 to 2001.[31] By the first quarter of 1999, Citigroup's total exposure to Enron increased to $1.668 billion, a level more than four times Citibank's internally-imposed limit for Enron.[32] At this time, internal Citibank documents indicate that it was making efforts to rein in this exposure. One company email late in 1999 states, "we still have an exposure issue as it relates to obligor limits; there is a developing view that limits are limits and not to be exceeded. This is something we will all have to deal with."[33]

Sometime in early 1999, Enron selected Salomon Smith Barney to create a security known as a Credit Linked Obligation (CLO).[34] This structure allowed for securitization of assets by issuing obligations that looked like corporate bonds and would free-up bank capacity by tapping the capital markets, selling bonds linked to Enron credit. Enron's objectives for the CLO included limited "Rating agency disclosure", "Substitution rights" and "flexibility."[35]

Yosemite was intended to be a synthetic Enron bond. Its first issuance would offer a fixed interest rate of 8.25% – roughly 200 basis points above U.S. Treasury bills of matching tenor. In the case of an Enron bankruptcy, it would emulate an Enron bond: Yosemite bondholders would receive claims to an equivalent holding of senior unsecured Enron debt.

From Citigroup's perspective this was good business to pursue. The newly merged Citigroup possessed or could develop key capabilities to carry out the structure arm that was to become Yosemite. But besides the substantial fees it would earn on the deal, it would be a way to significantly reduce Citigroup's own exposure to Enron by rolling over its Enron loans into the capital markets.

A Salomon Smith Barney official described Enron's goal of achieving flexibility typically associated with a bank facility through the CLO vehicle. The "black box" feature of the Yosemite vehicle, which hid from investors Enron's use of the proceeds turned out to be an ideal cloak for prepays. In fact, a "Yosemite Update" presentation points out that the structure "provides for a unique 'black box' feature which provides considerable flexibility for substitution...while limiting disclosure of the prepay to Citibank."[36] The presentation goes on to state, "The use of prepays as

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[31]Citigroup letter to the Subcommittee, May 2, 2002, in response to Subcommittee subpoena.

[32]This "Obligor Limit" was set to $375 million prior to mid-1999. Global Loans Approval Memorandum, "Truman" Extension Transaction. Bates CITI-SPSI 0103768.

[33]Citigroup email, "RE: Yosemite II (Europe)" November 10, 1999. Bates CITI-SPSI 0033633.

[34]Citigroup, Staff Interview, June 24, 2002.

[35]Enron Presentation, "Project Yosemite," January 1999. Bates CITI-SPSI 0035868.

[36]Bates ECa000196339.

a monetization tool is a sensitive topic for both the rating agencies and banks/institutional investors. The ability to continue minimizing disclosure will likely be compromised if transactions continue to be syndicated."

Both Enron and Citigroup clearly knew about and understood the accounting implications of Yosemite. An internal Enron memo states, "The use of the prepaid swap was not motivated by tax considerations but instead was necessary to report the transaction as part of ENA's price risk management activities rather than debt for financial accounting purposes."[37]

A Citigroup email provides an overview of the entire core functionality of the Yosemite transaction in a single, shorthand paragraph.[38] The text describes the transaction as "net net economically like a loan . . . E [Enron] gets money that gives them cflow [cash flow] but does not show up on the books as big D Debt."

The Yosemite Investments

Yosemite brought in a total of $825 million, $750 million from debt notes, and $75 million from equity certificates.[39] Of these proceeds, *all* were invested in so-called "Enron Investments"– specifically defined in the Offering Memorandum as "payment obligations supported, in whole or

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[37]Enron memo, "Yosemite I Withholding", January 10, 2000, Bates EC2 000011612, footnote 5. The Subcommittee staff verified the conclusions in this document through a Staff Interview, June 18, 2002.

[38]Citibank email, "My take on how to explain ECLN." Bates CITI-SPSI 0084924.

[39]For various tax, ERISA, accounting, and structural considerations, Citigroup and Enron settled on $75 million worth of equity "certificates" to be issued. For tax purposes, Yosemite would be structured as a debt vehicle, the certificates would be first loss, and the certificates would bear 11% interest. The certificates were to be split evenly between Enron and Citigroup such that neither company would be required to consolidate Yosemite on its books, nor report the structure in footnotes to financial statements.

Although there was no apparent business purpose for doing so, Citigroup set out to mask the identities of the certificate holders–including Citgroup's own identity. All of the four Yosemite Offering Memoranda state that the identities of the certificate holders will not be revealed. The *de facto* owners, Enron and Citigroup, each turned out to have issues with their certificates.

