UpFront

NEWS & VIEWS

The future of mark to market

Enron's supernova-like flameout has drawn attention to the inherent quirks of mark-to-market accounting (MtM). While Enron certainly was an MtM abuser, the question now is how to prevent other companies from abusing hypothetical future contract values and booking spurious cash flow in the present.

Solutions proposed run the gamut from doing nothing—letting the market wise up to what MtM is and how it works—to some analysts and industry watchers calling for abandoning mark-to-market, and figuring derivative values via the more traditional accrual accounting.

The consensus among many experts is that MtM shouldn't be discarded just because Enron abused the system. Tweaking may be required, not wholesale rejection.

"Mark-to-market is designed to show the full extent of a company's liabilities over a period of time so that there are no hidden landmines for investors," said Andre Meade, an energy analyst in New York for Commerzbank Securities. "Unfortunately, mark-to-market also can help distort a view of a company's earnings, and it makes modeling a company more difficult."

What is mark to market?

Simply put, mark-to-market accounting means financial assets—such as marketable securities, derivatives, and financial contracts—are reported on a company's balance sheet at their current market value at a specific point in time, although the actual realization of cash may not occur for years.

Earnings distortion is possible using mark-to-market accounting, but given investors' need to know just what an asset is worth today—not when it was purchased or acquired years ago—means mark-to-market is here to stay.

Mark-to-market accounting was implemented by the Financial Accounting Standards Board (FASB) nearly a decade ago for financial assets that have readily determined asset values—such as stocks, and trade futures and options. In 1996, the FASB extended MtM to all financial derivatives, even those without a traded market value.

That last phrase is key, because one of the criticisms of the use of MtM is that without a market, without benchmarks, companies using derivatives trading may have to rely on complex models to determine asset values based on dozens of assumptions. "People who build models may make up market data, to make it what they think the market should be," says John E. Parsons, a financial economist with Charles Rivers Associates, Boston.

Models based on economic reality

If there is no market for what's being traded, no benchmarks to base future prices on, companies should establish their models based on economic reality—not on fairy tale-like hypotheses, Parsons believes.

"A lot of company boards, treasury offices, and risk management offices need to determine how reliable the model being used for mark-to-market is, how widely accepted it is," Parsons adds. "Companies also need to test their models against market data, to ask how often they get the answer that the marketplace gets."

Transparency in plain English

Analysts, academics, and even the Securities & Exchange Commission are telling all companies to be more transparent when it comes to revealing numbers—and just as important—where those numbers came from. The bottom line: Gobbledygook-like explanations a la Enron no longer will be tolerated.

Closely aligned with transparency is the call by many numbers experts to call "a spade a spade." In other words, if 30% of a company's profits won't be realized for two years, put it in plain English on the balance sheet—not the income statement. The amount should not hit the income statement until the company can meet some high confidence level concerning future cash flows.

Mandating new rules

Who mandates and pushes required changes in the use of mark-to-market accounting? Frank Partnoy, a law professor at the University of San Diego law school and former Wall Street derivatives trader, likes the idea of federal legislation pertaining to gatekeepers, including law firms, auditors, banks, securities analysts, independent company directors, and credit rating agencies.

But many question the possibility of meaningful legislation from Congress in 2002. "It's hard to imagine Congress taking some forward steps in an election year," says Robert P. Strauss, professor of economics and public policy in the H. J. Heinz School of Public Policy, Carnegie Mellon University.

If not Congress, whom? The accounting profession largely regulates itself and for years has steadfastly resisted change. Lynn Turner, former chief accountant at the SEC and now director of the Center for Quality Financial Reporting at Colorado State University, believes the American Institute of Certified Public Accountants needs to put together a task force with oversight provided by the SEC to make MtM work. Thomas R. Weirich, an accounting professor at Central Michigan University, sees a united front from the SEC and the FASB teaming to make MtM changes.

Fewer, broader rules

University of San Diego's Partnoy believes that regardless of which body makes a move, enacting more and more precise rules is not the answer to the current accounting mess. Rather, broad general standards should be enacted.

"The problems with mark-to-market are partially resolving themselves," according to Commerzbank's Meade, "as investors and analysts get comfortable with MtM and demand to know more. It's hard to go back backwards with disclosure; we are likely to see even more disclosure in the future."

—Rick Stouffer

Small businesses have little faith in their utility

Most small business owners think their energy service provider can't be counted on to help their business, let alone understand their energy needs. This finding, from a recent survey by E SOURCE, a division of Platts based in Boulder, Colo., should serve as a wake-up call for ESPs, because small businesses account for over half of all U.S. commercial energy consumption and represent a large, untapped market for value-added services related to energy.

The E SOURCE survey tracked energy-related perceptions, needs, and preferences of 908 small-business decision-makers in the U.S. and Canada. A small business is defined as one having between five and 50 employees. Interviews were conducted in the following sectors: lodging, education, grocery, restaurant, healthcare, retail, light industrial/manufacturing, and office.

