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Enron Says Its Links to a Partnership Led to $1.2 Billion Equity Reduction

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Enron Corp. shrank its shareholder equity by $1.2 billion as the company decided to repurchase 55 million of its shares that it had issued as part of a series of complex transactions with an investment vehicle connected to its chief financial officer, Andrew S. Fastow.

Enron didn't disclose the big equity reduction in its earnings release issued on Tuesday, when the Houston-based energy giant announced a $1.01 billion charge to third-quarter earnings that produced a $618 million loss. But the company briefly mentioned it in a subsequent call with security analysts and confirmed it in response to questions Wednesday. As a result of the reduction, Enron's shareholder equity has dropped to $9.5 billion, the company said.

In an interview Tuesday, Enron Chairman Kenneth Lay said that about $35 million of the $1.01 billion charge to earnings was related to transactions with LJM2 Co-Investment LP, a limited partnership created and run by Mr. Fastow. In a conference call Wednesday with investors, Mr. Lay said that the 55 million shares had been repurchased by Enron, as the company "unwound" its participation in the transactions. In the third quarter, the company's average number of shares outstanding was 913 million.

According to Rick Causey, Enron's chief accounting officer, these shares were contributed to a "structured finance vehicle" set up about two years ago in which Enron and LJM2 were the only investors. In exchange for the stock, the entity provided Enron with a note. The aim of the transaction was to provide hedges against fluctuating values in some of Enron's broadband telecommunications and other technology investments. Mr. Causey didn't elaborate on what form those hedges took.

Subsequently, both the value of Enron's stock and the value of the broadband investments hedged by the entity dropped sharply. As a result, Enron decided essentially to dissolve the financing vehicle and reacquire the shares. When Enron reacquired the shares, it also canceled the note it had received from the entity.

In addition, Enron was receiving increasing criticism from analysts and major shareholders concerning the apparent conflict of interest involving the role of its chief financial officer in the partnership, from which he stood to make millions of dollars. In July, Mr. Fastow formally severed his connections to LJM. Mr. Fastow has declined to be interviewed.

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Given all the complexities of the LJM-related financing vehicle and the questions it raised outside the company, "the confusion factor wasn't worth the trouble of trying to continue this," Mr. Causey said.

Enron downplayed the significance of the share-reduction exercise. Mark Palmer, an Enron spokesman, described it "as just a balance-sheet issue" and therefore wasn't deemed "material" for disclosure purposes.

Jeff Dietret, an analyst for Simmons & Co. in Houston, said that a large reduction of equity could be "a flag for the rating agencies" because it could adversely affect a company's debt-to-equity ratio. Enron said Wednesday that as a result of the equity reduction, its debt-to-equity ratio rose to 50% from 46% previously.

On Tuesday, after Enron reported its big quarterly loss, Moody's Investors Service Inc. put Enron's long-term debt on review for a possible downgrade. Moody's said the move was related to "significant write-downs and charges reflecting substantially reduced valuations" in several of Enron's businesses. In recent years, Enron had moved aggressively into broadband telecommunications and the water business, both of which failed to produce expected returns.

Enron, which as of June 30 had $33.6 billion in current liabilities and long-term debt, has lately been attempting to shed assets to pay down debt.

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