



“Mark to Market Accounting” In the Energy Industry

Aggressive mark-to-market accounting (m-to-m) is one of the financial issues in the Enron debacle. Because other big energy companies use this accounting method in the same way, we expect to see additional similar problems in this industry.

It starts off easy. An energy trader sells three years of gas for say \$3.00/dt then buys the same quantity on the NYMEX for \$2.75. In accordance with m-to-m, the energy company can book the profit in the current quarter. The deal can even be sold to another party but the accounting treatment is the same.

Once the trading unit of the energy company gets used to these deals and their consequences on earnings, there is an incentive to do ever more long-term deals. After booking the example 3-year deal in the current quarter, the deal has made its contribution to profits. Future growth in profits requires additional deals.

Now, let's look at a 20-year deal where the energy company's generation unit builds and sells the output of a multi-million dollar power plant. There is no NYMEX for power prices going out 20 years so an estimate must be made. Accounting standards allow management to use its discretion to determine future income and cost. If it is determined that the company must sell the power for 4.8 c/KWH while realizing an estimated cost of 4.5 c/KWH, all these less-than-certain future profits are recognized in the present earnings. If in future quarters, when the real numbers come in and profits do not meet expectations, the energy company can offset the losses by entering into additional deals. The best way to cover up a bad deal is to make two more!

As Enron grew and vowed to increase earnings, more new players came into the market doing the same sort of m-t-m accounting so the real profits got slimmer and the estimates of future earnings for projects got more aggressive. These high earnings from long-term projects produced little cash in the early years. This lack of cash flow with high earnings was a sign Enron was in trouble.

In addition to energy trading and development of power plants the big energy companies offer a package of energy services to retail energy users. These services even included replacing and owning the boilers and chillers in the customer's facilities. Using an energy company to replace equipment that the initial owner could not justify because of the small savings, rarely makes sense. However, the energy services business unit could recognize these small savings upfront. The energy services unit could also use overly optimistic estimates of future energy costs and their projected ability to produce savings with operating improvements. This invited model manipulation to create bigger

bonuses on phantom profits. Clearly both parties, going forward, will review these kinds of deals much more carefully.

Enron's problems are not unique. The whole industry is infected with the Enron virus. The problems are starting to show up. One after another we hear energy companies are "cleaning up their balance sheets" by canceling future generation projects. Short term this will lead to more focus on accounting problems and their remedies. Long term these independent energy companies who were supposed to build the next round of power plants are not going to perform as expected. The current shakeout in the energy industry could cause another period of supply problems and high prices in the years ahead.

End User Actions

Energy buyers face continued price volatility and a need for means to mitigate that risk. There is now – thanks in part to Enron – an established energy services industry to help energy customers deal with the new complexities of the energy market. However, the big energy company often promotes as part of its total package their own risk management products, commodities and equipment financing arrangements that fit well into the m-to-m earnings model. Many of the actual services the customer needs such as contract administration, commodity procurement, rate analysis and risk evaluation do not offer big up front profits. Each customer needs individualized solutions to an array of energy service requirements. Driven by the need to sell its vested products, particularly long-term contracts that fit their accounting methods, the big energy companies have not given their retail customers the service they were promised. And the big energy companies all too frequently drop their retail services business at the first sign of trouble. It would be a coincidence if a package deal included the right mix of services and providers. The customer himself, using many different service providers, can build the best comprehensive or total energy program that includes energy management as well as financing and long term hedging.

Jim Clarkson, March 2002