Survey recipients were asked to rate the following statements from 1 to 10, with 9 and 10 equivalent to "strongly agree." My electric company:

- Values my business as a customer.
- Helps my business succeed.
- Understands my business needs.
- Understands my energy needs.
- Has earned my loyalty.

When asked if they believe their ESP values their business as a customer, only one quarter of the respondents offered a 9 or 10. Grocery and educational respondents were most likely to give a high score, which may be indicative of their relatively uniform needs or the existence of sector-specific initiatives on the part of their ESPs.

Do ESPs help their small business customers succeed? Only 28% of the respondents gave a score of 9 or 10. Similarly, only 23% strongly believe that their electricity supplier understands their business needs, with grocery, educational, and healthcare establishments expressing the most agreement with this statement.

ESPs didn't score measurably better on customer perceptions of whether they understand the energy needs of small businesses. Office and light industrial respondents are the least satisfied. And ESPs still have a long way to go to endear themselves to existing small business customers—to say nothing of what it will take to win the affections of new customers. On average, only 26% felt strongly that their electricity provider has earned their loyalty.

Deregulation

In the aftermath of California's rolling blackouts, as well as widespread publicity on deregulation implementation in such states as Texas, E SOURCE analysts were not surprised to discover that 82% of survey respondents are aware of industry deregulation and that they will be able to choose their energy provider.

However, respondents are skeptical about deregulation having a positive effect on their energy expenditures. Only 14% of respondents gave a score of 9 or 10 to the statement that an outcome of electricity deregulation will be lower energy prices for businesses like theirs. Despite expressing a lack of faith that their energy costs will decrease, only 17% of the respondents strongly believe that power reliability would be compromised.

Overall, respondents are not enthusiastic about deregulation moving forward. Only 27% are in strong agreement that efforts in this area should continue. Restaurant and lodging operators are the most apt to support continuing deregulation, while education and retail are the most resistant. Besides being skeptical about the advantages of deregulation for small businesses, many respondents also admit that restructuring has been difficult for them to grasp conceptually. Only 13% say they have an understanding of how electricity restructuring works. Office respondents are the most perplexed.

For more information, contact Clayton Fong, research director, E SOURCE, at (720) 548-5648, or clayton_fong@platts.com.

Exchanges rethink strategy under NETA

A year after the introduction of New Electricity Trading Arrangements in England and Wales, Great Britain's power exchanges are being forced to rethink their strategy. Exchange liquidity under NETA has fallen far short of the original hopes of exchanges themselves and regulator Ofgem.

In February, three of the power market's aspirant exchanges provided details of planned changes to their product offerings. Specifically, the International Petroleum Exchange (IPE) has suspended its base-load futures contracts, the UK Power Exchange (UKPX) said it would launch redesigned contracts in April, and Powerex announced a relaunch later this year. All of this adds up to an admission by the three exchanges that "We got it wrong!"

None of the three exchanges has attained contract liquidity. Indeed, each has struggled to achieve any trade whatsoever. In its admission of forthcoming changes in late February, the IPE admitted as much.

UKPX is to copy the trading format that has evolved in the over-the-counter market when it revamps its contracts. This appears to be a fundamentally sound approach at first glance, but if traders carry out deals in this format without an exchange, one must ask: What incentive is there for them to switch to an exchange with its extra costs?

The answer lies in clearing. And a clearing service is exactly what UKPX plans to launch at the same time as it revamps its contracts.

The collapse of Enron has sharpened the focus with regard to credit issues, and clearing would alleviate many of the worries in boardrooms and risk departments. As one market observer

Letter to the editor

Although James F. Wood makes a compelling case for the use of mobile generation (The Last Word, January/February issue), he picked the wrong example to illustrate his points. Contrary to the article, the 11 small gas-turbine power plants that the New York Power Authority has installed in New York City and on Long Island are neither trailer-mounted nor mobile.

In addition to the basic generating equipment, each unit includes more than $5 million worth of the most advanced available controls to minimize emissions and noise, together with stacks, gas compressors, water tanks, auxiliary-equipment and control buildings, high-voltage transformers, pumps and skids. Such components would make it infeasible to readily move the generators from one site to another.

Despite the scenario that Mr. Wood sketches for potential developers, the Power Authority's power plants are not "a means for exploiting" price spikes caused by inadequate power supplies or transmission congestion. In fact, as has been amply demonstrated, they not only help to keep the lights on in peak periods, but also depress prices by relieving congestion at other times as well. This is in addition to the environmental benefits they provide by replacing older, less-efficient generators.

EUGENE W. ZELTMANN
Albany, N.Y.
The writer is president and chief operating officer of the New York Power Authority.

Reply

You are certainly correct in your observation that the gas turbines installed in New York City are not trailer-mounted nor are they mobile in that sense. They are, however, peaking units, that might be considered "packages" by industry observers and in that sense could be considered mobile when compared to a combined-cycle facility of 150 MW, typical of those being developed in other parts of the country.