Citigroup set up a "front" certificate holder using BankBoston (now FleetBoston Financial) as a "conduit" or "balance sheet provider." Fleet had previously established a general-use, special-purpose, off-balance sheet entity called Long Lane Master Trust IV. On paper, Long Lane "owned" the Yosemite certificate. However, through a Total Return Swap transaction with Fleet, Citigroup would effectively retain the rights and risks (albeit remote) of ownership. During an interview with Subcommittee staff, June 19, 2002, officials from Fleet stated that it was not their habit to ask questions of Citigroup about how the conduit would be employed and that they would hold this transaction, like any other transaction, confidential. The Subcommittee staff believes that such conduit providers are commonplace and are thought to be permissible–at least in their simple building block form–under a literal interpretation of accounting rules.

Since Citigroup was providing $37.5 million of credit for its share of the trust certificates, it analyzed its own risk position in a Global Loans Approval Memorandum. As part of Citigroup's agreement with Enron, Citigroup's equity certificates would realize preferential payback in case of an Enron bankruptcy by a factor of two over the Yosemite noteholders.

After Yosemite closed, Enron determined that for accounting reasons related to the disclosure of Yosemite on Enron's financial statements, Enron actually still had too much equity in Yosemite. Therefore, Enron acted to find another buyer–before the year 1999 was out–for what amounted to 45% of the total Yosemite equity. Enron finally found a buyer in an Enron-related party, Whitewing. Enron did not sell its Yosemite certificate directly to Whitewing. Rather, the certificates were sold to Whitewing via LJM–the partnership managed by Enron Chief Financial Officer Andy Fastow–such that the certificates passed through LJM2's possession for a single day. Enron wanted to carry out a true value sale between the related parties, Enron and Whitewing. The transfer may well have missed the end-of-year deadline for a disclosure-related sale–the sale was formally closed in late February, 2000.

in part, directly or indirectly, by Enron." Specifically, $800 million were invested in a prepay through Delta Energy.[40] (This was the exact amount of prepay obligations due in the fourth quarter of 1999 to two Citibank-structured prepays known as "Roosevelt" and "Truman.")

Yosemite II, CLN I, CLN II

Yosemite II closed in February 2000 for £200 million. Structurally, it was identical to Yosemite I, except that it was incorporated in Jersey, Channel Islands, rather than Delaware.[41] After Yosemite I and II, two more versions, Yosemite III and IV were issued. To the outside world, these were known as the Credit Linked Note (CLN) I (issued in August 2000) and CLN II, CLN Euro, and CLN Sterling (issued in three currencies in May 2001). These CLN structures offered a number of minor but significant improvements over the Yosemite I and II structures. Most of these had to do with simplifying the security from the bondholder's perspective, but Citigroup also took steps to reduce its own exposure.[42]

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[40]The remaining $25 million was invested in what Enron called the "Magic Note." The Magic Note provided a "make whole" payment. The yield from Yosemite's investments inevitably fell short of the 8.25% advertised in the Offering Memorandum. Delta's note was set up to pay 7.25% interest. Therefore, a credit subsidy was needed to make up the spread between the actual and required returns. Bates EC2 000011608.

The $25 million "principal" was invested in Enron corporate bonds. The "interest" payments came back to Yosemite to exactly make up the difference in interest payments and certificate yield from the prepays that would be required to pay the noteholders and certificate holders the return they were advertised. The interest received for Yosemite I was nearly $10 million per year–an effective interest rate of 40% per annum.

[41]To provide further protection to Citigroup for Yosemite II, Citigroup's certificates would still receive preferential payback by a factor of two. Furthermore, an amount equal to the Citigroup certificate value of £11,125,000 Sterling was retained in the trust in the form of high-yield securities. This amount was intended to serve as collateral for Citigroup in the event of an Enron bankruptcy. Bates CITI-SPSI 0035139. As in Yosemite I, Enron transferred its share of all but 5% of the outstanding ownership of Yosemite II to Whitewing at year end 2000 for accounting disclosure reasons. However, instead of transferring the certificate to Whitewing via LJM2 as it had done for Yosemite I, Enron first transferred the certificate through FleetBoston's Long Lane Master Trust IV on its way to Whitewing. Bates AASCGA(TX)005886.

[42]The main difference with the CLN was that all the investments were AAA rather than a mix of high-yield and Enron investments. The broad specification of AAA investments was largely appearance, however, as the trust simply invested its proceeds into Citibank certificates. Citibank then entered into a prepay agreement with Enron with Delta Energy as the hedging counterparty.

Citibank took 100% of the certificate value, using Royal Bank of Canada as the conduit for CLN I and ING Baring for CLN II. Ultimately, Citibank (retroactively) chose to consolidate the CLNs on Citigroup's balance sheet, but at that point such consolidation was of no consequence to Citigroup since the bond proceeds would exactly cancel out the loan to Enron.

Collateral for the full amount of the certificate was retained in the trust for Citibank (i.e., not used in the prepays). In the event of an Enron bankruptcy and the Citibank swap, there would be essentially no risk for Citibank to recover its certificate investment. Internal Citibank emails appear to discuss the implications of such a position and point out that the Offering Memorandum "makes clear" that the certificate is not a first loss position for the noteholders. Bates CITI-SPSI 0081540.