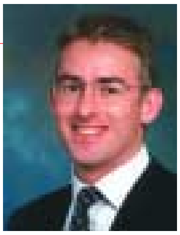
By GREG KEERS



Enhancing Credit Ratings

AT A TIME WHEN THEY NEED debt in order to expand and survive, utilities have come under the scrutiny of credit ratings agencies. After two years of blackouts, brownouts, Chapter 11s, counterparty defaults and price spikes—all capped by the Enron collapse—credit-rating agencies are closely evaluating the way they assess utilities' creditworthiness.

Credit-rating agencies base their analysis on a wide range of factors, both qualitative and quantitative, to assess the probability of default. Typically these include debt management history, debt equity ratios and current and forecasted cash balances. With regard to utilities, these agencies are looking for anything that might put too much strain on utility cash flow. Areas for concern include construction, dividend obligations and regulatory problems. But what precisely are they looking for in terms of trading and risk management?

TRADING AND RISK MANAGEMENT

One of the biggest concerns for the credit-rating agencies is how these utilities' exposure to the spot market will affect earnings and their ability to service their debts. They see volume risk as a major factor in markets where wholesale prices are particularly volatile.

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This reflects growing signs that the rating agencies recognize that Value at Risk (VAR) may not, by itself, be sufficient protection against volume risk. A broader-based metric such as Profit at Risk (PAR), for example, is more appropriate to capture the volatility of free cash flows, and hence a company's ability to sustain its debt repayments.

Similar commentary exists about the use of Mark-to-Market (MTM) and accrual accounting treatments in the competitive energy markets. In its report "Electric Power & Merchant Gas Sector Developments: Accounting Update," issued in October 2001, ABN Amro said: "It is our general expectation that the market will eventually award a higher value to earnings derived under accrual accounting versus mark-to-market gains."

In the wake of Enron's collapse, MTM accounting has been fiercely criticized. The episode has exposed the shortcomings of using this system for long-term, highly complex deals in markets that are not particularly liquid. However, MTM is still valid for speculative trading of liquid standard products over a short time horizon.

At the heart of this issue is a genuine concern about accounting and risk management techniques and a need to understand the source of a company's earnings and the uncertainties associated with them. It is therefore essential for a utility to be in a position to assess and manage the risks attached to its particular business model.

UTILITY TRADING BUSINESS MODELS

As markets deregulate, utilities respond by transforming themselves into competitive dynamic enterprises. The typical initial step is to set up a stand-alone trading arm, which is tightly controlled, but has little interaction with the rest of the business, e.g. physical operations. While this approach is an easy first move, it is not sustainable as a longer-term business model, because value is inevitably leaked to more aggressive, market-aware players.

Migrating to a more robust business model is a natural progression, but there is a range of models that a utility could adopt. Each of these involves a different level of exposure to the two fundamental risk drivers: spot price volatility and forward curve volatility. Consequently, the combination of accounting techniques and risk methodologies needs to reflect the relative importance of the underlying risk position.

ENHANCING EARNINGS

By choosing the right risk and accounting tools for their particular circumstances, utilities take the first step towards supporting an enhanced credit rating. World-class users of methodologies such as PAR recognize that by proactively seeking deals and strategic moves, they can improve the risk/reward return of their position.

Using a metric such as PAR, the company can check the effects of each hypothetical or potential deal on the company's portfolio and corporate earnings. The aim is, of course, to make better hedging decisions, which ease the pressure on the profit distribution.

CONCLUSION

Utilities are taking action on a number of fronts to repair their battered credit ratings. Clearly, moves to conserve cash flow are crucial, but to restore faith in their business, utilities need to tailor their risk management methodology and accounting policy to reflect the underlying risk drivers of their business model. ■

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