You are also correct that I intended to (and do, in fact) support NYPA's decision to install these facilities and the economic benefits they bring to residents of New York City, notwithstanding critics who believe a different outcome might have occurred if a more extensive environmental process had been followed.

The key here is related to regulatory processes that go beyond those really required to serve public health, in my view, and erect synthetic barriers that are more likely to hurt citizens rather than make their lives easier.

—James F. Wood

put it, "It all depends how much people want to pay for it."

—*Keiron Greenhalgh*

Gas prices rise

Average U.S. monthly natural-gas spot prices for March rose 18.75% from February, to $2.28/million Btu, as cold weather swooped into the South and East, and forecasts for tighter supplies later this year fueled stronger price expectations, according to data released by Platts, the energy information, research, consulting, and marketing services business of The McGraw-Hill Companies, New York.

An exclusive survey by *Inside FERC's Gas Market Report*, whose spot price surveys set the benchmark prices for most monthly spot contracts in North America, revealed that the average price of natural gas delivered to the premium New York and New Jersey markets for March was $2.76 compared with $2.58 in February and $5.63 in March 2001. In Southern California, where the monthly average reached $12.53/million Btu in March 2001, the average monthly spot price for March 2002 was just $2.28, up 12.78% from $2.02 in February.

Green Trading Summit debuts

The Green Trading Summit, believed to be the first conference addressing the triple convergence of the new markets of emissions, renewables, and negawatt trading in a risk management context, convenes in New York City, May 14-15. Developed by Global Change Associates and the MYA Group, both New York, and sponsored by *Global Energy Business*, the meeting will feature sessions focusing on SO_2, NO_x, and CO_2 trading as well as renewable-energy-credit and negawatt trading. Attendees will learn about creating environmental indexes for trading, establishing the forward curve for environmental products, and applying environmental trading for project finance in this emerging commodity market. For more information see ad, p. 29 or visit www.globalchange.com.

Supreme Court upholds FERC Order 888

The Mar. 4 Supreme Court decision affirming the Federal Energy Regulatory Commission's landmark open-access rules is a significant victory for advocates of more competitive power markets that will reshape electricity policy and could affect profoundly the relationship between FERC and state regulators, reports *Power Markets Week*, published by Platts, the energy information, research, consulting, and marketing services business of The McGraw-Hill Companies, New York.

A victory for FERC and competitive suppliers, the ruling is almost sure to result in a much bigger role for FERC in retail transmission and markets, and a more level field for suppliers who have long accused utilities of hoarding transmission capacity by reserving a good deal of it for their native loads.

The wholesale market should be the biggest benefactor of the decision, one attorney says, because it would appear to give FERC the legal backing to level the playing field between competitive suppliers and utilities in reaching end-use customers. Further, utilities' native-load exemption from open-access rules is clearly at risk. Competitive suppliers and large industrials have pushed for FERC to eliminate the exemption as discriminatory, and the high court said the commission does indeed have the authority to remedy undue discrimination where it finds it—whether in wholesale or retail service.

The decision is sure to increase jurisdictional tension between the commission and state regulators, who have held onto their authority over bundled retail sales, and to whom FERC has carefully deferred for years.

Some state sources downplayed the impact, but still they may seek congressional assistance to amend the Federal Power Act (FPA) in an attempt to limit FERC's now-confirmed jurisdiction.

While states did not appear to be publicly agitated by the ruling, one lobbyist described them as "somewhat in a tizzy." For FERC, the decision "arms their ability to take the next step if they so choose" and assert jurisdiction over bundled retail sales, according to a state source. For state regulators, "this is not good news. It clearly strengthens FERC's hand," the source said.

The open-access rule, set out in Order 888 in 1996, directed utilities to unbundle wholesale generation and transmission services and place all wholesale transmission transactions on an open-access transmission tariff. It also required all unbundled retail transmission services to be filed in the same tariff, but FERC did not extend its reach to bundled retail sales.

Retail transactions are interstate in nature, Justice John Paul Stevens said, and the FPA clearly gives FERC the ability to assert its authority over them.

"It is true that FERC's jurisdiction over the sale of power has been specifically confined to the wholesale market," the court said. "However, FERC's jurisdiction over electricity transmissions contains no such limitation. Because the FPA authorizes FERC's jurisdiction over interstate transmissions, without regard to whether the transmissions are sold to a reseller or directly to a consumer, FERC's exercise of this power is valid."

But the court went further, and in a 6-3 vote on a second part of the decision dealt with the question of jurisdiction over bundled, as well as unbundled, retail service. Enron Corp., Houston, had complained that FERC needed to go further to assure fair access to the grid by mandating unbundling of all retail sales.

Utilities still block access to the grid through bundled rates, Enron asserted, limiting the ability of competitors to serve customers. When it issued Order 888, FERC said mandating unbundling was unnecessary and would lead to "difficult jurisdictional issues." The court recognized that concern and determined that it was an appropriate policy call, but allowed that FERC could mandate retail unbundling if it found discriminatory behavior. ■